



## Impact of the Global Financial Crisis on Microfinance

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### Summary

The current global financial crisis has led to a significant decrease in international capital available to the microfinance sector. This decrease in capital inflow is adversely affecting the microfinance sector's ability to achieve existing revenue and expansion targets. But microfinance may be less adversely affected by increases in global capital illiquidity than many other business sectors.

### Introduction

Over the past three decades, the success witnessed in the microfinance sector has been due to low default rates, low levels of non-performing loans (NPL) and strong profit margins. However, in the last year, microfinance institutions (MFIs) have started to face rising NPLs, higher operating costs, lower borrower demand and decreasing low-cost savings deposits as a result of the increasing costs of fuel, food, and finance.

Inflation continues to plague consumers in emerging markets which has led to a significant decrease in demand for goods as well as increased food prices. The 2008 Commodity Cereals Price Index (includes Wheat, Maize (Corn), Rice, and Barley) rose to 232, from its 2007 level of 158. Noting that the poor typically spend more than 50% of their income on food, such a rise in food prices has had a tremendous impact on microfinance clients' spending habits and their ability to save and/or service debt.

### The state of microfinance funding prior to the global market crisis

Not so long ago, the availability of capital was not considered to be a concern to the microfinance industry. In the 2007 Banana Skins report published by the Centre for the Study of Financial Innovation (CSFI), the availability of capital was not considered a key risk for microfinance institutions. In the report, an advisor at Consultative Group to Assist the Poor (CGAP) stated that "the flood of international capital, coupled with new domestic sources in many markets, means capital availability isn't the problem. In fact over abundance pre-

sents a much bigger risk." This is only one example of the many experts who believed that the supply of funds would be more than sufficient to meet the aggressive growth plans being pursued by MFIs globally.

Prior to the market downturn, the microfinance sector was attracting attention from myriad new investors, such as investment funds, banks, private equity funds, pension funds and so on. Banks were designing new products and vehicles to attract commercial investors. The overall sense was that microfinance was an emerging asset class with strong earnings potential, above average growth rates, and low default rates - all enhanced by the sector's low correlation with global and domestic capital markets and with the economic cycles of emerging market countries.

### Global financial crisis

The significance of this current international financial crisis lies in the globalised nature of the microfinance investment market. In a recent article, Stephen Jen, Morgan Stanley Chief Currency Economist, discussed the downside risks facing emerging market currencies. He argued that not only will the cyclical downturn in the global economy be a major shock to the emerging market economies and currencies but that, due to structural reasons, investors will be less interested in taking on emerging market exposures in the future. Jen continued that the potential growth rate of emerging economies might be lower than projected due to the recent global slowing in economic growth, and the lack of adequate domestic consumer demand. These factors coupled with the reduced demand for exports from the developing world will lead to a significant adverse impact on emerging market economies.

Smaller economies have typically relied on foreign capital to fund growth in domestic financial markets. These countries have suffered in the international credit crunch, as international investors have fled to high quality government bonds issued by large economies. Governments have had to draw on reserve funds to help banks meet foreign currency commitments and maintain liquidity in the banking system.<sup>1</sup>

The international inter-bank funding structure is still largely stalled. There is a tight squeeze on liquidity and an inability for the markets to fund the global debt demand. Additionally, in certain markets hedging costs have spiked as the US dollar has rallied and unhedged borrowers are facing significant write offs. An example of this can be seen in Indonesia where hedging costs went from 300 basis points to 1000 basis points. As a result, microfinance institutions are also facing difficulties in raising capital to fund their projected portfolio growth and operational needs.



Many emerging markets lack access to long-term funding tools such as bonds and securitisation, therefore rising interest rates affect the cost of funding in the short-term. Since MFIs are often reluctant to raise client interest rates due to the amplified effect this will have on borrowers' disposable income and on the social objectives of providing financial services to the poor, the increase in funding costs diminishes their commercial viability and social performance.

## Investors

In recent years, the most significant source of new capital flowing into microfinance has been through Microfinance Investment Vehicles (MIVs). CGAP's 2008 MIV Survey estimated that, as of December 31 2007, 91 MIVs exist with assets under management of approximately USD 5.4 billion, representing a 78% increase from a year before. MIVs include all sources of funds and structured finance products ranging from commercial funds to a mix of hybrid and socially responsible products but exclude investments from International Financial Institutions (IFIs).

However, since the beginning of the global financial crisis currently unfolding, there has indeed been a decrease in capital investment from international commercial funders. For example, there have been no microfinance-related Collateralised Loan Obligations (CLOs) since 2007 compared with the previous two years when funding via CLOs/structured finance was approximately USD150-200 million a year.

One microfinance expert, Wagane Diouf, a Managing Director at Mecene Investment, has seen international funding dry up with local banks investing in treasury bills that are now at all time highs in many African countries. For instance, the treasury bill rate in Ghana has risen this year from 10% to 22%.

In addition, some investors who were dipping their toes into the industry for "double bottom line" purposes (such as US endowments, foundations, etc) are no longer as interested. Many potential investors will not enter this nascent asset class given the market realities and high opportunity costs to enter into investments that do not offer sufficient risk versus reward, especially at a time when many bonds are cheap and liquid.

Nonetheless, while still taking the above factors into account, it seems likely that individuals and organisations with a strong social bias will continue to invest in the microfinance sector but at a decreased level due to lower levels of available funds and lack of liquidity.

Given the capital markets inability to fund the microfinance industry's increasing demand for finance, IFIs have moved to

increase available capital and to mitigate MFI risk exposure to stale, illiquid markets. For instance, the International Finance Corporation announced it will double its total existing commitments in the microfinance sector to \$1.2 billion over the next three years.

## Who is affected?

As the global financial markets struggle to bounce back from the recent credit crisis, the flow of capital into the microfinance sector is being constrained by increasing interest rates due to a lack of liquidity, in some cases increasing by up to 200 basis points. Still, according to the World Bank, not all countries face the same level of vulnerability due to varying dependency on global trade and foreign direct investment and the fragility of their financial sectors. In Africa for instance, Diouf argues that economies have not yet seen the full impact of the financial crisis because African banks are not fully integrated in the international financial system. However, the economic downturn in Europe and the US is affecting foreign aid and is putting local governments under pressure. As a result, sub-Saharan Africa will ultimately see a slowdown.

Furthermore, for some MFIs customer deposits are a key source of finance. Deposits will experience a decrease due to the increase in food and fuel prices that are depleting profit margins in micro-enterprises and consumer surplus in household budgets. In this regard, the urban poor will be more adversely affected than their rural counterparts given the former's inability to grow their own food thereby increasing the inflationary impact on the urban poor market segment.

In Africa and beyond the effects of the global crisis will also depend on the size of the MFIs. The top tier MFIs will likely be less affected given their more diverse sources of capital and more developed operating models but they will still feel the pinch. The global microfinance sector demand for funding remains substantial with only approximately 10% of the estimated capital needed to meet the consumer demand currently being met.

It is the smaller, less experienced MFIs that are likely to suffer more from the current crisis. This is due to an expected decrease in charitable donations and foreign aid as a result of organisations and countries seeking to stabilise their own balance sheets and economies.

Laura MacInnis, from Reuters, recently argued that "charitable giving and foreign aid flows are likely to dry up as the global economy sours, with rising unemployment and inflation pinching already-tight household budgets, and as big corporate bailouts push governments to the fiscal brink."

## What are MFIs doing to adapt to the current environment?

To better understand and respond to the needs of the industry, Standard & Poor's (S&P) conducted a survey of MFIs, major investments banks, microfinance investment funds, the largest microfinance networks, microfinance industry associations, and a specialised rating agency. The survey concludes that many industry experts consider this period of dampened growth as a positive development since slower growth will encourage MFIs to improve their operating discipline, and ensure that their infrastructure (enterprise risk management systems, internal controls, management capabilities, and so on) is enhanced to meet the demands of future expansion.<sup>2</sup>

While relying heavily on financial investment from IFIs and social investors, some of the MFIs are revising growth targets downward and at the same time making sure their current portfolio remains as healthy as possible. Some MFIs are increasing their risk management processes in order to spot potential loan defaults to minimise increases in nonperforming loans. Some MFIs are attempting to increase client interest rates but this decision is complicated given local regulations and the perceived high level of existing interest rates.

According to Eric Savage, Managing Director, Unitus Capital, MFIs are reacting to the recent challenges in several ways, such as increasing interest rates, scaling back expansion plans, and/or seeking to expand their equity base. But more importantly, many MFIs are working to stay close to their clients to help in this time of need.

## Conclusions

To minimize the impact the global financial crisis will have on microfinance institutions, MFIs should consider several responses:

*First*, it is vital that MFIs remain focused on portfolio quality even in the face of decreasing profit margins and greater competition for funding.

*Second*, MFIs must enhance risk management processes to avoid a similar scenario to the U.S. sub-prime financial crisis. A number of risk management best practices will become relevant to the microfinance industry as it evolves toward greater unbundling, more competition, broader product breadth and a more complex funding structure.<sup>3</sup>

*Third*, MFIs and their representative networks should work closely with IFIs, development agencies and other investors to minimise disruption to sources of capital.

*Fourth*, MFIs should continue to seek to diversify and expand all sources of finance, including savings, equity expansion, and various forms of for-profit and not-for-profit wholesale funding.

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