



# Microfinance— A Risky Business

A Time for Strong Leadership

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## Foreword

The rapid growth of the microfinance sector in recent years has left many microfinance investors and institutions without an adequate understanding of the multitude of risks they face. The Running with Risk project at the Center for Financial Inclusion at Accion seeks to raise awareness about the importance of effective risk governance for institutional growth and sustainability. It aims to develop the resources, tools, and trainings needed to improve the risk management abilities of microfinance institution (MFI) board members and the quality of their risk dialogue with management. By clearly outlining the board's role in risk management at MFIs, and developing risk management training materials and resources, the Running with Risk project will create a common framework and language around risk so both the MFI's management and board of directors understand their roles, and can more adequately anticipate and manage risks.

In this paper, the first output of the project, David Lascelles, originator of the influential Microfinance Banana Skins series, shares his risk insights in a lively, conversational, and often provocative way. He argues that risk management and oversight are essential all the time, not just during crisis. Effective board oversight of risk should, in fact, help to anticipate and avert crises. This paper relates why practitioners and experts believe that MFI boards must take their role in risk governance very seriously. We offer the paper as a means to prompt discussion, raise awareness, and spark debate about this issue.

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## Microfinance—A Risky Business

### A time for strong leadership

Microfinance is changing. What began many years ago as a philanthropic movement to bring finance to poor people is rapidly becoming a big business and, at the same time, a more risky business. Microfinance institutions (MFIs) need to have “strength at the top” to succeed in this fast-changing world.

Some of these changes are for the better. The commercial objectives that increasingly drive MFIs are forcing them to expand their markets and become more professional. By some estimates, MFIs now serve close to 100 million people, and that number keeps growing. It’s a remarkable success story.

But some are not. The pressure of competition, for example, is making life more difficult for many MFIs. Research suggests that it can deflect MFIs from their social purpose and force them to adopt less prudent (and less ethical) practices to protect their market share and profitability. That is a broad statement about a highly diverse industry. But you don’t have to delve far into the microfinance world or read many newspapers to find unhealthy signs: worsening bad debts, mounting controversy over the behaviour of MFIs, even rising numbers of failures among MFIs, brought down by a tough market and bad management.

Above all, what these trends tell us is that microfinance is no longer the low-risk business that many people once saw it as, where borrowers paid off their debts, and well-meaning investors plugged the holes made by bad loans and management mistakes. Rather the opposite: microfinance has been shown to be a risky business like any other, exposed to the vagaries of markets, dealing with hard-nosed investors and customers, and losing the “fairy dust” that once veiled its flaws and weaknesses. And while the risks are growing, the MFIs’ ability to handle them is being put to the test.

This more sharp-edged view of microfinance is gaining hold, reinforced by the huge changes which are now running through the whole financial world. True, it is contested – often hotly – by those who maintain that the original business model still works, that dedicated MFIs can still meet their social aims and thrive financially. If there are difficulties, they say, it is because of the strains caused by the recent financial crisis, or by “taint” from banking more generally. Superficially, that may be true. But deeper structural changes are also transforming microfinance into a commercial business with all the dangers – and benefits – that implies, and this requires a big adjustment in thinking and business practice.

The crucial question is how clearly the industry itself recognises these changes, and how well it is adapting to them. In fact, we can focus the question more specifically on one clearly defined set of people: the directors and senior executives at MFIs who are personally responsible for the business and who have the job of ensuring that it survives and flourishes. Do they understand the risks in the new environment, and do they have the capacity to manage them? How strong are MFIs “at the top”?

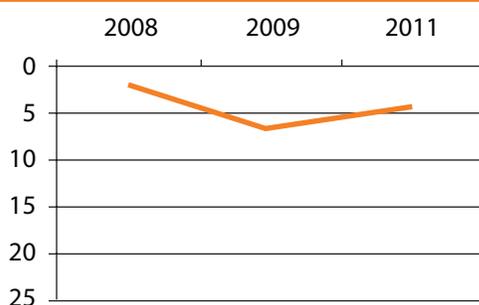
### Governance is an urgent concern

The quality of MFIs varies a great deal. Some are as well run as the best commercial enterprises, but others are plainly not. Some have strong boards of directors, some weak boards; some can ride a storm; others need help. But overall, the quality of microfinance governance is emerging as a key issue for all MFIs. One piece

of evidence to support this is the annual Microfinance Banana Skins<sup>1</sup> survey carried out by the Centre for the Study of Financial Innovation (CSFI), an independent London think tank, in cooperation with Citi, the Consultative Group to Assist the Poor (CGAP), and the Council of Microfinance Equity Funds (CMEF). This survey ranks the risks in microfinance based on the views of several hundred microfinance practitioners, analysts, and regulators around the world. Since the series started in 2008, corporate governance risk has consistently been close to the top of a list of more than two dozen concerns. It ranked No. 2 in the first survey in 2008. In 2009, it fell to No. 7 when it was edged out by more urgent concerns about the financial crisis, but it then came back again to No. 4 in 2011 (Figure 1).

### Corporate governance

**Figure 1: Ranking of Corporate Governance as a Risk**



Source: Microfinance Banana Skins 2011

Since the series started in 2008, corporate governance risk has consistently been close to the top of a list of more than two dozen concerns (Figure 1). The most recent survey also asked respondents how well prepared they thought MFIs were to manage risk. On a score of 1 (poorly) to 5 (well), the overall score was 2.7, just above average, which doesn't sound too bad. But a breakdown showed that this was because microfinance practitioners had a higher opinion of their skills (2.8) than investors (2.7) or analysts (2.5), let alone regulators (2.2). This was also supported by the comments that respondents made in their written replies. One, from a microfinance NGO, said: "weak corporate governance has been a key factor in existing portfolio crises, and it

1. *Microfinance Banana Skins 2011*. CSFI, London, February 2011.

will likely be one in future crises as well". Maybe practitioners know what they are doing, but maybe they are also being a bit complacent.

There is much anecdotal evidence (from investors, analysts, NGOs, and regulators) to support the view that MFIs have been slow to react to their changing risk environment. A number of factors might explain this. One is the complacency already alluded to. Many MFIs are used to being protected from risk and find it hard to react when things change for the worse. Indeed they often blame external circumstances for their problems rather than their own shortcomings. Another is lack of experience and know-how: they simply don't know what to do when circumstances worsen, and "freeze". A third may be entrenched interest: it does not suit the owners and managers of an MFI to change a business model that they have become comfortable with, whatever the pressures. In many of these cases, the real fault can be traced to poor governance, to a failure at the top to anticipate change and to deal with it by providing strong leadership and a clear sense of direction. In some cases there may even be a view that these issues are "none of your business". Like many organisations, MFIs don't always like being told how to run themselves.

### What are the risks?

A pressing reason for focusing on the ability of MFIs to handle risk is that risk itself is changing – and fast. In the past, risk in financial institutions mostly meant bad debts or operational problems such as fraud, systems breakdown, and faulty security. These continue to be important, but the range of risks has broadened enormously to include exposure to markets, to new technology, to regulatory compliance, and now to public opinion.

This widening territory even includes credit risk, traditionally the number one concern of commercial bankers, but long considered a low-order risk in microfinance. That, too, is changing. While loan repayment rates remain high by broader banking standards, they are falling, and worrying trends such as customer over-indebtedness, poor loan management and collection practices, and competitive pressures are emerging, suggesting that this is not just a fall-out from the crisis but a longer-run problem. Market risks are also growing. Many more MFIs are

now exposed to market-transmitted shocks such as changes in interest rates or foreign exchange values, and to the state of the wider economy, including fluctuating commodity prices. Liquidity management has become a major issue for larger MFIs, as it has long been for commercial banks.

However, these are all essentially financial risks which can and should be capable of being managed by competent staff and effective controls. There is a huge body of knowledge and experience in this field, and institutions which do not make use of it could, at the very least, be described as negligent. It is their job to get on top of them.

But in this time of change, new types of risk are also emerging which require more sophisticated forms of management. One is reputation risk. Where microfinance was previously viewed as above reproach, it now finds itself under increasing attack from disaffected customers and media that are always ready to turn saints into sinners. The accusations levelled against MFIs may well be unjust, but they cannot simply be dismissed. How should an MFI respond? It is no longer enough to invoke microfinance's good name: the response needs to be concrete and persuasive, supported by hard evidence to support the rebuttal. It should also get ahead of the game by developing good relations with influential figures and opinion formers.

Another is political risk. The number of countries where microfinance is vulnerable to outside interference seems to be growing. Again, this is not a risk that most MFIs are equipped to handle. In cases where political risk has materialised, as in Andhra Pradesh and Nicaragua, MFIs were thrown on the back foot and suffered considerable damage. A third is regulatory risk. In many countries, the regulatory framework is inappropriate for the healthy development of microfinance and is creating tensions within the industry. This difficulty needs to be firmly addressed by MFIs.

All these are what might be called "higher-level risks", ones which call for particularly clear thinking at the top and for integrity and a strong sense of direction, and for which it is also difficult to create good controls or employ traditional risk mitiga-

tion techniques. They are also "outward" risks in the sense that their focus is the business environment, rather than the "inward" risks associated with internal controls, capital and liquidity management, etc. Perhaps most important, many of these risks are heightened by the fact that the microfinance industry has a strong ethical dimension. People expect it to behave better than ordinary banks and businesses and are disappointed when it doesn't.

### The case for strong governance

Why should MFIs devote time and resource to building up strong governance when their business is relatively simple, when their top people are very familiar with it – maybe even set it up – and the pressures come from busy-body NGOs and management consultants? There tends to be a dismissive attitude in some parts of the MFI industry to the case for strong governance. One respondent to the Banana Skins survey in Latin America said: "MFIs believe this is a game, and you do not need to invest in this field". A governance expert says that it is relatively easy to install risk control systems in MFIs, but much harder to instil a risk mentality to make them work.

Part of the answer to the question why MFIs should care about governance has already been mentioned: that microfinance is becoming a riskier business – for the long term – and that it gets more difficult to manage as it grows in size and complexity. But research also suggests that weak governance is often a major cause of crisis within MFIs and that, conversely, strong governance is key to getting a troubled MFI back on its feet. A recent paper from the Washington-based Center for Financial Inclusion<sup>2</sup> examined 10 cases where MFIs ran into crises for a variety of reasons (difficult markets, fraud, political interference, poor risk management, etc.) and reached the broad conclusion that weak governance was a contributory factor in most of them. Among the 10 cases, the most successful turnarounds of troubled MFIs occurred where there were strong boards; two of the three MFIs that ultimately failed had major weaknesses at the board level. In one of them, in Nigeria, a newly founded MFI run by an

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2. Daniel Rozas, *Weathering the Storm: Hazards, Beacons, and Life Rafts. Lessons in Microfinance Crisis Survival from Those Who Have Been There*. Center for Financial Inclusion, 2011.

entrepreneur with no banking experience grew too fast in an overheated and poorly regulated market and, in desperation, sought to recoup its losses by speculating in real estate and stocks and shares and was wiped out. The board seemed to be in thrall to the entrepreneur and failed to take any independent action. In another, an MFI in Central Asia fell into the hands of a Madoff-style fraudster who ran it as a Ponzi scheme, with the board completely in the dark until, inevitably, it crashed. The report commented: “good governance is the ultimate backstop for crisis prevention and management”. Other reports have reached similar conclusions. For example, one which focused on Latin America<sup>3</sup> said: “the clearest and strongest conclusion derived from this study is that an institution’s governance structure proved to be the primary differentiating factor between those entities that overcame a crisis and those that did not”. Among the weaknesses it identified were excessive concentration of power in the hands of a dominant individual; ill-informed, inexperienced, and unskilled board members; and poor internal controls.

Another reason for having strong governance is that regulators increasingly require it. Recent initiatives such as the international Basel 3 accord on capital adequacy and liquidity,<sup>4</sup> and the raft of new measures following on from the crisis, stress the importance of strong boards, effective controls, and independent audit. Although these are aimed at banks, they are increasingly influencing the regulation of non-bank MFIs. They are also shaping the approach taken by investors when they assess MFIs for funding: the strength of corporate governance is now an item on their checklist.

### What is strong governance?

An MFI with strong governance is one which has a board with the independence and authority to ensure that the institution operates soundly and effectively, that is, it is commercially sustainable and it achieves its objectives. Independence means that the board is free of conflicts of interest (for example, directors who are suppliers to the MFI or

dependent on the favour of the chairman, or investors who want quick returns) and is able to make its own judgments about what is best for the business. Authority means that the board is composed of individuals who have the knowledge and commitment to oversee and guide the executive, to set policy and ensure that it is followed.

An MFI with weak governance is likely to have directors who lack the independence and knowledge to make their own judgments, or a board which is dominated by a small number of individuals who have special interests or which cannot control the executive. A strong board is more likely to nurture a positive culture in an institution, just as a weak one will encourage poor practices and a disregard for policy and procedures.

Finding good people to go on boards is not easy, even in the most advanced economies. Directors need to be knowledgeable, independent-minded, keen to challenge and explore, and undaunted by strong executives and complicated business models. They also need to have the success of the organisation at heart and be good ambassadors for it outside.

### The tasks of governance

What can governance do to help an MFI “run with risk”? The job of boards can be broken down into a number of areas.

The most fundamental of these is **setting a risk strategy**. The purpose is not to eliminate risk, but to decide how much of it to take on and how to control it. Moreover, this should be a continuous process: risks never sit still; new ones appear; old ones take new forms; risk appetite can change when markets change.

Some of the greatest pressures that MFIs face in their evolving world have to do with sticking to their risk strategy. They may have adopted a conservative risk policy, but this can be undermined by competitive pressure to lower risk criteria in order to meet growth or profitability targets, particularly on lending. Many of the difficulties that MFIs now face in their loan portfolios have their origins in a willingness to lower credit standards for the sake of achieving loan volume. If this is done as a result of a conscious change in policy at the board level,

3. Beatriz Marulanda, et al. *Taking the Good from the Bad in Microfinance: Lessons Learned from Failed Experiences in Latin America*. Calmeadow, June 2010.

4. *Principles for Enhancing Corporate Governance*. Basel Committee on Banking Supervision, March 2010.

then governance has to ensure that risk controls are adapted accordingly. But sometimes it occurs lower down the ladder, because of overambitious management or twisted incentive structures, in which case controls have clearly failed.

Another key task is **to understand the risks**. Many MFIs know their markets well: they have a “high-touch” relationship with them and meet regularly with their borrowers. They understand the credit and funding risks and can manage problems when things go wrong. But as MFIs grow or expand into new territory, this knowledge is inevitably diluted. MFIs lose familiarity with their borrowers, with their needs and lifestyles, and become more exposed to the risks of default and communication failure. Identifying customer needs and choosing the right products and the right markets become more important, as does the management of staffing risks, such as poor lines of command and flawed incentive schemes.

Entering new territory may also carry reputation risk, as when an MFI moves “upmarket” to access more lucrative customers, only to find itself accused of abandoning its social mission. Sometimes MFIs make this shift knowing the risk, but underestimating it or believing it can be managed – which is seldom the case. “Mission drift” has become an important component of reputation risk, and needs to be monitored through regular “social audits”.

Increasingly, the awareness of risk needs to include the “higher-level” risks mentioned earlier. A modern-day MFI should have a strong awareness of its public profile and the impact of its behaviour. Partly, this is a matter of having good business practices in the areas of product design, customer relations, pricing, etc., which can enhance reputation. But it also means fostering business attributes such as integrity, fair dealing, and consistency. A modern board should have good communication skills – something few MFIs have taken the trouble to develop because they were not needed in the past. Recent crises in the industry have left many MFIs floundering in this area.

A third is to **monitor and control risk**. Once risks have been identified and a risk strategy has been set, it is up to the board to put controls in place to ensure

that policies are followed. The task here is to create mechanisms to monitor what is going on, and report back – and to trigger corrective action when failings are discovered, or “creep” has begun to undermine controls. This is actually a dual function: ensuring that policies are followed, and checking that the monitoring systems are working. This is more important than it sounds: NGO investors say it is relatively easy to get MFIs to set up the structures, but quite a different matter to ensure that they actually work – something which requires not just a new organisation chart but a change in attitude and culture. Research has uncovered surprisingly simple lapses in these areas: for example, boards which have not set, let alone signed off on, credit policies, and an internal audit function which reports to the executive rather than to the board, meaning that the board never gets to hear when things start going wrong.

A fourth is to have **right relationship with the executive**. It is not a board’s job to run the MFI: that is what the executive is paid for. But the board must be able to manage the executive without cramping its style. It is a relationship which combines trust with distance, and one which depends on personalities and is difficult to get right. The executive may have different motivations from the board: a concern for their careers, greater opportunism, an eye on material rewards. The board must be interested in the long-term sustainability of the business, more circumspect about risk, less driven by short-term gain. This is not always the case; sometimes it is the board which presses for short-term results, particularly when its members include investors, and the management which takes the longer view. Which ever it is, though, there is likely to be tension. The clash often comes in the area of risk management. The ambitious executive is impatient about the risk function, seeing it as a brake on profitability, while a good board sees it as a means of limiting the potential for loss and building deeper strengths. With the growth of the profit culture in microfinance, this clash could get worse. For this reason, it is important for an institution to have a clearly defined risk appetite, to take a view on the best balance between risk and reward, and to enforce it through robust internal systems. If there is tension – and tension is not always bad – it needs to be creative rather than destructive.

## Moving forward

We have seen why microfinance is becoming more risky as structural change and competitive pressures intensify. With every step in their evolution, MFIs will find themselves more exposed to commercial risks such as credit loss and volatile markets, they will face growing tensions between the conflicting objectives of safety and profit, they will find their business and ethical behaviour under ever-closer public scrutiny, and they will need to make much more complicated decisions about the markets they want to serve and the products they want to sell.

And the difficulties will grow. To many observers of the microfinance scene, the industry is at a watershed between its early sheltered philanthropic phase and a new exposed phase as a branch of the commercial finance business. One of the respondents to the latest Microfinance Banana Skins survey commented: “shareholders, lenders, and leaders need to be prepared for a ‘generational’ transition of the industry from a phase characterised by rapid growth, commercial investment, and subsidised support, towards a more self-reliant industry featuring a systematic approach to management, governance, and organisational development”.

Change of this order sounds daunting. But it need not be if MFIs understand what is happening and take steps to deal with it by creating strong boards with good policies that encourage positive attitudes among the executive and staff. As MFIs become more commercial, like banks, they can draw on a huge body of existing knowledge and experience to achieve this.

But it is not quite as simple as that because MFIs are also different from banks. They have a special mission, and much of their reputation and effectiveness depends on how well they deliver it. This adds a unique dimension to the risks they face. Failure to live up to the expectations of their investors and customers could mean a loss of confidence and support, which could be fatal, and this places an additional responsibility on their boards to balance business with mission. It is therefore especially important for MFIs to have strength at the top, armed with a clear view of where they are going and how they intend to get there.

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**The Center for Financial Inclusion** at **Accion** (CFI) was launched in 2008 to help bring about the conditions to achieve full financial inclusion around the world. Constructing a financial inclusion sector that reaches everyone with quality services will require the combined efforts of many actors. CFI contributes to full inclusion by collaborating with sector participants to tackle challenges beyond the scope of any one actor, using a toolkit that moves from thought leadership to action.

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