

College of Agricultural Banking (CAB of the RBI), Pune
& Micro-Credit Ratings International Limited (M-CRIL), Gurgaon

Memorandum: Seminar on Risk in Indian Microfinance

at the CAB campus, Pune

14 January 2011



As the leading institution in India and Asia with a knowledge and understanding of risk in microfinance, M-CRIL has for some time now (pre-dating the ongoing crisis around the AP ordinance) been planning to organise a seminar on Risk in Indian Microfinance. Emerging from the crisis and following interactions on the issue of risk resulting from the developments in the industry over the past 3-4 years, M-CRIL decided to organise a seminar around the issue so that participants could develop a better understanding of

- 1) The status of the Indian microfinance sector as part of the overall financial services industry
- 2) The causes of the present crisis
- 3) Tools for identifying and understanding the various dimensions of risk - from governance and reputation risk to political and financial risk
- 4) Means of managing the specific types of risk identified during the seminar

The **RBI's College of Agricultural Banking, Pune** was kind enough to collaborate with **M-CRIL** for the purpose of this seminar which was held on their campus on 14 January 2011. The **seminar programme** is attached.

Key messages from the seminar

- **High growth** of the order of 90% per annum over a ten year period became unsustainable.
- MFIs sought to **minimize risk by limiting the loan size** to levels that did not adequately serve the needs of clients.
- MFIs faced **reputation risk** from low qualified, minimally trained staff dealing with clients under repayment stress resulting from over-indebtedness and/or rigid repayment schedules.
- The regulators' historical perception of microfinance as a tiny part of the financial sector created a **regulatory vacuum**.
- Growth has led to the **dilution of the tools of risk assessment**. Large MFIs have migrated away from auditors and rating agencies that specialize in microfinance so that MFI audits and rating processes have become routine exercises in the overall business of large firms. **This has led to highly graded ratings and routine audit certificates issued to MFIs with a deteriorating internal control environment**.
- The **nexus of growth and profitability** and the related perception of client exploitation is **created essentially by promoter expectations**; since promoters want high valuations for their shares, investors naturally expect high growth rates and high profitability.
- **A focus on demand-driven products is required**; MFIs need to migrate to an environment where products are designed with the needs of clients in mind rather than the needs of MFIs.
- There is a **need for regulatory forbearance** in the design and **provision of a range of financial products** – deposits, remittances – as well as a variety of loan products.
- Similarly **bankers need to evolve a coordinated approach to lending** to ensure that a responsible growth environment develops in microfinance.

Specific sessions held were as follows

- 1 Recent Trends in the Growth of the Microfinance Sector and its Impact on the Risk Environment – based on the discussion in the M-CRIL Microfinance Review 2010
- 2 Tools for Identifying and Understanding Risk – Financial and Social Rating, Financial Audits, Loan Portfolio Audits
- 3 Managing Specific Risks 1 – Reputation Risk, Credit Risk, Political Risk
- 4 Managing Specific Risks 2 – Governance and Mission Drift, Operational Risk and Financing Risk.

The key issues identified by participants were

- **High growth** of the order of 90% per annum over nearly ten years became unsustainable as the size of the industry grew; it led to problems in client acquisition, staff quality and training, portfolio management and information management.
- MFIs sought to **minimize risk by limiting the loan size** to levels that did not adequately serve the needs of clients thus pushing them simultaneously to obtain loans from other MFIs, leading to multiple lending and then to over-indebtedness (in some cases). The small loan size has also enabled MFIs to hire staff with limited qualifications since they only need to perform routine tasks. The removal of the task of loan appraisal from the equation has broken the historical relationship between MFIs and clients resulting in an environment of micro-money retailing rather than one of empathy and service.

- It was over-indebtedness and rigid repayment schedules combined with the response of staff with limited training but steeped in a culture of “zero tolerance” of delinquency that created the **reputation risk to MFIs**; cases of overbearing behavior if not coercion led to a public perception of client exploitation and, thereby, to the intervention of the state government of Andhra Pradesh.
- The regulators’ historical perception of microfinance as a tiny part of the financial sector undeserving of significant regulatory resources has created a **regulatory vacuum** that enabled the crisis to develop. NBFs undertaking microfinance are regulated, inspected and supervised in the same way as other NBFs, but this ignores the special needs of products, processes and control systems necessary in the microfinance sub-sector which has predominantly low income, mostly illiterate clients.
- Growth has led to the **dilution of the tools of risk assessment**. The growth of MFIs and the advent of international investors as well as the regulatory requirements of Basel II have led to other issues: Large MFIs have migrated away from auditors and rating agencies that specialize in microfinance towards the big five international audit firms and to corporate raters. The net result of this has been that MFI audits and rating processes have become a routine exercise in the overall business of these large firms. They fulfill all the routine requirements of the oversight function but the microfinance context is lost. Exercises by corporate agencies focus on financial statements and head office discussions while branch level checks and such issues as responsibility to clients/client protection, social performance, delinquency management, rescheduling and refinancing, industry growth and competition, MFI staff capabilities, collection practices and work culture and the control environment at branches (not just head office) are ignored. In another context, one MFI leader famously remarked, “We go to people who issue ratings based on balance sheets and high level information. We do not want to risk obtaining ratings from people who know microfinance.”

This has led to highly graded ratings and routine audit certificates issued to MFIs with a deteriorating internal control environment. M-CRIL’s loan portfolio audits of some of the leading MFIs show that the actual portfolio at risk is of the order of 5-7% rather than the 0.5% reported by MFIs.

- The **nexus of growth and profitability** and the related perception of client exploitation is **created essentially by promoter expectations**; since promoters want high valuations for their shares, investors naturally expect high growth rates and high profitability. It is the expectation of high value MFI equity accompanied by “tall promises” on profitability that has stimulated and fed the high growth environment in microfinance leading to many of the ills that have afflicted the industry in recent years.
- **A focus demand-driven products is required:** There was the general feeling that MFIs need to migrate to an environment where products are designed with an integrated livelihoods approach where the needs of clients for the financing of microenterprises, education, health/sanitation are kept in mind. For this purpose, there needs to be an integration of financial sustainability (for the MFI) with social performance (appropriate product design to serve clients).
- There is also a **need for regulatory forbearance** in the design and **provision of a range of financial products** – deposits, remittances – as well as a variety of loan products to enable

low income families to get real access to financial services so that financial inclusion can take place in the long term interests of poverty reduction.

- Similarly **bankers need to evolve a coordinated approach to lending** to ensure that a responsible growth environment develops in microfinance.

Participation in the seminar – 57 persons

Banks	Investors & MFIs (11)	Support institutions/ individuals (11)
<u>Central bank</u> Reserve Bank of India, Department of Non-Bank Supervision (DNBS) General Manager <u>Development banks (2)</u> NABARD, CGM + Principal CAB SIDBI, Executive Director <u>Commercial banks (12) – see below</u>	Arohan ASA India Bandhan Bellwether/Caspian Advisors Equitas Grama Vidiyal Grameen Financial Services Manaveeya Sonata Ujjivan Unitus Capital Represented by CEOs + Operations/Risk Managers	ACCESS Devt Services Grameen Capital IFMR Capital IFMR – Centre for MF Intellectap MFIN (MF Insttns Network) Represented by CEOs &/or Operations Managers Mr Brij Mohan* Mr V Nagarajan, CA Mr YC Nanda* Ms Girija Srinivasan Mr NSrinivasan*
Participation by Commercial Banks (13) – GMs/DGMs of Rural Finance/Priority Sector		
Axis Bank Bank of India Canara Bank Citibank	HDFC Bank HSBC ICICI Bank Indian Bank Kotak Mahindra Bank	Oriental Bank of Commerce Rabobank Standard Chartered Bank State Bank of India

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