Latin America's 3 Greatest Financial Inclusion Challenges, According to the Local Experts

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By Amanda Jacobson Manager of Latin America, Village Capital

For the past three years, our team at Village Capital has run programs for financial technology (FinTech) entrepreneurs in Mexico. I've written in-depth about the financial inclusion challenges across the country. Now, as we open our first regional program for entrepreneurs working to increase financial inclusion in Mexico, Colombia, Argentina, and Chile, we gathered experts to ask:

What financial inclusion challenges do these countries have in common?

To start, the World Bank's Findex shows that across these four geographies, the stats are consistent. In each country:

- Less than 63% of the population has a bank account,
- Less than 15% has access to formal savings, and
- Less than 16% has access to formal borrowing.

To understand the needs of individuals in the region, Alex Martin, Director of Strategic Partnerships at **ePesos**, a Village Capital company selected for investment in the 2016 program explained, "There are no options for low-income employees if they face an emergency. Most payroll advances are $38,000 pesos (or about $2,000 USD) and are repaid over 40 months. Almost no one is offering a rapid, short term solution for the mostly-informal, low-income workers."

Low-income unbanked and underbanked people, both from big cities and small towns, often have to struggle to work a half dozen jobs with little certainty of their cash flows. They need these financial products most, but often don't understand how to manage their finances and have few options to get help.

And the existing financial institutions just aren't innovating fast enough to step in and help. Even though the vast majority, 82%, of leaders in financial institutions agree that innovation is a critical factor in growing business, half of them admit that innovation still doesn't play any role in their strategic planning processes.

Without access to formal financial options or clear plans for existing institutions to find ways to address the special needs of these populations, many turn to informal options. Sometimes that's fine, and people can borrow from friends and family to get by.

But more often, they find themselves forced to turn to whoever has cash to lend in the neighborhood, later paying back their loans multiple times the amount lent (that's ridiculous considering that an average interest rate on a small loan would be around 26%; 85% being high!). In the worst cases, they feel pressured to take informal loans from "gota a gota" extortionists, which can be even more dangerous.

The current financial system clearly has gaping holes in it. But there is hope. Entrepreneurs across Latin America are emerging quickly to address problems in financial inclusion.

Village Capital is a global venture capital firm that finds, trains, and invests in entrepreneurs solving real-world problems, like those faced by individuals left out by the financial system. Since 2009 we have invested in over 70 ventures across 15 countries and supported hundreds more through our collaborative investment-readiness programs.

When we first entered Mexico in 2014, we went deep into building communities around financial technology (FinTech) entrepreneurs in Mexico. Since then, we've developed a worldwide collaboration with global digital payments leader PayPal and joined forces with local supporters like BlackRock and Citibanamex to provide resources and personalized attention for companies solving the most important problems in financial inclusion.

For the first time, this year the consortium will take the program to a regional level in Latin America, seeking entrepreneurs with solutions to financial inclusion challenges in Mexico, Colombia, Argentina, and Chile.

But before diving into recruiting ventures with the best *solutions*, we wanted to deeply understand the *problems*, straight from the local leaders who know best.

So, on May 23rd, we gathered 26 experts in Mexico City to join us for the *Village Capital FinTech: Latin America Roundtable*, including entrepreneurs, investors, financial institutions, foundations, policy-makers, and other thought leaders.

To really understand the region's challenges, we paired this in-person roundtable discussion with one-on-one conversations and surveys completed by similar thought leaders in Colombia, Argentina, and Chile, informed by experts like Daniel Spechar and Clementina Giraldo (CAF development bank), Fernando Esteban Amaya Valdés (State Bank of Chile), Alan García (Colombia's Asobancaria), and Álvaro Serrano (United Nations Population Fund).

After analyzing, brainstorming, and grouping all the core financial inclusion problems the group could think of, each participant chose what they saw as the biggest challenge we need to face. Formalization, education, data, availability of options (especially credit and savings), regulation, channel access, and larger societal problems were common themes.

After much discussion, it was time for a vote: *What are the three greatest challenges in financial inclusion, for you?*

It was clear that there is no one silver bullet solution. It's going to take many actors solving many specific problems to increase access to affordable financial products and services in Latin America. However, we were able to nail down these three pervasive issues:

Problem 1: Lack of Specific Offerings

For the most part, banks' and other financial institutions' products have focused on developing products that they can scale quickly and make healthy margins. This makes sense: almost any business would want to find a way to make the most money so it can continue to grow and stay competitive. Business 101.

For example, if your business is to loan money, you're going to have to accept that some people just won't be able to pay you back. That's the risk you're taking on. So you need to know the person you're dealing with and how likely they are to pay you back, so that the interest you earn from some, pays for the default of others.

Now picture making that risk calculation for a thousand people. A million people. More. Lenders create credit scores. Regulators make rules around which banks they're willing to back, so that if it goes bankrupt, people can still get their money. They make rules around "Know-your-Customer" (KyC) and credit scoring (we went deeper on this one last year; unfortunately, little has changed), so that they can trust that banks aren't giving out loans to people who usually don't pay back, based on the statistics.

According to Adriana Peon, Head of SMBs of Hispanic LatAm for PayPal, "There's a huge need for better loan products, but with little data available about people outside the traditional financial system, it's challenging to develop and extend improved credit options."

So, banks and regulators have worked together to make profiles of the "average" borrower who they had data on. They had more information about those privileged who borrowed in the past and paid back, could secure a stable income, and could grow their net worth high enough that the risk of not getting paid back would be low enough to trust them and offer the loan. This only gets more complex with strict money laundering laws in Mexico, anti-terrorism laws in Colombia, and similar barriers increasing lenders' transaction costs in other countries.

But the majority of people in Latin America are not that privileged. The poverty rate in Chile is 15%, both Colombia and Argentina hover around 30%, and the rate soars to over 50% in Mexico, according to the CIA World Factbook. Most financial products were not designed for the special needs of low-income individuals, women, minority groups, refugees, and so on. According to the International Labour Organization, only about 55-60% of working-age Chileans, Colombians, Argentineans and Mexicans have formal jobs.

Nalleli Garcia, Manager of the MetLife Foundation and CSR, pointed out that "the improvement, development, and delivery of formal financial products and services need to be relevant to the low-income population." This lead Pedro Solana, Director at Citibanamex to go on, "When we think of low-income populations, we need to make sure that we understand that it is not just people in rural towns, but also here, in big cities like Mexico City."

The conventional institutions often don't have products that meet their needs. So how can entrepreneurs step in to help?

Possible Solutions

1. Incentivize people to share (or even sell!) their personal information to better meet KYC compliance measure and be able to produce better credit scores. Manage and share that data through encrypted databases or networks of data. One way to manage this information could be through "hashes" on the blockchain.
2. Study the market and create products for large, widely unattended segments**.** For example, in Mexico there are 80,000 reported small businesses with 11 to 50 employees, and most financial products are only designed for micro-business or large established ones.
3. Identify the needs of particular segments of their target market (e.g. small businesses or women), develop products that understand those needs, and partner with existing banks and other financial solutions to help them scale the solutions.

Problem 2: Financial Education

Because products often aren't designed for various groups in society, the education those people need to understand interest rates, long-term savings options, and other financial products tend not to meet their needs.

When discussing the financial education gap, Jorge Andrés del Valle Papic, Latin America & Iberia Sales Team and Product Strategist at BlackRock questioned, "If we give everyone credit cards, will people use them? There's a gap in understanding. A rejection of cards. People would rather not use them because they're scary or confusing." Juan Luis Cárdenas, Subdirector of the Secretariat of Finance and Public Credit of Mexico, agreed, "People don't know how to use credit cards, and that can lead to heavy debt. There's no way to compare options."

In other cases, people will promise to pay charges they utterly don't understand. For example, if you go to Chile and go to the checkout line at a grocery store, if you pay with a credit card, the first thing the cashier will ask you is, "How many quotas?" Ask them what that means, and most will just say, "How many installments do you want to pay with." However, many don't realize that paying overtime comes with significant interest rate fees. Sometimes this is a question of transparency, other times a question of ethical banking.

As Citibanamex's Financial Education Offerings team points out, "This lack of financial education often leads people not to trust banks." When people don't understand what financial product they're signing up for, and get charges later, they may avoid working with formal institutions again.

And the numbers back it up. The PISA exam, which compares education levels across countries, found that of all countries surveyed, Colombia scored lowest in financial literacy with 379 points. Although the average in Chile was 432 points, students in the lowest income quintile only scored 377. (Data was not produced for Mexico and Argentina.) The OECD average was 486. There is a huge opportunity to improve financial literacy in the region.

Possible Solutions

1. Incorporate strong user experience and educational components into the development and distribution of financial products to increase financial literacy.
2. Build websites and other services that break down fees and interest rates to help people understand their options.
3. Take advantage of existing distribution channels and points of sales to collect data and learn more about those who are making transactions, as well as educate at the point of purchase of financial products.

Problem 3: Informal Cash Economy
Given that many feel that the financial options available were not designed with them in mind and they don't understand those existing financial products, many prefer to keep it simple and just stick to what they're familiar with: informal cash transactions, rather than cards or technology. "Cash economy" is king.

Behavior change is a huge challenge. People are used to paying cash for what they want. They don't perceive any fees (which may be built in) and don't run the risk of having to pay interest later. Financial institutions may need people make better trackable transactions to create new products, but in the day to day, people can still get just about anything they want if they pay in cash.

During the Roundtable, Pedro Solana of Citibanamex pointed out, "We shouldn't assume that people don't want to digitalize." There is a stigma that underbanked people aren't interested in replacing their cash transactions with digital payments or couldn't understand the technology. It is important to both build trust for non-cash options and a clear value proposition for why to make the transaction. Again, it's a question of incentive alignment.

Secondly, banks can't reach everyone. For example, if you're in the Lacandona Jungle in Mexico or Ibagué in Colombia, you can only even get to an ATM to withdraw if you take a 2-hour drive, assuming you have a car or can afford a *colectivo* to ride into the nearest town.

Possible Solutions
1. Provide digital payment options for no additional fees or at subsidized rates until reaching a mass of users. For example, Facebook, Whatsapp, and many other technology companies that don't charge, but aim to acquire millions of users to monetize on data or through other means. Maybe we could copy this model for the finance industry.
2. Pay out social services, entertaining prizes, or other valued services through a mobile wallet to encourage technology adoption. For example, Paytm draws people in India to adopt a mobile wallet to make top-up their cell phone minutes; a model that undostres is demonstrating can work in Latin America, too.
3. Have existing channels enable mobile money transactions. For example, in Mexico, Farmacias Similares pharmacies, OXXO convenience stores, and many other points of service already allow cash deposits for select services, like paying bills. Why not accept cash deposits for mobile wallets?

Village Capital and PayPal, as well as supporters BlackRock and Citibanamex, are committed to finding entrepreneurs with the best solutions to these real challenges in financial inclusion across Latin America.

After identifying and analyzing these three major problems during the Roundtable, we are ready to invite entrepreneurs to find solutions to Mexico's financial inclusion challenges. The following problem statement will guide our efforts to find, train, and invest in ventures with solutions to improve the lives of Latin Americans underserved by the current financial system:

Across Latin America, the financial system lacks specific offerings that meet the needs of particular groups, such as small businesses and women. Because most traditional credit, savings, and other products available are focused on the needs of large businesses and high-income individuals, people and companies outside of these well-served groups in both rural and urban communities lack access to quality financial products and the information that could empower them as consumers. The lack of specific offerings and financial education restricts underserved consumers to the informal "cash economy", which further limits their ability to graduate to formal credit, savings, or other more secure financial products.

Latin America needs a multi-pronged solution to address these financial health challenges and the problems associated with them. Village Capital believes that local entrepreneurs who understand these problems first-hand are best positioned to increase access to affordable financial products and services, in particular those that:

- **Include** strong financial education components and transparency around product features to address the needs of specific populations, helping them make better informed decisions when selecting financial products, including insurance, pension plans, and other forms of savings;
- **Enable** financial institutions to adopt technology and better gather data to identify users and meet know-your-customer (KyC) compliance, through databases, networks of data, and application of blockchain and related technologies;
- **Formalize** financial operations through digital banking and other strategies;
- **Innovate** in credit scoring to increase access to more affordable loans for people who previously did not have access to credit; and
- **Improve** or build upon existing distribution channel infrastructure for financial institutions to serve rural and urban un- and under-banked populations.

The Village Capital FinTech: Latin America program will deliver Village Capital's award-winning process, centered around personalized content and peer-learning. At the end of the program, participating entrepreneurs will rank each other to choose the top two companies solving major problems in financial inclusion in Mexico. These two peer-selected companies will be offered $75,000 USD investment each, from VilCap Investments.

Do you have a FinTech solution to these financial inclusion challenges?

If you or someone you know is developing a solution and could benefit from participating in the 2017 program, we want to know!

Applications for *Village Capital FinTech: Latin America 2017* are open through June 30 at vilcap.tl/FTLA17*.*

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