

Microfinance Investment Managers' Guidelines on Over-indebtedness

As investors in inclusive finance, we have a responsibility to promote the healthy and sustainable development of the markets in which we invest. In recent years, microfinance has expanded considerably due in large part to the success of local and international participants and the growth of funding to the sector. This expansion has also resulted, however, in rising concerns of the risk of over-indebtedness in various markets that can harm the borrowers whom the microfinance industry was formed to support.

As a result, we believe that it is important that we set a framework for making investment decisions in a responsible way in order to collectively avoid contributing to potential over-indebtedness in the markets where we work. The following guidelines reflect proposed actions that investors are encouraged to take during due diligence and monitoring of investments with regard to the markets where they work and the MFIs in which they invest.

These actions include, but are not limited to:

- **Maintain reasonable estimates of each market's growth capacity.**
 - Overly optimistic growth targets may contribute to aggressive lending, particularly in competitive markets. Investors should assess the growth targets and strategies of the MFIs in which they invest against their own analyses of the unmet demand. If they believe growth targets to be overly optimistic, they shall engage MFI management to discuss and justify the basis and underlying assumptions for such projections.

Suggested Practices:

- Conduct a thorough analysis of the market penetration in the areas where MFIs operate. This includes looking at this data not only at the country level, but at more local, disaggregated levels where information is available (individual provinces, cities, villages, etc.)
 - Assess the extent to which various market players target the same or different clients, and therefore the extent of overlap across various market players. Such assessment shall include both geographic coverage and product offering (SME vs. micro, group vs. individual product, rural vs. urban products, etc.).
 - Make use of available tools and research when assessing market potential (examples include the MIX financial inclusion maps - <http://maps.mixmarket.org/> - and the MIMOSA reports published by Planet Rating - <http://www.planetrating.com/EN/index.php>).
 - Engage in discussions with other investors regarding strategies for allocating investments in specific markets that could potentially be overheating.
- **Ensure that the MFIs in which they invest and to which they lend adequately assess and monitor their clients' repayment capacity.**
 - Thorough repayment analysis by MFIs, involving a specified debt service coverage ratio, is the first line of defense against over-indebtedness. Investors should conduct a thorough analysis of an MFI's lending methodology prior to investing, gathering a detailed understanding of the information sought during the underwriting process and the controls around the processing of this information.

Suggested Practices:

- The Smart Campaign has developed a tool for MFIs with regard to avoiding over-indebtedness. Funders should encourage the use of this or similar tools by MFIs and also check MFIs' client assessment procedures against these guidelines during their investment processes.
 - In addition to reviewing internal policy documents prior to on-site due diligence, investment officers should pull a sample of loan files during the diligence visit and review the credit assessment reflected in each one, ensuring that practices for assessing and monitoring repayment capacity match processes laid out in procedures manuals.
 - The loan file sample may be pre-selected by investment officers based on information from the MFI's MIS, allowing investment officers to target loans (1) that seem unusual based on the MFI's product offering, (2) are delinquent, or (3) have been restructured (among other combinations).
 - Specific examples of criteria that investment officers may review include the following:
 - Whether loan officers use actual or estimated historical cash flows to assess the net income of borrowers (they should use actual).
 - Whether or not remittances are included in these cash flows (they should not be, or at least should be limited).
 - Whether expenses include total household expenses (they should, and a minimum per person cost should be used as a benchmark).
 - Whether or not the information is collected on-site in a visit to the borrower's business and/or home (it should be).
 - If there is a specific debt service coverage ratio that an MFI uses in its policies.
 - In situations where an MFI lends in a foreign currency, investment officers should check that foreign currency loans are only provided to clients that earn foreign currency, or at least that the repayment analysis includes an allowance for the impact of a local currency depreciation.
 - Determine what other aggregate ratios related to client repayment capacity the MFI tracks (examples include: how many financial liabilities each borrower has outstanding; what portion of the portfolio is comprised of clients who have parallel loans); ideally, MFIs would have developed benchmarks or internal limits for each indicator they track.
- **Perform a rigorous analysis of other elements of the MFI's procedures and activities that could contribute to over-lending risks.**
 - Other practices followed by the MFI can also impact the risk of over-indebtedness, such as incentives provided to loan officers, appropriate checks on adherence to procedures, the appropriateness of products offered to clients and others. When conducting due diligence on MFIs, investors should look at how the MFI's operations as a whole may impact over-indebtedness in the markets within which they operate.

Suggested activities:

- Define a list of core practices that are critical to good MFI performance with regard to avoiding over-indebtedness and score an MFI's performance against these practices as part of a scorecard that influences credit decisions.
 - Assess how well the MFI has researched the appropriateness of credit products to the needs of its clients. Were market studies conducted before a product was launched? Has a need for the products been identified?
 - Assess the MFI's field staff incentive schemes to ensure that they do not encourage irresponsible lending and excessively rapid growth.
 - Check if the MFI has an Operations Control Group in place that thoroughly and systematically checks adherence to the MFI's underwriting policies, and assess the strength and consistency of the Operations Control Group's activities.
- **Engage in open dialogue with MFI management and Board to ensure that they are aware of the risks and warning signs of over-indebtedness.**
 - Over-indebtedness is an important issue to be discussed and addressed at the most senior levels of MFIs. Funders should reinforce this message through frank and open discussion with MFI senior management and Board members about over-indebtedness risks and warning signs, in addition to preventive approaches and measures as well as practical steps that may be taken to maintain responsible lending.

Suggested Practices:

- Share results of due diligence visits with senior management, highlighting strengths and weaknesses. Such information sharing may be formalized through the use of a formal letter listing strong and weak points on both the financial and social sides.
 - Encourage endorsement of the Smart Campaign and work with management to become familiar with the Client Protection Principles where needed.
 - Conduct risk management workshops involving the CEO and, if possible, a member of the Board. These workshops would aim to raise awareness of the risks in microfinance, including over-indebtedness.
 - Equity investors: Take Board seats when feasible and nominate highly qualified individuals with adequate time and preparation on over-indebtedness issues in particular to perform effectively as Directors. In this capacity, such investors should exercise active governance to ensure that risks of over-indebtedness are discussed and well taken into account in strategic decision making.
 - Debt investors: Ensure that covenants required in loan documentation do not promote irresponsible lending behavior by borrowing MFIs; refer to and endorse the "Lenders' Guidelines for Setting Covenants in Support of Responsible Microfinance."
- **Require the use of credit bureaus when they exist, and work to promote their development where they do not.**
 - Effective credit bureaus, while not the sole answer to problems of over-indebtedness, can be an important tool for MFIs to gain information about the debt levels of their clients and can assist in making responsible lending decisions. Funders should require the MFIs in which they invest to make effective use of credit

bureaus and other information sharing mechanisms, where they are available, and systematically use this information in their underwriting policies and processes.

- Taking into account the added risks inherent in markets where adequate credit information sharing systems do not exist, investors should ensure that MFIs put in place appropriate coping mechanisms to generate and use data for loan underwriting processes, including thorough efforts to assess household/borrower cash flow and liabilities from other lenders.

Suggested Practices:

- Include in pre-screening selection criteria a requirement that MFI partners make use of credit bureaus, where they exist, or other information sharing mechanisms, if applicable.
 - Debt investors: Include as a covenant the requirement that MFIs use credit bureaus where they exist or participate in market information sharing efforts.
 - For investors with appropriate resources available, work with credit bureaus to improve capacity.
- **Work together with peers in the industry to raise awareness, improve measurement and take individual and collective action in markets where there are concerns about rising risk of over-indebtedness.**
 - When red flags appear during routine due diligence or monitoring, investors should raise concerns in a responsible and measured way, and work together to ensure that their collective actions do not contribute to increasing risk in the market. In addition, investors should consider proactive measures against the development of possible future over-indebtedness.

Suggested Practices:

- Participate in information sharing activities/events for measuring funding levels per country and region.
- Engage constructively in country-level consultation and action groups and participate in dialogue with regulators when appropriate opportunities exist to discuss appropriate rules and measures to promote responsible lending across the market.
- Where resources permit (e.g., grants, technical assistance funds, ongoing policy/regulator engagements), advance country- and global-level tools to prevent and address the consequences of over-indebtedness and finance studies to assess the level or risk of over-indebtedness in specific markets.
- Encourage MFIs to provide financial literacy programs and training for clients.
- Debt investors: coordinate with other lenders to minimize over-lending to MFIs.