Special Report

The Microfinance Sector: Its Success Could be its Biggest Risk

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Related Research

- *Microfinance Institutions — Factors in Risk Assessment*

Summary

Microfinance can be defined as the supply of financial services to low-income populations excluded from the mainstream financial system – these are typically engaged in self-employment, and often operate in the informal economy.

The main providers of microfinance services are microfinance institutions (MFIs). The range of MFIs is very broad, and includes a variety of institutional types, missions and lending methodologies. MFIs have a common "double bottom-line mission" which gives equal weight to the developmental goal of bringing the poor into the mainstream economy and building socially inclusive financial sectors, but also to sustain and generate a positive financial return.

The microfinance sector has an estimated customer base of more than 65 million savers and 54 million borrowers globally, and total assets of more than USD 34 billion at end 2006. The majority of microfinance borrowers and assets are concentrated in a group of leading or "top-tier" MFIs numbering around 150 globally.

The success of microfinance has led to increased attention from socially responsible/ethical investors and capital markets investors. Its success has hinged on its business model, good asset quality, which typically compares favourably with the asset quality indicators of mainstream banks; reasonably stable financial performance indicators and some evidence of resilience to broader external macroeconomic shocks. Investors have also been drawn to the sector by the role microfinance plays in the development of a country's financial systems and economy, and on its ability to bring the poor into the mainstream economy.

However, the sector's track record is short and its success could increasingly expose it to greater risks. In particular, strong growth and increased need for external funding has put pressure on the internal control systems, and place new demands on quality of management and corporate governance structures, which MFIs struggle to meet. As MFIs seek to manage this growth, they increasingly choose to transform from not-for-profit to for-profit institutions, from NGO status to being deposit gatherers, seeking regulation and better access to funding, and thus open themselves to transformation risks and mission drift which drives them away from their target low-income customer base.

As MFIs transform and as MFI clients become more integrated into the mainstream financial sector, convergence occurs between microfinance and mainstream banking which would in Fitch's view reduce their resilience to the broader economy. The industry's success has led to greater competition from conventional banks moving 'down market' placing pressure on margins and skills resources. In some instances MFIs have moved 'up market' by following their clients as their financial needs grow, competing directly with the larger commercial peers.

Managing the dual targets of profit and social mission is a challenge added to which there are political/reputational risks associated with operating in the poor-low income market segment. MFIs face increased demands to document and quantify their social performance, as this is an important factor for the social or double-bottom line investors. These aims need to be balanced by the need to internally generate capital (ie profit) to support an industry that has potential to grow rapidly. The wide interest margins evident are to some extent driven by the business model, but do expose the industry to outside scrutiny and additional regulatory risks.

The Microfinance Sector

Microfinance originated in the 1970s in South Asia and Latin America. One of the landmark dates goes back to 1976, when Dr. Mohammed Yunus made a first loan of USD27 to a group of 42 women in Bangladesh. This first initiative of making small loans to groups of poor women further subsequently evolved into the Grameen Bank, which now serves 7.4 million customers, 97% of whom are women. Indeed, a large majority of microfinance borrowers consists of women, as they are often over-represented amongst the low-income population groups, and as they are suited to small-scale self-employment. In 2006, Dr. Yunus and the Grameen Bank were awarded the Nobel Peace Prize, highlighting the role of microfinance as an important tool for alleviating poverty.

The core of microfinance services to date has been the provision of loans to finance small-scale enterprises and household needs, but also and increasingly, savings, insurance and remittances. Microfinance customers in developing or transition countries typically include market and street vendors, small shops, household farmers and displaced people.

Micro loans are characterised by their small amounts, short maturities, regular and frequent repayments, relatively high margins and they are typically for working capital purposes. They have been characterised by their high repayment rates to date, with the working poor proving to be remarkably creditworthy.

What are Microfinance Institutions (MFIs)?

MFIs come in a variety of forms, in different regulatory environments and with different legal structures, lending methodologies, product ranges and target client bases. With the increased popularity of microfinance, the situation is complicated further: indeed, many institutions have “jumped on the bandwagon” and declare themselves MFIs, whilst not necessarily being institutions that target low-income populations for the provision of affordable and responsible financial services. Typical examples would include ‘loan sharks’, pawn brokers, or non-banks focusing on consumer loans.

There is no definite figure for the number of MFIs worldwide, but a generally-accepted estimate is some 10,000. Of this large universe, more than 1,100 MFIs report their financial and portfolio information into the MixMarket[1], a web-based microfinance information platform supported by the CGAP[2]. In this report, we use MixMarket figures as a proxy for the microfinance sector, since this provides the most comprehensive sector data available; and because the majority of microfinance borrowers and assets are concentrated in a group of leading or “top-tier” microfinance institutions, with the top 25 institutions representing more than two-thirds of microfinance borrowers worldwide, and 60% of outstanding loan balances[3]. These “top-tier” institutions are internationally active, and are increasingly sourcing funding from commercial investors and the capital markets. Nevertheless, given the sample size of the MixMarket, sector figures will tend to under represent real total sector figures. Some industry estimates for example put the number of microfinance borrowers at 100 million.

As at December 2006, MFIs reporting to the MixMarket had total assets of USD34bn, a growth of 33% on the previous year, and represented a customer base of 65 million savers and 54 million borrowers, with borrower numbers growing by 26% in 2005 and by 22% in 2006. Table 1 below shows a geographical breakdown of global

[1] http://www.mixmarket.org/

[2] CGAP is the Consultative Group to Assist the Poorest. It is a consortium of public and private funding organisations working together to expand poor people’s access to finance. CGAP acts as a global resource centre for microfinance

[3] MicroBanking Bulletin Issue 15 Autumn 2007

microfinance assets and liabilities, as well as the number of borrowers and depositors in each region.

Table 1: Geographical Breakdown of Microfinance Assets, Liabilities and Customers

	(USDm)			(m)	
Dec 2006	**Total assets**	**Loan portfolio**	**Deposits**	**Borrowers**	**Depositors**
Latin America/Caribbean	12,813.8	10,023.3	6,934.2	8.9	7.0
East Asia Pacific	7,568.9	4,743.3	5,185.9	10.5	32.2
Eastern Europe/Central Asia	7,117.0	4,910.1	2,280.4	1.8	2.7
South Asia	3,351.1	2,464.1	466.3	27.7	16.6
Africa	2,659.1	1,408.7	1,141.4	3.9	7.0
Total	**34,265.9**	**24,154.8**	**16,008.6**	**54.3**	**65.6**

Source: MixMarket

Asia, included under East Asia Pacific and South Asia in Table 1 above, is home to some of the largest and oldest MFIs, and includes large microfinance markets such as India, Bangladesh and Indonesia; it represents 70% of the total number of MFI borrowers and 74% of the number of savers. Latin America is the other mature microfinance market and represents 41% of outstanding sector loans.

The youngest microfinance markets of Eastern Europe and Central Asia, and Middle East North Africa are those currently experiencing the highest asset growth rates (57% and 76% respectively in 2006)[4]. In terms of number of borrowers, growth rates for 2006 yoy vary from a low of 12% to a high of 46% across regions. The fastest growth in borrower numbers is being experienced in the Middle East North Africa region, but also in the more mature sectors in Southern and Eastern Asia[5].

Most MFIs tend to operate in one country and typically only in one or several regions of that country; however, they generally benefit from their membership in larger international microfinance networks or their ownership by specialised holding companies and equity funds, or by International Financial Institutions (IFIs). There is typically no formal mutual support mechanism in place amongst the members of international microfinance networks, although they do benefit from their network's fundraising connections and technical assistance. Affiliates of microfinance holding companies benefit from financial support and the centralisation of supervision and strategic decisions at the parent company level.

The vast majority of MFIs operate in difficult operating environments — typical of emerging market countries. In addition, MFIs seek to operate in those regions where financial inclusion is the lowest, and thus enter rural or remote areas, where infrastructure and transport links are limited. Some MFIs bear the additional burden of dealing with large-scale health issues amongst their client base (such as HIV in some African countries), or working in areas prone to natural disasters (such as Bangladesh, which is prone to flooding).

The MFI Pyramid

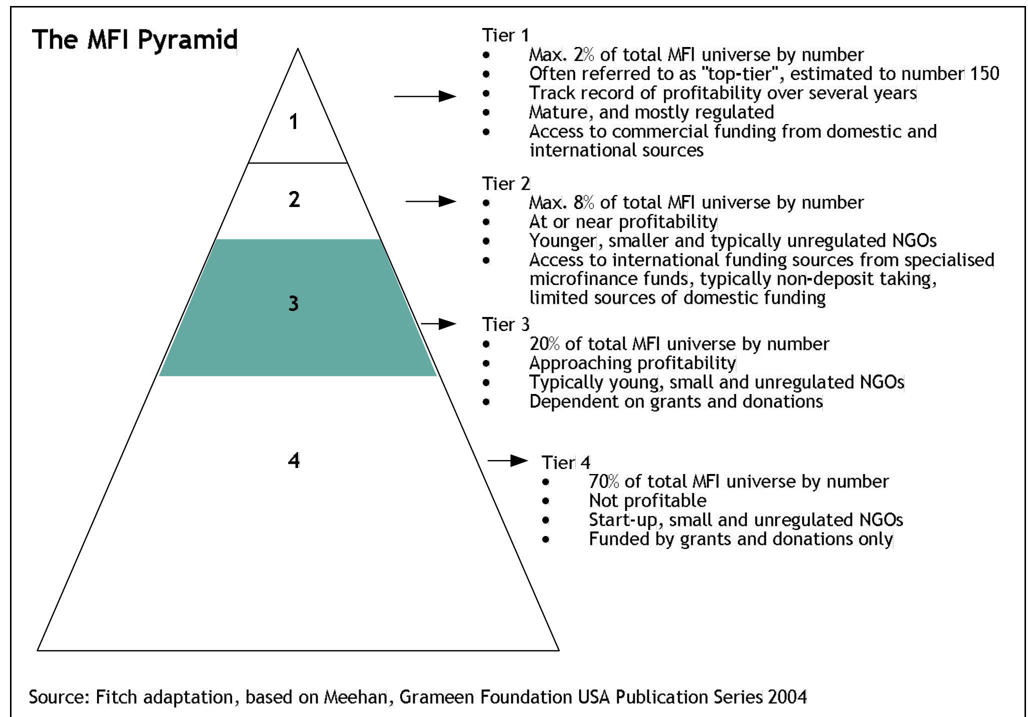
The universe of MFIs is frequently represented in the form of an MFI pyramid[6], as this helps to best reflect the variety that exists within the sector. Despite the variety and the relatively small size of individual MFIs[7], the majority of sector assets are concentrated amongst the tier 1 and 2 MFIs.

[4] MixMarket

[5] MicroBanking Bulletin Issue 15 Autumn 2007

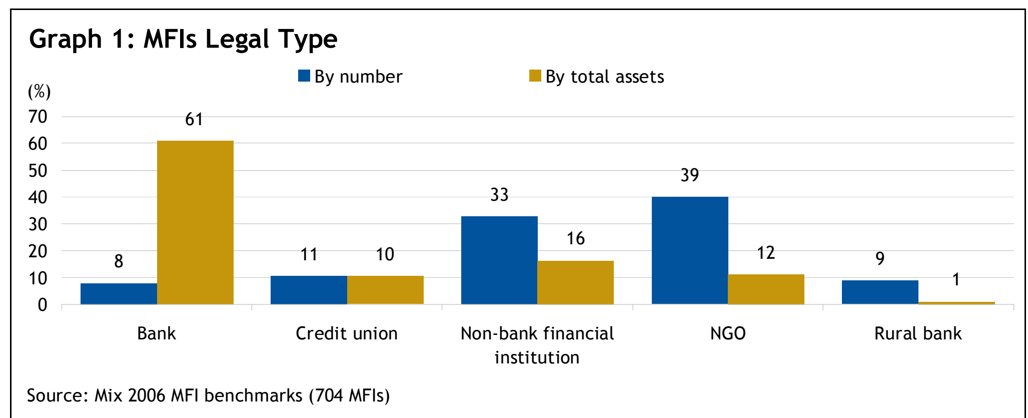
[6] Meehan, Grameen Foundation USA Publication Series 2004

[7] According to MicroBanking Bulletin Autumn 2007, at end 2006, there were only 46 MFIs with a loan book larger than USD100m, and 83 with a loan book larger than USD50m



Source: Fitch adaptation, based on Meehan, Grameen Foundation USA Publication Series 2004

MFIs have a large variety of legal forms, and include commercial banks, state banks, community-based institutions, credit cooperatives and unions, non-bank financial institutions, foundations and NGOs. As illustrated in Graph 1 below, although MFIs incorporated as banks only represent 8% of MFIs by number, they account for the vast majority of MFI assets (61%). A number of MFIs extend their remit, and offer healthcare support or business education to their borrowers, such as for example the ProMujer network in Latin America[8]. There are also some microfinance providers that operate on the basis of less formal structures, such as Rotating Savings and Credit Associations (ROSCAs) and self-help groups.



Source: Mix 2006 MFI benchmarks (704 MFIs)

Despite the fragmented nature of the MFI sector, consolidation has failed to materialise to any significant degree — against expectations, and despite some saturation of the microfinance space by MFIs in certain countries such as Bosnia or Bolivia. Examples of mergers and acquisitions are rare, even in those countries where the microfinance sector is fairly competitive (eg. Bosnia, Bolivia, Peru). This reflects the fact that, barring occurrences of over- or cross-indebtedness of MFI borrowers in the more competitive markets, and taking into consideration that MFIs operate mainly in countries where financial intermediation is low, there is still room for MFIs to grow organically whilst generally maintaining good profit margins.

[8] https://promujer.org/index.tpl?&ng_view=11

Additionally, MFIs tend to have strong affiliations with international networks, and therefore have strong "identities" which can act as barriers to mergers. Finally, MFIs are frequently managed by individuals with strong personalities who have great personal commitment to the MFIs' development, and who can be reluctant to share or diminish their leading role.

As is the case in the broader financial markets, the MFI sector would benefit from having larger top-tier MFIs to meet demand for microfinance in an efficient and sustainable manner. The development of a larger number of top-tier MFIs will require partnerships across the public and private sectors in order to best allocate capital for the purposes of supporting this development. This takes long-term support in the form of capital provision and technical assistance funding, both of which have been in much shorter supply than fixed-income investment.

Regulatory Environment

MFIs operate under a variety of regulatory environments which are country-specific, but which also depend on the legal structure of the MFI. For example, specialised microfinance banks are generally subject to prudential regulation by their respective countries' bank supervisory authorities, whilst credit cooperatives typically operate under a separate regulatory framework. Foundations and NGOs are typically not regulated. Some countries adopt special microfinance laws to cover MFI licensing and regulation (for example, Kyrgyzstan and Bosnia) which however do not always include prudential regulation; whilst in other countries (for example, India), MFIs increasingly seek to transform into non-bank financial institutions or banks in order to be covered by existing financial services regulation. The regulatory picture is complicated further by the fact that MFIs predominantly operate in emerging market countries, where financial services oversight and banking regulation suffer from certain weaknesses, credit bureaux often rely on lacking or incomplete data, and legal systems may not adequately support creditor rights.

The trend in microfinance however seems to be towards more regulation, as this allows for greater access to funding. Just under half of MFIs reporting to the MixMarket are regulated in some form, and they represent 60% of total borrowers and 75% of depositors[9]. The introduction of microfinance regulatory frameworks can in the short-term and in some instances lead to transformation- and legal risks for MFIs. A change in legal status can entail operational challenges, as it requires managing new, incomplete and sometimes conflicting legislation, and as it brings new sources of external oversight, new reporting requirements, and sometimes restrictions in terms of product range.

Characteristics of MFIs

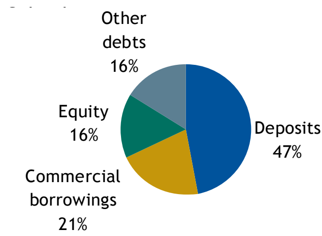
One major distinction to be made is between deposit-taking and non-deposit-taking MFIs, with the former typically regulated. Non deposit-taking MFIs tend to be heavily specialised in one activity — notably micro loans — whilst deposit-taking MFIs are more diversified, in terms of products, services and funding. Nevertheless, in both cases the loan book typically represents a majority of assets, resulting in a high reliance on interest income from micro- and small loans.

Ownership and Funding Profile

The majority of MFIs find their roots in the non-profit non-governmental organisation (NGO) world. Many successful MFIs have developed from local grass-roots NGOs (for example, ASA or Grameen Bank in Bangladesh), or were set up as affiliates of international non-profit microfinance networks (such as Opportunity or Finca International), which are themselves funded by donations or government aid budgets. A more recent trend, spurred on by the "double bottom-line" concept, is of MFIs being set up as specialised greenfield microfinance banks with capital provided by multilateral and bilateral development banks or international financial

[9] MicroBanking Bulletin Issue 15 Autumn 2007

Graph 2: MFI Liability Structure



Other debts include concessional borrowings, compulsory savings
Source: Mix 2006 MFI benchmarks (704 MFIs)

institutions (IFIs) such as for example IFC (International Finance Corporation, a member of the World Bank Group); or KfW (Kreditanstalt fur Wiederaufbau, the developmental arm of the German government, Fitch long-term IDR 'AAA'). These IFIs provide equity finance, fixed-income investment and technical assistance funds to MFIs. Their investment in microfinance, of both debt and equity, reached USD2.5bn in 2006, approximately 60% of a total foreign investment in microfinance of USD 3.9bn, and up from USD1bn in 2004[10].

Typically therefore, seed capital and funding for the early stages of development of MFIs come from these non-profit institutions, or quasi-governmental institutions. Increasingly, however, MFIs have sought to diversify away from aid-driven funding in order to find new channels to fund their growth, and to increase their strategic flexibility, and have turned their focus to attracting third-party commercial sources of debt funding, such as domestic savings, international microfinance investment vehicles (MIVs), or in some cases to accessing the local and international capital markets[11]. There are over 80 microfinance investment vehicles (MIVs), with USD3bn under management in 2007. The top ten MIVs are listed in Annex 1. As illustrated in Graph 2, commercial borrowings, which are mostly provided by MIVs and IFIs, account for 21% of total MFI sector liabilities.

This trend has resulted in the development of a unique ownership and funding profile for MFIs, combining public- and private-sector players, both of which are seeking a financial return and the fulfilment of their social mission, to differing degrees. Furthermore, the increasing interest in ethical finance by the private sector has supported microfinance fixed-income investments, which in turn have provided reasonable returns. Events of default by MFIs on third-party commercial or subsidized debt have to date been isolated incidents[12] and not fully documented.

Equity investment in MFIs remains the domain primarily of socially motivated and public investors – because of limited exit options and a lack of standards for valuation[13]. There remains a limited pool therefore of options for equity finance and this will limit the growth of MFI assets. However, the last two years have seen some new developments in MFI capital structures: the Mexican MFI Banco Compartamos (Fitch Long-term IDR 'AA-(mex)') successfully completed an IPO for a secondary offering of 30% of shares, raising USD 400 million in 2007; and a few private equity investors, reportedly driven by capital gains expectations, have made first investments of USD 20 to 40 million in some of the leading MFIs in India and Mexico[14].

Governance

Whilst a corporate governance structure will usually be in place, its strength and competence will vary across MFIs. Typically, the board of member-based cooperatives and NGOS will be staffed with cooperative members or NGO representatives, respectively. These tend to be voluntary positions, which are not remunerated, and whilst some independent directors might be present, the board in some instances may display some weaknesses of experience or know-how in such

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[10] CGAP Focus Note Feb 2008

[11] The most prominent examples of microfinance securitisations to date include ProCredit Bank Bulgaria, which completed the first ever true sale asset-backed securitisation for EUR 80 million in April 2006, and BRAC Bangladesh, which completed the first AAA-rated local currency securitisation of microcredit receivables for USD 180 million in 2006.

[12] For example, in June 2006, 8 local microfinance institutions were reportedly shut down by the Bank of Rwanda, as a result of poor management and credit risk management practices, and this required the government stepping in to compensate MFI clients for up to 50% of their deposits. Source: MicroCapital

[13] ProFund is the first microfinance equity fund to complete a cycle of investment and liquidity (1995-2005)

[14] Private equity investors such as Sequoia, Blackstone Group, Carlyle Group, Legatum

key areas as financial management. Governance and board quality are typically stronger in MFIs with some sort of international backing, although these MFIs often lack independent directors, as well as directors from the local community, which can be regarded as a weakness.

A critical governance issue often remains the extent to which the board is able to supervise MFI management, particularly given that strong personalities can often dominate the management team of MFIs.

Quality of Management

Management of MFIs is typically made up of a dedicated team of staff members, who have grown with the MFI since its early days. It however tends to be dominated by a single individual, who has often spearheaded the growth of the MFI, thus resulting in “key person risk”, with one strong leader and the lack of a real management team with appropriate division of responsibilities. Often, due to a lack of investment in training, managers may also lack some important competences, particularly in the areas of financial management and business planning. Weaknesses in management are also a reflection of the challenges inherent in retaining qualified managers in MFIs, which often operate in remote or rural areas, and which are not always able to offer competitive employment terms compared with commercial banks.

Types of Lending

There are differences between the types of products offered by MFIs, the lending methodologies they use, and the client base they target. The main differences are:

- Micro- versus small business loans

Definitions and parameters for micro or small loans will differ according to countries, and will typically depend on MFI internal guidelines or, in some cases, local legislation. Some MFIs – and in particular microfinance banks - will offer both micro- and small business loans, in part as a way to continue to serve good micro-loan clients who “graduate” into the SME business segment.

- Loans for entrepreneurs versus consumer loans

Some MFIs will focus on lending to entrepreneurs only, whereby the main source of repayment comes from a small-scale business activity, and the purpose of the loan is to fund the income-generating activity. Whilst most MFIs monitor the use of funds, it can be difficult to assess whether funds were ultimately invested in the business’s working capital, or used for domestic consumption, given that the micro-business and family budget are so integrated (for example, micro loans are often in demand for emergency life-cycle events such as paying for medical bills or for a funeral). For this reason equally, cash-flows for loan repayments will typically originate both from the business activity and other family income (for example, other family members’ salary or pension).

However, some MFIs also offer consumer loans which are salary-backed. It is important to distinguish between loans that are backed by future cash-flow from an income-generating activity, and consumer loans which are salary-backed. This is because the incentives for repayment are arguably different: a borrower with only one source of income — his business — and one source of finance — the MFI — is likely to have higher incentives for good repayment behaviour than a salaried employee or worker. Losing access to future loans, however, also acts as a strong incentive for good repayment behaviour.

Consumer loans are an important component, for example, of some of the Latin American MFI portfolios, with a third of the outstanding volume in that region in 2006 consisting of consumer loans[15]. This partly reflects MFIs in small competitive

[15] MicroBanking Bulletin Issue 15 Autumn 2007

markets seeking to diversify (eg. Bolivia), but also reflects banks or credit cooperatives seeking market share through outreach into the "unbanked" part of the population. Such "pure" consumer loans, as provided by mainstream commercial banks and cooperatives, are micro in terms of amounts, and do provide a source of competition for MFIs. However, Fitch believes that institutions which focus on the provision of consumer loans should be viewed differently to MFIs focused on loans to microentrepreneurs and their families. Whilst the former focus on the "unbanked", they often do not have a double bottom-line mission and their business model frequently does not fit into the microfinance business model characteristics described below (eg. African Bank and Capitec Bank in South Africa).

- Group lending versus individual loans

MFIs typically use two main categories of lending methodologies: group loans — also called solidarity- or village banking — are loans where group members take on joint liability and no collateral other than the group guarantee is taken by the MFI; individual loans are loans where the borrower is the sole counterparty, and are backed by a mix of collateral (see *Asset Quality*). It is generally accepted that group loans allow a deeper outreach into the lower-income segment, and have lower average amounts, whereas individual loans cater to a population which is slightly better off. Reflecting this, MFIs in South Asia tend to use group-based lending methodologies (for example, Grameen Bank in Bangladesh or SKS in India); whereas those in Eastern Europe and Central Asia typically use the individual loan methodology[16].

Microfinance Models

Several important trends can be seen from the evolution of MFIs:

- They are characterised by good asset quality (low delinquency and default rates), and typically compare favourably with the asset quality indicators of mainstream banks;
- The provision of microfinance can be done on a commercial and sustainable basis; and
- The microfinance model(s) in some instances have shown some resilience to external macroeconomic shock.

Asset Quality

There are a number of reasons why MFI asset quality has proven good to date.

MFIs have developed specific lending methodologies tailored to their target low-income group, characterised by a lack of bankable collateral and credit history. These include:

- A cash-flow-based, as opposed to an asset-based, evaluation of the borrower's creditworthiness;
- The key involvement of loan officers who are responsible for loan origination, analysis and monitoring, and whose pay is typically linked to loan delinquency levels in their own portfolios;
- A decentralised credit committee process so that decisions are "informed" and made "close" to the client, allowing for quick decisions and disbursements, both of which are also critically important for access to the target group;
- Adherence to a strict monitoring process, supported by the frequent repayment structure of loans;

[16] Of the 704 MFIs in the Mix 2006 benchmark, 35% by number use individual loans, 44% use a combination of both individual or group lending, and 19% use group lending only

- The use of repayment incentives based on peer pressure in the case of group of village loans, or for individual loans on the provision of collateral which will not necessarily have any real recovery or economic value, but which is deemed to have a personal value for the borrower;
- The use of repayment guarantees from friends and family;
- Conservative provisioning and write-off policies; and
- A zero-tolerance approach to arrears, although its extent will vary according to region and MFI.

In addition, microfinance providers are typically well integrated into the community, thanks mainly to the central role of loan officers, and to MFIs' localized branch networks. The proximity of MFIs to their customers is crucial to building trust and loyalty, which in turn helps ensure good repayment behaviour from customers.

Finally, microfinance providers often target women borrowers, who have over time displayed good repayment discipline[17].

Table 2 below illustrates portfolio quality indicators for MFIs over the period 2004-2006[18].

Table 2: MFI Asset Quality by Region

	PAR30			PAR90			Write-off ratio		
Median (%)	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
All MFIs	**2.5**	**2.2**	**2.6**	**1.1**	**1.1**	**1.4**	**1.4**	**1.3**	**1.2**
Africa	3.8	4.6	4.0	1.2	2.3	1.9	1.7	2.6	1.9
Asia	2.5	2.4	2.3	1.2	1.0	1.5	0.6	1.1	0.7
Eastern Europe and Central Asia (ECA)	1.1	1.0	1.2	0.4	0.4	0.5	0.8	0.7	0.7
Latin America (LAC)	3.4	2.7	3.4	1.7	1.5	1.9	2.3	1.5	1.7
Middle East North Africa (MENA)	0.5	0.6	1.2	0.2	0.3	0.3	0.4	0.3	0.5

Source: The Mix Publications

Table 2 shows strong and stable asset quality over the period 2004 to 2006, albeit with regional variations. In 2006, for all MFIs, median loans overdue by 30 days (portfolio-at-risk or "PAR30"[19]) were equal to just 2.6% of gross loans, and fell to just 1.4% for median loans overdue by 90 days or more. Furthermore, the write-off ratio was fairly low at 1.2%, and did not include recoveries. Some MFIs track their delinquent loans from the first day of delinquency ("PAR1"), and start measures to deal with overdue clients from that very early stage, in part helping to explain the typically low write-off rates of MFIs. However, it should be noted that asset quality problems, as measured at a particular point in time, can sometimes be concealed by the fast growth of MFI portfolios.

Asset quality indicators tend to vary across different regions. For example, the highest delinquency rates are in Africa, with PAR30 days of 4% in 2006, whilst the lowest delinquency rates are in Eastern Europe and Central Asia, and in Middle East North Africa, with a PAR30 days of 1.2%.

Regional differences in the non-performing loan rates of MFIs can be partly explained by the maturity of the microfinance sector in that particular region. For example, microfinance in Eastern Europe and Central Asia emerged only approximately 10 years ago, and, as such, is still a young sector, intent on

[17] The MixMarket 2006 sample of 704 MFIs show that the median percentage of women borrowers is 65%

[18] The Mix Publications – MFI Trends Benchmark Series 2004-2006; trend data over a constant set of 340 MFIs

[19] Portfolio at Risk 30 days is the outstanding balance on the portfolio overdue more than 30 days, divided by the average gross loan portfolio

establishing a track record of good portfolio quality and stable performance. The sector in those regions still has to live through the market and institutional effects which the more mature Latin American sector has gone through during its 30 years or so of history. These include market pressures such as financial crises (eg. Bolivia in 1999-2002), as well as institutional effects: as MFIs mature, and establish a proven track record, they can start to loosen their underwriting criteria for the sake of achieving greater customer outreach and business volumes, and therefore also scale and efficiency. For example, less stringent collateral requirements will allow MFIs to serve more customers more efficiently. However, a loosening of underwriting criteria can also result in higher levels of non-performing loans.

More mature microfinance markets, such as Latin America for example, can also display higher levels of competition, which can lead to erosion of underwriting standards and rising levels of cross-indebtedness, in turn, leading to higher PAR30 ratios.

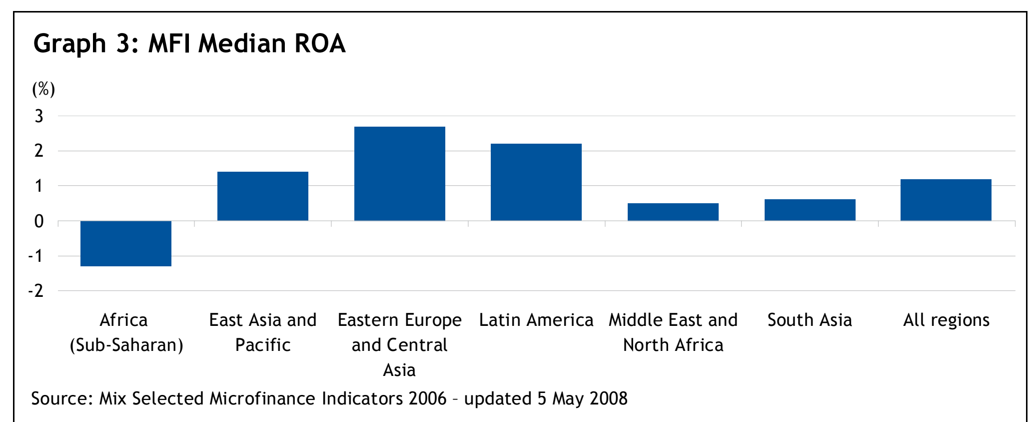
The operating environment can also be significant for MFI portfolio quality. Weak infrastructure and transport links, and the absence of registered home addresses of borrowers, are some of the additional challenges faced by MFIs in Africa for example. Such factors can also mean the business environment is challenging for the micro-entrepreneurs themselves.

Education levels are important in determining the size and quality of the available pool of staff for MFIs, which can, in turn, have a knock-on effect on asset quality. The prevailing credit culture in a particular country or region is also an important factor. MFIs in countries that have long histories of donor-funded social programmes often find it more difficult to enforce payment discipline amongst borrowers. Those in countries that experience widespread “consumer loan booms” also tend to experience weakening repayment culture amongst their customer base.

Delinquency rates also appear to be a factor of MFI intrinsic features, such as staff quality and turnover, quality of management, corporate governance, and quality of Management Information Systems (MIS) and internal control processes.

Performance

Graph 3: MFI Median ROA



Source: Mix Selected Microfinance Indicators 2006 – updated 5 May 2008

The emergence of a group of profitable and sustainable MFIs has been a key development in the sector over the past two decades. Although they represent only a small portion of the MFI sector (approximately 150), albeit a substantial part by total assets, they have contributed to a major “rethink” of a sector traditionally built on money from donors or aid. For the overwhelming majority of MFIs, reaching break-even point can take time, particularly as micro-lending is characterised by high operational costs and low transaction amounts, thereby necessitating high business volumes. MFIs have small average outstanding amounts ranging from a median amount of a low USD150 in Asia to a high of USD1,600 in the transition countries of Eastern Europe and Central Asia[20].

[20] MixMarket 2006 MFI Benchmarks

Whilst they are not representative of the sector as a whole, the sample below of the 10 largest MFIs by total assets reporting to MixMarket, serves to illustrate the profitability of some top-tier MFIs (see Table 3). Their ROEs and ROAs compare favourably with those of mainstream banks.

This sample also illustrates the wide variety of entities that exist within the microfinance sector, and includes data on banks which do not solely focus on microfinance, and some institutions which have large consumer lending activities (for example, Caja Libertad Mexico). PT Bank Rakyat Indonesia (Persero) Tbk (BRI)(Fitch Long-Term IDR: 'BB-' and National Long-Term Rating: 'AAA(idn)') is the leading bank for rural microcredits in Indonesia, the largest microfinance institution by assets worldwide, and the third-largest bank in Indonesia by assets. It has the highest rating on the National scale in Indonesia. This is supported by its strong franchise as the leading provider of microfinance in the country, its stable and low-cost funding base, its reasonable asset quality and conservative provisioning policy. BRI has total assets of USD19.4bn, and ROE of 27.4% as at September 2007. BRI's ROE and ROA at 2006 were 28.2% and 3.1%, respectively. The Vietnam Bank for Social Policies is a state-owned bank and had negative ROE and ROA in 2006, reportedly due to charging negative real interest rates to borrowers, which resulted in a loss for the bank. Caja Libertad's (Mexico) high ROE of 45.13% seems to be mainly a factor of this Mexican cooperative's success in mobilising local deposits, and in its focus on high-yielding consumer loans.

Table 3: Top-Ten MFI Performance Indicators

		(USDm)			(%)	
Dec 2006	Country	Total assets	Gross loan portfolio	Total equity	ROA	ROE
Bank Rakyat Indonesia (BRI)[21]	Indonesia	5,498.3	3,035.6	268.7	6.88	129.96
Caja Popular Mexicana	Mexico	1,337.5	941.7	158.6	3.15	29.00
Vietnam Bank for Social Policies	Vietnam	1,262.5	1,149.2	372.5	-4.04	-13.69
Grameen Bank	Bangladesh	819.8	482.1	88.6	2.44	22.15
Banco Estado	Chile	609.5	569.8	53.9	0.75	9.01
Caja Libertad	Mexico	555.7	488.5	80.7	6.00	45.13
Banco del Trabajo (Bantra)	Peru	421.1	345.9	37.5	0.24	2.47
Bangladesh Rural Advancement Committee (BRAC)	Bangladesh	393.5	350.1	116.3	6.90	23.27
MiBanco	Peru	388.4	320.4	52.2	5.13	34.44
ASA	Bangladesh	355.3	305.2	200.9	14.40	26.08

Source: MixMarket

Top-tier MFIs — which are typically larger and more mature — are profitable for a number of reasons (some of which can also be true of lower-tier MFIs):

- Greater economies of scale;
- Relatively high net interest margins;

In general terms, the main source of revenues is margin income, indicative of a narrow product range. As MFIs evolve to become fully-fledged banks, the product range increases and so too their ability to generate other sources of income.

The high interest rates, and the high net interest margins, are to some extent necessary to support the high operating costs linked to a labour-intensive lending methodology and the high distribution costs which characterise the MFI model, particularly in the case of MFIs working in rural areas (for example, BRAC). Interest rates and portfolio yields are typically higher on group loans than individual loans.

[21] Data relate only to the microfinance assets and portfolio of BRI (housed in a separate unit called BRI unit desa) which represent approx. 30% of the bank's total assets and portfolio

However, micro-entrepreneurs also tend to specialise in businesses which have high margins — small-scale trade in particular — and operate in economies where barriers to information and transport are high. This supports high profit margins, which in turn make a microfinance loan more affordable. Furthermore, MFI interest rates typically compare favourably to the other alternatives available to a typical MFI borrower.

Nevertheless, some MFIs operating in the less competitive microfinance markets are open to the criticism that they do not do enough to improve operating costs structures in order to gain efficiencies which can then be passed on to the final borrower in terms of lower interest rates.

- Preferential funding rates

MFI profitability figures, and in particular their net interest margins and cost ratios, can be distorted as a result of concessionary or below-market interest rates funding, or of technical assistance funds used to offset some operational costs (for example, loan officer training or branch expansion). This funding is typically provided by donor agencies or development banks. Nevertheless, increasing reliance on commercial funding is resulting in higher funding costs.

In some countries, profitability and operating margins are also being compressed by competition, particularly in smaller and well penetrated microfinance markets such as Bolivia or Bosnia. Whilst increased competition has the advantage of bringing more choice and lower interest rates to customers, and forces MFIs to become more financially sustainable, it carries with it risks of a weakening of underwriting standards, and of the cross- and over-indebtedness of borrowers.

Resilience to Crises

There is anecdotal evidence and some studies[22] that suggest MFIs may be less exposed to domestic and international macroeconomic events than commercial emerging-market banks, albeit not totally immune. This is typically expressed in terms of non-performing loans and other asset quality indicators, as well as profitability and asset growth indicators, of MFIs over a period of time, compared with banks or other emerging-market institutions, or compared with domestic or international economic indicators (such as GDP).

MFIs’ exposure to international macroeconomic or market events tends to be limited mainly because their asset base is domestic, and their funding sources are typically not fully reliant on capital markets or international commercial sources. Furthermore, where funding is sourced from international donor or aid agencies, such funding is not “flighty” and therefore arguably protects MFIs from systemic risk. Indeed, MFIs are more exposed to domestic events. They are vulnerable to changes in formal employment levels (which has a knock-on effect on the informal sector), declines in foreign remittances, and local currency devaluations (see *Funding and Reputation Risk* below). They are also particularly sensitive to movements in food price levels, since food expenditure is such an important part of a typical microfinance customer’s budget.

Nevertheless, individual cases have shown that in times of crises, and whilst the banking sector is experiencing a run on retail customer deposits, some MFIs have experienced a net inflow of domestic funds benefiting from a “flight to quality”, as was the case with ProCredit Bank Ukraine during the political uncertainty in 2004.

Experience drawn from the performance of MFIs and banks rated by Fitch in Indonesia and Bolivia, provides some illustration of MFIs’ relative resilience to domestic and international macroeconomic shocks.

[22] Gonzalez (2007) Resilience of Microfinance Institutions to National Macroeconomic Events; NYU Stern School of Business Krauss and Walter (Feb 2008) Can Microfinance Reduce Portfolio Volatility?

In Indonesia, like most of its peers BRI was badly affected by the 1997-1998 Asian financial crisis, particularly due to the foreign currency loans it had extended to large and heavily indebted corporates. However, its relatively larger exposure to rural-based consumer and SME borrowers mitigated the extent of its asset quality problems and losses at that time, as reflected in its relatively low NPL ratio of 6% during the Asian crisis, compared with a market-wide corporate NPL ratio of 70-80% in Indonesia during the crisis[23].

Table 4 below tracks the performance of banks and microfinance institutions around the time of the Bolivian financial crisis of 2000-2002, which was in part fuelled by aggressive consumer lending practices and the ensuing over-indebtedness of the population, and their performance in 2007.

For the purposes of this table, Banco Solidario, and, Banco Los Andes ProCredit (Fitch rated 'AAA' (Bol), which are commercial banks but have significant or majority microfinance activities,), have been included with MFIs. Whilst portfolio quality in 2000/2001 worsened for both microfinance institutions and banks, NPL ratios for MFIs peaked at 10% in December 2001, compared with a high of 18% for banks in December 2002. However, profitability deteriorated for all entities, due to higher levels of loan loss provisioning, which in the case of the MFIs was typically more conservative, explaining their weaker ROA over that period. However, the MFIs' ROA recovered more quickly than was the case for the banking sector.

Table 4: Bolivian MFIs' and Banks' Performance and Asset Quality Ratios, 2000-2007

	Dec 07	Dec 04	Dec 03	Dec 02	Dec 01	Dec 00
ROA						
Whole financial system	1.9	0.2	0.5	0.1	-0.4	-0.8
Banks (excluding the major microfinance banks)	2.1	-0.2	0.3	0.1	-0.4	-0.9
MFIs + major microfinance banks	1.9	2.1	1.7	0.2	-0.7	-1.0
NPLs/total loans						
Financial system	5.1	12.2	15.0	16.5	14.3	10.3
Banks (excluding the major microfinance banks)	6.4	14.5	17.1	18.0	14.4	10.3
MFIs + major microfinance banks	1.0	2.9	4.7	7.5	10.0	8.3

Source: Fitch

Given the fairly short history of microfinance globally, the notion that it is - and the extent to which it is - relatively insulated from macro-economic trends remains to be fully tested. Whilst microfinance is not immune to external shocks, the sector does benefit from a degree of insulation, particularly in comparison to commercial banks, based on the following factors which occur both at a borrower level and at the MFI — or originator — level.

MFI borrowers have characteristics that insulate them from external shocks. They tend to operate in the informal sector and are involved in businesses that cater to basic needs and are not so dependent on imports. These businesses may actually benefit from economic downturns, as local consumers turn to more affordable domestic products and services. The nature of micro-businesses also makes them more flexible and reactive to disruptions in the economic landscape: they typically have a small asset base with short lead production times, specialise in sectors with a high turnover of stock, are cash-intensive and often employ family members and friends — a more flexible pool of labour. Finally, an MFI loan is often the only source of future funding for micro-businesses, and this increases incentives for repayments.

[23] This is anecdotal information mainly, and Indonesian banks have changed their NPL calculations since the Asian crisis

MFIs tend to be more local or regional in nature and, as such, are more affected by local events than wider macroeconomic trends. Furthermore, their assets consist mainly of short-term working-capital loans with maturities of up to 12 months and frequent repayments (weekly to monthly) — this high turnover as well as the inclusion in loan agreements of events under which loan terms can be changed, mean that the MFIs can adjust lending terms over relatively short time-frames. However, it is potentially questionable whether they would be willing to do this in practice, given the social focus of their business. Finally, the relationship-based lending system in the context of small and close-knit communities appears to reinforce good repayment behaviour from borrowers during difficult times.

In times of stress, many MFIs benefit from the public-private mix present in their ownership and funding structures, and from the "double bottom-line" nature of their activities. MFIs are typically privately owned, usually by international public or private social investors, which are less sensitive to global market movements and more motivated by the social impact of their investment. MFIs which are donor-funded are typically the most insulated from wider market movements. Those which source their funding on a commercial basis, whether locally or internationally, will be most sensitive to movements in financial markets; however, likely less so than a commercial bank because of their recourse to specialised microfinance funds and a pool of socially responsible investors.

Key Trends

Growth

Growth in microfinance assets and in the number of microfinance clients has been significant in recent years. Based on the MixMarket data, in 2006 growth in the number of clients was 22% and growth in volume of MFI assets reached 33% (27% and 26% respectively in 2005). These growth indicators reflect the acquisition of new clients to the sector, but also the repeat servicing of clients and MFIs' regional and branch expansion.

Despite this growth, however, overall penetration levels of microfinance lending are still low, and the larger MFIs often remain regional players within their country of operation. The latter point is illustrated by Table 5 below which contains the top five microfinance countries by penetration levels. Furthermore, many microfinance countries with extensive microfinance operations, have even lower penetration levels than those shown in the table, for example Peru has a penetration level (as measured by the ratio of borrowers to poor people) of 14%, and India of 3%, although in India the sample includes more than 10 million borrowers[24].

Table 5: Microfinance Penetration Rates

	(m)			(%)	
	MFI borrowers	Total population	Poor	Borrowers/ population	Penetration rate borrowers/poor
Bangladesh	24.7	142	70.7	17	35
Bosnia Herzegovina	0.2	4	0.8	6	32
Mongolia	0.3	3	0.9	12	32
Sri Lanka	1.4	20	4.9	7	29
Vietnam	6.1	83	24	7	25

Note: Poor numbers based on national poverty rates; based on sample of 2,207 MFIs in 100 countries with a total borrower base of 76.9m
Source: MixMarket[25], Sep 2007

Another factor supporting the growth of microfinance is that business fundamentals in microfinance overall remain good, particularly in terms of underwriting standards and asset quality. Nevertheless, competitive pressure is being felt in some of the

[24] The MCril India Microfinance Review 2007 estimates that MFIs in India cover 15-20m clients

[25] Mix Publications How Many MFIs and Borrowers Exist? Sept 07

more competitive microfinance markets, and this could lead standards to weaken to some extent.

However, there are important constraints to growth.

- Managing rapid growth is a major challenge for MFIs. In particular, they face issues of capacity-constraint and can quickly start to lag in key areas such as building back-office and risk management functions, hiring and training sufficient numbers of loan officers and building an efficient middle-management line to supervise branch, staff and product expansion. The required changes and improvements to systems (to manage increasing volumes and complexity of transactions) often lag behind the growth curve. Fast growth only exacerbates the high operational risks to which MFIs are regularly exposed.
- As MFIs become more complex, management structures have to be strengthened and developed, so that leadership comes from a professional management team, and does not rely on a few key people, who, whilst dedicated, may be less strong on management skills and less commercially orientated.
- Finally, whilst foreign currency debt funding is widely available for the top-tier MFIs, local currency solutions remain limited, which means that local deposit mobilisation is key to funding continued growth.

The extent to which, and the speed at which, the microfinance sector can grow and achieve deeper penetration rates will most likely depend on how successfully MFIs mobilise domestic savings sources — since these remain the main source of low-cost local currency funding — and on how successfully they strengthen their institutions to deal with more complex service delivery models. It will also depend on the level and speed of development of the financial sector as a whole in their country of operation. The paradox, however, is that whilst a more sophisticated formal banking system benefits MFIs in terms of granting them access to sophisticated financial markets, it may also limit the rationale for the existence of MFIs as it becomes more able to serve an increasing majority of the population.

Some MFIs benefit from a strong franchise which allows them to mobilise a stable base of savings and deposits from their target low-income population group. This is the case in cooperative structures, some Asian NGOs such as ASA in Bangladesh — which has 6.4 million savers versus 5.1 million borrowers at December 2006 — but also at Bank Rakyat Indonesia (BRI), which as at end September 2007 had a balance sheet 80% funded by retail deposits.

Nevertheless, not all deposit-taking MFIs are successful in mobilising deposits on a meaningful scale. Experience in some countries — mainly in the transition countries of Eastern Europe and Central Asia — has shown that attracting deposits from a population which is new to the banking system is not an easy task, and costs of funding on savings and deposits can sometimes be higher than on third-party borrowings (a problem often exacerbated by competition).

Increasing Commercialisation: Transformation Risk

The emergence of top-tier MFIs with good asset quality and performance ratios, has generated a sector-wide movement towards commercialisation. Consequently, an increasing number of MFIs are seeking to transform from non-profit organisations to for-profit ones, and to diversify their sources of funding away from donor or development banks. Whilst the latter funds have the advantage of being at concessionary or subsidised interest rates, they are typically limited in availability, hostage to larger foreign policy and aid considerations, and come with operational restrictions attached which MFIs sometimes find constraining (eg. constraints on target groups, product features, or regional areas). MFIs have increasingly tapped commercial sources of funding: in 2006, 70% of MFI portfolios were funded from

commercial sources (deposits or commercial third-party borrowings), up from 60% in 2005[26].

Transformation to for-profit status entails several key events:

- A change in legal status from non-profit NGO to a for-profit limited liability or joint-stock company. Very often the founding NGO, association or parent microfinance network remains the sole, or key, shareholder if the ownership structure is expanded to include new shareholders. The aim is typically to find "like-minded" investors, with an equal commitment to the "double bottom-line" — these are generally found amongst a pool of development banks or microfinance funds, as instances of private capital for MFIs are still rare (see *Ownership and Funding Profile*);
- Becoming a regulated entity, either a bank or regulated MFI or non-bank financial institution, depending on the local regulatory environment;
- The addition of new product lines — particularly savings and deposits. This is also dependent on the regulatory framework, but the right to mobilise local savings is an important driver in transformation, as it is the main long-term source of local-currency funding;
- The accompanying change in the mindset of staff and management, from an NGO culture to a for-profit culture;
- A shift in the nature of the loan portfolio, with a trend to increasing average loan amounts and maturities;
- An increase in leverage and an increase in reliance on commercial funding which typically carry a higher cost than concessionary or subsidised funds.
- An increase in the complexity of asset and liability management, particularly because of maturity gaps, and foreign-currency mismatches.

The benefits of transformation are clear: the shareholder and ownership structure becomes clearer, regulation should add to the transparency and prudence of the institution, and a clearer path for funding sources and future growth is defined. However, transformation is a costly process — very few MFIs undertake it without some form of support from a development agency, parent NGO or microfinance network, to assist both financially and in terms of technical assistance and skills transfer. This also means transformation is not an option easily accessible to all MFIs.

The challenges are also significant, as this transformation process involves a radical change in the nature of the MFI. Several key institutional areas have to be built or further developed, including the asset-liability management function, liquidity and risk management; the management information systems; recruitment and training of staff on new products and procedures; and market research and advertising campaigns to support the MFI's commercialisation.

In addition, as the MFI transforms into a regulated entity, it loses some of the flexibility and approachability that typically engenders loyalty on the part of the client to the MFI. The risk is that a commercial regulated MFI becomes too bureaucratic and "remote" from its client base, and thus loses one of the key ingredients of its success. The search for profit also adds to the risk of "mission drift": it increases the temptation to move into higher loan amounts — with longer tenors and more traditional bank collateral — or into higher-yielding consumer loans, both of which are less costly to provide, but which move the MFI away from microfinance, its associated success factors, risk profile and client base.

[26] MicroBanking Bulletin Issue 15 Autumn 2007

As MFIs transform and commercialise, and as microfinance borrowers are integrated into the mainstream financial sector, there is the danger that the resulting convergence between microfinance and mainstream banking effectively strips microfinance of the very characteristics that help to insulate it to some extent from wider economic trends. This is a challenge particularly for the stronger and larger top-tier MFIs.

Funding and Reputation Risk

Microfinance investments have very much been "en vogue" over the last 2-3 years, in part due to the sector raising its profile through such initiatives as the UN Year of MicroCredit in 2005, but also in line with the benign global economic conditions and excess liquidity in the international financial markets, and the increased interest in socially responsible investments. Whilst debt funding has become increasingly available from both IFIs and private sources, it remains concentrated primarily in the top-tier MFIs; and notably in Eastern Europe and Latin America.

The majority of funding is primarily "socially" motivated, rather than purely profit driven. The 80 or so Microfinance Investment Vehicles (MIVs) attract mainly investors motivated by the "double bottom-line" returns of microfinance. These investors are interested in both the financial and social performance of MFIs: the lack of standardised tools for social performance measurement, examples of MFIs not behaving ethically, or indeed changes in perception or disillusionment with regards to microfinance as a poverty-reduction tool, are all issues which could cause a rethink of supporting microfinance and lead to outflows of capital from "double bottom-line" investors. In short, MFIs are particularly susceptible to reputation risk, given the composition of their investor base.

The development since 2004 of CDOs or CLOS backed by pools of loans to microfinance institutions has successfully attracted more commercial investors to the sector, with tranching allowing for the distribution of the junior notes to social investors or development banks who are able and willing to take this "first risk", whilst attracting commercial investors to purchase the senior notes. This contributed greatly to the increased availability of funding available to top-tier MFIs, and in some cases has resulted in downward pressure on MFI funding costs. However, given the current credit crunch, there is reduced appetite for such funding structures, making them less available as a source of funding.

Foreign Currency Risk

Debt funding is predominantly offered in foreign currency, and in USD in particular, with only 30% of international investments in microfinance in the first quarter of 2008 being made in local currency[27]. It remains a challenge for international investors to provide loans in emerging market currencies since these are often not hedgeable and local capital markets sources remain scarce, mainly because of shallow financial markets. Consequently, this creates currency risk — either at the MFI level, if the MFI's assets are predominantly in local currency, or at the borrower level, if the MFI chooses to pass on the risk. Many borrowers do not have foreign currency-denominated revenues, and could face serious repayment problems in the event of a local currency devaluation. These factors combine to increase MFIs' vulnerability to repayment problems, particularly in microfinance markets which display signs of over- or cross-lending.

If MFIs increasingly tap the international capital markets for funding, they also make themselves more prone to liquidity problems caused during global credit crunches. This undermines what is emerging as one of the main arguments for investing in microfinance for the global market investors — its lack of correlation to other emerging market asset classes — and could have a critical impact on the volumes of funding available, and therefore on growth expectations for the sector.

[27] CGAP Microfinance Capital Markets Update No. 25 March-April 2008

The availability of wholesale debt funding for MFIs from international or local banks may also be affected by the introduction of Basel II, which establishes minimum capital charges for regulated banks based on the ratings of individual borrowers in their credit portfolios. Since MFIs typically have no credit ratings or have sub-investment grade ratings, Basel II could result in higher capital costs for loans to MFIs, which in turn could constrain the availability of funding.

Political Interference

Owing to its historically social and developmental role, microfinance has been prone to political interference in certain countries, the most damaging forms of which are interest rate ceilings, direct lending from government funds at below-market rates, and the outright encouragement to borrowers not to repay loans.

For example, in 2007, the Ecuadorian authorities introduced hard caps on effective interest rates, fixed on a monthly basis and monitored by the Central Bank of Ecuador, to aid fair disclosure in terms of the full effective costs of an MFI loan (as opposed to the previous “soft cap” on nominal interest rates which could be circumvented by MFIs using disbursement fees or other fixed charges). The existence of such hard caps has the potential to stifle microfinance institutions as they restrict MFIs’ ability to charge interest rates high enough to cover their high operating costs and to generate sufficient capital. However, it also puts pressure on institutions to become more efficient. The introduction of interest rate caps is a permanent threat in microfinance markets such as Bolivia or India.

Local government interference also had an adverse effect on the performance of MFIs in Andhra Pradesh, India, in 2006. It seems that the government of Andhra Pradesh, motivated by concerns over MFI loan recovery practices and also interest rate levels, closed down the offices of several MFIs and encouraged MFI borrowers in the region not to repay their loans. After an increase in impaired loan rates and loan loss provisioning costs the MFIs concerned reduced their interest rates and soon resumed lending activities.

A more recent example, involves one of the leading MFIs in Africa, PADME[28] in Benin, which since March 2008 has undergone a major organisational shake-up due to government intervention, reportedly on the basis of operational concerns at the MFI.

With the recent increase in the profile of microfinance, potential government interference is likely to remain an issue.

Transparency and Quality of Information

The microfinance sector is on the whole making continued progress towards greater transparency. Some MFIs follow self-imposed standards on information provision, with for example, more than 1,100 MFIs reporting profile, financial and portfolio information on the MixMarket. In addition, more than 400 MFIs underwent external ratings in 2006, the majority of which are global risk assessments conducted by specialised microfinance rating agencies. These assessments are however not assessments of creditworthiness, and with the increasing interest of international commercial capital in microfinance, some of the top-tier MFIs have turned to mainstream rating agencies such as Fitch Ratings for credit ratings, which express creditworthiness in terms of relative measures of default likelihood (see Annex 2 for Fitch microfinance ratings).

Whilst a number of tier 1 and 2 MFIs produce externally audited accounts and financial reporting under US GAAP or IFRS, in an effort to be more comprehensible to the wider financial world, they remain limited. Even some of the top-tier MFIs continue to report under local accounting standards, for example in most Latin American countries.

[28] Association pour la Promotion et l’Appui au Développement de Micro-Entreprises

The information available from the sector overall is still of variable quality. Whilst the sector is celebrated for its high repayment rates, to some extent this information should be treated with caution: it requires careful attention to assess the correctness of data and procedures regarding the accounting treatment of non-performing loans, or the use of rescheduling or refinancing. Similarly, caution should be exercised when assessing financial performance, taking due care to correctly assess the accounting of grants/donations and subsidized funding, and their impact on profitability figures.

Quality of Governance and Management

The quality of governance and management will most likely continue to be areas of weaknesses in MFIs, particularly as the sector manages high growth rates and considerable changes to its environment, in particular growing competition and pressure on margins, and increased commercialisation and funding from the private commercial markets. MFI strategies will increasingly be hostage to the delicate balancing of social and commercial targets. Boards continue to be dominated by representatives of the "social" as opposed to "commercial" world, and often suffer from the lack of independent, well-remunerated members with the appropriate set of skills.

Performance and Competition

Fitch expects greater competition through new market entrants — in particular in the guise of consumer lending - through increased competition amongst MFIs due in part to the increased availability of debt funding but also through innovations in distribution channels using modern technologies, and through innovative linkages between microfinance providers and mainstream commercial banks. This should support innovation and the development of full-service microfinance institutions, which do not focus solely on micro-credit, but expand to offer micro-insurance, savings and remittances. It could also prompt consolidation in the sector, although this would be in the medium term, if at all.

Whilst competition supports greater operational efficiency and better and cheaper access to microfinance products for the end user, it also carries with it the danger of increased credit risk as MFIs may be forced to compromise on underwriting standards in order to achieve continued growth in business volumes. Competition also puts downward pressure on interest rates and raises the challenges of improved cost control if MFIs are to maintain margins. However, margins are likely to fall to some degree and are already under pressure, particularly in some of the more competitive microfinance markets of Latin America. Another contributing factor in this respect is the increasing financial expenses linked to a shift from concessionary donor funding to market-rate commercial funding.

Size Matters

MFIs' small asset and equity size remain a constraint, in particular with regards to MFIs' ability to absorb losses, and their generally limited ability to source external capital. However, MFIs benefit from the granularity of their portfolios and client base. Some MFIs can have more than 6 million borrowers, and they typically have low individual average exposures (eg. low top-20), insignificant related-party lending and good asset quality. This supports their ability to generate earnings on a consistent basis. Nevertheless, MFIs remain dependent on interest income and this makes their performance sensitive to margin pressure. Their small size could leave them short of the critical mass needed to weather unforeseen stresses to the performance of their assets, although counterbalancing this is the fact that MFIs tend to be more insulated from external shocks than mainstream banks.

Annex 1 – Top Ten Microfinance Investment Vehicles at Dec 2007

Ten Largest Microfinance Investment Vehicles

Name	Type	Total assets (USDm)	Total microfinance portfolio (USDm)
European Fund for South East Europe	Commercial Investment Fund	583	233
Oikocredit	Blended Value Fund	569	317
Dexia MicroCredit Fund	Registered Mutual Fund	298	255
SNS Institutional Microfinance Fund	n.a.	237	55
ResponsAbility Global Microfinance Fund	n.a.	193	184
Calvert Social Investment Foundation	n.a.	170	38
ResponsAbility SICAV (Lux) Microfinance Leaders Fund	Registered Mutual Fund	157	136
ASN Novib Fund	Registered Mutual Fund	118	81
BlueOrchard Loans for Development 2007-1	CDO	108	107
BlueOrchard Loans for Development 2006-1	CDO	101	97

Source: CGAP microfinance capital markets update February 2008, CGAP MIV 2007 Survey

Annex 2

Fitch Microfinance Ratings

		International scale					National scale	
	Issuer name	Long-Term IDR	Short-Term IDR	Individual Rating	Support Rating	Local Currency LT IDR	Long-Term	Short-Term
Latin America								
Bolivia	Banco Los Andes ProCredit Bolivia						AAA (Bol)	F1+ (Bol)
	FFP Ecofuturo Bolivia						A- (Bol)	F1 (Bol)
	FFP Fie Bolivia						AA (Bol)	F1+ (Bol)
	FFP Prodem Bolivia						AA- (Bol)	F1+ (Bol)
	Fundacion AgroCapital Bolivia						A- (Bol)	F1 (Bol)
	FFP Fortaleza						A (Bol)	F1 (Bol)
	FFP Comunidad						A- (Bol)	F1 (Bol)
	FFP Fassil						A- (Bol)	F1 (Bol)
	C. Jesus Nazareno						A- (Bol)	F2 (Bol)
	C. San Martin						BBB+ (Bol)	F2 (Bol)
	C. Fatima						BBB+ (Bol)	F2 (Bol)
Chile	Banco del Estado de Chile				2		AAA (Chl)	N1+ (Chl)
Dominican Republic	Pyme BHD						A (Dom)	F1 (Dom)
	Banco ADOPEM						A- (Dom)	F2 (Dom)
	FONDESA						BBB+ (Dom)	F2 (Dom)
	Banco ADEMI						BBB (Dom)	F3 (Dom)
	Fundacion Dominicana						BB+ (Dom)	B (Dom)
El Salvador	Banco ProCredit SA El Salvador						AA (Slv)	F1+ (Slv)
Mexico	Banco Compartamos						AA- (Mex)	F1 (Mex)
	FinSol						BBB+ (Mex)	F2 (Mex)
Nicaragua	Financiera Nicaraguense de Desarrollo (FINDESA)						BBB+(Nic)	F2 (Nic)
	Banco ProCredit SA Nicaragua						AA- (Nic)	F1+ (Nic)
Paraguay	Financiera el Comercio						A- (Bol)	F1 (Bol)
Venezuela	Bangente						BBB+ (Ven)	F2 (Ven)

Source: Fitch

Annex 2 (Continued)

Fitch Microfinance Ratings

		International scale					National Scale	
	Issuer name	Long-Term IDR	Short-Term IDR	Individual Rating	Support Rating	Local Currency LT IDR	Long-Term	Short-Term
Eastern Europe								
Albania	ProCredit Bank Albania	B+	B	D/E	4	BB-		
Bosnia Herzegovina	ProCredit Bank Bosnia & Herzegovina	B	B	D/E	4	B+		
Bulgaria	ProCredit Bank Bulgaria	BB+	B	D	3	BB+		
Georgia	ProCredit Bank Georgia	BB-	B	D/E	3	BB		
Macedonia	ProCredit Bank Macedonia	BB+	B	D/E	3	BB+		
Romania	ProCredit Bank Romania	BB+	B	D/E	3	BB+		
Serbia	ProCredit Bank Serbia	BB-	B	D/E	3	BB		
Ukraine	ProCredit Bank Ukraine	BB-	B	D	3	BB	AAA (Ukr)	
Western Europe								
Germany	ProCredit Holdings	BBB-	F3	C/D	2			
Asia								
Indonesia	PT Bank Rakyat Indonesia (Persero)	BB-	B	C/D	4		AAA (Idn)	
Mongolia	Khan Bank	B+		D	4	B+		

Source: Fitch

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