FINANCING RURAL FINANCE INSTITUTIONS IN MEXICO

MicroREPORT #74

FEBRUARY 2007
This publication was produced for review by the United States Agency for International Development. It was prepared by Marc de Sousa-Shields (Enterprising Solutions Global Consulting) and reviewed by Anna Bantug-Herrera (Chemonics International).

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Accelerated Microenterprise Advancement Project (AMAP) Financial Services
Contract: GEG-1-00-02-00013-00, Task Order #01
AMAP FS IQC, Knowledge Generation

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RURAL MFIS AND SPECIAL MARKETS = SPECIAL FINANCING CHALLENGES

In Mexico, as in most developing countries, financing rural enterprise remains a significant development challenge, regardless of whether it is on or off-farm enterprise in low or high income markets. Relatively high transaction costs, volatile agricultural commodity markets and poor infrastructure contribute to the development of inefficient rural financial systems to the detriment of all business activity, but particularly low income, small and micro enterprises.

However, unlike many developing countries, Mexico has relatively deep and sophisticated financial markets, strong savings instincts, and a plethora of financial institutions operating in rural and semi-rural areas.[1] Commercial banks are present in most rural centers (i.e., those under 25,000 in population), although few actually lend to small and micro rural enterprises. Cooperatives, non-bank financial institutions and other rural financial institutions (RFIs) abound in all but the remotest rural areas.

Despite the presence of financial institutions in rural Mexico, the demand for financial products and services - especially by small rural enterprises - remains largely unmet. While there has been much public sector bank and government financial support to rural areas, most of it has favored large rural enterprises (e.g., commercial farms, processors, wholesalers, or exporters) over small enterprises. These initiatives have also been heavily subsidized and poorly managed, creating a culture of non-repayment. This has resulted in limited sustainable access to appropriate financing for small and micro rural enterprises.

The advent of microfinance and increasing pressures on state banks for demand driven and sustainable programs is beginning to erode this culture. While rural financial markets remain far from efficient,

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[1] Mexico has seen largely positive public and private savings rates in since 2000 (see for example Bulir, Ales and Andrew Swinson (2006), *What Explains Private Savings in Mexico*, IMF Working Paper WP /06 /191.

advances in banking technology, risk management methodologies, and competitive pressure among private financial institutions have encouraged some interest in rural financial markets. Small, non-collateralized working capital loans to off-farm enterprises, for example, are proving to be profitable in high to medium density rural areas. Short-term, crop lending is also relatively low risk and profitable. However, medium term, non-working capital loans to low income farmers or entrepreneurs in rural areas still remains the frontier of rural finance as are long-term production loans (e.g., orchards, water and soil conservation or management, etc.).

FINANCING RURAL FINANCIAL INSTITUTIONS (RFIS)

Meeting the demand for financial services, particularly credit, from relatively low-income farmers as well as the micro and small enterprise markets in rural Mexico is as important as it may be daunting. It is not surprising that financing the RFIs that serve this market is similarly as difficult. RFIs face the same considerable biases in local capital markets as do their urban counterparts because of the risks (both real and perceived) that exist in rural markets. This perception of high risk and low profitability has led to there being only a few commercial capital suppliers or depositors willing to fund RFIs.

RFI FUNDING IN MEXICO

There are no reliable estimates on RFI funding nor is there a complete understanding of how they capitalize themselves. As in most countries, Mexican RFIs that can legally intermediate deposits prefer a deposit-led funding strategy; however, few RFIs are now heavily financed by deposits. Even if they were, because most deposit contracts are one year or less, financing medium and long-term assets remains a critical challenge in rural areas where the need for long-term loans is structurally very strong. Longer term RFI funding is scarce for good reasons, such as the history of credit abuse in rural areas and complex rural economic and project investment risk. Longer term finance is also scarce for unjustified reasons, such as imperfect market information and underdeveloped linkages to private capital on the part of RFIs.

As a result, most RFIs rely to varying degrees on state bank finance, much of which is available over the medium term (two to five years). This is better than short-term finance, but it does not resolve matching problems for longer term lending required for many agricultural needs. Collateral requirements from state banks can also complicate access to long-term funding unless RFIs have solid and liquid collateral (i.e., not a loan portfolio).

Table One shows where and on what terms a small sample of Mexican RFIs source their portfolio funding.[2] The longest term available is four

[2] The sample included the 7 RFIs attending the RAF Training course in Mexico, June 21-23, 2006. Information was provided by participants and may not reflect an entirely accurate description of the full funding policies of listed institutions, either due to reporting errors or specially negotiated arrangements.

years from PRONAFIM, a government agency which may or may not continue after the recent presidential elections.[3] Other government sources vary, ranging from one to three years. Both FIRA (the national agriculture development bank) and NAFIN (a national development bank) have made limited funding available to MFIs, while microfinance institutions (MFIs) report FinRural has significant volumes of available capital. Price is less related to term for government sources than it is for private capital, ranging from Mexican Treasury certificate (CETE) +1% to the equilibrium interbank interest rate (TIIE) +8%.[4] Collateral guarantees vary as well with at least one government agency, PRONAFIM, accepting portfolio alone.[5]

International lenders such as Oiko Credit and Blue Orchard, range in price, but do not necessarily require guarantees. They have limited volumes and typically only invest in the best performing RFIs in a given country. Nevertheless, many RFIs consider international funding reasonably priced and termed. This raises questions about why they can not attract more long-term local funding through improved pricing.

Commercial bank finance is available in Mexico, but most microfinance institutions (MFIs) and RFIs can not meet guarantee requirements or are unwilling to pay the relatively high cost of funds in local currency. In some cases, commercial banks who do lend to MFIs have some form of guarantee from a national development bank.

[3] PRONAFIN is a program that aims at promoting the productive initiatives of individuals and social groups in poverty conditions through encouraging and promoting a microfinancing system with the participation of MFIs as channels of distribution and execution of the credit in every region of the country with special emphasis in those with higher poverty levels.

[4] Mexico's two main base interest rates are the 28-day Mexican Treasury certificate (Certificado de Tesorería de la Federación—CETE) and the equilibrium interbank interest rate (tasa de interés interbancaria de equilibrio—TIIE).

[5] Survey of RFIs.

TABLE ONE				
MEXICAN RFI FUNDING SOURCES **ALL FIGURES IN $US DOLLARS**				
	MAXIMUM AMOUNT (US$)	**MAXIMIUM TERM**	**INTEREST RATE**	**GUARANTEE**
Commercial Banks	Depends on borrower	2 - 4 years	+/- 12-14% (TIIE +5-7%).	30% - 70% coverage
Deposits	$100 - $500	30 days - 2 years (longer terms are possible but not common)	From inflation rate to CETE (+1-2%)	None
FIRA (national development bank)	Depends on institution	2 years	Directly - TIIE +/- 3-6 (-SIEBAN) Through a commercial bank - TIIE +/-2 4+4	Up to 50% coverage
Financeria Rural (government finance to rural areas)	$0.25 million common, more upon approval	Negotiated	TIIE to + 8	Information not available
PRONAFIM Government microfinance support Program	$0.2 - 2 million	4 years	CETES + 4	None
NAFIM (national development bank)	Depends on institution (normally less than $1 million)	3 years	TIIE + 2 A + 4	Information unavailable
Oiko Credit	$1 million	3-4 years	6 - 9% (in dollars)	Guarantee preferred
Blue Orchard	$1 - 2 million	5 years	14% (in dollars)	Guarantee preferred
Planet Finance	$0.5 million	1 year	8% with guarantee, 9% without	Guarantee preferred
FOCIR	Project dependent	5 years	CETES + 4	

* CETES: Certificados de la Tesorería de la Federación (Certificate of the Federal Treasury) are available for a number of terms. A 28 CETE was quoted at 7.16 % annually on July 31, 2006.
** TIIE: Tasa Interbancaria de Equilibrio (Interbank Equilibrium Rate) are available for a number of terms. A 28 day TIIE was quoted at 7.32% on annually July 31, 2006.
*** SIEBAN: Sistema de Estímulos Bancarios (banking system support to offset the cost of small business loan transactions)
**** Fondo de Capitalización e Inversión del Sector Rural or Rural Sector Capitalization and Investment Fund.

Table Two shows the average of service given by Funders to rural financial institutions. Ratings are guided by a number of indicators including fund availability, appropriate terms, price and client

The financial rating process consists largely of three core tasks: (1) soliciting and analyzing financial and related institutional performance data, (2) soliciting, finding, and analyzing supplementary institutional information (internal and external), and (3) conducting in-depth interviews with Board members, management, staff (main office and field), and clients. These three core tasks likewise make up the core tasks of the USAID SPA tool.

Deposits are rated as the clear favorite with some government agencies rated highly as well. In many cases, *similar* RFIs rated their experiences (positive or negative) with the same suppliers very differently. This was particularly true with government sources. Commercial banks were rated poorly due to the cost and guarantee requirements.

TABLE TWO

FINANCING SOURCE: RFI AVERAGE RATINGS

INSTITUTION	RATING
Commercial Banks	C
Deposits	A
FIRA	C+
FinRural	B
PRONAFIM	B
NAFIM	C
Oiko Credit	B

RFI FINANCING: STRATEGIC CONSIDERATIONS

As with any financial institution, there are three primary strategic management financing considerations driving finance strategies: liquidity, operating costs to seeking and managing finance, and financial costs.

Each variable alone requires fairly simple strategic consideration. Assets and liabilities must maintain a certain ratio to ensure liquidity in times of demand for capital from suppliers or loans from clients. Operating costs as well as financing costs must be kept as low as possible. Taken together, however, these considerations invariably complicate financing strategies. While it is not within the mandate of this paper to explore finance strategy *per se*, it is important to consider some of the strategic considerations specific to RFIs.[6]

As noted earlier, ***deposits*** are the most obvious financing choice for those RFIs that can mobilize them, particularly for cooperatives and otherwise regulated institutions. Savings are the most predictable form of funding, and with proper pricing models, they afford the greatest liquidity and profit management flexibility. Pricing is a critical element to deposit mobilization, particularly in attracting longer-term capital, but research shows that few institutions are well-versed in pricing analysis, depending more upon existing competition (and prices) in the market to determine what they will pay for savings. This can have significant implications for liquidity matching and profitability. Even when deposits are available, the more successful RFIs have had to appeal to large, high income depositors to offset the high transaction costs associated with working with low income clients.[7] Deposit services also require tremendous management capacity, which many RFIs lack, particularly related to pricing.

Some institutions, such as FIE in Bolivia has been able to attract ***term deposits*** of up to seven years in tenor, and MiBanco in Peru sells

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[6] For a treatment of this topic please see Wisniwski, Sylvia, "Microsavings Compared to Other Sources of Funds," Eschborn, Germany: CGAP Working Group on Savings Mobilization - GTZ – BMZ, 1999.

[7] Richardson, David, "Going to the Barricades with Microsavings Mobilization: A View of the Real Costs from the Trenches" in The MicroBanking Bulletin Issue No. 9 July 2003.

medium-term certificates of deposits (CDs), some of which are tradable; but these institutions are the exception rather then the rule. Both FIE and MiBanco have clear and well-defined pricing policies and strong tools for managing pricing and matching risks (e.g., asset and liability committees, good marketing programs, etc.). Neither, however, exclusively serves rural clientele.

Some Mexican RFIs have developed ***links to international fund suppliers***. Most of these RFIs do not depend on these sources for more than 20% of funding, but enjoy the advantages of connecting to international funding networks, the credibility foreign investment can bring, and/or its ability to directly or indirectly leverage other sources of capital. International funding is typically viewed as a complement to other sources because loans can take time to arrange and can be costly in terms of price and currency exposure.

Many Mexican MFIs and RFIs also use ***international funds to guarantee commercial bank loans***. While generally expensive as a form of finance, guarantee arrangements have been particularly valuable to institutions unable to raise deposits. In the most successful cases, guarantees have helped lower the long-term cost of capital, increased the diversity of finance sources, and most importantly, established an institution's standing in the local banking community. However, guarantees have not been used as a first option for price and complexity reasons.

Somewhat more promising is ***access to commercial capital markets***. As a country with relatively deep capital markets, Mexico may offer an exceptional source of funding for RFIs. However, overcoming relatively high initial transaction costs, the preference for large placements, and the need to ensure that issues secure investment grade ratings remain challenging for smaller RFIs.

These challenges are not insurmountable as several high profile deals have demonstrated. Compartamos in Mexico and MiBanco in Peru strategically went to local capital markets with multiple bond issues over the last three years. Given the novelty of an MFI entering the capital markets, these early forays focused on relatively simple bond issues from larger institutions able to absorb the volumes of capital required to justify the transaction costs.

Other Mexican MFIs have since issued a variety of ***structured finance instruments*** (e.g., bond-like securitizations, portfolio securitizations etc. – see Figure One). Recent Blue Orchard deals, for example, pooled the income streams of several MFIs from around the world. Developing World Markets Inc. has designed several similar deals and will soon help an Indian MFI issue a local currency portfolio securitization.[8] Many of these deals have had the support of guarantees

[8]Developing World Markets Inc., is a socially oriented investment bank, which identifies socially beneficial business in emerging markets that are commercially sustainable and arranges financing for them from the international capital markets.

from international financial institutions (e.g., International Finance Corporation, Inter-American Development Bank etc.), or insurance (e.g., Overseas Private Investment Corporation (OPIC) or USAID), either to the issuer or to the institution itself. Many of these instruments have not only yielded significant volumes of capital, but more importantly, have enabled access to longer-term capital with over five years tenor.

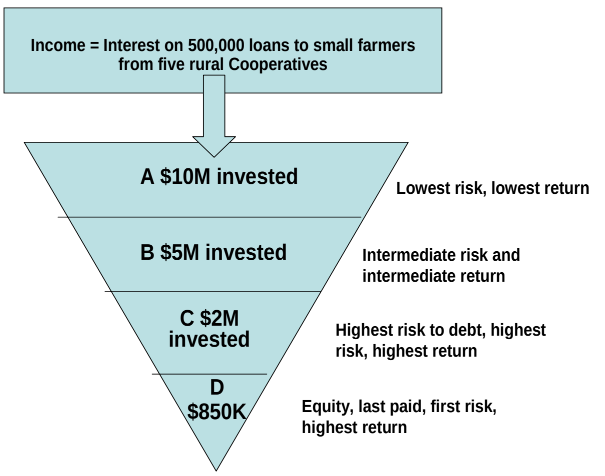
Securitizations are an intriguing option for smaller institutions, in addition to the terms and volume potential. For example, assets underlying an issue can come from not one institution (as in the case with a bond issue), but several at the same time. This feature decreases the overall risk to investors, particularly if participating RFIs are found in different regional economies (thereby diminishing covariant risk) and can increase the overall size of the issue, lowering the per dollar transaction cost to issuers. Larger issues also improve transaction cost efficiency to institutional investors, whose large minimum placement objective is calibrated to minimize such costs.

Figure One

Structured Finance - Securitizations

Structured finance products bundle together assets of similar characteristics, such as small loans to farmers in rural areas, which produce loans that pay income that is passed on to the investors. Securitizations offer different levels of risk and return, which in turn attract investors with different strategies. The figure below shows the inverted risk-reward triangle describing risk tranches of a typical structured finance arrangement. Level one offers the largest tranche of $10 million to institutional investors with moderate risk appetite and consequently, moderate, but virtually guaranteed return on investment. Each subsequent level offers greater return and risk to a smaller number of investors. Finally at the bottom of the inverted pyramid, sit equity investors who have no guarantee to income and face the greatest risk (i.e., if the underlying assets fail to perform, then equity investors are not paid first). They also enjoy the greatest potential reward due to the leveraging effect of their capital. Due to fiduciary responsibilities and investment laws which are fairly consistent across jurisdictional regulatory regimes, including Mexico, institutional investors are seldom found at this or even levels below B.

Figure One
Example Structured Finance Instrument



In Mexico, with its relatively deep financial markets and relative lack of opportunity for institutional investors to invest a significant portion of their capital locally, structured finance deals which involve pooling assets from several RFIs can be an attractive option. However, this would only be the case if some form of guarantee was made available (at least to the first few issues) to ensure investment grade rating on the offer. Certainly AFORES[9], insurance companies, public sector funds, and mutual funds in Mexico would consider, if not be eager for such investments. A group of fairly strong Peruvian RFIs are, in fact, in the process of issuing such a deal.

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[9] AFORES is the Mexican Association of Retirement Fund Administrators.

FINANCING SUCCESS LIES IN STRATEGY

By force and choice, Mexican RFIs have not taken a long-term strategic view of financing: by force because little long-term capital is *readily* available and by choice because RFIs have a demonstrated reliance on state bank funding, which is ultimately as limited as it is limiting.

AN OBSESSION WITH PRICE

The degree to which RFIs are satisfied with government suppliers is underpinned by a range of considerations from terms and conditions to reporting requirements. Lower cost debt is, however, invariably cited as the most important variable. As the assessment in Table One posited, the government source pricing advantage is not that clear.

If local savings is the most desirable form of funding, for example, why are government sources being tapped to such as extent? The advantages to deposits as a funding strategy are well-known and noted earlier, but few deposit taking MFIs around the world satisfy funding needs to the levels they want with savings. Competition for savings is partially responsible for this. Another reason, one could argue, is the *extra marginal costs of mobilizing and managing savings beyond a certain market penetration threshold* that tip the funding search calculation balance in favor of more familiar government sources of capital. It is simply easier to go to government sources (or international sources) than to develop deeper, stronger relationships with the market. This is no less true in Mexico than it is in the Uganda, Peru, the Philippines or Bangladesh.

This is unfortunate because private capital offers much that state bank capital does not - advantages not immediately captured in price considerations. Advantages include near limitless volumes (relative to state bank capital), rapid access in the case of crisis or time sensitive market opportunities, and, critically, access to a much larger and diverse capital network. Strong ties to private capital, including deposits, commercial banks, or capital markets can also provide greater operating flexibility and ultimately lower prices in the future, rather than the short-term price savings associated with government sources.

Arguably, short-term price fixation detracts from establishing *sustainable* strategic financing networks and plans. It also creates a financing dependency on state sources that place non market-based parameters around institutional growth potential. More practically, many RFIs could likely offset the extra costs of purely private capital through reduced operating costs, which are almost uniformly too high in Mexico and elsewhere around the world.

BEST PRACTICE FINANCING

Best practice MFI strategies for overcoming barriers to capital are slowly emerging. For RFIs, best practices are likewise emerging which are geared to their specific capital sourcing challenges. Figure Two lists some of the steps that RFIs can take to secure long-term capital. The most successful RFIs use deposits as the basis for long-term funding strategies. They turn strategically to state bank finance and quasi-private international investors to fill funding gaps and/or as "transitional" finance until sufficient deposits can be mobilized. Only a few take on other sources of local private capital (e.g., commercial banks loans or capital markets). Commercial capital market activity will only increase as financing models and transaction experiences evolve.

The most successful fund-raising RFIs have well-defined funding strategies that include long-term objectives linked to asset growth and business development plans. Plans dedicate resources and constantly build greater internal capacity to meet financing objectives. These RFIs uniformly have dedicated high-level management involvement.

Figure Two

Going Long: Sourcing Long-term Capital

There are many steps a rural financial institution of any size can take -- with or without deposits -- to prepare for and secure long-term finance. Here are a few:

Finance Strategies

Form Size-Appropriate Funding Management Team & Tools

Launch Fund Raising Strategy Based on Business Plan & Market Research

Organize Dedicated Fund Raising Team & Budget

Develop "Shareholder" (debt and equity) Relations Strategy

Tools

Create Liquidity Management Information System

Set up Asset & Liability Committee (or size appropriate equivalent)

Report Financial Performance Transparently

DONORS AND FINANCING

In some countries, donors have been instrumental in assisting MFIs and RFIs to access private capital. Support has ranged from basic private capital market education about RFI needs and potential, to providing technical assistance for fund raising, to funding innovative financing efforts such as bond issues and securitizations. The most effective support has three general characteristics: provides incentives for RFIs to seek private capital, does not distort local capital markets, and ensures continuous and sustainable future access.

CONCLUSIONS

Examples from around the world show how concerted and dedicated finance strategies can improve an institution's long-term funding base, contributing to profitable and scalable rural financial institutions. In Mexico and other developing countries, the main challenge is to overcome the deposit and capital market bias towards short-term funding. Barriers are considerable, but sentiment and opportunities are changing for low income financial services in Mexico, due both to the success of microfinance and to increased macro-economic stability and financial system reform.

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