



A different world

A follow-up to

Microfinance Banana Skins 2009
'Confronting crisis and change'

CSFI



February 2010

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In July 2009, the Centre for the Study of Financial Innovation published the second of its “Banana Skins” surveys of the microfinance industry, the first having been carried out early 2008. As before, the survey was sponsored by Citi and the Consultative Group to Assist the Poor (CGAP) with support from CMEF and the MIX.

The purpose of the Banana Skins process is to identify the main risks and challenges facing the industry. Since the value of the process grows with successive surveys, the second provided not just a snapshot of the microfinance risk landscape at an interesting moment, given the state of the global financial industry. It also showed how risk perceptions had evolved over the intervening 18 month crisis period. The report itself was therefore thick with messages, and the debate it provoked was extremely interesting and revealing.

After the launch of the survey, the CSFI and the sponsors of the report organised a number of meetings to promote its findings and raise discussion. These meetings took place in London (3), Frankfurt (1), Delhi (2), Dhaka (1) and Washington DC (2).

This paper takes stock of the main points that emerged from the survey and these discussions. It also seeks to identify issues which deserve further attention from practitioners, investors and officials, and offers views on how these might be taken forward.

Introduction

“Risks turned on their head”

The first survey was conducted at a time when crisis was already in the air, but before its impact on the microfinance sector had been felt. Its themes focused more on the internal challenges confronting the sector, than on external impacts. The risks it identified were mainly “institutional”: the quality of management and staffing, the problems of mounting competition and structural change, and the implications of growing commercial pressures for an industry with an essentially social/philanthropic purpose. Little concern was expressed in the survey about the potential impact of the looming financial crisis: indeed it reflected the belief that microfinance was “different” and therefore insulated from shocks at the global level. The only indication of trouble ahead was the identification of credit risk as a fast-rising risk, though at No. 5 it was not a top level concern.

The second survey delivered a totally different message. All the main risks it turned up were crisis-related: the impact of the credit crunch on funding markets, of the recession on credit quality, of tougher times on the industry's ability to sustain its reputation for good works. The previous survey's "institutional" risks were relegated to second place, except management quality, though the focus here narrowed to the ability of MFIs to navigate their way through the crisis. Essentially, the report reflected the growing acceptance that MF was not as insulated as once believed, and that one of its challenges lay in understanding how it fitted into a globalised finance industry. Indeed, many respondents feared that the recession might attack the industry's main perceived points of vulnerability: weaknesses in management and governance, and the growing problem of overindebtedness among MF borrowers.

Although the overall tone of the survey might be described as cautious, even pessimistic, it did contain some upbeat elements: a belief that MF had the resilience to come through the crisis in better shape than the mainstream banking industry, that its position would be strengthened as commercial banks withdrew from the MF market to lick their wounds, and that valuable lessons would be learnt about the need for stronger management.

One other point should be highlighted: the striking similarity between responses from differing regions of the world. All of these put crisis-related risks at the top of their lists. The only exception was Africa where institutional issues (i.e. management, corporate governance, staffing) continued to dominate. This is surely an indication of how globalised the industry has become.

Nonetheless, a preliminary note of caution is in order. It is extremely difficult to generalise about an industry as varied as MF. Despite the similarities mentioned above, the variations between regions, different sizes and types of MFIs etc. are enormous. Please bear this in mind when reading the comments that follow.

The analysis is arranged in five sections:

1. The impact of the global financial crisis
2. The need for stronger management,
3. The problem of competition
4. The growing challenge of customer management.
5. Attacks on MF's reputation
6. Banana Skins survey methodology
7. Going forward.

1. Crisis impact

“The pressures of global recession may find MFIs wanting”

The question that dominated both the report and the discussions was how the global financial crisis was affecting the microfinance industry. It quickly became clear that the answer was at least “noticeably” if not “potentially severely”. The traditional view that MF was insulated by its local character, its non-commercial values, and its enviable loan recovery record was strongly challenged by the report’s findings. Credit risk emerged as the top Banana Skin (having been No. 10 previously) and the state of the macro-economy as No. 3 (up from the depths of No. 23). Funding risks (liquidity, refinancing, capital availability) also ranked high where previously the main worry had been “too much funding” and an unsustainable expansion of capacity.

Credit risk. This was a dramatic turnaround to say the least. And it was validated – generally speaking – by the discussions, and by rising loan default numbers from many regions. Many people saw this as, to some extent, a self-inflicted risk, caused both by the sharp growth in MF lending in recent years due to rising competition, and by poor management of credit risk (inadequate credit assessment, multiple borrowing, poor documentation etc.). For example, MIX numbers show that while Latin America accounts for nearly half total MF lending volume, the greatest number of borrowers is in South Asia where overborrowing is at its highest.

There was a widespread view that improved credit management was an urgent priority both for MFIs and for industry wide initiatives for better credit information to combat overborrowing.

Funding. Also worrying, but less under MFIs’ direct control, were threats to funding, though generally these seemed to exist more as fears than actual experience. Many MFIs reported “no difficulty” on this front. A wrinkle here is the high place given to liquidity risk – again not something normally associated with MFIs. However growing numbers of MFIs now fund themselves directly in the banking markets, and since only a minority of MFIs take deposits, interbank lending has become crucial. The crisis has sharpened the question of whether more MFIs should go into deposit-taking: it has an obvious appeal, but in many jurisdictions the regulatory hurdles are high. Also, the survey’s findings suggested that so far as risk perceptions are concerned, little distinction is made between deposit-taking and non-deposit-taking MFIs. Loss of depositor confidence is also seen as a low-ranking risk.

An associated risk is foreign currency: as more MFIs fund themselves in international markets, the risk is growing and hedging opportunities are still limited. Some pass this risk straight on to their customers, which seems inappropriate given how financially unsophisticated many of them are.

Given the shocks that have hit world markets, it may be premature to expect abundant funding conditions to return soon. Caution about funding prospects may be in order.

The world economy. Entirely outside the MFIs’ control is the state of the world economy. Broadly, there seemed to be pessimism in the survey and the discussions

about the outlook, with the prospect being for a long and difficult recovery. But there were exceptions. Bangladesh appeared to have escaped the effects altogether. India also seemed buoyant, though our discussions in Delhi threw up notes of caution.

Although the larger, more sophisticated MFIs are those most heavily exposed to global markets, they are also probably those best able to manage financial risk. Small, local MFIs are the least exposed. Because of this, some of our discussants felt that the vulnerable tier lay in the middle: MFIs with a degree of exposure to global markets, but without the expertise to manage it. If one segment of the industry needed watching, this was it. Generally, though, there was an expectation that MFIs would come out of the crisis in better shape than commercial banks. During the period of the survey and the discussions, there had been relatively few MFI failures, and certainly nothing like the crisis on Wall Street and the City.

One message in this area was the need for better understanding of MF's ability to withstand macro-economic shocks. The links are now very close, through funding markets, and through the impact of recession on employment, remittances, commodity prices and interest rates, and more could be done to manage these exposures.

The next phase. It remains unclear how severely MFIs will be affected by the crisis. The numbers suggest that while growth in lending and profitability is weakening, the damage will be far less than in the commercial sector. Many MFIs have also reined in their lending deliberately to lower their risk profile. The international institutions are providing strong support. But there is certainly no room for complacency, given the structural challenges facing MFIs in many markets.

Completely outside the global crisis, for example, the Moroccan microfinance industry hit an air pocket in 2008 when a combination of unsustainable growth and overlending led to a massive increase in loan losses, and forced two of the country's largest MFIs into a merger. This solution seems to have worked: confidence returned and loan losses were contained, according to a study by CGAP. But the consequences of unsustainable growth need to be carefully watched.

2. Management

“Microfinance is in the risk business”

The quality of management in MFIs was the only Banana Skin from the 2008 survey which retained a high position in 2009, an indication that this remains a pressing concern. However the discussion this time had a different focus. It was no longer a matter of management being generally weak, but of an urgent need for a fundamentally more professional approach. The crisis had shown that many managements were

- unprepared for shocks,
- had little understanding of “new” risks such as liquidity, and
- knew little about risk management.

Moreover, some discussants felt there was a worrying tendency for MFIs to use the crisis as a scapegoat for their problems, and avoid addressing internal causes.

Many of the themes here have been widely discussed before. But it was felt that the main lesson of the crisis was the need to develop and institutionalise risk management skills in MFIs. Among the suggestions were the creation of a risk management “framework” for the industry, development of training at both governance and staff levels, emphasis on forward-looking action (rather than simply reaction), elimination of the view that MF is too special to need risk management.

Could the quality of risk management become a key differentiator for MFIs?

3. Competition

“MFIs are going to have to learn to live with competition”

The growth of competition was a big issue in the 2008 survey, though there was clear disagreement between those who saw it as a healthy development, and those who blamed it for eroding the industry’s standards. Concern cooled off in the 2009 survey because the global crisis removed some capacity from the market (more commercial than MF). But it remains a structural issue, and one which will probably still be there once the crisis has gone. The challenge is not to get rid of it, but to learn to live with it.

The crisis highlighted a number of undesirable aspects. One is overindebtedness, which can certainly be traced back to excessive capacity, overlapping MFIs and multiple borrowing. Another is that competition perversely favours short-termist, sharp business practices. We heard of several instances where aggressive newcomers outbid established MFIs for business, drove them out of the market, and then departed when times got tough, leaving communities without any MF service at all. It is very hard for well-run MFIs to keep their cool, let alone manage healthy businesses in such an environment.

Bangladesh, the home of microfinance and one of its most mature markets, was a good example. When the new regulatory agency recently invited MFIs to apply for licences, 4,000 came forward. In a poll we conducted of 27 practitioners, competition was voted the top Banana Skin. What was slightly worrying though, was that credit risk barely got a mention, even though the connection between excess capacity and overborrowing is well documented.

Part of the answer may lie in regulation: the authorities ensuring that service providers are fit and responsible, and encouraging consolidation. Part of it may also lie in dispelling the notion that MF is somehow “a risk-free business”, as it was described in a *Financial Times* publication last year. If anything, the crisis has shown it to be an increasingly high risk business.

This is a management issue: understanding the dynamics of competition, and positioning oneself to meet it.

4. Customer management

“MFIs are drifting away from their customers”

A theme that cropped up in several discussions was customer management, specifically whether MFIs do this as well as they should. The issue is closely related both to reputation and financial performance, and is obviously crucial to an industry which relies so heavily on social contact.

There are several issues:

- managing borrowers,
- dealing with delinquency,
- providing the right products,
- staying close to communities and individuals.

There is a sense that the structural shifts in the industry which have already been referred to are widening the gap between MFIs and their customers, leading to worse customer management, rising credit problems, declining client loyalty, and ultimately loss of business.

The theme came through most strongly in our discussions in India where the view was expressed that MFIs are drifting away from their customers. “Customer centricity is being replaced by product- and growth-centricity”, said one participant. In particular, MFIs are losing out to money lenders who manage these relationships extremely well through their informal networks and are taking business away from MFIs. This may be an undesirable social development, but there were nonetheless lessons that MFIs could learn about staying close to their customers, understanding their needs, and avoiding credit losses.

In other discussions, people made the point that MFIs needed to tailor their products more closely to demand: eg by focusing on flexible short term loans (linked if necessary to seasonal factors) rather than trying to shoehorn customers into ready-made products such as consumer loans, by offering more savings products, and by linking products to social needs such as food, housing, education and health. The need to monitor the suitability of loans and adjust terms as necessary was also stressed. A further point was that instead of seeing expansion in terms of moving into unserved rural areas, MFIs might consider the exact opposite: developing a greater presence in inner cities where financial exclusion was growing.

Close customer management should be a feature of microfinance.

5. Reputation

“What is the evidence that MF does good?”

A broadly-based concern that came out of the survey, and was substantiated by later discussions, was how the crisis and other challenges facing MF would affect its reputation. There was general agreement that the industry’s reputation is high, but vulnerable. Before the crisis struck, there was already concern that growing commercialisation would tarnish MF’s image and accelerate the phenomenon of “mission drift”. The newer crisis-driven worry was that stressful times would have two effects: they would force MFIs to take a tougher line with delinquent borrowers, and encourage borrowers to default, creating a crisis in the lender-borrower relationship.

The actual evidence for these concerns remains spotty, and it is hard to generalise. However there are growing signs of resentment in certain countries at the high rates of interest charged by MFIs, and of borrowers taking advantage of political attacks on MFIs to go on strike. We were presented with several examples: Nicaragua, Bosnia and, most striking of all, Pakistan where there had been a major borrowers revolt in the Punjab, fomented by local politicians.

It is expected that these trends will worsen, certainly while the global crisis lasts, but possibly beyond that too because of the industry’s gradual shift to a more commercial culture. When we asked one of our Indian round tables whether they thought the industry was heading for a flashpoint/crisis in the next 12 months, a quarter of those present voted yes.

Our discussions revealed a widespread concern among MF practitioners that the industry is vulnerable to the accusation that it has done little to alleviate poverty. This may or may not be true, but it is an easy charge for critics to make, and potentially very damaging. The Press is increasingly targeting the industry, and during the period of the survey the *Wall Street Journal* carried a long piece questioning the value of microfinance.

At our round table at CGAP in Washington, there was a detailed discussion about how this problem should be addressed. Too much of the evidence in support of MF’s role is internally generated or self-congratulatory. The need is for a substantial body of objective research to address this question and come up with credible findings. How might it be taken forward?

6. Methodology

The survey ran very smoothly, attracting 430 responses from 82 countries, a record for any Banana Skin survey. A few changes were made to the questionnaire from the previous survey: the number of Banana Skins was trimmed from 29 to 25, and a question about deposit-taking was added to explore possible distinctions between the risks facing deposit-taking and non-deposit-taking institutions (of which there turned out to be few). It would be interesting to receive

more comeback from respondents about the questionnaire and the presentation of the results. But as things stand we would change little if a further survey is carried out (which it may be in the latter part of 2010).

7. Going forward

“Lessons, good and bad”

The survey and the ensuing discussions provided many valuable insights into microfinance at what could turn out to be a critical time in its development. Several points emerged, some to do with the crisis, others with longer term issues.

For most MFIs, this is their first encounter with a full-blown global financial crisis, and it has produced many lessons, good and bad, which may prompt a reassessment of the essential nature of microfinance.

1. The crisis has underlined just how intertwined many parts of the MF sector have become with “the real world” through exposure to financial markets, the macro-economy and commercial competition. This has had a wide impact on the industry, affecting credit quality, profitability, growth prospects and the industry’s reputation. MFIs may have to manage their way through a period of low/zero growth and lower profitability until they regain their strength.
2. Although the impact varies greatly, there is a broad message: that MFIs are “in the risk business” and need to have the resources and skills to handle that. Many do not, or believe they do not need them because they are “special”.
3. When the crisis is over, many Banana Skins may lose their urgency, for example funding risks, and there is a danger of a return to complacency. However the lessons of the crisis need to be taken on board, and built upon, particularly in the area of developing stronger management skills.
4. The industry’s reputation has come under attack. Although this is partly crisis-related, it may also turn into a longer term issue which will need to be addressed and managed. The industry as a whole should be prepared to defend and justify itself.

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