

Confianza in Peru Overcomes Adversity by Diversifying Loan Portfolio

This case study was researched and written by Douglas Pearce and Myka Reinsch, with research support from Joao Pedro Azevedo, and Amitabh Brar, and financial support from the International Fund for Agricultural Development. Dieter Wittkowski of the Inter-American Development Bank and Frank Rubio also provided valuable comments as reviewers of this case.

Summary

Confianza is a small regulated microfinance institution in central Peru that today provides agricultural loans alongside a range of rural, urban, small business, housing, and consumer loans to low-income clients. From its beginnings as an Inter-American Development Bank-funded NGO program in 1993 until becoming a regulated microfinance provider in 1999, Confianza's loan portfolio was almost exclusively devoted to solidarity group loans for agricultural purposes. When a combination of factors, including plunging commodity prices, led to an arrears rate of over 50 percent in 1999, Confianza was forced to make a set of swift, substantial changes in order to survive:

The MFI altered its lending methodology, instituted stricter lending requirements and monitoring, and added urban and individual loans to diversify its portfolio. Its non-agricultural portfolio flourished, and Confianza also maintained a focus on agricultural lending (about a quarter of its total portfolio), with lending to agriculture almost quadrupling in volume over the next few years. By year-end 2002, Confianza had become financially sustainable, lending more than \$4 million annually, with a respectable arrears rate (portfolio at risk >30 days) of less than 4 percent and a 19 percent adjusted return on equity. Notably, its agricultural arrears rate has remained consistently lower than that of the portfolio as a whole.

Background

Confianza was established in 1998 when SEPAR,¹ a non-governmental organization (NGO), transformed its five-year-old agricultural lending program into an "Entidad de Desarrollo de la Pequeña y Micro Empresa" (EDPYME), a class of regulated MFI in Peru. SEPAR began lending to impoverished rural women in 1993 with a US \$500,000 grant from the Inter-American Development Bank (IDB). The portfolio that Confianza inherited in 1998 was comprised primarily of unsecured solidarity loans to groups of women, 95 percent of whom depended on agriculture—largely potato farming—for their livelihoods. Despite SEPAR's geographically dispersed borrowers, rudimentary loan appraisal process, and

minimal monitoring, the portfolio was considered healthy in 1998.²

Scarcely a year later, more than 50 percent of Confianza's US \$391,000-loan portfolio was at risk of default.³ Several factors had contributed to the dramatic decline by the end of 1999. The transition from NGO to regulated microfinance institution had proved difficult for staff members, many of whom either disagreed with the new emphasis on sustainability over poverty reduction, or were unhappy with the newly introduced culture of productivity and efficiency. An almost complete staff turnover ensued.

¹ SEPAR stands for "Servicios Educativos Promoción y Apoyo Rural" (Promotion of Educational Services and Rural Support).

² Per CGAP consultant interviews with Confianza; only anecdotal evidence was available for this time period.

³ According to a 2001 MicroRate report, the gross portfolio of Confianza was US \$391,000 as of June 1999.

At the same time, potato prices reached their lowest level in over 20 years, drastically eroding the repayment capacity of many clients. In reaction, some borrowers formed lobby groups to protest the repayment of their loans, contending that their obligations were with SEPAR and not Confianza.

Challenges

With potato prices bottomed out, dissatisfied staff departing, and SEPAR borrowers boycotting it, Confianza faced a host of challenges at the end of 1999. Although the acute delinquency crisis of late 1999 was triggered partly by factors out of Confianza's control, the root cause of the problem was an unsustainable lending methodology. The MFI's institutional viability was threatened by three main challenges, detailed below.

Portfolio Concentration and Restricted Clientele

The poverty and gender focus of SEPAR's initial portfolio resulted in a narrow clientele based on demographics rather than business or repayment potential. Loans were restricted to poor women in central Peru, which meant that many clients lived in rural zones far from branch offices. Most borrowers were farmers who depended on a single subsistence crop. The narrow client focus produced a dangerously homogenous loan portfolio with risk concentrated in agriculture, especially potatoes.

Insufficient Borrower Information

SEPAR and, in its early days, Confianza followed a lending model of solidarity loans to groups of three to seven women. Loan proceeds were not tied to crop or production cycles, but used at the discretion of borrowers. Each group nominated a coordinator to assume responsibility for monitoring group performance and collecting repayments. Confianza had little presence in the field and thus gathered insufficient information to predict or stem defaults. Since solidarity loans were collateralized only by mutual borrower guarantees, moreover, Confianza had no recourse when loans went into default.

High Cost of Rural Operations

Although certain staff recognized the need for better loan appraisal and monitoring, the expense of instituting such processes was prohibitive in remote rural regions. Reaching distant clients on a regular basis was impractical. Instituting an effective appraisal and monitoring system would require a different operational approach, new technical skills, rigorous staff training, and a more advanced information system. Confianza lacked the funds to

undertake such improvements and at the end of 1999, was in a poor position to secure additional financing.

Responses

With the support of the IDB, Confianza improved the quality of its portfolio in 2000–2001 through write-offs and the introduction of a new lending methodology that responded to the foregoing challenges.

Portfolio Diversification

Confianza began by revising its target clientele. Recognizing the inherent risks in agricultural lending and the potential balance that small business, housing, and consumer loans could provide, the target proportion of agricultural loans was reduced to 30 percent of the portfolio. Loans to both urban and non-farming rural borrowers were added. While Confianza's focus remained on rural lending, its target clientele shifted from poor women to low-income households.

Stricter Lending Requirements

Confianza began insisting on risk diversification at the borrower level too, making multiple income sources a requirement for agricultural loans. Households dependent on a single crop, or lacking irrigation, were excluded. The institution also moved away from solidarity lending in favor of partially secured individual loans. By the end of 2002, solidarity loans made up just 25 percent of its portfolio.

To further mitigate the risk of borrower defaults, Confianza began requiring more formal collateral, depending upon loan size and borrower credit history. For smaller loans (less than US \$2,500), informally registered land was accepted. Larger loans required machinery, cars, trucks and/or official mortgage titles as collateral.

Rigorous Loan Monitoring

More loan officers were hired and regular visits to the field were instituted. With more detailed information on hand from the beginning and a more consistent presence in the field, loan officers were better able to monitor borrowers' businesses, identify potential trouble spots during the repayment period, and help address crises before they ballooned out of control.

Production-Based Agricultural Lending

Confianza also changed its agricultural lending policies. While accepting that loans could be paid back from diverse income sources, Confianza designed its agricultural loans to more closely fit the income and expenditure cycles of agricultural production. Agricultural loans, ranging from US

\$150–\$10,000, were extended for specific crop production, usually to individual households owning an average of two hectares of land. Loan terms were flexible, with an average maturity of eight months, and disbursements and payments were tied to income flows. Borrowers could receive a loan in up to three disbursements, and repayments could be partially or fully amortized over the term of the loan. Interest rates ranged between 4.2 and 4.7 percent per month in local currency (between 2 and 3 percent in US dollars).⁴ Emergency lines of credit were also made available to clients with good repayment histories.

Loan officers used new data collection techniques to develop realistic business plans for specific crops and to analyze potential income sources for repayment. Strategic partnerships were also formed with local public and private sector institutions that monitored weather patterns and agricultural commodity prices, allowing Confianza to better predict repayment rates. The MFI also occasionally called on these organizations to help provide training to small farmers.⁵ Finally, agricultural clients were required to contribute, in cash or in kind, a portion of the total financing requirements for an agricultural production cycle.

Geographic Footprint Reduced

To offset the expense of its more labor-intensive lending model, Confianza trimmed its service area, limiting its services to clients within located 1½ hours from a branch office. It also upgraded its branches to handle multipurpose transactions and adopted a strategy of adding branches gradually—lending first to clients closest to the branch before venturing farther away. An effort was also made to establish branches in ecologically varied zones to diversify climatic risk.⁶

Changes Lead to Sustainability

By December 2002, Confianza's three branches held a combined portfolio of US \$4 million in loans to over 5,000 clients and its portfolio-at-risk rate (PAR > 30) had dropped to 4.2 percent. It had reduced its agricultural exposure to 29 percent of the total portfolio by adding loans for urban and rural small enterprises (55 percent), housing (8 percent), and

consumers (4 percent). The MFI offers no saving products.

Three years after its default crisis, Confianza's operational self-sufficiency ratio reached 1.75, and financial self-sufficiency ratio, 1.22. Most impressive, the MFI's adjusted return on equity reached 19 percent, compared to an industry average of just over 6 percent—making it the most profitable of the 13 EDPYMEs in Peru.

A new branch office in Lima, increased rural outreach, and the creation of a new microenterprise loan product fueled further growth in 2003, when the loan portfolio grew 81 percent in dollar terms and the arrears rate fell to 3.4 percent. Operational efficiency, as measured by the ratio of loan officers to clients, also improved, and operating expenses as a proportion of total portfolio value continued to fall (see table 1).

Growth in the value of the agricultural portfolio has almost kept pace with that of the total portfolio, expanding by 40 percent in 2002 and 64 percent in 2003 (see table 2) due to Confianza's concerted effort to increase penetration in rural areas, including new agricultural zones. The growth in the value of agricultural loans has been accompanied by their decline as a share of the overall portfolio (to 26 percent in 2003). Arrears on the agricultural portfolio also remained lower than that of the overall portfolio from 2001 to 2003.

Donors and Investors

Throughout its development, Confianza has benefited from donor and investor support in the following forms:

- Grants for technical assistance, staff training, systems development, product revisions, and branch expansion, principally from the IDB, with small grants from NOVIB
- Subsidized loans for on-lending from social investors such as NOVIB, Oikocredit, and ADA
- Commercial loans from LACIF and other international investors

The IDB has maintained a long-term relationship with Confianza since its inception as a lending program of SEPAR. Recognizing the commitment of the MFI's management team to build a healthy institution, the IDB supported the transition of SEPAR to a regulated EDPYME and helped facilitate a complementary pack-age of funding from other donors and investors.

The IDB also later assisted Confianza to overcome the 1999 repayments crisis by providing funding to help it modify its loan products and procedures, train staff, and strengthen its reporting and information systems.

⁴ MicroRate, "Confianza Report," 2002.

⁵ CGAP consultant report, based on interviews with Confianza staff, 2002.

⁶ The topography in Peru is diverse, and Confianza intentionally situates its branches in different zones in order to mitigate risk. In the state of Junin, for example, one branch is located in a jungle area, one in the city of Huancayo, and a third in a high-altitude plateau.

Table 1 Confianza Financial Indicators, June 1999–December 2003

	30 Jun 99	31 Dec 00	31 Dec 01	31 Dec 02	31 Dec 03 ^a
Outreach					
Number of loans outstanding	686	2,473	3,650	5,290	10,411
Outstanding gross portfolio (\$)	391,000	1,495,083	2,699,332	4,407,154	7,967,678
Average outstanding loan size (\$)	570	608	695	833	765
Average loan size as % of GDP/per capita	28%	29%	34%	35%	37%
Sustainability/Profitability					
Adjusted Return on Assets (%) ^b	-6.8%	5.1%	5.1%	3.5%	2.8%
Adjusted Return on Equity (%) ^b	-13.4%	18.5%	22.5%	18.7%	15.4%
Operational Self-Sufficiency (%)	NA	1.55	1.73	1.75	1.84
Financial Self-Sufficiency (%)	NA	1.22	1.35	1.22	1.24
Operational efficiency					
Operating expenses as % of portfolio	102.6%	19.7%	16.4%	15.9%	14.3%
Number of clients per loan officer	172	328	383	378	416
Number of borrowers per staff	NA	94	134	147	174
Portfolio quality					
Portfolio at Risk > 30 days as % of portfolio	NA	0.2%	4.5%	4.2%	3.4%
Write-offs as % of average gross portfolio	NA	1.1%	1.5%	0.9%	1.52%
Exchange Rate					
Nuevos soles/US\$	3.33	3.52	3.44	3.51	3.46

^a Unaudited financials

^b Reflects end-of-period assets or equity, rather than average figures.

Sources: Confianza staff, MicroRate reports, Confianza Annual Reports; CGAP consultant reports.

Table 2 Evolution of Confianza Agricultural Portfolio, 2000–03

Agricultural Portfolio Only	2000	2001	2002	2003*
Number of active clients	682	631	671	2,148
Number of active loans	791	1,085	1,300	2,195
Active portfolio (US\$)	559,394	913,713	1,280,407	2,094,578
Average loan size (US\$)	707	842	985	954
Portfolio at risk > 30 days	NA	1.0%	3.3%	3.3%
Agriculture as % of total portfolio	37%	34%	29%	26%

Sources: CGAP consultant report and Confianza staff. Preliminary financial data is as of early 2004. Note that Confianza reported an increase in agricultural clientele of more than 200 percent during 2003, while the number of loans increased by only 69 percent. The growth in clientele was due to increased rural penetration, while the relatively low growth in the number of active loans resulted from a policy change. Prior to 2003, clients could receive two or three parallel, simultaneous loans. Beginning in 2003, borrowers had to demonstrate creditworthiness by making timely repayments over the course of 12 months before becoming eligible for a maximum of one parallel loan.

Confianza's transparent reporting and the availability of rating and assessment reports by MicroRate have recently helped attract social investors, who (as of year end 2002) provided 82 percent of the institution's financing. Along with other Peruvian EDPYMEs, Confianza has shown that commercial financing can be a sustainable and profitable source of funds for microlenders.

Lessons Learned

Confianza's experience with turning around a poorly performing agricultural loan portfolio offers the following principal lessons:

- A viable and growing agricultural loan portfolio can be achieved by combining the *agricultural finance* approach of designing loan products to better fit agricultural production with the key *microfinance* tenets of sustainability, close client monitoring backed up by a well-functioning management information system (MIS), and portfolio diversification.
- A high degree of portfolio concentration in one crop makes financial institutions highly vulnerable to default, whereas a diversified loan portfolio, incorporating urban and non-agricultural rural loans, reduces vulnerability to agricultural risk.
- Agricultural lending can be profitable. Confianza's agricultural portfolio achieved an unadjusted return on equity of 11 percent in 2003 and has maintained lower arrears than its overall loan portfolio for three years.
- The risk of delinquency and default on agricultural loans can be lowered by only lending to households with other additional sources of income, and by matching disbursement and

repayment to agricultural expenditure and income cycles.

- Given the higher cost of operating in rural areas, an effective rural finance strategy is gradual expansion via full-service branch offices with mobile loan officers.
- Strong organizational management, including financial transparency and open communication with donors, attract well-targeted, coordinated investments and helps ensure that funds are put to good use.

Conclusion

This case study illustrates that it is feasible to conduct agricultural lending sustainably, even starting with a disastrous agricultural loan portfolio. Despite promising results and a recent surge in lending though, Confianza is still refining its lending methodology and it is still too early to for its long-term sustainability to be proved. Its ability to compete is likely to be tested over coming years, as MFIs in Peru proliferate and attempt to reach more rural areas, and as commercial banks downscale (particularly to the urban small enterprise and housing markets that helped rebalance Confianza's portfolio).

Confianza also continues to struggle with maintaining its poverty outreach. More loans are going to men (54 percent in 2001, 57 percent in 2002), increasing collateral is required to secure a loan, and the institution has presently curtailed services to clients in more isolated rural areas. The larger average loan size of recent years also reflects a slight up-market drift. While this trend is partly the result of Confianza's prudent and successful responses to the challenges of 1999, its road to sustainability has nevertheless reduced the proportion of highly impoverished people among its clients.

Bibliography

CGAP. Interviews with Confianza investors : Appui au Développement Autonome, NOVIB, and Oikocredit, September 2003.

EDPYME Confianza, SA. *Annual Report 2001*. Lima: Confianza, 2002.

EDPYME Confianza, SA. *Annual Report 2002*. Lima: Confianza, 2003.

EDPYME Confianza, SA. "Mid-year Rreport on Agricultural Activities." Internal Memorandum No. 1209 – EDPC/03. Lima: Confianza, August 2003.

Inter-American Development Bank. "Project Performance Monitoring Report." Washington, DC: IDB, February and July 2003

Latin American Challenge Investment Fund (LA-CIF). "Monthly Risk Report: Confianza EDPYME-Peru," June 2002.

MicroRate. "Confianza Report." Washington, DC: MicroRate. June 2001; June and December 2002.

Rubio, Frank. "EDPYME Confianza." Report to CGAP based on site visits and interviews, December 2002.

Agricultural Microfinance Case Studies

FINANCIAL INDICATORS DEFINITIONS TABLE

Outstanding gross portfolio—the outstanding principal balance of all of the MFI's outstanding loans including current, delinquent, and restructured loans, but not loans that have been written off.

Number of active borrowers—the number of individuals who currently have an outstanding loan balance with the MFI or are responsible for repaying any portion of the gross loan portfolio.

Average loan balance per borrower—the outstanding gross portfolio divided by the number of active borrowers.

Average loan balance as percent of GNI per capita—average loan balance per borrower divided by the country's World Bank-published gross national income per capita.

Total savings deposits—the total value of funds placed in an account with the MFI that is payable on demand to the depositor. This item includes any current, checking, or savings accounts that are payable on demand. It also includes time deposits, which have a fixed maturity date.

Number of savings accounts—the total number of deposit accounts at the MFI, as a proxy for the number of depositing individuals that the MFI is liable to repay. This number applies only to deposits that are held by the MFI, not to those deposits held in other institutions by the MFI's clients. The number is based on individuals rather than the number of groups. It is possible that a single deposit account may represent multiple depositors.

Average deposit balance—total savings deposits divided by number of savings accounts, as a proxy for average client savings.

Portfolio at risk (PAR > 30 days)—the value of all loans outstanding that have one or more installments of principal past due more than 30 days. This item includes the entire unpaid principal balance, including both the past due and future installments, but not accrued interest. It also does not include loans that have been restructured or rescheduled.

Return on assets (ROA)	$\frac{\text{Net operating income plus taxes}}{\text{Average assets}}$	Measures how well the MFI uses its total assets to generate returns
Return on equity (ROE)	$\frac{\text{Net operating income less taxes}}{\text{Average equity}}$	Calculates the rate of return on the average equity for the period
Operational self-sufficiency	$\frac{\text{Operating revenue}}{\text{Financial expense plus Loan loss provision expense plus Operating expense}}$	Measures how well an MFI can cover its costs through operating revenues. In addition to operating expenses, it is recommended that financial expense and loan loss provision expenses be included in this calculation as they are a normal (and significant) cost of operating.
Financial self-sufficiency	$\frac{\text{Adjusted operating revenue}}{\text{Financial expense plus Loan loss provision expense plus Adjusted operating expense}}$	Measures how well an MFI can cover its costs taking into account a number of adjustments to operating revenues and expenses. The purpose of most of these adjustments is to model how well the MFI could cover its costs if its operations were unsubsidized and it were funding its expansion with commercial-cost liabilities.
Operating expense ratio	$\frac{\text{Operating expense}}{\text{Average gross loan portfolio}}$	Includes all administrative and personnel expense, and is the most commonly used efficiency indicator
Loan officer productivity	$\frac{\text{Number of active borrowers}}{\text{Number of loan officers}}$	Measures the average caseload of each loan officer