Lessons learned from Microfinance crises: Viewpoints from investors

Microfinance Focus
By Matthew Fuchs
November 4, 2009

Microfinance Focus, Nov. 4, 2009: The ongoing Nicaraguan "No Pay" movement, which began Spring 2008 in the north of the country, is an example of an organized protest movement against microfinance institutions.

Fuelled by a spike in defaults caused by the economic crisis and allegations of excessive interest rates, customer over-indebtedness and heavy-handed tactics by some MFIs to reclaim loans.

There have been smaller and more localized movements, such as in the Kolar region in southern Karnataka, India, and in northern Pakistan. These critical issues highlight some of the challenges of investing in MFIs during economically and politically volatile times.

According to CGAP 2009 MIV Benchmark Survey, investment in microfinance remains highly concentrated, despite high growth in investment levels in recent years. How vulnerable, then, is microfinance investments to such movements or other disturbances? How can portfolio risk be minimized?

Microfinance Focus took up the issue with three managers of microfinance investment firms, Christian Speckhardt, Member of the Management Board and Chief Investment Officer, ResponsAbility Social Investments, David MacDougall, Risk Manager, BlueOrchard Asset Managers and Caroline Bressan, Senior Portfolio Associate, Calvert Foundation.

Here is a glance at their opinions on the issues:

Microfinance Focus: The Nicaraguan “No Pay” movement has highlighted an emerging risk. From the investor side, what can be done to manage this and prevent the emergence of future protest movements?

Christian Speckhardt (CS): In order to prevent such movements, we believe it is important that MFIs’ operations are sound, transparent and guided based on client protection principles. MFIs conducting unethical business practices may harm the industry’s reputation and lead to such movements. In addition to the MFIs’ activities on the operational level, it is also important to have a strong legal and regulatory framework in place in order to prevent such developments. Initiatives which have emerged out of the microfinance industry such as the CGAP Client Protection Principles and MF*Transparency* are therefore key. Investors in particular can get engaged by actively supporting such initiatives and by including criteria on client protection and transparency into the due diligence and investment process.

David MacDougall (DM:) Microfinance institutions can be affected by a broad range of risks. BlueOrchard manages these risks by performing extensive due diligence on the MFIs it lends to. This includes an evaluation of the MFIs position in the market and its ability to survive unanticipated events. We also review the economic condition of countries in which the MFIs are located.

Caroline Bressan (CB): What has happened in Nicaragua can be seen as a perfect storm: a combination of an overall economic downturn, the crashing of beef prices, and a climate of general political instability. As such, there are many lessons to be learned at every level of the microfinance supply chain. The result in Nicaragua has led to deterioration in the payment culture of the country which has proven to be more dangerous to the microfinance industry than even a natural disaster. The solution to this and future issues may lie in the re-structuring of incentives.

From an investor’s perspective, one thing that can be done is to fund those MFIs that are working to create positive incentives for those borrowers that do make their payments on-time. One example of this is BANEX in Nicaragua. They are currently raffling a new truck at each of their problem branches only to those clients who have kept making their loan payments. Another possibility is making certain types of loan products available only to those borrowers with a clean payment record or by creating a separate loan name for those same borrowers such as an Excellence Loan or Gold Level Loan, thereby creating something that they could be proud of.

Another lesson learned from this crisis is to scrutinize not only the procedures and policies of an MFI, but also the implementation of these practices. With the growth we've seen in the industry over the past few years… credit policies were relaxed in favor of higher growth rates. Many loan officers were incentivized based on the growth of their portfolio alone. Instead of focusing only on growth, the importance of portfolio quality and knowing their clients should also be stressed in loan officer training sessions and reflected in compensation packages. If loan officers are incentivized in the right way, they will put more energy into choosing the right clients for the MFI and avoid repeating what happened in Nicaragua, where some clients took out loans with no intention to repay.

Finally, an important aspect to consider is the over-indebtedness level of clients. If clients have borrowed beyond capacity, it is easy to see why they might throw their support behind a group that is telling them they do not have to make payments on this debt if there is a centralized credit bureau that both regulated and non-regulated microfinance entities report to, this over-indebtedness can be avoided. MFIs can implement new credit procedures that can accurately assess the repayment capacity of their clients. The Smart Campaign, launched by ACCION's Center for Financial Inclusion in conjunction with CGAP, has been working on garnering investor and MFI support for the past year. This campaign seeks to enhance client protection which includes the avoidance of client over-indebtedness. Investors that sign on to the campaign are expected to monitor how their MFI borrowers track the debt levels of their clients. In this way, investors, MFIs, and loan officers will all be incentivized to track over-indebtedness because they will be held accountable to their funders and the industry.

MF: Do you know if there are any similar movements in other countries? Do you foresee such movements emerging>

CS: We currently observe no movements of comparable scale in other countries. Having said that, we do however observe singular smaller and very local movements, such as for example in one of the Indian regions, where there are some community heads leading "No Pay" groups for a variety of economic, social or cultural reasons. In the past there have been singular cases in other countries, however on a much lower scale. Should the law legalize past debt defaults, i.e. should the Nicaraguan 'Moratorium Law' be approved, there could be a certain risk of the Nicaraguan example serving as a show case for similar movements in other countries. So far however, we have not seen any signs of such an imitation effect

DM: We are not aware of a similar movement at this time. However, prudent risk management requires that we consider the possibility and closely monitor markets. BlueOrchard benefits from a staff of 15 analysts specialized in microfinance. The analysts speak the languages of the countries in which they work. All of our MFIs are visited annually and analysts have calls monthly.

CB: One somewhat similar movement can be seen in Pakistan beginning in October of 2008. A recent case study was published by the Pakistan Microfinance Network (Unraveling the Delinquency Problem (2008/2009) in Punjab, Pakistan by Hus San-Bano Burki) that tells the story of microfinance solidarity groups “revolting” against the repayment of microfinance loans with the support of local politicians and the ensuing delinquency crisis. This type of movement has also happened before in Bolivia about ten years ago.

Nicaragua is not the only country out there with populist leanings. Another movement like “”No Pago” is possible, however if MFIs take the implementation of the Client Protection Principles to heart and the industry in each country is able to reinforce the culture of payment such an outcome can be avoided. It is also important to note the role that local trade associations like ASOMIF in Nicaragua and the Pakistan Microfinance Network, can and must play in political advocacy and public awareness-raising in support of the industry. This kind of advocacy should be conducted in both good times and bad.

MF: The CGAP 2009 MIV Benchmark Survey states that MIV investment is highly concentrated for example, 57% of sample concentrated in top five countries, 40% in top five investments. Does this indicate a lack of “investment worthy” MFIs despite the sector’s phenomenal growth?

CS: We have invested in 225 MFIs with our three traditional Microfinance fund products. In comparison with the CGAP MIV Benchmark Survey numbers, the top five countries together represent only 33% of total NAV of these funds and the top five MFIs together represent only 12% of the NAV. Although the investment universe is somewhat limited, a good level of diversification can be reached by being disciplined and through strong transaction origination capabilities.

DM: There are many factors that determine where MIVs are able to invest. They include whether such investment is practical under government foreign exchange controls, availability of local funding and development of microfinance in the country. If the sector is nascent, MFIs may receive grants and low cost funding from aid agencies or development banks. On the other hand very large institutions may have many funding options to choose from. MIVs may therefore play a small role.

CB: We have to be careful not to create our own "microfinance bubble" in these top five countries… As investors, we need to stay active in our search for "investment worthy" MFIs that might be located outside of the most developed microfinance markets. It can be easy to slip into a group-think mentality when investors of the same risk profile target the same MFIs. On the other hand, many MFIs have been negatively affected by the global financial crisis and some are still operating in an environment of uncertainty. This financial deterioration combined with cheaper capital from international financial institutions has made it more difficult for MIVs to find investment worthy MFIs.

MF: Does this have implications for risk management? What is an adequate level of portfolio diversification?

CS: Diversification in terms of countries, regions and institutions, i.e. MFIs, is key to mitigate risk for an MIV. As a fund manager, having a strict and rather detailed limit system in place, which ensures a high level of diversification, is very important. In addition to this, an active portfolio management and a dynamic country and market risk management system is key. Needless to say that the fundamental counterparty analysis is as important. As a general rule, the higher the diversification the lower the risk. We believe that our fund products are adequately diversified today. However, in line with the general rule, we are continuing to increase the number of countries and MFIs covered with our portfolios.

DM: Adequate diversification is achieved by establishing prudent exposure limits for countries and MFIs within a portfolio. BlueOrchard's internal risk management committee meets monthly to discuss diversification and other potential risks. BlueOrchard continues to diversify its portfolio by diligently investigating MFIs in many countries.

CB: Over-concentration in a handful of countries of course has an impact on risk management strategies. At the Calvert Foundation, our country limit is 15% of our total portfolio however this limit will and should vary depending on the structure of the MIV. Country limits alone should not determine an investment strategy. There are many diversification strategies outside of investing in multiple countries because there are many types of MFIs. These include investing in MFIs focused on different legal entities, regions, product types, and borrower profiles. The risk of investing in a large, regulated, microfinance bank are very different from those of a medium-sized NGO regardless of if they are located in the same country. Both investments carry their own separate risks which are important to understand during the due diligence process.

Source URL: http://www.microfinancefocus.com/news/2009/11/04/lessons-learned-from-microfinance-crises-viewpoints-from-investors/