

Microfinance for Housing

The Mexican Case

by Michael Goldberg
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Abstract: Can Microfinance Institutions (MFIs) help address the needs of millions of low-income families in Mexico for housing improvement loans? The paper assesses whether MFIs are suited to providing housing improvement credits and evaluates whether diversified housing portfolios can improve performance and mitigate risks for these institutions. After showing that the microfinance industry is at a nascent stage in Mexico, and that the current supply of housing microfinance credits is a tiny fraction of the estimated demand for these loans, the paper provides suggestions for government and donors to serve as short-term catalysts for the expansion of MFIs in the housing field. Recommendations include support for market studies to assess the characteristics of demand and to develop attractive housing microfinance products, providing incentives to help MFIs develop new or scale up existing housing portfolios, offering innovative sources of funds for housing microfinance, and encouraging franchising and joint ventures between various institutions involved in this field.

In the last decade, microfinance has proven to be a growing industry in many developing countries, with the leading Microfinance Institutions (MFIs) increasing their markets and becoming financially sustainable organizations. Despite clear indications of a large unserved demand for productive loans, MFIs often lack competition from commercial banks

and other financial institutions in the low-income market segment. As a consequence, MFIs have mainly grown “horizontally,” by offering the same products to new customers, rather than deepening the microfinance market by providing a range of diverse products. As the industry develops, many clients have become dissatisfied with the inflexibility of existing MFI products to meet their diverse needs, such as financing for insurance, healthcare, house construction, or home improvement. The inadequacy of current products is the main reason for relatively high levels of MFI client dropouts in various countries,¹ representing a high cost to the MFIs, which could be reduced through careful portfolio diversification (Wilson, 2001; Wright, 2001).

The objective of this paper is to illustrate the challenges and potential benefits for MFIs interested in diversifying into the housing microfinance field. The paper focuses on the Mexican case, because the demand for housing improvement loans is very large, government housing programs have often proven inefficient and ineffective, and MFIs lag behind in exploiting the opportunities of this new market.²

For this discussion, housing microfinance loans are defined as progressive loans provided to the economically active poor to finance (1) minor improvements, such as carpentry, plastering and painting, and the installation of doors, windows, and security bars; (2) major improvements, such as major repairs, the replacement of walls, floors, roofs, and sanitary fixtures, or retrofitting homes with hurricane-resistant technology; (3) expansions, such as the addition of a bathroom, kitchen, or living space; and (4) the creation of formal work spaces, such as sewing rooms or carpentry workshops, for home-based productive enterprises.

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While a considerable percentage of houses in Mexico need improvement (an estimated 76%, most of which belong to middle and low income people, according to the Harvard Joint Center (2000)) the poorly developed Mexican MFI sector has conducted a small number of unlinked urban pilots in the field of housing. The striking mismatch between demand and supply in this country is mainly due to (1) MFIs' lack of information on demand (i.e., geographic areas where houses are most in need of improvement and low income households' willingness and ability to pay for housing loans); (2) MFIs' inexperience in this field (i.e., lack of experience with housing microfinance loans and a lack of technical assistance); and (3) the unavailability of medium- to long-term, commercially priced credit lines providing MFIs with reliable funding to expand operations in the housing microfinance field.

This paper will show that (1) the demand for commercially priced housing improvement is enormous in Mexico, (2) the housing improvement loan is more like a microfinance product than a traditional mortgage loan, (3) lessons can be drawn from initial experiences in Latin America, and (4) there are some local pilots upon which to build. The paper concludes with recommendations on how to support Mexican MFIs that want to diversify their portfolios to include housing improvement loans.

The Demand for Housing Improvement Loans in Mexico

In Mexico, as in most developing countries, low income households usually prefer to improve and expand their current homes rather than purchase new units. Low and moderate income households often acquire lots in informal subdivisions and then construct temporary dwellings to vouchsafe the properties (Ferguson & Heider, 2000). After the buyers of the land have built small structures on the lots, they slowly improve and expand the houses, possibly adding a separate kitchen, an improved bathroom, or an extra bedroom. To finance

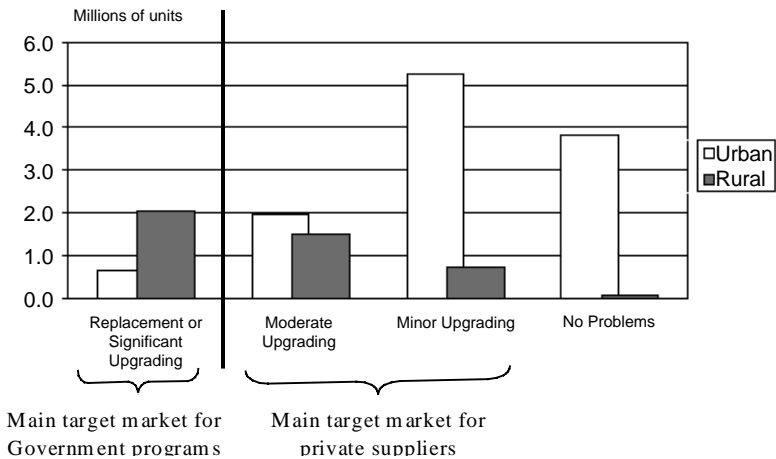
improvements and expansions, they usually rely on their own funds, borrow money from their acquaintances,³ or try to get loans from financial institutions. Often, funds are required from more than one of these sources to reach the target amount needed for a given stage of home improvement.

Recent studies show that the scale of demand for housing improvement in Mexico is substantial (Herbert & Pickering, 1997; Harvard Joint Center, 2000). Contrary to general belief, low income households are willing to spend a high percentage of their incomes to improve and expand their houses (World Bank & Capital Advisors, 1998). Based on a survey conducted in 1990 by the Mexican Census, the Harvard Joint Center for Housing Studies (2000) estimated that approximately 12.2 million of the total 16.1 million houses in Mexico (equivalent to 76% of the 1990 housing stock) needed improvements.⁴ Between 1990 and 1994, about 800,000 improvement loans were made, meeting only 7% of the estimated total market. Of the 12.2 million units in need of improvements in 1990:

- 2.7 million units (22% of the housing stock in need of improvement) needed replacement or significant upgrading. A large majority of these homes lacked almost all basic services, were made from nondurable materials, and provided limited living space for the families dwelling in them (one or two rooms for an average family of 5 people).
- 3.5 million homes (29% of the housing stock in need of improvement) needed moderate upgrades. These houses generally had floors made from durable materials and had access to electricity and gas for cooking. However, most had deficiencies, such as walls made of nondurable materials, and lacked a bathroom or a kitchen.
- 6 million housing units (49% of the housing stock in need of improvement) required minor changes. These houses were generally constructed from durable materials, had access to electricity and sewerage, and had kitchens and bathrooms. The most frequent problems were crowding, a lack of water in the unit, or roofs made from less durable materials.

While rural areas needed more housing replacement, urban areas mainly needed moderate and minor upgrading: of the 2.7 million houses deemed to need replacement or significant upgrading, 0.7 million were in urban areas, representing 5% of all urban units. Of the 3.5 million houses in need of moderate upgrading, 2 million were in urban areas, representing 24% of all urban units. Finally, of the 6 million houses in need of minor improvements, 4.5 million were in urban areas, representing 31% of all urban units. (See Figure 1.) While government institutions often provide loans and grants to low income communities for house building, replacement, or significant upgrading, they do not provide support for moderate and minor upgrading. Thus, the potential for private institutions interested in entering the housing improvement market in Mexico is significant, especially in urban areas.

Figure 1. Estimates of Housing Replacement and Upgrading Needs (1990)



Source: Herbert & Pickering (1997)

In 1997, the World Bank and Capital Advisors conducted a study on the willingness and ability of low income households to pay for housing improvement loans in three cities located at the border with the United States (Ciudad Juarez, Tijuana, and Matamoros). The study concluded that 14% of the low income households in need of home improvements in these three cities were willing to take out loans and could qualify for them. The value of the untapped market for housing improvement loans in these areas was about \$122 million (98,000 low income households with an average housing loan of about \$1,250).

If we extend the findings of the studies by Harvard University (2000) and by the World Bank and Capital Advisors (1998) to the country as a whole, by assuming that 14% of the 9.5 million households in need of moderate or minor improvements are willing to take on and qualify for a loan, we can conclude that there is a market for housing improvement loans of about \$1.6 billion (1.3 million households ready to take out a home improvement loan of \$1,250).

While these are rough estimates, they demonstrate that there is significant market potential for private institutions interested in providing housing improvement loans in Mexico, especially in large cities. More detailed market research is necessary to assess (1) which states and cities are the most promising, (2) low income households' willingness to take on housing loans in these cities and states, and (3) the percentage of these households that would qualify for a loan.

Mortgage or Microfinance?

To verify whether MFIs are suited to providing housing improvement credits, it is important to analyze the characteristics of these loans and to compare them with the characteristics of enterprise loans, which represent the core of MFIs' portfolios.

If housing improvement loans are small (\$1,500 to \$2,000) and have short-term ranges (1 to 2 years), MFIs may be the ideal suppliers. On the other hand, if housing improvement

loans are relatively large (\$5,000 to \$10,000) and long-term (5 to 10 years), mortgage institutions, such as commercial banks, limited purpose mortgage banks, and credit unions, may be the best providers.⁵

Based on the experiences of a number of MFIs and other organizations that have pioneered housing microfinance loans, these credits appear to have the following characteristics (Harvard Joint Center, 2000):

- *Loan structure:* amounts ranging from \$250 to \$5,000, maturities ranging from 3 months to 3 years, and interest rates substantially higher than the prime rate
- *Underwriting requirements:* personal guarantees with one or two cosigners (some loans also require periodic savings and group liability)
- *Collateral requirements:* paralegal titles or simple proof of ownership (e.g., the inhabitants of the village testifying that the borrower lives in the house), although some institutions require full legal title
- *Technical assistance:* for example, advice on construction, building materials, and costs.

Table 1 summarizes and compares the characteristics of housing microfinance, microenterprise loans and mortgage loans. The main findings of this comparison are

- While mortgage finance loans are directed to middle and upper income households, both microenterprise and housing microfinance loans, are directed to moderate and low income households
- The amounts and maturities of housing microfinance credits are usually significantly lower than those of mortgage loans and slightly higher than those of microenterprise loans
- The interest rates of housing microfinance loans are usually closer to those of microbusiness loans than to those of mortgage loans
- Housing microfinance loans and microenterprise loans require flexible, small collateral, while mortgage loans usually require full lien on property and legal ownership title

Table 1. Loan Comparison

	Mortgage finance	Microenterprise finance	Housing microenterprise
Borrowers	Middle and upper income households	Low and moderate income households	Low and moderate income households
Originator	Savings and loans, housing cooperatives, banks	Credit unions and NGOs traditionally; regulated financial institutions increasingly; also equipment suppliers	Credit unions and NGOs traditionally; also building suppliers and subdividers
Use of loan funds	Purchase of a new, commercially developed single-family unit	For microenterprise, but also for emergency expenditures	Home improvement; some new construction
Amount	\$5,000 and above	\$50-\$1,000	\$250 to \$5,000
Term	15 to 30 years	Under 1 year	Usually under 3 years
Interest rate	Prime plus thin margin	Prime rate plus a large margin	No standard
Collateral	Lien on property	Available goods, personal guarantees	Para-legal liens on property
Savings requirements and importance	From none to contract savings	Savings is often as important as loans	No standard
Underwriting	Evaluation of individual household income and credit worthiness and of property title and value	Building of relationship with individual borrower or with solidarity group, which commits to guarantee repayment of loans to its individual members	Evaluation of current income, borrower household income, building plans, and cost estimates
Technical assistance to borrower	None	Minimal	Technical assistance is often required

Source: Adapted from Ferguson & Heider (2000)

In light of their characteristics, especially their amounts, interest rates, and collateral, housing microfinance loans appear more similar to microenterprise loans than to mortgage loans. In addition, traditional mortgage lenders find low income households unattractive clients because they consider them too risky and not sufficiently profitable. On the other hand, MFIs are used to dealing with low income clients. They have developed specific lending methodologies to reduce the risk of low repayment rates; they have gathered information on their customers' credit histories and are able to select the ones that are best suited to receive larger, longer term loans, such as housing improvement credits, without endangering the quality of their portfolios. For these reasons, MFIs seem to be better positioned than mortgage institutions to satisfy the needs of low income clients in the housing improvement field.

Lessons from International Experiences

Both in Latin America and in other regions around the world, the performance of the leading MFIs have been increasingly impressive in recent years in terms of the scale of operations, profitability (after adjusting for the effects of subsidies), and financial soundness. Latin American MFIs that have achieved significant results include BancoSol, FIE, Caja de Los Andes, and Crecer in Bolivia; Compartamos in Mexico; Genesis Empresarial and the SIFFE Credit Unions in Guatemala; Banco Ademi and ADOPEM in the Dominican Republic; Financiera Calpia in El Salvador; and Caja Social in Colombia. Many MFIs have proven themselves to be sound financial institutions, capable of expanding into new markets and developing new products for their target clientele (statistical proof of outreach, profitability, and soundness is found in *Microbanking Bulletin Tables*, 2001).

By adding housing improvement loans to their product lines, MFIs could (1) increase the scale of operations and profitability, (2) reduce client drop-out rates and the covariance risk of the overall portfolio (housing loans tend to outperform

other loans), (3) provide additional repayment incentives and resources to proven clients, and (4) gain access to special affordable government funds (both short- and long-term) that are earmarked for housing purposes. These represent a very powerful set of incentives to MFIs.

Two key questions arise as one considers the path from a microfinance industry centered around one core product line to an industry offering diversified services. First, what would it take (in terms of incentives, market information, credit support, initial risk sharing mechanisms, and other support) for the microfinance industry to move beyond limited product lines of working capital and develop housing microfinance products that could be attractive to millions of potential clients? Second, how can sound MFIs build the institutional capacity and systems required to develop a housing microfinance pilot and eventually full-scale operations, and what role might the government and donors play in developing such capacity?

To answer these questions for Mexican MFIs, it is useful to turn to experienced, successful Latin American MFIs that have already introduced housing microfinance and to understand the path they took to develop this new field. Two Latin American MFIs that have successfully added housing microfinance products to their existing portfolio are Financiera Calpia (El Salvador) and Genesis Empresarial (Guatemala).

While the housing portfolios of these institutions are small (Calpia had a portfolio of 1,450 loans in the year 2000, and Genesis had only 330 active loans), their results to date have been very encouraging (Ferguson & Heider, 2000; W. Kurup & A de Rizz, personal communication, 2000). Both institutions have found that housing microfinance loans have increased their markets and improved client satisfaction, while lowering their portfolio risk through diversification. Both plan to expand their housing portfolios significantly in the coming years.

The key to successful diversification in both cases has been a gradual process of (1) ensuring the soundness of the institution with standard products before launching a new product (both MFIs had reached financial sustainability before introducing housing microfinance products), (2) conducting detailed market analysis to quantify demand and identify key product characteristics, (3) introducing housing credit through carefully monitored pilot project, (4) providing technical assistance to clients, and (5) scaling up housing microfinance products only after client performance and cost management warrant it. The lending methodology does not appear to be a key issue for housing microfinance, as both individual and group methodologies can be successful, provided that the methodology matches the needs and preferences of the selected target market (Ferguson & Heider, 2000; Kururp & de Rizzo, 2001; Bonilla, 2000).

Microfinance in Mexico: A Nascent Industry

As in most large Latin American countries, the microfinance industry in Mexico is still at a nascent stage. While the MFI industry has grown impressively in smaller Latin American countries (Bolivia, El Salvador, Nicaragua, and Honduras), the national industries have not developed in large Latin American countries (Brazil, Argentina, Mexico, and Venezuela), where huge pools of microbusiness clients have little or no access to financial services. This may be due to the lack of credible MFIs in large markets, or to the fact that barriers to entry for a dedicated microfinance banking institution are so high in these large markets that such institutions prove impractical (Christen, 2000).

In Mexico, there is one large and successful MFI (Compartamos), some innovative smaller institutions (such as FINCOMUN and CAME), and many small-scale MFIs with socially motivated approaches. In rural areas, there are dozens of village banks (*Cajas Populares*, the most well known being *Caja Popular Mexicana*), which have historically been mediocre performers and were, until recently, unsupervised and unregulated. Most Mexican commercial banks are not interested in

microbusinesses and low income households as clients, because of their lack of credit history, little physical collateral, irregular cash flow, and the high transaction costs involved in serving small clients. Table 2 presents a summary of the performance of the key Mexican MFIs, together with Caja Popular Mexicana. As shown in Table 2, the number of clients served by MFIs and by Caja Popular is very low: about 560,000 for a total amount lent of \$738 million in the year 2000. While the table does not include all MFIs operating in Mexico, we can assume that it provides a good approximation of the current offer of microfinance credits. The demand for micro and small business productive loans in Mexico was estimated to be about \$5.1 billion (Ashby, 2000). Thus, the current supply covers only about 14% of the potential market. It is also important to note that the supply is highly concentrated: CPM serves 84% of the total active clients, Compartamos 11%, and all other institutions less than 2%. These figures clearly indicate that the Mexican microfinance industry is underdeveloped. The key constraints to growth mentioned by existing Mexican MFIs during a recent survey are (1) the lack of well-trained loan officers, coupled with high staff turnover resulting in high training costs, (2) the lack of adequate software systems; (3) regulatory constraints; (4) high transaction costs for small loan amounts, (5) the current decline of the Mexican economy; and (6) the lack of sound judicial protection against client loan default (Enterprising Solutions, 2002). MFIs and regulatory authorities need to address these constraints to move towards a more mature stage of development, cover a larger share of the market, and venture into new products, such as housing microfinance.

Besides being the most successful Mexican MFI in terms of scale of operation and profitability, Compartamos is trying to address these constraints in innovative ways, serving as an interesting example for other local MFIs interested in increasing their market and improving their performance. Compartamos's most recent plans and actions include

Table 2. Leading Mexican Microfinance Institutions (2000)*

MFIs	Average loan size disbursed (\$US)	No. of active clients	PAR > 30 days (%)	Operating sustainability	Financial sustainability
Compartamos**	240	64,100	0.56	> 100%	> 100%
Fincomun *	800	10,500	3.0	> 100%	> 95%
CAME	200	8,975	< 1	88%	N/A
FOCOMI+	1,443	2,600	33	N/A	N/A
Emprendedores	880	551	4.1	N/A	N/A
Dignidad	500	400	18	> N/A	< N/A
UCME***	400	124	0	> 100%	< 100%
Caja Popular Mexican	N/A	488,310	14	> 100%	> 100%

Sources: Report for World Bank by consultant Lorna Grace (2000); interviews with Mexican MFIs.

* PAR is for microfinance portfolio only. This is the average first-time loan, rather than average loan.

** December, 2000 data for Compartamos.

*** Includes mainstream operations as well as microfinance operations

+ PAR 90 days

+ + CPM (Caja Popular Mexicana) figures include a large number of savers who do not have an outstanding loan. Data from 2000. While the average loan size figure is not available, 40% of CPM's active borrowers have annual income less than US\$2,975. PAR is 90 days for CPM.

portfolio diversification, an increase in the number of sources of capital, a reduction of operating costs, and a strong focus on internal training of its personnel.

Mexican Pilots in Housing Microfinance

While the microfinance industry is nascent in Mexico, and microfinance for housing is even less developed, there are a few Mexican institutions that are operating in this field, including (1) FUNHAVI, a small-scale lender in the northern border town of Ciudad Juarez; (2) the Caja Popular Mexicana (CPM); and (3) FINCOMUN. (Private building contractors, material suppliers, or land developers could represent additional channels of financing for home improvement loans but were outside the scope of this research.)

Among the interviewed institutions, FINCOMUN is the only MFI. Caja Popular is a national savings and loan system with over 300 branches (*cajas*), while FUNHAVI is an NGO specializing in the housing field. All three institutions have developed microfinance initiatives in response to Mexico's pressing need for housing microfinance, but they do not satisfy even a small part of the existing demand for these loans. In 2001, FINCOMUN and FUNHAVI offered a total of about 1,500 housing microfinance credits, a tiny fraction of an estimated demand of more than 1 million loans for moderate and minor improvements. Despite having a bigger housing portfolio, CPM has also been unable to meet the housing improvement needs of the country. Given that CPM has been operating in the housing field for more than fifty years and has had a specialized housing branch for ten years, the scale of its housing loan portfolio is not impressive.

The three institutions face different constraints on increasing their offers in the housing field. FINCOMUN's and FUNHAVI's key constraints, which are representative of the constraints faced by most MFIs and small institutions, are (1) limited access to affordable long-term sources of funds, (2) the lack of a decentralized branch structure throughout the

country or in states most in need of housing improvement, (3) the lack of grants to support market research to design attractive loan products for their potential clients, and (4) the lack of information on best practices in this field from within Mexico and other institutions throughout Latin America.

On the other hand, CPM's key constraints to growing in the housing field are (1) an excess of branches, some of which are unprofitable and should be closed; (2) high portfolio risk, which should be reduced to ensure that the institution is sound before broadening its offer in new areas; and (3) the lack of technical assistance to provide its clients with specific complementary services in the housing field.

*FUNHAVI*⁹

FUNHAVI was established in 1996 to address the housing and infrastructure needs of the tens of thousands of people moving to Ciudad Juarez to seek work in the expanding *maquiladora* (assembly) sector. As of 2001, FUNHAVI had 1,100 active clients and an outstanding portfolio of \$1.6 million. Its portfolio performance is very strong, with an on-time repayment rate of 97%.

The Cooperative Housing Foundation Mexico (CHF) set up FUNHAVI to ensure that private sector expansion benefited the city as a whole. CHF's initiative—which began as a pilot to support community banks and provide health services to the *maquiladoras*—was funded with US\$1 million in program assistance from the Ford Foundation, US\$324,000 in grants from leading *maquiladoras* (e.g., Cummins Engine Foundation or Johnson & Johnson), and US\$300,000 from the Inter-America Foundation. As the need for housing microfinance became more pressing, CHF expanded its program to include a full-scale housing microfinance program supporting projects such as adding a bathroom or a kitchen, improving water and electricity connections, and installing a new roof. FUNHAVI's housing loans range from US\$510 to US\$2,590, with an average loan size of about US\$1,550. The interest rate is 2.5% a month, calculated on the original loan amount, and

FUNHAVI adds a 2% upfront commission, for an effective interest rate of 54% per year, in line with other microfinance institutions in Mexico. The terms of the loans are between 6 and 36 months. A cosignature is required as guarantee.

The keys to FUNHAVI's success have been (1) a simple, streamlined, three-step review process that includes the necessary safeguards to minimize credit diversion and the misuse of funds, (2) the integration of technical assistance, and (3) the innovative use of partners, such as CHF and private local companies.

The loan preparation process, from first contact to the issuance of the loan, lasts no more than 15 days. Households must be able to demonstrate a monthly income of two to eight times the minimum wage (the equivalent of US\$250 to US\$900). No savings or credit history is required, but the client must be able to show recent pay stubs, provide the name of a guarantor, and offer proof of land (which is a less stringent requirement than formal land title). In addition, the community where the house is located must be stable; i.e., it cannot consist solely of newly arrived *maquiladoras*. It also cannot be close to a river, flood plain, or area subject to intensive erosion.

Technical assistance consists, first, of a 30-minute educational presentation to ensure that potential clients understand their rights and responsibilities under the program, as well as basic information about suppliers and budgets. This session provides key information on the characteristics of the loan (e.g., amount and collateral required). The second step is a visit by an architect, who reviews the construction plans and provides the budget for materials and labor. He or she charges a fee of \$22, the only charge in the loan preparation process. More than 70% of the households that attend the presentation invite the architect to visit their home and prepare an improvement plan and a budget for them. There are virtually no dropouts after this stage.

CHF Mexico has played a decisive role in the program. It provides technical assistance and capital to FUNHAVI and monitors its portfolio on an ongoing basis. CHF has also covered FUNHAVI's operating deficit, which has decreased sharply since the institution was founded.

The private sector has also played a decisive role in program expansion and streamlining. Cementos Chihuahua offers FUNHAVI quantity discounts on cement purchases, and all suppliers guarantee prices at the time of loan disbursement for the life of the loan. The ESMART grocery store chain provides access to 400 cash registers at its 19 area stores on a 24-hour basis, so that FUNHAVI clients can make loan installment payments. This shifts the burden of transactions and payment security from FUNHAVI to the ESMART chain. The architects who provide budgets and plans are also small-scale builders and work for FUNHAVI for a small honorarium.

FUNHAVI's future plans are to expand to other border cities, such as Tijuana, that also have a strong *maquiladora* sector and face a severe housing shortage, or to other attractive markets, such as Mexico City and Chihuahua. FUNHAVI is also planning to franchise its methodology to or partner with sound Mexican microfinance institutions.

*Caja Popular Mexicana*¹⁰

CPM is a traditional savings and loan system that covers 80 cities and surrounding rural areas in 18 states. It is a much larger operation than FUNHAVI and has a more diversified loan portfolio valued at US\$288 million at the end of 2001 (Caja Popular Mexicana, 2002), with an estimated 30% (about \$86 million) dedicated to progressive housing. Through its *cajas*, it has been providing loans for housing construction and improvement for more than 50 years, but only in the past ten years have these loans been treated as a distinct, progressive housing product. CPM management is aware of an enormous demand for progressive housing loans, as well as for new construction loans, in all the markets it serves, but the demand far

outstrips CPM's ability to deliver such services under current regulations governing savings-based financial institutions.

CPM's home improvement loans range from US\$200 to \$15,500, and new home construction loans from US\$5,200 to \$31,000. The loan amounts cannot exceed 40% of the borrower's earnings. Regulations limit the loan maturity to five years. Average loan maturity is 18 months, which indicates a preference for home improvement loans, and interest rates range from 1 to 2% per month.

To qualify for a loan, a household must be able to show proof of an income level of three to seven times the minimum wage and savings with CPM equal to 25% of the value of the loan. A guarantor is required to cosign. CPM requires much more time than FUNHAVI to review a loan application and does not provide borrowers with technical assistance for contracting or construction.

Although CPM's overall portfolio is weak by international standards, with a portfolio at risk (PAR 30 days or less) of about 17%, housing loans have outperformed the rest of the portfolio, with a risk level of 8%.

To improve its portfolio performance, CPM has begun to identify its weakest *cajas* and may close them, while establishing new ones in more receptive markets. Housing is likely to remain an important part of its portfolio, given the high demand and superior performance of this product line. CPM has expressed its intention to expand the housing microfinance program in Zacatecas, León, Morelos, Guadalajara, and Oaxaca over the next few years. Changes in financial sector regulations that provide a clear legal framework for savings-based financial institutions could facilitate the implementation of CPM's plan by allowing them to borrow from government credit lines intended to support housing construction and improvement.

Some key steps for CPM to grow successfully in this area include closing underperforming branches, restructuring its portfolio, and providing technical assistance to clients in the housing field.

*FINCOMUN*¹¹

FINCOMUN is a successful Mexican MFI with 17,200 clients in low income Mexico City neighborhoods, an outstanding loan portfolio of over US\$3 million, and good portfolio quality (PAR 30 days at 4.3%). FINCOMUN is supervised by Comision Bancaria Nacional y de Valores and is legally permitted to mobilize savings from its members.

FINCOMUN has recently experimented with home improvement loans, providing 500 loans to clients who have repaid enterprise loans promptly. These clients were selected on the basis of demonstrated cash flow generated by their microbusinesses and, in most cases, because their business was physically located in their house. Housing microfinance loans are seen by FINCOMUN management as an extension of enterprise loans and can be provided to clients who have outstanding enterprise loans from FINCOMUN. Housing loans range from US\$500 to US\$1,000, with weekly installments and an interest rate of 6% per month calculated on a declining balance basis. This makes the loan affordable—a typical family pays about \$80 per month for the loan. In addition, FINCOMUN estimates that 10% to 15% of the enterprise credit is diverted, in part, to cover home improvements related to business operations.

FINCOMUN, the only Mexican MFI that has chosen to enter the housing improvement field to date, seems well positioned to expand into this market—it is operationally and financially sustainable, it is supervised and therefore less risky than other MFIs, it provides larger loans than most Mexican MFIs, and it has a clear commercial orientation underlying its operations. However, scaling up its portfolio in this field represents a major challenge for FINCOMUN, because it does not have a capillary branch structure and lacks market information and expertise in the housing field.

Catalytic Role of Governments and Donors

This paper has shown that (1) there is enormous demand for commercially priced microfinance and housing microfinance loans in Mexico, (2) housing microfinance is more closely related to microenterprise than to mortgage finance, (3) some profitable products have been developed by Latin American microfinance institutions that offer important lessons (albeit at a relatively small scale), and (4) there are a few innovative efforts in Mexico upon which to build.

The final challenge is to determine how the government, with donor support, can serve as a short-term catalyst for market expansion until a convincing financial argument can be demonstrated to large-scale private sector investors and financial institutions, such as commercial banks. Well-designed government and donor financial and technical assistance inputs and incentives could help the Mexican MFIs to develop housing microfinance products. These interventions include the following:

1. Supporting market studies and pilot initiatives
2. Providing incentives to help institutions involved in this field to scale up their portfolios, or help to newcomers add a housing microfinance loan to their product line
3. Providing innovative sources of funds for housing microfinance
4. Encouraging franchising, joint ventures, and exchanges

1. Supporting market studies and pilot initiatives. Government and donors could provide short-term subsidies to MFIs and other financial institutions to support market research in large underserved markets (such as Mexico City and the northern and southern states) and disseminate pilot results widely. In addition, they could create a technical assistance facility to support pilots, in order to help MFIs and other financial institutions better understand the risks and dynamics of microfinance housing, as well as possible complementarities

between housing microfinance and existing microfinance loan products.

2. *Providing incentives.* Large financial institutions that have pilots in housing microfinance, such as Caja Popular Mexicana (with its extensive branch network and hundreds of thousands of clients), require technical assistance to help management assess this potential product line. Since CPM's portfolio is not performing well, additional technical assistance in delinquency management would be useful. Since CPM and other large financial institutions have ready access to large pools of savings, they do not require access to credit lines.

For small MFIs with an existing, effective product (such as FUNHAVI and FINCOMUN), access to affordable lines of credit is the main constraint to expansion. These MFIs can only attract limited grants and investors, so they must turn to other financial institutions as a source of funds. (See point 3 below for a discussion of this point.)

In addition, government and donors could consider providing incentives to home improvement chain stores to add housing microfinance to their consumer credit lines. Home Depot and other chains have a significant retail network on which to build, both in Mexico and in other Latin American countries. Housing improvement loans might prove to be a natural progression for such home improvement chains.

3. *Providing innovative sources of funds.* Without reliable and streamlined access to commercially priced funds, MFIs are unable to expand into housing microfinance in a significant way. Since the maturity of a housing loan is often two to three years, the maturity of the source funds has to be longer than those provided for working capital portfolios that are quickly turned over, which are typical of the Mexican MFIs. Good performance (measured by portfolio quality and administrative efficiency) could be used to qualify MFIs for access to large, commercially priced, performance-tracked credit lines for housing microfinance. In Mexico and much of Latin America, it is clear that the financial markets will not provide adequate

funding to address this opportunity, at least until there is stronger evidence of the commercial viability of MFIs and their housing portfolios.

Other channels should be developed that are commercially oriented and apolitical; these could be complemented by time bound incentives for housing microfinance experimentation and MFI institutional strengthening. FOVI has a program that channels credit to limited purpose finance companies to provide credit for new housing unit construction. However, the finance company (SOFOL) must identify a large construction company, usually for a financing package of 500 units in various apartment buildings. Eligible clients receive subsidized credit for 10 to 20 years and may also qualify for a grant for the down payment.

The FOVI program is not the ideal form of financing for millions of clients because it does not include the progressive housing market. It could, however, be the basis of a similar program for that specific market, or a specialized window could be developed to promote progressive housing.

4. *Encouraging franchising, joint ventures, and exchanges.* Innovative MFIs with significant housing microfinance portfolios (such as FUNHAVI) could be assisted in efforts to find sound partners and expand to very large markets such as Mexico City. Funding for dissemination activities, exchanges (within Mexico and to successful programs elsewhere in Latin America) could also have a high return in terms of rapid development of locally adapted products and delivery models. Joint ventures between institutions with technical skills and specific experience in the housing field, as well as sound institutions with a decentralized organization, would facilitate scaling up coverage of the housing improvement market in an efficient, capillary, and fast way.

Applying the criteria mentioned above, which have been used in the past to expand the coverage of working capital microfinance in other settings, would go a long way toward helping the private sector (MFIs, institutions

specialized in housing, home improvement chains, and other private organizations) to address the needs of the millions of potential clients in Mexico awaiting access to housing microfinance.

Notes

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1. In East Africa, the rate of client dropout ranges between 25 and 60% per annum. In Uganda, the norm is 25% or more. In Bangladesh, dropouts vary between 10 and 15%. While the reasons for desertion are multidimensional, “dissatisfaction with the characteristics of the current products” is the main one quoted consistently by interviewees across countries and institutions (Wright, 2001; Wilson, 2001).

2. This is due to two main causes. First, government programs do not allow borrowers to take on follow-up loans, thus discouraging them from paying the first loan back. Second, government loans’ very low interest rates lead the borrowers to regard these credits as endowments.

3. “Credit from friends and relatives mainly takes the form of unpaid labor, assuming that the borrower will also be available to lend a hand in the house building or house improvement efforts of the people who have helped him. Apart from the provision of labor, it is also common for monetary support to be given to a relative or a good friend who is improving or extending a house. Whether, and to what extent, interest is charged on these loans, depends on the closeness of the family ties in each case” (World Bank, 1997). For a more complete list of households’ possible informal financial sources, see Ferguson (1999), p. 189.

4. According to a recent study conducted by SEDESOL for the World Bank, 6.2 million Mexican houses (equal to 27.5 percent of the 2000 housing stock) need improvements (World Bank, 2002). Inconsistencies among the figures of different studies are mainly due to the differing definitions of “housing improvement” adopted by the various authors.

5. Multicredit Bank (Panama) and Mutual La Primera (Bolivia) are among the few examples of Latin American banks that offer microfinance housing loans. The Hatton National Bank is an interesting case: a Sri Lanka commercial bank that has decided to “go downscale” and offer microfinance services (Gallardo, Randhawa, & Sacay, 1997). For a complete list of commercial banks that are providing microfinance productive loans to micro and small businesses and that could potentially enter the housing microfinance sector, see Wenner & Campos (1998). Limited-purpose mortgage banks (SOFOLES in Latin America) are another source of housing credit in the commercial banking sector. They usually lend to developers during the building stage and then transfer the loans to homebuyers when the purchase takes place (Ferguson & Heider, 2000). Credit unions may also offer housing improvement loans. They have legal and capital requirements that are more flexible than are those of banks, and they can accept deposits and originate various types of loans. However, they have little experience in the housing field and, like commercial banks, are likely to have little interest in adding this line of credit to their portfolio.

6. This is often used as a proxy for the client’s poverty level.

7. Historically, the *Microbanking Bulletin* has used a 90% ratio rather than a 100% ratio to take into account the fact that the adjustment process (i.e., the calculation of the FFS index) may not be exact. As the numbers of FSS MFIs continue to grow, the *Bulletin* has raised the bar on performance standards to 99.5% which still leaves a small cushion for the adjustment judgment call (Churchill, 2001).

8. For more on Compartamos, see Bulletin case study on compartamos (1999), pp. 13–17.

9. Sources for the information included in this section are E. Adams from the Community Housing Foundation (CHF), personal communication; and Community Housing Foundation (1997).

10. Source for the information included in this section is M. Avina Bueno, Caja Popular Mexicana Vice Director of Planning and Organization, personal communication.

11. Source for the information included in this section is V. Fenoll, FIN-COMUN Executive Director, personal communication.

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