
Victor
Leon

THE UGLY SIDE OF MICRO-LENDING

By Keith Epstein and Geri Smith
Photographs by Bruce Gilden / Magnum

How big Mexican banks profit as many poor borrowers get trapped in a maze of debt

Juan Carlos Pérez Lopanzi is a collection agent in San Martín Texmelucan for Banco Azteca, which makes small loans to the poor

In a gleaming office tower in Mexico City secured with retinal scanners, bulletproof glass, and armed guards, dozens of workers in white lab coats dart around a large operations center monitoring long rows of computers. Along one wall, 54 enormous screens flicker dizzyingly with numbers, graphs, and fever charts: a relentless stream of data. You'd think the urgent mission involved tracking the trajectory of a spacecraft or the workings of a national power grid, not tiny amounts of cash and credit for Mexico's working poor.

The transactions are so minuscule they hardly seem worth the bother. The average loan amounts to \$257. But for Banco Azteca, a swiftly growing bank affiliated with Latin America's largest household retailer, the small sums represent a torrent of revenue that has caught even its founders by surprise. For three decades, micro-lending was seen as a tool of nonprofit economic development. Now poor people are turning into one of the world's least likely sources of untapped profit, primarily because they will pay interest rates most Americans would consider outrageous, if not usurious.

With no legal limits on interest levels and little government oversight, for-profit banks in Mexico impose annual interest rates on poor borrowers that typically range from 50% to 120%. That compares with a worldwide average of 31% among nonprofit micro-lending institutions, and the 22% to 29% that Americans with bad credit histories incur on credit-card debt. Azteca's business model succeeds not only because it can charge credit-starved clients almost whatever it wants. Equally important is that low-income Mexicans anxious about maintaining their reputation tend to pay back what they owe, regardless of the hardship. Those who slip behind receive frequent visits from motorcycle-riding collection agents. Default rates are infinitesimal. "We lend to them as much as they can borrow," says Azteca Vice-Chairman Luis Niño de Rivera, "and they can borrow as much as they can pay."

WHIFF OF PROFITS

In a Mexico that is modernizing economically even as most people still struggle to make ends meet, Azteca has discovered an improbable market for financial services. Much larger companies based in the U.S. and Europe also have picked up the whiff of profits. Wal-Mart Stores, which obtained a Mexican banking license a year ago, began offering loans for purchases at 16 of its 997 Mexican outlets in November. In the U.S., the retailer markets itself as a friend to the budget-conscious. In Mexico, it charges interest rates that might set off popular and political revolts back home, although Wal-Mart describes its terms as appropriate to the Mexican market. At one store west of Mexico City, a 32-inch LG plasma TV with a price tag of $957 can ultimately cost as much as $1,474, thanks to a 52-week payment plan that carries an annual percentage rate (APR) of 86% (page 42).

Banamex, Mexico's second-largest bank and a wholly owned unit of Citigroup, is stepping up its pitches of personal loans to the working poor in 127 cities where it operates shops called Crédito Familiar, or Family Credit. HSBC Holdings last year bought a 20% stake in Financiera Independencia, a high-interest consumer lender that went public on Nov. 1. The Swiss insurer Zurich Financial Services is underwriting term life insurance policies that are sold along with small loans in Mexico. And homegrown nonprofit Compartamos morphed into a full-fledged commercial bank last year; it went public in April, reaping hundreds of millions of dollars for investors (page 45). All are examples of how financial players worldwide are pursuing profits by putting loans within reach of deprived borrowers.

Access to credit opens opportunities for the poor. But it creates tempting hazards as well, which in Mexico are drawing many unsophisticated families into a maze of debts. Pawnshops and loan sharks, whose interest rates of up to 300% have plagued generations of Mexicans, now face rivals offering terms that are less harsh. But along the road to previously unavailable financing, some Mexicans are stumbling badly.

The Arana family is but a blip on one of the wide screens at Azteca's operations center. Beneath the digital glimmer lies a story of striving. Adrián Arana Sánchez, his wife, Francisca, and their extended family take whatever work they can find, adding a few pesos here and there. Last July, Adrián lost an $80-a-week job delivering soft drinks to stores in gritty, exhaust-choked San Martín Texmelucan, a city of 143,000 two hours southeast of Mexico City. He now brings home half that amount peddling vegetables door to door and making plaster-cast statuettes of Jesus. Francisca sells crunchy slices of jicama root outside an elementary school. With four children, two grandchildren, and a son-in-law, they live in a four-room cinderblock house in the shadow of snow-capped volcanoes once revered by the Aztecs.

Although indigent by U.S. or Western European standards, the Aranas see themselves as aspiring consumers and even as entrepreneurs in a society that makes all manner of goods

A BOOMING POVERTY MARKET

Major businesses and investors worldwide are profiting from poor borrowers

MEXICO
Wal-Mart and Citigroup units compete with homegrown banks Azteca and Compartamos, charging annual interest rates that can top 80%

INDIA
U.S. venture firm Sequoia Capital has an $11.5 million stake in SKS Microfinance, which lends to 1.4 million clients at rates of 24% to 30%

GHANA
U.S. pension manager TIAA-CREF anticipates up to a 15% return on its investment in micro-loans to thousands in Africa

MONGOLIA
Morgan Stanley and Lehman Brothers package securities based on loans to low-income Asian borrowers

AZERBAIJAN
Deutsche Bank offers securitized loans to the working poor that yield 6% to 7.5% returns for investors

PHILIPPINES
Merrill Lynch, Hewlett-Packard, and reinsurer Munich Re are among the investors in a commercial micro-lending fund returning 12%

The Aranas are trying to sell their house so they can pay back a $1,380 loan from Banco Azteca with an APR of 90%

and services available for what seem like manageable weekly payments. Banco Azteca plays a central role in that emerging credit economy. Started five years ago, it operates from the nearly 800 locations of its parent, Grupo Elektra, Latin America's largest electronics and home appliance chain. Elektra/Azteca has the sort of ubiquitous presence that Wal-Mart enjoys in the U.S.

SEEKING A MIDDLE-CLASS LIFE

The dazzling yellow facades of Elektra/Azteca outlets shout for attention in rundown neighborhoods. Inside the store across from the Catholic cathedral in San Martín Texmelucan, a tag on a six-speaker sound system throbbing with *ranchero* music carries a price of $691, but larger bold print stresses weekly payments of only $16. An installment plan can be arranged by Azteca staffers who work from metal desks at the back. Over 18 months, the weekly payments nearly double the price, to $1,248. That's an APR of 88%. APR is commonly used in the U.S. to compare total loan costs. In Mexico, Azteca isn't legally obliged to disclose it—and doesn't. (Mexican loans include a 15% tax on financial services.)

Adrián Arana, 50 years old and with a sixth-grade education, has become a regular customer at this branch of Elektra/Azteca. He and Francisca, who completed only the second grade, have obtained a series of small loans over the past four years to purchase a CD player, bicycle, TV, video camera, and bedroom furniture. In 2006 they took the next step, borrowing $920 to pursue a long-cherished ambition: opening a dry-goods store in the front room of their house. They saw the store as a means to achieve stability, and maybe a middle-class life. But like many tiny businesses started by inexperienced proprietors, this one soon failed. A neighbor had just opened a similar but better-stocked home shop. The Aranas toiled diligently at their other jobs to pay back the loan, missing some weekly payments and incurring late fees. With an APR of 105%, the loan ended up costing about $1,485 over a year. But they paid it off.

Determined to try again, they were back at Azteca in February with a new plan, this time to start a gift shop. Azteca granted them a bigger loan, for $1,380 over 18 months, but deducted $65 up front, leaving the Aranas with $1,315 and an

APR of 90%. They say they didn't understand these terms. They focused instead on the weekly payment of only $32. "They never tell you what the interest rate is," says Adrián. "They say, 'Sign here,' but they don't give you time to read everything."

Some Azteca executives concede that borrowers sometimes walk away confused. "Terms are explained to them, maybe not as clearly as they should be, but many clients don't understand," says Pedro Morales, head of the bank's local legal department. "They take on financial commitments they can't meet." But Niño de Rivera, the bank's vice-chairman, says: "There is no pressure to sign loans, and consumers are encouraged to shop around freely for what best suits their needs."

The Aranas used the $1,315 to buy picture frames, toys, and inexpensive cosmetics, which they displayed in their front room, beneath a dangling lightbulb illuminating a portrait of the Virgin of Guadalupe. Once again, their business faltered. Two textile factories in the area had closed recently, throwing thousands out of work. Mexico offers no government benefits to cushion such adversity. The Aranas saw few customers.

For six months they made their payments, but then, in July, Adrián lost his soft-drink delivery job. By September, past-due notices and interest charges were piling up, and an Azteca collection agent was visiting regularly. "We either eat or we pay off the loan," says Adrián. The despairing family resorted to borrowing $200 from a loan shark at 10% a month. Informal lending of this sort, despite its attendant threat of violence, is not prohibited in Mexico. Azteca's local collections chief, Alejandro Tejeda, says it's a shame that borrowers can land in such trouble. "But these people made a commitment, and they need to live up to it," he says.

With no money to pay the loan shark or Azteca, and fearing that the bank will seize their few belongings, the Aranas are trying to sell their house. So far they haven't found a buyer, and if they do, it's not clear where they would live. They're keeping food on the table, barely, with Adrián's door-to-door sales of tomatoes and herbs, which he transports in the basket of a large tricycle. "We never thought this would happen," he says. "We're sinking fast."

Banco Azteca and Grupo Elektra are key parts of Grupo Salinas, an amalgam of media, telecommunications, and retail businesses controlled by billionaire Ricardo B. Salinas Pliego.

WAL-MART BANKS ON THE 'UNBANKED'

Its new Mexican lending arm taps a fresh source of growth

By Geri Smith and Keith Epstein

Every day 2.5 million people walk through the doors of a Wal-Mart store in Mexico, generating nearly $20 billion in sales last year. Now they are potential customers of Banco Wal-Mart, the chain's new lending operation. So are the company's 12,000 Mexican suppliers, as well as its 155,000 employees. "We want to leverage this traffic we have in our stores," says Julio B. Gómez, Banco Wal-Mart's chief executive.

As in the U.S., Wal-Mart is Mexico's largest retail chain. It has 997 locations, including supercenters, food and clothing stores, and restaurants. It has diverted many Mexicans from traditional commerce and stirred occasional opposition from local merchants. But the president of Mexico's central bank, for one, publicly credits Wal-Mart's high-volume, budget-conscious retail strategy with helping tame inflation to the low single digits. Mexican regulators say they expect the newly chartered Banco Wal-Mart to spark competition that eventually could lower the cost of consumer borrowing.

For the moment, though, Wal-Mart is taking advantage of a market where annual interest rates often exceed 100%. A supercenter just west of Mexico City offers a side-by-side $1,100 Whirlpool refrigerator for 104 weekly payments of $23, which works out to an annual percentage rate of 86% and more than doubles the cost, to $2,295.

"We are not saints," Gómez told industry analysts in a Nov. 12 Webcast. "We've come into this business for volume and profitability similar to our other businesses, or else we wouldn't invest." Asked separately about Wal-Mart's rates, spokesman Raúl Arguelles says: "We offer very competitive [financial] products that we will be constantly evaluating to make them even more attractive."

When Wal-Mart sought a banking license in the U.S. two years ago, its path was blocked. Among the obstacles: American banks, unions, grocery store owners, and both Republicans and Democrats in Congress. Even then-Federal Reserve Chairman Alan Greenspan weighed in with worries about lightly regulated "industrial loan corporations" that could hobble the financial system. So the company looked south, where regulators couldn't have been more pleased to welcome Banco Wal-Mart.

Sixteen Wal-Mart bank branches are already offering installment plans on electronics and household appliances. By the end of next year, Banco Wal-Mart expects to operate in 100 stores, and it projects that it will be profitable within four years. It also intends to offer credit cards and micro-loans for entrepreneurs.

Consumer finance offers a fresh growth opportunity for a company whose huge outlets are maturing in Mexico as in the U.S., says Wayne Hood, a retail analyst at BMO Financial Group. "Their idea is, you have a core group of loyal customers who are 'unbanked' who shop every day. Why not try to provide them banking services?" he says. "It's easier to do in Mexico because the regulatory environment isn't as tough."

A maverick among Mexico's business elite, he has sparked controversy. In 2006 he settled civil fraud allegations by the U.S. Securities & Exchange Commission concerning the finances of his TV network, then traded on the New York Stock Exchange. He denied wrongdoing but paid $7.5 million and was barred for five years from serving as an executive or director of companies listed in the U.S.

Banco Azteca operates out of the retail locations of its parent, home appliance chain Grupo Elektra

The Salinas family began selling furniture on credit more than a century ago in the northern city of Monterrey. Ricardo, 51, says he learned early in life that those who work in Mexico's informal economy, without pay stubs or much collateral, and who can't afford sofas or blenders outright, will snap up merchandise if offered seemingly manageable terms. "If you want to become rich, sell to the poor," he recalls his grandfather instructing him.

He learned to get even richer by lending to the poor, and to those who are better off. Azteca targets 14.5 million Mexican families earning $5,100 to $33,600 a year. Mexico has a total population of 109 million, with a median annual household income of $7,297. Mainstream Mexican banks cater to the wealthier elite, while less than one-third of working-poor families have access to any banking services at all.

Azteca has absorbed Elektra's ethos of high-pressure employee quotas and incentives. Elektra clerks, clothed in the store's signature bright yellow, earn commissions on top of their standard weekly salary of $120 for tacking on extras such as warranties, life insurance, and even long-distance bus tickets. The biggest score comes from persuading a customer to spread payments over the longest possible period, 104 weeks. "Sell on credit and earn much more money!" an online company training manual states.

MOTORBIKE CAVALRY

The strategy has far exceeded the expectations of Grupo Elektra executives. The bank already contributes one-fifth of its parent's $5 billion in annual revenue. It boasts a consumer loan portfolio of $2 billion and a healthy 22.3% return on shareholder equity.

The main Elektra/Azteca branch in San Martín Texmelucan aims to meet a daily target of $9,000 in fresh loans. The money isn't spewed out carelessly. With efficiency unusual in the Mexican marketplace, the bank deploys a cavalry of credit and collection agents on motorbikes. These *jefes de crédito y cobranza* visit borrowers within 24 hours of a purchase or loan application.

Juan Carlos Pérez Lopanzi, a 25-year-old college graduate who studied international commerce, serves as one of 13 credit agents in San Martín Texmelucan. One October morning, he rumbles up to the home of Maria Teresa Hernández as neighbors peer from their windows. Hernández, a 50-year-old street vendor, wants to borrow $460 for a new hot dog wagon. She isn't home, so Lopanzi questions her adult daughter about the family's finances. Do they rent or own? Have they lived there at least two years? What do they spend on food?

With each answer, Lopanzi taps the screen of a handheld computer. Data will be routed to Azteca's operations center in Mexico City. The state-of-the-art system keeps the cost of processing 7 million transactions a day to a mere 3¢ per transaction, according to Azteca. "It's amazing—all this is for poor people," says Juan Arévalo Carranza, the bank's technology chief.

Back in dusty San Martín Texmelucan, Azteca's proprietary software alerts the agent, Lopanzi, that Hernández, who earns $276 a month, doesn't qualify for a $460 loan. He offers $370 instead. That will require $10.60 weekly payments for 12 months for an APR of 85%. Hernández will end up paying $551. "If she had more income, she could have a shorter payback period, and the interest rate would be lower," the agent explains to the daughter. She shrugs, then nods in acceptance.

"Tell her she can go by the store this afternoon for her check," Lopanzi says, as he registers the serial numbers of the daughter's stereo, DVD player, TV, and refrigerator. The items' resale value, preprogrammed into Lopanzi's digital device, must add up to around double the value of the loan. If the woman fails to pay, Azteca will cart away the daughter's possessions and sell them in a Grupo Elektra used-goods store.

Azteca deducts the depreciated value of seized goods from outstanding loan balances, so if someone who doesn't pay has enough possessions to cover the debt, the bank considers it paid. Azteca bars such customers from borrowing again but doesn't count them as having defaulted, which helps explain its stated loan failure rate of just 1%. Banks serving more prosperous clients average a 5.3% default rate on consumer loans.

Mexican lenders benefit from attitudes cultivated in a society lacking a welfare safety net, personal bankruptcy system, or meaningful consumer protection laws. Credit bureaus have recently sprung up in Mexico, including one that Elektra helped start in 2005, and many among the working poor worry about sullying their new credit ratings. They assume that, one way or the other, they or their relatives will just have to pay back whatever they borrow, says Gustavo A. Del Angel, an economic historian who studies micro-finance at the Center of Research & Economic Teaching in Mexico City.

'BAD MANNERS'

Borrowers who fall behind realistically fear public embarrassment. Photocopies of debtors' national identification cards sometimes turn up on telephone poles and at central marketplaces with warnings that say "DON'T LEND TO THIS PERSON!" Six months ago, an Azteca agent in San Martín Texmelucan posted such flyers. The company fired him. "Our system is not intended to be publicly shaming," says Niño de Rivera, Azteca's vice-chairman, but he acknowledges it "is intended to exercise peer pressure."

Even as Mexico's economy modernizes, companies operate with minimal oversight from government. Luis Pazos, head of Condusef, Mexico's regulator of consumer financial transactions, says his agency logs complaints about Azteca's collection methods and the adequacy of its disclosure of credit terms. "We've talked with that bank about the bad manners they've had," he says. But Condusef hasn't taken any substantial action against Azteca, which says it scrupulously polices the behavior of its employees. Last year, in a brash move characteristic of Grupo Salinas, lawyers for Azteca went to court rather than comply with a new law requiring banks to inform clients of the total financing costs they are charged. Azteca sought a type of protective order with which individuals or companies can shield themselves from application of a particular law or other government action. A federal judge granted the exception.

Freed of disclosure requirements, Azteca continues stressing weekly payments rather than long-term interest rates. When pressed for its average annual rate, Azteca asserts that it is about 55%. But Chuck Waterfield, a consultant based in Lancaster, Pa., who specializes in financial modeling for micro-lenders, points out that if Azteca's average rate is translated to make it comparable with APRs in the U.S., it comes to 110%. That's because Azteca charges interest on the full amount borrowed throughout the life of the loan, even as the principal declines—not on the declining balance, as is common in the U.S. An adjunct professor at Columbia University's School of International and Public Affairs, Waterfield has no relationship with Azteca.

When Azteca loans go bad, the results can be bruising for borrowers. Porfirio Soriano Pérez and his son Zalatiel bought a $1,435 Chinese-made motorcycle last year on an 18-month plan that required $29 weekly payments. They intended to use the bike to scout out customers for the parsley they grow on several acres just outside San Martín Texmelucan. The Sorianos knew the 68% financing would boost the motorcycle's total cost to $2,289, but they lacked cash to pay up front.

In February, disaster hit. A hailstorm wiped out their crop and with it their $350 monthly income. "Suddenly," says Porfirio, "we had nothing to sell, and no money." They fell behind on payments. Soon a collection agent began showing up at the extended Soriano family's unpainted home. In October, Azteca delivered written warning of legal action. "The problem is that people go into the store and buy out of pure emotion," says Morales, chief of Azteca's local legal department.

The Sorianos already had paid $1,560 on the motorcycle—more than the original sticker price—and owed about $700 more, but ended up returning the purchase. That erased the debt in Porfirio's name. The company will resell the bike and recover the money it's owed. The Sorianos, meanwhile, have nothing left to plant a new crop. BW

BUSINESSWEEK.COM | The authors' online exclusives include a look at the debate over nonprofit vs. for-profit micro-lending and the nagging lack of evidence that either approach helps the poor as a group. A slide show and podcast interview with the reporters provide the stories behind the story on tiny loans for the indigent.