Microfinance Banana Skins 2011

The CSFI survey of microfinance risk

Losing its fairy dust

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Centre for the Study of Financial Innovation

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Published by
Centre for the Study of Financial Innovation (CSFI)

Email: info@csfi.org.uk
Web: www.csfi.org.uk

ISBN: 978-0-9563888-6-5

Printed in the United Kingdom by Heron, Dawson & Sawyer

C S F I / New York CSFI

NUMBER NINETY NINE **FEBRUARY 2011**

Preface

THIS is the third “Banana Skins” survey of the global microfinance industry that the CSFI – primarily in the form of its Senior Fellow, David Lascelles with the assistance of Sam Mendelson – has prepared. Like its predecessors, it is funded by Citi and the Consultative Group to Assist the Poor (CGAP); we are very grateful to all of them.

In my opinion, this is by far the most interesting – and important – of the series. The reason is simple: Until very recently, scarcely a voice was raised against microfinance. It was regarded by governments, by academics and, increasingly, by the wider public as an unalloyed public good – and its most public face, Grameen’s Mohammed Yunus, received a well-deserved Nobel for his efforts. The only problem was one of scale. How could the ‘bottom-up’ approach of microfinance (which depends on tiny loans to poor people in small communities) be replicated widely enough to make a significant dent in the global problem of poverty?

I still believe in microfinance – not least, because it seems to me unequivocally true that the conventional top-down aid model is broken. But things have certainly changed in the last couple of years.

As this report makes clear, a lot of people – well-meaning, thoughtful people, who are in or close to the microfinance industry – are now worried that microfinance has taken a wrong turn, that it has drifted away from its original mission, that it has been co-opted (or even corrupted) by the pursuit of size and profitability, that it has become a political plaything etc etc. This is new and, as David’s report makes clear, it leaves microfinance and individual microfinance institutions at a ‘tipping point’. Will the industry continue to evolve - to grow, to offer new products, to move up-market – until it is essentially indistinguishable from conventional financial institutions (banks, consumer finance companies etc)? Or will it rediscover its roots as a more modest source of small-scale credit to a relatively limited market amongst lower-income groups in generally poor countries?

Inevitably, some institutions will go one way, and others another – but it is clear that the sector as a whole is coming under much harsher scrutiny. After years in which, essentially, it got a ‘free pass’ from most donor governments and agencies (as well as from the authorities in the countries in which microfinance institutions operate), the climate has become very different – and a lot less forgiving. As our survey results show, concerns about reputation, competitiveness, governance, management competence and politicisation abound, and there is a high degree of cynicism about what motivates at least a sizeable chunk of the industry.

But don’t throw the baby out with the bathwater. Many of the problems that the industry faces are just the products of its success; it is no longer beneath the radar, either domestically or internationally, and it must expect to be held to higher standards than it was in its earlier days. It remains one of the most promising vehicles for getting money to those people who need it most and who can use it most productively.

So let’s hope that its current problems can be overcome, and that the next survey paints a much more optimistic picture. In the meantime let me restate my thanks to our friends at Citi and CGAP for their sponsorship, to Deborah Drake of the Council of Microfinance Equity Funds (CMEF) for advice and support, to the MIX for the data and to Zach Grafe whose management of the online questionnaire helped immeasurably with what has become far and away the biggest survey of its kind.

Andrew Hilton
Director, CSFI

This report was written by David Lascelles and Sam Mendelson
Cover by Joe Cummings

Sponsors' foreword

The Microfinance Banana Skins report, now in its third year, reflects changing perceptions of risk in a dynamic and fast-moving industry. This year's report shows that microfinance has come of age, and with that, new issues have arisen. In an increasing number of markets, the rapid rate of growth and outreach means that microfinance is confronting the same forces of competition, credit cycles, and consolidation seen in other sectors.

The survey mirrors this evolution, highlighting the need for increased focus on clients' needs and related credit risk, as opposed to institutional risks such as funding and liquidity. Responses also reflect an industry that is at different stages of development in different regions of the world. Microfinance is only reaching 150m borrowers worldwide - a fraction of the global need. More than 2.7bn people still have no access to formal financial services that are cheaper and more reliable than the informal alternatives.

In a few markets, particularly where many microfinance institutions serve the same communities, some respondents to the survey expressed concern about an oversupply of credit and over-indebtedness. In other markets, we see the emergence of deposit-taking institutions, credit bureaus, comprehensive regulatory oversight, and credit expansion accompanied by savings, insurance, and other services.

Reputation risk and political risk are both placed more highly in the ratings this year. Notwithstanding recent questioning of the ability of microfinance, and particularly microcredit, to lift millions out of poverty, microfinance remains central to achieving financial inclusion, by enabling families to manage their household finances more effectively - allowing them to build assets, smooth consumption, and insure against risk.

This year's survey also reflects an evolving microfinance industry. The volume of concern may be amplified by recent events in a few markets, notably in the Indian state of Andhra Pradesh. But the questioning is undoubtedly healthy, and should lead microfinance practitioners to reassess the business models, and the practices and products that will most effectively serve the needs of low income people.

In many markets, MFIs and investors have already taken notice of the changing risks. MFI growth has slowed, lending standards have been strengthened, and more attention is being given to social performance. In several countries, the rate of increase in non-performing loans at MFIs is easing and more sustainable growth models are emerging. Most regulators now acknowledge the valuable contribution that the microfinance sector is making to financial inclusion, and see it as part of their country's financial infrastructure.

But more needs to be done. The industry needs to accelerate reform to shore up support in the face of growing reputation risk. MFIs need to further strengthen their lending standards, particularly with regard to over-indebtedness among borrowers. And in many countries, improved regulation will be essential to achieve financial inclusion.

A vision of financial inclusion that encompasses the majority of the world's population goes well beyond what is captured in this report. But it is clear from the survey that the landscape of access to finance will look significantly different five years from now. As the microfinance industry continues to evolve, new players and new business models are emerging. The opportunity - and the need - is immense.

We are grateful to the 533 participants from 86 countries who contributed to the survey. We would like to thank David Lascelles and Sam Mendelson for distilling participants' feedback and presenting it in such a cogent manner. We thank Deborah Drake at the Council of Microfinance Equity Funds, Philip Brown at Citi Microfinance, and Xavier Reille at CGAP for their contributions to the success of this survey.

Robert Annibale
Global Director of Citi Microfinance

Tilman Ehrbeck
CGAP CEO

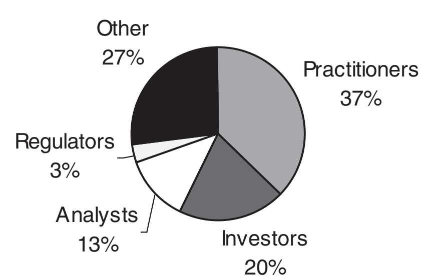
About this survey

Microfinance Banana Skins 2011 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers. It updates previous surveys carried out in 2008 and 2009. This survey was conducted in November and December 2010 and is based on 533 responses from 86 countries and multinational institutions.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the microfinance sector over the next 2-3 years. In the second, they were asked to rate a list of potential risks – or Banana Skins – both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of microfinance institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be named.

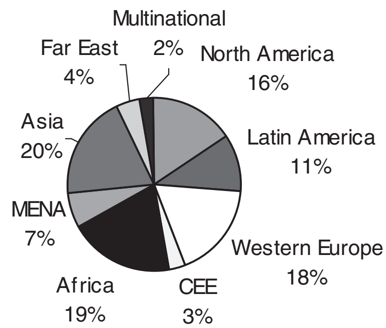
The views expressed in this survey are those of the respondents and do not necessarily reflect those of the CSFI or its sponsors.

The breakdown by type of respondent was as follows:



Just over half (55 per cent) of the practitioners represented deposit-taking institutions. The “other” category included aid officials, academics, accountants, lawyers, consultants etc..

The distribution of responses by region was as follows:



The responses by country were as follows

North America	
Canada	4
US	89

Latin America	
Bolivia	1
Brazil	2
Colombia	10
Costa Rica	3
Dominican Rep.	1
Ecuador	2
El Salvador	2
Guatemala	1
Haiti	3
Mexico	14
Nicaragua	2
Paraguay	5
Peru	7
Uruguay	1
Venezuela	2

Western Europe	
Austria	1
Belgium	4
Finland	1
France	16
Germany	10
Italy	3
Luxembourg	4
Netherlands	21
Spain	2
Sweden	1
Switzerland	7
UK	17

Central & Eastern Europe	
Azerbaijan	1
Bosnia & Herzegov.	5
Kazakhstan	1
Poland	1
Romania	2
Russia	3
Tajikistan	2

Africa	
Benin	5
Burkina Faso	4
Burundi	1
Cameroon	13
Congo Brazzaville	1
Côte d'Ivoire	7
Ethiopia	2
Gabon	2
Ghana	7
Guinea	1
Kenya	5
Madagascar	3
Mali	6
Mauritania	2
Niger	2
Nigeria	5
RD Congo	11
Rwanda	2
Senegal	7
South Africa	1
Tanzania	1
The Gambia	1
Togo	10
Uganda	6

Middle East & North Africa	
Egypt	8
Iraq	2
Jordan	3
Lebanon	4
Morocco	6
Palestine	2
Syria	1
Tunisia	1
UAR	2
Yemen	5

Asia	
Afghanistan	1
Bangladesh	6
India	82
Nepal	4
Pakistan	13
Sri Lanka	1

Far East	
Australia	3
Cambodia	2
China	4
Fiji	1
Hong Kong	1
Laos	1
New Zealand	2
Philippines	8
Vietnam	1

Multinational	13

Summary

This survey explores the risks facing the microfinance industry at a time when hard questions are being asked about its future, prompted by growing doubts about its effectiveness as a source of small scale finance for the poor. One of our respondents summed up the significance of these doubts, saying they could "dissipate the fairy dust that has historically coated everything related to microfinance". Many of the risks explored in this report reach the heart of the debate about where microfinance goes next.

Originally created as a grass-roots movement to provide credit to the neediest, microfinance has grown enormously over the last 20 years and is now firmly established as a major supplier of a wide range of financial services to millions of people in the emerging world. The one thousand-plus microfinance institutions (MFIs) that report to the Microfinance Information eXchange (MIX) have 88m borrowers and 76m savers, and numbers are growing by 20 per cent a year, more in some countries. Total assets of these MFIs amount to $60bn.

Many of the risks go to the heart of the microfinance debate

However in the last two years, microfinance has found its enviable reputation under attack for a number of perceived reasons: its growing commercialism, as evidenced by an increasing focus on size and profitability, a decline in standards, particularly in the area of lending, and a sense that the industry may be drifting away from its original "double bottom line" purpose. All have combined to cast microfinance in a new and unflattering light, and have raised doubts about the continued willingness of donors and investors to provide the support it crucially needs.

How serious are these developments? What are the new risks that the industry faces? Is microfinance coming to a crossroads in its evolution, and if so, what should be its new direction?

The survey results

This survey, the third in the series, was conducted to seek answers to these questions and put the risks into perspective. Its focus is on MFIs with more than $5m in assets which are profitable and capable of commercial growth. These number about 600, according to estimates from MIX, and account for the bulk of microfinance assets globally.

The survey asked a series of experts on microfinance (practitioners, analysts, regulators, investors etc.) to identify and comment on the biggest risks, or "Banana Skins", which they saw facing the microfinance sector over the next two to three years. Over 500 of them from 86 countries took part, the largest response to any Microfinance Banana Skins survey so far. The table on p.6 shows how they responded: it ranks the 24 Banana Skins they identified both as to severity and how strongly they are seen to be rising.

The overall message from the survey is that the immediate risks posed by the global economic crisis have receded – but have been replaced by larger concerns about the future direction of the industry.

Microfinance Banana Skins 2011

(2009 position in brackets)

Biggest risks	Fastest risers
1 Credit risk (1)	1 Competition (3)
2 Reputation (17)	2 Credit risk (1)
3 Competition (9)	3 Reputation (11)
4 Corporate governance (7)	4 Political interference (7)
5 Political interference (10)	5 Mission drift (13)
6 Inappropriate regulation (13)	6 Strategy (-)
7 Management quality (4)	7 Staffing (20)
8 Staffing (14)	8 Unrealisable expectations (17)
9 Mission drift (19)	9 Profitability (9)
10 Unrealisable expectations (18)	10 Inappropriate regulation (22)
11 Managing technology (15)	11 Corporate governance (12)
12 Profitability (12)	12 Management quality (18)
13 Back office (22)	13 Ownership (16)
14 Transparency (16)	14 Liquidity (5)
15 Strategy (-)	15 Product development (24)
16 Liquidity (2)	16 Macro-economic trends (2)
17 Macro-economic trends (3)	17 Managing technology (23)
18 Fraud (20)	18 Interest rates (10)
19 Product development (24)	19 Fraud (14)
20 Ownership (17)	20 Transparency (21)
21 Interest rates (11)	21 Back office (19)
22 Too much funding (25)	22 Too much funding (25)
23 Too little funding (6)	23 Too little funding (6)
24 Foreign exchange (8)	24 Foreign exchange (8)

The key finding of the survey is that **credit risk** constitutes the biggest threat to the industry over this turbulent period. Although this result is unchanged from the previous survey in 2009, the reasons behind it have shifted sharply.

Credit risk is still top of the list

The earlier result was largely explained by the difficulties facing borrowers during the economic crisis. This time, the reasons have multiplied. There is still economic stress, but also growing evidence of competitive pressures in the microfinance market, of poor credit management by MFIs, of greater cynicism among borrowers, and of increasing interference in the credit process by political forces. Above all, credit risk is seen to reflect the fast-growing problem of **overindebtedness** among millions of microfinance customers: poor people who have accumulated larger debts than they will ever be able to repay, often as a result of pressure from business-hungry MFIs. The potential for large microfinance loan losses is seen to be high in some markets, bringing a dramatic change to an industry which has always prided itself on its "99 per cent" repayment record.

Many of the top Banana Skins are linked to this finding. The surge in concern about **reputation risk** (up from No. 17 to No. 2) directly reflects view that MFIs have brought credit risk upon themselves through their aggressive lending and their desire for growth. This also accounts for the rise in the risk of **mission drift** (up from No. 19 to No. 9) because of the perception that MFIs are abandoning their commitment to poverty alleviation in favour of financial profit.

Another link is with the rise of **political interference** (from No. 10 to No. 5) as governments in some countries respond to the growing unpopularity of MFIs by imposing interest rate caps and encouraging repayment strikes. Although the current focus is on the Indian state of Andhra Pradesh where there have been severe political tensions over the behaviour of MFIs, the concern is that political risk is spreading.

A surge in concern about reputation risk

One of the major reasons behind MFIs' more aggressive approach to business is widely seen to be the intensity of **competition** in the microloan market (up from No. 9 to No. 3) caused by the ready availability of capital for MFI expansion and the entry of well-heeled commercial banks armed with mass marketing skills and new banking technology. At the same time, MFIs are seen to be institutionally weak in the areas of **corporate governance** (No. 4), **management quality** (no. 7) and **staffing** (No. 8), meaning that they may lack the resource and know-how to handle competitive pressures. A further contributor is **inappropriate regulation** (up from No. 13 to No. 6) which is failing to provide the right framework to keep MFIs on track.

The big movers

UP

Reputation: the good name of microfinance increasingly under attack
Competition: undermining business and ethical standards
Corporate governance: showing weakness under stress
Political interference: backlash against MFI lending practices
Inappropriate regulation: failing to provide a healthy environment

DOWN

Macro-economy: ebbing concern about the global crisis
Liquidity: cash shortages easing
Too little funding: investors returning to the market
Foreign exchange: "currency wars" not a major concern
Interest rates: lower and less volatile

Other areas of institutional weakness are seen to lie in the **back office** (up from No. 22 to No. 13) and the **management of technology** (up from No. 15 to No. 11), both of which may be contributing to the problem of imprudent lending through poor controls.

But a number of risks – mainly those thrust to the top of the rankings in the last survey by the global crisis – have fallen away quite sharply. **Liquidity** risk, which came No. 2 last time because of fears that MFIs would lose their access to working funds, has slumped to No. 16. In general MFIs, particularly the larger and healthier ones, are back in funds again. Similarly, concern about **too little funding** has subsided, down from No. 6 to No. 23. In fact, the only riser in this set of risks is **too much funding,** marking a return of concern that an over-supply of cash may fuel the risks of competition and overlending. Similarly, concerns about the state of the **macro-economy**, **interest rates** and the **foreign exchange** markets remain very low.

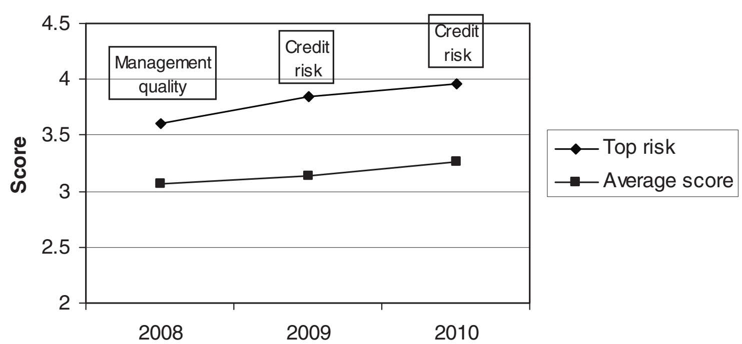
A breakdown of responses by type shows microfinance **practitioners** deeply concerned about the growth of credit and reputation risk which they see mainly caused by "unfair" competition and poor regulation. **Investors** in the microfinance industry have similar concerns, though they are also worried about political interference in the industry, and weakness in corporate governance. The main concerns of **regulators** lie in the areas of transparency, internal controls and the availability of funding. **Geographically**, credit risk, competition and reputation topped the concerns of most regions with the exception of Asia where the focus was on political risk. As in previous surveys, management issues ranked high in Africa.

Some risks are local, some global

Global versus local. This survey also points up a distinction between risks that apply to the industry in general, and those that are more localised. The anecdotal responses show that credit risk is very widespread, gaining a mention in 75 per cent of respondent countries. The impact of competition is more localised, though it can usually be traced to similar causes: excessive funding and pressure from commercial banks. The risk of political interference is also local, but its impact is wide because of negative media coverage. Regulatory risk is local, though the industry suffers from the generalised perception that microfinance regulation still needs to be "fixed". Institutional issues such as management and staffing are local. Risks in the area of funding also depend on MFI type and location, though there is a new concern that global reputation risk could damage the microfinance "asset class" more widely.

How well prepared are MFIs to handle these risks? On a scale of 1 (poorly) to 5 (well), respondents gave a score of 2.7, which is slightly better than middling, with Latin America seen to be the best prepared and Asia the worst. Among respondent types, practitioners were the most optimistic and regulators the least.

The Microfinance Banana Skins Index provides a picture of changing "anxiety levels" in the microfinance business. The top line shows the average score given to the top risk over the last three years, and the bottom line the average of all the risks. Both lines show a clear worsening in sentiment over that time, and suggest that anxiety over the present ructions in microfinance is higher than it was over the global economic crisis.



Health warning. A number of points should be borne in mind when taking messages from this report. One is that the results reflect the perceptions of respondents and are not forecasts or measures of likelihood. There is also a tendency, in surveys of this sort, to focus on the negative and overlook the positive, of which there is still a lot in microfinance. Linked to this is the risk of generalisation: microfinance is an enormously varied business, and its condition differs greatly from one market to another. Nonetheless, the broad trends this report describes suggest that microfinance faces a very testing period.

Who said what

Practitioners – people who run or work in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Competition
2	Competition	2	Credit risk
3	Reputation	3	Reputation
4	Inappropriate regulation	4	Mission drift
5	Staffing	5	Political interference
6	Corporate governance	6	Staffing
7	Mission drift	7	Strategy
8	Political interference	8	Profitability
9	Management quality	9	Liquidity
10	Profitability	10	Macro-economic trends

The main concern of practitioners is with **credit risk** and the pressing problem of **overindebtedness** which they see resulting from excess capacity in the microlending market and the intensity of **competition** from commercial banks. They also see high risks in **inappropriate regulation**, particularly where it is weak and obstructive, and hinders the healthy development of the industry.

Jose Ramon, finance director at Finca Perú, an MFI in Peru, said the greatest risk facing his industry was the growth of “indebtedness due to high competition in the market and the lack of regulation to limit this behaviour.”

Practitioners worry about bad debts

However, the big change in practitioners’ perceptions this year is the sharp rise in **reputation risk**, up from No. 18 to No. 3, a direct consequence of the mounting controversy over MFIs’ lending practices. Linked to this is a stronger risk of **mission drift** because of commercialisation pressures, and the growth of concern about **political interference**. Competition is seen to be the fastest rising risk facing the industry, more urgent than credit risk.

There is also strong concern among practitioners about internal issues, specifically **corporate governance, management** and **staffing**. This reflects a growing awareness within MFIs that their institutional strength needs closer attention.

By contrast, many of the risks which were driven to high levels last time by the financial crisis have ebbed away. Concerns about the **macro-economy**, **liquidity** and **funding** are out of the Top Ten. More worryingly possibly, given the difficulties facing microfinance, **strategic risk** is seen as lower order (No. 12), as are looming issues in the area of **technology management** (No. 13) and **product development** (No. 17).

Investors – people who invest in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Reputation
2	Reputation	2	Competition
3	Competition	3	Credit risk
4	Political interference	4	Political interference
5	Corporate governance	5	Inappropriate regulation
6	Inappropriate regulation	6	Mission drift
7	Management quality	7	Unrealisable expectations
8	Unrealisable expectations	8	Ownership
9	Mission drift	9	Strategy
10	Staffing	10	Staffing

The risk perceptions of investors in microfinance have changed sharply since our last survey in 2009. Back then, their top concerns were linked to the impact of the financial crisis: credit risk, funding, liquidity and the state of the global economy.

Today, concern with **credit risk** remains high, but most of the other risks in the Top Ten are linked to microfinance's tarnished image and issues of institutional strength. Investors are increasingly concerned about the industry's **reputation** and allegations that it may be failing in its mission to assist the poor. They are also worried about **bad regulation** and **political interference**, about the strength of **management** and **corporate governance**, all of which directly affect the quality of the business.

A US investor said: "The main risk over the next 2-3 years appears to be the state of the social compact between MFIs and clients. While growth of the industry is good in terms of extending access and creating innovative products, if it leads to overindebtedness via harassment, then microfinance is not delivering on one of its main objectives: to create real and sustaining social and economic value for low-income persons. There have been examples of this in certain markets, most of which did not have the regulatory controls in place to check the rapid growth of MFIs."

In another big shift, investors increasingly see **competition** as a risk to the industry (up from No. 15 to No. 3) where previously they saw it providing a stimulus to efficiency and innovation. A US-based investor said that competition "is likely to lead to poor management decisions. We see this as a high risk." On the other hand, investors' earlier concerns with **liquidity** and **funding** have eased with the passing of the crisis. **Macro-economic** risk has slipped from No. 4 to No. 16. They are also less concerned with strategic issues such as **product development** and **technology**.

But while investors are watching certain types of risk carefully, notably in the areas of credit, reputation and management, there is little in their responses to support fears that they are preparing to scale down their commitment to the industry. This is reflected in the low position given to funding risk (No. 23).

Regulators – government officials and those who regulate MFIs

	Biggest risks		Fastest risers
1	Transparency	1	Credit risk
2	Credit risk	2	Competition
3	Back office	3	Too little funding
4	Managing technology	4	Profitability
5	Too little funding	5	Interest rates
6	Profitability	6	Mission drift
7	Staffing	7	Strategy
8	Corporate governance	8	Managing technology
9	Management quality	9	Ownership
10	Reputation	10	Transparency

Regulators take a very different view of the risks from other respondent groups. Their main concern is unchanged from our last survey: the lack of **transparency** in the industry, both as to the quality of MFIs' reporting and to their openness about the terms and pricing of lending. Regulators worry that inadequate disclosure could erode the confidence of investors and customers.

Their concern about **credit risk** is also strong: it stands at No. 2, and is also their fastest-rising risk because of the problem of **overindebtedness.**

The inadequacy of **funding** for the industry is a growing worry. Their ranking on this score has risen sharply (up from No. 18 to No. 5), mainly because of the fall-out from the financial crisis, and is the highest of any respondent group. Fatoum Deen-Touray, deputy director of the Central Bank of The Gambia, was concerned about "the recapitalization of MFIs, especially as sources of funds dwindle particularly from international funding agencies including donors, banks, etc.".

Another strong area of concern is **operational risk**: weakness in the **back office,** the **management of technology,** and the **quality of staff**. Strategic issues are also on their minds. Alexander G. Cera of the Central Bank of the Philippines said that "regulated MFIs must contend with increasing competition, and provide a wider scope and range of services while aiming for sustainability. MFIs must deal with these issues with a long term perspective."

Regulators tended to be less concerned than other groups about **reputation** risk, and associated issues such a **mission drift**, focusing instead on the potential consequences, particularly in the area of funding. Two issues where they see less risk compared to other respondent groups are **inappropriate regulation** and **political interference**.

Deposit-takers – people who run or work in deposit-taking MFIs

Biggest risks		Fastest risers	
1	Credit risk	1	Competition
2	Reputation	2	Credit risk
3	Inappropriate regulation	3	Reputation
4	Profitability	4	Mission drift
5	Competition	5	Macro-economic trends
6	Management quality	6	Staffing
7	Staffing	7	Strategy
8	Managing technology	8	Political interference
9	Mission drift	9	Profitability
10	Fraud	10	Liquidity

MFIs which take deposits share other MFIs' concerns about the high level of personal indebtedness among their customers and the consequent threat of **credit risk**. They are also worried about the negative impact of **competitive pressures**, and mounting attacks on the industry's **reputation** over bad lending practices. In Russia, the director of a deposit-taking MFI said that commercial banks were "aggressively moving 'down' to increase margins, bringing with them retail experience, instruments, and financial resources which microfinance organisations cannot compete with".

These MFIs see a high risk of **inappropriate regulation**: rules governing deposit-takers are often tougher than those for non-deposit-taking institutions, and can create a competitive handicap. This is seen as a sharply rising risk, up from No. 19 to No. 3. They are also more concerned about the problem of **fraud**. On the other hand, this group is less worried than the lending side about the rise of **political interference**.

Among institutional risks, deposit-taking MFIs focus particularly on the **quality of management** and **staffing** issues. One respondent said that there was "a leadership deficit in this industry." A special concern is the danger of a flight of deposits in countries which lacked deposit insurance. An African respondent said that a crisis "can create a systemic risk of no confidence with massive withdrawals of deposits, reduced resources and a general slowdown in the financial sector."

Funding issues are relatively less pressing for deposit-takers so long as they can tap people's savings. However some respondents, particularly in Africa, are worried that savings might decline as a consequence of the global recession. A respondent from Côte d'Ivoire said that "poverty is gaining more and more ground. This will result in shrinkage in the collection of deposits".

North America

Biggest risks		Fastest risers	
1	Corporate governance	1	Reputation
2	Reputation	2	Competition
3	Credit risk	3	Political interference
4	Management quality	4	Strategy
5	Political interference	5	Credit risk
6	Competition	6	Unrealisable expectations
7	Staffing	7	Product development
8	Managing technology	8	Staffing
9	Back office	9	Management quality
10	Unrealisable expectations	10	Corporate governance

North American respondents were mostly investors and members of microfinance networks.

There has been a dramatic turnaround in the risk perceptions of this group. Last time their Top Ten was dominated by concerns about the crisis fall-out: funding and liquidity risks, the state of the global economy, turmoil in the financial markets. These have all disappeared except for **credit risk**. But even this risk is seen to be less urgent than institutional risks such as **governance** and **reputation**.

Peg Ross, director at the Human Capital Center of the Grameen Foundation, saw "a lack of next generation leaders who can step into senior roles, and a lack of focus on strategic human capital management practices. MFIs still don't uniformly understand the risk of not adopting these".

The growing reputational controversy over microfinance is a top level concern, with **political risk** seen to be fast-rising. A director of a US-based microfinance network said that there was "a risk of **mission drift** as microfinance institutions go for commercial sources of funding, with the concomitant drive to push for profitability/high returns. This in turn could lead to predatory practices, unfair treatment of clients, including exorbitant pricing. This is a risk we will be very alert to for all our MFIs."

Strategic issues are also on the up. A major US investor said: "Some of the main risks in my view are managing increasing competition, introduction of new products, and incorporation of new technologies, such as branchless banking, that create opportunity but also new risks."

The problem of poor **regulation** – a key concern for practitioner-dominated regions – is seen as less pressing, though rising. Interestingly, North Americans are much less concerned about financial issues such as the profitability of MFIs, and their ability to access **liquidity** and **funding**. The view is that funding will continue to be available to strong and well-managed MFIs.

Latin America

	Biggest risks		Fastest risers
1	Competition	1	Competition
2	Credit risk	2	Credit risk
3	Political interference	3	Political interference
4	Staffing	4	Profitability
5	Inappropriate regulation	5	Reputation
6	Profitability	6	Mission drift
7	Unrealisable expectations	7	Staffing
8	Reputation	8	Inappropriate regulation
9	Mission drift	9	Unrealisable expectations
10	Managing technology	10	Too much funding

Latin American respondents were mostly practitioners, which gave their response a strong “front line” feel. As in previous Banana Skin surveys, their greatest concern is with “external” issues, i.e. ones linked to the operating environment.

Chief among these is the impact of **competition** and the resulting pressures on **profitability** and **credit standards**. Many respondents said they faced “unfair competition” from commercial banks armed with ample resources but lacking “market knowledge”. Claudia Valladares, vice-president of community banking at Banesco in Venezuela, said that “with the rise of microfinance in many regions and countries, many MFIs tend to compete for the same customers and that carries the risk of over-indebtedness if there is no effective credit bureau”.

The other mounting risk is **political interference,** and the rise of populist regimes with an anti-MFI agenda: interest rate caps and the “no pago” movement in countries like Nicaragua. Marcelo A. Romero, a financial controller at Banco Pichincha in Ecuador, said this posed a huge risk to MFIs “because it completely changes [customers’] perceptions of their need to comply with their obligations”.

These concerns are linked to the other major risk in the region, **overindebtedness** which is widespread, and likely to throw up large loan losses. This is also due to the inadequacy of **regulation** in some countries. Frederic de Mariz, vice president of equity research at JPMorgan in Brazil, said that “incomplete and/or unfriendly regulations are a key risk for the sector”.

A set of fast-rising concerns surrounds **reputation risk**: the problems of **mission drift** and **unrealisable expectations**, all of which are up strongly. Luis Fernando Sanabria, general manager of the Fundación Paraguaya in Paraguay, said that “undoubtedly the main risk is mission drift. The average size of credits continues to rise and the resulting reduction in margins will increase this risk because institutions will be ‘tempted’ to solve their profitability problems by serving customers in even larger amounts”.

Western Europe

	Biggest risks		Fastest risers
1	Reputation	1	Credit risk
2	Credit risk	2	Reputation
3	Competition	3	Competition
4	Unrealisable expectations	4	Political interference
5	Management quality	5	Mission drift
6	Mission drift	6	Unrealisable expectations
7	Political interference	7	Ownership
8	Corporate governance	8	Strategy
9	Inappropriate regulation	9	Management quality
10	Staffing	10	Profitability

The Western European response was led by investors and groups supporting MFIs, such as professional firms and NGO networks. One of their top concerns is with the growth of **overindebtedness** and the impact of this on the industry's balance sheets and **reputation**.

Matthias Adler, principal sector economist at KfW, the German development bank, said that "due to unhealthy competition and the impact of the financial crisis, the problem of client overindebtedness in microfinance has become virulent in a number of countries. While this is still limited to particular submarkets and the overall sector remains robust in terms of shock resilience and responsibility of service provision, this may develop into a series of overreactions from the press, policy makers and, ultimately, from funders".

There was a big rise in Western European concern with **reputation** risk (up from No. 11 to No. 1) and the consequent risk of **political interference** (up from No. 9 to No. 7). Dinos Constantinou, managing partner of the Swiss-based consultancy Microfinance Strategy SARL, said that a worsening reputation "could take away the basis on which much of the development of the sector (at least in its early phases) has relied - namely the support of the development community".

Respondents see these developments stemming from overexpansion of microfinance markets, leading to excess capacity, fierce **competition** and a decline in lending standards. Linked to this is concern about the inadequacy of **management** and **corporate governance** in MFIs, particularly in the area of risk management. Lars-Olof Hellgren, CEO of Nordic Microcap Investment in Sweden, saw "a lack of capability to assess risks and to have sufficient internal control systems in place [because] MFIs tend to underestimate these aspects when they grow to a size where they must rely on systems."

Europeans are less concerned about **funding** issues such as access to **liquidity** and capital. In fact, they see a greater risk in over-funding for the industry. **Strategic** issues such as **technology management** and **product development** are also seen as lower level risks.

Central and Eastern Europe

	Biggest risks		Fastest risers
1	Credit risk	1	Reputation
2	Macro-economic trends	2	Competition
3	Profitability	3	Inappropriate regulation
4	Reputation	4	Product development
5	Inappropriate regulation	5	Macro-economic trends
6	Managing technology	6	Unrealisable expectations
7	Competition	7	Management quality
8	Unrealisable expectations	8	Managing technology
9	Product development	9	Corporate governance
10	Foreign exchange	10	Ownership

Respondents from Central and Eastern Europe consisted mostly of practitioners plus a number of analysts, investors and suppliers of services to the industry. Their biggest concern is **credit risk** in the context of difficult economic conditions. Several respondents pointed out that their economies were still in recession, but competition was intensifying and profitability was under pressure.

A respondent from Russia described the overall picture: “Crises will affect microfinance markets in various countries - clients' overindebtedness, the lack of consumer protection, high interest rates - which may result in disappointment in microfinance among policy makers and the public”. Reflecting fast-rising concern about **reputation risk,** she added that “there needs to be more realisation that microfinance is not a magic wand, and its potential to fight poverty or create jobs is limited”.

An additional problem in many countries is the absence of good microfinance **regulation**, adding to what Andrew Pospielovsky, CEO of Accessbank in Azerbaijan, described as “a challenging business environment for micro-business”. Part of that challenge is dealing with **competition** from commercial banks which are entering many markets in the region.

The Top Ten also reflect concern about the **quality of management** and specific issues such as **managing technology**. **Corporate governance** was seen to be a low but fast-rising risk. Sadina Bina, director of MCF EKI in Bosnia and Herzegovina, said that MFIs had “weak risk departments, a narrow range of products (more or less only loans) and weak internal controls”.

Strikingly absent from the high level risks – compared to other regions - is concern about **political interference**, though this gets a strong score in specific countries such as Bosnia and Herzegovina where political tensions run high.

Funding and **liquidity** risks ranked low.

Africa

	Biggest risks		Fastest risers
1	Credit risk	1	Competition
2	Corporate governance	2	Credit risk
3	Managing technology	3	Reputation
4	Management quality	4	Mission drift
5	Reputation	5	Liquidity
6	Transparency	6	Strategy
7	Profitability	7	Managing technology
8	Staffing	8	Macro-economic trends
9	Back office	9	Staffing
10	Competition	10	Management quality

Respondents from Africa were mostly practitioners, plus some investors, regulators and analysts.

As in other regions, the most pressing concern is on the **credit** front and the rise of overindebtedness and delinquency. The failure of a number of MFIs in Africa has added urgency to both these issues. This marks a change from the last survey in 2009 when Africa was the only region which did not put credit risk at the top of its concerns at the height of the financial crisis.

The bulk of Top Ten risks listed by African respondents this time centres on internal issues at MFIs such as the strength of **corporate governance** and **management,** and related issues such as **staffing** and the effectiveness of control systems. This is in line with previous surveys which have shown persistent concern about the robustness of African microfinance institutions.

A respondent from West Africa said: "The quality of governance and management remains a key risk for the majority of microfinance institutions in Africa. The failures of several deposit-taking institutions in Nigeria and Cameroon have exemplified this pattern".

The pressures of **competition** are relatively low at No. 10, but they are making themselves increasingly felt, and scored top among rising risks. Many respondents reported that commercial banks were moving aggressively into their markets. **Reputation** risk has risen strongly since last time (from No. 20 to No. 5) but **mission drift** at No. 13 remains a lower issue than elsewhere, and **political interference** at No. 22 scarcely puts in an appearance.

Concerns about access to **funding** have eased considerably. **Too little funding** has slipped from No. 8 to No. 14, and **liquidity** risk from No. 6 to No. 12, though the availability of funding is patchy: many of our respondents reported difficulties. The same with **inappropriate regulation**: while scoring relatively low at No. 15, it is plainly issue in particular markets.

Middle East and North Africa

	Biggest risks		Fastest risers
1	Credit risk	1	Competition
2	Corporate governance	2	Mission drift
3	Reputation	3	Credit risk
4	Unrealisable expectations	4	Reputation
5	Management quality	5	Staffing
6	Political interference	6	Corporate governance
7	Mission drift	7	Unrealisable expectations
8	Competition	8	Liquidity
9	Liquidity	9	Macro-economic trends
10	Staffing	10	Interest rates

Respondents from the Middle East and North Africa were mostly practitioners.

As in other regions, their top concern was with **credit risk**: the rise of personal indebtedness and its wider consequences. Mohammed Khaled, CGAP's representative in the region, saw a "growing vulnerability of the sector…because of repayment problems which are due not only to multiple loans but to governance and internal control issues etc.." This raised questions "about the whole future of the sector and the issue of access for the poor to financial services".

Much of respondents' high level concern centred on the commercial pressures confronting MFI **management** and the temptation to veer away from its social mission. Many respondents thought that MFIs were expanding their loan businesses dangerously fast under pressure from **competition** and hungry investors. One said that loan officers were becoming "mere distributors of funds" out to grab as many clients as possible. These trends are sharpening the risk of **political interference**, up strongly from No. 18 to No. 6.

The weakness of **management** and **corporate governance** is another top level concern. Yusef Yakubi, executive director of the Aden Microfinance Foundation in the Yemen, said that "most MFI boards have no experience of the microfinance industry and are usually appointed by influential bodies who do not normally care whether these boards have had training or exposure to the industry".

The risks in **liquidity** (No. 9) and **funding** (No. 17) are seen to be quite widespread, and higher than in many other regions. Amalik Aimane, internal controller at INMAA in Morocco, said that "after the global crisis, lenders and investors have lost confidence in the microfinance sector, so MFIs should monitor very closely the quality of their portfolio and take whatever measures are necessary". Respondents from other countries such as Iraq, Egypt and Syria said that funding difficulties were holding back the industry.

Compared to other regions, the quality of **regulation** (No. 13) emerged as less of an issue.

Asia

	Biggest risks		Fastest risers
1	Political interference	1	Credit risk
2	Reputation	2	Competition
3	Credit risk	3	Political interference
4	Liquidity	4	Mission drift
5	Inappropriate regulation	5	Liquidity
6	Competition	6	Reputation
7	Mission drift	7	Inappropriate regulation
8	Corporate governance	8	Interest rates
9	Management quality	9	Strategy
10	Product development	10	Unrealisable expectations

About half the respondents from Asia were practitioners, the remainder being analysts, investors and lenders to the industry. The bulk of the respondents were from India and Pakistan with a sprinkling from Nepal, Sri Lanka and Bangladesh.

With the turmoil sparked by events in Andhra Pradesh, it is no surprise that **political interference** made it to the top of the list. Swapnil Kant Neeraj, senior microfinance specialist at the International Finance Corporation in India, said that “”overzealous local politicians have still to reconcile themselves with the fact that microfinance can be done on a commercial basis. They will try to capitalise on the smallest aberrations by MFIs and … generalise things instead of taking a reasonable stand and isolating the rogue MFIs”.

Respondents are very concerned about the **regulatory** backlash and popular discontent. Brij Mohan, chairman of Access Development Services, said that local intervention “will cripple growth and hurt the poor”. The impact to the industry’s **reputation** is also severe (up from No. 21 to No. 2). Respondents see this damaging the business and frightening away investors, both of the commercial and ethical kind. Although **liquidity** risk has fallen a few places, it remains much higher in this region than elsewhere (No.4).

Risks of the political and reputational kind are seen as more severe than **credit risk** which tops the ranking in most other regions. Even so, overindebtedness is a major problem in this area, made worse by economic uncertainty, food price inflation and, in a country like Pakistan, a difficult security situation.

There is also concern about the institutional strength of MFIs. Although these risks have been edged out of the high positions they occupied last time, the **quality of management** and **corporate governance** remain in the Top Ten. A respondent in India said that “MFIs must juggle a significantly larger number of tasks and expectations as compared to the past. This will require a much higher level of management and leadership potential.”

Far East

Biggest risks		Fastest risers	
1	Competition	1	Competition
2	Credit risk	2	Reputation
3	Inappropriate regulation	3	Credit risk
4	Reputation	4	Mission drift
5	Corporate governance	5	Management quality
6	Management quality	6	Strategy
7	Mission drift	7	Managing technology
8	Unrealisable expectations	8	Political interference
9	Back office	9	Staffing
10	Political interference	10	Fraud

Respondents in the Far East included practitioners, investors, regulators and support professionals.

The negative impact of **competition** remains much the most pressing concern in the region. It is seen to be encouraging bad lending practices and declining business ethics. In particular, it is contributing to the widespread problem of **overindebtedness**, with the risk of potentially severe loan losses for MFIs.

Ruben C. De Lara, executive director of TSPI Development Corporation in the Philippines, said that the market was characterised by “a lack of credit discipline and an aggressiveness by some MFIs to grow their own business that tends to sidestep the value of credit education among their staff and clients as well”. A respondent from Laos said that the main risk in that market was “a desire for fast big growth which is not managed properly”.

The growth in over-lending is already affecting the industry’s **reputation** (No. 2 among the rising risks), and leading to concerns about **mission drift** (up from No. 20 to No. 7). This could affect **funding** prospects. In the Philippines, a microfinance manager said that over-rapid growth “has caused traditional lenders to take a wary look on the sector, and hence they are extending financial support too cautiously.” This is also a risk singled out by respondents from China.

Another of the region’s preoccupations is with the institutional strength of MFIs. **Management quality** and **corporate governance** are both among Top Ten risks. One respondent said “This is a sector that bleeds skills”. Another high level institutional risk is the **back office** (up from No. 15 to No. 9) because of the strain placed on systems by the hectic pace of growth.

However the region seemed more optimistic than most about its economic prospects. **Macro-economic** risk was placed at the bottom of the list.

1. Credit risk (1)

A STARK indication of the tests facing microfinance is the top position occupied by credit risk in this survey. For an industry which once prided itself on its enviable loan repayment record, the strength and persistence of this Banana Skin is a worrying trend.

Credit risk was top of the list in our last survey conducted in the depths of the 2009 economic crisis when, to some extent, it could be explained by the difficulties facing borrowers in a period of economic stress. But this time, the reasons for its high position have multiplied. There is still economic stress, but also growing evidence of competitive pressures, of recklessness among MFIs and their borrowers, and of interference in the credit process by political forces.

The breadth of concern about credit risk revealed by this survey is very striking. It was the No. 1 Banana Skin for all types of respondents except regulators who ranked it No. 2. Geographically it was a high level risk in all regions, suggesting that similar forces are endangering microfinance loan portfolios in many different markets.

Overindebtedness is becoming a bigger problem

Of these, much the most prominent is the problem of **overindebtedness**: large numbers of poor people who have accumulated bigger debts than they will ever be able to repay, with the prospect that MFIs will have to write them off and suffer heavy loan losses. This problem is now so broad that it has the makings of a worldwide social/economic phenomenon. Moses Ochieng, regional representative for CGAP/DFID in East and Southern Africa, warned of a possible "implosion of some of the key players" unless measures were taken to deal with it. A respondent from one of the large European funding banks said: "Increased delinquencies, program deterioration, damage to clients' well-being…We're seeing this issue crop up into too many markets."

Respondents identified many causes of overindebtedness. On the lending side, there is the intensity of **competition** in a business where growth is now a key objective for many MFIs. Elissa McCarter, director of development finance at CHF International in the US, said that "the tendency to focus on growth alone to generate the profits that shareholders anticipate has led to a weakening of microloan underwriting standards and greater risk of delinquency, fraud, and undercapitalised institutions that become exposed during crises".

This is leading to the problem of **multiple lending** (or, more strictly, multiple borrowing) when microfinance customers take advantage of competition among lenders and the lack of centralised credit information to tap many lenders at once. In Colombia, the managing director of an MFI reported that the number of micro-lenders to the average MFI customer had grown from 1.5 to 4, and that 75 per cent of MFI customers were borrowing from other institutions, mostly commercial banks which had entered the field.

Another reason is the **weakness of internal controls** at MFIs, poor incentive structures for loan officers, and misdirected management objectives. Edmond Atangana Evina of the ministry of finance in Cameroon said that in many cases "the failure of MFIs can be traced to enormous loans granted to clients, in breach of the checks and balances necessary to those institutions' survival". The need to **know your client** is an associated issue. Many respondents reported that loans were being made without proper credit checks or client information – and deliberately in order to meet business targets. A UK-based consultant said that "many MFIs do not have a good understanding of the borrowers' financial position and repayment capacity."

Then there is **political interference** in countries where the lending practices of MFIs have come under public scrutiny, leading to officially inspired borrowing binges and repayment strikes. Although the Indian state of Andhra Pradesh is the specific focus of this concern, respondents identified many countries where this was a problem, including Nicaragua, Azerbaijan, and Bosnia and Herzegovina. In Rwanda, a banking regulator said that borrowers were developing "a culture of non-repayment".

Although some respondents stressed that the severity of credit risk differed greatly among institutions and markets, this Banana Skin looks set to be the dominant issue for the industry over the next few years.

How a borrower thinks...

P.N. Vasudevan, managing director of Equitas Micro Finance in India, described the mindset of many overindebted borrowers: "With more MFIs in operation, clients are getting more options to borrow, and since loans are unsecured, the tendency of most people is to borrow more than their immediate need and to justify it by saying that they will use it for some 'good' purpose, and that they cannot be sure it will be available later when they might really need it. This can destroy the borrower's family peace which is what MFIs are supposed to promote!"

2. Reputation (17)

NO SURPRISE that this Banana Skin has soared after the torrent of bad publicity surrounding microfinance in the world's media, and events in Andhra Pradesh in particular. Reputation risk is up 15 places from the last survey when only a few far-sighted respondents waved a red flag about the dangers of growing commercialism.

Microfinance's reputation 'will never be the same'

Microfinance is becoming a punch bag from all sides – accused of exploiting the poor with burdensome debt, of losing sight of its social mission, of putting profits before poverty reduction, and in AP most notably - though elsewhere too - of driving people to suicide through tough loan terms and strong-arm debt collection practices.

Gil Lacson, relationship manager at Women's World Banking, said that "the industry will face a huge reputational risk with the growing clash between opposing ideology and expectations. Is microfinance primarily about financial inclusion or poverty alleviation? Is microfinance primarily a business opportunity or a development intervention? Does microfinance really meet both financial and social return expectations? Is it an 'either or'? Or has microfinance many faces? Whatever the answers, the industry's reputation will never be the same".

Reputation risk has many angles. For some respondents, it is the **commercialisation of microfinance**, as seen in the growing importance of profit as a goal, and the high-value flotation of MFIs on the stock market. Last year's IPO of SKS, India's largest MFI, was a ready theme for respondents the world over. Some saw it as a watershed, drawing popular attention to the profits now being extracted from microfinance.

For others, it is **unethical practices** as evidenced by the huge growth in **indebtedness** among MFI customers, much of it the result of aggressive marketing of loans whose true cost is obscured. Michaël de Groot, regional director of the

Rabobank Foundation in The Netherlands, said that "top-end, commercially-driven MFIs and banks are becoming the new loan sharks". Raksa Pheng, business development manager at Visionfund in Cambodia, said that defaulters took to "running away from their homes. In some cases, I could see that they reduced their food to save money to repay their debts, or in others, they forced their children to drop out from school to find jobs to earn more income to support the repaying of debts".

Another symptom is the emergence of "consumer lending" as a prime product to replace the business lending for which microfinance was originally devised. Xavier Reille, manager at CGAP in France, said that "previously, microcredit was seen as a good thing and money lending as a bad thing. With the increased focus on short term profit in several markets, the lines are blurring and the reputation of the sector is tarnished. The onus is on MFIs to show that they are following responsible practices".

The industry faces the backlash

For others still it is the exposure of microfinance as "a sham", with its social *bona fides* no longer a given. Joachim Bald, a senior consultant at the Frankfurt School of Finance and Management, said that a backlash was now on the cards. "We tend to celebrate every overpriced small loan to poor people as a life-changing breakthrough in access to finance. But where is the evidence that microfinance borrowers on their tenth cycle are better off than their peers who did not have access to microcredit?"

The consequences of reputation risk are potentially severe. A US investor warned that "if studies continue to show that microfinance is 'not working' and if news stories of overindebtedness, client harassment, excessive riches and other bad behaviour continue to make headlines, the industry will lose the moral high ground, and with it donors, investors and talent".

The consumer lending boom

A big concern in the industry is microfinance's shift from tiny, uncollateralised business loans for micro-entrepreneurs - "microenterprise finance" - to general lending to the unbanked for consumption purposes. This is widely seen as evidence of "mission drift", and could harm the industry's reputation for poverty alleviation. It's happening for several reasons: competition from commercial banks, pressure for short-term profitability, and the frequently voiced need for "product development".

Chikako Kuno, director of capital markets at FINCA International, said: "There are reputational risks as new commercial entrants, attracted by the volume and profitability of microfinance, come in without a clear double bottom-line objective and blur the boundary between predatory consumer finance and true microfinance". Daniel Schriber, director of investment analysis at Symbiotics in Switzerland, thought that the move towards consumer lending constituted "a huge reputational risk for the whole industry".

3. Competition (9)

ALTHOUGH competition in the microfinance market can deliver benefits to customers in the form of keener pricing and better service, it is more often seen as something bad, creating instability and encouraging dubious practices. In line with earlier surveys, this Banana Skin is high on the list this year, and is seen as a rising problem because of the proliferation of microfinance providers in most markets.

Geographically, this is a widespread concern: it got a high ranking in most regions, and was also seen as a top level risk by respondent types, practitioners in particular.

Competition is seen as dangerous because it can cause market disruption, squeeze margins, and spur MFIs to take greater risks. Several respondents referred to competition as "unhealthy" and "unfair". In particular, competition is widely seen as the prime cause of irresponsible lending and **overindebtedness**. A respondent from the Philippines said that "the presence of too many competitors encourages some MFI staff to become lax in implementing policies rather than take it as a challenge to improve products and services".

Competition is eroding business and ethical standards

Competition is also squeezing **margins**. A microfinance banker in Ecuador complained that "prices are going down every year and everywhere", driven by new competitors "without knowledge". Jaime Nieto, director of treasury at Camesa in Mexico, said that markets in accessible areas were all "saturated" and suffering a "rate war". Others saw competition driving MFIs to reach into new and riskier markets in search of business. A respondent from Tanzania said that "as more players such as banks enter the industry, the tendency is to move towards untapped market segments about which is little is known".

Respondents also regretted that competition was encouraging MFIs to adopt **unethical practices** such as loan pushing, poaching clients and staff, and deceptive advertising. Vaidyanath Yerraguntla, a consultant at Coromandel Infotech in India, said there was "very high pressures on the field collection teams translating into 'loan-sharking' behaviour with the borrower/s".

A feature of competition is that it pushes MFIs to focus on parts of the market that are already well served and ignore those that are not, usually the neediest and those out in the country. A respondent from Colombia said banks were exhibiting "herd behaviour" and concentrating "on areas with good economic performance with aggressive credit offers".

The reasons for greater competition include the **ready availability of funding** to expand capacity, and the **downscaling by large banks** into the microfinance market, a trend that is visible in most regions. Other competitive threats come from subsidised government lending programmes and, increasingly, from telecoms companies able to access the market through branchless banking. Hans Boon, managing director at Postfinance International Development in The Netherlands, said that "new scenarios of 'branchless' banking with larger banks downscaling via mobile and internet technology and franchise formulas for agents could heavily impact existing MFIs".

But others saw competition as a good thing because it put MFIs on their mettle. A US consultant said that competition "could be a net positive as MFIs are forced to be more innovative and provide higher customer service. Most MFIs know how to handle this but I am sure some markets will be overheated and get carried away".

4. Corporate governance (7)

Weak governance is making the credit crisis worse

CONCERN about the quality of corporate governance in MFIs is growing, reflecting the view – seen in earlier Banana Skin surveys – that this risk is fundamental to the business, and one which only the MFIs themselves can address. However the ranking of this risk was generally higher among those outside the industry (investors and analysts) than among microfinance practitioners who tended to play it down. For example, North American respondents – investors mainly – ranked it No. 1 while Central and Eastern European respondents – mostly practitioners in well-established and commercial MFIs – put it a lowly No. 21.

One region where concern about corporate governance was particularly strong was Africa, where it ranked No. 2. Marie-Jose Ndaya Ilunga, deputy director of the central bank of the RD Congo, said that "poor governance creates management problems, mainly in the area of lending. Most MFIs which close down in the RDC have run into governance problems".

The focus of concern is not only the quality of MFI boards, but the risk of conflicts of interest, of lack of independence and poor accountability, and other issues such as nepotism, cronyism, domineering personalities... Although the passing of the economic crisis has taken immediate pressure off MFIs, the new difficulties facing them on the reputational and credit fronts could make strong corporate governance even more crucial. Brian Slocum, regional coordinator for the Middle East and Africa at the Grameen Foundation, said that "weak corporate governance has been a key factor in existing portfolio crises, and it will likely be one in future crises as well."

One reason why governance is weak

"Too many conferences which take the best MFI leaders away from their desks".

Project leader
Microfinance network
The Netherlands

One concern is that MFIs themselves do not devote enough attention to governance because they are dominated by self-interested directors or view it as inconvenient. Diego Guzman, regional director for Latin America at ACCION International in Colombia, said that "MFIs believe this is a game and you do not need to invest in this field".

Several respondents said that it is not enough for governance standards merely to remain static because the evolution of the sector will require boards of ever higher calibre. Many referred to "the more challenging environment", "the exposure of the sector to the media" and "growing industry complexity".

However, it is wrong to generalize about this particular risk, and some respondents saw more positive trends emerging. More professionals were becoming involved, investors were pressing for higher standards, and regulators were taking a closer interest in the problem. Santhanam Srinivasan, a development finance consultant in India, said that "with stricter regulation, this area will improve".

5. Political interference (10)

The turmoil in Andhra Pradesh propelled this Banana Skin to a new high in the rankings as the microfinance sector assessed a whole new set of risks coming from a direction that was previously benign.

However the response was very varied. Asians, not surprisingly, put it top overall, and Latin Americans at No. 3. But Africans and Central and Eastern Europeans ranked it way down at No. 22. Among respondent types the most concerned were investors and analysts (No. 4), but for regulators it was No. 22.

Although severe political interference has only affected a few countries directly, it is nonetheless causing huge damage to the industry worldwide because of intense media coverage. Almost all our respondents commented on it one way or another. An international investor from Egypt said that "political interference in several markets is turning the public against microfinance industry in general."

Interference by politicians is growing

Political interference takes many forms. The most widespread is usury laws capping the interest rates that MFIs can charge their borrowers. Previously in decline, these are now on the increase again in the Indian sub-continent, Latin America, Africa and Central Europe, and pose a direct threat to MFI profitability. But while rate caps benefit MFI borrowers in the short run, they may also damage the microlending market further out. Pierre-Marie Boisson, chairman of Sogesol in Haiti, said they "could reverse 30 years of progress by driving MFIs to cut millions out of access to credit, forcing the majority to use moneylenders at a higher interest rate".

More immediately damaging are the populistic "no pago" campaigns seen in countries like Nicaragua, Pakistan and India where governments have told borrowers not to repay their loans because their interest rates are extortionate. These could drive MFIs out of business altogether.

Political interference can take other forms as well: product limitations, directed lending to "priority sectors" and subsidised competition from government loan programmes and state-supported banks. A respondent from Mali said that the state was "directing resources towards…high-risk customers through the disposition of public funds with little technical selection criteria".

The risks in political interference are seen to lie mainly on the funding side: the concern that investors will be frightened off by all the bad publicity. Eric Savage, president of Unitus Capital in India, wrote that "there is a very real risk that many of the largest MFIs in India could begin defaulting on their debt in the coming days, weeks and months…Political risk has made it more challenging to attract funding at reasonable rates, or in some cases, at all".

But it could also threaten MFIs by squeezing margins, taking away their business, and halting their growth. As one respondent said: "A persistent non-profit, credit-only (or overly politicised self-help group) sector will simply stop the industry where it is now".

Many respondents said that political risk resulted from a failure of understanding, wilful or otherwise, about the value of microfinance. As one respondent said: "We are not winning the war of ideas". Risk mitigation must lie in getting a better message across about the benefits of microfinance. But many respondents thought that the industry had brought this risk upon itself through its aggressive lending and

IPOs: good or greedy?

FEW EVENTS have turned public opinion against microfinance more than the lucrative Initial Public Offerings (IPOs) of MFI shares on the stock market. The resulting "windfall" gains reaped by shareholders seem inappropriate for an industry with a social purpose.

Many respondents said that IPOs were adding to the political and reputation risks in the industry, and would hasten a regulatory crackdown. Gert van Maanen, chairman of Microfinance Centre in Poland, said that microfinance's "original concept of 'How to enable poor people to earn a living' is moving towards 'How to accommodate investors in their wish to earn an attractive dividend and - if an IPO is feasible - a windfall profit'. Most popular support for microfinance is based on its social relevance, not on the earnings it brings to investors. IPOs imply that investment considerations are taking over and calling the shots".

Marcus Fedder, managing partner of Agora Microfinance Partners in the UK, said that IPOs also risked attracting the wrong sort of people into microfinance, "...people who are driven more by the business model of fast growth and big bucks through an early IPO than by sustainable, client-driven services for the poor. In the long run, this is likely to (a) lead to a sub-prime like bubble, (b) give a bad name to the whole industry and (c) probably deter socially-minded investors".

But some respondents saw good in stock market flotations. Shadab Rizvi, who runs the microfinance business unit at Darashaw & Co., an Indian investment house, said that MFI owners were "incapable of mobilising huge sums of equity on their own. Gradually we'll see private equity investors becoming owners of many MFIs, especially if the MFI is IPO-bound".

high profile IPOs. For them, the risk needed to be managed by halting mission drift and refocusing the business on its philanthropic goals.

There was little sense that this risk will subside. It may even grow. One respondent said gloomily: "I fear this misinformed boycott will spread outside of Andhra Pradesh and India to the rest of the world."

6. Inappropriate regulation (13)

THE QUALITY of the regulatory environment for microfinance is a rapidly rising concern, up seven places since the last survey. The problem varies greatly from one region to another: some countries have good regulation, others have poor or obstructive regulation. But the general sense is that the problem is growing rather than shrinking.

Many countries still lack good microfinance regulation

Regulation was high on the list for practitioners, particularly in Latin America, the CEE, Asia and the Far East where fast-growing microfinance industries are increasingly running into regulatory obstacles.

In a typical comment, Scott Richards, an associate at Developing World Markets, a US microfinance investment firm, said that "many countries lack microfinance-specific regulations, and in our experience, the regulatory regimes in place to govern deposit-taking banks and other financial institutions do not fully or effectively address the specific regulatory needs of the microfinance industry."

Many respondents saw regulation failing to take account of microfinance's special character: its social role, its ownership structure, its different cost base. Bad or non-existent regulation was hindering the growth and profitability of microfinance, it was stifling MFIs, holding back innovation, preventing it from competing with new entrants like commercial banks where regulation was more highly developed.

A respondent from East Africa said that poor regulation "is already taking its toll on regulated MFIs in many countries and is discouraging movement towards [a regulated industry] in others". Bassem Khanfar, CEO of the National Microfinance Bank in Jordan, said that unclear legislation and lack of professionalism could "put the industry under constraints and eliminate its growth", and that it was "better to live without a law rather than to live with a bad law". Some respondents said that poor regulation was undermining confidence in microfinance, which would affect clients and investors. It was also driving smaller MFIs out of business.

Much inappropriate regulation, such as interest rate caps, springs from political interference. But respondents also saw bad regulation jeopardising MFIs by making it difficult for them to diversify away from the increasingly risky business of lending, for example by offering new products or accessing people's savings. The CEO of an MFI in Pakistan said that microfinance was stagnating there because half the industry was not allowed to take deposits. "The industry cannot and will not grow unless a window is made available from the regulator at commercial rates. The industry potential is circa 30m while the current outreach is less than 2m".

The risks in regulation

Microfinance needs to find its place in the global financial system. Either there has to be a clear regulatory environment distinguishing and recognising the microfinance sector, or the industry needs to mainstream itself as part of the banking or non-banking segment as the case may be in each country. The risk of an unclear regulatory environment is probably the main risk at the moment.

Prashant Thakker
Global business head – microfinance
Standard Chartered Bank

The problem of 'unfair' competition

An increasingly pressing regulatory question is the creation of a level playing field between MFIs and commercial banks to deal with the problem of **"unfair" competition**. Many respondents felt that poor MFI regulation was putting them at a disadvantage *vis-à-vis* these new entrants, for example in the range of products they could offer and in their access to funding, and even their ability to move into new areas like mobile banking. Godwin Kihuguru, microfinance specialist in Uganda, said that regulators were "finding it difficult to keep pace with advances in microfinance service delivery". In some countries there is a reverse problem: regulators over-protecting the microfinance against new competition, and causing it to stultify.

A different sort of regulatory risk was raised by some respondents: the absence of good consumer protection legislation in many markets. This is allowing the growth of overindebtedness and increasing the risk of reputation damage to the microfinance industry. The growing number of loan defaults is also exposing the inadequacy of many legal systems in the area of loan recovery and liquidation. A microfinance practitioner in the Côte d'Ivoire said that in her country "apart from calling in the bailiffs, there is no law that obliges borrowers to repay their loans".

However the patchiness of regulatory risk was highlighted by a number of dissenting views which gave a more positive picture. An MFI respondent from Peru said that regulation there was encouraging better controls and risk management, and others said that regulators were increasingly professional and constructive.

7. Management quality (4)

CONCERN about the quality of management in MFIs has eased a bit, but is still in the Top Ten. It was a leading problem for most respondent types, though practitioners tended to rank it less high than outsiders. Geographically, concern was strongest among investor countries in North America and Western Europe, and lowest among practitioner countries (Latin America placed it No. 18) except for Africa where it ranked No. 4.

Still too many ‘will-do-good’ people in microfinance

As in earlier surveys, the focus remains on the **lack of professionalism and technical expertise** in MFIs, leading to poor internal controls, ineffective strategies, and poor management of increasingly important areas such as risk, product development and technology. As one respondent said: “There are still too many ‘will-do-good’ people with no real management skills”. Essma Ben Hamida, co-founder and executive director of Enda Inter-Arabe in Tunisia, said there was “a lack of local skills for working in MFIs, particularly at senior levels with experience of finance and banking to ensure strong management and succession to the older generation”.

In the African market, where management capacity is seen to be most stretched, a respondent from Ghana said that “the quality of governance and management remains a key risk for the majority of microfinance institutions in Africa. The failure of several deposit-taking institutions in Nigeria and Cameroon have exemplified this pattern. Regulators are not doing enough to hold managers accountable, especially for insider lending. This could damage the credibility of microfinance institutions among depositors”.

Growing pains

For many respondents, the risks facing microfinance could be summed up in one word: growth. The hectic pace at which microfinance has grown over recent years is arguably the cause of many of the difficulties it now faces: an overindebted clientele, stressed management and back office, loss of sense of mission, and an increasingly uneven distribution of resources within the industry. As one respondent said: “Managing growth has proven to be a risk area. At one end, you have institutions in specific country contexts that are growing in an unsustainable fashion and will overheat. At the other end, you have institutions in other country contexts where growth has been very slow relative to the business opportunity and the development need.”

But a growing concern is that as business becomes more difficult and the MFIs themselves become more complex, management will increasingly fail to cut the mustard. A respondent from one of the large international investor networks said that good management “is going to become much more important. MFIs must juggle a significantly larger number of tasks and expectations as compared to the past. This will require a much higher level of management and leadership potential.” A consequence of these rising demands is that **skills,** already in short supply, will become harder to find and more expensive. A US respondent expected to see “a dramatic increase in competition for good quality people, potentially leading to increased staff acquisition costs". Linked to this is the fear, expressed by Eric Duflos, senior microfinance specialist at CGAP in France, that "many institutions will not have the capacity internally to deliver the growth rates they have promised to their boards and their investors, and thus will fail".

With credit and reputation risk both growing, skills will also be needed in risk management, particularly in lending, and public relations, a relatively new area for MFIs. A risk manager at one of the large microfinance investment companies said that "in stressful situations, we have seen management incapable of addressing problems".

However some respondents felt that things were improving on the management front, which may be why it has fallen a few notches in the rankings. As one of them said, this is not an area where generalisation is possible: "This is primarily an MFI specific risk - although the economic pressures and over-indebtedness in mature microfinance markets will impose much greater pressures".

8. Staffing (14)

A wider range of skills is now required

STAFFING risks are on the rise again after falling in earlier surveys, perhaps because the crisis-related Banana Skins which displaced them in the 2009 survey have receded. This risk was ranked high by practitioners, regulators, Latin American and African respondents, suggesting it is more of a concern to those closely involved in the management of MFIs than to investors and analysts.

Perceptions of this risk varied. Staff **capability** was a recurring theme, with several respondents bemoaning the scarcity of good people with expertise in microfinance. The lack of "talent" and "competent manpower" came up frequently. Diego Villalobos, an analyst with ACCION in the US, said that "finding the right people to promote the growth and sustainability of an MFI is very difficult. From consultants to managers, MFIs have a very small source to choose from." As microfinance becomes more commercialised, there is also a growing need to balance different types of skills: social and business.

On the **skills** front, the growing role of technology is creating new demands. Mayuni Ozaki, a finance specialist at the Asian Development Bank in the Philippines, said that technology-based branchless or mobile banking will expand rapidly over the coming years, however "many MFIs, regulators, and policy-makers don't have the sufficient skills and capacity".

For others the problem was **staff retention**. A respondent at the National Bank of Rwanda pointed to low pay as the reason MFIs cannot recruit and retain qualified staff. Poaching is another problem created by rising competition. Another respondent said: "In Afghanistan they joke that a job as a loan officer leads to being a branch manager leads to a bank job and then to Canada. This is extreme, but not by much".

Other risks which respondents associated with staffing were fraud, credit risk (undertrained loan officers not understanding their borrowers), and regulation as ill-equipped staff grapple with increasingly complex microfinance legislation.

9. Mission drift (19)

THE RISK of mission drift is up sharply, in line with other risks in this area such as Reputation. It ranked high in most sectors except Africa where it was No. 13, and Central and Eastern Europe where it came down at No. 19.

The issue in this risk is the growing conflict between the social and commercial goals of microfinance, and the risk to MFIs if they switch their focus from the first to the second or, as some put it, from a double to a single "bottom line". But for many people, mission drift is about more than focusing on profit rather than poverty. It is also structural, epitomised by the shift from "good" microlending to "bad" consumer finance, and the huge growth in personal indebtedness that this is seen to have caused. The "rapid rise of consumer finance, whether disguised as housing loans, education loans, or loans for whatever 'funder-fashionable' purpose", is pulling the sector from its purpose of poverty alleviation and financial inclusion, according to a microfinance advisor in the Netherlands.

A further shift is from the rural poor to the already well-served urban masses. Jeffrey Ashe, director of community finance at Oxfam America, said that "the major challenge faced by commercial microfinance is…the ongoing issue of leaving out approximately 80 per cent of the market, essentially the rural poor, and developing effective tools for mobilising savings".

Mission drift is a risk that needs to be actively managed

But the notion of mission drift begs the question: from what *mission* is the sector *drifting*? As one respondent put it, "One person's 'mission drift' is another's 'product line extension'. The key is to ensure that values are reflected in strategy, operations, management and governance".

> **A simple guide to mission drift**
>
> "The bigger; the more commercial; the more mission drift".
>
> **Microfinance policy adviser**
> The Netherlands

The consequences of mission drift are already plain to see: political backlash, disillusionment among supporters, severe reputation damage – and confusion among microfinance's investors. Paul DiLeo, president of Grassroots Capital Management, wondered whether the purpose of microfinance was "social impact and social change, or financial return to investors? The two aren't mutually exclusive, and some may prioritise one over the other. But practitioners need to be clear where their priority lies".

Many respondents felt that the risk of mission drift required active management, like any other risk. A respondent from a major Western European microfinance investor thought that the test for MFIs now lay in "social performance management rather than in institutional and financial sustainability".

But, like many Banana Skins, this is one where generalisation should be resisted. The amount of mission drift varies greatly from country to country. A respondent from one of the largest Mexican MFIs said that cases of mission drift were "isolated; moreover we have a large number of intermediaries that maintain their original mission".

10. Unrealisable expectations (18)

This Banana Skin is sharply up on last time, like the related risks of mission drift and reputation, reflecting a fundamental theme of this survey: doubts about microfinance's effectiveness. But there was no clear pattern to the responses: Western Europeans ranked it No. 4, Africans No. 19.

This Banana Skin isn't about microfinance performing poorly. It is about its failure to meet expectations – both social and financial. So the risk lies in the perceptions that people have of microfinance, and the gap between these and reality: if people conclude that microfinance is not meeting expectations, it is judged a failure.

Microfinance is no magic wand

Several respondents expressed frustration. "Yes, MFIs can't end world poverty; they're a piece of the puzzle only!" wrote one US respondent, and a practitioner in Tanzania complained: "People's expectations of MFIs are normally beyond their ability to deliver and the situation will persist until such a time when people's perspectives on MFIs become more realistic".

But for others, the "myth" of microfinance as a panacea for poverty alleviation is being exposed. It is, as this report noted in 2009, "an industry surrounded by hype", with a permanent risk of disappointment, of expectations remaining unfulfilled. "Given all the growing momentum, interest, and attention to the topic of financial inclusion", one CGAP analyst wrote this year, "will microfinance live up to the hype? We need to temper expectations, to be clear about what microfinance is and is not, and continue to explore new ways of delivering financial services to poor people".

Many respondents said it was up to the industry to communicate its message better to ensure that expectations did not become excessive. Nigel Biggar, senior advisor at the Grameen Foundation in the US, said that "MFIs need to be able to defend their work not only from a financial perspective but, critically, from a social perspective. To do this, social performance management is the key: understanding and documenting the extent to which MFIs are reaching their target population - the poor, the very poor, the unbanked, marginalised, etc. and documenting how organisations manage their social performance to enable welfare gains for their target populations. This would not only deflect criticism, it would strengthen how microfinance delivers on its social objectives of poverty alleviation".

11. Managing technology (15)

THE PROBLEM of getting technology right is moving up the risk scale. MFIs face tough decisions on the management of their IT systems and their delivery strategies in the near future. Do they have the know-how and the resources to get them right? Some of our respondents thought these were among the most difficult issues facing MFIs today: failure could put an MFI out of business. A microfinance analyst said it was a case of "Invest in technology or cease to exist in five years". Concerns about this Banana Skin were strongest in Africa and the CEE.

Respondents identified several areas where MFIs needed to do better on technology. One was **internal systems**, given the need to reduce costs and tighten up management controls, for example in the area of credit. An Indian respondent said that "a significant ramp up is required".

Another was **business strategy** at a time when technology is bringing dramatic new forms of mobile banking which could be crucial to an MFI's ability to deliver the service and remain competitive against commercial rivals. A US microfinance consultant said there was a risk that the microfinance industry "won't position itself aggressively enough to take advantage of branchless banking services, and will be overtaken by mobile network operators and large banks who figure out how to get into rural areas and go down-scale".

A **lack of IT skills** was another concern. Many respondents feared that MFIs would be pressed to manage technology successfully, given the scarcity and cost of experts, and the high level of investment needed. A US policy adviser said that "all eyes are on mobile banking, but it has only been proven at scale in a very few institutions. The institutional capacity of the financial institution and the mobile phone provider and the quality of the partnership will be critical to more success stories".

12. Profitability (12)

ALTHOUGH concern about profitability has remained level, perception of this risk is shifting. It used to be that profits were seen as a good thing, an indication of the health and success of the microfinance industry. Increasingly, they are seen as bad, a symptom of the unwelcome commercialisation of the sector. The risk is therefore switching from finance to reputation.

Beth Porter, policy advisor to UNCDF, said it is "important for the industry to be profitable - and to be seen as a good and sound investment. But the returns to investors in IPOs should return to earth. Otherwise the backlash from politicians and the public may lead regulators to put in place draconian measures, and investors to move their support from innovation that is helping poorer and more vulnerable populations to less controversial investments".

An Indian respondent saw the risk to the industry lying in its "inability to address the issue of profits and profiteering".

Nonetheless, there is concern about the pressures on MFI profitability, and about the risks these pose to the sustainability of the industry. Sebastien Duquet, a director of Planis, a microfinance investor, said that profitability was shrinking on all continents. "Competition is finally playing its part. But it is weakening certain players, particularly the small ones." Some respondents feared that, by squeezing profitability, competition would spur MFIs to take greater risks, for example with their lending.

Are profits a good or a bad thing?

A further threat to profitability comes from political interference, in particular rate capping. Some respondents feared that MFIs might even have to reduce their profitability to protect themselves from political and media attacks. A Mexican respondent said that profits should come from "administrative efficiencies, and not higher interest rates".

But many respondents also emphasised that profits were healthy: it was a matter of how they were shared out between many stakeholders, not just investors. One US investor believed that "the commercial sector, funded in domestic markets, will lead an expansion of the industry with more stable institutions, with a wider range of services, and with less political interference."

13. Back office (22)

THE ABILITY of MFIs to keep effective control of their operations as they evolve is becoming a rising risk issue. Many respondents said that MFIs were growing at a faster pace than their back office systems could handle, and this was exposing them to credit risk and other dangers. A respondent from Peru said that the two most urgent risk issues facing MFIs were "the absence of internal controls to ensure quality growth portfolios, and the risks associated with the lack of technology for monitoring multiple credits…"

But concern about this risk varied greatly: it was high in Africa and the Far East but low in the CEE and the Middle East. It was also high among regulators but low among practitioners. Philippe Nsenga, inspector of microfinance at the National Bank of Rwanda, said that MFIs suffered from operational risk because of "ever growing operations and products versus poor management information systems".

Respondents saw a number of reasons for the rise in this risk: the pressures of competition, the need to expand the business to meet investor expectations, poor strategic planning, and a culture which treated the back office as boring. High cost was also a deterrent to adequate investment in control systems.

However, the risks were clear. Sanjay Sinha, managing director of Micro-Credit Ratings International in India, saw excessive growth "leading to a loosening of control systems which results in portfolio delinquency and/or customer abuse and a rising level of loan losses…"

Weak internal controls are hurting MFIs

Respondents said that badly managed MFIs were losing track of their borrowers and the status of their loans. This was exposing them to the additional risks of multiple borrowing, delinquency and fraud. One European investor said that "in workouts, lenders often realise that portfolio data is inaccurate". Poor management information systems lead to ill-informed decisions, and contribute to another set of risks: poor accountability and transparency.

But some respondents saw improvements in this area, under pressure from investors and regulators who are concerned about mounting loan losses. A respondent from Tanzania said that MFIs "are moving more and more into acquiring affordable advanced technologies, and building internal capacities to handle back office operations", and an Egyptian investor said that "best practices are now widely shared and applied".

14. Transparency (16)

TRANSPARENCY is a risk for MFIs if they do not disclose enough information about their business and services to preserve the confidence of investors and customers. Although MFIs are doing better on this front through fuller reporting, they may still be falling behind the rapid growth of investor and media interest in the business. This Banana Skin was a particular concern to regulators who put it at the top of their list.

A respondent from an MFI rating agency said that risk was rising "because more and more transparency is expected with the increasing attention of the international media."

Although many countries now require audited accounts, there is still scepticism about the quality of the numbers, particularly the reporting of bad loans. A ratings analyst in the Philippines said that "although there are MFIs who still report a one digit PAR, if we carefully examine their portfolio and how they report PAR, we can see that delinquency is still major problem among MFIs".

But the greater risk may lie on the social side where MFIs can no longer take their charmed status for granted. An investor in The Netherlands said that "the microfinance industry will increasingly have to prove the effect of its activities. More transparency will be needed towards MFI clients (about pricing and conditions), towards investors (about potential returns) and towards the outside world (about the image of exploiting people)". This calls for communication skills to be added to an MFI's expertise.

Khaled Al-Gazawi, chief executive officer of The First Microfinance Foundation in Egypt, said that "with more MFIs being created every day, and with more clients being served, transparency with clients on interest rates and hidden costs will be a challenge. Investors are in microfinance for profit, and the social goals of microfinance might not come on the top of the list. Regulatory frameworks should aim to balance a double bottom line and guarantee that the client knows the basis on which he/she will borrow".

15. Strategy (-)

THE ABILITY of MFIs to develop and implement a successful business strategy is becoming more urgent in these difficult times. For the first time this year we included Strategy among our Banana Skins; it received a middling ranking, but was also seen to be one of the faster-rising risks at No. 6 because of the big strategic issues facing MFIs.

A priori, MFIs need to have the skills to manage strategy. Some of our respondents felt these were absent from the governance structure of many MFIs. An MFI director in East Africa said that successful strategy "will depend on quality management, which is not abundantly available".

Respondents identified several aspects to strategic risk: scaling, profitability, funding, stakeholder confidence etc.. But the most difficult will be the need to balance business and social objectives so as to deliver sustainability as well as the microfinance service. (See Box)

MFIs with weak strategies could fail

The consequences of poor strategic planning could be severe. Some respondents expected that MFIs without effective strategies would fail or be taken over. An Egyptian respondent said that "badly managed MFIs will feel more challenged, and mergers might be more and more common in the market."

Julie Abrams, a consultant at Microfinance Analytics in the US, said that "this next phase could well become the years of the microfinance minefields. MFIs will have to be impeccably run, laser-focused and strategically sound to thrive. There will be no room for sloth or sloppiness in operations, governance, risk management, and customer focus; being proactive in all of these will be key. MFIs can no longer grow themselves into sustainability and profits, as some have in the past".

Is the business model broken?

The air of crisis surrounding microfinance raises the question whether the business model is in need of a makeover.

Far from depicting a thriving industry motivated by worthy social goals, one set of respondents to this survey painted microfinance as driven by greed, sustained by subsidised funds or profit-hungry investors, failing its clients by deserting the most needy or driving them into debt, with only a veneer of ethics and philanthropy. In a comment typical of very many in this vein, one of them observed: "Microfinance is slowly but surely losing what made it special and successful".

Another set of respondents portrayed MFIs as stuck in the past, lacking the resources to scale up or improve the service, self-pitying, and probably doomed to be wiped out by the first set. A microfinance analyst said that "MFIs, particularly small, local institutions, have not delivered scale in most countries and are not likely to do so alone. As new providers and delivery channels move in, what will happen to these organisations?" A Mexican respondent said that "the model is becoming eroded and many institutions are not doing anything to adopt a different one."

Both sets may be an exaggeration. But there is no mistaking the unease that exists about the traditional microfinance model at this possibly crucial stage in its evolution. Many of our respondents felt that microfinance needed to re-engineer itself to take account of new realities: the demands created by commercial investment, competition from powerful new entrants, the uncertain future for small MFIs, particularly those in rural areas, and the need, despite all these things, to keep sight of philanthropic objectives.

Philip Brown, managing director of microfinance risk at Citi, said that "strategy and business models have constantly to evolve to address changing client needs and market parameters. Learning from the past and recent history demonstrates that failure to adapt can lead to institutional stress and demise".

A re-think on group lending

Some respondents even wondered whether there was any future for the traditional "Grameen group lending model". A respondent from Peru said it was time to question the notion that "the group approach is the only way to reach microentrepreneurs lower down the pyramid. There are other ways of getting credits into rural areas at reasonable costs". Mahesh Mani, vice-president at Citibank in India, said there was an increasing need "to improve and innovate the product offering and re-look at the classical 'Grameen model' and make it more flexible and customised with respect to local conditions and the needs of the target market ...This is because the so-called biggest strength of the 'joint liability group' model can also become its biggest weakness".

Many respondents felt that the industry was coming to the end of a period of rapid and easy growth, and would have to restructure to survive: consolidation among small MFIs, specialisation among larger ones, with a focus on quality rather than quantity, on meeting demand rather than just supplying what they could. Alex Pollock, director of microfinance at UNRWA, said: "The ability to continue to grow and maintain profitability is limited by competition and national markets, and MFIs must recognise that at some point their operations will reach an optimal level, at which point they will need to concentrate more clearly on maintaining their edge through customer service and improvements in their business processes that they may have neglected because of the openness of the market".

16. Liquidity (2)

LIQUIDITY is no longer the concern it was in 2009 at the height of the financial crisis. The sharp downward change in position reflects the return to more normal conditions in global finance.

Nonetheless, the availability of liquidity clearly differs very much from one market to another, and among different types of MFI. Many respondents saw liquidity flooding into the more dynamic emerging markets as lending banks re-opened lines they had closed during the crisis. An Egyptian respondent said that "liquidity for good MFIs should not be an issue as there are more sources of cash now than ever".

But though this was welcome, it could also contain the seeds of new risks such as a resumption of poorly managed growth. Wilson Castro, director of small business lending at Banco Familiar in Paraguay, said that "high levels of global liquidity are moving towards emerging markets, especially where there are many MFIs, which increases the level of liquidity and sharpens the risk of overindebtedness". A respondent from one of the state development banks in Mexico said that MFIs there "suffer from excess liquidity and the challenge is to increase lending, but carefully".

A sharp drop in liquidity risk

But conditions in other markets can be very different. Roshaneh Zafar, managing director of the Kashf Foundation in Pakistan, said that a combination of a strained fiscal environment and caution among lending banks was squeezing MFIs. She added: "Given the increased credit risk and constraints on liquidity, MFIs will continue to have difficulties in being operationally and financially self-sustainable." Many respondents in Africa and Asia reported liquidity problems.

The markets are also discriminating in favour of the more robust MFIs. L.B. Prakash, a practitioner with Development Capital in India, said that most banks were playing it safe by lending only to large MFIs. "It is ironical that the microfinance sector started off for small loans, but does not get small borrowings". MFIs with access to local deposits are also better placed, though there is concern in some areas that the economic crisis and overindebtedness will deplete savings. Kebe Fodie, director of Union Mecap in Burkina Faso, said that "the level of savings is stagnating or decreasing".

But even if conditions are improving, MFIs have learnt lessons about the fickleness of liquidity. An Indian respondent said that "in the case of a repayment crisis or regulatory changes, liquidity risk is high."

17. Macro-economic trends (3)

CONCERN about the impact of the global economy on microfinance has fallen sharply with the resumption of growth in the major nations. However views differ widely over what lessons have been learnt from the crisis.

Many respondents felt that the stresses of the last 2-3 years had shown that microfinance cannot escape international shocks. The impact came in many forms: in weaker economic growth, in disruptions to world commodity markets, in lower remittances, in funding difficulties and in rising indebtedness. Hanns Martin Hagen, chief financial sector economist at Germany's KfW development bank said: "The financial crisis is not over yet. For the next one or two years, a large number of MFIs will have to work with their clients to preserve the quality of their portfolios".

Many respondents gave accounts of local impacts, particularly in CEE where concern on this front was strongest. A microlender in Tajikistan said that "microfinance is not immune from the problems of the overall world economy, and Tajikistan in particular is very vulnerable to shocks in the Russian economy as so much of local GDP is dependent on the remittances of Tajik workers in Russia." A manager in Syria commented that "with continued recession, we fear that the rate of success of small and medium size enterprises will be negatively affected". Con Keating, a specialist on the UK credit union movement, said that "in recessionary, high unemployment times, our membership is that most hurt. The credit standing of our membership is lower, much lower."

One concern is that economic stress will undo microfinance's good work at a time when its reputation is under question. A UK-based consultant said that "any levelling or reduction in microfinance lending within a locality will impact market liquidity and be a further adverse impact upon local purchasing capacity and the levels of local trade – and thus aggravate the credit quality situation". A US respondent feared that "resource limitations and a challenging macro environment will lead MFIs to cut down on their expansion plans, in-country and globally."

MFIs are not all immune to the global economy

But a number of respondents took a more upbeat view. US lawyer Howard J. Finkelstein said that microfinance had shown that it was strong enough to survive global shocks. "Did the crisis have its victims in the microfinance world? Absolutely. But as a whole it claimed fewer victims in the microfinance sector than it did in the commercial banking sector." Many other respondents commented on the "resilience" of microfinance institutions. A respondent from Latin America said that "in countries like Venezuela, with inflation rates above 20 per cent, this has not been an impediment to a flourishing microfinance industry".

18. Fraud (20)

THE OVERALL level of concern about fraud is little changed from last time, but with sharply contrasting attitudes. The regions of the world where this risk was ranked highest were Central and Eastern Europe, and Africa.

Some of our respondents felt the risk was getting worse because of the more stressful environment and declining standards in the industry, aided by the growing sophistication of fraudsters, particularly in the area of technology.

How to deal with fraud

"Train well, pay well, and punish".

MFI manager
RD Congo

Mounkaila Garba, director of Recherche-Action in Niger, said that "whatever the level of control, it is difficult to avoid this problem. People who commit these offences understand control systems and how to get round them". An East African respondent said that "this could be a major area of risk and if unchecked could be detrimental to the industry in the future**".** Several MFIs reported a growth in fictitious loan accounts as loan officers strove to meet lending targets. Fictitious business "failures" were also being used by customers to get out of their loans.

And fraud is not the only problem. Respondents mentioned money laundering, terror finance and identity fraud as further rising crime areas.

But other respondents felt that MFIs were doing better against fraud, by tightening up internal controls, centralising staff records, and installing stronger systems. An Egyptian respondent said that this was "always a risk, but it should be managed better with changing technology and know-how". A respondent from Pakistan noted that a staff reference bureau had been set up for the industry there.

19. Product development (24)

THE ABILITY of MFIs to raise their game by developing new and better products is becoming more of an issue. The majority of our respondents felt that, without product innovation, some MFIs risked failing in their mission and being overtaken by more aggressive competitors.

Stephanie Dolan, principal specialist at ACCION International, said that there has been "increasing discussion about how microfinance in many regions and institutions is still really mono-product, focused primarily on the provision of credit services. In order for microfinance to truly make a difference and maximize its potential, it will need to offer a full range of quality, affordable, relevant, and accessible financial services to clients". Some respondents were more forthright: one said that MFIs which offered a comprehensive product suite "are about as common as unicorns".

The need to expand beyond credit

Beyond credit. Many respondents were concerned that MFIs focused too much on credit products and services. This limited their business prospects and created over-reliance on an increasingly risky area of the market. Diversification was good to spread risk. A respondent from one of the large US funding organisations said that "the industry - meaning MFIs and those who support them - needs to be much more innovative and forward-thinking about a range of financial services that help the poor manage their financial needs. This may in some cases mean slower growth of *microcredit*, but faster growth of *microfinance*. Funders and investors need to understand that an MFI with a diversified product offering is, in the long run, going to be more sustainable than a credit-only mono-product institution delivering double or triple digit growth in gross loan portfolio every year".

Respondents were not short of suggestions for new products: payments, remittances, savings/deposits, loans for housing and education, insurance products etc.. Carlos Danel, vice-president at Compartamos in Mexico, said "there is still a lot to know and learn about which products work best and why, so that the industry can shift its focus from supply to demand."

Access. The other area of potential product innovation is service delivery with the arrival of mobile banking which will enable MFIs to compete with commercial banks, and extend their reach into rural areas, thereby strengthening financial inclusion. However, this presents difficulties of its own. Paul Rippey, senior fellow at the Center for Financial Inclusion, said that "banks serving the poor have a promising future…but savings groups and cell 'phone banking are disruptive technologies that will either take away clients or increase clients, depending on how banks react to them".

Constraints. Product development is expensive, and some respondents feared that MFIs would not have the resources to pursue it. In certain countries, the regulatory environment did not encourage innovation, for example in deposit-taking and telephone banking. Diversification is also, itself, a risk. Some respondents felt that MFIs would do better to "stick to their knitting". An Indian respondent said that "unnecessary diversification is more dangerous".

Know your customer

One of the concerns about the growth of microfinance is that MFIs are losing the personal touch: they see their clients as marketing targets rather than as people to be helped, and this risks destroying the essential character of the business – and generating bad loans for MFIs.

A respondent from one of the large European microfinance investors said: "We are concerned about the ethical issues of over-indebting needy clients. It has a negative reputational impact on the market and participants. As double bottom line investors we have a fiduciary responsibility to provide both an ethical and financial return."

Inherent in this risk is a failure to understand the customer, as to the products they need and their borrowing capacity. An East African respondent said there was a potential "failure to respond to needs of the market through proper product development strategies, through laxity, poor customer care and poor supervision." The spread of plastic cards, electronic funds transfer and paperless records is speeding up the depersonalisation of banking and making it harder for MFIs to assess their customers.

Emmanuelle Javoy, managing director of Planet Rating, emphasised the difficulties that poor customer contact created in times of stress. "What the last years have shown is that in troubled times strict repayment follow-up is not sufficient to keep credit risk low. A more differentiated approach, including rescheduling or refinancing, litigation in some cases and changes in loan officers' incentives schemes, is then necessary. This is certainly more complex and costly, but is key to maintaining the trust that is at the core of the relationship between an MFI and its borrowers."

20. Ownership (17)

The form of ownership of MFIs is a potential risk because it can create internal conflicts, for example between commercially-focused investors and other more socially-minded stakeholders. Such conflict could be destabilising, even fatal.

Ownership structures can create conflicts of interest

Most of our respondents saw the ownership issue in these terms, though they held different views about its severity. Prof. Hans Dieter Seibel of the University of Cologne said that MFIs which relied heavily on external debt funding and had few customer deposits would suffer "a lack of local ownership and governance, risking undue external influence, including profiteering (e.g., through IPOs)". S-P O'Mahony, CEO of Opportunity Microcredit in Romania, said that many MFIs now had commercial as well as social purpose funders, and would "need to balance sources wisely to ensure the strongest foundation for moving forward".

Another issue was the dominance of single individuals, often the creators of the business, who were reluctant to cede control. Srinivas Bonam, head microfinance at IndusInd Bank in India, said it would desirable "to have a diversified institutional holding in an MFI. Individuals, including promoters, should have a minimal holding". Another respondent said that dominant shareholders could stand in the way of consolidation among MFIs, preventing them from becoming stronger.

Some respondents felt these conflicts could only be resolved by the eventual withdrawal of certain types of investors. A US respondent said that "tensions between international financial institutions (IFIs) and private investors will continue until the IFI presence is substantially reduced". Matthew Gamser of the International Finance Corporation in Hong Kong said that "with western donors and social investors increasingly strapped for funds, we'll see how weak ownerships dominated by such interests really are".

But others saw it moving the opposite way. As the possibilities opened up, they saw commercial investors providing MFIs with access to capital, paving the way to a stronger future. One respondent said that "it is more likely that NGOs will find it difficult to cope in the changing environment".

21. Interest rates (11)

LITTLE RISK is seen on the interest rate front so far as volatility is concerned: global rates have been low for some time and are likely to remain so in the foreseeable future.

Little change seen on the interest rate front

This is good news for MFI funding: costs should remain low. However it is bad news for MFI lenders who live off high loan charges. It creates pressure on them to lower rates and accept lower margins. Many of our respondents therefore thought that an extended low rate environment could prove difficult for MFIs: it poses a risk both to profitability and reputation.

The major risk on this front lies in politically motivated moves to cap interest rates on loans and squeeze MFI margins, which complicates asset and liability management, and presents MFIs with the problem of re-pricing their loans to conform with the regulations. A US investor said that "the political fallout over interest rates could tarnish good and poor institutions alike, with possible systemic implications in some markets".

Further out, there is the prospect of rising interest rates as the inflationary effects of monetary easing flow through, which could inflame the whole interest cost issue. A Mexican respondent said that "the injured parties will be the users since demand for credit in this segment is highly inelastic to fluctuations in interest rates".

22. Too much funding (25)

THE PROBLEM of excessive funding for microfinance has eased, but not disappeared (and it is seen as a greater risk than a shortage of funding. See No. 23). Although it is dangerous to generalise, respondents see the flow of funding returning to the market after the crisis, often in quantities which the industry may find it hard to absorb without creating strains, especially at a time when growth is slowing.

Alex Silva, general manager of Omtrix in Costa Rica, said that "too much money is being made available to MFIs which, especially when it is combined with high return expectations, might force MFI managers to grow too rapidly at times overlooking good practices". An Egyptian respondent said that this was "a very serious risk. Some MFIs are close to drowning with all the cash thrown at them".

A UK-based development expert said that in some countries "the threat of a microcredit bubble popping is very real and it will lead to massive destabilisation of local economies artificially pumped up on microcredit and then cast adrift as the microfinance institutions either fail or refuse to roll-over microcredits. The international donors know this but cannot admit to a mistake that implicates 'the market' and 'profit-driven institutions' which are still sacrosanct in many development agencies, no matter what the consequences".

The fear is that MFIs which accept easy money will take risks with their business and the industry's reputation. Luc Vandeweerd, strategic director at ADA Asbl, a Luxembourg-based microfinance development group, said that "most of the largest investors are targeting the same markets, work with the same kind of MFIs offering the same kind of short term (1-2 years renewable) funding, and putting pressure on their clients' MFIs. The main risk is that these MIVs contribute to a growth without any control and to related consequences (loss of social values, over-indebtedness, etc.)".

The problem is not too little funding, but too much

Another risk is that the high valuations placed on MFI flotations may further tarnish microfinance's image and provoke a public backlash. Tanmay Chetan, co-founder and managing partner of Agora Microfinance Partners in the UK, said that over-valuations were "pushing the MFIs to try and maximise their returns from their clients. This is creating a bubble-like situation in some parts of the world, which can lead to a bust in some geographies like Southern India".

That there should be too much funding around is frustrating for MFIs who are suffering the reverse problem, usually the smaller ones serving difficult markets. Many respondents said that it was not a matter of too much funding but funding that was badly spread or indiscriminately dispersed. Lukas Wellen, CEO of Musoni in Kenya, said bad funding "keeps weak projects afloat". Another respondent said that "too much funding may be diverted to small scale projects, and we'll be in the same position in five years' time".

23. Too little funding (6)

ONE SIGN of a return to normality is the low level of concern about funding for the microfinance industry. As in pre-crisis days, the larger problem is an overabundance of finance and the risk of excess capacity.

But that is a generalisation. Concerns remain about the availability of funding in many markets and for particular types of MFI, for example the smaller and less profitable ones (which may also be the ones serving the neediest communities). Respondents reported funding difficulties in all regions, but overall concern was strongest in Africa and Asia. Regulators were particularly concerned about funding, placing this No. 5 on their risk list.

A growing issue is that the doubts that are now spreading about the effectiveness of microfinance will frighten off investors and lenders. A microfinance consultant said that "the double whammy of scarcity of investment capital (especially if international investors become disillusioned) and the need to increase regulatory capital (which has already happened in some markets but may be more of a feature in future if consumer protection worries spook regulators) may be too much for some MFIs to bear".

Growing political interference in the industry is another threat, identified particularly by respondents in the Indian sub-continent and Latin America. Danilda Almanzar, director of deposits at Banco Ademi in the Dominican Republic, said that "the economic policies adopted by populist governments in some Latin American countries could affect the issue [and cost] of foreign investments in each country".

As before, many respondents commented on the unsuitability of much of the available funding, on the need for MFIs to tap new sources and diversify their funding base, particularly into local sources, though this is not always easy. Syed M. Quader, managing director and CEO of Southtech in Bangladesh, the "home" of microfinance, said that "MFIs are unable to borrow from the public like commercial banks, and as they attempt to expand they are increasingly relying on relatively expensive funding from commercial banks. Their margins are getting narrower by the day although they are perceived to be charging high interest rates."

Although MFIs which take deposits are better placed for local funding, there is also concern in some places that economic difficulties will damage people's confidence in banks and reduce their savings. Bernard-Désiré Ntavumba of FSTE in Burundi said it was "difficult for poor people to make voluntary savings, and the consequence is a decrease in available cash".

Overall, though, the very low position scored by funding risk suggests that fears that investors will be scared off by controversy may be exaggerated.

24. Foreign exchange (8)

DESPITE all the talk of global currency wars and euro crises, foreign exchange is not seen as a big Banana Skin for MFIs because most of them have little exposure to currencies other than their own.

Few worries about foreign exchange risk

Respondents said that MFIs were tapping more local deposits and receiving more of their foreign funding in local currency. Foreign exchange expertise was also growing, and hedging possibilities had improved. A respondent from East Africa said that "most MFIs prefer to borrow from local sources, and those that borrow from overseas engage in hedging arrangements with local banks".

However, the importance of external funding to some MFIs means this could still be an area of risk particularly if, as respondents in particular markets noted, local funding sources are inadequate and hedging possibilities remain limited.

Fermin Vivanco, investment officer at the Inter-American Development Bank in the US, said that MFIs were "relying too much on hard currency loans from microfinance investment vehicles, instead of capturing deposits. The value of the dollar has been going down these last years, so debt in dollars has been cheap. But this exposure may become a problem in the long term if the economic environment changes".

Some respondents flagged an indirect foreign currency risk: the impact of foreign exchange volatility on the value of remittances, and through that on the local economy and borrowers' creditworthiness.

Preparedness

We asked respondents to score the preparedness of MFIs to handle the risks they had identified on a scale where 1=poor and 5=good. The total score was 2.70, which is slightly better than middling. However there were variations according to the category of respondent.

Geographically, respondents from Latin America were the most optimistic and those from Asia the least. Among respondent types, practitioners were the most confident about the level of preparedness and regulators the least.

Total	**2.70**
Practitioners	2.79
Investors	2.68
Analysts	2.51
Regulators	2.22
Latin America	3.12
MENA	2.96
CEE	2.78
Western Europe	2.72
North America	2.68
Far East	2.67
Africa	2.57
Asia	2.48

Respondents' comments about preparedness reflected concerns about MFIs' ability to manage risk successfully in the volatile environment that currently prevails, particularly in the areas of credit and reputation.

Preparedness could be better

Karla Brom, an MFI consultant in the US, said: "Most MFIs do not have the risk infrastructure in place to handle their current clients and products…There is not a large pool of trained risk managers to draw from, and very little comprehension of how to measure and manage the trade off between risk and reward…Operational risk grows as MFIs grow, and as their product and client mix grows as well. This leads to reputational risk since more eyes are focused on the sector, and MFIs can't explain their pricing or business models in a clear way to regulators or others."

Further out, respondents felt that the microfinance industry stood at the threshold of big long term decisions which needed to be firmly addressed to ensure survival. Sarah Nolan, regional risk director for East Europe, Asia and Africa at Opportunity International, said: "Shareholders, lenders and leaders need to be prepared for a 'generational' transition of the industry from a phase characterised by rapid growth, commercial investment and subsidized support, towards a more self-reliant industry featuring a systematic approach to management, governance, and organisational development".

APPENDIX: The questionnaire and guide

CSFI

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Microfinance Banana Skins 2011

This survey seeks to identify the risks facing microfinance institutions (MFIs) over the medium term (2-3 years), as seen by practitioners, investors and close observers of the industry. Its focus is the commercial microfinance sector, by which we mean institutions which are run for profit and have assets of more than US$5 million.

Who you are

Name:
Position:
Institution:
Country:

Replies are in confidence, but if you are willing to be quoted in our report, please tick

Your perspective on the microfinance industry

Practitioner   If yes, does your institution take customer deposits?
Investor
Regulator
Analyst
Other (please state)

Question 1. Please describe in your own words the main risks you see facing the microfinance industry over the next 2-3 years, and your reasons.

Question 2. Here are some areas of risk for MFIs which have been attracting attention. How do you rate their severity, and what is their trend: rising, steady or falling? Use the right hand column to add comments. Insert more risks at the bottom if you wish.

		Severity 1=low 5=high		Trend Rising Steady Falling		Comment
1	**Back office operations** How vulnerable are MFIs to risks in administration, accounting, systems and controls?					
2	**Competition** Will competitive pressures push MFIs to take greater risks in areas such as pricing, product innovation and credit quality?					
3	**Corporate governance** Are there weaknesses such as low calibre or lack of independence?					
4	**Credit risk** Will MFIs be damaged by borrowers failing to repay their loans because of overborrowing, poor credit management, poor client understanding or difficult economic conditions?					
5	**Foreign exchange** Could MFIs be harmed by currency fluctuations?					
6	**Fraud** Will MFIs be damaged by dishonest staff and customers?					
7	**Inappropriate regulation** Could MFI growth and profitability be constrained by bad rules?					
8	**Interest rates** Will MFIs be hurt by fluctuations in interest rates?					
9	**Liquidity** Will MFIs suffer a shortage of ready cash?					

10	**Macro-economic trends** Are MFIs vulnerable to pressures in the wider economy such as inflation, recession and volatile markets?					
11	**Management quality** Is MFI management up to the challenge of growing the business and managing the risks?					
12	**Managing technology** Will MFIs be able to master this difficult area?					
13	**Mission drift** How strong is the risk that MFIs will be deflected from their stated missions?					
14	**Ownership** Are the ownership structures of MFIs appropriate and stable?					
15	**Political interference** Will political interference harm MFI business, eg in the areas of interest rates, lending policy and subsidised competition?					
16	**Product development** Could MFIs fail to develop the right products and manage them successfully?					
17	**Profitability** Could inadequate profitability affect MFI growth and commercial viability?					
18	**Reputation** How severe are the threats to the industry's reputation?					
19	**Staffing** Will MFIs have difficulty recruiting and retaining good staff?					
20	**Strategy** Will MFIs be able to map strategies to survive and grow in today's challenging environment?					

21 **Too little funding** Will there be sufficient funding to sustain healthy growth in the industry?					
22 **Too much funding** Alternatively, does an overabundance of funding encourage MFIs to take unnecessary risks?					
23 **Transparency** Do MFIs report enough good information to sustain confidence in the sector?					
24 **Unrealisable expectations** Do people expect too much of MFIs, and what happens if they fail to deliver?					
25					

Question 3. How well prepared do you think MFIs are to handle the risks you have identified?

On a scale of 1-5, 1=poorly prepared, 5=well prepared

Thank you for your time.

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Registered Charity Number 1017353
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Published by
Centre for the Study of Financial Innovation (CSFI)

Email: info@csfi.org.uk
Web: www.csfi.org.uk

ISBN: 978-0-9563888-6-5

Printed in the United Kingdom by Heron, Dawson & Sawyer

C S F I / New York CSFI

NUMBER NINETY NINE FEBRUARY 2011

Preface

THIS is the third “Banana Skins” survey of the global microfinance industry that the CSFI – primarily in the form of its Senior Fellow, David Lascelles with the assistance of Sam Mendelson – has prepared. Like its predecessors, it is funded by Citi and the Consultative Group to Assist the Poor (CGAP); we are very grateful to all of them.

In my opinion, this is by far the most interesting – and important – of the series. The reason is simple: Until very recently, scarcely a voice was raised against microfinance. It was regarded by governments, by academics and, increasingly, by the wider public as an unalloyed public good – and its most public face, Grameen’s Mohammed Yunus, received a well-deserved Nobel for his efforts. The only problem was one of scale. How could the ‘bottom-up’ approach of microfinance (which depends on tiny loans to poor people in small communities) be replicated widely enough to make a significant dent in the global problem of poverty?

I still believe in microfinance – not least, because it seems to me unequivocally true that the conventional top-down aid model is broken. But things have certainly changed in the last couple of years.

As this report makes clear, a lot of people – well-meaning, thoughtful people, who are in or close to the microfinance industry – are now worried that microfinance has taken a wrong turn, that it has drifted away from its original mission, that it has been co-opted (or even corrupted) by the pursuit of size and profitability, that it has become a political plaything etc etc. This is new and, as David’s report makes clear, it leaves microfinance and individual microfinance institutions at a ‘tipping point’. Will the industry continue to evolve - to grow, to offer new products, to move up-market – until it is essentially indistinguishable from conventional financial institutions (banks, consumer finance companies etc)? Or will it rediscover its roots as a more modest source of small-scale credit to a relatively limited market amongst lower-income groups in generally poor countries?

Inevitably, some institutions will go one way, and others another – but it is clear that the sector as a whole is coming under much harsher scrutiny. After years in which, essentially, it got a ‘free pass’ from most donor governments and agencies (as well as from the authorities in the countries in which microfinance institutions operate), the climate has become very different – and a lot less forgiving. As our survey results show, concerns about reputation, competitiveness, governance, management competence and politicisation abound, and there is a high degree of cynicism about what motivates at least a sizeable chunk of the industry.

But don’t throw the baby out with the bathwater. Many of the problems that the industry faces are just the products of its success; it is no longer beneath the radar, either domestically or internationally, and it must expect to be held to higher standards than it was in its earlier days. It remains one of the most promising vehicles for getting money to those people who need it most and who can use it most productively.

So let’s hope that its current problems can be overcome, and that the next survey paints a much more optimistic picture. In the meantime let me restate my thanks to our friends at Citi and CGAP for their sponsorship, to Deborah Drake of the Council of Microfinance Equity Funds (CMEF) for advice and support, to the MIX for the data and to Zach Grafe whose management of the online questionnaire helped immeasurably with what has become far and away the biggest survey of its kind.

Andrew Hilton
Director, CSFI

This report was written by David Lascelles and Sam Mendelson
Cover by Joe Cummings

Sponsors' foreword

The Microfinance Banana Skins report, now in its third year, reflects changing perceptions of risk in a dynamic and fast-moving industry. This year's report shows that microfinance has come of age, and with that, new issues have arisen. In an increasing number of markets, the rapid rate of growth and outreach means that microfinance is confronting the same forces of competition, credit cycles, and consolidation seen in other sectors.

The survey mirrors this evolution, highlighting the need for increased focus on clients' needs and related credit risk, as opposed to institutional risks such as funding and liquidity. Responses also reflect an industry that is at different stages of development in different regions of the world. Microfinance is only reaching 150m borrowers worldwide - a fraction of the global need. More than 2.7bn people still have no access to formal financial services that are cheaper and more reliable than the informal alternatives.

In a few markets, particularly where many microfinance institutions serve the same communities, some respondents to the survey expressed concern about an oversupply of credit and over-indebtedness. In other markets, we see the emergence of deposit-taking institutions, credit bureaus, comprehensive regulatory oversight, and credit expansion accompanied by savings, insurance, and other services.

Reputation risk and political risk are both placed more highly in the ratings this year. Notwithstanding recent questioning of the ability of microfinance, and particularly microcredit, to lift millions out of poverty, microfinance remains central to achieving financial inclusion, by enabling families to manage their household finances more effectively - allowing them to build assets, smooth consumption, and insure against risk.

This year's survey also reflects an evolving microfinance industry. The volume of concern may be amplified by recent events in a few markets, notably in the Indian state of Andhra Pradesh. But the questioning is undoubtedly healthy, and should lead microfinance practitioners to reassess the business models, and the practices and products that will most effectively serve the needs of low income people.

In many markets, MFIs and investors have already taken notice of the changing risks. MFI growth has slowed, lending standards have been strengthened, and more attention is being given to social performance. In several countries, the rate of increase in non-performing loans at MFIs is easing and more sustainable growth models are emerging. Most regulators now acknowledge the valuable contribution that the microfinance sector is making to financial inclusion, and see it as part of their country's financial infrastructure.

But more needs to be done. The industry needs to accelerate reform to shore up support in the face of growing reputation risk. MFIs need to further strengthen their lending standards, particularly with regard to over-indebtedness among borrowers. And in many countries, improved regulation will be essential to achieve financial inclusion.

A vision of financial inclusion that encompasses the majority of the world's population goes well beyond what is captured in this report. But it is clear from the survey that the landscape of access to finance will look significantly different five years from now. As the microfinance industry continues to evolve, new players and new business models are emerging. The opportunity - and the need - is immense.

We are grateful to the 533 participants from 86 countries who contributed to the survey. We would like to thank David Lascelles and Sam Mendelson for distilling participants' feedback and presenting it in such a cogent manner. We thank Deborah Drake at the Council of Microfinance Equity Funds, Philip Brown at Citi Microfinance, and Xavier Reille at CGAP for their contributions to the success of this survey.

Robert Annibale
Global Director of Citi Microfinance

Tilman Ehrbeck
CGAP CEO

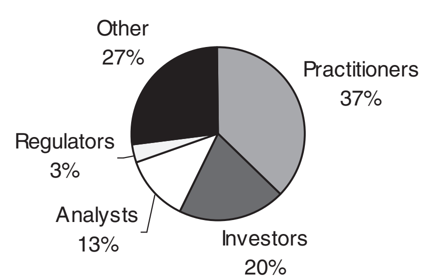
About this survey

Microfinance Banana Skins 2011 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers. It updates previous surveys carried out in 2008 and 2009. This survey was conducted in November and December 2010 and is based on 533 responses from 86 countries and multinational institutions.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the microfinance sector over the next 2-3 years. In the second, they were asked to rate a list of potential risks – or Banana Skins – both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of microfinance institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be named.

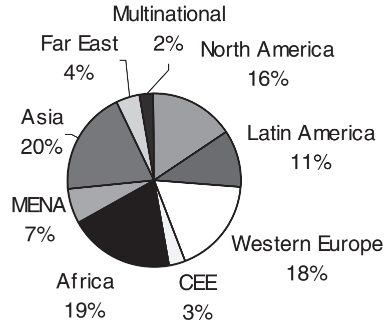
The views expressed in this survey are those of the respondents and do not necessarily reflect those of the CSFI or its sponsors.

The breakdown by type of respondent was as follows:



Just over half (55 per cent) of the practitioners represented deposit-taking institutions. The “other” category included aid officials, academics, accountants, lawyers, consultants etc..

The distribution of responses by region was as follows:



The responses by country were as follows

North America	
Canada	4
US	89

Latin America	
Bolivia	1
Brazil	2
Colombia	10
Costa Rica	3
Dominican Rep.	1
Ecuador	2
El Salvador	2
Guatemala	1
Haiti	3
Mexico	14
Nicaragua	2
Paraguay	5
Peru	7
Uruguay	1
Venezuela	2

Western Europe	
Austria	1
Belgium	4
Finland	1
France	16
Germany	10
Italy	3
Luxembourg	4
Netherlands	21
Spain	2
Sweden	1
Switzerland	7
UK	17

Central & Eastern Europe	
Azerbaijan	1
Bosnia & Herzegov.	5
Kazakhstan	1
Poland	1
Romania	2
Russia	3
Tajikistan	2

Africa	
Benin	5
Burkina Faso	4
Burundi	1
Cameroon	13
Congo Brazzaville	1
Côte d'Ivoire	7
Ethiopia	2
Gabon	2
Ghana	7
Guinea	1
Kenya	5
Madagascar	3
Mali	6
Mauritania	2
Niger	2
Nigeria	5
RD Congo	11
Rwanda	2
Senegal	7
South Africa	1
Tanzania	1
The Gambia	1
Togo	10
Uganda	6

Middle East & North Africa	
Egypt	8
Iraq	2
Jordan	3
Lebanon	4
Morocco	6
Palestine	2
Syria	1
Tunisia	1
UAR	2
Yemen	5

Asia	
Afghanistan	1
Bangladesh	6
India	82
Nepal	4
Pakistan	13
Sri Lanka	1

Far East	
Australia	3
Cambodia	2
China	4
Fiji	1
Hong Kong	1
Laos	1
New Zealand	2
Philippines	8
Vietnam	1

Multinational	13

Summary

This survey explores the risks facing the microfinance industry at a time when hard questions are being asked about its future, prompted by growing doubts about its effectiveness as a source of small scale finance for the poor. One of our respondents summed up the significance of these doubts, saying they could "dissipate the fairy dust that has historically coated everything related to microfinance". Many of the risks explored in this report reach the heart of the debate about where microfinance goes next.

Originally created as a grass-roots movement to provide credit to the neediest, microfinance has grown enormously over the last 20 years and is now firmly established as a major supplier of a wide range of financial services to millions of people in the emerging world. The one thousand-plus microfinance institutions (MFIs) that report to the Microfinance Information eXchange (MIX) have 88m borrowers and 76m savers, and numbers are growing by 20 per cent a year, more in some countries. Total assets of these MFIs amount to $60bn.

Many of the risks go to the heart of the microfinance debate

However in the last two years, microfinance has found its enviable reputation under attack for a number of perceived reasons: its growing commercialism, as evidenced by an increasing focus on size and profitability, a decline in standards, particularly in the area of lending, and a sense that the industry may be drifting away from its original "double bottom line" purpose. All have combined to cast microfinance in a new and unflattering light, and have raised doubts about the continued willingness of donors and investors to provide the support it crucially needs.

How serious are these developments? What are the new risks that the industry faces? Is microfinance coming to a crossroads in its evolution, and if so, what should be its new direction?

The survey results

This survey, the third in the series, was conducted to seek answers to these questions and put the risks into perspective. Its focus is on MFIs with more than $5m in assets which are profitable and capable of commercial growth. These number about 600, according to estimates from MIX, and account for the bulk of microfinance assets globally.

The survey asked a series of experts on microfinance (practitioners, analysts, regulators, investors etc.) to identify and comment on the biggest risks, or "Banana Skins", which they saw facing the microfinance sector over the next two to three years. Over 500 of them from 86 countries took part, the largest response to any Microfinance Banana Skins survey so far. The table on p.6 shows how they responded: it ranks the 24 Banana Skins they identified both as to severity and how strongly they are seen to be rising.

The overall message from the survey is that the immediate risks posed by the global economic crisis have receded – but have been replaced by larger concerns about the future direction of the industry.

Microfinance Banana Skins 2011

(2009 position in brackets)

Biggest risks	Fastest risers
1 Credit risk (1)	1 Competition (3)
2 Reputation (17)	2 Credit risk (1)
3 Competition (9)	3 Reputation (11)
4 Corporate governance (7)	4 Political interference (7)
5 Political interference (10)	5 Mission drift (13)
6 Inappropriate regulation (13)	6 Strategy (-)
7 Management quality (4)	7 Staffing (20)
8 Staffing (14)	8 Unrealisable expectations (17)
9 Mission drift (19)	9 Profitability (9)
10 Unrealisable expectations (18)	10 Inappropriate regulation (22)
11 Managing technology (15)	11 Corporate governance (12)
12 Profitability (12)	12 Management quality (18)
13 Back office (22)	13 Ownership (16)
14 Transparency (16)	14 Liquidity (5)
15 Strategy (-)	15 Product development (24)
16 Liquidity (2)	16 Macro-economic trends (2)
17 Macro-economic trends (3)	17 Managing technology (23)
18 Fraud (20)	18 Interest rates (10)
19 Product development (24)	19 Fraud (14)
20 Ownership (17)	20 Transparency (21)
21 Interest rates (11)	21 Back office (19)
22 Too much funding (25)	22 Too much funding (25)
23 Too little funding (6)	23 Too little funding (6)
24 Foreign exchange (8)	24 Foreign exchange (8)

The key finding of the survey is that **credit risk** constitutes the biggest threat to the industry over this turbulent period. Although this result is unchanged from the previous survey in 2009, the reasons behind it have shifted sharply.

Credit risk is still top of the list

The earlier result was largely explained by the difficulties facing borrowers during the economic crisis. This time, the reasons have multiplied. There is still economic stress, but also growing evidence of competitive pressures in the microfinance market, of poor credit management by MFIs, of greater cynicism among borrowers, and of increasing interference in the credit process by political forces. Above all, credit risk is seen to reflect the fast-growing problem of **overindebtedness** among millions of microfinance customers: poor people who have accumulated larger debts than they will ever be able to repay, often as a result of pressure from business-hungry MFIs. The potential for large microfinance loan losses is seen to be high in some markets, bringing a dramatic change to an industry which has always prided itself on its “99 per cent” repayment record.

Many of the top Banana Skins are linked to this finding. The surge in concern about **reputation risk** (up from No. 17 to No. 2) directly reflects view that MFIs have brought credit risk upon themselves through their aggressive lending and their desire for growth. This also accounts for the rise in the risk of **mission drift** (up from No. 19 to No. 9) because of the perception that MFIs are abandoning their commitment to poverty alleviation in favour of financial profit.

Another link is with the rise of **political interference** (from No. 10 to No. 5) as governments in some countries respond to the growing unpopularity of MFIs by imposing interest rate caps and encouraging repayment strikes. Although the current focus is on the Indian state of Andhra Pradesh where there have been severe political tensions over the behaviour of MFIs, the concern is that political risk is spreading.

A surge in concern about reputation risk

One of the major reasons behind MFIs' more aggressive approach to business is widely seen to be the intensity of **competition** in the microloan market (up from No. 9 to No. 3) caused by the ready availability of capital for MFI expansion and the entry of well-heeled commercial banks armed with mass marketing skills and new banking technology. At the same time, MFIs are seen to be institutionally weak in the areas of **corporate governance** (No. 4), **management quality** (no. 7) and **staffing** (No. 8), meaning that they may lack the resource and know-how to handle competitive pressures. A further contributor is **inappropriate regulation** (up from No. 13 to No. 6) which is failing to provide the right framework to keep MFIs on track.

The big movers

UP
Reputation: the good name of microfinance increasingly under attack
Competition: undermining business and ethical standards
Corporate governance: showing weakness under stress
Political interference: backlash against MFI lending practices
Inappropriate regulation: failing to provide a healthy environment

DOWN
Macro-economy: ebbing concern about the global crisis
Liquidity: cash shortages easing
Too little funding: investors returning to the market
Foreign exchange: "currency wars" not a major concern
Interest rates: lower and less volatile

Other areas of institutional weakness are seen to lie in the **back office** (up from No. 22 to No. 13) and the **management of technology** (up from No. 15 to No. 11), both of which may be contributing to the problem of imprudent lending through poor controls.

But a number of risks – mainly those thrust to the top of the rankings in the last survey by the global crisis – have fallen away quite sharply. **Liquidity** risk, which came No. 2 last time because of fears that MFIs would lose their access to working funds, has slumped to No. 16. In general MFIs, particularly the larger and healthier ones, are back in funds again. Similarly, concern about **too little funding** has subsided, down from No. 6 to No. 23. In fact, the only riser in this set of risks is **too much funding,** marking a return of concern that an over-supply of cash may fuel the risks of competition and overlending. Similarly, concerns about the state of the **macro-economy**, **interest rates** and the **foreign exchange** markets remain very low.

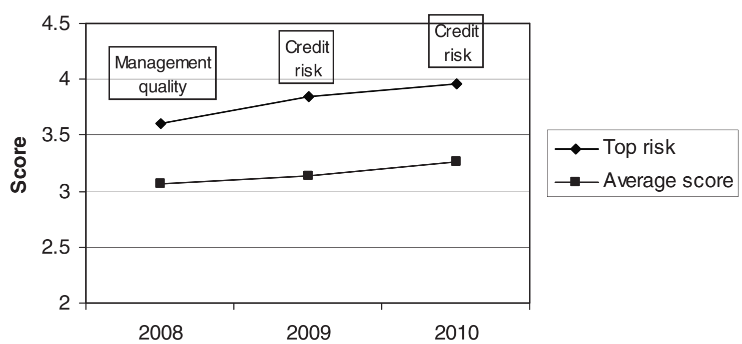
A breakdown of responses by type shows microfinance **practitioners** deeply concerned about the growth of credit and reputation risk which they see mainly caused by “unfair” competition and poor regulation. **Investors** in the microfinance industry have similar concerns, though they are also worried about political interference in the industry, and weakness in corporate governance. The main concerns of **regulators** lie in the areas of transparency, internal controls and the availability of funding. **Geographically**, credit risk, competition and reputation topped the concerns of most regions with the exception of Asia where the focus was on political risk. As in previous surveys, management issues ranked high in Africa.

Some risks are local, some global

Global versus local. This survey also points up a distinction between risks that apply to the industry in general, and those that are more localised. The anecdotal responses show that credit risk is very widespread, gaining a mention in 75 per cent of respondent countries. The impact of competition is more localised, though it can usually be traced to similar causes: excessive funding and pressure from commercial banks. The risk of political interference is also local, but its impact is wide because of negative media coverage. Regulatory risk is local, though the industry suffers from the generalised perception that microfinance regulation still needs to be “fixed”. Institutional issues such as management and staffing are local. Risks in the area of funding also depend on MFI type and location, though there is a new concern that global reputation risk could damage the microfinance “asset class” more widely.

How well prepared are MFIs to handle these risks? On a scale of 1 (poorly) to 5 (well), respondents gave a score of 2.7, which is slightly better than middling, with Latin America seen to be the best prepared and Asia the worst. Among respondent types, practitioners were the most optimistic and regulators the least.

The Microfinance Banana Skins Index provides a picture of changing “anxiety levels” in the microfinance business. The top line shows the average score given to the top risk over the last three years, and the bottom line the average of all the risks. Both lines show a clear worsening in sentiment over that time, and suggest that anxiety over the present ructions in microfinance is higher than it was over the global economic crisis.



Health warning. A number of points should be borne in mind when taking messages from this report. One is that the results reflect the perceptions of respondents and are not forecasts or measures of likelihood. There is also a tendency, in surveys of this sort, to focus on the negative and overlook the positive, of which there is still a lot in microfinance. Linked to this is the risk of generalisation: microfinance is an enormously varied business, and its condition differs greatly from one market to another. Nonetheless, the broad trends this report describes suggest that microfinance faces a very testing period.

Who said what

Practitioners –people who run or work in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Competition
2	Competition	2	Credit risk
3	Reputation	3	Reputation
4	Inappropriate regulation	4	Mission drift
5	Staffing	5	Political interference
6	Corporate governance	6	Staffing
7	Mission drift	7	Strategy
8	Political interference	8	Profitability
9	Management quality	9	Liquidity
10	Profitability	10	Macro-economic trends

The main concern of practitioners is with **credit risk** and the pressing problem of **overindebtedness** which they see resulting from excess capacity in the microlending market and the intensity of **competition** from commercial banks. They also see high risks in **inappropriate regulation**, particularly where it is weak and obstructive, and hinders the healthy development of the industry.

Jose Ramon, finance director at Finca Perú, an MFI in Peru, said the greatest risk facing his industry was the growth of "indebtedness due to high competition in the market and the lack of regulation to limit this behaviour."

Practitioners worry about bad debts

However, the big change in practitioners' perceptions this year is the sharp rise in **reputation risk**, up from No. 18 to No. 3, a direct consequence of the mounting controversy over MFIs' lending practices. Linked to this is a stronger risk of **mission drift** because of commercialisation pressures, and the growth of concern about **political interference**. Competition is seen to be the fastest rising risk facing the industry, more urgent than credit risk.

There is also strong concern among practitioners about internal issues, specifically **corporate governance, management** and **staffing**. This reflects a growing awareness within MFIs that their institutional strength needs closer attention.

By contrast, many of the risks which were driven to high levels last time by the financial crisis have ebbed away. Concerns about the **macro-economy**, **liquidity** and **funding** are out of the Top Ten. More worryingly possibly, given the difficulties facing microfinance, **strategic risk** is seen as lower order (No. 12), as are looming issues in the area of **technology management** (No. 13) and **product development** (No. 17).

Investors – people who invest in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Reputation
2	Reputation	2	Competition
3	Competition	3	Credit risk
4	Political interference	4	Political interference
5	Corporate governance	5	Inappropriate regulation
6	Inappropriate regulation	6	Mission drift
7	Management quality	7	Unrealisable expectations
8	Unrealisable expectations	8	Ownership
9	Mission drift	9	Strategy
10	Staffing	10	Staffing

The risk perceptions of investors in microfinance have changed sharply since our last survey in 2009. Back then, their top concerns were linked to the impact of the financial crisis: credit risk, funding, liquidity and the state of the global economy.

Today, concern with **credit risk** remains high, but most of the other risks in the Top Ten are linked to microfinance's tarnished image and issues of institutional strength. Investors are increasingly concerned about the industry's **reputation** and allegations that it may be failing in its mission to assist the poor. They are also worried about **bad regulation** and **political interference**, about the strength of **management** and **corporate governance**, all of which directly affect the quality of the business.

A US investor said: "The main risk over the next 2-3 years appears to be the state of the social compact between MFIs and clients. While growth of the industry is good in terms of extending access and creating innovative products, if it leads to overindebtedness via harassment, then microfinance is not delivering on one of its main objectives: to create real and sustaining social and economic value for low-income persons. There have been examples of this in certain markets, most of which did not have the regulatory controls in place to check the rapid growth of MFIs."

In another big shift, investors increasingly see **competition** as a risk to the industry (up from No. 15 to No. 3) where previously they saw it providing a stimulus to efficiency and innovation. A US-based investor said that competition "is likely to lead to poor management decisions. We see this as a high risk." On the other hand, investors' earlier concerns with **liquidity** and **funding** have eased with the passing of the crisis. **Macro-economic** risk has slipped from No. 4 to No. 16. They are also less concerned with strategic issues such as **product development** and **technology**.

But while investors are watching certain types of risk carefully, notably in the areas of credit, reputation and management, there is little in their responses to support fears that they are preparing to scale down their commitment to the industry. This is reflected in the low position given to funding risk (No. 23).

Regulators – government officials and those who regulate MFIs

	Biggest risks		Fastest risers
1	Transparency	1	Credit risk
2	Credit risk	2	Competition
3	Back office	3	Too little funding
4	Managing technology	4	Profitability
5	Too little funding	5	Interest rates
6	Profitability	6	Mission drift
7	Staffing	7	Strategy
8	Corporate governance	8	Managing technology
9	Management quality	9	Ownership
10	Reputation	10	Transparency

Regulators take a very different view of the risks from other respondent groups. Their main concern is unchanged from our last survey: the lack of **transparency** in the industry, both as to the quality of MFIs' reporting and to their openness about the terms and pricing of lending. Regulators worry that inadequate disclosure could erode the confidence of investors and customers.

Their concern about **credit risk** is also strong: it stands at No. 2, and is also their fastest-rising risk because of the problem of **overindebtedness.**

The inadequacy of **funding** for the industry is a growing worry. Their ranking on this score has risen sharply (up from No. 18 to No. 5), mainly because of the fall-out from the financial crisis, and is the highest of any respondent group. Fatoum Deen-Touray, deputy director of the Central Bank of The Gambia, was concerned about "the recapitalization of MFIs, especially as sources of funds dwindle particularly from international funding agencies including donors, banks, etc.".

Another strong area of concern is **operational risk**: weakness in the **back office,** the **management of technology,** and the **quality of staff**. Strategic issues are also on their minds. Alexander G. Cera of the Central Bank of the Philippines said that "regulated MFIs must contend with increasing competition, and provide a wider scope and range of services while aiming for sustainability. MFIs must deal with these issues with a long term perspective."

Regulators tended to be less concerned than other groups about **reputation** risk, and associated issues such a **mission drift**, focusing instead on the potential consequences, particularly in the area of funding. Two issues where they see less risk compared to other respondent groups are **inappropriate regulation** and **political interference**.

Deposit-takers – people who run or work in deposit-taking MFIs

Biggest risks		Fastest risers	
1	Credit risk	1	Competition
2	Reputation	2	Credit risk
3	Inappropriate regulation	3	Reputation
4	Profitability	4	Mission drift
5	Competition	5	Macro-economic trends
6	Management quality	6	Staffing
7	Staffing	7	Strategy
8	Managing technology	8	Political interference
9	Mission drift	9	Profitability
10	Fraud	10	Liquidity

MFIs which take deposits share other MFIs' concerns about the high level of personal indebtedness among their customers and the consequent threat of **credit risk**. They are also worried about the negative impact of **competitive pressures**, and mounting attacks on the industry's **reputation** over bad lending practices. In Russia, the director of a deposit-taking MFI said that commercial banks were "aggressively moving 'down' to increase margins, bringing with them retail experience, instruments, and financial resources which microfinance organisations cannot compete with".

These MFIs see a high risk of **inappropriate regulation**: rules governing deposit-takers are often tougher than those for non-deposit-taking institutions, and can create a competitive handicap. This is seen as a sharply rising risk, up from No. 19 to No. 3. They are also more concerned about the problem of **fraud**. On the other hand, this group is less worried than the lending side about the rise of **political interference**.

Among institutional risks, deposit-taking MFIs focus particularly on the **quality of management** and **staffing** issues. One respondent said that there was "a leadership deficit in this industry." A special concern is the danger of a flight of deposits in countries which lacked deposit insurance. An African respondent said that a crisis "can create a systemic risk of no confidence with massive withdrawals of deposits, reduced resources and a general slowdown in the financial sector."

Funding issues are relatively less pressing for deposit-takers so long as they can tap people's savings. However some respondents, particularly in Africa, are worried that savings might decline as a consequence of the global recession. A respondent from Côte d'Ivoire said that "poverty is gaining more and more ground. This will result in shrinkage in the collection of deposits".

North America

	Biggest risks		Fastest risers
1	Corporate governance	1	Reputation
2	Reputation	2	Competition
3	Credit risk	3	Political interference
4	Management quality	4	Strategy
5	Political interference	5	Credit risk
6	Competition	6	Unrealisable expectations
7	Staffing	7	Product development
8	Managing technology	8	Staffing
9	Back office	9	Management quality
10	Unrealisable expectations	10	Corporate governance

North American respondents were mostly investors and members of microfinance networks.

There has been a dramatic turnaround in the risk perceptions of this group. Last time their Top Ten was dominated by concerns about the crisis fall-out: funding and liquidity risks, the state of the global economy, turmoil in the financial markets. These have all disappeared except for **credit risk**. But even this risk is seen to be less urgent than institutional risks such as **governance** and **reputation**.

Peg Ross, director at the Human Capital Center of the Grameen Foundation, saw “a lack of next generation leaders who can step into senior roles, and a lack of focus on strategic human capital management practices. MFIs still don’t uniformly understand the risk of not adopting these”.

The growing reputational controversy over microfinance is a top level concern, with **political risk** seen to be fast-rising. A director of a US-based microfinance network said that there was “a risk of **mission drift** as microfinance institutions go for commercial sources of funding, with the concomitant drive to push for profitability/high returns. This in turn could lead to predatory practices, unfair treatment of clients, including exorbitant pricing. This is a risk we will be very alert to for all our MFIs.”

Strategic issues are also on the up. A major US investor said: “Some of the main risks in my view are managing increasing competition, introduction of new products, and incorporation of new technologies, such as branchless banking, that create opportunity but also new risks.”

The problem of poor **regulation** – a key concern for practitioner-dominated regions – is seen as less pressing, though rising. Interestingly, North Americans are much less concerned about financial issues such as the profitability of MFIs, and their ability to access **liquidity** and **funding**. The view is that funding will continue to be available to strong and well-managed MFIs.

Latin America

	Biggest risks		Fastest risers
1	Competition	1	Competition
2	Credit risk	2	Credit risk
3	Political interference	3	Political interference
4	Staffing	4	Profitability
5	Inappropriate regulation	5	Reputation
6	Profitability	6	Mission drift
7	Unrealisable expectations	7	Staffing
8	Reputation	8	Inappropriate regulation
9	Mission drift	9	Unrealisable expectations
10	Managing technology	10	Too much funding

Latin American respondents were mostly practitioners, which gave their response a strong "front line" feel. As in previous Banana Skin surveys, their greatest concern is with "external" issues, i.e. ones linked to the operating environment.

Chief among these is the impact of **competition** and the resulting pressures on **profitability** and **credit standards**. Many respondents said they faced "unfair competition" from commercial banks armed with ample resources but lacking "market knowledge". Claudia Valladares, vice-president of community banking at Banesco in Venezuela, said that "with the rise of microfinance in many regions and countries, many MFIs tend to compete for the same customers and that carries the risk of over-indebtedness if there is no effective credit bureau".

The other mounting risk is **political interference,** and the rise of populist regimes with an anti-MFI agenda: interest rate caps and the "no pago" movement in countries like Nicaragua. Marcelo A. Romero, a financial controller at Banco Pichincha in Ecuador, said this posed a huge risk to MFIs "because it completely changes [customers'] perceptions of their need to comply with their obligations".

These concerns are linked to the other major risk in the region, **overindebtedness** which is widespread, and likely to throw up large loan losses. This is also due to the inadequacy of **regulation** in some countries. Frederic de Mariz, vice president of equity research at JPMorgan in Brazil, said that "incomplete and/or unfriendly regulations are a key risk for the sector".

A set of fast-rising concerns surrounds **reputation risk**: the problems of **mission drift** and **unrealisable expectations**, all of which are up strongly. Luis Fernando Sanabria, general manager of the Fundación Paraguaya in Paraguay, said that "undoubtedly the main risk is mission drift. The average size of credits continues to rise and the resulting reduction in margins will increase this risk because institutions will be 'tempted' to solve their profitability problems by serving customers in even larger amounts".

Western Europe

	Biggest risks		Fastest risers
1	Reputation	1	Credit risk
2	Credit risk	2	Reputation
3	Competition	3	Competition
4	Unrealisable expectations	4	Political interference
5	Management quality	5	Mission drift
6	Mission drift	6	Unrealisable expectations
7	Political interference	7	Ownership
8	Corporate governance	8	Strategy
9	Inappropriate regulation	9	Management quality
10	Staffing	10	Profitability

The Western European response was led by investors and groups supporting MFIs, such as professional firms and NGO networks. One of their top concerns is with the growth of **overindebtedness** and the impact of this on the industry's balance sheets and **reputation**.

Matthias Adler, principal sector economist at KfW, the German development bank, said that "due to unhealthy competition and the impact of the financial crisis, the problem of client overindebtedness in microfinance has become virulent in a number of countries. While this is still limited to particular submarkets and the overall sector remains robust in terms of shock resilience and responsibility of service provision, this may develop into a series of overreactions from the press, policy makers and, ultimately, from funders".

There was a big rise in Western European concern with **reputation** risk (up from No. 11 to No. 1) and the consequent risk of **political interference** (up from No. 9 to No. 7). Dinos Constantinou, managing partner of the Swiss-based consultancy Microfinance Strategy SARL, said that a worsening reputation "could take away the basis on which much of the development of the sector (at least in its early phases) has relied - namely the support of the development community".

Respondents see these developments stemming from overexpansion of microfinance markets, leading to excess capacity, fierce **competition** and a decline in lending standards. Linked to this is concern about the inadequacy of **management** and **corporate governance** in MFIs, particularly in the area of risk management. Lars-Olof Hellgren, CEO of Nordic Microcap Investment in Sweden, saw "a lack of capability to assess risks and to have sufficient internal control systems in place [because] MFIs tend to underestimate these aspects when they grow to a size where they must rely on systems."

Europeans are less concerned about **funding** issues such as access to **liquidity** and capital. In fact, they see a greater risk in over-funding for the industry. **Strategic** issues such as **technology management** and **product development** are also seen as lower level risks.

Central and Eastern Europe

	Biggest risks		Fastest risers
1	Credit risk	1	Reputation
2	Macro-economic trends	2	Competition
3	Profitability	3	Inappropriate regulation
4	Reputation	4	Product development
5	Inappropriate regulation	5	Macro-economic trends
6	Managing technology	6	Unrealisable expectations
7	Competition	7	Management quality
8	Unrealisable expectations	8	Managing technology
9	Product development	9	Corporate governance
10	Foreign exchange	10	Ownership

Respondents from Central and Eastern Europe consisted mostly of practitioners plus a number of analysts, investors and suppliers of services to the industry. Their biggest concern is **credit risk** in the context of difficult economic conditions. Several respondents pointed out that their economies were still in recession, but competition was intensifying and profitability was under pressure.

A respondent from Russia described the overall picture: "Crises will affect microfinance markets in various countries - clients' overindebtedness, the lack of consumer protection, high interest rates - which may result in disappointment in microfinance among policy makers and the public". Reflecting fast-rising concern about **reputation risk,** she added that "there needs to be more realisation that microfinance is not a magic wand, and its potential to fight poverty or create jobs is limited".

An additional problem in many countries is the absence of good microfinance **regulation**, adding to what Andrew Pospielovsky, CEO of Accessbank in Azerbaijan, described as "a challenging business environment for micro-business". Part of that challenge is dealing with **competition** from commercial banks which are entering many markets in the region.

The Top Ten also reflect concern about the **quality of management** and specific issues such as **managing technology**. **Corporate governance** was seen to be a low but fast-rising risk. Sadina Bina, director of MCF EKI in Bosnia and Herzegovina, said that MFIs had "weak risk departments, a narrow range of products (more or less only loans) and weak internal controls".

Strikingly absent from the high level risks – compared to other regions - is concern about **political interference**, though this gets a strong score in specific countries such as Bosnia and Herzegovina where political tensions run high.

Funding and **liquidity** risks ranked low.

Africa

Biggest risks		Fastest risers	
1	Credit risk	1	Competition
2	Corporate governance	2	Credit risk
3	Managing technology	3	Reputation
4	Management quality	4	Mission drift
5	Reputation	5	Liquidity
6	Transparency	6	Strategy
7	Profitability	7	Managing technology
8	Staffing	8	Macro-economic trends
9	Back office	9	Staffing
10	Competition	10	Management quality

Respondents from Africa were mostly practitioners, plus some investors, regulators and analysts.

As in other regions, the most pressing concern is on the **credit** front and the rise of overindebtedness and delinquency. The failure of a number of MFIs in Africa has added urgency to both these issues. This marks a change from the last survey in 2009 when Africa was the only region which did not put credit risk at the top of its concerns at the height of the financial crisis.

The bulk of Top Ten risks listed by African respondents this time centres on internal issues at MFIs such as the strength of **corporate governance** and **management,** and related issues such as **staffing** and the effectiveness of control systems. This is in line with previous surveys which have shown persistent concern about the robustness of African microfinance institutions.

A respondent from West Africa said: “The quality of governance and management remains a key risk for the majority of microfinance institutions in Africa. The failures of several deposit-taking institutions in Nigeria and Cameroon have exemplified this pattern”.

The pressures of **competition** are relatively low at No. 10, but they are making themselves increasingly felt, and scored top among rising risks. Many respondents reported that commercial banks were moving aggressively into their markets. **Reputation** risk has risen strongly since last time (from No. 20 to No. 5) but **mission drift** at No. 13 remains a lower issue than elsewhere, and **political interference** at No. 22 scarcely puts in an appearance.

Concerns about access to **funding** have eased considerably. **Too little funding** has slipped from No. 8 to No. 14, and **liquidity** risk from No. 6 to No. 12, though the availability of funding is patchy: many of our respondents reported difficulties. The same with **inappropriate regulation**: while scoring relatively low at No. 15, it is plainly issue in particular markets.

Middle East and North Africa

	Biggest risks		Fastest risers
1	Credit risk	1	Competition
2	Corporate governance	2	Mission drift
3	Reputation	3	Credit risk
4	Unrealisable expectations	4	Reputation
5	Management quality	5	Staffing
6	Political interference	6	Corporate governance
7	Mission drift	7	Unrealisable expectations
8	Competition	8	Liquidity
9	Liquidity	9	Macro-economic trends
10	Staffing	10	Interest rates

Respondents from the Middle East and North Africa were mostly practitioners.

As in other regions, their top concern was with **credit risk**: the rise of personal indebtedness and its wider consequences. Mohammed Khaled, CGAP's representative in the region, saw a "growing vulnerability of the sector…because of repayment problems which are due not only to multiple loans but to governance and internal control issues etc.." This raised questions "about the whole future of the sector and the issue of access for the poor to financial services".

Much of respondents' high level concern centred on the commercial pressures confronting MFI **management** and the temptation to veer away from its social mission. Many respondents thought that MFIs were expanding their loan businesses dangerously fast under pressure from **competition** and hungry investors. One said that loan officers were becoming "mere distributors of funds" out to grab as many clients as possible. These trends are sharpening the risk of **political interference**, up strongly from No. 18 to No. 6.

The weakness of **management** and **corporate governance** is another top level concern. Yusef Yakubi, executive director of the Aden Microfinance Foundation in the Yemen, said that "most MFI boards have no experience of the microfinance industry and are usually appointed by influential bodies who do not normally care whether these boards have had training or exposure to the industry".

The risks in **liquidity** (No. 9) and **funding** (No. 17) are seen to be quite widespread, and higher than in many other regions. Amalik Aimane, internal controller at INMAA in Morocco, said that "after the global crisis, lenders and investors have lost confidence in the microfinance sector, so MFIs should monitor very closely the quality of their portfolio and take whatever measures are necessary". Respondents from other countries such as Iraq, Egypt and Syria said that funding difficulties were holding back the industry.

Compared to other regions, the quality of **regulation** (No. 13) emerged as less of an issue.

Asia

	Biggest risks		Fastest risers
1	Political interference	1	Credit risk
2	Reputation	2	Competition
3	Credit risk	3	Political interference
4	Liquidity	4	Mission drift
5	Inappropriate regulation	5	Liquidity
6	Competition	6	Reputation
7	Mission drift	7	Inappropriate regulation
8	Corporate governance	8	Interest rates
9	Management quality	9	Strategy
10	Product development	10	Unrealisable expectations

About half the respondents from Asia were practitioners, the remainder being analysts, investors and lenders to the industry. The bulk of the respondents were from India and Pakistan with a sprinkling from Nepal, Sri Lanka and Bangladesh.

With the turmoil sparked by events in Andhra Pradesh, it is no surprise that **political interference** made it to the top of the list. Swapnil Kant Neeraj, senior microfinance specialist at the International Finance Corporation in India, said that “”overzealous local politicians have still to reconcile themselves with the fact that microfinance can be done on a commercial basis. They will try to capitalise on the smallest aberrations by MFIs and … generalise things instead of taking a reasonable stand and isolating the rogue MFIs”.

Respondents are very concerned about the **regulatory** backlash and popular discontent. Brij Mohan, chairman of Access Development Services, said that local intervention “will cripple growth and hurt the poor”. The impact to the industry’s **reputation** is also severe (up from No. 21 to No. 2). Respondents see this damaging the business and frightening away investors, both of the commercial and ethical kind. Although **liquidity** risk has fallen a few places, it remains much higher in this region than elsewhere (No.4).

Risks of the political and reputational kind are seen as more severe than **credit risk** which tops the ranking in most other regions. Even so, overindebtedness is a major problem in this area, made worse by economic uncertainty, food price inflation and, in a country like Pakistan, a difficult security situation.

There is also concern about the institutional strength of MFIs. Although these risks have been edged out of the high positions they occupied last time, the **quality of management** and **corporate governance** remain in the Top Ten. A respondent in India said that “MFIs must juggle a significantly larger number of tasks and expectations as compared to the past. This will require a much higher level of management and leadership potential.”

Far East

	Biggest risks		Fastest risers
1	Competition	1	Competition
2	Credit risk	2	Reputation
3	Inappropriate regulation	3	Credit risk
4	Reputation	4	Mission drift
5	Corporate governance	5	Management quality
6	Management quality	6	Strategy
7	Mission drift	7	Managing technology
8	Unrealisable expectations	8	Political interference
9	Back office	9	Staffing
10	Political interference	10	Fraud

Respondents in the Far East included practitioners, investors, regulators and support professionals.

The negative impact of **competition** remains much the most pressing concern in the region. It is seen to be encouraging bad lending practices and declining business ethics. In particular, it is contributing to the widespread problem of **overindebtedness**, with the risk of potentially severe loan losses for MFIs.

Ruben C. De Lara, executive director of TSPI Development Corporation in the Philippines, said that the market was characterised by "a lack of credit discipline and an aggressiveness by some MFIs to grow their own business that tends to sidestep the value of credit education among their staff and clients as well". A respondent from Laos said that the main risk in that market was "a desire for fast big growth which is not managed properly".

The growth in over-lending is already affecting the industry's **reputation** (No. 2 among the rising risks), and leading to concerns about **mission drift** (up from No. 20 to No. 7). This could affect **funding** prospects. In the Philippines, a microfinance manager said that over-rapid growth "has caused traditional lenders to take a wary look on the sector, and hence they are extending financial support too cautiously." This is also a risk singled out by respondents from China.

Another of the region's preoccupations is with the institutional strength of MFIs. **Management quality** and **corporate governance** are both among Top Ten risks. One respondent said "This is a sector that bleeds skills". Another high level institutional risk is the **back office** (up from No. 15 to No. 9) because of the strain placed on systems by the hectic pace of growth.

However the region seemed more optimistic than most about its economic prospects. **Macro-economic** risk was placed at the bottom of the list.

1. Credit risk (1)

A STARK indication of the tests facing microfinance is the top position occupied by credit risk in this survey. For an industry which once prided itself on its enviable loan repayment record, the strength and persistence of this Banana Skin is a worrying trend.

Credit risk was top of the list in our last survey conducted in the depths of the 2009 economic crisis when, to some extent, it could be explained by the difficulties facing borrowers in a period of economic stress. But this time, the reasons for its high position have multiplied. There is still economic stress, but also growing evidence of competitive pressures, of recklessness among MFIs and their borrowers, and of interference in the credit process by political forces.

The breadth of concern about credit risk revealed by this survey is very striking. It was the No. 1 Banana Skin for all types of respondents except regulators who ranked it No. 2. Geographically it was a high level risk in all regions, suggesting that similar forces are endangering microfinance loan portfolios in many different markets.

Overindebtedness is becoming a bigger problem

Of these, much the most prominent is the problem of **overindebtedness**: large numbers of poor people who have accumulated bigger debts than they will ever be able to repay, with the prospect that MFIs will have to write them off and suffer heavy loan losses. This problem is now so broad that it has the makings of a worldwide social/economic phenomenon. Moses Ochieng, regional representative for CGAP/DFID in East and Southern Africa, warned of a possible “implosion of some of the key players” unless measures were taken to deal with it. A respondent from one of the large European funding banks said: “Increased delinquencies, program deterioration, damage to clients’ well-being…We're seeing this issue crop up into too many markets.”

Respondents identified many causes of overindebtedness. On the lending side, there is the intensity of **competition** in a business where growth is now a key objective for many MFIs. Elissa McCarter, director of development finance at CHF International in the US, said that “the tendency to focus on growth alone to generate the profits that shareholders anticipate has led to a weakening of microloan underwriting standards and greater risk of delinquency, fraud, and undercapitalised institutions that become exposed during crises”.

This is leading to the problem of **multiple lending** (or, more strictly, multiple borrowing) when microfinance customers take advantage of competition among lenders and the lack of centralised credit information to tap many lenders at once. In Colombia, the managing director of an MFI reported that the number of micro-lenders to the average MFI customer had grown from 1.5 to 4, and that 75 per cent of MFI customers were borrowing from other institutions, mostly commercial banks which had entered the field.

Another reason is the **weakness of internal controls** at MFIs, poor incentive structures for loan officers, and misdirected management objectives. Edmond Atangana Evina of the ministry of finance in Cameroon said that in many cases “the failure of MFIs can be traced to enormous loans granted to clients, in breach of the checks and balances necessary to those institutions’ survival”. The need to **know your client** is an associated issue. Many respondents reported that loans were being made without proper credit checks or client information – and deliberately in order to meet business targets. A UK-based consultant said that "many MFIs do not have a good understanding of the borrowers' financial position and repayment capacity."

Then there is **political interference** in countries where the lending practices of MFIs have come under public scrutiny, leading to officially inspired borrowing binges and repayment strikes. Although the Indian state of Andhra Pradesh is the specific focus of this concern, respondents identified many countries where this was a problem, including Nicaragua, Azerbaijan, and Bosnia and Herzegovina. In Rwanda, a banking regulator said that borrowers were developing "a culture of non-repayment".

Although some respondents stressed that the severity of credit risk differed greatly among institutions and markets, this Banana Skin looks set to be the dominant issue for the industry over the next few years.

How a borrower thinks...

P.N. Vasudevan, managing director of Equitas Micro Finance in India, described the mindset of many overindebted borrowers: "With more MFIs in operation, clients are getting more options to borrow, and since loans are unsecured, the tendency of most people is to borrow more than their immediate need and to justify it by saying that they will use it for some 'good' purpose, and that they cannot be sure it will be available later when they might really need it. This can destroy the borrower's family peace which is what MFIs are supposed to promote!"

2. Reputation (17)

NO SURPRISE that this Banana Skin has soared after the torrent of bad publicity surrounding microfinance in the world's media, and events in Andhra Pradesh in particular. Reputation risk is up 15 places from the last survey when only a few far-sighted respondents waved a red flag about the dangers of growing commercialism.

Microfinance's reputation 'will never be the same'

Microfinance is becoming a punch bag from all sides – accused of exploiting the poor with burdensome debt, of losing sight of its social mission, of putting profits before poverty reduction, and in AP most notably - though elsewhere too - of driving people to suicide through tough loan terms and strong-arm debt collection practices.

Gil Lacson, relationship manager at Women's World Banking, said that "the industry will face a huge reputational risk with the growing clash between opposing ideology and expectations. Is microfinance primarily about financial inclusion or poverty alleviation? Is microfinance primarily a business opportunity or a development intervention? Does microfinance really meet both financial and social return expectations? Is it an 'either or'? Or has microfinance many faces? Whatever the answers, the industry's reputation will never be the same".

Reputation risk has many angles. For some respondents, it is the **commercialisation of microfinance**, as seen in the growing importance of profit as a goal, and the high-value flotation of MFIs on the stock market. Last year's IPO of SKS, India's largest MFI, was a ready theme for respondents the world over. Some saw it as a watershed, drawing popular attention to the profits now being extracted from microfinance.

For others, it is **unethical practices** as evidenced by the huge growth in **indebtedness** among MFI customers, much of it the result of aggressive marketing of loans whose true cost is obscured. Michaël de Groot, regional director of the

Rabobank Foundation in The Netherlands, said that “top-end, commercially-driven MFIs and banks are becoming the new loan sharks”. Raksa Pheng, business development manager at Visionfund in Cambodia, said that defaulters took to “running away from their homes. In some cases, I could see that they reduced their food to save money to repay their debts, or in others, they forced their children to drop out from school to find jobs to earn more income to support the repaying of debts”.

Another symptom is the emergence of “consumer lending” as a prime product to replace the business lending for which microfinance was originally devised. Xavier Reille, manager at CGAP in France, said that “previously, microcredit was seen as a good thing and money lending as a bad thing. With the increased focus on short term profit in several markets, the lines are blurring and the reputation of the sector is tarnished. The onus is on MFIs to show that they are following responsible practices”.

The industry faces the backlash

For others still it is the exposure of microfinance as “a sham”, with its social *bona fides* no longer a given. Joachim Bald, a senior consultant at the Frankfurt School of Finance and Management, said that a backlash was now on the cards. “We tend to celebrate every overpriced small loan to poor people as a life-changing breakthrough in access to finance. But where is the evidence that microfinance borrowers on their tenth cycle are better off than their peers who did not have access to microcredit?”

The consequences of reputation risk are potentially severe. A US investor warned that “if studies continue to show that microfinance is ‘not working’ and if news stories of overindebtedness, client harassment, excessive riches and other bad behaviour continue to make headlines, the industry will lose the moral high ground, and with it donors, investors and talent”.

The consumer lending boom

A big concern in the industry is microfinance’s shift from tiny, uncollateralised business loans for micro-entrepreneurs - “microenterprise finance” - to general lending to the unbanked for consumption purposes. This is widely seen as evidence of “mission drift”, and could harm the industry’s reputation for poverty alleviation. It’s happening for several reasons: competition from commercial banks, pressure for short-term profitability, and the frequently voiced need for “product development”.

Chikako Kuno, director of capital markets at FINCA International, said: “There are reputational risks as new commercial entrants, attracted by the volume and profitability of microfinance, come in without a clear double bottom-line objective and blur the boundary between predatory consumer finance and true microfinance”. Daniel Schriber, director of investment analysis at Symbiotics in Switzerland, thought that the move towards consumer lending constituted “a huge reputational risk for the whole industry”.

3. Competition (9)

ALTHOUGH competition in the microfinance market can deliver benefits to customers in the form of keener pricing and better service, it is more often seen as something bad, creating instability and encouraging dubious practices. In line with earlier surveys, this Banana Skin is high on the list this year, and is seen as a rising problem because of the proliferation of microfinance providers in most markets.

Geographically, this is a widespread concern: it got a high ranking in most regions, and was also seen as a top level risk by respondent types, practitioners in particular.

Competition is seen as dangerous because it can cause market disruption, squeeze margins, and spur MFIs to take greater risks. Several respondents referred to competition as "unhealthy" and "unfair". In particular, competition is widely seen as the prime cause of irresponsible lending and **overindebtedness**. A respondent from the Philippines said that "the presence of too many competitors encourages some MFI staff to become lax in implementing policies rather than take it as a challenge to improve products and services".

Competition is eroding business and ethical standards

Competition is also squeezing **margins**. A microfinance banker in Ecuador complained that "prices are going down every year and everywhere", driven by new competitors "without knowledge". Jaime Nieto, director of treasury at Camesa in Mexico, said that markets in accessible areas were all "saturated" and suffering a "rate war". Others saw competition driving MFIs to reach into new and riskier markets in search of business. A respondent from Tanzania said that "as more players such as banks enter the industry, the tendency is to move towards untapped market segments about which is little is known".

Respondents also regretted that competition was encouraging MFIs to adopt **unethical practices** such as loan pushing, poaching clients and staff, and deceptive advertising. Vaidyanath Yerraguntla, a consultant at Coromandel Infotech in India, said there was "very high pressures on the field collection teams translating into 'loan-sharking' behaviour with the borrower/s".

A feature of competition is that it pushes MFIs to focus on parts of the market that are already well served and ignore those that are not, usually the neediest and those out in the country. A respondent from Colombia said banks were exhibiting "herd behaviour" and concentrating "on areas with good economic performance with aggressive credit offers".

The reasons for greater competition include the **ready availability of funding** to expand capacity, and the **downscaling by large banks** into the microfinance market, a trend that is visible in most regions. Other competitive threats come from subsidised government lending programmes and, increasingly, from telecoms companies able to access the market through branchless banking. Hans Boon, managing director at Postfinance International Development in The Netherlands, said that "new scenarios of 'branchless' banking with larger banks downscaling via mobile and internet technology and franchise formulas for agents could heavily impact existing MFIs".

But others saw competition as a good thing because it put MFIs on their mettle. A US consultant said that competition "could be a net positive as MFIs are forced to be more innovative and provide higher customer service. Most MFIs know how to handle this but I am sure some markets will be overheated and get carried away".

4. Corporate governance (7)

CONCERN about the quality of corporate governance in MFIs is growing, reflecting the view – seen in earlier Banana Skin surveys – that this risk is fundamental to the business, and one which only the MFIs themselves can address. However the ranking of this risk was generally higher among those outside the industry (investors and analysts) than among microfinance practitioners who tended to play it down. For example, North American respondents – investors mainly – ranked it No. 1 while Central and Eastern European respondents – mostly practitioners in well-established and commercial MFIs – put it a lowly No. 21.

Weak governance is making the credit crisis worse

One region where concern about corporate governance was particularly strong was Africa, where it ranked No. 2. Marie-Jose Ndaya Ilunga, deputy director of the central bank of the RD Congo, said that "poor governance creates management problems, mainly in the area of lending. Most MFIs which close down in the RDC have run into governance problems".

The focus of concern is not only the quality of MFI boards, but the risk of conflicts of interest, of lack of independence and poor accountability, and other issues such as nepotism, cronyism, domineering personalities... Although the passing of the economic crisis has taken immediate pressure off MFIs, the new difficulties facing them on the reputational and credit fronts could make strong corporate governance even more crucial. Brian Slocum, regional coordinator for the Middle East and Africa at the Grameen Foundation, said that "weak corporate governance has been a key factor in existing portfolio crises, and it will likely be one in future crises as well."

One reason why governance is weak

"Too many conferences which take the best MFI leaders away from their desks".

Project leader
Microfinance network
The Netherlands

One concern is that MFIs themselves do not devote enough attention to governance because they are dominated by self-interested directors or view it as inconvenient. Diego Guzman, regional director for Latin America at ACCION International in Colombia, said that "MFIs believe this is a game and you do not need to invest in this field".

Several respondents said that it is not enough for governance standards merely to remain static because the evolution of the sector will require boards of ever higher calibre. Many referred to "the more challenging environment", "the exposure of the sector to the media" and "growing industry complexity".

However, it is wrong to generalize about this particular risk, and some respondents saw more positive trends emerging. More professionals were becoming involved, investors were pressing for higher standards, and regulators were taking a closer interest in the problem. Santhanam Srinivasan, a development finance consultant in India, said that "with stricter regulation, this area will improve".

5. Political interference (10)

The turmoil in Andhra Pradesh propelled this Banana Skin to a new high in the rankings as the microfinance sector assessed a whole new set of risks coming from a direction that was previously benign.

However the response was very varied. Asians, not surprisingly, put it top overall, and Latin Americans at No. 3. But Africans and Central and Eastern Europeans ranked it way down at No. 22. Among respondent types the most concerned were investors and analysts (No. 4), but for regulators it was No. 22.

Although severe political interference has only affected a few countries directly, it is nonetheless causing huge damage to the industry worldwide because of intense media coverage. Almost all our respondents commented on it one way or another. An international investor from Egypt said that “political interference in several markets is turning the public against microfinance industry in general.”

Interference by politicians is growing

Political interference takes many forms. The most widespread is usury laws capping the interest rates that MFIs can charge their borrowers. Previously in decline, these are now on the increase again in the Indian sub-continent, Latin America, Africa and Central Europe, and pose a direct threat to MFI profitability. But while rate caps benefit MFI borrowers in the short run, they may also damage the microlending market further out. Pierre-Marie Boisson, chairman of Sogesol in Haiti, said they “could reverse 30 years of progress by driving MFIs to cut millions out of access to credit, forcing the majority to use moneylenders at a higher interest rate”.

More immediately damaging are the populistic “no pago” campaigns seen in countries like Nicaragua, Pakistan and India where governments have told borrowers not to repay their loans because their interest rates are extortionate. These could drive MFIs out of business altogether.

Political interference can take other forms as well: product limitations, directed lending to “priority sectors” and subsidised competition from government loan programmes and state-supported banks. A respondent from Mali said that the state was “directing resources towards…high-risk customers through the disposition of public funds with little technical selection criteria”.

The risks in political interference are seen to lie mainly on the funding side: the concern that investors will be frightened off by all the bad publicity. Eric Savage, president of Unitus Capital in India, wrote that “there is a very real risk that many of the largest MFIs in India could begin defaulting on their debt in the coming days, weeks and months…Political risk has made it more challenging to attract funding at reasonable rates, or in some cases, at all”.

But it could also threaten MFIs by squeezing margins, taking away their business, and halting their growth. As one respondent said: “A persistent non-profit, credit-only (or overly politicised self-help group) sector will simply stop the industry where it is now”.

Many respondents said that political risk resulted from a failure of understanding, wilful or otherwise, about the value of microfinance. As one respondent said: “We are not winning the war of ideas”. Risk mitigation must lie in getting a better message across about the benefits of microfinance. But many respondents thought that the industry had brought this risk upon itself through its aggressive lending and

IPOs: good or greedy?

FEW EVENTS have turned public opinion against microfinance more than the lucrative Initial Public Offerings (IPOs) of MFI shares on the stock market. The resulting "windfall" gains reaped by shareholders seem inappropriate for an industry with a social purpose.

Many respondents said that IPOs were adding to the political and reputation risks in the industry, and would hasten a regulatory crackdown. Gert van Maanen, chairman of Microfinance Centre in Poland, said that microfinance's "original concept of 'How to enable poor people to earn a living' is moving towards 'How to accommodate investors in their wish to earn an attractive dividend and - if an IPO is feasible - a windfall profit'. Most popular support for microfinance is based on its social relevance, not on the earnings it brings to investors. IPOs imply that investment considerations are taking over and calling the shots".

Marcus Fedder, managing partner of Agora Microfinance Partners in the UK, said that IPOs also risked attracting the wrong sort of people into microfinance, "...people who are driven more by the business model of fast growth and big bucks through an early IPO than by sustainable, client-driven services for the poor. In the long run, this is likely to (a) lead to a sub-prime like bubble, (b) give a bad name to the whole industry and (c) probably deter socially-minded investors".

But some respondents saw good in stock market flotations. Shadab Rizvi, who runs the microfinance business unit at Darashaw & Co., an Indian investment house, said that MFI owners were "incapable of mobilising huge sums of equity on their own. Gradually we'll see private equity investors becoming owners of many MFIs, especially if the MFI is IPO-bound".

high profile IPOs. For them, the risk needed to be managed by halting mission drift and refocusing the business on its philanthropic goals.

There was little sense that this risk will subside. It may even grow. One respondent said gloomily: "I fear this misinformed boycott will spread outside of Andhra Pradesh and India to the rest of the world."

6. Inappropriate regulation (13)

Many countries still lack good microfinance regulation

THE QUALITY of the regulatory environment for microfinance is a rapidly rising concern, up seven places since the last survey. The problem varies greatly from one region to another: some countries have good regulation, others have poor or obstructive regulation. But the general sense is that the problem is growing rather than shrinking.

Regulation was high on the list for practitioners, particularly in Latin America, the CEE, Asia and the Far East where fast-growing microfinance industries are increasingly running into regulatory obstacles.

In a typical comment, Scott Richards, an associate at Developing World Markets, a US microfinance investment firm, said that "many countries lack microfinance-specific regulations, and in our experience, the regulatory regimes in place to govern deposit-taking banks and other financial institutions do not fully or effectively address the specific regulatory needs of the microfinance industry."

Many respondents saw regulation failing to take account of microfinance's special character: its social role, its ownership structure, its different cost base. Bad or non-existent regulation was hindering the growth and profitability of microfinance, it was stifling MFIs, holding back innovation, preventing it from competing with new entrants like commercial banks where regulation was more highly developed.

A respondent from East Africa said that poor regulation "is already taking its toll on regulated MFIs in many countries and is discouraging movement towards [a regulated industry] in others". Bassem Khanfar, CEO of the National Microfinance Bank in Jordan, said that unclear legislation and lack of professionalism could "put the industry under constraints and eliminate its growth", and that it was "better to live without a law rather than to live with a bad law". Some respondents said that poor regulation was undermining confidence in microfinance, which would affect clients and investors. It was also driving smaller MFIs out of business.

Much inappropriate regulation, such as interest rate caps, springs from political interference. But respondents also saw bad regulation jeopardising MFIs by making it difficult for them to diversify away from the increasingly risky business of lending, for example by offering new products or accessing people's savings. The CEO of an MFI in Pakistan said that microfinance was stagnating there because half the industry was not allowed to take deposits. "The industry cannot and will not grow unless a window is made available from the regulator at commercial rates. The industry potential is circa 30m while the current outreach is less than 2m".

The risks in regulation

Microfinance needs to find its place in the global financial system. Either there has to be a clear regulatory environment distinguishing and recognising the microfinance sector, or the industry needs to mainstream itself as part of the banking or non-banking segment as the case may be in each country. The risk of an unclear regulatory environment is probably the main risk at the moment.

Prashant Thakker
Global business head – microfinance
Standard Chartered Bank

The problem of 'unfair' competition

An increasingly pressing regulatory question is the creation of a level playing field between MFIs and commercial banks to deal with the problem of **"unfair" competition**. Many respondents felt that poor MFI regulation was putting them at a disadvantage *vis-à-vis* these new entrants, for example in the range of products they could offer and in their access to funding, and even their ability to move into new areas like mobile banking. Godwin Kihuguru, microfinance specialist in Uganda, said that regulators were "finding it difficult to keep pace with advances in microfinance service delivery". In some countries there is a reverse problem: regulators over-protecting the microfinance against new competition, and causing it to stultify.

A different sort of regulatory risk was raised by some respondents: the absence of good consumer protection legislation in many markets. This is allowing the growth of overindebtedness and increasing the risk of reputation damage to the microfinance industry. The growing number of loan defaults is also exposing the inadequacy of many legal systems in the area of loan recovery and liquidation. A microfinance practitioner in the Côte d'Ivoire said that in her country "apart from calling in the bailiffs, there is no law that obliges borrowers to repay their loans".

However the patchiness of regulatory risk was highlighted by a number of dissenting views which gave a more positive picture. An MFI respondent from Peru said that regulation there was encouraging better controls and risk management, and others said that regulators were increasingly professional and constructive.

7. Management quality (4)

CONCERN about the quality of management in MFIs has eased a bit, but is still in the Top Ten. It was a leading problem for most respondent types, though practitioners tended to rank it less high than outsiders. Geographically, concern was strongest among investor countries in North America and Western Europe, and lowest among practitioner countries (Latin America placed it No. 18) except for Africa where it ranked No. 4.

Still too many ‘will-do-good’ people in microfinance

As in earlier surveys, the focus remains on the **lack of professionalism and technical expertise** in MFIs, leading to poor internal controls, ineffective strategies, and poor management of increasingly important areas such as risk, product development and technology. As one respondent said: “There are still too many ‘will-do-good’ people with no real management skills”. Essma Ben Hamida, co-founder and executive director of Enda Inter-Arabe in Tunisia, said there was “a lack of local skills for working in MFIs, particularly at senior levels with experience of finance and banking to ensure strong management and succession to the older generation”.

In the African market, where management capacity is seen to be most stretched, a respondent from Ghana said that “the quality of governance and management remains a key risk for the majority of microfinance institutions in Africa. The failure of several deposit-taking institutions in Nigeria and Cameroon have exemplified this pattern. Regulators are not doing enough to hold managers accountable, especially for insider lending. This could damage the credibility of microfinance institutions among depositors”.

Growing pains

For many respondents, the risks facing microfinance could be summed up in one word: growth. The hectic pace at which microfinance has grown over recent years is arguably the cause of many of the difficulties it now faces: an overindebted clientele, stressed management and back office, loss of sense of mission, and an increasingly uneven distribution of resources within the industry. As one respondent said: “Managing growth has proven to be a risk area. At one end, you have institutions in specific country contexts that are growing in an unsustainable fashion and will overheat. At the other end, you have institutions in other country contexts where growth has been very slow relative to the business opportunity and the development need.”

But a growing concern is that as business becomes more difficult and the MFIs themselves become more complex, management will increasingly fail to cut the mustard. A respondent from one of the large international investor networks said that good management “is going to become much more important. MFIs must juggle a significantly larger number of tasks and expectations as compared to the past. This will require a much higher level of management and leadership potential.” A consequence of these rising demands is that **skills,** already in short supply, will become harder to find and more expensive. A US respondent expected to see “a dramatic increase in competition for good quality people, potentially leading to increased staff acquisition costs". Linked to this is the fear, expressed by Eric Duflos, senior microfinance specialist at CGAP in France, that "many institutions will not have the capacity internally to deliver the growth rates they have promised to their boards and their investors, and thus will fail".

With credit and reputation risk both growing, skills will also be needed in risk management, particularly in lending, and public relations, a relatively new area for MFIs. A risk manager at one of the large microfinance investment companies said that "in stressful situations, we have seen management incapable of addressing problems".

However some respondents felt that things were improving on the management front, which may be why it has fallen a few notches in the rankings. As one of them said, this is not an area where generalisation is possible: "This is primarily an MFI specific risk - although the economic pressures and over-indebtedness in mature microfinance markets will impose much greater pressures".

8. Staffing (14)

A wider range of skills is now required

STAFFING risks are on the rise again after falling in earlier surveys, perhaps because the crisis-related Banana Skins which displaced them in the 2009 survey have receded. This risk was ranked high by practitioners, regulators, Latin American and African respondents, suggesting it is more of a concern to those closely involved in the management of MFIs than to investors and analysts.

Perceptions of this risk varied. Staff **capability** was a recurring theme, with several respondents bemoaning the scarcity of good people with expertise in microfinance. The lack of "talent" and "competent manpower" came up frequently. Diego Villalobos, an analyst with ACCION in the US, said that "finding the right people to promote the growth and sustainability of an MFI is very difficult. From consultants to managers, MFIs have a very small source to choose from." As microfinance becomes more commercialised, there is also a growing need to balance different types of skills: social and business.

On the **skills** front, the growing role of technology is creating new demands. Mayuni Ozaki, a finance specialist at the Asian Development Bank in the Philippines, said that technology-based branchless or mobile banking will expand rapidly over the coming years, however "many MFIs, regulators, and policy-makers don't have the sufficient skills and capacity".

For others the problem was **staff retention**. A respondent at the National Bank of Rwanda pointed to low pay as the reason MFIs cannot recruit and retain qualified staff. Poaching is another problem created by rising competition. Another respondent said: "In Afghanistan they joke that a job as a loan officer leads to being a branch manager leads to a bank job and then to Canada. This is extreme, but not by much".

Other risks which respondents associated with staffing were fraud, credit risk (undertrained loan officers not understanding their borrowers), and regulation as ill-equipped staff grapple with increasingly complex microfinance legislation.

9. Mission drift (19)

THE RISK of mission drift is up sharply, in line with other risks in this area such as Reputation. It ranked high in most sectors except Africa where it was No. 13, and Central and Eastern Europe where it came down at No. 19.

The issue in this risk is the growing conflict between the social and commercial goals of microfinance, and the risk to MFIs if they switch their focus from the first to the second or, as some put it, from a double to a single "bottom line". But for many people, mission drift is about more than focusing on profit rather than poverty. It is also structural, epitomised by the shift from "good" microlending to "bad" consumer finance, and the huge growth in personal indebtedness that this is seen to have caused. The "rapid rise of consumer finance, whether disguised as housing loans, education loans, or loans for whatever 'funder-fashionable' purpose", is pulling the sector from its purpose of poverty alleviation and financial inclusion, according to a microfinance advisor in the Netherlands.

A further shift is from the rural poor to the already well-served urban masses. Jeffrey Ashe, director of community finance at Oxfam America, said that "the major challenge faced by commercial microfinance is…the ongoing issue of leaving out approximately 80 per cent of the market, essentially the rural poor, and developing effective tools for mobilising savings".

Mission drift is a risk that needs to be actively managed

But the notion of mission drift begs the question: from what *mission* is the sector *drifting*? As one respondent put it, "One person's 'mission drift' is another's 'product line extension'. The key is to ensure that values are reflected in strategy, operations, management and governance".

A simple guide to mission drift

"The bigger; the more commercial; the more mission drift".

Microfinance policy adviser
The Netherlands

The consequences of mission drift are already plain to see: political backlash, disillusionment among supporters, severe reputation damage – and confusion among microfinance's investors. Paul DiLeo, president of Grassroots Capital Management, wondered whether the purpose of microfinance was "social impact and social change, or financial return to investors? The two aren't mutually exclusive, and some may prioritise one over the other. But practitioners need to be clear where their priority lies".

Many respondents felt that the risk of mission drift required active management, like any other risk. A respondent from a major Western European microfinance investor thought that the test for MFIs now lay in "social performance management rather than in institutional and financial sustainability".

But, like many Banana Skins, this is one where generalisation should be resisted. The amount of mission drift varies greatly from country to country. A respondent from one of the largest Mexican MFIs said that cases of mission drift were "isolated; moreover we have a large number of intermediaries that maintain their original mission".

10. Unrealisable expectations (18)

This Banana Skin is sharply up on last time, like the related risks of mission drift and reputation, reflecting a fundamental theme of this survey: doubts about microfinance's effectiveness. But there was no clear pattern to the responses: Western Europeans ranked it No. 4, Africans No. 19.

This Banana Skin isn't about microfinance performing poorly. It is about its failure to meet expectations – both social and financial. So the risk lies in the perceptions that people have of microfinance, and the gap between these and reality: if people conclude that microfinance is not meeting expectations, it is judged a failure.

Microfinance is no magic wand

Several respondents expressed frustration. "Yes, MFIs can't end world poverty; they're a piece of the puzzle only!" wrote one US respondent, and a practitioner in Tanzania complained: "People's expectations of MFIs are normally beyond their ability to deliver and the situation will persist until such a time when people's perspectives on MFIs become more realistic".

But for others, the "myth" of microfinance as a panacea for poverty alleviation is being exposed. It is, as this report noted in 2009, "an industry surrounded by hype", with a permanent risk of disappointment, of expectations remaining unfulfilled. "Given all the growing momentum, interest, and attention to the topic of financial inclusion", one CGAP analyst wrote this year, "will microfinance live up to the hype? We need to temper expectations, to be clear about what microfinance is and is not, and continue to explore new ways of delivering financial services to poor people".

Many respondents said it was up to the industry to communicate its message better to ensure that expectations did not become excessive. Nigel Biggar, senior advisor at the Grameen Foundation in the US, said that "MFIs need to be able to defend their work not only from a financial perspective but, critically, from a social perspective. To do this, social performance management is the key: understanding and documenting the extent to which MFIs are reaching their target population - the poor, the very poor, the unbanked, marginalised, etc. and documenting how organisations manage their social performance to enable welfare gains for their target populations. This would not only deflect criticism, it would strengthen how microfinance delivers on its social objectives of poverty alleviation".

11. Managing technology (15)

THE PROBLEM of getting technology right is moving up the risk scale. MFIs face tough decisions on the management of their IT systems and their delivery strategies in the near future. Do they have the know-how and the resources to get them right? Some of our respondents thought these were among the most difficult issues facing MFIs today: failure could put an MFI out of business. A microfinance analyst said it was a case of "Invest in technology or cease to exist in five years". Concerns about this Banana Skin were strongest in Africa and the CEE.

Respondents identified several areas where MFIs needed to do better on technology. One was **internal systems**, given the need to reduce costs and tighten up management controls, for example in the area of credit. An Indian respondent said that "a significant ramp up is required".

Another was **business strategy** at a time when technology is bringing dramatic new forms of mobile banking which could be crucial to an MFI's ability to deliver the service and remain competitive against commercial rivals. A US microfinance consultant said there was a risk that the microfinance industry "won't position itself aggressively enough to take advantage of branchless banking services, and will be overtaken by mobile network operators and large banks who figure out how to get into rural areas and go down-scale".

A **lack of IT skills** was another concern. Many respondents feared that MFIs would be pressed to manage technology successfully, given the scarcity and cost of experts, and the high level of investment needed. A US policy adviser said that "all eyes are on mobile banking, but it has only been proven at scale in a very few institutions. The institutional capacity of the financial institution and the mobile phone provider and the quality of the partnership will be critical to more success stories".

12. Profitability (12)

ALTHOUGH concern about profitability has remained level, perception of this risk is shifting. It used to be that profits were seen as a good thing, an indication of the health and success of the microfinance industry. Increasingly, they are seen as bad, a symptom of the unwelcome commercialisation of the sector. The risk is therefore switching from finance to reputation.

Beth Porter, policy advisor to UNCDF, said it is "important for the industry to be profitable - and to be seen as a good and sound investment. But the returns to investors in IPOs should return to earth. Otherwise the backlash from politicians and the public may lead regulators to put in place draconian measures, and investors to move their support from innovation that is helping poorer and more vulnerable populations to less controversial investments".

An Indian respondent saw the risk to the industry lying in its "inability to address the issue of profits and profiteering".

Nonetheless, there is concern about the pressures on MFI profitability, and about the risks these pose to the sustainability of the industry. Sebastien Duquet, a director of Planis, a microfinance investor, said that profitability was shrinking on all continents. "Competition is finally playing its part. But it is weakening certain players, particularly the small ones." Some respondents feared that, by squeezing profitability, competition would spur MFIs to take greater risks, for example with their lending.

Are profits a good or a bad thing?

A further threat to profitability comes from political interference, in particular rate capping. Some respondents feared that MFIs might even have to reduce their profitability to protect themselves from political and media attacks. A Mexican respondent said that profits should come from "administrative efficiencies, and not higher interest rates".

But many respondents also emphasised that profits were healthy: it was a matter of how they were shared out between many stakeholders, not just investors. One US investor believed that "the commercial sector, funded in domestic markets, will lead an expansion of the industry with more stable institutions, with a wider range of services, and with less political interference."

13. Back office (22)

THE ABILITY of MFIs to keep effective control of their operations as they evolve is becoming a rising risk issue. Many respondents said that MFIs were growing at a faster pace than their back office systems could handle, and this was exposing them to credit risk and other dangers. A respondent from Peru said that the two most urgent risk issues facing MFIs were "the absence of internal controls to ensure quality growth portfolios, and the risks associated with the lack of technology for monitoring multiple credits…"

But concern about this risk varied greatly: it was high in Africa and the Far East but low in the CEE and the Middle East. It was also high among regulators but low among practitioners. Philippe Nsenga, inspector of microfinance at the National Bank of Rwanda, said that MFIs suffered from operational risk because of "ever growing operations and products versus poor management information systems".

Respondents saw a number of reasons for the rise in this risk: the pressures of competition, the need to expand the business to meet investor expectations, poor strategic planning, and a culture which treated the back office as boring. High cost was also a deterrent to adequate investment in control systems.

However, the risks were clear. Sanjay Sinha, managing director of Micro-Credit Ratings International in India, saw excessive growth "leading to a loosening of control systems which results in portfolio delinquency and/or customer abuse and a rising level of loan losses…"

Weak internal controls are hurting MFIs

Respondents said that badly managed MFIs were losing track of their borrowers and the status of their loans. This was exposing them to the additional risks of multiple borrowing, delinquency and fraud. One European investor said that "in workouts, lenders often realise that portfolio data is inaccurate". Poor management information systems lead to ill-informed decisions, and contribute to another set of risks: poor accountability and transparency.

But some respondents saw improvements in this area, under pressure from investors and regulators who are concerned about mounting loan losses. A respondent from Tanzania said that MFIs "are moving more and more into acquiring affordable advanced technologies, and building internal capacities to handle back office operations", and an Egyptian investor said that "best practices are now widely shared and applied".

14. Transparency (16)

TRANSPARENCY is a risk for MFIs if they do not disclose enough information about their business and services to preserve the confidence of investors and customers. Although MFIs are doing better on this front through fuller reporting, they may still be falling behind the rapid growth of investor and media interest in the business. This Banana Skin was a particular concern to regulators who put it at the top of their list.

A respondent from an MFI rating agency said that risk was rising "because more and more transparency is expected with the increasing attention of the international media."

Although many countries now require audited accounts, there is still scepticism about the quality of the numbers, particularly the reporting of bad loans. A ratings analyst in the Philippines said that "although there are MFIs who still report a one digit PAR, if we carefully examine their portfolio and how they report PAR, we can see that delinquency is still major problem among MFIs".

But the greater risk may lie on the social side where MFIs can no longer take their charmed status for granted. An investor in The Netherlands said that "the microfinance industry will increasingly have to prove the effect of its activities. More transparency will be needed towards MFI clients (about pricing and conditions), towards investors (about potential returns) and towards the outside world (about the image of exploiting people)". This calls for communication skills to be added to an MFI's expertise.

Khaled Al-Gazawi, chief executive officer of The First Microfinance Foundation in Egypt, said that "with more MFIs being created every day, and with more clients being served, transparency with clients on interest rates and hidden costs will be a challenge. Investors are in microfinance for profit, and the social goals of microfinance might not come on the top of the list. Regulatory frameworks should aim to balance a double bottom line and guarantee that the client knows the basis on which he/she will borrow".

15. Strategy (-)

THE ABILITY of MFIs to develop and implement a successful business strategy is becoming more urgent in these difficult times. For the first time this year we included Strategy among our Banana Skins; it received a middling ranking, but was also seen to be one of the faster-rising risks at No. 6 because of the big strategic issues facing MFIs.

A priori, MFIs need to have the skills to manage strategy. Some of our respondents felt these were absent from the governance structure of many MFIs. An MFI director in East Africa said that successful strategy "will depend on quality management, which is not abundantly available".

Respondents identified several aspects to strategic risk: scaling, profitability, funding, stakeholder confidence etc.. But the most difficult will be the need to balance business and social objectives so as to deliver sustainability as well as the microfinance service. (See Box)

MFIs with weak strategies could fail

The consequences of poor strategic planning could be severe. Some respondents expected that MFIs without effective strategies would fail or be taken over. An Egyptian respondent said that "badly managed MFIs will feel more challenged, and mergers might be more and more common in the market."

Julie Abrams, a consultant at Microfinance Analytics in the US, said that "this next phase could well become the years of the microfinance minefields. MFIs will have to be impeccably run, laser-focused and strategically sound to thrive. There will be no room for sloth or sloppiness in operations, governance, risk management, and customer focus; being proactive in all of these will be key. MFIs can no longer grow themselves into sustainability and profits, as some have in the past".

Is the business model broken?

The air of crisis surrounding microfinance raises the question whether the business model is in need of a makeover.

Far from depicting a thriving industry motivated by worthy social goals, one set of respondents to this survey painted microfinance as driven by greed, sustained by subsidised funds or profit-hungry investors, failing its clients by deserting the most needy or driving them into debt, with only a veneer of ethics and philanthropy. In a comment typical of very many in this vein, one of them observed: "Microfinance is slowly but surely losing what made it special and successful".

Another set of respondents portrayed MFIs as stuck in the past, lacking the resources to scale up or improve the service, self-pitying, and probably doomed to be wiped out by the first set. A microfinance analyst said that "MFIs, particularly small, local institutions, have not delivered scale in most countries and are not likely to do so alone. As new providers and delivery channels move in, what will happen to these organisations?" A Mexican respondent said that "the model is becoming eroded and many institutions are not doing anything to adopt a different one."

Both sets may be an exaggeration. But there is no mistaking the unease that exists about the traditional microfinance model at this possibly crucial stage in its evolution. Many of our respondents felt that microfinance needed to re-engineer itself to take account of new realities: the demands created by commercial investment, competition from powerful new entrants, the uncertain future for small MFIs, particularly those in rural areas, and the need, despite all these things, to keep sight of philanthropic objectives.

Philip Brown, managing director of microfinance risk at Citi, said that "strategy and business models have constantly to evolve to address changing client needs and market parameters. Learning from the past and recent history demonstrates that failure to adapt can lead to institutional stress and demise".

A re-think on group lending

Some respondents even wondered whether there was any future for the traditional "Grameen group lending model". A respondent from Peru said it was time to question the notion that "the group approach is the only way to reach microentrepreneurs lower down the pyramid. There are other ways of getting credits into rural areas at reasonable costs". Mahesh Mani, vice-president at Citibank in India, said there was an increasing need "to improve and innovate the product offering and re-look at the classical 'Grameen model' and make it more flexible and customised with respect to local conditions and the needs of the target market ...This is because the so-called biggest strength of the 'joint liability group' model can also become its biggest weakness".

Many respondents felt that the industry was coming to the end of a period of rapid and easy growth, and would have to restructure to survive: consolidation among small MFIs, specialisation among larger ones, with a focus on quality rather than quantity, on meeting demand rather than just supplying what they could. Alex Pollock, director of microfinance at UNRWA, said: "The ability to continue to grow and maintain profitability is limited by competition and national markets, and MFIs must recognise that at some point their operations will reach an optimal level, at which point they will need to concentrate more clearly on maintaining their edge through customer service and improvements in their business processes that they may have neglected because of the openness of the market".

16. Liquidity (2)

LIQUIDITY is no longer the concern it was in 2009 at the height of the financial crisis. The sharp downward change in position reflects the return to more normal conditions in global finance.

Nonetheless, the availability of liquidity clearly differs very much from one market to another, and among different types of MFI. Many respondents saw liquidity flooding into the more dynamic emerging markets as lending banks re-opened lines they had closed during the crisis. An Egyptian respondent said that "liquidity for good MFIs should not be an issue as there are more sources of cash now than ever".

But though this was welcome, it could also contain the seeds of new risks such as a resumption of poorly managed growth. Wilson Castro, director of small business lending at Banco Familiar in Paraguay, said that "high levels of global liquidity are moving towards emerging markets, especially where there are many MFIs, which increases the level of liquidity and sharpens the risk of overindebtedness". A respondent from one of the state development banks in Mexico said that MFIs there "suffer from excess liquidity and the challenge is to increase lending, but carefully".

A sharp drop in liquidity risk

But conditions in other markets can be very different. Roshaneh Zafar, managing director of the Kashf Foundation in Pakistan, said that a combination of a strained fiscal environment and caution among lending banks was squeezing MFIs. She added: "Given the increased credit risk and constraints on liquidity, MFIs will continue to have difficulties in being operationally and financially self-sustainable." Many respondents in Africa and Asia reported liquidity problems.

The markets are also discriminating in favour of the more robust MFIs. L.B. Prakash, a practitioner with Development Capital in India, said that most banks were playing it safe by lending only to large MFIs. "It is ironical that the microfinance sector started off for small loans, but does not get small borrowings". MFIs with access to local deposits are also better placed, though there is concern in some areas that the economic crisis and overindebtedness will deplete savings. Kebe Fodie, director of Union Mecap in Burkina Faso, said that "the level of savings is stagnating or decreasing".

But even if conditions are improving, MFIs have learnt lessons about the fickleness of liquidity. An Indian respondent said that "in the case of a repayment crisis or regulatory changes, liquidity risk is high."

17. Macro-economic trends (3)

CONCERN about the impact of the global economy on microfinance has fallen sharply with the resumption of growth in the major nations. However views differ widely over what lessons have been learnt from the crisis.

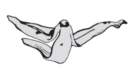
Many respondents felt that the stresses of the last 2-3 years had shown that microfinance cannot escape international shocks. The impact came in many forms: in weaker economic growth, in disruptions to world commodity markets, in lower remittances, in funding difficulties and in rising indebtedness. Hanns Martin Hagen, chief financial sector economist at Germany's KfW development bank said: "The financial crisis is not over yet. For the next one or two years, a large number of MFIs will have to work with their clients to preserve the quality of their portfolios".

Many respondents gave accounts of local impacts, particularly in CEE where concern on this front was strongest. A microlender in Tajikistan said that "microfinance is not immune from the problems of the overall world economy, and Tajikistan in particular is very vulnerable to shocks in the Russian economy as so much of local GDP is dependent on the remittances of Tajik workers in Russia." A manager in Syria commented that "with continued recession, we fear that the rate of success of small and medium size enterprises will be negatively affected". Con Keating, a specialist on the UK credit union movement, said that "in recessionary, high unemployment times, our membership is that most hurt. The credit standing of our membership is lower, much lower."

One concern is that economic stress will undo microfinance's good work at a time when its reputation is under question. A UK-based consultant said that "any levelling or reduction in microfinance lending within a locality will impact market liquidity and be a further adverse impact upon local purchasing capacity and the levels of local trade – and thus aggravate the credit quality situation". A US respondent feared that "resource limitations and a challenging macro environment will lead MFIs to cut down on their expansion plans, in-country and globally."

MFIs are not all immune to the global economy

But a number of respondents took a more upbeat view. US lawyer Howard J. Finkelstein said that microfinance had shown that it was strong enough to survive global shocks. "Did the crisis have its victims in the microfinance world? Absolutely. But as a whole it claimed fewer victims in the microfinance sector than it did in the commercial banking sector." Many other respondents commented on the "resilience" of microfinance institutions. A respondent from Latin America said that "in countries like Venezuela, with inflation rates above 20 per cent, this has not been an impediment to a flourishing microfinance industry".



18. Fraud (20)

THE OVERALL level of concern about fraud is little changed from last time, but with sharply contrasting attitudes. The regions of the world where this risk was ranked highest were Central and Eastern Europe, and Africa.

Some of our respondents felt the risk was getting worse because of the more stressful environment and declining standards in the industry, aided by the growing sophistication of fraudsters, particularly in the area of technology.

How to deal with fraud

"Train well, pay well, and punish".

MFI manager
RD Congo

Mounkaila Garba, director of Recherche-Action in Niger, said that "whatever the level of control, it is difficult to avoid this problem. People who commit these offences understand control systems and how to get round them". An East African respondent said that "this could be a major area of risk and if unchecked could be detrimental to the industry in the future**".** Several MFIs reported a growth in fictitious loan accounts as loan officers strove to meet lending targets. Fictitious business "failures" were also being used by customers to get out of their loans.

And fraud is not the only problem. Respondents mentioned money laundering, terror finance and identity fraud as further rising crime areas.

But other respondents felt that MFIs were doing better against fraud, by tightening up internal controls, centralising staff records, and installing stronger systems. An Egyptian respondent said that this was “always a risk, but it should be managed better with changing technology and know-how”. A respondent from Pakistan noted that a staff reference bureau had been set up for the industry there.

19. Product development (24)

THE ABILITY of MFIs to raise their game by developing new and better products is becoming more of an issue. The majority of our respondents felt that, without product innovation, some MFIs risked failing in their mission and being overtaken by more aggressive competitors.

Stephanie Dolan, principal specialist at ACCION International, said that there has been “increasing discussion about how microfinance in many regions and institutions is still really mono-product, focused primarily on the provision of credit services. In order for microfinance to truly make a difference and maximize its potential, it will need to offer a full range of quality, affordable, relevant, and accessible financial services to clients”. Some respondents were more forthright: one said that MFIs which offered a comprehensive product suite “are about as common as unicorns”.

The need to expand beyond credit

Beyond credit. Many respondents were concerned that MFIs focused too much on credit products and services. This limited their business prospects and created over-reliance on an increasingly risky area of the market. Diversification was good to spread risk. A respondent from one of the large US funding organisations said that “the industry - meaning MFIs and those who support them - needs to be much more innovative and forward-thinking about a range of financial services that help the poor manage their financial needs. This may in some cases mean slower growth of *microcredit*, but faster growth of *microfinance*. Funders and investors need to understand that an MFI with a diversified product offering is, in the long run, going to be more sustainable than a credit-only mono-product institution delivering double or triple digit growth in gross loan portfolio every year”.

Respondents were not short of suggestions for new products: payments, remittances, savings/deposits, loans for housing and education, insurance products etc.. Carlos Danel, vice-president at Compartamos in Mexico, said “there is still a lot to know and learn about which products work best and why, so that the industry can shift its focus from supply to demand.”

Access. The other area of potential product innovation is service delivery with the arrival of mobile banking which will enable MFIs to compete with commercial banks, and extend their reach into rural areas, thereby strengthening financial inclusion. However, this presents difficulties of its own. Paul Rippey, senior fellow at the Center for Financial Inclusion, said that “banks serving the poor have a promising future…but savings groups and cell ‘phone banking are disruptive technologies that will either take away clients or increase clients, depending on how banks react to them”.

Constraints. Product development is expensive, and some respondents feared that MFIs would not have the resources to pursue it. In certain countries, the regulatory environment did not encourage innovation, for example in deposit-taking and telephone banking. Diversification is also, itself, a risk. Some respondents felt that MFIs would do better to "stick to their knitting". An Indian respondent said that "unnecessary diversification is more dangerous".

Know your customer

One of the concerns about the growth of microfinance is that MFIs are losing the personal touch: they see their clients as marketing targets rather than as people to be helped, and this risks destroying the essential character of the business – and generating bad loans for MFIs.

A respondent from one of the large European microfinance investors said: "We are concerned about the ethical issues of over-indebting needy clients. It has a negative reputational impact on the market and participants. As double bottom line investors we have a fiduciary responsibility to provide both an ethical and financial return."

Inherent in this risk is a failure to understand the customer, as to the products they need and their borrowing capacity. An East African respondent said there was a potential "failure to respond to needs of the market through proper product development strategies, through laxity, poor customer care and poor supervision." The spread of plastic cards, electronic funds transfer and paperless records is speeding up the depersonalisation of banking and making it harder for MFIs to assess their customers.

Emmanuelle Javoy, managing director of Planet Rating, emphasised the difficulties that poor customer contact created in times of stress. "What the last years have shown is that in troubled times strict repayment follow-up is not sufficient to keep credit risk low. A more differentiated approach, including rescheduling or refinancing, litigation in some cases and changes in loan officers' incentives schemes, is then necessary. This is certainly more complex and costly, but is key to maintaining the trust that is at the core of the relationship between an MFI and its borrowers."

20. Ownership (17)

The form of ownership of MFIs is a potential risk because it can create internal conflicts, for example between commercially-focused investors and other more socially-minded stakeholders. Such conflict could be destabilising, even fatal.

Ownership structures can create conflicts of interest

Most of our respondents saw the ownership issue in these terms, though they held different views about its severity. Prof. Hans Dieter Seibel of the University of Cologne said that MFIs which relied heavily on external debt funding and had few customer deposits would suffer "a lack of local ownership and governance, risking undue external influence, including profiteering (e.g., through IPOs)". S-P O'Mahony, CEO of Opportunity Microcredit in Romania, said that many MFIs now had commercial as well as social purpose funders, and would "need to balance sources wisely to ensure the strongest foundation for moving forward".

Another issue was the dominance of single individuals, often the creators of the business, who were reluctant to cede control. Srinivas Bonam, head microfinance at IndusInd Bank in India, said it would desirable "to have a diversified institutional holding in an MFI. Individuals, including promoters, should have a minimal holding". Another respondent said that dominant shareholders could stand in the way of consolidation among MFIs, preventing them from becoming stronger.

Some respondents felt these conflicts could only be resolved by the eventual withdrawal of certain types of investors. A US respondent said that "tensions between international financial institutions (IFIs) and private investors will continue until the IFI presence is substantially reduced". Matthew Gamser of the International Finance Corporation in Hong Kong said that "with western donors and social investors increasingly strapped for funds, we'll see how weak ownerships dominated by such interests really are".

But others saw it moving the opposite way. As the possibilities opened up, they saw commercial investors providing MFIs with access to capital, paving the way to a stronger future. One respondent said that "it is more likely that NGOs will find it difficult to cope in the changing environment".

21. Interest rates (11)

LITTLE RISK is seen on the interest rate front so far as volatility is concerned: global rates have been low for some time and are likely to remain so in the foreseeable future.

This is good news for MFI funding: costs should remain low. However it is bad news for MFI lenders who live off high loan charges. It creates pressure on them to lower rates and accept lower margins. Many of our respondents therefore thought that an extended low rate environment could prove difficult for MFIs: it poses a risk both to profitability and reputation.

Little change seen on the interest rate front

The major risk on this front lies in politically motivated moves to cap interest rates on loans and squeeze MFI margins, which complicates asset and liability management, and presents MFIs with the problem of re-pricing their loans to conform with the regulations. A US investor said that "the political fallout over interest rates could tarnish good and poor institutions alike, with possible systemic implications in some markets".

Further out, there is the prospect of rising interest rates as the inflationary effects of monetary easing flow through, which could inflame the whole interest cost issue. A Mexican respondent said that "the injured parties will be the users since demand for credit in this segment is highly inelastic to fluctuations in interest rates".

22. Too much funding (25)

THE PROBLEM of excessive funding for microfinance has eased, but not disappeared (and it is seen as a greater risk than a shortage of funding. See No. 23). Although it is dangerous to generalise, respondents see the flow of funding returning to the market after the crisis, often in quantities which the industry may find it hard to absorb without creating strains, especially at a time when growth is slowing.

Alex Silva, general manager of Omtrix in Costa Rica, said that "too much money is being made available to MFIs which, especially when it is combined with high return expectations, might force MFI managers to grow too rapidly at times overlooking good practices”. An Egyptian respondent said that this was “a very serious risk. Some MFIs are close to drowning with all the cash thrown at them”.

A UK-based development expert said that in some countries “the threat of a microcredit bubble popping is very real and it will lead to massive destabilisation of local economies artificially pumped up on microcredit and then cast adrift as the microfinance institutions either fail or refuse to roll-over microcredits. The international donors know this but cannot admit to a mistake that implicates 'the market' and 'profit-driven institutions' which are still sacrosanct in many development agencies, no matter what the consequences”.

The fear is that MFIs which accept easy money will take risks with their business and the industry’s reputation. Luc Vandeweerd, strategic director at ADA Asbl, a Luxembourg-based microfinance development group, said that “most of the largest investors are targeting the same markets, work with the same kind of MFIs offering the same kind of short term (1-2 years renewable) funding, and putting pressure on their clients’ MFIs. The main risk is that these MIVs contribute to a growth without any control and to related consequences (loss of social values, over-indebtedness, etc.)”.

The problem is not too little funding, but too much

Another risk is that the high valuations placed on MFI flotations may further tarnish microfinance’s image and provoke a public backlash. Tanmay Chetan, co-founder and managing partner of Agora Microfinance Partners in the UK, said that over-valuations were “pushing the MFIs to try and maximise their returns from their clients. This is creating a bubble-like situation in some parts of the world, which can lead to a bust in some geographies like Southern India”.

That there should be too much funding around is frustrating for MFIs who are suffering the reverse problem, usually the smaller ones serving difficult markets. Many respondents said that it was not a matter of too much funding but funding that was badly spread or indiscriminately dispersed. Lukas Wellen, CEO of Musoni in Kenya, said bad funding “keeps weak projects afloat”. Another respondent said that “too much funding may be diverted to small scale projects, and we'll be in the same position in five years’ time”.

23. Too little funding (6)

ONE SIGN of a return to normality is the low level of concern about funding for the microfinance industry. As in pre-crisis days, the larger problem is an overabundance of finance and the risk of excess capacity.

But that is a generalisation. Concerns remain about the availability of funding in many markets and for particular types of MFI, for example the smaller and less profitable ones (which may also be the ones serving the neediest communities). Respondents reported funding difficulties in all regions, but overall concern was strongest in Africa and Asia. Regulators were particularly concerned about funding, placing this No. 5 on their risk list.

A growing issue is that the doubts that are now spreading about the effectiveness of microfinance will frighten off investors and lenders. A microfinance consultant said that “the double whammy of scarcity of investment capital (especially if international investors become disillusioned) and the need to increase regulatory capital (which has already happened in some markets but may be more of a feature in future if consumer protection worries spook regulators) may be too much for some MFIs to bear".

Growing political interference in the industry is another threat, identified particularly by respondents in the Indian sub-continent and Latin America. Danilda Almanzar, director of deposits at Banco Ademi in the Dominican Republic, said that "the economic policies adopted by populist governments in some Latin American countries could affect the issue [and cost] of foreign investments in each country".

As before, many respondents commented on the unsuitability of much of the available funding, on the need for MFIs to tap new sources and diversify their funding base, particularly into local sources, though this is not always easy. Syed M. Quader, managing director and CEO of Southtech in Bangladesh, the "home" of microfinance, said that "MFIs are unable to borrow from the public like commercial banks, and as they attempt to expand they are increasingly relying on relatively expensive funding from commercial banks. Their margins are getting narrower by the day although they are perceived to be charging high interest rates."

Although MFIs which take deposits are better placed for local funding, there is also concern in some places that economic difficulties will damage people's confidence in banks and reduce their savings. Bernard-Désiré Ntavumba of FSTE in Burundi said it was "difficult for poor people to make voluntary savings, and the consequence is a decrease in available cash".

Overall, though, the very low position scored by funding risk suggests that fears that investors will be scared off by controversy may be exaggerated.

24. Foreign exchange (8)

DESPITE all the talk of global currency wars and euro crises, foreign exchange is not seen as a big Banana Skin for MFIs because most of them have little exposure to currencies other than their own.

Few worries about foreign exchange risk

Respondents said that MFIs were tapping more local deposits and receiving more of their foreign funding in local currency. Foreign exchange expertise was also growing, and hedging possibilities had improved. A respondent from East Africa said that "most MFIs prefer to borrow from local sources, and those that borrow from overseas engage in hedging arrangements with local banks".

However, the importance of external funding to some MFIs means this could still be an area of risk particularly if, as respondents in particular markets noted, local funding sources are inadequate and hedging possibilities remain limited.

Fermin Vivanco, investment officer at the Inter-American Development Bank in the US, said that MFIs were "relying too much on hard currency loans from microfinance investment vehicles, instead of capturing deposits. The value of the dollar has been going down these last years, so debt in dollars has been cheap. But this exposure may become a problem in the long term if the economic environment changes".

Some respondents flagged an indirect foreign currency risk: the impact of foreign exchange volatility on the value of remittances, and through that on the local economy and borrowers' creditworthiness.

Preparedness

We asked respondents to score the preparedness of MFIs to handle the risks they had identified on a scale where 1=poor and 5=good. The total score was 2.70, which is slightly better than middling. However there were variations according to the category of respondent.

Geographically, respondents from Latin America were the most optimistic and those from Asia the least. Among respondent types, practitioners were the most confident about the level of preparedness and regulators the least.

Total	**2.70**
Practitioners	2.79
Investors	2.68
Analysts	2.51
Regulators	2.22
Latin America	3.12
MENA	2.96
CEE	2.78
Western Europe	2.72
North America	2.68
Far East	2.67
Africa	2.57
Asia	2.48

Respondents' comments about preparedness reflected concerns about MFIs' ability to manage risk successfully in the volatile environment that currently prevails, particularly in the areas of credit and reputation.

Preparedness could be better

Karla Brom, an MFI consultant in the US, said: "Most MFIs do not have the risk infrastructure in place to handle their current clients and products…There is not a large pool of trained risk managers to draw from, and very little comprehension of how to measure and manage the trade off between risk and reward…Operational risk grows as MFIs grow, and as their product and client mix grows as well. This leads to reputational risk since more eyes are focused on the sector, and MFIs can't explain their pricing or business models in a clear way to regulators or others."

Further out, respondents felt that the microfinance industry stood at the threshold of big long term decisions which needed to be firmly addressed to ensure survival. Sarah Nolan, regional risk director for East Europe, Asia and Africa at Opportunity International, said: "Shareholders, lenders and leaders need to be prepared for a 'generational' transition of the industry from a phase characterised by rapid growth, commercial investment and subsidized support, towards a more self-reliant industry featuring a systematic approach to management, governance, and organisational development".

APPENDIX: The questionnaire and guide

CSFI

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Microfinance Banana Skins 2011

This survey seeks to identify the risks facing microfinance institutions (MFIs) over the medium term (2-3 years), as seen by practitioners, investors and close observers of the industry. Its focus is the commercial microfinance sector, by which we mean institutions which are run for profit and have assets of more than US$5 million.

Who you are

Name:
Position:
Institution:
Country:

Replies are in confidence, but if you are willing to be quoted in our report, please tick

Your perspective on the microfinance industry

Practitioner If yes, does your institution take customer deposits?
Investor
Regulator
Analyst
Other (please state)

Question 1. Please describe in your own words the main risks you see facing the microfinance industry over the next 2-3 years, and your reasons.

Question 2. Here are some areas of risk for MFIs which have been attracting attention. How do you rate their severity, and what is their trend: rising, steady or falling? Use the right hand column to add comments. Insert more risks at the bottom if you wish.

		Severity 1=low 5=high	Trend Rising Steady Falling	Comment
1	**Back office operations** How vulnerable are MFIs to risks in administration, accounting, systems and controls?			
2	**Competition** Will competitive pressures push MFIs to take greater risks in areas such as pricing, product innovation and credit quality?			
3	**Corporate governance** Are there weaknesses such as low calibre or lack of independence?			
4	**Credit risk** Will MFIs be damaged by borrowers failing to repay their loans because of overborrowing, poor credit management, poor client understanding or difficult economic conditions?			
5	**Foreign exchange** Could MFIs be harmed by currency fluctuations?			
6	**Fraud** Will MFIs be damaged by dishonest staff and customers?			
7	**Inappropriate regulation** Could MFI growth and profitability be constrained by bad rules?			
8	**Interest rates** Will MFIs be hurt by fluctuations in interest rates?			
9	**Liquidity** Will MFIs suffer a shortage of ready cash?			

10	**Macro-economic trends** Are MFIs vulnerable to pressures in the wider economy such as inflation, recession and volatile markets?					
11	**Management quality** Is MFI management up to the challenge of growing the business and managing the risks?					
12	**Managing technology** Will MFIs be able to master this difficult area?					
13	**Mission drift** How strong is the risk that MFIs will be deflected from their stated missions?					
14	**Ownership** Are the ownership structures of MFIs appropriate and stable?					
15	**Political interference** Will political interference harm MFI business, eg in the areas of interest rates, lending policy and subsidised competition?					
16	**Product development** Could MFIs fail to develop the right products and manage them successfully?					
17	**Profitability** Could inadequate profitability affect MFI growth and commercial viability?					
18	**Reputation** How severe are the threats to the industry's reputation?					
19	**Staffing** Will MFIs have difficulty recruiting and retaining good staff?					
20	**Strategy** Will MFIs be able to map strategies to survive and grow in today's challenging environment?					

21 **Too little funding** Will there be sufficient funding to sustain healthy growth in the industry?					
22 **Too much funding** Alternatively, does an overabundance of funding encourage MFIs to take unnecessary risks?					
23 **Transparency** Do MFIs report enough good information to sustain confidence in the sector?					
24 **Unrealisable expectations** Do people expect too much of MFIs, and what happens if they fail to deliver?					
25					

Question 3. How well prepared do you think MFIs are to handle the risks you have identified?

On a scale of 1-5, 1=poorly prepared, 5=well prepared

Thank you for your time.

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