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"Responding to the Regional Financial Crisis: Practical Strategies for Managing Risk While Planning for Growth"

Encuentro Centroamericano de Microfinanzas
September 10 – 11, 2009
San Salvador, El Salvador

Conference Proceedings

"Microfinance offers one of the greatest opportunities to expand financial services to the poor – but in a changed environment."

– Robert Annibale, Citi Microfinance, regarding microfinance as affected by the global economic crisis

Introduction

Central America, like much of the world, is in the midst of an historic financial crisis. While the early part of the decade brought remarkable economic expansion, the Central American nations are now facing a dramatic contraction on a range of fronts: economic growth, employment, foreign direct investment, exports, and remittances, coupled with rising food and commodity prices. The region's microfinance sector has followed a similar trajectory, witnessing a phase of high growth earlier in the decade before experiencing a series of serious challenges over the past two years, due largely to the current financial crisis.

Aware of the difficulties facing the industry, the Citi Foundation and ACCION International, in collaboration with REDCAMIF ("Red Centroamericana de Microfinanzas"), organized the Encuentro Centroamericano de Microfinanzas on September 10 – 11, 2009 in El Salvador. The conference was specifically designed to focus on the challenges and practical solutions which are needed urgently by microfinance practitioners in the region. Experienced and diverse stakeholders discussed the most pressing issues facing Central American microfinance, shared valuable lessons on risk and portfolio management, and examined strategies employed in past economic and political crises.

Over the course of the conference, a number of recurrent themes emerged, along with practical recommendations to address both near-term difficulties, posed by over-indebtedness, the "No Pago" movement in Nicaragua, and the political crisis in Honduras, and longer-term challenges such as weak regulation, lack of savings mobilization, and competition. The effective resolution of these issues will ultimately allow the industry to emerge leaner, stronger and with greater outreach and product diversity. These recommendations include the following:

1) Management according to *a long-term, strategic vision*
2) *Appropriate adjustments to institutional strategy*, including attention to efficiency and implementation of risk units
3) *Financial stability*, through diversification of funding sources and careful liquidity management
4) *Rigorous credit methodology*, including deeper attention to actual client capacity to re-pay and use of credit bureaus
5) *Client-centric products* and customer service
6) *Internal focus on transparency and governance*
7) Attention to *MFI social performance*, including enhanced consumer protection
8) *Transformation* to a regulated institution and mobilization of savings deposits
9) *Relationship-building with regulators*, through dialogue, coordination, and collaboration
10) *Unity within the industry* and joint efforts towards common goals

The following summary highlights the main areas of discussion – and debate – during the conference. The paper was researched and written by Stephanie Dolan, Senior Program

Specialist, ACCION International. Through her work at the Center for Financial Inclusion at ACCION, she coordinates the Council of Microfinance Equity Funds (CMEF) and works closely with members of the private sector on research and projects related to MFI transformation, investment readiness, and risk management.

The paper is broken into seven segments, with each panel receiving specific attention. The official title of the panel and its speakers are included, followed by an analysis of the panel's proceedings and key recommendations. The preliminary panel, examining the state of the industry, receives the most attention because it laid the groundwork for the subsequent conference discussions.

Panel I: Microfinance and the Crisis: Practical Experiences Responding to the Regional Financial Crisis

- Robert Annibale, Global Head of Microfinance, Citi, United Kingdom
- Diego Guzmán, Senior Vice President of Operations, Latin America & the Caribbean, ACCION International
- Mario Perdomo, General Manager, Fundación Génesis Empresarial, Guatemala
- Raúl Sánchez, Executive Director, Red Katalysis, Honduras
- Victor Tellería, General Manager, Financiera Fama, Nicaragua

The first panel set the scene for the balance of the conference, examining the state of microfinance on a global, regional, and local level, describing the effects of the global crisis on Central American countries generally and the sector specifically, and outlining a range of potential institutional and industry-wide responses to address the challenges facing microfinance in the region.

The panelists described a challenging global financial environment, marked by the economic downturn that began approximately two years ago. The crisis has produced a sharp drop in the flow of capital to emerging markets, reversing the very positive flows of the previous decade.

Emerging markets are now facing the same tight liquidity environment that all financial institutions are facing, experiencing difficulties in securing both international and local funding, especially at an affordable cost. The capital flows to the developing world declined suddenly in 2008, from net banking lending of $401B in 2007 to $167B in 2008, and are expected to continue to decline through 2009, with an estimated *outflow* of $61B by year-end. As Diego Guzmán of ACCION International pointed out, "When the U.S. sneezes, Latin America catches a cold." Indeed, Latin America has caught quite the cold, with a per capita decrease in GDP of more than 3 percent between FY 2008 and 2009 and an expected 3.4MM people unemployed by year end.[1]

[1] Diego Guzmán. 2009, "Retos y desafíos de las microfinanzas en América Latina ante la crisis", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 1. Citing Alicia Bárcena, the United Nations' Economic Commission for Latin America and the Caribbean, 2008 - 2009.

Likewise, the microfinance sector is encountering a difficult operating and financial environment. It is difficult to argue now that microfinance is uncorrelated with the traditional banking market – and "largely due to its own successes," as Bob Annibale pointed out. The industry and some of its premier institutions are now known to prominent players in the capital markets; similarly, microfinance services to a growing portion of the world's population make it an integral part of the global financial landscape. While increasing connectivity has opened up the industry to new and varied sources of funding, as well as innovative partnerships and technology innovations, it has also brought with it the additional risk that comes with integration into the global economy.

Like larger financial institutions in most parts of the world, MFIs face a liquidity crunch, higher costs of funding, rising delinquency rates on loans, and client over-indebtedness. For instance, while the microfinance industry in Latin America grew at a rate of approximately 40 percent per year from 2002 through 2007, with loan portfolios doubling every year, its growth prospects are now much lower, leveling out at an expected 10 percent in 2009.[2] Some of the sector's challenges can be attributed to issues that trickled down from developed countries to the informal sector in emerging markets: the global economic recession, increasing food and commodity prices, rising unemployment in the U.S. and Europe, poor risk management at large financial institutions, and overly-flexible supervision and regulatory practices.

However, panelists pointed out that long-standing issues within microfinance also fed into the difficulties currently facing the industry. *Aggressive competition* has led to the implementation of consumer lending while increasingly *relaxed loan conditions* encouraged institutions to offer additional microloans to already indebted clients, resulting in *over-indebtednes.* Often pointed to as a primary cause of the difficulties currently facing MFIs, these faulty lending practices are partially a result of the *dearth of credit bureaus* for microfinance clients, *weak coordination and collaboration efforts* between local and regional institutions, *insufficient regulatory supervision***,** and *inadequate credit risk management.*

In addition to such industry-specific shortcomings, *adverse political intervention*, *popular unrest*, and *declines in remittances* have emerged as key, unique regional difficulties. The political environment in Honduras has destabilized the country, leaving many wondering how microfinance may be affected. More worrisome, the "*No Pago"* movement in Nicaragua has spurred popular demonstrations and vandalism against MFIs while government-sanctioned demands for debt forgiveness scapegoat financial institutions for the economic difficulties facing the country's low-income population, placing microfinance in a tenuous position. These hardships are compounded by the significant declines in remittances from the U.S. and Europe; remittances for the region are expected to be approximately $64B in 2009, down 7.7 percent from 2008.[3] When combined with *reduced tourism* (estimated to be 10 percent less in 2009, compared to 2008), *declines in production and trade*, and *rising unemployment rates*, these economic difficulties have directly affected the ability and willingness of microfinance clients to pay back their loans.

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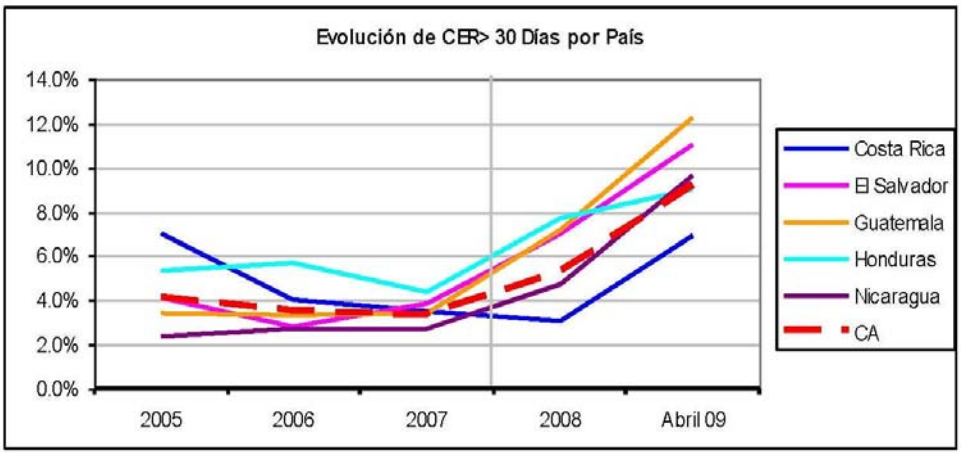
[2] Diego Guzmán. 2009, "Retos y desafíos de las microfinanzas en América Latina ante la crisis", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 2.
[3] Reynold Walter. 2009, "Estrategias Exitosas para el Futuro", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 4.

Faced with this combination of economic, financial and political challenges, the microfinance industry in Central America finds itself in the middle of its own crisis. REDCAMIF, the regional microfinance network of networks serving MFIs in Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama, reports that its membership has seen a 14 percent decrease in portfolio size during 2008 through April 2009, compared to a previous 34 percent annual growth rate from 2005 to 2007[4]. Even more dramatic is the increase in portfolio at risk (PAR); while the trend is significant in all Central American countries, as demonstrated in Table 1, it is particularly troubling in Nicaragua, where PAR>30 rose from 5.8 percent in June 2008 to nearly 11.6 percent by June 2009.[5] This decline in both loan demand and in clients' ability to pay (and, in some cases, willingness to pay), coupled with reduced availability of funding and increased costs associated with it, has contributed to a lack of solvency at MFIs, declining liquidity, shrinking profit margins, and difficulties in meeting the covenants in their investors' loan contracts and provisions required by their regulators.

Table 1: PAR>30 for members of REDCAMIF[6]



In light of both the global and regional crises, MFIs have had to change their growth and strategy plans – and, as Bob Annibale pointed out, they have proven to be more prepared to do so than the mainstream banking sector. While MFIs are undoubtedly facing a difficult operating environment, they have demonstrated an openness and flexibility to adjust to the different market conditions and needs of their clients. Diego Guzmán emphasized that, although the Latin and Central American economies are on the slow road to recovery, MFIs must remain focused on long-term strategies if they hope to set a path to recovery that is truly sustainable: "Typical reactions to the crisis are generally short-term and in many cases driven by the need for basic survival. Short term action is not enough; we must ask basic questions and attack fundamental issues."

[4] Ibid, p. 7.
[5] Victor Tellería. 2009, "Las Microfinanzas en Nicaragua", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 9. Please note that this data is for ASOMIF members, the majority of which are unregulated institutions.
[6] Reynold Walter. 2009, "Estrategias Exitosas para el Futuro", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 8.

Panelists from a Central American microfinance network and from two Central American MFIs presented their organizations' responses to the current crises, emphasizing steps to be taken in the near term (within 120 days) and those that involved more strategic, long-term actions. Although each institution had its own approach, a number of recurring themes emerged from their recommendations:

1) *Increased focus on portfolio health (near-term)*: Mario Perdomo of Genesis Empresarial in Guatemala stressed his institution's renewed determination to grow their portfolio conservatively and with the right kind of clients. Loan officers will be trained to search out these targets, at the same time that the institution launches an advertising campaign designed to build up brand recognition and loyalty.

2) *Re-examine MFI strategy (near-term)*: Raúl Sánchez of Red Katalysis spoke of the strategic assessment process that its network institutions are currently undergoing. Each institution is evaluating its existing strategic plan, with particular attention on scaling back unnecessary expansions, focusing on internal governance, and strict adherence to financial standards.

3) *Increased efficiency (near-term):* All panelists acknowledged the fact that, given narrower profit margins, MFIs will have to implement "austerity plans" to limit costs, monitor productivity, and ensure appropriate disbursement of funds. Diego Guzmán cautioned that in the future, efficiency will be the factor that differentiates leading institutions from second-rate players, and will ensure their sustainability.

4) *Review credit policies (near-term):* Risk managers and loan officers at all the panelists' institutions are reviewing existing credit policies. For example, Red Katalysis has seen its institutions implement stricter criteria for granting microloans, as well as instituting collateral requirements and other guarantees. Genesis is working to strengthen its methodology for assessing new customers, collecting payments, and provisioning for its portfolio.

5) *Financial stabilization (long-term):* MFIs are re-examining their funding needs in both the short and long term, and are reaching out to current and potential sources of capitalization. Red Katalysis encouraged its member institutions to emphasize savings products as a source of institutional capital, as well as bridge loans, guarantees, and subordinated debt.

6) *Client-centric products (long-term):* MFIs must ensure that their products are not only appropriate for their target markets, but also in demand. By producing alternative products for insurance, housing, healthcare, education and offering financial literacy programs and innovative distribution channels, institutions can make themselves more attractive to both current and potential customers.

7) *Invest in human capital (long-term):* Red Katalysis and Genesis advocated for increased focus on training, professional development, and appropriate incentive plans for staff to improve retention.

8) *Transformation to a regulated institution (long-term):* Panelists recommended that unregulated NGOs transform to regulated status, in order to mobilize deposits, which offer an additional source of capital and an added source of stability in times of financial crisis.

Victor Tellería of Financiera FAMA, a regulated MFI in Nicaragua, cautioned that these adjustments should not be made in a vacuum, on just at the institutional level. Rather, many of the changes call for collaboration among industry players in the region:

1) *Unity within the industry:* In situations like Nicaragua, the industry would benefit from a collaborative, not competitive, environment. Together, institutions could work on a campaign to rebuild a culture of repayment.

2) *Increased usage of credit bureaus:* MFIs should work with local authorities to make information from credit bureaus more useful and accessible to microfinance practitioners, or launch credit bureaus where they do not exist.

3) *Relationship-building with regulators:* Given the decisive role that central banks and supervisory authorities can play in microfinance, it is in the industry's best interest to educate the local regulatory authority on the sector and its products, methodology, needs and most important, impact on the lives of its target clients.

4) *Relationship-building with international organizations:* Having support from various international organizations may not only provide a buffer against harmful political intervention in microfinance, but it can also provide additional sources of funding.

Coming out of the opening panel, the general consensus was that, despite the difficulties, the microfinance sector is proving resilient and making appropriate adjustments to meet the industry's many challenges. A quote from Alicia Barcena of the Economic Commission for Latin America & the Caribbean captures the tone: "The engine of growth has come to a standstill and the hazard lights have come on. There are signs that the worst is over, but recovery will be slow."[7]

[7] Diego Guzmán. 2009, "Retos y desafíos de las microfinanzas en América Latina ante la crisis", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 1. Citing Alicia Bárcena, the United Nations' Economic Commission for Latin America and the Caribbean, 2008 - 2009.

Table 2: The 2008 Financial Crisis: Effects on the microfinance sector[8]

Before the Crisis	After the Crisis
The public sector (local and international) displaced the prívate sector.	The public sector (local and international) complements the private sector.
Sector believed to be counter-cyclical.	Sector is more tied to and reflective of the global economy than previously thought.
Sector growth of 30-40%.	Sector growth less than 20%.
Default rates considered to be "under control".	Default rates on the rise – rapidly.
Mobilization of savings deposit considered optional.	Mobilization of savings deposits considered key for future funding.
Regulation and supervision considered relevant, but not necessary to regularly engage.	Regulation and supervision considered imperative, particularly for risk and liquidity management.
Concentrated funding sources considered acceptable.	Diversification of funding considered necessary.

Panel II: Funding Microfinance in Central America

- Sandra Darville, Chief, Access to Finance Unit, Multilateral Investment Fund, Inter-American Development Bank (IDB), United States
- Gustavo Santivañez, Investment Officer – Central America, Triple Jump, Peru
- Carlos Felipe Galdámez, Country Director, Oikocredit, El Salvador
- Nicolas Blondeau, Investment Manager – Central America, Incofin, Belgium

Speakers on the second panel represented funds active in Central American microfinance, through a range of debt instruments (loans, bonds and subordinated debt), direct equity investments in MFIs, and technical assistance.

Highlighting the difficulties facing the industry, particularly competition, rising PAR, over-indebtedness, slower growth and shrinking margins, investors have witnessed a troubling increase in the number of investee MFIs having difficulty meeting loan covenants. As of June 2009, 83 percent of Oikocredit's MFI loan recipients in Central America are in breach of at least one covenant, up markedly from 39 percent in October 2008.[9] Incofin investment officer Nicholas Blondeau pointed out that while 43 percent of its South American investees have failed to comply with one or more covenants, 80 percent of itsr Central American investments were in

[8] Sandy Darville. 2009, "Entorno de negocios para las Microfinanzas: Qué se ha logrado? Qué falta por alcanzar?", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 4.
[9] Carlos Felipe Galdámez. 2009, "Fondeo de Micro Finanzas en Centro América: Efectos Inherentes de la Crisis y Provisión de Recursos Financieros a la Región", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 12.

non-compliance.[10] Sandra Darville of the IDB highlighted the aggressive competition, difficult regulatory frameworks, and political intervention as key concerns to investors active in the region.

Generally, investors are taking a more cautious approach when extending additional capital. All of the panelists explained that they have not only adjusted their methodology to reflect the increased risk, but also their expectations. For instance, Oikocredit now performs a *more rigorous analysis of more detailed financial statements and organizational documents*, both during due diligence and portfolio monitoring. Additionally, due diligence will focus heavily on an MFI's *liquidity and risk management practices* and *the quality – not quantity – of its microcredit portfolio*. *Country risk* is drawing more attention at both Triple Jump and Oikocredit, as is an MFI's *social performance* and compliance with good *client protection practices* as embodied in the global Smart Campaign. Oikocredit is also *reducing its average loan size* in the region from $2MM to $1MM and *restructuring debt agreements* to meet revised MFI forecasts, needs, and capabilities; as evidence of this, Oikocredit has *raised its threshold for PAR* at its investees from 8 percent to a more realistic 10 percent. Perhaps the key takeaway from the adjustments made by these investors is their plan to *increase contact and collaboration* not only with MFI management, but also with other investors and even regulators.

Although the panelists agreed that the region will eventually recover from the economic crisis, they shared the view that the funding needs of MFIs may be difficult to meet in the coming year: interest rates on debt financing are expected to remain at current (high) levels through the first half of 2010; equity capital may not be readily accessible to the majority of MFIs; and investors even questioned whether international financial institutions (IFIs) will have sufficient resources to meet the needs of the industry, even as the sector forecasts much slower growth.

To address these concerns, investors offered a number of recommendations to MFIs.

1) *Transformation into a regulated entity (individual institution):* Panelists underscored this time and time again, emphasizing the stabilizing role that savings deposits can play for an institution's capital during periods of crisis. Nicholas Blondeau presented particularly pertinent data on the positive effect of deposit mobilization for MFIs, indicating that both an institution's ROE and its ability to meet covenants in difficult financial times correlate positively with its ability to take savings deposits.[11]

2) *Increased efficiency (individual institution):* Investors stressed the importance of strong cost controls and effective liquidity management – both in boom and in bust times.

3) *Relationship-building (industry initiative):* All panelists emphasized the need for increased collaboration and communication in times of crisis. Industry players –

[10] Nicholas Blondeau. 2009, "Fondeo de Micro Finanzas en Centro América", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 11.

[11] Ibid, p. 6-8. Nicholas Blondeau's presentation compares Incofin's South American portfolio performance (in which 27 percent of capital comes from savings, as many of its investees are regulated institutions capable of offering savings deposit products) with its Central American portfolio performance (in which 1 percent of capital comes from savings because the majority of investees are unregulated NGOs unable to mobilize deposits).

practitioners, funders, donors, and regulators – must seek out strategic alliances, build relationships, and improve understanding between each other in order to develop an environment conducive to the stability and future growth of microfinance.

4) *Improve sector's transparency (industry initiative):* To become a more mature, transparent industry, institutions must work together with each other, funders, international organizations, and regulators to create uniform accounting rules, terminology, and reporting standards.

The above recommendations reiterated key takeaways from the first panel, fleshing them out by adding the unique investors' perspective; however, the final recommendation coming out of this panel represents a new suggestion:

5) *Focus on an MFI's social performance:* Investors drew attention to social performance, both as an increasingly-important aspect of their due diligence, but also as a potential remedy to the problems of over-indebtedness and consumer lending plaguing Central America. This could range from considering an MFI's impact on a client's economic well-being along with his community and the environment.to appropriate client protection practices and collections methodology. Please see Panel 5 for a more detailed discussion of this topic.

Panel III: Learning from Previous Financial Crises in Latin America

- José Andrade, Economist, Banco Pichincha, Ecuador
- Leonor Melo de Velasco, CEO, Fundación Mundo Mujer Popayán, Colombia
- Juan Uslar, CEO, BanGente, Venezuela
- Enrique Ferraro, ACCION Investments in Microfinance, re: BancoSol, Bolivia

Over the last ten years, Latin American microfinance has faced, and ultimately overcome, a number of dramatic set-backs. Whether it was an economic meltdown in Ecuador, government-run microfinance in Venezuela, interest rate caps in Colombia, or over-indebtedness in Bolivia, the MFIs in these countries have battled difficult odds and demonstrated flexibility and a true dedication to their mission to not only adjust to these conditions, but surmount them.

This panel summary addresses each individual panelist presentation, including background on the relevant crisis, effects on the microfinance sector, and key takeaways that may be applied to Central American challenges.

1. The 1999 financial crisis in Ecuador

What happened? Between 1998 and 1999, Ecuador went through a punishing economic crisis: GDP fell by 7 percent; approximately 65 percent of households and businesses were affected, with between 6,000 and 7,000 businesses failing and household and business wealth contracting

by $700MM.[12] Interest rates spiked in 1999, fueling speculation and loan defaults; the resulting economic deterioration caused many to lose confidence in the government and financial markets, breeding not just economic problems but political troubles as well. The crisis crippled the private banking sector, and the government had to take over 70 percent of the system.

How was microfinance affected? In 1999, microfinance, mainly in the form of credit cooperatives, was still in its early phase. In 1999, deposits at Ecuadorian MFIs fell by 15 percent and the loan portfolio shrank by 51 percent.[13] The cost of funds increased in local currency and availability of funding in dollars was limited to only a few institutions. However, the impact of the crisis on microfinance was significantly less than on the rest of the financial sector. In 1999, while the number of private banks dropped from 40 to 28, the number of microfinance cooperatives actually increased from 25 to 26.[14] MFIs also fared better with repayment rates and witnessed lower levels of non-performing loans.

What are key lessons learned? José Andrade attributed the decimation of the financial sector to a concentration in its loan portfolio, exposure to a collapsing local currency, and inadequate regulatory supervision. Aspects of these underlying problems are apparent in the current economic crisis, and underscore the importance of *appropriate regulatory supervision* – both of the financial sector, and of the microfinance sector. They are also evident in the regional microfinance crisis, and emphasize the need for *local funding*, improved *monitoring* and increased *diversification* of an institution's loan portfolio.

What did microfinance and Banco Pichincha do right? José Andrade credited microfinance's ability to withstand the crisis of 1998-1999 to its *highly diversified portfolios and funding sources*, as well as the institutions' *local knowledge of clients and the market*. More specifically, he highlighted the fact that, in the midst of the crisis, Banco Pichincha – and its microfinance division – benefited from its conservative management policies, relative to credit risk, investments, and liquidity management. The numbers speak for themselves: Banco Pichincha's ROA in 1999 was 1.21 percent, compared to a negative 16 percent for the financial sector as a whole.[15]

2. Interest rate caps in Colombia

What happened? In 2006, Colombia put into place new regulatory laws that would dramatically affect the reporting requirements and general operations of MFIs. The legislation was designed to implement the requirements of Basel II regarding capital adequacy, market discipline, and public disclosure. It also created the *Superintendencia Financiera*, the supervisory authority for the country's financial system, including microfinance. Part of the legislation encouraged the expansion of financial services to underserved Colombian citizens; microfinance was named a priority and commercial banks and cooperatives were mandated to begin offering microfinance products to clients. At the same time, the legislation established official interest rates and usury

[12] José Andrade. 2009, "Aprendiendo de las anteriores crisis financieras en América Latina", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 2.
[13] Ibid, p. 13 – 14.
[14] Ibid, p. 15 and 18.
[15] Ibid, p. 28.

rates for microfinance, consumer credit, and regular credit, implementing rate caps and requiring all institutions to disclose all rates to customers.

How was microfinance affected? With the forced entrance of commercial banks into microfinance, NGOs and regulated MFIs now had to compete with much larger institutions with more financing, better infrastructure, and more sophisticated back-office technology. At the same time, NGOs and specialized MFIs faced interest rate caps that limited how much they could charge clients; such caps often end up causing MFIs to withdraw from the market, grow more slowly, become less transparent about total loan costs, and/or reduce their work in rural and other harder-to-reach and thus more costly markets. With a ceiling on potential revenues, institutions in Colombia face the difficult position of providing innovative services to appropriate markets while coping with intense competition and strict cost controls in order to maximize narrow profit margins.

What are key lessons learned? As interest rate caps are of particular concern to Central American MFIs given the left-wing political environment, Leonor Melo clearly outlined a number of actions taken by FMM Popayán to address these challenges. First and foremost, she underscored the need to focus on *efficiency* and effectively *manage operational costs*, through performance monitoring systems, careful budget review, and proximity to clients. She also pointed to the need for *industry-wide systems, standards, and benchmarks*, which would ensure *transparency*, full disclosure of lending costs, and a level playing field for all practitioners. She emphasized the importance of *rigorous credit methodology* for extending and collecting loans, as well as *customer service* by well-trained, motivated employees who embrace the institution's mission and values. Finally, she too drove home the need to be *flexible* in order to cope with regulatory changes, and highlighted the importance of *constant dialogue with the government*, both legislators and regulators.

3. Competition with government-run microfinance in Venezuela

What happened? BanGente was founded in 1999, the same year that Hugo Chávez was first elected President of Venezuela. As the government moved towards socialism, it favored the provision of microfinance services via state-owned entities – initially, public sector MFIs, but more recently, publicly-funded community banks and cooperatives. Despite the discouraging environment, a number of private MFIs were created in 2006 and 2007. However, over time, as microenterprises have come to be seen as too capitalistic, the government implemented regulatory constraints (reserve and risk asset requirements) that were extremely difficult for these private MFIs to meet. As a result, although the government ultimately reduced these requirements, these changes came too late for most of the private lenders, several of whom had ceased operations or were in very weak financial condition by this time. BanGente, however, remains in good financial and operational shape.

What are key take-aways? Juan Uslar expects that BanGente will be one of the few meaningful microfinance banks in Venezuela, given the difficult operating environment, including high inflation, zero or negative economic growth, and the growing provision of loans and other financial services by government-owned entities at the expense of private businesses. It would be easier to operate profitable, sustainable institutions under the following conditions: access to

the country's *credit bureau*; *special tax treatment* for the microfinance sector; *uncapped interest rates*; more *flexible labor laws* to reduce operating costs; and an economy and government favorable to the private sector.

4. The over-indebtedness crisis in Bolivia: 2000-2002

What happened? In the late 1990s, an unexpected nation-wide recession in Bolivia combined with profound over-indebtedness to create a crisis that rocked the microfinance sector to its core. The entrance of aggressive consumer lenders into the lower income demographic led to intense competition with MFIs; to remain competitive, MFIs had to expand their product offerings, bringing benefits to clients such as faster turnaround and larger loans at lower prices. However, the competition to retain existing clients and attract new clients bred excessive over-indebtedness among MFI customers. Demonstrations against financial institutions, including MFIs, were launched by debtor associations, often backed by local politicians. The demonstrators demanded full debt forgiveness. These challenges, combined with unprecedented delinquency rates at MFIs, a dramatic slowdown in client growth rates, and drastic cuts in profitability, created a dire situation for microfinance institutions in Bolivia.

What are key takeaways? With the onset of the national crisis and the resulting decline in clients' ability to pay, the dangers of consumer lending practices, inadequate credit methodology, and client over-indebtedness rapidly became evident in the MFIs' bottom lines. It became clear that the institutions' previous growth and profits had masked default rates in past years - similar to the situation currently facing the institutions in Central America.

Enrique Ferraro, a long-time member of the Board of Directors of BancoSol Bolivia, outlined the various tactics employed by the industry to address the many dilemmas then facing the sector. Practitioners combated delinquency by placing greater *emphasis on client assessments* before the extension of credit, with particular attention to *tangible collateral*; at the same time, they also came to rely more heavily on *credit bureaus*. Institutions reformulated *staff performance targets* and focused incentives more narrowly on portfolio quality and successful collections. In the longer term, institutions focused on *innovative new products*, both to meet clients' needs, but also the institutions' needs for speed, efficiency, and cost-effectiveness. They also focused on *deposit-taking as a source of capital* and financial stability; those organizations that were unable to mobilize deposits re-focused their strategic plans on *transformation* into a regulated institution.

How has Bolivian microfinance responded to the current crisis? As of June 2009, BancoSol boasted a PAR>30 of 1.05 percent and ROE of 26.5 percent.[16] Enrique Ferraro attributed this success to a number of factors, but particularly BancoSol's focus on *quality growth*, *negligible arrears*, and *rigorous credit assessments*. He pointed out that while it is difficult to implement such significant changes in a short period of time – and it may not be possible for Central American MFIs to do so to resolve this economic crisis – such changes can dramatically benefit an institution in the long term.

[16] Please note that the ROE is an annualized number and does not factor in voluntary reserves.

Panel IV: Reviewing and Managing Risks: Results from *Microfinance Banana Skins 2009* & Implications for Central American MFIs

- Deborah Drake, Coordinator, Council of Microfinance Equity Funds (CMEF), United States
- Juan Carlos Pereira, Manager, Emergency Liquidity Facility (ELF) and Risk Management Facility (RMF), and Partner, Omtrix, Costa Rica
- Luis Felipe Derteano, President, ACP Holding, Peru
- Armando Gutiérrez, General Manager, PRESTANIC, Nicaragua

With the global financial crisis directing worldwide attention to risk and risk management, this topic has also become a central topic of conversation and issue of concern in microfinance. This panel centered its discussion on risks facing microfinance, regarding both the broader sector, and more specifically, the circumstances in Central America. The centerpiece for the discussion was the *Microfinance Banana Skins* report, which was published in July 2009 as a collaborative effort between the Centre for the Study of Financial Innovation (CSFI), Citi, and CGAP, with the support of the Council of Microfinance Equity Funds (CMEF). The report is based on the results of a survey distributed across the industry, to over 1,800 practitioners, investors and donors, policy makers, sector experts, and others, asking respondents to rank a list of 29 risks facing commercial microfinance, with the ultimate goal of raising awareness of the top risks. The 2009 edition was the second report of its kind for microfinance; the first report was produced in 2008, and provided a "base line" by which to compare following reports. As a result of the financial crisis, the 2009 findings have shifted significantly.[17] The top five risks from 2008 and 2009 are listed below:

Five Biggest Risks Selected in 2008

1. Management quality
2. Corporate governance
3. Inappropriate regulation
4. Cost control
5. Staffing

Five Biggest Risks Selected in 2009

1. Credit risk
2. Liquidity
3. Macro-economic trends
4. Management quality
5. Refinancing

As a member of the survey's Steering Committee, Deborah Drake of the CMEF presented the findings of this year's *Microfinance Banana Skins*. The 2009 report paid particular attention to the effects of the crisis on microfinance, how it has changed the risk landscape of the sector, and how the industry has reacted. Deborah compared this year's results to 2008, highlighting the dramatic shift in the top five risks; in 2009, *credit risk, liquidity, the macro-economic environment, management quality and refinancing* topped the list, compared to management quality, corporate governance, inappropriate regulation, cost control and staffing in 2008. Luis Felipe Derteano of Grupo ACP also pointed out that many of 2008's top risks remain fairly high on the list of 2009's rankings; they only moved down the list in 2009 as the more immediate, pressing concerns got top billing. He fully expects, as do the report's authors, that these long-term concerns, such as governance and management quality, will move back up the list as the crisis subsides.

[17] For more information on the *Microfinance Banana Skins 2009* report, please visit: www.csfi.org.uk/Microfinance%20Banana%20Skins%202009.pdf

Not only does the report confirm Bob Annibale's assertion in Panel 1 that microfinance is truly connected to the global economy, but its authors argue that microfinance is "vulnerable but resilient." While microfinance is exposed to deteriorations in the business climate, scarcity of financing and liquidity, and reputational risk, both the authors and the survey respondents adopt relatively positive long-term outlooks on microfinance.

All speakers agreed that those risks highlighted in the 2009 survey appropriately reflected the difficulties in the region as well. Armando Gutiérrez of the MFI PRESTANIC presented his institution's recent results as evidence for many of the Banana Skins findings, demonstrating credit risk by pointing to PRESTANIC's rise in PAR>30 from 4 percent at December 2007, to 6 percent at December 2008, to over 13 percent at July 2009, and tying in the liquidity challenges to his institution's declines in profitability, with ROE declining from 30.6 percent at December 2007, to 16.4 percent at December 2008 to -15.1 percent at July 2009.[18] He clearly explained the interconnections between declining profit margins and declining portfolio performance, weakening efficiency ratios, increased costs of funds, stricter loan covenants and increased provisioning for losses.

Juan Carlos Pereira offered a particularly unique perspective, as Omtrix not only offers a Risk Management Facility but also an Emergency Liquidity Fund (ELF). As a "lender of last resort," ELF was tapped in late 2008 and early 2009 to provide emergency debt financing to MFIs that were experiencing significant – and potentially debilitating – shortages in liquidity. He reported that ELF affiliates in Central America have been impacted by the major risks identified by the Banana Skins report, although not all to the same extent. For instance, he highlighted the particularly difficult liquidity environment in the region given the disproportionately high number of unregulated institutions that cannot accept savings deposits. Between October 2008 and June 2009, ELF distributed $15.6MM to 14 MFIs ($4.1MM to five MFIs in Central America).[19] Of these five institutions, none of them were regulated, and none were taking savings deposits; of the 14 total institutions served by ELF, ten were not able to accept deposits to mobilize capital and depended on loans – mainly from international sources whose capital was frozen – for their funding.[20] So, deposit-taking capability clearly provides greater stability.

Panelists presented strategies on how to manage the Banana Skins top five risks through the crisis. Their recommendations echoed the suggestions presented in earlier panels: MFIs' transformation into regulated institutions, diversification among funding sources, rigorous risk management procedures, and a complete reassessment of their credit practices.

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[18] Armando Gutiérrez. 2009, "Revisión y Administración de Riesgos", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 8 and 12.
[19] Juan Carlos Pereira. 2009, "Disponibilidad de fondos y cambios inducidos por la crisis sobre las IMFs en Centroamérica", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 8.
[20] Ibid, p. 9.

Panel V: Consumer Protection in Microfinance: Setting Guidelines & Standards for Our Industry

- Robin Ratcliffe, Director, The Smart Campaign, Center for Financial Inclusion at ACCION International, United States
- Ismael Medina Nava, Commercial Manager, Caja Morelia, México
- Gabriel Solórzano, President, BANEX, Nicaragua
- William Tucker, Executive Director, SEEP Network, United States

As pressure builds to add clients while cutting staff to streamline operations, MFIs may be tempted to concentrate on their bottom line, rather than on their social mission or clients' wellbeing. Aiming for high growth rates and corresponding profit margins, institutions may pursue growth at all costs – emphasizing quantity over quality, both in the size of their portfolio and the types of products offered. Under the pressures of competition, MFIs may provide financial products that are actually detrimental to clients, but, at least at face value, profitable for the institution. They may also unwittingly incentivize overly-aggressive collections practices to compel repayment. Central America is now witnessing the repercussions of an aggressively competitive environment that has bred mass client over-indebtedness and resulted in sky-rocketing PAR.

What is client protection? Speakers in this panel explained that good treatment of clients is a critical aspect of both the mission of microfinance and sustainable business practice; as Robin Ratcliffe, Director of The Smart Campaign for client protection[21], explained, "Treating clients ethically is not just the right thing to do; it is the smart thing to do." The Campaign was launched in 2009, as a global effort to unite microfinance leaders around a common goal of instituting client protection into all aspects of operations of MFIs, as well as their organizational culture, to better serve clients and strengthen the microfinance industry. With over 700 endorsers to date, the Campaign is working to raise awareness of and consensus around six core principles:

1. Avoidance of over-indebtedness
2. Transparent pricing
3. Appropriate collections practices
4. Ethical staff behavior
5. Mechanisms for redress of grievances
6. Privacy of client data

Why is it important? As prior panelists – both investors and practitioners – evidenced through their comments, an MFI's social performance, particularly around consumer protection, has become an extremely high profile topic in the industry. Within the past year, increasing attention is being paid to this issue, due to a combination of the U.S. sub-prime lending meltdown, the resulting global financial crisis, and the microfinance sector's over-indebtedness troubles, increasing competition, and rising consumer lending in some markets. With increased media and political attention to microfinance, efforts like The Smart Campaign help protect the industry from potentially harmful reputation risk. Moreover, as Ismael Medina Nava of Casa Morelia

[21] For more information on the Smart Campaign, please visit: www.smartcampaign.org .

explained, client protection doesn't just protect the clients: it also protects the institution, its reputation, its employees, its community, and its investors.

What can MFIs do? In addition to endorsing the principles of The Smart Campaign, it is important for MFIs to examine their own policies and practices, identify areas for improvement, and actively promote these principles among staff, management, and board members. Two MFIs that have embraced the client protection initiatives presented their experience with improving their internal methodology. Both agreed that consumer protection begins with *prevention* – MFIs should provide *quality products*, practice *strong credit evaluation policies* to protect against parallel lending, and embrace *customer service*; Ismael Medina Nava highlighted Caja Morelia's institutional philosophy of service, which is deeply embedded in its social mission, staff trainings, and organizational values. In particular, he emphasized how this attitude brings with it a "high touch" service that differentiates his institution from competitors and includes special attention to clients through financial education, convenient procedures, and open communication.

Speakers also highlighted the actual loan *process* as an opportunity to ensure client protection, with a *code of ethics* and *intensive training courses* for loan officers, *internal controls* to *monitor customer satisfaction*, and *evaluations by outside consultants* of their practices. For instance, Caja Morelia invited Beyond Codes[22], a collaborative action research project, to examine the organization and assess how it can best implement client protection practices within its operations. Gabriel Solórzano of BANEX in Nicaragua pointed out the role of *technology* in this initiative, highlighting the use of *specialized software* to examine and classify client data, as well as to access client information in *national credit bureaus*. Finally, he stressed the importance of *transparency*, not only in disclosure of interest rates, but also of client rights and mechanisms for redress of grievances. For a closer look at the state of consumer protection in Nicaragua, please see Table 3 below.

Table 3: Consumer Protection in Nicaraguan MFIs[23]

Principles of Consumer Protection	**State of Consumer Protection within Nicaraguan Microfinance**
1. Avoidance of over-indebtedness	Weak: Over-indebtedness abounds
2. Transparent pricing	Weak: Many unclear fees and charges attached to loans
3. Appropriate collections practices	Moderate to aggressive collection practices
4. Ethical staff behavior	Varied
5. Mechanisms for redress of grievances	Varied based on the institution; there is no relevant legislation
6. Privacy of client data	Adequate: Basic software in place

[22] For more information on Beyond Codes, please visit http://www.centerforfinancialinclusion.org/Page.aspx?pid=1319.
[23] Gabriel Solórzano. 2009, "Protección al Cliente: Tratando a nuestra gente con dignidad", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 4.

What can networks do? Bill Tucker of the SEEP Network, a "network of networks," stated that networks had two real roles in the client protection initiative: *stay informed*, both of risks facing their members and of ongoing solutions being implemented by their MFIs, and *formulate solutions* among members, to ultimately *establish standards and best practices* for the industry.

Panel VI: Collaborating to Advance Financial Inclusion

- Diego Cisneros Salas, Deputy Superintendent of Banks, Superintendency of Banks, Insurance, and Pension Funds, Peru
- Juan Vega, Regional Director, Promifin, Nicaragua
- Juan José Lagos, Vice President and General Manager, Fundacion Covelo, Honduras
- Denise Días, Policy Specialist, CGAP, United States
- Ariel Sanmartín Méndez, Executive Vice President & General Manager, Banco Delta, Panamá

In times of crisis, collaboration between key players in an industry becomes particularly important. While previous panels mentioned the importance of appropriate regulatory oversight and on-going dialogue with legislators, this panel specifically explored the ways in which MFIs, governments and regulators can work together to ensure broader access to financial services for low income people.

Why work with regulators? Supervisory oversight and regulatory requirements ultimately bring improved governance, transparency, standardization and internal controls to a still-maturing microfinance industry. In order to have a truly inclusive financial system, private and public players cannot work independently; rather, as Juan Vega of Promifin pointed out, there are areas of significant overlap that require discussion between these two groups, including interest rates, capital requirements, risk monitoring practices, and deposit-taking products. In the worst cases, an unfavorable regulatory environment can severely limit the growth of microfinance, putting in place difficult financial requirements, burdensome reporting practices, and even limiting the financial services offered by the sector. On the other hand, a positive regulatory environment can foster the development of MFIs, ease the development of new products, provide healthy capital and liquidity requirements that stabilize institutions, increase transparency to protect clients, and standardize that country's microfinance industry.

Where has this worked? Diego Cisneros Salas of the Peruvian Superintendency of Banks provided an interesting case study on the successful collaboration between his country's microfinance industry and the government. The government recognized from the beginning that the informal sector, particularly microfinance, is an important part of the Peruvian economy, and was determined to design a regulatory environment that would strengthen and encourage microfinance. While all financial institutions are subject to similar legislation, there is a special designation for MFIs that demands less documentation but still holds institutions accountable for specific financial requirements. He highlighted that, in fact, MFIs in Peru typically enjoy a strong financial position, with a cushion over and above the required levels. Because the authorities have made it easier for MFIs to expand their retail networks, the share of MFIs in the

total financial sector has nearly doubled to approximately 11 percent of total assets over the last six years, with 47 of the 62 regulated financial institutions in Peru engaged in some form of microfinance.[24]

How does Central America compare? Although different countries in the region face their own unique challenges with regulators and governments, panelists emphasized the crucial need in Central America for increased dialogue with authorities and provided case studies from Honduras and Panama to illustrate the work that is currently occurring.

In both cases, the microfinance sector has actively sought out collaboration with regulators, recognizing that each country's growing microfinance industry needed supervision, transparency, standardization, and the ability to capture savings deposits. The MFIs' proactive approach was spurred by the desire to develop a regulatory environment that would encourage innovation and creativity, have reasonable reporting and financial requirements, strengthen the credibility and financial soundness of regulated institutions, improve access to funding sources, and allow MFIs to provide other specialized services including insurance and deposits.

In the case of Honduras, MFIs worked with a wide range of players, including the Honduran Congress, Central Bank, National Banking Commission, President, USAID, and the national microfinance network REDMICROH, ultimately creating a special regulatory body to oversee regulated microfinance, implementing specific legislation for the creation and operation of MFIs, and developing criteria by which to evaluate these institutions. As a result of these actions, 11 institutional transformations have taken place since 2003.[25] Internal governance and management quality has improved and the credibility and reputation of microfinance in Honduras has strengthened.

Panama's microfinance sector is a relatively new entrant to this kind of collaboration. Despite high demand for microfinance products, the industry has received very little attention from the regulatory authorities. As a result, MF industry players have made recent efforts to focus attention and resources on the relatively neglected sector, beginning with the establishment of REDPAMIF, a network of Panamanian MFIs that was launched in 2006. In 2008 and 2009, REDPAMIF focused its efforts on collaborating with the government on draft legislation aimed at supporting the development of micro-, small-, and medium-enterprise sectors. The legislation will refine the role of the sectors' regulatory authority, set up an Executive Committee that will include REDPAMIF as a Committee member**,** and provide governmental support for the sector through technical assistance, financing for start-ups, and loan guarantees.

What are key take-aways? While panelists agreed that the Peruvian, Honduran and Panamanian cases have resulted in primarily positive changes in the regulatory environment, they were quick to point out that the *benefits* do come with *costs*, including increased reporting, higher operating

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[24] Diego Cisneros Salas. 2009, "El Mercado Microfinanciero y los avances en la inclusión financiera en el Perú", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 9.

[25] Juan José Lagos. 2009, "Colaborando en pro de la inclusión financiera", *Encuentro Centroamericano de Microfinanzas*, San Salvador, El Salvador, p. 11. Of the 11 institutional transformations between 2003 and 2009, 8 OPDs (Organización Privado de Desarrollo, or Private Development Organization), transformed into OPDFs (Organizaciones Privadas de Desarrollo Financiero, or Private Development Financial Organizations), and 3 OPDFs converted to banks.

costs, and more rigorous financial requirements, among others. They emphasized that collaboration with regulators is a *work in progress* and that there will always be *on-going discussions* with authorities on the creation and/or modification of regulation. Denise Días of CGAP underscored the need for constant dialogue between regulators, the government, and practitioners, so that these influential players truly understand the objectives and characteristics of microfinance, its operations, and the conditions and support that it needs in order to flourish.

Panel VII: A Conversation: Success Strategies for the Future

- Reynold Walter, Executive Director, Foundation of Financial Consulting to Institutions of Development and Social Service (FAFIDESS), Guatemala
- Luis Castillo, President, Apoyo Integral, El Salvador
- Javier Fernández Cueto, Director of Strategy and New Business, Compartamos Bank, México
- Carlos Sánchez Fabrega, General Manager, Microserfin, Panama

As the final panel at the conference, speakers in this segment predicted the best long-term strategies that would contribute to a healthy, sustainable microfinance industry in Central America. Keeping in mind recommendations by earlier panelists regarding specific actions to address the credit crisis, funding shortage, and political challenges, the final speakers encouraged participants to look beyond the short-term difficulties and adopt a comprehensive view that would strengthen institutions and the industry for the long-term.

Key strategies highlighted by the panelists included:

1) *Determine and commit to well-thought-out strategies:* Successful MFIs will be based on core strategies, most likely regarding quality growth, transparency, efficiency, sustainability and product innovation. These strategies must be steadfastly pursued through budgetary discipline, staff incentives linked to organizational strategy, increased communication within the organization, and commitment of significant time, money, and staff.

2) *Focus on internal governance structure:* Given increasing regulation and closer ties with the global financial markets, successful MFIs will have strong internal governance practices. New skills, strengths, and competencies will be integrated into the governance structures, particularly by incorporating board members and new members of management that are capable, educated, and experts in their field. Close ties with the capital markets will be built into the governance structure, as will a focus on capacity building and product innovation.

3) *Relationship-building with regulators:* As more microfinance providers become regulated institutions, MFIs will have close relationships with the regulatory authority and will consult frequently with them on relevant issues. Advocacy programs will promote public policies that will strengthen microfinance, and impact studies will be conducted and shared to promote microfinance as a tool for poverty reduction.

4) *Manage for the future:* Successful MFIs will adopt long-term thinking regarding their institution and the broader industry. Management will think as far in advance as possible, anticipating future strengths and weakness, and how to leverage the former while preventing the latter.

5) *Transformation and consolidation:* To raise capital, strengthen its financial stability, and offer more diverse products, NGOs will pursue transformation into regulated institutions, leading to a proliferation in the number of regulated MFIs in Central America. Moreover, as competition intensifies, institutions will consider opportunities to consolidate in order to maximize market penetration and minimize costs. As such, MFIs may no longer be local, but cross-border or region-wide, institutions.

Postscript

One immediate, concrete development in the wake of the Encuentro drew upon many of these lessons and may also provide some insight into the future dynamic of the industry. While at the conference, creditors with investments in Nicaraguan MFIs came together, *not as competitors but as allies*, to discuss a joint strategy regarding loan covenants, refinancing, and dialogue with the national government, in an effort to address both the economic and political crises. Following the conference, these investors continued discussions, and ultimately published a letter in the Nicaraguan newspapers, addressed to the government and arguing in favor of microfinance and an end to the No Pago Movement. Building on these efforts, the ACCION Network, representing institutions serving 3.5 million clients and decades of best practice experience, published two press statements supporting the value of the Nicaraguan microfinance industry and calling for collaboration between the government authorities and the microfinance industry.

In October, the Center for Financial Inclusion at ACCION International organized a meeting in Washington, D.C. between representatives of the regulated Nicaraguan MFIs and representatives of investors, international microfinance networks, and support organizations. These efforts were designed to further raise awareness of this challenging situation and garner lobbying and technical support for the institutions operating in Nicaragua.

The results of these voluntary, decisive, multi-pronged efforts to support the Nicaraguan microfinance industry are as yet unclear. However, they clearly reflect the conference's themes of industry unity, open communication, dialogue with regulators, and the importance of collaboration and cooperation, particularly in times of crisis.

This conference recap and analysis was prepared by Stephanie Dolan of ACCION International.