Risk mitigation as a cost-effective micro-finance strategy

Case Study: IDB-PERU Global Micro-Enterprise Credit Program

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Regional Operations Department 3
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Executive Summary

Governments and donor agencies are dedicating larger and larger amounts of resources to micro-finance programs with the goal of achieving broader access to financial services by micro-entrepreneurs and low-income population groups. The IDB-supported Global Micro-Enterprise Credit Program found that a relatively small component of the program has had a disproportional impact on achieving this goal. While over $60M was devoted to the credit component, a small fraction of this amount was devoted to supporting a risk reporting unit at the Central Bank Superintendency. The IDB assisted in the expansion of credit reporting to include loans of all size and also helped stimulate the emergence of a strengthened credit bureau industry.

These relatively mundane and overlooked elements of a larger program may have profound impacts and benefits if the early findings are indications of longer-term trends. Credit professionals in Peru are reporting that these improvements have improved the quality and lowered the cost of the credit decision. They have also reduced the waiting time of applicants. There has been an impressive expansion of credit access for micro-entrepreneurs. Banks have begun to compete with each other to lend to this sector. The case study also reveals a number of conditions that must be met for such a credit reporting system to emerge. These include the need to ensure universal cooperation in reporting, reliable identification, privacy and the protection of the consumer.

If the results of this case study are verified by similar results in other countries, risk-mitigation strategies may prove to be a powerful and cost-effective strategy for expanding micro-finance access. The provision of transparent credit histories lowers the risk of entering and serving this sector. It also promotes a culture of repayment. The poor, who have few initial assets apart from their reputation, seem to be good credit risks once such mechanisms are in place. Risk mitigation also helps to avoid a credit bubble. This case study suggests that more attention be devoted to establishing effective national reporting systems on arrears and delinquencies on loans of all sizes and the emergence of credit bureaus.

Introduction

Efforts to expand finance for microenterprise have been notable in recent years. It is helpful to ask what success would look like if it were achieved. The ultimate goals would be universal access to credit by all people who could use it responsibly. The following case study identifies an area, often neglected, that could have a powerful impact in achieving this goal.

Ever since the publication of El Otro Sendero by Hernando de Soto, the constraints facing Peruvian micro-entrepreneurs have become legendary. What is less well known is that some surprising new lessons are being learned about micro-finance from a recent IDB and Government of Peru initiative.

The following case study from Peru, supported by the experiences of countries such as Uruguay, highlights the surprising impact of the emergence of credit reporting systems on expanding access to microfinance. Credit reporting in Peru included both the expansion of mandatory credit information reporting on small loans by the Superintendency of Banks and Insurance and the emergence of credit bureaus. The following case study reveals the potential impact of this approach. By providing transparent information to the financial institutions on the credit history of small borrowers, one lowers the risk to financial institutions of lending to this sector. This expands access by the poor to credit. It also lowers the transaction costs to financial institutions of lending to this sector. Furthermore, it may also promote a culture of repayment and help avoid a credit bubble as economies expand.

The improvement of credit risk reporting may prove to be a far more cost-effective way of promoting nearly universal access to credit. At the very least, it would seem to be an important component of a micro-finance program.

1 Importance of the Micro-Enterprise Sector in Peru

Efforts to assist the poor in Latin America have, for many years, focused on the challenge of enabling poorer income groups to become productive through various initiatives focusing on micro-enterprise.

Peru is a country where this effort is extremely important because micro-enterprise employs 75% of the economically active population. According to the National Household Survey completed by the Ministry of Labor in 1996, there were 2,386,000 microenterprises in operation employing approximately 6 million people. They also account for approximately 40% of the GDP.

Some 80% of these enterprises were in the informal sector; that is to say they did not have an employer tax identification number or "RUC."[1] This meant that not only did they not contribute to the tax base but that they also lacked the formality that could enable them to get access to the formal credit system which would allow financial institutions to assess their credit-worthiness.

Hernando de Soto, in The Other Path, elucidating the excruciating number of steps to legally register a small enterprise in Peru in the 1980s, catalogued the difficulties of these small entrepreneurs in Peru. The sector has been characterized by limited access to services, especially financial services. Such services will be critical to the competitiveness and sustainability of these enterprises in an increasingly liberalized environment. By 1990, even the modest credit services available to the sector had largely collapsed.

The Government of Peru has set goals for rapid economic growth and also seeks to achieve the broad sharing of the benefits of such growth. Given the dimensions of the micro-enterprise sector in Peru, and its social importance, resolving the constraints affecting this sector must be a necessary part of the overall strategy.

President Fujimori, upon assuming office, introduced broad reforms. As a result of these economic reforms, salaried employees enjoyed a rebound in their purchasing power and living standards, which had deteriorated sharply during the inflationary and economically troubled early 1990s. The increase in demand for goods and services from this sector provided growing opportunities for the small and micro entrepreneurs of Peru.

1 RUC stands for "Registro Unico de Contribuyente."

2 The Peruvian Financial Sector: From Chaos to Reform

The Peruvian financial sector experienced major tremors and profound changes during the previous decade as a result of changes in the national and international economy and changes in government economic policy (see Exhibit 2). The financial sector survived the efforts of the government in the 1980s to nationalize the private banking and insurance companies amidst a major financial crisis that led the IMF to declare Peru ineligible to receive further economic assistance.

Until the early 1990s, the Peruvian financial system was made up of a variety of institutions including private banks, state banks, financial service companies and non-profit credit organizations. The economic crisis climaxed in 1990 with an inflation rate of 7,649% (Exhibit 3). This led to the collapse of the financial system as evidenced by the closure of the state development bank, the mutual institutions and many savings and loan cooperatives. The general lack of confidence in the system by the public and the virtual disappearance of credit at the micro-enterprise level were further symptoms of the breakdown.

To confront this crisis, a new legal framework was introduced focusing on prudential norms to give greater stability and security to financial institutions and to recover public confidence. Legislative Decree #637 sought to modernize the system, liberalizing the operations that financial institutions could undertake. In the same year, legislation was introduced to improve the efficiency and effectiveness of the supervisory and regulatory system.[2] This legislative framework was further enhanced with Legislative Decree 770 of 1993, and Law 26702 of 1996[3] -- better known as simply "the Banking Law." These reforms gathered together constructive elements of the earlier norms and also created a modern model for the Peruvian financial system.

These reforms liberalized the financial markets, allowing free setting of interest rates for both deposits and loans and eliminating direct state involvement in the financial system. The new legislation also gave the Superintendency the flexibility to interpret the regulatory norms and to afford equal treatment under the law for national and foreign investment. It also simplified the regulations for the financial sector and introduced the concept of risk by economic group.

One of the important areas touched on by the new reforms was the "Central de Riesgos" (Risk Center), widening the coverage of information that should be gathered and distributed. The changes in the regulatory environment opened the doors for the

[2] "Ley Organica de la Superintendencia de Banca y Seguros" of 1991.
[3] "Ley general del Sistema Financiero y del Sistema de Seguros y Orgánicas de la Superintendencia de Banca y Seguros" better known simply as the "Ley de Bancos."

reappearance and expansion of popular and micro-finance credit. The elimination of barriers to entry for foreign investment stimulated new products and services. The deregulation of interest rate ceilings also led to the introduction of new products directed at the micro-finance sector. At the same time, greater diffusion of credit information opened the way for a market for information, the axis of which was the Risk Center of the Superintendency of Banks and Insurance.

The resulting improvement in the financial sector is evidenced by the growing liquidity of the banking sector as a percentage of GDP which increased from approximately 5.1% in 1990 to approximately 20% in 1998 (Exhibit 3).

This situation, supported by reforms in the financial system, led to the introduction of a variety of financial products directed to this sector. One of the innovators was a local bank, Banco Orion, with close ties to commercial houses, and three banks with Chilean capital connected to a major retailer of household durable and non-durable products.

The first Chilean bank to establish itself in this market was the Banco del Trabajo (Workers Bank) in 1994. By 1997 there were 5 commercial banks and 2 financial services companies that offered personal loans to the low-income sectors (Sectors C and D) with a combined portfolio of US$490M. The average loan was approximately $450 with a minimum of $100 and a maximum of US$20,000.

Structure of the Peruvian Financial System

The Peruvian financial structure underwent a restructuring. At the beginning of 1999 it was comprised of 13 "Multibancos", 12 finance companies, 10 leasing institutions, 13 Municipal Savings and Loan Associations, and 10 Rural Savings and Loan Associations. There were also a number of micro-finance development social enterprises[4], operating under the jurisdiction of the Superintendency of Banks. One of these had already transformed itself into a bank, called Mibanco, targeted at the micro-enterprise sector. The Development Finance Corporation (COFIDE) operated as a second story bank. Finally, there was the Banco de la Nacion, which served the Peruvian Treasury. The entire system was regulated by the Central Bank[5] and by the Superintendency of Banking and Insurance (see Exhibit 4).

Role of Foreign Banks and Role in Stimulating Innovation

Foreign investment in the banking sector played an important role in expanding access to financial services by low-income sectors. Chilean banks in particular, under the new legal framework, introduced new strategies and new technologies for consumer and micro-enterprise credit. This resulted in greater competence and competition in reaching this sector. Foreign investment in the banking sector was estimated at 40% of the overall investment in the sector.

[4] Referred to as "EDPYMES" or Empresas de Desarrollo de las Pequeñas y Microempresas.
[5] Banco Central de Reserva

Relative to the prevailing prime rate of about 32%, the consumer loan rate of interest was relatively high and ranged from a low of 35% to 140% annualized and including commissions. These rates of interest were said to be the result of the high unit cost of processing these loans and the higher risk associated with lending to this sector. However, high interest did not seem to be the principal limiting factor for credit demand as the interest rates offered by informal moneylenders were typically higher than this range.

Despite these reforms, the Peruvian financial sector suffered further setbacks in 1998 as a result of the Asian crisis and El Niño, which slowed Peruvian growth. The arrears rate (including not only arrears but also refinanced arrears) had risen by March 1998 to 8.8% (Exhibit 5). Peruvian prudential norms were very exacting, even by international standards and required provisions for credit-at-risk on arrears of only 15 days (compared to 90 days in many countries) and also computed as in arrears all of the credit and not just the portion corresponding to the late payment.

Arrears were even higher in the consumer loan and micro-finance segments. The foreign banks were particularly hard hit. They had been using technologies proven in their home countries (e.g. Chile) which had good information systems. The situation revealed weaknesses in their client selection system.

3 *The IDB Global Micro-Enterprise Credit Program*

In 1995, the IDB signed an agreement with the Government of Peru to implement the Global Microenterprise Credit Program through COFIDE (Development Finance Corporation).

Objectives of Program

The general objective of the program was to broaden access to formal credit by the formal and informal microenterprises in urban and rural areas so as to enable people from low income groups who have entrepreneurial talent to take advantage of economic opportunity. The specific objectives were that intermediary financial institutions (IFIs) respond in a sustainable way to the growing microenterprise demand for credit, in keeping with the norms of their environment and using local resources.

Program Elements

There were two essential components of the program. The first was the credit component that included $35.7M, of which IDB provided US$25M. This credit would be handled by COFIDE as a second story bank, channeling resources to different institutions to be used to finance microenterprise.

The second component, a technical cooperation, was a non-reimbursable grant of US$3.95M of which $2.75M was provided by the Swiss Government through Cooperacion Suiza para el Desarrollo (COSUDE). This objectives were to improve the operational capacity of COFIDE, strengthen the operating and administrative capacity of the participating IFIs, promote expanded access to credit among Peruvian women and enhance awareness of issues related to the environment.

One very small component of the technical assistance program had to do with strengthening risk information systems. It would broaden the array of credit information services offered by the Central de Riesgos of the SBS to the formal financial sector, focused especially on loans under $4,500, a market segment that had not previously been covered.

In 1998, the Global Microenterprise Credit Program II was signed with a budget of US$42.86M, of which IDB supplied US$30M. The new programs did not include technical cooperation and the budget was devoted to credit. Because of the growing recognition of the importance of a good credit risk information system, and because not all of the resources from the earlier technical assistance had been used, IDB decided to continue making some resources available for technical cooperation to broaden the services of the Central de Riesgos.

4 *Central de Riesgos (CR) and the Emergence of Credit Bureaus*

Central de Riesgos (CR)

The CR is a unit charged with gathering, processing and distributing information on natural and juridical persons who have debts with Peruvian financial institutions. As a risk information center, the Central has been operating since 1968, although it was not until 1992 that banking legislation was introduced specifically referring to the term "Central de Riesgos."

Until 1998, the CR collected, processed and distributed within the financial sector only information about debts that were over the equivalent of US$4,500. The limit was set by virtue of the slowness of the information processing system, which was done manually. At the beginning bulletins were issued every three months, with 6 months of delay, and sent directly to the financial institutions. This bulletin was later published bi-monthly and included information regarding contingent credit and judicial "cobranzas". In 1980, with the procurement of new information systems, it was possible to change the format to include current and contingent debt, total debt and the number of institutions with which the individual or enterprise had financial obligations. Data were provided to the banks in the form of magnetic computer tapes.

Initially, the information was provided to the banks on their own clients and those who had obligations with two or more credit institutions. This was modified in 1992 and permitted the Superintendency to provide data on all the clients for the sector, thus permitting banks to perform credit checks on new potential clients.

The resurgence of microenterprise in Peru by 1994 generated pressures by the consumer and microenterprise banking industry to generate and receive information on even small creditors. This was initiated by the Superintendency, but at first with great delays. The system did not have the capacity to manage the data volume generated.

In 1995, as part of the technical cooperation program of Global Microenterprise Credit I, a new information system was designed with new technology and software attempting to manage this larger requirement to process risk information on small loans as well as large. Initial implementation problems were experienced and, as a result, the $4,500 limit was maintained.

Meanwhile, those banks lending to the consumer and microenterprise sector were anxious to have information in an agile, economic and reliable way. This continued to motivate the SBS to expand the credit reporting system. In October of 1997 a new agreement was reached with a different contractor to provide information. A dual system was created. One was located in the SBS for debts over $4,500. The other was located in the contractor's premises for loans under $4,500. The new system was launched in November of 1997. Banks provided on tape their data and another blank tape upon which they would later receive the entire set of information.

The early results of this information exchange were worrying. Some clients were found to have 8 loans guaranteed by the same collateral and without the adequate capacity to pay or with debts with high levels of delinquency. This created an even greater demand for information by these financial institutions.

By February of 1998, this additional pressure resulted in the provision of data over the Internet and the contract with the information service provider was amended to reflect this. Financial institutions were assigned a code and password. There were two information formats. One was for amounts over $4,500 and provided detailed information managed directly from SBS. The other was for loan amounts under $4,500 and provided less detailed information, outsourced to a data processing firm (Exhibits 6-7). The first system managed 170,000 registries whereas the second managed over 2 million.

Requests for credit profiles increased from 400 to 6,000 per month. The SBS system now had a time lag of 3 months during which time the SBS verified and validated the information. The second system, operating by Internet, had a time lag of only 23 days.

With the new system functioning, the banks began to ask for additional information, such as credit ratings, refinancing, judicial proceedings, credit guarantees and occasions on which guarantors had had to provide the repayment. It was also decided to include information from Savings and Loans and microfinance NGOs in the system. Information was solicited from them in a standardized and specific format. By early 1999 a total of 51 financial institutions were reporting to the system. Only 15 still remained outside the system for there to be a nearly universal credit reporting system in Peru and it was the goal of this initiative to have them incorporated in the coming months. This was seen to be feasible as it was now a legal obligation in Peru for all regulated institutions to report their information to the SBS. By early 1999, the SBS was planning to provide better service to the sector and to develop a new and amplified CR. This project was considered a priority and strategic activity of the SBS.

Credit Bureaus

The demand for credit reporting and the improved information availability achieved by SBS through the CR, permitted by 1995 the emergence of Peruvian private firms dedicated to collect, process and distribute information on the financial position of physical and juridical persons. This information was then sold to a diverse client base.

The first private credit bureau to emerge was Riesgo Cero ("zero risk"). A few months later, the Association of Banks decided to create their own "Central de Riesgos Comerciales" (CERTICOM), while at the same time a third credit bureau "INFOCORP" was created by two banks, Banco de Credito and Banco Wiese, two key national banks. Some months later, Trans Union acquired Riesgo Cero and INFORCORP was acquired by DICOM, a subsidiary of EQUIFAX. These last two acquisitions showed that Peru was attracting the attention of two of the global leaders in the credit risk industry.

The emergence of these three information agencies created increased competitiveness for the market. Each service sought to offer better and more reliable service in terms of the breadth of the information provided and the quality, accessibility and speed with which information was provided. They also competed on the basis of cost--all of which provided increased value to the financial institution users.

These information agencies would take commercial bank credit information from CR as a point of departure and then add value in a number of ways. They would supplement this information with additional information directly from banks. They would then provide additional value to their clients by collecting and processing other kinds of information relevant to the credit decision such as:

- Verification of legitimate address, employment, housing condition and/or business premises.
- Verifying the legitimacy of the identity card and name of the person on the National Identification Registry and Civil Status (RENIEC).
- Verification of registration with the tax authorities and that taxes have been paid.[6]
- Information on any possible protests filed at the Chamber of Commerce regarding IOUs, warrants or unfulfilled guarantees.
- Credit information from commercial houses.
- Credit information from the telephone, electricity and cable companies.
- Updating and cleaning the data base through cross-referencing the above information.

Contracts with credit bureaus would be through monthly charge according to the size of the client, which would provide for a certain minimum number of free credit reports per month. There were also contracts on a per-request basis and the average cost per credit report was $1.

Access to information from the credit bureaus was made in various ways. Clients could have interconnected systems through host-to-host servers, dedicated lines or through the Internet. Information could also be obtained through tapes, diskettes and fax. At the beginning of 1999, one of the credit bureaus had begun offering service through an 800 number.

By early 1999, the credit bureaus typically had between 300 and 700 institutional clients and managed databases with approximately 4 million "registros" each. The information flows to credit bureaus are presented in diagram form in Exhibit 8.

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[6] This was done through the "Registro Nacional de Identificacion y del Estado Civil (RENIEC).

5 *Evaluating the Impacts and Issues in Peru*

One immediate positive impact of the introduction of the CR reporting systems and the credit bureaus was that of improving the quality of the credit decision. A representative of the Banco del Trabajo commented:

> "The CR and the credit bureaus have had a favorable impact, permitting greater access to information. Before, only information on credit over $4,500 was reported. At the moment, for every 10 loan applications that we receive, 5.7 are registered, that is have some kind of debt. This shows the importance of having available information to filter clients so as to restrict ourselves to lending to those who are not over-indebted or having problems with late payments elsewhere."

Improved credit reporting also lowered the cost of transaction. According to Marco Amez of COFIDE:

> "A bank can now take a decision in minutes evaluating an application and rejecting it if there are problems or data inconsistencies."

It was, perhaps, too early in Peru to see these economies and efficiencies translated into savings for the borrower, but it was expected that the combination of greater competition, lower risk and savings in transaction costs would lead to more competitive offerings of financial products to Peruvians.

Mr. Higueras of INFOCORP agreed with this assessment and highlighted another implication for the loan applicant:

> "Credit bureaus lower the cost of credit evaluation and have reduced the waiting time of loan applicants from a week to 24 hours."

The importance of timely credit to microenterprise has been well documented in numerous studies that have demonstrated that timely credit is often more valuable to the entrepreneur than less timely credit even when the latter is offered at significantly lower interest rates.

Another impact was that of lowering the barrier to entry. As information has become more transparent and more available, it makes it easier for new financial institutions to enter the sector or for existing financial institutions to enter the consumer and microenterprise niches of the market serving lower income population groups. Microenterprise barriers of entry to formal finance are also lowered.

Ronal Bourgeois of CREDISUR explained:

> "From the moment we had access to information, our rejection of new loan applicants went up by 20% because of the high level of existing debt reported. We found many applicants that had already as many as 8 loans, many of them already delinquent. A serious financial institution should not work without access to a CR as they should know about the debt capacity of their loan applicants, their current delinquencies and their past and current behavior with regard to loan repayment."

Alfonso Higueras of INFOCORP noted the positive impact in terms of expanded access to credit. "We have been able to create synergy with credit institutions so as to permit a massification in a sector that before did not have access."

The system also was seen as having a positive impact in creating a culture of repayment. As people and enterprises have gotten to know and understand that unpaid debts have consequences for future access to credit, they have begun to make greater efforts to honor their commitments on a timely basis. This had an influence on the "pyramid of payment" or the hierarchy of priorities that people assign to their financial commitments and debts.

Issues Involved in Credit Reporting in Peru

The issue of individual privacy is closely associated with protection for the consumer. Errors in credit records can have a negative impact on the prospects for credit for an individual. Therefore, the system must be responsive to consumers who want to check the accuracy of their credit report and errors must be corrected on a timely basis. In Peru, the institution charged with defending the rights of the consumer is INDECOPI. To date, INDECOPI has not received complaints but is worried about the existence of errors in credit reports. INDECOPI representatives said they would not intervene as long as consumers had the right to review their reports and get errors corrected.

Oscar Ballon, Director of CERTICOM suggested:

> "There should be norms that regulate the kind of enterprise offering this service. The management of information implies power, especially when dealing with credit information. This should be entrusted to persons with sufficient moral solvency, in addition to the technical capacity to manage a data base."

Another issue is achieving nearly universal reporting. The active participation of all major financial institutions in providing information is critical to the credibility and success of a credit reporting system. Luis Bicchio, Director of Finance of the Banco del Trabajo noted:

> "There was some resistance to providing this information, especially from banks who had a relatively good internal information reporting system. These banks

> didn't want to make their credit information on their clients available to their competition, especially when they were providing a lot of information by their size and others were providing much less. For this reason, they were only reporting information on bad clients. As of January, 1999, they must report all of the information. To ensure reporting, there should be official requirements to provide all of this information to the supervisory authorities."

Financial institutions also have legitimate concerns regarding the <u>provision of proprietary information and its</u> <u>potential use by competitors</u>. Socorro Heysen, Deputy Banking Superintendent, indicated:

> "At the moment, we don't have problems with regard to the turning over of information. The problem was opposition by some banks in turning over information desegregated by institution. This has been resolved by aggregating all the data and not identifying the clients by financial institution. Also, credit reports are made on a one-by-one basis. Only if a person has late payments is the bank indicated to which the debt is delinquent."

There is the need to avoid the <u>free rider</u> problem whereby some financial institutions seek the benefits of credit reporting without providing information on their own operations. In Peru, the reporting regulations have been seen as a way to resolve this issue. There is also a need to explain the benefits of the system to the financial community.

<u>The appropriate use of rapidly evolving technology</u> is another issue that must be managed. The rapid expansion of Internet Service Providers, bandwidth capacity and telecommunications availability in Latin America, along with the expansion in computing power at lower and lower costs, provide new possibilities for collecting, processing and disseminating credit information with high levels of quality control and transparency.

6 Case Lessons: Conditions for an Effective Credit Reporting System

The case provides lessons regarding the conditions necessary for an effective credit reporting system.

The first condition is a clear delineation of roles of the private and public sectors. There are dangers of both under- and over-regulation as roles are being redefined. The public sector has generally retrenched from its prior role as a credit provider to socially important groups such as small farmers and small businesses. The private sector is expected to fill the breach but the gap in access often remains severe. Governments in Latin America are searching for the appropriate roles to achieve economic and social goals in this new paradigm. In some countries, credit reporting is largely a private sector function. In other cases, detailed reporting is required by the Central Bank. In Peru, the CR provides the regulatory framework, clearing house and reporting architecture; private banks and the credit bureaus do the rest.

The second condition is the need for universality of reporting. If not all banks or financial institutions report their information, the value of credit reporting is much reduced. There is the temptation for financial institutions to want to have a free ride--to enjoy the benefits of getting credit reports without having to provide information. In some cases this is handled by not providing credit reports to institutions that do not share information. In cases such as Peru, there are formal reporting requirements established by the legal and regulatory framework that accomplish this.

The third condition is that of reliable identification. In Peru, the emergence of effecive credit reporting coincided with improvements in the national identity card system. Even in countries such as the USA that do not require a national identity card, the social security number serves the same function. As digital technology creates the possibility for smart cards, the technical and economic feasibility for introducing reliable identification systems will improve.

The fourth condition is individual privacy and protection. Inaccurate information can cause economic and psychological hardship to people. It can be misused to intentionally cause damage. Therefore it is necessary to safeguard the rights of people to see their credit reports and to get prompt action to correct any false or misleading information. Credit bureaus must provide free copies of credit reports to the individuals and take prompt action to verify or correct wrong information that has been brought to their attention. A credit reporting system will not endure nor engender cooperation if the appropriate safeguards for personal privacy do not exist.

A fifth condition is protection of confidentiality and legitimate commercial interest. Financial institutions have made enormous investments in cultivating a good client base. They do not want their client lists or their lists of good versus bad credit risks shared broadly with competitors. As a result, credit reporting is usually made available on a case by case basis. Credit bureaus, to maintain their credibility, must ensure that their main data lists are not transferred wholesale. One must therefore have safeguards in place.

7 *Case Lessons: Benefits*

This brief case study illustrates the potential benefits of an institutionalized and effective credit risk reporting system. These are all the more important for being generally undervalued and poorly understood.

<u>Transparent risk reporting systems are a cost-effective way of promoting broader access to credit by small and low-income borrowers</u>. In the case of Peru, over $60M was spent on credit and only very modest investments were made in expanding the technical capability of the CR and credit bureaus. The case suggests that this "detail" should in fact be a central aspect of micro-finance strategy.

The development of an effective credit risk reporting system <u>lowers the barriers to entry.</u> It does this by lowering both the risk and the transaction cost of obtaining and processing good information relevant to the credit decision. It thereby encourages financial institutions to lend to this sector. One surprising finding in Peru was that new entrants targeted the SME sector because the larger firms were already taken. The SME sector was also a high growth sector.

Third, it <u>encourages competition among financial institutions to lend to this sector.</u> The desirable outcome is that private financial institutions compete with each other to serve this sector. Financial institutions begin to innovate with strategies, financial products and technologies to effectively lend to this sector. In Peru, the entry of Chilean banks brought in their own technologies and approaches for lending to this sector.

Fourth, effective credit reporting <u>lowers the risk of a financial bubble.</u> Emerging economies that begin to grow after reform experience a growth in credit demand. Banks tend to respond by expanding their lending. However, if there is no good risk reporting system in place, the risk during a downturn is greater.

A fifth benefit <u>promotes a culture of repayment,</u> especially once the telephone, cable and electric companies begin using credit histories. The priorities for payment begin to shift once there are consequences for delaying or defaulting on one's credit payments. Oddly enough, <u>poor people are often better credit risks</u>, once such systems have been established. This is because their reputation is often their principal asset. They also tend to view their line of credit as a lifeline and value it more. However, this is not automatic. In many countries, past paternalistic policies and close political and governmental involvement in the financial sector serving rural and poorer constituencies has led to a culture of non-repayment. The case shows ways to address this problem and facilitate the transition.

This case has shown how the expansion of credit risk reporting to include small and micro loans led to the development of credit bureaus and a large expansion of credit as private financial institutions began to compete with each other to serve this sector. They did this, in part, because they were able to use this information to evaluate risk and lower the transaction costs of lending to small entrepreneurs and low-income population groups. Developments in information technology make such systems every day more feasible and cost-effective. Yet, this component of micro-finance strategy is relatively neglected despite the high levels of resources being deployed. Should risk mitigation play a more leading role in micro-finance strategy? What have been the experiences in other countries? This case study has implications for Peru. More importantly, it may have unexpected and compelling implications for global microfinance strategy. Could it be that the design of financial architecture will have, in the end, more impact than additional increments of credit through existing structures? Is providing microfinance credit through traditional structures like putting new wine into old wineskins? The case of Peru provides some guidance for making new wineskins.

Exhibit 1

The Peruvian Microenterprise Sector

Number of Microenterprises	2,386,000
Direct Employment	6,000,000
Employment/Economically Active Population	75%
Percent of GDP	40%
Sector of Impact	Low Income
Degree of Informal Activity	80% not registered in the SUNAT (tax authority)
Principal Activity	Commerce

Source: Government of Peru, Ministry of Labor, 1996

Exhibit 2

Recent evolution of the Peruvian financial sector

Year	Event
1987	Nationalization of the banking system
1988	Reversal of the nationalization
1992	Hyperinflation. Collapse of the sector. Disappearance of state banking institutions, and savings and loan cooperatives.
1993	Liberalization of foreign investment in the sector and of interest rates. Entrance of municipal savings and loans associations in microenterprise financing.
1994	Incursion by foreign banks, especially in microcredit for consumers and microenterprise.
1995	Deregulation of consumer credit enterprises, mutuals, and mortgage banks. Broadening and strengthening of prudential norms.
1996	New Banking Legislation

Exhibit 3

Principal economic indicators for Peru

Year	GDP change (%)	Inflation (%)	Total Banking System Liquidity
1988	-8.3	1,722.3	7.5
1989	-11.7	3,321.3	7.7
1990	-3.7	7,592.3	5.1
1991	2.9	409.5	7.0
1992	-1.7	73.5	9.6
1993	6.4	48.6	11.6
1994	13.1	23.7	13.5
1995	7.3	11.1	15.0
1996	2.4	11.5	18.0
1997	6.9	8.6	19.4
1998	0.3	7.2	20.8

Exhibit 4

STRUCTURE OF THE PERUVIAN FINANCIAL SYSTEM

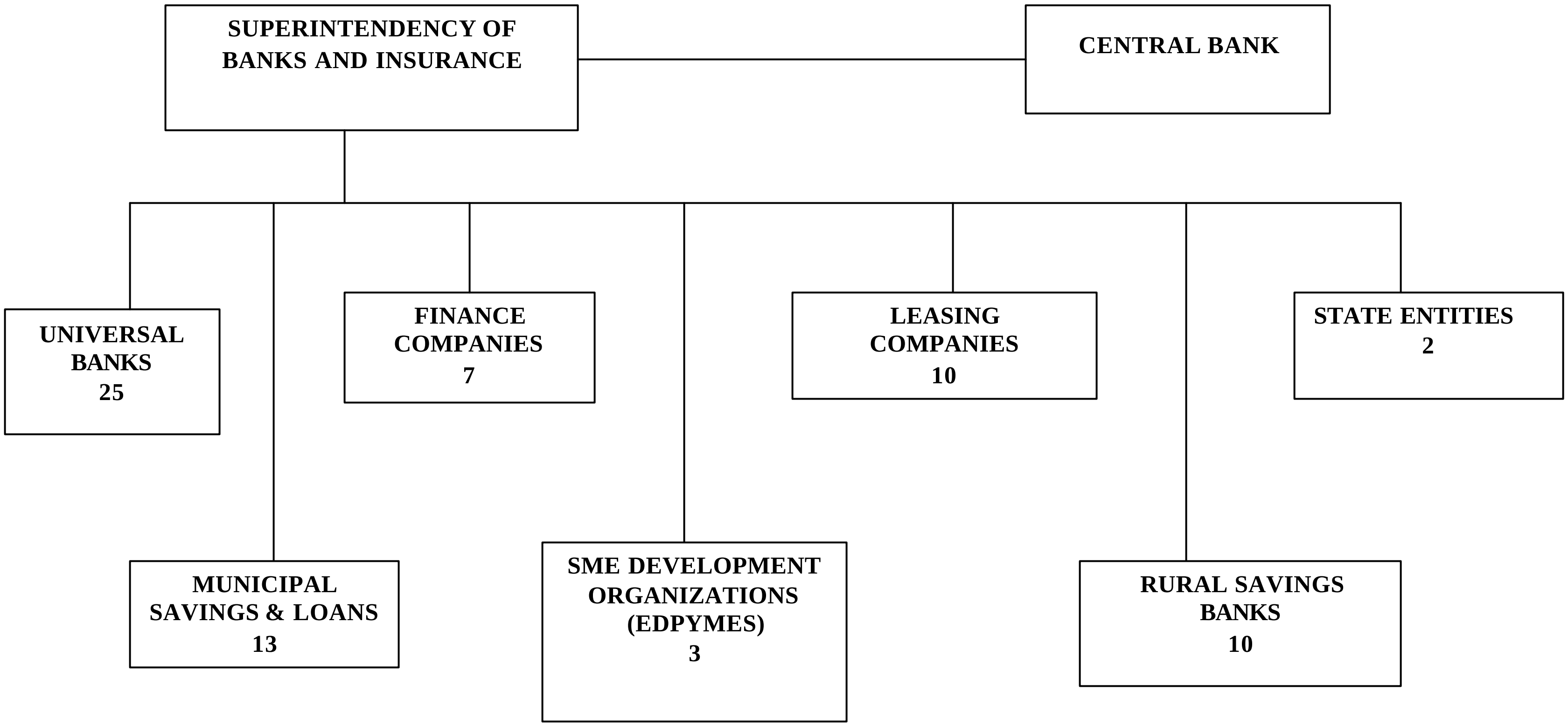


Exhibit 5

Quality of Universal Bank Portfolios (% gross commitments)

	Portfolio at Risk			**Portfolio at Risk and Refinanced**		
Bank	**Dec. 96**	**Dec. 97**	**Mar. 98**	**Dec. 96**	**Dec. 97**	**Mar. 98**
Bank of Boston	0.0	0.0	0.0	0.0	0.0	0.0
Citibank	3.9	1.2	0.5	4.0	1.2	1.1
Del País	N/A	0.5	1.6	N/A	4.6	7.7
República	1.3	1.8	2.3	8.6	4.0	4.0
Sudamericano	2.8	1.8	2.4	2.5	2.0	2.6
Nuevo Mundo	1.8	2.3	3.1	3.0	4.2	5.0
Financiero	6.6	3.0	3.1	14.6	4.8	4.6
Standard Chartered	3.1	3.1	3.8	3.8	3.9	4.6
Del Progreso	2.4	3.2	4.2	7.1	5.1	6.1
Lima	5.3	4.6	4.9	8.7	7.6	8.2
Interamericano	5.0	7.4	5.2	5.0	16.0	7.7
Del Trabajo	4.3	4.5	5.5	4.3	6.7	8.3
Wiese	4.7	4.8	5.8	8.4	9.4	10.1
Interbank	8.2	5.6	5.9	11.4	8.4	8.8
Banex	7.5	5.1	5.9	10.8	8.0	7.8
Orion	4.2	4.0	5.9	4.2	5.1	8.1
Crédito	3.9	5.1	6.0	4.9	6.7	7.5
Continental	5.8	5.1	6.2	9.8	9.7	10.7
Bancosur	8.4	6.2	6.6	10.3	10.2	10.5
Norbank	9.9	8.6	7.6	12.4	10.0	9.0
Latino	7.5	6.5	7.6	12.8	10.2	10.9
Comercio	9.8	7.4	8.8	19.2	14.8	17.8
Solventa	4.2	8.5	11.2	9.4	13.5	14.2
Serbanco	1.8	9.9	12.0	1.9	10.4	12.9
Santander	6.9	9.0	12.7	8.2	9.8	13.6
TOTAL	**5.2**	**5.1**	**6.0**	**7.9**	**8.0**	**8.8**

Source: SBS

Exhibit 6

Credit information provided by the risk center: minor debts

Client: **Magnitude**

CIUU: **Economic Group:**

RUC: **SBS Code:** **Qualification:**

Address:

Categories	**To xx/xx/xx**		**To xx/ xx/xx**
US$	**Soles**	**US$**	**Soles**
Accumulated Direct Debt			
Arrears (less than 60 days)			
Arrears (60 days or more)			
Accumulated Indirect Debt			
Accumulated Guaranteed Debt			
Credit Line			

Exhibit 7

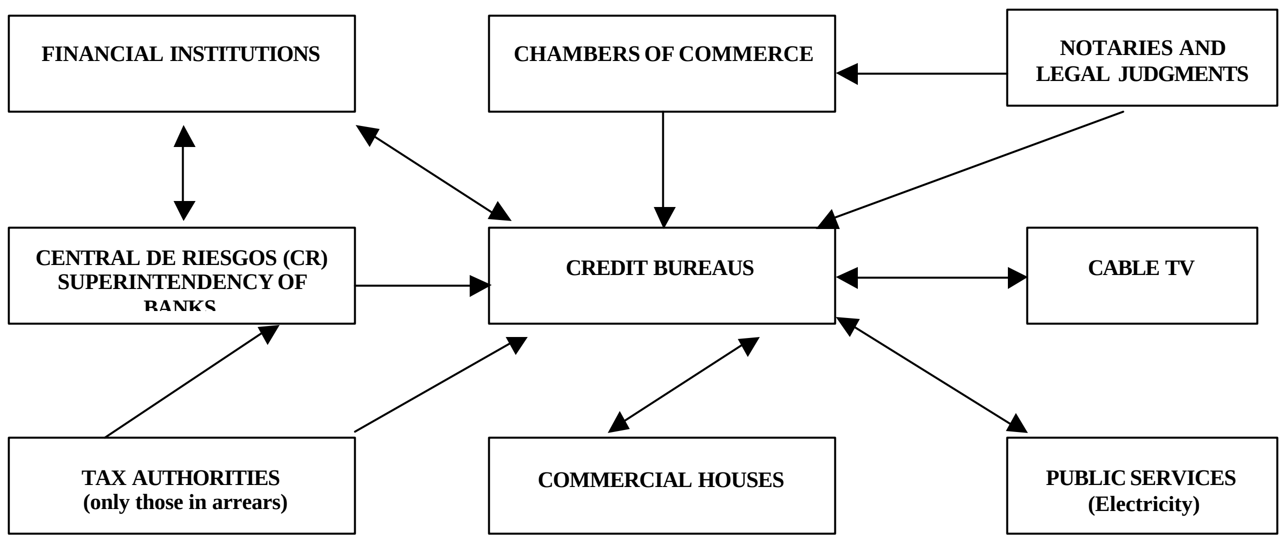
Credit information provided by the risk center: large debts

Client:		**Magnitude**
CIIU:		**Economic Group:**
RUC:	**SBS Code:**	**Qualification:**
Adress:		

Categories	**To xx/xx/xx**		**To xx/xx/xx**	
	Soles	**US$**	**Soles**	**US$**
Current Account Overdrafts				
Letters of Credit				
IOUs				
Loans				
Leases				
Commitments for Import Finance				
Refinanced Credit				
Interest and Commissions Receivable				
Interest and Commissions Suspended				
ARREARS				
Up to 4 months				
More than 4 months				
Arrears being settled in court				
UNDISBURSED CREDIT				
INDIRECT DEBTS				
Outstanding Guarantees				
Credit Cards Issued				
GUARANTEES				
Guaranteed Deposits				
Personal Guarantees				
Embargoes				
Machinery and Equipment				
Real Estate				
Mortgages				
Warrants				
Merchandise				
Inventory				
Other Guarantees				
TOTAL DEBT				

Exhibit 8

FLOW OF CREDIT INFORMATION



Annex I

MINI CASE STUDY: CLEARING DE INFORMES – MONTEVIDEO

Kevin X. Murphy

“Somos fieles a nuestra historia”
(We are faithful to our history)

December 26, 1998

Those who work in the area of micro-finance seek to achieve the democratization of credit. One key question is “what would success look like?” Another way of asking the same question is “how will we know when we have achieved our goal?” One answer to these questions can be found in Montevideo.

Uruguay—Nearly Universal Access to Credit

In Uruguay, there is nearly universal access to credit for those who know how to manage credit responsibly. For example, one can pick up the local newspaper and find ads for small consumer loans. One calls the number and over the telephone the informal credit provider checks one´s name and number and if the credit reference is good tells the individual where to drop off a photocopy of this documents and pick up the money later the same afternoon.

How did Uruguay achieve this surprising access? There are a number of factors. For example, Uruguay never had the kind of devastating inflation that was experienced in neighboring Argentina and Brazil. One important contributing factor is the existence of an excellent credit bureau and credit reporting system. The following is the case history of the company that created the credit reporting industry and helped contribute to this successful result. The story is based on interviews with the current CEO of the company and who is also the son of the founder.

The Origin of the Credit Reporting Industry in Montevideo

In 1954, a publisher in Montevideo made a substantial sale one day on credit to a distributor. In the late afternoon, over coffee, he reported this with satisfaction to a few colleagues in one of the cafes of Montevideo. One of his friends told him, “be very careful—I once made a sizeable sale on credit to that person and had a hard time later getting him to pay.

Instead of focusing on this problem or merely thanking his friend for the advice, the founder of Uruguay´s credit reporting industry said, “that information you have just given me is very valuable. I bet other people would also find it valuable.” He spent the next six months gathering information on people who paid and people who did not. After six months, he began selling this information to business people. It is sometimes said that “credit reporting existed before credit” and definitely grew along with it.

Companies were also willing to share information about those who paid and those who didn´t knowing that this would enable them to get a vastly expanded base of information. Over time, the credibility of the business community grew thanks to the confidence in the business ethics of Clearing. “We don´t sell lists of good clients to anyone,” say Clearing executives. Reports are sold on a one-by-one basis. Many banks and companies view their own base of knowledge of reliable customers as an asset they do not want shared.

Operations of Clearing de Informes

Clearing keeps data bases on delinquencies and on outstanding non-payments that have not been reconciled. It does not provide information on outstanding court cases as many of these are settled out of court and there is no way to verify this. “We don´t include anything in our data bank that cannot be confirmed, “ say Clearing executives. These operations are facilitated by the existence of a national identity card which is commonly provided for important financial transactions.

The company now provides over 200,000 individual credit reports per month. It manages sophisticated computer systems that constantly maintain and update credit files.

Those seeking access to the Clearing data base normally pay $50 per month which gives them the right to 50 reports after which the rate is $1.40 per report. These are simple one-page reports that indicate the recent credit history of the individual and whether there are any late payments recorded of instances of non-payment. Indications of non-payment, once rectified, are kept for a period of 4 years after which they no longer appear on the record.

Today in Montevideo, it is hard to get a loan, an apartment or even a telephone line without a good credit report. Even state-owned companies such as the telephone company, insist on such a report creating the impression in the minds of some that Clearing is somehow sanctioned by the government despite it being a purely private enterprise.

Knowing the payment history is also seen as superior to the traditional practice of requiring 3 letters from commercial and professional contacts as most people are astute enough to request such letters from people who will speak well of them.

Issues and concerns

Privacy

In 44 years of operation there have only been 5-6 lawsuits brought against the company and none have resulted in any liability for the company. All consumers have the right, free of charge, to review their credit reports and to request corrections to any aspect that they view is not correct. Clearing has a Consumer Department geared to providing this service and to answering questions. Users of the service promise not to divulge the information obtained. Some people ask what right Clearing has to collect and divulge information about individuals. The company responds that it simply passes on information provided by others and does not make judgements on any individual. It also notes that those who have a history of ethical financial practices have no worries.

Getting Cooperation

The system is dependent on the voluntary supplying of credit information by banks, finance companies and others who sell on credit. At times it was difficult to get this information from rural towns where there usually only one or two major credit providers who knew their client base well. One way to encourage the provision of such information is to impose conditions by not allowing access to the credit reporting system by those who do not also provide information. Another mechanism is to simplify the reporting process.

Competition

There have been as many as 20 attempts to form alternative credit bureaus but to date none has been able to rival Clearing. Access to information puts the company in a powerful position and creates an obligation to handle such information responsibly.

Technology

With the creation and promotion of UruguayNet (an intra country network) by Antel, the Uruguayan telephone company, the ability to gather and disseminate credit reports took a leap forward. The cost of a credit report is only that of a local phone call and US$1.40 per credit report. Antel had promoted widespread access to the Internet and especially UruguayNet as a means of increasing demand and utilization of telephone services which are 100% digital. It has become a powerful vehicle for Clearing de Informes as UruguayNet has good national coverage and penetration. Telephone and Internet rates are the lowest in Latin America. Some 80% of the credit reports are via direct contact with Clearings data base. The system operates at a relatively quick 64 baud and there are 70 lines available to customers. The computer system fails at a rate of less than one hour per year. Although the system functioned prior to the existence of the Internet, the latter has contributed to the successful expansion of Clearing.

Results of an excellent credit rating system

Being a user-friendly and low cost provider has led to high growth in the last few years. There are now over 3 million credit requests per year in an economically active population of 1.4 million people –believed to be the highest credit reporting rate per-capita in Latin America.

As a result of the confidence that Clearing has engendered, commercial banks and finance companies are fighting with each other to lend to small business and to consumers. There is also the rise of other more informal companies lending to higher risk groups at higher rates.

Starting with the access of lower rates because Uruguay has "Investment Grade", "the costs of providing credit are among the lowest in Latin America," according to executives of Clearing due to the availability of their services. "The delinquency rate is below 3% indicating relatively low risk. Knowing the payment habits of the borrower is extremely important and is in some ways more important than knowing the income stream or collateral base." It is observed that poor people often value credit more and take greater care in keeping their credit reputation intact.

Future challenges

The explosion of credit in recent years has coincided with the recent purchase of Clearing de Informes by the Exxel Group in July of 1998. A number of international credit agencies seem interested in Clearing. It is unclear if this change in ownership structure will affect future operations. There is also some concern that this information is all in private hands. The banking supervision system has not been involved in a formal way.

One of the challenges for the future is developing a good database on companies as well as individuals. At the micro-enterprise level, there may be little difference between credit reporting on individuals and credit reporting on small companies and this information is typically harder to get.

The impressive democratization of credit in Uruguay is the result of many factors but chief among them is the existence of an excellent credit-reporting bureau that has lowered the cost and risk of lending. There are important lessons here for other countries where there is an interest in expanding access to credit. One may conclude with the words taken from the founder of Clearing de Informes: **"Selling on credit is easy, selling correctly is difficult."** To this one could add that lending resources to low-income consumers and micro-entrepreneurs is easy. Lending correctly is difficult.

Establishing the architecture by which private companies compete with each other to intelligently lend to this sector is even more difficult.