

Microfinance Banana Skins 2014

The CSFI survey of
microfinance risk

Facing reality

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Preface

Microfinance is not what it was. When the CSFI began this series of *Banana Skins* reports, we pretty much knew what we were dealing with. Microfinance was almost exclusively *microcredit*, delivered through microfinance institutions, primarily to village groups. It was (relatively) straightforward, and unequivocally a good thing – epitomised by Grameen’s Nobel prize-winner, Muhammad Yunus.

Now – as this year’s survey makes clear – things are very different, and more complicated.

First, microfinance is now a lot more than just microcredit; indeed, micro insurance may be the fastest growing segment of the market. Second, it is not just provided by MFIs; established banks are muscling into what they clearly see as a good long-term growth business. And, third, the clients themselves are changing; they are (for the most part) more sophisticated, more worldly-wise and much more similar to mainstream financial services clients.

That’s not a bad thing. Indeed, it is, in large measure, testament to the success of the microfinance movement – which remains one of the few developmental initiatives that has clearly been on balance positive. But it does pose some interesting challenges.

This year’s MBS survey is a snapshot. It is not an attempt to pick ‘winners’ or ‘losers’, in terms of policies or institutions. It is not even designed to identify the ‘challenges’ that must be overcome if microfinance is to thrive (though it is not difficult to figure out what those challenges are). What it offers is a non-judgemental *tour d’horizon* of the main concerns that a range of players in the microfinance industry have about their business in the middle of 2014. Those players include microfinance providers, donors, regulators and observers; what they have to say may make uncomfortable reading, but it cannot be ignored.

It may be that microfinance is at or close to an inflection point. What was, a decade ago, little more than a laboratory-scale experiment in bottom-up development has gone mainstream – and with that transition have come mainstream problems, notably client over-indebtedness. No doubt, these problems can be (and are being) tackled, but the important thing to realise is that they signify success, not failure. Microfinance is becoming normal.

May I thank, once again, Citi (including the Citi Foundation) and the Center for Financial Inclusion at Accion for their continuing support for the survey. We are grateful to Bob Annibale, Philip Brown, Deborah Drake, Marjolaine Chaintreau and many others who helped to fund the work and evaluate the results. I am also very grateful to my colleague David Lascelles for overseeing the study, and for leading a team that now includes Sam Mendelson and Daniel Rozas, as well as our web master, Zach Grafe.

Andrew Hilton
Director
CSFI

This report was written by **David Lascelles, Sam Mendelson and Daniel Rozas**

Sponsor's foreword

The past four Microfinance Banana Skins surveys stand as time capsules of risk perceptions and reflect the increasing complexity of a maturing industry. This year's report is no exception. The title of the report, "Facing reality" refers to the fundamental structural changes that are taking place in the industry. It recognises the increasing diversity of microfinance service providers as well as the possibility that insufficient focus is being placed on the strategic development required to realise the sector's financial inclusion potential. Achieving sustainable growth, whilst addressing the concerns of overindebtedness raised in this report, will require reaching out to new client segments with appropriate products. Business models and credit methodologies will have to evolve accordingly.

Microfinance Information Exchange (MIX) data show that the microfinance sector globally continues to grow, and the 2014 Microfinance Banana Skins survey affirms that microfinance services are both core to financial inclusion and are increasingly integrated into the formal provision of financial services. As Andrew Hilton states in the preface to this report, "microfinance is becoming normal." The reality of this "new normal" is requiring new business models and technologies.

There is growing recognition that client centricity and managing external risks are as important as institutional risks. Three risk baskets – Client, Service Provider, and Market Environment – were introduced for the first time in this year's survey to highlight, beyond institutional risks, the context in which the institutions operate and the clients they want to serve. "Facing reality" highlights the importance of some of these market forces such as competition, and client-driven risks such as financial capability and client relationships.

This year's survey, like its predecessors, has been designed to contribute to a constructive debate around and serve as an educational tool about some of the salient risks the sector faces in its quest for sustainable growth. We are grateful to the 306 respondents from 70 countries who took their time to fill in the survey and share their thoughts and concerns about the sector, and to David Lascelles, Sam Mendelson, and Daniel Rozas for their efforts in managing the survey and interpreting and presenting this year's tapestry of results.

Citi Foundation
Center for Financial Inclusion

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Abbreviations

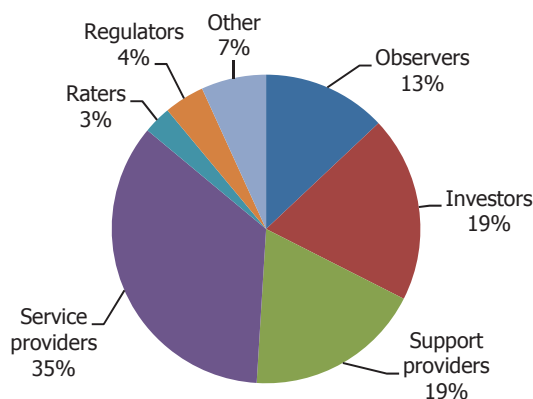
BoP:	Base of the Pyramid
CGAP:	Consultative Group to Assist the Poor
CWPF:	Community Welfare Projects Foundation
DFI:	Direct foreign investment
DFS:	Digital financial services
HR:	Human resources
KYC:	Know your customer
MF:	Microfinance
MFI:	Microfinance institution
MIV:	Microfinance investment vehicle
MIX:	Microfinance Information eXchange
MNO:	Mobile network operator
NBFC:	Non-banking financial company
NGO:	Non-governmental organisation
PaR:	Portfolio at risk
RCT:	Randomised control trial
SHG:	Self-help group
SME:	Small and medium sized enterprises
SPM:	Social performance management

About this survey

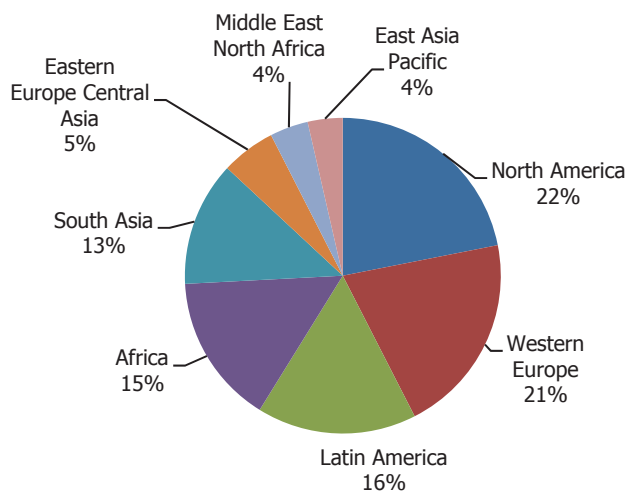
Microfinance Banana Skins 2014 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers. This survey was conducted in January and February 2014 and is based on 306 responses from 70 countries. It updates previous surveys carried out in 2008, 2009, 2011 and 2012.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the microfinance sector over the next 2-3 years. In the second, they were asked to rate a list of potential risks – or ‘Banana Skins’ – by severity on a scale of 1 to 10. In the third, they were asked to say what really keeps them awake at night. Replies were confidential, but respondents could choose to be quoted by name.

The breakdown by type of respondent is as follows:



The breakdown by geography is as follows:



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The breakdown by countries is as follows

Algeria	1	Germany	5	Palestinian Terrs.	2
Australia	2	Ghana	6	Paraguay	4
Austria	1	Guatemala	2	Peru	8
Azerbaijan	3	Honduras	1	Philippines	5
Bahamas	1	India	26	Poland	1
Bangladesh	2	Iraq	1	Romania	3
Belgium	4	Italy	4	Rwanda	1
Benin	4	Jordan	1	Senegal	4
Bolivia	2	Kazakhstan	2	South Africa	1
Bosnia & Herz.	5	Kenya	4	Spain	1
Brazil	2	Kosovo	1	Sri Lanka	1
Cameroon	4	Laos	2	Switzerland	8
Canada	6	Lebanon	2	Tajikistan	1
Chile	2	Luxembourg	4	Tanzania	2
Colombia	8	Madagascar	1	Togo	1
Congo, Rep. of	1	Mali	2	Uganda	4
Côte d'Ivoire	1	Mexico	15	UAE	1
Dominican Rep.	1	Morocco	1	UK	24
Ecuador	1	Mozambique	1	USA	61
Egypt	3	Nepal	3	Uruguay	2
Ethiopia	2	Netherlands	8	Venezuela	1
France	4	Niger	1	Vietnam	2
Gabon	1	Nigeria	6		
Georgia	1	Pakistan	7		

Summary

Microfinance Banana Skins 2014: Facing reality describes the risks to the microfinance industry in the early part of 2014, a time when the global economy was recovering from the economic crisis, and the industry itself was striving to shake off controversy and address the demands of an evolving market.

The survey, the fifth in a series dating back to 2008, is designed to assess two classes of risk: those that microfinance has faced for some years (i.e. quality of management, governance, funding, credit) and newer risks associated with its evolution: structure, strategy, product design and technological innovation. In a change from previous surveys, it recognises that microfinance is no longer the preserve of purpose-built institutions, but also of other types of provider such as commercial banks, and insurance, payment service and technology suppliers.

The survey asked experts on microfinance (practitioners, analysts, regulators, investors etc.) to identify and comment on the biggest risks, or “Banana Skins”, which they saw facing the microfinance sector over the next two to three years. A total of 306 of them from 70 countries took part. The accompanying table shows how they ranked the main risks, and subsequent pages give a breakdown of responses by region and type, and analyse their comments¹.

We have sub-titled this report *Facing reality* because we believe it paints a risk landscape that contains major challenges which the industry will have to address in the near term if it is to survive in a distinct form. In particular, it shows that microfinance continues to be seriously dogged by the problem of overindebtedness, and is not giving adequate strategic thought to its evolution at a critical time.

¹ The format of the survey has been substantially revised this year to take account of the changes coursing through microfinance. For this reason, like-for-like comparisons with past surveys may not always be possible.

The industry faces hard realities

Microfinance Banana Skins 2014 (2012 position in brackets)		
Rank	Risk	Score out of 10
1	Overindebtedness (1)	7.5
2	Credit risk (4)	6.9
3	Competition (8)	6.9
4	Risk management (6)	6.8
5	Governance (2)	6.7
6	Strategy (-)	6.7
7	Political interference (5)	6.5
8	Management (3)	6.5
9	Regulation (9)	6.4
10	Staffing (14)	6.3
11	Financial capability (-)	6.2
12	Product risk (-)	6.2
13	Macro-economic risk (13)	6.1
14	Client relationships (7)	6.1
15	Technology management (16)	6.0
16	Income volatility (-)	6.0
17	Transparency of objectives (11)	5.9
18	Funding (17,19)	5.8
19	Liquidity (10)	5.8

The results

The overall message from *Microfinance Banana Skins 2014* is that the most pressing risks facing the industry are those of the day-to-day running of the business, i.e. control of credit, the quality of management and governance, and dealing with competition. Longer term risks associated with the survival and evolution of the industry such as technological change, product development and funding are considered to be less urgent – and are less well defined.

While this may not be surprising, it does suggest that the long-term prospects for the industry are receiving less attention than they perhaps should at what could be a crucial juncture in its development, which may itself be a risk.

The key finding is that the **overindebtedness** of microfinance clients is perceived to be much the largest risk facing the industry, standing head and shoulders above the rest. Overindebtedness is ranked as the top risk by 15 of the 18 groups into which we segmented respondents (i.e. by geography, type, income level). Even where overindebtedness is seen as a lower risk, it has an indirect impact through the reputational damage it does to the industry as a whole.

A US investor in microfinance said: “In many countries we operate in, we see that financial inclusion is no longer the issue it was; on the contrary, we are seeing rising overindebtedness among borrowers.”

The existence of client overindebtedness is not new.² However the finding of this survey contradicts a view sometimes expressed in development circles that it is a past problem that is manageable and even declining.

It is possible that the actual incidence of overindebtedness is smaller than this ranking suggests because the survey measures perceptions rather than numbers (though, as just cited, several respondents said it was growing). However this result does show that overindebtedness remains the dominant concern, and as such has an influence on the sector as a whole. For instance, **political interference**, one of the manifestations of public concern about overindebtedness, occupies a prominent position at No. 7, even though the political temperature around microfinance has cooled, particularly in India. The quality of **regulation** (No. 9) remains a problem, with respondents describing it variously as inadequate, overbearing or inappropriate, and seldom as helpful. Nor is it, plainly, a barrier to overlending.

Overindebtedness is widely seen to be symptomatic of wider problems in the industry: surplus lending capacity, a lack of professionalism within MFIs, and an emphasis on growth and profit at the expense of prudence. It is also linked to the risk in No. 2 position, **credit risk**, which raises wider questions about the ability of microfinance providers to manage the lending process, including issues such as client evaluation, arrears and recovery practices and risk management systems.

The leading cause of overindebtedness is seen to be the risk in No. 3 position, **competition**, in particular the rapid growth in lending capacity created by abundant funding and new entrants for whom microfinance is a product rather than a mission. Market “saturation” was reported in many countries. This is driving microfinance

² For example: Too Much Microcredit? A Survey of the Evidence on Over-Indebtedness by Jessica Schicks and Richard Rosenberg. CGAP 2011

The risk of overindebtedness dominates the responses

High debt levels may point to wider problems

providers to cut their prices and lending standards to hold on to market share. In some places, MFIs are abandoning their traditional low-income business clientele and branching out into consumer and small business finance, where lending is easier but also riskier. According to one US-based observer, “Competitive pressures to grow portfolios and institutions have forced some MFIs to go overboard with their lending activities.”

An important reason for the decline in business standards is the risk in No. 4 position, **risk management**, an area of microfinance which respondents said remains weak despite the emphasis put on it in recent years. This is closely linked to risk No. 5, **governance**, where the quality of boards is still seen to be insufficiently high to provide the leadership that MFIs need. However governance risk, and associated **management risk** (No. 8), have both come down the rankings from previous years, suggesting that improvement has been recognised.

Broadly, microfinance practitioners attributed the overindebtedness problem to external factors, particularly the growth of competition, while non-practitioners showed a greater concern with internal issues such as the strength of governance and risk management.

Future risks

In No. 6 position is the first of the new risks we introduced this year to test forward thinking in the industry: **strategy**. This showed a strong level of concern about the lack of thought given to strategic planning. One respondent said: “Many MFIs are running without strategies. They respond as events unfold.”

Two linked risks in this area are **product risk** (No. 12) and **client relationships** (No. 14). These Banana Skins were added to the questionnaire to measure the risk of failure by institutions to connect with customers and address their changing needs. The fact that both of them ranked quite low suggests that people see little urgency in them. In general non-practitioners (i.e. investors, observers, analysts) ranked them higher than practitioners; indeed, practitioners ranked product risk at No. 18, one from the bottom. Significantly, the issue of **transparency of objectives**, seen by many as an essential attribute of a responsible MFI, ranked very low: No. 17. There was a similar lack of interest in **technology management** (No. 15) even though many respondents said that technological innovation was crucial to the future of microfinance. For MFIs, this was the lowest risk of all. These low rankings could mean that these risks are being well managed and are not therefore a source of concern. It could also mean that they are being under-rated in the context of the industry’s need to evolve, a point made by a number of respondents in their comments.

Among the lower ranking risks, a number are noteworthy. **Macro-economic risk** at No. 13 reflected growing optimism about the global economic outlook, and **funding and liquidity** at No. 18 and No. 19 respectively showed that these are not in short supply. Indeed, the concern was overabundance.

A breakdown of responses by type showed a strong consensus about the risk of overindebtedness. Of the six categories (practitioners, investors, support providers, observers, raters and regulators), all ranked it No. 1 except regulators who placed it No. 5. Broadly, practitioners gave a high ranking to immediate business issues such as credit, competition, risk and regulation, a middle ranking to institutional risks such as strategy, management and governance, and a low ranking to technical issues

'Many MFIs are running without strategies'

Concern about debt is widespread

such as product and technology risk. Non-practitioners attached greater importance to institutional issues (strategy, governance and management), and regulators gave top positions to credit risk, governance and risk management.

A **breakdown of responses by geography** also showed a strong focus on overindebtedness. Of the seven regions covered by the survey (Africa, East Asia Pacific, Eastern Europe and Central Asia, Middle East and North Africa, North America, South Asia and Western Europe) all but two placed it No. 1. The exceptions were Africa, where it came No. 3 after credit risk and governance, and South Asia where it came No. 2 after political interference. In general, responses from investor countries (i.e. North America and Western Europe) focused on institutional risks (governance, management) while practitioner regions focused on the operating environment (competition, political risk).

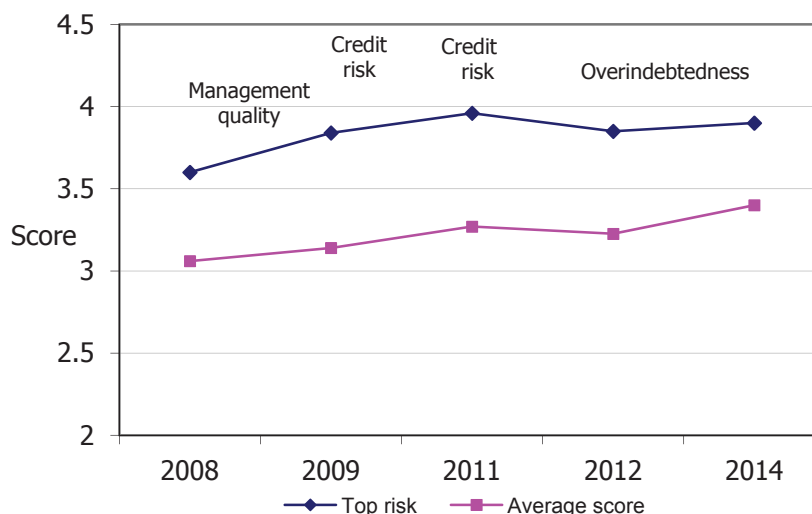
Key points

The concerns raised by this report are many and complex. Two, in our view, stand out, and represent the realities which need to be faced.

1. Contrary to assertions by a number of industry commentators, the problem of overindebtedness remains a dominant concern for the industry, and may even be growing. It is true that this survey measures perceptions rather than numbers, but perceptions on this scale are hard to dismiss since they influence vital aspects of the business such as management, clients, products, regulation and reputation.
2. At what is widely seen as a critical juncture in the evolution of the microfinance industry, insufficient thought is being given to its strategic development. Strategic risk ranks high in this survey because people see the industry paying too little attention to its future. Key long term development issues such as technology, new products and client management are seen as low order, particularly by the industry itself.

'Anxiety level'

The Microfinance Banana Skins Index provides a picture of changing “anxiety levels” in the microfinance business. The top line shows the average score given to the top risk over the five surveys since 2008, and the bottom line the average of all the risks. After rising strongly up to 2011, both lines showed a small downturn in 2012. But they resumed their upward trend this year, largely because of the high risk attached to overindebtedness³ which is seen by many of the respondents to this survey as a growing problem.



**'Anxiety levels'
are still high**

Health warning

A number of points should be borne in mind when drawing conclusions from this report. One is that the results reflect the perceptions of respondents and are not forecasts or measures of likelihood. There is also a tendency, in surveys of this kind, to focus on the negative and overlook the positive. Linked to this is the risk of generalisation: microfinance is a varied business, and its condition differs greatly from one market to another.

If reading the report makes you feel depressed, here is a response to cheer you up.

“Overall I see that the microfinance industry is improving at a solid pace. We see that in countries where there had been previously a tumultuous regulator-industry relationship things are beginning to pick up. There remain some risks in certain markets regarding issues like regulatory overreach, volatile market conditions, overeager competition, lack of credit-bureau information. Many of these issues are being dealt with by institutions and regulators finding common ground, in part due to the role played by national and sometimes international networks.”

Sergio Guzman

Lead specialist, The Smart Campaign, US

³ In previous surveys, scores were on a scale of 1 to 5. This year, in order to introduce greater refinement, they are on a scale of 1-10. The results have been converted to a 1-5 scale for the purposes of the chart.

Risk is interlinked

The risks identified in this survey do not stand in isolation. The responses showed that many of them belong to clusters (institutional, market, strategic etc.) which can be analysed more closely. For the first time this year, we calculated correlations between the risks on our list. We also divided the risks into baskets based on the direction they emanated from, i.e. the institution itself, the client or the market environment.

Correlation. Correlation measures the strength of relationships between different risks. Some risks are inherently inter-related: for example, respondents who found funding to be a high risk also tended to score liquidity as a high risk as well.

Based on these relationships, we prepared the accompanying map of risks, grouping them by the number of relationships and by subject matter. Thus, the three risks under the umbrella of “institutional structure” (governance, management, and staffing) were closely related to risks grouped under “effectiveness of execution,” which encompasses risks that come with running an institution, such as strategy, technology management, and similar. The map helps provide a mental framework for how different risks are related to each other.

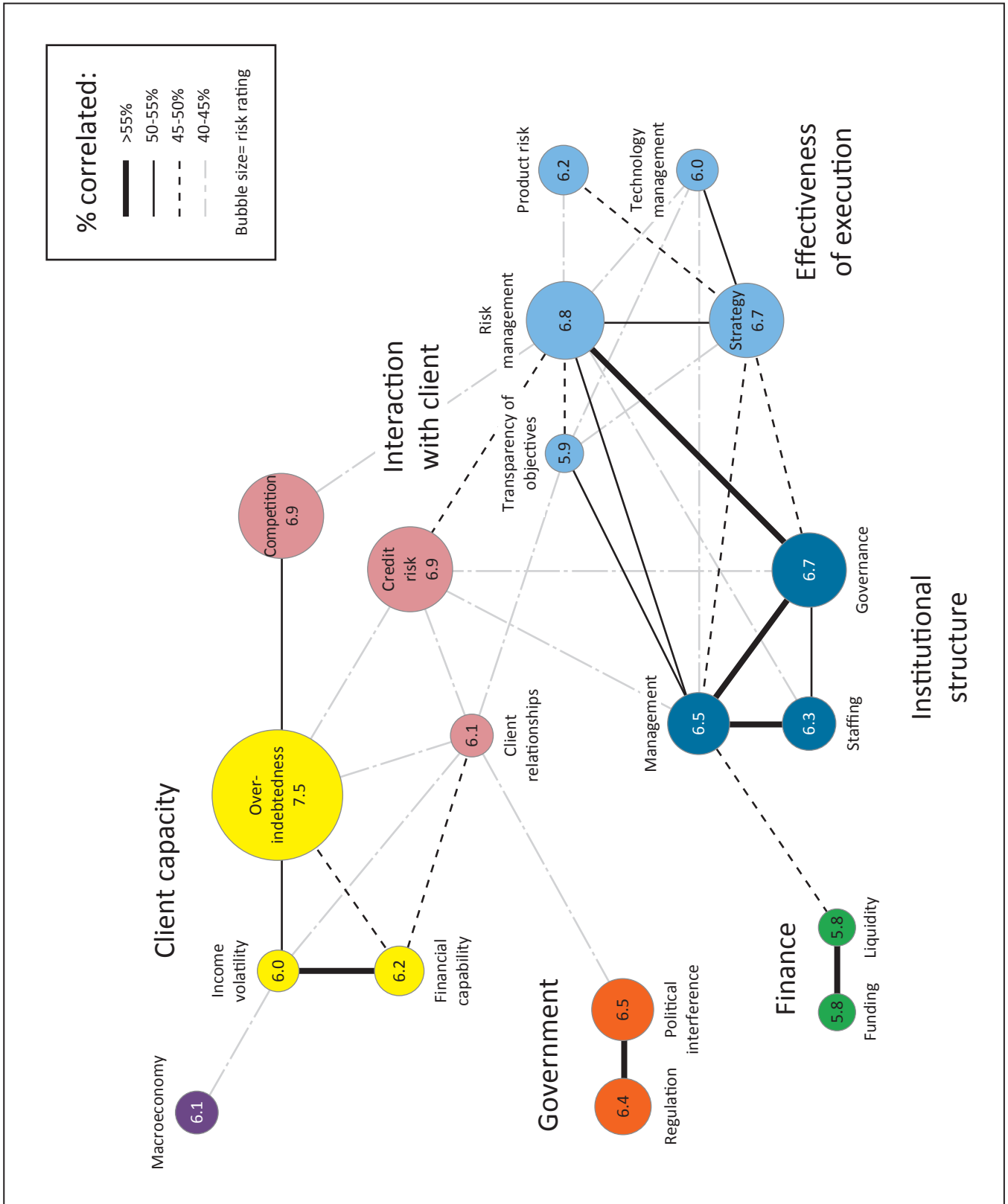
A few observations emerge from using this perspective. First, it's clear that respondents see a strong link across the organisational structure: most of those who scored governance as a high risk also ranked management and staffing as high risks. And these three in turn all have a strong correlation with risk management.

Closer to borrowers, over half of respondents who saw overindebtedness as a problem tended to put competition and client income volatility high as well. However, overindebtedness is less strongly related to credit risk, perhaps reflecting the fact that this is a longer-term risk, while credit risk is associated with greater anticipation of near-term repayment problems.

The clusters also show a connection between strategic risk and risk management more widely. There are also connections in this cluster to longer term strategic issues such as product risk and technology management.

A technical note: while all risks are correlated to some degree (mainly because some respondents are more comfortable employing higher scores, while others tend to limit scores to lower overall levels), we have only highlighted those correlations that are well outside the spectrum of most risk pairs.

Correlations reveal clusters of risks



Risk baskets. Risks with common characteristics may also be grouped into baskets whose riskiness can, in turn, be measured. For the purposes of this survey we grouped risks into three baskets, as shown in the accompanying table. These are based on the direction from which risks emanate, i.e. the service provider itself, the provider's clients, or the environment in which the provider operates.

The results showed that the biggest group risk was the client, mainly because of the very high score attached to the risk of overindebtedness. This was followed by risks from the provider itself (principally weak management and governance). Risks from the market environment came lowest, mainly because funding risk was seen to be very low, though this basket also contained high risks such as competition and political interference.

Client-related risks are the most serious

Risk baskets			
Risk rank	Basket	Risk score	Basket avg
Client			6.45
1	Overindebtedness	7.5	
11	Financial capability	6.2	
14	Client relationships	6.1	
16	Income volatility	6.0	
Service provider			6.38
2	Credit risk	6.9	
4	Risk management	6.8	
5	Governance	6.7	
6	Strategy	6.7	
8	Management	6.5	
10	Staffing	6.3	
12	Product risk	6.2	
15	Technology management	6.0	
17	Transparency of objectives	5.9	
19	Liquidity	5.8	
Market environment			6.34
3	Competition	6.9	
7	Political interference	6.5	
9	Regulation	6.4	
13	Macro-economic risk	6.1	
18	Funding	5.8	

These results emphasise the importance of client relationships in the management of risk. They also show that providers can do much to mitigate risk by strengthening their own internal processes and controls. However it is also comforting to see that risks over which service providers have least control, those emanating from the market environment, are also collectively seen to be the smallest.

What keeps you up at night?

To gain a deeper insight into people's concerns about microfinance, we asked respondents to tell us what really kept them up at night. Here is a selection of answers. We offer them without comment because they all speak for themselves.

We are a mid-size MFI focussing on empowerment and poverty reduction. We have invested a substantial amount in building their capacity to become entrepreneurs. We are following the self-help group model where some women have joined the group for savings/solidarity etc. We are being compelled to be aggressive and I don't want our clients to be over-indebted. I am not sure whether I will be able to withstand the pressure of the stakeholders who fail to understand how I feel about the issue.

Kalpana Sankar, Chair, Hand in Hand, India

More bad regulations coming in.

Associate director, MFI, Bangladesh

The risk that good organizations with good services, well-designed for a poor, vulnerable or hard-to-reach population, will be pushed out of business because they can't compete with the big boys in the more lucrative markets and can't cross-subsidize their work with the poorest.

Independent consultant, USA

Low profitability caused by increasing expenses. Each year, the same loan portfolio growth gives a lower profit.

Managing director, MFI, Kazakhstan

Some MFIs are not concerned enough about efficiency and internal controls; they appear to be more concerned about doing "good". When we try to explain that they will not do "good" long-term if today they are not running an extremely efficient and well-managed mass scale lending operation, we frequently get negative reactions. There is clearly a confusion between sustainability and profit maximisation, and social impact can be used as a poor excuse to avoid the topics/actions.

Portfolio manager, Development bank

My main concern would be another Nicaragua, Bosnia or Andhra Pradesh, which could be a tipping point for investors' confidence.

Mark van Doesburgh, managing director, Triple Jump, Netherlands

In the Indian context, the SPM Report of 2013 by Access has come up with a finding that in about 24% of MFIs, the remuneration of CEOs was in the range of 40-60 times that of a loan officer... This is not responsible financing. It is irresponsible financing by MFIs... This is going to be one of the grave risks for the MF sector in India.

Dr. S. Santhanam, Consultant, Development Finance, India

I never want to have to look back and fret as to how microfinance ended up in the junk pile of seemingly good ideas that turned out to be bad ones. We can avoid this if we proactively professionalize, strategize, use best practice governance and risk management, show how microfinance is a proof-of-concept of impact investing, and always be improving and evolving the microfinance concept.

Julie Abrams consultant, Microfinance Analytics USA

Liquidity - for a socially driven organisation that is running an operation in Malawi where the economy is on the edge.

CEO, microfinance foundation

I am concerned that the brand of microfinance is deeply damaged. For many traditional and committed supporters of microfinance, the industry no longer appears committed to working with, and improving the lives of, poor and food insecure populations. The balance has shifted too far to focus almost exclusively on profitability. We need to refocus on the core mission; creating sustainable approaches that impact the lives of poor clients.

Steve Hollingworth, president, Freedom from Hunger, USA

My main concern for our institution at the moment is to continue to work in providing microfinance outreach in the war conditions of Syria to ensure the institution survives and it is still able to provide the required services of clients and their households as they face the terror of war, economic devastation and absolute insecurity.

Alex Pollock, director, UNRWA Microfinance, Palestinian Territories

The risk that the opportunities gained by women will be lost as growth and expansion become more and more gender blind and neutral. We are not yet at a stage where there is equal opportunity for all.

Gil Lacson, manager, Women's World Banking, USA

The risk that too many clients are given loans for business which will never prosper because of the loan providers' eagerness to push a loan over the desk.

Counsellor, Ethiopia

That so many MFIs in the world are still so far away from looking like a true financial institution - from low skill levels of staff, to overall strategic vision and lack of 'service' orientation towards clients.

Independent consultant, USA

Political uncertainty in many countries leads to a slowdown in MF operations and MF regulation, whereas there is an increasing need to support populations in a context of challenging economic situations.

Microfinance investment officer, United Arab Emirates

The rapid growth in numbers of MFIs, which could exceed supervisory capacity, and the possible collapse of a number of them with consequences for the safety of small savers' deposits, as well as overall confidence in the financial system are the key risks that I see.

Banking supervisor, Africa

Who said what

Service providers: People who run or work in microfinance service providers

The top risks identified by microfinance service providers were all closely linked to the day-to-day running of the business: overindebtedness and credit risk were much the biggest concerns. In Mexico, the general director of an MFI said that his biggest worry was “the debt overhang that exists in Mexico. There is more credit on offer than there is financial literacy.”

For these respondents, the major cause of indebtedness is the rise in competition from powerful new entrants whom they see driving down prices and credit standards. Idowu Oshokoya, managing director/CEO Echo Microfinance Bank in Nigeria, said that “the main risks...include competition risk, due to new entrants into the industry, like the commercial banks, the mortgage banks and other non-registered deposit and loan institutions.”

Another major cause was the absence or ineffectiveness of credit bureaux. Where these did not exist there was little way to check the borrowing commitments of a loan applicant, and where they did, they were often ignored by less scrupulous lenders. Luis Miguel Diaz-Llaneza, chief financial officer of Financiera Independencia in Mexico, said that “many small and new entrant participants are eager to carve a market share for themselves, and are unfortunately willing to forego basic risk reduction practices, affecting not only their risk profile, but that for the entire industry. For example, many small companies forego participating in credit bureaux or limiting credit amounts to a feasible portion of clients' disposable income.”

As these comments imply, the quality of risk management is seen as another point of weakness in MFIs. One respondent said that risk management teams were “very stretched”.

Although other respondent groups expressed concern about management and governance in MFIs, the MFIs themselves tended to play these risks down. They were the only group which did not rank governance risk in its top ten (placing it No. 13). Similarly with product risk: whereas other groups said that MFIs risked losing their market position if they did not develop products that suited their clients, the MFIs themselves saw this as low risk, placing it No. 18 out of 19. A third low ranking risk was technology management. Other groups made much of the challenges facing MFIs from new technology and delivery systems such as mobile banking. For MFIs, this was the lowest risk of all.

1	Overindebtedness	7.8
2	Credit risk	7.3
3	Competition	7.0
4	Risk management	6.8
5	Political interference	6.7
6	Strategy	6.5
7	Regulation	6.5
8	Client relationships	6.5
9	Staffing	6.5
10	Management	6.4
11	Financial capability	6.3
12	Income volatility	6.2
13	Governance	6.1
14	Liquidity	6.1
15	Macro-economic risk	6.1
16	Funding	6.1
17	Transparency of objectives	6.0
18	Product risk	6.0
19	Technology management	6.0

Service providers worry most about debt and credit

Investors: People who invest in microfinance

The growth of overindebtedness is the top concern for people who invest in microfinance. The causes they mention include rising competitive pressures combined with MFI governance that is insufficiently strong to confront it.

An analyst at a large investment group in Switzerland said that “in some markets that constitute the traditional investment targets of MIVs and DFIs, the risk exists of overcrowding the sector and contributing to overindebtedness. This is especially true where regulation is not strong and the economy does not have solid foundations.”

Although the incidence of political interference in the microfinance industry seems to have diminished, this group continued to see it as a high risk. Christian Etzensperger Senior Research Analyst responsAbility Investments in Switzerland said that “politicians' short term interest can do enormous harm to the industry and to financial inclusion. The current macroeconomic troubles in developing countries (e.g. capital flight, currency volatility, inflation) can be managed on the level of the investee and/or the fund level, but government reaction (sometimes via the regulator) to them is notoriously unpredictable.”

Linked to this was concern about the quality of regulation. The executive director of a Luxembourg fund said that “many less developed markets continue to struggle to establish the necessary infrastructure (regulation, credit bureaus etc) to trigger substantial growth in financial inclusion”.

Despite their role as supporters of microfinance, investors seemed less concerned than other groups with how effectively MF providers were pursuing their social missions. Although a number of them said they were worried about mission drift and reputation risk, these only appeared low on the scale. And while many respondents said they feared that microfinance's tarnished reputation would frighten off investors, this was not a concern expressed by the investors themselves. They ranked funding risk at No. 16, and liquidity risk at No. 19.

If investors had a concern in this area, it had more to do with excessive investment, and the difficulty of finding good homes for their money. Pierre Berard, director, portfolio management at MicroCredit Enterprises in the US, said that “the amount of money flowing to developing countries, and to microfinance institutions, keeps growing, notably in commodity-rich countries. The question is whether MIVs and funders are not fuelling a bubble and whether the focus on social impact will be enough to curb the quest for growth.” However a number of respondents noted that the inflow of funds into emerging markets could quickly be reversed when the US Federal Reserve starts pushing up interest rates.

1	Overindebtedness	7.6
2	Competition	7.3
3	Governance	6.9
4	Political interference	6.9
5	Regulation	6.8
6	Credit risk	6.6
7	Strategy	6.3
8	Risk management	6.2
9	Financial capability	6.2
10	Macro-economic risk	6.1
11	Management	6.1
12	Staffing	5.9
13	Income volatility	5.9
14	Product risk	5.8
15	Technology management	5.7
16	Funding	5.5
17	Transparency of objectives	5.5
18	Client relationships	5.4
19	Liquidity	5.2

Investors are not about to pull out

Observers: Consultants, academics, industry experts

Although concern about overindebtedness dominated the response from observers (i.e. people close to, but not directly involved with, microfinance), their deeper worries were with the strategic issues facing MF providers.

Many feared that MFIs were losing their way in an increasing complex and competitive world. Julie Abrams, a consultant with Microfinance Analytics in the US, said her main concern was that “we won't plan strategically and will neglect to accurately analyze in order to foresee and plan for the future and address it head on in terms of understanding the changing market(s), understanding and meeting our clients' changing needs, practising excellent governance and risk management, and having solid internal operations to implement all of the above.”

Some respondents linked these weaknesses directly to inadequate governance and management at MFIs, particularly on the risk front. A US observer said that “Overindebtedness is still an issue. However, increasingly the lack of governance at MFIs is viewed as a hindrance to growth and sustainability.”

The need for good governance increases as MFIs grow. Getaneh Gobezie, microfinance expert at the Women Entrepreneurship Development Programme in Ethiopia, said that “when an operation is small, it may be easy to ensure a 'shared' vision/mission with all the staff (at board, management, middle level, and front line), and it may also be easier to monitor performance ... As their operations expand, the MFIs need a different management style”.

Inherent in this risk is the danger that microfinance providers will be drawn away from their social mission. One respondent said that the industry needed to show “Results! To demonstrate results, to demonstrate 'triple bottom line' results: that beyond financial returns microfinance can deliver the social, economic and poverty reduction outcomes they have promised for so long, and that they can achieve it in a sustainable manner, at scale and without harm such as overindebtedness or misselling.”

1	Overindebtedness	7.4
2	Strategy	7.0
3	Governance	7.0
4	Risk management	6.9
5	Competition	6.9
6	Credit risk	6.9
7	Political interference	6.7
8	Management	6.6
9	Product risk	6.6
10	Regulation	6.5
11	Staffing	6.3
12	Client relationships	6.1
13	Financial capability	6.1
14	Income volatility	6.1
15	Macro-economic risk	6.1
16	Transparency of objectives	6.1
17	Technology management	6.0
18	Funding	6.0
19	Liquidity	5.9

Lack of strategic planning is a top concern

Traditional suppliers 'could become uncompetitive'

Support providers: People who support microfinance through networks, NGOs and support programmes

This group sees the threat of overindebtedness as the greatest risk facing the industry. One programme coordinator said that “the main risk is a repeat of a debt crisis in urban areas where the supply [of credit] is too large, and where there is no credit bureau or effective supervision by the authorities”.

These respondents saw a number causes behind excessive lending including weak governance in MFIs and a failure to apply rigorous credit assessment. An investment officer in Costa Rica said that “markets are becoming more competitive, and there's need for better qualified key staff members and more solid governance structures.”

Some respondents also traced the problem to excessive growth: markets that are so saturated that lenders are forced to soften their terms to hold on to market share. One said: “The pressure to make loans faster and cheaper to compete has led to a deterioration of quality in process as well as relationships with clients, resulting in a deterioration of portfolio quality.”

Strategically, there was also concern about the ability of the industry to take on change. A consultant said: “I see big developments in a wider financial inclusion agenda with many new players coming into the market. This creates a risk that traditional MFIs who are attempting to be broad-based financial service providers will become uncompetitive. So for me the biggest risk is that MFIs fail to capitalise on their core niche in an evolving financial inclusion agenda which is based on a direct personal relationship with clients and an ability to leverage this to create value for clients.”

This group did not see funding as an important risk, ranking it at the bottom of the list.

1	Overindebtedness	7.1
2	Governance	7.1
3	Strategy	7.1
4	Risk management	6.8
5	Management	6.5
6	Credit risk	6.5
7	Competition	6.5
8	Product risk	6.5
9	Regulation	6.4
10	Technology management	6.4
11	Staffing	6.4
12	Political interference	6.3
13	Financial capability	6.1
14	Macro-economic risk	5.9
15	Transparency of objectives	5.9
16	Client relationships	5.8
17	Income volatility	5.7
18	Liquidity	5.4
19	Funding	5.3

New MF companies starting up 'day by day'

Raters: People who rate microfinance service providers

For raters, overindebtedness is the top risk for reasons which were summed up by Sebastian von Stauffenberg, chief executive officer of MicroRate in the US. He said that “over-indebtedness coupled with a slowdown of economies is straining MFIs and causing deteriorating portfolio quality. Boards and management are not reacting with a long-term view and may be underestimating the impact. Increasing credit risk is not matched with better credit methodology (to the contrary, it often produces lax credit methodology).”

A rater in Peru, one of the worst affected countries, said that saturated markets were producing slow growth and narrower margins. Credit risk was rising because MFIs were “increasing the average loan amount per customer and wanting to move into a higher market niche serving SMEs.”

Competitive pressures were noted in several countries. A UK rater said that competition was “resulting in margin pressure and potentially leading to an erosion of underwriting standards”, and a respondent from India said that microfinance companies were starting up “one by one, day by day”.

Management quality, particularly in the area of risk, was a strong concern for raters, but issues of funding and liquidity ranked low on the list. Their lowest concern was political interference in the microfinance industry.

1	Overindebtedness	8.1
2	Competition	7.9
3	Risk management	7.9
4	Credit risk	7.8
5	Governance	7.7
6	Strategy	7.1
7	Staffing	6.9
8	Macro-economic risk	6.7
9	Management	6.6
10	Financial capability	6.2
11	Income volatility	6.2
12	Transparency of objectives	6.2
13	Client relationships	6.1
14	Liquidity	6.0
15	Product risk	5.9
16	Technology management	5.9
17	Funding	5.8
18	Regulation	5.7
19	Political interference	5.6

Regulators: Government officials and those who regulate microfinance service providers

Regulators were the only category of respondent who did not put overindebtedness at the top of their list of concerns (it came No. 5). Instead, they focused on the wider issues of credit risk and governance in MFIs. Many painted a picture of MFIs suffering losses through lending practices that were not backed by strong governance and internal control.

A respondent from Kenya said that “most MFIs are faced with serious problems installing internal control systems and they have no measures to assess the institutional and business risks that are inherent in their operations.”

Philippe Nsenga, microfinance inspector at the National Bank of Rwanda, reinforced this message by saying that “institutions are not able to afford competent staff, and the boards of directors most of the time lack governance and financial skills. As consequence, institutions are exposed to governance and operational risks. The sector is not able to stand the competition posed by bank institutions.”

1	Credit risk	8.1
2	Governance	8.1
3	Risk management	7.8
4	Management	7.8
5	Overindebtedness	7.5
6	Competition	7.3
7	Funding	7.2
8	Financial capability	7.1
9	Macro-economic risk	6.9
10	Strategy	6.8
11	Staffing	6.6
12	Client relationships	6.5
13	Liquidity	6.5
14	Product risk	6.5
15	Technology management	6.4
16	Income volatility	6.2
17	Political interference	6.2
18	Regulation	6.0
19	Transparency of objectives	5.6

Weak governance leads to losses

Competition was a broad issue. Muhammad Ali, deputy director of the banking inspection department of the State Bank of Pakistan, said that more outsiders “are bringing unfair competition among loaning institutions which is not only exposing the soundness of banks but is also harmful for genuine borrowers”.

Regulators were more concerned than other groups with issues of funding, capital adequacy and liquidity. A West African regulator said he was worried that “a number of institutions could fail because of under capitalisation, inappropriate business models, lack of capacity in terms of knowledge and skills to manage the business and greed and fraud on the part of some entrants into the microfinance space.”

Although (unlike a number of other groups) regulators were reluctant to say that regulation was a risk issue for the industry (they ranked regulatory risk No. 18 out of 19), they recognised that it was still inadequate. One respondent said that because of technology changes and demand for better regulation and supervision, “the microfinance sector will face more and tighter regulations in future.”

Risk awareness is low in Africa

Africa

Africa was one of the two regions which did not rank overindebtedness as their top risk. However credit risk more widely was the No. 1 concern due to a combination of what respondents saw as weak credit management, poor governance, and difficult operating conditions.

Kevin Fryatt, director of technical assistance at MFX Solutions in the US, said: “The paramount risk facing the microfinance sector in Sub-Saharan Africa is that of governance, and more precisely risk governance. Within governance, there is a lack of appreciation and understanding of the role that risk management should play within a financial institution.”

John Masha, general manager of MESPT in Kenya, said that “credit risks remain high in Africa due to political and economic uncertainties facing many countries.” An MFI branch manager in Benin said that 30-day PAR rules were not being respected “because clients are overborrowed, and there is an economic slump in most countries”.

1	Credit risk	7.5
2	Governance	7.2
3	Overindebtedness	7.0
4	Risk management	6.9
5	Management	6.9
6	Strategy	6.7
7	Staffing	6.7
8	Competition	6.5
9	Liquidity	6.5
10	Technology management	6.5
11	Transparency of objectives	6.3
12	Client relationships	6.3
13	Income volatility	6.2
14	Product risk	6.2
15	Funding	6.2
16	Macro-economic risk	6.0
17	Financial capability	6.0
18	Regulation	5.8
19	Political interference	5.7

A related concern was the ability of MF providers to meet stiff competition from new entrants. Mounkaila Garba, director of credit at Taanadi S.A. in Niger, said that “rich institutions, especially from northern countries, are setting up in developing countries, putting at risk the viability of local institutions with little means. Generally these northern structures have resources but not an understanding of the business.”

Concern about liquidity and funding risk ranked higher here than elsewhere. Respondents said that growing loan demand, increased competition for people’s deposits and savings, and reluctance by investors and donors to fund smaller MFIs was creating strains. Loan default was a further problem. Alioune Diongue, head of internal control at Microsen in Senegal, said that liquidity risk was high because “the majority of institutions, for lack of alternatives, have to finance themselves through the banks in order to create loans for their clients. These often do not pay their loans back, which makes it hard for the MFIs to meet their commitments to the bank”.

A low-ranking but nonetheless widely cited risk was regulation, more specifically the lack of suitable regulation to encourage the growth of microfinance. The executive director of an MFI in The Gambia said that “regulators need to be innovative in setting up regulations in order to respond to the dynamism of the industry and encourage genuine and quality microfinance services providers.”

East Asia Pacific

Overindebtedness was, by a large margin, the top concern in this region. This was attributed to a number of causes. Ron Bevacqua, director of Access Advisory in the Philippines, said that “overindebtedness is a growing problem, related partly to lack of financial knowledge but more to the unwillingness of service providers to step outside their comfort zones to target new markets and develop more appropriate products”. Others attributed it to growing competition from banks, “unregulated growth in portfolios”, and weak MFIs.

The institutional risks in MFIs (i.e. governance, management) ranked, collectively, very high in this region, occupying positions No. 2, 3 and 4. A respondent from a regional investment bank said that “the main challenge is that most MFIs have laudable social objectives but lack the professionalism to grow and manage risk properly. Few institutions and networks have the vision to carry out this mandate professionally.” Lachlan Fleming, chairman/consultant at M-Pay/BSA Consulting Group in Vietnam, said that confidence in microfinance governance was “evaporating”, partly because of the growing incidence of fraud.

Angus Poston, founder of Bridge in the Philippines, said that “the microfinance business model is entering a period of significant change. In some countries, group-based lending will continue to experience large levels of bad debt. This could create a general perception that the objective of bringing inclusive financial services to those otherwise unserved is misguided.”

The growth of competition was a high concern, not just from incoming commercial banks but also from state subsidised entities. One respondent saw “growing political interference” in some countries.

Liquidity and funding issues were also mentioned. Betty Wilkinson, director, CWPF at the Asian Development Bank in the Philippines, saw “inadequate longer-term sources of funds for MFIs to balance growth; and mismatch between client financial needs and services provided (insufficient diversity of services and inadequate collaboration between service providers to benefit various client groups)”. In Laos, another development bank respondent said that “the high cost of funds on one hand makes the interest rate high; government regulation on the other hand, makes the institutions lower the cost. This limits competitiveness.”

1	Overindebtedness	8.0
2	Management	7.4
3	Governance	7.4
4	Risk management	7.0
5	Income volatility	7.0
6	Competition	6.7
7	Liquidity	6.6
8	Credit risk	6.5
9	Financial capability	6.5
10	Strategy	6.3
11	Product risk	6.1
12	Technology management	5.9
13	Client relationships	5.8
14	Staffing	5.8
15	Political interference	5.6
16	Funding	5.5
17	Macro-economic risk	5.5
18	Regulation	5.4
19	Transparency of objectives	5.0

MF providers 'stuck in their comfort zone'

Eastern Europe and Central Asia

The top concern in the former communist countries of Eastern Europe and Central Asia is the growth of overindebtedness. The problem was reported from many places: Romania, Azerbaijan, Tajikistan, Kazakhstan, and Kosovo. However some respondents hoped the situation might improve. In Kazakhstan, one said that the recent introduction of credit bureaux should ease the problem, and a respondent from Bosnia & Herzegovina said “We have largely overcome the crisis in repayment”.

The risk was closely linked with No. 2 on the list: competition. From Romania, an MFI chief executive said that the main issue facing MFIs was “achieving sufficient scale to compete with banks, who are once again aggressive in the marketplace with their limited ethics, especially when it comes to micro clients in both agri and non-agri sectors.”

Samir Jafarli, deputy chief executive at Vision Fund AzerCredit in Azerbaijan, said that “as a result of aggressive competition the average disbursed loan amounts will increase, which will cause greater overindebtedness issues. In reaction to overindebtedness, regulation will become stricter and some limitations might be introduced.”

Strategic risk occupied a high place because respondents saw a lack of initiative by MFIs in getting to grips with an increasingly uncertain future. An operations officer for an international financing agency in Bosnia & Herzegovina saw “an important need to think long term and how to continue to build the basics well in organizations that have weathered the storm and continue to develop”.

The funding of microfinance activities in the region is also an issue, though the problem lies in both over- and under-funding. On the overfunding side, one respondent said that “the oversupply of funding to MFIs and banks is distorting the market and risking wiping out the social purpose entities.” However, a respondent from Romania said that because the country was a member of the EU, it got neglected by funders “because they think there is no longer a need for microfinance”. In Georgia, a respondent said that MFIs had to borrow in foreign currency “because there is no possibility to get local funding at an acceptable price and long term” which meant that they faced foreign exchange risk.

1	Overindebtedness	7.5
2	Competition	6.7
3	Strategy	6.4
4	Macro-economic risk	6.3
5	Income volatility	6.2
6	Risk management	5.9
7	Client relationships	5.9
8	Financial capability	5.8
9	Political interference	5.8
10	Management	5.6
11	Regulation	5.6
12	Funding	5.6
13	Liquidity	5.5
14	Staffing	5.4
15	Technology management	5.4
16	Transparency of objectives	5.3
17	Product risk	5.3
18	Governance	5.1
19	Credit risk	5.0

Bank competitors show 'limited ethics'

Latin America

The problems of overindebtedness and credit risk were seen to be more acute in Latin America than in any other region. This was attributed largely to the growth of competition from new entrants, and an accompanying decline in lending standards and business ethics, as well as to inadequate risk management. In short, the top four risks are closely interlinked.

A respondent from Mexico described a market rife with “overindebtedness and socially irresponsible practice”. Several respondents linked this risk to poorly managed client relationships. A respondent from Costa Rica said that “as the markets are becoming more competitive, MFIs need to introduce new products to better serve all the financial needs of their clients, not just credit and savings. Some MFIs, instead of developing new products, push their clients towards higher loan amounts.”

The regional response was overshadowed by the problems of Peru where the growth of microfinance has gone into reverse because of large loan losses. Respondents there spoke of “excessive growth expectations” and “inadequate regulation”.

Whether these trends lead to a full-blown crisis is a matter of debate. Frederic de Mariz, director of UBS in Brazil, said that “overall, I do not see a risk of a crisis in asset delinquencies (different from India). But the natural strategy of MFIs to expand into new products/segments/geographies is causing a rise in delinquencies.”

Institutional risks (strategy, management, staffing) also ranked high. “For authorised institutions, one of the main risks is excessive growth which could generate problems of internal control and worsen financial indicators. Risks stemming from deficiencies in the governance of institutions also persist”, said a respondent from Mexico.

Funding concerns were also low; in fact liquidity in many markets was said to be excessive, and a cause of “over-growth”. A respondent from Guatemala said: “There is availability of funds for the sector but this could be affected if indebtedness shows trends and indicators of high risk.”

Concern about political interference in the microfinance sector, once a top level risk, has abated. Respondents seem to have accepted that it has become a fact of life.

1	Overindebtedness	8.4
2	Credit risk	8.3
3	Competition	7.7
4	Risk management	7.2
5	Strategy	7.0
6	Staffing	6.9
7	Client relationships	6.9
8	Financial capability	6.8
9	Transparency of objectives	6.6
10	Management	6.6
11	Product risk	6.6
12	Political interference	6.4
13	Governance	6.4
14	Regulation	6.4
15	Income volatility	6.2
16	Macro-economic risk	6.2
17	Technology management	6.2
18	Funding	6.1
19	Liquidity	5.7

Loan growth is causing more delinquencies

Dealing with a volatile environment

Middle East and North Africa

Concerns about overindebtedness headed the list in the Middle East and North Africa regions, the result of growing competition in key markets, and also very unstable economic and political conditions.

A programme co-ordinator in Egypt said the two main challenges were: “dealing in a political volatile environment and overindebtedness in urban areas”. Youssef Fawaz, executive director of Al Majmoua in the Lebanon, said that “general political volatility and associated security fragility are compounding the economic downturn and creating conditions of instability for the work of microfinance. This is further exacerbating the increase in PAR observed by many MFIs in the region.”

The unpopularity of microfinance in some markets is also adding to political risk. Bidouj Mustapha, chief executive officer of Attawfiq Microfinance in Morocco where microfinance has been through a crisis, said there were “risks that microfinance will become a political issue for reasons of ideology or patronage”.

The problems of microfinance are compounded in some markets by institutional weakness. A respondent from the United Arab Emirates saw “a lack of capacity strengthening, especially in a context where MFIs are adding more services (insurance, green products) and using new technologies to enhance their capacity”. In Algeria, a respondent said that there “a lack of qualified human resources”.

Inadequate – or non-existent – regulation is also a problem in some markets, for example Iraq where a respondent said that “the legal environment does not support microfinance”. Alaa Abbassi, a consultant in Jordan, said that “many central banks are acknowledging the importance of financial inclusion and are beginning to consider regulating and supervising the microfinance sector, so there is a risk of being over-regulated or of prudential regulation being forced on non-deposit taking MFIs.”

1	Overindebtedness	7.8
2	Macro-economic risk	7.3
3	Political interference	7.1
4	Regulation	7.1
5	Credit risk	6.9
6	Financial capability	6.8
7	Management	6.7
8	Competition	6.6
9	Strategy	6.6
10	Income volatility	6.6
11	Product risk	6.5
12	Technology management	6.4
13	Staffing	6.3
14	Liquidity	6.3
15	Risk management	6.2
16	Governance	6.2
17	Funding	5.9
18	Transparency of objectives	5.4
19	Client relationships	5.3

North America

'Lack of sensitivity to client needs'

The North American response consisted mostly of investors, donors, networks and consultants serving MFIs in other parts of the world. Their top concern was the problem of overindebtedness. The comment of one investor was typical of many. She identified “overindebtedness due to lack of coordination, poor regulation and lack of sensitivity to client needs; [also] predatory behaviour by competitors in more penetrated markets”.

This concern was closely linked to reputation risk. One respondent said that “the industry is running the risk of taking yet another hit in terms of credibility.” Many also mentioned the potential risk to funding as investors shied away from an industry tainted by controversy.

Respondents’ concern about institutional weakness in MF providers was also high: ineffective governance was ranked the No. 2 risk. One consultant said that “the lack of understanding of the role of the Board, finding suitable Board members, and poor understanding of the principles of good Corporate Governance continue to be issues for the industry”.

The quality of risk management was another high level concern, particularly as regards the ability of MF providers to handle increasingly difficult and complex markets. Brian Cox, president of MFX Solutions in the US, said: “I see risk management as a big challenge both for MFIs and MIVs. For MFIs, growth in size, complexity and breadth of product line is not being matched with better systems, risk management know-how and processes.”

Many respondents expressed concern about the future evolution of microfinance. This accounts for the high position (No. 3) occupied by Strategy in the rankings. A US investor said that MFIs had to face up to how they were going “to remain relevant and key players within the larger ‘financial inclusion’ space, with more diverse and technologically savvy players (MNOs, other tech provider partnerships)”. Increasingly, strategic risk includes the successful management of new technology, which this group of respondents ranked in their top ten risks, most often because they feared, as one of them put it, that MFIs would “miss the train”.

The risks of political interference and excessive, or inappropriate, regulation were also high for this group. MFIs remain vulnerable to “donor/politician over-reaction to crises and use of inappropriate policy measures which unnecessarily damage good institutions and services,” according to Matt Gamser, head of the SME Finance Forum, International Finance Corporation.

1	Overindebtedness	7.7
2	Governance	7.2
3	Strategy	7.1
4	Competition	6.9
5	Risk management	6.9
6	Credit risk	6.8
7	Regulation	6.6
8	Political interference	6.6
9	Management	6.5
10	Technology management	6.4
11	Financial capability	6.3
12	Staffing	6.3
13	Product risk	6.2
14	Transparency of objectives	5.9
15	Macro-economic risk	5.7
16	Income volatility	5.6
17	Client relationships	5.5
18	Funding	5.4
19	Liquidity	5.2

South Asia

Political interference still a high risk in South Asia

The fall-out from the Andhra Pradesh crisis resonates in the response from South Asia, where the risk of political interference tops the ranking. The chairman of a microfinance organisation in India said that “the major risk which the industry faces is from the decisions/interference of elected government and the political class.”

One reason is that the trigger of the AP crisis, overindebtedness, remains a high ranking concern, not just in India but in neighbouring countries such as Nepal, Bangladesh and Pakistan.

This risk was linked to concern about the quality of MFIs' relationships with their clients: whether lenders really understood their clients' needs and borrowing capacity, or whether, as one respondent said, “They just want to increase the loan size”. Govinda Bahadur Raut, head of the microfinance department at Muktinath Bikas Bank in Nepal, said that “MFIs are facing a challenge in analyzing loans and clients ...resulting in client over-indebtedness. This challenge will increase in the days ahead too.”

This cluster of risks included the growth of competition which many respondents saw driving MFIs to bad business and ethical practices. An Indian respondent said: “Competition has started in many markets and we can see the dilution of due diligence standards”. Regulatory risk, another vexed area on the sub-continent, continues to rank high, with intrusive rules such as interest rate caps earning many mentions.

Funding and liquidity concerns also remain high, in part due to fears that the damage to microfinance's reputation will put donors and investors off. This risk varies from one institution to another, but the chief operating officer of one microfinance network said: “Avenues for raising funds are shrinking”.

There was generally lower concern in this region about institutional risks: the quality of governance, management and staffing, though more can always be done to improve it. A respondent from India said that “most MFIs are managed by professionals and have good governance”.

1	Political interference	7.3
2	Overindebtedness	6.9
3	Client relationships	6.6
4	Regulation	6.5
5	Risk management	6.4
6	Funding	6.4
7	Competition	6.4
8	Liquidity	6.4
9	Credit risk	6.3
10	Management	6.2
11	Strategy	6.1
12	Product risk	5.8
13	Governance	5.8
14	Transparency of objectives	5.8
15	Financial capability	5.8
16	Staffing	5.6
17	Macro-economic risk	5.6
18	Income volatility	5.4
19	Technology management	5.3

Microfinance: An evolving industry

Sam Mendelson and **Daniel Rozas** provide the context to the risks identified by the *Microfinance Banana Skins* surveys over the last six years, and ask where microfinance goes next

Microfinance since 2007: An industry's changing face

When the first *Microfinance Banana Skins* was published in early 2008, the industry was enjoying the final months of what now looks like a golden era. The report's title – *Risk in a booming industry* – caught the spirit of the times. Muhammad Yunus had won the Nobel Peace Prize a couple of years earlier during the UN-declared Year of Microcredit. Microfinance institutions (MFIs) in many countries were enjoying double-digit growth rates, fuelled by an even faster influx of funds from enthusiastic investors. The process of commercialisation, i.e. putting microfinance onto a professional footing, was largely complete. The main risk seemed to be whether the industry could keep it up.

For example, the growth in investment meant that too much money ended up chasing too few institutions and clients, and produced an unsustainable growth in capacity. Rising commercialism meant that microfinance's social mission came increasingly to be neglected in favour of the pursuit of profit. MFIs in some markets lacked access to the human capital needed to run institutions that were becoming increasingly complex, offering a widening array of products and services. Hedging against currency risk – a growing problem for foreign-funded MFIs – was undeveloped. Regulators took actions which didn't always show an understanding of what the industry needed, for example by capping interest rates or prohibiting deposit-taking. The lack of credit bureaus leveraged the consequences of overheated markets to create problems of overindebtedness.

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Daniel Rozas, an independent consultant, is a leading expert on sector-level risks facing microfinance. In 2009, Daniel built a model showing the presence of a microcredit bubble in Andhra Pradesh, a state that one year later saw the largest crisis in the sector's history. He has co-created MIMOSA, an index that scores over 100 countries on their level of microcredit saturation. Prior to his microfinance career, Daniel gained first-hand experience with credit bubbles while working for the US mortgage investor Fannie Mae during 2001-08.

None of these underlying issues could be laid at the feet of Wall Street. They were created by the microfinance industry itself.

So when the global financial crisis struck, it brought a series of shocks, some internal, some not. The eruption of repayment crises in several countries and the collapse of a number of large MFIs made people realise that, far from occupying a special world of its own, microfinance was subject to risk like any other financial industry. Meanwhile, research of a more rigorous kind than had previously been conducted called into question the efficacy of microfinance as a means of improving the lives of the poor, and in so doing not only attacked the very foundations of the industry, but also opened up a whole new area of risk: that of reputation. Far from being the panacea for poverty-alleviation upon which the industry was originally based, it was now facing charges that microfinance was not even meeting the Hippocratic threshold¹.

But the *perception* of microfinance's role was evolving too. Other areas of research showed that the real needs of microfinance clients went well beyond the small, boilerplate loans which were the mainstay of traditional microfinance's product line. The focus on poverty alleviation began to give way to a broader Financial Inclusion agenda whose purpose was to deliver *"a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients"*².

New means of assessing the social impact of microfinance evolved to guide the industry's work. New technologies also made it possible to provide financial services that were cheaper, more accessible and better able to meet clients' needs. Specialist microfinance fund managers became an increasingly important source of microfinance investments. Alongside these developments, microfinance also became increasingly integrated in the formal financial sector, with MFIs becoming fully-licensed banks, commercial banks targeting lower income customers, and regulators taking greater oversight of both.

As a consequence of all this turbulence, microfinance is now an industry in flux, facing difficult choices about the next stage in its development. As Joanne Ledgerwood writes in the 2013 Microfinance Handbook: "Fifteen years [after the first Handbook], the shift to financially inclusive systems...appropriately broadens the objectives beyond economic development and poverty alleviation to include the ability of poor women and men to better manage risks, smooth income, invest in productive activities, and build assets". An analysis of the events which brought microfinance to this challenging point in its evolution helps illuminate the road ahead.

¹ To illustrate how extreme this perception had become, the UK Government's All-Party Parliamentary Group (APPG) on Microfinance in 2011 quoted Milford Bateman: "The microfinance movement...has failed to provide robust evidence that it is meaningfully associated with poverty reduction...many specialists [now believe] that microfinance actually undermines the process of sustainable poverty reduction and 'bottom-up' economic and social development".

² Definition from The Center for Financial Inclusion at Accion, Washington DC.

Microfinance in crisis

Most people view the crisis which engulfed microfinance in the last few years as a comparatively sudden event, the product of dramatic change in the industry. In reality, a disaster which affects the majority of MFIs in a single country is not new. The pioneer markets of modern microfinance, Bolivia and Bangladesh, both experienced episodes of high delinquency at the turn of the millennium³. There have also been examples of large MFIs collapsing after a period of runaway growth, for example Corposol in Colombia.⁴

Nevertheless, such events remained largely unknown until 2009 when four countries underwent repayment crises at the same time: Nicaragua, Morocco, Pakistan, and Bosnia & Herzegovina. That year's *Banana Skins, Confronting Crisis and Change*, highlighted the fallout from crises that had their roots in industry-specific risks. After expanding rapidly, these markets suffered the fatal combination of excessive competition, inadequate regulatory infrastructure (including credit bureaus), overstretched MFI systems and controls, and erosion of lending discipline in MFIs.⁵ The result was a mountain of bad debt and repayment strikes that caused the collapse of several large MFIs and extensive losses in others.

However, it was the crisis in the Indian state of Andhra Pradesh (AP) in 2010 that provided the explosive charge around that time. The 2011 *Banana Skins* report *Losing its Fairy Dust*, published within a few months of the AP crisis, captured the mood in the sector, which was just emerging from multiple repayment crises in smaller countries, only to see the largest microfinance market essentially implode, causing significant damage to the sector's reputation.

In just a few months, the thrust of media coverage of microfinance shifted from social entrepreneurs trying to solve the problem of poverty, to rapacious moneylenders reaping profit off the backs of the poor. Allegations proliferated about overborrowing, borrower suicides and usurious interest rates – even when the truth was more nuanced. The huge profits made by investors during the high profile IPO of SKS, India's largest MFI, added to the sense of scandal.

The government of AP responded by issuing an ordinance that effectively prohibited microfinance activity in the state.⁶ This action triggered a nationwide crisis of liquidity as Indian banks curtailed their lending to MFIs, forcing them to hold back loan disbursements, thus damaging their relationships with their customers, even outside AP. The impact reached

³ Asif Dowla: How to deal with a default tsunami in the microfinance industry: Lessons from Grameen Bank <http://bit.ly/1grCI1H>; E. Rhyne: [Commercialization and Crisis in Bolivian Microfinance](#)

⁴ Jean Steege: The Rise and Fall of Corposol (1998) <http://bit.ly/1ljGtn2>

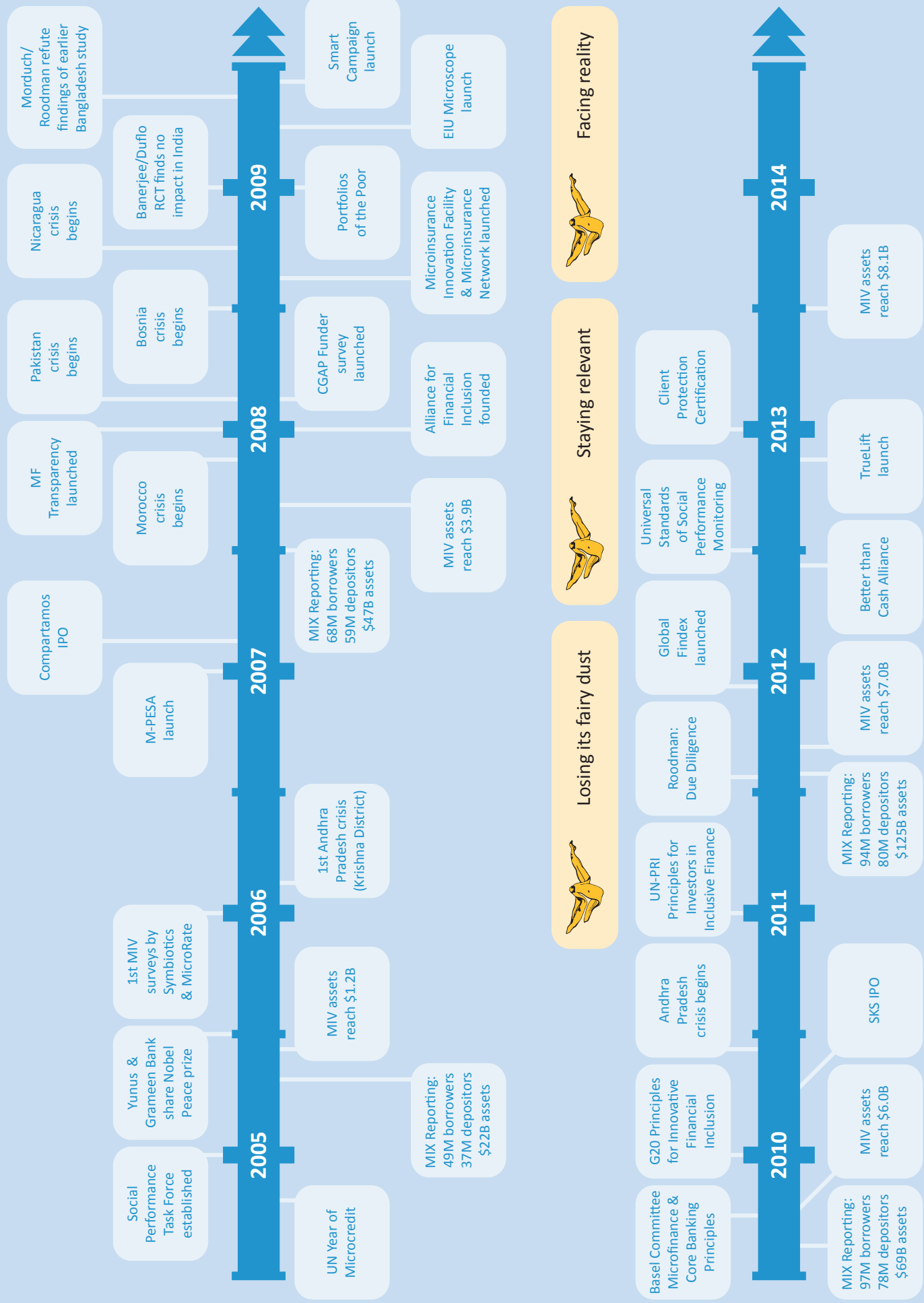
⁵ CGAP Focus Note 61 (2010): Growth and Vulnerabilities in Microfinance. <http://bit.ly/1sRCRhl>

⁶ This was not entirely without precedent. In 2006, the government of AP temporarily closed down microfinance offices in one district (Krishna), allegedly in response to complaints about usurious interest rates and highly commercialised MFIs 'hard-selling' microloans. On that occasion, however, MFIs were able to find an accommodation with the government.

Risk in a booming industry



Confronting crisis and change



Losing its fairy dust



Staying relevant



Facing reality



foreign investors – whose Indian exposure was mainly in MFI equity – via asset impairments that were taken over the subsequent year.

The crisis in India quickly came to dominate global headlines. For an industry that had spent the prior couple of years trying to settle a handful of smaller countries' problems, a full-blown crisis in the world's largest microfinance market was a major shock and a devastating blow to its reputation. For many people both inside and outside the sector, India was the first indication that microfinance might have problems that went beyond purely localised concerns.

And another problem that had been hidden at the heart of microfinance from its beginning was about to come to the fore.

From anecdote to RCT: the evolution of microfinance research

Since Mohammed Yunus' early claims that microfinance would put poverty in a museum, the industry had billed itself as a key tool for alleviating – and even eliminating – poverty. Initially, this claim was made largely by the industry's promoters themselves. But by the 1990s, a series of impact studies in Bangladesh showing substantial improvement in borrowers' livelihoods came to be viewed as the gold standard for proving microfinance's efficacy.

This changed in 2009 with two concurrent publications. One was a landmark study of the slums of Hyderabad, which showed that microfinance had had a relatively modest impact on a subset of clients, and little impact on most others.⁷ The study was conducted using randomised control trial (RCT) methodology which was more rigorous than earlier methods and better able to separate the impacts of microfinance from other factors that might affect the lives of the poor. While it was not the first microfinance RCT, it heralded a new trend in social science, becoming the new benchmark for microfinance research.

While the first study showed the new path for research, the second brought down the edifice on which microfinance had stood for over a decade. It sought to replicate one of the landmark 1990s studies in Bangladesh, and found that the methodology for its most prominent claim – that 5% of Grameen Bank's clients get out of poverty every year – was based on faulty methodology. Instead, it found that these same clients' well-being had been essentially unchanged by their affiliation with Grameen.

Summarising the impact from the new RCT studies and his replication of the earlier Bangladesh studies, David Roodman later wrote in his book *Due Diligence* that “on current evidence, the best estimate of the average impact of microcredit on the poverty of clients is zero” [emphasis ours].

⁷ <http://bit.ly/1qS5PMx>

The tremors set off by all this research came not just from the findings but also from the timing. To learn that microfinance was bad at helping the poor was one thing. To learn it just as microfinance seemed to be collapsing in one of its biggest markets was another.

2011 onwards

All this was not to say that the provision of financial services to underserved areas of the population didn't bring significant benefits. A noted RCT advocate Esther Duflo of the MIT Poverty Action Lab, attributed the controversy to the fact that the studies “showed that microfinance is not magic. But while we didn't discover that microfinance launches people out of poverty, we did discover that it's making a very real difference to some people. The new, forthcoming research will help us discover more about who benefits from microfinance and help us design financial products that work better for the poor⁸.” The 2012 *Banana Skins* survey, entitled *Staying Relevant*, encapsulated these issues well: how does microfinance continue to find a purpose in the face of pessimistic empirical impact results, commercialisation and consolidation? How does an industry that began touting its poverty-alleviating *bona fides* stay relevant today and tomorrow?

Another important study around this time, *Portfolios of the Poor* published by Princeton University Press, showed that far from being simple, the financial lives of the poor were extremely complex – characterised by many methods of informal financial disintermediation. This and other research into behavioural economics underpinned a new agenda of financial inclusion which placed its focus on understanding clients' needs and creating the products and services to meet them. For many, this was now the way forward for the industry.

Clients and products: how microfinance is learning to listen

Since the start of modern microfinance, the main focus has been on standardising products and services. This allowed service providers to reduce the cost of serving poor clients, but often at the expense of meeting their actual needs. The boilerplate microfinance product – the one-size-fits-all microenterprise loan – continues to play a central role. But it is not what is always best matched clients' needs, and monoline lending models based on such products have been implicated in several crises, especially in Andhra Pradesh.

Understanding client needs

Much recent research has pointed to under-appreciated aspects of poor people's lives. Being poor and financially excluded is about more than lack of money; the high *volatility* of people's incomes exacerbates their poverty and makes it difficult for them to service their loans. Income volatility also forces them to enter into smaller and more frequent financial transactions which are costlier to provide, and drive up rates for the borrower. The poor also bear a disproportionate share of the costs of banking because they often have to travel to a physical branch, and may be obliged to buy unsuitable products, for example, ones with

⁸ Microfinance Impact and Innovation Conference in New York: <http://www.cgap.org/news/first-look-new-research-microfinance-impact-and-innovation>

minimum balance requirements, or inappropriate loan terms, or instalments which do not fit their income patterns.

While income generation used to be the *raison d'être* of microfinance, *income smoothing* has become an important new goal. Clients rarely earn \$2 a day. They may earn \$10 one day and nothing at all for the rest of the week. In such circumstances, putting food on the table every day can be a struggle. People also need finance for *big expenditures*: life cycle events like birth, education, marriage, purchase of major assets, business investment, and so on. They also need finance (loans, savings and insurance) for *emergencies*: ill health, fires, floods and cyclones.

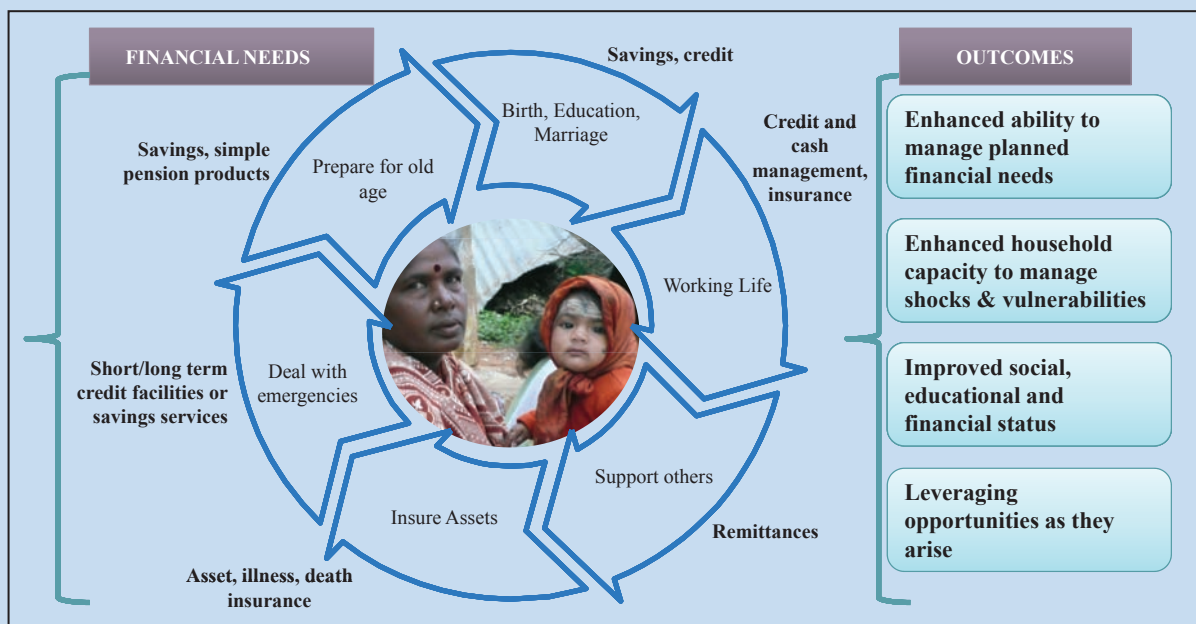


Fig 1: The Client Financial Lifecycle – with thanks to Microsave

Product design

What products *do* meet these criteria? They obviously vary with clients' needs: a soy farmer with a family in a village in sub-Saharan Africa trying to sell his produce in an urban market has different needs from an unmarried rickshaw driver in a Pakistani city. Graham Wright of Microsave argues that as a bare minimum, poor people need a transaction or basic savings account (perhaps with an overdraft attached); deposit accounts for different purposes; a short-term (up to one year) loan for working capital and consumption smoothing, education etc.; a longer term secured loan to facilitate purchase of a large asset such as a house or a vehicle, and a life insurance policy and possibly health, livestock and asset insurance too. This suite of products⁹, matched to a person's life cycle, is illustrated in the figure above.

⁹ For further on the appropriate use of credit and savings, see <http://bit.ly/1hesMX4>

How the Banana Skins results track industry trends

Some Banana Skins come and go, some are hardy perennials. A tabulation of the Top Ten Banana Skins since the survey series began in 2008 shows how risk perceptions change over time, sometimes dramatically – see below.

The first survey, in 2008, was conducted before the full impact of the financial crisis was known. The top concerns were about the institutional strength of MFIs – their management, their governance, their ability to run healthy, growing businesses. Credit risk is barely on the radar screen at No. 10.

The picture changes dramatically in 2009, with the industry in the thick of the financial crisis. Credit risk shoots to the top of the list, closely followed by liquidity risk as fears grip the banking markets. Concerns about institutional strength are still there, but they have been edged out of their high places by more urgent, life-threatening risks.

The world has calmed down a bit by 2011. However, credit risk remains the top concern with overindebtedness frequently mentioned as a cause – although not a specific Banana Skin. The newcomers to the ranking are reputation risk and political interference, reflecting the combined impact of visceral critiques from India and elsewhere, as well as sceptical findings from the ivory towers of academia. The picture becomes clearer in 2012: credit risk concerns dominate with the emergence of overindebtedness as a top issue for the industry. But most of the risks in the Top Ten are institutional: the quality of management and corporate governance, along with related issues of risk management and client management.

The 2014 survey shows that concern about overindebtedness and credit risk has not gone away, despite an improving global economy; in fact it may be getting worse in some places. Again, governance and management remain high level concerns. This cluster of risks has persisted in a high position throughout the series, suggesting that they represent some of the toughest challenges facing the industry.

This year's survey also addresses more far-reaching risks facing the industry: the need for fresh strategies, products, technology and structures, all of which are closely linked to the industry's evolution and survival. But the survey shows up a paucity of strategic thinking in MFIs, and a striking lack of concern about the risk of getting it wrong in key areas such as products and technology. Along with the cluster mentioned above, this could turn out to be another major area of risk for the industry.

Microfinance Banana Skins Top Ten 2008- 2014

2008

Risk in a booming industry

- 1 Management quality
- 2 Corporate governance
- 3 Inappropriate regulation
- 4 Cost control
- 5 Staffing
- 6 Interest rates
- 7 Competition
- 8 Managing technology
- 9 Political interference
- 10 Credit risk

2009

Confronting crisis and change

- 1 Credit risk
- 2 Liquidity
- 3 Macro-economic trends
- 4 Management quality
- 5 Refinancing
- 6 Too little funding
- 7 Corporate governance
- 8 Foreign currency
- 9 Competition
- 10 Political interference

2011

Losing its fairy dust

- 1 Credit risk
- 2 Reputation
- 3 Competition
- 4 Corporate governance
- 5 Political interference
- 6 Inappropriate regulation
- 7 Management quality
- 8 Staffing
- 9 Mission drift
- 10 Unrealisable expectations

2012

Staying relevant

- 1 Overindebtedness
- 2 Corporate governance
- 3 Management quality
- 4 Credit risk
- 5 Political interference
- 6 Quality of risk mgt.
- 7 Client management
- 8 Competition
- 9 Regulation
- 10 Liquidity

2014

Facing reality

- 1 Overindebtedness
- 2 Credit risk
- 3 Competition
- 4 Risk management
- 5 Governance
- 6 Strategy
- 7 Political interference
- 8 Management
- 9 Regulation
- 10 Staffing

Together, these products should deliver:

- *convenience*, which requires proximity to the MFI and user-friendly hours;
- *accessibility*, which means local agents, ATM cards or mobile money to avoid having to deal with crowded branches and complicated forms; and
- *affordability*, which needs to encompass direct as well as indirect or hidden costs (bribes, hidden fees, compulsory savings, etc.).

Despite these needs, financial institutions serving the mass market rarely seem to have the time (or inclination, as some *MBS* respondents have observed) to conduct market research to identify prospective clients' real needs and aspirations. Many rely on so-called "bath-tub product development" – products based on senior management's experience and gut instinct, and rolled out without any pilot testing or consultation. Finding out what clients need is key to successful product design. This is true for all three main product areas: credit, savings and insurance.

Credit

While microenterprise credit has been at the heart of the sector since the beginning, there have been significantly fewer advances beyond that. Its core innovation was the introduction of relatively short-term loans (usually less than a year) with fixed repayments, usually weekly or fortnightly, that include both principal and interest. This has enabled the sector to make small loans at a relatively low cost.

It turns out that such loans are well suited to the cash flows of market traders and some small producers, mainly for funding working capital. They also work for some types of income smoothing, which is why microcredit targeted at enterprises is so commonly used for household expenses. However, such loans are less suited for acquiring larger assets, funding crop inputs, making home improvements, and other activities that can benefit from appropriately-designed credit.

This form of lending often requires components such as initial grace periods and longer terms (along with larger sizes and lower interest rates). Income-smoothing can also help when clients are able to top-up or pay-down their loans depending on changes in their income.

Each of these, and other, areas has seen significant innovation by many MFIs, but in the aggregate, they remain subordinated to microcredit loans. Without embracing and effectively serving these broader needs, MFIs will remain relegated to the relatively limited segment of traders and small producers that comprise the world's poor.

Savings

Access to savings products is as important to clients as credit. First, so long as savings are secure and accessible, they are essentially risk-free to the client. They are also a much cheaper way to smooth expenditure than borrowing.

Despite this, only 25% of adults in lower income countries have a formal savings account (in high-income countries, the figure is 89%).¹⁰ The number of depositors reported to the MIX rose from 37m with \$11.9bn saved in 2005 to 86m with \$71bn in 2011 (although many accounts are dormant). As CGAP has outlined in its extensive work on the subject, most poor people use informal ways to save: putting it under the proverbial mattress, participating in savings clubs, investing in livestock or saving with family. A lot of the time, there is a risk of loss, theft or depreciation.

Though small deposits may entail significant operating costs to MFIs, they also have a number of advantages. They are an important means of strengthening client relationships, and in competitive markets they may prove an important way of retaining clients and cross-selling profitable products, such as money transfers and insurance. Clients who save also make less risky borrowers. And although small savings rarely raise enough funding on their

Microinsurance: reducing cost and reaching scale

To reach new markets, microinsurance will need to continue to innovate on:

- controls (paring the long list of exclusions and requirements for claims settlement);
- marketing (building trust and conveying information in a way that gets through to a low income market);
- agents (traditional agents are not effective in selling microinsurance);
- policy documents (making them easier to understand for clients with low literacy);
- product features (making them adaptable to the needs of the market);
- understanding the market, its segments and clients, and their needs; and
- delivery (getting products out to millions of people efficiently and effectively).

own, the infrastructure supporting them can be leveraged to draw in large deposits. Together, they can provide a strong foundation of local deposits that reduces dependence on banks and foreign lenders, while eliminating foreign currency risk.

Insurance

Poor clients are susceptible to shocks, and the consequences of them are greater. Billions of poor people – even those who have recently escaped poverty – live on the edge of disaster. A single major shock, such as serious illness or death of a breadwinner could push a family into complete destitution. And while saving for the unexpected is a useful and common practice, it is rarely sufficient to cover major shocks.

While microfinance has come to encompass both credit and savings for many MFIs, insurance for the underserved (or ‘microinsurance’) remains the least developed part of the

¹⁰ World Bank Findex, 2011

financial product suite. It is also harder to deliver. Providers have found it difficult to offer insurance beyond credit life (which pays off the insured's loan in the event of death).

Despite coming late to the sector, the microinsurance sector has evolved dramatically in the last decade. Health, funeral and crop insurance are being offered in many countries. Index-based insurance pushes down costs. Alternative delivery channels such as mobile network operators (MNOs) are being deployed. Education about the importance of being insured is proliferating. While microinsurance is in some ways the hardest product to offer, it can provide potentially the biggest reward for clients and institutions alike.

Responsible Finance & Social Performance Management: doing good while doing well

One of the features of the recent phase of microfinance has been the growth of public concern about “mission drift”, the risk that MFIs might be drawn away from their social purpose into more profit-led enterprises. Driven by this and concerns that microfinance (both non- and for-profit) might sometimes harm clients, a number of initiatives have been launched to strengthen and measure MFIs’ social performance. The emergence of these frameworks, collectively known as Social Performance Management (SPM), has been one of the most important developments of the past decade.

While some of these efforts date back to early 2000s (the CERISE social audit tool was first created in 2001), the majority of them have come about since 2007 and have involved a number of initiatives covering the work of both MFIs and investors. At heart, they seek to balance reporting on financial metrics, so as to put the social returns of double-bottom line institutions on a more equal footing. Nearly all propose a number of indicators that MFIs and others could adopt in order to better monitor their social return.

Though the number of such initiatives may appear burdensome, they are largely complementary. MFTransparency sets out standards for disclosure of interest rates, while the Smart Campaign’s Client Protection Principles set out a basic list of do-no-harm standards (including MFTransparency-based interest rate disclosures). The UN-PRI’s Principles for Investors in Inclusive Finance (PIIF) largely incorporate these two initiatives, but in a manner that is appropriate to investors.

Other initiatives go beyond the do-no-harm standard, seeking to measure social return itself. The Universal Standards for Social Performance Management spell out a set of metrics that socially-motivated MFIs may seek to measure, while the Truelift Pro-Poor Seal of Excellence provides outside recognition for MFIs that demonstrate verified commitment to social objectives.

Many of these efforts have been supported by specialized microfinance ratings agencies, which have participated in the formulation of social performance standards and conducted

independent assessments and social ratings of MFIs. Social reporting has also been added to the sector’s primary MFI reporting portal, the MIX Market.

SPM has its supporters and critics. In only a few years it has become enormously influential, affecting regulators, investors, donors, practitioners, and ultimately clients. But the proliferation of standards, reporting requirements and ratings risks becoming a burden – particularly on smaller institutions. If social compliance by these institutions comes at the expense of other goals such as better management and service, SPM risks winning a pyrrhic victory.

Technology’s promise

The two biggest obstacles to reaching underserved members of the population, particularly in remote areas, are cost and access. Since 2007, some of the most exciting developments in microfinance have been those which promise to reduce, even overcome, these obstacles using new technology and delivery channels.

One of these is mobile money: the use of mobile phones to transfer funds and make payments. As of June 2013, 219 services were operating in 84 countries¹¹ with 61m accounts, up from 37m a year before. By the end of the decade, 300m Africans are expected to have a smart phone. The development of M-banking, market/value chain applications, biometric ID, agent models, Point of Sale devices and Near Field Communication, 3G Internet outreach and the affordability of cloud-based MIS for even small institutions will provide opportunities for cost reduction and outreach which were unthinkable only a few years ago.

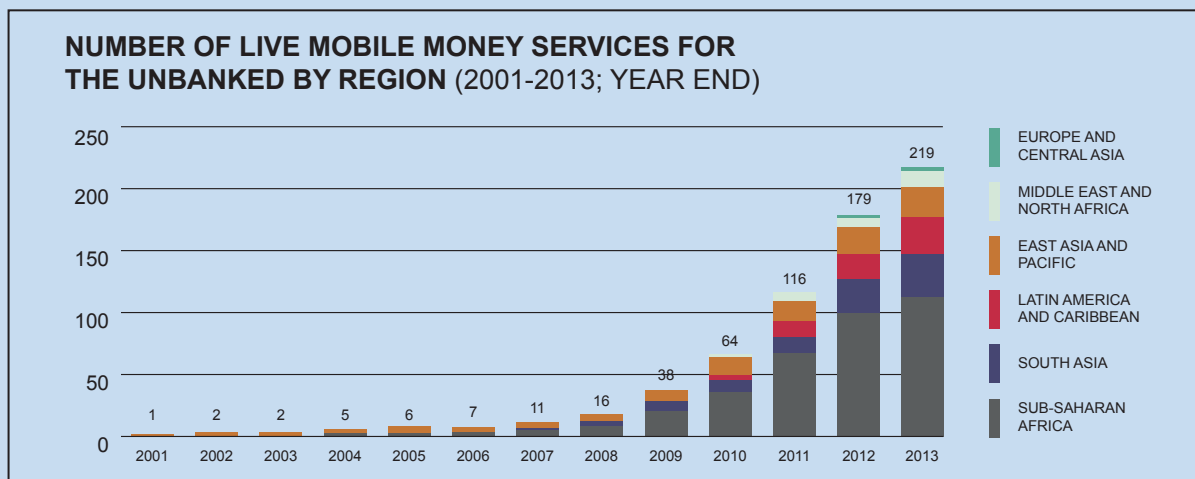


Fig 2: Ledgerwood, 2013: The New Microfinance Handbook

At the end of 2013, nine markets (Cameroon, the DRC, Gabon, Kenya, Madagascar, Tanzania, Uganda, Zambia and Zimbabwe) already had more mobile money accounts than

¹¹ GSMA, Mobile Money for the Unbanked programme, 2013 state of the industry report (Feb. 2014) <http://bit.ly/1kh9em2>

bank accounts, compared to just four markets the year before¹². According to the GSMA, the trade body of the mobile phone industry, as of June 2013, 53,000 merchants were accepting payments via mobile money and 16,000 organisations use mobile money as a payment platform for accepting bill payments or making salary payments¹³.

Mobile technology offers more than payments, for example remittances which, according to World Bank estimates, amounted to \$514bn in 2012, and could be double that after including informal mechanisms such as *Hawala*. Migrant workers send home US\$450bn a year to their families in developing countries – five times official ODA, and over the next five years these could total more than US\$2.5tr. Most of this goes to urban areas, but the greatest impact is in rural areas which receive some 40 percent of the total.

Bill payment and airtime top-up rank alongside bulk payment and merchant payment as new mobile opportunities. Insurers are joining up with MNOs such as Tigo in Ghana and MTN in Kenya to offer free credit life policies as part of PAYG mobile products.

But promising though these new technologies may be for reaching the underserved in a sustainable way, they also present their challenges. It will take an enormous joint effort by practitioners, investors, and support providers to exploit them successfully and avoid the risks, for example of further depersonalising the client relationship, or even of making financial services – especially credit – too easy to obtain. Regulators will also have to create frameworks which support pro-poor banking, and these are very different from bricks-and-mortar branching. The Better than Cash Alliance (www.betterthancash.org) was launched by several governments, NGOs, foundations, payments platforms and financial institutions in October 2011 with the objective of making “the transition from cash to digital payments to achieve the shared goals of empowering people and growing emerging economies”.

Investment in microfinance

The structure of investment in microfinance has been another important area of change.

Although the microfinance industry funds itself largely from local sources, foreign funding has long been vital to its development. In the early days, this was dominated by grants, guarantees and debt from public and non-profit entities. This has continued. But with awareness generated by Yunus’ Nobel Prize and the UN’s Year of Microcredit, the sector also saw the emergence of a new source of funding: social investors seeking to make a difference to poor people’s lives while generating commercially competitive returns. These investors continue to play a dominant role in MFI development, even as their importance to the MFI funding mix has decreased.

The primary channels for social investors are Microfinance Investment Vehicles (MIVs) – investment funds dedicated to microfinance run by specialised managers using traditional investing expertise adapted to the needs of MFIs. The first of these MIVs were launched in

¹²The New Microfinance Handbook 2013

¹³<http://bit.ly/1kh9em2>

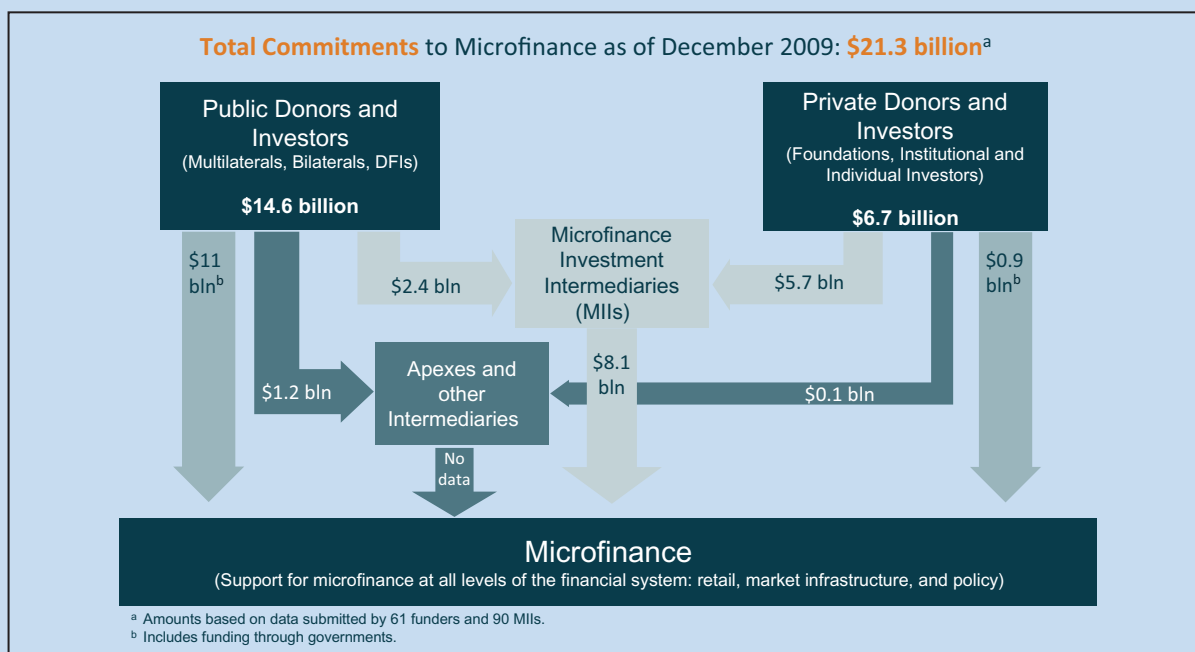


Fig 3: Source: El-Zogbi, 2011

the early 2000s, but 2006-07 saw an explosion of commercial funding in the sector. According to the annual MicroRate survey, MIV investment grew by 350% in those two years and then doubled again over the next five. Throughout the period, the share of investment intermediary investing (mostly from MIVs) remained high, and was responsible for channelling nearly 40% of all cross-border funding in microfinance in 2009.

Although MIVs are able to invest in NGOs, their natural preference is for “investment-ready” MFIs, which usually means commercial entities: banks and non-bank financial institutions (NBFIs). Unsurprisingly, the growth of MIVs paralleled the trend towards commercialisation of microfinance, with fast-growing, profitable MFIs becoming the most popular recipients of such funding.

The need to invest in rapidly-growing funds in countries and institutions able to receive them has also led to significant concentration of investments, especially at the country level. In 2010, 60% of foreign investment (including MIVs) went to just 10 countries which were selected more for their investment climate than the level of financial exclusion: nearly all were middle-income countries, with a combined population of 100 million.¹⁴ Two of the largest recipients – Nicaragua and Bosnia & Herzegovina – also subsequently became primary “crisis” countries, provoking comment that social investment vehicles were creating overcapacity and undermining the stability of the very markets in which they invested.

Despite the growth of MIVs, the flow of cross-border funding continues to be dominated by public sector investors, especially development finance institutions (DFIs) who provided nearly 75% of all such investment in 2012.¹⁵ A significant proportion of their money comes through MIVs, which are better equipped to find and manage small investments. In addition,

¹⁴ Reille et al. “Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns”

¹⁵ Calculations based on CGAP (<http://www.cgap.org/data/trends-international-funding-financial-inclusion>)

DFIs channel a substantial portion of their investments through holding companies, which invest primarily in greenfield institutions which are often located in less established markets and, unlike most MFIs, operate as fully licensed banks from the start.

It is certainly the case that MFIs' ability to tap deposits has reduced their dependence on foreign lenders for funding. However, locally-based investors in both debt and equity, such as banks and investment funds, have also grown substantially, and in a number of markets, pose a major competitive challenge to traditional microfinance investors. Meanwhile, more socially-oriented funding through crowdfunding platforms, high net worth individuals and institutional grants continues to contribute a small but steady share of funding too.

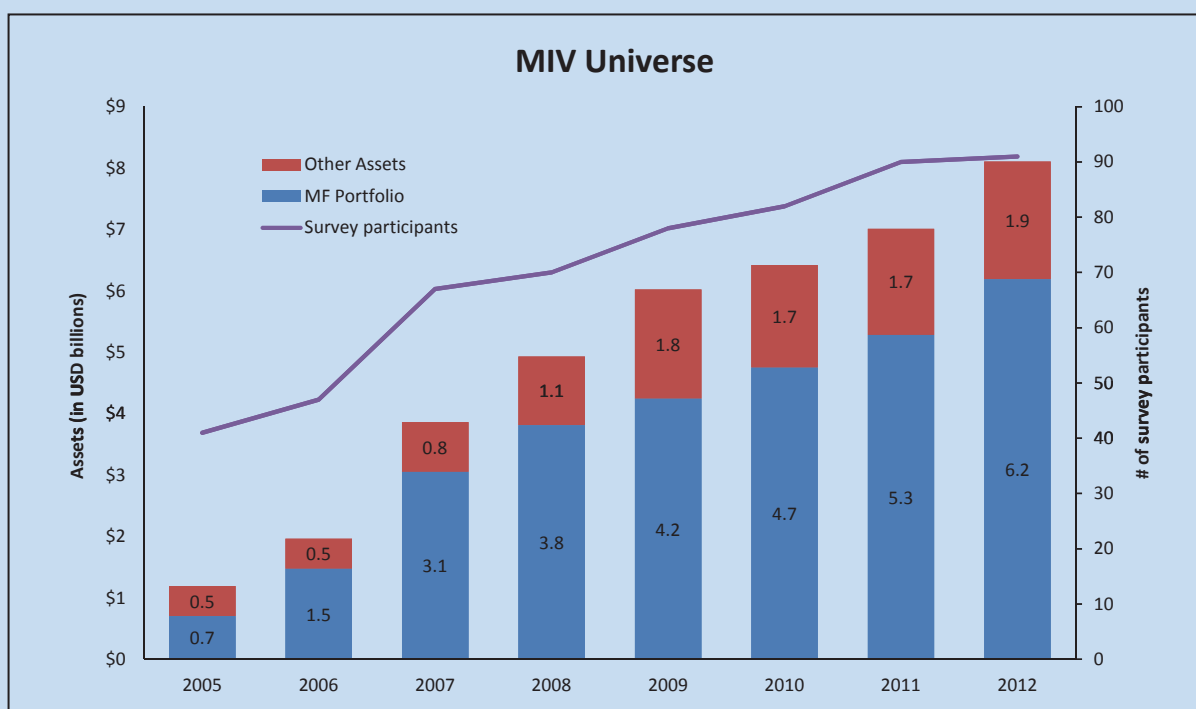


Fig 4: Source: MicroRate MIV Survey 2013

The way ahead

As we argued at the outset, microfinance is an industry in flux. It's criticised for what many see as its questionable, even negative record on poverty alleviation, and is apparently unable to forcefully defend its achievements or articulate a clear future for itself in a fast-changing world. Much of the current discourse around it is about new objectives such as financial inclusion and impact investing, leaving traditional microlending looking very much like "yesterday's news".

But microfinance is still here, and demand for what it offers – the chance for poor people to get on the financial ladder – remains huge. Reaching these people requires strategies which identify and respond to what the market wants, exploit new opportunities (mobile technology, for example, among many), and run sound and efficient businesses which are able to serve the needs of clients who have thus far been bypassed.

There are immense challenges ahead. Regulation has to be appropriate without stifling innovation and growth. Overheating markets must be recognised before they slide into repayment crises, but market forces have to be allowed to work. Savings must be recognised as crucial to clients, but need to be delivered while maintaining profitability. Insurance innovation must be encouraged, but it needs massive scale to work.

Affordable funding must continue to flow into the industry, but with better signals for recognising when it may be too much or too concentrated. Similarly, donor and grant funding should target new markets and segments that cannot yet support fully commercial activity.

Technology is the great emancipator, and can do what microfinance always needed: reduce the costs of providing service, with higher quality services provided profitably and more cheaply to a broader range of clients. But not to the extent that they again bypass the needs of clients.

New service providers and platforms, such as insurance companies, MNOs, commercial banks, specialised lenders, retailers and mobile money have expanded microfinance beyond the traditional MFI. But they must remain mindful that providing services to the poor and vulnerable carries with it particular responsibilities.

Who would undertake such an apparently Sisyphean task? We recognise the size of the challenges. But there is innovation everywhere, and the lessons from the hubristic early decades of microfinance have probably been learned. What's left now that the smoke has cleared is an industry focused on how to roll out quality, demand-led financial services to the underserved from larger, commercial providers; Doing No Harm of course, but less myopically driven to Do Good.

What will this look like in the years ahead? Perhaps the need to take advantage of (by then) more established alternative delivery channels will have been subsumed by a preoccupation with the consequences of ever-increasing commercialisation: fewer, larger providers, less focus on social mission, higher staffing standards and needs. The effects of climate change may start to be particularly felt in some key microfinance markets. It's foreseeable too that regulators in other markets which suffer credit crises will react with interest rate and margin caps, scaring away the remaining investors from microfinance and towards 'impact investment' and vogueish social investment opportunities.

The decreasing cost of cloud-based IT systems, Point of Contact and other mobile technologies and cheaper connectivity will help smaller providers better manage their portfolios and compliance requirements, while remaining competitive in the face of increasingly consolidated Tier 1 MFIs, as well as commercial banks and alternative service providers such as MNOs. Some of these smaller providers will find niches where they can leverage technology and field presence to reach new segments that remain unserved. Those who don't will fade away.

Finally, overindebtedness has been the highest risk in the past two Banana Skins reports. It is an “inherent” risk, and one which is both driven by competition (via bad lending practices) and which drives others (credit risk, reputation and funding). It’s likely to remain a high concern for some time – and it may well be that *Microfinance Banana Skins 2019* still includes it as *the* top risk. This largely depends on how well institutions build their understanding of clients and are able to leverage credit bureaus, which will be increasingly widely available.

But these market tools by themselves are no panacea. Over the past decade, we’ve seen overlending on a massive scale to consumers in the world’s most developed economies, despite their strong regulators, credit bureaus, risk management systems, and all the other standard responses for strengthening microfinance.

It was not always thus. Following the New Deal regulation in the US in the 1930s, the banking sector saw extraordinary stability lasting into the mid-1980s. Overlending was a low risk. Starting in the early 1980s, deregulation in the US and UK ended this. Since then, financial crises have become more frequent and more severe.

While developed economies struggle to enact needed regulation, countries with active microfinance markets will probably continue to lag behind, especially because they have the additional burden of balancing the need for stability with the desire to increase financial inclusion.

Given this context, we find it difficult to imagine that the risk of overindebtedness – with its tendency to spill over into regulation, funding, and other perennial risks – can be eradicated any time soon.

The primary chain of risks for microfinance is that credit risk and high overindebtedness make markets increasingly sensitive to adverse macroeconomic conditions and other external shocks. The combination of these factors can lead to repeated market failures and a deteriorating reputation of the industry (both as a social intervention and a commercial investment) which can have the double impact of government interference at a local level and investors fleeing – leaving an industry which cannot survive or thrive.

We see the risk of this chain reaction becoming significantly reduced, while the downside risks can be made less severe on both clients and institutions. The warning signs of overindebtedness are becoming better understood, and having this risk at the front of the minds of so many makes it less likely that the sector will race over the proverbial cliff. Instead, steps are being taken to reduce the likelihood of extreme crisis, as well as mitigate the effects of a downturn, including via stronger client protection measures.

We are witnessing exactly this process in Peru right now, where the signs of high credit risk and overindebtedness are very strong, but the reaction of both government and investors has

been towards stabilising the market, rather than upending it entirely. Likewise, client protection requirements, including limits on collection methods, have mitigated the impact on clients.

So overindebtedness may remain a spectre hanging over the industry's head for the long term, but it is less of an existential risk that it was just a few years ago. Despite dealing with serious threats, the past several years since the first *Banana Skins* report has revealed an industry which can still learn, innovate and adapt.

Western Europe

For West European respondents, the greatest risk facing the microfinance industry is overindebtedness and its financial and reputational fall-out. Daniel Schriber, director, investment operations at Symbiotics in Switzerland, said that “growth has been globally strong and well managed in most regions over the past few years. Regulation has improved in most countries. However, risks linked to over-indebtedness in some countries remain and as such I continue to think that this is the largest risk microfinance is facing in the coming years.”

Respondents linked these risks to intense competition in many markets driving MFIs to take greater lending risks, and to weakness in internal governance and controls. A respondent from a leading investment firm was concerned that there had been “no real progress in the improvement of governance and good practices”. On the risk management front, there was concern that improvement was proving slow. A senior executive at an investment fund said that “there is a need for the industry to more widely embrace the best practice risk techniques of the banking sector.”

1	Overindebtedness	7.3
2	Governance	7.2
3	Competition	7.1
4	Regulation	6.9
5	Political interference	6.9
6	Risk management	6.8
7	Strategy	6.7
8	Credit risk	6.7
9	Staffing	6.4
10	Macro-economic risk	6.4
11	Management	6.3
12	Income volatility	6.2
13	Product risk	6.2
14	Financial capability	6.1
15	Client relationships	5.8
16	Technology management	5.8
17	Funding	5.7
18	Transparency of objectives	5.6
19	Liquidity	5.4

Competition is driving greater risk taking

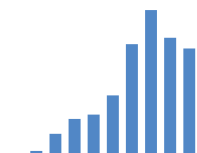
Respondents from this region also saw microfinance as vulnerable to action - or non-action - by the authorities. The ability of regulation to make things worse is seen to be high, either because it fails to provide a healthy operating environment, or its motivation is questionable, particularly in politically charged markets. Maria Teresa Zappia, chief investment officer at BlueOrchard Finance in Switzerland, said that “regulatory issues seem to be more and more a challenge that microfinance providers need to be ready to deal with. Changes in regulation may happen overnight (e.g. interest rate caps, restrictions on local currency hedging, on short-medium term money inflows from abroad) and MFIs are often not prepared to react smoothly.” Although the political heat around microfinance has abated, one respondent said that “it can arise quickly as the sector is naturally easily politicised”.

The high place (No. 7) given to strategy risk reflects the feeling among many European respondents that the microfinance industry is not giving enough thought to its future in increasingly difficult times. Emmanuelle Javoy, a microfinance expert in France, said that MFIs had reached a size where they needed to “defend their specificities/necessities/results/ etc. in a convincing way”. But their failure to do so meant that “microfinance is essentially at risk of being fully diluted in the classic banking sector without having brought significant/meaningful changes to the way banks operate.”

The Banana Skins



1. Overindebtedness: The risk that clients will borrow beyond their capacity to repay.



Score: 7.5⁴
Previous position: 1

“Overindebtedness, again and again,” said Frank Abate, executive director of the Fundación Dominicana de Desarrollo in the Dominican Republic, summarising the dominant risk theme of this report – and repeating the message of the previous Banana Skins report in 2012 when overindebtedness also ranked as the top concern and contributed to a major credibility crisis in the industry.

The perception that overindebtedness is the top risk is widespread. It came No. 1 in all geographic regions save two: South Asia (where it came No. 2) and Sub-Saharan Africa (No. 3). The most concerned region was Latin America where a number of countries have serious debt problems (see box). Respondents of every type ranked it No. 1 except regulators who put it at No. 5.

Some MFIs are 'going overboard' with their lending activities

Who worries most?	
Rating of overindebtedness risk by region (out of 10)	
Latin America	8.4
East Asia/Pacific	8.0
Middle East/North Africa	7.8
North America	7.7
Eastern Europe/Central Asia	7.5
Western Europe	7.3
Africa	7.0
South Asia	6.9

The risk of overindebtedness was head and shoulders above the rest with 57% of respondents scoring it at least 8 on a 10-point scale. More than a third of respondents (36%) who provided unprompted comments mentioned overindebtedness specifically.

If there is a theme behind overindebtedness it is the growth of competition with which it has a 50 per cent correlation. This is likely to continue because of the heavy inflow of funds into this market, and the strong interest shown by non-microfinance institutions in acquiring a share of the business – but on commercial rather than socially-driven terms. According to one US-based observer, “competitive pressures to grow portfolios

and institutions have forced some MFIs to go overboard with their lending activities.”

Chuck Waterfield of Microfinance Transparency worried that “short-term profit seeking, growth for growth's sake, inability to resist overindebting people, and the frequent habit of charging very high, non-transparent prices, all risk converging to create a massive crisis in country after country, destroying what remains of the

⁴ The mini chart at the head of each section shows the score distribution on a scale of 1-10. “Score” is the average score of the risk out of ten. “Previous position” shows the position of this risk in the last Banana Skins survey in 2012.

Is overindebtedness just a legacy of the bad old days?

image that the goal of microfinance is to help the poor.” Larry Reed from the Microcredit Summit saw more ominous possibilities. “We’ve had collapses in Morocco, Bosnia, Nicaragua, Pakistan and India. Now there is talk about Peru and Mexico being next. How many more of these will we need to go through before we learn how to prevent them?”

Powerful though these numbers and comments are, they represent perceptions rather than realities and can therefore be challenged. But perceptions on this scale are hard to dismiss, particularly since the overindebtedness problem touches so many issues surrounding microfinance: apart from competition, they include client-level risks such as income volatility (53%) and financial capability (47%). It also has a highly damaging impact on reputation which triggers other risks such as political backlash and public anger. In the microfinance community itself, it can foster disillusion and dismay.

For some respondents, overindebtedness is a legacy from the bad old days which will eventually wash through. Therefore, while the potential for losses is still large and worthy of concern, the risk is on a downward path. Remedial action is also progressing: a growing number of credit bureaux are making over-borrowing easier to identify, regulation of the industry is growing, risk management practices are improving, and economic conditions in many parts of the world are healthier. Progress in all these areas is uneven and, as one respondent put it, “glacially slow”, but it is happening.

For these and other reasons, a significant number (39%) of respondents saw the risk as moderate (score of 4-7). Christian Etzensperger of responsAbility, a Swiss fund manager, said that overindebtedness is “a perennial risk in microfinance, but service providers should by now have understood it and have appropriate underwriting standards in place.” A consultant from North America saw improvement, noting that the “SMART Campaign ... [is] raising awareness in this area.” Similarly, Rashmi Singh of SKS Microfinance, India’s largest MFI, said that the “use of the credit bureau by most MFIs in India has reduced the risk of [client] overindebtedness”. However, only a few respondents were dismissive of this risk: only two scored it as 2, and none scored it as 1.



2. Credit risk: The risk that poor lending practices will lead to loan losses

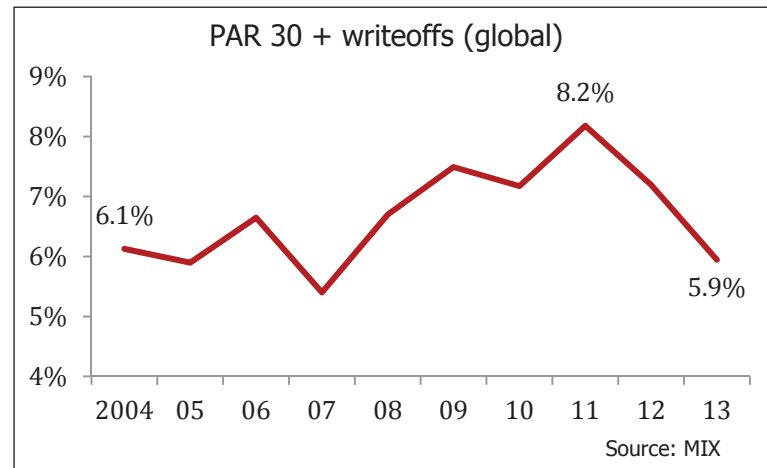


Although the specific problem of overindebtedness heads the list of risks in this survey, the more fundamental issue of credit risk is not far behind.

This risk has edged up the rankings for a number of reasons. One is the slippage that people see in MFIs’ lending standards as they confront growing business pressures: competition, pricing, staffing difficulties and inadequate market information. Of these, rising competition, particularly from financially powerful new entrants, was

The debt puzzle

Although overindebtedness emerges from this survey as by far the largest risk concern in microfinance, it comes at a time when the sector's bad debt experience seems to be improving. According to the Microfinance Information eXchange (MIX), bad loans have been declining in all regions except Africa in the last two years. How can this be?



There are a number of possible explanations. One is that bad debts are not the same as overindebtedness: people can remain overindebted without defaulting on their loans. Overindebtedness becomes a problem when it is exposed by a crisis, as happened in the US sub-prime market in 2007, and in India in 2011. On the present outlook, a major global debt-induced crisis in microfinance seems unlikely, but if it did occur, the financial and reputational shock could be severe. Just how severe is hard to say because there are no reliable statistics on the level of overindebtedness in microfinance markets.

Another explanation is that this survey is about perceptions rather than numbers. People perceive overindebtedness to be a big problem even though that may not be the case statistically. However this still makes it a problem: perceptions influence behaviour and decisions, and affect reputations.

A third explanation could be that people are confusing overindebtedness with multiple borrowing. People who take out several loans with different lenders may not be overindebted, though it is likely that they are.

A fourth is that overindebtedness is confined to specific markets, as is the case, but has a generalised impact which means that the true scale of the problem needs to be measured more closely.

A final explanation is that MFIs may be concealing the size of their bad debt problems, or rolling over doubtful loans in order to prevent them showing up as bad. This would mean there is an accounting issue.

often identified as the chief culprit. Jessie Greene, senior investment officer at Développement international Desjardins in Canada, said that “new entrants in the microlending segment...don't adhere to best practice, lending large amounts without the necessary procedures.”

A particular concern is multiple borrowing, usually a symptom of sloppy lending practices plus the absence of market information such as credit bureaux to identify the over-borrowed. Many respondents focused specifically on internal control issues at MFIs, such as the deleterious effect of competitive pressure on credit procedures and pricing, and low staff quality. A respondent from Guatemala said that “credit culture has deteriorated: there is no responsibility to [make] good loans...”

Linked to this is the issue of client relationships: these may be deteriorating as loan officers strive to reach lending targets rather than help their customers, or as automated loan procedures take over from human judgment. Frank Streppel, deputy managing director of Triodos Bank in the Netherlands, said there was an “increasing push for process-oriented credit delivery rather than one based on a client relationship”.

Others believed the problem arose when MF providers moved into new markets to sustain their growth, notably consumer finance where demand was strong and access easier, but where credit quality was often lower. A development bank respondent from the Philippines said that “the risk here is the confusion of enterprise finance with consumer finance, which has proven to be a higher credit risk and detrimental for borrowers”.

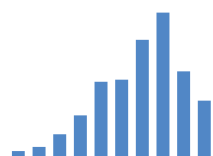
However not everyone shared a gloomy view of the credit outlook. The chief financial officer of a large international investment fund said that “credit is always a risk if sound lending practices are not followed. However, it is one that is capable of being mitigated by good practices.” and a development officer in the Philippines said “With better understanding, this risk is starting to decrease.”

Credit risk was most strongly correlated with weakness in MFIs’ management and controls, i.e. risk management (48%), management (43%) and governance (42%). It was also linked to the quality of the MFIs’ client relationships (41%).

Is the client relationship weakening?



3. Competition: The risk that the growth of competition from existing providers and new entrants will cause microfinance service providers to compromise their business and ethical standards



Score: 6.9
Previous position: 8

Concern about the growth of competition in the microfinance market is showing a resurgence, mainly because there is more of it due to the rapid enlargement of lending capacity. People see it undermining credit practices, squeezing margins and eroding ethical standards in an industry where ethics matter.

The growth of competition stems mainly from the entry of new institutions into the microfinance market, many of them commercial banks seeking a share of the action, but also non-banks such as telecom companies with mobile payment systems, and finance companies offering consumer loans. The fact that many of them are not regulated as banks, or don't stick to industry rules, makes this competition "unfair" in people's eyes.

Luis Miguel Diaz-Llaneza, chief financial officer of Financiera Independencia in Mexico, said that microfinance in his country "faces a strong challenge in oversupply and bad practices introduced in the last couple of years. Many small and new entrant participants are eager to carve a market share for themselves, and are unfortunately willing to forego basic risk reduction practices, affecting not only their risk profile, but that of the entire industry."

In India, Dr N. Jeyaseelan, chief executive officer of Hand in Hand, said that "competition has started in many markets and we can see the dilution of due diligence standards". For many respondents, excessive competition lay behind the problem of overindebtedness. This survey's results showed a correlation of 50% between the two.

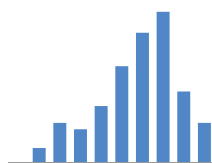
The level of concern about competition varies greatly from one market to another. It is strong in Eastern Europe and Central Asia, for example, where it ranks No. 2, and in Latin America (No. 3), but lower in the Middle East and Africa (both No. 8). It is also more prevalent in urban areas where there is a larger concentration of potential business than in rural areas.

It is also a high concern for investors in microfinance (No. 2) and the MFIs themselves (No. 3) but less so for outside observers, many of whom said that competition was a good thing. A UK microfinance consultant said that "sometimes new entrants bring credibility or industry bargaining power with the regulator, or innovation. They may also exacerbate competition for the same clients; bringing down margins and rates is still beneficial from a macro point of view!" Some also said that commercial entities did not automatically have to be unethical: "the two concepts are not mutually exclusive!" one of them said.

Oversupply is leading to bad practices



4. Risk management: The risk that microfinance service providers will fail to identify and manage the risks in their business



Score 6.8
Previous position: 6

Although much emphasis has been placed on strengthening risk management in microfinance institutions in recent years, this is still an area of concern, for two reasons. One is that progress has been slow. The other is more worrying: that risks may be multiplying faster than the industry's ability to keep up with them. One African respondent said that "increasing complexity may outpace the level of risk management competences in the sector."

'Still a weak understanding of what risk management is about'

Respondents identified several strands to this risk. One was a poor grasp of the importance of risk management in the industry. As a respondent said: “Many MFIs engage in risk management efforts due in part to pressures they face from regulators or investors rather than from a deep appreciation of risk management and the social and financial value it can bring to an institution.”

Another was whether, at the practical level, adequate systems were being put in place to manage risk. A respondent from Kenya said that “most MFIs are faced with serious problems installing internal control systems, and they have no measures of assessing the institutional and business risks that are inherent in their operations.”

Evidence of the failings of risk management lies most obviously in the growth of overindebtedness which suggests that credit risk controls are ineffective or being bypassed. But, as a number of respondents pointed out, risk management also needs to be applied beyond traditional credit risk into the areas of operational, financial, product and even reputational risk. A microfinancier in Guatemala said that “there is still a weak understanding among all the staff of financial institutions of what integrated risk management is about...”

As innovation, competition and growth take MF providers into new and unfamiliar territory, risk management practices have constantly to evolve. A respondent from a US NGO said that “the microfinance industry has changed significantly in the last several years, becoming more competitive in several markets, with more diverse customer segments and increasing regulatory requirements. The smaller, weaker institutions may not have the resources to evolve with the market or respond to the regulatory requirements. Specifically, some institutions may attempt to move 'up market' without sufficient grounding in risk management and new product development to control the additional risk they may be taking on.”

Concern about risk management was fairly evenly spread among the geographical regions and respondent types. It correlated closely with the quality of governance (56%) and management more generally (54%).

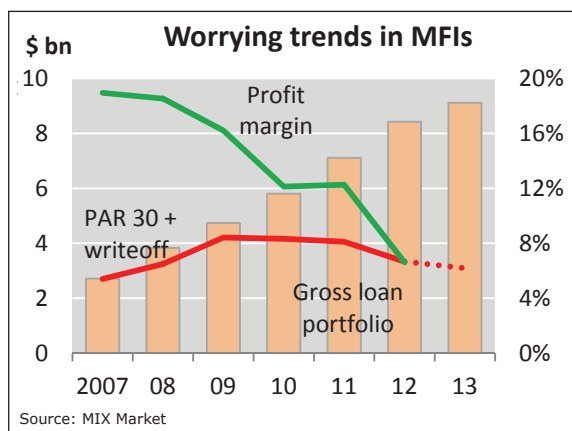
A number of respondents, however, came up with a more positive message: awareness of the importance of risk management is growing, systems are being built, risk mitigants such as credit bureaux are spreading, and greater professionalism is being applied. A respondent from Mexico said that “risk management is a new theme for the popular financial intermediaries in the country and is one of the most important areas for improvement.”

Peru under stress

The country that stands out on risk is Peru. Respondents there gave credit risk an average score of 9.5 out of 10, far higher than the global average of 6.9.

The top risks identified by these eight respondents are all closely linked to portfolio performance in the country's microfinance service providers. In the free comment section, six of them mentioned overindebtedness as a risk, most often as the top risk. Their comments referred to "narrow operating margins, especially in saturated markets," "inadequate regulation of banks affiliated with [consumer] retailers," "inadequate consumer protection," and "excessive growth expectations by some managers."

How Peru scored		
	Peru	World
1 Credit risk	9.5	6.9
2 Overindebtedness	9.0	7.5
3 Client relationships	8.4	6.1
4 Risk management	8.3	6.8
5 Strategy	8.1	6.7



The context for these findings is noteworthy because Peru was ranked at the top of the scale by the Microscope index of microfinance business environment for six years in a row.⁵ Its MFIs are well-developed, many having full banking licences and large deposits. They are also well-regulated, featuring mandatory ratings and a reliable credit bureau. However, performance

trends during that time have been poor: bad loans increased, profit margins shrank. In 2013, perhaps in response to these pressures, the country's MFIs slowed their growth to single-digits.

A symptom of the sector's malaise is the recent sale of MiBanco, the country's largest MFI. Beset by internal liquidity problems, MiBanco's main shareholder ACP, put it up for sale in a bid to raise cash. Unfortunately, MiBanco's own subpar performance – high credit losses resulting in (slightly) negative returns in 2012 and full recovery not expected until 2015⁶ – dampened excitement among potential buyers. Its sale valuation was nearly half that commanded by other Peru MFIs in the recent past,⁷ and not only because of MiBanco's immediate problems. When such a well-known brand commands so little premium, it's a sign that investors are less bullish on the sector itself.

Peru is the world's largest microfinance market by assets⁸, and also its largest for foreign investment⁹. Put together, the situation in the country is worrying. Yet there are also signs of hope. The sector's highly ranked infrastructure and regulation may yet prove their worth in averting a crisis.

⁵ <http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=38098109>

⁶ Fitch Ratings Press release, October 1 2013.

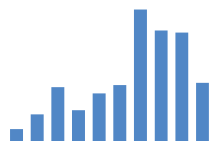
⁷ MiBanco was sold to Edyficar for 1.3x its book value. By comparison, when Edyficar itself was sold in 2009, its valuation was nearly twice that – 2.5x book value.

⁸ MIX 2012 data

⁹ Microrate MIV survey 2013



5. Governance: The risk that the boards of microfinance providers will fail to provide the necessary oversight and strategic direction



Score: 6.7

Previous position: 2

'Still room for improvement' in governance

Board-level risk has always been a high Banana Skin in the six years we have been running these surveys, and it persists in this latest one. Governance is a concern in two ways: whether people at the top of MFIs are up to the job, and whether boards have what it takes to lead their institutions forward in increasingly difficult times. The head of strategy at a large global network said that there was “significant room for continued improvement in board skills and knowledge”.

On board quality, the concerns were familiar from previous surveys and included insufficient knowledge and experience among board members, poor training, lack of independence, failure to stand up to strong executives or charismatic founders etc.. But respondents are now seeing additional risks as microfinance becomes more competitive: poor understanding of the structural changes taking place in the industry, pressure to compromise the institution’s social mission in order to sustain growth, uncertainty about strategic direction, and failure to grasp the essentials of risk management.

Andrew Pospelovsky, a non-executive director of AccessBank in Tajikistan, said that “historically MFIs have relied on volunteer board members; the industry is becoming more complicated and requires professional boards.”

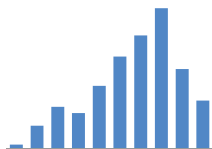
The need for more strategic thinking and foresight at board level was also stressed by respondents. Philip Brown, managing director of microfinance risk at Citi UK, said that boards “are no longer overseers but have to be more strategic and risk management focussed.” From Bangladesh, Fazlul Hoque, associate director of Sajida Foundation, said that “not the least challenge [is] to develop the manager/leader who could take the social mission of NGOs forward”.

A number of respondents felt that governance was improving with better people and more responsibility. If there were difficulties, they tended to be localised or confined to particular sectors, like the co-operatives. Alejandro Puente, director of external relation at Genera in Mexico, said that “leading institutions increasingly have more professionalized structures”.

Governance was seen to be a high level risk among all respondent types except the MFIs themselves (who ranked it No. 13) which may carry a message about the need for greater attention to this area. Geographically, concern was strongest in investor and network regions (e.g. North America and West Europe) and lowest in practitioner regions (e.g. East Europe and Central Asia and Latin America) with the exception of Africa where it ranked No. 2. A bank examiner in West Africa said that “the main risks facing microfinance industry [...] are poor corporate governance at board and management level as well as poor understanding of how to implement a functional microfinance model.”



6. Strategy: The risk that microfinance service providers will fail to provide a service that makes them relevant and competitive in a changing marketplace.



Score: 6.7

Previous position: Not included

For the first time this year, we included a question about strategic risk in the Banana Skins survey, and it emerges high in the ranking.

The reason for listing it as a specific Banana Skin is that we already ask questions about the components of strategic risk: governance, management, competition, product development, funding etc.. But there is a bigger picture question: how important is strategic risk for MF providers in an increasingly complex world?

The main point that emerges from the responses is that MFIs don't give much thought to strategic risk. They are concerned with the day-to-day running of the business, and only occasionally have to make decisions that might be described as strategic: a big investment, the introduction of a new product or technology, a new funding opportunity. As a respondent in Africa said: "Many MFIs are running without strategies. They respond as events unfold."

In the view of many respondents, MFIs without a clear business strategy are putting themselves at risk at a time when the outlook for microfinance has never been more uncertain. A UK consultant said: "The biggest risk is that MFIs fail to capitalise on their core niche in an evolving financial inclusion agenda which is based on a direct personal relationship with clients and an ability to leverage this to create value for clients." Laurie Spengler, president of Enclude in the US, linked strategy to funding risk. A focus on strategic planning and effective execution "will strengthen the ability of MFIs to attract and maintain funding relationships", she said.

'Insufficient thought' given to strategic planning

The sector needs to innovate and take back the initiative of developing new ways to finance the poor ... It seems to prefer riding a wave of soft funding, high margins and slow write-offs believing itself to be on unassailable moral high ground. Microfinance risks becoming simply an alternative method of delivering government and aid subsidies.

Kevin Kennedy
Clearcape, Uganda

As a number of respondents noted, the overriding strategic risk is that MFIs lose their relevance as financial institutions amid the whirlwind of change (see box). Martin Holtmann, global head of microfinance at the International Finance Corporation, said that "while there is generally adequate risk management in the conventional sense of managing credit risk and operational risks, many MFIs are not adequately focusing on (or guarding against) the risk of becoming obsolete".

This was a risk to which observers of the microfinance industry (including strategy consultants) attached a considerably greater weight, placing it No. 2, than practitioners who placed it No. 6.

Yes, but what is microfinance *for*?

The biggest existential risk facing MFIs is that they may no longer have a role to play. Many respondents to this survey saw traditional microfinance being overtaken by change: new entrants, new technologies, different objectives such as “financial inclusion” and “impact investing” - all putting its future at risk.

To address what might be called “obsolescence risk”, MFIs need to be clear about their role. Should they fight to preserve microfinance's special mission, concentrating on the financially excluded, the rural communities, on value-driven services, and live off special funding? Or should they recognise the new realities and try to become more like commercial banks to meet the competition?

As a London-based banker said, microfinance “is diverging into two streams, the larger and more commercial players that ‘get’ broader financial inclusion and carve a leading role, while the smaller organisations do not yet understand the financial inclusion ecosystems in their countries”.

Complexity makes the strategic choices harder. Gil Lacson of Women's World Banking said that “as the sector became an industry, it evolved from simple micro-credit to a more complex commercial microfinance to inclusive finance and soon expanding to inclusive business”. Furthermore, the re-labelling of microfinance players as purveyors of a broader service could make things worse by “leading to dilution of core skills, confusion, lack of focus, as microfinance players aim to cover too much ground without the appropriate skill set”, according to Isabelle Barres, director of the Smart Campaign.

The best of both worlds?

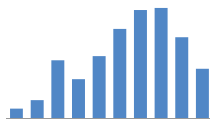
The goal, of course, should be to deliver the best of both worlds. A consultant in Canada thought that “microfinance would benefit from seeing itself as a type of banking and adopt to the extent possible the governance, internal controls and risk management structures of mainstream banks, while of course, adapting these norms to microfinance's typical 'double bottom line'.”

Angus Poston, founder of Bridge in the Philippines said that “rather than defensively justifying their existence, microfinance providers should innovate and expand their ambition, to reach more people through new business models and grow to meet the challenge of the vast numbers of unbanked. Ultimately, success in this innovation will prove that inclusive banking is both commercially viable and demanded.”

Jesse Fripp of Enclude, an advisory firm, saw the MFIs' dilemma as “akin to the old Black & Decker sales adage: ‘Are you selling drills, or are you selling holes?’ In other words, [is the] true focus on the *outcome* of full inclusivity, or the *instrument* of the traditional MFI? As disruptive technology innovations, new business models, and the big data approach drive a ‘mainstreaming’ of market focus, traditional MFIs face a potentially existential crisis if they cannot learn and adapt to new market realities and changing client demands”.



7. Political interference: The risk that intervention by politicians will harm the microfinance sector and distort the market



Score: 6.5
Previous position: 5

Interference by governments and politicians in the microfinance business is a high level risk, but in specific jurisdictions, many of which are well-known. It ranked high in South Asia (where India has seen a lot of it) and the Middle East/North Africa, for example Morocco which has had its microfinance troubles. Outside these areas, respondents tended to play it down. It was rated lowest in East Europe Central Asia and East Asia Pacific. Significantly, concern has also declined in Latin America where it was rife a few years back, though some respondents said it could still rebound.

Political interference usually takes the form of manipulating the microfinance business through controls such as interest rate caps, directed lending or prohibitions on certain types of activity (e.g. deposit-taking). In extreme cases, it includes political support for “no pay” movements by borrowers against unpopular MFIs, as occurred in Bolivia and Nicaragua in recent years.

The main risk in my country is the increasing intrusion of the state into private activities. Today we have a law on Economía Popular y Solidaria (EPyS) and more than five committees and institutions to address the subsector, including a Superintendent and a financial institution.
Financial controller, Ecuador

Political interference on the wane in some places

Well-intentioned political interference doesn't necessarily make good policy, either. Government-sponsored loan programmes, such as Kenya's UWEZO Fund, distort the market and take clients away from MFIs. As a respondent from Ghana said: “Some clients think that microloans are free in areas where governments participate directly in retail lending activities”.

Where will it go from here? Strong and appropriate regulation may reduce the scope for political meddling, as will “mainstreaming”. A South American investor said the risk was high after “the sector's PR fiasco in the past 5 years...but will dissipate in a future cycle”. But others were more pessimistic. A UK investor said: “As the sector becomes increasingly commercialized, I feel it will be ever more on the radar of governments, tax authorities and regulators. I see 'tax grabs', interest rate caps, foreign exchange restrictions and regulatory limits on capital and liquidity all playing a greater role in our lives.”

Not all political interference is negative. Some respondents saw political “involvement” as something to be welcomed. A Madagascan central banker said that state intervention in regulation had improved the legal and institutional framework for microfinance in his country, and supported MFIs in trouble.

This risk runs very close to regulatory risk with which it is 61% correlated, as might be expected. Among respondent types, it was ranked highest by MFIs and investors. Groups giving it a low ranking included credit raters and regulators.

Reputation still at risk

Although we did not ask a question specifically about reputation risk, many of our respondents said it was a very live issue for microfinance.

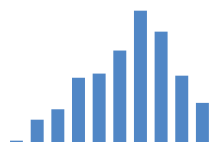
The main source of reputation damage continues to be the problems of overindebtedness and over-charging which, while present only in specific markets, taint the image of the industry as a whole. Hanns Martin Hagen, chief financial sector economist at KfW Entwicklungsbank in Germany, said that one of the main risks over the next 2-3 years was “reputational risk ... stemming from irresponsible lending practices”. Madeleine Dy, an independent consultant in the US, said that reputation and overindebtedness risk “are both growing and the impact of crises in the sector over the last couple of years does not seem to have diminished”.

There are also wider questions about microfinance losing its sense of mission and failing to prove its worth as an answer to poverty and financial exclusion. A respondent from a Far East development bank said that “microfinance as a panacea for poverty reduction has lost credibility with the public, especially after the 2009 financial crisis, and hence in the appetite of public investors to support the industry.” Eric Savage, president and chief executive of Unitus Capital in India, said that “the industry's poverty alleviation benefits have been oversold, so we risk looking foolish relative to the claims. This can have many demoralizing effects for participants.”

As for the consequences of reputation risk, respondents saw these taking the form of further political backlash, tougher regulation and loss of confidence among clients and investors.



8. Management: The risk that poor management in microfinance service providers will damage the business.



Score: 6.5
Previous position: 3

Although management in MF providers has become stronger and more professional, there is still a widespread perception that improvement needs to continue, particularly as the pressures on the business increase. A development bank respondent from South East Asia said that “the main challenge is that most MFIs have laudable social objectives but lack the professionalism to grow and manage risk properly.”

This is not a risk about which it is possible to make generalisations. The level of concern differs greatly from one region to another. It is highest in the East Asia Pacific region (where it ranks No. 2), followed by Africa (No. 5) and Middle East and North Africa (No. 7). There is also a question of size: generally bigger MFIs are better run than small.

Not sufficient for MFIs to have 'well-meaning management'

If there is a consensus about the message behind this risk, it is that microfinance needs strong and capable leaders at a time when competition is growing, business conditions are getting tougher, and big questions are being asked about microfinance's role. More MFIs are also reaching a size where professionalism must replace philanthropy. "There are too many do-gooders" said one respondent.

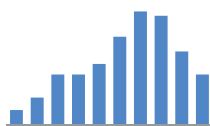
Among the specific issues identified were poor succession planning, inadequate training and lack of knowledge of the increasingly complicated systems needed to run a modern MF business. The chairman of an NGO in the US said that the challenges facing microfinance were "balancing growth and delivery quality - which requires leadership and management skills that are too often a constrained resource".

The problem of balancing commercial and philanthropic interest also requires particularly well-honed skills. Jacques Boribond, a former World Bank microfinance adviser to the Central Bank of Kosovo, said: "It is not sufficient for MFIs to have well-meaning management with high ethical intentions. MFIs are financial institutions and as such must have management with suitable experience of the financial sector."

Among respondent types, only the regulators placed this in their top five risks. The people who actually run microfinance institutions and their investors placed it around the No. 8 mark. A number of respondents said that there was a generally improving trend and many MFIs were very well run. Dragane Mehmedovic, secretary general of the Association of Microcredit Organizations in Bosnia & Herzegovina, said that "many MFIs have excellent management and procedures".



9. Regulation: The risk that microfinance services will not develop because of a lack of appropriate prudential supervision and regulation.



Score: 6.4
Previous position: 9

Regulation, which should support the microfinance industry, tends to be viewed as unhelpful, which is why it continues to feature in the Top Ten Banana Skins. A large number of responses saw regulation as a process which, while necessary, was not always helpful.

This risk correlated strongly with Political Interference (e.g. in cases such as the imposition of interest rate caps). It was highest in the Middle East and North Africa region and South Asia, and lowest in Eastern Europe and Central Asia and the East Asia Pacific. Among respondent types, it was ranked highest by investors (No. 5), and lowest, perhaps unsurprisingly, by regulators (No. 18).

Several respondents said that the real risk was not lack of regulation, as our definition implied, but too much of it, or the wrong type. An NGO representative argued that "there won't be a lack of regulation, but [the problem is] it may not always be appropriate". An investor in Colombia said it was not a question whether

microfinance services “will not develop” but that they “will develop in a way that is not propitious for the good of all stakeholders”.

Nevertheless, a number of respondents did see the absence of (good) regulation as a risk. “Without well-structured and appropriate supervision and regulations, the problems which have plagued the microfinance sector will continue to give it the negative image that it has acquired in many countries”, wrote one, adding that “without supervised regulations appropriate for commercial MFIs (including their transformation from NGO status) the microfinance sector faces decline, and ‘light touch’ regulation of the microfinance sector is a relic of the past and is a disservice to the sector”. Others emphasised that regulation was an opportunity as much as a risk. An Ecuadorian practitioner said: “In my country [we] would rather risk excess [than dearth] of supervision and control”.

Absence of good regulation still a major risk

The risk in regulation is that it will hit the wrong note by being burdensome, stifling and costly for an industry which, as one respondent pointed out, is increasingly weighed down by its self-imposed social performance management reporting requirements.

Regulation also needs to evolve to take account of changes such as the convergence of traditional MFIs and commercial banks, and the introduction of new technologies and delivery channels. Some respondents said this evolution was not happening. Henry Mbaguta, assistant commissioner at the Ministry of Finance in Uganda, said: “I am a little uncertain as to the future of the mobile money revolution. Mobile banking seems to be growing at a faster pace than the imaginative capacities of the regulators. The tendency is therefore to wait first as the service providers experiment.”

Regulation varies from country to country, of course. Judging by the responses, countries where regulation is good or improving include Pakistan, Mexico, Peru and Colombia, while it is worsening in Brazil, Nigeria and Jamaica, and is virtually non-existent in Myanmar and Iraq. (See separate box for India).

Regulation is only as strong as the people who implement it. Philip Appiah-Mensah of UDF Microfinance in Ghana wrote that “some central banks lack the human resources capacity to regulate and supervise”.

Where next? Whatever their view, respondents saw more regulation coming. “The less able MFIs will balk at such ‘impositions’; the better-quality MFIs will see this as a plus to set themselves above the rest, due to their ability to comply with the new regulatory environment as well as grasping innovation for their continued development”, wrote Jesse Fripp of Enclude. “But to achieve this, MFIs will have to access more capital in the future, thus giving commercial MFIs the advantage over their NGO competitors”.

India: the fever cools

India, the world's largest microfinance market by number of customers, has had a turbulent relationship with the industry. In earlier Banana Skins surveys, rows about usurious interest rates, overindebtedness, the Andhra Pradesh affair, regulation and reputation all occupied a high place in the results.

But things have changed. The fever has abated to the extent that Indian respondents this time rated many risks lower than respondents from elsewhere. In the accompanying table note particularly the lower scores for overindebtedness and credit risk. The strongest echo from the past is political risk which continues to dominate the ranking suggesting that, in this respect at least, India still hasn't got back to normal.

How India scored (out of 10)		
	India	World
1 Political interference	7.0	6.5
2 Regulation	6.6	6.4
3 Overindebtedness	6.4	7.5
4 Risk management	6.2	6.8
5 Client relationships	6.2	6.1
6 Funding	6.2	5.8
7 Liquidity	6.2	5.8
8 Strategy	6.0	6.7
9 Competition	6.0	6.9
10 Credit risk	5.8	6.9

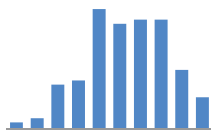
The regulation of the microfinance industry was a strong theme among respondents. Some were supportive of the Microfinance Bill which was tabled in Parliament last year but subsequently sent back for reconsideration. “Had it been cleared, the legitimacy of the industry could [be] better”, wrote one practitioner.

The Reserve Bank of India's post-2010 interventions were welcomed by some. The creation of the separate class of non-banking financial company (NBFC) “has brought in clarity among various stakeholders”, wrote the chairman of an NBFC, who nevertheless said that the main risk to the industry continues to be political interference. According to another respondent, politicians devise microfinance schemes that are not sustainable, such as low cost loans, and have a habit of declaring loan waivers on the eve of elections.

The government's response to the AP crisis led to the mainstream banking sector being dragooned into providing microfinance services. The government “has a strong financial inclusion agenda [for] which the responsibility to deliver is being discharged through the banking sector”, wrote Geoff King of Aircel Ltd in India. “This is leading to a high level of resistance from banks, over-amplified fears over risks [and] resistive governance which is squeezing the energy and resources of the microfinance providers”.



10. Staffing: The risk that microfinance service providers will fail to recruit and retain suitably qualified staff.



Score: 6.3
Previous position: 14

Concern about human resources is growing because the industry is expanding, and new entrants are creating critical staff shortages in many markets. The risk is that the microfinance industry may have neither the will nor the resources to counter these tendencies, and that the quality of their business will decline.

Respondents from many countries reported difficulties in recruiting and retaining good staff. The pay offered by microfinance institutions is often low compared to other industries, and the prospects are distinctly less glamorous than in competing careers in telecoms and commercial banking.

Even where MF providers do manage to recruit good people, there is a high probability that they will be poached by competitors, particularly the commercial banks who are willing to pay for their skills. The problem is particularly acute in middle management where staff demand is strongest. Some said that MFIs were investing in staff for sales but not the back office, which meant that their systems suffered.

A US-based microfinance consultant said that “if institutions do not invest more in building adequate training systems for their field staff, we are likely to see declining portfolio quality and increasing scandals involving abuse and fraud.” Fonahanmi Idris, deputy general manager at Safetrust Mortgage Bank in Nigeria, said that “most microfinance lenders/promoters cannot attract and retain qualified and skilful key staff; they prefer paying peanuts and always having high staff turnover”.

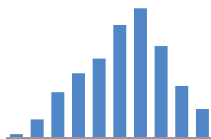
The level of risk varies according to local conditions and individual types of MF provider. Marjolaine Chaintreau, vice-president at Citi Microfinance, said: “This risk needs to be seen in a context of growth and competition. When institutions are growing fast, recruitment and training become one of the major issues, but it might not apply to all institutions or business environments.” A number of respondents agreed that this might only be a temporary problem. A banker in Mexico said that “microfinance is emerging as a strong industry where staff can see a career path. This generates greater retention”.

Regions where this risk ranked highest were Latin America (No. 6) and Africa (No.7).

MF careers not glamorous enough



11. Financial capability: The risk that clients will not be able to make informed decisions because of lack of financial knowledge.



Score: 6.2

Previous position: Not applicable

**Are MF clients
'more savvy'
than people
say?**

The financial capability of microfinance clients was a moderate concern for most respondents, even though it had a strong correlation (47%) with overindebtedness, the top risk. Geographic variation was also moderate, though for respondents in Sub-Saharan Africa financial capability ranked No. 17 out of 19 risks – significantly lower than the rest.

Responses revealed sharply different perspectives on this risk between the borrower and the lender. From the borrower's side, it was an issue of whether the client had the ability to make appropriate financial decisions. Ron Bevacqua of Access advisory in the Philippines, saw this risk as important, "to the extent that lack of financial knowledge leads clients to over-borrow."

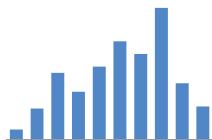
On the lender side, many viewed capability as a non-issue. Chris Linder, International Executives Service Corps, Italy, said that "there is way too much still in paternalistic attitudes about financial literacy/education. Clients are much smarter and sophisticated than any of us." This view was shared by many. Danielle Piskadlo from the Center for Financial Inclusion at Accion pointed out that "clients have always been more financially savvy than they are given 'credit' for."

If the two perspectives have a common ground, it is in how MF providers manage their relationship with clients, especially in the area of transparency of pricing and product terms. One US-based observer described the intersection in these words: "Clients can most likely make decisions if they are presented with actual facts on pricing, etc. Most are pretty astute about financial matters if presented properly." However, a central bank regulator commented that "given the education level of the target customer, any understanding of contracts written in the national language is not always obvious."

A respondent from the cooperative movement in Mexico said that financial education would help "eradicate the culture of non-payment".



12. Product risk: The risk that microfinance service providers will not offer appropriate products to clients because of a failure to understand their changing needs.



Score: 6.2

Previous position: Not applicable

MF providers 'show little innovation'

The risk to microfinance service providers who offer poor or inappropriate products is that they will lose business and put their existence at risk. But there is also an ethical issue: true microfinance exists to provide a specific service, and MFIs who do not provide products that help their clients escape poverty are failing in their mission.

Although this risk was not ranked among the top ten, it was one which aroused strong feelings. Many respondents felt that MFIs were running one or both of the risks described above. Alvaro Rodriguez Arregui, vice chairman of Compartamos in Mexico, said: “I see most microfinance institutions trapped in the early 90s with very little innovation”.

MFIs may fail to meet their customers' needs for a number of reasons. One is that they attach little importance to them. For MFIs, this was the No. 18 risk out of 19, strongly suggesting that product development is low on their agenda.

A related reason is that MFIs may lack the resources or the desire to conduct market research, so they are “second-guessing what their clients actually need” as one respondent put it. Brigit Helms, director of DAI in Mozambique, said that “service providers talk a lot about understanding clients better but are largely unwilling to invest in proper market research.” Some respondents said that the product range was driven not by client needs but by what could be turned out easily and profitably.

A third reason is regulation. This is a particular concern in India where regulations on new products and savings are tight, preventing innovation. But it was also mentioned in other countries, Bosnia & Herzegovina for example. A respondent from India said that “given regulation, MFIs in India offer very standardized products to clients.”

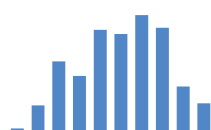
Even where MF providers know what their clients want, they might not have the means or ability to develop suitable products. A US microfinance consultant said: “I continue to be surprised at how little capability most MFIs, and especially cooperatives, have for developing new products. Even if they see clients changing, they are ill-equipped to translate these observations into meaningful product adaptations or new products.” Product weaknesses might lie in range or design, or, increasingly, in the form of delivery. Some respondents regretted that where MFIs extended their product range, it tended to be into undesirable areas such as consumer finance.

This risk could grow in importance as changes in the microfinance industry accelerate and technology speeds up new products and delivery channels. Deborah Drake, vice-president of the Center for Financial Inclusion at Accion International in the US, said that “the microfinance industry must continue to evolve in order to remain relevant and provide the services and products that clients need and which are increasingly being provided by new entrants such as telcos.”

Some respondents felt these concerns were exaggerated, and that microfinance's record on the product front was often better than portrayed. Tamsir Boris Sembene, senior internal auditor at Microcred in Senegal, said that “adjustments are often made to products and services to meet customer needs, taking into account the need for client protection and product innovation”. A respondent from Mexico said that “all the time, there is a greater awareness of the importance of designing products and services that meet the needs of customers and to accompany this with financial education.”



13. Macro-economic risk: The risk that microfinance service providers and their clients will be damaged by trends in the wider economy, such as inflation, volatile commodity prices and lack of growth



Score: 6.1
Previous position: 13

Macroeconomic risk is moderate thanks to the generally improved state of the global economy. This risk was assessed lowest in South Asia (5.6), East Asia Pacific (5.5) and North America (5.7) and highest in the Middle East and North Africa region (7.3) – a result of continued economic turmoil, post-Arab Spring.

Microfinance more vulnerable to global ups and downs

However, the theme of the responses is that while overall macroeconomic risk has lost its crisis severity, it is still there, notably in volatile food and fuel prices. Microfinance may also have become more vulnerable to the ups and downs of global markets and to the policies adopted by governments to deal with them. Daniel Schriber, director of investment operations at Symbiotics in Switzerland, said there was “an increasing correlation between the global economy and microfinance, which used not to be the case. But as many MFIs are growing fast, developing their portfolios not only in the pure micro-entrepreneurs segment, but also in sectors like SME, housing, consumer lending, etc., there are more and more ties between the country macro-economic situation and the performance of an MFI.”

Although this risk affects microfinance providers directly through interest rates and general business conditions, it most often reaches them through clients who have been hit by economic difficulty or retreat from buying financial services. A Latin American practitioner said that during 2012 and 2013 export prices tended to stagnate and even decrease, “a situation that affected the domestic economic performance of countries, resulting in lower demand for goods and services, job losses or reduction of wages in agriculture, and lower exports”.

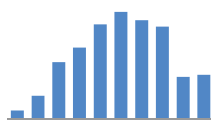
Agrifinance is arguably more susceptible to macro-economic swings than bread-and-butter urban enterprise lending. The chief operating officer of a non-profit social investment fund wrote that for lending to small to medium agricultural enterprises in rural areas, “the competitive pricing landscape is one of the biggest risks...Agricultural businesses face a series of inherent risks - weather, disease, crop failure, and the lack of adequate insurance, and most agricultural businesses are faced with commodity-based pricing and have little to no opportunity to adequately manage price risk”.

All that being said, several respondents sought to downplay this risk, noting that while markets can be affected, microfinance providers with good credit risk systems and quality portfolios should be resilient, and there is an onus on the investor too: “Funds that monitor macro risk can limit damage”, wrote one investor.

Macroeconomic risk was largely uncorrelated with others, reflecting its special position as a complex external risk but one that can exacerbate other risks at the client and service provider level. The risk did, however, correlate 42% with Income Volatility, reflecting the effect that food and fuel prices can have on household income at the Base of the Pyramid.



14. Client relationships: The risk that poor client relationship management will lead to damaging client behaviour, e.g. an unwillingness to repay their loans.



Score: 6.1
Previous position: 7

The nature of the relationship between MF providers and their clients is changing along with the character of the business.

The fact that concern about poor relationship management has fallen quite sharply in the rankings suggests that things are getting better. Indeed, many respondents supported this view with their comments. Godwin Ehigiamusoe, managing director of LAPO Microfinance Bank in Nigeria, said that “client engagement/relationship management has improved in most countries in recent years”.

Nonetheless, respondents identified a number of issues in this area which they saw as pressing and exposing the industry to risk. The fact that overindebtedness continues to be a big problem is evidence that MF providers are not paying close attention to their customers’ financial capacity. A US consultant said that “the pressure to make loans faster and cheaper to compete has led to a deterioration of quality in process as well as relationships with clients, resulting in a deterioration of portfolio quality. This trend seems particularly strong in markets like Peru where rapid expansion and increasing competition have led to some very poor practices and is putting the whole sector at risk.”

Some respondents saw this as part of a broader process in which contact between MF providers is becoming more distanced because microfinance is becoming more commercial, because technology is automating the relationship, and MF providers are losing interest in the personal touch, for example by not extending their physical branch networks into deprived areas. The head of wholesale lending at a microfinance bank in India said that “the overall management focus is going to be on efficiency and productivity and not on customer centricity.”

Some respondents were concerned that, as this gap opened up, MF providers would lose touch with their clients (an issue described more fully under No. 12 Product risk and No. 6 Strategy) and therefore fail in their mission. A consultant in the UK said: “For me the biggest risk is that MFIs fail to capitalise on their core niche in an

Do MF providers measure clients’ financial capacity?

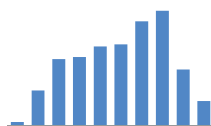
evolving financial inclusion agenda which is based on a direct personal relationship with clients and an ability to leverage this to create value for clients.”

A related issue is that of client protection where respondents felt that much remains to be done about the transparency of loan terms and costs, and in understanding of borrowers’ financial capacity. Alioune Diongue, in charge of internal control at Microsen in Senegal, said that MFIs were “very exposed to this risk, especially those who do not comply with rules on data protection, and do not respect their customers (for example by pursuing them for loan payments at their homes at unsocial hours).”

There was reason for optimism about the management of this risk insofar as microfinance service providers ranked it much higher (No. 8) than non-providers (No. 12) and investors (No. 18), suggesting that there is an awareness of the issues. This issue ranked highest in South Asia (No. 3) and Latin America (No. 7) and lowest in the Middle East and North Africa (No. 19).



15. Technology management: The risk that microfinance service providers will suffer losses from IT mismanagement or fail to capitalise on new developments in IT.



Score: 6.0
Previous position: 16

MFIs could ‘miss the technology train’

Risks in this area fall into two broad categories: systems and new types of banking.

On systems, the story is little changed from earlier Banana Skins surveys: a lot of MFIs have inadequate information and control systems, and lack the resources and skills to improve them. Poor systems lead to inefficiency and weak risk management, increasing the danger of losses.

The newer concerns relate to the emergence of technologies which are reshaping the provision of banking services, particularly online and mobile. To many respondents, this is the crucial issue because it touches on a whole new phase of microfinance evolution which could make or break many institutions.

The key thing about these technologies is that they offer a solution to the access and distribution problems that have hampered MFIs in the past. C. Ross Croulet, microfinance advisor in the US, said that “digital financial services (DFS), which can breach the limits to financial inclusion cost effectively, is a strategy that many MFIs will need to adopt quickly to maintain relevancy and market share.”

However, a number of respondents were cautious about new technology. One concern was that it could encourage over-borrowing by making access to loans easier, and by removing the personal element from banking relationships. One of them was concerned about “mobile money leading to more aggressive ‘push’ lending, further exacerbating the problems of overheated markets and overindebtedness.”

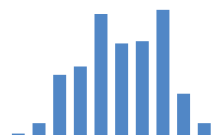
An equally important risk, in many respondents’ view, was “missing the train” as one of them put it, i.e. lacking the foresight to exploit new technology. An NGO respondent said that MFIs could “fail to fully embrace technology. It will disrupt

current delivery models and that can feel threatening, but without major change too many clients will remain unserved.”

This risk was closely correlated with Strategy (53%), underlining the importance of technology issues to the future of MF providers.



16. Income volatility: The risk that fluctuations in clients’ income will affect their capacity to repay their loans.



Score: 6.0

Previous position: Not applicable

Although this risk relates closely to a borrower’s loan repayment ability and therefore to overborrowing, it is seen as low ranking. Many respondents stressed this link, but said that borrowers were often better at managing their finances than people gave them credit for, and conditions were getting better. Sergio Guzman of the SMART Campaign said that “Income volatility will always be a concern for those of us who work at the BOP, since the clients we work with are one event away from being destitute. Often these events are unpredictable. However (fingers crossed) I do not envision an economic downturn of the proportions of 2008 happening in the developing world in 2014.” Another respondent said that “this is always a high risk in any MF portfolio, but it can be managed.”

**MF clients are
‘one event away
from destitution’**

We are trying to improve people's lives in a prudent way, and yet there remains a significant risk that individuals may be negatively impacted by the debt they take on. Since we are impact investors, the risk of a negative effect on borrowers’ lives is the biggest risk to us. We do invest with commercial return expectations, but financial loss would almost be more bearable than negative effects on the lives of borrowers that we funded.”

Investment banker, UK

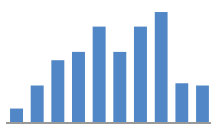
Geographically, this risk was ranked highest by Eastern Europe (No. 4) and East Asia Pacific (No. 5), but low elsewhere. It did not vary much by respondent type.

Income volatility is seen to be closely linked to a client’s financial capability and to the nature of that person’s work, particularly agriculture. It is also seen to be country specific when it comes to politics and catastrophes. One UK-based consultant suggested that income volatility “comes close to top three [risks] in most conflict-affected and fragile states.” An MFI representative in Guatemala saw several factors at work, including “changes in the price of agricultural products, product substitution which causes reduced sales, the impact of climate change, the issue of gender”. One US-based consultant noted that “The poorer the client, the more vulnerable they are to interruptions in income - most commonly due to health shocks and other household crises but also due to theft, fire, accidents and crop failure.”

Some commentators viewed the risk in quite a different light, noting that one of the services that microfinance can provide is the management of income volatility. Jesse Fripp of Enclude saw this risk being “mitigated by a broader shift to a blend of income-smoothing/asset protecting credit and non-credit products and services.”



17. Transparency of objectives: The risk that microfinance service providers will lose the confidence of funders, partners and clients by failing to live up to their stated objectives and mission.



Score: 5.9
Previous position: 11¹⁰

MF risks losing its distinctive social character

The responses to this Banana Skin were full of passion: “With the recent commercialization of the sector in total disregard of the initial social objective, the reality of this loss of confidence increases by the day!” said Anthony Kamau Mwangi, head of microfinance at K-Rep Bank in Kenya. Yet the reality is that this Banana Skin ranked very low on the risk scale. Moreover, concern on this front has fallen sharply since our last survey in 2012 (when the question was specifically about the risk of Mission Drift).

The concern was the familiar one that MF providers will be pushed by commercial pressures into easier and more profitable markets than the deprived ones they were set up to serve. This would include lending into concentrated urban markets when they should be out seeking the financially excluded, lending for consumption rather than business development. This would cause them to lose their distinctive social character and becoming like banks. In Africa, an MFI respondent said his competitor was now earning more as an insurance broker and estate agent than as a purveyor of microfinance services.

Luis Fernando Sanabria, general manager of Fundación Paraguaya, said that “many microfinance institutions have forgotten their original mission of providing tools for clients to progress, and have focused on ensuring corporate profitability and solvency.”

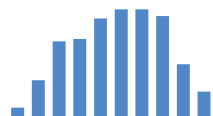
The potential risks are clear. Elisabeth Rhyne, managing director of the Center for Financial Inclusion in the US, said that “the microfinance sector risks being absorbed in the bigger financial system and being unable to maintain its distinctive social character. It risks being unable to continue to raise donor support for the social side of its activities”.

However, judging by the low risk score attached to this Banana Skin, the damage remains potential rather than actual. A respondent from Madagascar said that “there is generally strong loyalty between investors and credit institutions. The achievement of social and financial objectives is broadly on track.” A consultant in France said there was “little risk here because the donors probably need the MFIs more than the MFIs need to remain in the MF sector. (They support MFIs for political visibility purposes.)”

¹⁰ In 2012, this risk was defined as “Mission drift”



18. Funding: The risk that microfinance service providers will fail to attract and retain diversified sources of debt and equity



Score 5.8
Previous position: 17,19¹¹

Funding is seen overall as a low risk, as it was in the previous survey in 2012, mainly because it remains generally plentiful, though this view varies widely across the spectrum of MFIs.

Concern about the availability of funding was strongest in South Asia (6.4) and Africa (6.2), but was very low among North American and European respondents where investors and observers predominate. In short, those *receiving* funding were more concerned than those *providing* it.

Generally, funding for microfinance is abundant, some would say too much so given the rapid expansion of capacity in recent years. Investors want to be involved with microfinance, and new providers continue to appear. As one respondent said: “There are too many MIVs chasing too few MFIs”.

The risk issues have more to do with who gets the money. Smaller MFIs in poorer countries typically find funding a struggle. A respondent from Kazakhstan said: “We have a lack of interest from donors and investors”, and R. Siriwardhane, general manager/CEO of the Regional Development Bank in Sri Lanka said that “the funds mobilized by us are not sufficient to meet demand for microfinancing. If we could obtain low cost funds we could provide a better service with wide coverage.”

For some respondents, the main concern was the increased diversion of capital to commercial MF providers and banks, and away from socially driven NGOs and NBFs. A US support provider said: “The funders clearly prefer Tier 1 and the upper half of Tier 2 MF providers. At a macro level this can lead to the amount of funding to [microfinance] being sufficient, but at a micro level (the MFI level) there will be a clear dominance of certain MFIs at the expense of others”. According to the chief executive officer of a global support network: “Lots of private venture money is going into the for-profit lenders – that’s terrific, but not if the end result is higher priced capital for the non-profit lenders.”

However there is an opposite concern: that an overabundance of donor money for weaker MFIs has created a dependency which is holding them back. Hans Dieter Seibel, professor emeritus at the University of Cologne, said that “continual donor support to unviable and unsustainable credit NGOs [is creating] dependence on investors and donors as sources of funds, instead of self-reliance on deposit mobilization and retained earnings.”

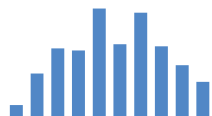
Reputation concerns were also expressed. An American support provider believed that “the impact of crises in the sector over the last couple of years does not seem to have diminished, and some international donors have new, greater priorities, other than microfinance”. However, as the responses from investors to this survey show, this risk does not appear to have materialized – yet.

¹¹ In the 2012 survey, we distinguished between Too little funding, which ranked No. 17, and Too much funding, No. 19.

The problem with funding is that there may be too much of it



19. Liquidity: The risk that microfinance service providers will have insufficient liquidity to finance their business needs.



Score: 5.8
Previous position: 10

Liquidity risk is low but could bounce back

A sharp decline in concern about liquidity is one of the big changes in sentiment identified by this survey. At the height of the global financial crisis, this was seen as a top Banana Skin facing the industry. But times have changed.

The fall can be attributed to a number of things. One is tighter regulation, and closer involvement by central banks in some countries in the provision of liquidity to MF providers. Another is the abundance of funding in many markets, and the readiness of donors to provide liquidity assistance where needed.

Nonetheless, this is not a risk which can be viewed with any complacency. As a number of respondents pointed out, liquidity crises can hit overnight, and cash flow management remains crucial. Many were concerned that, as one respondent put it, “most MFIs do not have much skill in liquidity management”.

Another concern is the impact of growing competition for savings and deposits in a market where established MFIs such as co-operatives have long enjoyed a surplus of funds. Angela Maria Valencia Maya, director of Microfinanzas Confiar Cooperativa Financiera in Colombia, said that “given the high level of competition for this market, banks cannot afford to be behind in losing strategies and opportunities.”

This is also an area where the level of risk varies with local conditions. The survey showed concern to be high in Africa, South Asia and East Asia Pacific, but low in Latin America, Middle East and North Africa. In the Philippines, a respondent from a development bank said that liquidity shortage was “a major impediment to growth”, but in Guatemala, a banker said “there is availability of funds for the sector, but this could be affected if indebtedness grows and risk indicators rise”.

MiBanco. Banex. Both cases prove that even an “industry darling” MFI that has been highly successful, was previously well-performing, deposit-taking, amply funded locally and cross-border, can fail or be sold at low price if it has insufficient liquidity. It can happen to any MFI, and very quickly with dire results. MFIs are financial intermediaries: liquidity is paramount.
Julie Abrams, Microfinance Analytics, USA

APPENDIX: The questionnaire

Microfinance Banana Skins 2014

Each year we ask practitioners and observers of the microfinance industry to describe their main concerns about the risks facing the business as they look ahead 2-3 years. The focus of the survey is on microfinance service providers of all types who are commercially scalable.

1. **Who you are:**

- a. Name
- b. Institution
- c. Position
- d. Country where you are based
- e. Replies are in confidence, but if you are willing to be quoted by name in the report please check the box.

2. **Please select what best describes your role in microfinance:**

Option 1. I work for a microfinance service provider.

- i. A for-profit financial institution (NBFI, bank)
- ii. A not-for-profit financial institution (NGO, cooperative)
- iii. Other microfinance service provider/non-financial institution (including microinsurance, payment services, technology, etc)

Please indicate the share of your institution's business in microfinance:

- i. 0-1/3
- ii. 1/3-2/3
- iii. More than 2/3

Option 2. I invest in microfinance service providers as a

- i. Private sector investor
- ii. Development finance institution
- iii. Fund manager/MIV
- iv. Other

Option 3. I provide support to microfinance service providers as a

- i. Network/association
- ii. Foundation
- iii. Donor
- iv. Other

Option 4. I work for an organisation which regulates or supervises institutions which provide microfinance services.

Option 5. I am an observer, academic or consultant with microfinance.

- i. I work primarily with microfinance service providers
- ii. I work primarily with investors/donors
- iii. I work primarily with regulators
- iv. I work with all the above.

Option 6. I work for a rating agency

Option 7. Other (please state)

3. **Please describe, in your own words, the main risks you see facing the microfinance industry over the next 2-3 years, and any sub-sector with which you may be especially familiar.**

4. **Risks**

Below is a list of potential risks to the microfinance industry grouped by whether they originate mainly from the service provider, the client or the market environment. Please rate the severity of each on a scale of 1-10 (1 being negligible, 10 being acute), and provide comments.

SERVICE PROVIDER

1. **Credit risk** The risk that poor lending practices will lead to loan losses.
2. **Governance** The risk that the boards of microfinance providers will fail to provide the necessary oversight and strategic direction.
3. **Staffing** The risk that microfinance service providers will fail to recruit and retain suitably qualified staff.
4. **Liquidity** The risk that microfinance service providers will have insufficient liquidity to finance their business needs.
5. **Management** The risk that poor management in microfinance service providers will damage the business.
6. **Product risk** The risk that microfinance service providers will not offer appropriate products to clients because of a failure to understand their changing needs.
7. **Risk management** The risk that microfinance service providers will fail to identify and manage the risks in their business.
8. **Strategy** The risk that microfinance service providers will fail to provide a service that makes them relevant and competitive in a changing marketplace.

9. Technology management The risk that microfinance service providers will suffer losses from IT mismanagement or fail to capitalise on new developments in IT.

10. Transparency of objectives The risk that microfinance service providers will lose the confidence of funders, partners and clients by failing to live up to their stated objectives and mission.

CLIENT

11. Client relationships The risk that poor client relationship management will lead to damaging client behaviour, eg an unwillingness to repay their loans.

12. Financial capability The risk that clients will not be able to make informed decisions because of lack of financial knowledge.

13. Income volatility The risk that fluctuations in clients' income will affect their capacity to repay their loans.

14. Overindebtedness The risk that clients will borrow beyond their capacity to repay.

MARKET ENVIRONMENT

15. Competition The risk that the growth of competition from existing providers and new entrants will cause microfinance service providers to compromise their business and ethical standards

16. Funding The risk that microfinance service providers will fail to attract and retain diversified sources of debt and equity

17. Macro-economic risk The risk that microfinance service providers and their clients will be damaged by trends in the wider economy, such as inflation, volatile commodity prices and lack of growth

18. Political interference The risk that intervention by politicians will harm the sector and distort the market

19. Regulation The risk that microfinance services will not develop because of a lack of appropriate prudential supervision and regulation.

5. What keeps you up at night?

Please describe risks which concern you particularly as an institution or an individual involved with microfinance.

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