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The Global Financial Crisis and Its Impact on Microfinance

Compared with other financial institutions, microfinance institutions (MFIs) have emerged relatively unscathed from the financial crises of the past few decades. During the currency crises in East Asia and the banking crises in Latin America in the 1990s, institutions serving poor customers generally performed better financially than mainstream banks. At that time the clients and microenterprises financed by MFIs were not integrated into local banking and currency markets.

Although it still has deep shock-resistant roots, microfinance now has many more links to domestic and international financial markets, and as a result today's financial crisis is more likely to infect its institutions. Many may suffer, and some may fail, but the sector has built sound foundations. Many strong institutions and the vast untapped market of creditworthy clients will ensure that the microfinance sector will survive the setbacks brought on by the current financial crisis.

The effects of today's global crisis are likely to be more complex, deeper, and more difficult to predict than in the past. What is clear is that the medium- and longer term effects of a worldwide recession are likely to be punishing for many poor people and the institutions that serve them. Anecdotal evidence from different markets suggests that as the consequences of the crisis ricochet around the globe—credit crunch, currency dislocations, job losses, and falling demand—MFIs are being impacted in very different ways. How institutions are affected will depend on factors such as the structure of an institution's liabilities, its financial state, and the economic health of its clients. So far, policy makers have mostly focused on macro-level measures. And in some regions like Latin America, they are taking a cautious wait-and-see attitude for the first semester of 2009, with more clarity on their steps to be expected later this year.[1]

Clients: Changes in Income Sources and Expenses

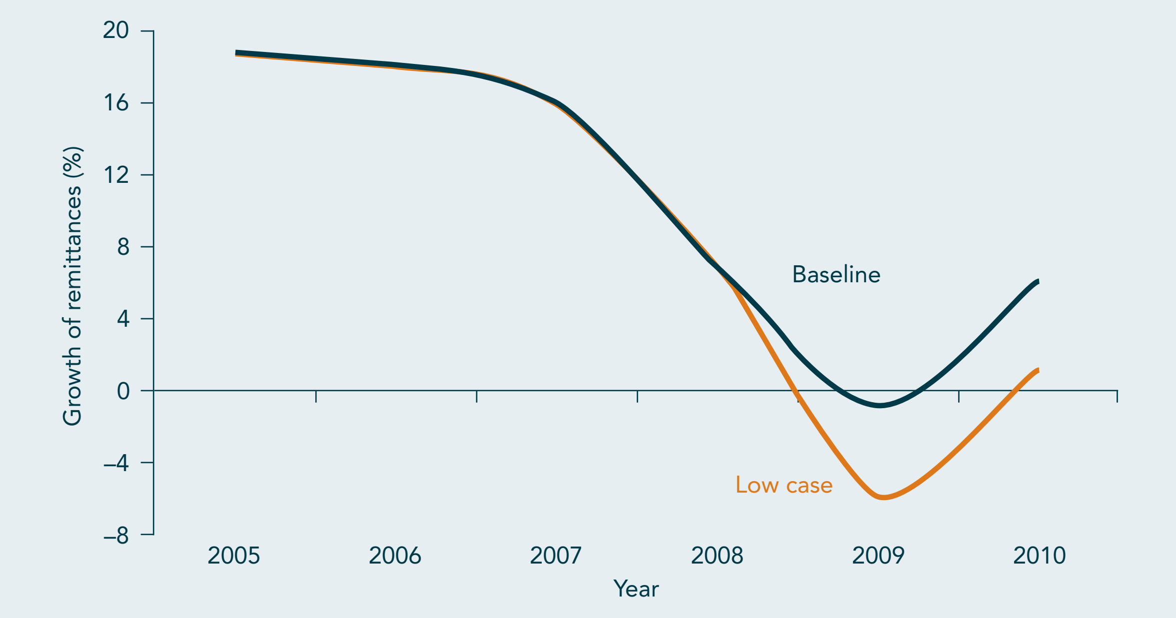
So far, there is only anecdotal evidence on how microfinance client households have been affected by the financial crisis. It is also not easy to separate the effects directly related to the financial crisis from preexisting conditions like the food crisis. But reports from the field do suggest that the dual forces of increased prices and an economic slowdown are leading to a squeeze on household income. While food prices have come down in recent months, they remain very high in many places, and low-income people have been struggling to adjust. A recent CGAP survey (Duflos and Gaehwiler 2008) of a limited set of MFIs revealed that rising food prices caused clients to withdraw savings, cut back on nonfood expenses, and in some cases, have difficulty with loan repayments.

> [M]any of the clients of cooperatives are herders who have income from selling of cashmere, meat or skin, [the] market price of which has declined during the last months. With yearly inflation of around 30% the living expenses of herders like all people increased significantly. In addition, the liquidity shortage has led other banks to stop or restrict loan disbursements in remote areas.
>
> *—Gerelmaa Yu, XacBank, Mongolia*

Recent research from Pakistan indicates that an inflation rate of nearly 25 percent has surprisingly not had a damaging effect on microfinance clients as of late 2008 (Zaidi et al. 2008). On the contrary, those clients producing food crops and agricultural commodities have actually benefitted from higher market prices. Still, inflation is likely to have a negative effect on most microfinance client businesses later this year.

1 Telephone interview with CGAP policy advisory consultant Ernesto Aguirre (8 January 2009).

Figure 1: Predicted Growth of Remittance Flows



Source: Ratha et al. (2008).

Making matters worse, MFI managers from countries as diverse as Mongolia, India, Rwanda, Mali, and Pakistan report that clients already hurt by inflation are now doubly affected by the economic downturn in developed countries: job losses in the United States and Europe have already meant fewer remittances from relatives abroad (CGAP 2008). According to World Bank predictions, growth of remittance flows from developed countries to developing countries will reach their lowest point in 2009, but they will bounce back to reach solid growth rates as early as 2010 in the base scenario (see Figure 1). Remittance inflows in U.S. dollars are expected to decrease in five of the six developing regions during 2009–10, with sharp declines compared with recent years (Ratha et al. 2008). This means fewer resources flowing to poor families.

MFIs: Funding Structure Matters

MFIs report that client purchasing power has gone down and cash needs have gone up, causing savings to be withdrawn and sometimes straining repayments. This creates both liquidity and credit risks for MFIs. Fortunately demand for subsistence goods tends to remain steady during times of economic contraction, and this is the business of many microenterprises. Some say that nimble clients might even benefit if, for example, they can adapt their inventory to sell cheaper goods to meet newly frugal customer demands (CGAP 2008).

> The financial crisis has reduced the inflow of remittances from citizens/relations abroad and so many members now have to fall on their savings or take loans.
>
> —*Daniel Mensah, credit union member from Ghana*

That said, most industry observers expect pressure on customers to translate broadly into higher arrears over time. Small business lenders and lenders to salaried workers may experience this more acutely than classic microenterprise lenders, whose clients tend to be less affected by downturns. Thus far, such deterioration is only anecdotal; as of the fourth quarter 2008 the Symbiotics 50 benchmark, which tracks large MFIs worldwide, denotes no major changes in terms of profitability or risk (Symbiotics 2009).

Stability of Deposits

MFIs with a broad base of deposits are less exposed to refinancing risks. Most deposit-taking MFIs, including the many savings-led institutions in Africa, are relatively well-cushioned compared to MFIs that rely on international funders who have been hit by the credit contraction. That said, some types of deposits are more stable than others, and deposit-taking MFIs don't take in deposits just from poor customers. In fact, many are quite dependent on large institutional deposits that, unlike local retail deposits, tend to be quite volatile.

In a world where communications are global and news travels fast, bank failures in the United States and Europe could potentially lead to a loss of confidence in local banks. Microfinance banks in Eastern Europe and Central Asia, like other banks in the region, saw a steady withdrawal of deposits for several weeks following the announcement of the Lehman Brothers collapse. In Russia, monthly deposit withdrawals in the banking sector peaked in October at about 5–7 percent of the total deposit base, but the problem subsided soon afterwards. Reportedly, banks' safe boxes are becoming an increasingly popular service—people prefer to keep their money in cash. Some banks have increased their fees for providing this service by 5–20 percent.[2] Outside of Eastern Europe, large-scale savings withdrawals have occurred in only isolated cases.

Deposit insurance can be as essential a financial safety net for MFIs as it is for the rest of the banking system. Most microfinance clients are served by regulated institutions, many of which are covered by national deposit insurance schemes, depending on national legislation and their legal form. Several countries increased their deposit insurance coverage levels in the course of 2008 as a response to the financial crisis. This year will most probably see broadening deposit insurance mandates in several countries, bringing more MFIs into these programs.[3]

Institutional Refinancing Risks

The most immediate concern in most countries is how the global liquidity contraction will affect the cost and availability of funding to nondeposit-taking MFIs. In recent months, MFIs worldwide have seen liquidity tightening and costs of borrowing rising (Fitch 2009). Money from both domestic and international banks has become more scarce and expensive, and investors have become more risk averse. Steep rate increases are being reported—from 250 basis points (bps) in Eastern Europe, to as high as 400 bps in some Latin American countries, to 450 bps or more for top-tier institutions in South Asia (CGAP 2008). In Africa, some European bank lenders have requested MFI loan prepayments, with offers to waive prepayment fees. Some international banks are pulling out altogether.

While the immediate pricing hikes have come from international banks, domestic banks, which depend on global credit markets themselves, are also cutting back lending.

Most bank and investor funding of MFIs is of a one- to two-year tenor, so refinancing problems are likely to become more acute as loans come due in 2009 and 2010 (CGAP 2008). (IFC, KfW, and three big fund managers recently estimated the refinancing needs of MFIs in their portfolios at $1.8 billion for 2009.) As MFIs anticipate shortage

2 Telephone interview with CGAP regional representative Olga Tomilova (12 January 2009).
3 Presentation of Canada Deposit Insurance Corporation at the World Bank, 21 October 2008.

in funding, they are likely to slow growth and curtail new lending. They will likely stick mainly to current clients, and some may extend only smaller amounts or not renew loans at all. This might make sense in terms of asset and liability management, but it could hurt asset quality as it undermines repayment incentives. According to an MFI from Rwanda that is slowing its credit growth, clients are defaulting on loans because they have little hope of receiving further loans.

National and multinational development agencies have responded to the credit contraction by establishing liquidity facilities:

- The Inter-American Development Bank (IDB) announced in October 2008 a $20 million financing facility to help Latin American MFIs weather the crisis.
- In November 2008, the Reserve Bank of India extended a $1.5 billion credit line to SIDBI, the country's development bank for small industries.[4] This is intended primarily for emergency liquidity for small and medium-size enterprises, but SIDBI has the discretion to use the new liquidity to finance MFIs.
- In February 2009, KfW and IFC launched a $500 million cross-border refinancing facility for MFIs.[5]

Such emergency funding is critically needed but should be short term and priced as a last resort, so as not to crowd out local sources of funds or create disincentives to deposit mobilization. Over the long term, funders should encourage the progression of institutions to become licensed to mobilize deposits. Maintaining good relationships with socially responsible investors, both retail and institutional, will be important.

Foreign Currency Dislocations

MFIs borrowing in foreign currency are facing both interest rate hikes and currency depreciation, but thus far few have been unable to service debt as a consequence (CGAP 2008). Approximately 70 percent of MFI cross-border borrowing is denominated in hard currency (Reille and Forster 2008). Local currency exchange rates against the dollar have moved significantly down over the past two months in many countries (up to 20 percent in some cases). In those cases where cross-border borrowings are denominated in local currency, some lenders in Latin America are exercising options to convert those local currency loans into dollars at short notice.[6]

While liquidity seems fine through the end of 2008, some organizations are likely to experience problems in refinancing their debt obligations through 2009, especially if they have accepted "hot money" from fickle investors.

—Martin Holtmann, IFC

In the past few years, MFIs with foreign exchange losses reported these losses at up to 7–43 percent of their profits, with one Latin American MFI reported to have lost 75 percent in a single year (CGAP 2008). In top-tier institutions, foreign currency denominated loans from development finance institutions (DFIs) like IFC and KfW equal a significant part of their equity base. This is especially true in Latin America and Eastern Europe, where foreign currency exposure sometimes exceeds equity. In Latin America, dollarized economies, such as Ecuador and El Salvador, will not be affected, but the bulk of MFIs can be found in countries whose currency is decoupled from the dollar. At this point, the real size of the problem is still unclear, but the combination of strong adverse

4 http://www.financialexpress.com/news/rbi-set-to-finalise-special-line-of-credit-for-sidbi/384026/.
5 http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=212F81 02D22F14C985257554400557050.
6 Telephone interview with a Latin American MFI.

currency movements and mismatched assets and liabilities is likely to cause real problems for some institutions (Fitch 2009).

Development Investors: DFIs Gain Importance

The financial crisis has triggered a shift in attention from commercial to development investors. The market for collateralized loan obligations (CLOs) is all but closed, and bank financing has dried up. Microfinance funds and other private investment vehicles are not reporting significant retail redemptions, but they do expect fundraising in the coming months to be a tougher sell. Retail investors are cautious and loath to realize losses in existing investments to make money available for new microfinance investments. As government budgets are drained by financial bailouts, overall aid budgets will be cut, and microfinance will be competing with other aid priorities, such as agriculture and relief. Foreign aid dropped by 8.4 percent in 2007, and most donors are not on track to meet their stated commitments to scale up aid (OECD 2008). Against this backdrop, government agencies and DFIs have stepped up in recent weeks to provide necessary liquidity. They are likely to continue to fill the gaps left behind by contracting commercial players in the coming months.

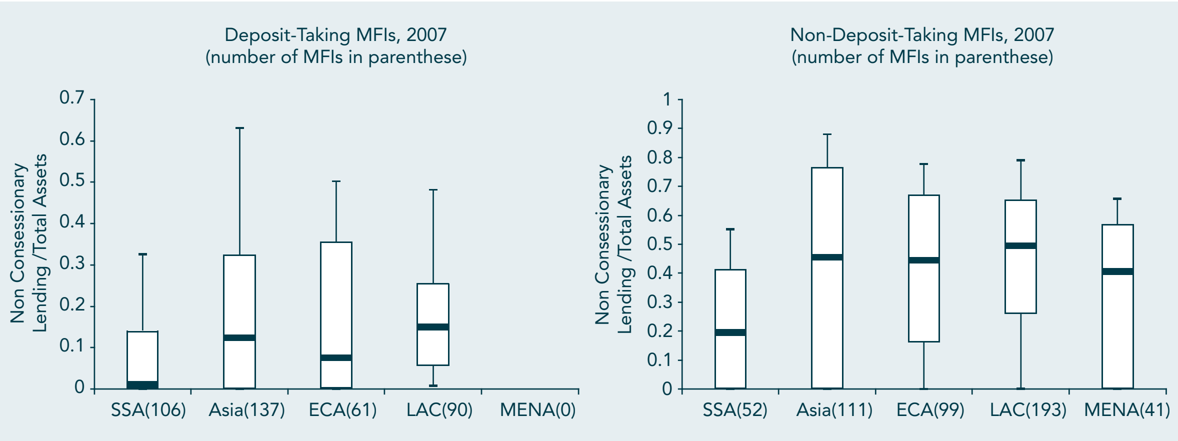
Everyone is increasingly cautious—to free up capital to invest in microfinance private equity funds sometimes requires liquidation of existing investments at a substantial loss.... [This] is emotionally difficult regardless of the social imperative. But so far we are have not experienced a slowdown, especially with respect to equity.

—Cecelia Beirne, MicroVest

Microfinance in 2009: The Road Ahead

How vulnerable are MFIs to a prolonged credit crunch in 2009? Figure 2 shows market rate[7] (nonconcessionary) borrowing as a percentage of total assets, broken down on a regional level.

Figure 2: Borrowing at Market Rates, by Region



Source: MicroBanking Bulletin, 2007

Notes: SSA=Sub Saharan Africa, ECA=Eastern Europe and Central Asia, LAC=Latin America and the Caribbean, MENA=Middle East and Northern Africa; sample size in brackets. The thick horizontal bars represent medians; the top and bottom of the white boxes represent the 75th and 25th percentiles, respectively; and the high and low short bars represent the 95th and 5th percentiles, respectively.

7 Defined as the 90-day deposit rate from the International Financial Statistics (IFS line 60L).

Deposit-taking institutions show higher levels of market rate borrowing, but even nondeposit-taking MFIs are obtaining a significant portion of their funding from commercial sources. There may be some liquidity risk, especially for MFIs in Latin America and Eastern Europe, but the true nature (i.e., the sources) of this borrowing is unclear. It is reasonable to assume that borrowings from DFIs or donors, even if priced at market rates, are less prone to withdrawal than standard bank loans.

The widely hailed robust, anti-cyclical characteristics of the microfinance sector may actually work against the sector […], as some donors may reduce support to this sector under the hypothesis that MFIs are better placed to take care of themselves as the crisis unfolds, whereas the most vulnerable sectors will soon be desperately needing increased support.

—Alice Brooks, USAID Bolivia

Here are some ideas for various market participants to consider as they navigate the crisis.

MFIs. MFIs will want to increase reserves and adjust growth plans to be more conservative in light of tighter credit. But they must honor their implicit contract to grant prompt follow-on loans to existing borrowers who have repaid faithfully. When MFIs fail to do this, repayment motivation almost always suffers, and delinquency grows fast.

MFIs need to focus more than ever on sound practices, ensuring that customers understand their loan terms, and appraising repayment ability to protect both borrowers and the MFI against overindebtedness. MFI managers need to communicate proactively and openly with lenders and investors about refinancing concerns and other issues related to the impact of the crisis.

Greater attention to asset–liability management is warranted, especially maturity mismatches and foreign currency exposure. Overall, an effort to either rationalize or diversify funding sources to a manageable but balanced number is important.

And perhaps most important of all is for nondeposit-taking MFIs to take steps in the ongoing challenge to become licensed to mobilize deposits and thus limit dependence on cross-border financing. These measures will take time, money, and expertise that many MFIs lack and will need to build.

Governments. There is a need to demonstrate to policy makers that inclusion and stability can go hand in hand, provided the products are designed, underwritten, and marketed appropriately. While caution is an understandable reaction to the financial crisis, there is some concern that regulators will become overly conservative across the board, casting a wide net that inadvertently catches activities that are not linked to crisis-related risks. Restricting new licenses for deposit taking or limiting branch expansion may be examples of restraints that may needlessly limit access to finance while not providing additional support to stability.

Also, progress on policies that stimulate access may falter as governments' attention focuses on the more immediate concern of the health of the overall financial system. Some well-intentioned steps to alleviate effects of the crisis—for instance, loan forgiveness, subsidized lending, or interest rate caps—would probably hurt financial access in the long run. Policy makers need to be careful that short-term fixes do not hinder long-term access to sustainable financial services.

Donors and Investors. In the short term, funders should stand by sound institutions facing liquidity problems, help them reschedule loans, recapitalize, or provide emergency funding for viable institutions. Such emergency funding should be short term and priced as a last resort, so as not to crowd out local sources of funds or create disincentives to deposit mobilization. Over the long term, funders should encourage the progression of institutions to become licensed to mobilize deposits. Maintaining good relationships with socially responsible investors, both retail and institutional, will be important.

Amid the Crisis, Opportunity

The microfinance field is, at its core, robust. It is likely to survive the financial crisis chastened but intact. There are and will be serious problems with specific institutions and in specific markets, many of them brought on by factors independent from the crisis but exacerbated by it. But on the whole, the financial contraction, like so many crises, also brings opportunity. Some microfinance markets had become overheated in recent years, with sensational growth rates, deteriorating underwriting standards, and crumbling risk-return tradeoffs. Slower growth, scarcer credit, more conservative policies, better products, and even consolidation of weaker institutions into stronger ones may be beneficial in the long run. The crisis may accelerate long overdue consumer protection measures that are part of responsible lending.

At the very least, the crisis has clearly illustrated the value of adopting a deposit-led approach to building sound and permanent domestic financial systems that can serve the poor with both credit and savings services.

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