MicroRate
The Rating Agency for Microfinance

MFInsights

The Impact of the Global Financial Crisis on Latin American & Caribbean Microfinance Institutions

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This report is based on insights and data from the following institutions:

MIVs	
ACCION Gateway Fund	Hivos Triodos Fund Foundation
ASN-Novib Fund	Impulse Microfinance Investment Fund
Blue Orchard Loans for Development 2006-1	Incofin CVSO
Blue Orchard Loans for Development	LocFund
Blue Orchard Microfinance Securities 1	MicroAccess Trust 2007
Dexia Microcredit Fund	MicroVest LP
Deutsche Bank - Global Commercial Microfinance Consortium	Oikocredit
Deutsche Bank - Microfinance-Invest. Nr 1- First German Fund for Microfinance	responsAbility Microfinanz-Fonds
Global Partnerships Microfinance Fund 2005	responsAbility Global Microfinance Fund
Global Partnerships Microfinance Fund 2006	responsAbility Microfinance Leaders Fund
Global Partnerships Microfinance Fund 2008	Triodos-Doen Foundation
	Triodos Fair Share Fund

MFIs			
Adopem	CMAC Maynas	FIE	Prodesa
Agrocapital	CMAC Sullana	FIE Gran Poder	Proempresa
Alsol Chiapas	CMAC Tacna	FINCA México	ProFinazas
AMA	CMAC Trujillo	Fincomun	Pro Mujer Bolivia
AMC	Compartamos	Fondo Creación	Pro Mujer México
BancoSol	Confianza	FRAC	Pro Mujer Nicaragua
Banco Visión	CRAC Los Andes	Funbodem	Pro Mujer Perú
Banex	CREAR Arequipa	Fundeser	Raíz
Caja Los Andes	CREAR Tacna	Idepro	WWB Bogotá
Procredit El Salvador	D-Miro	MicroFin	WWB Bucaramanga
CMAC Arequipa	Edyficar	Mide	WWB Colombia
CMAC Cusco	El Comercio	FJ Nieborowski	WWB Medellín
CMAC Ica	FDD	Nueva Visión	WWB Popayán

Others	
Emergency Liquidity Fund (ELF)	Women's World Banking (WWB)
FINCA International	

Table of Contents

Charts, Tables & Boxes

Acronyms

ALADI	Asociación Latinoamericana de Integración
ASOMIF	La Asociación Nicaragüense de Instituciones de Microfinanzas
BBVA	Banco de Bilbao y Vizcaya Argentaria
bp	Basis point
CAGR	Compound annual growth rate
CAIS	Central American Integration System (see SICA)
CAF	Corporación Andina de Fomento
CARICOM	Caribbean Community
CAFTA	Central America Free Trade Agreement (see DR-CAFTA)
CEPAL	La Comisión Económica para América Latina (see ECLAC)
CGAP	Consultative Group to Assist the Poor
CIA	Central Intelligence Agency
CMAC	Caja Municipal de Ahorro y Crédito
CSFI	Centre for the Study of Financial Innovation
DR-CAFTA	Dominican Republic – Central America Free Trade Agreement (see CAFTA)
GDP	Gross domestic product
ECLAC	Economic Commission for Latin America and the Caribbean (see CEPAL)
ELF	Emergency Liquidity Fund
FARC	Fuerzas Armadas Revolucionarias de Colombia
FX	Foreign exchange
FDI	Foreign direct investment
IDB	Inter-American Development Bank
IDI	International development institution
IFC	International Finance Corporation
IFI	International financial institutions
IMF	International Monetary Fund
KfW	KfW Entwicklungsbank
LAC	Latin America and the Caribbean
Mercosur	Mercado Común del Sur
MFI	Microfinance institution
MIF	Multilateral Investment Fund
MIV	Microfinance investment vehicle
NAFTA	North American Free Trade Agreement
NGO	Non-governmental organization
OECD	Organisation for Economic Co-operation and Development
SAP	Sociedades de Ahorro y Préstamo
SBS	Superintendencia de Banca, Seguros y AFP
SFP	Sociedades Financieras Populares
SICA	Sistema de la Integración Centroamericana (see CAIS)
SME	Small and medium enterprises
SOFOL	Sociedades Financieras de Objeto Limitado
SOFOM	Sociedades Financieras de Objeto Múltiple
Unasur	Unión de Naciones Suramericanas
USAID	United States Agency for International Development
WWB	Women's World Banking

Methodology

Research for this report was conducted by MicroRate between September 2008 and February 2009. Interviews, surveys and data were collected from microfinance industry participants—including MFIs and MIVs—and analyzed by MicroRate staff and contributors.

We are very grateful to all those people who generously shared their time and knowledge for this report. The views expressed herein do not necessarily reflect those of the institutions appearing below:

MIV Name	Country of Domicile	Type of Vehicle
ACCION Gateway Fund	United States	Private Equity Funds
ASN-Novib Fund	Netherlands	Registered Mutual Funds
Blue Orchard Loans for Development	Luxembourg	Structured Finance Vehicles (passive)
Blue Orchard Loans for Development 2006-1	Luxembourg	Structured Finance Vehicles (passive)
Blue Orchard Microfinance Securities 1	Luxembourg	Structured Finance Vehicles (passive)
Deutsche Bank - Global Commercial Microfinance Consortium	Cayman Islands	Structured Finance Vehicles (active)
Deutsche Bank - Microfinance-Invest. Nr 1- First German Fund for Microfinance	Germany	Structured Finance Vehicles (passive)
Dexia Microcredit Fund	Luxembourg	Registered Mutual Funds
Global Partnerships Microfinance Fund 2005	United States	Commercial Investment Funds
Global Partnerships Microfinance Fund 2006	United States	Commercial Investment Funds
Global Partnerships Microfinance Fund 2008	United States	Commercial Investment Funds
Hivos Triodos Fund Foundation	Netherlands	Blended Value Funds
Impulse Microfinance Investment Fund	Belgium	Commercial Investment Funds
Incofin CVSO	Belgium	Blended Value Funds
LocFund	United States	Commercial Investment Funds
MicroAccess Trust 2007	United States	Commercial Investment Funds
MicroVest LP	United States	Commercial Investment Funds
Oikocredit	Netherlands	Blended Value Funds
responsAbility Global Microfinance Fund	Luxembourg	Registered Mutual Funds
responsAbility Microfinance Leaders Fund	Luxembourg	Registered Mutual Funds
responsAbility Microfinanz-Fonds	Luxembourg	Registered Mutual Funds
Triodos Fair Share Fund	Netherlands	Registered Mutual Funds
Triodos-Doen Foundation	Netherlands	Blended Value Funds

MFI Name	Country	Regulated	Portfolio *
ADOPEM (Asociación Dominicana para el Desarrollo de la Mujer)	Dominican Republic	Y	$ 35,811
Agrocapital (Fundación AgroCapital)	Bolivia	Y	$ 22,900
Alsol Chiapas (ALSOL, A.C.)	Mexico	N	$ 3,479
AMA (Asociación Mujeres en Acción)	Peru	N	$ 2,828
AMC (Sociedad Cooperativa de Ahorro y Crédito AMC de R.L.)	El Salvador	Y	$ 17,467
Banco Visión (Visión Banco S.A.E.C.A.)	Paraguay	Y	$ 137,441 **
BancoSol	Bolivia	Y	$ 293,404 **
Banex (Banco del Éxito, ex FINDESA)	Nicaragua	Y	$ 138,828 **
CMAC Arequipa (Caja Municipal de Ahorro y Crédito de Arequipa)	Peru	Y	$ 286,731
CMAC Cusco (Caja Municipal de Ahorro y Crédito de Cusco)	Peru	Y	$ 131,834
CMAC Ica (Caja Municipal de Ahorro y Crédito de Ica)	Peru	Y	$ 77,804
CMAC Maynas (Caja Municipal de Ahorro y Crédito de Maynas)	Peru	Y	$ 50,679
CMAC Sullana (Caja Municipal de Ahorro y Crédito de Sullana S.A.)	Peru	Y	$ 158,981
CMAC Tacna (Caja Municipal de Ahorro y Crédito de Tacna)	Peru	Y	$ 78,505 **
CMAC Trujillo (Caja Municipal de Ahorro y Crédito de Trujillo)	Peru	Y	$ 303,782
Compartamos (Banco Compartamos, S.A., Institución de Banca Múltiple)	Mexico	Y	$ 462,958
Confianza (EDPYME Confianza)	Peru	Y	$ 71,314

CRAC Los Andes (Caja Rural Los Andes)	Peru	Y	$ 8,706
Crear Arequipa (EDPYME Crear Arequipa)	Peru	Y	$ 53,117
Crear Tacna (EDPYME Crear Tacna)	Peru	Y	$ 19,942 **
D-Miro	Ecuador	N	$ 17,840
Edyficar (Financiera Edyficar S.A.)	Peru	Y	$ 154,570
El Comercio (Financiera El Comercio)	Paraguay	Y	$ 52,134
FDD (Fundación Dominicana de Desarrollo)	Dominican Republic	N	$ 3,722
FIE (Fondo Financiero Privado para el Fomento a Iniciativas Económicas)	Bolivia	Y	$ 207,029
FIE Gran Poder (FIE Gran Poder S.A.)	Argentina	N	$ 10,095
FINCA Mexico	Mexico	N	$ 25,266
Fincomun (Servicios Financieros Comunitarios)	Mexico	Y	$ 47,638
FJ Nieborowski (Fundación José Nieborowski)	Nicaragua	N	$ 18,239 **
Fondo Creación (Fondo Creación SA de CV)	Mexico	N	$ <10
FRAC (Fundación Realidad AC)	Mexico	N	$ 4,644
Funbodem (Fundación Boliviana para el Desarrollo de la Mujer)	Bolivia	N	$ 7,893
Fundeser (Fundación para el Desarrollo Socioeconómico Rural)	Nicaragua	N	$ 18,924
Idepro (IDEPRO Desarrollo Empresarial)	Bolivia	N	$ 5,228
MicroFin (Caribbean Microfinance Limited)	Caribbean	Y	$ 3,168 ***
Mide (Microcredito para el Desarrollo)	Peru	N	$ 1,275
Nueva Visión (EDPYME Nueva Visión)	Peru	Y	$ 15,543
Pro Mujer Bolivia	Bolivia	N	$ 22,817
Pro Mujer Mexico	Mexico	N	$ 5,426
Pro Mujer Nicaragua	Nicaragua	N	$ 4,308
Pro Mujer Peru	Peru	N	$ 10,108
ProCredit Bolivia (Banco Los Andes ProCredit)	Peru	Y	$ 339,553 **
ProCredit EL Salvador (Banco ProCredit El Salvador)	El Salvador	Y	$ 191,665
Prodesa (Fundación Para La Promoción y el Desarrollo)	Nicaragua	N	$ 17,608 **
Proempresa (EDPYME Proempresa)	Peru	Y	$ 34,642
Profinanzas (Caja Rural de Ahorro y Crédito Profinanzas S.A.)	Peru	Y	$ 29,933
Raíz (EDPYME Raíz)	Peru	N	$ 84,256****
WWB Bogotá (Corporación Mundial de la Mujer Colombia - Bogotá)	Colombia	N	$ 77,380
WWB Bucaramanga (Fundación Mundial de la Mujer Bucaramanga)	Colombia	N	$ 137,981
WWB Colombia (WWB Colombia - Cali)	Colombia	N	$ 260,859
WWB Medellin (Women's World Banking - Medellín)	Colombia	N	$ 91,087
WWB Popayán (Fundación Mundo Mujer Popayán)	Colombia	N	$ 170,115

* in US$ thousands; as of June 2008 unless otherwise noted

** as of December 2007

*** as of December 2005

**** as of December 2008

Source: (MicroRate MFI Sample; MIX Market)

Executive Summary

Purpose of the Study

The purpose of this study is to gauge the impact of the global financial crisis on the microfinance sector in Latin America and the Caribbean (LAC). The situation is still clearly evolving. For example, in October 2008, when interviews with microfinance institutions (MFIs) first began, a majority of responses reflected that growth had slowed somewhat, but not dramatically. Nonetheless, preliminary data show that by the end of 2008, portfolio growth had indeed slowed dramatically. Even now, it is apparent that the crisis is having a more profound impact than those directly involved realized only a few months ago. This study attempts to describe the situation as it has evolved during the last quarter of 2008. The study is not intended to be a comprehensive or methodical survey of the entire microfinance sector. Rather, it combines a number of interviews with leaders of MFIs and microfinance investment vehicles (MIVs)[1] with MicroRate's own observations gathered during many ratings of MFIs since the fourth quarter of 2008.

Synopsis

The international financial crisis was quick to affect the financial markets of the LAC Region. MFIs already feel the effects of tightening credit markets. With some exceptions, such as countries that were already struggling with economic difficulties (Nicaragua and Ecuador), the slowdown in the real economy has taken longer to be felt. In fact, by the end of 2008 most countries had not yet seen an impact on the population MFIs serve.

In October and November 2008, MFIs reported that the crisis in world financial markets had not yet affected the real economy in which micro-enterprises operate. Nonetheless, prompted by tightening credit markets, most of the MFIs surveyed cut back on growth during the second half of 2008. They did so not only because of funding concerns, but also in anticipation of a deteriorating economic situation which they believe will affect the quality of their portfolios.

In the past, demand drove MFI growth and the pace of growth was limited by how fast institutions could expand their staff and organizations. As 2008 drew to a close, that pace was being set by very different forces. The looming threat of an economic crisis prompted many MFIs to slow growth as a preemptive measure.

MFIs have reacted to this environment by mitigating risk through stricter lending criteria, strengthening provisioning policies, focusing on existing clients while reducing the number of loans to higher risk clients. A number of MFIs are even moving down-market by reducing their average loan size. They expect less competition and a more shock-resistant clientele at lower levels of the microcredit market.

MFIs that experienced significant growth in the past decade frequently did so at the expense of increasing institutional capacity. Now that MFIs are scaling back growth, they are able to dedicate resources to institution building activities.

The very latest—but not final—figures show, however, that lending in 2008 slowed more dramatically than MFIs admitted in October and November 2008. Worried about signs of

[1] MicroRate defines an MIV as an independent investment vehicle which satisfies all the following three criteria: (1) vehicle must be an independent legal entity, (2) presence of and/or open to multiple investors, (3) focus on investing in microfinance.

tightening credit markets, many MFIs are borrowing whenever an opportunity presents itself, rather than borrowing only as necessary. This, and a general increase in the cost of credit, causes an increase in their funding expenses.

As domestic credit becomes scarce, access to foreign borrowing assumes new importance for MFIs. Unfortunately, MIVs cut back their lending in the last quarter of 2008. But in the survey of MIVs, they expressed caution, more likely a reaction to the turmoil in financial markets and not necessarily a consequence of funding difficulties. MIVs were accumulating cash in anticipation of a potential investor slowdown—or worse, an increase in redemptions—that has yet to manifest itself. In addition to market uncertainties, foreign exchange risk is a real impediment for capital flows from rich countries to MFIs. Exchange rates are fluctuating wildly and unpredictably.

MFIs that mobilize savings have a clear advantage as domestic credit tightens. Therefore, one would expect MFIs to accelerate plans to transform themselves into deposit-taking institutions. Paradoxically, the opposite may be happening. In the short-run, such a transformation is expensive and associated with risks that MFIs are currently unwilling to assume.

It is clear that the resilience of the microfinance sector will be tested. Many are feeling the effects of capital market volatility and increased risk from loans in areas less protected from this volatility, such as consumer credit and lending to small businesses. True microcredit—short-term lending to highly flexible clients for productive purposes—will prove more resistant.

Is microfinance correlated to economic cycles?

The accepted wisdom is that microfinance is impervious to the global markets but the data so far do not support or refute this claim. Portfolio quality has deteriorated somewhat, but not significantly. And what little deterioration there has been is probably more a consequence of slowing portfolio growth than of deteriorating quality.

MicroRate expects that microfinance will be more affected by economic cycles than it has been in the past. The reasons are twofold: (1) MFIs today are more tightly integrated into the financial sector than they were a decade ago, at the time of the East Asian or Bolivian crisis, and (2) the definition of "microcredit" now includes many forms of lending to the poor not previously considered microfinance.

MFIs that help the poor create wealth should do well, even in times of recession. But institutions that lend for other needs—consumption in particular—will find themselves heavily exposed to economic cycles. Microcredit has grown to include small business lending as well. Small businesses don't have the flexibility that characterizes micro-enterprises. Since small businesses often carry considerable fixed assets, they are highly vulnerable when the economy contracts. MFIs that have strayed over the boundary that divides microcredit from consumer, or small lending will be more vulnerable than those MFIs that remain focused on core microfinance services.

Introduction

Microfinance institutions (MFIs) throughout the world face an uncertain future. Since the crises of the late 1990s and early 2000s, microfinance in Latin America and the Caribbean (LAC) has grown at an exponential rate and is increasingly integrated into the Region's formal economy. Many MFIs have reached economies of scale and levels of professionalism that allow them to compete effectively against more established financial institutions, such as commercial banks. Today, the global financial turmoil is only beginning to impact local LAC economies. While it is certain that these economies will be affected, the depth and manner micro-enterprises will be influenced still remains unclear.

Microcredit is utilized mainly to produce goods and services that inherently adapt to market conditions and that tend to be inelastic in demand. This partially insulates the sector from global shocks. Nonetheless, the economic slowdown is still expected to trickle down and affect spending among micro-entrepreneurs. In the face of deteriorating economic conditions, clients may become increasingly unable to repay loans on time. After many years of uninterrupted rapid growth, few MFIs are accustomed to operating under adverse environments which leaves a real possibility that some MFIs may fail.

On the other hand, current events are likely to force more people out of jobs in the formal economy and into the informal sector in order to make a living. In addition, as employment opportunities for workers living abroad diminish, a steady reverse immigration is expected to increase the ranks of the informal sector.

Furthermore, the behavior of clients, like that of the MFIs, has altered in response to the anticipated and actual changes of the economic environment. Clients have found other sources of credit to be increasingly difficult to obtain, due to decreased liquidity and increased interest rates. Credit cards, consumer loans, and small and medium enterprise (SME) lending have been particularly affected. This squeeze in liquidity has also contributed to an increase in demand for microcredit.

Many have made the claim that microfinance is immune to economic cycles or even that it is counter-cyclical. MFIs can already see that the economic downturn and the return of emigrant labor will increase the pool of potential clients and on the whole, portfolio quality remains excellent. However, the crisis has not yet fully hit and it is uncertain what will happen when it does. Those MFIs that have stuck to true microcredit by concentrating on a borrower's ability to create value should be relatively safe. But MFIs whose lending methodologies do not allow them to determine the borrower's capacity to create value will be vulnerable. Those MFIs that have openly moved into consumer credit are most exposed to adverse effects of the crisis.

Macro Environment

LAC has seen an impressive period of growth over the last 25 years. From the early twentieth century through the debt crises of the 1980s, LAC was plagued by innumerable setbacks. But the circumstance has changed due to more recent political reform and economic expansion. During the last decade, hyper-inflation, fiscal mismanagement, economic implosion as well as the political environments that cause these circumstances have largely become a thing of the past.

That progress is now in jeopardy. Although as recently as July 2008, the International Monetary Fund (IMF) held that LAC was sufficiently independent from the United States and able to withstand any significant adverse effects from their neighbors to the north, that prognosis has quickly changed. World Bank President Robert Zoellick and IMF Managing Director Dominique Strauss-Kahn amended their advice following the global financial shocks of September 2008 and instead suggested that LAC would soon feel the pressure that has rippled through developed economies around the world (Barber 2008).

It is impossible to predict precisely how and when any adverse effects will hit LAC. A close look into LAC's current economic status reveals continued, albeit slightly reduced, expansion. Gross domestic product (GDP) growth for the Region showed a positive trend, although it was somewhat tempered. Even after September 2008's financial turmoil, estimates by the Economic Commission for Latin America and the Caribbean (ECLAC[2]) still projected nearly 5 percent growth through 2008 (CEPALSTAT Database ECLAC). The latest 2009 GDP figures estimate a range of 1.9 to 3.25 percent growth, reflecting continued deceleration in global credit and commodity markets and an overall weak financial outlook (IMF, 2008).

Inflation rose to almost 9 percent in the 10 months up to October 2008, the highest level in five years. Many LAC governments have adopted monetary policies that target inflation through various monetary controls. Unfortunately, lower commodity prices, lower demand growth and tightened fiscal policies are impeding the inflation-targeting efforts. Central banks have responded by increasing interest rates to balance appreciating exchange rates. These measures should help lower inflation through 2009.

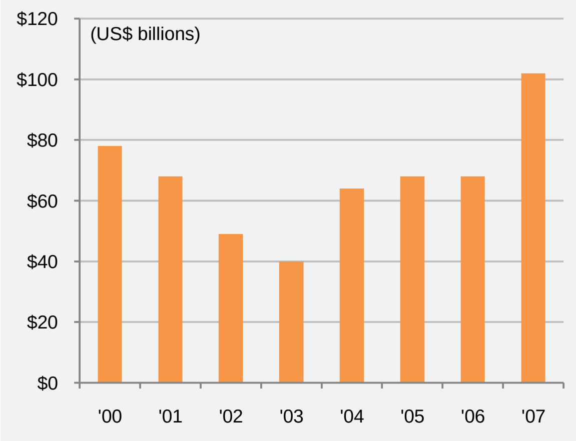
The political climate in LAC has made much of this growth possible. Although not completely void of political malaise, the violent coups and civil wars have slowly transformed into peaceful elections and enterprising marketplaces ripe for economic and infrastructure development. A new wave of pro-growth political and economic reforms has led many LAC countries to establish ministries and political organizations to foster economic activity both domestically and abroad.

Meanwhile, macroeconomic stability has encouraged increased external funding (*see Chart 1*) and fiscal surpluses (*see Chart 2*). Many LAC central banks predicted the boom in commodity prices would only be temporary, so they built up cash reserves to cushion the impact of large swings in export revenues. Meanwhile, foreign direct investment (FDI) increased as a result of open markets and lucrative incentives.

International trade was the central economic activity of many LAC economies over the last decade. As demand for commodities by

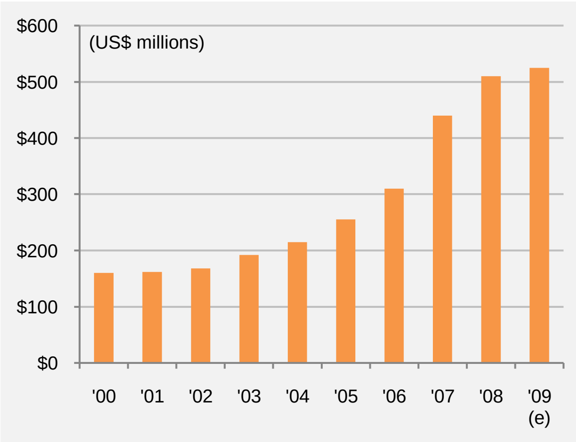
[2] A United Nations commission.

Chart 1: FDI Inflows to LAC



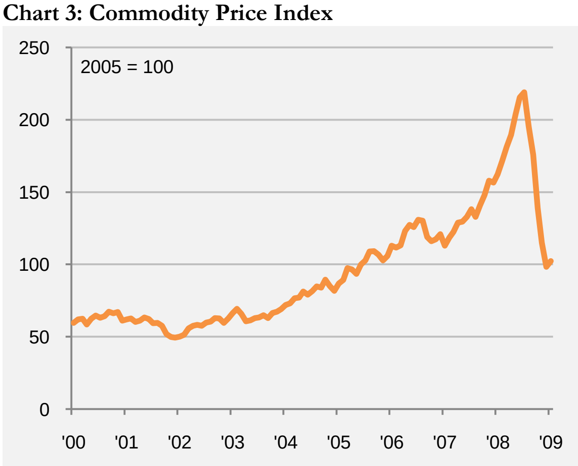
Source: (Bertuol, October 10, 2008)

Chart 2: Latin American Reserves



Source: (Bertuol, October 10, 2008)

Chart 3: Commodity Price Index



Source: (IMF World Economic Outlook, 2008)

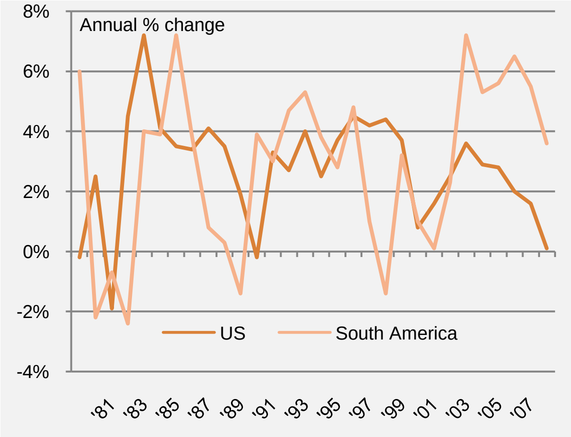
developing nations worldwide, in particular China and India, expanded, LAC continued to increase its production levels in proportion. Commodities quickly became the fastest growing industry in LAC and as commodity prices exploded *(see Chart 3)*, it also became the most profitable.

Expanding export markets also enabled a decoupling from U.S. dependency. For years, LAC nations viewed themselves as cogs in the U.S. trade machine and felt trapped by restrictive policies and irreconcilable imbalances. With a new, diverse group of trading partners—both at home (domestic and regional) and abroad (global developing nations)—LAC countries could take advantage of open markets where new, more profitable and equitable trade terms could be negotiated. The following Regional trading blocs have been organized to help promote LAC trade worldwide: Asociación Latinoamericana de Integración (ALADI), Central American Integration System (CAIS), Caribbean Community (CARICOM), Dominican Republic – Central America Free Trade Agreement (DR-CAFTA), Mercado Común del Sur (Mercosur), North American Free Trade Agreement (NAFTA) and Unión de Naciones Suramericanas (Unasur).

Even though many LAC nations fought off U.S. dependence, the United States maintains a strong influence in nearly every economy and the correlation of economic prosperity between the two is undeniable (*see Chart 4*). In the last four U.S. recessions, LAC GDP growth trends show a direct correlation, either simultaneously or slightly delayed.

The severity of the recession's effects on LAC is also growing. Following the 1981 and 1991 U.S. recessions, LAC did not experience a slowdown until after the United States rebounded and the effect was not very pronounced. In the 2001 and 2008 recessions, however, there is a one-to-one correlation between the United States and

Chart 4: Real GDP Growth - US vs. South America



Source: (IMF World Economic Outlook, 2008)

Chart 5: Latin America Sovereign Credit Index

Source: (Bertuol, October 10, 2008)

Table 1: 2008 Sovereign Credit Ratings - Q4 Updates

County	Long-term IDR	Date	Action	Outlook
Argentina	B- *	Dec-08	Affirmed	-
Aruba	BBB	Oct-08	Affirmed	Stable
Brazil	BBB-	Nov-08	Affirmed	Stable
Chile	A	Nov-08	Revision	Stable
Ecuador	RD	Dec-08	Downgrade	-
El Salvador	BB+	Oct-08	Revision	Negative
Jamaica	B	Nov-08	Downgrade	Negative
Mexico	BBB+	Nov-08	Revision	Negative
Peru	BBB-	Nov-08	Affirmed	Stable
Venezuela	B+	Dec-08	Downgrade	Stable

Source: (Fitch Ratings, 2008)

** Long term Local Currency IDR; Long term IDR is RD.*

LAC in terms of both the severity and the timing of recessions.

Collectively, LAC's economic expansion efforts were reflected in sovereign credit ratings (*see Chart 5*). Ratings have increased since 2003, but have not yet matched the high of 2001. The latest updates (*see Table 1*) show a downward retreat; four of the ten ratings updated in the fourth quarter (Q4) 2008 are either in default or received a downgrade or negative outlook. So far, Ecuador (in December 2008) and Argentina (in December 2001) are the only LAC nations to default since 2000.

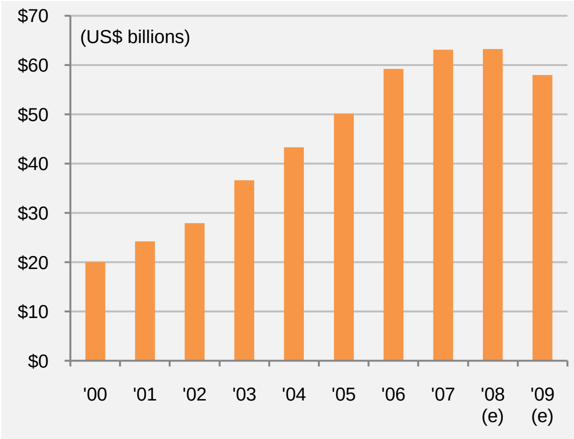
While the latest sovereign credit rating updates were largely pessimistic about LAC's future claims-paying ability, one has to wonder if the mainstream rating agencies were too late, just as they were with the subprime mortgage ratings. On the day following Ecuador's most recent default announcement, Standard & Poor's (S&P) downgraded Ecuador from B- to CCC-.

Although hindsight offers convenience, there is a real need for more accurate prediction and assessment of risks in LAC to help anticipate these devastating events.

The expected decline in remittances (*see Chart 6*) could have a significant effect in several LAC countries. 2008 remittances are equivalent to 10 to 25 percent of GDP for seven LAC countries and over 5 percent in six additional countries (*see Chart 7*). Troubles in originating countries have led to a sharp fall in the growth rate of remittances to the Region, although there is still positive growth in all countries but Mexico and Ecuador.

Labor markets in the LAC Region have changed remarkably from a generation ago. LAC is comprised of 600 million people that live in 33 countries. Poverty, extreme poverty, and unemployment still abound although they are down roughly 20 percent

Chart 6: LAC Remittance Inflows



Source: (Ratha, Mohaptra, & Xu, 2008)

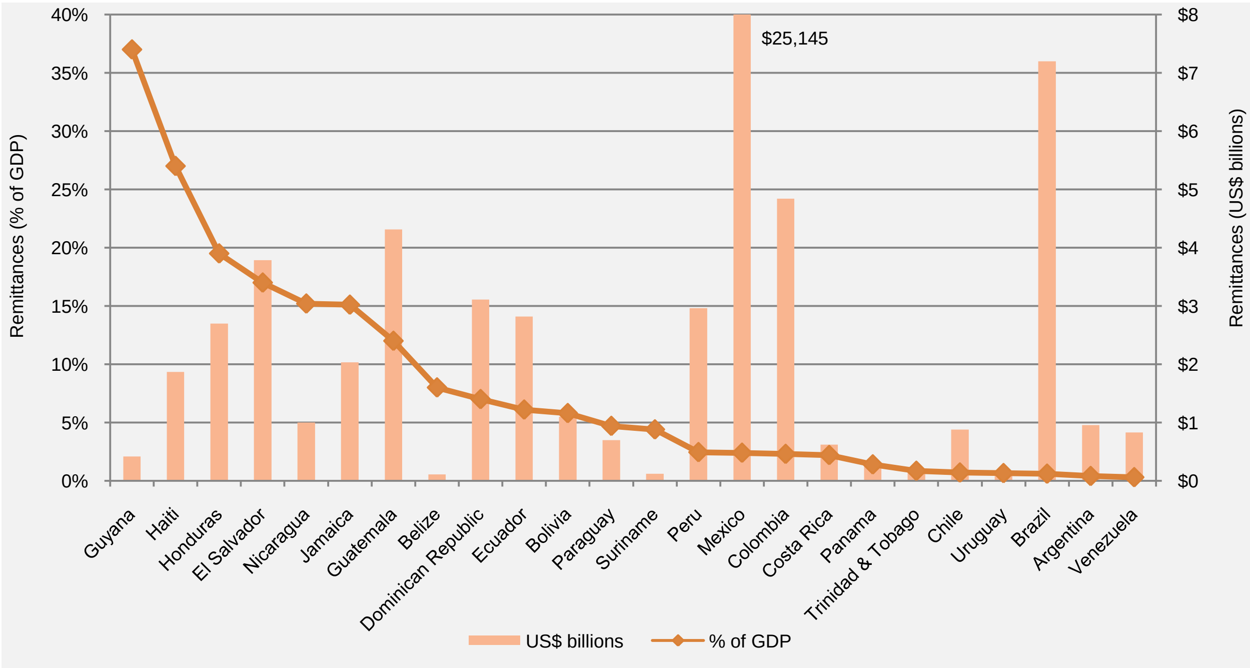
from their 2003 highs (CEPALSTAT Database ECLAC).

Similar to East Asia's economic boom in the 1990s, LAC's demographics favor economic expansion. The Organisation for Economic Co-operation and Development (OECD) predicts the LAC workforce will increase by 127 million within the next 25 years. More importantly, the dependency ratio—the proportion of non-workers (children and elderly) relative to the working population—will continue to fall. Between 1990 and 2033, the ratio is projected to be cut nearly in half from 1.8 to 1 non-worker per worker (Martinez-Diaz 2008). If productivity gains are made, LAC's growing workforce could be a substantial catalyst for economic growth or at least a solid defense from external economic contractions.

The LAC Region currently faces a turning point. The global recession will create a slowdown of unknown size and scope. Demographic changes have mandated costly social, political and economic reforms. The oil and food crises are a harsh reality. Demand from developed economies has already plummeted, causing commodity prices to drop dramatically from their record peaks in mid-2008. National savings will decrease and sound fiscal policy will be tested as populist political messages prescribe short-term solutions that will take decades to repay.

Although better equipped to handle economic downturns than in the past, LAC is currently experiencing drops in export volume, profit margins, remittances, tourism, and FDI. The length and severity of these declines is unknown.

Chart 7: 2008 LAC Remittance Inflows



Source: (Inter-American Development Bank (IDB) / Multilateral Investment Fund (MIF), 2009)

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Box 1: Credit Crisis Timeline - Jun 2007 thru Jan 2009

2007	Jun	Concerns over U.S. mortgage market intensify; Bear Sterns suffers heavy losses
	Sep	Bank of England liquidity lifeline to (UK mortgage bank) Northern Rock – later nationalized
	Oct	Write-offs of $6.5 billion then $11 billion hammer Citigroup profits
	Nov	HSBC announces £22 billion bail-out of its structured investment vehicles
	Dec	Huge injections into banking systems by five leading central banks to support liquidity
2008	Jan	UBS writes off more than $18 billion in 2007 (add another $18 billion in April 2008)
	Mar	U.S. Fed Reserve presses Bear Stearns into rescue sale to JPMorgan Chase with gov't gtys
	Jun	Californian home financier Indy Mac collapses – third biggest bank bankruptcy in U.S. history
	Sep	10th – U.S. gov't takes over control of mortgage giants Fannie Mae and Freddie Mac
		14th – Merrill Lynch sold to Bank of America for $50 billion
		14th – Lehman Brothers files for bankruptcy protection
		16th – Federal Reserve $85 billion rescue injection into insurance giant AIG
		21st – U.S. government proposes $700 billion plan to acquire U.S. banks' bad debts
		22nd – Goldman Sachs/Morgan Stanley give up i-bank status, become regulated banks
		29th – Run on UK mortgage bank Bradford & Bingley forces nationalization
		29th – German mortgage bank Hypo Real Estate seeks €35 billion rescue from gov't and banks
		29th – €11.2 billion bail-out of Belgian-Dutch bank Fortis by Belgium, Netherlands & Luxembourg
		30th – €6.4 billion bail-out of Franco-Belgian bank Dexia by Belgium, France & Luxembourg
	Oct	2nd – U.S. Congress approves TARP
		5th – German gov't gives guarantees to all savers in private banks
		6th – Panic sets in on world stock markets
		7th – IMF estimates worldwide losses of $1.4 trillion and fears they will grow much more
		9th - Iceland's financial sector crashes
		13th – Countries unite on support plan for Eurozone banks
		16th – Swiss gov't agrees to fund vehicle to take on up to $60 billion of toxic debts held by UBS
		16th – ING accepts €10 billion Dutch Gov't injection
2009	Jan	U.S. gov't commits billions to aid Bank of America in its acquisition of Merrill Lynch
		Citigroup announces $8.29 billion Q4 loss and a 2008 total net loss of $18.72 billion.
		Obama administration proposes $825 million economic stimulus package

Source: Credit Crisis Timeline - Jun 2007 thru Jan 2009 (Deutsche Bank, 2009)

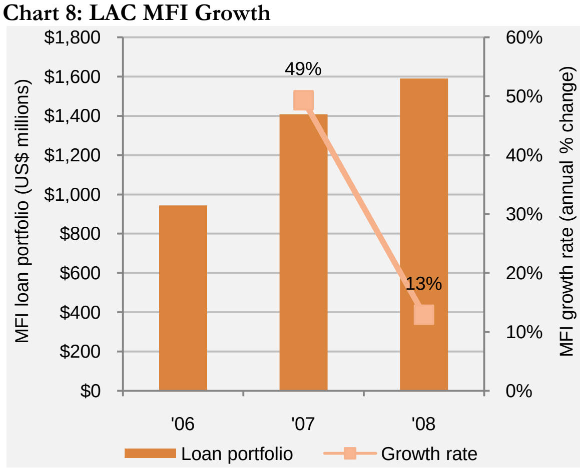
MFI Environment

MFI GROWTH

Microfinance in Latin America and the Caribbean has grown at an extremely rapid rate. The average growth rate of MFIs from the Region tracked by MicroRate[3] has been over 40 percent per year since 2002. The loan portfolios of these MFIs increased nearly five-fold in the five years ending in 2007. During the first half of 2008, growth remained strong at 34 percent annually but is expected to decline sharply in the second half of the year.

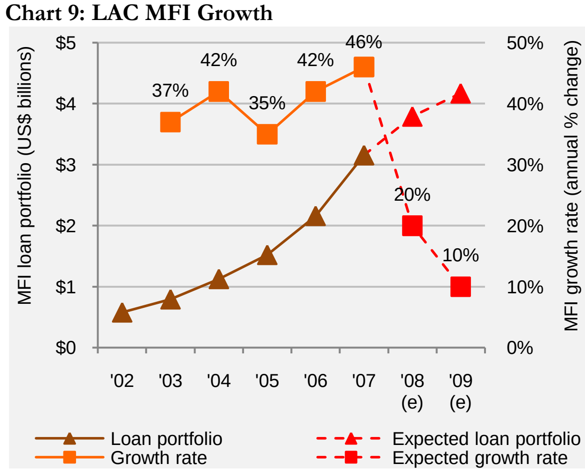
the reverse is true. But the effect of exchange rate fluctuations explains only a small part of what happened. Preemptive action, another reason given by most MFIs, can also only provide partial causality for a slowdown of this magnitude. MicroRate believes that during the fourth quarter (Q4) 2008, demand did indeed slow down significantly (*see Chart 9*). This is especially alarming given that Q4 is traditionally the period when MFIs experience most of their annual growth.

Chart 8: LAC MFI Growth



Source: (MicroRate sample of 18 LAC MFIs)

Chart 9: LAC MFI Growth



Source: (MicroRate sample of 42 LAC MFIs)

A sample of 18 MFIs that provided 2008 numbers reported a cumulative portfolio growth of 49 percent from US$943 million to US$1.41 billion during 2007. During 2008 that growth rate slowed to 13 percent from US$1.41 billion to US$1.59 billion (*see Chart 8*). This very large difference is partly explained by currency movements. To make them comparable, MicroRate converts MFI numbers into U.S. Dollars. When the U.S. Dollar depreciates, as it did in 2007, growth is exaggerated when expressed in U.S. Dollar terms; when it appreciates, as it did in 2008,

MFIs have generally made much more conservative growth estimates for 2009. Growth projections for the first six months have on average been cut in half. Projections for all of 2009 have also been reduced in order to remain conservative, but most managers believe that growth will revert to 2008 levels during the second semester of 2009. Interestingly, most MFI managers interviewed felt they would continue to grow during 2009. The most mature and highest rated MFIs typically gave more conservative estimates. The overall impression is that MFIs have not fully recognized the potential impact of the crisis on their future growth

[3] MicroRate sample of 42 LAC MFIs.

because the crisis has not fully affected the micro-entrepreneurs.

Declining growth expectations can largely be attributed to a combination of three factors: more stringent lending policies, tightening liquidity and declining economies.

In many cases the conservative growth estimates for 2009 reflect a change in policy at MFIs, rather than a change in economic condition or a decrease in demand for loans. In fact, demand for loans is expected to increase in many countries. However, due to the increased perceived risk and a pronounced tightening of credit markets, MFIs are becoming more conservative in their lending practices. This more stringent approach to lending is manifested in tightening credit standards, decreasing average loan size, shifting portfolio mix, and focus on untapped and less competitive market segments. As competition among MFIs increased over the last few years, MFIs fought for market share by lowering lending standards. Growth was considered to be the first priority by many. This trend is now reversing itself as MFIs absorb the impact of tightening credit markets and as they anticipate more difficult economic times ahead.

Although most MFIs expect slowdowns in growth, several commented that the economic slowdown will offer new opportunities as part of the workforce is pushed down market and into the informal sector. Many MFIs are looking to move down-market to a client base that is easier to defend from competition and that will not be as affected by the global crisis. As other MFIs and lending institutions withdraw or limit their exposure to certain market segments, the better run MFIs capitalize on the opportunities. For example, commercial banks have decreased their exposure to poor segments of the population, particularly by cutting back on consumer credit. Recognizing that to some extent consumer credit also funds productive activities, MFIs with strong balance sheets are seizing the opportunity to replace consumer credit with microcredit and in the process to gain new clients.

FUNDING AND LIQUIDITY

Until recently funding and liquidity were not concerns for most MFIs in the LAC Region. Capital was abundantly available from both domestic and international sources. Many, including MicroRate and the Consultative Group to Assist the Poor (CGAP) warned of a potential over-abundance of funding fueled by exuberance in how markets saw microfinance. In fact, a CGAP-sponsored study of the primary risk factors for the industry entitled "Banana skins – Risk in a Booming Industry" listed "too much funding" as its 21st biggest risk and 4th fastest riser for the industry, ahead of "too little funding" which ranked 29th (Centre for the Study of Financial Innovation (CSFI) 2008).

In the current financial environment, "too little funding" would probably top the industry's biggest risks list. The slowdown in portfolio growth is most notably due to the increased uncertainty of sources of funding. As economies slow down and credit markets tighten, both domestic, and even more so, international capital becomes scarce. A MicroRate sample of 42 LAC MFIs' funding sources revealed that from 2002 through 2007 despite high growth rates, the distribution of funding remained remarkably proportionate (*see Table 2*). Debt averaged just under one third of total funding while savings and equity accounted for roughly 40 and 30 percent, respectively. The share of equity in total funding increased from 26 to 30 percent. Even though leverage expansion would be expected in a time of fast growth, indeed just the opposite occurred—the equity share of total funding grew. This increase in equity and corresponding decrease in leverage will better position MFIs to deal with the approaching shocks.

Table 2: Sources of LAC MFI Funding

US$ millions	2002	2003	2004	2005	2006	2007
Debt	$197,060	$249,646	$330,586	$440,617	$654,468	$844,825
	33%	*31%*	*30%*	*31%*	*33%*	*31%*
Domestic	$139,595	$181,518	$234,401	$278,115	$399,797	$543,448
	23%	*23%*	*22%*	*20%*	*20%*	*20%*
International	$57,465	$68,128	$96,185	$162,502	$254,672	$301,377
	10%	*8%*	*9%*	*12%*	*13%*	*11%*
Deposits	$245,590	$344,669	$461,876	$580,134	$787,004	$1,065,105
	41%	*43%*	*43%*	*41%*	*40%*	*39%*
Equity	$153,332	$209,737	$292,201	$391,046	$536,185	$808,645
	26%	*26%*	*27%*	*28%*	*27%*	*30%*
Total	$595,982	$804,052	$1,084,663	$1,411,797	$1,977,656	$2,718,575

Source: (MicroRate sample of 42 LAC MFIs)

As liquidity tightened through 2008, MFIs increasingly targeted lower cost deposits that are less likely to be affected in the short-run. They have also sought government and multilateral funding and improved their equity position. As a result of the uncertain markets, MFIs are less likely to secure inexpensive, longer term funding, particularly from MIVs. This illustrates a significant shift in the MFI's focus from portfolio growth to financial stability and cost management.

While in the past, the pace of growth was set by demand and by the institutional capacity of MFIs, funding has now become the main factor that determines growth. MFIs are managing their asset mix to reflect the increased volatility of their funding sources. Some MFIs show large increases in liquidity as institutions decided to borrow whenever attractive opportunities offered themselves, instead of pacing their borrowing in step with their funding needs. This is a direct result of the perception that credit markets are tightening and that they are expected to tighten further.

As the global financial crisis has reached the LAC Region, local financial sectors have become much less liquid and lending rates have increased rapidly. This has affected the access of MFIs to local commercial funding. In countries such as Mexico where virtually all large banks are owned by international banking groups, the effects of the financial crisis were felt very rapidly. In those countries, even large MFIs that until recently had been inundated with funding offers, saw their credit lines disappear as early as the second quarter of 2008, as international commercial bank reacted to events in the United States and Europe. Some MFIs reported having to move quickly to find alternative funding. MFIs continue to resist the (increasing) commercial or quasi-commercial rates that MIVs offer, even though it is longer term funding than is available from most other alternative sources. MicroRate suspects that reluctance to assume foreign exchange (FX) risk was also a factor in these decisions.

As capital markets tighten, savings deposits become more attractive as a stable, low-cost funding source. Those MFIs that have already invested in mobilizing deposits find this diversification of their funding paying off. A few MFIs have only recently obtained licenses to mobilize savings. They will find that it is difficult to expand deposits rapidly. Typically, during times of very fast portfolio growth, savings deposits lag behind as a source of funding. Similarly, it will be challenging to expand savings deposits quickly enough to substitute for disappearing commercial credit. The main problem however, is that in most of the Region's countries high regulatory hurdles must be overcome, before financial institutions are allowed to accept savings deposits. As a result, not many MFIs in the Region have access to this source of funding. At a time of crisis in financial markets and uncertainty about future economic growth, many MFIs may hesitate before they incur the expense and risk associated with transforming themselves into deposit-taking institutions. This area may offer one of the most promising opportunities for international financial institution (IFI) support.

Undoubtedly, the current financial crisis will postpone the regulatory plans of many MFIs as their capital is constrained and they do not have the liquidity to meet the infrastructure and capital requirements necessary to become regulated deposit-taking institutions. In addition, as the economic situation weakens, depositors may stop saving and begin spending their deposits, putting the MFI under more funding pressure.

To offset the impact on MFIs of tightening local credit markets, governments are increasing funding for microfinance through second tier wholesale banks as well as other government programs. In addition, multilaterals and IFIs are trying to find ways to fill the funding shortage created by tightening credit markets. In February 2009, KfW Entwicklungsbank (KfW) and the International Finance Corporation (IFC) launched a cross-border refinancing facility for microfinance institutions. The facility was created to supply liquidity to the sector and has a target volume of US$500 million. Earlier, the Inter-American Development Bank (IDB) committed US$20 million in "Emergency Liquidity Funding" to MFIs in LAC.

Any large scale financial support for microfinance by IFIs must be careful to avoid damaging the channels through which private funding reaches MFIs. In the long run, only private investment can provide the funding volume that will be necessary to make credit available to all the poor who can use it productively. It appears that the IFC and KfW have learned this lesson. Their facility will use existing MIVs to reach MFIs and will not undercut private funding.

FUNDING COSTS

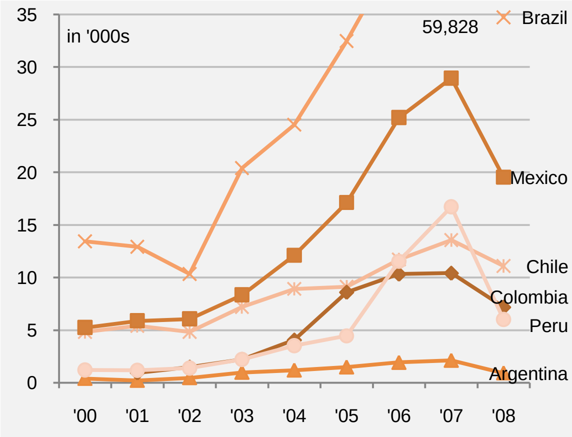
The LAC capital markets were quick to adjust to the global situation (*see Table 3*). Interest rates on commercial debt skyrocketed (by 500-1,000 basis points[4] (bps)), in step with the global financial crisis. International inter-bank funding stalled much like in the United States. Stock markets and pension funds have rapidly declined and risk premiums for Latin sovereigns have risen but remain well below junk bond risk spreads in both level and volatility (*see Chart 10*).

For MFIs, liquidity and funding costs have become a major concern. Capital flows that were pouring into microfinance over the last five years have begun to tighten. All types of funding sources from local to international, public to private are being affected. In many countries capital is still available for top tier MFIs but smaller institutions report that funding for them has all but disappeared. In nearly all cases credit to MFIs has become more expensive with an average increase of 200-600 bps (in local currency). In an effort to hedge risk, funding sources are shortening their loan tenors and restricting lending to existing clients (*see Microfinance Funding Environment, page 30*).

Loans from international lenders that are denominated in local currency are becoming

[4] A basis point is a unit that is equal to 1/100th of a percentage point (0.01%)

Chart 10: LAC Stock Market Performance



Source: (Trading Economics, 2009)

Table 3: Percentage Change of Local Stock Market

Dec 2007 – Jan 2009	In US$ terms	In local currency
Argentina	-55.2	-50.6%
Brazil	-54.5%	-39.7%
Chile	-33.4%	-16.3%
Colombia	-37.3%	-30.2%
Mexico	-48.4%	-34.0%

Source: (The Economist, 2009)

increasingly scarce and expensive. Hedging mechanisms, in the few countries that offered them, that allowed MFIs to protect themselves against FX risk associated with hard currency loans have become all but inaccessible as exchange rates have become extremely volatile. In Mexico for example, small volume hedges are unobtainable and to cover volatility hedging costs are soaring as spreads rise. As the U.S. Dollar rallied against many Latin American currencies, unhedged loans are becoming a major risk for some MFIs. Even MFIs that have resisted exposing themselves to FX risk now face increasing pressure to change that policy. To the extent that local credit is disappearing, they must choose between borrowing hard currencies and assuming FX risk in the process, or stopping portfolio growth.

MFIs are reluctant to increase the interest rates they charge their clients. Nevertheless, these rates are coming under pressure as MFI's cost of funding increases and margins tighten.

MARKET DEMAND

Overall, demand for microfinance services remains high throughout Latin America. Although financial services have expanded and they now reach many more people than in the past, millions of the working poor remain underserved. Demand varies by country depending on its economic situation, financial services availability and many other factors. In Nicaragua, a country which is suffering from an economic and political crisis that pre-dates recent events in world markets, demand has dropped. In most countries the effects of the crisis have so far been slow to reach micro-entrepreneurs. In these countries the constraining factor remains liquidity and the reluctance of MFIs to expand rapidly in the face of economic uncertainty.

The continued high demand for loans could be influenced by the fact that the cost of microcredit has risen much more slowly than the cost of most other forms of credit. It could also be a result of reduced remittance flows and of tighter credit markets that have choked off the supply of other sources of credit. But most MFIs agreed that the crisis is so far confined to credit markets, whereas the real economy, and especially the informal sector, has not yet felt the impact of the world economic crisis. As mentioned previously, preliminary numbers for a sample of 18 MFIs interviewed between October and December 2008, show that portfolio growth slowed to 13 percent in 2008 from 49 percent in 2007. A slowdown of this magnitude cannot be entirely explained by caution on the part of MFIs. Rather, it seems that lending during the crucial Christmas season was far below levels most MFIs had expected. If that was indeed the case, then this would be a sign that demand is beginning to be affected.

RISK IDENTIFICATION

According to the interviews with MFIs, their top five risks are: (1) decreases in their liquidity, (2) deterioration of their loan portfolio, (3) increasing credit risk profiles of clients, (4) increasing costs of funding, and (5) the possibility of government interference.

1. Liquidity

MFIs see lack of liquidity as the greatest threat. Ten years ago, MFIs still depended strongly on donor funding and donors could be counted upon to provide additional funding if a crisis occurred. The microfinance sector in LAC and throughout the world is now much larger and it has outgrown the funding capacity of development institutions. In the late 1990s, the funding needs of all the Region's MFIs were approximately US$100-200 million. Today, they are measured in billions. Today MFIs are much more exposed to the cycles of the financial system, and most MFIs are aware of this dependence.

MFIs are securing funding, by renewing maturing credits and by trying to increase them wherever possible. As has been mentioned above, there are signs that MFIs are "hoarding" loans. Whenever an opportunity offers itself, they build up large liquidity cushions as insurance against a further tightening of credit in the future. The resulting high levels of liquidity increase costs, but this is seen as a reasonable price for having adequate liquidity at a time of tightening credit markets. A simple and quick way to build up liquidity would be to reduce loan disbursements below the expected rate of loan repayments. But this is only happening in extreme cases. Liquidity concerns are apparently not yet strong enough to justify such a measure. What deters them is the prospect of losing hard-earned market share and the fear that the quality of their remaining portfolio will deteriorate rapidly as borrowers no longer expect to receive a new loan when their current one is repaid.

Smaller and weaker MFIs are particularly threatened by a pronounced flight to quality among funders.

2. Portfolio Quality and 3. Changing Borrower Risk Profiles

Portfolio quality remained very good through most of 2008 but signs of deterioration became evident in the fourth quarter. This is especially true of near-term measurements, such as loans that are overdue for one to sixty days. There was no indication yet that write-offs by MFIs have increased.

Client over-indebtedness is another major concern because it is difficult to quantify. The number of clients who are over-indebted is most likely increasing. This is especially the case in countries, such as Mexico and others, where credit bureaus do not cover parts of the microcredit market. If real economies contract, over-indebted clients would of course be highly vulnerable. Even now, over-indebted clients constitute one of the single greatest risks for MFIs operating in competitive markets that are inadequately covered by credit bureaus.

4. Cost of Funding

Cost of funding is another risk factor. Throughout this decade MFIs became accustomed to very liquid financial markets, where it was relatively easy to obtain funding at historically low rates. Even MFIs in Nicaragua, Ecuador and Bolivia, with low country ratings were able to borrow from MIVs at rates of 8 and 9 percent. Local funds were often available at comparable rates. Local markets in particular could tighten to the point where interest rates multiply on their recent levels. Rates charged by MIVs are less volatile, but they already increased substantially as international loans are now in short supply.

MFIs usually can pass on higher funding costs to their clients since their loans are typically short term. MicroRate has noticed however, that over the last three to four years, terms of microloans have lengthened under the pressure of competition. In competitive markets, the average term of a MFI portfolio now often exceeds 1.5 and even 2 years. This exposes MFIs to the risk of narrowing margins if borrowing costs increase rapidly. Rising funding costs will eventually be passed on to borrowers who will suffer corresponding erosion in their repayment capacity. However so far, MFIs have absorbed part of the funding cost increases. They are helped in this by the fact that their gearing is relatively low by banking standards.

5. Government Intervention

In several countries, microfinance institutions fear government intervention, primarily in the form of interest rate caps. As microcredit reaches millions, the temptation for governments to resort to populist measures like interest rate caps is much greater than when MFIs were small. The temptation will be greater still if large numbers of borrowers are unable to repay their loans. Bolivia in 1999-2000 gave an early example of how debtor organizations can rapidly gain political clout. Today, Nicaragua, Ecuador and Bolivia have populist governments that are exerting populist pressures on their microfinance industries. These pressures will grow considerably in times of economic crisis.

Other Risk Areas

As previously mentioned, the definition of "microcredit" has slowly expanded. This suited MIVs who then could assure their investors that their money was indeed going to microcredit. It also allowed lenders with less than impeccable reputations such as consumer credit agencies come to mind, to cloak themselves in the mantle of microfinance. *Microcredit in the true sense of that term always enables the borrower to create wealth*. It is the ability of microcredit to generate funds with which loans are repaid, that explain the extraordinarily high quality of microcredit portfolios. Wherever MFIs have lent for purposes that do not increase the wealth of the borrower, they face higher portfolio risk. That risk is especially high when the economy ceases to grow.

RISK MANAGEMENT PRACTICES

Although at the time they were interviewed, many of the MFIs reported that they did not yet see the impact of the financial crisis on their clients, most recognized some of the risks that the crisis represented. A minority of MFIs reported that they do not think the crisis will affect them or their environment. The best run MFIs are proactively adapting themselves through a series of risk management measures.

The top measures mentioned include:

- Adopting stricter loan policies;
- Shortening tenor of loans;
- Reducing loan size;
- Increasing provisions;
- Focusing on existing clients;
- Limiting the number and amount of loans from other institutions they allow a borrower to carry;
- Reducing consumer loan portfolio;
- Increasing savings mobilization.

Policy Changes

Most of the MFIs interviewed focused on the risks associated with their lending to clients. Virtually all have tightened their underwriting standards and switched their lending to shorter-term loans with lower loan amounts. This focuses their operations on lower risk clients and lower risk products. The shorter tenor decreases their risk, especially in a volatile situation with a weakening economic environment. The smaller loans allow them to diversify their portfolio. In addition, many MFIs have capped the maximum loan size, thus driving down the average loan size in the portfolio. In some cases this is a reflection of their move down market to a sector of the industry that is more difficult to enter for downscaling commercial banks. Since competition usually decreases along with loan size, MFIs also hope to face less pressure on their lending rates as they move down market. This move is also a move away from SME lending. Small businesses are seen as riskier borrowers at a time of economic difficulties. This is a marked shift for the industry, which as a whole had been moving up market and was beginning to compete vigorously with downscaling commercial banks.

Demand for loans has been increasing as measured by increased loan applications. MFIs, applying their stricter underwriting criteria have rejected far more applicants than in the past. Despite this, they are increasing their number of clients, more than compensating for the lower loan amounts.

MFIs identify poor credit profiles of borrowers as one of their biggest risks and are seeking ways to capture and retain those with the best profiles. They are utilizing loyalty programs with their existing clients and some are trying to recruit top clients of other MFIs.

Consumer lending in LAC is facing a more precipitous decline in portfolio quality, reflected in double-digit loans in arrear in some cases. Almost all MFIs with consumer loan portfolios have decided to decrease or limit their exposure in anticipation of increasing portfolio quality problems.

Anticipating greater future arrears, MFIs are increasing their provisioning for bad loans. By June 2008, MFIs in MicroRate's sample already had median loan loss provisions equivalent to 109.5 percent of Portfolio at Risk on loans over 30 days in arrears (PAR 30), up from 106.7 percent one year earlier. MFIs indicated that their provisioning levels continued to increase in the second semester of 2008 with the increased risk of portfolio deterioration. The slight increase in arrears that MicroRate observes in MFIs is too recent to have already caused an increase in write-offs of bad loans.

Renewed emphasis on savings mobilization is another key aspect of MFIs' abilities to operate in tightening credit markets. Savings mobilization affords MFIs cheap access to a stable source of capital that is unlikely to contract even when credit is scarce. As has been mentioned, only a small minority of MFIs are authorized to mobilize savings.

COUNTER-CYCLICALITY

Microfinance claims to be unaffected by changes in the global capital markets and even that it is countercyclical. Past crises have generally supported this claim. When the economy performs poorly, formal employment opportunities disappear and the demand for microcredit grows. However the examples that are usually cited as proof, the Asian crisis of 1997-98 and the Bolivian recession of 1999-2000, are from the early days of microfinance, when MFIs were small and market penetration was low. Now, MFIs compete with each other and it is common for micro-entrepreneurs to borrow from more than one institution simultaneously.

Nonetheless, the Region's MFIs are in a good position to weather economic downturns. Overall they tend to have healthy portfolios (average PAR level of 5.1 percent as of June 2008), very strong loan loss reserves, highly atomized, short tenure loan portfolios, a strong financial position with a low level of indebtedness, and high profitability (the return on equity of MFIs tracked by MicroRate, adjusted for inflation and subsidies, averaged 11.4 percent at the end of the first semester 2008).

Table 4: LAC MFIs - Key Indicators

as of June 2008	1st Quartile	Average	Median	3rd Quartile
Annual change in Gross Loan Portfolio	58%	45%	46%	34%
Portfolio at Risk / Gross Loan Portfolio	2.7%	5.1%	4%	5.5%
Loan Loss Reserves / Portfolio at Risk	128%	161%	109%	89%
Debt / Equity	1.59	3.54	3.34	5.08
Net Income / Average Equity (ROE)	24%	11.4%	13.2%	1.9%

Source: (MicroRate sample of 50 LAC MFIs, 2008)

Their greatest argument for being able to withstand an economic downturn is that they provide vital funding for their clients. Microcredit does not finance consumption, which is cut back in hard times. Microcredit allows poor borrowers to generate the income which they depend on to survive. Borrowers will therefore go to extraordinary lengths to service their loans on time because that assures them access to future borrowing. Where MFIs have strayed from this role of enabling poor borrowers to generate income, they will be vulnerable. In that sense the approaching crisis is likely to separate true microcredit institutions from those who have merely provided small loans to poor borrowers, without being overly concerned about the purpose of the loans.

MicroRate has also noticed that MFIs tend to lower their lending standards as they fight for market share. Borrowers who have accumulated multiple loans as the economy grew could find themselves over-indebted if the economy contracts. If this scenario proves to be correct, then microfinance may no longer be as counter-cyclical today as it was eight or ten years ago. Furthermore, the tendency of MFIs to evolve into regulated financial intermediaries that look more like traditional banks, has in many ways increased their exposure to the cycles of financial markets. MFIs are now much more exposed to unavailable local credit and to highly volatile interest rates, than they were ten years ago when they were financed largely by development institutions.

Nonetheless, managers from well-established MFIs express the belief that while some MFIs will lose clients or fail, a recession could be an opportunity for stronger institutions. The percentage of LAC's labor force that is not formally employed has risen steadily and is now at well over 50 percent. A recession would further add to the growth of the informal sector and thereby increase the potential demand for microcredit.

Country Profiles

BOLIVIA

Table 5: Bolivia	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	4.4%	5.4%	4.3%	11.7%	11.9%
Currency devaluation	2.8%	-0.6%	-0.9%	-3.9%	-7.2%
Exchange rate: Boliviano/US$	8.05	8	7.93	7.62	7.07
3-month deposit rate	7.4%	4.9%	4.0%	4.5%	5.7%
GDP growth rate	3.6%	4.1%	4.6%	4.6%	6.5

Source: (IMF International Financial Statistics Browser, 2009)

Last year, 2008, marked the third consecutive year of economic growth for the Bolivian economy led by Evo Morales, the nation's populist president. This period of growth, however, was fueled by unusually high commodity prices. As one article stated, "Roughly one-quarter of the country's exports are minerals, whose prices have fallen by up to 50 percent" (Chávez, 2009). 2009 promises to be a greater challenge as export revenues continue to fall, unemployment rises and remittances shrink as the recessions in Spain and the United States force Bolivians home.

GDP grew over 6 percent in 2008, bucking the economic contraction trend that plagued most of LAC in 2008. Inflation reached 11.9 percent, a direct result of the food shortage and commodity crisis that have increased prices in Bolivia. This has caused most businesses to favor foreign currency transactions. Luckily, Bolivia's isolation from the world financial system has effectively insulated them from the tightened credit markets.

In 2008, both the accumulation of reserve assets and current account surpluses increased. Revenues also grew on account of Morales' nationalization of the energy sector in 2006. An accompanying tax reform targeted the energy industry companies suspected of taking advantage of Bolivia's natural resources. The new policy mandated that all contracts with foreign oil companies were to be renegotiated for the purpose of imposing increased royalties and taxes. These actions, coupled with the expulsion of the U.S. ambassador and the Drug Enforcement Administration in late 2008, sunk a trade agreement with the United States and with it a large portion of Bolivia's exports.

President Morales is also using the reserve assets to increase public spending to a record-breaking $1.8 billion. This counter-cyclical investment is the administration's central tool for combating the financial crisis burden. It will focus on infrastructure, energy distribution, agriculture and mining projects.

Bolivia continues to be a politically charged country split along geographic, class and racial lines. The newly ratified constitution grants autonomy and political seats to the country's numerous indigenous groups. This has exacerbated the division between the economically prosperous eastern provinces and the highlands where much of the indigenous poor is concentrated. These politically motivated moves to gain the support of the majority, along with the tumbling of global oil prices and strong social inequalities could be the beginning of a calamitous period in Bolivian politics.

Bolivian Microfinance

The Bolivian microfinance sector is characterized by strong competition, institutional development and maturity. It has among the lowest interest rates and the most flexible loan terms in the LAC Region's. The sector operates under a regulatory framework specifically designed for microfinance with central credit bureaus.

The country received the top ranking in a 2007 survey of the microfinance business environment in Latin America (The Economist Intelligence Unit, 2007). The sector's regulatory framework and institutional development continue to foster one of the most competitive environments in Latin America. The regulated sector, composed of two specialized banks and six non-bank MFIs, grew at 30 and 40 percent, respectively. The non-regulated segment, primarily made of NGOs, grew at 16 percent. These rates represent comparatively higher growth than the general Bolivian financial system.

Nonetheless, the recurring social and political conflicts create a highly uncertain environment that could affect the development of the microfinance sector. The acquisition of Fondo Financiero Privado PRODEM (PRODEM), Bolivia's third largest MFI, by a Venezuelan government bank and the fusion of two public second tier wholesale banks—Nacional Financiera Boliviana (NAFIBO) and Fondo de Desarrollo del Sistema Financiero y de apoyo al sector productivo (FONDESIF) to create Banco de Desarrollo Productivo (BDP)—caused significant uncertainty and concern in the sector. The fear is the possibility that either institution could make loans below market rates; Bolivian MFI rates are already among the lowest in the world as portfolio yield of Bolivian MFIs is 22 percent, compared to 44.7 percent of the MicroRate 50 sample from June 2008.

Demand for microfinance continues to rise even in the face of political and economic difficulties. In spite of limited access to capital markets, Bolivian MFIs still grew at an astonishing rate. However, despite a robust microfinance sector, political risk and country risk is high, especially for international funders.

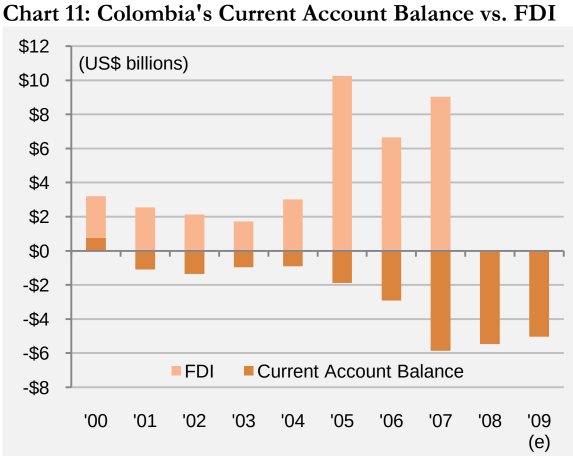
COLOMBIA

Table 6: Colombia	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	5.9%	5.1%	4.3%	5.7%	7.7%
Currency depreciation	-13.3	-5.3%	-1.9%	-11.2%	12.9%
Exchange rate: Peso/US$	2,412	2,284	2,239	1,988	2,244
3 month deposit rate	7.8%	7.0%	6.3%	8.0%	9.6%
GDP growth rate	4.8%	5.2%	4.0%	7.6%	2.8%

Source: (IMF International Financial Statistics Browser, 2009)

Although Colombia's GDP growth contracted from nearly 8 percent in 2007 to 4 percent last year and growth is projected to decline further in 2009, the country has fared relatively well in the face of the global financial crisis. Current accounts remain negative through 2009 but foreign direct investments are anticipated to cover the shortfall (*see Chart 11*). More positively, reserves exhibited strong growth in 2008 and remittances rose 6.6 percent last year to US$5.6 billion, after a 21 percent rise in 2007 (IMF, 2008) and (Ratha, Mohaptra, & Xu, 2008).

Chart 11: Colombia's Current Account Balance vs. FDI



Source: (IMF World Economic Outlook, 2008)

Colombia's financial sector has not been directly affected by the global crisis so far, primarily due to its low exposure to foreign loans and a comparatively modest presence of foreign banks. The Central Bank has strongly discouraged foreign borrowing by requiring a 40 percent mandatory deposit on foreign loans.

The Uribe government, originally focused on fighting inflation, has begun to concentrate on supporting the financial system. After 16 consecutive interest rate increases designed to slow inflationary pressures, rates have recently been reduced twice. The government is also said to be planning a major program of foreign borrowing, part of which would be used to inject liquidity into the financial system.

Export volume, a major part of Colombia's economy, remains healthy although export revenues have plummeted as world prices for oil and coffee have fallen. Plans to increase export volumes in 2009 are in place in order to offset falling prices but given the worldwide recession, this does not sound realistic.

Colombian Microfinance

Non-governmental organizations (NGOs) dominate the microfinance sector in Colombia more than in any of the other large microfinance market in the entire Region. Official statistics show that NGOs account for over 40 percent of the outstanding loan volume. In reality, their preponderance is far greater due to the very broad definition of microcredit, as it is in Mexico and Peru, among others. In Colombia, the law defines any enterprise with up to 10 workers and with assets not exceeding 501 minimum salaries (a common Colombian regulation that applies to businesses worth over US$100,000) as a micro-enterprise. This wide definition allows commercial banks and other lenders to attach the label "microcredit," highly coveted for its positive connotations, to a substantial part of their small business lending (von Stauffenberg & Perez Fernandez, 2007).

At the end of 2007, the microcredit portfolio of official financial institutions stood at US$923 million in Colombia. Among true microcredit institutions, the five affiliates of Women's World Banking (WWB) occupy a dominant position. At the end of 2007, before the five WWB affiliates together accounted for nearly 90 percent of microfinance lending by NGOs. Their combined portfolio exceeded US$600 million. Despite their rapid growth, they remained firmly committed to the lower segment of the microfinance market, with an average loan size equivalent to 23 percent of per capita GDP, compared to 60 percent for the LAC Region as a whole (von Stauffenberg & Perez Fernandez, 2007).

The WWB affiliates have been pioneers in more than one sense. First, they achieved levels of efficiency, staff productivity and portfolio quality that few others have been able to equal. These MFIs are among the largest and most consistently profitable MFIs in the Region. To date, no other MFI in the Region excels in all three areas simultaneously as the Colombian WWBs do. Second, they have disproved the widely held belief that MFIs have to formalize when they reach a certain size in order to raise the large amounts of commercial funding needed to grow. The three largest WWBs among them had outstanding loans totaling nearly US$500 million and 620,000 borrowers at the end of 2008.

The WWBs' ability to overcome funding restrictions typical for NGOs is partly because their growth coincided with a time when funders were eager to lend to microfinance. With their excellent performance, they found it surprisingly easy to attract domestic and foreign lenders. In addition, WWB Colombia in Cali, the largest of the WWBs, tapped into the Colombian bond markets on conditions only slightly less advantageous than those obtained by the government.

In 2008, the two smaller of the five WWB affiliates merged into "*Bancamia,*" a microcredit bank that is being set up by the Banco de Bilbao y Vizcaya Argentaria (BBVA) Foundation. The new regional bank has since acquired MFIs in Peru and is said to be negotiating the purchase of MFIs in other countries as well.

The curious position where large NGOs dominate the microfinance sector has no parallels in the Region or even in the rest of the world. Market conditions are nearly ideal for microfinance in Colombia but the regulatory environment is decidedly not. Colombia remains the only important microfinance country in the Region to not create any regulatory or legal framework for MFIs. At the same time, regulatory requirements for conventional financial institutions are so heavy and tightly enforced that it would have been virtually impossible for microfinance NGOs to comply. This inadvertently smothered the development of microfinance and forced MFIs to develop outside the existing legal structure. Additionally, the country's usury laws make it difficult for any MFI to charge an adequate interest rate.

The Uribe administration recognized the problem created by the usury laws. Instead of addressing directly, the government opted to leave the existing laws in place but allow exceptions for microcredit. These exceptions are meant as provisional patches that could be easily removed if the political pressure to do so is great enough. In any country, there is no substitute for a stable regulatory and legal framework that sets clear rules for the development of microfinance.

Colombia provides a unique example of a country that developed into a highly efficient microfinance sector despite government inaction and laws that inadvertently act as a powerful disincentive to microfinance.

It seems unlikely that Colombian microfinance will continue to prosper without a stable legal and regulatory framework. NGOs with hundreds of thousands of clients should be regarded as aberrations not well equipped to weather storms in the financial system. As NGOs, they cannot mobilize deposits and run the risk of losing access to credit if the financial system becomes illiquid. Also, these large financial intermediaries would pose a systemic risk if they were to fail.

ECUADOR

Table 7: Ecuador	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	2.7%	2.4%	3.0%	3.3%	8.8%
Currency	0.0%	0.0%	0.0%	0.0%	0.0%
Exchange rate: US$	1.0	1.0	1.0	1.0	1.0
3-month deposit rate	4.1%	3.5%	4.1%	5.0%	5.1%
GDP growth rate	7.9%	4.7%	4.6%	2.9%	5.3%

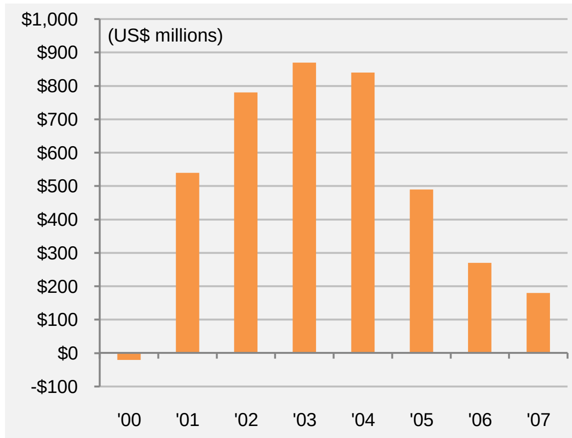
Source: (IMF International Financial Statistics Browser, 2009)

Political and economic uncertainty dominates the picture in Ecuador. The situation climaxed in December 2008 and January 2009 when Ecuador defaulted on interest payments on government bonds sold to international investors. This was the first default by a Latin American government since Argentina defaulted in 2001 and the second by Ecuador in ten years. This latest default was not caused by inability to pay—the amounts involved were relatively small and the government could have easily met its obligations—but by a claim by President Rafael Correa that approximately US$4 billion in bonds had been illegally issued by previous governments.

Meanwhile, the collapse in oil prices has opened a wide gap in the country's trade balance and government finances, as oil accounts for the bulk of export and government revenue. To curb a fast-growing trade deficit, the government has resorted to import restrictions. Economic growth is expected to slow down dramatically in 2009. Already, the government has drastically curtailed public investment.

The sense of uncertainty is heightened by accelerating inflation in a country which nine years ago had adopted the U.S. Dollar as its currency. Inflation increased from 3.3 percent in 2007 to 8.8 percent in 2008 and President Correa, who is campaigning for re-election in April 2009, has publicly raised the possibility of breaking from the U.S. Dollar (IMF, 2008).

Chart 12: Ecuador's FDI



Source: (IMF World Economic Outlook, 2008)

As a result of the country's financial instability, foreign investment, which has steadily decreased since 2004, may by now have turned negative (*see Chart 12*).

In addition to its already gloomy economic outlook, the large number of emigrants is a cause for concern as Ecuador has come to depend on their remittances. In the past, about 8 percent of the country's GDP was made up of such remittances (Ratha, Mohaptra, & Xu, 2008). Most remittances originated in Spain, which is now suffering from a severe recession. Unemployment has reached double digits and is said to be much higher among immigrant workers.

Ecuadorian Microfinance

Ecuador, a country of about 14 million inhabitants, has a large and diversified microfinance sector. At the top of the industry are three of Latin America's largest microfinance institutions: Credife, Banco Solidario and Procredit Bank. Credife is the microfinance arm of a commercial bank, Banco de Pichincha. It is one of the oldest and most successful examples of a commercial bank branching out into microcredit. As of November 2008, it had a loan portfolio of US$250 million and 125,000 borrowers. Banco Solidario is the western hemisphere's second-oldest microfinance bank (after BancoSol in Bolivia). At the end of 2007, it had 125,000 borrowers and outstanding loans of US$224 million. Banco ProCredit, the third largest, with an average loan size of nearly US$4,000, caters to larger clients, most of them small businesses rather than microenterprises. At the end of 2007, it had 50,000 borrowers and an outstanding loan portfolio of US$187 million. In addition to these three MFIs, there is an estimated 40 specialized MFIs as well as 400 credit cooperatives many of whom also serve micro-entrepreneurs.

Because of the relatively high density of MFIs, competition among them has become strong. This raises the risk of multiple borrowing by clients and of over-indebtedness. Private credit bureaus help protect against this risk, but they only reliably cover loans obtained from regulated financial institutions and the lending from NGOs and by credit cooperatives often goes unreported.

Since 2007, the government has introduced increasingly restrictive ceilings on rates for microlending. By December 2008, the maximum permitted effective interest rate stood at 33.3 percent. With inflation at 8.8 percent and increasing, this leaves little room for any MFI, even the most efficient, to earn a positive return in real terms.

The large MFIs and all credit cooperatives mobilize large amounts of savings and also borrow abroad from MIVs and IFIs. If the Ecuadorean default upsets the flow of private foreign funding, MFIs could face a serious shortage that would force them to restrict growth. The situation would be more serious if the government does abandon the dollar as the national currency. Such a move would leave the MFIs with large foreign debt service obligations, whereas their assets and revenues would be converted into a presumably weak and depreciating new local currency. In such a worst-case scenario, debt rescheduling, possibly accompanied by contraction of loan portfolios, would appear to be inevitable.

MIVs, however, give no signs of retreating from Ecuador. As of late January 2009, one Ecuadorean MFI that has nearly all of its loans come from foreign MIVs, had obtained enough new loan commitments to continue its growth, albeit at about half the rate of 2008. Portfolio quality at that MFI remained high through the end of 2008, despite the worsening economic situation.

MEXICO

Table 8: Mexico	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	4.7%	4.0%	3.6%	4.1%	7.2%
Currency devaluation	0.2%	-4.3%	0.9%	0.2%	40.4%
Exchange rate: Peso/US$	11.3	10.8	10.9	10.9	15.3
3-month deposit rate	2.7%	3.5%	3.3%	3.3%	3.4%
GDP growth rate	4.4%	3.0%	4.8%	2.7%	2.1%

Source: (IMF International Financial Statistics Browser, 2009)

Mexico has benefited from effective policies and reforms within the country's economic, political and social environment, enabling significant progress in a relatively short period of time. Most recently, Mexico's greatest challenge has been to sustain those trends despite the global financial crisis.

Chart 13: Mexico's Real GDP Growth

Source: (IMF World Economic Outlook, 2008)

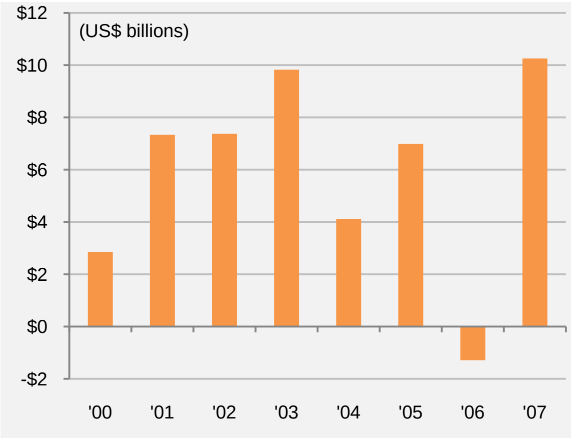
As Chart 13 above indicates, GDP growth was 2.1 percent in 2008 compared to 2.7 percent in 2007. Projections for 2009 suggest an even further slowdown. Mexico's dependence on its trade relationship with the United States, which alone accounted for 82 percent of Mexico's exports in 2007, is cause for concern (Central Intelligence Agency (CIA), 2008).

Exports have steadily grown since 2000; 2008 was no exception and exports totaled US$270 billion. This trend is expected to continue, given the sharp depreciation of the currency. Industrial production, however, slipped 2 percent from 2007 through the third quarter (Q3) 2008 (IMF, 2008).

In 2007, President Felipe Calderón issued a new National Development Plan that aims to continue structural reforms and increase infrastructure spending. Monetary policy has targeted inflation, which jumped to 7.2 percent at the end of 2008 (IMF, 2008). Foreign exchange rate policy has been predominantly a market-neutral approach. Recently, the Mexican Peso has suffered significant devaluation, losing over 31.7 percent against the U.S. Dollar from September 2008 through February 2009 (MXN – USD Interbank rate 09/01/08 – 02/28/09, www.oanda.com). Current account deficits are projected to grow to US$26 billion in 2009 although FDI should cover that amount.

Mexico's healthy accumulation of reserves (*see Chart 14*) should help provide partial insulation from external financial shocks. Thus far, Mexico has come away largely unscathed by the United States and Western Europe's sub-prime mortgage market mess. In December 2008, Mexico successfully auctioned US$2 billion in 10-year notes at 5.98 percent (390 bps above U.S. treasuries). Although credit markets do remain open,

Chart 14: Mexico's Reserve Assets



Source: (IMF World Economic Outlook, 2008)

commercial credit lines to MFIs are becoming increasingly more difficult to access.

As Mexico's largest commodity, oil dominates the economic landscape. But with world commodity prices at record lows, an ailing U.S. economy and the dramatic Peso devaluation, Mexico will be faced with a difficult economic situation.

Numerous social issues could affect Mexico's success of weathering the financial crisis. While strides have been made to reduce poverty and correct income inequality, both problems continue unabated. Remittances also cause concern. The imploding U.S. labor markets have started affecting unskilled labor, which will have serious consequences for remittance levels. Deposit-taking MFIs could see a dramatic drop in what used to be a steady supply of equity assets. If these unskilled labor markets shrink further, there is also the possibility that Mexico will experience a net *inflow* of emigrants. Although this will put pressure on the macro economic situation, it may be potentially beneficial for MFIs. First, those who return to Mexico likely have skills suited to the informal economy and microfinance activities. A large unskilled labor market and a growing informal economy will mean more potential clients for MFIs.

Mexican Microfinance

Mexico's microfinance sector is still in an early stage of development, but has been progressing at a rapid pace. Success stories such as Banco Compartamos have led to a wave of interest from investors and have resulted in the founding of numerous MFIs with different legal forms. The Mexican microfinance sector has been characterized by high growth and deteriorating portfolio quality (PAR rose from 2.2 percent in 2005 to 4.9 percent in 2007) (von Stauffenberg & Perez Fernandez, 2007), increased competition, the Region's highest average interest rates as well as the highest average operating expense ratio at 63 percent as of June 2008 (MicroRate sample of 9 Mexican MFIs).

Mexico's microfinance sector has been one of the most dynamic in the Region. Although it is considered a late comer, the vast markets of untapped potential clients have drawn countless new MFIs. The market is especially attractive because of its high profitability and interest rate levels as well as lower competition. New entrants including commercial banks, consumer lenders, specialized MFIs such as Banco Compartamos (with over 1 million clients) and small unregulated MFIs have altered the competitive landscape. This dynamic change has been facilitated by free floating interest rates and the ease of creating an unregulated (non deposit-taking) MFI.

Despite the large untapped market, there are signs of increasing over-indebtedness. The fact that many MFIs do not report to credit bureaus due to its high cost further exacerbates the situation. In addition, banks and other financing companies have aggressively promoted credit cards and consumer credit alongside traditional microcredit loans. Often, these products have been labeled microcredit although they have a significantly higher risk profile. Multiple loans and loan types with numerous institutions has increased the risks of over-indebtedness for both the commercial banks as well as the MFIs.

The Mexican government has shown an increasing level of commitment to the microfinance sector. Although there is no specific legal framework for microfinance, the 2000 and 2007 Savings and Loan laws governing non-deposit-taking MFIs were a first step to regulate the industry. Despite the attempts to define the sector, the types of MFIs in the sector is dizzying; they range from Sociedades Financieras Populares (SFP) (for profit finance companies) to Sociedades de Ahorro y Prestamo (SAP) (not-for-profit savings and loans) to Sociedades Financieras de Objeto Multiple (SOFOM) and Sociedades Financieras de Objeto Limitado (SOFOL) in addition to the banks that serve the sector (von Stauffenberg & Perez Fernandez, 2007).

The Mexican government is active on both a federal and local level in providing funding and technical assistance to the sector mainly through second tier wholesale banks. These sources of funding represent over half of funding in the MicroRate Mexico sample (MicroRate sample of 42 LAC MFIs, June 2008) and have become increasingly important during the present credit crisis. They have helped to fill the vacuum left by retreating commercial banks and local sources of funding that are closely linked to the volatile capital markets. Interviews with MFIs and experts in Mexico reveal that the funding from these government sources is readily available for those institutions that have an ongoing relationship with the government but may be more difficult for emerging MFIs as well as less established MFIs. Furthermore, the amount of funding available is limited and does not fully cover the larger MFIs' funding needs.

It is interesting to note Mexican MFIs' low levels of leverage when compared to the rest of the LAC Region, indicative of a relatively immature market, and the predominance of local currency funding. Although the average loan tenor has increased over the last few years, MFIs have reported that the tenor for debt that was negotiated in 2008 was predominately short-term.

In 2009, funding costs are expected to continue to rise which will put pressure on margins and profitability. Portfolio quality will continue to deteriorate as the economy slips. MFIs that were focused on growth and profitability at the expense of their organizational and operational development will be especially affected. New MFIs with weak organizational structures and weak loan methodologies will pull out of the market or consolidate, leaving market opportunities for stronger, more mature MFIs.

NICARAGUA

Table 9: Nicaragua	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	10.1	9.4	9.5	16.9%	15.4%
Currency devaluation	5.0%	5.0%	5.0%	5.0%	5.0%
Exchange rate: Cordoba/US$	16.3	17.2	18.0	18.9	19.9
3-month deposit rate	4.5%	4.0%	4.9%	6.6%	8.9%
GDP Growth rate	5.1%	4.0%	4.0%	n/a	n/a

Source: (IMF International Financial Statistics Browser, 2009) *and* (Banco Central de Nicaragua, 2009)

Nicaragua is the second poorest country in the LAC Region—after Haiti—according to a study by the World Bank. Nicaragua has been under economic distress long before the financial crisis. The populist government, led by President Daniel Ortega, has endeavored to deal with the country's economic situation by creating a number of infrastructure projects to stimulate Nicaraguan economic growth and attempting to develop an export-based economy in which private and state-run entities can co-exist and compete.

Shying away from the Central America Free Trade Agreement (CAFTA) in favor of domestic productivity and reliance upon other Central and South American partners for trade, Ortega's basic aim was to first free his people from the grips of poverty. The economy, however, has not responded as planned. GDP growth has fallen drastically and remains well below the Central American average—3.8 vs. 6.6 percent, respectively, in 2007 and 3.0 vs. 4.6 percent in 2008. Projections for 2009 show the GDP gap narrowing to 3.5 vs. 4.2 percent (IMF, 2008). Additionally, the country's public debt is out of control, with little help from external sources and insufficient internal capacity.

The oil and food crises have certainly impacted Nicaragua. Food price inflation rose from 11 percent annually in January 2006 to 34 percent annually in August 2008 (The FINANCIAL 2009). The impact of these crises has a disproportionate impact on Nicaragua's poor as a larger percentage of their income must be devoted to food costs. Additionally, this also may have amplified the country's poor GDP growth in 2007 and 2008. To help ease the burden of high food costs, Nicaragua has been granted two aid packages from World Bank and UN food shortage programs.

In addition to the food and oil crises, the financial crisis has affected Nicaragua as it has throughout most of Central America; Nicaragua has seen tightened liquidity and decreasing export. Export revenue is down, due to decreased orders from export partners because of their own fiscal tightening or simply because of lower commodity prices. Remittances are an important source of capital to make up for the lack of export revenue. Remittances are the equivalent of over 12 percent of Nicaragua's GDP. In 2008, 40 percent of Nicaraguans received more than US$750 million in remittances (mostly from the United States); 90 percent of these remittances were spent on consumer goods (Ratha, Mohaptra, & Xu, 2008). Remittances will be sharply down because of the downturn in the U.S. economy.

Nicaraguan Microfinance

Country-wide poverty has motivated many people to become micro-entrepreneurs. Competition in the microfinance sector is strong, especially in the urban centers. Relatively high levels of over indebtedness are observable although this risk is partially offset by a good central credit bureau.

The microfinance sector faces daunting economic and political challenges. In addition to the general drought of liquidity in the financial sector and other economic difficulties outlined above, there are strong political elements affecting the microfinance sector. The combination of economic and political issues predates the financial crisis and has severely affected growth and quality of microcredit for some time.

The government continues to place ceilings on MFIs' effective interest rates and started to negatively label commercial microfinance as usury. The government has implemented a program called *"Hambre Cero"* (Zero Hunger) with US$2 million of subsidies for rural areas and *"Usura Cero"* (Zero Usury) that offers small loans at 5 percent annually (less than 14 percent of the average for the industry). Both programs are currently offered on a small scale but strong publicity undermines the willingness of borrowers to repay their existing loans. The negative view of microfinance catalyzed the *"Movimiento de no pago"* (No Payment Movement) in the northern part of the country. This group was behind a series of riots in which some MFI branches were burnt down. As a result, the country's largest microfinance network (La Asociación Nicaragüense de Instituciones de Microfinanzas – ASOMIF) agreed to new softer loan conditions which include refinancing of debt and reductions in interest rates.

In the face of increasing political and economic instability, MIVs have a large exposure in this small country. A survey of 23 MIVs (*see Contributors, page iii*) revealed that as of September 2008, Nicaragua had the second highest concentration of MIV funding behind Peru, representing 17 percent of the sample's US$1 billion invested in the LAC Region. Client over-indebtedness and portfolio quality deterioration, coupled with the harsh political view of the industry are the strongest factors contributing to the challenges facing the sector.

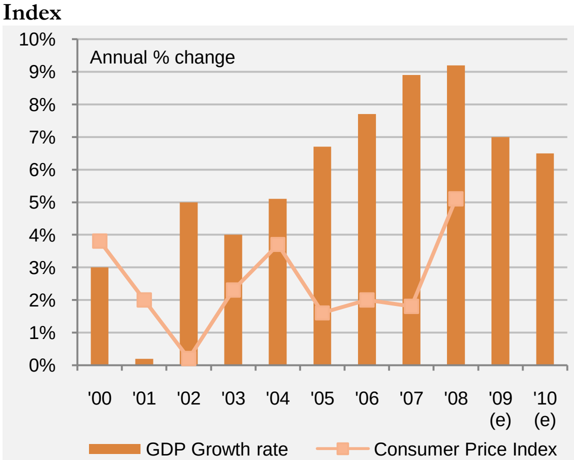
PERU

Table 10: Peru	Dec 2004	Dec 2005	Dec 2006	Dec 2007	Dec 2008
Inflation	3.7%	1.6%	2.0%	4.0%	6.5%
Currency devaluation	-5.2%	4.6%	-6.8%	-6.3%	4.8%
Exchange rate: Sol/US$	3.3	3.4	3.2	3.0	3.14
3-month deposit rate	3.0%	3.4%	3.2%	3.3%	3.7%
GDP growth rate	5.6%	6.5%	8.0%	8.4%	9.8%

Source: (IMF International Financial Statistics Browser, 2009)

Despite the global financial crisis, Peru has still maintained excellent economic growth rates and achieved a positive macro-economic policy. Coupling these achievements with a stable socio-political situation places it among the highest performing countries in the Region. During 2008, Peru's GDP grew an astonishing 9.8 percent (*see Chart* 15). In recognition of these achievements, S&P and Fitch Ratings elevated Peru's country rating to investment grade.

Chart 15: Peru's Real GDP Growth vs. Consumer Price Index



Source: (IMF World Economic Outlook, 2008)

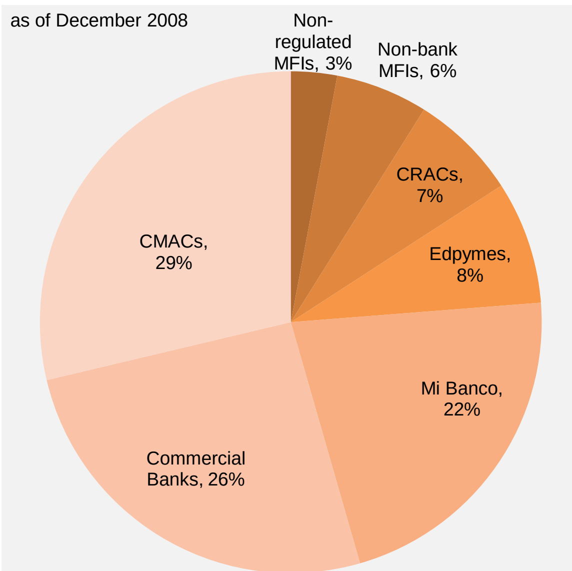
In the face of the global financial crisis, Peru may be less affected than other countries as they have accumulated significant international reserves and have strong internal demand that fuels continued growth. The country has employed a conservative fiscal and monetary policy to help manage the crisis. Nonetheless, the interest rate volatility resulting from uncertainty in the international capital markets is worrying. Inflation and currency devaluation are additional causes for concern, as they both acutely affect the purchasing power of the poor. This is particularly relevant considering 53 percent of the population is below the poverty line as of December 2007 (CEPALSTAT Database ECLAC).

Peru is still expected to continue to grow through 2009, though at a lower rate, despite declining commodity prices (commodities account for 80 percent of exports), lower capital inflows and eroding consumer confidence.

Peruvian Microfinance

Peru's microfinance sector continues to be a vibrant and large industry, consisting of some of the most sophisticated and advanced MFIs in the world. Competition, especially in urban centers, is fierce and has led to product innovations, evolved organizational structures and strong risk management. Virtually all microcredit uses an individual methodology (as opposed to village banking) with borrowers often receiving loans from numerous institutions. The sector has proven to be a valuable alternative for Peru's entrepreneurial self-employed and is served by specialized banks, municipal banks (Caja Municipal de Ahorro y Créditos (CMACs)), rural banks, NGOs, other specialized financial institutions as well as the commercial banking sector (*see Chart 16*). The sector has a well-defined, mature regulatory framework that encourages high levels of competition and product innovation. Currently, there are several large commercial banks, 39 regulated MFIs and more than 20 NGOs active in the sector (Superintendencia de Banca, Seguros y AFP, 2009).

Chart 16: Peru's MFI Market



Source: (Superintendencia de Banca, Seguros y AFP, 2009)

Competition has led to consolidation of the industry. The traditional commercial banks have become increasingly more active in micro and small business loans. Local regulatory bodies define microcredit as loans less than US$30,000. In 2008, a large commercial bank acquired Banco de Trabajo (a bank specializing in microfinance) and converted it into a non-bank MFI—CrediScotia. Banco de Credito (Peru's largest bank) and BBVA continue to be active in the industry. Decreasing financial margins and a serious risk of client over-indebtedness pose the greatest challenges. A strong banking superintendent and two private credit bureaus attempt to alleviate credit risk by providing relatively (2-month delay) current information on client behavior.

Positive changes to the financial system norms allow regulated MFIs to offer more products. Beginning July 2009, financial institutions will have to follow Basel II norms including those that regulate capital requirements that attempt to cover credit, operative and market risk. In order to face the international financial crisis, the banking superintendant has developed contingency measures that include larger provisions. [5]

Overall 2009 should see the microfinance sector continue to grow at a healthy pace led by deposit-taking institutions such the municipal banks and the regulated MFIs. Increased competition in urban centers will continue to push MFIs into new geographic regions, particularly toward the underserved jungle regions. Less established MFIs that are not approved deposit-taking institutions may encounter difficulties in raising capital from international sources as many MIVs and IFIs are reaching their lending limits for the country.

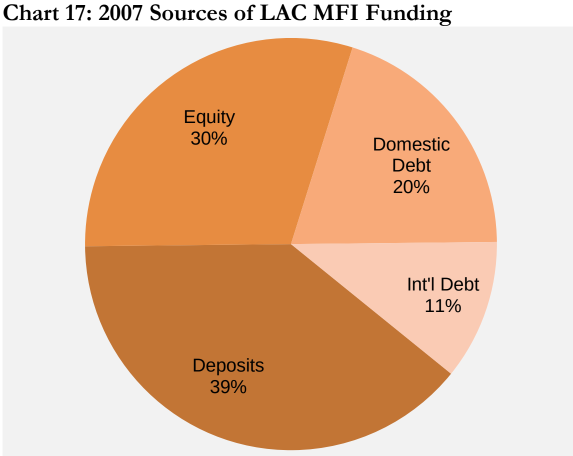
[5] From the Bank for International Settlements (BIS), "Basel II is an effort by international banking supervisors to update the original international bank capital accord (Basel I), aims to improve the consistency of capital regulations internationally, make regulatory capital more risk sensitive, and promote enhanced risk-management practices among large, internationally active banking organizations" (United States Federal Reserve Board, 2009)

Microfinance Funding Environment

SOURCES OF FUNDING

Microfinance institutions in the LAC Region have been able to successfully diversify their sources of funding. Chart 17 divides funding according to the principal sources. Domestic sources, including deposits, local commercial loans and government/second tier wholesalers make up almost 60 percent of MFI funding. Equity, coming from both domestic and international sources, accounts for another 30 percent. In the next chapter, this study will pay special attention to international sources of funding. In particular, it will focus on international microfinance investment vehicles[6] (MIVs) that, together with IFI funding, make up 11 percent of the 2007 funding of MFIs in the Region (MicroRate sample of 42 LAC MFIs, as of June 2008).

Chart 17: 2007 Sources of LAC MFI Funding



Source: (MicroRate sample of 42 LAC MFIs, 2008)

Although MIV debt only makes up a relatively small portion of MFI funding, it has become increasingly important in funding the growth of MFIs in the Region. According to the 2008 MicroRate survey of the MIV market, MIVs have grown 639 percent from 2004 to 2007 to almost US$4 billion globally. As of December 2007, MIVs invested over US$2.5 billion and US$477 million MFI debt and equity, respectively. The LAC Region represents over 40 percent of MIV investment.

Local Funding

Deposits – The financial crisis has not greatly affected deposits. Most deposit-taking institutions have seen an overall increase in savings. In two cases, MFIs reported that retail client deposits were increasing while savings from institutional clients were declining.

Government and Second Tier Wholesale – Government programs and second tier banks are playing an increasingly important role in most markets. In countries such as Mexico, they have started to fill the void left by private sector players. Similar to private sector investors, these programs initially target more mature, established MFIs with lower levels of risk. The liquidity available from these programs and second tier banks is generally not available to smaller and younger MFIs and is still not sufficient to cover the entire demand from large MFIs[7].

Commercial banks – Local commercial banks have been the first to retreat from investing in the microfinance market. Many have cancelled lines of credit, reduced the size of available loans or renegotiated terms.

[6] MicroRate defines an MIV as an independent investment vehicle which satisfies all the following three criteria: (1) vehicle must be an independent legal entity, (2) presence of and/or open to multiple investors, (3) focus on investing in microfinance.

[7] MicroRate size categorizes for MFIs in Latin America: Large > US$$50 million loan portfolio; Medium US$10-50 million loan portfolio; Small < US$10 million loan portfolio.

Countries with more sophisticated financial systems that are connected to the international markets have witnessed the fastest and strongest reaction. In places where local commercial banks still offer liquidity, interest rates have increased significantly. Loan tenors have been reduced almost exclusively to short terms of 6 to 12 months.

International Funding

MIV and Commercial Funding (*see MIV Funding, page 31*) – Most MIVs placed their growth on hold during Q4 2008 until they get a better sense of the crisis depth and the reaction from their funding sources. Interviews with MFIs confirm that MIVs are approaching the situation cautiously. MFIs report that while MIVs honor their present commitments and renew old loans, existing loans are not necessarily increasing and loans to new clients are carefully made. MIVs are reported to be completely pulling out of the equity market for the time being. New capital for consolidations or takeovers has also dried up. Much like other sources of MFI funding there is a noticeable flight to quality. Low-risk, regulated MFIs still attract funding but large MFIs with funding needs in excess of US$10 million are finding it difficult to raise these funds.

IFIs – International financial institutions are generally perceived by MFIs as being slow to react to the financial crisis situation. This seems to be a prejudice based more on past experience than present facts. The MIF was quick to provide US$20 million to the existing Emergency Liquidity Facility (ELF) during Q4 2008 and the new IFC-KfW refinancing facility, launched in Q1 2009, has already been mentioned (*see Funding and Liquidity, page 8*). IFIs seem willing to play an active role in protecting the microfinance sector from the consequences of a worldwide financial crisis. Yet, contrary to the official IFI position, several MFIs in the Region reported that their negotiations with IFIs were cancelled. The perception is that IFIs tend to crowd into low risk investments and they are not playing an active role in markets with a high level of demand, particularly in countries such as Argentina, Bolivia and Ecuador where local capital is scarce. Smaller, less developed MFIs (those categorized Tier 2 and Tier 3) comment that IFI funding does not reach them.

Equity – Equity represents an increasing percentage of total MFI funding (*see Table 3*). As previously mentioned, the increase in equity and corresponding decrease in leverage allow MFIs to better endure market volatility. Since the crisis, equity investments have virtually disappeared. Commercial banks such as BBVA, which once showed strong activity in equity investments, have faded into the background. MicroRate expects equity investments to restart once the markets stabilize, largely due to the amount of capital accumulating in equity funds, a prime example being the US$82 million SNS Equity Fund launched in February 2009.

MIV Funding

Table 11: Profile of the Interviewed MIVs

As of Sept 2008; US$ millions	Dec 2007*	Sep 2008 (9 mos.)**	Annualized 2008***	% growth (annualized)
Total outstanding portfolio (A)	$1,927.68	$2,679.67	$3,572.89	85%
in the LAC Region (B)	$940.06	$1,149.23	$1,532.31	63%
% invested in the LAC Region (B/A)	48.77%	42.89%	42.89%	

* *Source:* (MicroRate 2008 MIV Survey, 2008)

** *Excludes the amounts brokered by network organizations (WWB and FINCA).*

*** *Annualized portfolio was calculated by assuming that portfolios would grow at the same pace during Q4 2008 at which they had grown during the first three. This is clearly unrealistic. All indications suggest that funding from MIVs slowed down drastically during the fourth quarter.*

The following section is based on interviews with 23 MIVs and three other fund providers to MFIs. The interviews were conducted in November 2008 and most information is based on data as of the end of the third quarter of 2008. The main purpose of the interviews was to measure the effect of the crisis on the supply of MIV funding to MFIs in the LAC Region. However, many of the interviews also yielded information on how MIVs see the impact of the crisis on the Region's MFIs.

The interviews were conducted as the crisis in financial markets was evolving. By November 2008 it was obvious that the financial sector in rich countries was beset by a severe crisis, but the extent and likely duration of the crisis was less clear. Given this uncertainty, some of the interviewed persons probably opted for caution and the answers reflect a certain reluctance to give an unvarnished account of an uncertain situation.

MAIN RESULTS

The interviewed MIVs accounted for 77 percent of the outstanding microfinance portfolio in the LAC Region at the end of 2007, based on the *MicroRate 2008 MIV Survey*.

If the interviewed MIVs had continued to expand their worldwide investments at the same pace they grew through September 2008 (85 percent annualized), the outstanding portfolio would have grown from US$1.9 billion in December 2007 to US$3.5 billion in December 2008. The LAC portion of their collective portfolio grew at a somewhat slower 63 percent annually. Interviewed MIVs confirmed that they are trying to diminish their strong concentration in the LAC Region. Although growth during the first nine months of 2008 remained high, the pace of growth has dropped significantly when compared to 2006 and 2007 (MicroRate 2008 MIV Survey, 2008). There can be little doubt that portfolio growth slowed further during the last quarter of 2008.

Debt and Equity

Debt accounted for approximately 91 percent of the participant MIV's outstanding portfolio in LAC.

Local Currency vs. Hard Currency

With the exception of one fund lending 100 percent in hard currency and another 100 percent in local currency, the remaining funds lent primarily in hard currency.

Regional vs. Global focus

84 percent (by number of participants) of the MIVs are global players. Only 14 percent of the interviewed MIVs are Regional.

Country Exposure

As of September 2008, Peruvian MFIs held more funds from MIVs (US$205.5 million) than any other country in the LAC Region (*see Table 12*). Since Peru has the largest microfinance sector in the western hemisphere and Peru itself is considered to be one of the most creditworthy countries, this was not surprising. The two countries with the next largest country exposure however, are surprising: Nicaragua occupies the number two spot with US$166.3 million and Ecuador is number three (US$144.6 million). Both rank ahead of Bolivia, Mexico and Colombia. The high concentration of the portfolio in these two countries was unexpected because of their low country ratings, due to political and economic instability. Moreover, compared to their size, these two countries have relatively large microfinance sectors, which increases the risk of over-indebtedness of borrowers and limits prospects for future growth. Accelerating inflation moreover makes it difficult for MFIs to earn positive returns in real terms. MFIs in Nicaragua face an especially hostile political environment and it would not be surprising if one or more Nicaraguan MFIs were unable to meet their obligations in 2009.

Only six countries hold 91 percent of the investment by the interviewed MIVs for the entire LAC Region—Peru, Nicaragua, Ecuador, Mexico, Bolivia and Colombia. None of the MIVs invested in Chile, Costa Rica, Uruguay or in the English-speaking Caribbean.

Table 12: Outstanding MIV Assets
as of September 2008

Country	US$ million	% of total
Peru	$205.5	21.8%
Nicaragua	$166.3	17.6%
Ecuador	$144.6	15.3%
Mexico	$137.4	14.6%
Bolivia	$124.4	13.2%
Colombia	$86.3	9.1%
El Salvador	$40.6	4.3%
Honduras	$13.9	1.5%
Paraguay	$9.8	1.0%
Brazil	$6.9	0.7%
Guatemala	$3.7	0.4%
Argentina	$3.1	0.3%
Panama	$1	0.1%
Dominican Republic	$0.6	0.1%
Haiti	$0.2	0.0%
Venezuela	$0.1	0.0%
Total *	$944.3	100%

Source: (MicroRate 2008 MIV Survey, 2008)
** Does not tally with total since the break-up by country for one MIV is not available.*

OVERALL IMPACT OF THE GLOBAL FINANCIAL CRISIS

All interviewed MIVs felt the financial crisis is too recent to have had a dramatic impact on the MFIs yet although they expected the impact to be felt soon.

As MIVs described the current situation, "Overall credit markets have tightened; there is restricted investor appetite, an increase in interest rates and a decrease in tenor." Interest rates at which MFIs borrow have, according to the MIVs, increased from 50 to 200 bps, and include a few cases where the increases have exceeded 400 bps. Tenors, originally averaging four to five years before the crisis, have shortened to one to three years at present.

The MIVs observe a similar situation in other regions as well. Some reported that the impact in the LAC Region is not as pronounced as in other regions such as Central Asia. The LAC Region's share in total MIV portfolios is expected to decline as lenders try to diversify geographically but it is likely to remain close to 40 percent.

According to MIV managers, the most worrisome MFIs are those heavily exposed to foreign exchange risk or who have relied on short term funding. Regulated deposit-taking MFIs are less impacted by the crisis. So far, Central American MFIs have more strongly felt the crisis than those in South America. One interviewed MIV commented that in dollarized countries (Ecuador and El Salvador) MFIs have felt an impact from the crisis more rapidly. Similar to MicroRate's own observation, MIVs report that portfolio quality at MFIs has begun to deteriorate although not to a troubling extent. Exceptions are Argentina (where MIV exposure is insignificant), Bolivia and particularly Nicaragua, where portfolio at risk (greater than 30 days) has doubled in a number of MFIs and liquidity levels have reached a five year low.

At this stage, MIVs describe MFIs as mainly worried about funding access. However, questions about the impact of the crisis on the real economy in the future remain. Will MFIs prove to be countercyclical as in the Asian crisis ten years ago or in Bolivia in 1999-2000? Or will they behave more like commercial banks which typically are hit hard when the economy contracts?

With funding becoming scarcer, MIVs report that some MFIs are actively shopping for additional credit lines. As one MIV put it, "MFIs are calling all the names on their rolodex to tie up financing for 2009."

IMPACT OF THE FINANCIAL CRISIS ON MIVs

The value of publicly traded equity investments has decreased significantly as share prices have slumped. The share price of the LAC's largest MFI (in terms of number of borrowers), Banco Compartamos in Mexico, has declined by 62 percent since these shares were sold through an IPO in April 2007. These declines have occurred despite Banco Compartamos' strong performance: earnings per share increased by 28 percent in 2008. MIVs with unlisted equity investments have not yet seen a drop in their book values.

MIVs observe an increase in requests for waivers as MFIs breach or come close to breaching covenants of their loan agreements. In such cases, terms of the investments including pricing are re-negotiated.

Almost all the MIVs who participated in this study reported that they were at or near their maximum exposure in some countries in the LAC Region; the countries most frequently mentioned were Peru and Bolivia. The MIVs are eager to reduce their exposure in some countries, like Nicaragua. To date, there have been no defaults in repayment of interest or principal to the MIVs. None of the MIVs expected any write downs during 2008.

According to MIVs, investor appetite has clearly declined between August and October 2008. More recent information, however, suggests that investment inflow has somewhat recovered. ResponsAbility, one of the largest MIVs, reports that its assets increased from US$313 million to US$378 million between August and December 2008. SNS Asset Management, a Dutch company, launched a new €130 million MIV in November 2008, followed by a US$82 million equity fund in February 2009.[8]

The larger part (approximately 70 percent) of the portfolios of interviewed MIVs is held in hard currencies, mainly U.S. Dollars. However, some MIVs lend entirely in hard currency and one case lent entirely in local currency. Although MIVs nearly always raise funding in hard currencies, approximately 30 percent of outstanding portfolios is denominated in local currency, suggesting MIVs have been able to hedge currency risk

[8] Interviews with SNS Asset Management. February 2009.

to a surprising extent. However, foreign exchange rates have become so volatile that traditional hedging mechanisms are either no longer available or are prohibitively expensive. One of the major problems facing microfinance is that as MIVs grow, MFIs borrow more hard currency and therefore incur foreign exchange risk. In the past many LAC MFIs have protected themselves against this foreign exchange risk mostly by depositing the proceeds of the MIV loan with a bank and using it as collateral for a local currency loan. Such "back-to-back" arrangements are expensive, but the cost decreases if the lending bank accepts less than the full loan amount as collateral. With less liquidity in the financial systems, the costs of this method and other hedging mechanisms are rising and MIVs and MFIs both report that they can no longer afford to hedge foreign exchange risk.

Even though MIVs reported increasing redemptions, particularly from September 2008 on, none admitted to a net outflow of funds. MIVs attributed this to a loyal investor base and comparatively good returns to date. In MicroRate's opinion, all investors in MIVs are driven to some extent by social concerns. Therefore, these investors are much less likely to withdraw as long as their investments have a developmental impact and remain safe.

All interviewed MIVs expected to meet their projected returns for 2008.

PREPARING FOR 2009

MIVs have shown extreme caution towards new investments and are strengthening their monitoring processes. Every MIV interviewed conducts a case-by-case detailed review of its portfolio. MIVs mention working closely with MFIs to understand the MFI's cash flow requirements for 2009 and to anticipate potential refinancing risks. MIVs are particularly concerned about MFIs in their portfolio that are exposed to foreign exchange risk. In some cases, MIVs report proactively rescheduling loans that come due in 2009.

In a few cases, MIVs with equity investments have requested MFIs to lower or suspend dividends. Although this reduces the MIV's revenues, it allows the MFIs to conserve cash. Where MIVs do renew loans, the rates are higher and the terms shorter. Terms now rarely exceed three years and typically average approximately 18 months. Most MIVs indicated they did not intend to reduce the size of their renewed loans.

MIVs generally expect that their portfolio quality will decrease in 2009. Where the law allows them to do so, MIVs expect to increase their provisions in 2009.[9]

2009 Pipeline

MIVs almost unanimously agree that 2009 will see much slower portfolio growth. Political risk and foreign exchange exposure are the most often mentioned threats facing MFIs.

Most of the MIVs interviewed said that they intend to meet needs of existing clients but would show caution about accepting new clients. MIVs with existing equity investments are willing to provide additional equity capital, on a case-by-case basis, even if it is to meet an MFI's losses.

Many sense a flight to quality among their fellow MIVs and investors who may tend to be more conservative. Some participant MIVs see an opportunity for shifting their lending from lower tier MFIs to strong Tier 1 MFIs. In the past, the top MFIs were inundated with lending offers from MIVs. This, as the reasoning goes, has stopped and MIVs should now be able to lend to Tier 1 MFIs on attractive terms. If existing MIVs indeed reorient their lending to the strongest

[9] In many jurisdictions, Funds cannot provision against expected future losses since this is seen as disadvantaging investors who want to withdraw now.

MFIs, it raises the question how smaller MFIs will fund themselves. If the trend is confirmed, Tier 2 and Tier 3 MFIs may need help from IFIs. In this context, it is to be regretted that the US$500 million IFC/KfW facility apparently aims primarily at Tier 1 MFIs.

The pipeline is closely linked with the availability of funds. Not all interviewed MIVs were prepared to project their volume for 2009, but the six MIVs that did expected to disburse approximately US$500 million.

Funds proposed to be raised in 2009

Participating MIVs said they hope to raise US$1.3 billion during 2009 which would meet their entire global requirements for the year. These figures have been scaled down substantially from their original projections. All MIVs expect that only a fraction of their requirements can be raised during the first half of the year and hope that the remainder will be mobilized during the second semester when economic activity begins to pick up.

Investor returns

All MIVs interviewed are increasing liquidity to prepare for larger redemptions in 2009. Although MIVs claim they do not expect lower returns in 2009, this hardly is compatible with larger holdings of cash and increased provisions. As one MIV put it cautiously, "the probability of loss in 2009 is higher than 2008."

Consolidation

MIVs do not expect that the crisis will lead to significant consolidation among MFIs. An exception could be a mature market like Nicaragua, where arguably too many MFIs are vying for too few clients. MIVs expect that microfinance will go through a period of slower growth but they doubt that the sector will face widespread difficulties. In fact, some observers see slower growth as a welcome interlude to allow MFIs to strengthen their organizations.

Potential Roles for International Development Institutions

- Foreign exchange coverage is either becoming prohibitively expensive or unavailable altogether. This raises the worrying prospect that MFIs, no longer able to obtain loans domestically, will borrow U.S. Dollars or Euros. Faced with a choice between being starved of funding and assuming foreign exchange risk, they may opt for the latter. International development institutions (IDIs) could make a major contribution to microfinance if they supported mechanisms that allow MIVs and MFIs to cover foreign exchange risk.

- Although savings mobilization allows MFIs to tap into less expensive local funding, many MFI are having difficulties overcoming the high regulatory hurdles most countries in the Region erect before they allow financial institutions to mobilize deposits. The cost associated with transforming into a deposit-taking institution could force MFIs to postpone plans to transform in order to preserve liquidity. IDIs could cushion the risks of transformation by providing long-term funding and technical assistance for this purpose.

- IDIs could continue to help protect the sector from the consequences of a worldwide financial crisis by supporting existing emergency liquidity funds. However, on the whole IDIs should be careful about injecting massive amounts of funding into the microfinance sector. MIVs are already performing that task more efficiently than IDIs could. If IDIs crowd out MIVs the end-effect on microfinance would be negative.

- There is a real need for IDIs to play a more active role in countries (such as Argentina, Bolivia and Ecuador) where demand for microcredit continues to be high but local and international capital is scarce. IFIs should take care to avoid crowding into low risk investments and crowding out private flows of capital.

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