Microfinance crisis: results from several surveys

Mini-conference // Microfinance

Moderator

Jean-Michel Servet
Professor, IHEID

Speakers

Sébastien Duquet
CEO, PlaNIS responsAbility

Marco Fischer
Senior research analyst, responsAbility Social Investments AG

Mariana Paredes
Consultant, Marulanda Consultores

Executive summary

This round table presented the results of different surveys about the microfinance crisis. The three speakers, **Mariana Paredes, Sébastien Duquet,** and **Marco Fischer**, shared their views and conclusions on the origins of the crisis.

Mariana Paredes insisted on six key points which explain the failures of MFIs: flawed methodology, loan embezzlement, lack of growth regulation, growing prospects outside the microcredit niche, flawed design and political interference. These mistakes outline the need for regulation and governance policies.

Marco Fischer introduced the results of an international study on over-indebtedness and proposed an early warning index based on 14 indicators, among which 3 are essential: the market penetration rate, the signals coming from credit institutions, and multiple lending.

Finally, for **Sébastien Duquet**, the crisis emphasizes MFIs' most obvious shortcomings: weak infrastructures, including legal ones, market saturation, risk management, group lending, and investors' behavior, that needs to become more responsible.

Synthesis

Mariana Paredes' study is based on ten MFIs in six different Latin American countries. Each MFI is a good example of one specific failure. **Mariana Paredes**' presentation was focused on 6 types of mistakes that caused these MFIs big problems and in some cases took them down. It also included the lessons learned from these mistakes.

Those errors are:

1. Methodological flaws: Most of the time, there was poor or partial implementation of typical microcredit methodology. The emphasis was put on granting bonuses to loan officers rather than monitoring risks.

2. Regular frauds in management (lending to stakeholders, contracting out relatives) and in sales (ghost loans and inaccurate information, connivance between the client and the loan officer). Although these frauds did not impact profit negatively, they undermined the MFI's ethics.

3. Unregulated growth: These MFIs have experienced a strong growth in the short term and actively recruited loan officers whilst neglecting management issues.

4. Operating in new markets outside microcredit: MFIs looked into new activities before strengthening their own microcredit business. They also penetrated other segments without adjusting their risk assessment model. **Mariana Paredes** insisted on the fact that far too many products entered the same market without previous benchmarks or the development of business models.

5. Design flaws: There was no investigation of the potential market, and it is no small task to extrapolate successful experiences to all countries and institutions.

6. Public intervention: Governments investing directly in MFIs gave way to politically related credits. Moreover, public financing created market distortion and saturation, and thus participated in the development of financial misconducts. Furthermore, public approval created moral hazard.

Multiple lessons have been learned. First of all, one solution cannot solve all problems. **Mariana Paredes** claimed adversity stimulates creative thinking as a way to conceal increasing losses. MFIs use creative financial arithmetic. **Mariana Paredes** recommended hard work to strengthen the specific methodology developed to meet the microcredit market's main characteristics. In each case, a comprehensive risk management system is required.

Mariana Paredes then addressed the question of loosened access to funding: is it a positive or negative evolution? Is over-indebtedness exacerbating governance problems? Does loose funding hinder dynamism? In her study, she shows that it allows for a higher growth rate which can cause some problems. The political risk is also a huge one for MFIs. The challenge is now to regulate and identify a set of rules and control mechanisms that are capable of maintaining a proper risk management system. Besides, good governance makes the difference. Concentrating all means of action on one individual should be avoided, given the board's limited influence and the lack of internal control in MFIs.

Marco Fischer presented his study: "Over-indebtedness and microfinance, constructing an early warning index". Over-indebtedness occurs when the borrower cannot repay the full amount of his debts on time, as occurred in Bosnia, Morocco, and Nicaragua in 2008 and 2009. The consequences of over-indebtedness are social and financial damages, and a negative impact on borrowers, MFIs and investors.

The purpose of the study was to develop an over-indebtedness early warning index and use it on a specific number of countries, in order to help prevent future crises and develop risk assessment on the market. The selected methodology was to choose several indicators and carry out an extensive survey on 120 MFIs, along with a synthesis of all academic research on the topic, to finally design an over-indebtedness index.

14 indicators were chosen. **Marco Fischer** focused on three of them.

1. market penetration, because it reflects market saturation, which is a key driver of over-indebtedness;

2. the quality and effective use of credit indicators, as in credit bureaus, to prevent over-indebtedness;

3. multiple lending, which illustrates the increasing risk of over-indebtedness.

Marco Fischer then introduced the over-indebtedness country ranking based on his index. For instance, highest levels of over-indebtedness are located in Peru, Cambodia, and Bosnia. This ranking is not supposed to support or rein in investments in any ways but to arouse discussions and debates. It is but the first step of a process that demands a lot of supplementary research in the future, since this is the first cross-country academic study.

In **Sébastien Duquet**'s opinion, the crises shed light on many underlying problems:

- weak legal system and lack of proper infrastructures like credit bureaus,

- market saturation
- lack of transparency and inadequate communication between MFIs,
- methodological problem of group lending,
- risk management issues.

How does one take over-indebtedness into account during the investment process? Evaluating credit methodology requires checking on some specific points: client selection, activities monitoring, control processes, the use of collaterals, and finally the thorough examination of debt repayment ability during the credit approval process. Risk management should be assessed at all levels: at the board of directors and management levels, at the human resources level, at the internal audit level, and at the branch level. Social performance management should also come as a priority.

To approach over-indebtedness responsibly, investors should channel their investments, reduce their amount and their term, send formal letters expressing their concerns to MFIs' boards of directors and executive committees, build over-indebtedness indexes, and participate in all relevant studies on the matter.

Questions

What is the difference between being over-indebted and cumulating three loans?

Marco Fischer: It depends on market conditions, on your cash flows, and on your financial resources.

Sébastien Duquet: Over-indebtedness is usually affecting individual entrepreneurs. Unfortunately, it has pushed MFIs to stop financing social entrepreneurs, altough small businesses are less risky than medium-sized businesses. A solution must be found.

Public comment: Excessive liquidity preceded over-indebtedness, providing disproportionate credit supply. We need to look into the role of institutions.

Public comment (Marc Roesh): It is always difficult to define over-indebtedness. For instance, it occurs in India when people cannot find a new lender. It differs from one family to another and depends highly on the informal system.

Official rapporteur:
Claire Alambik, BNP Paribas