

Over-Indebtedness:

A Risk Management Approach



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About the Microfinance CEO Working Group

The Microfinance CEO Working Group is a collaborative effort by the CEOs of eight pioneering microfinance organizations: Accion, FINCA International, Freedom from Hunger, Grameen Foundation USA, Opportunity International, Pro Mujer, VisionFund International, and Women's World Banking. Collectively, the Working Group encompasses more than 250 microfinance institutions (MFIs) in 70 countries, representing over 40 million clients. Since 2011, the Working Group has sought to support the microfinance industry in bringing a broad range of financial and related services to those who have traditionally been excluded. The Center for Financial Inclusion at Accion serves as the secretariat for the Working Group.

Purpose of This Paper

This paper has been prepared by the Risk Management Group (consisting of the lead risk managers from Accion, FINCA, Pro Mujer, and VisionFund) on behalf of the Microfinance CEO Working Group. Its purpose is to provide a brief overview of the risks surrounding over-indebtedness, intending to address the following areas:

- What are the leading indicators that highlight the trend toward over-indebtedness risk materializing?
- What steps can we take to prepare our MFIs? What are the mitigants and controls that will reduce the likelihood of our MFIs being affected and the impact should over-indebtedness hit the wider market?

The aim is to suggest practical steps that MFIs can take to reduce the likelihood of over-indebtedness risk occurring, and if it does occur in the wider market, to reduce its impact on the MFI. This paper is intended to provide support and guidance to risk managers at microfinance institutions or networks.

While the majority of the content in this paper is general and applicable to any microfinance market, it was produced during a particular investigation into the state of the microfinance market in Mexico. For more information about the current state of the Mexican market, please see the companion paper, *Over-Indebtedness in Mexico: Its Effect on Borrowers*.

Takeaways—Key Mitigants for MFIs

In this paper we outline a summary of the environments in which over-indebtedness becomes more likely, the parties that will be affected, and the recommended mitigants to tackle this risk. However, if the paper were to draw out the most significant mitigants that would have the greatest impact on reducing the likelihood of over-indebtedness among clients, it would be these:

1. **Mandate high-quality reporting by all MFIs and other lending institutions that operate in the same markets (such as pawnshops and commercial banks moving into the microfinance market) to a universal credit bureau operated by a governmental organization.** In the meantime, before mandatory reporting is required, this paper would urge institutions to proactively engage with their credit bureaus so that information can be shared, and potential damage through widespread over-indebtedness of clients can be limited.
2. **Strengthen the process of borrower screening**, to ensure visibility of the existing financial obligations of borrowers before more loans are dispersed. There is a danger in the group lending model that individual payment capacity can be overlooked. Therefore this paper would urge MFIs to conduct more individual borrower analysis, particularly in the area of payment capacity.

3. There needs to be a **greater awareness by MFIs and other lending institutions about market-competitive hotspots**, which should be derived not just from anecdotal evidence but from geographic concentration analysis. Some MFIs will need to decide to reduce their portfolio in a particular area or even withdraw altogether if the risk becomes severe.
4. Research indicates that a client's risk of falling into arrears increases greatly with the number of loans. **MFIs should adopt a provisioning policy with an increasing scale based on the number of client loans**, e.g., if a client already has an existing loan, a new loan could require provisioning at a higher level. Provisioning norms should also be regularly reviewed to establish appropriate provisioning percentages based on risk.

Summary of Analysis and Recommendations

There are certain environments in which the risk of over-indebtedness becomes greater. Below we have briefly outlined our analysis of factors contributing to over-indebtedness, the affected parties, and recommended mitigants.¹

Environments with a greater risk of over-indebtedness:

1. Many informal sources of finance are available
2. Consumer lenders are moving into the same market as microfinance
3. The environment is competitive, with a number of MFIs competing for the same clients
4. Credit bureaus are not available, inadequate, or not widely used
5. Growth is pursued with no consideration of the risks involved
6. Due to high growth, the MFI's systems are overstretched, and the controls appropriate to a smaller MFI are no longer sufficient
7. Products are not suitable for the clients in the market, either because they are too expensive (so the clients' businesses are unable to service the repayments), or the loan sizes are too small for the clients' needs (so they end up taking out multiple loans)
8. Policies regarding the assessment of clients' ability to meet their obligations are inadequate
9. Practices in the field to assess clients' ability to meet their obligations are inadequate
10. The institution lacks good governance, a good management information system (MIS), or strong controls, or has a poor or nonexistent risk management function
11. High staff turnover leads to a reduction in the quality of client analysis and other credit controls
12. In environments with perverse incentives for Loan Officers, little attention may be given to the longer-term situation
13. In urban and semi-urban areas, where the operating costs are lower, competition tends to be higher

These risks are faced by the following parties:

1. Clients who are over-indebted (may face financial problems and a bad credit rating as a result)
2. Clients who are not over-indebted (may no longer have a service if local industry collapses)
3. The microfinance industry
4. Other lending institutions, such as pawnshops and commercial banks, moving into the microfinance market
5. Investors in MFIs

¹ Some of these have been observed by respondents to the Microfinance Banana Skins Report. Center for the Study of Financial Innovation, "Microfinance Banana Skins 2012: Staying Relevant" (New York: CFSI, 2012), <http://www.citi.com/citi/microfinance/data/news120628.pdf>.

Recommendations for mitigants that can defend an organization against these risks (our priority recommendations are in bold):

1. **Mandate quality credit reporting to a universal credit bureau**
2. **Strengthen the process of borrower screening**
3. **Maintain awareness of competitive hot spots and monitor closely for signs of over-indebtedness**
4. **Adopt a provisioning policy with an increasing scale based on the number of client loans**
5. Engage with leading self-regulatory consumer protection initiatives, such as the Smart Campaign and MFTransparency
6. Ensure that MFI is client-centric
7. Promote strong boards that adequately challenge Management
8. Ensure that the Management team gives the appropriate focus to both strategy and riskmanagement
9. Provide financial education with loans, particularly covering with clients the importance of affordability and the risk of over-indebtedness
10. Develop more appropriate pricing of products
11. Consider internal caps on the effective interest rates charged to clients
12. Practice lending methodologies that take into account payment capacity rather than relying entirely on the group support/pressure common in some communal and solidarity methodologies.
13. Change the scheme of interest rates, by lowering them and applying them on the balance of the loan
14. Introduce a policy whereby an applicant can borrow from, for example, a maximum of two lenders, and special approval is required for any exceptions
15. Monitor and challenge what is being done to mitigate against the risk of over-indebtedness through a proactive Risk Managementfunction
16. Gather aManagement Risk Committee regularly to review these risks and mitigating actions
17. Develop an effective Internal Audit function that follows up on the extent to which processes are being followed, particularly in branches
18. Collect credit information frequently and with good quality control
19. Share information among MFIsinformally where appropriate
20. Implementgood corporate governance practices (which take time, but are a necessary mitigant)
21. Engage with the regulator on being actively involved
22. Include the PAR 30 (Portfolio at Risk greater than 30 days) as part of the credit policy regulations
23. Encourage the formation of a specialized regulator to formulate policy guidelines and to monitor the performance of unregulated institutions that grant credit today

Definition of the Problem

Over-indebtedness of individuals or households can be defined as the inability “to repay all debts fully and on time.”² However, not all repayment problems are due to over-indebtedness, so it is important to distinguish when over-indebtedness is the main driver of the delinquency.

A study by the Centre for Micro Finance at the University of Zurich³ categorizes the industry as in its

²Oliver Haas, “Overindebtedness in Germany” (working paper, International Labour Office, 2006), http://www.ilo.org/wcmsp5/groups/public/@ed_emp/documents/publication/wcms_117963.pdf.

³Vivien Kappel, Annette Krauss, and Laura Lontzek, “Over-indebtedness and Microfinance: Constructing an Early Warning Index” (Center for Microfinance—University of Zurich, 2010), <http://www.accion.org/Document.Doc?id=899>.

“adolescence”; hence the industry is still developing the appropriate responses to the risks and challenges it faces. This is an opportunity for concerned MFIs to lead the way in addressing these areas that need development.

Why is Over-Indebtedness Seen as Such a Significant Risk?

The fallout from over-indebtedness can be extensive, and can be summarized primarily in three areas:

- First, from the point of view of the industry’s social responsibility, it is not desirable to see clients become over-indebted. Many MFIs are operating with the prime intention of helping poor clients. The consequences to a client of not being able to meet his or her repayment obligations can lead to social, economic and psychological problems.
- Second, if over-indebtedness among clients is widespread, it can easily lead to defaults, which can result in an adverse financial impact on an MFI and its investors. The whole development of financial services in a country can be hindered by damage to the relationship between MFIs and their clients.
- Third, over-indebtedness can result in negative reputational damage both to the MFIs involved in the saturated market and to the wider industry in general. This can lead to additional problems for MFIs, such as fewer donations and a lack of confidence from funders that could potentially cause them to pull out of certain markets. Reputational damage can have a significant impact because of the effect of contagion. MFIs in countries where there are no signs of over-indebtedness can be adversely affected by irresponsible actions from MFIs in a different part of the world. The contagion of reputational risk within an industry has no geographical boundaries.

Examples of Over-Indebtedness and Leading Indicators

To date, a few countries have undergone a significant crisis of over-indebtedness: Bolivia in 1999, Bosnia and Herzegovina in 2009, Morocco and Pakistan in 2008, and India (notably in Andhra Pradesh) in 2010. In addition, Nicaragua had a related repayment crisis during 2008 and 2009. Two of these crises are discussed in further depth in the appendices.

In a qualitative cross-country analysis of these microfinance over-indebtedness crises, the main causes as identified by Chen et al.⁴ were:

1. a concentrated market, which is manifested through competition and the existence of multiple borrowing,
2. overstretched MFI systems and controls, and
3. an erosion of MFI lending discipline.

These factors have been echoed elsewhere in academic literature. For example, the European Fund for Southeast Europe (EFSE) identifies multiple borrowing (i.e., borrowing from different sources during the same period) and an overuse of salaried individual guarantors who are also borrowing themselves as some of the major factors contributing to over-indebtedness in Bosnia and Herzegovina.⁵ Additionally, a

⁴Gren Chen, Stephen Rasmussen, and Xavier Reille, “Focus Note: Growth and Vulnerabilities in Microfinance,” CGAP Focus Note No. 61 (Washington, D.C., CGAP, 2010), <http://www.cgap.org/publications/growth-and-vulnerabilities-microfinance>.

⁵Klaus Maurer and Justyna Pytkowska, “Indebtedness of Microcredit Clients in Bosnia and Herzegovina” (Germany, European Fund for Southeast Europe, 2010), <http://www.efse.lu/media/pdfs/studies/responsible-finance-studies/summary-overindebtedness-bih.pdf>.

look at over-indebtedness in Morocco by Xavier Reille in 2009⁶ showed that during a period of strong market growth, many MFIs relaxed their credit policies in order to keep up with the competition, contributing to over-indebtedness.

Another key factor that emerges from a review of the literature is the impact of consumer lending. Elisabeth Rhyne attributes one of the main causes of the 1999 over-indebtedness crisis in Bolivia to the increase in consumer lenders offering similar products to MFIs (in terms of loan amounts, loan terms and prices), but using consumer lending techniques.⁷ Puja Campos (2008) also points out that high levels of sales of fast-moving consumer goods along with low levels of financial literacy were some of the primary reasons that led to the over-indebtedness of Chilean commercial bank customers.⁸

Early Warning Systems

The Centre for Micro Finance at the University of Zurich, sponsored by ResponsAbility, the Council of Microfinance Equity Funds, and Triodos Investment Management, has produced a paper constructing an early warning system for over-indebtedness in microfinance.⁹ This is based on factors in four categories (or indicators):

1. Macro-level indicator
2. Microfinance market indicator
3. MFI-level indicator
4. Household-level indicator

The macro-level indicator assesses factors such as GDP per capita growth, remittances, inflation, political and economic stability, corruption (based on the Corruption Perceptions Index), and governance.

The microfinance market indicator considers market penetration, number and size of MFIs, loan portfolio growth rates, client numbers, quality and use of credit information systems, commercial bank involvement, level and trends in competition, investment flows, and MFI's liquidity positions.

The MFI-level indicator recommends looking at average loan balance per borrower, loan requirements and lending methodologies, Loan Officer productivity, client-staff ratio, growth and market targets, cases of multiple lending, and existence of consumer lending.

There were no suggested early warning signs for the household-level indicator, given the need for intensive field work and individual research. However, the report highlights that MFIs must understand both the macro environment and the local microfinance industry, in addition to focusing on what they can control within their own internal environment.

⁶ Xavier Reille, "The Rise, Fall, and Recovery of the Microfinance Sector in Morocco," *CGAP Brief* (Washington, D.C., CGAP, 2010), <http://www.cgap.org/sites/default/files/CGAP-Brief-The-Rise-Fall-and-Recovery-of-the-Microfinance-Sector-in-Morocco-Jan-2010.pdf>.

⁷ Elisabeth Rhyne, "How Lending to the Poor Began, Grew, and Came of Age in Bolivia" (Boston, Kumarian Press, 2001).

⁸ Alejandro Puja Campos (2008), "Programa credito y sobreendeudamiento de los consumidores" (Santiago de Chile, Consumers International - Fundacion Avina, 2008).

⁹ Vivien Kappel, A. Krauss, and L. Lontzek, 2010.

A Risk Management Approach to Over-Indebtedness

A Systematic Risk Management Approach

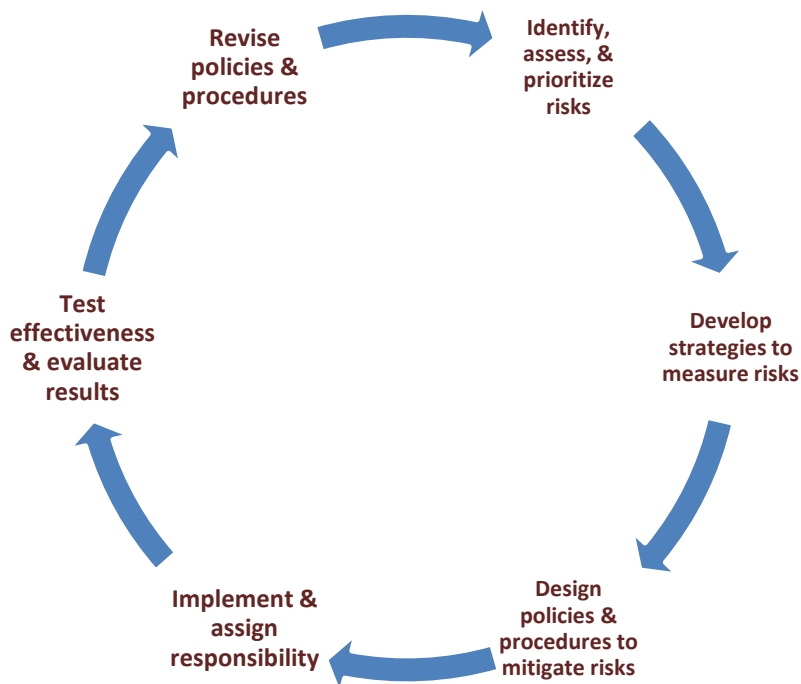
In the middle of a high-growth environment, while responding to intense competition, an appropriate analysis of over-indebtedness risk may be overlooked. Therefore we recommend that over-indebtedness risk be addressed, like any other risk, through a formalized risk management approach. Effective risk management is fundamental to any MFI's ability to sustainably meet its strategic objectives.

By systematically approaching risk management throughout the organization, the MFI will increase its risk awareness, allowing for the early warning of potential problems. Such an approach requires that responsibility be assigned, in order to ensure there is clear accountability for the mitigants. Risk management is an organization-wide activity and should apply to all the MFI's activities and decisions.

Using the Risk Management Feedback Loop

Each MFI's approach to the risk of over-indebtedness should be a continual process of systematically assessing, measuring, monitoring and managing key variables to address the particular exposure it has to that risk. Inherent within this methodology is the concept of "root cause analysis," i.e., finding out why any failure occurs and fixing it.

The risk of over-indebtedness can be approached using the methodology of the Risk Management Feedback Loop (see diagram below):



It is absolutely essential that the assessment of the risks of over-indebtedness and the design and implementation of appropriate strategies to deal with them are continuously reviewed to ensure that new risks are covered and existing risks are managed in the most effective way. Enabling the organization to undertake the rigor of "risk thinking" is one of the key values of this feedback loop methodology.

Defensive Actions against Over-Indebtedness

In any MFI there should be three lines of defense:

- The first is the Operational front line, which is effectively all the staff who work for the MFI. They are required to ensure the effective management of risks within the scope of their direct organizational responsibilities; hence all employees have responsibility for risk management. Here there should be the appropriate checks and balances to ensure that credit policies and procedures are sufficiently robust and are being diligently followed.

Everyone who works for an MFI is the “Risk Owner” for the risks within the sphere of influence that they have. Risk Owners are responsible for highlighting any significant risks to Management, and for ensuring that risks are being mitigated. A more detailed look at the responsibilities of the first line of defense is set out below:

- Ensure all material risks are identified, assessed, mitigated, monitored and reported
 - Define and maintain mitigating policies and key internal controls for material exposures
 - Ensure effective communication of policies and other control requirements
 - Ensure all applicable policies, procedures, limits and other risk control requirements are implemented and complied with
 - Monitor material live risk issues and events and ensure appropriate management action is being taken to mitigate their impact
 - Identify emerging risks on a regular basis
 - Identify activities that should be a focus for independent assurance
 - Assess existing controls and propose control enhancements and improvements
 - Maintain an understanding and awareness of applicable laws and regulations
- The second line of defense comprises the Risk function, which is the activities of anyone, full time or part time, who is involved in the practices of risk management within the organization. The Risk function helps provide the appropriate structures, tools and forums to ensure that risks are properly assessed and that those decisions are made transparently on the basis of this proper assessment. This function proactively looks at the controls and mitigation environment and provides policies and tools that help the Risk Owners assess their risks and the strength of their mitigating actions. Even in a small MFI, where there is insufficient budget to have a dedicated Risk Manager, there can still be a “Risk Champion” who as part of his or her job helps to ensure that the business is assessing its risk, reporting it, and addressing the weaknesses the assessment highlights.

At VisionFund International, the Risk function is independent from the operational side of VFI, to enable it to more freely challenge whenever risks are not aligned with control requirements or risk appetite. Like Internal Audit, Risk should be free to work independently from all business processes, so it is in the best position to identify weaknesses within any processes.

The Risk function is responsible for:

- Ensuring the organization has an overall framework for managing risk and that it has clearly defined and is measuring its risk appetite
 - Effectively communicating and implementing the Risk Management Framework
 - Administering related governance and reporting processes, such as a consolidated Risk Register to log risks material to the organization
- The third line comprises the independent assurance provided by Audit. This includes both the Internal Audit (IA) function and external auditors. IA helps by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance

processes. External auditors then determine whether the MFI's accounting records are accurate and complete, and whether they represent a true and fair view of the MFI's financial position. The third line has the authority to challenge and hold the first and second line to account.

Mitigations to the Risk of Over-Indebtedness

Awareness of the environments that give rise to a greater risk of over-indebtedness is critical in order to be prepared and take action.

After reviewing the existing literature and conducting numerous conversations drawing upon our real world experience, our Risk Management group has identified a number of indicators in which an environment is more prone to the risk of over-indebtedness:

1. Many informal sources of finance are available
In assessing the competitiveness of the market, it is very important to include both formal and informal sources of finance. It is not enough to look only at the classic microfinance players, because the target market may also be served by non-regulated institutions and informal money lenders. Obtaining appropriate data related to the informal sector is often a challenge, so being aware of the number of players in a market and building upon the experience of local people are essential parts of developing a picture of the extent of the risk. Even if it can't be proved empirically, often there is a lot of anecdotal evidence of this risk.
2. Consumer lenders are moving into the same market as microfinance
In many parts of the world, the banking sector is increasingly reaching down into the same market segment as the microfinance industry. This increases competition and heightens the risk that lending criteria can be slackened in order to gain market share quickly.
3. The environment is competitive, with a number of MFIs competing for the same clients
Rigorous credit checking processes could slip if the prize of growth is pursued too aggressively. In an environment where an MFI desires to grow, Loan Officers are incentivized accordingly and so are motivated to cut corners to reach their targets.
4. Credit bureaus are not available, inadequate, or not widely used
Effective credit bureaus are one of the main defenses against the risk of over-indebtedness. However, these are only as good as the information given to them, so it is imperative that where these exist each MFI attempts to provide as accurate and complete information as possible.
5. Growth is pursued with no consideration of the risks involved (reflecting weakness in boards, Risk Management functions)
Growth pursued with no consideration of risk reflects a weakness in governance. Ultimately a strong board should hold Management accountable for managing growth very carefully and taking considered decisions within a defined strategy. This should be reinforced by an Executive Management team that proactively manages its growth in a responsible way.
6. Due to high growth, the MFI's systems are overstretched and the controls appropriate to a smaller MFI are no longer sufficient
An MFI's staff, policies and procedures, and MIS systems need to grow at a pace with the client growth of an MFI. The risk is that Loan Officers may be financially incentivized to continue the growth trajectory and Management may be too enamored of the desire to gain market share that the institutional change doesn't keep pace with the growth. In this case, procedures may not be followed, new staff may not be adequately trained, and systems may not be able to cope with the new size of the MFI.

These in turn can easily lead to weaker controls and oversight and can exacerbate the risk of client over-indebtedness and delinquency.

7. Products are not suitable for the clients in the market, either because they are too expensive (so the clients' businesses are not able to service the repayments) or the loan sizes are too small for the clients' needs (so they take out multiple loans)

If the client's business is not able to service the debt repayments, then the risk of the client becoming over-indebted is high. Currently in Mexico the prevailing interest rates are high, as MFIs are pricing risk into their interest rates due to their ineffectiveness in making proper risk assessments. In many parts of the world, although a portion of clients are financially astute and literate, some are not. It is our moral duty to ensure we are offering appropriate products to our clients.

Product loan sizes should be an adequate size for the client's business. If they are too small for the client's needs, the client may seek multiple loans from elsewhere to make up the shortfall.

8. Policies regarding the assessment of clients' ability to meet their obligations are inadequate
The policies that Loan Officers use to assess a client's ability to repay his or her loan obligations have to be logically and clearly laid out. It is not sufficient to rely on the Loan Officer's judgment or experience, although these play a part. The institution should have clearly defined checks and parameters to ensure an MFI is giving appropriate products to its clients.
9. Practices in the field to assess clients' ability to meet their obligations are inadequate
Policies are ineffective unless there is adherence to them in the field. The Internal Audit function in an MFI should check adherence regularly.
10. The institution lacks good governance, good MIS, or strong controls, or has a poor or nonexistent Risk Management functions
An MFI that doesn't have good reporting, as well as controls that can be tested and followed, creates an environment in which the risk of over-indebtedness becomes much higher. Likewise, if there is no Risk Management function to challenge whether risk is being monitored and managed, then Operations is not held accountable.
11. High staff turnover leads to a reduction in the quality of client analysis and other credit controls
In order to effectively follow credit assessment procedures, Loan Officers need to be trained and should shadow other Loan Officers. In environments of high turnover, such training often does not happen, so the risk of lending inappropriately increases.
12. In environments with perverse incentives for Loan Officers, little attention may be given to the longer-term situation
Appropriate Loan Officer incentives are critical to driving the right behaviors. Where Loan Officers are compensated purely for portfolio size, they will be motivated to grow the portfolio recklessly. When other aspects such as PAR, average loan sizes, etc., are also taken into account, the Loan Officers will be motivated through compensation to rigorously follow the credit assessment procedures.
13. In urban and semi-urban areas, where the operating costs are lower, competition tends to be greater
Many institutions tend to concentrate in urban and semi-urban areas, where the operating costs are lower; hence the risk of over-indebtedness is higher.

Below we list recommendations for mitigants that can defend an organization against these risks. Our priority recommendations have been listed in bold:

1. Mandate quality credit reporting to a universal bureau

There should be mandatory reporting by all MFIs and other lending institutions that operate in the same markets (such as pawnshops and commercial banks moving into the microfinance market) to a universal credit bureau operated by a governmental organization.

In the meantime, before mandatory reporting is required, we urge institutions to proactively engage with their credit bureaus—with quality information—so that information can be shared and potential damage through widespread over-indebtedness of clients can be limited. It is important for MFIs to set an example in being actively involved with credit bureaus, even if not all MFIs do so. If MFIs do not get involved because the quality is not good, the situation will never improve.

2. Strengthen the process of borrower screening

The process of borrower screening should be strengthened to ensure visibility of the existing financial obligations of borrowers before more loans are dispersed. There is a danger in the group lending model that individual payment capacity can be overlooked. Therefore this paper would urge MFIs to conduct more individual borrower analysis, particularly in the area of payment capacity.

The institution should have clearly defined and communicated policies to assess the suitability of potential clients. It is important to use appropriate credit methodologies for each target client segment, for example, utilizing a debt servicing multiple, which requires income to be a minimum multiple over repayment.

3. Maintain awareness of competitive hot spots and monitor closely for signs of over-indebtedness

It is important for MFIs to understand the concentrations of loans geographically and to know which areas are more prone to intense competition and therefore a greater risk of saturation. MFIs should also look at economic activity analysis, i.e., the sectors of the economy in which the risk of over-indebtedness is higher.

Concentration by geography or by product type can be done by analyzing what proportion of the loan book is in each segment. An MFI can choose to restrict its concentrations by predetermining tolerances, and monitor actual concentrations against these tolerances. The areas that are more prone to competition can be determined with a mixture of local and industry knowledge.

Monitoring for signs of over-indebtedness can be done formally and informally. Formally, if a credit bureau exists, or via empirical studies of over-indebtedness in an area. Informally, by the knowledge of local branch managers and Loan Officers who know the clients and the competitors in the area.

4. Adopt a provisioning policy with an increasing scale based on the number of client loans

MFIs should adopt a provisioning policy with an increasing scale based on the number of client loans, e.g., if a client already has an existing loan, the new loan could have to be provisioned at a higher level. Provisioning norms should also be regularly reviewed to establish appropriate provisioning percentages based on risk.

5. Engage with leading self-regulatory consumer protection initiatives, such as the Smart Campaign and MF Transparency

The Smart Campaign is a global initiative, led by the microfinance industry itself, to promote understanding and adoption of seven “Client Protection Principles”—the minimum standards that clients should expect to receive when doing business with a microfinance

institution. MF Transparency provides a platform for MFIs to be transparent about their interest rates. These initiatives mark important steps forward for responsible practices within the microfinance industry and MFIs should take an active role in engaging with them.

6. Ensure MFI is client-centric
Essentially, the focus must always be on the client. Social indicators should be used to ensure that the clients are not used just as a way to generate income.
7. Boards are strong and adequately challenge Management
Board members should be very aware of the risk of over-indebtedness in their markets and should play a key role in holding Management accountable for this risk being observed, reported on and managed.
8. A quality Management team gives the appropriate focus to both strategy and risk management
The Management team needs to be very aware of the extent of competition, as the markets in which they operate are continually changing.
9. Provide financial education with loans, particularly covering the importance of affordability and the risk of over-indebtedness with clients
Many clients may be unaware of the effective interest rate of their loan and therefore not be aware how at risk they are of falling behind with repayments. It is the duty of responsible MFIs to ensure that clients are educated about managing any debt that they take on. Messages about household debt management and over-indebtedness risk should form part of any consumer awareness and financial literacy promotion.
10. Develop more appropriate pricing of products
We recommend a closer look at product pricing—shifting to declining balance rates rather than flat rates, which are more likely to disguise the true effective interest rate to the client.
11. Consider internal caps on the effective interest rates charged to clients
This will reduce the risk of clients being unable to service their loans and taking on additional debt to do so.
12. Practice lending methodologies that take into account payment capacity rather than relying entirely on the group support/pressure common in some communal and solidarity methodologies
Especially as loan amounts and terms grow, structure payment plans to match expected cash flows as much as possible.
13. Change the scheme of interest rates by lowering them and applying them on the balance of the loan
A gradual reduction of interest rates over time is recommended. The interest charged can also be linked to a repayment performance, e.g., over the last six months. We also recommend increasing the average duration of the loans, as this makes the repayment obligations easier to meet.
14. Introduce a policy whereby an applicant can borrow from, for example, a maximum of two lenders, with special approval required for any exceptions
MFIs can internally restrict their exposure to clients with multiple loans. A recent study by an MFI in Mexico shows the likelihood of default increases rapidly with the number of loans simultaneously taken out.
15. A proactive Risk Management function will help to monitor and challenge what is being done to mitigate against the risk of over-indebtedness

A Risk function is able to proactively look at an MFI's market and its control environment, and to push the MFI to strengthen its controls and mitigate against its risks.

16. A Management Risk Committee regularly meets to review these risks and mitigants
A Management Risk Committee should be composed of senior managers in the organization and should periodically consider the risks faced by the organization. These risks should be prioritized and wherever possible addressed.
17. Develop an effective Internal Audit function that investigates the extent to which processes are being followed, particularly in branches
Internal Audit is useful for the MFI to confirm whether or not controls are being followed. It is important that branches know they can be visited randomly and that there is not too long a period between visits.
18. Credit information should be collected frequently and with good quality control
If MFIs commit to collecting credit data and try to assure its quality, the whole industry will be less exposed to over-indebtedness if that information is widely circulated and used well.
19. Encourage the industry to actively share information with and use credit bureaus
Ideally, reporting to credit bureaus should be mandatory for both regulated and nonregulated institutions, with the purpose of protecting the consumer from over-indebtedness, as well as protecting the public's deposits and funding coming from the government.
20. MFIs share informally where appropriate
In some countries, MFIs have a loose arrangement whereby branches in the same localities can do informal credit checking for new clients. This requires a degree of trust and cooperation among the MFIs.
21. Implement good corporate governance practices
Many MFIs think their risk management and corporate governance is strong because they have a number of good policies in this area. However, the proper implementation, which involves adoption and feedback, can take up to five years in some cases to do properly. Good corporate governance practices take time, but are a necessary mitigant.
22. Engage with the regulator and encourage active involvement
The government has an important role to play in ensuring a properly functioning market that takes care of clients. The regulator needs to regulate lending practices that may create incentives for reckless lending. Rules need to be defined requiring effective disclosure and complaints handling by lenders. Measures are needed to improve lending practices, potentially including guidelines on affordability assessments and the oversight of agents or brokers.

The credit bureau in Bolivia is a great example in terms of the information offered to financial institutions. Bolivia has three credit bureaus: one run by the regulator (ASFI, the Financial System Supervisory Authority), one run by the Chamber of Commerce, and one put together by MFIs. Regulated financial institutions are required to submit their database to ASFI each month. ASFI then delivers this information to the various credit bureaus.

The MFI bureau is especially helpful because it includes not only supplemental information but supplemental institutions—it gathers information from both regulated and unregulated institutions. It also includes client history for the last 18 months and any entities that have recently inquired about the client.
23. Include PAR 30 as part of the credit policy regulations

Currently in Mexico, a client is considered in arrears after 90 days. After this sort of arrears, the percent recovery is far below 50 percent.

24. Encourage the formation of a specialized regulator to formulate policy guidelines and monitor the performance of nonregulated institutions that grant credit today

This would bring the nonregulated sector under some supervision and subject it to some constraints, lowering the risk of client over-indebtedness.

Appendix 1: Bolivia's Microfinance Crisis

Bolivia's microfinance crisis in 1999-2000 holds significant lessons for today. Like other markets that have experienced troubles, problems began with aggressive new entrants—in this case consumer lenders who pursued multiple borrowing by clients.¹⁰ According to Elisabeth Rhyne, “[The consumer lenders’] pitch said, ‘If you're a good microfinance client, come to us. We'll give you a bigger loan and you'll get it faster.’ This appeal allowed them to double the total number of small loans outstanding in the market within a year.”¹¹

Over-indebtedness in Bolivia began to increase just as the country started to experience a recession, which led to repayment difficulties. Politically motivated actors then began a debt protest movement, which included street marches, hunger strikes, destruction of MFI property, and “the takeover of the banking superintendency by dynamite-wearing protestors.” In essence, consumer lending affected the microfinance market in Bolivia, then crashed with the onset of a recession—damaging the microfinance sector in the process. This shows the risks present from externalities, as well as from numerous players catering to the same small market.

However, today Bolivia has moved beyond its microfinance crisis, with all of the leading microfinance institutions having stabilized. Steps that Bolivian MFIs took to recover included both short- and long-term actions. In the short term, MFIs diffused protests by working with the government and announcing that they would resolve the repayment issues of every client named in protests. In the long term, MFIs:

- Wrote off many loans, relying on their financial cushions
- Strengthened associations and their linkages with government
- Worked with government and associations to build strong credit bureaus
- Improved client repayment analysis
- Offer a broader product line to better meet client needs
- Working to reduce interest rates by cutting costs so as to avoid government repercussion—from 35 percent to just under 20 percent

In addition, regulators limited debt service for consumer loans to 25 percent of a person's salary, requiring most consumer lenders to shut down operations. This weeded out a large percentage of the “bad players.” Banking authorities also realized the need to hire supervisors dedicated to microfinance and initiate regular dialogue with industry associations.

¹⁰ Elisabeth Rhyne, “Repayment Crises: Lessons Learned from Bolivia,” Blog post, *Center for Financial Inclusion Blog*, Mar. 1, 2010. Center for Financial Inclusion <http://cfi-blog.org/2010/03/01/repayment-crises-lessons-learned-from-bolivia/>

¹¹ Elisabeth Rhyne, “A Tale of Microfinance in Two Cities,” Blog post, *Huffington Post*, Dec. 13, 2010. Huffington Post. http://www.huffingtonpost.com/elisabeth-rhyne/a-tale-of-microfinance-in_b_795840.html.

Appendix 2: India's Microfinance Crisis

In 2010 India experienced what is undoubtedly the most infamous microfinance crisis, whose effects are still being felt today. Its epicenter was the state of Andhra Pradesh (AP), where microfinance began its takeoff in the country. As a result, several of the largest MFIs (and those most damaged) were headquartered in AP or had major operations there. The crisis was triggered by “sensationalized newspaper accounts of suicides among over-indebted clients of some of India’s biggest MFIs,” coupled with rising debt stress among thousands of clients.¹² This resulted in a restrictive ordinance from the Andhra Pradesh state government, which severely curtailed lending (and still does so today).

An analysis by M-CRIL identified numerous internal factors that contributed to the crisis, including high growth in saturated markets (without regard to client repayment capacity), loan size, multiple lending, over-indebtedness, client retention and client protection, lack of product diversity, and staff working conditions. MFIs pursued growth “at the cost of staff-client interaction.”¹³

However, MFIs were not solely to blame. The high growth by MFIs was fueled by easy commercial funding, indicating a role for investors who pushed for high growth. Intense media coverage contributed to the government intervention. The government of Andhra Pradesh (which promoted rival government-run self-help groups) then enacted reactive and restrictive regulation that brought lending to a standstill. Government officials also directed borrowers to cease repayment of existing loans.

So what happened to MFIs, and the borrowers, as a result of the crisis?

First, AP loan disbursement shrank from \$1.1 billion during the first half of 2010 to less than \$2 million during the second half.¹⁴ As of March 2011, cost per borrower had increased 33 percent over the prior year, operating expense ratios increased by 14.3 percent, and PAR 30 increased from 0.67 percent to 25.5 percent countrywide (given that AP was a primary location for microfinance lending in the country), leaving India with among the worst microfinance portfolio quality worldwide. Collections in Andhra Pradesh declined to 5 percent.¹⁵

Clients were also hit hard. In September 2012, a study by MicroSave found that in the absence of available microfinance, borrowers returned to moneylenders: 59 percent of people surveyed in four districts said they had taken loans, while fully a third of respondents said they had to reduce the scale of their businesses given the lack of credit.¹⁶

Little has changed in AP since the enactment of the state law. Lending remains at a standstill. By the end of 2012 and early 2013, MFIs with large exposure in Andhra Pradesh continued to struggle. Several MFIs

¹²Elisabeth Rhyne, “On Microfinance: Who’s the Blame for the Crisis in Andhra Pradesh?” Blog post, *Huffington Post*, Nov. 2, 2010. http://www.huffingtonpost.com/elisabeth-rhyne/on-microfinance-whos-to-b_b_777911.html.

¹³M-CRIL, “M-CRIL Microfinance Review 2011: Anatomy of a Crisis Executive Summary” (Gurgaon, India, Micro-Credit Ratings International Limited, 2011) <http://www.m-cril.com/BackEnd/ModulesFiles/Publication/Executive-Summary-Review-2011.pdf>.

¹⁴Legatum Ventures, “Microfinance in India: A Crisis at the Bottom of the Pyramid” (Dubai, Legatum, 2011).

¹⁵Tamal Bandyopadhyay and Dinesh Unnikrishnan, “SKS Microfinance: The Inside Story,” *Livemint/Wall Street Journal*, Feb. 7, 2013. <http://www.livemint.com/Industry/hvWN2IbllrX5hXKj3keERL/SKS-Microfinance-The-inside-story.html>.

¹⁶Arvind Jayaram, “In AP, moneylenders rush to fill vacuum created by MFIs,” *The Hindu Business Line*, Sep. 4, 2012. <http://www.thehindubusinessline.com/industry-and-economy/banking/in-andhra-pradesh-moneylenders-rush-to-fill-vacuum-created-by-mfis/article3859259.ece>.

were beginning to initiate mergers,¹⁷ while others reported declining (or negative) net worth or worried that they would be unable to pay their restructured debts. SKS, perhaps the most famous MFI in India, saw its share value decline 91 percent and its loan book decline 72 percent, and experienced seven consecutive quarters of loss. Its branches declined from more than 2,400 to less than 1,300, and employees shrank from 27,000 to 11,200.

Elsewhere in the country, however, there were renewed signs of life, with MFIs adjusting to new regulations and attracting investor funding.¹⁸

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¹⁷Namrata Acharya, "Consolidation: A Way Forward for the MFI Industry," *Business Standard*, Oct. 2, 2012, http://www.business-standard.com/article/companies/consolidation-a-way-forward-for-the-mfi-industry-112100200114_1.html.

¹⁸G. Naga Sridhar, "MFIs: Moving Beyond AP Crisis." *The Hindu Business Line*, Dec. 29, 2012, <http://www.thehindubusinessline.com/companies/microfinance-institutions-moving-beyond-ap-crisis/article4253239.ece>.



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