



# Ten Risk Questions for Every MFI Board

A Running With Risk Project  
Expert Exchange

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## Foreword

The Running with Risk project at the Center for Financial Inclusion at Accion seeks to raise awareness about the importance of effective risk governance for institutional growth and sustainability. It aims to develop the resources, tools, and trainings needed to improve the risk management abilities of board members at microfinance institutions (MFIs), and the quality of their dialogue about risk with management. The Running with Risk project is creating a common framework and language around risk so both the MFI's management and board of directors understand their roles, and can more adequately anticipate and manage risks.

In the first output of this project, David Lascelles shared his risk insights in a lively, conversational, and often provocative way in the paper *Microfinance – A Risky Business*. Lascelles argued that risk management and oversight are essential all the time, not just during crisis.

Ultimately, the business of lending money and holding other's people money is inherently risky, and this is even more true when working with vulnerable clients in developing countries. Risky operational situations can arise gradually as portfolio-at-risk (PAR) levels sneak up or liquidity slowly diminishes. It is therefore important that boards – the ultimate guardians of MFIs – understand their role in determining and assessing how much risk is acceptable. Boards also have to be able to recognize the warning signs of when risk levels are starting to become abnormal or unacceptable, and be able to raise a red flag to avoid a major crisis. In order for boards to fulfill their role in managing both external and internal risks, they first need to know what they don't know. And in order to do so, they need to be asking the correct questions and ensuring that they receive adequate answers. Effective risk management at the board level means ensuring that the correct policies, procedures, and people are in place to handle any events outside the norm of “business as usual.”

With this risk expert exchange, *Ten Risk Questions for Every MFI Board*, the second publication of the Running with Risk project, the CFI has asked 10 microfinance risk experts to candidly respond to the top risk questions that every board member should be asking, and should be able to answer. We hope this expert exchange will empower board members to speak up when they are uncomfortable about a move an MFI is making, or when they feel an indicator may actually be an early warning sign of a larger problem. This expert exchange is also intended to provide board members with concrete suggestions of warning signs and strategies for effectively managing or avoiding certain risks. Ultimately, a stronger, more effective board presence on risk mitigation will contribute to the health of MFIs around the world.

The Center would like to thank risk experts Lynn Exton, Karla Brom, Alex Silva, Liliana Botero, Daniel Rozas, Petronella Chigara Dhitima, Stephan Hartenstein, Andrés Calderon, Christian Ruehmer, and Philip Brown who so graciously shared their time, experience, and knowledge with us for this questionnaire. We would also like to recognize Citi Foundation and Citi Microfinance for their generous financial and intellectual contributions to the Running with Risk project.

*The opinions expressed in this publications are the authors' and do not necessarily reflect that of their respective institutions.*

## 1. How Should Boards Be Involved in the “Risk Conversation”?

**Alex Silva**

Before we can talk about the risk challenges boards face, we need to get boards seriously talking about risk. Risk is a board issue, a fact few directors would disagree with. However, many directors have yet to take risk to heart. Risk culture at the board level needs to be strengthened with a more proactive attitude toward risk management, an activist role for the board, and well-structured procedures.

To start, microfinance institutions and their boards need to recognize that risk mitigation does not fall solely under the purview of the risk manager. At the institutional level in recent years, MFIs (particularly Tier 1 MFIs) have begun to decentralize risk management. However, this lateral shift in responsibility rarely climbs up the governance ladder into the boardroom, and boards remain largely silent in the risk conversation. While some regulators impose risk management requirements on boards, few directors move beyond these requirements to make comprehensive risk management a top priority. This reluctance can be detrimental to institutions, as recent literature on failures among MFIs points out. Poor governance is the leading cause of institutional failure. There is perhaps no surer path to failure than a lethargic response by the board.

This lack of attention to risk does not necessarily emerge from a lack of interest. The division of responsibility between board and management in this area is a fuzzy, shifting line. In corporate risk management practices, there are functions assigned to the board, but these corporate practices do not always apply well to MFIs. Additionally, there is no differentiation of methodologies, tools, and techniques according to the degree of institutional development and sophistication of MFIs, making it difficult to implement appropriate risk management in institutionally less developed MFIs (institutionally vulnerable). Consequently, many of these functions fall by the wayside in MFI boardrooms. Directors should be disabused of this tendency to discard non-applicable risk mitigation methods. Instead, they should proactively seek to improve in-house risk management practices tailored to MFIs and/or hire outside expert assistance to improve board-level risk controls.

MFIs face risks beyond those traditionally cited in corporate risk management literature. Historically, boards step in when a risk is potentially critical to the institution. In other words, the criterion for board involvement in risk management seems to be quantitative: How big is the risk perceived to be? This method excludes the board from much of the day-to-day risk conversation. To inject themselves in the risk conversation, directors can elevate the importance of often overlooked risks – the ones at the bottom of the risk manager’s priorities as he/she deals with the more traditional risks (credit, financial, or operational). These often-overlooked risks include reputational, political, regulatory, and external shock risks. These risks are all external to the institution and concerned with how the institution fits into the various environments it occupies (financial, political, economic, etc.). These types of risks call for clear leadership, integrity, and direction at the top. Thus, an opportunity emerges that makes a board’s role in risk especially qualitative; how do we navigate this institution through stormy environments? Of course, this does not mean that boards should be excluded from dialogue on credit, liquidity, market, or operational risk, but simply that there is an opportunity for boards to both step in and address the often overlooked or less quantifiable risks, and adopt a broader and more activist role in risk mitigation.

As boards take on a more proactive role, directors will need to be more knowledgeable about risk management. Boards need to find the right tools, procedures, and outside help to share best practices in the microfinance industry. There are many corporate risk literature and tools available, but very few tailored to the needs of MFIs that face vastly different landscapes than a typical commercial bank. For example, few commercial banks lend to informal businesses or clients without credit scores. Even fewer banks have to worry if serving a new clientele will lead to accusations of mission drift, or if their credit officers' motorcycles will break down on rural roads and pose a safety hazard for the credit officers. Thus, it is of critical importance that in this socially oriented industry, boards monitor mission adherence and ethics lest they face a crisis like that faced by the microfinance industry in Andhra Pradesh, India, in 2010. For an industry concentrated in volatile emerging markets, board involvement in strategic and business continuity planning is critical lest they face a crisis like that of the non-payment movement in Nicaragua in 2009.

To improve board oversight on risk, the board needs to require formal and regular updates pertaining to risk, the regulatory framework, and compliance, and to improve channels of communication between directors and senior managers, at times without the presence of the CEO as such practice allows the board to be better informed about their CEO's performance. Furthermore, the correct identification, monitoring, targeting, and triggering guidelines at the board level can amplify and complement the efforts of the risk management unit, rather than duplicate efforts.

There is certainly a role for boards in comprehensive risk management, and the greatest challenge many boards face right now is in defining exactly what that role is. A shift in the fundamental nature of how and when a board addresses risk needs to take place, and with the right tools and procedures, boards and management can work together in a manner that is complementary. However, clearly defined board roles and procedures will amount to little more than paperwork unless directors genuinely want to engage in a serious, wide-ranging risk management conversation – a priorities shift that may require a little soul-searching.

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### **Alex Silva, General Manager, Omtrix and Executive Director, Calmeadow**

Alex Silva is the President and Founder of Omtrix as well as Executive Director of Calmeadow and represents this Canadian NGO on the Board of Africap, a fund specialized in providing equity and long-term funding to African MFIs. Prior to establishing Omtrix, Silva worked for the Inter-American Investment Corporation (IIC), a multilateral financial institution, as the head of its Central American office. He was the Executive Director of ProFund International, where he was responsible for the management of a regional investment fund specializing in equity investments in MFIs in Latin America and the Caribbean. Silva has served as a board member of numerous MFIs in countries such as Nicaragua, Haiti, Venezuela, Mexico, Colombia, Ecuador, Peru, and Bolivia.



## 2. What “Newer” Risks Should Boards Be Aware of?

### Lynn Exton

Emerging risks are likely to impact every company and MFI in some way: compliance risks, weather related risks, technology related risks, discrimination, employment practices, reputation risk, and more.

To define what we believe to be emerging risks:

1. Risks that have an increase in severity
2. Risks that have an increase in frequency
3. Risks that are new (like cloud computing risks)

The two risks below are among the more significant that boards of MFIs must be vigilant about.

**Reputation risk.** In age of instant communication, positive and negative information can be transmitted instantaneously and spread globally before the target MFI has time to react. Boards therefore need to be proactive and be able to respond to a range of qualitative and quantitative events, which together can impact the organization’s reputation. If mishandled, such “headline risk” can lead to a damaging impact on the MFI’s ability to raise funds from donors and lenders. An example of this is the public scrutiny on the question of whether microfinance is delivering on its promises to lift millions out of poverty with its products. MFIs are under the microscope to prove that they are doing what they say they do.

**New technologies.** Weak regulatory environments and internal controls in MFI are magnified by all the “buzz” around the benefits of these technologies, sometimes without providing enough caveats around the need for the appropriate risk management and failure of stakeholders to understand the full extent of risks.

For example, mobile and agent banking as product delivery channels have been adopted by many MFIs. From a risk management perspective, one of the main motivations is to mitigate the risks associated with cash handling by field staff, without compromising the planned outreach.

While mobile and agent banking has many positives, it is clear that new risk can be anticipated from these new delivery channels. The following emerged as new risks in a pilot done at an African MFI:

- Failure to get qualifying agents in the rural areas where many operations are carried out. In many rural areas with the MFI’s clients, it’s hard to get merchants with adequate cash to meet the clients’ needs. Clients’ deposits’ security may also be a concern.
- Group cohesion and client transformation. Weekly group meetings will be reduced significantly, hence clients’ closeness is reduced, possibly affecting the group methodology.
- Product or technology challenges and error. Clients may face difficulties in using the new payment system, especially rural clients who are not familiar with electronic banking. This might create numerous errors and possibly resulting in reputation issues at the end.

### **Lynn Exton, Independent Consultant**

Lynn Exton was the Chief Risk Officer for Opportunity International. In this role, she managed Opportunity International's risk profile and related policies. Before joining Opportunity International in April 2008, she worked with Moody's Investors Service, Merrill Lynch, and Chase Manhattan Bank where she was based in London, Hong Kong, New York and Rio de Janeiro. Exton has been involved with the SEEP's Financial Services Working Group since 2009. She has been a member of the SEEP Network's Board of Directors since November 2010.

### 3. How Can Contingency Plans Be Used Effectively to Prepare for a Variety of Potential Risk Scenarios?

**Karla Brom**

Board members need to be involved in the strategic and annual planning processes, and need to set the risk appetite for the organization. It isn't enough to look only at the annual and strategic plans and risk appetite assuming that everything will stay the same as it is today. In addition to planning and approving for "business as usual" or business as it is today, boards need to look at and anticipate a variety of adverse scenarios and make sure the MFI has a plan in place in case those scenarios do happen.

One example is continuity of business (COB) planning. All MFIs should have a plan for what will happen in case of a natural disaster, or another serious event that could potentially disrupt the continuity of business (this could include loss of a key manager). The COB plan needs to go into sufficient operational detail so all management and staff know what is expected of them in order to keep the business going during an unexpected crisis event, and may even include some "drills" to see how it works in practice (for example, if there were a fire at the head office, are employees prepared with evacuation plans and call/SMS trees, etc.?). The COB would be designed and documented mainly by operations staff, then approved by the board.

Contingency Funding Plans (CFPs) are equally important, and are usually required by regulators. These are plans that anticipate how the MFI would continue business as usual in the case of a disruption of funding. They are usually prepared by the chief financial officer/finance manager, in cooperation with the risk manager, but vetted through the Asset Liability Committee (ALCO). Normally the MFI needs to have a plan for what they would do in case of a disruption of funding that is limited to their institution, and another CFP for a disruption of funding due to a larger market event, like a natural disaster or run on savings due to political instability. How would the MFI ensure that it could keep doing business and meeting obligations in one of these situations? Would it continue to disburse loans as originally planned? Does it have a standby letter of credit it can draw on? Would equity owners step in and inject liquidity? The actions that the MFI can take to access additional funds are different depending on what kind of liquidity disruption occurs (limited or market wide). Boards should understand the CFPs and approve them. They should be reviewed and updated quarterly by management to make sure that all actions are still reasonable, and any changes should be presented to the board for approval as well.

Finally, MFIs should be doing many types of stress testing and have a plan if the potential worst-case scenario happens. An organization doesn't do business in the same way when they are in crisis as they do when they are not in crisis. Some examples would be to look at what might happen if funding costs increase by 1 percent, 2 percent, 3 percent etc., or if foreign exchange rates change significantly, or if PAR increases significantly. If MFIs perform stress tests they can anticipate the potential negative impacts of any changes and agree, in advance, to how they might shift their business strategy in the time of stress. It is also important to then monitor macro indicators that will give management an idea of what is going on in the economy in which they do business, and in the economies where their funding sources are located. This monitoring forms a type of early warning system that the business environment is changing and the business plan will have to change as well.

In my experience, MFIs and their boards do very little of any of the above and are then often scrambling to respond to crisis once it happens. Time invested up front to think these things through can save a business if and when the worst-case scenarios happen.

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**Karla Brom, Consultant**

Karla Brom is an international banking and finance expert. She has been advising and training on microfinance and financial risk management since 2001, working with Accion, ATTF/ADA, Banyan Global, CGAP, Citi's Global Microfinance Group, EFSE, EBRD, Grameen Foundation, the IFC, MEDA, Mercy Corps, SEEP and Women's World Banking. Brom was formerly a Senior Vice President at Citi, where her responsibilities included risk management oversight of Citi's 23 branches in Latin America.

## 4. What Are the Most Important Risk Management Measures a Board Should Focus On?

### Liliana Botero

Board members should focus on the key measurements that are essential for defining the organization's risk appetite, and they should oversee the risk culture of the microfinance institution to keep it in alignment with the strategy and objectives of the business. The board has a responsibility to establish and monitor these measurements, which should be embedded in the institution's risk management framework and processes.

If the board fails to define the microfinance institution's target market, set explicit goals, or determine risk tolerance limits, it will not be able to measure progress (or lack thereof), determine if results are good or bad, or analyze the drivers of performance. At a minimum, a board should focus on the measurements of target market, goals, and risk tolerance described below, which represent the key building blocks of an institution's risk strategy and culture. All board members, not just those with backgrounds in banking and finance, are responsible for fully understanding, and monitoring these risk management measurements regularly. Risk is dynamic and affects the institution, so board members must consistently review and either reaffirm or revise the risk strategy and appetite.

The key risk management measurements fall into three categories:

- Defining the target market
- Establishing clear goals
- Setting risk tolerance limits

**Target market.** Key indicators for target market include a) average level of clients' income, b) average sales of client businesses, c) rural or urban market, and d) type of business (industry, trade, services).

**Goals.** The institution's strategy regarding growth and outreach drives goal-setting. These goals are a function of the double-bottom line orientation of microfinance institutions that strive to achieve both social and financial goals. The board focuses on the number of new clients as the basis for revenue and asset growth while outreach can be defined as the total number of clients reached or specific segments of clients as defined by target market indicators above. Key risk management measurements related to goals include a) size of portfolio, b) asset quality, c) profit margin and d) growth rate.

**Risk Appetite.** The board reviews, challenges, and sets the MFI's risk appetite. Risk appetite is the board's view of how strategic risk-taking will help achieve business objectives while keeping in mind the constraints the institution faces. The risk appetite will be articulated in part as risk limits, such as limits on the kind of exposures or implied risks that a bank may take. The board is responsible for setting risk tolerance limits not only for the extension of credit but for all enterprise risk including liquidity, market, and reputation risks. Not all risks are measurable but must be taken into account, e.g. a reputational risk event that could cause a run on the MFI. Some of the most important risk tolerance limits with respect to credit exposure include a) maximum and minimum amounts per customer, b) maximum exposure per group, c) maximum exposure per region, d) maximum exposure per economic sector, and f) maximum exposure per type of credit.

### **Liliana Botero, Vice President for Risk, Accion**

With Accion, Liliana Botero has led the development and implementation of selection, segmentation, and credit-collection scoring for the microfinance industry in Bancosol (Bolivia), Mibanco (Perú), Banco Solidario (Ecuador) and Finamérica (Colombia). Botero's professional participation in the area of risk management includes the design of risk models in Colombian banks, in coordination with the Banking Superintendency and the Banking Association of Colombia, and technical assistance in credit risk for Banco Solidario (Ecuador) and Mibanco (Perú). Botero has also represented Fogafin in the Board of Directors of FES and in the Credit Committee of the Board of Directors of Banco Agrario de Colombia. Botero represented Accion in the Board of Directors of Finamérica - CFC. As Credit and Collections Products Manager at Datacredito-Computec (Colombian Credit Bureau), during the past two years she directed the development and implementation of two generic scores for microcredit analysis and the management and surveillance of all credit and collection products.

## 5. How Can Technology Help Manage Risk?

### Daniel Rozas

The first step in using technology in risk management is to recognize that technology cannot manage risk at all. Solid control over operations, a good understanding of the market, a healthy dose of skepticism, and good common sense are far more important than fancy technology. However, as a facilitating tool, technology can be very useful, and in one area – portfolio risk management – it is indispensable.

The key to understanding portfolio trends and to be able to look those precious few months into the future is to have the best possible insight into what's happening inside the portfolio. MFI management can easily miss emerging risks if they rely only on basic delinquency reports, with no further insight as to what may be driving trends, or more worryingly, hiding them. The good news is that getting good portfolio insight requires relatively standard technology, easily available off-the-shelf. The work is in making sure it's set up and used properly.

A prerequisite, of course, is a solid core banking system that can capture sufficient relevant information and store it in a way that makes it accessible. And accessible means right away – querying the data beyond what's available in standard reports shouldn't require asking the IT team to produce a special report that will take two weeks to deliver. Often, this will entail restructuring the data into a format that supports complex analysis and then accessing it through a solid analytical platform.

For example, say your curious and clever risk manager wants to know how many cycle one loans have been delinquent for five or more days at least twice during their first six months? She should be able to do that! And then she wants to look at the performance of these borrowers during their subsequent loans, and compare them to loans that have never been five or more days delinquent. Maybe she wants to separate out those borrowers who also have a voluntary savings account with at least \$10 average monthly balance? She should be able to do that as well. And none of this should require spending half a day finessing the data just to run these queries.

The ability to conduct useful analysis also means collecting data in a consistent way. That also means limiting data collection to truly relevant data and being able to say “no” to yet another data field that may seem like a good idea, but that will never be used. Having an integrated database that links across different areas (such as between current and past credit, savings, insurance, and other activity) is more important than having lots of data. Sure, you probably read that latest McKinsey article on Big Data, but before you head there, make sure your MFI can make full use of the small data it already has.

Making full use of data and technology also means having the right people, but which also means investing in a good risk manager. Data have many stories to tell, but it takes someone who welcomes the challenge of teasing them out, whose eyes light up over at the mention of the word “database.” At the same time, such a manager must be able to relate those data stories to the real world. A good risk manager should spend at least one day a week in the field, sometimes with loan officers and sometimes going incognito, so as to get the pulse of what's really happening on the ground. Ultimately, the technology platform will only be as good as the person using it.

Once you have met those three requirements -- good data collection, a solid analytical platform, and a good risk manager -- don't forget the next step: instilling an appreciation for risk management in the organization's culture. And one of the easiest and most effective things you as a board director can do is insist on receiving direct updates from the risk manager. Remember, technical gadgetry is often enticing and can help your organization stand out. But in the end, having the basics will give you a far better return.

## **Daniel Rozas, Consultant**

Daniel Rozas is a microfinance consultant based in Brussels, with broad-ranging expertise, including risk and crisis management, business strategy, market analysis, funding, and client protection. Rozas advises clients across all levels of the sector, including MFIs, regulators, investors and investment managers, networks, and support organizations. Prior to entering microfinance, Rozas worked for the U.S. mortgage investment company Fannie Mae where he held multiple roles from 2001-2008. Rozas has been co-author of various publications, including CGAP's *Foreign Capital Investment in Microfinance: Reassessing Financial and Social Returns*, *Indian Microfinance Goes Public: The SKS Initial Public Offering*, and *All Eyes on Asset Quality: Microfinance Global Valuation Survey 2010*.



## 6. How Can MFIs Identify and Prevent Fraud?

### Petronella Chigara Dhitima

A typical answer to the question “who identifies fraud?” is the internal audit team. However, staff members and clients identify most fraud, and naturally so. Staff members work together on a daily basis, interact with clients, and can see and hear what goes on both in the field and in the office. Usually by the time fraud is recognized by the internal audit team, most staff members within the unit or branch already know. How then can MFIs ensure they receive information as soon as a fraud is identified? There are numerous ways which revolve around two core issues: creating a culture of transparency and integrity among staff members and clients; and educating clients on their rights and ensuring there is a mechanism for whistle-blowing. The MFI must create a culture where every staff member has the confidence and ability to speak out when things go wrong.

When clients know their rights and obligations, it's easy for them to point out deviations from the norm. Providing a platform through which clients can speak goes beyond just collecting complaints and suggestions from clients. MFIs should exhibit values and an image that promotes client feedback. Client complaints should be analyzed periodically to check for trends and red flags. For example, a client complaint on charges may be referring to an MFI's charges but could also be an indicator that clients are being charged more than what is stipulated. Additionally, at the operational level, management should speak directly with the borrowers. In some instances, the client is unaware that transactions are being handled incorrectly. Therefore, when asked to explain their loan acquisition process, they will give an honest answer that will sometimes expose the existing fraudulent activities. Customer forums, market research, and client satisfaction surveys provide ample opportunities for identifying pointers to fraud. Even at a board level, there should be ways of staying in contact with the borrowers.

Operational spot-checks are also often used to check on adherence to procedures and pick out fraudulent transactions. There should be monitoring systems where supervisors check on the work of their subordinates. Methodology and financial audits can also be used to identify fraud. One of the variables that should not be overlooked in audit samples is “excellent performers,” especially for loan officers. Excellent performers who are highly productive may easily hide fraudulent activities within high-volume transactions. Senior managers should use the audit reports and risk reports to detect fraud. Senior management should establish and constantly look out for early warning signs and red flags. At the board level there should be subcommittee members who always check board reports including risk reports, specifically ratios, variances, and trends. It is also critical to ensure that an internal audit is independent and reports directly to the board of directors. Client complaints should be reviewed and analyzed; what issues are coming up and what has management done to deal with these complaints? Market research and client satisfaction surveys should also be done by independent people (such as individuals at headquarters doing research in branches).

Information Technology reports are very helpful when looking at anomalies on system access levels, managers, and staff rights, and review overrides. In addition, a spot-checking system where supervisors randomly check on tellers, the loan disbursement processes, and others will contribute to identification of fraudulent activities. Supervisors should be vigilant with field monitoring by visiting clients and checking compliance to policies. Senior management's vacations should also be analyzed (who is not going on leave and why?). Lastly, in regards to treatment of fraudulent cases, one should identify how many cases get to the board and how does the management deal with them.

With regards to fraud prevention, there should be clear policies and procedures in place for all areas of an MFI. These should include: policies and procedures for credit processing, approval and disbursements limits for each level, cash handling, IT, delinquency, purchasing or buying, rescheduling, and writing off loans. Operational policies should clearly outline segregation of duties, where for example, the person who approves the loan does not disburse the loan, maintaining the dual custody, and cash limits.

Human resources policies should outline what constitutes fraud, how fraudulent cases are treated, and penalties for different fraudulent activities. Staff and management rotation is also very useful. Microfinance is a relationship-oriented business. Typically front-office staff establish close relationships that may be exploited by fraudsters. By rotating the staff so that the same staff is not always serving the same clients, it is possible to destabilize these relationships and often fraudulent transactions are uncovered. The rotation should include branch managers as well. MFIs should develop recruitment policies and procedures that ensure that people with integrity are hired. Compensation levels must also be fair and market related. Vacation policies must be implemented, with both staff and management taking vacation as and when it is due. Promotion should be on merit, with clear guidelines on who qualifies and why. A performance management system should include qualitative variables that assesses one's adherence to institutional values.

Many of the identification methods can also prove to be preventative measures. A culture of zero tolerance to fraud is a prevention strategy that also promotes detection. MFIs that promote openness, transparency, and integrity educate their clients and collect and analyze client complaints. Fraud generally thrives where there is confusion, complex processes, or a high volume of disorganized transactions. Maintaining clear, simple, streamlined processes that are free of clutter, even in physical office appearance and organization, is a simple yet crucial step in preventing fraud.

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### **Petronella Chigara-Dhitima, Senior Operational Director, Accion**

Petronella Chigara-Dhitima is a consultant to Accion as part of its global training team based in Zimbabwe. Prior to this role, she was Accion's Africa Hub Manager and Project Manager. She led the technical assistance team for the microfinance program EB – Accion and headed the Africa Training Center based in Ghana. Chigara-Dhitima has taught at the Boulder Microfinance Training program for the past 10 years. She brings more than 19 years of experience in microfinance, SME development, and organizational development across Africa. Chigara-Dhitima has held operational, managerial, and senior advisory positions in microfinance institutions at both wholesale and retail levels, including Accion, International Labor Organization (ILO), CARE Zimbabwe, and Zambuko Trust.

## 7. How Can MFIs Be Prepared to Identify Risks?

### Stephan Hartenstein

There are three main components that ensure that the necessary information about risks is identified:

1. A well-functioning risk management system
2. Expertise and skills to process the risk information appropriately
3. Risk awareness among all employees, from doorkeeper to board chair

Let's look at the risk management system first since it's the core of an institution's measures to contain risks.

Risk management is mainly a process, in many respects very comparable to other business processes like accounting, human resources, etc. The main process steps in risk management are:

1. Identification
2. Evaluation and quantification
3. Treatment
4. Monitoring and control
5. Documentation and communication

Identification can be considered the most important step since it starts the process and if not identified, risks are hard to manage. So the institution should execute some regular activities to ensure risks are identified and information about them is collected professionally. This, for example, can be achieved with thorough risk assessments. In such risk assessments business experts and risk experts review current business processes with the purpose of identifying possible gaps that would allow risks to materialize. Another standard process to identify risks is a new-risk-approval process, which is basically the same thing, but for new products, processes, or systems that are in the pipeline for implementation. A third tool is a risk event management system, which ensures professional management of risks once they have materialized. In a way, this is just another means of identifying a risk - by becoming aware once it strikes.

Once risk identification is implemented, the institution would surely be able to collect most of the risk-relevant information it needs to know. Of course, that does not work automatically so risk professionals need to be there to execute the process professionally and to understand the information collected, ensuring the right conclusions can be drawn. This means an institution needs to have qualified people to collect risk information as outlined above, to be able to quickly evaluate the severity of the risks identified and then, to support management taking the appropriate measures to deal with the risks. In addition, managers need to understand risks to be able to take well-balanced decisions that fit the institution's objectives and strategy. And lastly, board members or other control risk guardians need a good understanding about relevant risks so they can set the right strategic goals in the first place that correctly reflect the institution's risk appetite and risk strategy.

Lastly, all of the above will fail if there is no overall awareness and understanding about risks and risk management in the institution. So, in order to complete the system to ensure all relevant information about risks is captured and processed as it should, there must be regular risk training for all people working in the institution. The point is that the risk experts, who know how to deal with the different risks the institution faces, are dependent on the information passed to them by others. Risk managers surely have many possibilities to identify risks (as outlined in the first section above), but there are two factors limiting their capacities:

- They don't understand business details as well as the people executing the business
- They are not present everywhere to "smell" the risks

Fostering cooperation between risk managers and everyone else in the institution is important in order to spin a comprehensive safety net. This can be achieved by regular training and information sharing among all staff to support them develop their own risk management skills in addition to their business skills.

To conclude, the above considerations hold for every type of risk – external risks, credit risk, market risks, or internally caused operational risks – and it goes without saying that management and board members need to have a good understanding about all these risks to successfully steer the institution. Building adequate risk management capacities in the way outlined above may take a few years, and one main challenge for MFIs is the lack of risk management skills in local markets. External support may therefore be very much required.

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### **Stephan Hartenstein, Managing Director, NomoRisk GmbH**

Stephan Hartenstein has broad expertise in management and governance in the financial industry. He has also provided consultancy, project management services and training for more than 20 institutions, with a focus on microfinance. Hartenstein was Global Head of Operational Risk Management at ProCredit Holding AG where he was in charge of building risk management standards in the ProCredit group. Prior to this, he was the COO of JPMorgan Asset Management in Germany. As COO, Hartenstein was responsible for all operational areas at the German office, including risk management, audit, finance, tax, legal, operations, and client services. In 2011, he founded NomoRisk GmbH, consultancy firm focused on servicing small financial institutions and MFIs in the area of risk management.

## 8. What Leads a Client to Over-Indebtedness and What Are Some Preventative Measures?

### Andrés Calderon

Although over-indebtedness is a recurring challenge in the financial industry, it is an emerging phenomenon in the microfinance industry. Originally, MFIs were unique in their markets and could assume clients lacked access to other sources of debt. However this has changed with the growth in both the number and scale of MFIs.

Over-indebtedness has long been one of the consequences of competition, as has been seen with consumer lending when lenders prefer to reach out to experienced borrowers in order to minimize risk. As a result, provisions were made for a percentage of clients who were expected to be over-indebted. This, however, is a vicious cycle incited by lenders especially in saturated markets where the lender will find a good client who has three loans, for example, and has been making his or her payments on time. As the client is a good borrower, the lender would want him or her to take on a fourth loan. Regardless of the three prior loans, as a lender, you want your loan to be prioritized. This desire of lenders causes the borrowers to increase their debt and begins a cycle of over-indebtedness.

The social nature of the MFI industry relies on providing financial services to those who lack them as a mean to alleviate poverty, so it may be concluded that competition should not exist in our industry; however, competition broadens product offering and services, benefitting the end user. However, competition is becoming one of the causes of over-indebtedness among the impoverished.

My experience in tracking portfolio performance has highlighted a very important issue when looking at over-indebtedness, especially in MFI clients. I have found that over-indebtedness is related more with the character of the client than with his or her capacity to pay. Capacity varies from client to client but it is character that prevents a person from getting into too much debt. When one assesses the capacity of a client, the evaluation predicts a very short-term performance. Even with substantial information and history, one can predict 3-6 months into the future at most. However, if you are looking beyond six months of that initial loan, what guarantees that the client will continue to pay is not the capacity (as it will fluctuate), but the client's willingness to pay. This willingness is highly correlated with the client avoiding getting into more, or too much, debt.

The willingness of clients to repay their loans is dependent on a few things. To begin with, the MFI must be consistent and virtuous in both the collection of the loan repayments, as well as treatment of the client. Consistency in collections helps prevent a client from becoming delinquent. In addition, the MFI must portray a strong and positive message that if a client is doing well, he or she will be able to continue to receive loans in the future. As a lender has no control over the external pressure of competition, it relies on the character of clients to maintain loyalty. If they have strong character, they will remain faithful to the MFI no matter what the competition proposes.

As competition has reached MFIs, we have seen a very commercial approach in this newly saturated market. As with consumer lending, the competition will see a good client of another lender and will offer a loan under better conditions, tempting the client to take on the new loan in addition to his or her original arrangement. This is why it is so important to facilitate client loyalty. MFIs' strengths tend to be in their methodology of approaching and approving clients as borrowers, but the retention of clients is a point of weakness. It is almost as if we only remember our clients when it is time to sell a new loan. To keep loyalty high, we must

give our clients a better option once we know what the competition is offering them. If our client receives more loans than the ones we have given, then his or her ability to repay these loans becomes seriously impaired, and we will ultimately lose that client.

In Cameroon for example, Accion's clients are very good at paying back their loans within the first three months, but once they have paid back the sum originally borrowed, willingness to repay diminishes greatly. This means that even if it is meant to be a 6-9 month term loan, if the principal amount has been repaid within three months, clients stop repaying. This behavior must be prevented through keeping client loyalty and willingness to repay high. As there is no credit bureau in Cameroon, there is no consequence for not paying back loans. Instead, the client will go to another MFI and there will be no record of default on any previous loan. It is therefore extremely important for MFIs to promote client education in order to foster both loyalty and willingness to pay.

Haiti also lacks a credit bureau, but has proven to be an interesting case. In addition to client education and effective collections, MFIs in Haiti have begun using an unofficial network where they share information about their borrowers. Although the process is informal, the idea is to eventually have a regulated bureau where one can check the client's performance. Sharing of client credit histories can become quite risky because once MFI A confirms with MFI B that a borrower is "good," MFI B is at risk of their client becoming indebted to MFI A. It is great to know who the bad clients are, but we don't want the competition to know who our good clients are.

Nonetheless, as credit bureaus do not exist in all MFI locations, MFIs must take proactive measures towards the prevention of over-indebtedness among their clients. The most effective ways of preventing clients from falling into this vicious cycle are: constantly monitoring clients through tools and payment collections, keeping the willingness to pay high, maintaining client loyalty, and also through client education.

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### **Andrés Calderon, Risk Vice President Africa-Asia, Accion**

Andrés Calderon is an industrial engineer with experience in credit score development, portfolio management, risk control, and collections, and consumer banking in South America and the Caribbean. He holds the position of Risk Vice President for International Operations in Accion, with specific responsibilities in the non-Spanish speaking countries (Caribbean, Africa, and Asia). His past positions at Citibank include, scoring, portfolio growth, collection, and risk forecasting management for the Latin American region. Calderon served as collections manager in Bank Colmena, country risk head for Ripley CV Financial Company, and consumer banking portfolio manager for Bank Colpatria in Colombia.

## 9. What Are the Main Risk Responsibilities that Boards Commonly Fail to Address?

### Christian Ruehmer

Being a board member of a MFI is a very challenging task. As MFIs are evolving, board members face an ongoing stream of strategic questions and more technical expertise and specific knowledge about financial products are becoming necessary. As an MFI grows, employees and stakeholders have increasingly high expectations for board members.

The challenge for the board member is to be a coach as well as control the management, and stay engaged despite the fact that the MFI is always changing.

Risk management is one changing area. Risk management is no longer just a small function hidden in the finance department. More risk types are becoming relevant including such “exotic” categories like reputational and legal risk. In addition, increased integration into countries’ financial systems also means a higher exposure to interest rate risk and liquidity risk, and increased awareness by the regulatory authorities.

How can board members play an active and useful role for the MFI that faces such challenges?

#### 1. Stay Engaged or Increase Your Involvement in the MFI

The MFI might look different than when the board member joined, but it is still the MFI he or she is representing. This requires a stronger involvement and personal commitment. The board member should spend more time with the MFI, participate in more meetings, pay visits to the institution, and test the products the MFI is offering. One suggestion is to organize social gatherings including dinners around the time of board meetings and invite selected employees to join. If well organized, such gatherings promote information exchange and a better understanding of the tasks and responsibilities on both sides.

#### 2. Don’t Be Defensive

Some board members react with fear and uncertainty to change. This leads to defensive behavior and less exposure. In facing the external world, an MFI requires a very present board member who is approachable. Also be aware that there are high expectations from the stakeholders. A board member needs to be up-front in his or her communication.

#### 3. Accept Personal Limitations and Use Them to Involve More Experts

The technical challenges and knowledge requirements for risk management are complex and occasionally are difficult to understand. Even if the board member has risk management experience, the requirements over the last 10 years have changed dramatically. As a consequence, it is acceptable to either ask for additional explanations or request that specific experts be added to the board or invited as coaches. A board member will not be blamed for admitting a lack of knowledge, but will be held responsible for not communicating.

#### 4. Stick to the Strategy

Board members are responsible for the MFI’s strategy. They need to recognize that the execution of strategies

usually requires more time than hoped. While it is important to make sharp decisions once a specific development does not go as expected, a board member should not turn to tactical adjustments as soon as the strategy is not implemented perfectly.

## **5. Maintain a Positive Relationship with Regulators**

Regulators are powerful, and they prefer transparent and well-managed MFIs. Such a reputation can be built by maintaining a positive and professional relationship with the regulators. If the communication flow is constant and based on mutual respect, then difficult scenarios or small crises can be solved more easily.

## **6. Step Down to Free the Space for New Faces**

If the challenges above become too much, it is the most honorable decision of a board member to step down and free the space for someone with the right expertise. Executing such a step in the regular course of business will preserve the reputation of the board member. Many companies have created advisory boards which reputable members of the community and experts are invited to join. Such advisory boards are not subject to regulations, therefore generally no liability can arise from membership. But the advisory board does allow experts to contribute to the strategic development of the MFI. A departing board member could join such an advisory board.

Board members should know that the challenges they are facing may sound unique but are actually shared among board members in all sectors in all countries. Few board members only face problems with which they are already familiar. It is therefore useful to reach out to colleagues in similar situations. Social networks like LinkedIn might help in contacting other board members and sharing questions and concerns. Just as lifelong learning and an ongoing curiosity is expected from the staff of an MFI, it is equally relevant for board members.

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### **Christian Ruehmer, Independent Consultant**

Christian Ruehmer is a senior consultant in risk management for microfinance for several organizations, including the IFC. He is the co-founder of Perfect Point Partners srl (PPP), a consulting company that focuses on efficiency and risk for MFIs. Ruehmer has worked with MFIs since 2001 and advised over 50 MFIs in Latin America, Europe, Africa, and Asia. Ruehmer's areas of expertise include risk management, treasury management, and restructurings, and he is also a chartered financial analyst and financial risk manager. Ruehmer is the founder of Proyecto Horizonte, a village development project that supports over 800 children and families in Bolivia.



## 10. How Can MFI Boards be Explicit About Risk Strategy and Appetite?

### Philip Brown

It may not be explicitly articulated and maybe just “what we do,” but all MFIs have risk strategy and appetite. Many established MFIs are now regulated financial institutions, with developed and formalized risk and governance practices, so these observations are focused more on MFIs that are growing and transforming.

Each board member brings different perspectives to the table but collectively the board needs a view on the key macro and micro entity and performance risks and their possible impact on the MFI. At a high level these risks can be broken down into Strategic/Business model risks (i.e. clients, products, and delivery channels), Operational risks (i.e. how the MFI functions), Financial risks (i.e. funding, liquidity, FX risk, etc.), and Compliance risks (i.e. adherence to regulations, client code of conduct etc.). However setting and monitoring risk strategy and appetite is not a checklist exercise. There are some on-going broader risk guidance principles that boards might utilize as part of being explicit about risk strategy and appetite.

#### 1. Set Risk Culture/Tone at the Top

Risk management is about managing MFI performance against expected performance. Boards represent shareholders and stakeholders who have an established view on the MFI’s expected performance and business and risk boundaries. This view is evidenced in the plans, guidelines, minutes, and the focus of on-going board agendas. New investors, which signify change, can create a dilemma to maintain this consensus around expected future risk, profile and performance. In any event the view of risk is dynamic. Market vagaries and operational performance will inevitably require on-going risk profile adjustments to strategic, operational, financial, and compliance risks and lending models. This degree of risk tolerance, “how we operate” will trickle-down throughout the entire institution from the board to the management to the individual, daily staff decisions.

#### 2. Create Risk Boundaries

For overall and major business decisions, boards should discuss the potential range of expected outcomes, including the ideal, base and downside cases with a stress testing approach to (operational, credit, funding etc.) risk assumptions. Discussion can then focus on the interaction of these risks identifying “Achilles heel” issues. The range of tabled results or “risk curve” helps to explicitly identify business/risk trade-offs to establish an agreed position and shared understanding of likely downside scenarios and the related financial P & L and Balance Sheet and other risk implications. It is the board that sets the boundaries around the business (clients, products, geography, operational platform, etc. – and resultant risk profile) based on these risk trade-offs and provides direction to management about these risk boundaries and business risk tolerance.

#### 3. Know What You Don’t Know

Part of every board meeting should be dedicated to “looking out the windscreen not just the dials” to identify material strategic risks that are inherent with the MFI’s business model. Once determined, this leads to a shared perspective on the key metrics that need to be monitored. There should be periodic strategic updates and discussion on how changes will impact the business of the MFI, with boards asking “what about this?” to raise concerns over politics, over-indebtedness, etc. The board composition, drawing on relevant knowledge

or experience, should facilitate a collective “reading the tea leaves” to provide an understanding of the larger context within which the MFI is operating. As part of regular business reviews, the board should ask the question: “What don’t we know?” and with that, “Who should we be asking?” How do we “look out the windscreen” to surface unknown risks and implement appropriate mitigating actions to minimize surprises?

#### **4. Risk is Part of the Business**

All financial institutions are inherently in the risk business. Risk is an integral part of the business and should be an aspect of every business discussion and decision. With lending, the upside is interest net margin, while the downside is loss of principal and interest. So, with this, negative gearing risk is at the core of any financial institution’s business model. Risk appetite is determined looking at projected risk exposure against risk bearing capacity and expected returns.

Some established institutions have set up a formal Board Risk Committee reporting to the Board of Directors on the institution’s risk profile and risk management framework, including the significant policies and practices employed to manage risks in the business, as well as the overall adequacy of the Risk Management function. The changing titles of the Microfinance Banana Skins surveys highlight how the macro risk landscape has changed from a focus on entity management/capacity building risks, to external, macroeconomic, reputation, competitive environment, and on-going relevancy to clients. This is illustrative of the ever-changing context which requires an evolving and collectively understood business model and risk position. This requires boards to take a proactive, holistic, informed, and disciplined approach to setting agreed explicit business and risk boundaries and monitoring and managing against them. What are our key context/business concerns? What are the risk profile/performance implications? What are the appropriate mitigating actions? Where might we expect surprises? Have we set the tone at the top and appropriate business and risk boundaries?

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#### **Philip Brown, Managing Director of Risk, Citi Microfinance**

Philip Brown is Managing Director of Risk for Citi Microfinance’s global business. He is the senior credit officer responsible for the development of policies, programs and risk tools to enable Citi’s businesses to commercially engage with the sector. Before moving to Citi Microfinance he was the Risk Manager for Project Finance and Structured Trade Finance within EMEA. Brown joined Citibank in 1971 and has had a variety of client, product, and business management assignments. These span financial institutions, corporate, commercial, investment, and private banking with product roles in cash management and trade. They have included country head; business and staff positions in the United States, Europe, Sri Lanka, Channel Islands; audit and risk review for EMEA; and head of regulatory for Citicorp UK. Brown is a fellow of the Institute of Financial Services, a member of the Governing Council of the Centre for the Study of Financial Innovation, and former Chairman of the Strategic Planning Society.

The Center for Financial Inclusion at Accion (CFI) helps bring about the conditions to achieve full financial inclusion around the world. Constructing a financial inclusion sector that reaches everyone with quality services will require the combined efforts of many actors. CFI contributes to full inclusion by collaborating with sector participants to tackle challenges beyond the scope of any one actor, using a toolkit that moves from thought leadership to action.

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