Financial Services
Special Report

Microfinance Through the Crisis

Some Lessons from Eastern Europe and Latin America

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Related Research

- *Microfinance - Testing its Resilience to the Global Financial Crisis (January 2009)*
- *The Microfinance Sector - Its Success Could be its Biggest Risk (June 2008)*
- *Microfinance Institutions - Factors in Risk Assessment (June 2008)*
- *Nicaraguan Microfinance Sector Facing Increasing Challenges (September 2009)*
- *Sovereign Review (June 2009)*

Summary

The timing and speed of microfinance institutions' (MFIs) recovery from the crisis will depend on their operating environment, but also on institution-specific factors. The economic slowdown in eastern Europe and Latin America in 2009-2010 will undoubtedly affect the outlook for MFIs in those regions. MFIs in countries where financial systems are constrained by funding imbalances, eg many eastern European and central Asian countries, will find recovery much slower.

The regulatory framework in which MFIs operate will either support their growth or interfere with their development. An MFI's institutional capacity — including quality of management and corporate governance, as well as its credit and operational risk management systems — will be key, as will the strength of its underwriting standards, commitment to a clear social mission, and sources of support from shareholders or international microfinance networks.

Overall, MFIs have reported much slower or even negative growth of their loan book (their main asset) and weakening asset quality in 2009, both of which are putting pressure on their financial performance.

However, not all regions and not all MFIs have been affected equally by the global financial crisis, and there are some mitigating factors: financial performance at well-managed MFIs is often supported by wide net interest margin (NIMs); reported asset quality ratios often remain stronger than those in their respective banking sector; access to long-term funding from international financial institutions (IFIs) helps to manage refinancing risk; and for some MFIs, their risk profile benefits from institutional and funding support from international microfinance networks.

Microfinance Through the Crisis

In a special report, "*Microfinance - Testing its Resilience to the Global Financial Crisis*" (see *Related Research* in left-hand sidebar), Fitch put forward its view that the microfinance sector was coming under pressure from the global financial crisis.

Asset Quality Worsening

Arrears rates reported by MFIs have increased across the globe, as has the use of restructured/reprogrammed loans. There are several main drivers for worsening arrears rates.

- MFI borrowers have lower levels of income (from business income or remittances), which reduces their ability to service existing loans as well as their demand for new loans.
- In some countries, particularly in eastern Europe (eg Ukraine), strong local currency devaluations against the USD have put repayment pressure on borrowers who are servicing USD loans but have no FX income.
- MFIs' repayment rates have been affected by political pressure for non-payment (see *Case Study: Nicaragua* below and *Related Research*).
- Over-indebtedness has resulted in arrears, particularly in countries which have seen large increases in consumer finance and high levels of competition from both MFIs and the banking sector before the crisis (see *Case Study: Bosnia & Herzegovina* below).

Financial Performance Under Pressure

MFIs' financial performance is undoubtedly coming under pressure from higher impairment charges, linked to a deterioration in asset quality (partly due to high rates of loan loss provisioning, typically more than 100% of loans in arrears more than 30 days), stagnant/negative loan portfolio growth and higher funding costs. Absence of loan growth in an environment of reduced new lending (driven by lower demand but also by MFIs' more stringent lending criteria) can be quite rapid for MFIs, given that the majority of their loans are annuity loans with monthly principal repayments, although this acts as an important source of internally generated liquidity.

Case Study: Nicaragua

Non-performing loans in Nicaraguan MFIs have increased since July 2008, after the president's public call on debtors of such institutions to breach the payment of their obligations, thus leading to the creation of the "Movement of No-Pay". This movement has also been responsible for acts of vandalism against some MFIs, leading to a further escalation of the business environment risks.

In light of the adverse local environment and the increased pressure on loan portfolio quality, Fitch expects greater levels of non-performing loans, restructurings, write-offs, and executions of foreclosed assets, which would result in further deterioration of the risk profile of MFIs in Nicaragua.

Case Study: Bosnia & Herzegovina

At end-Q309, Bosnia & Herzegovina, a small country with population of 3.7 million, counted 26 MFIs. The 13 members of the Association of Microfinance Institutions (AMFI), which `account for the bulk of the sector, reported a fall in gross loans to EUR0.5bn at end-Q309 from EUR0.6bn at end-2008.[1] The banking sector consisted of 30 banks[2] (21 of which were foreign owned) and reported gross loans of EUR7.4bn at end-H109. Both the MFI and the bank sectors had registered strong growth in their loan books in the years leading up to Q408 (2007 growth of 85% and 28%, respectively), when the financial crisis hit the country.

MFI growth had been financed by relatively cheap cross-border funding from microfinance investment funds (MIVs), as well as by funding from local commercial banks. Banks, the majority of which are foreign-owned, benefited from funding support from their parents. The availability of funding led to high levels of competition, to which MFIs responded by loosening their underwriting standards (eg increasing maximum loan amounts and widening loan purposes) and introducing new products (eg consumer loans). In the absence of a centralised credit bureau until 2008, this led to relatively high levels of cross- and over-indebtedness among MFI borrowers.

With the onset of the financial and economic crisis, these borrowers started experiencing repayment pressures, as remittances fell, unemployment rose and business turnover fell. Loans in arrears increased sharply: by end-Q309, AMFI members were reporting loans in arrears more than 30 days of 6%, which came as a shock for a sector used to reporting arrears rates of less than 1%. In parallel, funding became less available and more expensive for MFIs, and they were forced to adjust to a stagnant/low growth scenario, put increased attention on arrears management, and in many cases put on hold plans for transformation to deposit-taking structures. Fitch expects further increases in levels of non-performing loans, restructurings and credit-related losses.

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[1] MFI sector data from AMFI; MIX and AMFI, "Bosnia and Herzegovina Microfinance Analysis and Benchmarking Report 2008"

[2] Bank sector data from Central Bank of Bosnia & Herzegovina Bulletin 2, 2009

Mitigating Factors

There are relatively strong regional variations: MFIs in eastern Europe and central Asia are having to deal with more severe economic adjustments than those in Latin America; but they also have shorter institutional memories and experience, which likely affects their response to the macro environment. The performance of MFIs in central America seems particularly affected by political risk or uncertainty. Other regions, for example India, seem to report continued growth and stable asset quality, despite intermittent pressure from political interference and over-indebtedness of the MFI borrower base.

Despite a rapidly worsening arrears rate, in most cases, they worsen from a low base. Headline asset quality ratios of MFIs typically remain better than those reported by their respective banking sectors (see *Case Study: Bolivia*).

The financial performance of MFIs will continue to be supported by relatively wide NIMs. Despite pressure from increasing costs of funds (both customer and wholesale funding), NIMs remain comfortable, due to MFIs' high-yield/high-cost business model.

While funding appeared to be a major challenge for MFIs in 2008, particularly in H208, it was appears to have been less of a constraint in 2009, with many reporting sufficient liquidity as they were less able to place loans to customers. Deposit-taking MFIs experienced pressures on customer deposits in H208, often in line with wider national banking sector trends; but they were typically able to stabilise their levels of customer funding in H109, albeit often at a higher cost. Longer-term funding (often sourced from MIVs and IFIs), has also been forthcoming in 2009, albeit often at a higher cost and in foreign currency. So while funding is available at higher costs, it appears to be sufficient at least to cover the moderate growth levels now being planned by MFIs for 2009-2010.

Case Study: Bolivia

Bolivian MFIs' performance and asset quality indicators have held up better than the banking system's in 2009. The loan portfolio growth rate decreased to 12.4% in January-September 2009 from 30.5% in January-September 2008. This was basically due to stricter measures taken by most MFIs in view of deteriorating loan portfolio quality in an economic environment where indicators have deteriorated less than in its neighbours, in spite of political tensions due to forthcoming presidential elections.

Loan portfolio quality deteriorated slightly, with non-performing loans increasing to a still favourable 1.2% of the gross loan portfolio at end-Q309 (Q308: 1.0%). Coverage is high at 400.1% due to the sector's conservative stance and to higher new loan-loss reserve requirements since end-2008.

MFI loan portfolio quality remains sensitive to potential devaluation of the local currency because 60% of the sector's loans are USD-denominated. This composition reflects the dollarisation of the Bolivian economy, and MFIs' funding mix. However, it creates residual foreign-currency risk for borrowers with no regular foreign-currency income, and this in turn could translate into credit risk for MFIs.

Market liquidity is at record-high levels and has led to high growth rates for savings and term deposit since 2007. High liquidity levels have helped improve the sector's historically tight liquidity ratios, but capitalisation ratios remain low. Fitch does not expect further deterioration of the risk profile of Bolivian MFIs in the coming months, which could lead to rating downgrades.

Outlook

How quickly and which MFIs recover from the crisis will depend on several key factors.

Operating Environment

Growth and performance prospects for MFIs will depend on the macro environment, and on the health of the financial sector in which MFIs operate. Countries where financial systems are constrained by funding imbalances (over-reliance on foreign sources) will find recovery slower, eg many eastern European and central Asian countries.

The economic adjustment — in terms of GDP decline — is less severe in Latin America than in eastern Europe. Fitch forecasts growth of –4.6% in Emerging Europe in 2009 and 1.5% in 2010, compared with –2.5% and 1.9% in Latin America (see "*Sovereign Review*" under *Related Research*). This undoubtedly affects the outlook for MFIs in those regions.

Regulatory Environment

The regulatory framework in which MFIs operate will be important. It can support their growth, for example by establishing a strong regulatory body for MFIs or a credit bureau. In contrast, it can interfere with their development, for example by setting interest rate caps or through government-subsidised loan programmes for the poor.

Institutional Capacity and Risk Management

An MFI's ability to manage the challenges from the operating environment will be critically affected by the quality of its management; its investment in training of staff and loan officers; and adequate risk management processes. The management of credit and operational risks remains a key challenge for MFIs, due to their decentralised labour-intensive business model and to their operations in remote areas.

Strength of Underwriting Standards, Both Historical and Current

A key issue here will be what cushions, if any, were typically built in to an MFI's assessment of a borrower's repayment capacity before the crisis, which could now absorb the fall in the borrower's total income due to unemployment, or lower business volumes.

Also key will be the quality and future performance of an MFI's reprogrammed or restructured loans. Most MFIs (particularly in eastern Europe and central Asia) have no real track-record in arrears management and loan restructuring, and their success in managing this will determine future loan portfolio quality and financial performance.

Mission Drift

MFIs which drifted most from their original mission (for example, as part of a transformation process from non-profit roots to a for-profit status) may have diversified away most from their core products when they leveraged up during "the good times" preceding the liquidity crunch. These MFIs will have to manage this pool of unseasoned loans, typically consumer loans, SME loans, or newly introduced individual loans for MFIs which historically provided group loans.

Funding and Reputation Risk

The management of reputation risk will be a key issue for future funding from "double bottom-line" investors such as MIVs, interested in both a commercial and social impact from their investment. The sector has come under increased scrutiny since the UN Year of Microcredit in 2005 and the award of the Nobel Prize to the Grameen Bank founder in 2006. MFIs will be under increasing pressure to prove their ethical work with vulnerable/marginal population groups and to better document and build a track record with regards to their actual social impact.

While access to this anti-cyclical source of "double bottom-line" funding from IFIs and MIVs is a strength for MFIs' funding profile, access to a stable base of local-currency funding (from customer deposits or local debt issues) undoubtedly remains central to a well-diversified funding base and growth.

Ownership and Support

Shareholders and global microfinance networks (eg Accion, Finca and Opportunity International) will play a major role in supporting the development of their subsidiaries or partner-MFIs in several important areas: in particular, developing adequate risk management processes, sound corporate governance, training for management and staff, access to funding and intra-group liquidity support, and commitment to a clear mission. They also play an essential role for the long-term development of MFIs, by being the clear providers of equity capital, access to which remains crucial for supporting renewed growth.