

# FEATURE ARTICLES

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## Microfinance: Where do we Stand Today?

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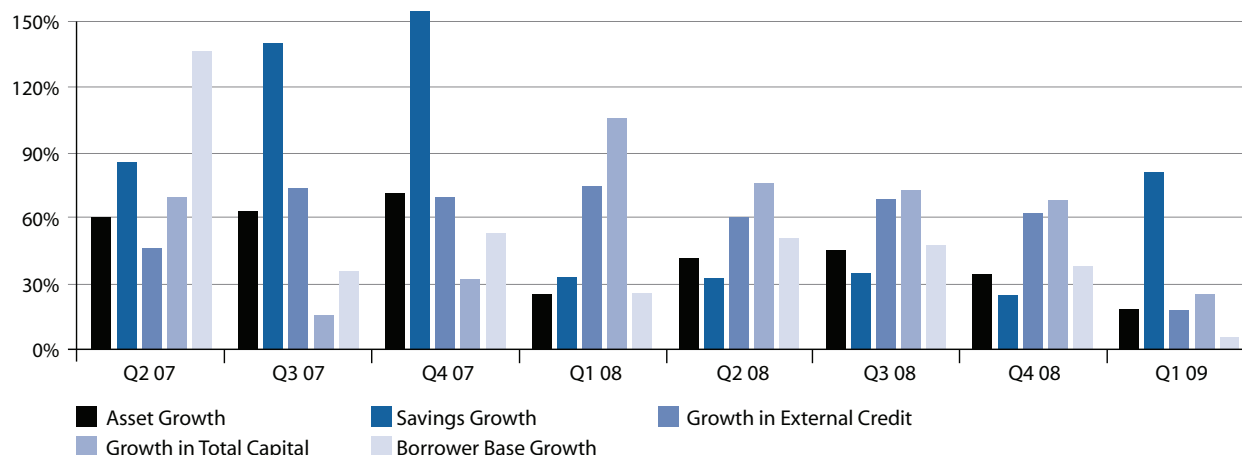
### Microfinance — Does Everything Correlate in Bad Times?

In the last ten years, conventional wisdom has held that microfinance as an asset class enjoys a striking lack of correlation with trends in the global economy. The informality of most of the micro-businesses feeding into the microfinance industry was supposed to shield it to a certain degree from macroeconomic booms and busts. Challenging this assertion, however, is another tenet that emerged from the decade of Long Term Capital Management, which holds that in bad times, everything correlates. With waves of the international financial crisis rippling through the global economy, the current situation provides an opportune testing ground to determine which of these seemingly opposed conventional wisdoms holds water. While microfinance has certainly not proved to be immune from the travails of the traditional banking sector, it has not come close to suffering the same damage, suggesting that opportunities still exist in the microfinance sector for MFIs and for investors. Indeed, MFIs have shown remarkable resiliency and foresight as they respond

to the crisis by shoring up their core operations and returning with new purpose to their social missions.

The last decade has witnessed a remarkable rise for microfinance. International investors discovered the potential of microfinance in zeal in the second half of the 2000s, as structured products permitted microfinance investment vehicles (MIVs) to market funds to a wide range of investors, from the socially-oriented development agencies to pension funds with fiduciary roles. The first microfinance CDO was closed in 2004, and it was followed shortly afterward by a string of other structured funds, which offered private and institutional investors a new opportunity to acquire notes collateralized by loans to MFIs. These products allowed MFIs to access large new pools of funding to fuel remarkable expansion. The models of structured credit products in microfinance have stayed conservative, after an initial spurt in innovative risk distribution mechanisms. The first microfinance CDO was structured by Blue Orchard and had been offered with a 100 percent guarantee to the Senior note holders. This structure soon gave way to a partial guarantee structure with 40 percent subordination to the Senior note holders. The Global Commercial

**Graph 1** Growth Patterns in Microfinance



The microfinance industry witnessed rapid growth over the last few years and in the recent past, much of this growth was funded through savings deposits and increasing interest of the mainstream finance industry in microfinance balance sheet components. This was complemented by the increasing appetite of MFIs for a more levered capital structure. However, the impact of macroeconomic crisis can be clearly seen in the lowered growth rates over 2008 – 2009.

Microfinance Consortium transaction structured by Deutsche Bank was one of the first of such kind. Most of the structures marketed since have been modeled with very similar risk classification mechanisms.

### Risk of Mission Drift

Booming local economies spurred the growth of savings deposits (among MFIs whose legal structures permitted savings mobilization), as more clients were able to afford to stash away some of their earnings for a rainy day. These two pools of funding continued to deepen up until 2008, providing the means for MFIs to grow their portfolios and client bases at a staggering pace, some by 50 to 100 percent year on year.

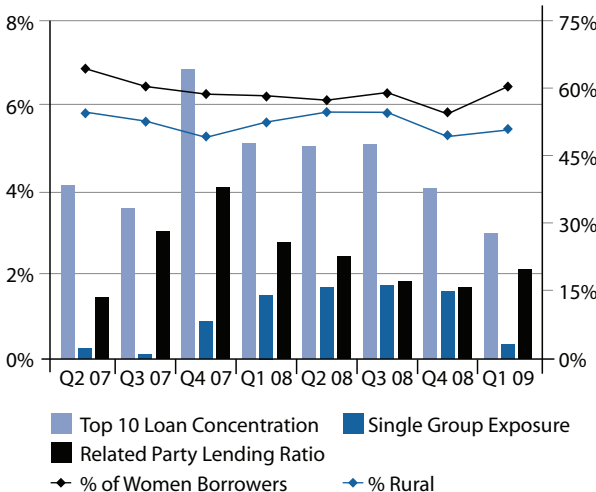
Although such growth meant that more poor clients were able to access financial services, not all side effects of the MFIs' rapid growth were so positive. As the sector has embraced commercialization, some MFIs seeking to take advantage of the commercial funds that were suddenly so readily available moved away from their traditional areas of strength, such as micro group lending, into less familiar products such as SME lending, in an effort to attract more clients and cover rising financial costs and operational costs associated with expansion. With this move into new businesses came an element of mission drift for some institutions.

A recent Women's World Banking study discovered that as MFIs transformed from NGOs into commercial entities, their average loan sizes began to grow, and the number of women served began to decline, despite the missions of many MFIs in the sample to serve the poor and in particular, women. Even more disturbingly, in some markets, as MFIs have grown, they have encroached upon their peers' areas of operation, generating fierce competition and leading to over-indebtedness of the very borrowers that the institutions originally sought to aid.

### Investor Appetite

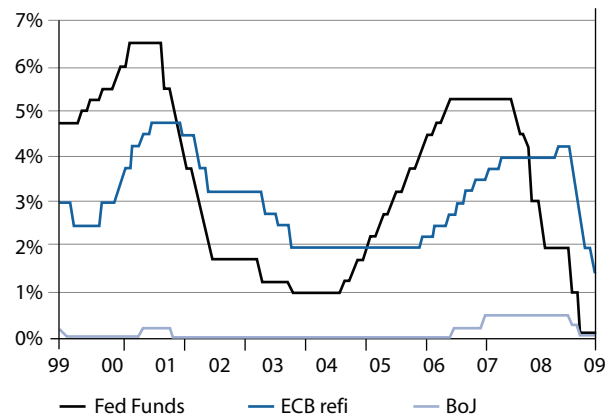
When the financial crisis struck in its full strength in 2008, blowing out credit default spreads to levels not seen in decades, it hit the microfinance investment industry along with the traditional banking sector. Liquidity dried up almost overnight, with planned microfinance funds being pulled late in the marketing process. Deutsche Bank had been in the process of structuring a USD 350 million global microfinance fund during Q3-2008 and was forced to shelve the marketing plans following a precipitous widening of credit spreads and a near shut-down of structured credit products market.

**Graph 2 Concentration Risk in Microfinance Portfolio**



The rapid growth of the industry also witnessed a spike in concentrated exposures to specifically profitable loan groups and the larger borrowers. This trend however has been on the decline for the last three quarters, possibly due to a conservative approach taken by most MFIs as a response to the global macroeconomic crisis.

**Graph 3 Key Rates in the G3 Countries**

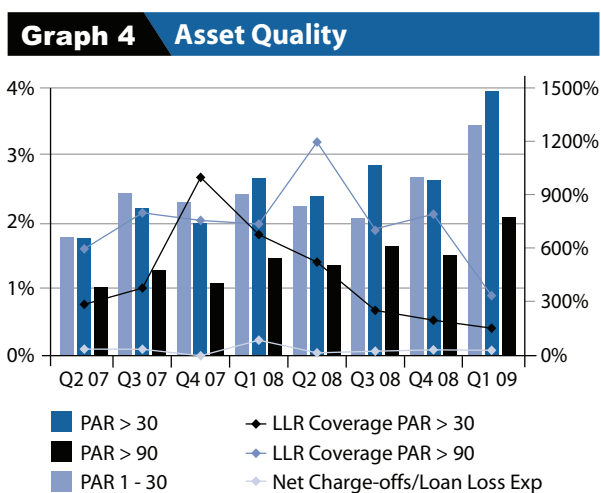


Various central banks across the world have acted in close coordination to bring down the overall cost of borrowing. In microfinance, the cost of borrowing has typically been significantly below commercial funding levels.

Finding themselves with fewer funds available to put to work in alternative investments, such as microfinance, investors are now tuning in more closely to the risks involved in microfinance investments. Their questions are centering on topics such as portfolio quality, liquidity risk, open FX risk and internal controls. In addition, investors are seeking to

be as catalytic as possible with their limited funding, carefully selecting targeted countries and MFI profiles. Commitment to a double bottom line objective has reemerged as a concern for investors, perhaps an acknowledgement of the unscrupulous lending practices in the developed world that contributed to the financial crisis.

As investors take a closer look at these elements of MFIs' operations and finances, the picture that emerges is not as discouraging as the global economic malaise would suggest. While portfolio quality has generally deteriorated across regions, MFIs are demonstrating an ability to return to their operational strengths, even in countries that have been hit hardest by the crisis.



The portfolio delinquencies, as measured by PAR > 30 days and PAR > 90 days have been on the rise over the last two years.

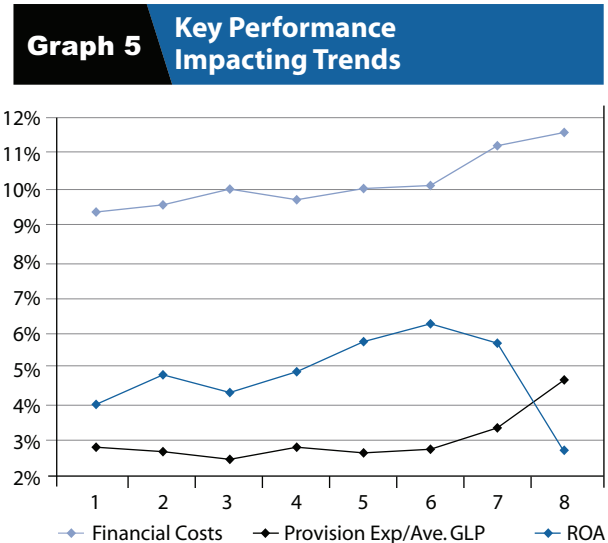
## Responding to the Crisis: Conservative Measures

Across Deutsche Bank's portfolio, in a trend mirrored by the portfolios of other microfinance fund managers, Portfolio at Risk > 30 days has risen from an excellent 1.8 percent to a less spectacular, but hardly alarming 3.8 percent. In some cases, while MFIs were growing rapidly, rising loan portfolio values and client counts masked problems in the portfolio. Now that the funding that was feeding this growth has lessened, these problems are beginning to emerge. In other cases, MFI clients are feeling the squeeze of the economic circumstances, as demand for their goods has fallen off, and they are less able to repay their loans. MFIs seem to be reacting to these problems by tightening their credit standards and by lowering the size of the loans that they offer.

These prudent measures have caused a decline in the average gross loan portfolio for the first time in many periods, as MFIs respond to falling portfolio quality and uncertain future funding by tightening lending standards, shrinking disbursed loan sizes, and holding more cash on hand. Interestingly, however, the average number of active clients has continued to grow, albeit more slowly than before, signaling that MFIs on the whole have not been dramatically wounded by the recent external shocks.

Rather, they seem to be returning to the basics of microfinance: small loan sizes for short terms provided in the form of standard products.

Profitability has been leaner since the crisis struck, though on average it is still positive. As the US dollar has recently appreciated versus many world currencies, MFIs that borrowed heavily in hard currency in the last few years without hedging that exposure are experiencing losses related to foreign currency mismatches. In response, MFIs are demanding more loans in local currency and are working to eliminate these mismatches by all means at their disposal. In addition, MFIs are allocating more expenses toward provisioning to ensure that they have adequately reserved for delinquencies.



Rising Financial costs and loan loss provision expenses have impacted the overall profitability of microfinance institutions.

## Conclusion

Certainly MFIs face challenges as slowing growth and funding opportunities force them to refine their risk management systems, to tackle rising delinquencies, and to actively manage their liquidity, for the first time for many MFIs. However, we prefer to view the current situation in the microfinance market as an opportunity for the best run MFIs to distinguish themselves, for social investors to prove their commitment to the field, and for the industry to return to its original social mission, with renewed attention to initiatives such as the Client Protection Principles.

To look back to the two original conventional wisdoms that we began with, perhaps instead of debunking one or both, we could add a truism of our own: microfinance may not have completely decoupled from the global economy, but its resilience in challenging times should be the envy of banks across Wall Street.

**Note:** All charts in this document have been drawn based on data from the portfolios managed by the Global Social Investments Group at Deutsche Bank.