MICROFINANCE CURRENCY RISK SOLUTIONS

MFX Summary on FX Risk in Microfinance

The Problem

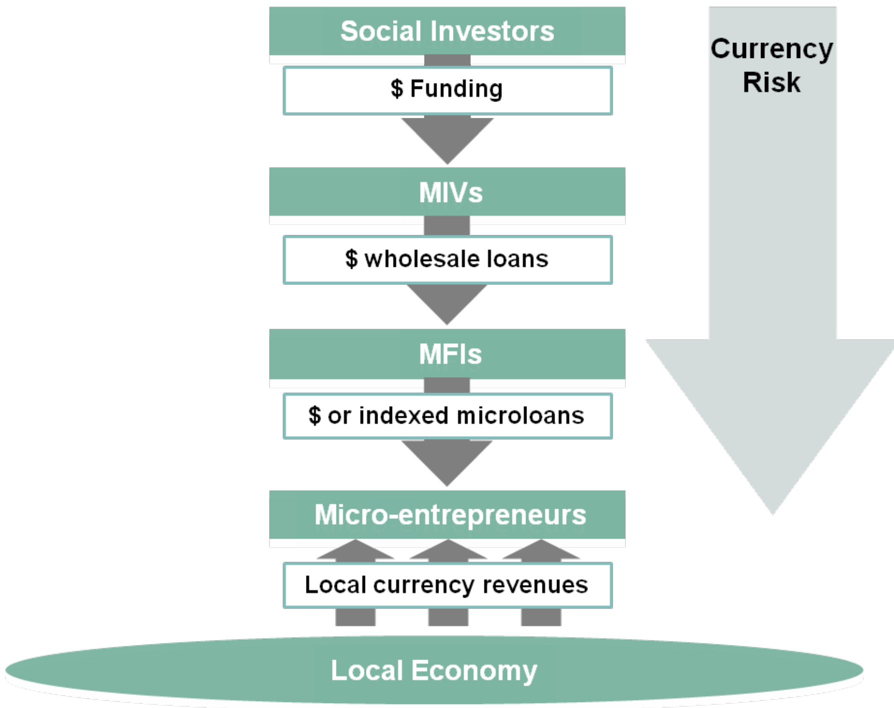
The problem of currency risk in microfinance arrived with the first hard currency loan from a lender in the developed world to an MFI in a developing country. That loan had to be repaid in hard currency (generally US Dollars or Euros) but the ultimate income that would repay the loan -- the money earned by the micro entrepreneurs – would be earned in local currency. If that local currency depreciated, the hard currency loan still had be repaid in full. The MFI faced a dilemma: it could lend to it micro-entrepreneur in dollars thereby passing through the risk, or it could lend in local currency and bear the risk itself. In either case, risk was pushed down to the lowest and most vulnerable link in the value chain.

This fundamental problem remains at the heart of microfinance. Globally, MFIs' hard currency liabilities now stand at around $4 Billion. While local currency lending has increased from 10% to 25% over the last 4 years, hard currency exposure continues to grow at roughly $500M per year (CGAP). Microfinance was able to survive and even thrive despite this underlying weakness partly because 9 years of generally stable emerging market currencies favored risk takers. In the absence of the usual emerging market shocks, many MFIs borrowed at lower hard currency interest rates and ignored the possibility of depreciation.

The global economic crisis has brought home the dangers of currency risk. As a result of devaluations in emerging market currencies, many MFIs have experienced significantly lower earnings, higher debt service costs, weakened creditworthiness, and greater difficulty in meeting regulatory norms. For MIVs, whose dollar loans contributed to the current situation, this creates a moral and competitive imperative to shift to local currency lending to help safeguard their MFI clients.

While currency risk poses a problem for MFIs who carry mismatch on their books, its most pernicious effect is on weaker MFIs in more economically volatile markets. In many cases, these MFIs have been shut out of international capital altogether because of currency risk. Africa, for example, receives only about 8% of international microfinance debt capital. MFX research shows that the inability to deal with currency risk is a major factor in preventing lending to the region. When MFX surveyed MIVs and asked where they would lend if they were able to eliminate currency risk, over half of them (56%) said Africa, implying a large pent up demand to lend to Africa if currency risk can be addressed. The challenge, therefore, is to strengthen the capacity of MFIs to measure and manage currency risk and thereby increase demand for local currency, while giving MIVs affordable hedging tools to allow them to provide the local currency that the MFIs need.

Figure 1


Social Investors
$ Funding
MIVs
$ wholesale loans
MFIs
$ or indexed microloans
Micro-entrepreneurs
Local currency revenues
Local Economy
Currency Risk

Example: Indonesian MFI in 2008

To understand, the impact of currency risk on an individual MFI, please see the following illustrative example of an Indonesian MFI that was at one point perceived to be a sound, well managed institution by international investors. A snap shot of their balance sheet in July 2008 indicates a Debt to Equity ratio of 2. What the ratio doesn't capture, however, is the composition of the debt – which is significantly comprised of hard currency debt (35.8%, as shown in Figure 2). It is likely that the MFI's liabilities reflect a propensity to take loans in dollar denominated debt, as these were offering attractive borrowing rates.

Figure 2

July 31, 2008
Indonesian Rupiah/USD Rate: 9090

% of Total Liabilities	
35.8%	USD Debt
46.5%	Local Rupiah Funding
17.7%	**Equity**

USD debt/equity: 2.0
Status: **Creditworthy**

IDR Depreciation 22.3%

December 31, 2008
Indonesian Rupiah/USD Rate: 11,123

% of Total Liabilities	
43.8%	USD Debt
46.5%	Local Rupiah Funding
9.7%	**Equity**

USD debt/equity: 4.5
Status: **Not creditworthy**

Between July and December 2008, the Indonesian Rupiah (IDR) depreciated by approximately 23%. And the impact that this event had on the balance sheet is seen in bottom half of Figure 1. Dollar debt made a 22.3% leap (to 43.79% of the total liabilities). Meanwhile, equity depleted by 45.3%, as a larger portion of the MFI's equity went into servicing the ballooned hard currency debt. The new debt to equity ratio is now a staggering 4.5. While this MFI may have performed well on a variety of other metrics, the impact of currency mismatch has been enough to dramatically alter its credit profile to investors.

Lack of Hedging Solutions to Manage the Problem

Unfortunately, while the crisis has spurred demand for local currency loans and better currency risk management, MFIs and MIVs are far from having the tools they need. In particular, standard currency derivative products, the mainstay of currency risk management for banks and businesses, are for the most part unavailable to MF lenders. This is due to lack of familiarity, small transaction size, perceived poor credit or the high perceived risks of the frontier markets where MFIs operate. Furthermore, MFX's market research indicates that a major reason for the relatively low levels of international MF lending to high risk markets such as sub-Saharan Africa stems from an inability to deal with currency risk. Therefore, any strategy to help the industry move to a more sustainable path and expand lending into underserved markets must involve greater access to currency risk management tools.

FX Risk and the Micro-entrepreneur

The real measure of better currency risk management is how it affects the ultimate borrower: the micro-entrepreneur. As an insurer against currency volatility, MFX's mission is, in part, to make sure that existing flows of microfinance lending are not disrupted by currency devaluation. But MFX's mission is also based on the idea that reducing currency risk can drive lending to countries and clients who otherwise would not have access to microfinance. Therefore, in high-risk markets in Africa and elsewhere, hedging can have a transformative development effect.

Here is how reducing currency mismatch can directly benefit poor borrowers in developing countries:

- **Continuity of lending growth:** MIVs can lend safely in local currency or MFIs can borrow more safely in hard currency when they hedge currency risk. In each case the lender or borrower can convert the unwanted currency into the currency that matches its own balance sheet. Either way the MFI is protected in the event of a currency devaluation or the micro-entrepreneur is protected from a sudden reduction in lending capacity.

- **Avoiding pass-through risk:** A common practice for MFIs facing currency risk is to pass the risk on by lending in hard currency to their micro-entrepreneur customers or by indexing their lending interest rates to a given foreign exchange rate. In the event of devaluation, this hurts the borrowers who face higher than expected payments relative to their domestic currency revenue and thus higher default risk. By hedging currency risk, MFIs can lend to their clients in their own currency, ending the morally questionable practice of passing currency risk to the most vulnerable link in the microfinance value chain.

- **Efficient use of capital:** Currency mismatch requires microfinance institutions to set aside additional capital to compensate for the risk of devaluation. This is capital that could otherwise be leveraged for additional lending. Hedging permits more capital to be available for funding loans so MFIs can serve more micro-entrepreneurs.

- **Increase lending to underserved markets:** When MFX asked microfinance lenders where they would lend if they knew they could hedge the risk, the results were striking (Chart 1). The current portfolios of MIVs are heavily weighted to Latin America and Eastern Europe, which account for roughly 80% of total lending. However, with cost-effective hedging available, lenders indicate they would dramatically shift new lending toward Africa and other higher-risk markets. Figure 3 (based on 2008 data) shows that providing lenders with the means to manage currency risk can fundamentally change lending patterns in the industry in favor of micro-entrepreneurs in the Africa and other underserved market.

Figure 3