

GLOBAL RECESSION AND MICROFINANCE RISK GOVERNANCE IN DEVELOPING COUNTRIES

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Abstract

Global recession, started in 2008, is still proving an unresolved perfect storm and the financial crisis has affected also the real economy, creating widespread social unrest. Microfinance institutions (MFIs) in developing countries seem however less affected by the worldwide turmoil, due to their segmentation and resilience to external shocks. Recession has a big impact on governance mechanisms, altering the equilibriums among different stakeholders and increasing the risk of investment returns; any governance improvement is highly welcome and recommended. No governance, no money for growth or bare survival. In the confused phase we are living in, at the moment there are not evident winners, but the underbanked poorest, unless properly supported, once again risk being the ultimate losers.

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1. The Magic in Microfinance: Is It a Solution for Adverse Selection, Moral Hazard, Strategic Default and other Governance Issues?

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”, according to Shleifer and Vishny (1997). In synthesis, it is essential to give investors legal protection from expropriation by managers, limiting self dealing.

In a broader sense, corporate governance sets the rules of cohabitation and the behavior of the different stakeholders that pivot around the MFI (borrowers, lenders, shareholders, supervisory authorities ...). As pointed out by Kostyuk et al. (2011) and Choi and Dow (2008), corporate governance mechanisms greatly differ across the world, reflecting country specific attitudes.

Information asymmetries - a classical governance problem - traditionally arise since borrowers have better information about their creditworthiness and risk taking than the lending bank has. They originate conflicts of interest which might seriously prevent efficient allocation of finance: the liquidity allocation problem derives from the fact that although money is abundant, it is nevertheless not easy to give it to the right and deserving borrowers.

Relationship lending relies on personal interaction between borrower and lender and is based on an understanding of the borrower’s business, more than to standard guarantees or credit scoring mechanisms, and represents a key factor in countries with a weak financial system counterbalanced by strong informal economic activity (World Bank, 2008, p. 9); multi-period and state contingent contracts – typical of relationship lending – are an efficient device for dealing with asymmetric information (Petersen and Rajan, 1995).

Adverse selection is a typical problem in money lending and it occurs even in traditional banks, when – not knowing who is who – they cannot easily discriminate between good and risky borrowers, who should deserve higher interest rate charges.

Moral hazard is a classical “take the money and run problem”, since borrowers might try to abscond with the bank’s money or try not to fully get engaged in the project for which they have been financed.

Strategic bankruptcy is false information that the borrower gives about the outcome of his financed investment, stating that it has failed even if it is not true only in order not to give back the borrowed money. Poor borrowers generally have little or no collateral, so they might have little reason to avoid strategic default.

These classical corporate governance problems are well known in traditional banking and they naturally bring to sub-optimal allocation of financial

resources and to capital rationing problems that frequently affect even potentially sound borrowers, if they are not able to differentiate themselves from those who bluff.

Standard banks in developed countries normally react trying to reduce information asymmetries, using credit scoring analyses, monitoring and asking for guarantees (in the form of sizeable collateral with an intrinsic market value).

Since microfinance borrowers are normally unable to give any worthy guarantee, these problems normally are even more acute in a context that has also to take care of greater information fallacies and weak judicial systems (Armendariz De Aghion and Morduch, 2010).

As a consequence, any attempt or device to find a solution which can contribute to mitigate these conflicts of interest between the lending bank and the borrower is of crucial importance for the success of microfinance. As we shall see, if microfinance bears higher problems on some aspects, in others it can intrinsically reduce risks, if compared to traditional banks. Specific microfinance loan contracts are designed with distinctive features (such as joint liability and dynamic incentives) to mitigate these pervasive problems.

The standard agency problem concerns conflict of interests between a potential lender (the principal), who has the money but is not the entrepreneur, and a potential borrower (the agent), a manager with business ideas who lacks the money to finance them. The principal can become a shareholder, so sharing risk and rewards with the agent, or a lender, entitled to receive a fixed claim. Agency theory explains the mismatch of resources and abilities that can affect both the principal and the agent: since they need each other, incentives for reaching a compromise are typically strong. In microfinance, equity stakes are typically rare (Pretes, 2002) and the standard model is concerned with a peculiar form of lending, which tries to overcome the abovementioned problems.

The main differences in dealing with these agency problems between traditional banks and microfinance institutions are the following:

- limited liability companies, where shareholders risk only the capital invested, are frequently financed by traditional banks, whereas MFI mainly finance households or small companies with unlimited responsibility; limited liability protects borrowers who might not be stimulated to repay their debt, especially if it exceeds their equity stake;
- the motto “no collateral, no money” traditionally applicable in standard banking undergoes severe problems in poor areas, where the collateral is mostly nonexistent (by definition, those who have valuable collateral ... are not poor) or difficult to seize, also due to unclear property rights, a primitive judicial system and ethical problems (taking resources away from poor

households might seriously undermine their chances of survival);

- microfinance loans have very short maturities, if compared with traditional banking loans, which can last even several years, and this gives the lender a big monitoring and enforcing power, checking weekly or monthly the repayment of interest rates, cashing early the lent capital and preventing the borrower from asking new money if he has proven delinquent with the first loan;
- microloans typically consist of very limited amounts, which strongly reduce the magnitude of the lending risk and allow for a better diversification;
- monitoring MF borrowers is more expensive and difficult, since credit scoring devices, computerized data, credit histories with delinquency rates and proper bookkeeping from the borrower are normally nonexistent or present at an infancy stage; on the other side, weekly meetings between the MFI and the group members (borrowers) allow the creditor to monitor the repayment status of each debtor publicly, increasing the transparency within the group and generating a form of peer pressure which is expected to foster internal monitoring, minimizing debt screening costs (Deutsche Bank, 2007, p. 4);
- *ex post* moral hazard, which emerges after the loan is made and when the investment is in process, might lead to the abovementioned “take the money and run” temptation, even invoking a fake strategic default (Tedeschi, 2006)⁵: while this well known phenomenon might be present in both cases, in traditional banking guarantees can represent a parachute, while in a MF context the absence of guarantees can be counterbalanced by a deeper in site (on field) control on the borrower and lower chances for him to leave his rural area (take the money without knowing where to run away might prove difficult); as a matter of fact, poor have poor chances for escaping repayments ...
- reputation also plays an important role in preventing opportunistic behavior and poor borrowers, who at first sight do not have much to lose, in reality often are more concerned about this issue, since the chances they have are very limited and new opportunities strongly depend on a good track record; they also face the abovementioned mobility problems and, in general, these “problems”, which can become positive chances for enforcing reputation, are stronger in women, so introducing a gender discrimination – well known in the MF experience – according to which at least in some

⁵ Dynamic incentives, such as access to additional loans, prove useful in reducing the strategic default option.

areas⁶ women are better borrowers than men and might have stronger incentives to pay back the borrowed money, seen as a chance of emancipation (breaking gender-based barriers, typically considerable in underdeveloped countries), taking also profit or their better understanding of basic rural economics, since they – more than men – tend to run the limited resources of the family;

- strong information fallacies and asymmetries which evidently affect poor borrowers are in reality offset by good local information and enforcement mechanism which characterize rural lenders;
- MF might soften information asymmetry problems, if relationship lending and peer monitoring – often associated with mutual responsibility – is in place;
- microsaving and microinsurance can be positively linked to microloans, with a double side effect: if they are not available – as it frequently happens – than the whole microfinance circuit is weakened and more exposed to conflicts of interest.

The lender and the borrower might align their interests, paddling in the same direction – so reducing opportunistic behavior, one of the worst and most slippery hidden problems – if the borrower participates to the MFI business, becoming also a depositor and, possibly, a shareholder, this being a possible solution especially for loyal and not-so-poor customers; multi-role stakeholdership is a well known device to reduce many conflicts (and to worsen others)⁷.

Adverse selection and moral hazard are, as a matter of fact, mutual governance problems, since they might characterize not only the behavior of the borrower towards the MFI, as it is universally known, but also the strategy of the MFI which, for instance, might use its informational advantage in the money market to charge too high loan rates or to take on too much risk with depositors' money.

High cost of capital (interest rate charges and banking fees) and short term repayment schedules represent an incentive for proper allocation of the loans to cash-flow-producing investments, able to ensure the service of the debt, preventing the temptation to address loans to consumables or working capital, which normally act as cash burning devices. The property of small investment fixed

assets (e.g., cars, agriculture tools ...) might sometimes represent a limited guarantee for the lender, so decreasing the overall risk of the loan.

Short term (high-frequency) repayment installments, unrelated to the gestation timing of investments and to their ability to generate cash flows, are based on current income and assets of the borrower, marking a difference with the rigid philosophy of Basel II principles, now applying to mainstream banks in Western countries, according to which the capacity to generate adequate cash flow to service debt repayment should be the key parameter for lending scrutiny.

Lending is normally cash-flow based or collateral-based but with micro-credit this general banking classification seems too rigid and unable to describe its peculiar nature; poor borrowers with hardly predictable cash flows and unworthy collateral might still get credit, using typical microfinance innovative products. Improving cash-flow forecasting and/or use of effectively worthy collateral might be of great help in reducing interest rates: while this strategy seems hardly consistent with the poorest real possibilities, it might prove easier – at least to some extent – for the not-so-poor taking individual loans, with an established and growing business.

Focusing on ambitious but realistic scopes, albeit difficult to reach, is the right strategy, especially for illiterate poor who are not culturally used to targeting.

Progressive lending, a powerful device experimented in particular within group lending, might show some drawbacks – well known to industrial or trading corporations which increase their sales to clients which have gained a good reputation, but then start to misbehave, avoiding payments – if borrowers who lack the increased repayment capacity, go to other lenders in search for bridge loans, and pay old debts making new ones, exploiting information asymmetries and moral hazard techniques, in a well-known spiral of growing indebtedness, concealing and deferring the solution of problems that sooner or later come to a final judgment.

Adverse selection is also present, since riskier borrowers have a natural incentive in looking for extreme scenarios, while safer ones are more concerned about their reputation. The social or macroeconomic scenario, should external shocks occur (conflict; natural disaster; raise in interest rates ...) might worsen these governance problems. Offering a borrower a lower interest rate on his next loan is a financial innovation device which had a huge impact on repayment of the current one (see the South African evidence analyzed by Karlan and Zinman, 2005).

The limited size and the short time horizon of loans is however a major obstacle to riskier but higher value-added projects, which become increasingly important with the growth of the

⁶ This is the case in Bangla Desh, where up to 95% of the clients of Grameen Bank are women, but not elsewhere, for example in Sub-Saharan Africa ...

⁷ A multi-role stakeholder simultaneously occupies different positions and he can act as a shareholder, lender, borrower, worker, manager. This context is typical in cooperatives (even credit cooperatives). Corporate governance problems might arise if the multiple stakeholder interest are not properly known outside, due to information asymmetries, and he has an undeclared and hidden prevailing interest, potentially harmful for the other players.

economy, and the consequent higher demand for differentiation. For these investments, other financial intermediaries are more adapt, being represented by bigger MFIs (ranking as Tier 1 institutions) or ordinary commercial banks.

In synthesis, microfinance can in some cases become a “magic tool” to produce new, cheap, flexible and simple ideas to circumvent information problems and asymmetries that are the main obstacle to optimal allocation of capital, exploiting smart innovations in corporate governance, contract theory and (flexible) product design. But enchantments soon vanish and are uneasy to deal with: MF soon reveals to be a difficult instrument, to manage with care, which needs fine tuning and constant monitoring. A useful device, although not a miracle or a panacea that comes for free.

In MFIs, separation of ownership and control, the standard agency problem of which corporate governance is much concerned about, is often somewhat milder than in traditional private corporations and social objectives might soften the conflicts of interests between the different stakeholders, although risking to decrease the stimuli for a better performance, harder to measure whereas non monetary parameters are also considered.

Even in MFIs, corporate governance is far from optimal and in underdeveloped countries it greatly suffers its backward environment. Any improvement in corporate governance mechanisms, both internal within each MFI and at the larger macroeconomic level (domestic financial system and country's economic and legal framework) can substantially reduce the cost of collected capital, in times of dramatic capital rationing, where those who do not fully comply with stricter rules are increasingly prevented from having any access to capital – if you do not follow the international rules of the game, you are not admitted playing.

2. THE HARMFUL IMPACT OF THE GLOBAL RECESSION ON POOR MICROFINANCE STAKEHOLDERS: HIGHLIGHTS AND EMPIRICAL EVIDENCE

It is widely recognized that "wild" globalization - without any control and driven by an unchallenged trust in the "market" - brings to growing inequalities between the richer and the poorer; recession typically worsens this perverse divergence of status, bringing to an increased necessity of financial access and outreach to relief the poorest. In this, microfinance can play a small but increasingly significant role.

The June 2008 Fitch's report⁸ highlighted the growing integration of the microfinance industry into the global financial system. Fitch finds evidence of a

positive relationship between the size and level of integration of an MFI and the impact that the financial crisis is having on its business plan, performance, and asset quality, outlining the dual impact that the crisis will have on MFIs: a funding or liquidity impact and an economic impact.

The report outlines the main sources of wholesale funding for the MFI sector as:

- 1) wholesale funding from development finance institutions (DFIs), socially-motivated funders, and to a lesser extent customer deposits
- 2) commercially orientated public and private sector funding.

While the first category of funding is usually counter-cyclical, MFIs access to commercial funding has been reduced and become more expensive when it is available. This has led to increased levels of refinancing risk, although the level of financing constraints varies by region. For example, Fitch notes that Eastern Europe (see also Dragan et al., 2009), central Asia, and the Balkans are experiencing tighter funding constraints than central and Latin America and raises the concern that from an operational standpoint, some MFIs may not be prepared to deal with these challenges⁹.

According to Wellen and Mulder (2008), although microfinance did not feel the impact of some of the past financial crises, the current global financial crisis has brought tough times for most MFIs, first because of their greater integration within the larger financial markets, and second because the economy itself is suffering a hit due to rising inflation and reduced remittances. For the microfinance sector, it means that the capital funds will dry up, there will be shorter-term credits, and the demand for microfinance may eventually diminish. The authors suggest that in order to withstand the crisis, MFIs will have to diversify the sources of their funds, get a clear picture of their capital costs, develop a workable liquidity plan, diversify their portfolio, and increase operational efficiency.

There has been a dearth of international funding as a result of the current global financial crisis, as Murphy (2008) points out. This means that MFIs have to rethink their existing strategy to achieve their revenue and expansion targets. Standard & Poor's conducted a survey of MFIs, investments banks, microfinance investment funds, microfinance networks, microfinance industry associations and a rating agency to examine the needs of the sector. His paper highlights that industry experts see this phase as a positive development since slower growth will encourage MFIs to improve their operating discipline and enhance infrastructure to meet future expansion demands. It also recommends that MFIs should ensure portfolio diversification; improve risk management processes; work closely with

⁸ <http://www.microcapital.org/microfinance-paper-wrap-up-the-microfinance-sector-its-success-could-be-its-biggest-risk-fitch-ratings/>.

⁹ See also <http://www.microcapital.org/paper-wrap-up-fitch-ratings-report-microfinance-testing-its-resilience-to-the-global-financial-crisis-by-sandra-hamilton/>

international financial institutions, development agencies and investors; and diversify the sources of funding to perform well in the current financial environment.

Krauss and Walter (2008) argue that microfinance, supported by donor agencies and non-government organizations, is traditionally recognized as a self-sustainable tool for alleviating poverty. In recent years, the access to funding by MFIs has diversified, for example, client deposits, refinancing via interbank deposits and commercial loans, and raising funds in capital markets. This paper analyzes both the market risk associated with microfinance, as well as the relative market risk by comparing MFIs to other potential emerging market investments. It concludes that MFIs seem to be significantly detached from global capital markets, both in absolute and relative terms. However, as the microfinance industry matures, market risk associated with MFIs will increase, although to a lower level than for most other emerging market investments.

Kyereboah-Coleman (2007) examine the impact of capital structure on the performance of microfinance institutions. The paper reports that most MFIs are experiencing slow growth, which is both a cause and effect of the global recession. Refinancing risk is a great concern for large and smaller donor-driven MFIs. Lower growth may make debt more expensive for current borrowers and practically unavailable for the new ones, causing a heavy blow to MFIs. Some financial consolidation happen as a result of small MFIs converging to cope with the crisis, however, it would be premature to say that bigger entities will survive the crisis unscathed.

Other sources, with almost daily updates, are easily found in the Web (Watson, 2009)¹⁰.

Optimism about the capacity of MFIs located in developing countries to withstand the recession might be overestimated, since international Microfinance Investment Vehicles (MIVs) are naturally reluctant to admit that they are reducing their funding, if they so do. The main trade-off is between problems at home, due to exhausted shareholders of MIVs which recall funds to cover their own capital losses, and the attractive investment returns in a diversified business with good growth expectations. Risk is the other hot issue and since international investors have consistently mispriced risky Western assets, we wonder if they are enough lucid and capable to fairly price and assess the risk of MFIs in developing countries - a completely different case, increasingly looking for specialized investors.

In the confused phase we are living in, there are not evident winners, but the underbanked poorest once again risk being the ultimate losers.

3. THE IMPACT OF RECESSION ON THE RISK MATRIX OF A MFI

As we have seen, MFIs operating in developing countries are bound to face some impact during the ongoing global recession despite profiting from the double safety net of both being only partially correlated to their domestic financial markets, which in turn are often segmented from international markets. Bad and good news are blended and interact in many possible combinations, with so many potential outcomes that forecasts are difficult to make. As Niels Bohr used to say "it is very difficult to make forecasts, especially for the future".

The risk matrix might be conveniently interpreted in extreme situations, using stress tests to simulate problems and solutions in different scenarios; the simple and unsophisticated nature of many MFIs - especially the small, NGO driven, entities - makes this analysis difficult, even if not useless.

The matrix of risks which affect the MFIs, often interacting among them, has a deep impact on the corporate governance of the MFI, since the reaction of the different stakeholders (domestic and foreign shareholders and bondholders; employees; depositors; borrowers; NGOs; local communities related to the MFI; government ...) is asymmetric and brings to new *ex post* equilibriums.

According to Watson (2009), there is a critical dimension of country and capital, if we consider the impact of the current recession on MFIs. Not all countries are in the same conditions and, among the different MFIs within each country, a big discriminator is represented by cash and capital, considered as a shelter against adversities and as an unavoidable fuel for growth.

Liquidity constraints increase risk and might also have unfavorable pro-cyclical effects, since lack of provision of adequate finance to borrowers can stop their investment plans and undermine their survival capabilities, preventing them to pay back their debt. Increasing default rates exacerbate liquidity constraints, with a spiral and self fulfilling effect which might prove extremely dangerous, even from a psychological point of view - "irrational" expectations, often neglected by purist academicians, are unfortunately quite common.

It takes years to build up trust and reputation whereas few weeks are enough to destroy both. And hysteria in financial markets is difficult to handle and might bring to "run to deposits" behaviors and panic selling, often irrational but in any case harmful.

In comparing the impact of recession in rich western countries versus poor and underdeveloped countries, the first - obvious - consideration is that at the very bottom line of poverty, there is not much wealth to be destroyed and if this might paradoxically look as good news for the destitute, well we should also consider that they have no parachutes or safe

¹⁰ See, for instance, <http://www.microcapital.org>; <http://www.microfinancegateway.org>; www.cgap.org.

nets and little if any shelter against adversities. The poorest can't simply lose what they already do not have! And financial exclusion for the destitute is paradoxically protecting them from the global turmoil.

In such a context, bad events such as recession might seem less harmful - since the poorest are much closer to bareness - even if they can give the kiss of death to those - and they are many - who are too weak to stand additional adversities, the last straw potentially being the fatal one.

Credit is a fundamental but dangerous human right, to handle with care, especially by those who are unfamiliar to it, preventing over-indebtedness.

The reaction of the poorest is often silent and their problems consequently underestimated, this being one of the hidden costs of being neglected.

Table 1 shows the different types of risks associated with MFIs, their behavior during the recession period and the impact on corporate governance mechanisms.

Table 1. The impact of microfinance risks on the MFI and its stakeholders during the recession period

Type of risk	Description of risk	Impact of recession	Impact on the MFI's stakeholders
Country and political (sovereign) risk	The likelihood that changes in the business environment will adversely affect operating profits or the value of assets in a specific country. Political risk derives from harmful political decisions or instability. In times of distress, sovereign risk becomes effective; credit default swaps spreads "explode" and recovery value shrinks.	Recession brings to a domino effect of country risk and credit default swaps on Government Bonds show a higher premium.. Successful MFIs show flexibility and resilience from economic volatility and since MFIs are not strongly correlated to the country's GDP and macroeconomic situation, they are most likely to experience less country risk which is affected by recession. See Krauss, Walter (2008).	Country and political risk increases the cost of capital and might discourage intervention of foreign investors (equityholders and bondholders). Even foreign NGOs can be frightened. Domestic stakeholders might consequently suffer and growth can be put at risk.
Financial Market risk	The risk that the financial conditions will be adversely affected by changes in market prices or interest rates, foreign exchange rates and equity prices.	During a recession, market risk for MFIs remains low as they are less dependent on capital markets. Institutional risk (due for example to Central banking or stock market regulations) can be a consequence of overreaction to the crisis by policymakers.	If interest rates increase or lending policies become stricter, borrowers find it increasingly difficult to get credit, but the whole workings of the MFI slows down, with a subsequent impact even on other stakeholders.
Foreign exchange risk	The risk of losses due to unstable currency exchange rates and adverse changes, such as devaluation of the local currency. MFIs face foreign exchange risk only to the extent that debt is denominated in hard foreign currencies.	Weak currencies are likely to devalue against harder currencies and recession might speed up this process, if local inflation is higher and country risk worsens. Credit crunch deriving from recession and bank crises dries up foreign funds, so limiting new sources of risk.	If the MFI suffers an exchange risk unbalance, it becomes more fragile and all its stakeholders sooner or later get troubled.
Interest rate risk	The risk that changes in interest rates might affect operating and net margins of the MFI. Interest rates increases raise the cost of collected capital and are not always transmittable to more expensive loans, since borrowers might be unable to pay higher rates and their default risk might increase.	During a recession, basic interest rates normally decrease, since inflation is low. Risk premiums conversely tend to increase, due to a general higher default risk. The net effect often brings to an overall increase of interest rates and, consequently, to a higher risk of non - repayment from borrowers.	Borrowers' natural resilience and elasticity to interest rates helps to cope with this problem - up to a certain limit. Beyond that, borrowers are affected, with a chain reaction on other stakeholders.
Operational risk	It considers the risk that operational costs are higher than revenues, with consequent negative margins (borrowing and running costs are higher than lending profits).	MFIs face less operating risk due to the relationship they have with their clients who closely monitor their MFIs. Operational margins squeeze, due to creeping costs of funding and higher delinquency of borrowers. Growth is hindered and fixed costs have an evolutionary higher break even point.	Equityholders are the first who suffer from margins' shrinking. Other stakeholders, such as debtholders, follow and even borrowers, sooner or later, pay their price, in the form of higher interests or reduced access to credit.

Type of risk	Description of risk	Impact of recession	Impact on the MFI's stakeholders
Credit (repayment or delinquency) risk	Credit risk applies to lending and investing activities and it considers the risk of financial losses resulting from borrowers' delay or nonpayment of loan obligations.	Credit risk is likely to grow during recession due to higher interest rates, higher repayment difficulties and probabilities of default. Emergency consumption dries up savings, so eroding guarantees and ability to match obligation from the poorest.	Capital rationing, which almost automatically follows any credit risk increase, affects borrowers, hardening new loans, and erodes margins and capital, damaging also the other stakeholders.
Liquidity risk	The risk of losses that arise from the possibility that the MFIs may not have sufficient funds to meet their obligations or be unable to access adequate funding.	During recession, funding is most likely to squeeze as donors hold back their subsidies and due to increased interest rates on the capital markets, MFIs will reduce acquisition of more debt financing. However MFIs should mobilize other sources of funding in the form of local savings and local debt.	No cash, no loans for borrowers, but also no job for the MFI.
Strategic risk	Earnings or capital arising from adverse business decisions or improper implementation of strategies, due to mismanagement or organization fallouts.	Strategic risk increases in recession as targets are more difficult to be reached. Mission drift might be a consequence of high strategic risk and subsequent fight for survival.	If the MFI modifies its targets, it changes also its stakeholders, bringing problems to the old ones and opportunities to newcomers.
Inflation risk	Probability of loss resulting from erosion of an income or in the value of assets due to the rising costs of goods and services. Surge in inflation levels might bring to deposits withdrawals for survival needs.	In recession, inflation risk normally decreases. The impact in poor countries is however asymmetrical and very volatile.	Foreign investors might get frightened, shrinking investments in local devaluating currencies (linked with inflation through the Purchasing Power Parity theorem), with a chain effect on other stakeholders.
Capital adequacy risk	Capital adequacy risk refers to the possibility of losses resulting from the firm's lack of sufficient capital to finance business operations. With under-capitalization, small adverse shift in circumstances can impair the solvency of the MFI, if bad loans erode the capital.	Capital adequacy of most MFIs might decline during the recession and may render some MFIs insolvent. The cost of raising capital grows when there are liquidity constraints and lack of confidence in the inter-bank loan market and in the capital markets.	No capital, no loans and no upgrading to higher ranking Tier MFIs. All stakeholders, again starting from borrowers, are affected.
Savings risk	Strongly linked with liquidity and funding risk, this risk has a direct impact on the licensed MFI's ability to collect deposits, which also represent a guarantee for loans to the same depositors	The attitude to save in recession is psychologically higher but physically much more difficult, since revenues are falling, affecting households' income. Survival consumption (cash needs) and lower remittances burn savings.	Depositors - borrowers are the first affected.
Default risk	The inability of the MFI to meet its obligations, unless occasional, brings it to bankruptcy. The risk can be considered an unlucky combination of some of the other risks described above, with particular reference to operational, credit and liquidity risk.	In recession risks are typically higher and their combination might be more frequent.	Game over for all the stakeholders! Lucky debtholders might get back some of their loans.

4. RISK GOVERNANCE AND BANANA SKINS AFFECTING MICROFINANCE STAKEHOLDERS

The Microfinance Banana Skins surveys explore the risks that the worldwide microfinance industry faces, considering both the current hazards and their trends (fastest rising risk factors). A table with the 2011 microfinance banana skins can help to have a first glimpse on the issue.

For what concerns in particular governance risk, it should be noted that (Moro Visconti, 2011, ch. 23):

- reputation, fast rising in ranking, is linked to transparency and other related factors (accountability, corporate governance, fairness ...);
- corporate governance, also growing in its ranking, is concerned not only with the good management quality seen above, but also - more generally - to the set of regulations, agreements, processes, customs, and policies that affect the way a MFI is directed, administered or controlled, pivoting around its stakeholders;
- transparency concerns the real cost of microfinance loans and, more generally, the accountability of the business. It is closely linked with confidence and fair corporate governance relationship among stakeholders with potentially diverging interests. Shortage of funding increases

competition and incentives towards better transparency.

Banana skins are closely related among them and require a holistic managerial approach to risk handling, adapting the MFI's business objectives and reengineering survival strategies, as an answer to external shocks such as recession.

5. GOVERNANCE IMPLICATIONS AND TRENDS: HOW RECESSION AFFECTS THE DIFFERENT MICROFINANCE STAKEHOLDERS

Recession affects different microfinance stakeholders, starting from the international equityholders and bondholders, which suffer severe cash constraints which might dry up Microfinance Investment Vehicles financing. Even borrowers might face increasing repayment difficulties and when the delinquency rate grows, lenders tend to become overcautious.

But MFIs have a gravity problem and growth cannot decelerate too much and too suddenly; rebalancing of power and new equilibriums among the different stakeholders is a typical consequence of the elasticity with which MFIs try to cope with the crisis, considering also the classical shanghai effect, according to which if You move one stick, all the others might follow, with a chain effect difficult to forecast.

Table 2. Microfinance banana skins 2011 (2009 position in brackets)¹¹

Biggest risks	Fastest risers
1 Credit risk (1)	1 Competition (3)
2 Reputation (17)	2 Credit risk (1)
3 Competition (9)	3 Reputation (11)
4 Corporate governance (7)	4 Political interference (7)
5 Political interference (10)	5 Mission drift (13)
6 Inappropriate regulation (13)	6 Strategy (-)
7 Management quality (4)	7 Staffing (20)
8 Staffing (14)	8 Unrealisable expectations (17)
9 Mission drift (19)	9 Profitability (9)
10 Unrealisable expectations (18)	10 Inappropriate regulation (22)
11 Managing technology (15)	11 Corporate governance (12)
12 Profitability (12)	12 Management quality (18)
13 Back office (22)	13 Ownership (16)
14 Transparency (16)	14 Liquidity (5)
15 Strategy (-)	15 Product development (24)
16 Liquidity (2)	16 Macro-economic trends (2)
17 Macro-economic trends (3)	17 Managing technology (23)
18 Fraud (20)	18 Interest rates (10)
19 Product development (24)	19 Fraud (14)
20 Ownership (17)	20 Transparency (21)
21 Interest rates (11)	21 Back office (19)
22 Too much funding (25)	22 Too much funding (25)
23 Too little funding (6)	23 Too little funding (6)
24 Foreign exchange (8)	24 Foreign exchange (8)

¹¹ Source: http://www.cgap.org/gm/document-1.9.49643/Microfinance_Banana_Skins_2011.pdf.

The impact on different MFIs is diverse, and each of them has its own reaction, according to its identifying parameters¹² (location; size; stage of development; Tier classification of capital; type of clients; funding and lending structure ...). Some cope better than others and can even take advantage of this Darwinian selection. Time will tell which are the fittest who survive and the weakest might disappear or merge into stronger entities (the sooner, the better); this might drive to a consolidation within the microfinance industry, considering also that the current recession is a concrete obstacle to new initiatives, especially if sponsored by exhausted Western NGOs.

Conflicts of interest among different stakeholders arise when they pursue different goals - and this is what normally happens, following the "mors tua, vita mea" Roman motto - and any attempt to minimize them, aligning their interests with cooperative behaviors, can be of great help in the reduction of corporate governance problems. No conflicts, no governance puzzles.

And any change in the stakeholders' relationship and balance of power, induced also by the recession impact, is normally quite far from Pareto improvements, according to which a change from one allocation to another can make at least one individual better off without making any other individual worse off¹³. Even zero sum games normally incorporate huge asymmetric imbalances, with winners and losers, the latter sometimes being too weak to survive.

The conflicts of interests can be somewhat different and milder in credit cooperatives where multiple stakeholders interact, i.e. stakeholders which simultaneously cover different positions (shareholder, worker, lender and borrower ...). Some primitive forms of dual stakeholdership are traditionally in place and proving effective in many MFIs, if borrowers are also lenders, with a deposit channeling which represents a partial guarantee for repayments (decreasing the net exposure towards the MFI); synergic use of microinsurance products can also help to reduce risk.

A hardly investigated frontier is represented by multilevel governance, which sets the rules of co-living between single MFIs (with their stakeholders) and a broader set of other MFIs and more complex financial institutions: renouncing at least partially to each MFI's sovereignty is a key step towards cooperation and flexible integration, with potentially

relevant spill over on financial inclusion. Relationship banking, traditionally weak in underdeveloped countries and in small MFIs, is becoming harder in an international context where banks increasingly mistrust each other.

Table 3 contains a preliminary outlook of some conflicts of interests, with the identification of the stakeholders that originate the conflict and the counterpart, represented by other stakeholders. In many cases, multilateral events occur and conflicts are intertwined. The impact of recession is also described, following two main event streams:

- 1) global recession and credit crunch dries up the resources of international investors in MFIs located in developing countries, rationing the flow of funds;
- 2) the underserved clients of the MFIs, due to the slow down of exports to Western countries, remittances from abroad and the relative stagnation of local economies, are less eager to save and deposit their money in MFIs, run short of the capital they need for investments and when they get it, they pay more than before.

What damages the MFI has - sooner or later - a harmful impact on its clients. The MFI's celebrated resilience can soften this effect, but unfortunately for miracles we need something more.

¹² Performance benchmarks used to set up peer groups of MFIs might conveniently divide MFIs in groups using more characteristics.

See, for a good example, <http://www.themix.org/sites/default/files/MBB%2017%20Autumn%202008.pdf>, page 33.

¹³ Pareto optimality and corporate governance have broad applications in game theory and might be an interesting field of research, unfortunately beyond the aim of the present study.

Table 3. Conflicts of interests among the different stakeholders and impact of the global recession on the MFI

Stakeholders	Source of the conflict of interest	Description of the conflict	Impact of recession
International (professional) equityholders	Economic return has a priority over social achievements (maximization of outreach ...). Sharp decrease in funding.	The targets of Microfinance Investment Vehicles or other institutional investors might privilege expected returns over outreach. With no additional money, repatriation of previous investments becomes harder and the investment might be a sunk cost.	International investors might transfer their own problems (concerning also their own Western shareholders) of MFIs, rationing capital injections, cutting investments and growth and speeding up disinvestments
International (professional) bondholders	Similar to those of equityholders, although with a softer risk/return profile	Even here returns for investors and sustainability of the MFI might predominate over outreach of the destitute; if debt is denominated in hard currencies, foreign exchange risk is borne by the MFI	Similar to that of international equityholders. If there is not money for equity, there are also no resources for debt underwriting.
International (NGO) equityholder	Capital rationing (also considering foreign exchange risk exposure)	If money dries up in Western countries, growth and development of MFIs slows down and might stop, preventing also the welcomed transition from NGOs to banks.	Recession typically slows down donations and might erode the equity of the NGO foundation, with an impact on funding.
International (NGO) bondholders	Same as above; foreign exchange risk is here only sometimes borne by bondholders	NGO bondholders often intervene at a later stage, when the MFI is about to transform into a regulated bank. So, the conflict might hit the MFI at a crucial stage of its development.	In recession, if there is little money for equity, a similar pattern applies to bonds.
borrowers	Opportunistic behavior (moral hazard; strategic bankruptcy ...)	Borrowers might have an incentive to give false information about their economic status, in order to get otherwise undeserved credit or to stop repayments ¹⁴	Recession can polarize behaviors, making MFIs overcautious, while desperate borrowers might exacerbate opportunistic attitudes, having nothing to lose
depositors	Lack of trust in the MFI	While borrowers do not have to trust the MFIs, since they have an inflow of money, depositors need to be cautious and carefully check the solvency of the MFI	Deposits are not regular and withdrawals for survival reasons are more frequent in recession, especially during crises which affect primary needs ("foodflation"; biblical plagues ...), with systemic effects (everybody is affected) often difficult to handle. Financial stability of MFIs can be endangered.
employees	Opportunistic behavior (minimization of the job effort to get the salary anyway) from the workers' side; overexploitation and underpayment from the MFI's side.	The conflict between employers and employees is a classic in human history and life: any part wants to get the most at the expense of the other; long and continuous bargaining is unavoidable. Monitoring of performance is often difficult.	Employees bargaining power decreases in recession, when risk of unemployment substantially grows.

¹⁴ For further details, see paragraph 1.

Stakeholders	Source of the conflict of interest	Description of the conflict	Impact of recession
Central Bank / supervising authorities	Over / under regulation; independence	Under regulation might be ineffective and useless, while over regulation and bureaucracy can be suffocating and again useless, especially if form prevails over substance. Skilled supervisors are highly wanted and often missing. Like a medicine, regulation is effective if properly weighed out: too little is useless and too much kills the patient.. Supervisors are often in collusion with supervised, especially in countries where corruption is endemic.	With recession, solvency problems within banks - and regulated MFIs - normally exacerbate and overreaction is frequent, increasing the competitive disadvantage of being regulated, so providing incentives to informal and not transparent institutions (oh gosh, back to moneylenders?)
Other banks / domestic and international financial system	Competition might bypass cooperation and economic marginality of single institutions can be pursued at the expense of the stability of the financial system	Banks and MFIs at different stages of development compete for the best customers (the biggest and safer, able to generate higher margins), to the detriment of the neglected underserved. The regulating role of Central Banks might be weak and ineffective in preventing crises	With recession and financial crises, banks mistrust themselves and interbank loans, whose importance is essential for the circulation of liquidity within the financial system, might dramatically drop. Fly to quality strategies, addressed at serving only the marginal fittest clients, shrink the market, making finance unavailable for most customers, and the underserved become untouchable, with a strong halt to outreach and severe social consequences.
Microinsurers and Other intermediaries	Lack of cooperation and self dealing - no team synergies with other intermediaries	The interactions and the synergies within the financial intermediation chain, which aims at giving customers a segmented and wider set of possible products and services, slow down and self interest strategies tend to prevail	During the recession and the financial crisis, intermediaries soften their links, often not trusting each other. Synergic products (microinsurance linked to microloans and microdeposits) are harder to find when they are most wanted and needed. Financial inclusion is at risk, especially for the neglected poorest
Stock Exchanges (Domestic and International)	Timing for listing and raising new equity tends to privilege historical shareholders - at the expense of newcomers	Information asymmetries and conflicts between old and new shareholders are well known; any capital increase discounts these conflicts, increasing the cost of issuing equity	Stock exchanges of underdeveloped countries are very primitive and - albeit partially segmented from international stock exchanges and so insulated from global recession - traditionally illiquid. Linkages with international financial and stock markets slow down with recession and deglobalization - which might lead to protectionism - this being good news for further risk reduction and segmentation but bad news for development and maximization of outreach and financial inclusion.

6. LESSONS FROM RECESSIONS

Recession has started in the U.S. with the subprime crisis in mid 2007, with a breaking point in mid September 2008, when the U.S. Treasury refused to rescue the ailing Lehman Brothers investment bank - with unprecedented and uncontrollable global chain effects - and has rapidly infected the highly connected financial and banking institutions of other developed countries.

International banks have shown to have incredibly complex business models, intrinsically characterized by information asymmetries, and as a consequence risk of underlying assets - magnified by an increasing multiplier effect induced by leverage beyond any control - has led to a systematic mispricing of assets, not properly perceived when the whole drugged market was growing and expanding beyond any reasonable control, but suddenly evident to everybody, at the burst of the speculative bubble.

By sharp contrast, MFIs in underdeveloped countries follow a basic and simple business model, intermediating funds (when they can afford it, if allowed to collect deposits) between unsophisticated and often illiterate counterparts. No toxic assets, no strange derivatives or awkward and pro-cyclical accounting principles - as IAS and IFRS have shown to be, especially with marking to market and impairment methods - little if any information asymmetries and a sound and continuous link with real problems and "tangible" clients, so far from an increasingly virtual reality built on highly inflammable paper money.

Microfinance clients, many of whom are below the poverty line, have felt the squeeze with rising food and energy prices, decreases in remittances and less availability of loans. Many MFIs, particularly those not permitted to mobilize deposits, have struggled to maintain the liquidity to continue loan cycles without interruption. As the situation worsens, equity investors continue to show interest in investing in large microfinance institutions, confident that many established MFIs will weather the crisis. Over 80 percent of investors have not reduced their microfinance investment portfolio due to the global recession¹⁵.

Information asymmetries - a classical governance problem - consistently stronger in informal markets, are typically blamed by corporate governance advocates, since they increase the conflicts of interests between the different stakeholders, making the credit market riskier and more expensive, so preventing optimal outreach to the poorest.

These pitfalls are real in any state of the economy, even if during a global recession they may -involuntarily - represent a natural shield against market shocks, softening overreaction and panic selling against price fluctuations.

The portfolio quality of microfinance does not decline during an economic shock simply because their clients are in the informal sector. This is because economic shocks like a global recession affect the informal sector less than the formal sector.

In times of recession, bargain prices are the rule more than the exception - and this is unsurprisingly the best timing for investments, following the old but still valid rule "buy low and sell high"¹⁶: the problem with this golden rule that everybody shares but hardly anybody follows (making it marginally more convenient) is that pessimism is even more contagious than euphoria and it is difficult, if not impossible, to detect when prices have reached their minimum; also, in difficult times, ideas - even smart ones - might prevail over funds' availability (the

contrary being a much more dangerous situation, as the excess of liquidity experienced till mid 2007 has shown). And with no cash to support them, ideas simply remain dreams.

Microfinance institutions in these circumstances begin to seem, if not recession-proof, at least recession resistant. Even as the value of their loan portfolio declines on international markets, the volume of loans they service can increase, because traditional banks tighten their lending habits.

Should we look more carefully at the ultimate root of the problem - corporate governance and the relationship between different stakeholders - we might find that a comparison between the stakeholders which pivot around western banks, on one side, and those who are connected with MFIs in developing countries, on the other, could hardly be more different: extreme sophistication against illiteracy; technology and abundance of products, devices and alternatives versus bareness and little if any choice; self fulfilling wealth with apparent no ceilings against a spiral of poverty where starvation is the ultimate floor ...

If different stakeholders find a compromise concerning their naturally divergent interests, they can all start paddling in the same direction, doing the best they can to reach common and shared goals. Efficiency gains can be impressive and any stakeholder can get unprecedented and long lasting benefits - synergies and common enthusiasm can really make the difference. Even in economic and banking issues, psychology does matter.

The social life in rural villages of the poorest countries is a little but remarkable micro-example of what sharing is about, since in extreme conditions, any deviation from basic survival rules can bring to death and mistakes are simply not affordable.

Is there something to learn from the governance of the underserved?

In comparing the impact of the recession in rich Western countries versus poor and underdeveloped countries, the first and most obvious consideration is that at the very bottom of the pyramid there is not much wealth to be destroyed. However, we would do well to consider that the poor have no parachutes or safety nets and little, if any, shelter against adversities. Long term investors have to be more patient than ever and keep hard at it; early and unplanned exits from investments (fire sales) destroy value, especially in countries where secondary markets are non-existent. Disinvestments and de-leveraging can have severe drawbacks, especially on MFIs with ambitious growth plans; even if their plans are now unrealistic, they cannot suddenly decrease beyond break even. In hard and confusing times, it pays to be small, flexible and simple. Only the fattest and the fittest of MFIs will survive this Darwinian selection.

¹⁵

https://www.microfinanceinsights.com/press_release_details.asp?id=19.

¹⁶ See, for an example, <http://www.indiamicrofinance.com/2009/03/recession-is-best-time-for.html>.

7. CONCLUDING REMARKS: FROM CRISIS TO CATHARSIS?

The current severe recession in Western countries has many origins and causes and from this experience we can draw many useful lessons for the future, remembering that those who forget historical events are condemned to live again past experiences.

One theoretical lesson should bring to a paradigm shift, in order to change the interpretation of the market economy, somewhat distant from the experience of small MFIs located in rural areas, but still dominating in the capitalistic world.

MFIs in underdeveloped countries are, at varying degrees, more or less insulated from these problems, even if globalization has sharply reduced their distance from the Western financial markets. As interested – if not concerned – witnesses, it is however important for MFIs to carefully look at what happens abroad, trying to figure out the impact on themselves. Any outcome is possible and good news interact with bad ones in such an unpredictable way that any forecast is impossible – maybe that is why historians are much more common than prophets.

Codes of conduct structured around core values such as transparency, fair practices, dignified treatment, privacy, fair disclosure, inclusiveness (outreach), sustainability and client satisfaction can positively affect MFI's governance, easing the relationship among its stakeholders and smoothing conflicts of interest¹⁷.

Recession can however bring to deglobalization and protectionism, which is – obviously – particularly harmful for poor countries that hardly have anything to protect. Should capital rationing continue, underserved borrowers would have an increasingly difficult access to finance and outreach of the poorest mixed with financial stability – the ultimate dream and target of microfinance – would be puzzled and hardened for a long time.

A better governance can really help MFIs in underdeveloped countries to get to adult age, making a jump of quality and relying less and less on volatile external help. This may consistently reduce the MFI's risk.

The impact of the recession on the different stakeholders is unsurprisingly asymmetric and winners and losers will emerge when the storm is finished – when rainy days are over, time will tell.

Paraphrasing Orwell's *Animal Farm*, all stakeholders are born equal, but some are more equal than others.

¹⁷ See, for example <http://www.microfinancegateway.org/content/article/detail/55222>; http://www.grameenkoota.org/fair_practices_code.pdf; <http://www.microcapital.org/microcapital-story-code-of-ethics-proposed-for-microfinance/>.

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