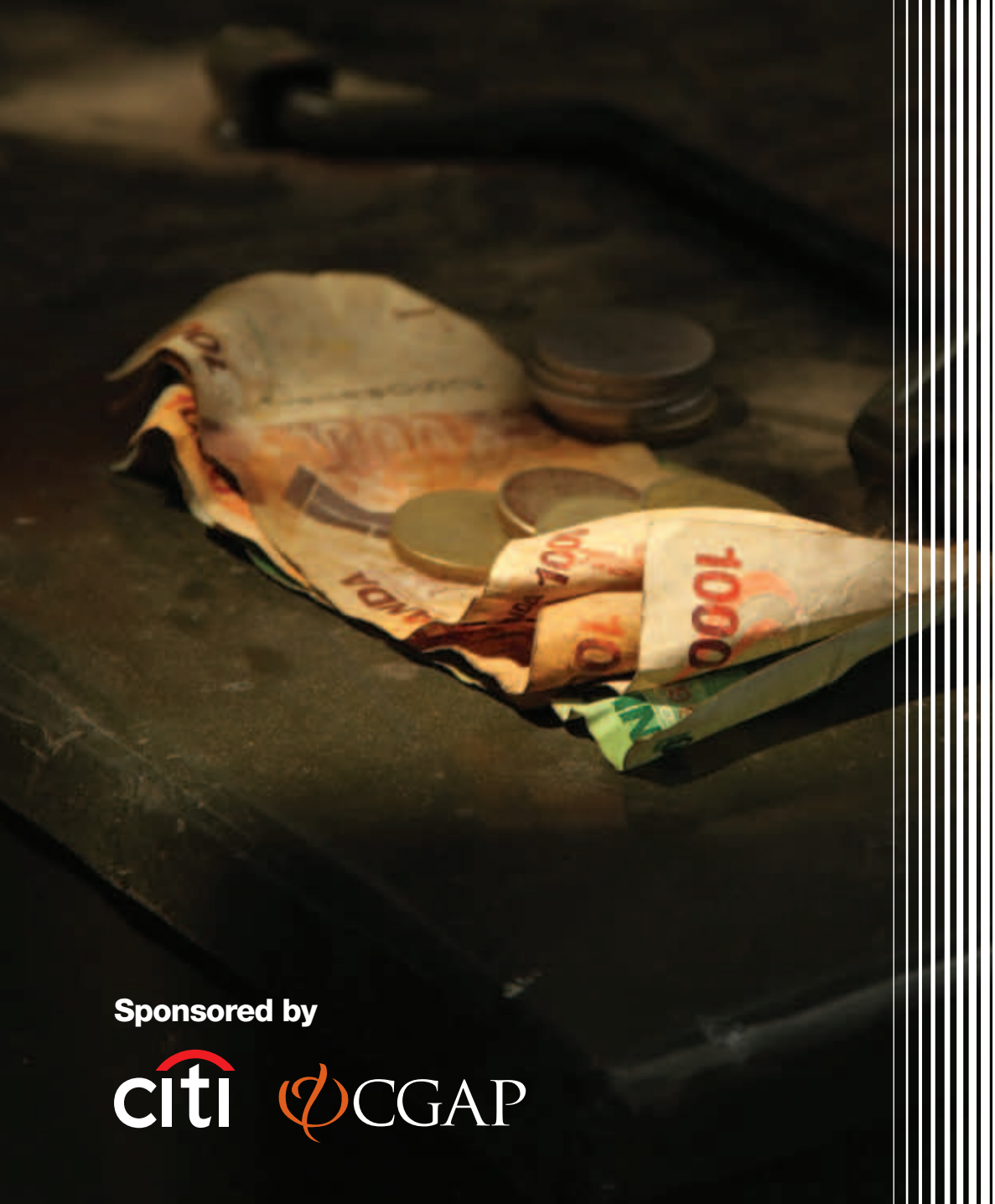
Microfinance Banana Skins 2012

The CSFI survey of microfinance risk

Staying relevant



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Preface

This is the fourth *Microfinance Banana Skins* survey that my colleague, David Lascelles, has produced – and the third to be co-authored with Sam Mendelson (who has recently become the CSFI's Development Fellow). As always, it is a fascinating read. The microfinance industry is evolving steadily, and our surveys are a great opportunity to assess progress made – and concerns for the future.

Our last report (published in February 2011) was controversial, in that it exposed a concern that too many microfinance institutions were starting to look too much like conventional lenders – or so many people inside and outside the industry thought.

This year, our survey has identified another worrying trend – a widespread perception that the industry could well find itself facing the kind of bad debt problem that many conventional financial institutions have had to cope with in the last few years. The reason is simple: too many clients of too many MFIs have taken on too much debt. Hard figures are difficult to come by – and some observers of the industry believe that the worst of the problem is actually behind us. But the most striking result of this year's survey is clearly the very high risk ranking attached to over-indebtedness among MFI clients. Still, forewarned is forearmed – and, whatever progress has been made to date, the industry (and the donor institutions that support it) now has no excuse not to tackle the problem. It is also worth making the point that this problem is one of success – not of failure. It reflects the ubiquity of the microfinance model, and the way it has penetrated into those parts of the global credit market that others cannot reach. As the industry strives to retain its relevance in the face of big changes, this is one of its undoubted strengths.

Of course, there are other threats, beyond over-indebtedness, that this year's survey casts a light on. The rise in concerns over corporate governance are clearly a worry – though, again, this really reflects the success of the microfinance model: as it moves into the financial mainstream, it is generating the same kind of concerns as other mainstream financial providers and products. The high ranking given to concerns over the laxity of risk management is also noteworthy – though (as with over-indebtedness) we did not separate out this risk in our last survey. Conversely, it is interesting to see how financing issues – interest rates, foreign exchange risks, funding – are firmly rooted at the bottom of the risk pile. One of the lessons we have drawn from our other Banana Skins surveys, notably banking, is that, if one is looking for predictions of future disaster, it sometimes makes sense to turn the Top 20 list of risks on its head…

As usual, my personal thanks go to David and Sam for the time and effort they have put into this report – as well as to the hundreds of respondents from around the world. MBS has become almost a global brand – something that pops up on the desks of finance ministers and senior officials in the most unlikely places. Thanks also to our friends at the Citi Foundation and CGAP for their generous support – as well as to the MIX, the Council of Microfinance Equity Funds and, of course, to Zach Grafe for his help with the on-line survey.

Andrew Hilton
Director
CSFI

Sponsors' foreword

As part of a growing industry with over 200 million clients and $73 billion of loans outstanding, traditional microfinance players today face new and different challenges. As the sector matures, new players — such as mobile network operators and banks that are interested in serving low income clients — emerge. An industry that has thrived upon innovation at the same time faces many changes to the regulatory environment. How then is this sector to stay relevant in an increasingly complex landscape?

Each year, the Microfinance Banana Skins sets out to measure perceptions of risk in the industry. The 2012 survey highlights concerns about overindebtedness, which was ranked as a top risk by respondents in over half of participating countries. This is, without a doubt, a serious issue that presents both reputational and practical risks that go to the heart of the mission of microfinance: client welfare.

As the sponsors of this report, we are pleased to see the degree of self-awareness the 2012 Microfinance Banana Skins reflects among microfinance practitioners. Awareness of risk is, after all, a "precondition to coping," as one survey respondent noted, and a first step in beginning to manage and move beyond the risk. Practitioners reported a fair degree of confidence in their overall preparedness and ability to handle the risks identified. Already we have seen awareness morphing into action through the responsible finance agenda, with initiatives such as the Smart Campaign and the Principles for Client Protection gaining traction around the world. However, the Banana Skins survey results do raise important questions about MFIs' capacity to rise to the occasion, and in particular management and staff capacity to cope with the complexities of the new operating environment.

As Andrew Hilton mentions in the preface to this report, "forewarned is forearmed." The path forward is not yet clearly defined, but it is evident that the industry is aware that action on the overindebtedness front is a necessary next step. Client financial literacy and appropriate products have become ever more important. But do clients understand their financial capability? Are they offered products that address their specific needs or are they borrowing from multiple entities because existing products do not meet their needs?

The shift from simply the provision of loans toward full financial inclusion is underway. The result is a more complex operating environment for many institutions, but also potentially a more rewarding opportunity for poor clients who need access to a full range of financial services just as much as wealthier people.

We are grateful to the 360 participants from 79 countries who contributed to this survey. We also take this opportunity to thank David Lascelles and Sam Mendelson for managing the survey and summarising the findings; Philip Brown of Citi Microfinance, Deborah Drake of the Council of Microfinance Equity Funds (CMEF) and Greg Chen and Erin Scronce of CGAP for their contribution to the success of the survey.

Robert Annibale
Global Director of Citi Microfinance

Tilman Ehrbeck
CGAP CEO

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This report was written by
David Lascelles and **Sam Mendelson**

Cover photo:
Cash box, Uganda

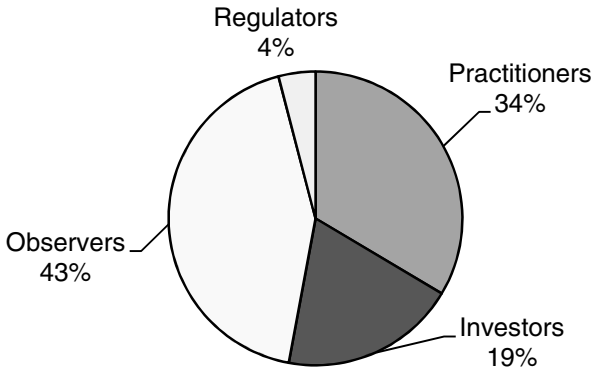
By **Egil Mongstad,**
Finalist
2011 CGAP Microfinance photo contest

About this survey

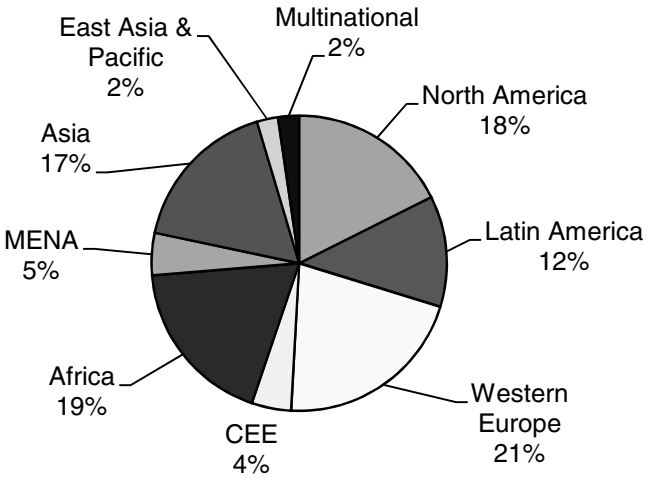
Microfinance Banana Skins 2012 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers. It updates previous surveys carried out in 2008, 2009 and 2011. This survey was conducted in April and May 2012 and is based on 360 responses from 79 countries.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the microfinance sector over the next 2-3 years. In the second, they were asked to rate a list of potential risks – or 'Banana Skins' – by severity on a scale of 1 to 5. In the third, they were asked to rate the preparedness of microfinance institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be quoted by name.

The breakdown by type of respondent was as follows:



The distribution of responses by region was as follows:



The responses by country were as follows

North America		Central and Eastern Europe		Middle East and North Africa	
Canada	5	Azerbaijan	2	Egypt	4
US	58	Bosnia & Herzeg.	3	Jordan	2
		Kazakhstan	2	Lebanon	3
Latin America		Moldova	1	Palestine	1
Argentina	1	Poland	1	Tunisia	1
Bolivia	1	Romania	2	UAE	2
Brazil	2	Russia	2	Yemen	1
Colombia	9	Serbia	1		
Costa Rica	2	Tajikistan	2		
Dominican Rep.	1			**Asia**	
Ecuador	4	**Africa**		Afghanistan	1
El Salvador	1	Benin	2	Bangladesh	9
Honduras	1	Botswana	1	India	38
Mexico	5	Burkina Faso	2	Nepal	3
Nicaragua	4	Cameroon	6	Pakistan	10
Paraguay	4	Côte d'Ivoire	2		
Peru	7	Ethiopia	2	**East Asia and Pacific**	
Venezuela	1	Gabon	2		
		Ghana	6	Australia	1
		Guinéé-Conakry	2	Cambodia	1
Western Europe		Kenya	4	Fiji	1
Belgium	4	Madagascar	2	Hong Kong	1
Denmark	1	Mali	3	Mongolia	1
France	10	Mauritania	1	New Zealand	1
Germany	6	Nigeria	10	Philippines	4
Ireland	1	RD Congo	1	Singapore	1
Italy	3	Rwanda	3	Vietnam	1
Luxembourg	3	Sénégal	1		
Netherlands	7	South Africa	2	Multinational	8
Spain	1	Tanzania	8		
Switzerland	8	Togo	3	Total respondents	360
UK	34	Uganda	2	Total countries	79

The views expressed in this survey are those of the respondents and do not necessarily reflect those of the CSFI or its sponsors.

Summary

This survey describes the risks facing the global microfinance industry in the early part of 2012, a time when it was struggling to recover from the global financial crisis, and from attacks on its reputation as a service to the world's poor.

For many practitioners and observers of microfinance, the current period is one of exceptional fluidity which could have a strong influence on the shape of this evolving industry as it moves into the next stage of its development.

An impressive record– but under attack

Originally created in the 1970s as a grass-roots movement to provide credit to the neediest, microfinance has grown enormously over the last 40 years and is now firmly established as a major supplier of a wide range of financial services to millions of people in the developing world. In 2010, the latest year for which full numbers are available, the two thousand-plus microfinance institutions (MFIs) which report to the Microfinance Information eXchange (MIX) had 105m borrowers and 70m savers, with numbers growing by 20 per cent a year; more in some countries. Total assets of these MFIs amounted to $72bn.

However in the last three years, microfinance has found this impressive record coming under attack, for a number of reasons. The perception has arisen in some regions that the industry has allowed growth to go to its head, that it has lost sight of its social purpose, and given priority to more commercial objectives such as profit and volume instead. Hand in hand with this, critics see MFIs allowing their business and ethical standards to slip as they pursue business targets, disregarding the interests of their customers, and putting the industry at risk. As well as the reputational consequences of this shift, there is the practical concern that investors and donors could become less willing to fund an industry whose main objective is perceived to be profit.

According to more optimistic observers though, microfinance has already begun to emerge from this difficult period and is in a stronger state, having learnt its lessons and resolving to do better. Nonetheless, questions remain over the direction the industry will now take. Can it find a future which combines its social objectives with the more demanding commercial world in which it operates? As it navigates its way forward, what are the risks that it faces? Can it, as one respondent said, "stay relevant"?

Staying relevant

The financial services industry is changing dramatically with new technology altering the way banking is done. New entrants seeking large scale deployment are entering into the traditionally reserved market segment for microfinance. Macro-economic dynamics are rapidly making the industry more complex and competitive. Microfinance providers need to become more sophisticated to stay relevant, and with a squeeze on capital it will be challenging to be as prepared as is required in the short time frame.

Bunmi Lawson
CEO, Accion Microfinance Bank
Nigeria

The survey

This survey, the fourth in the series originally launched in 2008, was conducted to seek answers to these questions and put the risks into perspective. Its focus is on MFIs with more than $5m in assets which are profitable and capable of commercial growth. These number about 650, according to estimates from MIX, and account for more than 80 percent of microfinance assets globally.

The survey asked a series of experts on microfinance (practitioners, analysts, regulators, investors etc.) to identify and comment on the biggest risks, or "Banana Skins", which they saw facing the microfinance sector over the next two to three years. Some 360 of them from 79 countries took part. The table accompanying this summary shows how they ranked the main risks, and subsequent pages give a breakdown of responses by region and type, and analyse their comments[1].

The results

Overindebtedness now the top risk

The overall message from the survey is that the immediate risks posed by the global economic crisis and by the controversy over the industry's mission have eased – but that larger questions about the future direction of microfinance remain.

The key finding of the survey is that **overindebtedness** among microfinance borrowers is now seen to be much the most pressing risk facing the industry. It was given a high score by respondents from over half of the participating countries, mainly because it has the potential to cause both financial and reputational damage to the industry, and thereby harm MFIs even in countries where the problem does not exist.

Overindebtedness is widely seen to be symptomatic of deeper difficulties in the industry: an excess of lending capacity created by over-expansion and the arrival of new entrants, a lack of professionalism within MFIs, and an emphasis on growth and profit at the expense of prudence. It is also linked to the risk in the No. 4 position, **credit risk,** which relates to the heavy exposure of MFIs to the lending business at a time of economic uncertainty and bank unpopularity.

Microfinance Banana Skins 2012

(2011 position in brackets)

1	Overindebtedness (-)
2	Corporate governance (4)
3	Management quality (7)
4	Credit risk (1)
5	Political interference (5)
6	Quality of risk management (-)
7	Client management (-)
8	Competition (3)
9	Regulation (6)
10	Liquidity (16)
11	Mission drift (9)
12	Back office (13)
13	Macro-economic risk (17)
14	Staffing (8)
15	External risks (-)
16	Technology management (11)
17	Too little funding (23)
18	Interest rates (21)
19	Too much funding (22)
20	Foreign exchange (24)

[1] The format of the survey has been substantially revised this year to take account of the changes coursing through microfinance. For this reason, like-for-like comparisons with past surveys may not always be possible. The risk definitions are included in the questionnaire which is reproduced in the Appendix.

This also explains the presence of three other high-ranking Banana Skins. **Corporate governance** (No. 2) is widely perceived to be inadequate, failing to provide sufficiently strong leadership to keep MFIs on a healthy growth path. **Management quality** (No. 3) is also seen to be lacking in many markets, especially those where MFIs adopt aggressive lending practices to achieve growth targets, including the **quality of risk management** (No. 6) which is seen to be low or non-existent in some sectors.

A related risk is that of **client management** (No. 7) which reflects concerns that MFIs are not focusing adequately on their clients' financial needs and abilities, and thereby contributing to the overindebtedness problem.

The risk of **political interference** (No. 5) remains high because of the continued perception among politicians that MFIs overcharge for their loans and use unethical lending and loan recovery practices. Although the risks in **regulation** have declined from No. 6 to No. 9, they continue to be present because regulation, though improving, is often seen to be oppressive or inappropriate.

Most of the top risks are 'internal'

Of the top 12 risks, eight are what might be called "institutional risks", i.e. ones under the direct control of the MFIs themselves - such as the strength of leadership, the quality of the loan book and the effectiveness of internal controls. The others are external risks such as political interference and regulation, but even they, to some extent, represent reactions by the external world to the behaviour of MFIs. This implies that many of these risks could be made more manageable through greater professionalism within MFIs. These are, of course, generalisations. Respondents recognised that many MFIs are extremely professionally managed. But it is often those that are not which attract publicity and cause the damage.

Much of the perceived decline in quality and standards in microfinance is traced to the pressure of **competition** (No. 8) which continues to grow in most markets, and by **mission drift** (No. 11) – the shift of purpose among MFIs from serving the poor to making profits, and the accompanying loss of reputation.

A strong concern is that excess capacity and a tainted reputation will damage microfinance's access to finance from banks, investors and donors. **Liquidity** risk has risen sharply, from No. 16 to No. 10, and concerns about **too little funding** have come up from No. 23 to No. 17. Similarly, concerns about the state of the **macro-economy** are up, from No. 17 to No. 13 because of the continuing uncertainty on global markets. However concern about **interest rates** (No. 18) remains low with little prospect of change from today's low levels. Similarly, **foreign exchange** risk is small (No. 20) because of the minimal exposure of most MFIs and significant advances in hedging capability.

The risks from **external events** (war, natural catastrophes, etc.) are generally seen to be low (No. 15), though they spike in specific regions (civil war in the Middle East, earthquakes and floods in Asia and the Far East).

Among the lower Banana Skins, the risks in the **back office** occupy a middling position at No. 12, though there is a widespread view that this is an area where efficiency and risk control could be greatly improved. **Technology management** is also seen to be a low order risk at No. 16, even though many MFIs face difficult decisions over investment in IT and new mobile delivery channels.

A breakdown of **responses by type** shows practitioners of microfinance to be chiefly concerned with the problems of overindebtedness and credit risk, while non-

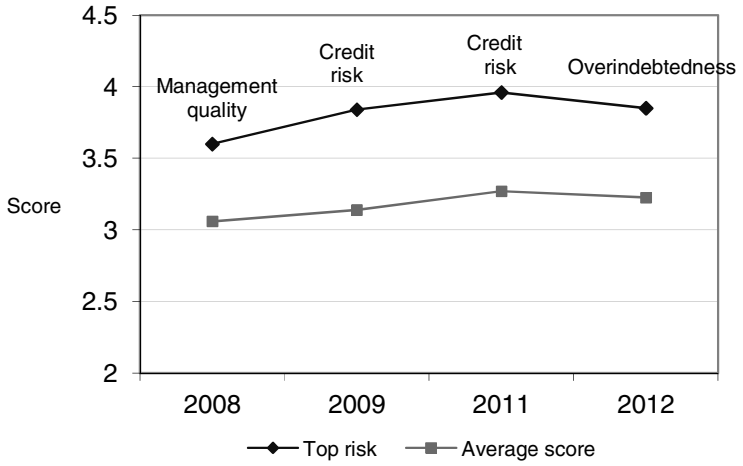
practitioners (investors, regulators and observers) put a heavier stress on institutional risks such as low corporate governance and management skills. Practitioners also see greater risks in the intensity of competition than other classes of respondent.

Geographically, overindebtedness and related credit risks feature strongly in most regions, suggesting that this is not a localised concern. A notable exception is Asia where the picture is dominated by the fall-out from recent political controversies in India, and worry that these will curtail MFIs' access to funding. In general, concerns about the health and image of microfinance are widespread around the world, but other risks, such as the quality of management, the intensity of competition, the appropriateness of regulation and access to funding tend to be localised.

The industry is only moderately well prepared to handle risk

How well prepared are MFIs to handle risk? We asked respondents to tell us on a scale of 1 to 10 how well prepared they thought MFIs were to handle the risks they identified. The overall average was 5.49, which could be described as middling. In general, microfinance practitioners are more confident than non-practitioners about their ability to handle risk. Geographically, the most confident region is Latin America, and the least confident Western Europe.

The Microfinance Banana Skins Index provides a picture of changing "anxiety levels" in the microfinance business. The top line shows the average score given to the top risk over the last four years, and the bottom line the average of all the risks. After rising strongly up to 2011, both lines show a small downturn this year, suggesting that anxiety is beginning to ease from the stresses of the previous years, though the scores are still slightly higher than they were in 2009.



Health warning. A number of points should be borne in mind when drawing conclusions from this report. One is that the results reflect the perceptions of respondents and are not forecasts or measures of likelihood. There is also a tendency, in surveys of this kind, to focus on the negative and overlook the positive, of which there is still a lot in microfinance. Linked to this is the risk of generalisation: microfinance is a very varied business, and its condition differs greatly from one market to another. Nonetheless, the broad trends which this report describes suggest that microfinance continues to face a testing period.

Who said what

A breakdown of responses by type and geography shows both similarities and differences in risk perceptions.

Practitioners – people who run or work in MFIs

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

Practitioners of microfinance are concerned above all with developments on the credit front: the growth of overindebtedness among their borrowers and credit risk more generally.

Carlos Labarthe, executive president of Compartamos Banco in Mexico, said that "there is a risk that all of us are trying to serve the same client, causing the supply of financial services to become much greater. This is very good for the client and for the country. The risk I see is that many clients do not have the financial literacy to handle this supply, and the information that is available in the credit bureaux is not that great. So there is a risk that some of these clients will become overindebted".

Although practitioners recognise that credit problems often result from their own control weaknesses (which is a positive development), they also see external pressures such as tougher competition and political interference pushing them to take greater credit risks. Of all the respondent groups, practitioners are the most concerned about competitive pressure as a major source of risk.

On the other hand, practitioners do not see the quality of their risk management (at No. 9) to be as pressing an issue as other respondents groups (e.g. investors who rank it No. 4). But they do recognise a need to improve their client management, for example by developing their product range and treating their borrowers with greater understanding.

Client indebtedness is a risk that practitioners see harming them both financially and reputationally. The chief financial officer of a large microfinance fund said: "I think the increased pressure for the industry to move towards a more commercial business model places us in considerable danger of mission drift with the attendant risks to reputation".

Financial issues (e.g. liquidity and funding more generally) are seen to be lower order risks which affect mainly the smaller and weaker MFIs. External market risks (the macro-economy, interest rates and foreign exchange) are also among the lowest groups of risks.

Deposit-takers – people in MFIs which accept deposits

1 Overindebtedness
2 Corporate governance
3 Credit risk
4 Client management
5 Management quality
6 Staffing
7 Competition
8 Quality of risk management
9 Technology management
10 Mission drift

The concerns of deposit-taking institutions are very similar to those of microfinance institutions in general: a focus on credit risks and management issues. Andrew Pospielovsky, CEO of Accessbank in Azerbaijan, said that "excess liquidity and intensifying competition among financial institutions are driving multiple lending to the same clients, resulting in overindebtedness of clients and deteriorating portfolio quality".

Deposit-takers are more concerned about reputation issues, possibly because they need to have a good image to give savers confidence. Carolina Benavides, manager of the social programme at Mibanco, Banco de la Microempresa in Peru, said that "microfinance has grown in recent decades and has enjoyed a good image. This has attracted new players, but it carries the risk of moving away from social goals and sacrificing them for commercial and competitive interests. This affects the industry's reputation, and therefore that of microfinance institutions that compose it".

Concerns about funding and liquidity are slightly lower in this group, but respondents gave little sense that deposit-taking provides them with a strong advantage. Many of them said that they faced competition from larger banking organisations which were able to offer more attractive terms. Being a deposit-taker also entails heavier regulation and higher costs.

Lefani Yakobe, general manager, finance, at Akiba Commercial Bank in Tanzania, was concerned about "the high cost of sustaining microfinance operations in an environment of stiff competition due to many entrants, such as traditional banks going to lower market segments which are the niche of microfinance institutions".

Investors – people who invest in microfinance

1 Corporate governance
2 Overindebtedness
3 Management quality
4 Quality of risk management
5 Political interference
6 Regulation
7 Credit risk
8 Competition
9 Liquidity
10 Back office operations

The top concern of investors in microfinance is the institutional strength of MFIs: the quality of their corporate governance and management, and their ability to manage risk. In particular, the response from investors suggests that they believe an MFI's main purpose is to run a healthy commercial concern, even if that means occasionally overriding its social goals. For example, investors' concerns about mission drift (MFIs moving away from a focus on serving the financially underprivileged) is at the relatively low position of No. 12, while risks associated with the strength and leadership of MFIs occupy three of the top four positions.

Lauren Burnhill, managing director of One Planet Ventures in the US, said that "management quality is an issue for investors too. Choosing someone for their dedication to the mission sounds like a good idea, but not if it means a shortage of key skill sets needed for growth and expansion".

Investors are also concerned about MFIs' ability to manage risk effectively. The managing director of a major government development finance institution said that "the risk management procedures of MFIs are inadequate for an increasingly complex business environment, or procedures are not properly followed, thereby leading to institutions becoming distressed or failing".

Investors also see external pressures posing risks to MFIs: the growth of political interference, of inappropriate regulation and competition, mainly because these tend to interfere with sound business judgment.

Despite the concerns voiced by other classes of respondent (particularly practitioners) about the danger of investors turning away from microfinance because of its recent problems, there was little indication of this in investors' responses. They gave a very low score to funding risk.

Regulators - government officials and those who regulate MFIs

1 Corporate governance
2 Management quality
3 Credit risk
4 Overindebtedness
5 Mission drift
6 Back office operations
7 Staffing
8 Client management
9 Liquidity
10 Macro-economic risk

Regulators see the greatest risks in the institutional weaknesses of MFIs, the quality of their corporate governance and management. For example, a bank examiner in Nigeria said that "the main risk facing the industry is strategic risk, arising from the inability of institutions to implement appropriate business plans, strategies, decision-making and resource allocation, and an inability to adapt to changes in the business environment".

This view of the microfinance industry explains why regulators also give a high score to other institutional risks such as the strength of the back office and staffing.

Regulators showed strong concern about credit risk and overindebtedness, and with funding issues such as liquidity management. Another regulator said that credit risk was a major concern "due to the fact that most MFIs fail to put in place adequate credit policies and procedures, fail to analyze the creditworthiness of their borrowers and targeted groups, and this leads to high non-performing loans, and these MFIs end up with huge losses".

A bank regulator in Mongolia said that "the recent introduction [of consumer protection regulation] and its compulsory use by financial institutions could lead to a slowdown in lending growth or, eventually, higher non-performing loans since MFIs now have the full picture of their clients' indebtedness".

On the other hand, regulators were much less worried about some of the external risks that MFIs themselves see as major threats, such as the growth of competition and political interference.

Surprising, possibly, is the low ranking of risk management itself (down at No. 15), though less surprising is the fact that regulators consider regulation itself to be a low level risk (No. 16).

Observers – consultants, analysts, academics etc.

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

Observers of the microfinance industry see the greatest risks in the institutional weaknesses of MFIs: governance, management, risk management etc. They believe that MFIs need to be sharper about responding to tougher business conditions, or risk losing out to better equipped competitors.

Diego Villalobos, an analyst at Accion in the US, said, that "the levels of competitiveness, efficiency and scale now required for an MFI to achieve success have increased significantly over five years. The risk is that poor performance in the institutional leadership (executive) has a greater impact on these factors than before".

Observers also saw overindebtedness as a high ranking problem – and a symptom of weakness within MFIs. Otto Wormgoor, operations manager at Planet Rating in France, said that "many MFIs are not sufficiently prepared to deal with high competition in a sound way, leading to over-indebtedness of clients and hence increasing non-performing loan levels and reduced financial performance, and simultaneously increasing reputation risk for the sector. This stems from the underlying weaknesses in governance and management of the MFIs which often play catch-up to sector trends, rather than sound governance and management that can identify and manage arising risks in their industry".

On external risks, the observer category was particularly concerned by the growth of political interference, but considered regulation and the macro-economic environment to be lower risks.

North America

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

The North American response, consisting mainly of investors and international NGOs, focused strongly on the institutional strength of MFIs: weakness in corporate governance and aspects of management. Christian Novak, chief investment officer at Capital Asset Management in Canada, said that "governance is still poor and skilled management is limited; growth of the sector will emphasize the risks related to these limitations".

Notable was the high concern shown about the quality of risk management in MFIs – No. 4, the highest of any geographical group.

Respondents also focused on the growth of overindebtedness, which they saw damaging microfinance financially and reputationally. A US-based international investor was concerned about "the spread of irresponsible finance, particularly over-indebting clients, such that a liquidity bubble in some countries leads to rising micro-borrower defaults, negative reactions from regulators, reputational harm to some MFIs, and overall damage to the microfinance industry".

Generally, this respondent group was less concerned with funding issues; if anything they considered an excess of funding to be a greater risk than too little of it.

This group also stressed the need for microfinance to have a good strategy if it wanted to survive and make its contribution. The vice president of social finance at one of the large US commercial banks said: "I would highlight the primary risk as continuing to scale and grow the industry while simultaneously pursuing financial profitability/sustainability as well as the commitment to serving the poor in a fair and equitable way. The results of what happens if this risk is not appropriately safeguarded have been painfully highlighted in the media the last few years."

Latin America

1 Overindebtedness
2 Competition
3 Corporate governance
4 Political interference
5 Client management
6 Quality of risk management
7 Credit risk
8 Regulation
9 Mission drift
10 Staffing

The problem of overindebtedness is easily the top concern in Latin America, featuring in almost all the countries represented.

In responses which were mostly from practitioners of microfinance, the problem was blamed squarely on the sharp growth in competition from new entrants in recent years, and the deterioration in lending standards that this has brought about. The lack of centralised credit information was identified as a contributory cause.

A bank auditor from Colombia said that overindebtedness "has materialised in the last four years and continues to grow due to increasing competition from new players and the policy of aggressive expansion of current competitors".

These concerns produced comments on the need for stronger risk management in MFIs and better regulation. A respondent from Peru said that microfinance was facing governance problems "because the professionalism of the boards and the quality of management are not advancing at the same speed as the changes occurring in the industry".

The impact of this on the reputation of the industry is also causing concern: people see microfinance drifting away from its social mission and attracting criticism. In contrast to other regions, though, there was less concern in Latin America than in other regions about funding issues and the amount of liquidity available to MFIs.

Western Europe

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

The Western European response consisted of a mix of investors, credit analysts and non-governmental organisations (NGOs). Their top concerns centred on overindebtedness and credit risk, and the institutional weaknesses which they saw causing them: flaws in corporate governance, management quality and risk management.

Emmanuelle Javoy, an analyst at Planet Rating in Paris, said that "Despite an increasing awareness, [credit] risk remains one of the most difficult to manage correctly, notably because competition forces push MFIs to find shortcuts in the credit analysis to provide faster services. They also push MFIs to grow relatively fast. The fact that clients are also in a conflict of interest between their present need for cash, and their potential future difficulty to repay makes it even harder to prevent over-indebtedness".

This group also showed a strong concern with the controversies which have been hitting the industry, particularly the perception that it is "drifting" away from its original mission. One UK-based investor said that MFIs would have to "manage the balance between 'charitable' and commercial goals …to maintain investment and market goodwill". These perceptions also lay behind concern about the growth of political interference in the industry.

Closely related was the worry that MFIs are not sufficiently focused on their clients. Anton Simanowitz, social performance specialist at Oikocredit in the Netherlands, said that "the biggest risk is that the challenges seen around client harm and lack of impact are not taken seriously enough and that it becomes business as usual. The crises in a number of countries are not isolated incidents, but a sign of fundamental weaknesses in the assumptions and systems of microfinance".

Central and Eastern Europe

1 Overindebtedness
2 Competition
3 Credit risk
4 Quality of risk management
5 Macro-economic risk
6 Client management
7 Management quality
8 Corporate governance
9 Foreign exchange
10 Liquidity

Client overindebtedness caused by the presence of too many lenders in the market is the top concern in Central and Eastern Europe.

In a response consisting of a mix of practitioners and investors, respondents said it had not only become a serious problem, but showed little sign of abating. Agharazi Babayev, analyst of Eastern Europe and Central Asia for the Microfinance Information Exchange in Azerbaijan, said that "there are several markets which have to be closely watched in the coming years due to a high risk of overindebtedness. The fact that these markets have credit registries which are used by MFIs does not change the fact so long as there is no clear agreement between institutions on cross and multiple lending".

According to a respondent from Russia, the industry was suffering from reputation risk due to its poor practices and the arrival of new players who call themselves microfinance "but have no social agenda".

The high place occupied by overindebtedness was attributed by respondents to insufficiently strong risk management in MFIs; some added that there were also unethical lending practices, weak regulation, and low levels of financial literacy among borrowers. Generally, there was a relatively high sense of vulnerability in this region to developments at the macro-economic level.

However, in contrast to many other regional groupings, this region did not consider political risk to be particularly high, and staffing risk appeared at the bottom of the list.

Africa

1 Credit risk
2 Management quality
3 Corporate governance
4 Liquidity
5 Overindebtedness
6 Client management
7 Staffing
8 Quality of risk management
9 Technology management
10 Back office operations

The African response was dominated by concerns about the growing indebtedness of microfinance borrowers, which is now visible in many countries. According to respondents, this has been caused by inadequate risk management on the part of MFIs, and the growth of competition in the microlending sector.

A credit rating director said that client overindebtedness was "already a significant problem in many sub-Saharan African countries. However MFIs are failing to adequately address this through improved assessment… There is a lack of implementation of proper governance structures, leading to a sector that is not improving, or not sufficiently timely".

Weaknesses in corporate governance and management remain high level concerns, as they have in previous Banana Skin surveys, and worries about staffing (quality, turnover etc.) are the highest of any geographic group.

Funding concerns are also higher than in other groups. Many MFIs said they were worried about their access to liquidity and funding because of the industry's poor image. A respondent from Kenya said that "a 'backlash' builds as it becomes clear the extent to which micro-finance has over-promised and under-delivered against poverty reduction objectives. This could result in a reduction in appropriate donor support (not the most severe risk), much tighter regulatory controls and a reversion to state-funded finance".

Technology management also earns a conspicuous place in this region's ranking probably because Africa has made the greatest advances in mobile banking technology and is aware of the need to make the right investments.

Middle East and North Africa

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

Not surprisingly, given recent developments in the Middle East, the risk of external events (political disturbances, civil war etc.) ranks high in this group. The violence and upheavals of the last two years have greatly increased the uncertainties facing the microfinance industry.

Abed Mouqadem, regional manager of the Lebanese Association for Development, said that there were "regional conditions that trigger some risk drivers, like the political changes coming from the revolutions in the Arab world which affect the social and economical condition of those countries as well as neighbouring countries. Also there are local challenges like competition and its impact on cross lending, especially if you are working in a saturated market and in a fragile economic system where overindebtedness is so common".

However, as this quote suggests, the problem of overindebtedness emerges as the top concern. Despite the disturbances, the number of competitors in the field continues to grow and attempts to curb multiple borrowing through credit bureaux and other measures have not been effective.

The deputy general manager of a women's MFI in Jordan, said that "microfinance clients are widely aware of MFIs and exposed to many different ones. A lack of financial literacy will cause household financial debts". A respondent from the United Arab Emirates said that "a culture of borrowing is being encouraged in microfinance". A related concern is that the regulation of microfinance in many countries is restrictive or inappropriate.

Although management concerns were lower here than in other regions, one respondent said that the industry had been growing so fast that "it has reached a point where we begin to see some cracks in the system. But I think this is normal, and the sector will have to fine-tune itself in preparation for a new phase of growth".

Funding concerns were also lower in this part of the world. A respondent from Tunisia even said that investors were falling over themselves to help microfinance re-establish itself after the revolution.

Asia

1 Liquidity
2 Political interference
3 Corporate governance
4 Management quality
5 Regulation
6 Client management
7 Overindebtedness
8 Too little funding
9 Credit risk
10 Quality of risk management

The Asian response was dominated by the fall-out from the political controversies in India over the last two years, notably the anti-microfinance movement in Andhra Pradesh. This propelled political risk to second position in the list, the highest of any geographic grouping.

The concern focused on the potential consequences of the controversy, the risk of loss of liquidity and funding as investors and banks shy away. Toughening regulation was also a high level preoccupation.

Vineet Rai, managing partner at Aavishkaar, a social investor in India, said that "the Andhra crisis has impacted the lending psychology of the banks and it will take years to repair. We believe that the crisis has taken the sector back by five years. At the same time, when the sector does come back, it will have the ability to produce much better results on the development index as the growth is controlled and manageable".

Corporate governance and management quality issues remain a high priority. One respondent said that "the biggest risk to the microfinance industry currently is a reputational one. Many bad actors have been appropriately revealed, and now the burden of proof is on the microfinance industry to prove it is well governed and making a difference in people's lives".

Compared to other regions, concerns about overindebtedness and credit risk are lower down the ranking. India has imposed controls on multiple lending which are having an effect. Concern about the macro-economic situation is also low.

In Bangladesh, home of microfinance, there were also concerns about the standing of the industry, though problems with staffing were high on the list. A senior director at one of the large MFIs said that the main risk facing the industry was "the inadequate availability of competent human capital to perform and lead its development".

East Asia and Pacific

1 Corporate governance
2 External risks
3 Overindebtedness
4 Competition
5 Macro-economic risk
6 Political interference
7 Regulation
8 Back office operations
9 Management quality
10 Quality of risk management

The East Asia and Pacific group consists of a wide variety of geographical respondents, all the way from Fiji to Hong Kong, and does not, therefore, present as coherent a pattern of risks as other regions. The respondents were a mix of microfinance practitioners and investors.

Some of the highly ranked risks from other areas are here, such as corporate governance and overindebtedness, which underlines how widespread that problem has become. In Mongolia, Bold Magvan, CEO of Tenger Financial Group, said that the main risk there was "over-indebtedness…due to increased consumption loans for the low-income segment of the population and a lack of enhanced credit information bureau services".

The region is also concerned about external risks, mainly of the natural kind: earthquakes, tsunamis, flooding etc.

A respondent from the Asian Development Bank in the Philippines provided this overview: "As the economic downturn continues, the effects are now being felt in Asia's largest economies. Long to medium term funding is scarce and is compounded by the fact that deposit-taking by MFIs is still not permitted in most of the Asian economies. At the same time, uncontrolled and unregulated growth in some countries has placed borrowers at high risk, and the chances of a repeat of what happened in India is becoming apparent".

Preparedness

Total (out of 10)	**5.49**
By type	
Deposit-takers	5.85
Practitioners	5.81
Observers	5.39
Investors	5.19
Regulators	4.90
By region	
Latin America	6.94
East Asia and Pacific	6.17
North America	5.46
MENA	5.36
Asia	5.22
Africa	5.14
Central & E. Europe	5.07
Western Europe	5.05

We asked respondents to tell us on a scale of 1 to 10 how well prepared they thought MFIs were to handle the risks they had identified. The overall total was 5.49, which is middling.

Rupert Scofield, president and CEO of Finca International, said that "while there are some areas in which MFIs have made significant strides over the past few years due to blistering experience (overindebtedness and risk management to name a couple), there is still much work to be done to ensure that the purpose and methods of responsible MFIs are understood by our most important stakeholders: clients, regulators, and investors".

Many respondents said it was difficult to generalise, so we broke the responses down. (NB: these are not judgments of types and regions, but responses by type and region).

By type. Deposit-takers appeared to be the most confident, possibly because their customer deposits give them a greater feeling of security. Practitioners were also more confident about their ability to handle risk than other groups. For example, Roshaneh Zafar, managing director of the Kashf Foundation in Pakistan, believed that "recent 'shocks' to the sector have made MFIs more aware and cognisant of the nature of risks that can be faced".

But other classes of respondent were less confident. Observers and investors gave a below average response, and regulators gave the lowest response of all. A German investor said that "microfinance providers in many cases know about the risk (which is a precondition to cope with them). However in many countries we see a lack of qualified management and staff. Both of these are necessary to put adequate measures in place".

> I think it's more of a range between 7 and 9 where the providers are doing well in some areas and not so well in others. But consistent with what has been demonstrated, the providers have come through. There has been no 'mass slaughter' of providers, or a mass withdrawal from the industry.
>
> **Gil Lacson**
> **Manager**
> **Women's World Banking**
> **USA**

Regulators also gave a cautious response. For example, a bank inspector in Mali said that "without necessarily lowering their guard, microfinance institutions do not have sufficient human and financial resources to man all fronts at once. Hence the need to deal with them in stages".

By region. Latin America emerged as the most confident region with a very strong score which was reflected in the comments. Julio Flores Coca, general manager of the Local Development Fund in Nicaragua, said that "the past three years have provided big lessons in how to manage risk". However, again, it is best not to generalise. A respondent from one of the regional development funds said that "it depends on the market. In Bolivia, Colombia and Peru, institutions are very well prepared. Yet we see that in countries like Argentina, Uruguay or Brazil, specialized institutions have very fragile structures and are vulnerable to various risks that arise in the market and the environment".

Among the lower scoring regions, respondents said that while things were also improving in Africa, there was still "a lack specialised services for managing risk".

The Banana Skins

1. Overindebtedness (-)

Overindebtedness among microfinance borrowers ranks as the highest risk currently facing the microfinance industry, according to respondents to this latest Banana Skins survey. Although the exact scale of overindebtedness is not precisely known, the perception is strong that growing numbers of microfinance users are in danger of borrowing beyond their capacity to repay. For the majority of our respondents, this trend is causing financial as well as reputational damage to the industry at a time when it is already facing criticism about its effectiveness.

Respondents identified many causes behind the rise of this risk, notably the intense pressure that many MFIs face from competitors and investors to defend their markets and meet their profit targets. This is causing MFIs to lower their credit standards in order to win new business and build up their loan portfolios. S-P O'Mahony, chief executive of Opportunity Microcredit in Romania, saw "pressure for over-growth driven by over-commercialisation of the sector, resulting in overindebtedness of clients and associated risks for MFIs and their fund providers".

Multiple lending is seen as a growing problem

Overindebtedness can often be traced to multiple lending (or more, accurately, multiple borrowing) when customers take out several loans from different lenders for a variety of motives: to increase available cash, to pay off existing loans, or simply to take advantage of competition among lenders. The growth in multiple lending was blamed by many respondents on the lack of credit reference bureaux and accurate data on people's borrowing commitments (see box). But responses also reflected the view that MFIs have become less diligent about checking out the financial position of potential borrowers because they want the business.

But while overindebtedness received a high score, the size of the problem is hard to judge. At one end of the scale, Leonor Melo de Velasco, executive president of Fundación Mundo Mujer in Colombia, said that "this is the most serious risk we have facing us". But in India, the chairman of a microfinance support company said that overindebtedness "was the case till 2010, but not now". The responses, however, are impressive. More than 60 per cent of our respondents ranked this as a serious risk, giving it a score of 4 or 5 out of 5. Overindebtedness appeared as a risk in responses from 70 of the 79 countries which participated in the survey, and was among the top five risks in seven of our eight regions (the exception being Asia where there has been a severe crackdown on lending).

Respondents also differed as to whether the risk was growing or shrinking. Some thought that the structural changes in the industry (growth of competition, ease of access to markets, erosion of credit standards) meant that, as one said, "multiple lending will continue and grow". But others were more optimistic, arguing that the problem was confined to a declining number of countries, and that, as one of them said, "these problems should have worked their way through the balance sheet over the coming 12 months"[2].

[2] According to figures from the Microfinance Information eXchange (MIX), the trend in Portfolio at Risk numbers in most of the 20 or so countries which it tracks on a quarterly basis was "steady or declining" in the second half of 2011.

However, if overindebtedness is a smaller problem than many think, there is clearly a wide perception gap, even among practitioners and close analysts of the industry. Judging by the results of this survey, the prevailing view is that overindebtedness is big and possibly growing. This contains risks of its own, notably that the industry may be suffering unnecessary reputation damage.

Are credit bureaux the answer?

Many respondents blamed the growth of overindebtedness on the absence of centralised lending data such as credit reference bureaux that would enable MFIs to assess the borrowing capacity of potential clients.

For example, the chief financial officer of a large Mexican microlender said that “overindebtedness is definitely what I perceive as the highest risk to the microfinance industry. The lack of good communication coupled with the industry's other deficiencies will ultimately foster overindebtedness and thus, credit default. Better organisation is required to develop a credit bureau, a solution that would, on the one hand, help lenders identify potential overindebtedness risks and, on the other, help clients build a credit history to continue on their path to economic growth”.

Others were more cautious. They pointed out that the effectiveness of credit bureaux depended on the willingness of MFIs to use them, which might not be strong when sales staff are under pressure to add loans to their books. Also, bureaux data might be incomplete, failing, for example, to capture the loans made by informal money lenders and new entrants into the microloan market.

Aldo Moauro, executive director of Microfinanza Rating in Italy, said that “multiple lending is increasing and, regardless of the presence of credit bureaux, the institutions are not following rigorous practices to avoid over-indebting clients. All the stakeholders show concern about these issues but very little, if anything, is actually done to make a change. Some MFIs have taken initiatives to address the problem. But without a thorough approach binding all the actors (in particular MFIs and investors), any isolated action has little effect since it leaves room for free riders to take advantage of it”.

Credit bureaux can even be politically unpopular because they give MFIs a reason to deny credit to people whom the government might wish to see getting loans. Marcelo A. Romero, financial control analyst at Banco Pichincha in Ecuador, said that there was a government initiative there “to eliminate credit information bureaux, not for technical reasons but for political and doctrinal ones”.

2. Corporate governance (4)

Concern about the strength of corporate governance in the microfinance sector remains high; if anything it is becoming stronger. Although much work has been done to improve it in recent years, the perception persists that wide areas of the industry have a low commitment to improving their leadership and do not, therefore, inspire confidence.

A microfinance credit analyst said that corporate governance and management "are the two key factors which can differentiate stronger from weaker microfinance providers, and they are typically in short supply."

This downbeat view was widely shared across the regions surveyed, though judgments varied from one country to the next. Respondents said that poor governance was one of the fundamental sources of weakness in MFIs because it impacted the quality of management and staff, of strategy and decision-making, and the prospects for healthy growth. It was often accompanied by a lack of transparency about accounting and business practices which affected public confidence.

> In our region, this has been a major risk as the overwhelming majority of our providers are NGOs, which means that the people on the board are volunteers, many of them coming from a social background which has nothing to do with finance etc
>
> **Microfinance specialist**
> **International financing agency**
> **Middle East and North Africa**

Quality of leadership is the key differentiator among MFIs

Many also saw the controversies about mission drift and overindebtedness resulting from a failure at the top of MFIs to provide strong leadership. As well as weakening individual MFIs, poor governance encouraged microfinance's growing army of political and media critics at a time when the industry was already going through a difficult period. One of the concerns expressed was that the resulting reputational damage would deter investors and donors. Sory Ibrahim Sidibe, a specialist at Planet Finance in Mali, said that poor governance produced a combination of deteriorating loan portfolios and lack of transparency, the consequence of which would be that "funding will be increasingly rare".

Some respondents pointed up the problem of entrenched MFI leaders who were reluctant to share power or change. Ruben C. de Lara, president of Serving Humanity through Empowerment & Development (SHED) in the Philippines, said that "some boards have the tendency to show a 'messianic' attitude simply because of their authority as governors, without having a clear understanding and appreciation of what is happening at the ground level. Some have not even visited the actual conditions of the poor…". Eric Savage, co-founder and president of Unitus Capital in India, said that "the days of what are essentially family businesses being trusted by investors and banks are over".

But other respondents were more optimistic, seeing signs of progress in a difficult area. Narasimhan Srinivasan, a consultant to the World Bank in Asia, said that "this risk is declining with so much attention from investors, funders, regulators and others".

3. Management quality (7)

The risks associated with poor management have always occupied a high place in this survey: they topped the ranking in the first survey in 2008, after which they fell back a bit. This year they have bounced up again, mainly because people see MFI management falling behind the rapid changes in the microfinance industry.

Most of the responses focused on the shortage of skilled personnel which is increasingly a feature of the microfinance business as it expands: people with experience, management ability and the vision to steer their institutions through

difficult times. A frequently voiced concern was that managers are good at delivering growth, but less good at "capacity building", i.e. putting MFIs on a sustainable long term path.

As with many Banana Skins, this is not one where it is easy to generalise. But these comments give a flavour of the breadth of respondents' concerns about this risk:

Management quality still lagging

The problems are "over-ambitious leaders and a total lack of management strategies." *Microfinance regulator, Mali*

"This is an on-going problem as MFIs here in Fiji (except for one which is operating as a company) do not have the financial resources to afford recruiting and retaining qualified and experienced management staff. Short seminars and workshops are not adequate and most MFIs tend to settle for less in terms of quality management in the areas of finance and human resources." *Microfinance manager, Fiji*

Microfinance is "still thin on managers who really can handle operations at significant scale. Underinvestment in HR matters". *Officer, international development agency, Hong Kong*

"With the expansion of the financial services and capital markets in emerging/developing economies, there is an increased demand for qualified management with escalating compensation which is more than MFIs can afford - so they will lose good trained staff if they cannot compete". *US investor*

"Middle managers are often left to fend for themselves without clear expectations, career plans, or training and mentoring about what else their job entails other than hitting productivity and portfolio quality targets." *European development finance consultant*

"In Africa, this is the major risk as the pool of good local management and salespersons remains insufficient for a fast-growing industry. Plus, new constraints on financial literacy and client protection will put additional stress on staff skills". *Microfinance consultant, UK*

"It is scary that the very same MFIs who are on top 100 lists are growing irresponsibly without putting proper controls in place despite the lessons learned from the past couple of years. The cracks in the programs are very evident, but the bigger risk is the lack of solutions for dealing with the inherent weaknesses that are becoming more apparent". *Microfinance investment support, Afghanistan*

But some respondents said that the situation was improving with greater professionalism and better training. Javier Navarro, manager of personal banking at Banco AV Villas in Colombia, said that "proficiency levels have been increasing. Some banks are beginning to engage in microfinance, and many microfinance institutions today are under strong pressure to increase the efficiency of the business". The general manager of a financial NGO in Ghana said that "the industry is becoming very attractive, and hence attracting more efficient and qualified hands".

4. Credit risk (1)

For the first time in three years, credit risk does not occupy the top position in the Banana Skins ranking. But this is only partly good news because the focus in this area has narrowed to concern about overindebtedness, which has emerged as the most serious risk facing the industry. (See No. 1)

The wider risks of impaired credit in microlending continue to be very pressing and geographically widespread. Virtually all the regions surveyed ranked credit risk as a high level problem.

The majority of respondents saw it resulting from management failings of various kinds: poor response to competitive pressure, weak internal controls, poor credit assessment, badly structured incentive schemes, and poor procedures for dealing with arrears and defaults.

'Irresponsible lending practices'

The chief financial officer of a large Mexican MFI said that "the main risks I see for the microfinance industry in the next two to three years are the absence of credit bureaux for the sector, irresponsible lending practices and overindebtedness. Unfortunately, these factors build upon each other to create the biggest risk to our industry: credit default". A credit rating director commented that "it is a challenge for MFIs to maintain tight underwriting processes in times of growth; and a challenge to manage repayment pressures on borrowers during down cycles, for example through restructuring". In one example, Akpali Ayao Agbelengo, director of internal audit at EMF-FINAM in Gabon, said that bad debts caused by poor credit management accounted for over half of the losses of MFIs that went bankrupt in his country. A bank regulator in the Philippines said that "credit pollution is a big risk

The two sides of credit risk

Several respondents highlighted the fact that it is often borrowers, not lenders, who create bad loans.

There is "a tendency by borrowers to misunderstand terms and conditions associated with loans, and to miscalculate their ability to repay them…"
Clara Lipson, founder and chief executive of Aboutmicrofinance in the US.

The risk of default is high in Africa "because we take credit as a gift. There must be a revolution in the popular mindset and a financial education of the population at large".
Gaspard Turabumukiza, microfinance inspector, National Bank of Rwanda.

"Few people really take advantage of their loans, i.e. by managing their affairs so as to be able to repay them. They do not hesitate to take out a further loan at another MFI and so on. Ultimately, we find ourselves in a vicious circle".
Dogbe Kponon-Eklou, director of CECPF, a women's MFI in Togo

In **Bangladesh**, a respondent highlighted the problem of internal migration. Poor borrowers, he said, leave their communities and "break the relationship with the microfinance institute, and as a result their loan becomes overdue forever."

that the industry is facing right now. For a number of jurisdictions, including the Philippines that do not have a very well-functioning credit bureau system, this problem might escalate".

Although the availability of credit varies from one region to another, it is clear that its abundance in many markets – due to generous funding or strong competition – is another problem. Respondents spoke of easy money, not just for businesses, but in the form of consumer credit and credit cards. They also pointed to the growing commercialisation of the microlending business, and a deterioration in the relationship between MFIs and their clients, with personal contact being replaced by automated credit scoring or depersonalised incentive-driven loan programmes.

However, levels of concern about credit risk varied among the responses. Among the more positive was the observation that poorly managed MFIs brought credit risk on themselves, while well-managed ones minimised it. This risk could, therefore, be made more manageable. The managing director of a microfinance bank in Nigeria said that "with increasing knowledge of the business and improvements in monitoring and collection of credits, this risk is becoming lower, although it is still of great concern". Others made the point that, as microfinance became more like banking, it must learn that loan loss is part of the business, and manage it.

Some respondents even felt the credit situation was improving, such as Betty Wilkinson, principal financial sector specialist at the Asian Development Bank, who said that this was "a lower risk, and now organisations are more conscious of competition and growth management." A bank regulator in El Salvador said that "the risk is low. Small businesses are those that are more concerned about paying their debts, to maintain access to credit that will grow".

5. Political interference (5)

This risk kept its high ranking from the last survey when it was driven largely by concern about events in Andhra Pradesh. But with the dust now settling, some more general points are emerging.

Incidents reverberate around the world

The first is that while the reverberations of incidents of political interference echo across the world, the direct impact is very localised. Dinos Constantinou, an analyst in Switzerland, said that "the severity of this risk depends almost entirely on the country in question. In most countries this risk is negligible, while in others (e.g. Venezuela, Argentina, Nicaragua and Azerbaijan) the risk is very high".

> Particularly in Africa, microfinance is exposed to disturbances related to inappropriate interventions by government: the creation of new microfinance institutions, the injection of a lot of money in small credits to the poorest, accompanied by government propaganda that does not stress the obligation to repay the funds received. So there is risk of further deterioration in the loan portfolio.
>
> **Gabin Koukponou**
> **Microfinance consultant**
> **Benin**

Another point is that political risk can take many forms. It often stems from the political pressures on a particular government and the type of people who borrow from MFIs. An Indian respondent said that "The Bottom of the Pyramid – the target customer base of MFIs - also forms the largest voter base for the political class".

A respondent from Bosnia Herzegovina, another country which has seen populist attacks on microfinance, said that "with microfinance suffering in terms of reputation, there is an increased risk of politicians setting up cheap or interest free loan funds that are easy to sell and distort markets". There is also the point, made by Mark Hannam, chairman of Fair Finance in the UK, that the very success of microfinance can cause political discomfort. "It is clear that, in some parts of the world, the growth of the microfinance industry is perceived as threat to its influence by national or regional government".

Even in countries where governments do not attack microfinance outright, they may create political risk by interfering with market mechanisms, setting interest rates, creating regulatory uncertainty and tilting the playing field.

A third point is that the effects can spread beyond the locality in question, and be long-lasting. Mona Kachhwaha, director of investments at Caspian Advisors in India, said that the Andhra Pradesh experience had cost the industry "its commercial, self-sustaining nature. While the industry grew and flourished without any subsidies or soft money until recently, MFIs today are getting crippled due to a lack of liquidity as private investors and commercial lenders are questioning its viability. There are serious concerns around capped margins and returns, without any apparent compensating improvement in operational risks".

The reputational impact on the industry – in the eyes of funders for example – can also be far wider than the countries in which political interference actually occurs. An investor in the UAE said that "based on recent crises in Africa and Latin America, there is risk that commercial investors exit the microfinance industry and donors/DFIs become the primary funders in the industry".

However some respondents acknowledged that governments have a role to play in the microfinance industry, setting rules and creating the right environment. So interference can also be well-intentioned and constructive. One UK consultant said that "interference by governments and regulators is not that bad a thing at a time when the industry needs to regain public confidence. However it has to be proportionate and consistent".

6. Quality of risk management (-)

Low levels of risk awareness

This is the first year that we have asked respondents to comment specifically on the quality of risk management in microfinance institutions. The high placing shows that this is seen to be an area of management weakness. Although it ranked as a Top Ten risk in all the regions surveyed, it obviously varies a lot from one MFI to another.

Respondents pointed to a low level of risk awareness in many MFIs, particularly the smaller, less sophisticated ones. But where such awareness existed, there were often inadequate risk management skills - and even a view that risk management itself was costly and unnecessary. For example, the executive director of a microfinance NGO in Bangladesh saw "a lack of knowledge in most of the providers". As MFIs get bigger and more complex, these failings become more apparent. The general manager of an NGO in Cameroon said that "with the introduction of innovative products offered in partnership with multiple operators (e.g. use of information and communication technologies) this risk will be significant".

A respondent from Benin highlighted a different sort of problem. "Although controls are in place at most institutions, it is important that these are considered to be beneficial management tools to improve the performance of the institution. Often textbooks and other devices exist, but are not understood by the staff".

While many respondents believed that poor risk management is caused by inadequate resources and training, some argued that the problem lay deeper, in a lack of conviction among MFI boards and management about its value. One UK-based microfinance investor said that "good risk management practices should be within the ability of management to introduce. The worry is that many just see it as an additional unproductive overhead".

But many respondents also stressed that things were improving, under pressure from regulators and investors. Prashant Thakker, global business head of microfinance at Standard Chartered Bank in India, said that "generally, the sector has this under control", and a UK-based consultant said: "I see much better awareness and risk identification. The challenge is more action about these risks: how to improve information systems, human resources, governance, and finances to prevent then deal with these risks."

Some respondents were sympathetic with smaller MFIs' reluctance to become too involved. Gerhard Coetzee, head of the inclusive banking segment at Absa Bank in South Africa, felt that excessive emphasis on risk management "runs up the cost to serve and also thus the cost to the client". A respondent from Kenya was more forthright about risk managers: "This emerging profession is determined to shut down microfinance!" he said.

7. Client management (-)

The risk in poor client management is a new Banana Skin in this year's survey. Defined as "the risk that microfinance providers will lose business by failing to understand or communicate with their clients, or by failing to develop appropriate products", it reflected the view that recent market crises stemmed, at least in part, from precisely that risk.

Do MFIs really understand their clients?

Beth Porter, policy advisor on financial inclusion at the UN Capital Development Fund, said that "the biggest risks to the microfinance industry are related to inadequate attention to the wants and needs of the client. This has contributed to pushing inappropriate products, often resulting in overindebtedness and a product mismatch. Further, this has resulted in a lack of client protection through acts of commission (such as aggressive/abusive sales and collections practices) or omission (such as lack of transparency in pricing and absence of recourse mechanisms). The resulting risks to the industry take the form of credit risk and reputation risk".

> Part of developing appropriate products for clients entails treating clients with respect and dignity. The bad treatment that some companies are giving clients has generated resentment towards the industry, and thus, increased the probability of clients viewing lenders as loan sharks and not as a source of social benefit.
>
> **Chief financial officer, MFI Mexico**

Many respondents shared the view that overindebtedness represented a failure of client management. "Many microfinance institutions seem to have too little understanding of the true repayment capacity of clients", said Ruben Smit of SNS Asset Management in the Netherlands, while an international investor said that "many microfinance providers are living an illusion that they are close to their clients when in reality they have no clue who their customer is. Otherwise why would we have an overindebtedness problem and multiple cross borrowings?"

MFIs could develop more products

A lack of product development was also mentioned as a symptom of poor client management, particularly the apparent reluctance or inability of many MFIs to move beyond credit to offer other financial products that people need. A UK microfinance investment consultant said that "we are starting to see progress, under duress. Managers are trying hard to understand their clients' needs but may not yet be in tune. The 'microcredit-biased' model remains entrenched when clients seem to be willing for other services (savings, remittances, maybe insurance...) to be developed at the same pace".

Not all responses were negative. A respondent from a global ratings agency observed that generally, microfinance providers are quite good at communicating with clients, given "a labour-intensive model that centres on loan officers' close relationship with borrowers". But the real challenge "is ensuring that the wealth of information on clients held by loan or field officers, feeds back into product development by the institution. If done effectively, this could be a serious competitive advantage for a microfinance provider".

Innovation – risk or opportunity?

The ability of the microfinance industry to innovate is increasingly seen as an element of survival, and therefore as a potential risk. Many respondents felt that MFIs were weak on this front.

Howard J. Finkelstein, a US attorney specialising in microfinance, was among them. He said that claims that the industry "didn't do enough" were unfair. "On the other hand, the key risk is from microfinance managers and funders becoming too set in their ways and unwilling to innovate. We see successful MFIs refusing to diversify into other life-improving businesses (such as SME, housing, healthcare finance). We also see IFIs and other MIVs refusing to invest in MFIs that are not Tier I or upper Tier II. Habits are easily formed and hard to break...Microfinance and microfinance investment were built upon innovation".

Stagnation, reluctance, and failure to adapt new technology were the dominant concerns. Aside from customer neglect, there is the risk that faster-moving rivals will gain market share if the industry does not come up with new products and delivery channels. Camilla Nestor, a vice president at the Grameen Foundation, said: "Microfinance institutions and banks tend not to be the most innovative institutions...but new, innovative players are rapidly entering and have potential to eclipse MFIs' relevance - especially in Africa with mobile network operators".

Not all respondents saw an absence of innovation. Philip Brown, managing director of microfinance risk at Citi, said that "with further technological innovations such as mobile banking, prepaid cards and a willingness to explore new distribution channels for financial services, the microfinance sector can be expected to undergo a paradigm shift as its extends further to hard-to-reach clients".

Elissa McCarter, vice president of CHF International, said that "the overindebtedness critics have made most MF managers wake up to the need to pay more attention to consumer protection and what and how they are lending", while the director of a microfinance support network in Africa said that "this is a big risk given where microfinance is coming from. We are seeing some positive change here, but support for microfinance is likely to falter if the value proposition doesn't strengthen".

8. Competition (3)

Although it has fallen in the rankings, people still tend to see competition as a bad thing which damages markets, particularly ones like microfinance which aim to provide a social as well as a commercial service, rather than as a spur to efficiency and innovation. The entry of mainstream banks with no social bottom line, and of consumer lenders offering easy credit with few credit checks both pose threats to MFIs, as does the emergence of mobile network operators offering financial services.

Competition still seen more as a bad than a good thing

These concerns are held more by practitioners (their No. 5 risk), who feel the heat directly, than by observers who may believe that competition can also be a good thing (they ranked it No. 8 as a risk). It is also a particular concern in Latin America and the Central and Eastern European (both have it at No. 2) where most of the responses came from practitioners.

Marjolaine Chaintreau, vice president at Citi Microfinance, said that "the issue of competition varies dramatically from market to market. But it is particularly problematic in mature markets where clients have not been sufficiently segmented, or products diversified. So microfinance providers tend to compete for the same client segment with a similar product".

The difficulties created by competition were graphically described: predatory pricing on loans and savings and the power of deep pockets to make heavy inroads against weaker incumbents. Syeda Kazim, a consultant in Pakistan, said that "providers continue to enter already saturated markets, which leads to negative competition, staff and client poaching and reduction in the ethical standards of the sector".

> Many players are not yet ready to see the truth. They think that, somehow, magically, they are better than their competitors, and that they will escape the inevitable erosion of margins. Many of the MFIs that I observe are not doing enough to rationalize their networks and cut their costs".
>
> **Martin Holtmann**
> **Head of microfinance**
> **Global financial markets**
> **International Finance Corporation**

For many respondents, excess competition was one of the chief causes of overindebtedness because it drove up the availability of credit while also driving down its cost. In a typical comment, Jose Bedoya, director of microfinance at the Fundacion Mario Santo Domingo in Colombia, said that "the major risks that microfinance faces in the coming years are those associated with the eagerness of institutions to penetrate these markets, [which then] cause overindebtedness among their customers". A consultant added: "Weak MFIs seem to hide their bad performance behind the competition excuse, while the strong performers welcome more players to diversify products and segment clients, being better placed to engage with regulators, donors and funders".

Some respondents said the problem was the exact opposite: a lack of competition resulting in poor service and bad value for the customer. Claudia Valladares, vice president of community banking at Banesco in Venezuela, said that the low level of competition in some markets "means that some institutions continue charging their customers very high interest rates".

9. Regulation (6)

This Banana Skin has fallen a few places because, as a number of respondents noted, regulation is generally getting better. But concern persists about over-regulation of the microfinance industry as much as it does about the absence of good regulation.

The stifling effects of poor and uncertain regulation

The CEO of an MFI in Nigeria said that "the perception by governments has begun to change globally, and there are more regulations restricting operators now, bringing microfinance closer to mainstream banking. Unfortunately, this has also meant that operational costs are increasing in order to meet the regulations and thus access to finance is limited". J.D. Bergeron, senior director of social performance at Kiva in the US, said that "when done well, regulation can be the enabler of a self-sustaining and client-centric microfinance industry. Poor regulation, however, can destroy value for institutions, borrowers, donors and investors".

This is a risk that varies greatly from one country to the next. The areas of greatest concern are countries like India where the fall-out from the Andhra Pradesh crisis has brought severe regulatory restrictions on the operations of MFIs: caps on margins and interest rates, as well as higher capital and other operating requirements. "Only players with critical levels of capital and customer base can survive in the regulated markets, because the margins are capped", said one Indian respondent.

But more widely respondents also reported what they saw as the stifling effects of poorly handled – and uncertain – regulation. Cost was a big issue, both of operating requirements such as capital, and of compliance. The head of business development at an MFI network in Tanzania said that the capital requirement for each branch was now $250,000; despite this, the branch could not call itself a bank – which hampered its ability to compete for savings.

Concern about the restrictive effect of regulation on innovation - the ability to diversify and offer new products - was also high. A respondent from a women's MFI in Jordan said there was "a lack of proper regulations that support the development and growth of the microfinance industry". The area of savings and deposit-taking – banned in many countries – is particularly contentious.

As microfinance becomes bigger and more complex, all these issues are likely to grow rather than recede, causing many respondents to see regulation as an advancing rather than receding risk. However, some also noted that regulation was improving, both as to its understanding of the industry and its quality. There was better dialogue between MFIs and their regulators, and the logic behind regulation was becoming clearer. For example, a credit risk rater in Peru said regulation there "is adequate and modern". A UK consultant added: "Let's not put too much blame on regulators who navigate between growth of the sector, outreach/poverty objectives, and protection of the sector's clients and financial stability. My discussions with senior regulators are more positive than two years ago".

Perhaps the final word should go to a regulator. Philippe Nsenga, microfinance inspector at the National Bank of Rwanda, said that "microfinance institutions suffer from a bad reputation. Efforts are needed to inspire confidence that they can operate safely and show that they can compete with banks".

10. Liquidity (16)

Worries about liquidity are on the rise again, mainly because conditions in financial markets are so unsettled.

Liquidity risk relates to the ability of MFIs to finance the short-term cash needs of their business, and is a classic anticipatory risk: even financial institutions with a strong liquidity position worry that conditions could change for the worse overnight, for political as well as economic reasons.

Liquidity risks are rising because of financial uncertainty

Jaime Nieto, director of treasury at Camesa in Mexico, ranked the risk high "because of global economic uncertainty – and the elections in Mexico". There are also concerns that the controversies surrounding microfinance could affect the industry's access to liquidity from institutions and banks. Anup Singh, a specialist at Microsave in India, said that "the after-effects of recession are still very strong, which has a cascading impact on liquidity management for MFIs. What worsens the situation is the recent microfinance crisis in India. Investors are not very positive about investing in the microfinance sector".

Most MFIs lack skills in treasury management, and most of the time, due to market shocks, they cannot honor their liabilities as required which leads to high reputational risk.

Gerard Nsabimana
Microfinance inspector
National Bank of Rwanda

Those at risk are particularly the smaller MFIs who may be less favoured by providers of liquidity, or who lack treasury skills to manage their liquidity needs. A respondent from Peru said there were "liquidity problems in small and medium MFIs, because suppliers concentrate their resources on large MFIs". Other respondents pointed out that new international regulatory requirements on liquidity put further pressure on MFIs to hold ready cash.

However, it was also clear from the responses that one cannot generalise about liquidity risk: the position is unique in all institutions, and many do not have a problem. Some respondents even said that there was not a shortage of liquidity but a glut, particularly where it encouraged MFIs to lend too liberally.

Many respondents also made the point that liquidity was a risk that well-run MFIs should be able to manage. The director of a rating agency in Africa said that "liquidity shortages are quite common, though they usually result from lack of management, not a lack of funding available externally". Andre Wegner, vice-president at Alitheia Capital in Nigeria, said that liquidity "is a problem in some cases, especially highly geared NGOs. However, most microfinance banks have a poor fund utilization ratio and plenty of cash for operations".

Although MFIs which take deposits should be in a better liquidity position than those which don't, this is not necessarily the case. M. Ismail, a consultant at

Nedbank in South Africa, said that "attracting deposits at current [low] interest rates is difficult, and will continue to be difficult", while the chief financial officer of a large international microfinance investor said that "some MFIs are turning to deposits as an alternative funding source, but the true cost of providing deposits is often underestimated, and becoming a deposit-taker ratchets up the reputational risks".

11. Mission drift (9)

The perception persists that microfinance is "drifting" away from its intended focus on poverty alleviation towards more commercial objectives, though the risk continues to occupy only a middling position in the ranking.

Is microfinance drifting away from its social agenda?

For many respondents, mission drift is about the risk of another Andhra Pradesh, in which competition driven by the expectations of investors, in combination with aggressive collection practices and a burgeoning market for consumer lending take microfinance far from its original social agenda. A Tanzanian practitioner wrote, "As competition increases, and the regulator becomes more stringent, practitioners will have to divert their product to the higher end [of the market] with more returns and secure lending as compared to unsecured lending to the poor."

For some, this risk is an ideological one, that microfinance is in danger of betraying its purpose. But the more practical consequence could be a loss of reputation and funding. The 'double bottom line' approach, wrote a practitioner, "must be taken seriously and balanced in order to mitigate this risk because either way, both the funders and the microfinance providers will not achieve their objectives if the financial objectives are prioritised over the social objectives and *vice versa*".

Several respondents noted the various social performance management (SPM) initiatives underway in the industry, such as the Smart Campaign and SPTF. However, there were concerns about SPM's potential polarising effect. "I see mission *divide* as one of the main risks facing the microfinance industry in the coming years, as some MFIs become more commercialised and others stay very socially mission-driven", wrote Danielle Donza from Accion. "This divide will make it increasingly difficult for the industry to reach consensus around objectives, standards and reporting".

However, the acuteness of the crisis over mission drift has clearly passed for most respondents, and the general sense is that the reputational damage caused by some press reports could have been worse. Nevertheless, the high interest rates charged to borrowers, the continuing growth in consumer lending, and MFIs' preference for the easily targeted urban markets remain concerns, even if the last survey's repeated references to suicides and aggressive collection methods have subsided.

12. Back office (13)

Back office risks (poor management systems and controls etc.) continue to be ranked as middle level, with many respondents claiming to see an improvement in an area which has traditionally been a low priority for MFIs, but others reporting only slow progress.

On the minus side, respondents painted a picture of MFIs overwhelmed by the speed of growth in the industry and the consequent stresses on back office systems. Many still relied on paper-based processes or obsolete technology run by inadequately trained staff. Hans Boon, managing director of Postfinance International Development in the Netherlands, said that "the scale of operation of many microfinance providers is often (too) small to ensure an adequate and cost efficient back office operation with proper controls and management information. Unless cloud computing for microfinance becomes a real solution within the next 2-3 years, cost, quality and other weaknesses will result in increased risk for many of the smaller MFIs".

Back office systems improving, but slowly

Respondents said that weaknesses were particularly prevalent in fast-growing MFIs: those with an expanding loan book, new products on offer and freshly recruited staff. A credit rating analyst said that "as an MFI grows, business development usually grows faster than back office and risk management systems, and this can create weaknesses in controls and opportunities for fraud."

On the plus side, respondents see MFIs reacting positively to recent stresses by raising their investment in back office systems and hiring better qualified staff. Elisabeth Rhyne, managing director of the Center for Financial Inclusion, said: "Haven't we solved this one? Only an incompetent MFI would have serious risk in this area at this stage". In Paraguay, Luis Fernando Sanabria, general manager of Fundación Paraguaya, said that "the industry has learnt a lot about controlling these risks".

Those respondents who took a positive view said that MFIs now realise that good information and control systems help them run a better credit business, with lower costs and losses, and a reduced risk of fraud.

13. Macro-economic risk (17)

Concern about the state of the global economy has risen slightly this year because of the persistence of economic uncertainty.

According to Belgian analyst Daniel Rozas, the experience of 2009-10 "has shown microfinance to be a lot more susceptible to macro-economic shifts than previously thought. There is no reason to believe that this has changed. Meanwhile, the global economy is continuing to sail in highly uncertain waters, which should keep macro-economic risk high for the foreseeable future".

Macro-economic risk, as some pointed out, "will always be there". Eric Duflos of CGAP in Singapore said that "while we have talked many times about how microfinance institutions managed to survive the global crisis, some of them were affected, and it is unclear to me whether they are better prepared for a new global financial crisis".

Inflation up, remittances down

Two themes emerged from respondents. One was the problem of rising fuel and food prices. A Tanzanian practitioner noted that inflation was up to 19 per cent from 6 per cent in 2009. A UK microfinance consultant warned of "economic pressures upon the cost of essential domestic expenditures (such as food, energy, education) which erode the net disposable income of clients and increase the usage of loan funds for consumer subsistence needs".

The problems of the developed world also loomed large for several respondents. A respondent from a credit rating agency noted that microfinance providers would be required "to manage the knock on effects of the economic weakness in the EU and the US, for example, through remittances and access to cross-border funding". Other countries suffered economic risk for specific reasons, such as the Arab world where revolutionary turbulence disrupted markets and drove up prices.

But some respondents were more optimistic. Frank Streppel of Triodos in the Netherlands observed that in most emerging markets "the macro-economic outlook is positive compared to Europe and the US. The global economic downturn will impact economies in developing markets as well, but as home markets increase, this dependency slowly reduces".

Growth: too much of a good thing?

Is microfinance growing too fast for its own good? Or is it running out of steam, and failing to deliver?

These apparently contradictory risks loomed behind many of this year's Banana Skins. On the one hand, respondents remembered pre-2010 Indian hyper-growth rates and their damaging political fall-out. The outcome there suggested that there may be a limit to how fast MFIs can grow without incurring risks to their business and reputation. On the other hand, respondents regretted the lack of ambition in MFIs who were prepared to settle for business as usual, failing to invest in new platforms or delivery channels, or serve up new products. These MFIs were also, in their way, giving microfinance a bad name. Even where MFIs want to grow, there is the fear that funding for the industry will dry up if it appears that pre-AP growth rates may no longer be possible.

In the current environment, growth has become more muted, partly because of global economic uncertainty and tougher regulatory and political controls, partly because competition has become more intense, and partly too because of specific concerns such as overindebtedness. But many respondents argued that MFIs need to grow to survive and keep microfinance going.

Paul di Leo, president of Grassroots Capital Management, a US investor, said that microfinance had emerged stronger from the past few years "so the risks to performance are perhaps somewhat diminished. I think that what faces microfinance is rather the risk of missing the opportunity to build a diversified sector that can acknowledge and support the diversity of models that will be required to maximize both investor engagement across the full investor spectrum and impact - including poverty impact! - on clients. Failure to accept the legitimacy of this full range of models threatens to breed confusion and disillusionment, and squander microfinance's potential".

14. Staffing (8)

Staffing risk, the ability to recruit and retain good people, has shown a volatile trend in the Banana Skins surveys, once as high as No. 5 and now down to No. 14. With this year's improved result, it might be possible to say that the general trend is downwards, and that staffing risk may be easing.

This is certainly reflected in some – though not all – of the responses. The more optimistic said that MFIs were developing better human resource programmes, were training and paying their staff better, and were reducing turnover. A bank inspector in Mali said that "the problem is shrinking with the proliferation of microfinance training centres".

Competition for good staff is hotting up

But there was also a less encouraging side to the picture.

Respondents from many regions said that, if anything, the situation was getting worse. Competition for scarce talent was increasing, and new entrants to microfinance such as commercial banks were poaching the best staff and bidding up salaries. The more commercially-minded MFIs were driving their staff harder and straining their loyalty. Staff turnover was on the increase, and recent controversies were putting people off.

The managing director of a US-based investment firm said that "with the expansion of the financial services and capital markets in emerging/developing economies, there is an increased demand for qualified management with escalating compensation which is more than MFIs can afford - so they will lose good trained staff if they cannot compete".

The issue of training and career development loomed large. Although much has been done to improve both these demands, it was the lack of skilled personnel that drew the most comment, particularly in the area of middle management where MFIs compete most directly with banks.

Sergio Guzman, lead specialist at the Smart Campaign at Accion International, said that "competent loan officers are very hard to keep, in every market that I have analyzed. Also, since MFIs are not growing as fast as they were before, there are fewer opportunities to move up within some MFIs, so loan officers and branch managers quickly get scooped up by competitors (often commercial banks looking to get into microfinance). Some competent network and MFI staff move to other industries or to larger financial institutions who are hungry for their skills". Kevin Kennedy, operations director at Solarnow in Uganda, said that staffing risk was "fairly high" because of "the continuing view that these businesses can be managed by well-meaning but limited semi-professionals".

15. External risks (-)

This Banana Skin is a new entry in this year's survey. It was included to identify risks which are beyond the MFIs' day-to-day control, and outside more conventional external issues like macro-economic risk. With the Arab Spring, civil strife, flooding, earthquakes in several burgeoning microfinance markets, and drought affecting agricultural areas, there was potentially much to say.

Earthquakes, tsunamis, civil war, hail and drought

The significance of these risks was clear to many respondents. "By definition, we operate in countries subject to political instability due to income inequality and often suffering difficult environmental and climate conditions", said Jenny A. Hourihan from Pro Mujer International, and an investor said that "economic, political, natural disasters, tribal conflicts are all constant risks in a number of emerging markets, particularly in Africa".

Even though this Banana Skin emerged as a low order risk overall, the response was uneven geographically, as might be expected. One high risk region was the Middle East, for obvious reasons. Fadhel Briki from Enda Inter-Arabe in Tunisia said that his organisation "has faced this year various types of external risk; the [Arab Spring] revolution and its impact [through] aggression [against] loan officers, closing of branches, loss of clients' income" – as well as unusual climatic events like flood and hail.

Microfinance and the Green Revolution

After the revolutions, several donors tried - and continue to try - to bring in money to show their support. The pressure [on microfinance institutions] to spend on one hand, and the lack of coordination among donors and the nasty competition in some cases, can really hurt the sector."

Senior microfinance specialist
International funding agency
Middle East and North Africa

Other respondents pointed out country-specific risks. A credit rating analyst in Kenya said that the risk is greatest "for those [MFIs] having a large part of their clientele working in the same geographical area or sector – like agriculture in case of droughts, floods etc".

But there was also a positive side to this risk. Chris Linder, a consultant from AZMY based in Italy, said that crises offered opportunities, too. "I have seen MFIs rise as leaders in their communities and use their resources to help - whether it was Fonkoze and money transfers for earthquake victims in Haiti, or Enda providing new products to refugees in Tunisia during and after the regional revolutions... the MFIs have a real opportunity to fulfil their mission in an impactful way".

16. Technology management (11)

Technology management was down in the rankings this year, even though the microfinance industry has a heavy technology agenda with potential risks. As respondents noted, the growth of mobile phone banking represents one of the big investment decisions MFIs need to make in the near future. Then there are IT systems, biometric identification devices, and cloud computing to be considered.

The human and financial resources needed to take on large and complicated projects are considerable, - possibly beyond the means and skills of the average MFI. Many respondents saw this as a point of vulnerability in the industry, particularly as new competitors arrive equipped with both money and technology. Part of the pressure on MFIs in this area comes from the new – and widely held - perception that high-tech delivery systems are essential to MFIs if they are to hold their place in the market and reach their clients.

A microfinance network representative in Canada said that "the growing pressure of e-wallet solutions for financial inclusion objectives requires sophisticated IT

Big IT decisions loom

platforms which MFI generally lack", and Michael Rauenhorst of Moody's in the US said that "mobile banking/financial services will become the predominant model for delivering financial services to low-income people." But will "these mobile banking/financial services...be delivered on a scale too large for MFIs to manage?"

Several respondents felt this was an area where funding agencies should step in to fill the gap. There was also a strong case for industry-wide initiatives, in which case MFIs should be ready to strike up partnerships with competitors and suppliers. A respondent from Ecuador thought that "the state, the private sector and the academic community should coordinate efforts for the creation of science parks to prepare students in the application of new technologies".

However, a number of respondents also felt that this was an area where MFIs had made progress, particularly the larger ones, though keeping pace with change was always difficult. One of them said that "risk still exists for smaller MFIs. But many of the technology investments have already been made, and MFIs have evolved their understanding of the role of technology in supporting operations. The desire to implement new technologies (mobile banking, POS devices, etc.) is also likely to drive innovation. There'll be failures along the way, but the overall technology foundation of MFIs should see significant improvement over the medium term".

The risks in microinsurance

Most of this survey is about microbanking: lending and deposit-taking. But there are other aspects to microfinance, notably microinsurance which is still in its infancy but nonetheless coming on to the radar screen as MFIs seek to diversify their services and meet more of their clients' needs.

Most of the respondents who commented on insurance felt that MFIs were missing out on opportunities in this field by offering little more than the usual credit/life insurance.

Martin Hinz, microinsurance coordinator at Allianz, the German insurance giant, gave a more detailed picture of the risks facing the business.

His overarching concern was that microinsurance had yet to prove its viability, and if it does not "there is always the risk that commercial insurance companies shift their focus elsewhere". He also believed that microinsurance could suffer a similar backlash to microcredit in Andhra Pradesh "if transparency and customer value are not increased and well documented". Client management risk was higher in insurance than in credit "because the product is more difficult to explain, and products are for more specific purposes (risks) than credit and savings". Nonetheless, he felt that microinsurers were, on the whole, well-governed and tightly regulated.

Some respondents felt that microinsurance was already making a difference, by protecting people's lives and property. The general manager of a microfinance NGO in Ghana said that "the growth of microinsurance is minimizing the effect [of external risks]".

17. Too little funding (23)

Some MFIs are beginning to feel the pinch

In the last survey, the risk of "too much funding" was seen to be higher than that of "too little funding" because of concern that heavy inflows of funds into the microfinance market were fuelling unsustainable growth. This time the position has been reversed. After a period of abundant funding, microfinance is beginning to feel the pinch. The fall-out from the financial crisis, plus the controversies surrounding the business have reduced the flow of funds to the sector, and created anxieties. Or so it seems, because the picture is far from uniform.

On the donor side, aid budgets are being cut back. Private investors are having greater difficulty raising funds, and the commercial banks have become more tight-fisted with their loans, all of which makes life more difficult for MFIs, particularly those at the smaller end of the scale. A senior economist with one of the large European development banks, said that "the risk is whether enough private responsible investors will enter the market; those investors might feel discouraged by the current (negative) perception of microfinance."

A concern facing investors is whether microfinance can sustain its attractive returns given the risk of mounting loan losses and tighter political constraints on its activities. A particular worry in this regard is India where the Andhra Pradesh affair has led to much tougher regulation, including caps on interest rates. Shadab Rizvi of Darashaw & Company said that an industry "that once grew at a rate of 70% - 80% has recorded negative growth owing to the delinquencies in Andhra Pradesh, and the AP Microfinance Regulation Bill. Despite the best efforts of the MFIs and the central regulator, banks have not yet fully resumed funding to MFIs. Foreign investors have also shied away from the sector owing to the inherent political risk. Devoid of sources of funding, smaller MFIs may be forced to shut up shop."

AP may be an extreme case, but other respondents, particularly from Africa, also said that funding was becoming an issue. The managing director of a Nigerian microfinance bank said that "the availability of funding, especially the donor type, is thinning out", while the manager of an MFI in Kinshasa said that "the lack of funds and donors is a risk which threatens the industry". Funding concerns were also expressed by respondents in East Europe, the Far East and Latin America. In Tajikistan, Shuhrat Abdulloev, deputy director of the Association of Microfinance Organizations, said that "only large MFIs will have access to investors; small and medium ones will not be able to compete or will be closed. Today only MFIs with a loan portfolio over US$1.5m work with investors; the rest of the MFIs are not interesting for them". In Cambodia, a bank regulator said his main concern was "a lack of sustained sources of funding because Cambodian MFIs rely heavily on overseas, mainly from the EU countries which are facing uncertainties themselves".

But there were also respondents who reported no problem. The president of a large Bolivian MFI said that "this risk is low in Bolivia: there are plenty of internal and external funding sources", and in Colombia, the head of a mobile banking technology company said: "On the contrary. Microfinance is in fashion here". Some even saw a period of funding constraint bringing benefits, such as an encouragement to the industry to wean itself off aid and develop local sources of funds. A return to austerity might also thin out an overpopulated market. Malcolm Harper, chairman of M-CRIL rating agency, saw an opportunity for banks to move in "offering the full range of financial services, and a 'ladder' for clients to graduate to 'grown-up' banking rather than remaining in the ghetto of microfinance".

18. Interest rates (21)

The risks in volatile interest rates – defined here as the MFIs' funding costs rather than the rates they charge their borrowers - are seen to be small: this is not a time when rates show much sign of moving from their low base, though that can also cause problems.

Interest rate volatility is low

Joachim Bald from the Frankfurt School of Finance and Management thought that MFIs' funding costs were a small concern. "Given the high overall cost of microcredit and the dominance of operating cost margins over the cost of funds, base rate volatility is really a minor risk in traditional short-term working capital lending", he wrote.

Politically imposed interest rates present a much higher risk to MFIs. The risk is "especially due to pricing caps being frozen and not linked to market interest rates", said an Indian practitioner. In some cases, MFIs have suffered higher funding costs because of rising reputational risk, though that usually resulted from the fact that they charged high rates of interest for their loans in the first place.

19. Too much funding (22)

While generous funding from public and private sources has been widely blamed for the excesses of the microfinance industry in the last few years, the problems have been mainly in Latin American and Asian markets. The bigger problem remains too little funding. (See No. 17).

Excess funding can cause damage

Many respondents said that excessive funding had done considerable damage to the industry by encouraging irresponsible lending, fuelling "mission drift" and bringing the industry into disrepute with its bubbles and binges. A respondent from Fiji said that there was still the risk of "more donors and investors moving into with agendas that are not aligned to the objectives of the industry, thus putting pressure on the MFIs to meet their funding obligations whilst striving to maintain/honour the mission/vision of the organisation and what microfinance really stands for".

Excessive donor and investor funds can also have a big distorting effect on local markets. An investment officer with a microfinance investor in Costa Rica said that "the problem is that in some cases, funders not only encourage microfinance providers to pursue risky and overly aggressive strategies, but they also crowd out saving deposits."

A regulator in Africa said that "managers do not take the same care

> The driving force behind the key risks in microfinance for the next two years is the impact of the current over-supply of subsidized funding in a range of important markets.
>
> Subsidized funding can drive rapid credit expansion in microfinance markets, which fuels intense price-based competition often focused on urban areas to which a broad spectrum of micro-lenders have ready access. When combined with weak institutional & regulatory infrastructure, such as the lack of a sufficiently robust credit bureau, this rapid growth in micro-lending can lead to mispricing of borrower credit risk and ultimately over-indebtedness.
>
> **Klaus Tischhauser**
> **CEO, Responsibility AG**
> **Switzerland**

when using such funds, and borrowers tend to default as they think that it is free money they get from donors".

The risk consequences of this are mixed. Some respondents feared that bad publicity plus the disappointing performance of many investments could drive investors away, and create a funding shortage. Damian von Stauffenberg, founder and chairman of Microrate, said that "a surplus of foreign funding for microfinance is squeezing the margins earned by microfinance funds (MIVs). Rates charged by those funds often don't cover the risks of lending to MFIs in shaky countries. The main risk I see is that investors will turn away from microfinance, which now combines a tarnished reputation with increasingly uninteresting returns".

20. Foreign exchange (24)

MFIs are learning how to handle forex risk

Foreign exchange continues to be seen as a very low order risk, mainly because MFIs have a low exposure to foreign currency, and, where they do, they have learnt how to handle it.

Big strides have been made in currency hedging, and for most MFIs, this risk is now small. Said one respondent, "The new hedging facilities serving the sector have largely eliminated the need for MFIs to take on F/X exposure, and have made it possible for foreign investors to increase their levels of local currency lending".

A further development is the increase in local currency funding and in currency matching. As Michael Edberg of MicroVest Capital observed, "Many MFIs are now deposit-taking, raising local currency and becoming self-funded. Reliance on forex loans is becoming less of a risk".

A Middle Eastern respondent summarised progress. "Successful and growing MFIs in our region [have] managed to convince local banks to lend to them in local currency. We saw this in Morocco, Tunisia, Egypt, Jordan and in countries like Palestine and Lebanon. MFIs borrow in dollars and lend in dollars".

Microfinance Banana Skins The Top Ten 2008-2012

	2008		2009
1	Management quality	1	Credit risk
2	Corporate governance	2	Liquidity
3	Inappropriate regulation	3	Macro-economic trends
4	Cost control	4	Management quality
5	Staffing	5	Refinancing
6	Interest rates	6	Too little funding
7	Competition	7	Corporate governance
8	Managing technology	8	Foreign currency
9	Political interference	9	Competition
10	Credit risk	10	Political interference

	2011		2012
1	Credit risk	1	Overindebtedness
2	Reputation	2	Corporate governance
3	Competition	3	Management quality
4	Corporate governance	4	Credit risk
5	Political interference	5	Political interference
6	Inappropriate regulation	6	Quality of risk management
7	Management quality	7	Client management
8	Staffing	8	Competition
9	Mission drift	9	Regulation
10	Unrealisable expectations	10	Liquidity

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

The first survey, in 2008, was conducted before the full impact of the financial crisis was known. The top concerns were all about the institutional strength of MFIs – their management, their governance, their ability to run a healthy, growing business. Note that credit risk is barely on the radar screen at No. 10, reflecting the traditional view that bad debts are not a feature of microfinance. The availability of funding is not even a Top Ten concern. The picture changes dramatically in 2009. We are now in the thick of the financial crisis with turbulent markets and collapsing economies. Credit risk suddenly shoots to the top of the list, closely followed by liquidity risk as fears grip the banking markets. Concerns about institutional strength are still there, but they have been edged out of their high places by more urgent, life-threatening risks.

The world has calmed down a bit by 2011, and funding worries have eased. But credit risk remains the top concern because microfinance borrowers are increasingly

hard-pressed, with overindebtedness mentioned as a cause. The newcomers to the ranking are reputation risk and political interference following the eruption of attacks on microfinance's lending and business practices in places like Andhra Pradesh. Corporate governance and management quality remain stubbornly high among the Top Ten risks.

The picture becomes clearer still in 2012: credit risk concerns dominate with the emergence of overindebtedness as a top issue for the industry. But most of the risks in the Top Ten are institutional: the quality of management and corporate governance, along with related issues of risk management and client management. This cluster of risks has persisted in a high position throughout the series, suggesting that they represent the greatest challenges facing the industry.

APPENDIX: The questionnaire

CSFI

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Microfinance Banana Skins 2012

Each year we ask senior practitioners and close observers of the microfinance industry to describe their main concerns about the risks facing the business as they look ahead. We'd be very grateful if you would take a few minutes to fill out this form, and return it to us by April 24th.

Who you are

Name _____ **Position** _____

Institution _____ **Country** _____

Replies are in confidence, but if you are willing to be quoted by name in our report, please tick ☐

Your perspective on the microfinance industry

1. Practitioner ☐ **If so, do you take deposits?** ☐

2. Investor ☐ **3. Regulator** ☐ **4. Analyst** ☐

Other (please state) _____

Question 1. Please describe the main risks you see facing the microfinance industry over the next 2-3 years, and the reasons why.

Please turn over

Question 2. Here are some areas of microfinance risk which have been attracting attention. How do you rate their severity? Use the right hand column to add comments.

		Severity 1=low 5=high	Comment
1	**Back office operations** The risk that microfinance providers will be damaged by weak administration, accounting systems, controls etc.		
2	**Client management** The risk that microfinance providers will lose business by failing to understand or communicate with their clients, or by failing to develop appropriate products		
3	**Competition** The risk that microfinance providers will be driven by competition to lower their business and ethical standards		
4	**Corporate governance** The risk that weakness in governance (eg boards of insufficient quality and independence) will put microfinance providers at risk		
5	**Credit risk** The risk that microfinance lenders will lose money because of default or delinquency		
6	**External risks** The risk that microfinance providers will be affected by events beyond their control, e.g. social and environmental change, natural calamities, public disorder (please specify).		
7	**Foreign exchange** The risk that microfinance providers will be adversely affected by volatility in the currency markets		
8	**Interest rates** The risk that microfinance providers will be adversely affected by fluctuations in interest rates.		
9	**Liquidity** The risk that microfinance providers will suffer a shortage of ready cash to fund their operations		
10	**Macro-economic risk** The risk that microfinance providers will be adversely affected by trends in the wider economy, such volatile commodity and fuel prices, and lack of growth.		
11	**Management quality** The risk that microfinance providers will fail to thrive because of weaknesses in management, strategy, internal controls, incentive structures etc..		

12 Mission drift

The risk that microfinance providers will suffer loss of confidence among funders, partners and clients for being seen to depart from their stated missions.

13 Overindebtedness

The risk that microfinance providers will be adversely affected because their clients have borrowed, possibly from multiple lenders, beyond their capacity to repay.

14 Political interference

The risk that interference by governments and politicians will harm the microfinance business by imposing controls or distoring the market.

15 Quality of risk management

The risk that microfinance institutions will not adequately identify and manage the credit, operational and other risks in the business

16 Regulation

The risk that microfinance will fail to thrive because of inappropriate or inadequate regulation.

17 Staffing

The risk that microfinance providers will not thrive due to a failure to attract and retain good staff.

18 Technology management

The risk that microfinance providers will fail to make the most of new developments in information technology and delivery systems to run a thriving business and reach their customers

19 Too little funding

The risk that there will be insufficient funding from investors to sustain healthy growth in the industry

20 Too much funding

The risk that an overabundance of funding will encourage microfinance providers to pursue risky and overly aggressive strategies

Are there any other risks you would like to mention?

Question 3. How well prepared do you think microfinance providers are to handle the risks you have identified?

1=poorly, 10=well

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