USAID
FROM THE AMERICAN PEOPLE

Capital Markets and the Crisis

Moderator: Martin Holtmann (IFC)

Panelists: Eliza Erikson (Calvert)
Monica Brand (ACCION)
John Wasielewski (USAID)

First in a *Microfinance Learning and Innovations After Hours mini-series* on the impact of the global financial crisis on MFIs & their clients.

December 10, 2008

Calvert Foundation

Investing in Microfinance

Impacts of the Global Financial Crisis

Eliza M. Erikson, Portfolio Manager, Microfinance

About Calvert Foundation

Mission: To End Poverty Through Investment

Goals:

- Maximize capital flow to disadvantaged communities to foster more equitable, sustainable societies (***US***: *affordable housing, small business, community facilities;* ***International:*** *microfinance)*
- Establish community investment as a new asset class in the financial services industry: *focus on retail investors*
- Calvert Foundation employs a range of innovative financial products & services that raise funds from the U.S. public

History:

- Investor in microfinance since Foundation's inception in 1995
- $60 million outstanding in 85 countries
- Risk averse to protect the everyday, retail investor

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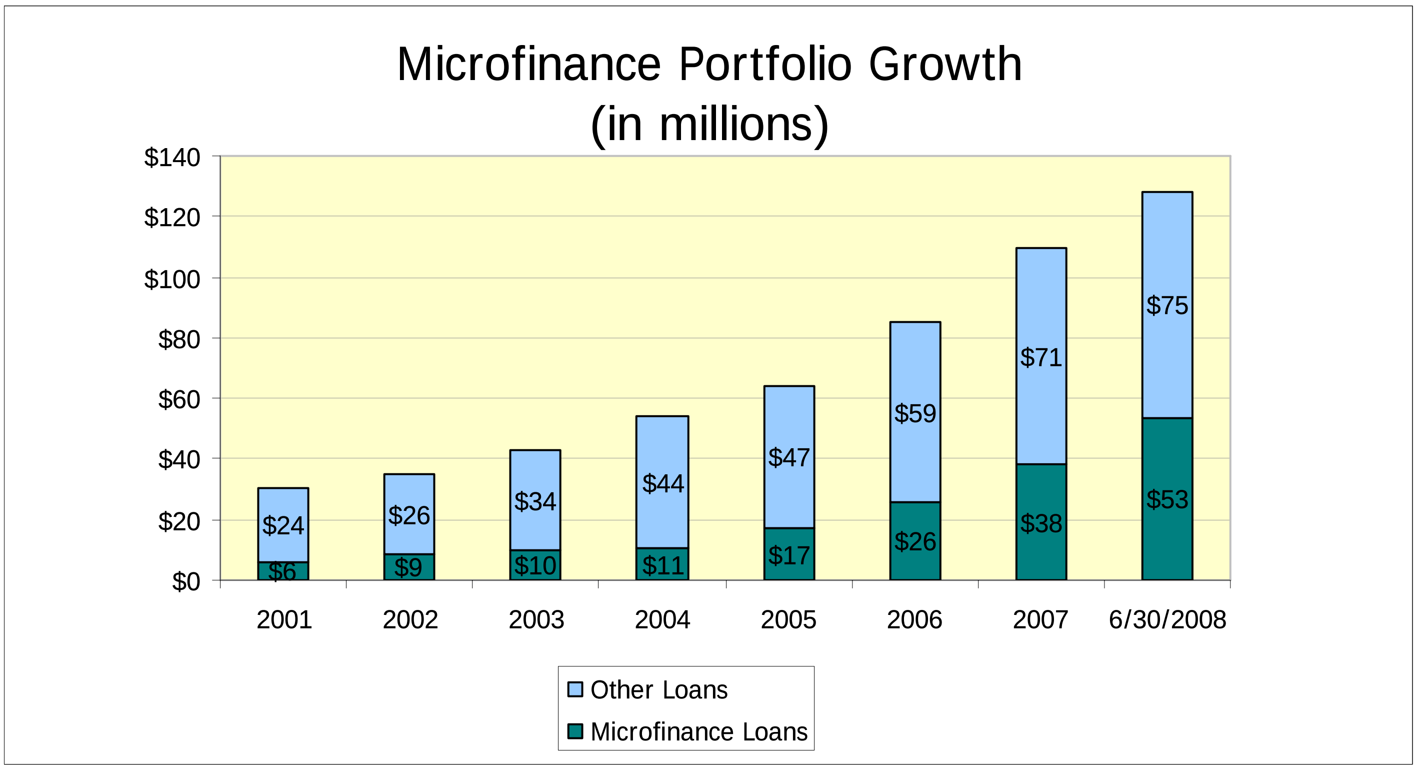
Portfolio Growth



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Macro Industry Issues: "That was Then" (2007)

- **Increase in Microfinance Investors** ($2.7B in 2004 → $6.7B in 2007)
  - Lower rates in mature markets due to increased competition
  - Pressure for investor consolidation, co-investment, transition "down-market" to Tier 2 MFIs
  - Total portfolio outstanding of MIVs increased by 110% from 2005 to 2006 reaching US$2 billion.
- **Increased Access to Capital Markets**
  - Structured Offerings/CDOs (Diversification & FX mgmt; cost effective deployment of larger amts)
  - Share Issuance
    - Equity Bank trades on Nairobi stock exchange (August 2006)
    - MFI SKS secondary offering (March 2007)
    - Compartamos IPO (April 2007)
  - Debt Issuance
    - BRAC $180M securitized receivables in microfinance (2006)
    - ProCredit Serbia EUR125M public bond issuance (March 2007)
- **Foreign Exchange Risk Management**
  - Increasing awareness of risk of hard currency debt on investor & MFI
  - Increasing availability of local currency & hedging through FX facilities
- **Annual growth rates of top MFIs ranging from 50-70%**

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** Microfinance Banana Skins 2008; Risk in a Booming Industry. CSFI, sponsored by Citi & CGAP.*

Macro Industry Issues: “This is Now” (2008)

NEW ECONOMIC ENVIRONMENT

- **Increased global inflation**
  - Increased food prices and benchmark rate result in pricing pressure and decreased repayment capacity for MFIs and end borrowers
  - *Potential impact: lower portfolio quality, decreased growth and profitability, increased lending rates*

- **Reduction in liquidity/credit crunch**
  - Limited liquidity in local/international banks and decrease in CDOs/structured finance threatens MFI funding and increases cost of funds: increased refinancing risk
  - *Potential impact: increased refinancing risk, reduced growth, compressed margins, lower profitability*

- **Depreciation of emerging markets currencies vis-à-vis US Dollar/Euro**
  - Local banks & governments exhaust foreign hard currency reserves → depreciation of local currency
  - *Potential impact: increased FX risk, increased costs of FX hedging*

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Country Case Study: Bosnia

- Withdrawal of international capital from financial market led to 55% decrease in BiH’s stock exchange value since early 2008, creating a dramatic liquidity loss.
- MFIs are increasingly willing to accept higher priced debt by up to 250 bps due to lack of liquidity & high inflation rates (projected to be 9% for 2008).*
- Leading MFIs scaling back growth plans not only because of the financial crisis but also because the Bosnian microfinance market is overheated.
- Increased financial costs may prove too burdensome for smaller MFIs leading to +market consolidation w/ opportunity to purchase portfolios at discounted prices.
- There have been deposit runs reported that stabilized in November.

** CGAP Virtual Conference: Microfinance and the Financial Crisis, November 18-20*

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Country Case Study: India

- Liquidity tighter especially for smaller institutions. Banks have dramatically cut back on new disbursements to MFIs.
- Previously committed funds are being renegotiated, credit limits are being reduced, banks are taking longer to disburse. In some cases the banks are asking for personal guarantees from MFI directors.
- Interest rates on loans to MFIs have jumped by up to 450 basis points.*
- Reserve Bank of India (RBI) took steps in Sept. to improve liquidity by reducing bank reserve requirements by +200 basis points. Investors calling for elimination of foreign investment restrictions to improve availability of funding; no action to date.
- Local MFI industry likely to experience consolidation in the very near future.

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CGAP Virtual Conference: Microfinance and the Financial Crisis, November 18-20
http://microfinancegateway.org/content/article/detail/53396
http://www.microcreditsummit.org/enews/2008-10_asia.html

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MFI and Investor Reactions

- **MFIs:**
  - Reduced growth plans: focus on existing clients to preserve portfolio quality
  - Increased focus on portfolio risk management: tightening credit policies
  - Increased general and loan loss reserves
  - Focus on asset-liability management: FX risk management
  - Early and frequent communication with current and prospective investors

- **Investors:**
  - Reduced growth plans: focus on existing clients
  - Conserve liquidity
  - Increased general and loan loss reserves
  - More focus on portfolio risk management: monthly reporting from MFI clients, portfolio stress testing

- **Silver lining:**
  - Exponential expansion of microfinance investment in 2006-2007 created growth rates that outstripped MFI/MIV internal controls and operational capacity
  - Will the crisis bring a much-needed market correction and force both MFIs and investors to return to the basics (i.e. tighter credit policies, more measured growth)?

APPENDIX

Economic Context: Global Trends & Risks

Despite lack of direct influence, global trends will impact the microfinance sector

Economic Observations & Trends	Implications for Microfinance
• Global and local inflation* – Prices in 1 of 4 countries accelerating at double-digit rate – Food prices have jumped 39% from Feb. 2007 to 2008 led by wheat, soybeans, corn and edible oils	• Puts pressure on MFIs & end clients – Increased benchmark rates to curb inflation will put upward pressure on MFI rates – FX Hedging costs will likely increase – Potentially higher client indebtedness & lower repayment capacity
• ***Financial /credit crisis:* Resulting tightened liquidity**	• **Potential constraint on capital supply from CDOs & local banks; increased cost of funding, reduced growth and profitability**
• Lax underwriting process in sub prime market – Over-reliance on credit scores – Outsourcing of loan marketing and origination	• Careful underwriting, risk management techniques and strong focus on portfolio quality imperative
• Unsustainable products precipitated sub prime crisis – Higher priced, poorer quality and complex products targeted to lower income individuals	• Increasing evidence of delinquency or over-indebtedness in highly competitive markets (Nicaragua, Bolivia, Bosnia) • Introduction of aggressive products & underwriting practices in Mexico, India and E. Europe should be monitored
• Increased regulatory scrutiny	• Final shape of US policy & regulatory responses will influence rules of the game

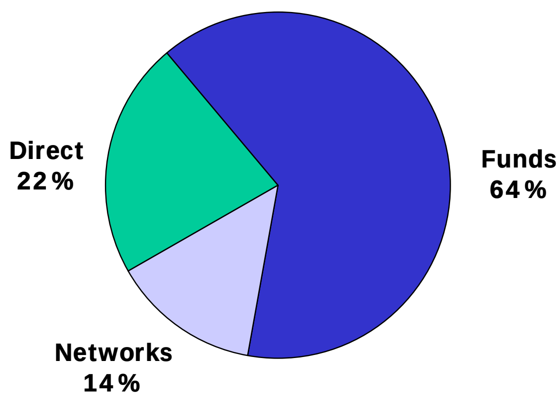
** Symbiotics, Indonesia: Crippling effect of global inflation to microfinance (July, 2008).*

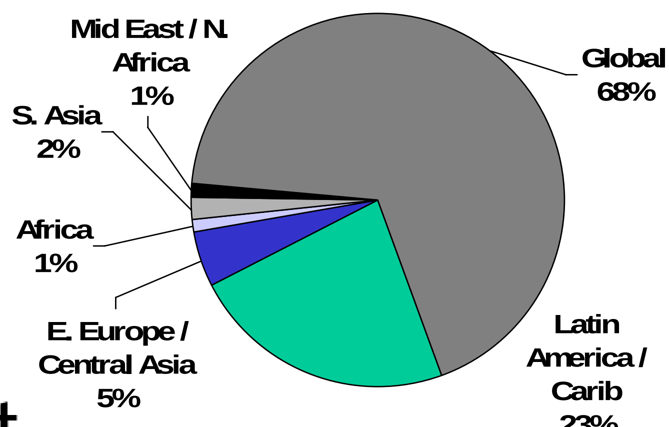
Country Case Study: Peru

- Peru in a strong position (esp. relative to other LAC countries) to survive current downturn. Central bank enforces strong monetary & macreconomic policy. Interest rates have increased 6 times this yr (150 bps increase in interbank rate) to keep inflation to 6.5%.
- Many large, well established MFIs having problems finding significant funding to fuel rapid growth plans. Drying up of CDO market esp. affected Peruvian MFIs.
- Diminishing international funds available, exit of major depositors, decrease in remittances will necessitate revision of growth projections and planning.
- As crisis has hit, cost of Peruvian Sol currency swaps with USD & Euros have become prohibitively expensive. Available tenors have shortened considerably. MFIs have to take on hard currency debt or find local (expensive) guarantees.
- The IFC has made $500 million available for MFIs and SMEs in Latin America to help weather the crisis.

Evolution of Portfolio Profile: Increased Investment in Direct MFIs and EECA/African Regions

4/30/06





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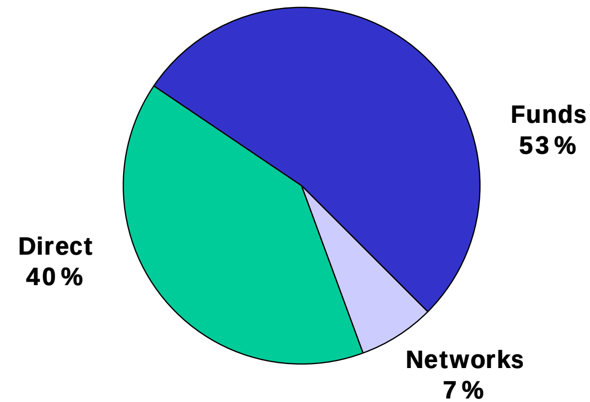

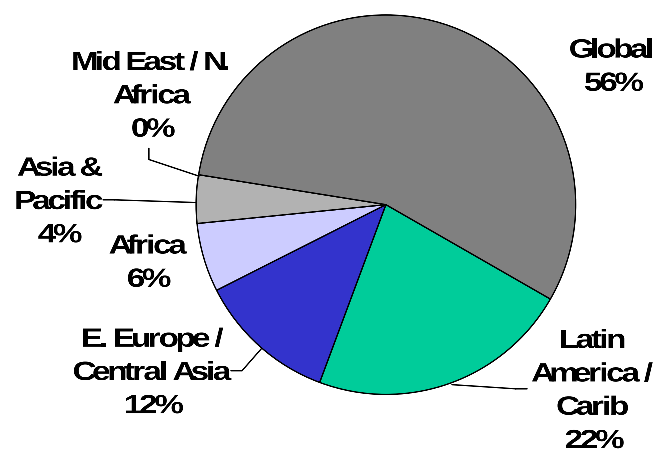

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Financing Microfinance

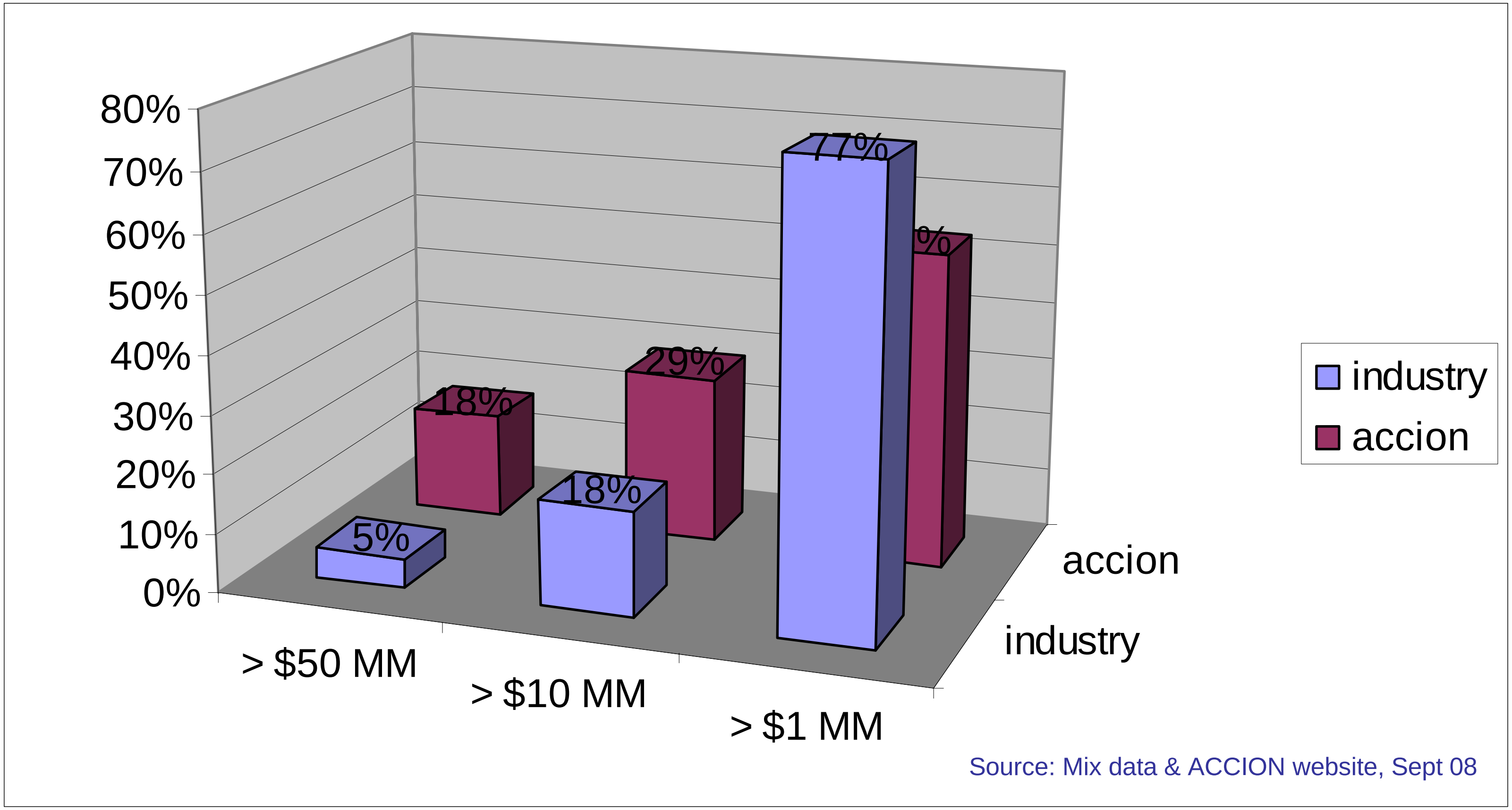
The Impact of the Financial Crisis

December 10, 2008 – After Hours Seminar

Monica Brand, Principal Director

Gateway Microfinance Innovation Fund

ACCION's partners – larger equity base cushion



Initial impact muted, but evident

So far, ACCION's partners are stable, growing & report initial impact from the crisis has been modest. Still, there are troubling signs:

- **Slight deterioration in portfolio quality**
  - Small rises in portfolio at risk, especially on *urban* poor (ACCION's focus)
  - Causes?: increase in commodity prices; economic slow down; drop in remittances; over-indebtedness; increased interest rates
- **Shortage of portfolio capital, especially @ past growth rates**
  - Banks more hesitant to extend credit; confusion with consumer lending
  - Delay or cancellation of credit facilities – especially in politically unstable countries (like Bolivia) and well-integrated markets (e.g., Mexico, India)

ACCIÓN

Initial impact muted, but evident

- **Re-pricing & renewal risks:**

  Cost of fund increases (e.g. Mexico: 200 – 600 basis points; India: 100-300 bp; Ghana: >10%)

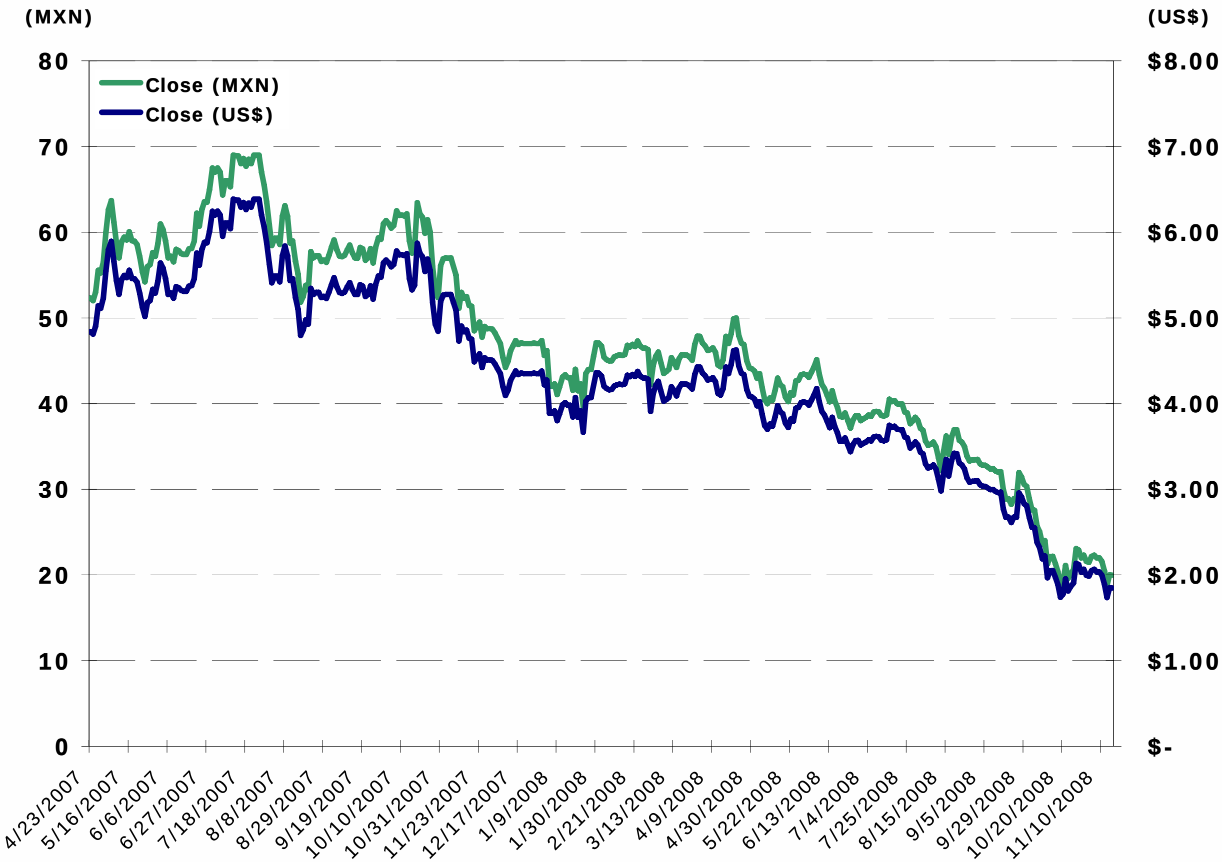
  Could get worse given anticipated financing gap ($200 - $400 MM, internal estimates + MIX data)

- **Deposit mobilization is stable** (though large withdrawals feared given local political environment, especially in Ecuador, Argentina, and Bolivia)

- **IPO market** has dried up for the time being. Buy back opportunity?

ACCION

Stock price performance



Source: Yahoo! Finance

As of close November 14, 2008 the price was US$1.85 which implies a loss of 62% in value from its IPO and a current market cap of US$791 MM.

		EPS (Mx Ps)
Q2 07	$	0.51
Q3 07	$	0.50
Q4 07	$	0.53
Q1 08	$	0.59
Q2 08	$	0.58
Q3 08	$	0.64

Source: Analyst Reports

Flight to Quality?

Expect over time, as investors become educated, they will look to MF as a sound strategic investment decision

- Healthy balance sheets.

  Debt equity ratios are low (average of 3.2 x; range from 1.6x for NGO MFIs, 3.3x for NBFI MFIs, and 5.6 x for bank MFIs)

  Assets are relatively liquid: Portfolio makes up 70%-80% of total assets and generally matures in relatively short periods

- Solid cash generation potential: solid track record of profitability
- Sound risk assessment: methodology based on capacity to repay and accountability

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ACCION Response: Support for short term liquidity crunch

- Shore up financial position by increasing equity
  - Retain more earnings; pay out lower dividends
  - ACCION Investments: capital to expand equity base
- Diversify funding sources & secure additional funds
  - ACCION credit enhancements; Emergency Liquidity Facility
  - Collaborate with IFIs, national & international government aid agencies; broker relationships / negotiate terms
- Rationalize operations
  - reduce operating costs (to address decreasing profit margins)
  - tighten risk management controls (to maintain healthy portfolios)
  - manage portfolio growth: emphasis on those products that are shorter in term, have smaller loan sizes and are more profitable

ACCION

Building and expanding sustainable, commercial microfinance programs worldwide.

ACCIÓN

Microlending & the Financial Crisis

John Wasielewski, Director, USAID Office of Development Credit

USAID After Hours Seminar, "Capital Markets and the Crisis"

December 10, 2008 - QED, Washington DC

How does USAID support capital markets development?

- Developing stock exchanges
- Strengthening legal and regulatory frameworks
- Supporting government securities
- Encouraging regulation
- Developing OTC exchanges
- Assisting NBFIs, i.e. pension funds, insurance companies
- ***Bond guarantees (using the Development Credit Authority)***

Bond Guarantee: Example

- In 2002 USAID guaranteed the first bond issuance of a microfinance institution on Lima's Stock Exchange
- Citibank acted as placement agent, issuance was oversubscribed
- Proceeds of bond were lent to microenterprises

- Results: Since the 2002 issuance, Mibanco has issued and sold subsequent bonds at better terms and without external credit enhancements

Bond Guarantee: Example

- USAID partnered with Deutsche Bank in 2004 to create a $55 million cross-border debt financing facility targeting commercial MFIs

- Created and expanded linkages between the microfinance sector, domestic, and international capital markets

- First time that the microfinance industry had accessed international institutional investors

- Results: Guarantee enabled DB to access more capital; follow-on guarantee for $25 million facility in 2006

In light of the current crisis…

The credit situation in developing countries BEFORE the credit crisis:

- Large liquidity reserves
- Minimal lending to private sector
- Banks investing in government securities

What will be the effect of the financial crisis on *partner banks*?

- Could face reduction in liquidity
- Shielded from securities meltdown (i.e. mortgage-backed securities) b/c our partner banks didn't invest in them
- Similarly shielded from derivatives meltdown (i.e. credit default swaps)

"Businessmen and budding entrepreneurs have always moaned about the excessive regulations and conservatism of African banks…Now, however, this very de-linkage from the Western financial system has turned out to Africa's advantage."

…From <u>The Economist</u>

What will be the effect of the financial crisis on the bank's *borrowers*?

- Inflation → higher cost of inputs
- Reduced economic growth → reduced revenues for MSMEs, especially in the export sector
- Lower demand in bond market → potential decrease in municipal infrastructure, housing, and utility projects

What is USAID doing about the financial crisis?

- USAID is reviewing its risk exposure to countries and financial institutions
- Through the DCA monitoring system, we are able to catch any significant rise in defaults
- USAID offers technical assistance to banks, borrowers, and institutions to support regulated, well-supervised financial markets

Thank you!

A screencast of this presentation will be available shortly at www.microlinks.org/afterhours.

For more news and resources on the global financial crisis, visit www.microlinks.org/financialcrisis.

The second seminar in this mini-series,

on “The Role of Donors and the Crisis,”

will take place in January 2009.