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The Need for Speed: Helping the Microfinance Industry Stay Afloat in Times of Crises

Microfinance has been a lifeline for many low-income people at the base of the pyramid, helping them break the cycle of poverty and improve their lives. Yet the rapid growth of the microfinance industry, combined with limited financial literacy among its customers, made it particularly vulnerable during the 2008–2009 global financial crisis. To expand short-term financing solutions to the microfinance industry following the crisis, to keep credit flowing during a period of unprecedented financial strife, IFC launched the Microfinance Enhancement Facility, one element of its comprehensive Counter-Cyclical crisis-response package. A timely response was critical, and implementation risks were high. This SmartLesson shows how strong cooperation with partners and the decision to develop an outsourced model contributed to the success and reliability of this crisis-response initiative.

Background

Prior to the crisis in 2008–2009, the microfinance industry had experienced nearly 15 years of successful growth and had been recognized as a valuable financial-service tool for the poor, with strong growth potential at the base of the pyramid. While microfinance institutions had faced various local or regional crises such as political threats, inflation, recessions, and financial meltdowns, these prior threats were quite different from those prevailing at the time of the global financial crisis. The greater integration of microfinance into the financial sector and further commercialization of the industry were necessary to foster the growth and broad outreach of the industry. At the same time, these factors had drastically changed the beneficial circumstances and exposed the industry to new threats, putting its past achievements at risk.

Consequently, the financial crisis had an adverse impact on microfinance institutions by reducing their ability to tap commercial (local or international) funds for growth through loans, securitizations, or deposit mobilization. Resources for refinancing quickly dried up in many markets, and in some cases deposits began to erode. Therefore, leading microfinance investors and partners agreed that the foregoing developments required an immediate and coordinated response. As one of the industry's main players, IFC, together with its partner KfW Development Bank, recognized the need to instill continued confidence in the microfinance industry, catalyze uninterrupted access to funding, safeguard deposits, and counterbalance the potential reduction of access to financial services to underserved lower-income segments of the population.

In February 2009, IFC and KfW, along with other partners (EIB, FMO, OeEB, OFID,

BMZ, and SIDA),[1] launched the $500 million global Microfinance Enhancement Facility (MEF), designed to provide short-term and medium-term financing to sound microfinance institutions that were facing funding shortfalls during times of unprecedented financial stress. MEF's objective was to serve as a defensive facility to support strong institutions around the world that required liquidity so they could conduct regular lending activities and keep serving their core clients with fresh credit. (For an example, see Box 1.)

MEF, established as a special-purpose vehicle in Luxembourg with three classes of shares, is executed through the industry's largest and most experienced fund managers (Blue Orchard Finance, Cyrano Fund Management, and ResponsAbility Social Investments AG) to provide a rapid and flexible response to market needs, achieve maximum possible outreach, and ensure efficiency. MEF also hired a general secretary responsible for coordinating activities and communication among the investors, investment managers, custodian bank, and hedging manager. (See Figure 1 for the detailed organizational structure of MEF.)

Overall, MEF succeeded in providing the important signaling effect required during the worst of the crisis and has contributed to the stabilization of the sector. MEF's investment pace picked up considerably during 2011–2013, with a growing pipeline and disbursements to a wider range of microfinance institutions that now cover all of the world's regions. The graphs in Figure 2 provide details of MEF's regional distribution and country distribution.

As of December 2013, the outstanding microfinance institution investment portfolio was $441 million in 150 loans to 86 institutions across 33 countries. Since its launch, MEF has cumulative disbursements of $651 million in 214 loans to 99 institutions. MEF has also responded to the market demand for local-currency loans and has significantly increased its local-currency lending to microfinance institutions, amounting to 20 percent of its portfolio as of December 2013. The whole local-currency portfolio of MEF is fully hedged to the U.S. dollar through five different counterparts, including IFC. Portfolio quality has consistently remained strong, with impairments below 1 percent of the total portfolio, and the financial performance of MEF has exceeded targeted returns since 2011.

MEF has continued to evolve over the years, expanding into new regions, providing new products, and responding to unexpected local crises. As demonstrated by the crisis situations in Bosnia and Herzegovina, Nicaragua, India, and most recently in Cambodia, the crises in microfinance are ongoing. Such crises will likely continue to occur in the microfinance industry (with the current eurozone crisis as a salient example), and MEF will serve as a flexible vehicle that can respond quickly and decisively to provide stability.

Box 1: The ACBA Story

The Agricultural Cooperative Bank of Armenia (ACBA) was established in Armenia in 1995, initially to finance small and medium agricultural enterprises and individuals. In 2006, Credit Agricole S.A. of France made an equity investment in ACBA, and the bank was reorganized and renamed ACBA Credit Agricole Bank CJSC. The largest shareholder is Credit Agricole, with 28 percent. The other main shareholders are 10 agricultural cooperative regional unions.

The impact of the global financial crisis on Armenia was severe because of significant decreases in 1) trade with Russia and other major trading partners, 2) foreign investment, and 3) remittances (accounting for 20 percent of GDP) from the Armenians in Russia, the United States, and Europe. As a result, GDP decreased by 14.4 percent in 2009, and the Armenian dram was devalued by over 20 percent on March 3, 2009.

In keeping with its track record of conservative financial policies and a strong management team, ACBA had implemented a variety of preventive measures both before and during the crisis. As a result of these proactive measures, the impact on the bank was minimal despite the economic turmoil that gripped the country. As of the end of 2009, the portfolio at risk greater than thirty days (PAR>30) was only 1.3 percent, and this was well provisioned. By December 2010, PAR>30 had decreased to under 1.0 percent. ACBA maintained strong profitability during the crisis, along with low leverage and high levels of liquidity.

As a sign of its confidence in the bank, MEF extended a $15 million loan to ACBA in October 2009. During the first nine months of 2009, in U.S. dollar terms, senior debt had decreased by over 10 percent, but it increased by nearly 11 percent in the six months following MEF's loan. While not the only factor, we believe that MEF's loan had an important signaling effect on the market.

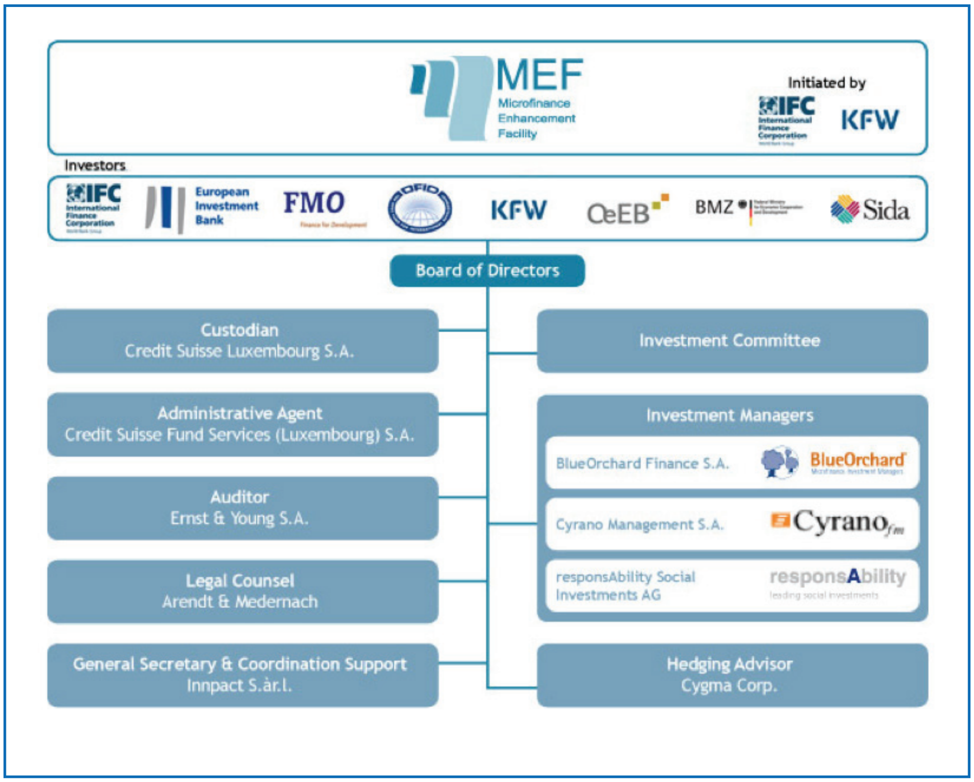
Lessons Learned

Lesson 1: Strong cooperation with key partners is a critical element behind quick launch and successful mobilization efforts.

While IFC played a leading role in the structuring of MEF through the combination of its sectoral expertise, knowledge of operational best practice, and expansive network, the partnership with KfW was critical in creating a sustainable and efficient liquidity facility with sufficient firepower to adequately support the microfinance industry and quickly react to market needs. IFC worked closely with the many stakeholders to react quickly and to create a structure that mitigated

1 EIB = European Investment Bank; FMO = The Netherlands Development Finance Company; OeEB = Oesterreichische Entwicklungsbank AG (Development Bank of Austria); OFID = OPEC Fund for International Development; BMZ = Federal Ministry for Economic Cooperation and Development; SIDA = Swedish International Development Cooperation Agency

Figure 1: Microfinance Enhancement Facility Organizational Structure



Source: Microfinance Enhancement Facility (http://www.mef-fund.com/about-mef/structure.php)

implementation risk resulting from the complicated structure and number of players involved. Using lessons learned from EFSE,[2] a previous regional initiative established by IFC and KfW, the partners developed an efficient structure in a timely manner to meet market needs.

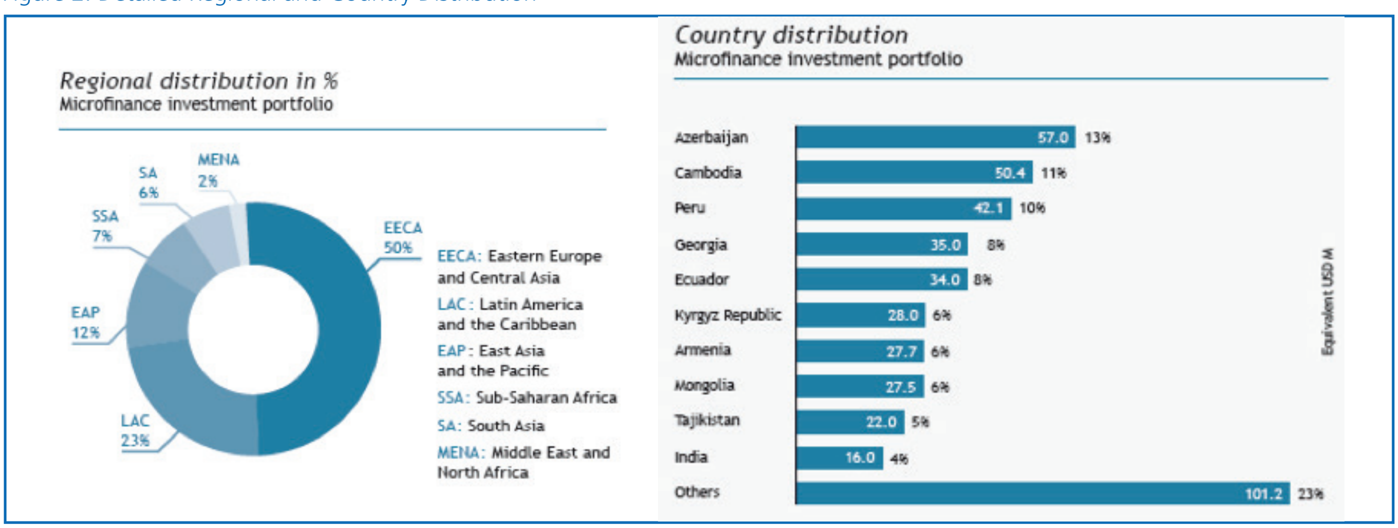
IFC and KfW stepped up and committed $150 million and $130 million, respectively, to provide comfort and send an important market signal to other investors to participate. IFC's strong cooperation and partnership with KfW facilitated significant mobilization from various governmental and quasi-governmental entities and other international organizations. Through the efforts of the two anchor investors, MEF was successful in raising over $470 million in investor commitments in a short time. This coordinated effort continues today as the investor group helps bring MEF additional funding from such private sector players as Deutsche Bank and other like-minded investors to meet the increasing demands of the facility.

Lesson 2: An outsourced funding structure resulted in reduction of the transaction time required to deliver crisis relief.

The MEF structure was created to deliver a rapid and flexible response, achieve maximum possible outreach, and ensure efficiency and rigorous risk management. To achieve these objectives, IFC and its partners decided in the structuring phase to outsource the origination, execution, and monitoring of loans and to proceed with an outsourced model that would execute the program through the industry's largest and most experienced fund managers, Blue Orchard Finance, ResponsAbility, and Cyrano Management.

These three investment managers were selected based on their reputation, professionalism, track record, and reach in the microfinance sector. To avoid any conflicts among them, each investment manager was assigned

Figure 2: Detailed Regional and Country Distribution



Source: Microfinance Enhancement Facility (http://www.mef-fund.com/press/)

2 EFSE = European Fund for Southeast Europe

specific microfinance institutions from a list of systemic institutions. To ensure strong accountability from the investment managers and to be sure investments are made according to the MEF objectives, an investment committee composed of representatives from the largest investors was created and given the authority to make all final investment decisions. The investment committee's oversight of the investment process also ensures that investment managers present quality investment proposals in a consistent and standardized manner. Investment managers are also required to report on a monthly basis to the fund administrator and are rewarded an incentive bonus at the end of the year, based on their performance and achievement of selected indicators.

By streamlining the investment process and bypassing internal investor bureaucracy, the MEF structure is capable of achieving a two-week to four-week turnaround for a loan, as opposed to the months-long process typically required for IFC to book a senior loan. This reduced transaction time was critical for many microfinance institutions that required immediate liquidity funding, and it has created a strong reputation for MEF as a reliable and speedy source of funding for the microfinance industry.

Lesson 3: Multiple tranches of shares linked to one another can create complications in implementation if disbursements of specific tranches are delayed.

While the structuring and mobilization efforts of the anchor investors proved to be effective and timely, MEF experienced a slow deployment of funds after its launch in 2009. The inability of MEF to disburse loans following the first closing was mainly due to delays in receiving the first loss tranche from one of the investors. The delay was caused by administrative complications of disbursing the allocated funds, and it severely affected the ability of MEF to disburse other classes of shares due to restrictions agreed to in the structure of the facility. As part of an effort to keep the risks appropriately balanced among the different classes of shares, risk ratios were introduced that required a minimum outstanding balance of each class of shares compared to the overall investment portfolio and outstanding balances of the other classes of shares. In this case, the delay in the receipt of the first loss tranche limited MEF's ability to disburse A and B tranche shares until the agreed risk ratios were met.

The introduction of risk ratios is a necessary component of the risk structure of MEF. However, it is important to understand the ramifications these restrictions can have, if there are any delays in disbursing specific tranches of shares, and their impact on a timely response in a crisis situation. While this was the main reason behind the early delays, the functioning of the facility—with the processing complexities involved with having three investment managers—also took some time to work itself out. MEF has since increased its efficiency in processing transactions and has picked up its investment pace considerably since 2011, with a growing pipeline and disbursements to a wider range of microfinance institutions, which is expected to continue in the years ahead.

Conclusion

Delivering a crisis-response initiative quickly was critical in providing the confidence needed to calm investors and markets and meet short-term liquidity needs of microfinance institutions. But ensuring that the initiative is efficient and effective in its implementation is just as important in delivering the desired impact.

Participation of the industry's main players, successful mobilization of funding to create a sizeable response, and creation of an efficient processing structure—all have contributed to MEF's ability to successfully serve the microfinance industry and to counterbalance the potential reduction of access to financial services to underserved lower-income segments of the population. Given the never-ending strong demand for its funding and the likelihood that the volatility of capital markets will persist, the investors of MEF decided in 2013 to extend the life of MEF another five years so it can continue to respond quickly and decisively to local crises and provide a stable source of funding for the microfinance industry.