

Foreign Currency Risk for Second-Tier MFIs: Fact or Folly?

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Are we hyping foreign currency risk? Is our cautionary message nuanced and targeted appropriately?



An estimated 92% of all international debt issued to MFIs is in hard currency (US dollars or euros). In a recent industry study of 25 countries with an active microfinance industry, 23 experienced currency devaluation in at least three of five years with an average annual devaluation of 8.8%.

Is foreign currency risk a common, and therefore pressing, problem?

Currency Devaluations and Loan Defaults

What is the demonstrated causal relationship between macro-economic currency devaluations, which most certainly do occur, and MFI loan defaults, which seem to occur rarely?

For that matter, just how many MFI domestic and international loan defaults occur for any reason at all? As recently as October, 2005, a [SEEP study](#) noted that "there have not been sizeable publicized losses to date." As microfinance scales up, it would be naïve to suggest MFI loan defaults will not occur in the future. Understanding the causes of defaults and then pragmatically managing risk will therefore be essential. Unfortunately, the necessary evidence remains anecdotal and murky.

[MicroCredit Enterprises, LLC](#) leverages private capital as collateral for loans to finance micro-businesses in developing countries. It provides loans to creditworthy, locally-run and locally-controlled microfinance programs that are not top tier MFIs, but qualify as "second tier" MFIs. Learn more about the organization and its approach at: www.mcenterprises.org

The rapid increase in private sector, international investment in microfinance, plus a dose of common sense, makes foreign currency risk management an important topic for microfinance lenders and borrowers. Indeed, foreign currency risk seems to be Topic One at virtually every industry conference.

Notwithstanding our conferencing and furrowed foreheads, reliable data on MFI bankruptcies and loan defaults that are a result of currency devaluations is needed. Martin Rees, Professor and Master of Trinity College, University of Cambridge, teaches, "Our present satisfaction with the state of our understanding may reflect the paucity of the data rather than the excellence of the theory."

Attracting Investments

The recently released [World Economic Forum's "Blended Value Investing"](#) report thoughtfully describes the microfinance investment landscape and soberly reminds us "...as good as it is, microfinance still has not developed the requisite infrastructure needed to attract mainstream capital." The report further notes capital markets require:

- a common terminology
- transparency
- adherence to standard accounting practices
- regulation by third parties
- investment rating services
- fund comparison data
- insurance and
- liquidity through secondary markets.

Broadly summarized, the authors conclude significant progress is needed in all eight categories, a view loudly echoed at almost every industry gathering.

To mitigate the risk engendered by marketplace imperfections and to serve investor-donors ROIs, noteworthy private sector organizations including [MicroVest](#), [Developing World Markets](#), [Citigroup](#) are focused on building viable capital markets for so-called "top-tier MFIs". By some estimates, mature, stable, larger, commercial bank-like MFIs comprise some **2%** of the entire MFI marketplace. Highly-leveraged, top-tier MFIs that are already managing diverse capital sources (local deposits, local borrowing and international finance) in a highly professional manner are very appropriately concerned about foreign currency risk.

What about the remaining 98% of MFIs?

"Second-tier" MFIs face a plethora of important management challenges: MIS development, transparency, portfolio risk management, mission drift, maintaining high client satisfaction, integrating borrower educational programs, rigorous accounting, etc. The list is long.

Both MFIs and MFI lenders must ask "What priority is foreign currency risk among these many concerns?" The suspicion (at least from anecdotal evidence) is that more MFIs have suffered financial problems from mudslides, political unrest or bad management than fluctuating currencies.

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Achieving Sustainability and Avoiding Foreign Currency Risks

For the beleaguered second-tier MFI -- challenged to achieve sustainability, striving to reach the deeply impoverished and neglected by most capital suppliers -- the seemingly sound advice to avoid (or hedge) foreign currency is marginally useful at best. Two practical factors come to mind:

One, [CGAP](#) and others properly note the asymmetric knowledge gap about foreign currency risk. Many MFIs executives appear not to understand foreign currency risk exposure issues. That acknowledged, for any number of reasons a second-tier MFI may not be able or may not want to borrow locally. Small businesses with newer credit histories (which is one way to view second-tier MFIs) frequently access credit from alternate sources often with more stringent and menacing terms and conditions. Doubtless, an MFI, like any other business, should comparison shop, but such advice presumes options such as multiple local lenders or international lenders.

Evidently, stand-by letters of credit and other cross-border guarantee structures are constructive financial instruments (compliments to the [Grameen Guarantee Fund](#), [Shared Interest](#) and others for leading the way). However, in-country guarantees only make sense when local lenders are charging affordable interest rates with workable terms and when the MFI can afford to pay for the additional cost of the guarantee on top of the interest charged by the local lender. With the constant drumbeat about foreign exchange risk (to the near exclusion of other capital formation challenges/risks), are we inadvertently (paternalistically?) predetermining which option is best in each local situation for second-tier MFIs?

Two, perhaps MFI decision-makers are wiser and better marketplace analysts than we acknowledge or respect. Conventional wisdom is that many defaulted loans are refinanced, written off and otherwise hidden (a negative legacy of the non-profit fundraising mentality which fosters donor-oriented happy-face talk about accomplishments), so quite reasonably MFI executives may perceive that the true operational risk of borrowing in foreign currencies is, in reality, relatively low.

The industry can separate perceived and actual versus costs of currency risk by asking several questions:

- What hard data exists on international lenders that have foreclosed on MFIs because of currency devaluation-induced defaults?
- What credible data exists on international lenders - whose missions include poverty reduction - that have failed to refinance MFI loans after a major devaluation?

- Concerning the reputational risk issue for MFIs (i.e, a currency devaluation-linked loan default irreparably mars an MFI's credit rating), what evidence supports the thesis that MFIs are suffering reputational devaluations specifically linked to currency devaluations?

Call for Evidence and Collaboration

[MicroCredit Enterprises, LLC](#) is firmly committed to serving as a friendly, mission-aligned lender for the second-tier MFI market. In the second-tier market, MFIs appear to be increasingly interest rate sensitive, competition among lenders is growing and any individual lender that unilaterally adds on the cost of currency risk management will soon be out of the market. MFI financiers, lenders and borrowers need an industry-wide, affordable solution based on solid evidence about global MFI loan repayment and an objective assessment of foreign currency risk relative to other MFI challenges. [MicroCredit Enterprises, LLC](#) looks forward to learning from and working with other microfinance organizations and capital market groups on this issue.

Questions or comments? Write to the author [Jonathan Lewis](#), Founder and CEO of [MicroCredit Enterprises, LLC](#).

For information on microfinance investment vehicles, see [MicroCapital's](#) comprehensive list of Microfinance Funds:
<http://www.microcapital.org/FundsBlog2.htm>.