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David Roodman's Microfinance Open Book Blog

Death of a Microfinance Institution

August 9, 2010

By David Roodman Tags: bubbles, microfinance as business, Nicaragua

Four years ago, the Dutch bank ABN AMRO commissioned a **report** from CGD on what makes some microfinance institutions succeed as businesses. I wrote it with Uzma Qureshi. We began the project by networking, looking for good people to talk to and good institutions to learn from. Perhaps it was **Beth Rhyne** who pointed us to Gabriel Solorzano, the founding head of FINDESA in Nicaragua. We called him.

As you can tell from the number of times we cite him in our report, he is a great interview. Gabriel told us that FINDESA, a regulated financial institution, was born out of the non-profit INDE, which had been created, or at least assisted, by the German aid agency GTZ in its early years. Gabriel's goal was to make FINDESA a "world-class institution." He said he was applying the Japanese model to microfinance. In part, this meant observing examples around the world and copying what worked. He studied the regulatory system in Peru, the survivors of an early bubble in Bolivia, the fast-growing Compartamos in Mexico. He studied at Harvard too. But the Japanese model was also for him a philosophy of learning. Learning came in three stages, he told us: schooling, on-the-job training, and "self-illumination."

Gabriel said FINDESA had grown 70–80%/year for four years, which stressed the organization. He described the mechanisms in place to achieve "safe growth." There was a four-level hierarchy of loan review committees, the largest loans going highest. Employees received bonuses when arrears among their clients were below 2%. If a branch's arrears were high, all its officers lost bonuses.

FINDESA made not "Asset-Based Credit" (ABC, loans backed by collateral) but "Integrity-Based Credit" (IBC). To judge integrity, loans officers used subtle techniques. They would check with neighbors about drinking and gambling problems. They knew every financial statement they received was fake, at least to the extent of leaving out the salary of owner. So to judge that "shadow salary," they looked at whether the applicant had kids in school, a new car, a big or small home. Officers would show up unannounced at the applicant's store at 5pm to compare cash register contents to claims on the application.

FINDESA took pride in its independence from microfinance network organizations such as Accion International and Women's World Banking.

In October 2008, FINDESA obtained a banking license—permission to take savings—and **became BANEX**. But by then its situation was already coming unglued. Years of rapid growth in the Nicaraguan microfinance industry collided with shock waves from the financial crisis in the United States. A populist *movimiento no pago* (no-payment movement) caught fire; the debtors' revolt **won backing from President Daniel Ortega**. Microfinance institutions **and their foreign investors** fought back in the media and presumably behind the scenes. (Ironically, at same time, the Royal Bank of Scotland **nearly collapsed** after recognizing huge losses on its take-over of ABN AMRO.)

Last week, BANEX **entered liquidation**. Since **Microcredit Portfolios Are Sand Castles**, in financial value terms, the overseer won't find much more than a pile of sand (or should I say scattered ashes?).

Some in the microfinance movement will be tempted to blame the Nicaraguan crisis entirely on *movimiento no pago*. I believe that would be a mistake. The best analysis I have seen so far is **that** of Greg Chen, Stephen Rasmussen, and Xavier Reille at CGAP. Generalizing about Nicaragua and three other nations with bubble troubles, they write:

> These local events influenced the crises and the public dialogue about the crises, but they were symptoms of underlying vulnerabilities within the microfinance industry itself and not root causes of the crises.

Among the root causes: rapid lending growth, inadequate internal controls, multiple borrowing on the part of clients, and reviews from rating agencies that failed to spot problems.

The CGAP trio wrote that the delinquency crisis hit all 22 Nicaraguan microcreditors. Perhaps foreign network groups will rescue some of their Nicaraguan affiliates. Perhaps, that is, BANEX's independence from such groups was another factor in its demise.

To the list of afflictions for the industry as a whole, I would add: the large flow of money from foreign investors, which inflated the bubble. The fault, dear Brutus, is not in our stars, but in ourselves, and all that. According to figures **I blogged before**, the largest investor in the top five Nicaraguan microfinance institutions was **Blue Orchard**, with $46 million at end-2008. The **Central American Bank for Economic Integration (CABEI)** had $33 million; **ProCredit Holding**, $28 million; **Financiera Nicaragüense de Inversiones**, a (defunct?) Nicaraguan government using money from Germany's **KfW**, had $27 million; and **responsAbility**, $15 million.

All of this money came from public and private organizations with "social" missions. I wonder: are the recent bubbles in microcredit the first in history to have been fueled by generosity rather than greed? I suppose the universal ingredient is hype.

BANEX was a young microfinance institution. By all appearances, it had a bright future ahead of it. It died too young. What should the microfinance industry do to prevent a repetition of this tragedy? Here's **one partial answer**.

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11 Comments on "Death of a Microfinance Institution"

1. *Elmira* Says:
   August 9th, 2010 at 12:39 pm

   Thanks for pointing out the importance of internal controls and reviews as well as other things overlooked in the microlending field: rapid growth and multiple borrowing. Good intentions don't always lead to good solutions.

2. *Asif Dowla* Says:
   August 9th, 2010 at 12:42 pm

   Credit Bureau is the answer, really? We had the housing bubble, the presence of Moodys, Standard and Poor and Fitch notwithstanding. If the credit rating agencies of rich countries are not able to prevent bubble–many say, with justification, that these agencies fueled the bubble–why do you think credit rating agencies dealing with institutions in poor countries will be able to prevent bubble in microfinance?

3. ***David Roodman*** Says:
   August 9th, 2010 at 1:13 pm

   Asif, I offered it as "one partial answer," not "the answer."
   But anyway, you might be right that it wouldn't work. The practical question is whether it is worth trying. I think there is *some* reason to hope that a credit bureau in which the subjects are microfinance institutions would work better than the credit bureaus in the United States in which the subjects are individuals. Most of the money moving into microfinance is still coming from public institutions and social investors who seemingly would care about getting this right. In addition, as I envision it, the body would do more than share information about borrowings. It would track relevant market trends and perhaps even issue guidance.

   Do you think there are any practical lessons from the recent bubbles?

4. *Daniel Rozas* Says:
   August 10th, 2010 at 6:20 am

   This is probably the largest MFI failure in recent years that ended up in liquidation. I look forward to seeing a detailed case study produced by the aforementioned investors that looks at the causes of the failure and also documents the liquidation process and ultimate outcomes for borrowers, staff and investors. Such a study would be useful to investors, practitioners, academics, and others, and if transparency means anything, it ought to also mean sharing one's failures so others could learn from them.

5. *Asif Dowla* Says:
   August 10th, 2010 at 11:04 pm

   Research shows that many of the mortgage companies ignored the FICO scores when approving the loans (Micheal Lewis, The Big Short) because they were into 'originate and distribute' mode. They did not care whether loans will be repaid as long as they could sell the loans to investment banks who in turn bundled them into CDOs and sold it to the "suckers from Dusseldorf". The credit rating agencies stick them with AAA ratings. The mortgage companies,investment banks, and credit rating agenceis were only interested in collecting commissions and fees.

   So the lesson is clean–to avoid bubble in microfinance industry, monitor the incentives–who is going to gain and are there check and balances on these gains.

6. ***David Roodman*** Says:
   August 11th, 2010 at 6:45 am

   Asif, that seems quite sensible to me. But what does it mean in practice? Who will do the monitoring? What incentives are to be monitored? Keep in mind that what I am purposing is not domestic credit bureaus that would monitor individual borrowers, but an international body that would monitor MFIs as borrowers.

7. *Jonathan C* Says:
   August 13th, 2010 at 3:27 pm

   There is no question that lots of uncoordinated investment by DFIs and "social investors" flowed into the Nicaraguan microfinance market and this led to rapid growth and competition and deteriorating loan quality.

   But the irony here is that much of this "social investment" was primarily to promote the commercialization and for-profit transformation of MFIs in directions that led to rapid expansion but also "drift" in the sense of rising loan sizes and the substitution of more arms length contracting and collateral-backed lending rather than the closer monitored relationships of more traditional microfinance. It was 'social' in the sense of being at least partly public or philantrhopic in origin but I think a healthy debate can be had about whether at the end of the day they were subsidizing the social or the private side of the businesses they were investing in.

   In the subprime mess in the USA (and simplifying massively) one camp also argues that the problem was "too much social investment" (e.g. those who blame Fannie/Fredie for buying MBS and/or blame the supposed mandates of the 'CRA' and socially minded politicians wanting to help the poor). On the other side are those who say that the problem was unregulated private enterprise gone wild.

   Most would agree that the problem in the US was that securitization allowed loan originators to sell off much too large a share of their loan portfolio exposures leaving loan originators/servicers with far too little skin in the game and hence lousy incentives to carefully screen and monitor loans. Government regulators failed to step up to fix or foresee this failure of incentives/governance partly b/c policymakers became enamored with the view that private markets would self-discipline and deliver only positive financial innovation or, less charitably, because the regulatory apparatus was captured by industry.

   In Nicaragua (where regulators don't have the infrastructure/resources to regulate a fast changing sector even if they wanted to) one would have hoped that 'social investors' such as the ones you mention above would have been more careful about making sure that the local lending institutions in which they were investing (and taking equity shares) would avoid similar mistakes and not alienate (and or mess up the incentives of) their customers.

   But these particular "social investors" were also led by a very strong ideology of transforming social enterprises into privately held investor-owned enterprises which has implications for how financial intermediaries are owned and governed (for illustrative language just randomly browse the websites of Procredit, Blue Orchard or any of the other 'social investors' on that list). Their stated mission was to attract private investment and then get out of the way.

So in the end was the problem too much attention on the ‘social’ or too little? Did too much of a focus on the social wreck Nicaraguan microfinance or was it too much of a focus on the private via growth, leverage and profits?

And what should the lessons be for these funders (in Nicaragua, or in the next country)? Close down and put the money elsewhere (probably not a bad idea in many cases) . Or should they redouble their efforts to be yet more fiercely dedicated to the project of replacing ‘social investment’ by purely commercial capital as fast as possible via the formula of privatization = fast growth =profits = private investment? Is there a better way for social investors to exit, if that's what should happen? I'm not entirely sure myself but I think we need to rethink the roles of ‘social investors’ and ask ourselves what it is that they are and should be doing,

8. *Rebecca* Says:
   August 21st, 2010 at 2:13 pm

   With the millions of dollars pouring in from public and private organizations with “social” missions, why did the interest rates for entrepreneurs remain so high?

9. ***Lee Coppack*** Says:
   August 25th, 2010 at 12:27 pm

   Many MFIs are in places vulnerable to widespread natural catastrophes. I wonder how many of them have taken this into account in their risk management?

10. ***David Roodman*** Says:
    August 25th, 2010 at 12:34 pm

    Interesting question. Several Bangladeshi MFIs have been around at least 20 years and have survived major floods there, sometimes forgiving loans in the process. I guess they need to maintain adequate reserves.

11. *Chale Espinosa* Says:
    September 7th, 2010 at 11:42 pm

    Agree some of Banex reasons for banks failure were management or lack thereof, uncontrolled growth of their lending portfolio (bad extension, NO collateral or not properly secured) , inadequate controls operational, lack of adequate credit administration, rapid expansion of branch network in areas of country that were not profitable, multiple borrowing on the part of clients, reviews from rating agencies that failed to spot problems, & investors that were not engaged. But the main problem was the it was a financial institution run by non bankers that got involved in lending to the Ag/cattle sector were they lacked the necessary expertise or understand the idiosyncrasy of their borrowers. Also, lending rates were so high that borrowers took the money with the intention or hope that they were not going to repay loan. Common sense.
    There are lessons to be learned as there are more MFIs that will follow the BANEX route.

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