



Weathering the Storm: Hazards, Beacons, and Life Rafts

Lessons in Microfinance Crisis Survival
from Those Who Have Been There



Deutsche Bank

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**CENTER FOR
FINANCIAL INCLUSION**
AT ACCION INTERNATIONAL

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This study would also not have been possible without the many individuals who have shared their experiences dealing with crisis. For most of us, discussing one’s own failures can be extremely difficult. Yet the employees, managers, directors, investors, clients, and others who have provided their feedback have taken the adage that the greatest failure is a failure to learn, and turned it outward, enabling others to learn from their own travails and mistakes. Mindful of the sensitivities involved (some institutions are still struggling), we have taken pains to protect the organizations and individuals involved. As a result, we have changed the names of the microfinance institutions (MFIs) in the study and avoid any mention of the names of specific individuals or organizations. However, in order to communicate both market-level and institutional lessons, in most cases we provide the country name, along with those institutions whose identification becomes unavoidable as a result (e.g. a central bank). The sole exceptions to these rules are the three “mini-case” studies (PADME, ShoreBank, and Bank Dagang Bali), which refer to the real names of the institutions.

Naturally, we cannot recognize any of these contributors here, but to us as researchers, you are not anonymous, and to each of you, we give our heartfelt thanks.

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List of Hazards, Beacons, and Life Rafts

RISK CATEGORIES (HAZARDS)	
Methodological Flaws	Failure to correctly implement selected microfinance methodology
Systematic fraud	Large-scale fraud perpetrated by field-level or executive staff
Uncontrolled growth	Rapid growth pursued with weak internal or market-level controls
Loss of focus	Deviation from core strengths without appropriate preparation
Design flaws	Problems with the original business model of the organization
State intervention	Inappropriate role of the state, including failure to regulate
Financial vulnerability	Weaknesses in the organization's financial structure
Macroeconomic shock	Economic downturn as primary factor of institution's crisis
PRE-CRISIS RECOMMENDATIONS (BEACONS)	
Focus on governance	Appropriate role and staffing of board of directors
Look beyond PAR	Focus on leading risk indicators that precede PAR (a lagging indicator)
Keep leverage low and liquidity high	Maintain a cushion of capital and liquid assets
Know who is making the loans	Focus on actors in the lending process (staff and external loan agents)
Be professional	Define and use policies and procedures appropriate to the organization
Funders also have responsibilities...	Outside funders must provide monitoring appropriate to funding level
...And so do regulators	Examples of finding balance between over- and under-regulation
Political risk	MFIs should take precautions against political repercussions
TURNAROUND FACTORS (LIFE RAFTS)	
Liquidity	Focus on maintaining minimum liquidity level during crisis
Client confidence	Maintain client confidence to avoid repayment strikes and deposit runs
Staff confidence	Maintain staff confidence to avoid undermining client confidence
Creditor confidence	Maintain creditor confidence to insure funding, including debt restructuring
Capital	Minimum capital cushion to insure organizational continuity
Replace management/board	Provide new blood, lose historical baggage, find expertise to deal with crisis
Address collections	Approaches to collecting overdue loans
Strategic redirection	Rethink institution's strategy for long-term survival
Last rites	When failure is unavoidable, minimize collateral damage

Summary of Cases

To protect the confidentiality of contributors, the names of the microfinance institutions (MFIs) in the seven cases below have been changed. However, the three “mini-case” studies (PADME, ShoreBank, and Bank Daging Bali) use the real names of the institutions.

1. *The Run That Wasn't. Artemis, Ghana*

A badly and fraudulently managed depository MFI is found to be insolvent and is taken under conservatorship by regulator, while management and board are replaced. External consultant is brought in to assess the situation and is later hired as interim CEO.

During the turnaround, the MFI overhauls internal processes, reduces cost basis (incl. staff & expense reductions), implements a loan recovery process, and embarks on new lending strategy (shift from individual to group). Throughout the far-reaching restructuring, the MFI is able to maintain client confidence and thus successfully stave off a bank run by its depositors. Having completed the turnaround, Artemis is currently seeking equity investment.

Risk Categories

- Methodological flaws
- Systematic fraud (mgmt)
- Loss of focus

Turnaround Factors

- Client confidence
- Replace management and board
- Address collections
- Strategic redirection

2. *Tale of the Shrinking Star. FuegoNord, Nigeria*

A depository MFI is founded by a Nigerian expat entrepreneur with no experience in banking or microfinance. MFI grows rapidly in the context of an overheated market with little regulation. Internal processes are weak; board governance is ineffective. MFI goes through two cycles of crisis and restructuring, each time shrinking the portfolio as it rebuilds. The MFI also invests large portions of its equity in real estate and the stock market. When the financial crisis hits Nigeria and its deposits start flowing out, the MFI shrinks its portfolio to near-zero, and is eventually closed after failing to secure new equity.

Risk Categories

- Methodological flaws
- Financial instability
- State intervention (weak regulatory regime)

Turnaround Factors

- Liquidity
- Client confidence

3. *The Dangerous Race. Phaethon, Morocco*

A leading MFI wants to be #1, but finds another contender claiming the prize. Undeterred by its already over-extended systems and an overheated market with 40 percent of clients holding multiple loans, this \$30-million organization embarks on two-year growth of 570 percent. This cannot last, and soon enough delinquencies balloon, forcing a write-off of 1/4 of the portfolio. Unable to absorb the losses, the MFI announces that it will declare bankruptcy, thus threatening the stability of the entire sector. To avert a market meltdown, the Moroccan government engineers a merger with another MFI.

Risk Categories

- Uncontrolled growth
- Methodological flaws
- Systematic fraud (field-level)

Turnaround Factors

- Client confidence
- Address collections
- Last rites

4. *The Invisible Pyramid. Loki, Europe and Central Asia region (ECA)*

A promising MFI led by a widely respected CEO gains a new investor and sets off on a rapid growth path, funded entirely by foreign loans. But the growth is a mirage created by a con artist who is building the microfinance equivalent of a Madoff fund – much of the MFI is a Ponzi scheme, so masterfully executed that it remains undetected even after three portfolio audits. Once the full scale of the fraud becomes known, investors decide to liquidate the organization.

Risk Categories

- Systematic fraud (mgmt and field-level)
- Uncontrolled growth

Turnaround Factors

- Address collections
- Last rites

5. *Sailing the High Seas. Caravela, Kazakhstan*

A “missing-middle” MFI with exposure to real estate is hit by a major economic downturn. With client incomes on a steep slide and home prices collapsing, its portfolio goes into a tailspin. Its “missing-middle” market is damaged for years. Undeterred, the MFI pivots 180°, throws out its old business model and dives head-on into rural group-lending. And it pays off. Within two years, the MFI successfully transforms itself into a rural group-lender, emerging from the crisis with fewer than 100 “missing-middle” clients and just one loan officer to serve them.

Risk Categories

- Design flaws
- Loss of focus
- Macroeconomic shock
- Financial vulnerability

Turnaround Factors

- Strategic redirection
- Staff confidence
- Address collections

6. *When Agents Strike. Hestia, Pakistan*

In an environment of intense competition, Pakistan’s foremost MFI accelerates its growth. Its group leaders adopt the role of commission agents and multiple lending becomes rampant. When a local politician advocates waiving the loans of a group of borrowers, he sets off a non-payment wave that quickly spreads across the region. Within months, some 80 percent of borrowers stop paying. Unable to repair the problems directly, Hestia focuses its energies on growing its nascent Hestia Bank subsidiary, while largely abandoning the original portfolio. The bank is now a successful early stage institution.

Risk Categories

- Uncontrolled growth
- Methodological flaws
- State intervention

Turnaround Factors

- Client confidence
- Strategic redirection

7. *The Crowded Kitchen. Belavoda, Southeast Europe*

When the economic crisis gathers force, the MFI’s portfolio weaknesses are revealed, and delinquency rises steeply. It does not take long to trip the many financial covenants of its 12 creditors, resulting in the freezing of all new disbursements and threatening a liquidity crisis when the next batch of principal payments come due later in the year. The CEO and board chairman sit down with the MFI’s 12 creditors to begin talks on restructuring. Though most lenders recognize the issues at stake, the different personalities involved and the necessity of reaching a unanimous decision make the process far more difficult than expected. In the end, the loans are restructured. With its portfolio improving, the MFI appears to have survived the brunt of the storm.

Risk Categories

- Financial vulnerability
- Methodological flaws

Turnaround Factors

- Liquidity
- Creditor confidence
- Address collections

8. *The Beacon of Law Goes Dark.* PADME, Benin (mini-case)

An MFI's plans for transformation run afoul of the government's wishes to retain control. Using trumped-up charges, the government effectively nationalizes the institution.

Risk Categories

- State intervention

9. *Caught in the Great Storm.* ShoreBank, USA (mini-case)

A low-income bank with a residential mortgage portfolio falls victim to the housing crisis and subsequent recession, and is closed.

Risk Categories

- Macroeconomic shock

10. *The Price of the Prodigal Son.* Bank Dagang Bali, Indonesia (mini-case)

One of the first modern MFIs becomes insolvent when a set of insider transactions by the founder's son goes bad. It is subsequently closed and liquidated by the central bank.

Risk Categories

- Systematic fraud (mgmt)

Introduction

Learn from the mistakes of others. You can't live long enough to make them all yourself.
—Eleanor Roosevelt

The years 2009-2010 were a watershed for the microfinance industry, with many MFIs experiencing serious downturns for the first time. Dealing with this was challenging, and MFIs found themselves devising solutions on the fly – some successfully, others less so. Yet they had no choice. Available literature on microfinance crises was sparse and dealt with market-level failures rather than MFI-specific ones¹ and only a handful of MFI-level case studies existed.² There were no best practices or compendiums of case studies available that could provide guidance on managing MFIs in crisis.

In the absence of such guidance, practitioners had to rely on their own wits. The results have been varied, but what has been uniformly true is that those directly involved with recent crises have emerged from the experience with knowledge that had previously only been available to a handful of veterans. After all, along with the pain, crises carry the most densely packed learning available, stamped forever in the memories of their accidental pupils. However, those still untouched by crisis have not had such benefit, and even the veterans themselves have only witnessed their own battles, not those of others. Only a very select few have had the opportunity to glimpse the inner operations of multiple MFIs as they navigated through their storms.

This paper is an opportunity to do just that, and in the process, learn the valuable lessons that until now have been available only to those who happened to be on deck. And while we cannot assure that those lessons will be as memorable as experiencing them directly, we do guarantee that the learning process will be far less hazardous.

The seven case studies and three short overviews of MFIs included here describe the different paths that can lead to crisis. Some MFIs took the road of reck-

less growth, others wandered in through weak operations and internal controls, and still others were undone by government action or serious economic downturns. In each case, the MFI faced existential threats. Some parried the threats successfully and survived. Others succumbed and are no longer with us. All left their lessons behind.

This paper extends the work begun in a recently published paper by Beatriz Marulanda, “Taking the Good from the Bad in Microfinance: Lessons Learned from Failed Experiences in Latin America,”³ which reviewed 10 cases of Latin American MFIs in crisis. This paper introduced a typology of crises as well as practices that can either increase or reduce the chances of experiencing one. Following this example, we move beyond Latin America to institutions that faced situations serious enough to constitute an existential test – during the depths of their crises, each institution faced a very real possibility that it might not emerge intact.

Like the many hazards of the sea – invisible shoals, hurricanes, rogue waves – microfinance crises can be categorized, thus facilitating their detection and avoidance. Following the path laid out by Marulanda, but with some important differences, we devote Section One of the paper to exploring the crises – or hazards – that the MFIs in our sample have experienced.

And as with the beacons that help ships avoid such hazards, in Section Two, we describe a set of warning flags that MFIs and their stakeholders should heed carefully. Each of these beacons signals one or more failings that make MFIs vulnerable to crises and that MFI managers, investors, and others should use to steer themselves away from the hazards of the business. Many of these beacons also draw from Marulanda’s findings.

1. See for example Rhyne 2001, Patten 2000

2. See for example Steege 1998.

3. Marulanda 2010.

In a departure from the Latin American antecedent, Section Three explores survival and turnaround strategies – life rafts – that MFIs in our sample employed when trying to navigate through their storms. Some MFIs emerged successfully from their struggles, while others foundered, leaving behind some lessons that ought to be emulated – or avoided. To our knowledge, this is the first study of crisis management in microfinance, and while we would like to hope that its lessons will rarely be needed going forward, the reality is that MFIs will continue to experience crises, and their investors, directors, managers, and regulators will find the lessons here a useful guide for navigating their own future storms.

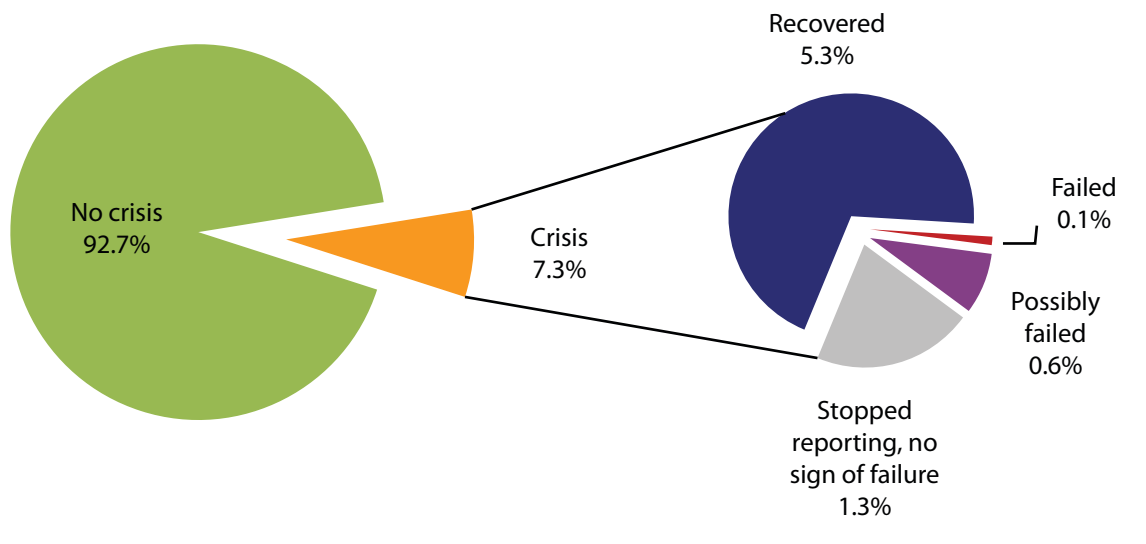
Finally, a word of caution. Reading this paper and its cases can be like watching one of the ubiquitous safe-driving videos that teenagers are shown as part of driving school curriculums. The gory outcomes of careless auto accidents can be a useful deterrent against reckless driving, but for some weaker souls they can become deterrents from driving itself. That

should not be the lesson here. For all the discussion of crises and failures, one should bear in mind that serious microfinance crises are rare and often survivable.

An examination of MIX Market data finds that 7.3 percent of MFIs experienced a crisis between 2002-2008. But fewer than 1 percent of the MIX total ended up failing outright.⁴ Although the rate of crisis and failure is certain to increase when 2010 data become available on MIX (several MFIs, including a number of our cases, failed in 2010), the overall pattern is likely to remain unchanged, with the majority of crisis-stricken MFIs surviving their ordeal.

4. MIX Market 2002-2009. Crisis is defined as PAR30 + Write-off ratio > 20 percent as reported in 2008 or earlier. To exclude chronically underperforming (subsidized) MFIs, we only include only those MFIs that report PAR30 + writeoff < 20 percent one year immediately prior to the crisis and < 5 percent during at least one year sometime before the crisis. The sample is restricted to MFIs that reported total assets > \$1 million sometime before the crisis.

Figure 1: Crisis is rare, failure rarer still



Source: MIX Market

Section 1. Mapping the Sea: Hazards

Some crises are self-created. Others are inevitable. Avoiding the first and preparing for the second are key aspects of risk management. Conveniently, in most cases establishing a single set of strong microfinance practices will meet both objectives. Conversely, the same set of failings may either bring about crisis or make an institution more susceptible to external shocks.

The Marulanda paper identified six typical causes of crisis, and our findings largely fit this framework, with the addition of two additional causes appended to the original six.

1. Methodological Flaws

The most common feature found among our set of cases is the failure by MFIs to either correctly and fully maintain their selected microfinance methodology or implement it in the first place. This encompasses issues such as improper client evaluation, inappropriate use of staff incentives, weak reporting systems, overly large increases in loan amounts between lending cycles, and so on. This is perhaps the most common issue that can cause or amplify an MFI crisis. Among the cases in this study, it was the primary factor in Artemis (Ghana), FuegoNord (Nigeria), Hestia (Pakistan), and a supporting factor in Phaethon (Morocco).

The case where methodological problems were most fundamental was Artemis. Its processes were, strictly speaking, a mess. Despite a large operation touching some 100,000 clients, Artemis had no credit policies in place, and was run largely at the whim of the CEO and a handful of executives. This frequently meant that loans – often of very large size – were issued upon instruction of these executives, with little to no credit evaluation or collateral. In many cases, the loans went to friends and family. Meanwhile, branch managers were left to develop lending standards as they saw fit, with little coming from the head office

by way of guidance or requirements.

For group-based MFIs, a common flaw can appear when group or center leaders over time become loan agents, tak-

ing on many of the duties of loan officers, from client identification and evaluation, to disbursement and collections – all without official sanction from the MFI and with no accountability. In the case of Hestia, such loan agents charged (and pocketed) commission payments from borrowers and in some cases were so dominant that borrowers viewed them, rather than the MFIs they worked with, as the source of the loans. Loan agents can also co-opt or outright invent borrowers in order to take out multiple MFI loans for themselves, which in the right circumstances can create a strong incentive for them to encourage other borrowers not to repay their loans and thus provide cover for their own delinquency. Agents played an important role in promoting and maintaining the repayment crisis at Hestia.⁵

2. Systematic Fraud

This can be of two clearly distinct types: fraud by borrowers/field staff and fraud by senior executives.

Fraud by borrowers/field staff is usually enabled by weak supervision, absence of clear delegations of authority, weak reporting systems, lack of internal controls and audits, and other operational weaknesses. This was not the primary factor in any of the cases in our study, but was a contributing factor in Phaethon (Morocco), Hestia (Pakistan), Artemis (Ghana), FuegoNord (Nigeria), and Loki (ECA).

5. For more on loan agents in microfinance, see Ramesh Arunachalam, *The Centre Leader as A Micro-Finance Agent: Some Insights Into The Operational Model...*, blog 27 Jan 2011 (<http://microfinance-in-india.blogspot.com/2011/01/centre-leader-as-micro-finance-agent.html>)

For example, at the peak of Phaethon’s crisis, about 1/3 of its loan portfolio was found to be comprised of ghost clients. While a substantial part of this was due to loan officers seeking to cover up defaults by issuing new loans, the rest was largely the result of fraud on the part of loan agents or even loan officers themselves seeking to borrow in the names of other individuals, real or imagined. While this practice was largely enabled by uncontrolled growth – a separate category – field-level fraud was an important element in ultimately bringing down the institution.

At Loki, it was Madoff Microfinance – a giant Ponzi scheme fed by the continuing flow of foreign funds.

Fraud committed by senior executives can be more insidious, given their ability to conduct it on a large scale. At the same time, some execu-

tives’ knowledge of internal controls, and in some cases even the ability to subvert them altogether, can make the fraud harder to detect. It was a key factor in the failure of Loki (ECA) and Bank Dagang Bali (Indonesia), and an important contributing factor in Artemis (Ghana).

Loki is easily the standout example of executive-level fraud. In essence, it was Madoff Microfinance – a giant Ponzi scheme created by the CEO and fed by the continuing inflow of foreign funds. Like Bernie Madoff, Loki’s CEO was a prominent and well-regarded individual in his country’s microfinance scene, overseeing an organization that delivered outstanding returns – it was in the rarefied group of only 20 MFIs worldwide with return on assets above 11 percent in both 2007 and 2008. The fact that it achieved such profitability on a reported portfolio yield of 37 percent is all the more remarkable – especially as its internal operations were demonstrably sub-par, and many staff, including branch managers who had extensive powers delegated to them, were clearly unqualified for their positions.

Of course, many of the staff (some of them the CEO’s relatives) were not there to perform their nominal duties, but rather to support the fraud scheme. They performed their roles so well that the scheme went undetected by multiple ratings assessments, due diligence reviews, and even three detailed portfolio audits commissioned with the specific objective of uncovering suspected fraud. During the last and most in-depth portfolio audit, these special auditors interviewed 30 randomly-se-

lected clients at Loki’s largest branch and walked away believing that this branch presented minimal risk to the institution. In fact, the 30 clients had been coached in advance, and a few months later, the branch was discovered to have been the epicenter of the scheme, with some 80 percent of its loans completely fake.

3. Uncontrolled Growth

When MFIs grow too quickly, they can weaken or abandon their internal controls, or undermine their methodological foundations (e.g. making larger loans than prudent). Such growth can also take place at the market level through multiple lending, in some cases leading to client overindebtedness. This issue has received extensive attention lately as a significant contributor to the crises faced by many MFIs in the past two years.⁶ It was also a critical factor in the case of Phaethon (Morocco) and Hestia (Pakistan), and a supporting factor in FuegoNord (Nigeria).

Phaethon is perhaps the poster-case of the risks of uncontrolled growth. Having lost the rank of the largest MFI in Morocco, Phaethon set as one of its objectives to regain the top spot. It achieved this by increasing both client outreach and loan sizes, 123 and 200 percent over two years, respectively. The resulting 570 percent growth in portfolio was impressive, and though rare, is not unheard of among MFIs of similar size (Phaethon had a \$30 million portfolio at the start of this growth cycle and \$200 million at its peak). However, the growth took place in an already saturated market, with 40 percent of borrowers holding multiple MFI loans. And it was achieved on a foundation of a highly inadequate MIS and weak internal controls. One of Phaethon’s strategies was to let field staff set up their own branches, while providing only minimal supervision from headquarters. The resulting spread of fraudulent and ghost loans was only the naturally expected outcome. In the end, the portfolio Phaethon had thus built up proved too toxic and ephemeral for the company to survive.

4. Loss of Focus

In some situations, MFIs may deviate too far from their core strengths or venture into new markets or

6. See for example, Growth and Vulnerabilities, Reille 2010.

Loans to wholesalers were collateralized only by inventory, which defaulting borrowers proved adept at selling before Artemis could claim it.

technologies in which they have limited expertise. Alternatively, MFIs can branch out into too many directions at once.

In both cases, this loss of focus can both undermine performance as well as erode capital due to a potentially expensive investment that ends up in a loss. This was not a primary factor in any of the cases studied, but it did play an important supporting role in Artemis (Ghana), and minor supporting roles in Caravela (Kazakhstan) and ShoreBank (US).

One of the distinguishing features at Artemis was the presence of large loans over \$15,000, which, at over 23 times GNI⁷ per capita, was far outside the microfinance segment in Ghana. Many of these loans, made to friends and family, were outright fraudulent, but some were legitimate loans to wholesalers in Accra's markets. The trouble is that the methodology with which they were issued was inappropriate for loans of that size. Many were issued without any collateral. But even when collateral was present, it was clearly unsuitable as security. For example, loans to wholesalers were collateralized only by inventory, which defaulting borrowers proved adept at selling before Artemis could claim it. The weakness of this portfolio was clearly evident in its subsequent delinquency rate of 80 percent, which contributed a major share to the company's losses.

5. Design Flaws

Some MFIs simply start off wrong. An MFI whose founding premise was faulty may have located in a market with little demand for microfinance services or adopted an inherently unworkable business model. Unlike the Marulanda study, which found several examples with this type of flaw, only one MFI in our sample falls clearly within this category: Caravela (Kazakhstan), with its focus on lending to the entrepreneurs in the "missing-middle." This is by no means an obvious point. There is nothing wrong with serving this market, and Caravela's loyal clients were a clear indication of demand. The pertinent question

in this case is whether Caravela was the right institution to focus on this segment and whether it had the business model to make it work.

The in-between nature of this market segment in many respects requires an in-between lender. On the one hand, many clients require the type of personal, on-location appraisal that MFIs can provide, and at this Caravela was very good. But at the same time, their needs run beyond what MFIs traditionally provide – larger loans, longer terms, and, quite probably, lower interest rates. One of Caravela's clients had expanded from a small market retail space into a car repair business employing some 40 people. Such investments typically require credit of different types – a mortgage, equipment loans, and so on. And yet, the best Caravela could provide for such clients were 3-year loans at 30 percent interest. And the \$100,000-loans some clients required would have comprised 2.5 percent of Caravela's portfolio – a concentration level that was untenable. It is thus unsurprising that Caravela saw many of its best clients head to banks for their growing needs.

The in-between status of Caravela also made it especially vulnerable to the economic downturn that hit Kazakhstan. While banks also suffered, their im-

Caravela tried to play the role of a microfinance bank, but without the benefit of scale and access to deposits.

portance to the economy gave them access to special government rescue programs established in response to the crisis – programs for which Caravela, as a non-banking institution, was not eligible. Caravela tried to play the role of a full-fledged microfinance bank, but without the benefit of scale and access to deposits needed to both serve SME clients and manage their risks. And in this, it was flawed from the start.

6. State Intervention

This entails two essentially opposing issues. First, there is direct intervention that undermines an MFI's operations, such as proclaiming loan waivers, setting unsustainably low interest caps, or rolling out a subsidized loan program while demonizing sustainable microfinance. The second form of intervention is when the state, either through inattention or

7. Gross National Income

over-eagerness to promote microfinance, creates an environment that fosters uncontrolled lending and mutually destructive competition. State intervention was the primary factor in the case of PADME (Benin), where the state effectively nationalized the institution, and an important supporting factor in two others – FuegoNord (Nigeria) and ShoreBank (US), where the state failed to provide sufficient regulation to temper runaway market enthusiasm that ended in a burst credit bubble.

FuegoNord is a perfect example of over-eager state intervention. The microfinance market in Nigeria took off only after the Central Bank of Nigeria (CBN) created the Microfinance Bank (MFB) structure. However, very low entry requirements (only \$150,000 starting capital) led the CBN to sanction some 800 MFBs in a very short time – far beyond its capacity to regulate. Moreover, CBN itself was still learning microfinance, and its supervisors used a lens more suited for overseeing banks. Tellingly, CBN even began publishing the *Nigerian Microfinance Newsletter*, where the heads of many of Nigeria’s leading MFBs contributed their articles. It was essentially the kind of publication a national microfinance association might put out, but it is not clear that this is an appropriate role for a regulator charged with the oversight of those same organizations. The result was perhaps predictable – a whole breed of MFIs (FuegoNord among them) pursuing reckless policies oriented exclusively towards growth and profitability, without due attention to the attendant risks. After three years and a market implosion, the central bank withdrew 224 MFB licenses, including that of FuegoNord.

7. Financial Vulnerability

Some MFIs feature weaknesses in their financial structure – currency mismatches, bad asset-liability planning, excessive leverage, and similar

factors – that make them especially vulnerable to shifts in financial markets or downturns in the broader economy.

For Caravela, the protection offered by a currency hedge turned out to be a mirage.

And unlike methodological flaws, financial vulnerability is not specific to microfinance, but a risk for any financial institution. It was the primary element in the case of Belavoda (Southeast Europe), and an important supporting cause in FuegoNord (Nigeria) and Caravela (Kazakhstan).

The case of Belavoda truly exemplifies the issue. After the economic crisis came upon the countries where Belavoda is located, the effects soon showed in its portfolio. By the end of 2009, it had written off some 10 percent of portfolio, and PAR30 still stood at 15 percent. Such numbers and the resulting impact on financial performance were more than enough to trip multiple loan covenants (such as maximum allowed PAR, or minimum required ROA) in place with its 12 creditors. The result was that any new disbursements were frozen, and with 2/3rds of its debt maturing over the next 18 months, Belavoda was looking at a major liquidity crisis on the horizon. It was clear from the start that there was only one solution – the creditors would have to reschedule the loans, granting extensions for the loans maturing in the near future, but that obvious outcome proved far harder to reach than one might presume. In the end, Belavoda was successful, but the sheer number of creditors, and the different personalities involved, kept the outcome highly uncertain until the end.

Another useful example of financial vulnerability is a currency mismatch between assets and liabilities. This has been a widely recognized issue in microfinance literature,⁸ but most participants assume that having a hedge in place largely eliminates the problem. However, hedges are complicated instruments, and in one of the study cases, the protection they offered turned out to be a mirage. Caravela had an outstanding foreign currency loan hedged with a back-to-back loan from a local bank. Unfortunately, after the currency was devalued by some 20 percent, the bank raised Caravela’s hedging fee by four times, to 16 percent of the loan amount. With no other hedging facilities available, Caravela felt compelled to continue the hedge at the higher rate, fearing that it might otherwise remain exposed to further devaluations. The result was that the ultimate cost of the hedge proved the same or greater than what it would have been without any hedge at all, and the

8. See for example, Littlefield & Kneiding, 2009; or Apgar & Reille, 2010.

hedge cost had to be borne at a time when its capital was especially scarce.

8. Macroeconomic Shock

Most crises experienced by MFIs involve an economic downturn in one form or another, usually as a trigger that sets off institutional weaknesses already present – a finding articulated by the Marulanda study. We would thus caution organizations from citing this factor unless they can confidently demonstrate that other factors are not more directly implicated. Nevertheless, in some

circumstances macroeconomic shock can be said to be the primary factor in undermining an otherwise well-run and well-designed organization – as evidenced in ShoreBank (US) and to a lesser degree Caravela (Kazakhstan). While other vulnerabilities were also present at these institutions, their core weakness was the very nature of their business – their explicit choice to serve a vulnerable market segment with a small and non-diversified institutional setup.

In Caravela’s case, the institutional setup was simply the wrong one chosen for the market it sought to serve,

Caught in the Great Storm

Founded in 1973 in Chicago, ShoreBank was a first-generation titan of the modern microfinance world. It was founded explicitly with the mission to serve the poor, mostly African-American communities on the South Side of Chicago that had been abandoned by banks through the practice of “redlining” – excluding communities largely on the basis of race.

ShoreBank pursued a model of high-impact targeting that sought to provide a single neighborhood with a broad range of financial services and support programs to catalyze and sustain the virtuous cycle of economic growth. In doing so, it served as a model for thousands of community development investment institutions that were subsequently created in the U.S., and which continue to play a critical role in America’s poor urban communities. Its founders also provided frequent and direct consultation to Grameen Bank, BRAC, and other pioneering MFIs.

By the mid-2000s, the core of ShoreBank’s loan portfolio consisted of small-scale multifamily mortgages for largely post-WWII buildings housing anywhere from 6 to 36 or more families each. The clients for these mortgages were developers who were either local residents or individuals with strong ties to the community. These clients bought the run-down buildings, refurbished them, and rented them out to low- and middle-income families. The business model of these entrepreneurs rested on the income from long-term rentals – as long as the community remained healthy, these developers would as well, and so would ShoreBank’s mortgages.

The other side of its mortgage portfolio consisted of occupant-owned single-family residences. By 2006, most of this market in ShoreBank’s communities had been taken over by subprime lenders, who offered borrowers the opportunity to take cash out of their homes, after having helped drive up the real estate prices in communities that had been stagnant for decades. Unsurprisingly, many borrowers jumped at the chance, often encouraged by purposefully misleading, and at times downright fraudulent, loan offers.

The subprime crash needs no description. The same forces that it unleashed throughout the country hit ShoreBank’s communities with an even greater fury. At one point, the company estimated that 9 out of 10 home sales on the South Side of Chicago were the result of foreclosure or short-sale. But the worst was still to come: As the Great Recession took hold, it hit the blue-collar workforce – the economic bedrock of these communities – especially hard. Unemployment skyrocketed, by some accounts reaching 30-40 percent in these areas.

The loss of income by so many renters hit the landlords and their mortgage payments to ShoreBank. And because the real estate market was frozen, the write-downs on these mortgages – even if they continued to generate substantial cash flow – proved devastating to the bank’s capital. With time running out, ShoreBank placed its hopes in the rescue by the U.S. Treasury (via TARP). However, this ultimately proved in vain, for ShoreBank had two strikes against it: It wasn’t too big to fail, and its social mission put it in the sights of ideologues who were very vocal against the bank’s rescue.³

These ideologues were largely right to focus on the mission, but for the wrong reasons. ShoreBank’s mission did ultimately become its undoing, but not because it lost sight of business priorities by pursuing its mission. Forty years of successful operations is a strong argument that ShoreBank got that right. In the end, it was the high-impact targeting model that meant that the bank simply did not have the diversification it needed to survive as severe and as devastating a storm as the Great Recession of 2008.

a. <http://michellemalkin.com/2010/05/21/the-shady-ShoreBank-bailout/>

and hence the finding of Design Flaws as another leading risk factor. However, the same cannot be said of ShoreBank, whose entire mission was founded on a model of high-impact targeting that sought to provide a single neighborhood with a broad range of financial services and support programs to catalyze and sustain the virtuous cycle of economic growth. It was non-diversified by design. Instead, it is truly an example of an

otherwise well-run institution being felled by a rare but hugely damaging event – a “black swan.” Nor was it alone – by the time ShoreBank was seized by regulators, the economic crisis had claimed 37 banks (few, if any, of which were subprime lenders) in the state of Illinois alone – a number higher than the combined number of bank failures in all 50 states over the prior seven years.

Section 2. Before the Storm: Beacons

The eight hazards above serve as stark reminders of the need for constant vigilance. Of course, many of them are self-evident: Establishing a proper lending methodology is clearly a critical foundation for an MFI's growth. However, the fact that these mistakes are made testifies to the difficulty of getting things right.

To help steer clear of such hazards, we list below a set of recommendations – or beacons – that practitioners can follow. These largely follow the recommendations originally laid out in the Marulanda paper, though with some notable differences.

1. Focus on Governance

Good governance is the ultimate backstop for crisis prevention and management. Marulanda found

Good governance is the ultimate backstop for crisis prevention and management.

governance structure to be the primary differentiating factor between those MFIs that survived a crisis and those that did

not. This should not be surprising – a strong board can prevent catastrophic decisions, as well as help turn around companies already going through crisis.

The findings in this study support this view. Among the 10 cases studied, the most successful turnarounds (Caravela, Artemis, Belavoda) involved especially strong boards, while both FuegoNord and Loki – two of the three MFIs that ultimately failed – had major weaknesses on their boards. None of FuegoNord's initial shareholder-directors had microfinance experience, and recovery efforts were moreover led astray by competing interests, personal disagreements, and insistence on regaining paper profitability, whether it was sustainable or not. At Loki, the majority shareholder was represented by only two board members, both with little knowledge of the local market. Moreover, neither they nor any other board members had any significant microfinance experience.

On the other hand, Caravela's founding (and only) shareholder with extensive microfinance experience was instrumental in instituting a turnaround plan in the very early days of the crisis. This fast response proved critical to saving the company. Similarly, the board chairman of Belavoda was directly involved from the early days of their crisis, and worked closely with management and its creditors to develop a restructuring plan. At Artemis, the newly reconstituted board brought in outside personnel and adopted a system of frequent monitoring and reporting.

2. Move Beyond PAR

Regular assessment of portfolio quality is a critical factor in assuring institutional sustainability. Boards, executives, or creditors that make this assessment primarily on the basis of PAR are abdicating their responsibilities. For microcredit portfolios, and especially for group loans, PAR is a lagging indicator. By the time an increase can be observed, it's often too late – the institution may have already entered crisis.

For MFIs especially, delinquency levels can jump in ways unimaginable to most traditional bankers. Caravela – an individual lender – saw its PAR30 jump by 15 percent in just one quarter. Even more stunningly, at Hestia (a group lender), PAR30 went from less than 1 percent to 80 percent in five months. FuegoNord at one point paid bonuses to staff on the basis of reaching break-even, only to find a few months later that its accounting profit had been an illusion – its PAR30 had hit 50 percent. And in the case of Loki, low PAR was simply the manufactured façade of a pyramid scheme.

In fact, proper evaluation of portfolio quality must include monitoring of risk factors captured at the time of loan issuance, such as evaluations of

For microcredit portfolios, PAR is a lagging indicator.

borrowers' repayment capacity (yes, even in group lending!) and their outstanding debts – ideally from both credit bureau reports and loan officer due diligence. This is an element that has been bypassed by far too many MFIs – in fact nearly all of them in this study's sample ignored existing indebtedness levels when conducting borrower assessments. And no less importantly, a strong internal audit that is independent of management is critical to making sure that the information being reported is in fact accurate – that borrowers are real, their loans and repayments are real, and other areas potentially subject to malfeasance are as they appear to be. And from an investor's perspective, portfolio audits can yield valuable insight, without relying on the MFI's internal reporting.

Careful monitoring also insures that when the portfolio does start to sour, there is more information available on which to base decisions, thus supporting faster and more appropriate reactions. For example, within months of recognizing the start of a repayment crisis – which would last for some two years – Caravela was able to react by massively scaling its then-tiny group lending portfolio that was unaffected by the crisis, thus giving itself a far better chance of survival than had it waited another six months.

3. Keep Leverage Low and Liquidity High

Conservative leverage and liquidity policies are beacons that are also life rafts. In calm weather, they are little more than excess ballast whose weight serves to pull down returns. But in storms they are nothing less than lifesavers. Caravela is still in operation largely because it had a significant capital cushion, which the crisis greatly eroded but did not fully deplete. Artemis' liquidity cushion gave it room to restructure its operations and maintain a sufficient reserve to handle all but the biggest runs on deposits.

When evaluating leverage levels and available liquidity, look out for underwater hazards, since the ratios may not tell the full story. FuegoNord maintained plenty of equity, but it was tied up in illiquid assets, putting the life raft out of reach when it was needed. With default to depositors untenable, its only option for meeting savings withdrawals was to shrink its loan portfolio and staff – the very income-generating assets that might have pulled it out of cri-

sis. Similarly, Belavoda had plenty of liquidity, but both the MFI and its creditors failed to recognize prior to the crisis that a large portion of its debts were set to mature around the same period, which, as luck would have it, came in the midst of crisis. The crisis itself was serious, but not existential. The liquidity crunch looming on the horizon made it so.

Naturally, no ship can sail when loaded with so many life rafts that it has no room left for passengers. The key is finding the right balance. The actual levels of leverage and liquidity depend greatly on specific markets, the MFI's business model, and many other factors. However, the targets and minimum thresholds must be set by the board with full recognition of business needs and crisis scenarios. And once set, they must be regularly monitored and reevaluated annually. Moreover, any breaches must be taken seriously.

4. Know Who Is Making the Loans

An MFI never lends – its loan officers do. Thus, the skills, incentives, and decision-making authority of loan officers and mid-level staff must be evaluated to insure that loan approvals are

An MFI never lends – its loan officers do.

based on genuine and effective assessments of credit-worthiness. That also means regular monitoring and training as needed. FuegoNord viewed its field-level staff as expendable resources that were jettisoned with the same amount of consideration with which they were brought on board, which is to say minimal. The resulting poor portfolio performance should surprise no one.

One particularly risky practice among some MFIs – especially in South Asia – has been to rely on external loan agents to recruit clients and form groups, and sometimes even conduct borrower assessments and handle disbursements and repayments. While agents' knowledge and ties to the local community can provide real value, their role must be officially recognized by the MFI, with the appropriate alignment of incentives, training, and supervision that the practice requires. To do otherwise is to outsource one's own lending process to multiple third parties that were never assessed

and whose incentives can greatly differ from those of the MFI. The risks are evident in the case of Hestia. And these risks will continue to emerge until the industry recognizes the issue.⁹

5. Be Professional

An MFI, once it grows beyond a certain size, is not a family business. So it shouldn't be run like one. Clear policies must delineate what the institution can do and how it can do it, as well as which functions

Respect for structure cannot be avoided if one is to have a sustainable financial institution.

(not individuals!) are empowered to make what decisions. And it goes without saying that these policies need to be implemented

thoroughly. No individual, no matter how senior, should be able to singlehandedly seek out a borrower, evaluate her credit-worthiness, define the loan terms, and disburse (or order the disbursement). Such functional processes should cover other areas, including collections, back office operations, HR, accounting, and so on.

Decision-making must be done efficiently and transparently, and must include or be communicated to those whose job descriptions provide them with the relevant authority. It is inappropriate for senior managers to bypass hierarchy to provide specific instructions to lower-level subordinates – especially if the intermediate managers aren't informed (Artemis). Loans to friends and family should be beyond the pale, regardless of credit-worthiness (Loki, Artemis, Bank Dagang Bali). And what is true for lending should also be true for hiring, unless the friends/relatives are in separate branches of the hierarchy and have little substantive work-related interaction.

Naturally, professionalism doesn't imply rigidity and an absence of a warm, supportive atmosphere. But respect for structure cannot be avoided if one is to have a working, sustainable financial institution. Its absence can cause the MFI to run aground on several of the hazards described above. And the seriousness of this weakness cannot be over-emphasized; aside from the

9. Arunachalam 2011.

handful of large insider transactions undertaken by the founders' son, Bank Dagang Bali was otherwise a well-run institution. Yet that one critical error was enough to fell this founding legend of microfinance. Similarly, the presence of multiple friends and relatives at Loki provided critical support for the massive fraud scheme undertaken by the CEO.

6. Funders Also Have Responsibilities...

The role of funders in microfinance crises has recently been a hot topic.¹⁰ The funders' role vis-à-vis MFIs is in many ways akin to that of the role of MFIs themselves vis-à-vis their borrowers. Like MFIs, nearly all international donors and investors in microfinance have some type of social mission. And while these missions differ between funders, at a minimum, they all include, whether implicitly or explicitly, the precepts of the Hippocratic Oath – do no harm. And yet, far too many funders have not carried out that responsibility.

The majority of MFIs in our sample were non-deposit-taking, and thus grew primarily through borrowed funds, many of which came from investors who regard themselves as socially responsible. Thus Phaethon, which grew 570 percent over two years on the back of inadequate systems and weak oversight, was able to fund the expansion by increasing its borrowings by nearly 900 percent over the same period. Much of this came from local banks, but a significant portion was made available by a Moroccan refinancing facility that was in turn backed by international development finance organizations. Surely, increasing funding by such levels comes with some responsibility for oversight. With Phaethon's internal systems and processes so clearly inadequate to support such growth, it was the creditors' responsibility to say "no." That is the meaning of prudential lending.

When internal processes are clearly inadequate to support fast growth, it is the creditors' responsibility to say "no."

10. See for example David Roodman, "Who Inflated the Micro-credit Bubbles?" David Roodman's Microfinance Open Book Blog, Center for Global Development, March 27, 2010. (http://blogs.cgdev.org/open_book/2010/03/who-inflated-the-bubbles.php)

The Price of the Prodigal Son^a

Before there was Grameen, before PRODEM, before... well, before any modern-day MFI, there was Bank Dagang Bali (BDB). Founded in Bali in 1970 by a former tailor and a market moneylender (respectively, Mr. and Mrs. Oka), who had been lending informally in the local markets since the 1950s, BDB provided financial services to the local community of tradespeople and merchants. It was a full-fledged, licensed bank, offering both savings products and individual loans. Notably, BDB did not focus solely on the microenterprise sector – while 50 percent of its borrowers had loans below \$550, this accounted for less than 5% of portfolio value. Conversely, loans above \$50,000 made up over half of the portfolio, while representing only 3 percent of borrowers. This made BDB a broad-based MFI that for decades remained without parallel anywhere in the world.

By 2004, after over 30 years of banking activity, BDB had grown into an important regional bank in Indonesia. More importantly, its innovative approach to serving the active poor had influenced many others in Indonesia, including Bank Rakyat Indonesia (BRI). One of the pioneering practices of BDB was the use of lotteries as a means of attracting savings – a practice that had proven especially popular with low-income clients. Lotteries have been since adapted by BRI and other Indonesian banks. Even halfway around the world, Bolivia's BancoSol implemented lotteries to mobilize savings – a practice it picked up from BDB via BRI.^b

BDB was also a survivor, having lived through the Asian Financial Crisis of 1998, which hit Indonesia especially hard and caused a 13 percent drop in GDP in 1998. Moreover, BDB survived this period without significant subsidy or government rescue. This record of innovation and survival makes the manner of its downfall all the more tragic.

In 2004, when the elder Okas were already in their 70s, BDB was a thriving institution. Yet it took just a handful of transactions to undo their decades of work. As it happened, one of their sons was married to the daughter of another banker, the owner of Bank Asiatic. The son engineered several interbank loans (in the form of Negotiable Certificates of Deposit and other instruments) from BDB to Bank Asiatic, which he in turn pledged as collateral for another loan. It is unclear whether his father, who was still the CEO of BDB at the time, was aware of this transaction. However, the sum of these transactions was staggering – with a combined value of close to IDR 1 trillion (\$120 million), they nearly doubled BDB's outstanding liabilities.

When the loans inevitably turned sour, BDB became insolvent. Upon learning of the situation, the regulators moved swiftly, with the Indonesian Central Bank revoking BDB's operating license and appointing a liquidation team. Thus ended the world's pioneering MFI. Perhaps as a testament to the strength of the bank's microfinance portfolio, by the time the liquidation team called it a day, some 95 percent of its small loans had been successfully recovered.

a. Based on the case study by Rozas, D., *Throwing in the Towel: Lessons from MFI Liquidations*, Microfinance Gateway, 2009.

b. Marguerite Robinson, *The Microfinance Revolution: Lessons from Indonesia*. World Bank, Washington: 2002, p. 158. BDB would hold lotteries several times a year with each saver receiving tickets in relation to the size of their deposits, with prizes awarded ranging from small items to motorbikes and even a house. The goal was to use the popularity of lotteries among the poor to help build savings discipline.

The nature of foreign funding – generally short- to medium-term loans – should also come into question, especially when a large number of lenders are funding a single institution. A serious downturn in Belavoda's portfolio performance tripped a slew of loan covenants among its 12 creditors, with the effect of preventing any further loans or disbursements. And yet Belavoda remained responsible for repaying maturing loans. Without access to new credit, it could only meet these obligations by suspending new loan disbursements. But that, of course, would have been tantamount to institutional suicide – a fact well-known to Belavoda's creditors. And so while the lenders and Belavoda's shareholders should be credited for ultimately working out a restructuring plan, it should not have required extraordinary ef-

forts and brinkmanship to achieve. The fact that any one of the 12 lenders possessed an effective veto over any restructuring plan strongly suggests that microfinance lenders need to develop a better system for restructuring debts.

Finally, lenders making hard-currency loans have yet another responsibility – insuring that they do not burden the MFI with currency risk that the organization cannot absorb. Many have in fact instituted requirements that the debt be hedged. And yet, in the case of Caravela, the institution's hedge, whose cost rose exponentially following a devaluation, became an albatross that ate up precious equity. This happened at a time when that equity was needed most (and ultimately turned out to cost well

above the value of the devaluation itself). Thus, for responsible lenders, it is not enough to simply verify that a hedge is in place without validating the details of the specific agreement. The growing prevalence of local-currency loans should be welcomed,¹¹ but in those cases where a socially responsible lender is unable to provide one, it might at least be appropriate for them to share some of the foreign currency risk, rather than pass it entirely on to the MFI that is almost certainly ill-positioned to handle it.¹²

7. ...And So Do Regulators

As microfinance matures and ever more money is available on the market, regulators have ever-greater responsibility to understand the sector and develop appropriate regulatory frameworks and supervision. A number of mature markets, especially in Latin America, already have this in place. In other countries, there is still much room for improvement.

The regulator's task is a difficult one – to navigate between overly lax regulation that creates a free-for-all market where borrowers and depositors can get hurt, and stifling regulation that might keep some clients safe, but only by limiting financial access for the rest of the unbanked. And all this has to happen while avoiding the kind of regulation that usurps the role of private lenders as allocators of capital to the most productive segments of the economy. The cases in this study span the full range of regulatory responses.

The inappropriate actions of the Central Bank of Nigeria as more of a promoter than regulator of the country's microfinance industry have been described above. But regulatory shortcomings are not limited to emerging markets. The failure of ShoreBank – a victim of the U.S. housing crisis and the Great Recession it spawned – has many roots. But much of the responsibility can be laid at the feet of U.S. policymakers, who during the critical years of 2003-2007 – when

the subprime industry was gathering steam – chose to stand back and do nothing.

In ShoreBank's communities of South Side Chicago, as elsewhere in the nation, the lead-up to the crisis was dominated by destructive practices of subprime lenders who lured clients with promises of lower payments and larger loan sizes that belied the pernicious nature of these products. In part as a result of the weakening of legislation governing financial institutions, in part due to insufficient funding and staffing, but mostly out of an ideological preference for a *laissez-faire* approach to regulation, the U.S. regulators never stepped in to limit the use of such inherently toxic loans or even require transparent disclosure of their terms.¹³ Nor did they choose to address any of the major failings in the long value chain of mortgage finance, too numerous and complex to name here. In the short run, this caused an unprecedented run-up in home prices. However, when the tide turned, the subprime lenders fled, leaving ShoreBank to deal with a collapsing real estate market, a once-in-a-century recession, and no help from the government to deal with its effects. And unfortunately for ShoreBank, it was also small enough to be allowed to fail.

Despite the above examples, most of the cases where a regulatory role was prominent actually demonstrate a competent and supportive regulator playing an important and constructive role in the industry. One notable example is the case of Phaethon. Given the MFI's dominant role in Morocco, its announced intention to declare bankruptcy threatened to undermine the entire sector, which was already struggling with high delinquencies. The country's financial authorities recognized the risk. Instead of watching 300,000 clients being cut off from financial

Instead of watching 300,000 clients being cut off from services and dealing with the effects, regulators engineered a quiet merger with another MFI.

11. Reille, Xavier, Sarah Forster, and Daniel Rozas. "Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns." Washington, D.C.: CGAP, May 2011.

12. This is not to excuse the far too prevalent tendency of MFIs to opt for cheaper hard-currency loans instead of the more expensive, but less risky, local currency ones – a practice Caravela had itself engaged in at least once.

13. The Federal Reserve Bank had such authority, but chose not to exercise it. Former chairman Alan Greenspan himself admitted that it was a serious error to rely on the "self-interest of lending institutions" as a substitute for regulation. See The New York Times, "Greenspan Concedes Error on Regulation," 23 Oct 2008 (<http://www.nytimes.com/2008/10/24/business/economy/24panel.html>).

services and dealing with the effects, it engineered a quiet merger with another leading MFI that conveniently happened to be a subsidiary of a state bank. Exactly how many clients were in fact transferred as a result of the merger is unclear, but through this action, the regulator was able to maintain the semblance of continuity. As long as enough staff were transferred, sufficient collections were continued, and a minimum number of loans were made, clients would not perceive the transition as a collapse, thus avoiding potentially disastrous rumors about the stability of other MFIs. And as an added benefit, the merger largely avoided much of the negative news coverage that would have been generated by the failure of a major MFI.

8. Political Risk

Recent events in some of the largest microfinance markets in the world – the freezing of the sector by legislative action in the Indian state of Andhra Pradesh and the persecution of Grameen’s Mohammed Yunus by the government of Bangladesh – have highlighted the large and often negative impact that direct political interference can play in microfinance. It is easy to rue this interference after the fact, but in most cases, the warning signs are present long before. And yet, although many microfinance providers are aware when they have a precarious relationship with political actors, they too often fail to take preventive action and are still caught unawares by the political onslaught.

The Beacon of Law Goes Dark

PADME was the largest MFI in Benin and among the premier MFIs in Africa. During an economic slowdown in 2005-2006, the organization stumbled, after having gone through a period of fast growth built on weak internal controls. PADME spent the next two years repairing its portfolio and strengthening its processes. The culmination of this phase was to be a transformation into a commercial institution and the entry of several international investors, with the aim of positioning it for the next phase of growth.

It was not to be. From its beginning as a partnership between the World Bank and the Government of Benin, PADME worked closely with government stakeholders. Over time, structural changes had reduced the government’s role, and in the lead-up to the transformation, the government’s main authority over PADME was exercised through the MFI’s steering committee (*comité de pilotage*). While this provided the government with the power to regulate, it precluded participation in direct decision-making. Importantly, so long as PADME complied with the relevant laws and regulations, there was no legal basis by which the government could stop the transformation.

From the time that the possibility of transformation was broached, the government representatives on the steering committee had made clear their displeasure with the plan, and put up obstacles throughout the process. From the government’s perspective, the transformation entailed the loss of what little control it still possessed. It also didn’t help that PADME’s government supervisors were inherently suspicious of independent microfinance institutions, as was the government more generally.^a For a government not keen on microfinance to begin with, the idea of losing all control over Benin’s premier MFI was simply too hard to swallow. So it found a way not to.

In late 2007, the Ministry of Finance ordered an audit of PADME’s operations. This audit was but an example of the time-honored tradition of authoritarian governments using sham investigations to provide cover for actions that would otherwise be *prima facie* indefensible. And lest there be any doubt about the audit’s purpose, its finding of false loan guarantees should quickly dispel it: The lone “randomly selected” customer (out of 50,000) whose file contained such false documents happened to be the sister of the head auditor himself.

On the basis of this audit, just a few months before the transformation was to be finalized, the Benin Council of Ministers removed PADME’s board and its long-time managing director, replacing the latter with its own appointed interim manager. This was a *de facto* nationalization, and it naturally put an end to the transformation plans.

PADME continues to operate to this day with the same interim manager in place. However, the ripple effects of the events of 2008 continue to be felt in Benin’s microfinance sector, where investors now fear to tread.

a. The newly-elected president of Benin at the time used to give away cash gifts during campaign rallies, calling them microfinance.

One such case in the study is PADME, where the government unexpectedly nationalized the institution instead of seeing it slip from state control by transforming itself into a commercial entity. The MFI and its future investors were well aware that the government disliked the transformation plans, but they had not expected such a sudden and drastic response. However, such seemingly sudden actions are hardly unusual – the government of Andhra Pradesh had for years harbored suspicions about the commercial MFIs in the state, but the actual issuance of the ordinance that stopped microfinance activity in its tracks nevertheless took MFIs by surprise. Likewise, Sheikh Hasina’s seemingly sudden persecution of Mohammed Yunus in 2011 was born from a dislike that had been simmering since Yunus’ 2007 foray into Bangladeshi politics.¹⁴

Microfinance actors should recognize that these apparently sudden actions are often calculated, with the government choosing to act on long-held desires by seizing a promising opportunity, such as a sudden media firestorm over farmer suicides or the release of a documentary (falsely) accusing Yunus of financial impropriety. In the case of PADME, there was no outside opportunity, but the approaching date of the transformation forced the government to impose its will using the results of a manufactured “audit” as an excuse.

14. Amy Kazmin, “Bangladesh escalates anti-Yunus campaign,” *Financial Times*, February 28 2011.

These are unfortunate, yet none-too-rare stories of government interference without much concern for legal niceties. They should come as a surprise to no one.

In most industries, companies operating in countries with weak legal environments devote extensive efforts to managing relationships with governments. Rarely would a company take steps in direct contravention of the wishes of important government officials without first taking proactive measures to protect itself from the potential consequences. And yet, in Benin – as in Andhra Pradesh and Bangladesh – microfinance practitioners acted with little more than the law on their side – an admittedly weak protector in countries where government is regularly above the law.

With the industry’s much-increased presence and visibility, practitioners can no longer afford to ignore the political scene. Instead, they should strive to develop better political antennae, and seek to anticipate negative political responses, taking measures to avert them or otherwise protect their institutions. In many cases, that also means developing stronger media reaction capabilities in local markets and keeping up relations with political actors of different parties, while carefully maintaining political neutrality.

It is easy to rue state interference after the fact, but in most cases, the warning signs are present long before.

Section 3. Navigating the Storm: Life Rafts

Whether adequately prepared for or not, crises do arrive, and preparation must turn into action once the waves start pounding. The MFIs in this study have reacted very differently to crises. Some succeeded exceptionally well, others failed outright, still others succeeded, but not without stumbles or significant costs along the way. Regardless of outcome, they all left behind valuable lessons that can serve as useful guides for MFIs that encounter crises.

Although navigating an existential crisis will inevitably require improvisation, it is still helpful to have a simple framework as a point of reference. This can be outlined as a three-step process: 1) insure immediate survival, 2) find and repair the underlying problems, and 3) redirect the institution's strategy towards a long-term sustainable path. When all else fails and the institution cannot be saved, the last and final step is to take measures to minimize the collateral damage from the ultimate collapse.

Though this approach might appear sequential, in practice, it is more of a mental framework than a chronological one. At an obvious level, it surely does little good to secure an MFI's immediate survival by undermining its long-term viability. A perfect example of this would be cutting off loan disbursements, which might conserve needed capital and liquid assets, but often at the risk of permanently destroying the MFI's portfolio and thus costing as much or more through lost repayments. And yet organizations still do this – when Hestia cut off disbursements in response to a client repayment strike, it only further entrenched its delinquency crisis.

Assuring immediate survival is also inextricably linked to Step Two – repairing underlying problems. After all, that is the ultimate objective of any turnaround. Covering up problems with capital injections and new lending will only insure that they will fester further, eventually surfacing with even greater ferocity. The investors of Artemis (Ghana) discovered this

after three years during which they made two separate capital injections into an institution that was already beset by major internal problems, whether they were aware of them or not. It took the action of the central bank to replace the management and board and start the difficult work of rebuilding the institution. But finding and addressing the causes of crisis are neither simple nor quick matters, often requiring a year or more. And in the interim, it is critical to insure that the organization can continue to operate.

When Hestia cut off disbursements in response to a client repayment strike, it only further entrenched the delinquency crisis.

While Step Two essentially consists of tactical solutions (repairing systems and processes, replacing/retraining staff, restructuring finances, and so on), Step Three, setting the institution on a long-term sustainable path, is the strategic side of the process. It may not always be required, for not all crises are indications of strategic misdirection. However, in many cases it will be necessary to reevaluate the organization's market positioning, business model, and even the mission itself – to the point that the organization that finally emerges at the other side of the process may be altogether unrecognizable. Such change naturally requires courage and serious dedication, but it is very much possible, as demonstrated by Caravela, which survived only because in a period of two years it was able to transform itself from an urban, individual, “missing-middle” lender to a rural, group, bottom market microfinance provider.

The cases studied here provide useful examples for each of these three steps. We review them below.

Step 1: Insure Immediate Survival

One common element across nearly all crises is time, or rather, its acute absence. This is especially true in the early days, when urgent decisions must be made that will affect the institution's ultimate prospects of

survival. In some situations, even hours may count, such as in reaction to a rapidly unfolding repayment strike experienced by Hestia. And reaching such decisions is made all the more difficult by the fact that in a crisis, choices are inherently constrained, forcing the institution to balance between competing needs – each of them critical in its own way. Thus, as the crisis looms, it may be helpful to prioritize these requirements for institutional survival. Conceptually, these are similar to Maslow’s hierarchy of needs, but focused on MFIs instead of human beings (Figure 2).

1. Liquidity

This comes first in order of priority. An MFI that runs out of cash is facing death. It may yet survive for a brief time, but the odds are against it. Once the money is gone and salaries stop being paid, a staff exodus is guaranteed to start. And once core staff is gone, the prospects of recovery approach zero. None of the MFIs in the study got to this point, but it did happen to SOMED in Uganda, where field staff, after not being paid, pocketed whatever borrower repayments were still coming in, before quitting their posts altogether.¹⁵

So when in crisis, above all, safeguard your cash. However, safeguarding is not the same as hoarding – once liquidity is sufficient to meet core operational costs for the immediate period (weeks, not months), the cash must be deployed to address the crisis itself. One should certainly not sacrifice client confidence in order to augment a cash buffer that is already able to meet current salaries. Likewise, maintaining li-

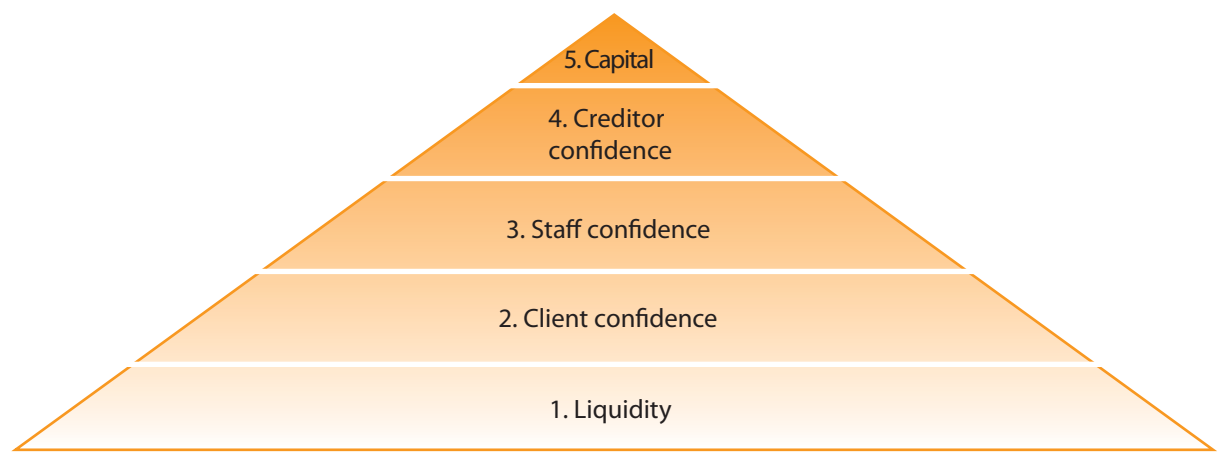
quidity entails bringing in new cash flows as much as it means reducing outflows. Don’t concentrate on one by neglecting the other. Caravela’s entry into group lending, besides being a major strategic shift, also had the benefit of providing positive cash flow in the short run, thus insuring that the organization could survive long enough to implement its strategic turnaround.

Note that for deposit-taking institutions, liquidity is a special case. In most situations, it’s quite likely that once a depository reaches a point where it’s concerned about liquidity, it won’t need to worry any longer – by then the problem will belong to the relevant regulatory body charged with protecting public deposits, which will have seized the institution. However, in environments where weak regulatory oversight delays such a takeover, it is possible that the MFI will be able to continue to operate on its own. In such a case, the need for liquidity becomes superseded by the need to avoid a collapse in client confidence, leading to a bank run.

Attempting to preserve liquidity by refusing to disburse savings withdrawal requests is nothing less than suicidal, as it will almost undoubtedly cause a bank run, which will alert the (sleeping) authorities, and the game will be over. If a group of depositors comes to withdraw, move mountains to meet their request. Then pray that no other depositors will come asking. In the very worst case, make a clear promise about when the money will be available, and then move

15. Rozas 2009

Figure 2: MFIs’ Hierarchy of Needs During Crisis (Nod to Maslow)



more mountains to keep that promise.¹⁶ However, one possible exception may be for fixed-term deposits of very large borrowers, who in some respects can be treated like creditors. In the end, such depositors realize that their financial exposure is tied to the stability of the institution – if they themselves spark a bank run, it will be a run on their own money. This could be a case where some sensitive negotiations may be a way out – an approach taken by Artemis when dealing with a couple of very large depositors.

The final days of FuegoNord provide a primer for liquidity management of a depository in severe distress, but not yet in the hands of the authorities. The situation in Lagos was especially difficult at the time, as other MFIs had already failed, and depositors were understandably concerned. Unfortunately, due to prior mistakes, FuegoNord's liquidity position was already weak. While it was able to maintain sufficient trust with its savings clients (most of whom had demand deposit accounts) and some inflows were still coming in, its outflows were substantially higher. To meet these cash-flow needs, the MFI was forced to cut its productive assets (i.e. stop disbursing loans), lay off 25 percent of core staff, and cut salaries for the rest. It also employed a scheduled withdrawal technique, promising clients to pay out their deposits on a specified day, and then – critically – keeping that promise. With this technique it was able to avoid an all-out run. It was a last-ditch effort, and in the end FuegoNord did not survive, but it did buy some additional months of life, during which it might have succeeded in securing the new equity it was desperately seeking. Once it became clear the equity wasn't forthcoming, core senior staff left, and the institution hobbled on for another half-year until it was finally closed down by the government for failing to pay taxes.

2. Client Confidence

Clients are the lifeblood of any MFI. Undermining their confidence will result in either a run on deposits (see liquidity above) or a rapid drop in repayments. That means MFIs in crisis must continue at least some reasonable level of loan disbursements, and do

16. Of course this depends on the legal/regulatory environment. The ability to do such "scheduled withdrawals" for demand deposits is already breaking contract, so it assumes an already permissive environment.

it in a way that doesn't obviously communicate the crisis that the MFI is facing. This is especially true for group lending methodologies, which can rapidly propagate and amplify the non-payments that result from loss of confidence.

This effect is exemplified by the case of Hestia, where the decision to stop disbursing in response to a repayment strike only served to entrench the position of the borrowers and the loan agents that were advocating for loan waivers. In some cases, borrowers had tested the MFI's assurances that new loans would be disbursed following repayment of existing loans. When those disbursements were not made quickly, the borrowers interpreted it as a sign of the MFI's weakness and spread that view to others.

On the other end of the spectrum is the example of Artemis, which though it had substantially rolled back disbursements and eliminated many loan products altogether, had nevertheless identified its best clients in the markets and continued disbursing to them, thus gaining valuable spokespeople on the ground.

However, there is one exception to maintaining borrower confidence. For an MFI whose loans are well-collateralized, or which operates in an environment with a strong legal framework and/or credit bureau, the need to maintain borrower confidence need not be as core a consideration in times of distress. Because such environments effectively eliminate the expectation of future loans as the primary repayment incentive, disbursements can be suspended with little effect on repayment rates.¹⁷

For deposit-taking MFIs, the loss of client confidence can be a near death-sentence, unless it happens to be sitting on lots of liquidity. Thus, the need to protect depositor confidence is paramount. The case of Artemis is a remarkable example of how such confidence can be maintained even in the face of severe institutional distress.

17. None of the cases in this sample exhibited such a situation, but it did occur in Croatia in 2007, when regulatory action had shut down all microfinance lending. Despite this, borrowers, whose loans were collateralized by salary and who were aware of the relative efficiency of the legal system, continued making payments. The net effect was but a 1-2 percent bump in delinquency levels. (Rozas, 2009)

Artemis entered its self-made crisis insolvent, with nearly all of its liabilities in the form of deposits. Recognizing that liquidation would have entailed substantial losses for depositors, the Bank of Ghana allowed

Whenever a client raised concerns or mentioned a rumor, she would be visited by the branch manager to allay her fears.

Artemis to continue to operate with no restrictions for raising deposits or issuing loans (though under close monitoring). As Artemis entered a period of restructuring, which saw massive changes to its loan products and lending procedures, it zeroed in on the need to maintain depositor confidence. Whenever a client raised concerns or mentioned a rumor, she would be visited by the branch manager to allay her fears. Management repeatedly communicated to staff the importance of not alarming the clients regarding the organization's situation, emphasizing that doing so would imperil their own jobs. And executives took a proactive approach to communicating with large clients, treating them to lunch and listening to their concerns. Meanwhile, the Bank of Ghana provided the necessary support by avoiding any negative public pronouncements regarding Artemis. In the end, the MFI pulled off the feat: By the end of the year-long restructuring, not only had it avoided a bank run, Artemis actually increased its total deposits base. To this day, Artemis clients have no idea that in 2010, the institution went through an existential crisis.

3. Staff Confidence

Any serious crisis will shake staff morale. This is inescapable. However, it is imperative to avoid the worst effects of sagging morale. The first objective is to make sure that disaffected staff do not communicate their concerns to the clients. When clients – whether savers or borrowers – hear from staff that the institution may not survive, they will take the statements at face value and pass them on to others, at which point the institution will be facing the more serious problem of lost client confidence. The wave of withdrawal requests at FuegoNord was in fact partly driven by disaffected staff telling clients that the institution was untrustworthy, and what prevented a worse result was that this was largely limited to just a few branches.

Maintaining staff confidence in times of distress is a major challenge. In many situations, other require-

ments like the need to maintain liquidity will often entail layoffs, salary cuts, and almost certainly cuts in benefits and perks. These are guaranteed to create disaffection, but how they are carried out is important. At the end of the day, staff are more concerned about the future than the present – if they are convinced of management competence in dealing with crisis, they will be more likely to bear the pain. And one must not neglect the human side of management. Staff who recognize that management cares about them and is acting out of sheer necessity will be more responsive than if they walk away with the impression that they are little more than disposable resources. However, compassionate management can only go so far – it might mitigate the effects of cuts and layoffs, but it won't work for outright salary suspensions. Delaying salary payments or issuing IOUs is simply the last gasp of a dying institution. At that point, one might as well take the honorable step and throw in the towel.

As a general rule, it's best to get cuts done in one fell swoop rather than incrementally; the effects on staff morale of a stretched-out layoff process are far more damaging. Naturally, where fraud or massive incompetence is involved, do not hesitate to fire responsible parties outright. However, in some cases they can be used to collect on the fraudulent loans they made – an approach taken by Phaethon.

Artemis offers a wealth of lessons for dealing with staff issues. The company faced a problem of high staff costs relative to market, so cuts were unavoidable. Part of the job was done by freezing salaries and letting inflation – a hefty 18 percent – take care of the rest. The other part was a large cut in benefits. The resulting disaffection was real (prior management had promised a 40 percent pay hike for the year), and 22 percent of the staff left over the course of the year (a positive development, given the company's excessive staffing level). However, staff received open, transparent communication, along with a promise of pay raises once the restructuring period was completed.

Withdrawal requests at FuegoNord were partly driven by disaffected staff telling clients that the institution was untrustworthy.

Artemis was also creative in dealing with staff. After selling 13 vehicles from its bloated car fleet, the institution was left with 13 excess staff, namely the drivers. The obvious choice would have been to lay them off, paying them legally mandated severance in the process. Artemis found a better way – it retrained these drivers to mobilize borrower groups. After all, the drivers had the minimal education required and were members of the same social class as the target clients. In the process, Artemis was able to jumpstart its new group lending strategy, saving money on both hiring and severance costs and buying itself a small morale boost in the process.

These are just a handful of examples. For the rest, general management literature is full of books dealing with how best to approach staff cuts and layoffs. These books are worth consulting when facing the decision.¹⁸

4. Creditor Confidence

For MFIs that have large borrowings, being transparent and proactive with creditors is critical. In many situations, debts will need to be rescheduled or restructured. In worst-case scenarios, they will need to be partially written off. As much as possible, the MFI needs to maintain trust with its creditors so that creditors will be more willing to take the difficult decisions that will ultimately protect their ability to recover as much of their funds as possible.¹⁹

Debt restructuring played an important role in the turnaround of Caravela (Kazakhstan) and was attempted at Loki (ECA), but it is best highlighted by the case of Belavoda (Southeast Europe). Belavoda's ability to negotiate a one-year extension in principal repayments with each creditor was critical to avoiding default and its consequences. However, the experience also highlights how the presence of large numbers of creditors – 12 in Belavoda's case – can complicate the already difficult requirement for unanimity among creditors, without which debt rescheduling cannot be accomplished.

18. See for example: N. Frederic Crandall, *The Headcount Solution: How to Cut Compensation Costs and Keep Your Best People*. McGraw-Hill, 2003.

19. For more on debt restructuring, see *Charting the Course: Best Practices and Tools for Voluntary Debt Restructurings in Microfinance*, IAMFI and Morgan Stanley, 2011.

Rescheduling or restructuring debts is, at its core, a case of the prisoner's dilemma.²⁰ As a group, the creditors all realize that not reaching an agreement would make each of them individually worse off, and all would prefer to avoid a default if possible. However, in order to reach the agreement, they each have to sacrifice something. The complication here is that the creditors each face a different set of calculations. An asset manager overseeing a closed-end fund with a fast-approaching maturity faces an implicitly higher cost for extending loan maturity than a creditor that has no investor payouts on the horizon (both cases present in Belavoda). Creditors with stricter sets of loan covenants, such as higher thresholds of profitability or lower allowable delinquency rates, may find it more difficult to agree on a common set of ground rules. Finally, the different decision-making groups and individuals inside the creditor organizations that play a role in the restructuring approval process can further complicate the process, making even obviously positive outcomes difficult to achieve.

Creditors themselves have learned much from this experience and improved their internal procedures for managing restructurings. Similarly, those creditors who have proved uncooperative or who acted in bad faith in past rounds of restructuring will get their comeuppance in future rounds.²¹ Such repeated rounds of restructuring should make the prisoner's dilemma more manageable, but the (one hopes) relative infrequency of restructuring may not be sufficient to enforce behavior through retaliation alone, especially when so many players are involved. It may be useful for creditors to consider establishing another process altogether – something akin to a bankruptcy court (see box).

There is no honor in running down an institution's core liquidity or undermining its client or staff confidence to critical levels in order to meet debt payments.

In some cases, when negotiations don't yield the required results, the MFI may need to act unilaterally

20. For a concise yet useful summary of the prisoner's dilemma, see wikipedia.org/wiki/Prisoner's_dilemma

21. One creditor stated this directly: "To those who take the money and run...people don't forget. Behavior comes back to haunt you." (IAMFI 2011).

A “Bankruptcy Court” for MFIs?

Many countries where microfinance is active lack bankruptcy laws that force lenders to restructure debts through court order. For MFIs and their creditors, this creates a trap: Since most restructurings require unanimous agreement among creditors, they can be very difficult to implement, even when they are to the obvious benefit of the large majority of the lenders involved. As an alternative, microfinance creditors should consider using a special mediator as their own “bankruptcy court.” The mediator could then be called upon to adjudicate cases where an MFI requires debt rescheduling and restructuring.

– through default. Between institutional failure and default, default is the lesser evil. There is no honor in running down an institution’s core liquidity or undermining its client or staff confidence to critical levels in order to meet debt payments (Figure 2). No doubt, if a solution can be found to meet creditor demands while protecting these more important needs, then of course it should be pursued with full vigor. But when this is not possible, only one real option remains: default.

At a minimum, default will focus creditor attention, which may not always be fully focused until then. It may also set in motion legal action by lenders, the consequences of which can vary greatly, depending on the situation and the country. However, in most cases, legal action is likely to take time – a highly precious resource during a crisis – and that time may be enough to get the MFI back onto firmer ground. The MFI can then face the subsequent consequences from a more stable position. Default is not a decision to be taken lightly, but if it is to be taken, sooner is better than later, before the institution’s liquidity position has reached critical levels.²² Of course, in situations where default can trigger regulatory action, a different set of calculations would have to be involved.

5. Capital

Preserving capital during times of crisis is critical, especially for institutions that risk regulatory sanc-

22. This was a key finding from one of the cases studied that for various reasons could not be included in the report.

tions – including seizure – if minimum thresholds are breached. However, in most cases, regulators recognize that seizure of an MFI risks undermining the organization’s entire unsecured portfolio. Thus, conserving capital should not come at the expense of undermining the viability of the institution with respect to its clients, staff, and creditors.

However, where capital conservation is critical is in avoiding new investments before underlying problems have been solved and the institution has been stabilized. Expanding into new branches – even if new capital is received and regardless of how profitable the new opportunities may appear – is not an appropriate response for an institution dealing with severe internal issues. Unfortunately, that was exactly the mistake made by FuegoNord, which used nearly 20 percent of a new equity investment to enter into long-term leases on three expensive buildings – despite the fact that much of its operations were still woefully underdeveloped. The very same mistake was committed by Artemis, which signed 20-year leases for 15 new premises that were to become mini-branches, but most of which it never actually occupied.

Conservation of capital also frequently entails an infusion of fresh equity, whether by new or existing shareholders. However, it is imperative that the new investments not be made too soon, that is, not before the institution has repaired the underlying problems that gave rise to the crisis. The presence of such new equity will only ease the pressure on the MFI to make further changes, which are nearly always difficult and thus avoided as much as possible. In the lead-up to its last crisis, Artemis’ shareholders had in fact made just such equity investments, despite the fact that the organization was exhibiting serious problems, including a large operating deficit.

Step 2: Repair Underlying Problems

Once an organization’s immediate survival needs are met, the next stage is to look at getting it back on track and finding and repairing whatever underlying problems caused the crisis in the first place. As mentioned before, this isn’t a strictly chronological issue, and thus many of these activities will take place alongside those above. Nevertheless, the focus in this phase is no longer on immediate survival.

The list of issues at this stage is also far longer, as they essentially relate directly to the specific problems facing the institution – improving systems and processes, resetting growth expectations, enhancing audit and monitoring, and so on. Therefore, we focus below on some of the general tactics that are likely to be relevant in a large number of cases, and thus are helpful to consider.

1. Address Collections

An MFI facing high rates of delinquency must attempt to return to normal operations, while working to minimize total loss. The first requirement takes precedence in all cases; however, once the situation has been sufficiently stabilized, it is useful to look at collecting on loans that are still overdue. Moreover, focusing on collections has additional benefits besides providing a means to recover funds.

First, collecting on delinquent loans provides an opportunity to generate much-needed cash flow. Furthermore, assuming a loss reserve has already been set aside for these loans or if they have already been written off, any collections made will accrue directly as income, less the administrative cost required to carry out the collections. But these important considerations aside, a serious focus on collections also provides the institution with the opportunity to reconnect with a large segment of its client base, and through perseverance, potentially help reestablish some lost credibility as a lender. In cases where collections had previously been lax, refocusing on the issue may help shift the organizational attitudes towards collections, which can have benefits for normal operations as well. This was found to be the case at Artemis, whose reputation as a “soft” lender had to a large degree contributed to the crisis in its portfolio. Refocusing on collections with a seriousness of purpose allowed Artemis not only to reduce its losses, but also to improve its image among clients, which significantly improved its long-term sustainability.

When collecting on overdue loans – especially long-term overdues – it is usually helpful to provide both positive and negative incentives for borrowers to repay, such as interest waivers and threats of legal action, respectively. Interest waivers can be a risky strategy, since providing them can undermine the

performance of current loans. However, the tactic was employed to good effect by Bank Dagang Bali during the final phase of its liquidation, when there were no current loans outstanding anymore. An alternative and perhaps less risky strategy would be to reschedule payments or reduce or waive accumulated penalties.

The use of a “bad bank” arrangement, where delinquent loans are explicitly separated from the rest of the portfolio, can also be helpful. In some cases the loans could be sold outright, in other cases this arrangement facilitates better targeting for special collections efforts, while removing unnecessary distraction from day-to-day lending operations. At the same time, it helps the new operations focus on tracking the performance of the new portfolio, without data “noise” from the legacy portfolio.

Whatever strategy is adopted, it goes without saying that no collections should ever use strong-arm tactics that undermine privacy and personal dignity, even in countries where such actions are not explicitly proscribed.²³

2. Replace Management/Board

In some cases, it is best for management and/or the board to be replaced. Starting with a clean slate helps the organization focus on the turnaround without being held back by prior decisions or mistakes – something that former managers may have a harder time avoiding. Naturally, newly brought-in managers come without the deep knowledge of the institution, but with rare exceptions, the value of such knowledge is far outweighed by their fresh perspective. Moreover, it may be easier for a new manager to make decisions affecting staff than might be the case for an existing manager. And in some situations, new management and a reconstituted board can actually help restore the confidence of creditors and staff.

Normally, the sooner this is done, the better. However, there are exceptions: In the rare cases where the cause of the crisis was largely outside the manager’s control, it makes sense to retain current management.

23. Refer to the Smart Campaign’s Client Protection Principles for more information.

In other cases, removing managers may be difficult due to lack of board independence, and especially when the manager happens to be a large or even majority shareholder. Unfortunately, in such cases the likelihood of the turnaround's success is also greatly reduced, as was the case in Hestia and FuegoNord. On the other hand, in the cases studied, successful turnarounds featured both replacement of management and board (Artemis) and retention of both (Caravela and Belavoda).

What goes for the management goes double for the board. Reconstituting the board can be done on a partial basis, thus taking advantage of both institutional knowledge and a fresh perspective. Moreover, reconstituting the board provides the added opportunity of bringing in individuals with specific expertise needed for the turnaround.

Perhaps the most impressive story is that of Artemis, whose new board was seated after the central bank forced the previous management and board to be replaced. One of the most critical decisions by the new board was to retain a specialist consultant with turnaround expertise, and then bring him on as interim CEO. The new CEO and reconstituted board went on to oversee a complete revamp of the organization, including a new lending operations process, near-complete revision of loan product offerings, implementation of new HR policies, and complete repositioning of the company's long-term strategy. Not surprisingly, at least some of the board members were experienced microfinance professionals and were actively involved in monitoring the situation.

But timing and other circumstances ultimately dictate. FuegoNord also brought in consultants and even a new board chair, but the latter proved to be too late to avert failure. As for its consultants, while they made important contributions, they were unable to overcome the weaknesses of the organization.

Step 3: Strategic Redirection

It might appear that resolving underlying problems and getting an MFI back on the path of normal operations should signal the end of the crisis. And from the perspective of near-term risk, it probably does. But in fact only a minority of turnaround cases emerge without the need for deeper rethinking. Recall that most crises are triggered by an external event, often an economic downturn. And such events often have the effect of significantly altering market conditions for a period of time, and possibly even permanently. More often than not, after fixing their internal problems, MFIs have still more change to undergo to adapt to the changed market environment.

A large shift in market positioning and strategy were important components in two of the three turnaround successes, Artemis and Caravela. During the course of the turnaround, both reoriented their operations downmarket using group lending. In the case of Artemis, group lending was introduced in the same urban environments where it already operated as a way of building its own niche within an already crowded microfinance market in Accra. Meanwhile, Caravela went even further and shifted operations to rural areas. Indeed, Caravela's strategic redirection proved so extensive that the organization became all but unrecognizable. It implemented the shift in the first days of the crisis. Three years later, with its "missing-middle" clients continuing to flounder, Caravela had reduced the staff dedicated to this portfolio to just one loan officer.

This redirection to new target markets wasn't just limited to turnaround successes. In the case of Hestia, while the organization itself did not appear to have successfully recovered from its crisis, it was able to survive by focusing on the recent launch of a subsidiary, Hestia Bank, whose wealthier, more urban, and more male individual loan clients were substantially removed from Hestia's poorer, rural, and mostly female borrower groups.

Section 4. When All Else Fails: Administering the Last Rites

Planning for crisis is part of traditional risk management. Planning for failure is not. Yet there are times when failure is unavoidable, and planning for it is no less critical, so as to insure that impact on clients, staff, creditors, and the local market is minimized. That said, it is neither reasonable nor helpful to expect MFI staff to contemplate the subject themselves, especially when dealing with an immediate crisis. Thus, this type of planning should be left in the hands of investors and government authorities.

While turnarounds were attempted in nearly all cases studied here, not all succeeded. Yet in their failure, those MFIs that ultimately closed also left behind valuable lessons.

After taking over Bank Dagang Bali, the Indonesian regulatory authority put in place a liquidation team, headed by the company's former COO. The team proceeded to carry out a long, drawn-out liquidation that lasted some five years, but in the process, it succeeded in recovering the bulk of the assets.

In the case of Phaethon, the Moroccan government recognized the potentially catastrophic effect the institution's failure would have on the overall microfinance market in the country, and engineered a quiet merger with a subsidiary of a state bank. Though operations were greatly scaled back and many branches closed, the negative effects were successfully localized and the rest of the industry was unaffected.

But perhaps the most difficult case was that of Loki, where the investors faced the prospect of unraveling one of the most complex frauds in the history of microfinance, and separating it from the legitimate operations of the institution. The process entailed letting go of large numbers of staff that were involved in the fraud, then dealing with efforts by that same staff to undermine the organization's efforts to pursue recoveries. But partly because the fraud was centered in one branch, the management was able to continue collections on a large portion of the portfolio, at last writing recovering some 65 percent of the outstanding amount.

Conclusion

We began our exploration with an admonition from Eleanor Roosevelt to learn from the mistakes of others. And the preceding pages are filled with numerous reminders of just how many different ways MFIs can fall into crisis, and how many more mistakes can be made during the crisis itself.

But there is also much that went right. It is inspiring to learn from MFIs that realized the difficulty of their situations and focused their energies on rebuilding their institutions, often from the ground up, using the lessons of their own mistakes combined with useful advice from outside to right their ships. Of the many lessons packed in these pages, the most pertinent ones are to take things in stride: don't panic, take the time to think things through but then be decisive, and most importantly, listen to advice. For there is no more important time to have an outside perspective than when mired

in an existential crisis, with one's thinking clouded by prior mistakes, what-ifs, and assigning of blame.

Ideally, an MFI will be lucky to have experienced members on the board. But if this is not the case, then seek out expertise from outside and be willing to pay for it. Unless faced with an immediate liquidity crisis, it will be well worth the cost. Every successful turnaround in our study had this advantage of outside expertise – whether through board members or hired consultants.

But above all, do not lose hope. Recognize that no matter the difficulty of the situation, others have probably already been there and many found their compass. Then remember that you have one advantage they did not possess – a small library of their most important lessons. Good luck and sail safely!

Appendix I: Methodology

Conducting this research presented a special challenge – identifying the MFIs that had faced a serious crisis. As such situations are generally not communicated outside a circle of insiders, developing a list of potential candidates required reaching out through individual networks in the microfinance sector. From this a list of 25 MFIs was compiled, and background research on each was conducted.

Of the 25, about 15 MFIs were contacted with the request to conduct the study. Based on the responses and on factors such as the nature of the case study, geographic location, and the MFI's willingness to participate, 12 MFIs were ultimately selected for the study: 8 of which were to be in-depth case studies and another 4 were planned to be “mini-cases.” However, for various reasons, two cases had to be omitted at different points in the study. The resulting list of 10 case studies represents a broad mix of crises and geographic dispersion – three in sub-Saharan Africa, one in Middle East/North Africa, one in Eastern Europe, two in Central Asia, one in South Asia, one in East Asia/Pacific, and one in North America.

Six of the seven case study MFIs were visited in person by one of the two field researchers on the project, who conducted extensive interviews with the principals, staff, clients, competitors, and local market experts. These interviews were further supplemented

by phone and email interviews with directors, creditors, donors, and rating agencies. Where relevant, organizations were asked to provide internal documentation and reports, and external reporting was also utilized throughout, including the MIX Market, and rating, donor, and local microfinance association reports, as well as other relevant references.

To protect the names and reputations of the MFIs and their stakeholders, the study was conducted on a confidential basis. The paper and case studies avoid any mention of organization or individual names, and the names of the MFIs themselves have been changed. In some cases, by request of the MFIs or other stakeholders, reference to the MFIs has been limited only to the regional level, without the mention of a country name. The sole exception of this confidentiality rule has been reference to country-level institutions, such as the central bank, where the reference cannot be avoided if the country itself is mentioned. And in a number of cases, we felt that mentioning the name of the country was especially important, given the importance of the market-level context.

Note that for the three mini-cases interspersed through the paper (PADME, ShoreBank, and Bank Dagang Bali), actual organization names are used, which was decided either with the agreement of the interviewees or because the reference sources are already public.

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THE CENTER FOR FINANCIAL INCLUSION pursues the proposition that low-income people deserve high-quality financial services and that these services can best be provided through commercial models that incorporate social purpose. The Center works on behalf of the microfinance industry as a whole, serving as a bridge to leverage private sector interest in microfinance. In collaboration with others, the Center works to bring the best minds and expertise to bear on industry problems. We are outcomes-focused, setting specific goals and measures of accountability for real-world change.

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