

Managing Microfinance Risks: Some Observations and Suggestions

Presentation by

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Outline

- Introduction
- Recent developments in microfinance (MF) risk
- Sources of changes in risk profile
- Microfinance industry experience with losses
- Microfinance risk management (MFRM):
current state of affairs
- Some general principles for MFRM
- Managing agricultural microfinance risks
- Conclusions

Introduction

- Microfinance industry: rapid growth during last two decades
- Some MFIs: annual growth rates over 100%
- Institutional expansion: geographic; products; scope; breadth/depth of outreach
- Growth in size of the individual organizations
- The industry: relatively stable in most countries
- But crisis in some MFIs

Recent Developments in Microfinance Risk

- The foundation of MF industry: credit risk management by MFIs
- Later more attention to liquidity risk
- Many other risks have become important
 - foreign exchange risk
 - interest rate risk
 - operational risk
 - competition risk and mission drift risk
 - political risk and reputation risk

Sources of Changes in Risk Profile

- Growth: breadth, depth, and scope
- Technology
- Commercialization
- Changes in liability structure
- Competition
- Increased political attention

Industry Experience with Losses (selected cases)

- Very limited data and information on this aspect
- Great Delinquency Crisis: 2001, ACLEDA
 - in 11 mature branches: write-offs increased to 10.2% from 4.02%
 - in two of these: PAR (over 30 days) and write-offs exceeded 20% (for microloan portfolio)
 - burst of Balloon Loans (Box 1 in the draft paper)
 - Balloon Loans were for agriculture

[Source: Clark. 2006. When There Was No Money]

Other cases include:

- Delinquency crisis at NWTF, Philippines (1992-1994)
- Delinquency crisis at Proshika, Bangladesh (since 2000)
- Liquidation of Bank Dagang Bali, Indonesia (2004)
- Political crisis in microfinance in Andhra Pradesh (early 2006)
- Corposol/Finansol Crisis in Colombia (1995-1996)
[see draft paper for more details]
- Overindebtedness and Crisis in Bolivia (1998-2000)

Microfinance Risk Management (MFRM): Current Status

- “Risk pervades finance as gravity pervades physics” (J.D. Von-Pischke)
- Greater recognition of MFRM in recent years
 - primarily due to external pressure
- But only few MFIs systematically manage risk
- Most do not have comprehensive systems
- Attention to RM is highly uneven
- Many MFIs consider crisis management as RM

MFRM cont'd...

- Even credit risk management is inadequate in many
 - high PAR: low Risk Coverage Ratio
[see Table 1 in the draft paper]
- Many overlook strategic risk, operational risk, and political risk
- Inadequate attention to greater risk associated with ambitious growth efforts
- RM is not an integral part of discussions of daily operations

Do MFIs manage agricultural MF risk?

- More difficult to discuss this question
- Data/information scanty. Money fungible.
- Many MFIs avoid agriculture-focused operations
- But some MFIs have agriculture portfolios: AMRET; ACLEDA
- About 70% of AMRET's loan volume in agriculture; 35% in crop loans
- AMRET portfolio quality looks very good:
 - PAR over 30 days: 0.07%; write-offs: 0.03%;
Risk Coverage: 773% (at end of 2005)

MFRM: Some General Principles

- RM must be an integral part of the institutional culture
- One-size does not fit all
- A comprehensive approach is needed. Many risks interrelated.
- Explicit recognition: cognitive biases of decision-makers; organizational pressures
- Financial ratio management is not MFRM
- Market oriented practices (Can MOUs prevent competition?)
- MFRM measures must go beyond own institutional boundaries and be extended to cover clients

Managing Agricultural Microfinance Risks

- Rural transformation: many rural households are pluriactive
 - relative importance of non-farm income has increased
 - India study of 240 villages across 16 states (1971-1999)
 - from 19% to 48%
- Financing agriculture of those households are less risky

Agricultural MFRM: Some General Principles

- Take external environment for agriculture as given
 - this implies the focus on internal capacity to handle agricultural microfinance
- Adopt specific limits on the ag portfolio
- Achieve diversity within ag portfolio
- Recognize the need for specially trained and knowledgeable staff
 - inexperienced and new staff create excessive risk

Agricultural MFRM cont'd...

- Use household cashflow for credit decisions
- But avoid unrealistic assumptions like
 - normal year conditions prevail
 - no adversities will occur
 - no senior claims on surpluses
- Attention to household debt capacity is crucial
- Risk-based adjustments in analysis: critical
- Poor credit analysis is a major factor for poor collection performance of farm loans

Agricultural MFRM cont'd...

- If a polluted credit culture exists, take firm measures to address it
- Hard stance on repayments necessary
- Bad perceptions must be changed
- Combine ag lending with other financial services
 - will reduce information asymmetry
- Rely on appropriate partnerships and alliances
 - weather-based insurance looks promising

Conclusions

- MFRM is still not as widespread as it should be
- Agriculture microfinance risk management must be seen in the wider context of MFRM
- If MFIs focus on building MFRM, they will have better capacity to do agriculture microfinance
- External pressure, technical assistance and a centralized risk information facility will help
- More research on agricultural microfinance will also provide insights

Thank you.

For more information on ADB's
microfinance operations,
www.adb.org/microfinance