

BULLETIN HIGHLIGHTS

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Operating Efficiency: Victim to the Crisis?

Blaine Stephens, Chief Operating Officer and Director of Analysis, MIX

As the world watched the financial crisis and ensuing economic slowdown unfold in developed economies in late 2008, observers of microfinance braced themselves for the fallout on microfinance institutions, some of which began to appear by the end of 2008. The exact causes and their contributory impacts will still take time to work out. How did rising food and fuel prices affect credit needs of poor households and their businesses? To what extent did changes in the financial markets impact MFI growth through greater pressure on MFI capital raising and refinancing needs? Would diminished household revenues from slower remittance flows and local economic slowdown put significant pressure on portfolio quality and lead to slowdown in credit growth? Whatever the combination of causes, stress signs appeared in microfinance institutional performance by the end of 2008, as growth rates slowed, profit margins tightened and, in some countries, portfolio quality deteriorated. These Highlights look at the major trends in institutional performance and explore the impact of slowed growth on operating costs.

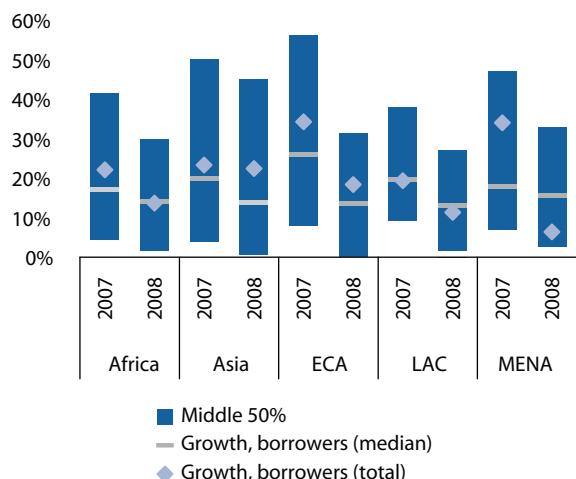
The 2008 Microfinance Benchmarks capture the operational and financial performance of nearly 1,100 MFIs from just under 100 countries. These reference points mark the first global data set of this magnitude to capture the impact of the crisis and economic slowdown on the operational and financial performance of MFIs. Together, 2008 benchmarked MFIs served 74 million borrowers with 38 billion USD in loans, and collected 23 billion USD in deposits from 67 million depositors. The subsequent analysis also makes use of a trend lines data set of 600 MFIs from 84 countries and representing 89 percent of the borrowers served in the full 2008 benchmarks data set. Taken together, the 2008 benchmarks and 2006-08 historical data offers a robust prism through which to analyze the changes in MFI performance at the onset of the financial crisis and economic downturn.

2008 Performance At-a-Glance

As global economic growth slowed in 2008, microfinance institutions around the globe began to feel the impact in their own portfolios and performance. The sustained expansion in borrowers served in the first part of the decade ceded to slower growth and rising operating costs by 2008. The following graphics highlight some of the more important trends:

- While banks in developed markets severely restrained lending by the end of 2008, microfinance institutions continued to expand access to credit, albeit at lower growth rates than in previous periods. For the typical institution, borrower growth rates (approximately 25 percent per annum up through 2007) slowed to nearly 15 percent in 2008. Loan portfolio growth in USD terms (20 percent) fell to similar levels. Leading markets, however, did not always follow regional trends. In Asia, while borrower growth fell for MFIs in the Philippines and Bangladesh, India's total outreach actually increased by nearly 65 percent in 2008, up from 50 percent a year earlier. At the other end of the spectrum, the Moroccan market contracted its total credit outreach by just under 10 percent in 2008, faced with overlending and worsening portfolio quality throughout the portfolio, whereas Egypt, Jordan and other countries in the Middle East/North Africa region expanded access, but at slower rates. **(Figure 1)**.
- Evidence from past crises has shown that microcredit arrears do rise in periods of economic slowdown, but that these delayed payments do not translate into significant portfolio loss. 2008 MFI repayment performance confirms these findings, as portfolio delinquency increased in several regions during the year; however, a handful of markets represented much of this change.

Figure 1: Growth in borrowers slows, 2006–08

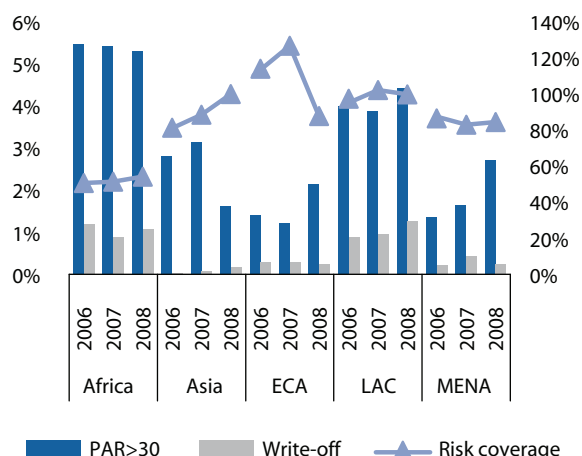


Source: MIX data 2006-08. Data are for a balanced panel of MFIs and represent medians, unless otherwise indicated.

In some high growth markets, like Morocco and Bosnia, delinquency rose in 2008, doubling in both cases, but to levels lower than 5 percent. Other high growth markets, like India, however saw no significant change in delinquency.

- Even as delinquency rose in 2008, MFIs carried very low levels of uncovered credit risk exposure. Many regions provisioned at over 100 percent of portfolio at risk over 30 days. This provisioning provided a cushion against immediate loss, with MFIs in markets like Morocco and Bosnia drawing down on the cushion as arrears rose early in 2009. Small scale MFIs proved an exception to this rule and carried the most uncovered credit risk, with risk coverage levels dropping to 80 percent of portfolio at risk over 30 days in 2008, even as these institutions faced higher delinquency levels than their larger peers. (Figure 2)
- Profits margins narrowed further in 2008. Changes in MFI funding structures raised financing costs in at least two regions. MFIs in both Eastern Europe and Central Asia (ECA) and in the Middle East and North Africa (MENA) witnessed a one percentage point increase in funding outlays relative to total assets, a trend that continued throughout the period. Other regions, by comparison, experienced increases of less than half that

Figure 2: Arrears rise, but risk coverage remains high, 2006–08

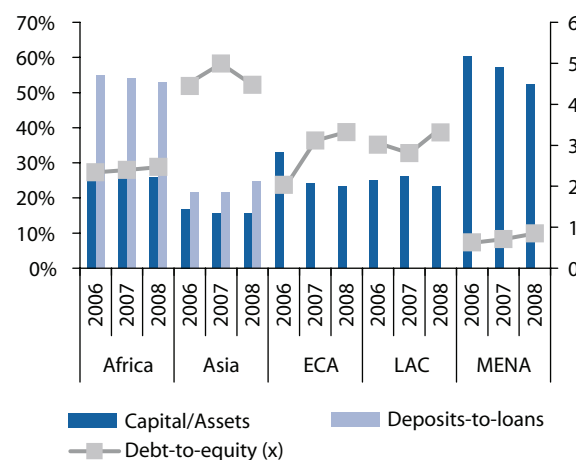


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rate. This shift continued to underscore the cross-border debt and local market refinancing activity that has expanded rapidly in both regions in the last few years, replacing subsidized funding from prior periods. (Figure 3, Figure 4)

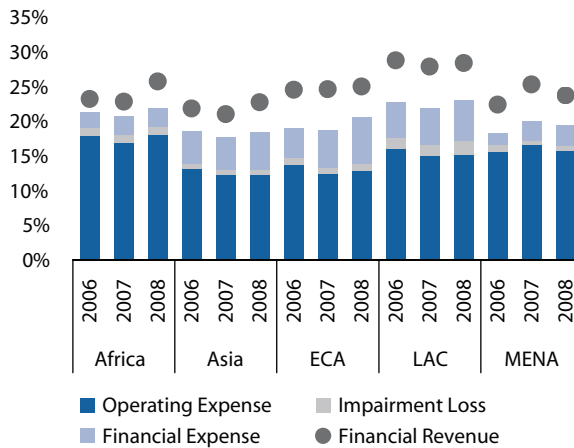
- The persistent decline in microcredit delivery costs slowed by 2007 and actually reversed for most regions in 2008, putting further pressure on profit margins in 2008.

Figure 3: MFIs continue to leverage capital, 2006–08



Source: MIX data 2006-08. Data are for a balanced panel of MFIs and represent medians, unless otherwise indicated.

Figure 4: Returns narrow, 2006-08



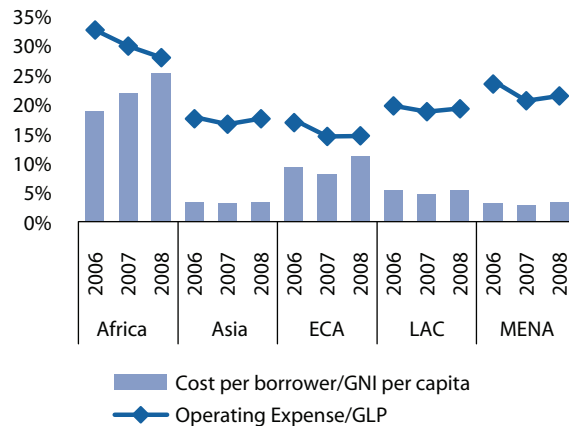
Source: MIX data 2006-08. Data are for a balanced panel of MFIs and represent medians, unless otherwise indicated.

The typical African MFI witnessed the largest increase in operating costs, with costs per borrower rising 15 percent relative to local income levels from 2006 to 2008. Only Asian MFIs held costs steady over the period, but even this flat line masks diverse operating costs across the region. Efficiency gains in Indian and Afghan MFI costs counterbalanced increases in markets like Cambodia. (Figure 5)

Slower Growth Puts Pressure on MFI Operating Models

The strong growth in microfinance borrower outreach over the last decade underlines the mission of MFIs focused on expanding access to financial services, particularly credit, by poor households lacking reliable access to such services. These growth rates inform all aspects of an MFI's business planning, from projections for growth trends in start-up institutions, to operational planning for new points or services, from planning needs for new financing to the design of incentive systems used to keep staff focused on sustainably expanding the reach of credit services. Raised in a global climate of 25 percent annual expansion in borrowers for most of this decade, MFIs, one can imagine, may have based their planning on similar levels of future growth. But what happens when actual growth slows down, not for a few MFIs, but across the board? Indeed, what does the microfinance business look like when the majority of markets – 60 out of 85 countries tracked

Figure 5: Declining costs reverse course, 2006-08



Source: MIX data 2006-08. Data are for a balanced panel of MFIs and represent medians, unless otherwise indicated.

(Figure 6) over the 2006 - 2008 period – experience slower growth rates?

Improved efficiency would appear to be among the first victims of slower growth. Over the last several years, these Highlights and other reviews of global MFI performance data have underscored the gradual improvements in operating costs, which, at nearly two-thirds of total costs, represent the biggest barrier to more affordable access to credit services by microfinance clients. In the 2002–2005 period, for example, global yields on microcredit portfolio rates dropped nearly three percentage points, without loss in profitability, backed by declines in operating costs. Productivity gains played an important part in these gains in efficiency.

In the beginning of the 2006–08 period, operating costs leveled off at a global and regional level. Almost all regions experienced flat cost trends between 2006 and 2007, with the global weighted average staying at 4.5 percent of GNI per capita for both years. By the end of the period, this trend towards greater efficiency may have hit its first peak in this global slowdown of microfinance outreach. For all but a handful of markets that experienced slower growth in borrower outreach in 2008, costs associated with serving a single borrower increased when normalized for differences in local income levels (Figure 6). Is there a link between slowing growth rates and rising operating costs?

Trends in staffing point to one explanation for this reversal of efficiency gains. Microfinance, a

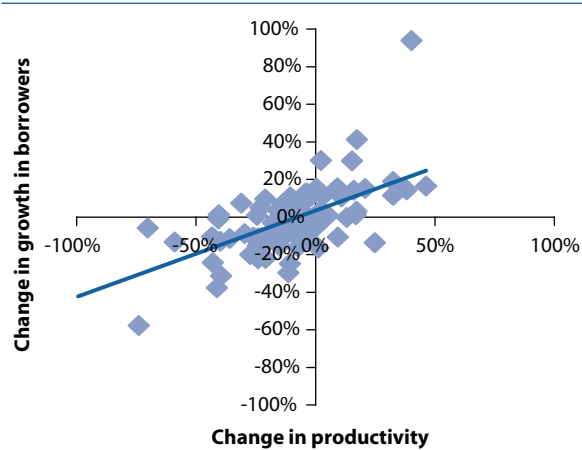
Figure 6: Costs start to rise as growth slows

Country	Growth in borrowers			Cost per borrower/GNI per capita		
	2006–07	2007–08	Trend	2007	2008	Trend
Africa	22%	14%	Down	16.0%	18.4%	Up
Benin	-5%	28%	Up	34.8%	30.2%	Down
Ethiopia	12%	14%	Up	4.1%	5.2%	Up
Ghana	15%	18%	Up	22.6%	25.6%	Up
Kenya	57%	14%	Down	19.2%	23.1%	Up
Mali	-2%	-1%	Up	12.3%	14.8%	Up
Mozambique	25%	9%	Down	76.5%	98.3%	Up
Senegal	7%	-4%	Down	18.0%	26.7%	Up
Tanzania	-3%	13%	Up	29.7%	33.8%	Up
Uganda	13%	9%	Down	76.5%	83.5%	Up
Asia	23%	22%	Down	2.4%	2.9%	Up
Afghanistan	23%	-1%	Down	22.7%	30.8%	Up
Bangladesh	14%	4%	Down	2.1%	2.4%	Up
Cambodia	32%	31%	Down	13.6%	16.6%	Up
India	48%	65%	Up	1.4%	1.5%	Up
Indonesia	67%	42%	Down	1.5%	1.2%	Down
Nepal	2%	5%	Up	4.4%	6.0%	Up
Pakistan	29%	24%	Down	5.8%	4.7%	Down
Philippines	37%	19%	Down	3.2%	3.5%	Up
ECA	34%	18%	Down	14.8%	17.4%	Up
Albania	16%	21%	Up	13.4%	15.6%	Up
Armenia	34%	32%	Down	5.6%	6.5%	Up
Azerbaijan	70%	29%	Down	8.0%	10.0%	Up
Bosnia and Herzegovina	53%	22%	Down	6.4%	6.4%	Down
Bulgaria	25%	4%	Down	15.0%	18.6%	Up
Georgia	15%	6%	Down	15.2%	20.2%	Up
Kosovo	38%	26%	Down	31.1%	30.4%	Down
Kyrgyzstan	48%	35%	Down	23.0%	27.1%	Up
Russia	25%	11%	Down	14.2%	17.1%	Up
Tajikistan	94%	24%	Down	78.0%	87.8%	Up
LAC	19%	11%	Down	5.7%	6.6%	Up
Bolivia	19%	12%	Down	13.9%	17.9%	Up
Brazil	-27%	-2%	Up	1.8%	2.4%	Up
Colombia	30%	12%	Down	5.6%	6.0%	Up
Costa Rica	10%	8%	Down	6.4%	7.3%	Up
Ecuador	14%	14%	Up	6.2%	6.3%	Up
El Salvador	23%	8%	Down	7.0%	7.5%	Up
Guatemala	29%	12%	Down	4.6%	5.0%	Up
Honduras	22%	-8%	Down	9.1%	10.6%	Up
Mexico	30%	26%	Down	1.7%	1.9%	Up
Nicaragua	15%	6%	Down	16.7%	17.9%	Up
Paraguay	7%	23%	Up	9.3%	12.7%	Up
Peru	28%	4%	Down	4.8%	5.9%	Up
MENA	34%	6%	Down	2.7%	3.1%	Up
Egypt	34%	31%	Down	2.0%	2.1%	Up
Jordan	45%	19%	Down	3.4%	3.7%	Up
Morocco	34%	-6%	Down	2.5%	3.1%	Up

Source: MIX data 2006–2008. Data are for a balance panel of MFIs and represent weighted averages by region and country for all countries with more five or more MFIs reporting over the period.

high touch business, currently relies on significant human resources to deliver credit to clients. Many MFIs make significant investments in training new staff on the systems and processes that help identify clients, minimize credit risk, and manage service delivery of microloans. This combination of intensive personnel use and extensive training increases the lead time necessary for an MFI to gear up to serve more clients. When slowdowns have a rapid onset, MFIs will likely have already fielded new staff based on earlier projections, leaving the providers overstaffed compared to optimal productivity rates. Staffing and borrower growth trends bear out this analysis: MFI staffing increased faster than growth in borrowers in over two-thirds of all markets where growth rates slowed in 2008. **Figure 7** summarizes the impact of this phenomenon on productivity. As business slowed, productivity declined.

Figure 7: Productivity declines as growth rates slow

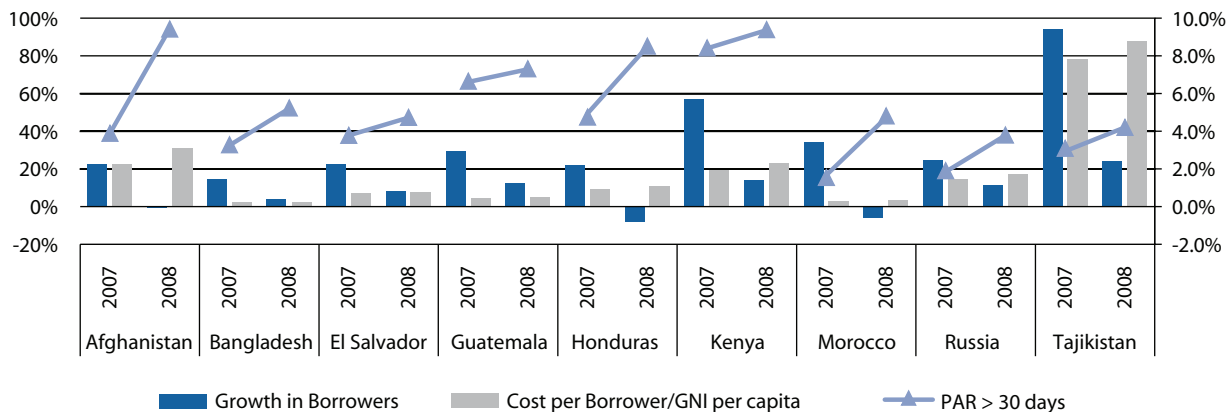


Source: MIX data 2006–2008. Data are for a balance panel of MFIs and represent weighted averages by country.

Rising arrears offer another explanation for increased operating costs. As delayed repayments rise within a portfolio, staff must shift time from building and maintaining microcredit portfolios to recovering delinquent loans. This resource shift accentuates the trend already highlighted. At a global level, portfolio quality deteriorated by more than 50 percent in 25 markets. Few arrears rates moved into double digits, but such increases represented a departure from historical performance. In all but one of these countries, the cost of serving borrowers also made a marked increase. As **Figure 8** shows, countries with pronounced changes in delinquency rates, such as Afghanistan, Bangladesh, Honduras, Kenya, and Tajikistan, all experienced reversals in efficiency gains as portfolio quality deteriorated.

Whatever the cause of slower growth rates – whether refinancing constraints from outside the MFI or MFI management reining in growth faced with rising credit risk – the impact on the microfinance business is tangible: an increased cost of delivering loans. To MFI managers, this poses an extra challenge of maintaining their business in difficult times while positioning themselves for growth and recovery as the economy improves. Laying off excess staff would cut costs, but the investment in training and relationships would be difficult to recover when lending opportunities rebound. Likewise, running an overstaffed MFI for more than a year would maintain a springboard for relaunching its growth trajectory, but the increased cost load will either eat into equity or increase costs

Figure 8: Slowed growth with rising PAR push up operating costs



Source: MIX data 2006–2008. Data are for a balance panel of MFIs and represent weighted averages by country.

to clients in the long term. Microfinance analysts should monitor these cost trends in 2009 and 2010 to see whether MFIs manage to resume their

relentless pursuit of lower cost service or if this slowdown in the growth model marks an inflection point for microfinance.