Impact of the financial turmoil on MFIs[1]

Introduction

This paper discusses the influence of the financial turmoil on MFIs and how MFIs can cope with the emerging challenges. MFIs and their clients have proven to be fairly stable during previous Asia, Rouble and Peso crises at the end of the last millennium. However, it is likely that the current financial turmoil will have greater influence on the micro finance sector; first because the global economy will be affected (which will diminish remittances, tourism and demand for commodities from developing countries) and second because many MFIs are more linked to the global financial markets than previously.

Higher costs of capital, lower demand

The financial crisis will affect the MFIs at least in the following ways:

- It will become more difficult and expensive to attract funding as capital streams dry-up due to lack of confidence in the repayment capacity of counterparts. This is also happening for MF-funders that get their funding from sources such as pension funds, banks and individuals, which are directly affected by the crisis.
- Shorter term credits will prevail. This direct impact on MFIs will be noted when attracting (new) funding; credit terms will possibly be shorter as the funders might be afraid that they are not able to refund their own funding and because they are less sure that they will get their outstanding credits back (the very nature of crises is the unknown nature of unknown factors, which funders considered manageable previously)
- The global economic slowdown will likely diminish demand for micro finance. A direct impact of the financial crisis is that the global economy is slowing down, which negatively influences sending of remittances, tourist spending and commodity exports and – consequently - those working in export related industries. Hence, it is likely that the economies of developing countries will slow down, which will slow down demand for micro finance.

Coping with the crisis

MFIs will have to deal with a period of limited liquidity. Total demand for micro finance may slow down, while cost of capital increases. This double attack puts MFIs to the test. We recommend the following:

Spread funding risk. First, the MFI will have to get its figures right and determine the total costs of capital it could afford, preferably by comparing the *additional* income versus the *additional* costs of funding. This gives a clear idea till where the MFI can negotiate prices with funders. Second, the funding sources need to be diversified to diminish current and future funding risk by having at least 3 funders for smaller MFIs and 5-10 funders for medium sized MFIs. The funders should preferably be from different countries, continents and backgrounds to diminish risk.[2] Third, relations with these funders deserve extra attention as the crisis will put a strain on the relations: repay and report on time and consider appointing a funder relationship manager. Fourth, the local market

[1] TJAS-discussion papers contain general lessons learned. Contact Marnix Mulder (*marnix@triplejump.eu*) or Lukas Wellen (*Lukas@triplejump.eu*) for more information.
[2] Diversify between funders with investor and with donor money.

should be tapped to diversify funding opportunities. Even though these markets are often quite shallow, they may be less affected by the financial crisis. Finally, the MFI may want to attract long-term savings if allowed by the financial authorities.

Manage liquidity. A liquidity plan that shows when which amounts are needed for at least the coming 12 months is the first step to avoid liquidity problems. The liquidity plan should be discussed monthly, with the operations and credit managers giving their projections and the finance manager showing which progress has been made in attracting funding. The MFI could consider installing a Treasury committee or an Assets-Liability committee for high level support and control. For MFIs borrowing and lending in a different currency, it is useful to follow the currency mismatch and to estimate regularly the influence of currency movements on profitability and equity. Although most MFIs have short term credits and longer term funding and hence a positive asset-liability mismatch, it is still useful to update the assets-liability matrix regularly.

Spread portfolio risk. To diminish risk on the income side it is recommended to spread the portfolio over areas and sectors by installing sector limits. This is always prudent, but is only practically possible if the MIS captures data about sectors and areas. Note that diminishing credit to clients does not necessarily diminish risk as their credit needs might be fulfilled by other creditors at higher prices which diminishes the financial position of the client and thus increases the risk for all parties involved.

Lean and mean operations. Making the operations leaner and meaner is required to cope with higher costs of capital. Efficiencies can also be used to increase profit and to build buffer capital through retained earnings, which might even decrease the cost of capital as higher capitalised MFIs are perceived as safer by the funding market.
Creating efficiencies can only be done if the MFI knows yields and costs of the different products and branches. Cost allocation or – even better but more complicated to estimate – activity based costing can be helpful in assigning costs to products and profit centres. Where no financial sustainability is likely to happen in the coming period, MFIs should consider discontinuing activities.[3]
Finally, an overall cost-benefit consideration of the organizational structure and procedures is useful. More employees, business units or procedures do not always solve issues, but might only create additional work.

All of the above mentioned issues apply also in normal economic times, as they structurally improve management information, diminish funding risk and make operations more efficient. However, it is the urgency of the current situation that places these improvements on the top of the agenda. It is the same sense of urgency that creates the opportunity for management to enforce difficult, but long lasting structural improvements that will allow the MFI to jump to the next level and have it serve its mission even better.

[3] Remember to estimate how these actions would influence overall sustainability, as overhead costs would have to be assigned to the remaining activities. Furthermore, some MFIs operate at a loss as they do not charge sustainable rates to their clients. Even though this might be useful for them in the short term, the results in the long-run might be negative both for the clients and the MFI as the MFI will not be able to build buffer capital, will therefore have difficulties attracting funding, will therefore have difficulties reaching more people and as a result will have difficulties reaching economies of scale.