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Microfinance Institutions: Changing Strategies For Changing Times

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Microfinance Institutions: Changing Strategies For Changing Times

Microfinance institutions (MFIs) have made significant strides over the past few years in generating interest among commercially oriented investors. Some commercial investors' interest is based on the possibility of doing "societal good" while potentially doing well for themselves.

In the past, heightened levels of global liquidity had pushed investors to seek newer ways to diversify their portfolios. The better-positioned MFIs with relatively low delinquency and default rates and solid profit margins piqued these commercial investors' interest in the sector. Because of this, many MFIs had the ability, until the recent downturn, to raise capital at longer tenors and, competitively, at below-market rates that averaged 8%.

The sector also appeared to benefit from the added global visibility that came to the industry when Grameen Bank's Muhammad Yunus won the Nobel Peace Prize in 2006. As a result, MFI portfolios, especially from the better-positioned institutions, experienced a boon in growth from invested funds. The most recent Consultative Group to Assist the Poor (CGAP) study estimates that microfinance investment funds had US$5.4 billion in total assets under management in 2007. The institutional investor segment of this amount more than doubled between 2006 and 2007, increasing to 41% from 14%. Total MFI lending is supporting 100 million to 150 million borrowers compared with the global estimate of 1.5 billion to 2 billion working poor who may be eligible for microfinance loans.

Reevaluating Growth Objectives

This trend has obviously changed in recent months and continues to change, along with the contours of the overall financial landscape. Indeed, troubles in the global economy will likely inhibit some of the sector's development and could, in Standard & Poor's Ratings Services' view, substantially dampen optimistic forecasts. MFIs have already seen an increase in the cost of capital—in some cases greater then 100 basis points—as the mainstream investors have shown signs of slowing their participation in microfinance. We believe that the immediate impact of this for MFIs will be narrowing profit margins.

MFIs will have to respond to this changing environment, which includes fewer competing funding offers to choose from, and the current absence of structured finance vehicles. They will most likely have to reevaluate their growth objectives as they relate to funding and liquidity strategies, while ensuring the maintenance of a sound capital structure and strong liquidity measures. The good news, however, is that existing socially responsible investors (SRIs) are expected to maintain their current funding levels. Current market conditions have, in our view, curtailed MFIs' ability to pursue initial public offerings (IPOs) to expand their capital bases (we do expect to see some private transactions, however).

Rethinking Risk Appetites

We have observed that MFIs are beginning to take a closer look at their risk appetites in light of the current liquidity and credit environment. The subprime mortgage lending crisis may have offered a lesson for the sector by underscoring the need for maintaining and strengthening underwriting standards—even in the face of increasing competition. In our view, correctly correlating and measuring an MFI's credit, operating, and market risks are also crucial tasks for MFI management going forward. As many MFIs expand their services to provide product diversity, we think it will be necessary for them to develop an enterprise risk management (ERM) with a more holistic approach to risk oversight and management. Standard & Poor's considers risk management in its analytical processes for financial services firms, which includes MFIs.

Another lesson MFIs may draw from the current market conditions is the need to diversify funding sources since there's always the risk that a particular funding flow will suddenly dry up. MFI managers will likely need to emphasize their focus on asset/liability management (ALM), with the goal of stabilizing existing funding sources while developing alternative lower cost funds (for example, local currency deposits, if available) and ensuring these funds have the appropriate level of diversity, stability, and tenor.

Standard & Poor's believes that MFIs will have to maintain a solid management and operating reputation. MFIs with a clear and enunciated strategy to achieve scalability while maintaining strong asset quality and profitability generally benefit as investors embark on a "flight to quality" in times of crisis.

Prices Are Falling, But Inflation Is Still Taking Its Toll

Global food and fuel prices may have retreated from their record highs, but they're still putting pressure on microfinance borrowers' already-tight disposable incomes. In many instances, microfinance borrowers are having to choose between repaying their debts or meeting their daily survival needs. In general, these higher inflationary trends, in our view, could result in many MFIs experiencing a rise in nonperforming loan levels (NPLs), lower future loan demand, and declining funding from low-cost savings deposits. Further compounding these negative factors are higher operating costs that result from inflation-based payroll increases and the need for MFIs to step-up their portfolio monitoring and absorb increasing capital costs. The bottom line for MFIs, we believe, is that they will face shrinking margins and a renewed need for capital contributions.

Competition Stiffens As The Market Matures

The industry's successes and growing popularity over recent years have inevitably increased competition, pressuring many MFIs' profitability. Still, MFIs continue to respond with innovation, searching for efficiencies through technological advances and streamlined systems, strategies that take on increasing importance in today's environment.

Standard & Poor's has observed some examples of effective responses to competition in Latin America, such as the use of technology to create systems to improve management decision-making, establishment of tighter cost controls, expansion of distribution channels, and more cost-effective staff allocation.

Standard & Poor's believes that MFIs will need to be on guard that competition doesn't lead to compromise on underwriting standards and pressure on loan officers to achieve continued growth. The introduction of new products and the cross-selling of these with traditional services may result in overburdening a client's capacity to repay borrowings or pay for new offerings.

Regulation: Supervising The MFIs

The trend for MFI regulation, especially deposit-taking MFIs, appears to be increasing. Standard & Poor's believes that regulators will need to have a clear understanding of microfinance and its risks. This understanding may aid in appropriately balancing prudential supervision and the fundamental objectives of systemic stability and customer protection (including capital adequacy, liquidity, reporting standards, the measurement of NPLs, and truth in lending), without limiting the expansion of appropriate financial services and their supporting industries. Supervision should focus on the actual risks posed.

Standard & Poor's Assessments In The Microfinance Industry

We are currently validating our MFI rating methodology through 10 pilot credit ratings in Latin America and the Caribbean under the sponsorship of the Inter-American Development Bank. We're also conducting nonsponsored ratings in other global regions with rapidly developing microfinance sectors. In our view, the bulk of the global credit rating demand is likely to come from the upper-end of the MFI market. We look forward to providing investors, MFIs, and other stakeholders with our global credit ratings and their comparison benchmarks.

Related Articles

The following articles are available on RatingsDirect at www.ratingsdirect.com:

- "Special Report: Microfinance: Taking Root In The Global Capital Markets," June 19, 2007.
- "Credit FAQ: Developing A Global Ratings Framework For Microfinance Institutions," March 11, 2008.
- "Methodology And Assumptions: Standard & Poor's Approach To Rating Microfinance Securitizations," Nov. 6, 2008.

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