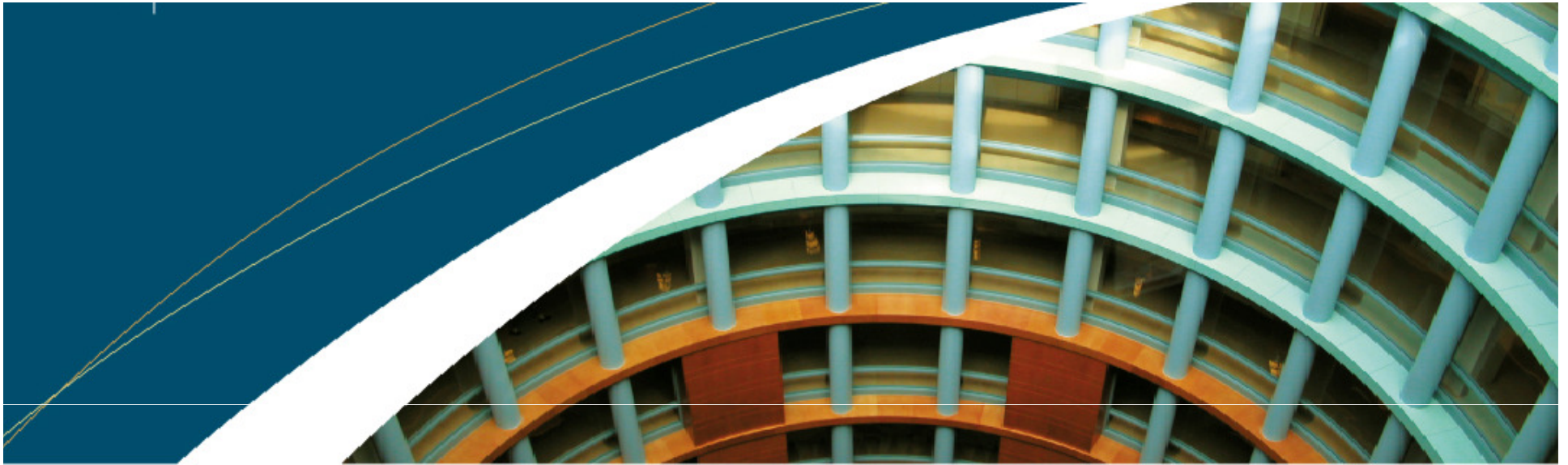




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Risk Management and Governance A framework for Microfinance

Phnom Penh – August 20, 2009

Hicham Bayali

**Program Manager Microfinance - MENA
International Finance Corporation**

Risk Management and Microfinance: Outline



- **Why is Risk Management important to MFIs?**
- **Lessons learnt: Colombia, Morocco and Indonesia**
- **Effective Risk Management: a direct result of a balanced and pro-active Governance system**
- **Implementing Risk Management**

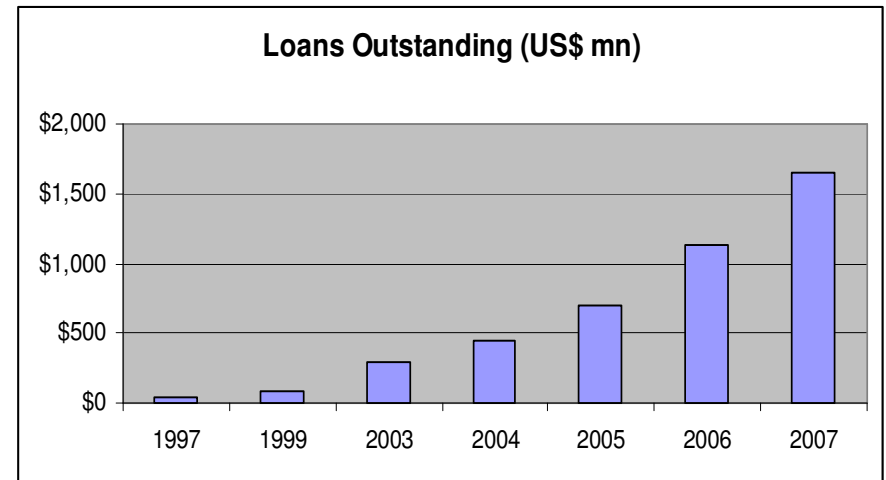
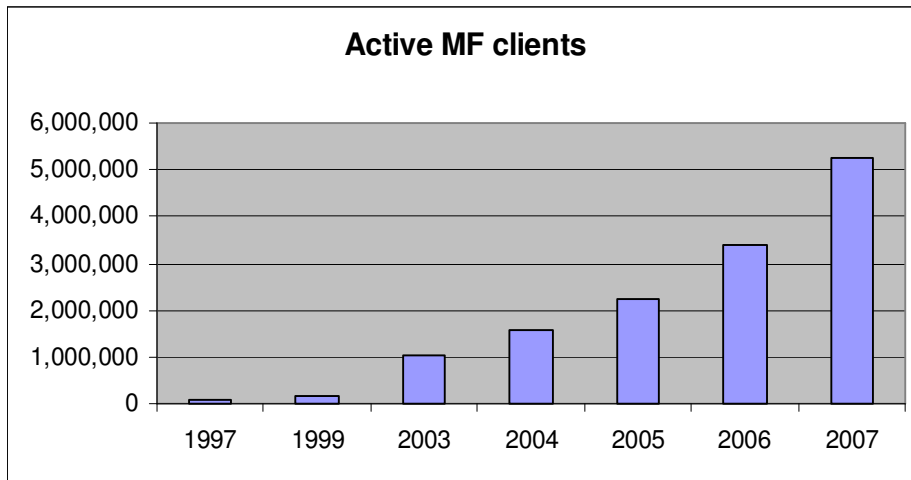


Why is Risk Management important to MFIs?

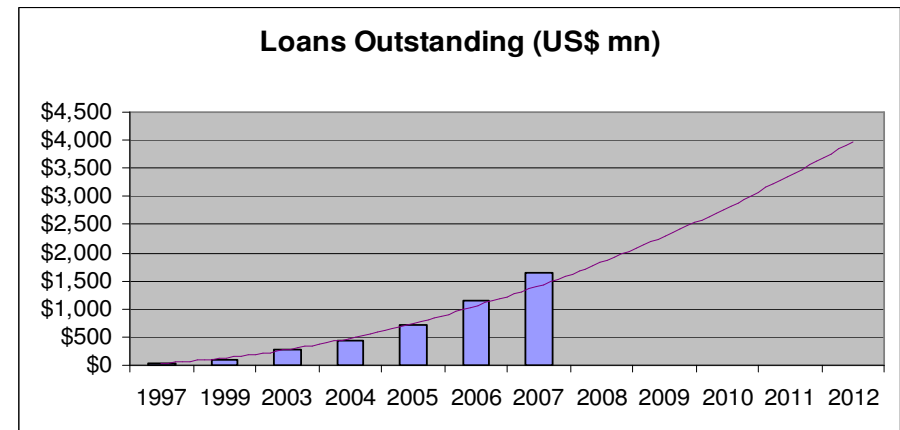
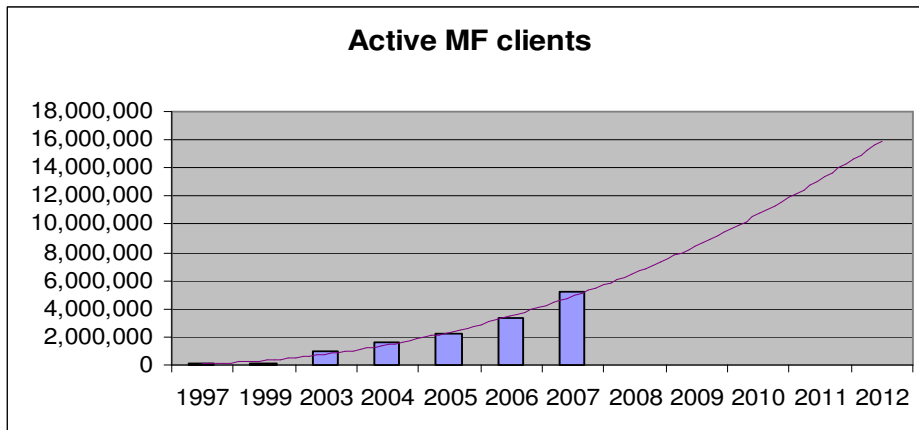


Why is Risk Management important to MFIs?

A rapid growth...

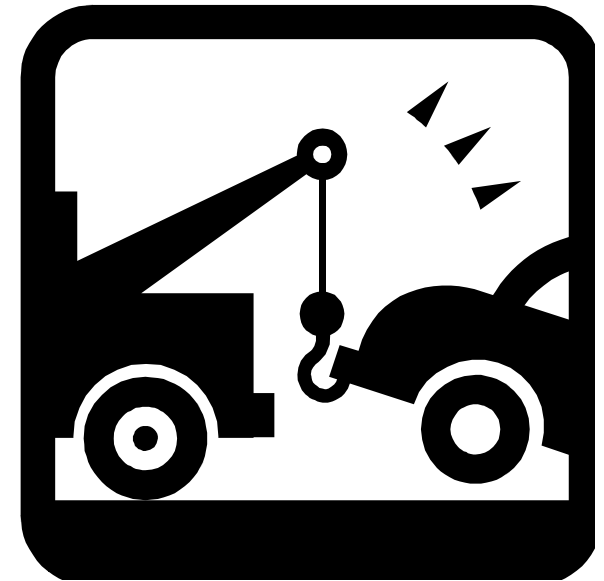
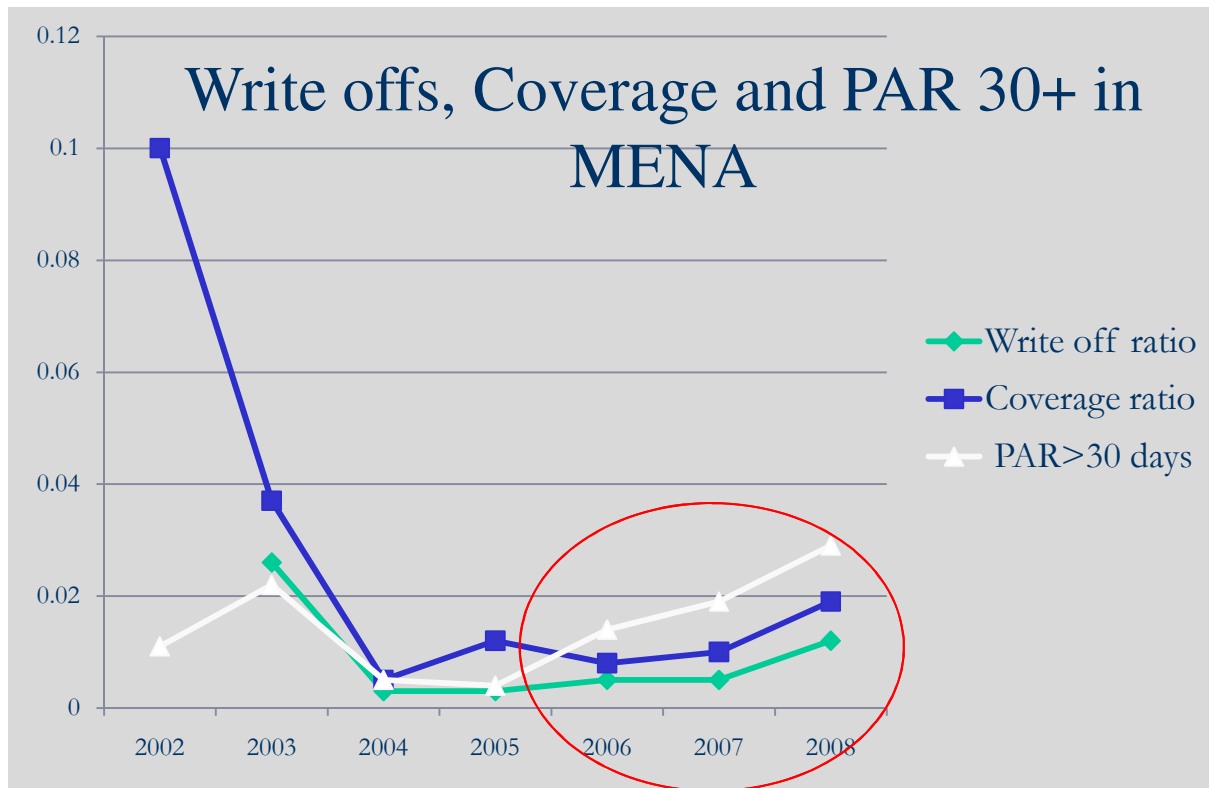


5-Year Extrapolations



Why is Risk Management important to MFIs?

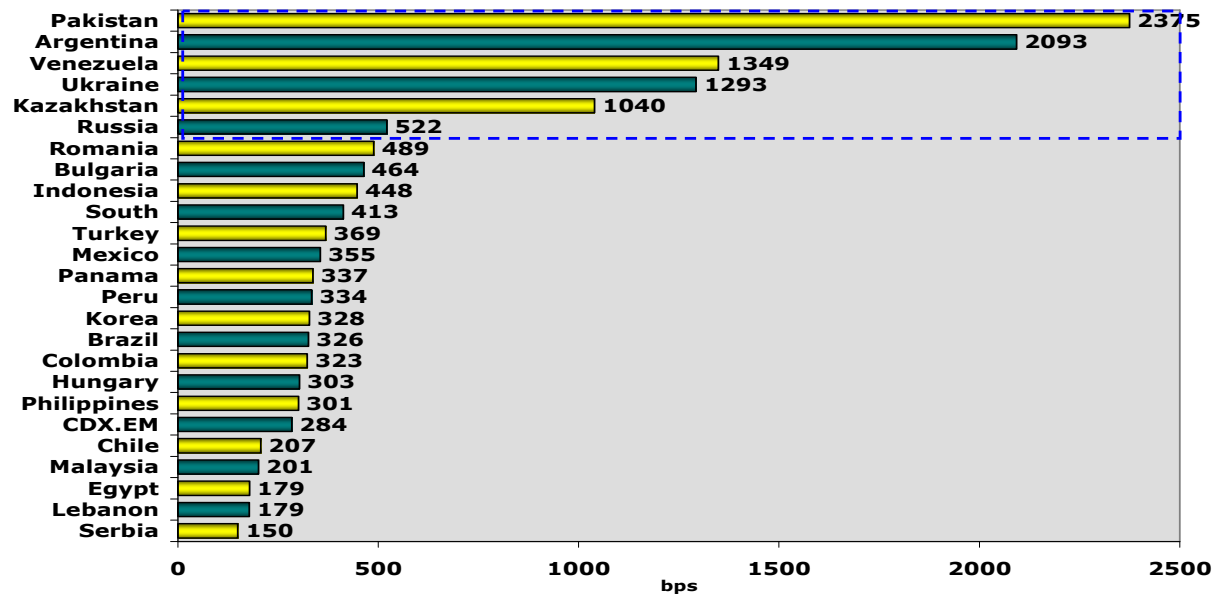
With some collateral damages...impacting asset quality



Why is Risk Management important to MFIs?

... and a crisis that might take its toll on MENA

Increase in CDS Spreads (5-year) since June 2007



CDS

5-year Spread (USD senior debt, bps)

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	Bulgaria	Hungary	Poland	Romania	Russia	Ukraine	Panama	Pakistan	Indonesia	Philippines	Korea	Malaysia
30-Dec-05	367	225	20	167	63	221	221	34	27	16	38	68	163	148		208	269	25	26
29-Dec-06	203	100	19	114	41	91	129	17	21	13	20	44	156	81	198	124	122	18	17
31-Dec-07	462	103	32	130	69	116	452	72	49	24	82	88	242	118	416	153	153	45	42
14-Oct-08	2178	275	168	280	258	279	1422	406	330	111	440	443	1598	293	2204	580	580	271	172
Average	396	149	31	155	72	134	323	62	54	26	72	79	227	127	391	195	210	44	43
Maximum	2343	402	220	407	391	406	1627	478	330	153	507	565	1598	407	3069	804	447	345	225
Minimum	183	62	12	65	28	60	118	13	16	8	17	37	126	61	109	92	93	14	12

Source: Bloomberg; CEQ Calculations

Why is Risk Management important to MFIs?

Risk Management: still a long way to go...

- Most MFIs don't behave as mainstream financial players : their internal risk management systems are often a step or two behind the scale and scope of their activities.
- Focus is at best on credit risk, and less on equally important risks such as funds management and liquidity.

...while external stakeholders are increasingly demanding

- Regulators of commercially chartered MFIs enforce certain standards.
- Non-regulatory bodies representing investors and donors also have a vested interest in better risk management within the industry to protect their investments.

Why is Risk Management important to MFIs?

Governance lies often at the heart of the problem...

- The risk associated with inadequate governance or a poor governance structure is the most understated and underestimated risks within any organization

...But why is that?

- Microfinance institutions are particularly vulnerable to governance risks because of their institutional structure and ownership : no ownership = no financial stake => ineffective governance.

-The social mission of MFIs attracts many high profile bankers and business people to serve on their boards; but these directors are often reluctant to apply the same commercial tools that led to their success when dealing with MFIs.

- Management succession and need to recruit managers that can balance social and commercial objectives: role of directors becomes more important to ensure continuity and focus.

Why is Risk Management important to MFIs?

Other obstacles to Risk Management

- **Success breeds over-confidence**
- **Donors encourage MFIs to take on new risks.**
- **Regulators overlook the distinctions of microfinance.**

Why is Risk Management important to MFIs?

Major risks to Microfinance Institutions

Many of them are common to all financial institutions, from banks to unregulated MFIs. They can be grouped into three general categories: financial risks, operational risks and strategic risks

Financial Risks	Operational Risks	Strategic Risks
Credit Risk Portfolio risk Liquidity Risk Market Risk Interest rate risk Foreign exchange Risk Investment portfolio risk	Transaction Risk Human resources Risk Information & technology risk Fraud (Integrity) Risk Legal & Compliance Risk	Governance Risk Ineffective oversight Poor governance structure Reputation Risk External Business Risks Event risk

...And some additional challenges

Rapid growth and expansion - Succession planning - New product development

Why is Risk Management important to MFIs?

Some usual suspects: examples of Common Operational Risks

- **The MIS** does not correctly reflect **loan tracking**, e.g. information disbursed, payments received, current status of outstanding balances
- **Inconsistencies** between the loan management system data and the accounting system data, and between the cash figures and the banking statements;
- **Misrepresentation of loan payoffs**, e.g. payoffs with inadequate or post dated checks;
- **Rescheduling disguises loan quality problems**, e.g. rescheduled treated as on-time;
- Inconsistent implementation of the loan administration;
- Lack of portfolio related fraud controls, e.g. no client visits to verify loan balances;
- **Loan tracking information is not adequate**, e.g. no aging balance, inadequate credit histories.

Lessons learned from experiences in Colombia, Morocco and Indonesia



Lessons learned

The Challenge of Growth in Colombia : the Corposol / Finansol Crisis 1/2

- 1996: Finansol, a regulated financial intermediary in Colombia, suffered from severe deterioration of its loan portfolio: rapid growth & poor risk management but also lack of transparent and separate accounting from its parent NGO, Corposol.
- 1995: Finansol's portfolio grew from \$11 million to \$35 million.
- Many new/not well trained credit officers, who were simultaneously responsible for promoting 3 new untested microfinance products for Corposol.
- No mechanism to prevent clients from receiving multiple loans from the MFI (2-3 loans per client) + unsuccessful products + inadequate MIS to manage the diversity of products.
- Temporary measure to reduce the negative impact of provisioning on the IS: Finansol refinanced loans on a wide scale and extended loan terms → This further concealed Finansol's deteriorating asset quality.

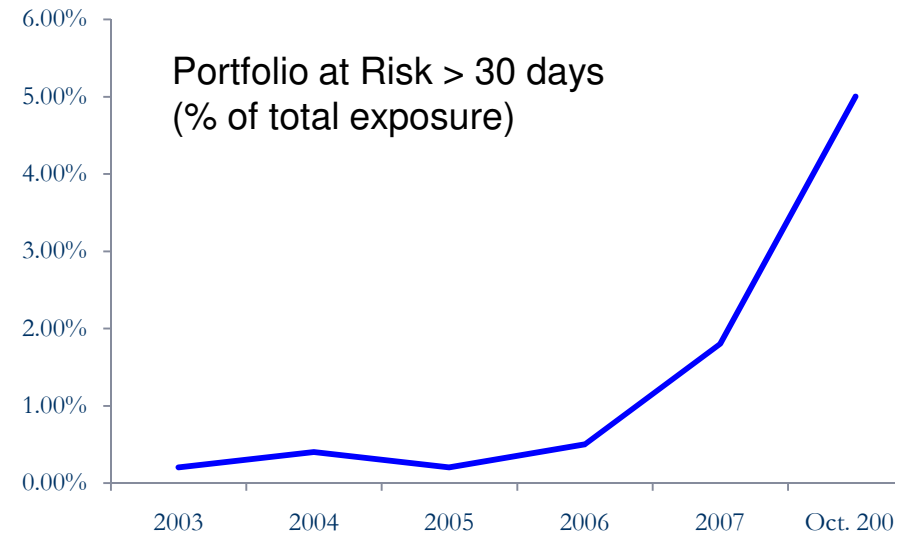
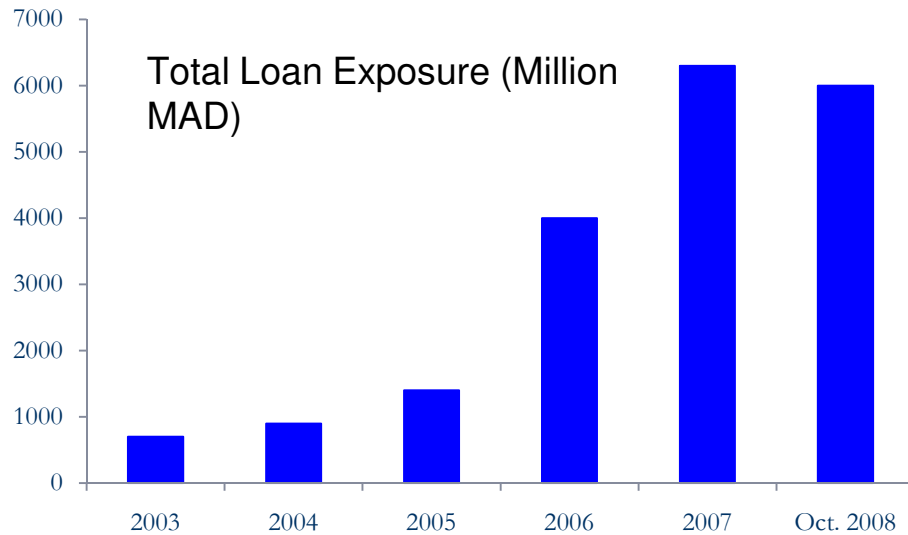
Lessons learned

The Challenge of Growth in Colombia : the Corposol / Finansol Crisis 2/2

- Pressure to generate revenue for Corposol, whose operating revenues were heavily dependent on training fees from new clients → loan officers continued to add new clients without much regard for credit risk.
- To circumvent a government policy that limited the asset growth of regulated financial institutions to 2.2 percent per month, Corposol retained a significant portion of Finansol's loan portfolio on its balance sheet, which further distorted Finansol's financial statements.
- July 1995, ACCION International conducted a formal evaluation of the entire microfinance operation.
- A recapitalization plan called for an end to the relationship between Corposol and Finansol and the recruitment of new investors to raise the level of capital high enough to meet the Superintendency's requirements and to fuel future growth. → Successful recovery plan = FINAMERICA S.A.

Lessons learned

The challenge of growth: how MFIs are learning in Morocco 1/2



The Moroccan Micro credit sector has seen explosive growth in recent years, virtually doubling lending volume annually. Since early 2007, however, delinquency rates have shot up and reached unsustainable levels.

Lessons learned

The challenge of growth in Morocco: key findings 2/2


- Strong shift towards more risky product characteristics, such as e.g. longer loan terms, explaining roughly 40% of the recent increase in delinquency.
- Significant increase of the average debt burden from micro-credit lending: has more than doubled since 2001.
- The underwriting and monitoring processes do not put enough emphasis on risk
- Substantial cross lending (about 39% exposure weighted) in the sector. Since levels have been high already before the crisis (about 32% in December 2005), cross lending is not seen as causing the crisis but rather aggravating it and changing its dynamics.
- Governance issues and operational weaknesses most likely played a crucial role, affecting most other dimensions.

Lessons learned

How BRI Survived the Indonesian Economic Meltdown 1/3

- 1997: economic crisis in Asia; several Indonesian FIs severely undercapitalized, many bank closures.
- High interest rates in Indonesia caused a flood of short-term investment in the banking sector which quickly departed when confidence dropped
- Large Indonesian businesses had borrowed a significant amount of dollars abroad, which ran up a short-term foreign exchange debt.

Despite these external risks, BRI's Unit system fared fairly well through the crisis.

- As of June 30, 1999, over 97 percent of all microloan clients were repaying on time and the twelve-month loss ratio remained steady at 1.49 %.
- BRI's microsavings increased, as savers rushed to move savings from failing private institutions to public institutions, such as  where clients trusted their funds would be safe.

Lessons learned

How BRI Survived the Indonesian Economic Meltdown 2/3

Four factors explain the BRI Units' success in maintaining strong repayment throughout the crisis:

1. BRI's microenterprise loans are installment loans linked to the borrower's cash flow. Over time, many of the microenterprise clients built up their equity and lowered their loan leverage, thereby reducing their vulnerability to external crisis.
2. Second, microenterprise clients are more likely to be engaged in the purchase and sale of domestically-produced essential goods and services, which are less sensitive to fluctuations in the exchange rate and to economic downturns.

Lessons learned

How BRI Survived the Indonesian Economic Meltdown 3/3

Four factors explain the BRI Units' success in maintaining strong repayment throughout the crisis:

3. BRI's Units operate primarily in rural areas where the impact of the monetary crisis is less than in urban areas because of a greater reliance on the agricultural economy. However, the drought had a greater impact in rural areas, but has subsequently been mitigated by two good rice crops since then.
4. BRI's Unit clients value their access to microfinance services and do not wish to lose their banking relationship, even if it means reduced consumption in the short-run. BRI has reinforced this relationship by ensuring that on-time repayers have rapid access to another loan.

Effective Risk Management



Effective Risk Management

Need to concentrate on a safer/sustainable growth pattern

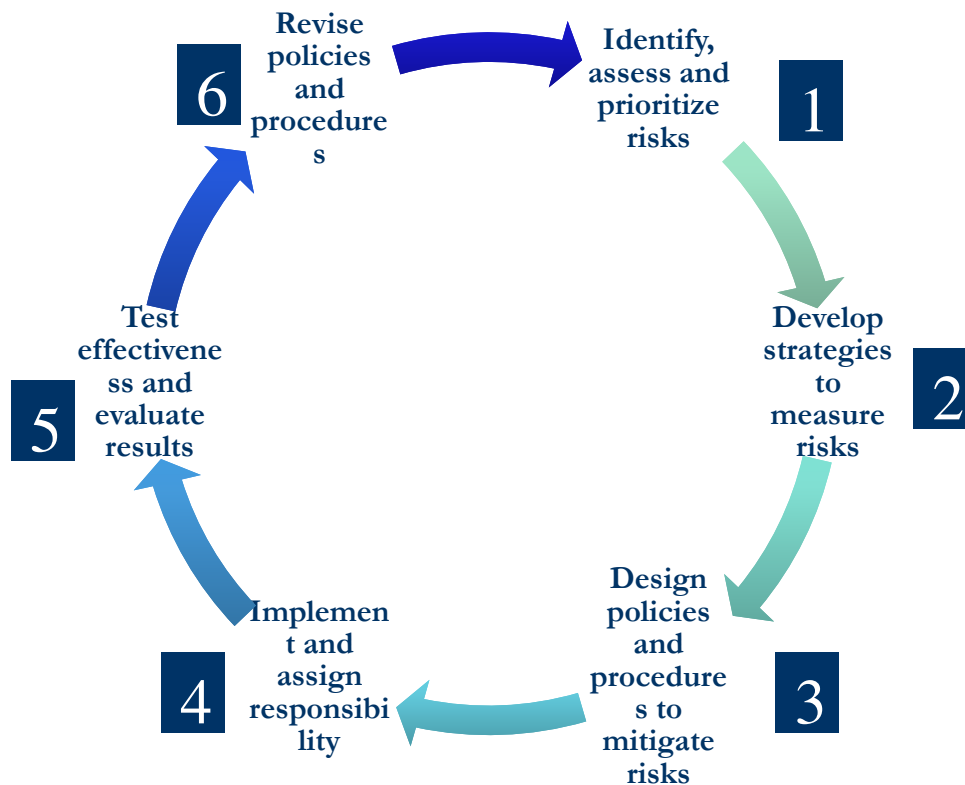
➔ Key Elements of Effective Risk management ...

1. Governance & organizational structure
2. Rigorous Operating Rhythm
3. Well defined Risk classifications & definitions
4. Clear Risk Appetite & Strategy
5. Relevant Measurements/metrics
6. Strong Control processes

➔ Governance lies at the heart of this framework

Effective Risk Management

A continual Feedback Loop



- The frequency with which this process occurs depends on the priority assigned to the risk.

- Significant risks, such as credit risk, liquidity risk, and others that threaten the financial viability of the MFI, are generally tracked via monthly reporting to senior management and the board of directors.

- Others may be reviewed quarterly or semi-annually

- Board of directors and senior management to review risk management policies once a year.
- Risk management: interactive and continual process to ensure that senior management is in-tune with the actual changes in its internal or external business environment.

Effective Risk Management

1. IS the right Governance & Organizational structure in place to manage risk?

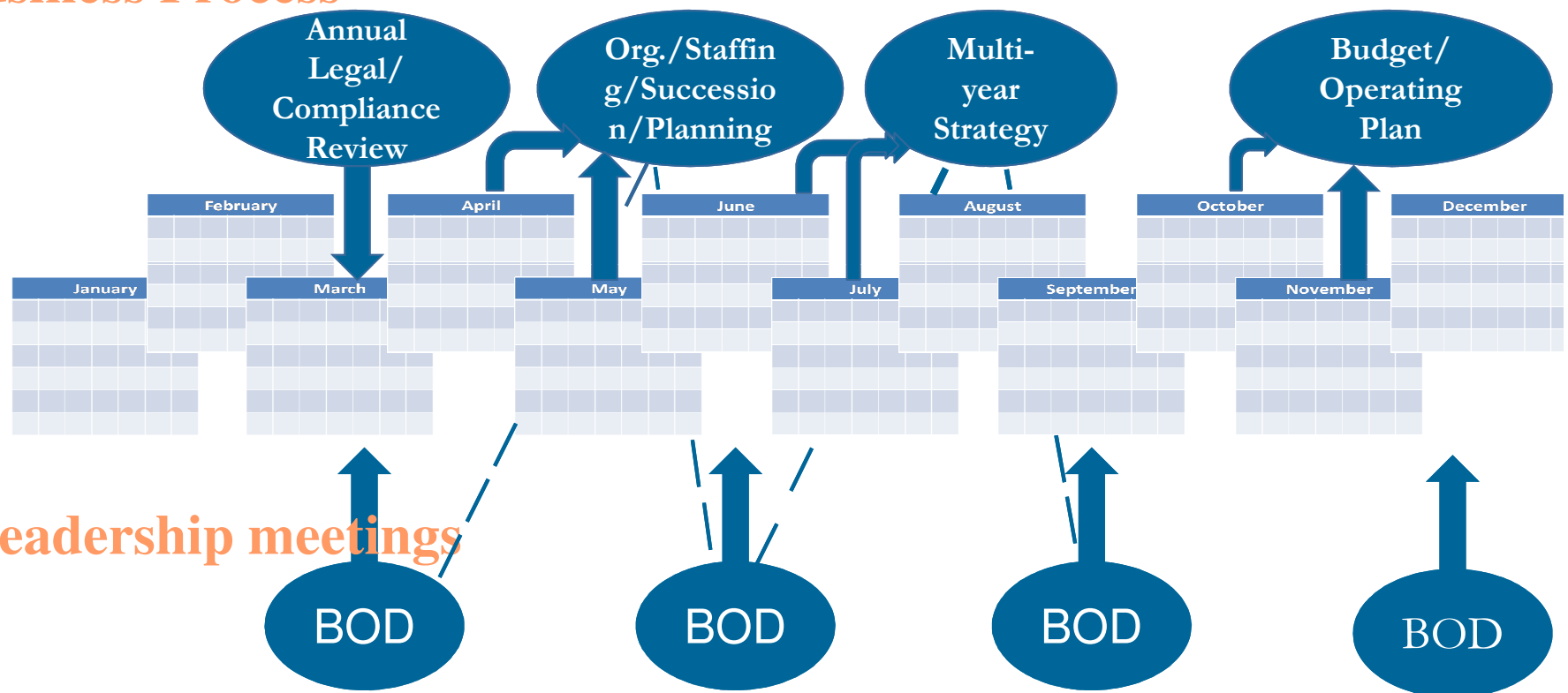
- **Board members**
- **Senior Mgt Team**
- **Chief Risk Officer**
- **Internal Audit**

Risk management starts with the right people & adequate authorities

Effective Risk Management

2. Does the MFI have the right Operating Rhythm in place?

Business Process



Leadership meetings

Planning is the key navigation tool

Effective Risk Management

A perspective from a leading bank...

“Many are surprised to learn that the Banco Santander board’s risk committee meets for half a day twice a week and that the board’s 10-person executive committee meets every Monday for at least four hours, devoting a large portion of that time to reviewing risks and approving transactions. Not many of the banks do this. It consumes a lot of our directors’ time. But we find it essential and it is never too much.”

Emilio Botin, Banco Santander Chairman, Oct 16, 2008



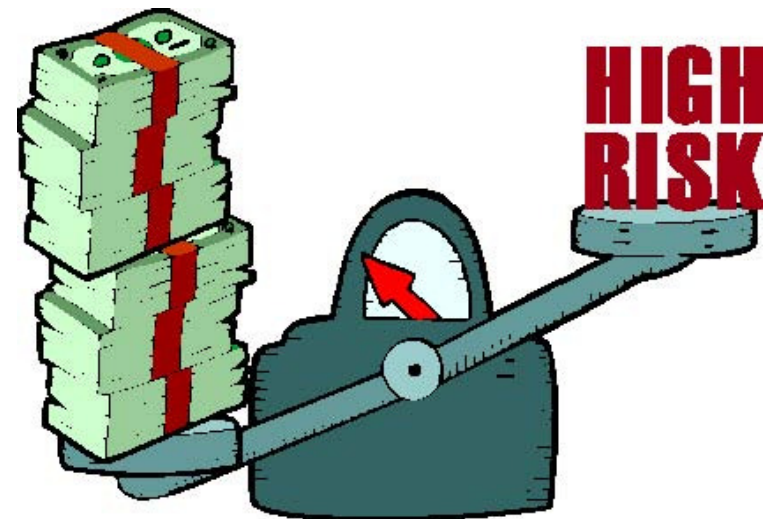
Effective Risk Management

3. What risks is the MFI looking at and are they measured correctly?

Effective Risk Management

Some risk classifications

- **Credit risk**
- **Country and transfer risk**
- **Market risk**
- **Interest rate risk**
- **Liquidity risk**
- **Operational risk**
- **Legal risk**
- **Reputational risk**



Effective Risk Management

4.a. Do you have a transparent risk appetite statement?

Qualitative:

- **Mission Statement & Values**
- **Remuneration policies**
- **Rewards**

Quantitative:

- **Amount of risk to be taken by segment, product, region, economic sector**

Internal & external communication

Effective Risk Management

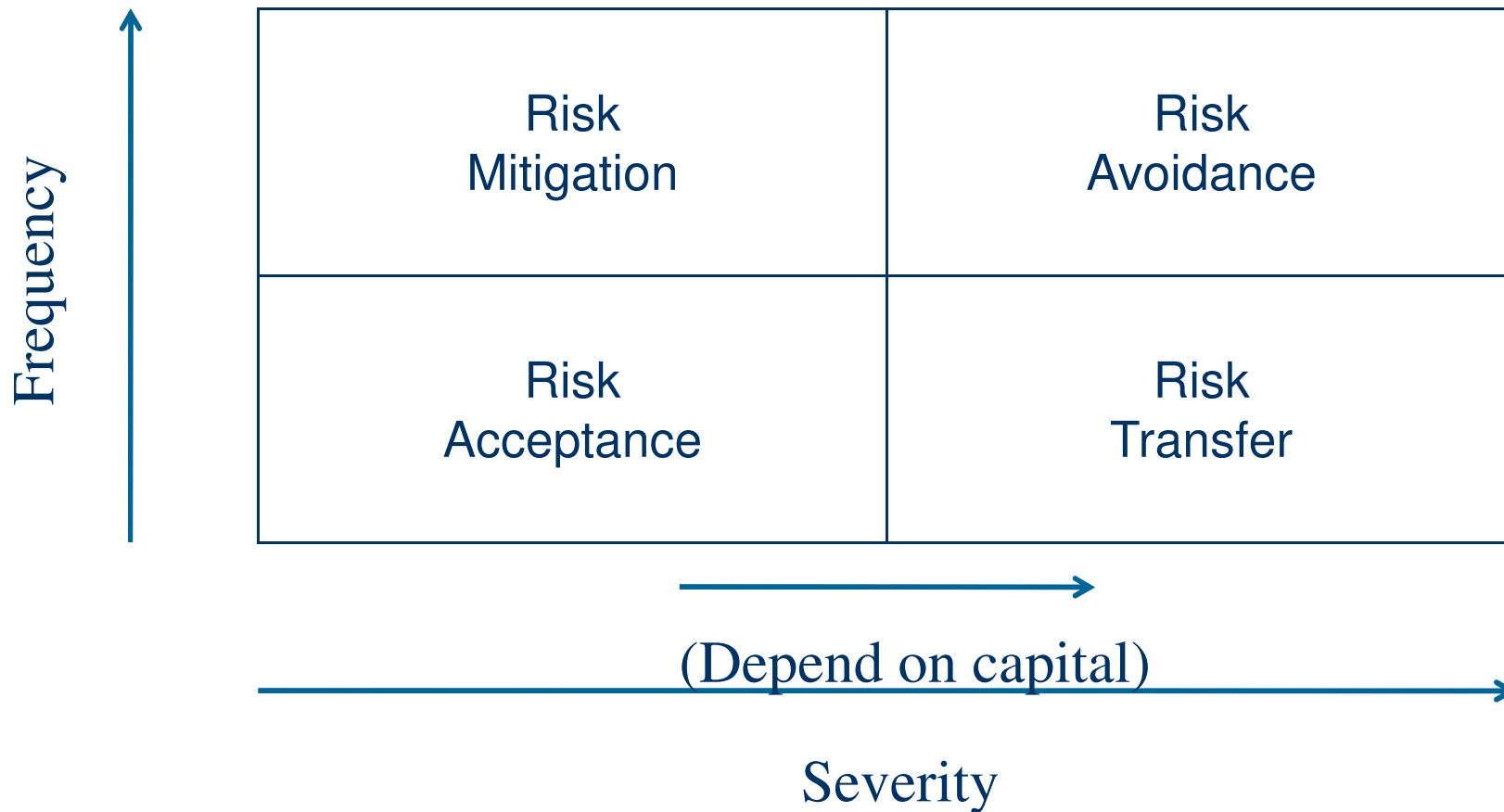
Formulation of a CREDIT RISK Strategy

Strategy:

- The MFI's plan to grant credit based on various client segments and products, economic sectors and geographical location;
- Target market within each lending segment, preferred level of diversification/concentration;
- Pricing strategy.

Effective Risk Management

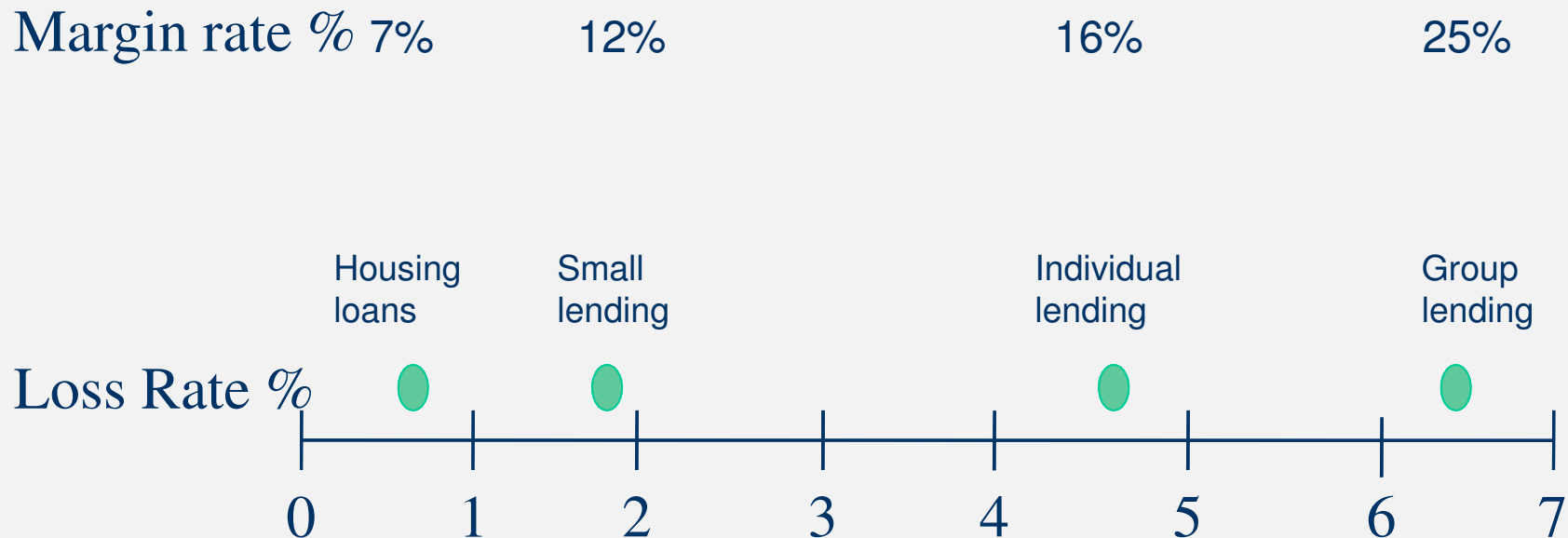
Risk Management Strategy



Effective Risk Management

Product Risk / Return balance

...Higher Spreads Compensate for Higher Losses

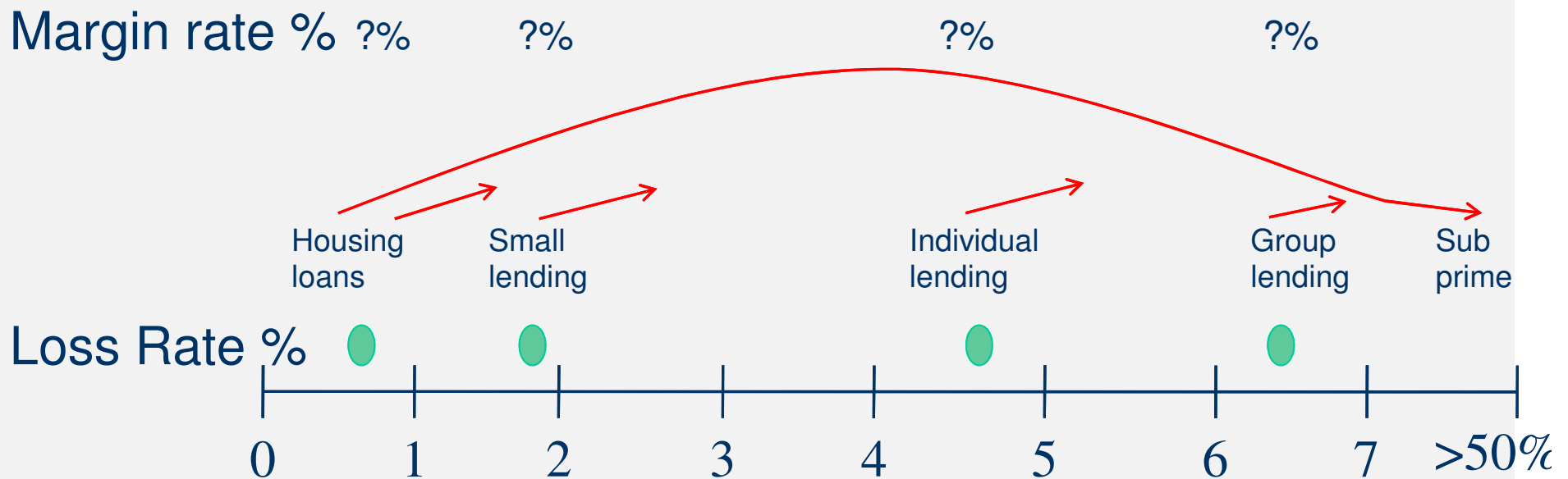


Product Margin Correlated to Loss Rate %

Effective Risk Management

Product Risk / Return balance

...Higher Spreads Compensate for Higher Losses



It's important to understand the loss data

Effective Risk Management

Understanding the drivers of risk can better help...

Balance Sheet

Focus

- 1 Portfolio mix
 - Exit Low Return Assets
- 2 Capital & Leverage
“Efficient”
 - “Right” Leverage for Risk
 - Dividend policy (if applicable)

Income Statement

Focus

- 1 Net revenue
 - Price
 - Volume
 - Mix
- 2 Losses
 - Underwriting/ Structuring
 - Collection effectiveness
- 3 Productivity
 - Asset Management
 - Digitization & Simplification

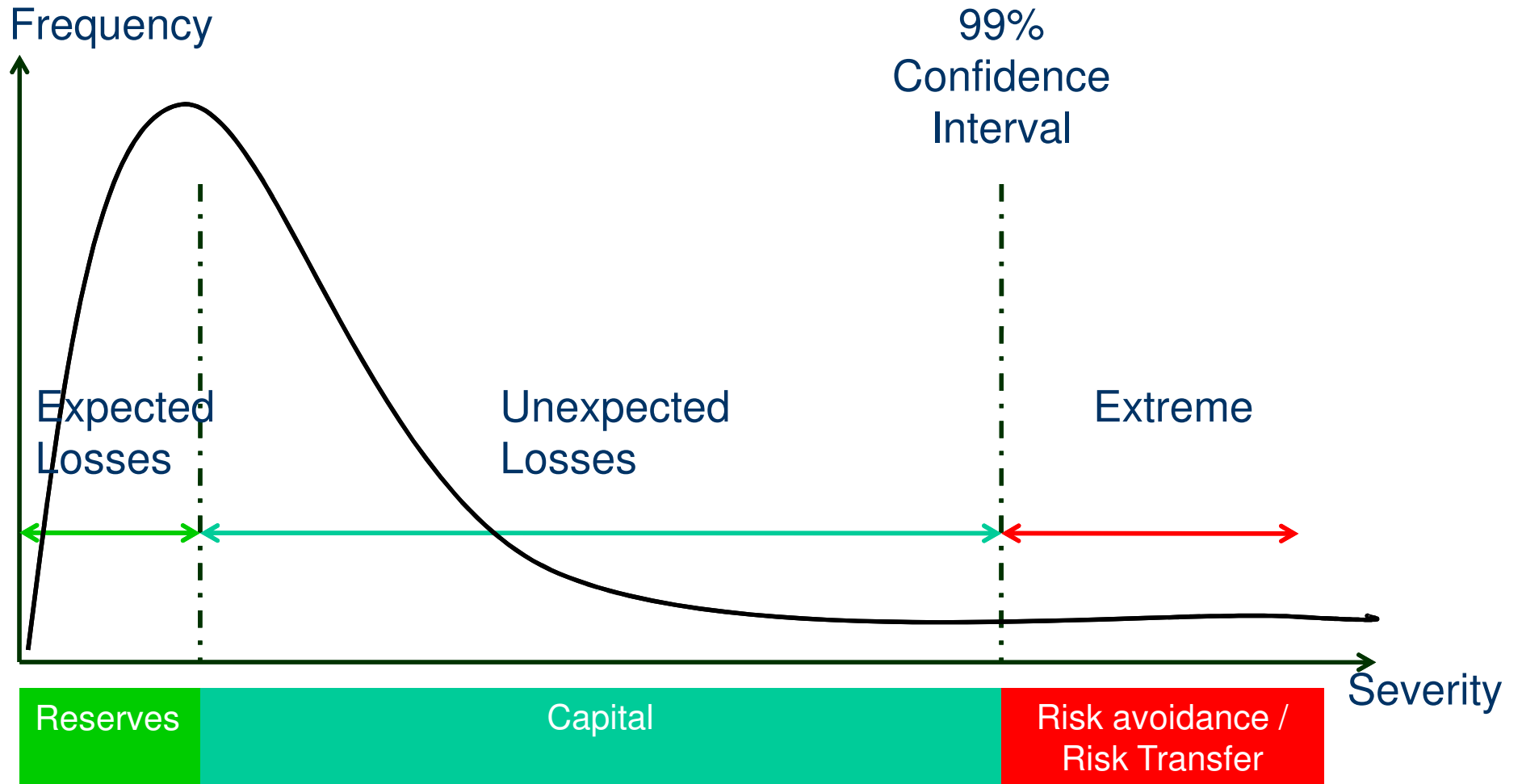
...in managing and planning the future direction

Effective Risk Management

4.b Does the MFI rely on prescribed capital allocation methodologies or does it develop its own “internally ratings based” approach?

Effective Risk Management

Risk Dispersion



Effective Risk Management

5. Measurement & metrics?

Effective Risk Management

Risk Management metrics

Lagging indicators:




- write-offs
- assets
- net income/ROE/ROA

Leading indicators:

- volume
- repayment rates
- pre-payment
- 1+ to 7+ to 14+ to 30+ conversion

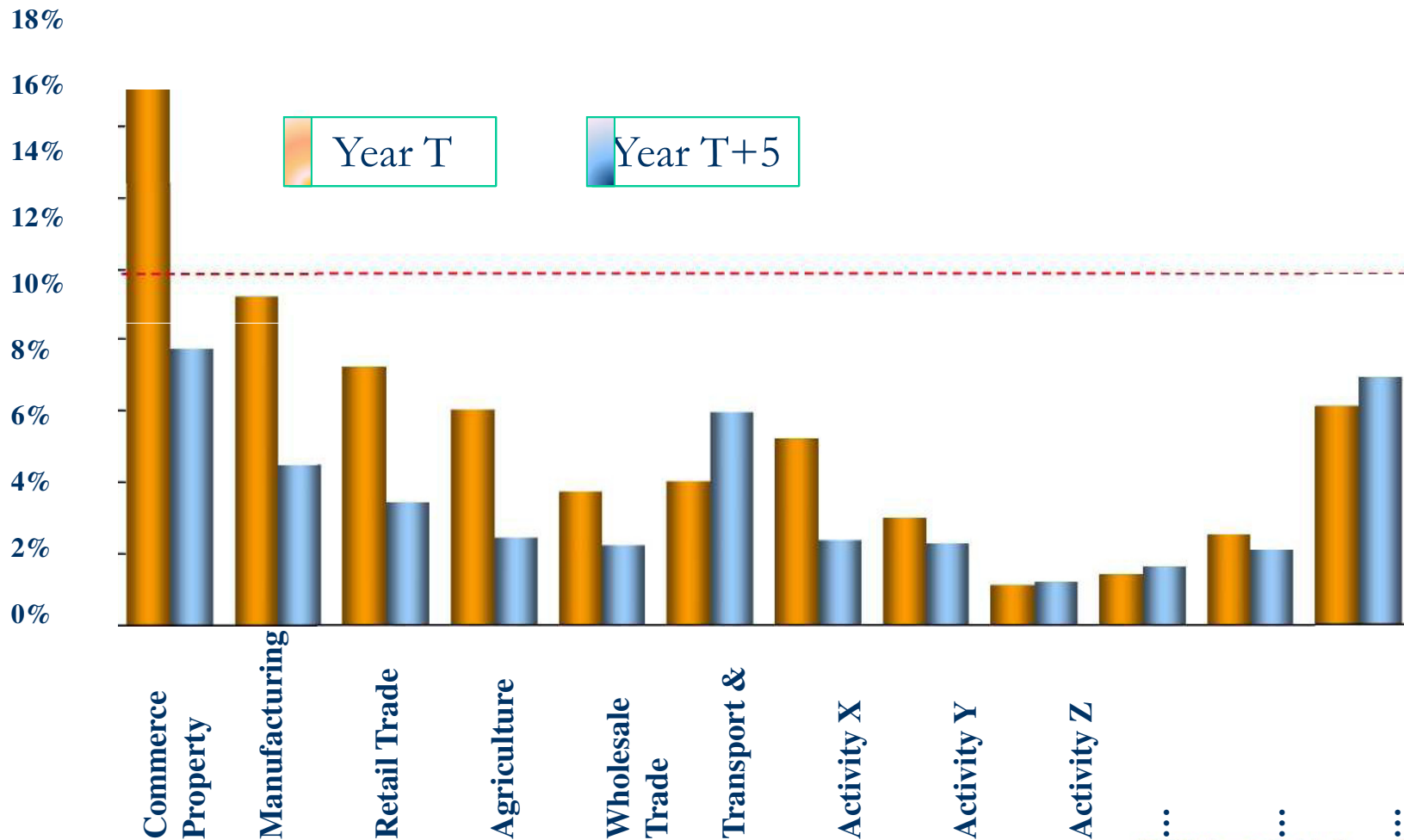
Effective Risk Management

ROA Metric for highly leveraged products

<u>Product</u>	<u>Secured</u>	<u>Leverage</u>	<u>ROE</u>	Equivalent ROA	ROA Hurdle of 1.5%
Housing Loans	Low	7:1	20%	0.87%	
Group Loans	None	6:1	20%	1.67%	
Small Lending	None	6:1	20%	1.82%	

Effective Risk Management

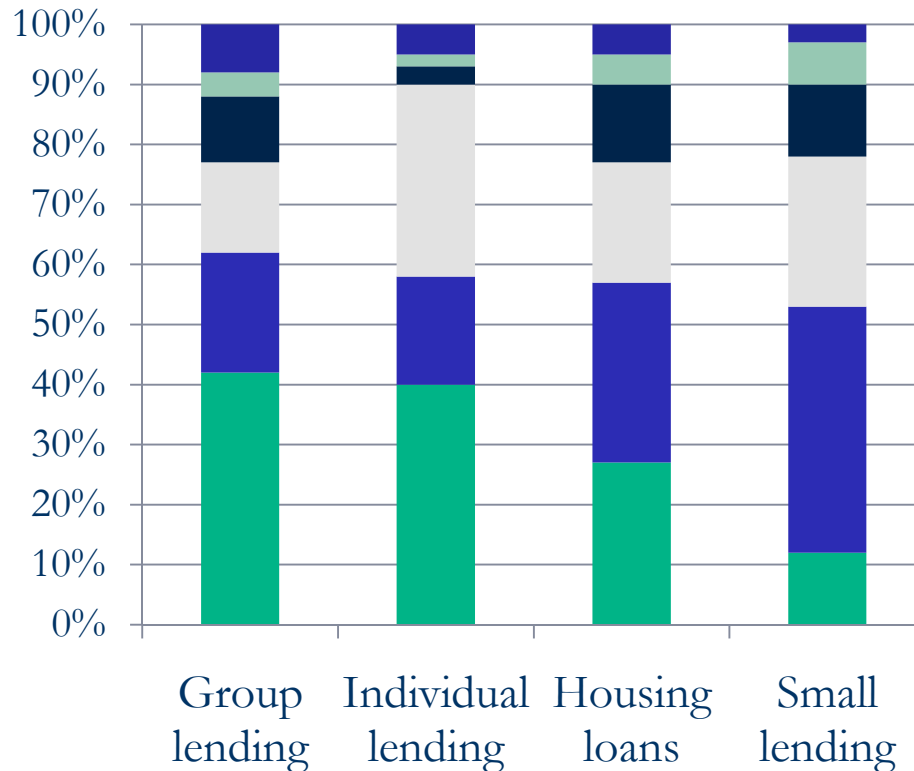
Portfolio caps also help drive diversification



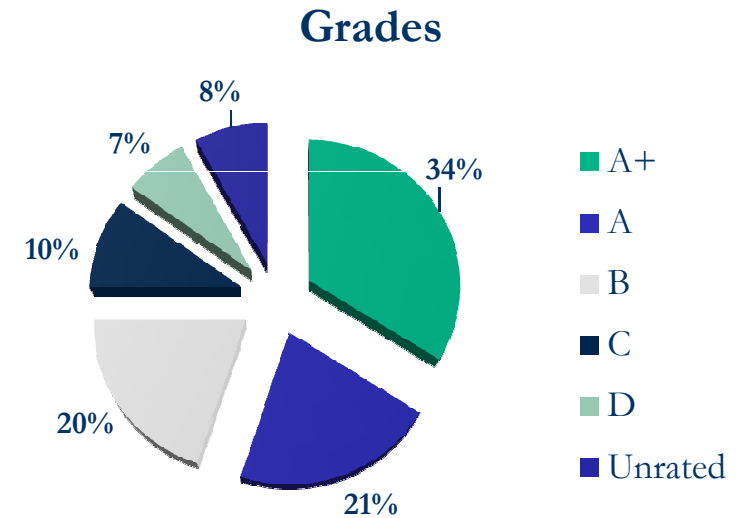
Effective Risk Management

Managing the portfolio based on Client/activity mix Risk Profile

Products Outstanding By Credit Risk Grade



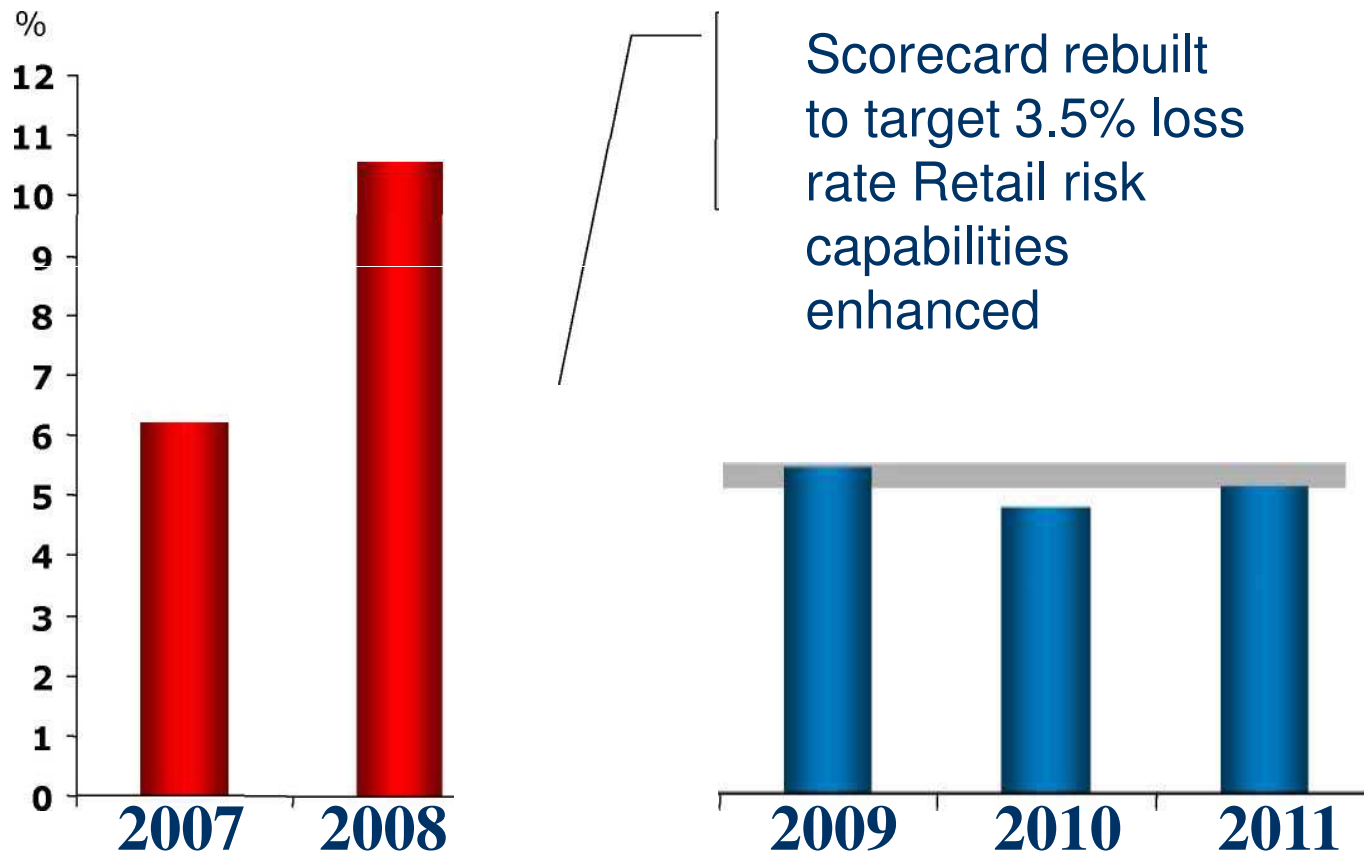
Balances Outstanding By Credit Risk Grade



Ex: Serving Diverse segments, ~75% are B or Better

Effective Risk Management

Credit Policies & "Scorecards": the key risk management tools in small lending (Example)



Effective Risk Management

6. Controls and Stress-testing?

Effective Risk Management

Common View of Risks

- Internal audit, risk management and business units should work together to reach consensus on where the risks are.
- Departmental heads can be territorial and feel such dialogue undermines their position
- Where they are isolationist, mutual distrust often arises
- Where they do liaise, the bank Wins
- The board should encourage this..



Effective Risk Management

How do you know if an MFI has enough capital to fund growth and to mitigate against future losses?

How do you know if an MFI has enough liquidity to manage through a tough cycle?

Effective Risk Management

Stress Testing is a key supplement to other risk management approaches ...

Importance:

- to provide forward looking assessments of risk
- overcomes limitations of historical data
- to improve capital & liquidity planning
- to aid Sr. Management & BOD when setting risk tolerances
- supports your communications
- facilitates risk mitigation and contingency planning

... and a BASEL II-inspired system could do..



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Implementing Risk Management



Effective Risk Management

MFIs should not discourage risk taking within the organization, but rather encourage prudent risk taking.

The Board of Directors

While it is important that risk management permeate all levels of the MFI, responsibility for the system starts at the top of the organizational hierarchy.

- BOD (1) guides the institution in fulfilling its corporate mission, and (2) protects the institution's assets over time": strategic direction, management oversight, fiduciary protection of assets, and fulfillment of legal obligations.
- Risk management transcends these individual areas and is not easily separable into its own category or committee function. It must be part of the culture of the board, just as it must be woven into the cultural fabric of the MFI itself.

Effective Risk Management

Senior Management: The Risk Management Officer

- Managing director or CEO responsible for the MFI's overall risk management system; therefore usually acts as the “risk management officer”
- Difficult to delegate RM overall responsibility below that level: every senior manager has RM responsibilities within his or her scope of operations

Specific Risk Managers

- Specific managers to oversee different risks;
- Risk management should be an explicit part of their line functions (e.g., program, financial, legal, etc.). Examples: branch managers = credit, operational and fraud risks; treasury managers = institution's investment portfolio and to manage the institution's overall investment funds risk.

The MFI should not assume that managers understand their role in managing risks simply because they fall under their areas of supervision, but should clearly state the expectations and limitations of their risk management responsibilities.

Effective Risk Management

Key Elements of Effective Risk management ...

1. Governance & organizational structure
2. Rigorous Operating Rhythm
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THANK YOU

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