Imp-Act Consortium

Making microfinance work for the poor and excluded

Risk management: *Integrating SPM into microfinance capacity building*

Guidance Note

Introduction

Risk management is a systematic approach to identifying, measuring, monitoring and managing the various risks faced by an institution. Within microfinance institutions (MFIs), risk management systems and capacity building initiatives have mostly focused on financial and operational risks. But other unmitigated risks, such as reputation risk, can result in serious financial risk and loss of goodwill towards an MFI. The following risks, which relate to social performance, have until now often been overlooked in risk management capacity building materials.

This briefing shows the importance of integrating a social lens into risk management strategies and capacity building in microfinance. It provides a quick overview of the main non-financial and operational risks typically overlooked by MFIs. It discusses the key institutional questions raised and the importance of analysing existing practices to assess how the MFI may be overlooking some of these risks. It also presents emerging practices that MFIs are finding useful to help them integrate social performance into their risk management activities.

Reputation risk

Reputation risk can be defined as 'the current and prospective impact on earnings and capital arising from negative public opinion'[1]. Essentially, reputation is about responsible finance: ethics, trust, relationships, confidence and integrity. Organisations may not fully realise how significant reputation is until it is lost or damaged. Some MFIs have suffered damage to their reputations, whether real or perceived, from coercive loan collection practices and questionable human resources (HR) practices (see **Box one**). Reputation, though an intangible asset, has far-reaching consequences for an institution's ability to secure resources and function effectively.

> **Box one: Headlines highlight reputation risk**
>
> **Headline: 'Child taken hostage for loan'**
>
> **The Telegraph (India), 6 June 2008**
>
> Focusing only on financial performance, MFI managers are often unaware of the approaches that some of their employees use to achieve their target results. One can imagine that the MFI that was the target of this headline suffered from the following unintended consequences:
>
> - lost a significant number of good clients
> - had more difficulty attracting new clients (especially those with children)
> - faced increased costs in trying to do damage control through the media
> - lost income, as the portfolio shrank and costs increased.
>
> Given all these potential effects, one has to ask: *was collecting that one bad loan worth it?*

Mission drift risk

Mission drift risk can be defined as a lack of institutional alignment with social goals (derived from the mission), or even a lack of clearly

Written by Rashmi Ekka and the EDA Rural Systems team (R. Chaudhary and F. Sinha). Contributions from A. Campion, V. Thiel, A. Simanowitz, C. Linder, S. Naik, B. Simmes, W. Tounytsky, J. de Wit, C. Ben Mboho, O.Torres, T.Cherikov, Dr J. Bald, N. Agarwal, J. Bliek, C. Velasco and C. Loupeda.

[1] *Large Bank Supervision, Bank Supervision and Examination Process*, Comptroller's Handbook, Washington DC, 1998

defined social goals. It can also, therefore, have implications for reputation risk. Mission drift can occur when an MFI:

- fails to define its target market(s) as part of its mission
- fails to stay focused on its target clients, or lacks monitoring mechanisms to ensure that it is providing appropriate financial services to its intended clientele
- focuses narrowly and strongly on growth and profitability
- fails to contribute to positive change.

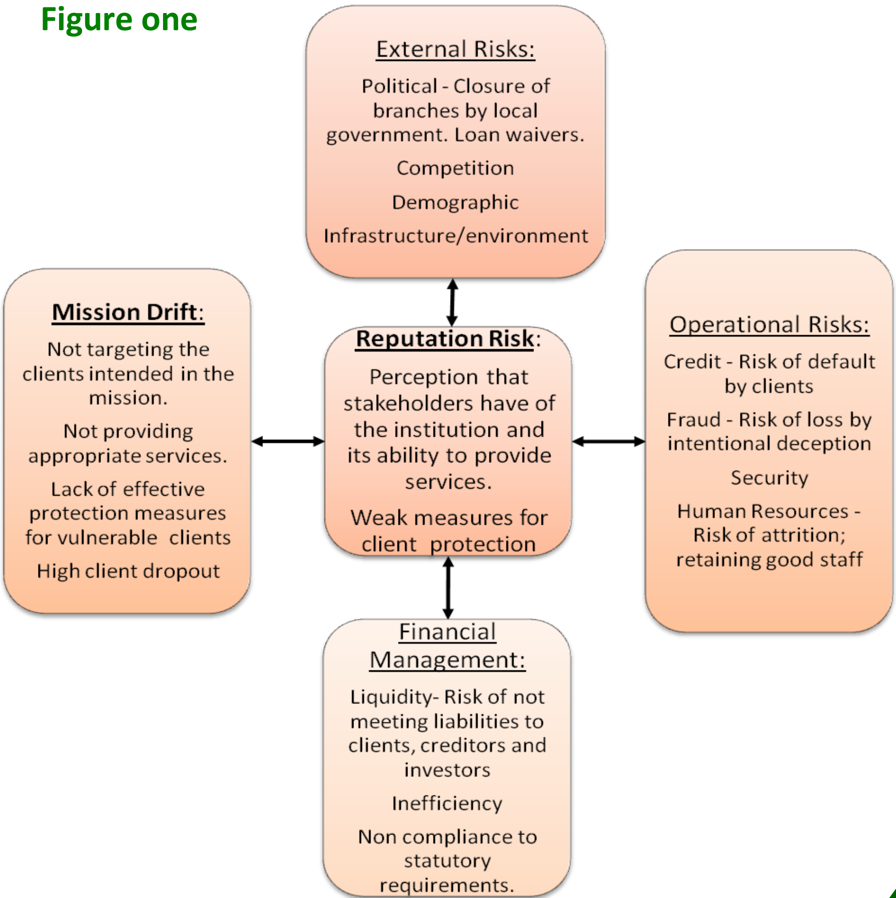
Mission alignment is about 'walking the talk' – doing what microfinance is intended to do. A typical example of mission drift is when an MFI bypasses more vulnerable clients, often in remote areas, and moves 'up market'. A degree of 'up market' diversification may be necessary to institutional sustainability. The challenge is to include different client segments, so that the poor are not completely bypassed.

Client vulnerability risk

Poor people face ongoing risks or sudden shocks resulting, for example, from ill health, natural disasters, and irregular or uncertain incomes. Risks that reduce clients' incomes, or sudden large expenses, are risks to the MFI as well. MFIs should take measures to protect their clients against shocks, and to respond to ongoing risks. Such measures must stem from understanding client livelihoods and cash flows. They include appropriate financial product design (credit and insurance) and adjusting the loan repayment schedule. They should help to protect clients and, at the same time, help to protect the institution's reputation and mission.

Figure one sets out the key categories of risk that MFIs face, including financial management, operational, reputation and external risks. It also shows how the different types of risk are interconnected. The reputation of an MFI is the central factor, and is affected by all other types of risk. A comprehensive risk management strategy and capacity building initiatives must be developed using a social performance lens so that social performance risks are addressed together with other risks.

Figure one



Key questions

- How do current risk management practices address the institutional risks faced by MFIs?
- How can an MFI protect itself from a reputation crisis? Once a crisis has occurred, what can the MFI do to redeem itself?
- What should an MFI do to prevent mission drift, and how can it address the specific needs of vulnerable clients?
- What is the role of governance in the risk management environment, within MFIs in general, and towards institutional risks in particular?
- How can an MFI protect itself from operational risks?

Consider your audience when building capacity

Few MFIs have dedicated risk management departments, so the responsibility often falls on the chief financial officer or the accounting or internal control department. Therefore, those most closely involved in microfinance risk management usually have strong financial and accounting backgrounds, and as such, might consider social performance management to be more of a 'soft' skill, better left to the sociologists and die-hard 'do-gooders'. One way to start to engage these key staff, and build buy-in, lies in the language we use. Trainers and others engaged in building capacity should use phrases such as 'responsible finance' and 'balanced performance management' that will appeal to managers whose orientation is focused on 'harder' financial skills. They should also use practical examples that highlight the importance of mitigating institutional risks for long-term financial sustainability.

Existing practices may overlook social or institutional risks

MFIs should review their strategies with regard to reputation and mission to see whether existing practices that support conventional microfinance at the institutional level may be overlooking some important client-level risks. For example:

Loan size limits: these mitigate an MFI's exposure, especially to new clients who do not have collateral. But depending on the type of client being reached, there may be a very significant mismatch with clients' credit needs/ capabilities. In competitive environments, clients may end up borrowing from other MFIs and run the risk of becoming over-indebted.

Standardised (simple) loan terms: these make it easier (for staff and clients) to monitor repayments, but might represent a significant mismatch with different livelihood cash flows.

'Zero tolerance on delinquency': this defines a culture of repayment, but could backfire (especially in the context of standardised loan terms), leading to aggressive staff behaviour (see **Box one**), and possibly pushing clients into multiple borrowing and over-indebtedness.

Group-based lending: although this methodology is used by many MFIs, it may exclude some of the poorest clients, who find it difficult to join a group (self-selection principle) or may be pushed out from their group by their peers (peer pressure principle).

Emerging good practices

A number of good practices have emerged that promote responsible and inclusive lending. They relate to several aspects of institutional management and governance, which MFIs need to implement as part of effective risk management.

Implement the Client Protection Principles

Coordinated by the **Smart Campaign**, a consensus has emerged around six principles for client protection. These are the minimum standards a client should expect to receive when dealing with an MFI:

1. Avoidance of over-indebtedness
2. Transparent and responsible pricing
3. Appropriate collections practices
4. Ethical staff behaviour
5. Mechanisms for redress of grievances
6. Privacy of client data

The Smart Campaign now has 1,000 endorsers, including 250 MFIs, nearly 100 investors/donors, 70 support organisations and 45 networks or associations, as well as individuals. MFIs are now working on ways to put these principles into practice. These include:

- improving loan appraisal methods
- sharing information through credit bureaus
- ensuring effective communication of loan terms to clients (and catering for low levels of literacy among clients)
- employing a clear, phased process in case of loan default, including careful guidelines and transparent accounting for loan rescheduling
- creating clear channels for customer complaints, with effective response
- monitoring processes as part of the internal audit (at institutional as well as field staff level).

Know your client – collect and use client profile information

MFIs collect valuable information from clients as part of the loan appraisal process, including information about the client's family, asset base, income sources, access to other sources of finance, and level of poverty. But this information is rarely collated, analysed and used. If systematically collated, with careful selection of indicators, the data could be used to track outreach, and identify the different market segments and the products that would serve them best. The data could also serve as a baseline for tracking change over time, enabling the MFI to assess whether it is realising its mission and goals. For example, **Fonkoze** (Haiti) and **Prizma** (Bosnia and Herzegovina) have designed products for clients experiencing different levels of poverty. They also use a systematic approach to assessing poverty, such as the **Progress out of Poverty Index**.

Client education

Informing clients of their rights and responsibilities in the loan process is a critical preventive control. Basic training should include: having an official receipt, having passbooks regularly updated, and knowing the appropriate channels to use to voice concerns and complaints. Some MFIs are beginning to offer more broad-based financial literacy as a means of helping clients to plan their financial needs.

Systematically collect and use client feedback

An MFI needs to listen to clients' views about its performance in order to improve its services and be responsive to clients' needs. It should therefore ensure that channels exist to receive such feedback. Information can be collected through formal and informal channels. Formal channels include internal audit staff visits to a sample of clients, market research (including the 'mystery shopping' technique of researchers posing as clients, and providing feedback on the experience), client satisfaction surveys, and bi-annual or annual forums for clients or their representatives to raise issues. Informal channels include routine staff visits and meetings. By considering clients' needs, an MFI can work towards reducing risks – both for its clients, and for the institution.

Track and analyse exit rates

MFIs have not usually tracked client exit. Nevertheless, high rates of growth in overall number of clients and portfolio can mask high levels of client exit. Client retention is a useful proxy indicator of client satisfaction, signifying loyal clients and a useful service. Client retention also contributes to more cost-effective institutional growth. Of course, some client exit is normal in any programme, especially perhaps after the first loan cycle, during which both clients and the MFI 'try each other out'. But increasing levels of exit can represent a significant risk, reflecting client dissatisfaction, inappropriate products or effective competition from other local microfinance providers.

MFIs are now beginning to define, measure and track dropouts through the management information system (MIS). But to do so, the MIS must have unique client identification systems and be able to distinguish between dropouts and clients who are simply resting between loans (and who eventually re-join) – as well as any who have graduated to formal institutions. Tracking and analysing the client exit rate is a useful tool for monitoring client dissatisfaction; asking ex-clients why they left and analysing their reasons is an important additional element of market research.

Manage human resources and staff perceptions

Satisfied, appropriately motivated staff are key to an MFI's success. Its mission and core values need to be part of organisational systems and culture. A code of conduct for staff can be a useful way of ensuring this. But, more importantly, senior management need to demonstrate and reinforce the organisation's mission and values through their own behaviour as well as through implementing relevant performance appraisals and incentives. If incentives are driven by disbursements and repayment performance, other critical aspects of outreach – such as ethical behaviour with clients, communication and debt collection practices – may be overlooked.

Effective feedback mechanisms such as group or individual discussions with employees can help management understand any problems staff are experiencing at field level. Staff can be encouraged to identify and report risks, as well as offer suggestions about how to mitigate them.

MFIs can offer small rewards to reinforce positive behaviour in preventing social and financial risks.

Assess whether clients' enterprises have negative environmental or social effects

MFIs should not support activities that could damage natural resources (e.g., chemical agriculture, over-fishing and charcoal burning) or community health (e.g., illicit manufacturing of 'home-made' liquor). There may also be health and safety issues around the working conditions of some activities. MFIs should develop their own policies, clearly stating activities for which they will not lend. For example, an environmental protection policy could steer loan officers away from lending to businesses known to create pollution. MFIs could also go further and develop a more proactive strategy, encouraging alternative approaches and livelihoods that could help microfinance clients and their communities in the long term.

Communication and transparency

MFIs need to routinely report on their performance to all stakeholders. This communication is largely through their annual report, reporting to the MiX[2], to investors and regulators. Social reporting, if it is included at all, is usually limited to a couple of anecdotal case studies in the annual report. MFIs need to systematically report on their social performance for their internal as well as external stakeholders. Recently, the MiX launched its online social performance standards matrix, and MFIs have now begun to report on these indicators, along with their financial indicators. Once social performance reporting is effectively in place and verified, transparency and reputation is enhanced. MFIs can also use their social performance reports (including information on clients) to help assess what progress they are making towards achieving their mission.

A crisis situation, such as bad press, can affect the reputation of the entire microfinance industry. In such a situation, it becomes imperative for an MFI or a network of MFIs to develop a clear communications strategy to communicate with all stakeholders: staff and clients, the media, investors and competitors.

Role of governance

The role of governance is crucial. There has to be an effective board to ensure that all systems (including risk management policies and practices) are fully aligned with the MFI's mission and values. The extent to which the board can effectively carry out its role depends on the balance of experience and perspective of directors. Typically, an MFI board has an audit committee, and others dealing with HR, borrowing or loans. Some MFIs are now appointing a social performance committee, whose role is to monitor information and reports that relate to mission and reputation, and to ensure that all operations are seen through a social performance lens – an essential feature in implementing a comprehensive risk management framework.

Role of internal auditors

MFIs usually focus primarily on financial and operational risks (e.g., credit or fraud), and their management systems (accounting, MIS, etc) are usually designed to mitigate these types of risk. Internal auditors also have a key role in terms of verifying how well these risks are being managed and mitigated, and whether any necessary adjustments are being made.

[2] The MiX (Microfinance Information eXchange) provides detailed financial and social performance data from MFIs, as well as business information from market facilitators and leading donors and investors. For more information, visit: **www.mixmarket.org**

Similarly, procedures must be developed to equip the internal auditors to verify the management of risks pertaining to social performance (mission drift, reputation risk, etc).

Managing risk is something that should concern all levels of an MFI; every member of the organisation has a role to play. Staff must work together to develop effective risk management procedures at all levels, and for all types of risk– financial as well as social performance risks.

Conclusion

It is important for MFIs to remember that it takes a long time to build a good reputation, but only a short time to destroy it. Therefore, being proactive about how to mitigate reputation risks before they occur can also be one of the best ways to reduce the risk of financial loss. Defining the mission and applying it to all operations ensures that the MFI does not risk mission drift, and this, in turn, is critical to reputation.

The challenge for MFIs is to manage growth while ensuring that there are adequate institutional systems to support mission and values. When several MFIs are growing rapidly in the same geographical area, there is also the challenge of managing competition.

Very rapid growth could dilute both an MFI's mission and values, and possibly increase client vulnerability (e.g., through over-indebtedness). MFIs need to put clients first, especially their target clients. Ultimately, being customer-focused is one of the best risk management strategies.

References

Bald, Dr J. (2009) Training on 'Fundamentals of Asset and Liability Management', Germany: Frankfurt School of Finance and Management

Campion, A. and Linder, C., with K. Knotts (2008) *Putting the 'Social' into Performance Management: A Practice-Based Guide*, Brighton: Institute of Development Studies

CGAP (2009) *Operational Risk Management for Microfinance Institutions*, **www.cgap.org**

--- (2003) *Operational Risk Management,* Participant Course, materials (presentation) **www.cgap.org**

Comptroller of the Currency, Administrator of National Banks (1998) *Large Bank Supervision, Bank Supervision and Examination Process*, Comptroller's Handbook, Washington DC

EDA (2009) 'Using SPM to Mitigate Institutional Risks', **www.edarural.com** (accessed 1 March 2010)

FMO, *Social and Environmental Management Guidance for Micro Finance Institutions*, **www.fmo.nl** (accessed 11 November 2010)

Economist Intelligence Unit (2005) 'Four out of Five Companies Say Threats to Corporate Reputation are Rising', 8 December, **www.eiuresources.com/mediadir/default.asp?PR=850001885** (accessed 11 November 2010)

Resnick, J.T. (2006) *Reputational Risk Management: A Framework for Safeguarding Your Organization's Primary Intangible Asset*, Princeton, NJ: Opinion Research Collaboration

About this series

This series of Guidance Notes emerges from a collaboration between the *Imp-Act* Consortium and key industry technical experts. Recognising that the ongoing support to MFIs from funders and support organisations is critical to ensuring a balanced approach to performance management, this series aims to help them integrate the missing "social lens" into existing MFI training materials. The notes provide targeted guidance on critical issues, as well as details on further resources available.

Development process

The *Integrating social performance management into mainstream capacity building* initiative, led by the *Imp-Act* Consortium, involves a three-part strategy:

Linking SPM experts with experts in key technical areas: Consortium members and associates join forces with industry experts to apply a social lens to key technical areas.

Reviewing existing mainstream training materials: Through online workshops between project partners, gaps in training currently provided to MFIs are identified and prioritised.

Facilitating online knowledge sharing discussions: Each technical area is addressed in a facilitated discussion on the **SPM Network** in order to add to the rich experience base of these Guidance Notes.

Imp-Act Consortium: *Learn, connect, share*

A range of online resources are available to help you improve your SPM practice:

The **SPM Resource Centre** offers step-by-step guidance on integrating a social lens into MFI performance management systems, including an interactive SPM self-assessment tool. Head to: **www.spmresourcecentre.net**

The **SPM Network** connects individuals and organisations who are committed to managing and achieving social performance in microfinance. The Network is a virtual space for practitioners to share experiences and information, and debate new ideas in SPM. Join in today! **www.spmnetwork.net**

The ***SPM Practice Guide*** offers step-by-step guidance on integrating SPM into your MFI alongside real MFI case studies. Download today in English, French, Spanish or Arabic.

Fulfilling the Promise is a new film by the *Imp-Act* Consortium that captures the SPM experience of two mission-driven MFIs, SEF (South Africa) and AMK (Cambodia). Short and long versions are available in English, French, Spanish and Arabic.

Learn more about the *Imp-Act* Consortium and its work by visiting **www.Imp-Act.org**.

Imp-Act Consortium
Making microfinance work for the poor and excluded