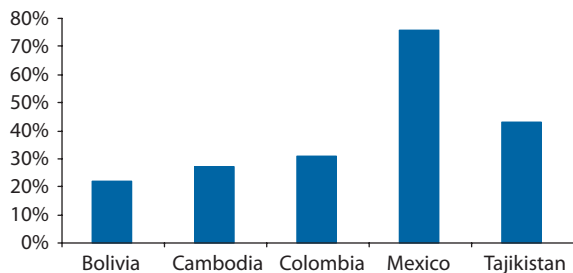


Bolivia, the Model of Successful Inclusion

Bolivia is often quoted as a model of success in the microfinance sector. Its microfinance total gross loan portfolio is estimated to be more than USD 1 billion and includes almost half a million borrowers. It boasts some twenty active microfinance institutions (MFIs), among which there are four very strong players that are exemplary for the microfinance world in terms of growth, efficiency and innovation capacity: BancoSol, Banco Los Andes Procredit, FFP Fie and FFP Prodem. Strong competition amongst these and other medium-sized MFIs with excellent operations, such as Ecofuturo, Fades, Agrocapital, Crecer and Funbodem, has driven the interest rates charged to micro-entrepreneurs to some of the lowest levels in Latin America and worldwide. The average portfolio yield of a Bolivian MFI is between 20% to 25%.

This means that micro-entrepreneurs get better services at a lower cost, and, even more importantly, that the majority of the population now has access to

Figure 1: Average Effective Gross Annual Interest Rate charged in the Microfinance Sector of Selected Countries



Source: BlueOrchard database, figures as of May 2008

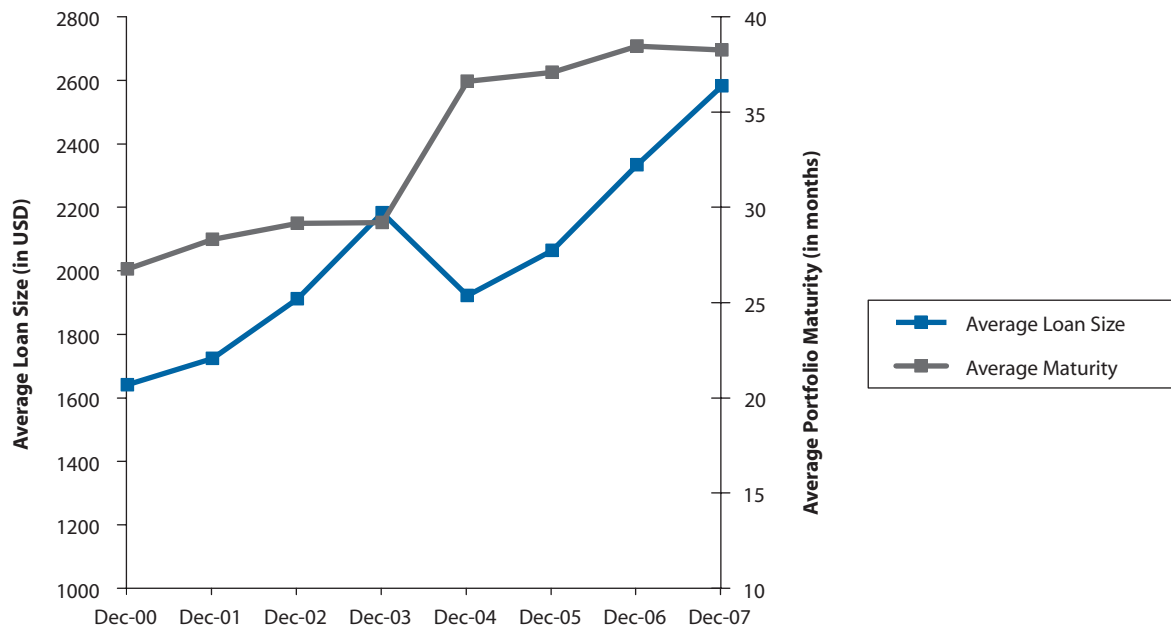
¹ The views and opinions expressed in this article are those of the author. They do not represent the views or opinions of BlueOrchard.

financial services. So much so, that in a government program launched at the end of 2007 with the goal of providing loans to people previously excluded from the financial system, the government had to change the main eligibility requirement from “not having had access to any previous loans,” first, to “not having received a loan for the past year,” then, to “not having received a loan for the past six months,” and ultimately to “not currently having an outstanding loan.” It is expected that the criteria may be relaxed even more to having only one loan with one other institution. The reason for changing this requirement was that otherwise, no loans could be placed. Beyond doubt, the penetration of microfinance to people at the bottom of the pyramid is very high in Bolivia. Having successfully dealt with the challenge of lack off access, the sector is in a position to re-think its most important challenges and risks today.

Client Over-Indebtedness

Most of those who in the past were excluded from financial services have now gained access through the development of the microfinance environment, to the extent that one can observe some worrying signs of clients becoming over-indebted. In this and other highly competitive microfinance market, loan officers are under increased pressure to place credits. Often² they are rewarded with direct financial incentives proportional to their loan portfolio and they are quite often as well assigned ambitious targets. As a rule, the bonus payments are affected by the portfolio-at-risk of the loan officer, with some institutions placing a higher emphasis on portfolio quality than others. Additionally, MFIs have a well-ingrained practice to use credit bureaus, which are improving their surveillance constantly, including, for some, an early warning system to track potential problems with borrowers. Nevertheless, in general, the lending requirements towards clients are becoming increasingly flexible and loan underwriting practices are becoming more aggressive.

² Although not in all MFIs.

Figure 2: Average Loan Size vs. Average Maturity in Bolivian MFIs Portfolios

Note: The data in this graph comes from calculating yearly weighted averages for the largest 7 MFIs in Bolivia, which together have a combined portfolio of USD 1.03 billion.

Source: BlueOrchard database

At the root of this issue lies the fact that while the calculation of a potential client's disposable income can be fairly arbitrary, this is the main basis for evaluating how much debt the client may acquire. Each loan is given with the expectation that a client's disposable income will continue to be in the future at least the same as it was in the past, assuming that even with an economic downturn, borrowers will still make sales and generate profits. Moreover, as tends to happen in competitive credit markets, the average size of loans granted by MFIs to their clients is increasing at the same time as the average portfolio maturity (see **Figure 2**). Actually, looking at the data, the increases in loan amounts are not too surprising, the way the average maturities are. They will tend to increase the duration of the loans in order to make the monthly repayments smaller and thus fit the clients' monthly repayment capacity³.

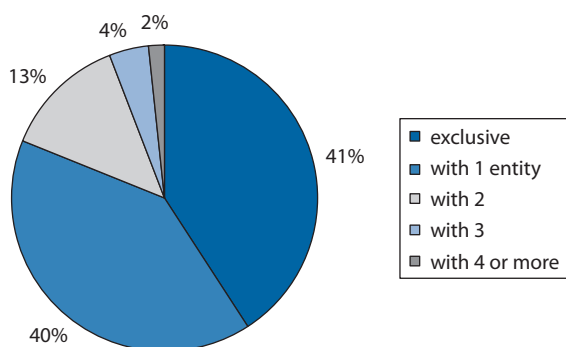
With money so easily available at low rates and for long terms, and given that money is fungible, it is probable that only a smaller part of the loan proceeds are in fact invested in micro-enterprises. When a small trader selling fruit in the streets of La Paz

receives USD 3000 for 18 months, it seems unlikely that he uses it mostly as working capital. Rather, he is almost certainly planning to buy consumer goods on credit. In the past, with stricter and more costly credit conditions, more of the loan proceeds were invested in running businesses. This would lead to higher income generation and an increased repayment capacity as well as a larger leeway in case of an economic downturn. As more of the loan proceeds are used for direct consumption, it can be argued that the borrowers are more vulnerable to a downturn in their economic activity. It is impossible to tell how often this "diversion of funds" occurs as MFIs claim borrowers often forgo improvements in their living conditions to continuously reinvest in their business.

Another important factor to consider in a fiercely competitive environment like Bolivia, is that a collective action problem can materialize. Insufficiently disciplined underwriting practices from one lender could potentially generate a risk of a client becoming over-indebted to other MFIs, as well as providing competitive pressure for the other MFIs to loosen underwriting standards. Micro-entrepreneurs can now easily have two or three loans and women in village banking groups can belong to two or three groups or take out additional individual loans in addition to their village-banking loan. Furthermore, most MFIs have a practice of buying loans from other MFIs, so that the amount of shared clients may reach 50% for a MFI at a

³ The fact that the average maturity of loans at year end 2007 for the largest 7 MFIs in Bolivia is above 3 years says is striking. In small businesses which benefit from microfinance one expects to find a majority of short term loans to finance working capital. In most countries, microfinance portfolios don't exceed an average maturity of 24 months.

Figure 3: Exclusive vs Shared Clients in Bolivian MFIs



Source: BlueOrchard database, figures as of April 2008

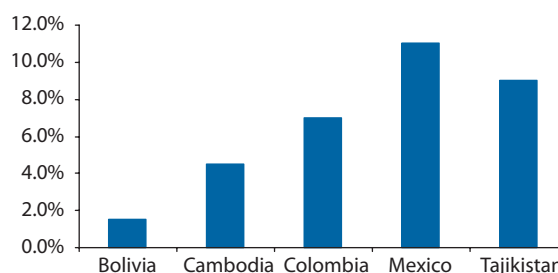
given moment. However, the amount of their portfolio that is subject to competition is higher than the amount of shared clients and they can be driven to aggressive lending practices by the level of competition, as illustrated by the rising loan maturities (see **Figure 3**).

Fortunately, the economy has been growing steadily and overall macro-economic conditions are stable which has prevented the appearance of payment delinquencies, in fact, delinquencies have been dropping for most MFIs. Micro-entrepreneurs are currently seeing a constant revenue stream, given stable or even increased in sales, and thus can service their debt on time. However, if there were an economic downturn, it may become arduous for many borrowers to pay back all their loans, seen as their present level of indebtedness is certainly higher on average than in the past. A macro-economic crisis occurring 1-2 years from now could have very serious consequences if many more poor people become burdened with large and long term debt. It would be logical to expect an economic downturn, given that economies around the world have historically shown cyclical behavior in their behavior.

In addition, the risk generated by client over-indebtedness is exacerbated by three further characteristics of the Bolivian microfinance market: 1) thin margins, 2) currency risk and 3) high leverage.

Note: The data in Figure 3 comes from calculating weighted averages for the shared clients indicators of 5 of the largest MFIs in Bolivia, which together have a combined portfolio of USD 650 million. We tried to include all the top 7 but 2 MFIs lacked this data. Also, please note that there were significant variances amongst shared clients indicators across MFIs. This is caused by the different loan methodologies: some MFIs require the spouse of the client to also sign loan agreements and, as such, loans for either spouse show up as shared loans. For other MFIs, the spouses' loans would not enter into the calculation of this indicator, although they do consider the entire family's cash flow for the calculation of the client's repayment capacity.

Figure 4: Average ROAs in the Microfinance Sector of Selected Countries



Source: BlueOrchard database, figures as of May 2008

Thin Margins

A consequence of the maturity of the Bolivian microfinance market is its thin margins, which are due to the low interest rates charged to clients, which in turn are conditioned by the high competition on the supply side. The returns on assets of market leaders are situated between 1.5% and 2.5%, meaning that there is not much room for MFIs to lower interest rates any further. These margins are close to the best they can be, given that the operational efficiency of MFIs in Bolivia is already very good with operational expense ratios averaging 10% to 12%. The cost of funding is also relatively low compared to other countries, especially for those MFIs that are regulated and thus able to capture savings. In many cases the MFIs are competing on interest rates, since all strong MFIs have fast processes. While the margins are not as low as for other types of lending, they are much lower than in other microfinance markets around the world. A particularly contrasting example is Mexico, where the quasi-monopolistic market allows for very high interest rates charged to clients and extremely high returns.

Currency Risk

The Bolivian financial sector has been fully dollarized for the past decades, even if the real economy at the micro-enterprise level is run in the local currency, the Boliviano (BOB). But it is very difficult for MFIs to obtain funding in Bolivianos. Some non-governmental organizations (NGOs) borrow in US Dollars (USD) to on-lend in Bolivianos leaving them exposed to currency fluctuations. Most MFIs capably manage to match currencies from assets and liabilities. However, most micro-entrepreneurs do not generate income in dollars. Consequently, the foreign exchange risk is passed on to the clients and this could easily into credit risk for the MFIs in the event of a sharp devaluation.

Over the past couple years, the USD has depreciated against the BOB and thus Bolivians have started

keeping their deposits in Bolivianos, while in the past they saved in USD due to lack of confidence in the local currency. Consequently, MFIs that capture savings are rebalancing both their assets and liabilities towards more Bolivianos, going from 15% BOB and 85% USD, to 30% and 70% and even 50% and 50% in 2008, in the most balanced cases. This is good news, and, given that the country has high USD reserves thanks to a rising USD income from exports of natural gas, minerals and agricultural products, the BOB is expected to continue appreciating in the short to medium term.

But in the longer term, if there were to be a sharp devaluation of the local currency, as was the case during the financial crisis in Argentina, the MFIs that have the most funding from external sources in USD would be the worst hit, given that external debt cannot be re-denominated the way domestic debt and savings would most likely be. The MFIs in this group are mostly relatively small NGOs that cannot capture savings; but the big MFI banks also have large amounts of external USD-denominated debt and could also see their Capital Adequacy Ratios affected severely by a major devaluation.

As long as the shifts in the exchange rate are not major, the Bolivian microfinance sector can handle the foreign exchange risks, as it has demonstrated in the past three decades. However, the current positive macro-economic conditions, and thus the strength of the Boliviano, could see a weakening in the long term, and this could have a major impact on the ability of micro-entrepreneurs to honor their obligations.

High Leverage

Over-indebtedness, thin margins and currency risk are less of a threat for institutions that have strong capital adequacy ratios. However, the picture changes in institutions with high leverage, which is actually the norm in the top five Bolivian MFIs, which have debt / equity ratios of about 10 times. While these meet the capital adequacy ratios required by Basel II, they are high in the world of microfinance. High leverage means that if there are shakes in the economy, due to either a recession or a strong foreign exchange movement, MFIs have less of a capital base to cover losses. One important mitigating factor, though, is that the regulated MFIs in Bolivia have very high loan loss reserves- the average is above 300% of Portfolio at Risk above 30 days. If the reserves covered just 100% of PAR (as seen in most countries) the D/E ratios would be in the range of 6-8 for most of the large players. This is more moderate, but a major economic downturn or devaluation could still threaten even the top MFIs.

Re-Thinking Social Impact: From Lack of Access to Over-Indebtedness

All these factors combined constitute an important microfinance sector risk in Bolivia: increased client over-indebtedness, thin margins, currency risk and high leverage. Among these, the most aggravating factor is the micro-entrepreneurs' increased indebtedness and potential over-indebtedness, which is particularly high in Bolivia compared to other microfinance markets around the world. The situation in Bolivia is particularly acute, given the strength of competition amongst MFIs. However, it is by no means the only country facing these risks today, other similar examples are its next door neighbors Peru and Ecuador.

Thin margins and high leverage are results of a vibrant, dynamic and competitive microfinance, which result in good service and relatively low interest rates for borrowers. One can argue that over-indebtedness is brought about by "too much supply," and thus that the Bolivian microfinance sector's success is at the source of its biggest risks today. Viewed as such, Bolivia is an interesting case study of a microfinance market with a strong growth that signals possible future developments in other countries with similarly competitive and dynamic microfinance sectors such as Bosnia and Herzegovina, Cambodia or Bangladesh. Moreover, it is an enlightening case study in presenting where the microfinance markets around the world are headed towards in the long term, as they become more competitive and sophisticated.

Finally, the Bolivian example tells us that it is important to reflect on whether high growth in the MFIs' portfolios is good both from the perspective of the MFIs' financial sustainability, and, even more importantly, from the perspective of the socio-economic development of their clients. Does accumulating several large, long-term loans really benefit a poor borrower? The recent examples of sub-prime borrowers in the USA show that people are often driven to take on more debt than they can handle in the long run. This, together with ambitious growth targets from MFIs' Board of Directors transmitted to loan officers, could be a recipe for a "bubble". Should the bubble burst in Bolivia, the over-all developmental impact of microfinance will suffer a serious set back.

As a consequence, now that access to financial services for poor people has been largely achieved, the highest priority should be to focus on responsible lending at all levels of the chain, from the MFIs to their borrowers and from lenders to the MFIs.