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Association Luxembourgeoise de Risk Management

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## Welcome !

Every November, ALRiM, the ATTF and ADA collaborate to host a workshop/conference on risk management and microfinance. The key focus of the conference is to bring together the people who manage microfinance institutions across the world with experts in risk management who are based in Luxembourg. The six sessions of this workshop/conference that have been held in the past have shown how important this cross-fertilisation is, not only for microfinance institutions, but also for Luxembourg, which is strongly committed to supporting and developing microfinance. Luxembourg's expertise in financial risk management is a crucial part of the success that this initiative has shown. In view of ALRiM's participation and support of the initiative "Risk Management Excellence in Microfinance", this issue of the

ALRiM Risk Newsletter is dedicated to risk management and microfinance. The issue contains an article by **Kevin Fryatt, Director, Risk Management Initiative in Microfinance, Washington D.C.**, two interviews, one with **Nergui Sandagjav, Executive Director, ReachFinance NBFi, Ulaanbaatar, Mongolia** and the other with **Yves Mathieu, Senior Finance and Microfinance Advisor, Luxembourg**. The issue finishes with an article by Yves Deceuninck, Coach and Trainer, Luxembourg.

Any ideas for future issues of the *ALRiM Risk Newsletter* or any comments that you have are always welcome. Please send them to: [info@alrim.lu](mailto:info@alrim.lu).

### Bonne lecture!

Paul Kleinbart, Editor

# When listening to clients becomes a risk: the current state of the microfinance industry and a call for better microfinance risk management



*Kevin Fryatt,  
Director, Risk Management  
Initiative in Microfinance,  
Washington D.C.*

To remain competitive, microfinance institutions (MFIs) must listen to their clients, innovate, and find creative ways to lower the cost of service provision. As the rhetoric goes, the needs of the client come first. To serve clients better, MFIs have innovated through the use of new technologies such as: mobile money, agent banking networks, and driving savings mobilisation through savings group linkages to deposit-taking MFIs. In and of itself, tailoring one's business to the needs of its clients is a sound business practice. Too often, the conversation stops here. Client feedback is solicited, new products are developed, the business grows. Client feedback is solicited, new products are developed, the business grows - and so the story goes.

This story, the current narrative of the microfinance industry, is incomplete and broken. MFIs are implicitly told that balance sheet growth must be realised to reach financial sustainability, and this may be true in many respects. However, what is largely missing is the narrative of risk management - a key component of the fundamental decision-making framework of any financial institution. Risk management plays an important role, not only in the health of financial institutions and their shareholders' investment, but most importantly on the overall well-being of clients. Balance sheets have grown in size and complexity on the back of less than adequate personnel skill-sets, static risk management approaches, and frameworks in risk management, which do not adequately reflect the double-bottom line nature of microfinance. The microfinance industry is now playing catch-up and feeling the impact.

Over-indebtedness as a risk has received much attention in recent years. Yet this is only the tip of the iceberg. In Africa alone, the effects of these trends have been evidenced through an alarming number of MFI collapses. In August 2014, the Reserve Bank of South Africa bailed out African Bank Investments Limited (ABIL), due to issues that arguably point back to poor and imbalanced credit risk management. In Ghana, a country with no deposit guarantee scheme, the microfinance sector has experi-

enced a risk management crisis that resulted in the collapse of over 50 MFIs. The collapse of many of these institutions was caused by failing to implement the basic tenets of liquidity risk management and solid financial intermediation by funding long-term assets with short-term liabilities. The subsequent result was severe liquidity crises, institutional collapse, loss of customer deposits and a reputational loss in sector confidence. One might stand back and wonder how we have arrived at this point in the development of this sector. The answer is complex and multifaceted.

## **Misaligned incentive mechanisms for proper implementation of risk management.**

The incentives for conducting risk management in microfinance need to be viewed from the value they bring to an institution's double bottom line - both social and financial. Currently, many institutions are wrongly incentivised by the licensing requirements for becoming a deposit-taking MFI or through investor requirements rather than from a deep understanding of the underlying value and importance risk management plays within a financial institution. As a result: Underperforming risk functions, robust policy manuals developed but not well understood or functionally used by staff and resounding cynicism towards risk management are resulting trends.

## **Lack in understanding of the proper role and value of risk management.**

The risk management function is one of the most misunderstood functions within a MFI, often being confused with the roles of internal audits and compliance rather than playing its primary role of supporting the business units in maintaining policies and procedures, which ensure that all risks are identified, measured and managed throughout the institution. The damage and confusion caused by the improper creation and implementation of this function often outweigh the intended benefits. Without a proper understanding of the role and value of risk management, a MFI's willingness to invest its own resources to build out this important function is negatively affected.

“The goal of being a client-centric industry is a noble one. This goal must inevitably continue if we are ever to meet our aspirations of being a genuine double bottom line industry. However, as the industry shifts towards increasingly more financial intermediation, use of new technology and sophistication of balance sheets, the entire industry must take seriously a balanced approach that considers the risk implications of these and future developments.”

Kevin Fryatt

#### Lack of appropriate and generally accepted risk management standards in microfinance.

Feedback from recent microfinance risk management capacity-building programmes and industry stakeholders highlighted the need for comprehensive risk management industry standards for MFIs at different levels of their development. Given the variety of institutional types and their associated complexity, the industry is overdue for a scalable set of risk management standards. These standards would provide a MFI with forward-looking visibility on their risk management needs vis-à-vis the strategic growth included in their business plan. These standards would allow a MFI to proactively consider the risk management implications of meeting client demand, while simultaneously managing risk in the business planning and execution process.

In 2013, the Luxembourg-based NGO *Appui au Développement Autonome* (ADA) and seven other Founding Members, including Calmeadow, The Center for Financial Inclusion at Accion (CFI), Mennonite Economic Development Associates (MEDA), MFX Solutions, Microfinanza Srl., Oikocredit, and Triple Jump created the *Risk Management Initiative in Microfinance* (RIM). RIM is a collaboration of organisations with a vested interest in raising the standards of risk management in the microfinance industry. RIM provides a platform for risk management standards development, information sharing, and industry cooperation.

RIM has successfully undertaken the development of the Risk Management Graduation Model<sup>(1)</sup>, a pathways-based, best practice standard for risk management in the microfinance sector. The Risk Management Graduation Model has been designed to bridge the gap between the current state of risk management systems, tools, practices and required capabilities and that of the more sophisticated approaches proposed by the Basel Committee on Banking Supervision (BCBS). Through a diagnostic process, MFIs can assess their current risk management systems, structures and capabilities against RIM's Risk Management

Graduation Model and determine their adherence to best practice risk management standards applicable to their institutional tier level. Through a six-step institutional risk management improvement process, MFIs will be able to 1) Identify their institutional tier level and the appropriate standards within, 2) Assess their level of adherence to the Risk Management Graduation Model standards, 3) Strategise their Risk Management Graduation Path – a strategic improvement pathway, 4) Plan the necessary financial and human resources required to achieve the improvement goals, 5) Execute the plan within a project management framework and 6) Evaluate their plan's level of success.

The goal of being a client-centric industry is a noble one. This goal must inevitably continue if we are ever to meet our aspirations of being a genuine double bottom line industry. However, as the industry shifts towards increasingly more financial intermediation, use of new technology and sophistication of balance sheets, the entire industry must take seriously a balanced approach that considers the risk implications of these and future developments. This is only possible if the microfinance sector itself agrees on the need to address the underlying incentive structures that exist, improve upon the current understanding and appreciation of risk management and its approaches and support the refinement and adoption of global microfinance risk management standards. To this end, the interests of the microfinance industry's ultimate stakeholders - the clients themselves – can be protected.

(1) The Risk Management Graduation Model framework will be available in mid-November 2014 and its associated Diagnostic Tool in 2015. Please visit RIM's website to learn more: [www.riminitiative.org](http://www.riminitiative.org)

## Risk Management in Microfinance



*Nergui Sandagjav,  
Executive Director, ReachFinance  
NBF, Ulaanbaatar, Mongolia*

“*The biggest risk for microfinance is the repayment capacity of the clients. In most MFIs, loan officers think collateral is the main risk-protection tool. In reality, collateral does not decrease risk; on the contrary, it may increase the cost of working with delinquent loans.*”

*Nergui Sandagjav*

**ALRiM: How do you see the relationship between microfinance and risk management?**

**Nergui Sandagjav (NS):** Risk management is one of the core management issues of microfinance and it cannot be separated from the success of a microfinance institution (MFI). There are no industries that function without any risks. We should not be afraid of risk; instead we should find better management solutions to overcome risk. Traditionally, low-income clients without collateral have always been considered as risky clients, implying that risk in microfinance is higher than in traditional financing. This situation also motivates the microfinance industry to develop more innovative risk management tools as a means of supporting the sustainable operation of MFIs.

**ALRiM: Can you give us examples of this relationship from your own experience in Mongolia?**

**NS:** The main goal of MFIs is to provide loans to low-income people to help them meet their financial needs. Financing the business of low-income people always has more risk than traditional financing. Firstly because low-income people usually do not have sufficient collateral, they often lack proper business planning and experience in running a business. All these issues challenge MFIs to have better and more innovative risk management methods. In Mongolia, we implement various risk management tools that include a friend's guarantee system for those who have no physical collateral. Our loan policy requires having a co-loan recipient with proved income. We are not allowed to make a contract with a single person, even though the loan will be used by the particular individual. Also in Mongolia, some MFIs provide training in business planning for their clients to help improve the knowledge of their clients in business management.

**ALRiM: What would you see as the main obstacles to realising the full potential of risk management in microfinance?**

**NS:** Training human resources is one of the most important issues in risk management for MFIs. In my practical experience, MFIs might not allocate appropriate budgets for training and capacity building of its staff, because the operational cost is always higher than the equivalent with traditional financial institutions. I would say, therefore, that lack of trained professional staff is one of the main obstacles to improving the risk management of MFIs.

**ALRiM: Based on your own experience in Mongolia and other countries, what would you identify as the priorities for change?**

**NS:** The biggest risk for microfinance is the repayment capacity of the clients. In most MFIs, loan officers think collateral is the main risk-protection tool. In reality, collateral does not decrease risk; on the contrary, it may increase the cost of working with delinquent loans. Instead, the right identification of the client's income flow is one of the important risk management tools. Therefore, the mentality of thinking that collateral is the main risk protection tool should be changed in microfinance. The low income of microfinance clients usually means an absence of collateral, but, on the other hand, collateral is not a real risk-protection tool.

**ALRiM: How do you see risk management in microfinance developing in the future?**

**NS:** MFIs should create industry-wide standards in risk management and share the best practices among MFIs via various domestic and international networks.

A credit information bureau (CIB) is a very important risk management tool. If MFIs are not connected to a central CIB in their country, then the MFIs should at least create a common registration system that is accepted by all MFIs in the relevant country.

Microfinance institutions are vulnerable to macro-economic issues. Therefore MFIs need to have a flexible policy in changing their products and services in accordance with the macro-economic environment. Risk managers should consider how the macro-economic environment affects the MFI clients and their businesses.

Reputational risk is one of the major risks for MFIs. In the future, the image and loyalty of employees will be considered a priority issue for better risk management of MFIs.

**ALRiM: Thank you for sharing your views with us! ●**

● Interview

## Risk Management in Microfinance



Yves Mathieu,  
Senior Finance and Microfinance  
Advisor, Luxembourg

“ Risk management can introduce major improvement in microfinance, but only if MFIs have a realistic understanding of the utility and the value of risk management, on the one side, and the effort that is required to implement risk management effectively, on the other. ”

Yves Mathieu

**ALRiM: How do you see the relationship between microfinance and risk management?**

Yves Mathieu (YM): The two are apparently far apart in the sense that risk management focuses on events and how they can impact the future development of an organisation. Microfinance, on the other hand, is focused on helping the poorest of the poor. The primary concern of risk management is to prevent losses in the future. Microfinance focuses on changing situations in the present and creating sustainable solutions. Sustainability is the most important criterion for microfinance, while risk management tries to foresee problems in the future and keep them from occurring through preventive measures or, if something does occur, then reducing its impact through mitigation. However, intrinsically, risk management is also dealing with sustainability, since it is not only a present concern. And the first sustainable solution to find is the one of the survival of the microfinance institution (MFI) itself and to avoid critical losses originated by risks.

**ALRiM: Can you give us examples of this relationship from your own experience?**

YM: Although I have had many years of experience working with microfinance, specific examples of its interaction with risk management are not easy to provide. The reason for this situation is that our involvement as risk managers usually happens at the beginning of a project. We help MFIs lay the foundation for a risk management function. If we have performed our job well, the MFI takes over the project, builds on the foundation that we helped them lay and develops their own risk management function. In such cases when we return to visit an MFI, it is the employees of the MFI who have performed the majority of the work on their own. Our contribution was to set the stage for developing the risk management function, but it is the MFI that developed it and completed the task. Thanks to the coaching in risk management that we provide, MFIs develop the risk management function with prudence and sustainability.

**ALRiM: What would you see as the main obstacles to realising the full potential of risk management in microfinance?**

YM: I think that there are two main obstacles. One is a lack of understanding about what risk management is and is not. MFIs often have high expectations for risk management and assume that it can work magic. Risk management is viewed as a universal solution for all kinds of problems. This is of course not the case. Risk management

is not a simple solution and it only brings results, if the appropriate level of work and understanding are invested in it. The results that risk management can produce depend on the effort that the MFI invests in it. The second main obstacle is a shortage of focus on risk management by the senior management of MFIs. Because the senior managers have numerous concerns and priorities, the importance of risk management is often underestimated. To address this issue, senior managers must understand the role of risk management in a MFI and what risk management can (and cannot) resolve for the MFI. Through a more realistic understanding of risk management, senior managers will appreciate the amount of work and resources that are required to ensure the effectiveness of risk management in a MFI.

**ALRiM: Based on your own experience with microfinance, what would you identify as the priorities for change?**

YM: The focus for change would be defined by the two obstacles that I just mentioned. On the one side, MFIs need to gain a better understanding of what risk management is and is not. Risk management is not a panacea that can be implemented simply by writing a few documents. Risk management must be integrated into the strategy of a MFI and implemented through redefining procedures, training employees and adapting an MFI's priorities accordingly. Senior management have a major role to play in this transformation. They must become actively involved in implementing and developing risk management within their MFIs. Achieving these goals requires a realistic understanding of risk management and a significant effort on the part of everyone involved in a MFI.

**ALRiM: How do you see risk management in microfinance developing in the future?**

YM: Risk management can introduce major improvement in microfinance, but only if MFIs have a realistic understanding of the utility and the value of risk management, on the one side, and the effort that is required to implement risk management effectively, on the other. As coaches in risk management, we see our role in this development as helping MFIs to acquire the tools they need and to gain a realistic understanding of how risk management can help microfinance.

**ALRiM: Thank you for sharing your views with us! ●**

## Microfinance: A Journey to Risk Intelligence



Yves Deceuninck,  
Coach and Trainer, Luxembourg

“ Talking to the best microfinance credit officers, we see that the underlying risk process and business approach are more long term. When they assess risks related to a client’s project, they implicitly visualise the continuity of business with this client (e.g., this loan is not the only one, nor the final one). They keep an eye on the big picture and do not focus on instant gratification. ”

Yves Deceuninck

During the last six years, I have been involved in microfinance via the ATTF-ADA-ALRiM programme. This experience was driven by the conviction that returning to the source of finance would help me to learn another route to the new global paradigm.

With an initial background in finance and advanced degrees in financial risk management (e.g., VaR models) and internal audit (e.g., COSO model), I was a fervent admirer of rational thinking. Then I became a certified coach and studied psychology, which taught me that the best decisions by traders were driven by their emotions and not by their rationality. My devotion to Descartes started to sink.

One day a young risk manager in a microfinance institution asked me a candid question: “Why in your big banks are you facing so many losses, although you have numerous and highly trained risk managers? We don’t have the losses, because we talk to our clients! ”

If, according to John C. Maxwell, good leaders ask great questions, then this is a perfect example. A first observation is that microfinance positions risk management closer to the front office, closer to their clients and closer to their regulators than banks. so they focus more on facts and evidence.

The best credit officers of microfinance institutions have a very good track record in preventing losses, although they have no sophisticated tools or models, no financial statements or cash flows projections. Do they have a martingale or is it pure luck? Or is it something that we do not use, train or nurture anymore? It is something that is not Intelligence Quotient (IQ), nor totally Emotional Quotient (EQ), nor completely Social Quotient (SQ), but maybe Risk Quotient or Risk Intelligence. Microfinance practitioners have a different approach to uncertainty.

Dylan Evans (*Projection Point*) defines risk intelligence as “the ability to estimate probabilities accurately”. David Agpar, a consultant, defines risk intelligence as “the ability to reach accurate judgments about a specific new risk”. For Frederick Funston of Deloitte & Touche, it is “the ability to effectively distinguish between 2 types of risks: the risk that must be avoided to survive by preventing loss or harm and the risk that must be taken to thrive by gaining competitive advantage”.

Lerner’s experiments at Harvard highlighted that when we are sad, we tend to increase the valuation of an asset. She came to the assumption that much of what appeared in terms of influencing a decision is outside conscious awareness. The door of neurosciences is now open to risk management. The exploration of the limbic system (i.e., the centre of our emotions) becomes a must.

Talking to the best microfinance credit officers, we see that the underlying risk process and business approach are more long term. When they assess risks related to a client’s project, they implicitly visualise the continuity of business with this client (e.g., this loan is not the only one, nor the final one). They keep an eye on the big picture and do not focus on instant gratification. They see the bigger game to play between the institution, their performance and the client. They are of course result driven, but more action focused. The traditional approach of the efficient market driven by the “quants” who are looking for patterns and try to improve performance by using derivatives as a management tool and mathematics as a measurement tool seems to me important, but too narrow to capture all the dimensions of the risk universe. Keynes said “the market can stay irrational longer than you can stay solvent”.

Professor Schiller from Yale University talked about irrational exuberance when analysing the growth of housing prices before the crisis of 2008. This idea is of course rejected by the partisans of the efficient market theory.

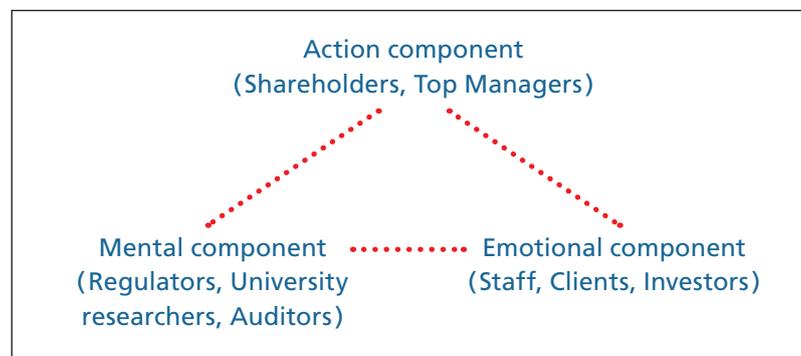
In psychology, we have two schools: The naturalist one focused on facts and statistics to explain behavior and the humanist one focused on value, consciousness and the recognition of the subjectivity of each individual. In economics, the “Chicago School” driven by the efficiency of markets could be assimilated to the naturalist wave and behavioral finance to the humanist approach. In risk management, the model addicts and “quants” could also be seen as naturalists, but I think that risk management will add a new component that we can call neuro-risk management.

Neuro-risk management will attract new profiles with backgrounds in psychology-neurosciences to help companies, risk managers and management to improve the risk intelligence of a company and reduce the psychological biases inherent in the risk intelligence level of

their employees and stakeholders. Maybe after ERM we will add a new dimension with an emphasis on the risk intelligence of each component. Instead of creating a barrier between the approaches, the opportunity to find some common routes to collaborate for a better risk management approach should be given priority.

Finally, as I like holistic views I was tempted to compare the players in financial markets with brain components: The new brain (neo-cortex), centre of rationality and mental activities, the limbic brain, centre of our emotions, and the reptilian brain (our instinct). A system tends to a homeostatic state (equilibrium between the components). In the financial sector, homeostasis is reached when the mental component performed by regulators, auditors and university researchers is balanced with the action and instinct component represented by shareholders and managers and the emotional component composed by the staff, clients and investors. I call this model the Global Risk Intelligence.

#### Global risk intelligence scheme



Each component plays a role to maintain the balance of the global risk intelligence. One element, but not the only one, which destabilised the model during the crisis of 2008 was the recruitment of researchers by the action component to create quantitative models to validate their actions and new markets/products (e.g. sub-prime loans) and convinced the emotional component to buy (clients, investors) or process (staff) the transactions.

In the case of Enron, an audit firm compromised the mental component and their independence by validating the actions (accounting practices)/markets/products of the action component.



Theme for the next issue:  
*Cyber Security*