

Introduction

The microfinance industry is finding that rapid growth introduces new questions and issues. One of the biggest barely appeared on most radar screens just a few years ago: currency risk.

Five years ago, there were few U.S. dollars in the microfinance system. Loans were made by international aid institutions and local commercial banks to microfinance institutions (MFIs) in local currencies, and were distributed to local borrowers in those same currencies. Few foreign investors were demanding an actual return on their money. So if there was a sharp depreciation in a currency, no one asked for or expected to be compensated for the loss.

That has all changed.

Commercial microfinance has introduced MFIs to a new source of funding: dollar-, euro-, and yen-based private investors who expect to be paid back in their own currency. Unfortunately, most MFIs that borrow from foreign funds turn around and lend them out to places like Indonesia, Guatemala, Russia and a dozen other developing markets whose weak local currencies are frequently depreciating against the world's hard currencies.

As companies, banks, governments and investors all discovered during the Mexican peso crisis of 1994-95 and again in the Asian currency crisis of 1997, borrowing in dollars and lending in local currencies is extremely risky. Traditional money managers reduce FX risk by using various techniques, including currency hedges, portfolio diversification, and maintenance of dollar accounts in local banks.

Almost across the board, however, MFIs are not taking any steps to reduce their foreign currency risk. This paper assesses just how big the problem of currency risk is for MFIs, and for the industry as a whole. It looks at how commercial investors are affected by that risk, and examines possible solutions to the problem.

How Serious a Problem?

While it's hard to pinpoint just how much commercial investment is in the microfinance system, commercial lenders and the World Bank-led Consultative Group to Assist the Poor (CGAP) estimate that globally around 20 percent of the total outstanding loan volume is in microfinance. Not all of that is in dollars. However, a large amount of dollar-based investment originates from public sources and subsequently enters microfinance through commercial, profit-driven enterprises. CGAP estimates total outstanding loan volume from foreign sources into microfinance amounted to \$1 billion as of January 2004, of which about 70 percent, or \$700 million, was denominated in hard currency. Most of that is in dollars, but a growing portion has been in euros, especially in the countries of Eastern Europe and Africa, while yen-based lending has been widespread in Asian countries as well.

MicroRate, the Washington-based agency that provides audits and credit ratings for MFIs, estimates that 12 percent of all money loaned to MFIs in Latin America is now made in hard currency – usually dollars. While 12 percent is still small, that percentage has grown from virtually zero just five years ago and continues to grow rapidly.

Almost without exception, it is the MFI that accepts the risks of currency depreciation.

“This is a very serious problem,” says Jonathan Lewis, former managing chairman of Freedom From Hunger and now a founding partner at MicroCredit Enterprises LLC, a microfinance asset management firm based in David, Calif. “One way or another, the

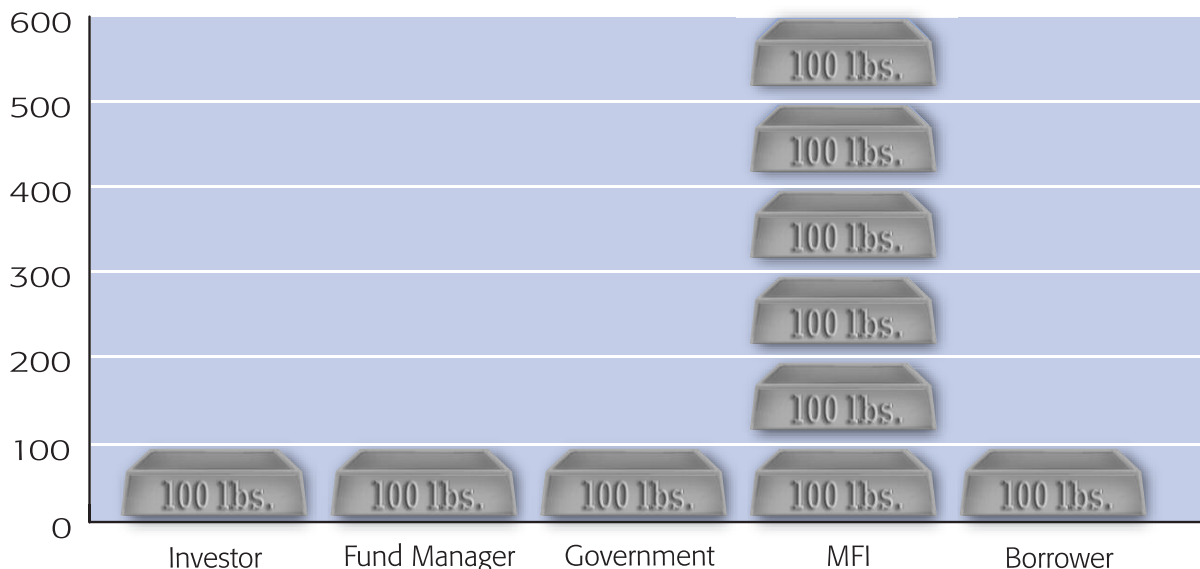
MFIs are getting stuck by having to protect private capital sources from foreign currency risk, and the MFIs are not capable of responding to this problem.” To be sure, MFIs that borrow in dollars and lend in local currencies are not the only ones that would be affected by a sharp decline in a local currency's value. Depreciation generally occurs when inflation is high. This erodes the lending power of MFIs that are being paid by borrowers at fixed interest rates. This is so even when MFIs deal exclusively in local currencies.

To date, there has not yet been a massive shakeout in the microfinance industry due to currency-related losses. During the last two major currency crises in Mexico and Southeast Asia, dollar-based assets in microfinance were minimal. Nonetheless, Indonesian MFIs in particular did feel the sting of devaluations in the late 1990s. Several struggling or bankrupt MFIs were then consolidated under a government-regulated MFI umbrella.

A white paper by Paul McGuire and John Conroy of the Australia-based Foundation for Development Cooperation outlined the “Effects on Microfinance of the 1997–1998 Asian

Financial Crisis,” describing the impact as the most severe by far on Indonesia. By the end of 1998, the paper reported, “The value of loans outstanding by Bank Rakyat Indonesia's Unit Desa and the rural banks had fallen by between one quarter and one half in constant price terms since the onset of the crisis. These institutions were supporting a much reduced level of activity among small entrepreneurs, at the same time as living standards were falling significantly. Moreover, at least in aggregate,

EXCHANGE RATE RISK: Who Carries the Weight?



the rural banks were running down the real value of their capital stock at an alarming rate.”

As an example of how one MFI can be affected, Bina Swadaya, which at the time was one of Indonesia’s leading MFIs, reported that between 20 and 70 percent of borrowers had fallen into arrears during the crisis, and at branches for which data was available an estimated 16 percent of borrowers had gone into bankruptcy. As a result, Bina Swadaya was forced to extend repayment terms or reschedule loans, and later boosted lending rates by between 0.5 and 0.75 percentage points a month to cover increased operational costs and loan losses.

While the Indonesia case is the most severe example to date, a similar situation happened recently in the Dominican Republic. While no MFIs were forced to shut down, several took substantial foreign currency losses, which in the end dramatically pushes up their funding costs.

Today, another major regional currency crisis would most likely be felt more severely given the expansion of dollar-based lending. Most observers interviewed for this report, however, agreed that the risk is not yet severe, and that we are still several years away from the possibility of a worst-case scenario where a major regional devaluation forces numerous MFIs to default on loans and shut their doors.

Potential Impact on Foreign Investors

If there were a massive currency crisis in the microfinance industry, what would the impact be on investors?

If the crises of 1994 and 1997 serve as any guide, investors tend to have short memories. They lick their wounds, withdraw their money for a time, and then plunge back in when returns again look attractive. In microfinance, however, such might not be the case. First of all, microfinance is still being tested. Investors, perhaps uncertain of their commitments, could be shaken out of participation by a major crisis that could take the industry years to recover.

On the other hand, because of the philanthropic nature of microfinance, some investors might be even quicker to forgive and forget.

“I don’t think there’s a bubble, in part because this business of getting private sector capital into the microfinance world is still a sliver of the total activity that occurs in microfinance,” says MicroCredit’s Lewis. “Also, the overwhelming majority of MFIs are non-profits, the overwhelming source of their funds is public, and the primary focus is philanthropic, not investment. At the end of the day, you can’t really foreclose on the MFI.”

Peter Knoll, manager of capital markets at FINCA, one of the largest microfinance lenders, says it’s impossible to tell how big the problem might be until a currency crisis strikes. “Nobody thought that Thailand or Russia would be a problem either,” he said, alluding to the

devaluations in those countries in 1997 and 1998, respectively. “If investors lose their money, people will not want to lend, and funding will dry up for a while.”

For most foreign investors, though, the impact of currency risk is small. As we have already stated, MFIs, rather than foreign investors, take on most currency risk. Even if collapsing currencies forced multiple MFIs to default or go under, most large funds such as Blue Orchard, FINCA and Accion are diversified enough across countries and regions to withstand the impact without a substantial dent to the returns they provide investors. Blue Orchard, for example, has investments throughout Africa, Latin America, Eastern Europe and South Asia. Both FINCA and Accion, while concentrated mostly in Latin America, are diversified throughout the region in both dollar-based MFIs and those that lend in local currencies.

Still, most funds realize that forcing MFIs to accept currency risk is no solution, and in the end, investors will suffer as well. Accordingly, many funds protect themselves by targeting their lending to MFIs in countries with dollarized or semi-dollarized economies, such as Peru, El Salvador, Panama or Bolivia.

Already, though, those countries are hitting the point of saturation, says Damian von Stauffenberg, founder of MicroRate. “The capacity for dollar-based microfinance loans has mostly been filled up, so most of the increase in dollar lending will also lead to an increase in foreign exchange exposure.”

What Can Be Done?

To date, the microfinance industry has chosen to deal with the problem of currency risk largely by ignoring it. Almost across the board, investors, MFIs, funds and borrowers have apparently decided that fixing a currency crisis after it happens would be easier than implementing preventative measures beforehand.

Whether or not that is a valid argument remains to be seen. Indeed, the costs of reducing currency risk can be high, and in many cases few alternatives are available. MFIs have also become ill-accustomed to a culture – fostered by the World Bank itself – in which they assume that their loans will be forgiven if a currency crisis erodes capital repayment. Private commercial lenders have an uphill battle to convince them otherwise.

Nonetheless, the bottom line is that if dollar-based lending continues to flow into the microfinance system, investment funds will have to reach out to a broader base of MFIs across regions where currencies are volatile. And as that happens, MFIs will be forced to reduce their foreign exchange exposure to be competitive and receive funding from private lenders. The need for funding from private lenders, meanwhile, is becoming increasingly important as funding from public sources has actually declined in recent years. Funding from

private sources has been growing by an estimated 50% a year.

The microfinance industry currently employs several methods to mitigate currency risk.

1. Risk Avoidance – Microfinance funds have dealt with currency risk by avoiding lending to MFIs that have large dollar-based borrowing and large local currency loan portfolios, especially in countries with volatile currencies. Likewise, at the MFI level, some lenders have targeted their lending to small business owners and entrepreneurs that receive some or even all of their income in dollars, often because they work in the tourist industry. The result has been to target microfinance dollars to areas and individuals who need it least, and in many cases where the return potential is lowest.

2. Off-Setting Risk – At the MFI level, the most widespread way to deal with currency risk has been to simply charge high enough interest rates and fees to offset any potential risk from currency devaluation. The obvious fallout from this strategy is that fewer clients have access to credit at such high rates, and market penetration suffers. A more acceptable method, though one that is not used often, is to combine a base rate with a fluctuating rate reflecting the rate of currency depreciation. In that way, the end users are not exposed to a high degree of uncertainty, while the MFIs ensure that depreciation is addressed at least partially.

3. Risk Diversification – At the fund level, the most popular way of dealing with currency risk is to spread that risk around to different countries and regions, such that a major diversification would have a limited effect on the fund's overall portfolio. However, not all funds follow this strategy, and indeed there are several major funds that are over-concentrated in one region, or that have heavy weightings in one or two countries.

4. Risk Mitigation – This is one of the best ways to reduce currency risk, but unfortunately, it is the least used method in microfinance. In the next section, we discuss risk mitigation techniques and which ones might be best suited to microfinance.

Risk Mitigation

For a variety of reasons, most of the risk mitigation techniques employed by major corporations and investors worldwide are simply not available to microfinance institutions, or they are available at prohibitively high costs.

Currency futures contracts, for example, do not exist for most developing market currencies. In some countries where they are traded, they've been used sparingly. For example, Financiera Compartamos in Mexico, one of the largest lenders in Latin America, has purchased peso futures, in part at the prodding of some of its major foreign investors. In the absence of a more systemized mechanism for microfinance, we see currency futures contracts growing in use in microfinance

but only on a limited basis in the few countries that have publicly-traded currency futures. Even then, most MFIs are not large enough and savvy enough to go through the trouble and expense of purchasing such contracts.

Other methods employed by multinational corporations, such as currency swaps and forward contracts, are largely unavailable to MFIs due to their risk profiles and the high costs that would be involved if they were to find institutions willing to broker such contracts.

Currency options is another alternative, and indeed one that could be put into effect in some markets. But again, it would require finding investors that were willing to sell put options to the MFIs on hard currencies such

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as the dollar or the euro, at strike prices relative to their local currency.

One simple and effective way to reduce foreign exchange exposure is for the MFI to simply open dollar-based deposits at commercial banks in their host country. While this method is used by some larger, well-financed MFIs, most MFIs do not have the resources to commit to dollar deposits on a meaningful basis.

Finally, one solution is to structure loan repayments so that the cash receipts of borrowers can be quickly and efficiently converted back into dollars. This would reduce the amount of currency exposure but would require an accessible and inexpensive banking process.

A Coordinated Solution?

The upshot of all of this is that if left to the MFIs themselves, currency risk will likely grow and remain largely ignored until a major crisis erupts. For this issue to be properly addressed, an industry-wide effort must devise a standardized solution.

“I don't know what the right answer is, but I know that everybody should agree on the right answer,” says Lewis of MicroCredit Enterprises. “On the other hand, if some people are hedging and others are not, then you get disgruntled investors.”

For a while, CGAP attempted to address the issue of currency risk. Unfortunately, its solution was to simply warn MFIs against taking on foreign exchange risk; it failed to recognize that a market-based solution is both possible and desirable.

“CGAP is substituting for the markets,” says MicroRate's von Stauffenberg. “If they were to take

their financial clout and come up with an insurance solution that MFIs can use to cover their foreign exchange risk, they would do a lot more good than simply lending money to MFIs.”

Increased regulation and banking supervision is another alternative. In a 2000 white paper for the Consulting Assistance on Economic Reform project, Harvard researchers Thomas Fitzgerald and Robert Vogel concluded, “There is no doubt that alternatives to traditional forms of banking supervision need to be considered and, as countries develop and improve their supervisory capabilities they will need to define the types of supervision that they want to practice.” The paper posited that by replacing traditional banking supervision with risk-based supervision in some cases, currency and other risks might be lessened.

Still, increased regulation and banking supervision can only go so far, especially in microfinance where so many of its institutions are outside the traditional banking network. That leaves the industry itself to come up with a solution to currency risk.

Von Stauffenberg said one solution would be to enlist the help of a major international insurance company,

such as AIG, to structure a reinsurance product designed specifically for microfinance, which MFIs could then purchase to cover their risk.

FINCA’s Knoll said another solution would be to get a commercial bank to design hedge products for microfinance. “So far, though, we haven’t found any willing players. They are no more interested in bundling up multiple currencies than they are in hedging any one of them.”

FINCA prefers that its affiliates borrow in local currency. It also limits and monitors borrowings in foreign currency, seeks the right to repay borrowings (especially foreign currency borrowings) at any time, and constantly monitors local financial markets and political situations.

Knoll also pointed out that FINCA provides letters of credit on behalf of its local affiliated MFIs to allow them to secure loans in local currencies.

Nonetheless, Knoll agrees that an industry-wide solution would be a much better way of addressing the growing problem of currency risk in microfinance.

“We know foreign currency risk is a big problem,” posits MicroCredit’s Jonathan Lewis. “The solution is the creation of an institution in which all the others can participate.”



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