CHAPTER 4:

Micro-bubble or Macro-immunity? Risk and Return in Microfinance: Lessons from Recent Crises in Latin America

Thierry Benoit Calderón[1]

AXA Investment Managers & Sciences Po

At first glance, investing in microfinance institutions (MFIs) appears extremely risky. MFIs are small institutions in comparison to typical commercial banks, their clients generally cannot provide traditional guarantees, and they operate in risky country environments. In the last six years, the majority of Latin American countries with highly developed microfinance markets have suffered banking and/or financial crises: Bolivia, Peru, Ecuador, the Dominican Republic, Nicaragua and Colombia. The mystery is that commercially oriented investors are increasingly funding these MFIs, and often provide loans with comparable or lower interest rates than those they would be willing to accept from larger clients. A dilemma follows: either we are facing a "micro-bubble" based on irrational exuberance, or microfinance institutions are partially immune from macroeconomic or country risk factors. The issue of risk and return in microfinance is explored here, focusing on the quality of MFIs' assets, the riskiness of their liabilities and the threats posed by their integration into local banking systems.

Crises and Portfolio Quality

One of the most striking features of the recent development of regulated MFIs in Latin America is their capacity to maintain healthy portfolio quality in difficult times. I will briefly comment on the Bolivian, Peruvian and Dominican cases.

Bolivia

Bolivia has suffered a long period of economic stagnation and political turmoil that has taken its toll on commercial bank portfolios, which have considerably declined since 1995 (Figure 1). In comparison, the aggregate portfolio of regulated

[1] I would like to thank Fernando Lucano, Louise Schneider, Maria Otero, Camila Van Malle and Marc Flandreau for helpful conversations and comments.

MFIs[2] has rapidly grown; it equalled less than 2 % of the portfolio of commercial banks in 1995 and over 12 % in 2003 (Figure 2).

Furthermore, the banks' portfolio quality, measured by arrears over 30 days as a percentage of the loan portfolio, has heavily deteriorated. The arrears of MFIs have been lower than those of banks over the entire 1995 – 2004 period, except in 1999 (Figure 3). A more demanding measure of portfolio at risk (arrears plus reprogrammed loans as a percentage of the loan portfolio) shows the extent of the difference between banks and MFIs (Figure 4).

Peru

The Peruvian case, shown in Figures 5 and 6, is less dramatic but reveals two similar patterns: MFIs[3] tend to have better portfolio quality than banks, and the spread between the arrears of banks and MFIs tends to be lower in times of prosperity (2002 – 2004) as might be expected.

The Dominican Republic

It is undoubtedly too early to draw definite conclusions from the recent banking and financial crisis faced by the Dominican Republic, even though anecdotal evidence tends to be consistent with the Bolivian and Peruvian examples. A large part of the banking system collapsed in 2003, at a cost of over 20 % of GDP. In contrast, MFIs such as ADOPEM suffered only a slight deterioration in portfolio quality. ADOPEM's arrears over 30 days peaked at only 3 % of its portfolio.

Other Cases

Data from other countries suggests that these are not isolated cases. Evidence includes the resistance of Ecuadorian MFIs and cooperatives to the financial and banking crisis of 1999. While two-thirds of the banking system collapsed, MFIs and cooperatives grew at a fast pace and maintained high levels of portfolio quality. More scattered evidence exists on the resistance of MFIs to the 1997 – 1998 Asian financial crisis (see references).

---

[2] We refer to the five regulated MFIs that are authorised to take deposits (BancoSol, Caja Los Andes, ECOFUTURO, FIE and PRODEM). Data are from the Superintendencia de Bancos y Entidades Financieras de Bolivia.

[3] The MFIs represented here consist of all regulated MFIs allowed to take deposits (Mibanco and the 13 Cajas Municipales). All data is from the Superintendencia de Banca y Seguros del Peru.