Microfinance Banana Skins 2009

Confronting crisis and change

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Preface

This is the second in what we hope will be a continuing series of Banana Skins surveys looking at the global microfinance industry. It is co-sponsored by Citi Foundation and CGAP, but editorial responsibility rests with the CSFI – and specifically with my colleague, David Lascelles (who got valuable assistance this time from our former programme director, Sam Mendelson).

The first survey was published in early 2008 – just as the global financial crisis was starting to unfold. This one reflects the fact that the financial crisis has become an economic recession, and that no one is immune – not even the microfinance industry, which many believed only a year or so ago to be more or less insulated from the vicissitudes of mainstream finance.

Indeed, the main message to take from this year's survey is that the climate for microfinance has changed, just as surely as the broader financial and economic climate has changed. The big concerns this year are familiar to all of us: credit risk, the danger that liquidity will dry up, the impact of global recession, overindebtedness. In comparison, the main concerns of 2008 – weak management, governance issues – now seem like small beer.

But it is not just the top Banana Skins. In my opinion, it is impossible to read this year's text without coming to the conclusion that microfinance is at a crossroads, and that it might do the industry a power of good if it was able to call a "time-out" to reassess its role. In the popular press, microfinance is still very much the developmental flavour of the month – and even the most battle-hardened aid veteran has to acknowledge its appeal as an alternative to the conventional 'top down' model for wasting taxpayers' money. But, as the final box in this report makes clear (p 37), microfinance currently faces serious challenges – challenges that have been exacerbated by the global crisis. Should microfinance institutions shift from their essential social role to a (perhaps) more sustainable profit-seeking model? Can they go on relying (as they have done) on subventions of one sort or another from Western investors? Should they develop into more or less full service financial institutions, and become part of the formal financial sector?

These kinds of questions pose real challenges to the microfinance industry, and I very much hope that this Banana Skins survey prompts practitioners, investors, donors and regulators to have a good, long think about where they are going. In the meantime, thanks to Citi and CGAP for making the survey possible. Thanks also to Deborah Drake of the Council of Microfinance Equity Funds, to Philip Brown, risk director of Citi Microfinance, to Xavier Reille of CGAP, and to the MIX for their valuable help and support. And, of course, thanks to David and Sam for pulling a phenomenal amount of material together.

Andrew Hilton
Director, CSFI

This report was written by David Lascelles and Sam Mendelson
Cover by Getty Images

Sponsors' foreword

Look back to the first edition of the Microfinance Banana Skins Report, "Risk in a booming industry" published in early 2008, and you'll see how perceptions of risk have changed.

At the time of the first report, microfinance institutions (MFIs) were growing at double-digit rates in many countries; new equity and debt funds were being launched, and a wider spectrum of private sector investors was emerging. The report showed an industry that was mostly concerned with internal risks, and focused on capacity building to support rapid expansion.

Eighteen months later the global and industry landscape has changed dramatically. Microfinance is being challenged by the impact of an unprecedented global economic and financial markets crisis. Liquidity has tightened and credit spreads have widened for MFIs. Currency dislocations and the global recession are affecting MFIs and their clients. MFI clients' household cash flows have been squeezed by inflation, especially arising from dramatic food and fuel price increases, and, for the first time in many countries, by reduced remittance inflows.

There are strong country and regional differences in how MFIs are being impacted by changing market forces. But in general, whether out of prudence or pressure, MFIs have significantly slowed their pace of growth. Particularly in more globally integrated economies where MFIs were more reliant on international sources of funding and access to capital markets, funding and liquidity have become widely identified as key risks, while savings-based MFIs appear more resilient.

Despite the severity of these challenges, MFIs have shown comparative robustness in their capacity to weather the financial crisis. Public investors, multilateral and bilateral donors and lenders, as well as global microfinance networks, have stepped in and are providing emergency liquidity to some MFIs. Large new financing facilities are helping to maintain a degree of stability and confidence in the sector. MFI managers are going back to fundamentals; tightening credit policies and procedures, diversifying funding sources, raising capital, hedging currency mismatches, and focusing more on human resources and training. Network leaders and investors are pushing for higher governance standards, improved transparency and better risk management. Finally, the sector is beginning to experience some consolidation and MFI mergers, with new holding company and diversified ownership structures emerging.

The 2009 Microfinance Banana Skins Report presents the findings of a global industry survey on the risks affecting the growth and viability of microfinance institutions. And it reflects their progress toward financial sustainability, and greater outreach and inclusion. While by no means exhaustive, the 25 risks identified provide an illuminating snapshot of the microfinance industry today.

We are grateful for the 430 participants from 82 countries who contributed to this survey. We would like to thank David Lascelles and Sam Mendelson for distilling participant feedback and presenting it in such a cogent manner. Also our thanks to Deborah Drake at the Council of Microfinance Equity Funds for her efforts to expand the range of respondents and for guiding the work of the Steering Committee. Philip Brown at Citi Microfinance and Xavier Reille at CGAP represented our institutions on the Committee for both reports. Finally, we are appreciative for all of the input provided by the MIX.

We hope that this report will contribute to the ongoing debate on the issues confronting the future evolution of the microfinance sector, and its capacity to realise the goal of financial inclusion.

Bob Annibale
Citi Microfinance

Elizabeth Littlefield
CGAP

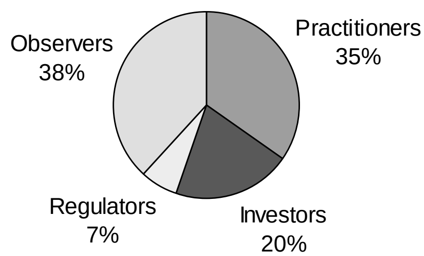
About this survey

Microfinance Banana Skins 2009 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers of the microfinance sector. It updates a previous survey carried out in early 2008. This survey was conducted in April and May 2009 and is based on 430 responses from 82 countries and multinational institutions.

The questionnaire and accompanying guidance (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.

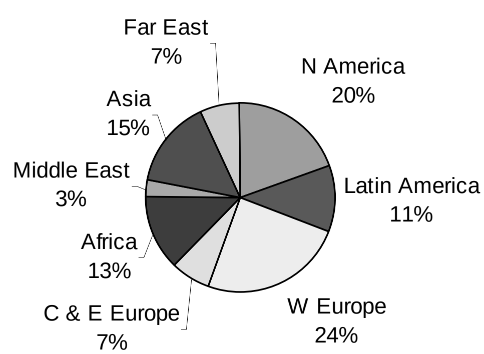
The views expressed in this survey are those of the respondents and do not necessarily reflect those of the CSFI or its sponsors.

The breakdown by type of respondent was as follows:



Just over half (57 per cent) of the practitioners represented deposit-taking institutions. The “observers” category included analysts, aid officials, academics, accountants, lawyers, consultants etc.

The distribution of responses by region was as follows:



The responses by country were as follows

Afghanistan	1	Georgia	2	Nigeria	5
Albania	5	Germany	6	Norway	2
Argentina	1	Greece	1	Pakistan	13
Armenia	1	Guatemala	4	Palestine	4
Australia	1	Haiti	2	Papua New Guinea	1
Azerbaijan	3	India	28	Paraguay	1
Bangladesh	5	Indonesia	2	Peru	7
Belgium	5	Iraq	1	Philippines	3
Benin	1	Italy	2	Poland	2
Bhutan	2	Japan	2	RD Congo	3
Bosnia & Herzegovina	8	Jordan	5	Romania	6
Brazil	2	Kenya	9	Russia	6
Burkina Faso	3	Kosovo	4	Rwanda	1
Burundi	1	Kyrgyzstan	1	Senegal	1
Cambodia	8	Laos	1	Sri Lanka	2
Cameroon	9	Lebanon	2	Switzerland	13
Canada	5	Luxembourg	3	Syria	2
China	6	Madagascar	2	Tajikistan	4
Colombia	7	Malawi	1	Tanzania	2
Costa Rica	2	Mauritius	1	Thailand	4
Côte d'Ivoire	2	Mexico	10	Togo	1
Denmark	1	Mongolia	6	Tunisia	1
Ecuador	2	Morocco	3	Uganda	3
Egypt	3	Mozambique	1	UAR	1
Ethiopia	1	Multinational	7	UK	37
Finland	1	Nepal	1	US	75
France	15	Netherlands	16	Venezuela	1
		Nicaragua	5		

Summary

This survey explores the risks facing the microfinance industry at a time when upheavals in global financial markets are adding to the pressures of change in the sector, raising new and unfamiliar challenges.

Originally a small-scale, philanthropic movement to provide credit to the neediest, microfinance (MF) has grown enormously in recent years and is now firmly established as a major supplier of a wide range of financial services to millions of people around the world. The 1,200 microfinance institutions (MFIs) that report to the Microfinance Information eXchange (MIX) have 64m borrowers and 33.5m savers, and numbers are growing by 25 per cent a year, more in some countries. Total assets of these MFIs amount to $32bn.

However the sector is also undergoing profound structural change. Its success has attracted billions of dollars of outside investment, fuelling rapid expansion. Convergence is also occurring between MF and mainstream banking as MFIs grow in size and sophistication, and commercial banks enter the market. These trends have boosted the dimension and quality of the MF sector, but also created new pressures of competition and sharper expectations.

All these developments could, however, be thrown into confusion by the global credit crunch and the ensuing recession. How will these dramatic events affect the sector? Will it be able to get through the crisis relatively unscathed? If not, what are the risks to the business and its future?

Banana Skins results

The crisis has transformed perceptions of risk

This survey, the second in the series, was conducted to seek answers to these questions, with a special focus on MFIs with more than $5m in assets which are profitable and capable of commercial growth. These number about 350, according to estimates from MIX, and account for the bulk of microfinance assets globally.

The survey asked respondents to identify and comment on the major risks, or "Banana Skins", which they saw facing the MF sector over the next two to three years. The responses numbered 430 from 82 countries. The table on p 6 shows the ranking of the 25 Banana Skins identified by the survey, both as to severity and trend.

The key finding is that the economic crisis has completely transformed perceptions of the MF risk landscape: risks that were thought minor in the 2008 survey have been propelled to the top of the rankings, edging out risks that were previously seen as crucial to the prospects for microfinance. Broadly, these new risks fall into three "clusters" of vulnerability for MFIs:

- the worsening business environment;
- threats to funding and liquidity, and
- potential damage to MF's reputation.

The big risers include **credit risk** (up from No. 10 to No. 1) and **too little funding** (up from No. 29 to No. 6), while the big decliners are **management quality** (down from No. 1 to No. 4), **corporate governance** (down from No. 2 to No. 7) and **staffing** (down from No. 5 to No. 14).

Microfinance Banana Skins
2009
(2008 position in brackets)

Biggest risks	Fastest risers
1 Credit risk (10)	1 Credit risk (5)
2 Liquidity (20)	2 Macro-economic trends (24)
3 Macro-economic trends (23)	3 Competition (1)
4 Management quality (1)	4 Refinancing (27)
5 Refinancing (28)	5 Liquidity (23)
6 Too little funding (29)	6 Too little funding (29)
7 Corporate governance (2)	7 Political interference (3)
8 Foreign currency (12)	8 Foreign currency (18)
9 Competition (7)	9 Profitability (20)
10 Political interference (9)	10 Interest rates (9)
11 Interest rates (6)	11 Reputation (11)
12 Profitability (22)	12 Corporate governance (12)
13 Inappropriate regulation (3)	13 Mission drift (7)
14 Staffing (5)	14 Fraud (14)
15 Managing technology (8)	15 Depositor confidence (-)
16 Transparency (11)	16 Ownership (8)
17 Reputation (19)	17 Unrealisable expectations (10)
18 Unrealisable expectations (13)	18 Management quality (17)
19 Mission drift (14)	19 Back office operations (25)
20 Fraud (15)	20 Staffing (2)
21 Depositor confidence (-)	21 Transparency (26)
22 Back office operations (18)	22 Inappropriate regulation (21)
23 Ownership (17)	23 Managing technology (13)
24 Product development (24)	24 Product development (19)
25 Too much funding (21)	25 Too much funding (4)

MFIs look vulnerable to the global crisis

The reason is plain. Contrary to the hope expressed by many people in the earlier survey that MFIs would be insulated from shocks in the "real economy", they are now seen to be vulnerable to them through financial markets, credit conditions and the fortunes of their customers. This is reflected in the sharp rise in the ranking of risks posed by **macro-economic trends** from No. 23 to No. 3.

Fears about the impact of recession on loan portfolios, particularly the problem of overindebtedness, dominated the responses. This marks a sharp turnaround from the earlier view that MF borrowers had a good repayment record; respondents blamed the growth of competition and the erosion of lending standards for encouraging people to borrow beyond their ability to repay.

Sharp rise in credit and funding risk

The credit crunch has also raised concerns about the **liquidity** of MFIs (up from No. 20 to No. 2) and the prospects for **refinancing** funding commitments (up from No. 28 to No. 5). The fact that much funding arrives in non-local currency has also given a sharp boost to **foreign currency risk** (up from No. 12 to No. 8) owing to volatility in the foreign exchange markets. All these concerns are summed up in the rise of **profitability** as a risk from No. 22 to No. 12.

There is also concern that recession will expose “naked swimmers”: weak MFIs with poor funding and inefficient management who were being buoyed by good economic conditions and overabundant funding. The risk of institutional failure is seen to be high.

Many respondents saw a vicious circle here: the recession creating a worse business environment, leading to mounting delinquencies and shrinking markets, leading to declining profitability, leading to loss of investor confidence, leading to cutbacks in funding, and so on. One consolation for hard-pressed MFIs is that the pressure of **competition**, which was the top risk for some in 2008, has eased (down from No. 7 to No. 9). Another is that the risk of losing **depositor confidence** (No. 21) was not considered high.

The big movers

UP
Credit risk: microlending no longer seen as a low risk business
Macro-economic trends: microfinance not insulated from the “real economy”
Liquidity: MFIs vulnerable to the global credit crunch
Too little funding: risks to the cost and availability of funding
Profitability: crisis will damage viability and investor confidence

DOWN
Management quality: edged out by more urgent concerns, but still a high risk
Corporate governance: also edged out, but still seen as key long term issue
Competition: pressures will ease in the recession
Interest rates: lower and less volatile
Staffing: difficulties could ease in slacker markets

Microfinance reputation could come under attack

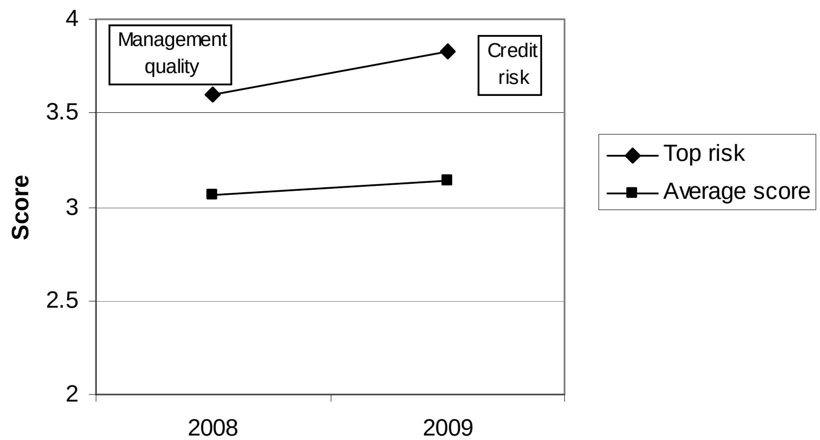
Fall-out from the recession may also create other risks, notably of **political interference** (No. 10) as governments try to ease the pain of recession by setting conditions for lending and even condoning non-repayment of loans. Linked to this is concern that MFIs will be swept up in a global regulatory backlash against banks which could lead to ill-designed measures and **inappropriate regulation** (No. 13).

A further recession-led concern is for the **reputation** (No. 17) of the industry if MFIs are unable to sustain their flow of lending or are forced to become tougher about loan re-payment. Any hardening of the MFIs’ position would add to concerns about **mission drift** (No. 19) and the perception that MFIs are abandoning their social objectives. Linked to this is the risk that investors in MF and users of the service have **unrealisable expectations** (No. 18) about what MF can deliver.

A breakdown of responses by type shows MF practitioners deeply concerned about the impact of the crisis on loan quality and funding, while investors focused more on refinancing and foreign currency risk. The concerns of regulators centred on management strength. Geographically, economic issues topped the concerns of respondents in virtually all the regions, showing that this truly is a global crisis. One exception was Africa where the top risks are still seen to lie in institutional weakness.

How well prepared are MFIs to handle these risks? Only 5 per cent of respondents thought they were well prepared, and 13 per cent thought they were poorly prepared. The rest gave a mixed response. This is a more negative result than last time when 27 per cent said "well" and only 5 per cent said "poorly". Respondents thought that too many MFIs had been lulled by good times into thinking that the global economic crisis would not affect them. On the other hand, some respondents stressed the traditional resilience of the MF sector as a reason why they should be able to ride the storm. Generally, large, commercially-minded MFIs were seen to be among the better prepared. Smaller MFIs, with weak management and a heavy reliance on donor funding could be vulnerable.

MFIs seen as less well prepared than before to meet risk



The Microfinance Banana Skins Index provides a picture of changing "anxiety levels" in the MF business. The top line shows the average score given to the top risk over the last two years, and the bottom line the average of all the risks. Both lines show a clear worsening in sentiment since last year.

Of course, these results represent the perceptions of respondents, and are not forecasts or measures of likelihood. There is also a tendency, in surveys such as this, to focus on the negative and pass over the positive. This should be borne in mind when taking messages from this report. But if a single word was needed to sum up its tone, it is "ominous".

Who said what

Practitioners – people who run or work in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Macro-economic trends	2	Competition
3	Liquidity	3	Macro-economic trends
4	Too little funding	4	Too little funding
5	Competition	5	Liquidity
6	Management quality	6	Interest rates
7	Interest rates	7	Political interference
8	Inappropriate regulation	8	Foreign currency
9	Foreign currency	9	Refinancing
10	Profitability	10	Reputation

The top risks for microfinance practitioners all relate to the impact of the economic crisis on their business: the rise in credit risk, the availability of funding, their liquidity and the state of the world economy. Of these, only credit risk appeared in their 2008 top ten, an indication of the dramatic change in risk perceptions that has occurred since then. New risks include threats to profitability, interest rates, foreign currency and refinancing. The appearance of reputation as a rising risk is also notable at a time when financial markets are stressed and microfinance is becoming more controversial.

Investors – people who invest in MFIs

	Biggest risks		Fastest risers
1	Refinancing	1	Credit risk
2	Foreign currency	2	Macro-economic trends
3	Credit risk	3	Political interference
4	Macro-economic trends	4	Liquidity
5	Liquidity	5	Foreign currency
6	Corporate governance	6	Refinancing
7	Management quality	7	Profitability
8	Too little funding	8	Too little funding
9	Inappropriate regulation	9	Competition
10	Political interference	10	Interest rates

Investors are concerned about the aspects of the crisis that could reduce the value of their commitments: the ability of MFIs to manage their liquidity and funding, the effect of currency fluctuations on cross-border exposures, and the impact of credit risk on their soundness and profitability. As in 2008, investors remain concerned about the quality of management and corporate governance in MFIs, as well as the impact of regulation and political interference which may increase due to the economic crisis. Unlike practitioners, they tended to see competition as a good thing.

Regulators – government officials and those who regulate MFIs

Biggest risks		Fastest risers	
1	Transparency	1	Too little funding
2	Credit risk	2	Competition
3	Corporate governance	3	Corporate governance
4	Management quality	4	Credit risk
5	Depositor confidence	5	Political interference
6	Reputation	6	Macro-economic trends
7	Competition	7	Refinancing
8	Liquidity	8	Depositor confidence
9	Managing technology	9	Fraud
10	Political interference	10	Interest rates

The biggest concerns for regulators centre on the institutional strength of MFIs and their ability to get through the crisis. Issues such as credit risk, management quality, transparency, profitability, depositor confidence and staffing were all in their top ten. They also saw funding, refinancing and the macro-economy as rising problems for MFIs. Of respondent groups, they were the most concerned about operational issues such as the growth of fraud and reputation risk. Interestingly, they also saw political interference as a fast-rising risk for microfinance.

Deposit-takers – respondents from MFIs which take savers' deposits

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Management quality	2	Competition
3	Macro-economic trends	3	Too little funding
4	Competition	4	Macro-economic trends
5	Too little funding	5	Fraud
6	Corporate governance	6	Refinancing
7	Liquidity	7	Foreign currency
8	Interest rates	8	Liquidity
9	Foreign currency	9	Back office operations
10	Staffing	10	Ownership

Deposit-taking MFIs shared practitioners' concerns about rising credit risk and the state of the world economy and funding, but were less worried than the sector as a whole about liquidity issues, possibly because of the protection offered by their deposit base. They showed little concern about the risk of losing depositor confidence (which ranked No. 21 on their list), though they did see ownership as a growing issue. Institutional risks ranked high: management, corporate governance and staffing. Because many of them receive overseas investment, currency risk was also a growing concern.

North America

	Biggest risks		Fastest risers
1	Credit risk	1	Macro-economic trends
2	Refinancing	2	Credit risk
3	Liquidity	3	Refinancing
4	Macro-economic trends	4	Liquidity
5	Too little funding	5	Too little funding
6	Corporate governance	6	Foreign currency
7	Foreign currency	7	Political interference
8	Management quality	8	Competition
9	Political interference	9	Profitability
10	Inappropriate regulation	10	Corporate governance

Respondents from the US and Canada, who included a large proportion of investors, saw the greatest risks lying in the impact of the crisis on the value of their investments, notably credit risk and MFIs' ability to manage their funding and their liquidity. The risk that MFIs would fail to refinance was high on their list, as was foreign currency risk. As in 2008, investors in North America were concerned about institutional aspects of MFIs: the quality of governance and management. Investors also saw a rising risk of political interference in MFIs rising as a consequence of the economic crisis.

Latin America

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Competition	2	Competition
3	Political interference	3	Too little funding
4	Macro-economic trends	4	Political interference
5	Interest rates	5	Macro-economic trends
6	Liquidity	6	Mission drift
7	Too little funding	7	Fraud
8	Profitability	8	Interest rates
9	Inappropriate regulation	9	Liquidity
10	Refinancing	10	Depositor confidence

Latin American respondents, who were mostly practitioners, focused on the impact of the economic crisis on their business: the rise in credit risk and difficulties with funding and liquidity. They were among the few groups who saw loss of depositor confidence as a rising risk. They were also concerned about other crisis-driven risks such as greater political interference and inappropriate regulation. The pressures of competition are a top concern for the region, as they were in 2008. Respondents also saw mission drift as a rising risk because it could fuel controversy over the role of microfinance.

West Europe

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Foreign currency	2	Refinancing
3	Liquidity	3	Macro-economic trends
4	Macro-economic trends	4	Foreign currency
5	Refinancing	5	Liquidity
6	Management quality	6	Political interference
7	Corporate governance	7	Profitability
8	Too little funding	8	Too little funding
9	Political interference	9	Reputation
10	Profitability	10	Competition

West European respondents, who consisted mostly of investors, had equal concerns about the impact of the crisis on MFIs (e.g. credit risk, the macro-economy and liquidity) and the implications of this for investors (foreign currency losses, refinancing and funding difficulties). They were also concerned about the institutional aspects of MFIs: the quality of management and corporate governance, as well as the industry's reputation. The investors in this region saw the risk of more political interference in microfinance in a possible backlash to the crisis.

Central and Eastern Europe

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Interest rates	2	Interest rates
3	Foreign currency	3	Foreign currency
4	Liquidity	4	Macro-economic trends
5	Macro-economic trends	5	Competition
6	Competition	6	Liquidity
7	Profitability	7	Managing technology
8	Reputation	8	Reputation
9	Management quality	9	Too little funding
10	Inappropriate regulation	10	Refinancing

CEE respondents, who consisted mainly of practitioners, saw credit risk and its impact on profitability as the biggest risks facing MFIs in the crisis. They were also concerned about funding risks: liquidity and foreign currency. They were less concerned about institutional issues such as management and governance, though reputation was seen as a rising risk. The pressures of competition from other MFIs and commercial banks entering the sector are a worry at a time when markets are shrinking and profitability is declining. Inappropriate regulation is a big concern in much of the region.

Africa

	Biggest risks		Fastest risers
1	Management quality	1	Too little funding
2	Staffing	2	Refinancing
3	Corporate governance	3	Competition
4	Credit risk	4	Liquidity
5	Macro-economic trends	5	Macro-economic trends
6	Liquidity	6	Credit risk
7	Interest rates	7	Staffing
8	Too little funding	8	Ownership
9	Competition	9	Interest rates
10	Fraud	10	Foreign currency

African respondents consisted mainly of practitioners and members of aid organisations and NGOs. The African response was very different from the rest, focusing strongly on institutional issues, particularly weaknesses in management, governance and staffing. Economic crisis issues took second place, though they were seen as fast-rising, particularly liquidity and credit risk. A rising worry was the threat to funding and refinancing. There was much concern that the crisis would cause weaker MFIs to fail and damage confidence in the sector as a whole.

Middle East

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Macro-economic trends	2	Competition
3	Interest rates	3	Liquidity
4	Too little funding	4	Macro-economic trends
5	Inappropriate regulation	5	Mission drift
6	Mission drift	6	Unrealisable expectations
7	Liquidity	7	Too little funding
8	Competition	8	Foreign currency
9	Corporate governance	9	Interest rates
10	Fraud	10	Reputation

Respondents from the Middle East included microfinance practitioners, investors and NGOs. Their response focused on the credit risk impact of the crisis and the threats to funding, but also showed concern with wider issues, such as the rise in what they see as unhealthy competition. Striking was the high risk assigned to mission drift, and the related problems of unrealisable expectations and damaged industry reputation. Institutionally, respondents highlighted the weakness of corporate governance and the likelihood of a regulatory crackdown in response to the crisis.

Asia

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

The Asian response was strongly tilted towards practitioners who saw the biggest challenges lying in the area of management, particularly corporate governance, technology and staffing. Their concern about the impact of the economic crisis was more muted: liquidity risk and credit risk concerns appeared in their top ten, but not in the concentrated form of other groups. Concerns about the standing of microfinance also showed up strongly in the high place given to the risk of mission drift and unrealisable expectations. Political interference is another big issue, particularly in India.

Far East

Biggest risks		Fastest risers	
1	Competition	1	Competition
2	Credit risk	2	Credit risk
3	Management quality	3	Political interference
4	Macro-economic trends	4	Foreign currency
5	Transparency	5	Transparency
6	Staffing	6	Macro-economic trends
7	Too little funding	7	Managing technology
8	Foreign currency	8	Refinancing
9	Managing technology	9	Back office operations
10	Refinancing	10	Reputation

Respondents from the Far East included microfinance practitioners, investors and NGOs. Their greatest concern was with the growth of competition, particularly from banks, and the impact of this on the service offered by MFIs, which they thought damaging. They were also strongly concerned with management issues, including staffing, technology and the back office. On the institutional front, the transparency of the MF sector was a high level issue. The risks associated with the crisis – particularly credit risk and funding – were seen as generally lower, though fast-rising.

1. Credit risk (10)

The emergence of credit risk as the top Banana Skin in this survey is the clearest indicator of the dramatic new challenges that face the microfinance industry in these turbulent times. In the past, credit risk (the risk of loss when loans are not repaid) was seen as a minor problem in a business whose typical customers had an excellent repayment record (in our 2008 survey it was ranked No. 10). But not any more. A combination of stressful economic conditions and structural change within the microfinance (MF) industry has greatly increased concern about default and loan loss.

Peter Wall, executive director of the Microfinance Information eXchange (MIX), which compiles data about the global MF industry, said that credit risk is rising "across the chain, from micro-borrower through MFI and even among MFI lenders. The chain is increasingly being broken at different points".

Credit risk was ranked No. 1 by MF practitioners, those closest to the action, and was among the top five risks in all other respondent categories. It also dominated all the geographical responses, except Africa and Asia. Respondents from countries as diverse as Russia, Mexico, Syria, Bosnia & Herzegovina, Indonesia and Cameroon all reported that credit risk was on the rise. In Poland, a respondent expected overdue loans to reach record levels.

The economic crisis is likely to increase this risk in many ways: through economic slowdown, rising unemployment, volatile commodity prices and stress on management, to name but a few. Many MF clients live close to the edge and are perilously exposed to worsening economic conditions. Richard Murray of Liability Dynamics Consulting in the US said that MF borrowers were burdened with "virtually no alternative repayment options in times of reduced cash flow".

Many MFIs are also seen to be poorly equipped to deal with a surge in bad debts, lacking good credit management systems and adequate capital to absorb losses. The risk of institutional failure could grow.

But there are also wider concerns. Respondents see the economic crisis hitting microfinance at a time when credit quality is already deteriorating for reasons linked to the more competitive nature of the industry and a more calculating attitude to debt among borrowers. The concern is that the crisis will cause these unwelcome trends to accelerate.

The looming threat of too much personal debt

Overindebtedness. One of the biggest concerns is the high level of indebtedness that already exists among MF borrowers in many markets. Damian von Stauffenberg of MicroRate in the US said that "overindebtedness is rising and could come back to haunt the microcredit industry". Sanjay Sinha, managing director of M-CRIL in India, said that "the over-indebtedness of clients is emerging as a key problem in the microfinance sector. This could lead to portfolio quality problems in the medium term". Similar responses came from most parts of the globe.

Many respondents blamed this on the recent growth of competition among MFIs and commercial banks. This has led to an erosion of standards as lenders fight for market share and borrowers accept easy credit. Symptomatic of change has been the shift from group lending (where groups of borrowers guarantee each others' loans) to riskier individual lending.

Newly aware borrowers are able to tap several lenders at once because of a lack of industry-wide credit information. Worrying practices such as “bicycling” (using one loan to pay off another) are spreading. More borrowers are simply “walking away” from their debts. Antony Lythgoe, head of financial infrastructure at the IFC in Australia, said that “the lack of credit information sharing amongst MFIs, coupled with increasing competition and a migration away from group lending to direct lending is resulting in multiple loans being granted to the same individuals – who themselves lack the knowledge to manage their financial affairs responsibly”. A respondent from Uganda said that MF customers in cities and towns “do not have a permanent residence and keep shifting, and hence are difficult to monitor”.

The rise in credit risk could have wide repercussions for the industry. Losses and institutional failure would affect the confidence of depositors and investors, while attempts by MFIs to take a tougher line with defaulters could heighten reputational and political risk in such a sensitive industry.

2. Liquidity (20)

Like credit risk, liquidity risk has risen dramatically in the last 18 months to be seen as one of the most significant risks to the sector. In our last survey, conducted at the beginning of the financial crisis, respondents put it at only No. 20 (though some did warn that “liquidity has a nasty habit of drying up when most needed”). Now, they see it as a make-or-break issue. Brigit Helms, head of advisory services, IFC Indonesia, said: “This is perhaps the most serious risk in the short term”.

Banks are cutting back their lines of credit

Liquidity (having cash available to make loans, meet deposit withdrawals etc.) essentially comes from an MFI’s deposits and credit lines with other banks. The challenge to MFIs is to manage their dependence on these sources. Banks have already cut back their lines because of the credit crunch, and there is the fear that depositors could lose confidence and pull back too. This will affect MFIs’ business prospects and financial strength.

Olubunmi Lawson, managing director of ACCION Microfinance Bank in Nigeria, said that since the start of the financial crisis, “lines of credit available to microfinance banks have become almost non-existent, and the larger commercial banks are chasing the same savings deposits as microfinance banks – especially with depositors’ confidence shaken with some reported failures of microfinance banks”.

Gabriela Braun, from GTZ in Germany, said that a dry-up in liquidity would particularly affect “those MFIs that receive the lion’s share of their funding from microfinance investment vehicles (MIVs) or international credit lines”. Karla Brom, an independent consultant in the US, said that MFIs need to get a better understanding of liquidity management “and focus as much on this as they do on profitability”. One of the issues is whether deposit-taking MFIs are better placed to weather the storm than MFIs which rely on bank lines. Broadly, the answer seems to be yes. (See Box)

This risk was geographically widespread, an indication of the global impact of the crisis. Respondents from all the main markets put it high on their list: it was even considered a high level risk in smaller markets such as Syria and Albania. There was little variability across the sector, with practitioners, analysts, deposit-takers, investors and observers all ranking liquidity among their top risks.

‘Take deposits – or die!’

One outcome of the economic crisis could be a shift in the MF industry towards more deposit-taking. Currently, only a minority of MFIs take deposits from their customers. But funding difficulties have shown up the advantages of a reliable deposit base. Deposit-takers have, on the whole, fared better in the crisis than the rest. They have more stable funding bases, their cost of funds is lower, and they have no foreign exchange risk.

A respondent from Uganda said: “Take deposits – or die! MFIs will have to come up with alternative ways of running the business if they are to stay afloat. Deposits will be one of the cheapest ways to raise money.” An American consultant said that “so far, credit unions and other MFIs relying mostly on small deposits have not experienced the full extent of the liquidity crunch, but the economic crisis has not reached its height either”.

But deposit-taking is not easy. For one thing, it pitches institutions more directly into competition with commercial banks. One respondent also warned that authorisation to take deposits “will mean increased regulation and compliance costs. The industry is not prepared yet for this step”.

3. Macro-economic trends (23)

The global economic crisis is seen to pose a high risk for microfinance, despite the conventional wisdom that MFIs inhabit their own business world. Many respondents said that MFIs could no longer claim to be insulated from shocks in the “real economy”: there are too many links through financial markets, credit conditions and the fortunes of their customers. This marks a sharp change in attitude from our last survey when macro-economic trends were ranked down at No. 23, the view then being that the emerging crisis would pass MFIs by.

MFIs are no longer insulated from the ‘real economy’

In fact, some respondents this time thought that the crisis would be specially damaging to the developing world where fragile economies had already been hit by volatile food and energy prices, and by the contraction of foreign aid and investment. One said that “even small macro-economic changes can have a huge impact on the lives of millions when they are already living on the edge of starvation”. Nisreen Karkotli, head of economic research at the Central Bank of Syria, said that “although prices have shown some decline, the real effects of the international financial crisis have not shown through yet”.

Although no part of the world seems to be immune from economic downturn, the impact varies. Respondents from most geographic regions put this risk in their top five; the exception was Asia which placed it at No. 15. Among categories of respondents, those most concerned about the economic outlook were practitioners, particularly deposit-taking MFIs, and investors. These variations reflect local views about the vulnerability of the industry to economic slowdown and funding difficulties.

The recession and the associated credit crunch will impact MFIs in many ways, by depressing their markets and squeezing their sources of funds. Respondents saw MF being hit by rising unemployment, worsening bad debts, falling remittances, and declining investor and depositor confidence.

In Latin America, Alberto Jimenez, an advisor on MF technology to IBM, said that "deceleration in domestic growth of Latin American economies will increase unemployment and subsequently increase the non-performing loan portfolios of institutions of all sizes. This will be particularly acute in Argentina, Mexico and Venezuela". In Kenya, a respondent said that "the aftershocks from the global economic crisis will affect the economies of low income countries more profoundly than currently expected, eventually impacting on microfinance borrowers".

Are MFIs more resilient than the big banks?

Similar comments came from respondents in Asia, Central Europe, and North America. A US investor said that "MFIs accustomed to growth will find managing an economic contraction a challenge, e.g. staff incentive systems, managing delinquency, expectations of growth and return". Some respondents also expressed concern about the longer term outlook, fearing that the crisis could lead to institutional failure, and do lasting damage to the industry as a whole.

A small number of respondents accentuated the positive, particularly the resilience of MFIs and the likelihood that emerging markets would recover more quickly than developed markets. In any case, testing times could have a healthy effect on the MF sector. One said: "It's not all 'gloom and doom'. A shake-up in the market will likely be painful in the short-term, but beneficial in the long run. The flight to quality is a bumpy ride".

Naked swimmers exposed

To say that the microfinance sector is not immune from the global economic crisis sounds obvious. But it was not always so. Respondents to our 2008 survey were very upbeat about the ability of MFIs to survive the credit crunch and economic downturn. But in mid-2009, it is clear that MF is being impacted in many ways: through a tougher business environment and structural change.

Xavier Reille, senior manager at CGAP in France, said that the crisis was acting as "a revelator of poor practices." It was exposing MFIs "who have been swimming naked with open currency positions, over-indebted clients, uncontrolled growth and a concentrated funding base." On the other hand, it was also showing that "prudent and savings-based MFIs are still resilient," and on the whole MFIs were doing better than their Wall Street counterparts.

As for the crisis issues facing MFIs, an analyst from one of the large rating agencies provided the following check list:

- Slower growth because of funding difficulties and economic slowdown;
- Refinancing risk, particularly for those non-deposit-taking MFIs which are reliant on wholesale local and cross-border funding;
- Deteriorating asset quality;
- Pressure on profitability because of rising bad debts, higher funding costs and lower loan revenues;
- Growing event risk driven by an increase in economic hardship from the global slowdown. This can come in the form of political and economic events.

4. Management quality (1)

Concern about the quality of management in MFIs has eased from the No. 1 position it occupied in the last survey. This is partly because it has been overtaken by more urgent risks created by the economic crisis, but also because there does seem to have been progress. It was not seen as a rising risk last time, nor is it this time (it ranked only No. 18 as a trend), and several respondents said there had been an influx of talent (e.g. from the ailing mainstream banking sector) and a drive to raise quality.

But that is a generalisation. In Africa, respondents ranked this as the number one risk. A credit analyst wrote: “Middle management remains an area of concern – especially in Africa, but also in other parts of the world – where well educated staff at this level is difficult to come by and vulnerable to poaching from commercial banks. The absence of this capacity increases operational and credit risk”. Management was also seen as a big problem in the Far East (No. 3). Regions where it was less of a concern included Latin America, Central and East Europe, Asia and the Middle East. Respondent groups for whom it was a high concern included deposit-taking institutions.

Is management up to leading MFIs through the crisis?

Many of the challenges behind management quality persist: difficulties in attracting and retaining talent, poaching, lack of training facilities, conflicting social and commercial missions etc... Brian Busch, investment officer at Omtrix in Costa Rica, said that “institutional capacity must continue to improve to match the growing complexity of a given MFI and the industry as a whole”.

The big question, though, is whether MFI managements are up to leading their institutions through these testing times. Respondents saw a need for more skills in the areas of risk management, cost control and strategy as MFIs faced tougher competition and difficult market conditions. (See Box).

Godwin Kihuguru, advisor to Integrated Microfinance Bank in Nigeria, said that “as the financial meltdown takes its toll, microfinance institutions will have to operate more efficiently to offset the pressure of higher borrowing rates (from commercial banks) and increase investment in deposit mobilisation. If the recession persists or increases in intensity, it might lead to downward pressure on interest rates as is already happening with commercial banks. Again, this can only be managed by increased productivity (loan officer caseloads) and efficiency”.

Nothing so risky as risk itself

One of the biggest risks facing MFIs is the management of risk itself. Are they up to it?

Geert Peetermans, chief investment officer at Incofin in Belgium, said that “risk assessment has to adapt to a new reality. This applies to MFI managers and boards, as well as to investment managers. Asset and liability management and business planning are more important than ever. In particular the general sense of risk awareness has to be strengthened. In an environment of rapid change, a sense of urgency and decisiveness will be a critical qualification that will make the difference”.

Philip Brown, risk director at Citi Microfinance, said that “effective risk management (strategy, processes and culture) has become a differentiator of performance... Greater instability and uncertainty exists across the spectrum of macro and micro business risks. These risks have stressed some businesses, resulting in cracks appearing with negative performance, in some cases threatening business survival... There is a renewed focus on the monitoring and management of risks associated with business fundamentals”.

5. Refinancing (28)

This is another Banana Skin that was ranked close to the bottom in the last survey but is now seen as a serious and fast-rising risk.

Refinancing risk addresses the danger that MFIs may not be able to renew their base funding from investors or donors because of changes in their circumstances or – currently – owing to the stresses of the economic crisis.

A recession could force changes on the MF business model

This Banana Skin was one of the top concerns for investors who ranked it No. 1, as opposed to practitioners who appeared much more relaxed about it, placing it No. 15. There was significant geographic variation too, with North American respondents ranking it at No. 2, Latin American respondents at No. 10, and the Middle East at No. 14 – perhaps reflective of the samples: North American respondents are more on the investor side, more closely tapped into capital markets and pessimistic about the credit crisis.

How safe is the MF business model?

The economic crisis will test the strength of the MF business model. How will it fare?

Some respondents expect it to expose weaknesses and force change. The vice-president of an MF network that covers Africa and Asia said that microfinance was specially exposed to the crisis because it depends on “continuous soft funding, and ... the group lending model which is extremely vulnerable to political and social issues”. Other respondents felt that the biggest challenge facing MFIs would be to explain to investors that recent strong investment returns were exceptional, and that profitability would not return to earlier levels.

But others were more optimistic. Alex Silva, chief executive of Omtrix in Costa Rica, said that “the fundamentals of the basic business model remain sound. In fact, the current financial crisis is perhaps just one of many for MFIs who deal with national political crisis, natural disasters and specific regulatory constraints on an almost continual basis”.

Howard J. Finkelstein, a US legal adviser to MFIs, believed that the major risk facing the industry “will be to survive its first-ever slow period while at the same time maintaining public optimism about its future. For instance, over the next 12-15 months, it is likely that one or more MFIs will default on debt owed to commercial investors. The risk is that potential future investors will view this as a warning sign that the business model is not as good as previously thought. The industry's burden will be to show that the business model is not inherently flawed”.

As one US investor said: “Over the years, debt investors have been willing and able to refinance loans to MFIs, allowing their capital to remain in the field and be productive. As the global credit crunch continues, refinancings will likely become less common, with debt investors requiring repayment of their loans”.

Investor nervousness is a direct consequence of mounting financial pressures on MFIs: the growth of loan delinquency and operating losses, the slowdown in new business, and worries about liquidity. Yet if funding dries up, MFIs’ prospects could get even worse. As with many of this year’s top Banana Skins, there is a concern here about a perfect storm – with each of the risks exacerbating each other.

A rating analyst saw the further risk of a domino effect. “If lenders start playing a game of ‘hot potato’ in which nobody wants to be the last lender exposed to an MFI, one early termination or unwillingness to renew could trigger a cascade of terminations.”

Respondents were unsure which type of institution was most at risk: the large commercialised MFI which had become over-reliant on investor funds, or the smaller MFI which had few sources of funds to call on. Eliza Erikson, a portfolio manager at the Calvert Foundation in the US, said that “MFIs in middle income countries that are more integrated with, and therefore exposed to, capital markets will have challenges raising sufficient funds to underwrite growth”. But others feared that the victims would include weaker MFIs who did not have investor confidence to support them.

6. Too little funding (29)

The economic crisis has turned the issue of funding on its head.

More funding for top tier MFIs, less for the rest

In our 2008 survey, the big worry was that the MF sector was being swamped by indiscriminate funding which was leading to excess capacity, dangerous levels of competition and the risk of disappointment. The problem of too little funding was considered minimal. This time, the fear is that the economic crisis will cause funding to dry up. Frederic de Mariz, an analyst at JPMorgan in Brazil, said: “It appears that MFIs – even the largest ones – are not able to access funding from commercial banks or from the market, as they were before”.

This is a risk that particularly concerned practitioners who listed it No. 4 and saw it as a serious threat to their business. Investors were less concerned: they put it No. 8. Geographically, concern seemed to be evenly spread among investor and practitioner regions.

Funding difficulties raise many issues to do with the sustainability of the industry, MF’s place in the global investment market, and longer term questions of structural change.

One of the most pressing is whether funding is a generalised risk for the sector, or only for weaker MFIs. Some respondents argued that the crisis will concentrate funding in a few top MFIs, and make life difficult for the rest. A US investor said that “access to capital will be a constraint for Tier 2 and 3 MFIs in many markets. However I wouldn’t generalise to say that access to capital is constraint for the industry, as I don’t believe it will be a constraint for Tier 1 MFIs who often, by their very size, are serving a majority of clients in many markets”.

The investment case

The primary risk is whether MFIs will navigate the current economic and financial stresses in a way that supports the case for microfinance as an asset suitable for the mainstream capital markets. While sustainability and profitability have been demonstrated to the satisfaction of industry participants, investors generally are waiting for more track record to develop. The current environment could confirm the resilience of MF, or set back the process of building the case that investors require.
Paul DiLeo
Managing partner
Grassroots Capital Management, US

However, virtually all practitioner respondents said they were either facing, or worried about, funding difficulties, both as to availability and cost. The comment from a practitioner in Peru was typical: “Many MFIs only have access to external funding sources. The hardening of the conditions of these will make them less competitive.” Eric Savage, managing director of Unitus Capital in India, described the lack of funding as “potentially life-threatening to many MFIs and their clients”. Kim Nadejda, business development director at the Russian Microfinance Center, said that “we observe a growth in [funding] costs because of the influence of the world financial crisis”.

This shift in funding could bring about longer term change in the industry by favouring larger commercial institutions and driving smaller MFIs out of business. Although such a shake-out is seen as potentially healthy by some respondents, others fear it would only edge MF further away from the markets it should be serving. Taufiq Zahidur Rahman of the Shakti Foundation for Disadvantaged Women in Bangladesh said that “with the global meltdown, the flow of funds to microfinance will surely shrink. Moreover this meltdown will increase the poverty level”.

Some respondents saw new realities developing on the funding front, with less money coming from disillusioned private investors and wealthy individuals. Peter Platan, investment manager at Finnfund in Finland, said that “private sector funding for the industry was overabundant a few years back. But due to the crisis, private investor interest in microfinance could decline for many years to come”. Some even thought that “donor fatigue” would cause philanthropic funds to switch back to direct means of financing poverty alleviation. Meanwhile those MFIs that did continue to receive commercial funding would probably have to adjust to tougher terms.

Many respondents noted the vicious circle in the crisis, with a funding shortage leading to liquidity problems, leading to overindebtedness and a reduction in portfolio quality – making funding even less attractive. This link between the top Banana Skins was a recurring theme.

7. Corporate governance (2)

Corporate governance remains a challenge for many MFIs

As with management quality, concerns about the strength of corporate governance in MFIs have been overtaken by more urgent considerations, hence the fall of this Banana Skin in the rankings. But it has not gone away. The responses suggested that corporate governance remains a challenge for MFIs in many parts of the world, particularly in this period of stress, and is widely viewed as a central long term issue.

> **Who’s next?**
> A key issue among many in governance and management is succession – a topic that almost everyone wants to avoid but will eventually happen. Looking at the microfinance landscape, the early leaders and pioneers are facing a clock that is (or should be) winding down. Are the institutions prepared?
> Gil Lacson
> Relationship manager
> Women's World Banking, US

An analyst with one of the MF rating agencies said: “Good governance will remain a key area to mitigate risks for MFIs. [Institutions] will need to keep board capacities ahead of the increasing complexities of the industry. Foreseeing risks will become more important in the maturing industry, while relying on reactive governance/management will expose MFIs to bigger risks”. Many made the point that the recession would sort out the good from the bad.

The regions where concern was highest included Africa and Asia. Concerns also showed in regions where responses were dominated by investors rather than practitioners, e.g. North America and Europe. In Latin America it was relatively low (No. 15).

Among the issues raised by respondents were the low calibre of boards, conflicts of interest among directors and executives, and a lack of independence and accountability. One North American investor described the skills of many boards as “limited at best”. The economic crisis may also present boards with challenges they cannot meet: declining credit quality, mounting losses and staff who lack the qualifications or experience to handle difficult business conditions.

Some respondents blamed weak governance on the fact that times had been too good for many MFIs and the business lacked rigour. Markets had been strong, funding, including “soft” money, was plentiful, and MF’s philanthropic status reduced the need for accountability. This could magnify the impact of the crisis.

An Italian microfinance investor said: “After years of very high growth rates, the economic and financial crisis is imposing a significant slowdown on most MFIs. Past growth rates, facilitated by abundant funding, have often hidden important intrinsic weaknesses, especially in the areas of corporate governance, management quality and risk management – issues which are now rapidly becoming evident. The crisis will give an opportunity to the best managed MFIs to consolidate their operations, while the weakest ones will likely gradually lose market share”.

However some respondents felt that corporate governance was widely recognised as a key issue, and much was being done to strengthen it, particularly among MFIs undergoing transformation. One said that “the current ‘popularity’ of microfinance has elevated the calibre of board talent available, so there is no excuse for not having strong governance and quality oversight. Investors have made governance reviews a priority”. An Indian practitioner said: “Unlike the past, a lot of training programs are now available. It is up to the MFI to equip itself to meet global standards”.

8. Foreign currency (12)

Foreign currency risk is rising because turmoil in financial markets has exposed weaknesses in the microfinance investment model.

For years, investors have been investing in MFIs with hard currency – mainly dollars – to fund loans which are disbursed in local currency. The volatility of currency relationships means, in the words of one respondent, that “even a zero default rate will not ensure repayment of hard currency funding if the local currency of borrowings devalues”. The respondent continued: “This is a fundamental flaw in the model which, if not provided for, is a major accident waiting to happen”.

Even a zero default rate can’t ensure repayment of hard currency funding

Volatility can cut both ways, of course. Not long ago, the weakness of the US currency made dollar borrowings easier to repay. But the dollar’s (and the euro’s) recent appreciation against local currencies, particularly in Eastern Europe and Central Asia, is making repayments more expensive.

The problem, as several respondents warned, is that MFIs are not able to hedge their positions. Denominating loans in dollars or euros is not realistic, nor is receiving investment in local currency. There is “far too much USD/EUR debt financing flowing to MFIs that are either not able, or not equipped, to hedge”, noted the vice-president of a large MFI.

The problem is not just lack of know-how but an absence of hedging mechanisms for highly illiquid currencies. This means that investors may have to swallow the currency risk, which hardly encourages further funding. As one respondent argued: “International development players should make it an absolute priority to subsidise or otherwise support nascent efforts to develop more liquidity in hedging instruments or provide local currency funding”. Some remedies are, however, in the works, including cross-currency swaps and advice on hedging and FX management.

Foreign currency risk can take other forms as well. Nugzar Murusidze, microfinance regulator in Georgia, said that the devaluation of the national currency had boosted inflation and damaged the local credit business.

Views on this risk varied by region, understandably given its geographic nature. Investor regions such as North America and West Europe gave it a high ranking (No. 7 and No. 2 respectively), while practitioner regions ranked it lower. Again, investors were the most concerned group, ranking it No. 2, while regulators breathed a collective yawn and placed it No. 24.

9. Competition (7)

The MF sector continues to have very mixed views about the value of competition. Does it spur progress or merely destroy the good things that MF is supposed to be about?

Competition is blamed for the ‘erosion’ of credit standards

In the 2008 survey, this Banana Skin was seen as the fastest-rising risk, particularly by practitioners. But it has eased this time, reflecting the changed conditions brought on by the economic crisis.

Many respondents felt that competition, particularly the entry of well-heeled commercial banks into the market, had made MF especially vulnerable to a downturn by encouraging irresponsible lending. Clara de Akerman, president of Women’s World Banking in Colombia, said that banks which had entered the market “lack the proper methodology to deal with credit financial services to poor micro-entrepreneurs. This can be seen in the growing indebtedness of small customers”.

There were frequent references to the problems of overindebtedness, particularly in regions such as Latin America and Asia, with blame pinned on pressure for market share, declining credit standards, tight pricing, and a new awareness among borrowers that they can play lenders off against each other.

Marcus Fedder, a partner in UK investment firm Moringaway, said that “some regions may reach saturation, resulting in more competition, lower lending rates and, importantly, borrowers taking out more than one loan, leading to increased danger of defaults”. Kalpana Sankar, chief executive of Hand in Hand in Tamil Nadu, said that “even governments and private banks are entering the field, and the sector is losing its core value of closeness with the target group to reach scale and make more profits. This could pose a major problem and the bubble might burst”.

However, other respondents saw competition as a healthy force that was spurring innovation and driving out inefficiency. A North American microfinance investor said: “We consider competition to be a good thing, and see an increase as positive”.

The economic crisis was widely expected to take some of the force out of competition, particularly as the commercial banks adopt more cautious strategies, and funding becomes more difficult for MFIs. Several respondents said they thought the crisis would encourage consolidation in the industry, leading to fewer but larger players. This might reduce competition, but would also alter the character of the industry.

Could consumer lending damage MFIs’ reputation?

Protecting consumers

Competition between banks and MFIs is blurring the line between microlending and consumer lending in many markets. This is creating confusion which could damage microfinance.

Consumer lending consists of small loans to individuals to buy personal items. Microlending consists mostly of small loans to finance business. But the distinction is disappearing as banks and MFIs compete at the small end of the market. Many respondents feared that the more aggressive style of consumer lending would taint microlending and make it riskier.

Elizabeth Littlefield, director of CGAP in the US, said that “while the microfinance community is very clear about how its values are distinct from mainstream low-income financiers, there is little distinction at the operational level, where money is often lent without regard for repayment capacity, at rates that are needlessly high and unclear to the customer”.

Daniel Schriber, director of investment analysis at Symbiotics in Switzerland, said that “the reputation of the microfinance industry as a whole is going towards too much consumer lending, which could scare away investors and destroy the goodwill that microfinance is benefiting from today”.

Several respondents also feared that aggressive lending to consumers would expose MFIs to actions under consumer protection regulations which would be bad for the industry’s reputation. A US consultant said that “consumer protection issues, particularly over-indebtedness, transparency, collection practices and fraud are likely to gain more visibility”.

10. Political interference (9)

The overall level of concern about political interference in the MF industry is little changed, but this Banana Skin varies greatly from one region to another.

Latin American respondents, for example, ranked it No. 3 while Asia put it at No. 8, and Central/East Europe and Africa at No. 23. As for types of respondents, concern was higher among investors than practitioners. Deposit-taking MFIs expressed little concern, suggesting that this risk lies more on the lending side.

Political interference takes many forms: directed lending, interest rate caps, loan forgiveness, subsidised competition. The two most frequently mentioned by practitioners were asset grabs in countries where MFIs were well-resourced, and controls on the cost and availability of loans.

A credit rating analyst said: “Undue government influence is likely to come up every now and then in countries as politicians hope to capitalise on the success of MFIs for their own benefit (e.g. Uganda). A cap on interest rates is often discussed, although fortunately so far the soup has been served much hotter than it has been eaten…Unfortunately many other examples exist and this trend seems to be on an increase”.

Microfinance is becoming more political

Geographically, respondents pointed to Asia and Latin America as regions where political interference was growing. One respondent noted that the Nicaraguan government was supporting a “non-payment group”, and respondents from Colombia and Venezuela said that interest rate caps were stunting the growth of the market.

> **The political threat**
>
> There is political and regulatory risk in markets hit by the food/fuel/financial crises and the downturn in the real economy. This could take the form of calls for debt moratoria, interest subsidies, uneconomic capping of interest rates and similar populist reactions, as well as well-intentioned, but disproportionate, consumer protection and other market conduct regulation that imposes significant compliance costs. This would price sustainable providers out of harder-to-serve/less profitable markets.
>
> Timothy R. Lyman
> Senior policy advisor
> CGAP, US

One worry is that the risk could get worse as governments use the economic recession as a pretext to exert greater control over MF activity. Jacco Minnaar, a fund manager with Triodos Investment Management in the Netherlands, warned that the economic downturn “could also lead to less stable political environments, as poverty may rise again, leading to social unrest. This could in turn hurt the microfinance industry and we may see that anger and frustration will be directed at MFIs in some countries”.

Some respondents felt that international agencies and MF sponsors could/should do more to combat this risk by highlighting incidents and showing how MF client interests were being harmed.

11. Interest rates (6)

Interest rate risk is seen to have fallen quite sharply, mainly because the earlier volatility has eased, and rates are generally much lower. But the difficult economic environment could expose MFIs to unfamiliar challenges on this front.

This Banana Skin was of greatest concern to practitioners (No. 7) and deposit-takers (No. 8), less so to investors (No. 12). For similar reasons, geographical concern was concentrated in the large practitioner regions such as Latin America and Central and Eastern Europe.

The consensus view is that MFIs have sufficiently large interest rate margins to absorb considerable volatility, and the decline in interest rates is an opportunity to widen margins by maintaining lending rates while cutting deposit rates. But this is a risky strategy because it invites customer resentment and political interference, a point made by several respondents, especially in India.

The alternative is to pass lower rates on to borrowers, which many MFIs have tried to do. But this is also risky because at some point interest rates will shoot back up again, and loan rates will have to as well. Daniela Gaga of Opportunity Microcredit in Romania, said that changes in interest rates would affect profit targets, and a similar point was made by A.B. Ariyaratne, general manager of Sabaragamuwa Development Bank in Sri Lanka.

The real challenge, therefore, is how to manage what is likely to be a much more volatile interest rate environment. An MF investor from the Netherlands said that "MFIs will be confronted with the need to accept more variable interest rates than they did before".

12. Profitability (22)

Concerns about profitability are rising, as might be expected in difficult economic times, though from a low level which reflected the earlier view that MF is more about philanthropy than making money.

Profits matter even more in a crisis

Concern was strongest among practitioners (No. 10), deposit-takers and investors (No. 11 and No. 12 respectively). It was weaker among analysts (No. 16), which is perhaps surprising, but it echoes the finding of our 2008 survey. Regionally, concern was strongest in Central and East Europe (No. 7) and Latin America (No. 8). In Asia, it ranked No. 22.

The main pressures on profitability are higher funding costs and bad debts. Gabriel Solorzano, chairman of Banex in Nicaragua, said: "What profitability? Does anyone still have profits?"

The drive for profitability

Few MFIs earn their cost of capital, once donations are removed from the picture. Yet for the industry to maintain its growth post-crisis, it will need to attract capital on an arm's-length, non-subsidised basis. The combination of macro-economic/credit factors and irresponsible competition is likely to continue to put further downward pressure on MFI profitability. The good news is that strong MFIs are focusing on cost containment, efficiencies from system investments, and new products/revenue sources, to drive for reasonable profitability.
Phillip Goodeve
Chief financial officer
FINCA International, US

Much depends on MFIs' ability to pass on higher funding costs, which is not easy in such a sensitive business. Many respondents said that their margins were being squeezed by a combination of competition and inability to raise charges to their borrowers for social and business reasons. One respondent said that profitability was "a two-edged sword…High profits in stressful times can boomerang (*à la* Compartamos), while poor profits/no profits can hit the supply and cost of funding".

What is striking from the responses is the strength of the view that profitability is key to survival. One Indian practitioner said: "Without profitability there can be no sustainability. But these should not be huge profits as we are working with a very poor clientele". Jo Henriksen, an investor with Kolibri Kapital in Norway, said that "a high focus on profitability is essential for being sustainable".

One respondent said that lower profitability would "potentially reduce the attraction [of microfinance] to mainstream commercial investors". Some respondents also wondered whether MFIs would ever regain their earlier profit levels because of lasting changes to the structure of the industry.

13. Inappropriate regulation (3)

This is a risk that comes in many forms. Depending on who you are and where you are, there is either too much regulation or too little, it is either ineffective or oppressive. But broadly the sense seems to be that regulation is getting there, if slowly. This Banana Skin is slipping down the rankings, and is not considered to be getting worse.

Microfinance could be hit by the regulatory backlash against banks

The category of respondents which is most concerned about this risk are practitioners who ranked it No. 8 and investors (No. 9). Analysts, by contrast, were much less worried, ranking it No. 19. Regulators ranked it No. 21. Geographically, concern was strongest in the Middle East (No. 5) and Latin America (No. 9).

The concern most frequently cited by respondents is that many countries still lack specific MF regulation, which means that MFIs are either unregulated, or forced to conform to other, mainly commercial banking, regulation. This is a particular issue for deposit-taking, an activity that more MFIs want to get into. The wrong regulation can affect the viability of the business model, undermine depositor and investor confidence, and expose MFIs to political interference.

Martin Holtmann, head of the microfinance unit of the IFC, said that inappropriate regulation “prevents many mature MFIs from raising deposits”. Dieudonné Gnanvo, director of RENACA, the Benin savings bank network, said that “new West African regulations do not conform to the realities on the ground, and could introduce new constraints on the development of the sector”.

Another aspect of the risk is the poor quality and ineffectiveness of regulation. One example is China where, according to Chengyu Bai, secretary-general of the China Association of Microfinance, the lack of a suitable regulatory framework means that MFIs flout the law, raising deposits without authority, and focus on business lending rather than microcredit. “This is distorting the industry”, he says.

In Bangladesh, Muhibur Rahman, senior assistant secretary at the Ministry of Finance, said that the authorities lacked the capacity to regulate properly. “The weak regulatory mechanism could result in a fragile financial market with money laundering and financial crime becoming uncontrolled”. Jules Gbato Gonnet, microfinance regulator in the Côte d'Ivoire, said that “microfinance innovates more rapidly than regulation”.

> Unless regulators have the will power to come up with conducive, friendly and water tight regulations, the industry will be in a major war, pitting itself against the established commercial banks.
> Darius Njenga
> Programme coordinator
> INAFI Africa Trust, Kenya

An ongoing issue is “transformation”, the transition of MFIs from unregulated to regulated status, a process which can cause disruption and uncertainty. Voluntary transformation is increasing as more MFIs seek to grow and take deposits, a trend which has brought them into competition with commercial banks in many countries. Enforced transformation, notably in the Balkans, continues to cause serious problems for MFIs in Bosnia & Herzegovina.

Overshadowing all this is the worry that microfinance could get swept up in a worldwide move to re-regulate the financial system in the wake of the crisis. This could lead to hasty, ill-thought out measures. Carlos Labarthe, co-chief executive officer of Compartamos in Mexico, said that the financial crisis “is generating a lot of efforts by regulators to increase regulation for financial institutions in general, so the possibility that this will affect our operations is huge”. Bob McDowall research director at TowerGroup saw MFIs “being caught in the slipstream of excessive and undeserved additional financial regulation intended for mainstream financial institutions that will erode margins and make some areas of business uncompetitive”.

On the other hand, a number of respondents said that regulation was improving. A credit analyst in Peru said that regulation in that country was “very appropriate”.

14. Staffing (5)

Concerns about staffing, which loomed large in the 2008 survey, seem to be easing. This Banana Skin has fallen very sharply in the rankings, and is seen to be on a declining trend.

Staffing risks are seen to be declining

One reason could be that the huge amount of resource that has been applied to staffing is beginning to pay off. Another is that the recession has eased staff shortages, and a third is that MFIs who transform themselves into banks are often able to offer more interesting and better paid jobs.

Geographically, the risk remains most acute in Africa, which ranked it No. 2, and the Far East (No. 6). A respondent from Kenya said: “Human resource development is a major concern for the industry. The development of skills is probably not keeping pace with the development of the sector – at least in Kenya”.

Among respondent categories, the biggest worries lay with deposit-taking MFIs who placed it No. 10. Sadaffe Abid, chief executive of the Buksh Foundation in Pakistan, said that “most MFIs lack management depth to grow and expand their business. They are usually dependent on a few individuals. MFIs need to have strong leadership development initiatives and systems in place”. Investors seemed to be less concerned. “It’s becoming easier” said an MF funder in the Netherlands.

The talents in shortest supply are loan officers and risk managers. Staff is particularly short in MFIs away from towns and those without automated systems. A

Africa’s challenges

Africa’s problems are often described as the toughest of any MFI region. Here Julie Bally, director of the Première Agence de Microfinance in West Africa, describes the challenges.

“The crisis has revealed weaknesses in individual MFIs, such as uncontrolled growth, poor governance, excessive competition, overindebtedness owing to multiple borrowing, weak human resources, particularly loan officers, a lack of product diversification, a concentration of activities in towns (where debt problems are greatest), inadequate management information systems, poor credit management, ineffective bonus systems, a lack of professionalism, excessive profits (because of investor pressure), poor knowledge of the market and customers, lack of funding, lack of capital, lack of protection against foreign exchange risk, etc.. However, it must be said that the microfinance sector is healthier than the formal financial sector, and it seems that the industry here in Africa is less affected by the crisis because it is less integrated into the formal financial sector than may be the case in Latin America or Eastern Europe.”

US academic analyst saw the problem as acute in sub-Saharan Africa, "especially in rural areas because of severe endemic poverty and the resultant lack of qualified people".

There was some good news. Some respondents reported that the global crisis had taken the pressure off the jobs market and eased shortages and poaching. There were even cases where commercial bankers had switched to the MF sector to bring their skills and "give something back".

15. Managing technology (8)

This is one of those long-term, strategic risks that have been brushed aside by more urgent concerns about the economic crisis. Technology remains a big Banana Skin for MFIs, and could become more so as cost and competition pressures increase.

An industry analyst said that technology is "not evenly present in the industry, and smaller MFIs with few economies of scale will find it difficult to keep up with new applications, given costs". A Japanese practitioner said that "technological innovation is rapid and requires significant investment to catch up with it".

Back office efficiency and distribution are the key issues

This was seen as a middling risk by most respondent groups, except Asians who placed it No. 6. A respondent from Tanzania said that "most MFIs still lack appropriate and effective management information systems, and, partly as a result, continue to have problems managing portfolio quality".

Essentially, there are two issues, back office efficiency and distribution.

On the first, the concern is that MFIs may lack the will and skills to take advantage of modern systems to manage costs and risks. The vice-president of one of the large international MF networks in Africa and Asia thought that "back office systems are not ready to face a recession environment". A ratings analyst said that "an increase in efficiency will be key to remaining profitable as interest rates remain under pressure. The use of technology will increase, of which risks so far have remained limited".

On distribution, huge advances are taking place in communication which MFIs need to exploit, for example to develop branchless banking. Paul Makin of Consult Hyperion in the UK thought that "MFIs risk being left behind by the mobile revolution. Most do not have the staff, the technical expertise, or the necessary investment funds to be able to take advantage of technological developments. This is particularly the case for 2G banking technologies, such as M-PESA and Wizzit. The principal concern is that these shortcomings will severely limit their reach to new customers, whilst also leaving them unable to drive down their own administrative costs".

Several respondents made the point that this is an area where sponsors and investors can help mitigate risk by offering personnel, technical advice and guidance on standardisation.

16. Transparency (11)

Concern about poor transparency in the MF industry has fallen, reflecting some improvement on this front, often under pressure from investors and rating agencies who want better information and accountability. The director of a capital markets group which advises women's banks said that "the greater focus from investors will drive toward better transparency".

The cost of MF loans remains 'a murky area'

However a murky area remains the cost of MF loans where MFIs may be reluctant to come clean because their charges are very high. Narasimhan Srinivasan, a consultant to MFIs in India, said transparency was "poor in many MFIs; they are unwilling to let others have an independent look". Another advisor said: "I expect more and more markets to implement basic transparent loan cost disclosure measures".

Several respondents made the point that transparency could become a key issue in sorting out the good MFIs from the less good in times of crisis. Lynn Exton, chief risk officer at Opportunity International Network, Canada, said: "The industry benefited from relatively benign conditions up until 2008. The external environment has changed significantly and there is likely to be a shakeout… The industry may suffer as a whole while the market sorts out the strong from the weak, which is not easy given the low level of transparency in MFIs".

Nonetheless, many MFI respondents said that transparency was key to building confidence among investors and depositors, and some felt that the rigours of the crisis would produce improvements on this front.

An Italian microfinance investor said: "The limited availability of funding will trigger a greater effort towards transparency, information sharing and clear governance. Therefore, although over the next 1-2 years we will likely witness a stalling in the overall growth of the industry and a worsening in portfolio quality, in the longer term the sector should end up being more robust, transparent and less fragmented".

17. Reputation (19)

Broadly the MF industry has a good reputation, but our responses threw up several worries. One is that the growing commercialisation of the business will draw it away from its social goals and earn it a bad name. Leading on from this, another is that MF will be "exposed" by an unsympathetic Press as having failed to improve the lot of its target communities. A third is that the recession will force MFIs to be tougher on their customers and attract bad publicity. All these could damage the industry's reputation and affect the availability of funding. William Knight, a consultant with CGAP in Canada, said that "any entity dealing with money in any form is under the microscope for the next two-three years".

Interestingly, reputation was ranked higher as a risk by investors (No. 14) than practitioners (No. 18) who, on the whole, felt they were managing it quite well. None of the regions showed an exceptional level of concern, high or low, except the CEE which ranked it No. 8.

Many respondents raised the spectre of negative publicity about MF's alleged failures or, even worse, its contribution to new problems such as overindebtedness.

Paul Blyth, head of business development at MicroPlace, saw the possibility of “a bad PR story hitting the mainstream Press, transforming microfinance from a positive term into a negative one”. A Norwegian investor said that the industry could be questioned “if the media begin to see that MFIs keep an informal economy afloat and that children are often working in small enterprises”.

The industry’s reputation is linked to the issue of “mission drift” (See No. 19).

Dealing with a negative Press

The economic crisis could be bad news for MF if it forces institutions to be more tight-fisted with their lending, and more exacting with their debt collection. Paul Luchtenburg, chief executive of AMK in Cambodia, said that as business conditions worsened, MFIs would have to deal with “an increasingly negative press”. A practitioner in Peru said it was already evident that MFIs were taking a “less caring attitude” towards their clients.

On the other hand, some respondents felt that the crisis could help MF’s image by highlighting its social commitment at a time when commercial banks are cutting back or failing. T.K Weerawareana, a manager with Sarvodaya Economic Enterprises Development Services in Sri Lanka, said the MF would emerge “with a good reputation from the prevailing macro economic crisis”.

Reputation at risk

The director of an MFI in Bosnia and Herzegovina described how the economic crisis is hurting MF’s reputation in his country. “The crisis is having a very negative impact on our clients, specially because of the problem of overindebtedness. There have been tragic incidents in some families, including suicides. This has attracted the attention of the media who are not supportive of MF because of the high interest rates we charge. A chain reaction follows. Media pressure prompts politicians to move against MFIs by getting the regulator to become more repressive. This, in turn, scares our lenders who are withdrawing their funds and creating a huge liquidity problem for us.”

18. Unrealisable expectations (13)

In an industry surrounded by hype, there is always a risk of disappointment, of expectations remaining unfulfilled. The question is whether current conditions increase or reduce it. Will MFIs rise to the occasion or stumble?

Practitioners and investors shared the view that this was a middling risk (both put it at No. 17), with the broad feeling being that MF was bound to create disappointment: it was a question of managing expectations. Daniel Kalbassou, general manager of Crédit du Sahel in the Cameroon, said that “MFIs on their own cannot solve the problem of poverty because poverty is a whole set of problems. The MFI makes its contribution”.

On the negative side, respondents saw the crisis hurting the MF business by squeezing margins and driving up bad debts, and also by making it harder for MFIs to live up to their social roles. Analysts saw profitability falling, which could be dangerous in an industry so much in vogue. The failure of weaker MFIs could also be damaging.

But on the positive side, several respondents felt that the MF industry could come through the crisis in much better shape, tempered and strengthened by harsher conditions, with much of the fluff blown away. Its profitability could be higher than the financial sector average, which would attract investment back into the sector. One respondent said: “Many MFIs are taking advantage of this lull in their growth to remedy underlying problems in management, to build support for their previous growth, to shore up their business plans”.

19. Mission drift (14)

Are MFIs losing sight of their social goals?

Although the risk of mission drift (MFIs being deflected from their social goals by commercial interest) has fallen, this was a Banana Skin that attracted much comment. There is the ongoing dilemma over the microfinance balance between business and philanthropy, but the new concern is that the economic crisis could tilt the balance towards commercial survival. Most respondents saw this as a rising risk.

Concern about mission drift was strongest among the MFIs themselves. Chuck Waterfield, chief executive of MicroFinance Transparency in the US, said that “most MFIs strive for a social/business balance, respecting clients while building sustainable institutions. This is in line with the origin of the microfinance industry. But the lure of quickly generated, very large profits is drawing some MFIs to focus on profits at the expense of fair treatment of their clients”.

Geographical concern was strongest in the Middle East (No. 6) and Asia (No. 9). Alnuman Adra, country manager of Micro Credit Facility in Syria, saw “a trend in many commercial MFIs to increase profits and therefore ignore poor and very poor customers,” and in Egypt Motaz El Tabaa, executive director of the Alexandria Business Association, reported that MFIs were losing sight of their social goals and transforming themselves into non-social “for-profit” institutions. In China, Jiao Ta of GTZ Microfinance said that the trend was to move away from “real micro clients” to bigger business clients.

> **Is microfinance doing its job?**
> As microfinance becomes increasingly commercial, the question of whom and to what extent the sector is serving is a viable one. There needs to be a rigorous examination of the aims of microfinance and how it is contributing to poverty alleviation.
> Peter Westman
> Capital development manager
> Mimo Finance, India

Many respondents blamed mission drift for aggravating the problem of overindebtedness by encouraging irresponsible lending. A respondent from Bosnia & Herzegovina reported that loan officers were forced to fill “crazy” monthly quotas. “Disbursement is based on the principle of ‘Just take a loan, you’ll pay it back in some way’”, he said. Mike Dyer, a member of the risk management team at Opportunity International in the UK, said that “there needs to be a thorough review of the way in which loans officers are incentivised”.

In some countries – Romania was cited as an example – social lending has almost completely disappeared, having been replaced by commercial lending. Teshome Y. Dayesso, chief executive of Busa Gonofa MFI in Ethiopia, saw MFIs “moving away from smallholders in favour of small and medium enterprises in urban areas”. Joy Cadangen, finance manager ECLOF International in Switzerland, saw MFIs "closing the doors to high-risk clients/markets, thereby leaving the high-risk clients to the social-oriented MFIs who may not have the funds for them (such as agriculture)”.

Some respondents feared that these trends would be sharpened by the crisis because MFIs would be forced to take a more hard-nosed approach to their customers. Lynne Curran with ACCION International in the US, said that “given difficult financial times, the trend may be to move upmarket”.

20. Fraud (15)

Although the risk of fraud has dropped down the rankings, it has only been overtaken by more urgent concerns. It continues to be seen as a rising problem in many regions, and could be made worse by the recession.

The group that is most concerned about fraud are the deposit-taking institutions (No. 11). Investors and analysts were more relaxed about it (No. 19 and No. 24). Geographically, the top areas seem to be Africa and the Middle East (both No. 10).

The risk of fraud rises in a recession

Many respondents made the point that a downturn and fraud go hand in hand. A practitioner in Poland said that “a recession always leads to higher fraud or attempted fraud”. A regulator in the Middle East said that “a growing economy typically yields large scale financial fraud (i.e. Madoff). However, a declining economy typically yields small scale financial fraud (lying on applications, falsifying income sources, lying on insurance claims, etc.). This small scale fraud has a potential to hurt microfinance institutions”.

Others felt that MFIs were not taking advantage of modern means, technological and managerial, to combat the problem. Oluseyi Olojede, an executive with the Integrated Microfinance Bank in Nigeria, said there was “a risk of cash suppression by officers and teeming and lading [the practice of rolling cash receipts forward to conceal a misappropriation]”.

Some respondents were more upbeat. One said that growing reports of fraud were the result of better tracking rather than more crime. Another felt that this was one area that would benefit from the industry-wide drive to strengthen management and systems.

21. Depositor confidence (-)

With confidence in banks badly shaken by the financial crisis, we thought we should test the level of depositor confidence in MFIs. The results were encouraging – or complacent depending on your point of view. The loss of depositor confidence is not seen as a high level risk by any of the categories of respondents to this survey except regulators who put it No. 5.

Practitioners and deposit-taking institutions put it at No. 23 and No. 21 respectively, and investors only slightly higher at No. 20. Geographically, the region where concern was highest was Latin America at No. 12.

Many respondents could see potential for risk here: a loss of confidence in financial institutions leading to a run on deposit-taking MFIs. This could severely cripple affected MFIs and even bring them down. Keith Flintham, managing director for Eastern Europe at Opportunity International, raised this possibility in his area, and others wondered whether we were really past the worst on the banking front. A US respondent thought that "deposit-taking MFIs will be tested for their ability to manage liquidity". Some respondents pointed out that MFIs – even strong ones – might have to take on more liquidity as a precaution, which would be expensive.

The loss of MFI depositor confidence is not seen as a high risk

Although some respondents reported incidents of deposit withdrawals in their markets, the general feeling seemed to be that MFIs were weathering the storm quite well. "No loss of deposits yet by clients," said Peter Ziwa, risk and standards manager at Opportunity International Bank in Malawi. However, a looming problem in this area is the growth of competition for deposits as more MFIs transform themselves into authorised institutions, and commercial banks step up their drive for people's savings.

22. Back office operations (18)

The quality of MFI back offices remains a source of concern, but not a pressing one. However many respondents felt that the economic crisis would expose those that were weak in this area because there were so many potential points of stress: information and control systems, risk management, fraud prevention and cost efficiency. A US MF advisor said the back office was "never a strong point among MFIs. As numbers and scope increase, [they face] increased back office problems".

Practitioners put it down at No. 24, arguing that much improvement had been made to systems and controls, particularly in Latin America. There were slightly higher levels of concern in Africa, the Middle East, Asia and the Far East.

Among those who saw risk in this area, Richard Kossi Amoussou, an MF advisor in the Congo, said that "information systems have not always kept up with the size and complexity of MFIs' operations". Other respondents also feared that back offices were suffering from under-investment and inadequately trained staff. The need to keep track of loan performance and control costs during the recession would be a key test.

But some respondents thought things were getting better. Masami Hayashi, director of MicroFinance Network in Mexico, said "The risk may decrease because of less workload". Malcolm Hayday of Charity Bank in the UK said: "As technology improves back office risk should fall".

23. Ownership (17)

Respondents identified two types of risk in ownership, one the form of ownership (was it appropriate?) and the other that MFIs are changing their ownership structures, either voluntarily or under regulatory pressure, which can be a risky process.

Ownership is a key issue because it determines the character of an MFI: is it a philanthropic organisation or one aiming to make profits for its shareholders? Many MFIs are caught between the two, which is why tensions over ownership structures are appearing. A US academic analyst said that "with the industry growing rapidly in many new directions, ownership risk is high and likely rising".

Some respondents described this dilemma as "painful". One said that "changing ownership, changing governance, especially under time pressure of a deadline, increases the risk profile of an MFI". Another said that "unfortunately this is a legacy issue that has to be worked through. International development organisations and investors could be helpful in providing resources to well-managed MFIs who need project management and other talent to drive these transformations through to completion without disrupting existing operations".

24. Product development (24)

Despite frequent calls for greater imagination in MF product development, this did not emerge as a high profile issue. It was not a big Banana Skin in the 2008 survey, and its position remains unchanged.

Most MFIs understand their clients' needs

Respondents tended to say that most MFIs are very close to their clients, and understand their needs. There are also plenty opportunities to partner with product developers and providers to keep up with new ideas. A respondent in India said: "This is a very easy area to handle if the concerns of the clientele are taken into account".

A rating analyst also said that "given funding constraints in both the MFI and banking sectors, there is less competitive pressure for MFI's to diversify into non-core activities".

25. Too much funding (21)

Everybody gets it wrong sometimes. In the last survey, this was a lowish risk (No. 21 out of 29), though it was rated as trending upwards and seen as potentially destabilising for the MF industry. This year, it is dead last: a surfeit of funding is not seen as the problem it once was. In fact, some respondents thought this was a good thing. "Many institutions may have been over-financed over the last few years", said a US loan fund manager.

To the extent that it is a problem, it is diverse and market/sector specific, for example for Tier 1 MFIs who now enjoy a disproportionate amount of what funding is available. But it's a good problem to have, and hardly a 'risk'. However, the popularity of some of the top institutions, fuelled by media profiles, case studies and ratings models, could still lead to too much money chasing too few good loans. Jessie Greene, senior investment officer at Triple Jump in the Netherlands, feared that "bad capital will crowd out good capital, in other words, reckless microfinance investors will crowd out careful investors, with the risk of causing a microfinance sub-prime crisis".

For the time being, this is not a risk. The question for the longer term is whether economic recovery will see a return to the indiscriminate funding of past years, or whether it will leave investors more cautious about their exposure to the MF sector.

New pressures of structural change

And the further outlook is...

One effect of the economic crisis could be to accelerate the pace of structural change in the microfinance industry. This may be a good thing, but it also carries the risks of uncertainty and failure.

Respondents saw a number of trends developing. One is that the pressures of cost and deteriorating loan portfolios will prompt MFIs to shift their attention to more lucrative markets, i.e. wealthier individuals, small and medium sized enterprises, which would take them away from their social goals. Respondents say this would advance the trend of commercialisation which is making MF more business-minded, but also more controversial.

A second trend is towards transformation. Funding difficulties will drive more NGO-led MFIs to become shareholder-owned authorised banks in order to attract investment and tap the deposit markets. Other MFIs are also going down the transformation route in order to grow. This need not take them away from their target markets, but it will give them heavier commercial responsibilities.

Chikako Kuno, director of small business finance at the EBRD, commented: “Accelerated growth particularly over the last two years in Eastern Europe, the Caucasus and Central Asia has pushed MFIs to a size where they are no longer small lending organisations but must put into place strong institutional frameworks to manage risk, human resources, client services, develop new products. This will require different strategies, potentially different priorities, and significant financial and human resources”.

A third is consolidation. The problems of reduced funding, bad debts and economic recession could drive smaller and weaker MFIs into mergers to avoid having to shut down. This would make them stronger. But consolidation might also take MFIs out of the countryside and other underserved areas, reducing the availability of microfinance where it is most needed. Gustavo Lasala, chief financial officer of ACCION in Texas, said that this trend “will gain speed in years two and three, bringing challenges related to the availability of skills and talent to manage consolidation and growth”.

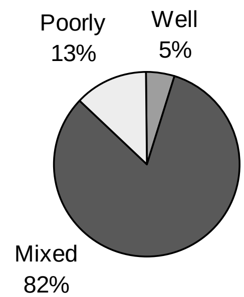
Preparedness

We asked the question:

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

MFIs are seen to be less well prepared than before

Five per cent of respondents answered well, 82 per cent gave a mixed reply, and 13 per cent said poorly. In 2008, 27 per cent said well, 68 per cent said mixed and 5 per cent said poorly. Among the reasons given for this more negative result, respondents said that MFIs realised too late that they would be impacted by the economic crisis, particularly by its effect on credit and funding. Respondents who gave a positive reply stressed the quality of management and the strength of institutional support.



Emmanuelle Javoy, managing director of Planet Rating in France, said that “overall, one third of MFIs have systems, procedures and performance that should really allow them to manage the above stated risks without major problems, while another half have decent systems or procedures or performance, but that might take a little time to adapt to changing situations”.

A breakdown of responses by category shows practitioners to be the most optimistic, with ten per cent of them believing that MFIs were well prepared. Although 18 per cent of regulators thought MFIs were well prepared, a further 18 per cent of them answered poorly. Investors were the most pessimistic, with only 2 per cent answering well.

%	Practitioners	Investors	Regulators	Observers
Well	10	2	18	3
Mixed	77	89	64	83
Poorly	13	9	18	13

APPENDIX: The questionnaire and guide

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION
5, Derby Street, London W1J 7AB, UK
Tel: +44 (0)20 7493 0173   Fax: +44 (0)20 7493 0190

Microfinance Banana Skins 2009

This survey seeks to identify the risks facing microfinance institutions (MFIs) over the medium term (2-3 years), as seen by practitioners, investors and other close observers. 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.

Please read the accompanying guide for information on how to complete the questionnaire.

Please complete and return this questionnaire to us by May 8th.

Name ☐ **Position** ☐

Institution ☐ **Country** ☐

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

What is your perspective on the microfinance industry?

1. Practitioner ☐ **If yes, does your institution take customer deposits?** ☐

2. Investor ☐ **3. Regulator** ☐ **4. Analyst** ☐

Other (please state) ☐

Question 1. Please describe the main risks you see facing microfinance institutions and the industry as a whole over the next 2-3 years, and the reasons why.

Please turn over

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			
2	Competition			
3	Corporate governance			
4	Credit risk			
5	Depositor confidence			
6	Foreign currency			
7	Fraud			
8	Funding - too little			
9	Funding - too much			
10	Inappropriate regulation			
11	Interest rates			
12	Liquidity			
13	Macro-economic trends			
14	Management quality			
15	Managing technology			
16	Mission drift			
17	Ownership			
18	Political interference			
19	Product development			
20	Profitability			
21	Refinancing			
22	Reputation			
23	Staffing			
24	Transparency			
25	Unrealisable expectations			
26				
27				

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

Poorly ☐ Mixed ☐ Well ☐

Microfinance Banana Skins 2009

Guide to the questionnaire

The Banana Skins questionnaire is designed to find out how people see the risks facing the microfinance sector over the medium term. The sector is defined as microfinance institutions (MFIs) which operate for profit and have assets of at least US$5 million.

In **Question 1**, we ask you to describe in your own words what your concerns about the risks facing MFIs over the next 2-3 years, and the challenges they will have to meet to sustain continued profitable growth. Please identify geographies or MFI types which you feel face particular risks.

In **Question 2**, we ask you to score a list of potential “Banana Skins” by the severity of the risk on a scale of 1 to 5, and whether you see this risk as rising, steady, or falling (please mark R,S or F). There is space for you to add brief comments, for example about particular countries, markets or MFI types. An explanation of the various Banana Skins follows.

1. **Back office operations.** How vulnerable are MFIs to risks in administration, accounting, systems and controls?

2. **Competition.** Competitive pressures in microfinance are mounting with the proliferation of MFIs, new entrants and unregulated institutions. Will these push MFIs to take greater risks in areas such as pricing, product innovation and credit quality?

3. **Corporate governance.** Are there weaknesses in the corporate governance of MFIs which could damage the business, for example because of a lack of independence, low calibre, or a failure to bring in fresh blood?

4. **Credit risk.** Will MFIs be damaged by borrowers failing to repay their loans?

5. **Depositor confidence.** How safe are MFIs from the risk of a run on their deposits and funding?

6. **Foreign currency.** Many MFIs fund themselves in foreign currency, creating foreign exchange risk. Is this a risk they can manage?

7. **Fraud.** Will MFIs be damaged by dishonest staff and customers?

8. **Funding – too little.** Can MFIs maintain their access to funding for their lending activities, particularly those which are not in the deposit-gathering side?

9. **Funding – too much.** Is the problem of funding that MFIs have more funds than they can prudently employ for loans?

10. **Inappropriate regulation.** Will rules imposed by regulators constrain or damage the growth of MFIs by failing to offer an appropriate regime?

11. **Interest rates.** Will MFIs be able to protect themselves against changes in interest rates which are beyond their control, for example those set by competition or central banks? These rates apply both to their cost of funds and their loan pricing.

12. **Liquidity.** Will MFIs be able to manage their cash resources successfully, both those for whom it is in short supply, and those with a surplus? Will the current financial crisis constrain MFIs' ability to obtain cash to run the business?

13. **Macro-economic trends.** Are MFIs vulnerable to pressures in the wider economy, for example inflation, recession or volatile commodity prices?

14. **Management quality.** Will MFI management be up to the challenge of growing the business and managing the risks?

15. **Managing technology.** With technology an increasingly key part of managing and delivering microfinance, will MFIs be able to master this difficult area?

16. **Mission drift.** Are MFI missions commercially viable; will they be able to stick to their stated missions?

17. **Ownership.** Are the ownership structures of MFIs appropriate and stable for their line of business?

18. **Political interference.** MFIs may face political pressures, for example in the areas of interest rates, lending terms and subsidised government programmes. How big a risk do these pose to the business?

19. **Product development.** Will MFIs be able to develop the right products and manage them successfully?

20. **Profitability.** Will the MFI sector be able to sustain adequate levels of profitability to ensure growth and commercial viability?

21. **Refinancing.** Will investors and donors renew their financial support for the capital of the business when the time comes?

22. **Reputation.** Will MFIs be able to sustain their good reputation?

23. **Staffing.** Will MFIs be able to recruit and retain good staff?

24. **Transparency.** Do MFIs report enough good information to sustain confidence in the sector? Do they conform to international accounting standards?

25. **Unrealisable expectations**. Is the sector vulnerable to hype? Do people expect too much of microfinance, and what happens if MFIs fail to deliver?

In **Question 3**, we ask you to say how well prepared you think MFIs are to deal with the risks you mentioned. Please tick Poorly, Mixed or Well.

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Preface

This is the second in what we hope will be a continuing series of Banana Skins surveys looking at the global microfinance industry. It is co-sponsored by Citi Foundation and CGAP, but editorial responsibility rests with the CSFI – and specifically with my colleague, David Lascelles (who got valuable assistance this time from our former programme director, Sam Mendelson).

The first survey was published in early 2008 – just as the global financial crisis was starting to unfold. This one reflects the fact that the financial crisis has become an economic recession, and that no one is immune – not even the microfinance industry, which many believed only a year or so ago to be more or less insulated from the vicissitudes of mainstream finance.

Indeed, the main message to take from this year's survey is that the climate for microfinance has changed, just as surely as the broader financial and economic climate has changed. The big concerns this year are familiar to all of us: credit risk, the danger that liquidity will dry up, the impact of global recession, overindebtedness. In comparison, the main concerns of 2008 – weak management, governance issues – now seem like small beer.

But it is not just the top Banana Skins. In my opinion, it is impossible to read this year's text without coming to the conclusion that microfinance is at a crossroads, and that it might do the industry a power of good if it was able to call a "time-out" to reassess its role. In the popular press, microfinance is still very much the developmental flavour of the month – and even the most battle-hardened aid veteran has to acknowledge its appeal as an alternative to the conventional 'top down' model for wasting taxpayers' money. But, as the final box in this report makes clear (p 37), microfinance currently faces serious challenges – challenges that have been exacerbated by the global crisis. Should microfinance institutions shift from their essential social role to a (perhaps) more sustainable profit-seeking model? Can they go on relying (as they have done) on subventions of one sort or another from Western investors? Should they develop into more or less full service financial institutions, and become part of the formal financial sector?

These kinds of questions pose real challenges to the microfinance industry, and I very much hope that this Banana Skins survey prompts practitioners, investors, donors and regulators to have a good, long think about where they are going. In the meantime, thanks to Citi and CGAP for making the survey possible. Thanks also to Deborah Drake of the Council of Microfinance Equity Funds, to Philip Brown, risk director of Citi Microfinance, to Xavier Reille of CGAP, and to the MIX for their valuable help and support. And, of course, thanks to David and Sam for pulling a phenomenal amount of material together.

Andrew Hilton
Director, CSFI

This report was written by David Lascelles and Sam Mendelson
Cover by Getty Images

Sponsors' foreword

Look back to the first edition of the Microfinance Banana Skins Report, "Risk in a booming industry" published in early 2008, and you'll see how perceptions of risk have changed.

At the time of the first report, microfinance institutions (MFIs) were growing at double-digit rates in many countries; new equity and debt funds were being launched, and a wider spectrum of private sector investors was emerging. The report showed an industry that was mostly concerned with internal risks, and focused on capacity building to support rapid expansion.

Eighteen months later the global and industry landscape has changed dramatically. Microfinance is being challenged by the impact of an unprecedented global economic and financial markets crisis. Liquidity has tightened and credit spreads have widened for MFIs. Currency dislocations and the global recession are affecting MFIs and their clients. MFI clients' household cash flows have been squeezed by inflation, especially arising from dramatic food and fuel price increases, and, for the first time in many countries, by reduced remittance inflows.

There are strong country and regional differences in how MFIs are being impacted by changing market forces. But in general, whether out of prudence or pressure, MFIs have significantly slowed their pace of growth. Particularly in more globally integrated economies where MFIs were more reliant on international sources of funding and access to capital markets, funding and liquidity have become widely identified as key risks, while savings-based MFIs appear more resilient.

Despite the severity of these challenges, MFIs have shown comparative robustness in their capacity to weather the financial crisis. Public investors, multilateral and bilateral donors and lenders, as well as global microfinance networks, have stepped in and are providing emergency liquidity to some MFIs. Large new financing facilities are helping to maintain a degree of stability and confidence in the sector. MFI managers are going back to fundamentals; tightening credit policies and procedures, diversifying funding sources, raising capital, hedging currency mismatches, and focusing more on human resources and training. Network leaders and investors are pushing for higher governance standards, improved transparency and better risk management. Finally, the sector is beginning to experience some consolidation and MFI mergers, with new holding company and diversified ownership structures emerging.

The 2009 Microfinance Banana Skins Report presents the findings of a global industry survey on the risks affecting the growth and viability of microfinance institutions. And it reflects their progress toward financial sustainability, and greater outreach and inclusion. While by no means exhaustive, the 25 risks identified provide an illuminating snapshot of the microfinance industry today.

We are grateful for the 430 participants from 82 countries who contributed to this survey. We would like to thank David Lascelles and Sam Mendelson for distilling participant feedback and presenting it in such a cogent manner. Also our thanks to Deborah Drake at the Council of Microfinance Equity Funds for her efforts to expand the range of respondents and for guiding the work of the Steering Committee. Philip Brown at Citi Microfinance and Xavier Reille at CGAP represented our institutions on the Committee for both reports. Finally, we are appreciative for all of the input provided by the MIX.

We hope that this report will contribute to the ongoing debate on the issues confronting the future evolution of the microfinance sector, and its capacity to realise the goal of financial inclusion.

Bob Annibale	Elizabeth Littlefield
Citi Microfinance	CGAP

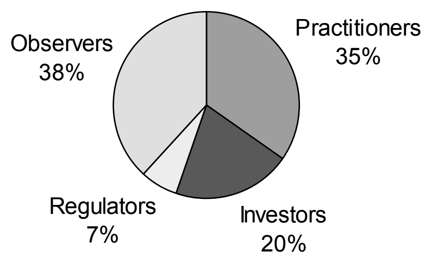
About this survey

Microfinance Banana Skins 2009 describes the risks facing the microfinance industry as seen by an international sample of practitioners, investors, regulators and observers of the microfinance sector. It updates a previous survey carried out in early 2008. This survey was conducted in April and May 2009 and is based on 430 responses from 82 countries and multinational institutions.

The questionnaire and accompanying guidance (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.

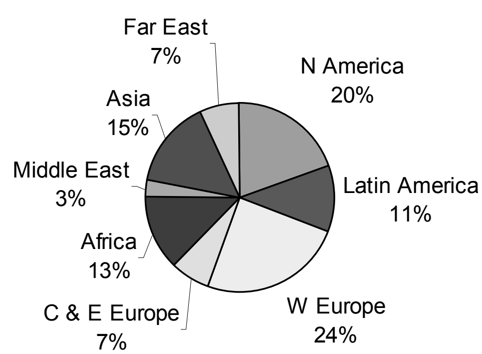
The views expressed in this survey are those of the respondents and do not necessarily reflect those of the CSFI or its sponsors.

The breakdown by type of respondent was as follows:



Just over half (57 per cent) of the practitioners represented deposit-taking institutions. The “observers” category included analysts, aid officials, academics, accountants, lawyers, consultants etc.

The distribution of responses by region was as follows:



The responses by country were as follows

Afghanistan	1
Albania	5
Argentina	1
Armenia	1
Australia	1
Azerbaijan	3
Bangladesh	5
Belgium	5
Benin	1
Bhutan	2
Bosnia & Herzegovina	8
Brazil	2
Burkina Faso	3
Burundi	1
Cambodia	8
Cameroon	9
Canada	5
China	6
Colombia	7
Costa Rica	2
Côte d'Ivoire	2
Denmark	1
Ecuador	2
Egypt	3
Ethiopia	1
Finland	1
France	15
Georgia	2
Germany	6
Greece	1
Guatemala	4
Haiti	2
India	28
Indonesia	2
Iraq	1
Italy	2
Japan	2
Jordan	5
Kenya	9
Kosovo	4
Kyrgyzstan	1
Laos	1
Lebanon	2
Luxembourg	3
Madagascar	2
Malawi	1
Mauritius	1
Mexico	10
Mongolia	6
Morocco	3
Mozambique	1
Multinational	7
Nepal	1
Netherlands	16
Nicaragua	5
Nigeria	5
Norway	2
Pakistan	13
Palestine	4
Papua New Guinea	1
Paraguay	1
Peru	7
Philippines	3
Poland	2
RD Congo	3
Romania	6
Russia	6
Rwanda	1
Senegal	1
Sri Lanka	2
Switzerland	13
Syria	2
Tajikistan	4
Tanzania	2
Thailand	4
Togo	1
Tunisia	1
Uganda	3
UAR	1
UK	37
US	75
Venezuela	1

Summary

This survey explores the risks facing the microfinance industry at a time when upheavals in global financial markets are adding to the pressures of change in the sector, raising new and unfamiliar challenges.

Originally a small-scale, philanthropic movement to provide credit to the neediest, microfinance (MF) has grown enormously in recent years and is now firmly established as a major supplier of a wide range of financial services to millions of people around the world. The 1,200 microfinance institutions (MFIs) that report to the Microfinance Information eXchange (MIX) have 64m borrowers and 33.5m savers, and numbers are growing by 25 per cent a year, more in some countries. Total assets of these MFIs amount to $32bn.

However the sector is also undergoing profound structural change. Its success has attracted billions of dollars of outside investment, fuelling rapid expansion. Convergence is also occurring between MF and mainstream banking as MFIs grow in size and sophistication, and commercial banks enter the market. These trends have boosted the dimension and quality of the MF sector, but also created new pressures of competition and sharper expectations.

All these developments could, however, be thrown into confusion by the global credit crunch and the ensuing recession. How will these dramatic events affect the sector? Will it be able to get through the crisis relatively unscathed? If not, what are the risks to the business and its future?

Banana Skins results

The crisis has transformed perceptions of risk

This survey, the second in the series, was conducted to seek answers to these questions, with a special focus on MFIs with more than $5m in assets which are profitable and capable of commercial growth. These number about 350, according to estimates from MIX, and account for the bulk of microfinance assets globally.

The survey asked respondents to identify and comment on the major risks, or "Banana Skins", which they saw facing the MF sector over the next two to three years. The responses numbered 430 from 82 countries. The table on p 6 shows the ranking of the 25 Banana Skins identified by the survey, both as to severity and trend.

The key finding is that the economic crisis has completely transformed perceptions of the MF risk landscape: risks that were thought minor in the 2008 survey have been propelled to the top of the rankings, edging out risks that were previously seen as crucial to the prospects for microfinance. Broadly, these new risks fall into three "clusters" of vulnerability for MFIs:

- the worsening business environment;
- threats to funding and liquidity, and
- potential damage to MF's reputation.

The big risers include **credit risk** (up from No. 10 to No. 1) and **too little funding** (up from No. 29 to No. 6), while the big decliners are **management quality** (down from No. 1 to No. 4), **corporate governance** (down from No. 2 to No. 7) and **staffing** (down from No. 5 to No. 14).

Microfinance Banana Skins
2009
(2008 position in brackets)

Biggest risks	Fastest risers
1 Credit risk (10)	1 Credit risk (5)
2 Liquidity (20)	2 Macro-economic trends (24)
3 Macro-economic trends (23)	3 Competition (1)
4 Management quality (1)	4 Refinancing (27)
5 Refinancing (28)	5 Liquidity (23)
6 Too little funding (29)	6 Too little funding (29)
7 Corporate governance (2)	7 Political interference (3)
8 Foreign currency (12)	8 Foreign currency (18)
9 Competition (7)	9 Profitability (20)
10 Political interference (9)	10 Interest rates (9)
11 Interest rates (6)	11 Reputation (11)
12 Profitability (22)	12 Corporate governance (12)
13 Inappropriate regulation (3)	13 Mission drift (7)
14 Staffing (5)	14 Fraud (14)
15 Managing technology (8)	15 Depositor confidence (-)
16 Transparency (11)	16 Ownership (8)
17 Reputation (19)	17 Unrealisable expectations (10)
18 Unrealisable expectations (13)	18 Management quality (17)
19 Mission drift (14)	19 Back office operations (25)
20 Fraud (15)	20 Staffing (2)
21 Depositor confidence (-)	21 Transparency (26)
22 Back office operations (18)	22 Inappropriate regulation (21)
23 Ownership (17)	23 Managing technology (13)
24 Product development (24)	24 Product development (19)
25 Too much funding (21)	25 Too much funding (4)

MFIs look vulnerable to the global crisis

The reason is plain. Contrary to the hope expressed by many people in the earlier survey that MFIs would be insulated from shocks in the "real economy", they are now seen to be vulnerable to them through financial markets, credit conditions and the fortunes of their customers. This is reflected in the sharp rise in the ranking of risks posed by **macro-economic trends** from No. 23 to No. 3.

Fears about the impact of recession on loan portfolios, particularly the problem of overindebtedness, dominated the responses. This marks a sharp turnaround from the earlier view that MF borrowers had a good repayment record; respondents blamed the growth of competition and the erosion of lending standards for encouraging people to borrow beyond their ability to repay.

Sharp rise in credit and funding risk

The credit crunch has also raised concerns about the **liquidity** of MFIs (up from No. 20 to No. 2) and the prospects for **refinancing** funding commitments (up from No. 28 to No. 5). The fact that much funding arrives in non-local currency has also given a sharp boost to **foreign currency risk** (up from No. 12 to No. 8) owing to volatility in the foreign exchange markets. All these concerns are summed up in the rise of **profitability** as a risk from No. 22 to No. 12.

There is also concern that recession will expose "naked swimmers": weak MFIs with poor funding and inefficient management who were being buoyed by good economic conditions and overabundant funding. The risk of institutional failure is seen to be high.

Many respondents saw a vicious circle here: the recession creating a worse business environment, leading to mounting delinquencies and shrinking markets, leading to declining profitability, leading to loss of investor confidence, leading to cutbacks in funding, and so on. One consolation for hard-pressed MFIs is that the pressure of **competition**, which was the top risk for some in 2008, has eased (down from No. 7 to No. 9). Another is that the risk of losing **depositor confidence** (No. 21) was not considered high.

The big movers

UP

Credit risk: microlending no longer seen as a low risk business
Macro-economic trends: microfinance not insulated from the "real economy"
Liquidity: MFIs vulnerable to the global credit crunch
Too little funding: risks to the cost and availability of funding
Profitability: crisis will damage viability and investor confidence

DOWN

Management quality: edged out by more urgent concerns, but still a high risk
Corporate governance: also edged out, but still seen as key long term issue
Competition: pressures will ease in the recession
Interest rates: lower and less volatile
Staffing: difficulties could ease in slacker markets

Microfinance reputation could come under attack

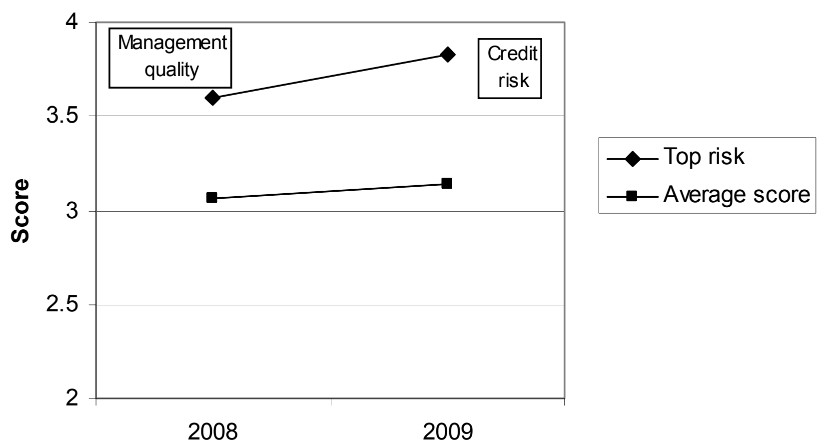
Fall-out from the recession may also create other risks, notably of **political interference** (No. 10) as governments try to ease the pain of recession by setting conditions for lending and even condoning non-repayment of loans. Linked to this is concern that MFIs will be swept up in a global regulatory backlash against banks which could lead to ill-designed measures and **inappropriate regulation** (No. 13).

A further recession-led concern is for the **reputation** (No. 17) of the industry if MFIs are unable to sustain their flow of lending or are forced to become tougher about loan re-payment. Any hardening of the MFIs' position would add to concerns about **mission drift** (No. 19) and the perception that MFIs are abandoning their social objectives. Linked to this is the risk that investors in MF and users of the service have **unrealisable expectations** (No. 18) about what MF can deliver.

A breakdown of responses by type shows MF practitioners deeply concerned about the impact of the crisis on loan quality and funding, while investors focused more on refinancing and foreign currency risk. The concerns of regulators centred on management strength. Geographically, economic issues topped the concerns of respondents in virtually all the regions, showing that this truly is a global crisis. One exception was Africa where the top risks are still seen to lie in institutional weakness.

MFIs seen as less well prepared than before to meet risk

How well prepared are MFIs to handle these risks? Only 5 per cent of respondents thought they were well prepared, and 13 per cent thought they were poorly prepared. The rest gave a mixed response. This is a more negative result than last time when 27 per cent said "well" and only 5 per cent said "poorly". Respondents thought that too many MFIs had been lulled by good times into thinking that the global economic crisis would not affect them. On the other hand, some respondents stressed the traditional resilience of the MF sector as a reason why they should be able to ride the storm. Generally, large, commercially-minded MFIs were seen to be among the better prepared. Smaller MFIs, with weak management and a heavy reliance on donor funding could be vulnerable.



The Microfinance Banana Skins Index provides a picture of changing "anxiety levels" in the MF business. The top line shows the average score given to the top risk over the last two years, and the bottom line the average of all the risks. Both lines show a clear worsening in sentiment since last year.

Of course, these results represent the perceptions of respondents, and are not forecasts or measures of likelihood. There is also a tendency, in surveys such as this, to focus on the negative and pass over the positive. This should be borne in mind when taking messages from this report. But if a single word was needed to sum up its tone, it is "ominous".

Who said what

Practitioners – people who run or work in MFIs

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Macro-economic trends	2	Competition
3	Liquidity	3	Macro-economic trends
4	Too little funding	4	Too little funding
5	Competition	5	Liquidity
6	Management quality	6	Interest rates
7	Interest rates	7	Political interference
8	Inappropriate regulation	8	Foreign currency
9	Foreign currency	9	Refinancing
10	Profitability	10	Reputation

The top risks for microfinance practitioners all relate to the impact of the economic crisis on their business: the rise in credit risk, the availability of funding, their liquidity and the state of the world economy. Of these, only credit risk appeared in their 2008 top ten, an indication of the dramatic change in risk perceptions that has occurred since then. New risks include threats to profitability, interest rates, foreign currency and refinancing. The appearance of reputation as a rising risk is also notable at a time when financial markets are stressed and microfinance is becoming more controversial.

Investors – people who invest in MFIs

	Biggest risks		Fastest risers
1	Refinancing	1	Credit risk
2	Foreign currency	2	Macro-economic trends
3	Credit risk	3	Political interference
4	Macro-economic trends	4	Liquidity
5	Liquidity	5	Foreign currency
6	Corporate governance	6	Refinancing
7	Management quality	7	Profitability
8	Too little funding	8	Too little funding
9	Inappropriate regulation	9	Competition
10	Political interference	10	Interest rates

Investors are concerned about the aspects of the crisis that could reduce the value of their commitments: the ability of MFIs to manage their liquidity and funding, the effect of currency fluctuations on cross-border exposures, and the impact of credit risk on their soundness and profitability. As in 2008, investors remain concerned about the quality of management and corporate governance in MFIs, as well as the impact of regulation and political interference which may increase due to the economic crisis. Unlike practitioners, they tended to see competition as a good thing.

Regulators – government officials and those who regulate MFIs

Biggest risks		Fastest risers	
1	Transparency	1	Too little funding
2	Credit risk	2	Competition
3	Corporate governance	3	Corporate governance
4	Management quality	4	Credit risk
5	Depositor confidence	5	Political interference
6	Reputation	6	Macro-economic trends
7	Competition	7	Refinancing
8	Liquidity	8	Depositor confidence
9	Managing technology	9	Fraud
10	Political interference	10	Interest rates

The biggest concerns for regulators centre on the institutional strength of MFIs and their ability to get through the crisis. Issues such as credit risk, management quality, transparency, profitability, depositor confidence and staffing were all in their top ten. They also saw funding, refinancing and the macro-economy as rising problems for MFIs. Of respondent groups, they were the most concerned about operational issues such as the growth of fraud and reputation risk. Interestingly, they also saw political interference as a fast-rising risk for microfinance.

Deposit-takers – respondents from MFIs which take savers' deposits

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Management quality	2	Competition
3	Macro-economic trends	3	Too little funding
4	Competition	4	Macro-economic trends
5	Too little funding	5	Fraud
6	Corporate governance	6	Refinancing
7	Liquidity	7	Foreign currency
8	Interest rates	8	Liquidity
9	Foreign currency	9	Back office operations
10	Staffing	10	Ownership

Deposit-taking MFIs shared practitioners' concerns about rising credit risk and the state of the world economy and funding, but were less worried than the sector as a whole about liquidity issues, possibly because of the protection offered by their deposit base. They showed little concern about the risk of losing depositor confidence (which ranked No. 21 on their list), though they did see ownership as a growing issue. Institutional risks ranked high: management, corporate governance and staffing. Because many of them receive overseas investment, currency risk was also a growing concern.

North America

	Biggest risks		Fastest risers
1	Credit risk	1	Macro-economic trends
2	Refinancing	2	Credit risk
3	Liquidity	3	Refinancing
4	Macro-economic trends	4	Liquidity
5	Too little funding	5	Too little funding
6	Corporate governance	6	Foreign currency
7	Foreign currency	7	Political interference
8	Management quality	8	Competition
9	Political interference	9	Profitability
10	Inappropriate regulation	10	Corporate governance

Respondents from the US and Canada, who included a large proportion of investors, saw the greatest risks lying in the impact of the crisis on the value of their investments, notably credit risk and MFIs' ability to manage their funding and their liquidity. The risk that MFIs would fail to refinance was high on their list, as was foreign currency risk. As in 2008, investors in North America were concerned about institutional aspects of MFIs: the quality of governance and management. Investors also saw a rising risk of political interference in MFIs rising as a consequence of the economic crisis.

Latin America

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Competition	2	Competition
3	Political interference	3	Too little funding
4	Macro-economic trends	4	Political interference
5	Interest rates	5	Macro-economic trends
6	Liquidity	6	Mission drift
7	Too little funding	7	Fraud
8	Profitability	8	Interest rates
9	Inappropriate regulation	9	Liquidity
10	Refinancing	10	Depositor confidence

Latin American respondents, who were mostly practitioners, focused on the impact of the economic crisis on their business: the rise in credit risk and difficulties with funding and liquidity. They were among the few groups who saw loss of depositor confidence as a rising risk. They were also concerned about other crisis-driven risks such as greater political interference and inappropriate regulation. The pressures of competition are a top concern for the region, as they were in 2008. Respondents also saw mission drift as a rising risk because it could fuel controversy over the role of microfinance.

West Europe

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Foreign currency	2	Refinancing
3	Liquidity	3	Macro-economic trends
4	Macro-economic trends	4	Foreign currency
5	Refinancing	5	Liquidity
6	Management quality	6	Political interference
7	Corporate governance	7	Profitability
8	Too little funding	8	Too little funding
9	Political interference	9	Reputation
10	Profitability	10	Competition

West European respondents, who consisted mostly of investors, had equal concerns about the impact of the crisis on MFIs (e.g. credit risk, the macro-economy and liquidity) and the implications of this for investors (foreign currency losses, refinancing and funding difficulties). They were also concerned about the institutional aspects of MFIs: the quality of management and corporate governance, as well as the industry's reputation. The investors in this region saw the risk of more political interference in microfinance in a possible backlash to the crisis.

Central and Eastern Europe

Biggest risks		Fastest risers	
1	Credit risk	1	Credit risk
2	Interest rates	2	Interest rates
3	Foreign currency	3	Foreign currency
4	Liquidity	4	Macro-economic trends
5	Macro-economic trends	5	Competition
6	Competition	6	Liquidity
7	Profitability	7	Managing technology
8	Reputation	8	Reputation
9	Management quality	9	Too little funding
10	Inappropriate regulation	10	Refinancing

CEE respondents, who consisted mainly of practitioners, saw credit risk and its impact on profitability as the biggest risks facing MFIs in the crisis. They were also concerned about funding risks: liquidity and foreign currency. They were less concerned about institutional issues such as management and governance, though reputation was seen as a rising risk. The pressures of competition from other MFIs and commercial banks entering the sector are a worry at a time when markets are shrinking and profitability is declining. Inappropriate regulation is a big concern in much of the region.

Africa

	Biggest risks		Fastest risers
1	Management quality	1	Too little funding
2	Staffing	2	Refinancing
3	Corporate governance	3	Competition
4	Credit risk	4	Liquidity
5	Macro-economic trends	5	Macro-economic trends
6	Liquidity	6	Credit risk
7	Interest rates	7	Staffing
8	Too little funding	8	Ownership
9	Competition	9	Interest rates
10	Fraud	10	Foreign currency

African respondents consisted mainly of practitioners and members of aid organisations and NGOs. The African response was very different from the rest, focusing strongly on institutional issues, particularly weaknesses in management, governance and staffing. Economic crisis issues took second place, though they were seen as fast-rising, particularly liquidity and credit risk. A rising worry was the threat to funding and refinancing. There was much concern that the crisis would cause weaker MFIs to fail and damage confidence in the sector as a whole.

Middle East

	Biggest risks		Fastest risers
1	Credit risk	1	Credit risk
2	Macro-economic trends	2	Competition
3	Interest rates	3	Liquidity
4	Too little funding	4	Macro-economic trends
5	Inappropriate regulation	5	Mission drift
6	Mission drift	6	Unrealisable expectations
7	Liquidity	7	Too little funding
8	Competition	8	Foreign currency
9	Corporate governance	9	Interest rates
10	Fraud	10	Reputation

Respondents from the Middle East included microfinance practitioners, investors and NGOs. Their response focused on the credit risk impact of the crisis and the threats to funding, but also showed concern with wider issues, such as the rise in what they see as unhealthy competition. Striking was the high risk assigned to mission drift, and the related problems of unrealisable expectations and damaged industry reputation. Institutionally, respondents highlighted the weakness of corporate governance and the likelihood of a regulatory crackdown in response to the crisis.

Asia

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

The Asian response was strongly tilted towards practitioners who saw the biggest challenges lying in the area of management, particularly corporate governance, technology and staffing. Their concern about the impact of the economic crisis was more muted: liquidity risk and credit risk concerns appeared in their top ten, but not in the concentrated form of other groups. Concerns about the standing of microfinance also showed up strongly in the high place given to the risk of mission drift and unrealisable expectations. Political interference is another big issue, particularly in India.

Far East

Biggest risks		Fastest risers	
1	Competition	1	Competition
2	Credit risk	2	Credit risk
3	Management quality	3	Political interference
4	Macro-economic trends	4	Foreign currency
5	Transparency	5	Transparency
6	Staffing	6	Macro-economic trends
7	Too little funding	7	Managing technology
8	Foreign currency	8	Refinancing
9	Managing technology	9	Back office operations
10	Refinancing	10	Reputation

Respondents from the Far East included microfinance practitioners, investors and NGOs. Their greatest concern was with the growth of competition, particularly from banks, and the impact of this on the service offered by MFIs, which they thought damaging. They were also strongly concerned with management issues, including staffing, technology and the back office. On the institutional front, the transparency of the MF sector was a high level issue. The risks associated with the crisis – particularly credit risk and funding – were seen as generally lower, though fast-rising.

1. Credit risk (10)

The emergence of credit risk as the top Banana Skin in this survey is the clearest indicator of the dramatic new challenges that face the microfinance industry in these turbulent times. In the past, credit risk (the risk of loss when loans are not repaid) was seen as a minor problem in a business whose typical customers had an excellent repayment record (in our 2008 survey it was ranked No. 10). But not any more. A combination of stressful economic conditions and structural change within the microfinance (MF) industry has greatly increased concern about default and loan loss.

Peter Wall, executive director of the Microfinance Information eXchange (MIX), which compiles data about the global MF industry, said that credit risk is rising "across the chain, from micro-borrower through MFI and even among MFI lenders. The chain is increasingly being broken at different points".

Credit risk was ranked No. 1 by MF practitioners, those closest to the action, and was among the top five risks in all other respondent categories. It also dominated all the geographical responses, except Africa and Asia. Respondents from countries as diverse as Russia, Mexico, Syria, Bosnia & Herzegovina, Indonesia and Cameroon all reported that credit risk was on the rise. In Poland, a respondent expected overdue loans to reach record levels.

The economic crisis is likely to increase this risk in many ways: through economic slowdown, rising unemployment, volatile commodity prices and stress on management, to name but a few. Many MF clients live close to the edge and are perilously exposed to worsening economic conditions. Richard Murray of Liability Dynamics Consulting in the US said that MF borrowers were burdened with "virtually no alternative repayment options in times of reduced cash flow".

Many MFIs are also seen to be poorly equipped to deal with a surge in bad debts, lacking good credit management systems and adequate capital to absorb losses. The risk of institutional failure could grow.

But there are also wider concerns. Respondents see the economic crisis hitting microfinance at a time when credit quality is already deteriorating for reasons linked to the more competitive nature of the industry and a more calculating attitude to debt among borrowers. The concern is that the crisis will cause these unwelcome trends to accelerate.

The looming threat of too much personal debt

Overindebtedness. One of the biggest concerns is the high level of indebtedness that already exists among MF borrowers in many markets. Damian von Stauffenberg of MicroRate in the US said that "overindebtedness is rising and could come back to haunt the microcredit industry". Sanjay Sinha, managing director of M-CRIL in India, said that "the over-indebtedness of clients is emerging as a key problem in the microfinance sector. This could lead to portfolio quality problems in the medium term". Similar responses came from most parts of the globe.

Many respondents blamed this on the recent growth of competition among MFIs and commercial banks. This has led to an erosion of standards as lenders fight for market share and borrowers accept easy credit. Symptomatic of change has been the shift from group lending (where groups of borrowers guarantee each others' loans) to riskier individual lending.

Newly aware borrowers are able to tap several lenders at once because of a lack of industry-wide credit information. Worrying practices such as “bicycling” (using one loan to pay off another) are spreading. More borrowers are simply “walking away” from their debts. Antony Lythgoe, head of financial infrastructure at the IFC in Australia, said that “the lack of credit information sharing amongst MFIs, coupled with increasing competition and a migration away from group lending to direct lending is resulting in multiple loans being granted to the same individuals – who themselves lack the knowledge to manage their financial affairs responsibly”. A respondent from Uganda said that MF customers in cities and towns “do not have a permanent residence and keep shifting, and hence are difficult to monitor”.

The rise in credit risk could have wide repercussions for the industry. Losses and institutional failure would affect the confidence of depositors and investors, while attempts by MFIs to take a tougher line with defaulters could heighten reputational and political risk in such a sensitive industry.

2. Liquidity (20)

Like credit risk, liquidity risk has risen dramatically in the last 18 months to be seen as one of the most significant risks to the sector. In our last survey, conducted at the beginning of the financial crisis, respondents put it at only No. 20 (though some did warn that “liquidity has a nasty habit of drying up when most needed”). Now, they see it as a make-or-break issue. Brigit Helms, head of advisory services, IFC Indonesia, said: “This is perhaps the most serious risk in the short term”.

Banks are cutting back their lines of credit

Liquidity (having cash available to make loans, meet deposit withdrawals etc.) essentially comes from an MFI’s deposits and credit lines with other banks. The challenge to MFIs is to manage their dependence on these sources. Banks have already cut back their lines because of the credit crunch, and there is the fear that depositors could lose confidence and pull back too. This will affect MFIs’ business prospects and financial strength.

Olubunmi Lawson, managing director of ACCION Microfinance Bank in Nigeria, said that since the start of the financial crisis, “lines of credit available to microfinance banks have become almost non-existent, and the larger commercial banks are chasing the same savings deposits as microfinance banks – especially with depositors’ confidence shaken with some reported failures of microfinance banks”.

Gabriela Braun, from GTZ in Germany, said that a dry-up in liquidity would particularly affect “those MFIs that receive the lion’s share of their funding from microfinance investment vehicles (MIVs) or international credit lines”. Karla Brom, an independent consultant in the US, said that MFIs need to get a better understanding of liquidity management “and focus as much on this as they do on profitability”. One of the issues is whether deposit-taking MFIs are better placed to weather the storm than MFIs which rely on bank lines. Broadly, the answer seems to be yes. (See Box)

This risk was geographically widespread, an indication of the global impact of the crisis. Respondents from all the main markets put it high on their list: it was even considered a high level risk in smaller markets such as Syria and Albania. There was little variability across the sector, with practitioners, analysts, deposit-takers, investors and observers all ranking liquidity among their top risks.

‘Take deposits – or die!’

One outcome of the economic crisis could be a shift in the MF industry towards more deposit-taking. Currently, only a minority of MFIs take deposits from their customers. But funding difficulties have shown up the advantages of a reliable deposit base. Deposit-takers have, on the whole, fared better in the crisis than the rest. They have more stable funding bases, their cost of funds is lower, and they have no foreign exchange risk.

A respondent from Uganda said: “Take deposits – or die! MFIs will have to come up with alternative ways of running the business if they are to stay afloat. Deposits will be one of the cheapest ways to raise money.” An American consultant said that “so far, credit unions and other MFIs relying mostly on small deposits have not experienced the full extent of the liquidity crunch, but the economic crisis has not reached its height either”.

But deposit-taking is not easy. For one thing, it pitches institutions more directly into competition with commercial banks. One respondent also warned that authorisation to take deposits “will mean increased regulation and compliance costs. The industry is not prepared yet for this step”.

3. Macro-economic trends (23)

The global economic crisis is seen to pose a high risk for microfinance, despite the conventional wisdom that MFIs inhabit their own business world. Many respondents said that MFIs could no longer claim to be insulated from shocks in the “real economy”: there are too many links through financial markets, credit conditions and the fortunes of their customers. This marks a sharp change in attitude from our last survey when macro-economic trends were ranked down at No. 23, the view then being that the emerging crisis would pass MFIs by.

MFIs are no longer insulated from the ‘real economy’

In fact, some respondents this time thought that the crisis would be specially damaging to the developing world where fragile economies had already been hit by volatile food and energy prices, and by the contraction of foreign aid and investment. One said that “even small macro-economic changes can have a huge impact on the lives of millions when they are already living on the edge of starvation”. Nisreen Karkotli, head of economic research at the Central Bank of Syria, said that “although prices have shown some decline, the real effects of the international financial crisis have not shown through yet”.

Although no part of the world seems to be immune from economic downturn, the impact varies. Respondents from most geographic regions put this risk in their top five; the exception was Asia which placed it at No. 15. Among categories of respondents, those most concerned about the economic outlook were practitioners, particularly deposit-taking MFIs, and investors. These variations reflect local views about the vulnerability of the industry to economic slowdown and funding difficulties.

The recession and the associated credit crunch will impact MFIs in many ways, by depressing their markets and squeezing their sources of funds. Respondents saw MF being hit by rising unemployment, worsening bad debts, falling remittances, and declining investor and depositor confidence.

In Latin America, Alberto Jimenez, an advisor on MF technology to IBM, said that "deceleration in domestic growth of Latin American economies will increase unemployment and subsequently increase the non-performing loan portfolios of institutions of all sizes. This will be particularly acute in Argentina, Mexico and Venezuela". In Kenya, a respondent said that "the aftershocks from the global economic crisis will affect the economies of low income countries more profoundly than currently expected, eventually impacting on microfinance borrowers".

Are MFIs more resilient than the big banks?

Similar comments came from respondents in Asia, Central Europe, and North America. A US investor said that "MFIs accustomed to growth will find managing an economic contraction a challenge, e.g. staff incentive systems, managing delinquency, expectations of growth and return". Some respondents also expressed concern about the longer term outlook, fearing that the crisis could lead to institutional failure, and do lasting damage to the industry as a whole.

A small number of respondents accentuated the positive, particularly the resilience of MFIs and the likelihood that emerging markets would recover more quickly than developed markets. In any case, testing times could have a healthy effect on the MF sector. One said: "It's not all 'gloom and doom'. A shake-up in the market will likely be painful in the short-term, but beneficial in the long run. The flight to quality is a bumpy ride".

Naked swimmers exposed

To say that the microfinance sector is not immune from the global economic crisis sounds obvious. But it was not always so. Respondents to our 2008 survey were very upbeat about the ability of MFIs to survive the credit crunch and economic downturn. But in mid-2009, it is clear that MF is being impacted in many ways: through a tougher business environment and structural change.

Xavier Reille, senior manager at CGAP in France, said that the crisis was acting as "a revelator of poor practices." It was exposing MFIs "who have been swimming naked with open currency positions, over-indebted clients, uncontrolled growth and a concentrated funding base." On the other hand, it was also showing that "prudent and savings-based MFIs are still resilient," and on the whole MFIs were doing better than their Wall Street counterparts.

As for the crisis issues facing MFIs, an analyst from one of the large rating agencies provided the following check list:

- Slower growth because of funding difficulties and economic slowdown;
- Refinancing risk, particularly for those non-deposit-taking MFIs which are reliant on wholesale local and cross-border funding;
- Deteriorating asset quality;
- Pressure on profitability because of rising bad debts, higher funding costs and lower loan revenues;
- Growing event risk driven by an increase in economic hardship from the global slowdown. This can come in the form of political and economic events.

4. Management quality (1)

Concern about the quality of management in MFIs has eased from the No. 1 position it occupied in the last survey. This is partly because it has been overtaken by more urgent risks created by the economic crisis, but also because there does seem to have been progress. It was not seen as a rising risk last time, nor is it this time (it ranked only No. 18 as a trend), and several respondents said there had been an influx of talent (e.g. from the ailing mainstream banking sector) and a drive to raise quality.

But that is a generalisation. In Africa, respondents ranked this as the number one risk. A credit analyst wrote: "Middle management remains an area of concern – especially in Africa, but also in other parts of the world – where well educated staff at this level is difficult to come by and vulnerable to poaching from commercial banks. The absence of this capacity increases operational and credit risk". Management was also seen as a big problem in the Far East (No. 3). Regions where it was less of a concern included Latin America, Central and East Europe, Asia and the Middle East. Respondent groups for whom it was a high concern included deposit-taking institutions.

Is management up to leading MFIs through the crisis?

Many of the challenges behind management quality persist: difficulties in attracting and retaining talent, poaching, lack of training facilities, conflicting social and commercial missions etc... Brian Busch, investment officer at Omtrix in Costa Rica, said that "institutional capacity must continue to improve to match the growing complexity of a given MFI and the industry as a whole".

The big question, though, is whether MFI managements are up to leading their institutions through these testing times. Respondents saw a need for more skills in the areas of risk management, cost control and strategy as MFIs faced tougher competition and difficult market conditions. (See Box).

Godwin Kihuguru, advisor to Integrated Microfinance Bank in Nigeria, said that "as the financial meltdown takes its toll, microfinance institutions will have to operate more efficiently to offset the pressure of higher borrowing rates (from commercial banks) and increase investment in deposit mobilisation. If the recession persists or increases in intensity, it might lead to downward pressure on interest rates as is already happening with commercial banks. Again, this can only be managed by increased productivity (loan officer caseloads) and efficiency".

Nothing so risky as risk itself

One of the biggest risks facing MFIs is the management of risk itself. Are they up to it?

Geert Peetermans, chief investment officer at Incofin in Belgium, said that "risk assessment has to adapt to a new reality. This applies to MFI managers and boards, as well as to investment managers. Asset and liability management and business planning are more important than ever. In particular the general sense of risk awareness has to be strengthened. In an environment of rapid change, a sense of urgency and decisiveness will be a critical qualification that will make the difference".

Philip Brown, risk director at Citi Microfinance, said that "effective risk management (strategy, processes and culture) has become a differentiator of performance... Greater instability and uncertainty exists across the spectrum of macro and micro business risks. These risks have stressed some businesses, resulting in cracks appearing with negative performance, in some cases threatening business survival... There is a renewed focus on the monitoring and management of risks associated with business fundamentals".

5. Refinancing (28)

This is another Banana Skin that was ranked close to the bottom in the last survey but is now seen as a serious and fast-rising risk.

Refinancing risk addresses the danger that MFIs may not be able to renew their base funding from investors or donors because of changes in their circumstances or – currently – owing to the stresses of the economic crisis.

A recession could force changes on the MF business model

This Banana Skin was one of the top concerns for investors who ranked it No. 1, as opposed to practitioners who appeared much more relaxed about it, placing it No. 15. There was significant geographic variation too, with North American respondents ranking it at No. 2, Latin American respondents at No. 10, and the Middle East at No. 14 – perhaps reflective of the samples: North American respondents are more on the investor side, more closely tapped into capital markets and pessimistic about the credit crisis.

How safe is the MF business model?

The economic crisis will test the strength of the MF business model. How will it fare?

Some respondents expect it to expose weaknesses and force change. The vice-president of an MF network that covers Africa and Asia said that microfinance was specially exposed to the crisis because it depends on “continuous soft funding, and ... the group lending model which is extremely vulnerable to political and social issues”. Other respondents felt that the biggest challenge facing MFIs would be to explain to investors that recent strong investment returns were exceptional, and that profitability would not return to earlier levels.

But others were more optimistic. Alex Silva, chief executive of Omtrix in Costa Rica, said that “the fundamentals of the basic business model remain sound. In fact, the current financial crisis is perhaps just one of many for MFIs who deal with national political crisis, natural disasters and specific regulatory constraints on an almost continual basis”.

Howard J. Finkelstein, a US legal adviser to MFIs, believed that the major risk facing the industry “will be to survive its first-ever slow period while at the same time maintaining public optimism about its future. For instance, over the next 12-15 months, it is likely that one or more MFIs will default on debt owed to commercial investors. The risk is that potential future investors will view this as a warning sign that the business model is not as good as previously thought. The industry's burden will be to show that the business model is not inherently flawed”.

As one US investor said: “Over the years, debt investors have been willing and able to refinance loans to MFIs, allowing their capital to remain in the field and be productive. As the global credit crunch continues, refinancings will likely become less common, with debt investors requiring repayment of their loans”.

Investor nervousness is a direct consequence of mounting financial pressures on MFIs: the growth of loan delinquency and operating losses, the slowdown in new business, and worries about liquidity. Yet if funding dries up, MFIs’ prospects could get even worse. As with many of this year’s top Banana Skins, there is a concern here about a perfect storm – with each of the risks exacerbating each other.

A rating analyst saw the further risk of a domino effect. “If lenders start playing a game of ‘hot potato’ in which nobody wants to be the last lender exposed to an MFI, one early termination or unwillingness to renew could trigger a cascade of terminations.”

Respondents were unsure which type of institution was most at risk: the large commercialised MFI which had become over-reliant on investor funds, or the smaller MFI which had few sources of funds to call on. Eliza Erikson, a portfolio manager at the Calvert Foundation in the US, said that “MFIs in middle income countries that are more integrated with, and therefore exposed to, capital markets will have challenges raising sufficient funds to underwrite growth”. But others feared that the victims would include weaker MFIs who did not have investor confidence to support them.

6. Too little funding (29)

The economic crisis has turned the issue of funding on its head.

More funding for top tier MFIs, less for the rest

In our 2008 survey, the big worry was that the MF sector was being swamped by indiscriminate funding which was leading to excess capacity, dangerous levels of competition and the risk of disappointment. The problem of too little funding was considered minimal. This time, the fear is that the economic crisis will cause funding to dry up. Frederic de Mariz, an analyst at JPMorgan in Brazil, said: “It appears that MFIs – even the largest ones – are not able to access funding from commercial banks or from the market, as they were before”.

This is a risk that particularly concerned practitioners who listed it No. 4 and saw it as a serious threat to their business. Investors were less concerned: they put it No. 8. Geographically, concern seemed to be evenly spread among investor and practitioner regions.

Funding difficulties raise many issues to do with the sustainability of the industry, MF’s place in the global investment market, and longer term questions of structural change.

The investment case

The primary risk is whether MFIs will navigate the current economic and financial stresses in a way that supports the case for microfinance as an asset suitable for the mainstream capital markets. While sustainability and profitability have been demonstrated to the satisfaction of industry participants, investors generally are waiting for more track record to develop. The current environment could confirm the resilience of MF, or set back the process of building the case that investors require.

Paul DiLeo
Managing partner
Grassroots Capital Management, US

One of the most pressing is whether funding is a generalised risk for the sector, or only for weaker MFIs. Some respondents argued that the crisis will concentrate funding in a few top MFIs, and make life difficult for the rest. A US investor said that “access to capital will be a constraint for Tier 2 and 3 MFIs in many markets. However I wouldn’t generalise to say that access to capital is constraint for the industry, as I don’t believe it will be a constraint for Tier 1 MFIs who often, by their very size, are serving a majority of clients in many markets”.

However, virtually all practitioner respondents said they were either facing, or worried about, funding difficulties, both as to availability and cost. The comment from a practitioner in Peru was typical: “Many MFIs only have access to external funding sources. The hardening of the conditions of these will make them less competitive.” Eric Savage, managing director of Unitus Capital in India, described the lack of funding as “potentially life-threatening to many MFIs and their clients”. Kim Nadejda, business development director at the Russian Microfinance Center, said that “we observe a growth in [funding] costs because of the influence of the world financial crisis”.

This shift in funding could bring about longer term change in the industry by favouring larger commercial institutions and driving smaller MFIs out of business. Although such a shake-out is seen as potentially healthy by some respondents, others fear it would only edge MF further away from the markets it should be serving. Taufiq Zahidur Rahman of the Shakti Foundation for Disadvantaged Women in Bangladesh said that “with the global meltdown, the flow of funds to microfinance will surely shrink. Moreover this meltdown will increase the poverty level”.

Some respondents saw new realities developing on the funding front, with less money coming from disillusioned private investors and wealthy individuals. Peter Platan, investment manager at Finnfund in Finland, said that “private sector funding for the industry was overabundant a few years back. But due to the crisis, private investor interest in microfinance could decline for many years to come”. Some even thought that “donor fatigue” would cause philanthropic funds to switch back to direct means of financing poverty alleviation. Meanwhile those MFIs that did continue to receive commercial funding would probably have to adjust to tougher terms.

Many respondents noted the vicious circle in the crisis, with a funding shortage leading to liquidity problems, leading to overindebtedness and a reduction in portfolio quality – making funding even less attractive. This link between the top Banana Skins was a recurring theme.

7. Corporate governance (2)

Corporate governance remains a challenge for many MFIs

As with management quality, concerns about the strength of corporate governance in MFIs have been overtaken by more urgent considerations, hence the fall of this Banana Skin in the rankings. But it has not gone away. The responses suggested that corporate governance remains a challenge for MFIs in many parts of the world, particularly in this period of stress, and is widely viewed as a central long term issue.

Who’s next?

A key issue among many in governance and management is succession – a topic that almost everyone wants to avoid but will eventually happen. Looking at the microfinance landscape, the early leaders and pioneers are facing a clock that is (or should be) winding down. Are the institutions prepared?
Gil Lacson
Relationship manager
Women's World Banking, US

An analyst with one of the MF rating agencies said: “Good governance will remain a key area to mitigate risks for MFIs. [Institutions] will need to keep board capacities ahead of the increasing complexities of the industry. Foreseeing risks will become more important in the maturing industry, while relying on reactive governance/management will expose MFIs to bigger risks”. Many made the point that the recession would sort out the good from the bad.

The regions where concern was highest included Africa and Asia. Concerns also showed in regions where responses were dominated by investors rather than practitioners, e.g. North America and Europe. In Latin America it was relatively low (No. 15).

Among the issues raised by respondents were the low calibre of boards, conflicts of interest among directors and executives, and a lack of independence and accountability. One North American investor described the skills of many boards as “limited at best”. The economic crisis may also present boards with challenges they cannot meet: declining credit quality, mounting losses and staff who lack the qualifications or experience to handle difficult business conditions.

Some respondents blamed weak governance on the fact that times had been too good for many MFIs and the business lacked rigour. Markets had been strong, funding, including “soft” money, was plentiful, and MF’s philanthropic status reduced the need for accountability. This could magnify the impact of the crisis.

An Italian microfinance investor said: “After years of very high growth rates, the economic and financial crisis is imposing a significant slowdown on most MFIs. Past growth rates, facilitated by abundant funding, have often hidden important intrinsic weaknesses, especially in the areas of corporate governance, management quality and risk management – issues which are now rapidly becoming evident. The crisis will give an opportunity to the best managed MFIs to consolidate their operations, while the weakest ones will likely gradually lose market share”.

However some respondents felt that corporate governance was widely recognised as a key issue, and much was being done to strengthen it, particularly among MFIs undergoing transformation. One said that “the current ‘popularity’ of microfinance has elevated the calibre of board talent available, so there is no excuse for not having strong governance and quality oversight. Investors have made governance reviews a priority”. An Indian practitioner said: “Unlike the past, a lot of training programs are now available. It is up to the MFI to equip itself to meet global standards”.

8. Foreign currency (12)

Foreign currency risk is rising because turmoil in financial markets has exposed weaknesses in the microfinance investment model.

Even a zero default rate can’t ensure repayment of hard currency funding

For years, investors have been investing in MFIs with hard currency – mainly dollars – to fund loans which are disbursed in local currency. The volatility of currency relationships means, in the words of one respondent, that “even a zero default rate will not ensure repayment of hard currency funding if the local currency of borrowings devalues”. The respondent continued: “This is a fundamental flaw in the model which, if not provided for, is a major accident waiting to happen”.

Volatility can cut both ways, of course. Not long ago, the weakness of the US currency made dollar borrowings easier to repay. But the dollar’s (and the euro’s) recent appreciation against local currencies, particularly in Eastern Europe and Central Asia, is making repayments more expensive.

The problem, as several respondents warned, is that MFIs are not able to hedge their positions. Denominating loans in dollars or euros is not realistic, nor is receiving investment in local currency. There is “far too much USD/EUR debt financing flowing to MFIs that are either not able, or not equipped, to hedge”, noted the vice-president of a large MFI.

The problem is not just lack of know-how but an absence of hedging mechanisms for highly illiquid currencies. This means that investors may have to swallow the currency risk, which hardly encourages further funding. As one respondent argued: “International development players should make it an absolute priority to subsidise or otherwise support nascent efforts to develop more liquidity in hedging instruments or provide local currency funding”. Some remedies are, however, in the works, including cross-currency swaps and advice on hedging and FX management.

Foreign currency risk can take other forms as well. Nugzar Murusidze, microfinance regulator in Georgia, said that the devaluation of the national currency had boosted inflation and damaged the local credit business.

Views on this risk varied by region, understandably given its geographic nature. Investor regions such as North America and West Europe gave it a high ranking (No. 7 and No. 2 respectively), while practitioner regions ranked it lower. Again, investors were the most concerned group, ranking it No. 2, while regulators breathed a collective yawn and placed it No. 24.

9. Competition (7)

The MF sector continues to have very mixed views about the value of competition. Does it spur progress or merely destroy the good things that MF is supposed to be about?

Competition is blamed for the ‘erosion’ of credit standards

In the 2008 survey, this Banana Skin was seen as the fastest-rising risk, particularly by practitioners. But it has eased this time, reflecting the changed conditions brought on by the economic crisis.

Many respondents felt that competition, particularly the entry of well-heeled commercial banks into the market, had made MF especially vulnerable to a downturn by encouraging irresponsible lending. Clara de Akerman, president of Women’s World Banking in Colombia, said that banks which had entered the market “lack the proper methodology to deal with credit financial services to poor micro-entrepreneurs. This can be seen in the growing indebtedness of small customers”.

There were frequent references to the problems of overindebtedness, particularly in regions such as Latin America and Asia, with blame pinned on pressure for market share, declining credit standards, tight pricing, and a new awareness among borrowers that they can play lenders off against each other.

Marcus Fedder, a partner in UK investment firm Moringaway, said that “some regions may reach saturation, resulting in more competition, lower lending rates and, importantly, borrowers taking out more than one loan, leading to increased danger of defaults”. Kalpana Sankar, chief executive of Hand in Hand in Tamil Nadu, said that “even governments and private banks are entering the field, and the sector is losing its core value of closeness with the target group to reach scale and make more profits. This could pose a major problem and the bubble might burst”.

However, other respondents saw competition as a healthy force that was spurring innovation and driving out inefficiency. A North American microfinance investor said: “We consider competition to be a good thing, and see an increase as positive”.

The economic crisis was widely expected to take some of the force out of competition, particularly as the commercial banks adopt more cautious strategies, and funding becomes more difficult for MFIs. Several respondents said they thought the crisis would encourage consolidation in the industry, leading to fewer but larger players. This might reduce competition, but would also alter the character of the industry.

Could consumer lending damage MFIs’ reputation?

Protecting consumers

Competition between banks and MFIs is blurring the line between microlending and consumer lending in many markets. This is creating confusion which could damage microfinance.

Consumer lending consists of small loans to individuals to buy personal items. Microlending consists mostly of small loans to finance business. But the distinction is disappearing as banks and MFIs compete at the small end of the market. Many respondents feared that the more aggressive style of consumer lending would taint microlending and make it riskier.

Elizabeth Littlefield, director of CGAP in the US, said that “while the microfinance community is very clear about how its values are distinct from mainstream low-income financiers, there is little distinction at the operational level, where money is often lent without regard for repayment capacity, at rates that are needlessly high and unclear to the customer”.

Daniel Schriber, director of investment analysis at Symbiotics in Switzerland, said that “the reputation of the microfinance industry as a whole is going towards too much consumer lending, which could scare away investors and destroy the goodwill that microfinance is benefiting from today”.

Several respondents also feared that aggressive lending to consumers would expose MFIs to actions under consumer protection regulations which would be bad for the industry’s reputation. A US consultant said that “consumer protection issues, particularly over-indebtedness, transparency, collection practices and fraud are likely to gain more visibility”.

10. Political interference (9)

The overall level of concern about political interference in the MF industry is little changed, but this Banana Skin varies greatly from one region to another.

Latin American respondents, for example, ranked it No. 3 while Asia put it at No. 8, and Central/East Europe and Africa at No. 23. As for types of respondents, concern was higher among investors than practitioners. Deposit-taking MFIs expressed little concern, suggesting that this risk lies more on the lending side.

Political interference takes many forms: directed lending, interest rate caps, loan forgiveness, subsidised competition. The two most frequently mentioned by practitioners were asset grabs in countries where MFIs were well-resourced, and controls on the cost and availability of loans.

A credit rating analyst said: "Undue government influence is likely to come up every now and then in countries as politicians hope to capitalise on the success of MFIs for their own benefit (e.g. Uganda). A cap on interest rates is often discussed, although fortunately so far the soup has been served much hotter than it has been eaten…Unfortunately many other examples exist and this trend seems to be on an increase".

Microfinance is becoming more political

Geographically, respondents pointed to Asia and Latin America as regions where political interference was growing. One respondent noted that the Nicaraguan government was supporting a "non-payment group", and respondents from Colombia and Venezuela said that interest rate caps were stunting the growth of the market.

One worry is that the risk could get worse as governments use the economic recession as a pretext to exert greater control over MF activity. Jacco Minnaar, a fund manager with Triodos Investment Management in the Netherlands, warned that the economic downturn "could also lead to less stable political environments, as poverty may rise again, leading to social unrest. This could in turn hurt the microfinance industry and we may see that anger and frustration will be directed at MFIs in some countries".

> **The political threat**
> There is political and regulatory risk in markets hit by the food/fuel/financial crises and the downturn in the real economy. This could take the form of calls for debt moratoria, interest subsidies, uneconomic capping of interest rates and similar populist reactions, as well as well-intentioned, but disproportionate, consumer protection and other market conduct regulation that imposes significant compliance costs. This would price sustainable providers out of harder-to-serve/less profitable markets.
> Timothy R. Lyman
> Senior policy advisor
> CGAP, US

Some respondents felt that international agencies and MF sponsors could/should do more to combat this risk by highlighting incidents and showing how MF client interests were being harmed.

11. Interest rates (6)

Interest rate risk is seen to have fallen quite sharply, mainly because the earlier volatility has eased, and rates are generally much lower. But the difficult economic environment could expose MFIs to unfamiliar challenges on this front.

This Banana Skin was of greatest concern to practitioners (No. 7) and deposit-takers (No. 8), less so to investors (No. 12). For similar reasons, geographical concern was concentrated in the large practitioner regions such as Latin America and Central and Eastern Europe.

The consensus view is that MFIs have sufficiently large interest rate margins to absorb considerable volatility, and the decline in interest rates is an opportunity to widen margins by maintaining lending rates while cutting deposit rates. But this is a risky strategy because it invites customer resentment and political interference, a point made by several respondents, especially in India.

The alternative is to pass lower rates on to borrowers, which many MFIs have tried to do. But this is also risky because at some point interest rates will shoot back up again, and loan rates will have to as well. Daniela Gaga of Opportunity Microcredit in Romania, said that changes in interest rates would affect profit targets, and a similar point was made by A.B. Ariyaratne, general manager of Sabaragamuwa Development Bank in Sri Lanka.

The real challenge, therefore, is how to manage what is likely to be a much more volatile interest rate environment. An MF investor from the Netherlands said that "MFIs will be confronted with the need to accept more variable interest rates than they did before".

12. Profitability (22)

Concerns about profitability are rising, as might be expected in difficult economic times, though from a low level which reflected the earlier view that MF is more about philanthropy than making money.

Profits matter even more in a crisis

Concern was strongest among practitioners (No. 10), deposit-takers and investors (No. 11 and No. 12 respectively). It was weaker among analysts (No. 16), which is perhaps surprising, but it echoes the finding of our 2008 survey. Regionally, concern was strongest in Central and East Europe (No. 7) and Latin America (No. 8). In Asia, it ranked No. 22.

The main pressures on profitability are higher funding costs and bad debts. Gabriel Solorzano, chairman of Banex in Nicaragua, said: "What profitability? Does anyone still have profits?"

The drive for profitability

Few MFIs earn their cost of capital, once donations are removed from the picture. Yet for the industry to maintain its growth post-crisis, it will need to attract capital on an arm's-length, non-subsidised basis. The combination of macro-economic/credit factors and irresponsible competition is likely to continue to put further downward pressure on MFI profitability. The good news is that strong MFIs are focusing on cost containment, efficiencies from system investments, and new products/revenue sources, to drive for reasonable profitability.
Phillip Goodeve
Chief financial officer
FINCA International, US

Much depends on MFIs' ability to pass on higher funding costs, which is not easy in such a sensitive business. Many respondents said that their margins were being squeezed by a combination of competition and inability to raise charges to their borrowers for social and business reasons. One respondent said that profitability was "a two-edged sword…High profits in stressful times can boomerang (*à la* Compartamos), while poor profits/no profits can hit the supply and cost of funding".

What is striking from the responses is the strength of the view that profitability is key to survival. One Indian practitioner said: "Without profitability there can be no sustainability. But these should not be huge profits as we are working with a very poor clientele". Jo Henriksen, an investor with Kolibri Kapital in Norway, said that "a high focus on profitability is essential for being sustainable".

One respondent said that lower profitability would "potentially reduce the attraction [of microfinance] to mainstream commercial investors". Some respondents also wondered whether MFIs would ever regain their earlier profit levels because of lasting changes to the structure of the industry.

13. Inappropriate regulation (3)

This is a risk that comes in many forms. Depending on who you are and where you are, there is either too much regulation or too little, it is either ineffective or oppressive. But broadly the sense seems to be that regulation is getting there, if slowly. This Banana Skin is slipping down the rankings, and is not considered to be getting worse.

Microfinance could be hit by the regulatory backlash against banks

The category of respondents which is most concerned about this risk are practitioners who ranked it No. 8 and investors (No. 9). Analysts, by contrast, were much less worried, ranking it No. 19. Regulators ranked it No. 21. Geographically, concern was strongest in the Middle East (No. 5) and Latin America (No. 9).

The concern most frequently cited by respondents is that many countries still lack specific MF regulation, which means that MFIs are either unregulated, or forced to conform to other, mainly commercial banking, regulation. This is a particular issue for deposit-taking, an activity that more MFIs want to get into. The wrong regulation can affect the viability of the business model, undermine depositor and investor confidence, and expose MFIs to political interference.

Martin Holtmann, head of the microfinance unit of the IFC, said that inappropriate regulation “prevents many mature MFIs from raising deposits”. Dieudonné Gnanvo, director of RENACA, the Benin savings bank network, said that “new West African regulations do not conform to the realities on the ground, and could introduce new constraints on the development of the sector”.

Another aspect of the risk is the poor quality and ineffectiveness of regulation. One example is China where, according to Chengyu Bai, secretary-general of the China Association of Microfinance, the lack of a suitable regulatory framework means that MFIs flout the law, raising deposits without authority, and focus on business lending rather than microcredit. “This is distorting the industry”, he says.

In Bangladesh, Muhibur Rahman, senior assistant secretary at the Ministry of Finance, said that the authorities lacked the capacity to regulate properly. “The weak regulatory mechanism could result in a fragile financial market with money laundering and financial crime becoming uncontrolled”. Jules Gbato Gonnet, microfinance regulator in the Côte d'Ivoire, said that “microfinance innovates more rapidly than regulation”.

> Unless regulators have the will power to come up with conducive, friendly and water tight regulations, the industry will be in a major war, pitting itself against the established commercial banks.
> Darius Njenga
> Programme coordinator
> INAFI Africa Trust, Kenya

An ongoing issue is “transformation”, the transition of MFIs from unregulated to regulated status, a process which can cause disruption and uncertainty. Voluntary transformation is increasing as more MFIs seek to grow and take deposits, a trend which has brought them into competition with commercial banks in many countries. Enforced transformation, notably in the Balkans, continues to cause serious problems for MFIs in Bosnia & Herzegovina.

Overshadowing all this is the worry that microfinance could get swept up in a worldwide move to re-regulate the financial system in the wake of the crisis. This could lead to hasty, ill-thought out measures. Carlos Labarthe, co-chief executive officer of Compartamos in Mexico, said that the financial crisis "is generating a lot of efforts by regulators to increase regulation for financial institutions in general, so the possibility that this will affect our operations is huge". Bob McDowall research director at TowerGroup saw MFIs "being caught in the slipstream of excessive and undeserved additional financial regulation intended for mainstream financial institutions that will erode margins and make some areas of business uncompetitive".

On the other hand, a number of respondents said that regulation was improving. A credit analyst in Peru said that regulation in that country was "very appropriate".

14. Staffing (5)

Concerns about staffing, which loomed large in the 2008 survey, seem to be easing. This Banana Skin has fallen very sharply in the rankings, and is seen to be on a declining trend.

Staffing risks are seen to be declining

One reason could be that the huge amount of resource that has been applied to staffing is beginning to pay off. Another is that the recession has eased staff shortages, and a third is that MFIs who transform themselves into banks are often able to offer more interesting and better paid jobs.

Geographically, the risk remains most acute in Africa, which ranked it No. 2, and the Far East (No. 6). A respondent from Kenya said: "Human resource development is a major concern for the industry. The development of skills is probably not keeping pace with the development of the sector – at least in Kenya".

Among respondent categories, the biggest worries lay with deposit-taking MFIs who placed it No. 10. Sadaffe Abid, chief executive of the Buksh Foundation in Pakistan, said that "most MFIs lack management depth to grow and expand their business. They are usually dependent on a few individuals. MFIs need to have strong leadership development initiatives and systems in place". Investors seemed to be less concerned. "It's becoming easier" said an MF funder in the Netherlands.

The talents in shortest supply are loan officers and risk managers. Staff is particularly short in MFIs away from towns and those without automated systems. A

Africa's challenges

Africa's problems are often described as the toughest of any MFI region. Here Julie Bally, director of the Première Agence de Microfinance in West Africa, describes the challenges.

"The crisis has revealed weaknesses in individual MFIs, such as uncontrolled growth, poor governance, excessive competition, overindebtedness owing to multiple borrowing, weak human resources, particularly loan officers, a lack of product diversification, a concentration of activities in towns (where debt problems are greatest), inadequate management information systems, poor credit management, ineffective bonus systems, a lack of professionalism, excessive profits (because of investor pressure), poor knowledge of the market and customers, lack of funding, lack of capital, lack of protection against foreign exchange risk, etc.. However, it must be said that the microfinance sector is healthier than the formal financial sector, and it seems that the industry here in Africa is less affected by the crisis because it is less integrated into the formal financial sector than may be the case in Latin America or Eastern Europe."

US academic analyst saw the problem as acute in sub-Saharan Africa, “especially in rural areas because of severe endemic poverty and the resultant lack of qualified people”.

There was some good news. Some respondents reported that the global crisis had taken the pressure off the jobs market and eased shortages and poaching. There were even cases where commercial bankers had switched to the MF sector to bring their skills and “give something back”.

15. Managing technology (8)

This is one of those long-term, strategic risks that have been brushed aside by more urgent concerns about the economic crisis. Technology remains a big Banana Skin for MFIs, and could become more so as cost and competition pressures increase.

An industry analyst said that technology is “not evenly present in the industry, and smaller MFIs with few economies of scale will find it difficult to keep up with new applications, given costs”. A Japanese practitioner said that “technological innovation is rapid and requires significant investment to catch up with it”.

Back office efficiency and distribution are the key issues

This was seen as a middling risk by most respondent groups, except Asians who placed it No. 6. A respondent from Tanzania said that “most MFIs still lack appropriate and effective management information systems, and, partly as a result, continue to have problems managing portfolio quality”.

Essentially, there are two issues, back office efficiency and distribution.

On the first, the concern is that MFIs may lack the will and skills to take advantage of modern systems to manage costs and risks. The vice-president of one of the large international MF networks in Africa and Asia thought that “back office systems are not ready to face a recession environment”. A ratings analyst said that “an increase in efficiency will be key to remaining profitable as interest rates remain under pressure. The use of technology will increase, of which risks so far have remained limited”.

On distribution, huge advances are taking place in communication which MFIs need to exploit, for example to develop branchless banking. Paul Makin of Consult Hyperion in the UK thought that “MFIs risk being left behind by the mobile revolution. Most do not have the staff, the technical expertise, or the necessary investment funds to be able to take advantage of technological developments. This is particularly the case for 2G banking technologies, such as M-PESA and Wizzit. The principal concern is that these shortcomings will severely limit their reach to new customers, whilst also leaving them unable to drive down their own administrative costs”.

Several respondents made the point that this is an area where sponsors and investors can help mitigate risk by offering personnel, technical advice and guidance on standardisation.

16. Transparency (11)

Concern about poor transparency in the MF industry has fallen, reflecting some improvement on this front, often under pressure from investors and rating agencies who want better information and accountability. The director of a capital markets group which advises women's banks said that "the greater focus from investors will drive toward better transparency".

However a murky area remains the cost of MF loans where MFIs may be reluctant to come clean because their charges are very high. Narasimhan Srinivasan, a consultant to MFIs in India, said transparency was "poor in many MFIs; they are unwilling to let others have an independent look". Another advisor said: "I expect more and more markets to implement basic transparent loan cost disclosure measures".

The cost of MF loans remains 'a murky area'

Several respondents made the point that transparency could become a key issue in sorting out the good MFIs from the less good in times of crisis. Lynn Exton, chief risk officer at Opportunity International Network, Canada, said: "The industry benefited from relatively benign conditions up until 2008. The external environment has changed significantly and there is likely to be a shakeout… The industry may suffer as a whole while the market sorts out the strong from the weak, which is not easy given the low level of transparency in MFIs".

Nonetheless, many MFI respondents said that transparency was key to building confidence among investors and depositors, and some felt that the rigours of the crisis would produce improvements on this front.

An Italian microfinance investor said: "The limited availability of funding will trigger a greater effort towards transparency, information sharing and clear governance. Therefore, although over the next 1-2 years we will likely witness a stalling in the overall growth of the industry and a worsening in portfolio quality, in the longer term the sector should end up being more robust, transparent and less fragmented".

17. Reputation (19)

Broadly the MF industry has a good reputation, but our responses threw up several worries. One is that the growing commercialisation of the business will draw it away from its social goals and earn it a bad name. Leading on from this, another is that MF will be "exposed" by an unsympathetic Press as having failed to improve the lot of its target communities. A third is that the recession will force MFIs to be tougher on their customers and attract bad publicity. All these could damage the industry's reputation and affect the availability of funding. William Knight, a consultant with CGAP in Canada, said that "any entity dealing with money in any form is under the microscope for the next two-three years".

Interestingly, reputation was ranked higher as a risk by investors (No. 14) than practitioners (No. 18) who, on the whole, felt they were managing it quite well. None of the regions showed an exceptional level of concern, high or low, except the CEE which ranked it No. 8.

Many respondents raised the spectre of negative publicity about MF's alleged failures or, even worse, its contribution to new problems such as overindebtedness.

Paul Blyth, head of business development at MicroPlace, saw the possibility of "a bad PR story hitting the mainstream Press, transforming microfinance from a positive term into a negative one". A Norwegian investor said that the industry could be questioned "if the media begin to see that MFIs keep an informal economy afloat and that children are often working in small enterprises".

The industry's reputation is linked to the issue of "mission drift" (See No. 19).

Dealing with a negative Press

The economic crisis could be bad news for MF if it forces institutions to be more tight-fisted with their lending, and more exacting with their debt collection. Paul Luchtenburg, chief executive of AMK in Cambodia, said that as business conditions worsened, MFIs would have to deal with "an increasingly negative press". A practitioner in Peru said it was already evident that MFIs were taking a "less caring attitude" towards their clients.

On the other hand, some respondents felt that the crisis could help MF's image by highlighting its social commitment at a time when commercial banks are cutting back or failing. T.K Weerawareana, a manager with Sarvodaya Economic Enterprises Development Services in Sri Lanka, said the MF would emerge "with a good reputation from the prevailing macro economic crisis".

Reputation at risk

The director of an MFI in Bosnia and Herzegovina described how the economic crisis is hurting MF's reputation in his country. "The crisis is having a very negative impact on our clients, specially because of the problem of overindebtedness. There have been tragic incidents in some families, including suicides. This has attracted the attention of the media who are not supportive of MF because of the high interest rates we charge. A chain reaction follows. Media pressure prompts politicians to move against MFIs by getting the regulator to become more repressive. This, in turn, scares our lenders who are withdrawing their funds and creating a huge liquidity problem for us."

18. Unrealisable expectations (13)

In an industry surrounded by hype, there is always a risk of disappointment, of expectations remaining unfulfilled. The question is whether current conditions increase or reduce it. Will MFIs rise to the occasion or stumble?

Practitioners and investors shared the view that this was a middling risk (both put it at No. 17), with the broad feeling being that MF was bound to create disappointment: it was a question of managing expectations. Daniel Kalbassou, general manager of Crédit du Sahel in the Cameroon, said that "MFIs on their own cannot solve the problem of poverty because poverty is a whole set of problems. The MFI makes its contribution".

On the negative side, respondents saw the crisis hurting the MF business by squeezing margins and driving up bad debts, and also by making it harder for MFIs to live up to their social roles. Analysts saw profitability falling, which could be dangerous in an industry so much in vogue. The failure of weaker MFIs could also be damaging.

But on the positive side, several respondents felt that the MF industry could come through the crisis in much better shape, tempered and strengthened by harsher conditions, with much of the fluff blown away. Its profitability could be higher than the financial sector average, which would attract investment back into the sector. One respondent said: “Many MFIs are taking advantage of this lull in their growth to remedy underlying problems in management, to build support for their previous growth, to shore up their business plans”.

19. Mission drift (14)

Are MFIs losing sight of their social goals?

Although the risk of mission drift (MFIs being deflected from their social goals by commercial interest) has fallen, this was a Banana Skin that attracted much comment. There is the ongoing dilemma over the microfinance balance between business and philanthropy, but the new concern is that the economic crisis could tilt the balance towards commercial survival. Most respondents saw this as a rising risk.

Concern about mission drift was strongest among the MFIs themselves. Chuck Waterfield, chief executive of MicroFinance Transparency in the US, said that “most MFIs strive for a social/business balance, respecting clients while building sustainable institutions. This is in line with the origin of the microfinance industry. But the lure of quickly generated, very large profits is drawing some MFIs to focus on profits at the expense of fair treatment of their clients”.

Geographical concern was strongest in the Middle East (No. 6) and Asia (No. 9). Alnuman Adra, country manager of Micro Credit Facility in Syria, saw “a trend in many commercial MFIs to increase profits and therefore ignore poor and very poor customers,” and in Egypt Motaz El Tabaa, executive director of the Alexandria Business Association, reported that MFIs were losing sight of their social goals and transforming themselves into non-social “for-profit” institutions. In China, Jiao Ta of GTZ Microfinance said that the trend was to move away from “real micro clients” to bigger business clients.

> **Is microfinance doing its job?**
> As microfinance becomes increasingly commercial, the question of whom and to what extent the sector is serving is a viable one. There needs to be a rigorous examination of the aims of microfinance and how it is contributing to poverty alleviation.
> Peter Westman
> Capital development manager
> Mimo Finance, India

Many respondents blamed mission drift for aggravating the problem of overindebtedness by encouraging irresponsible lending. A respondent from Bosnia & Herzegovina reported that loan officers were forced to fill “crazy” monthly quotas. “Disbursement is based on the principle of ‘Just take a loan, you’ll pay it back in some way’”, he said. Mike Dyer, a member of the risk management team at Opportunity International in the UK, said that “there needs to be a thorough review of the way in which loans officers are incentivised”.

In some countries – Romania was cited as an example – social lending has almost completely disappeared, having been replaced by commercial lending. Teshome Y. Dayesso, chief executive of Busa Gonofa MFI in Ethiopia, saw MFIs “moving away from smallholders in favour of small and medium enterprises in urban areas”. Joy Cadangen, finance manager ECLOF International in Switzerland, saw MFIs "closing the doors to high-risk clients/markets, thereby leaving the high-risk clients to the social-oriented MFIs who may not have the funds for them (such as agriculture)”.

Some respondents feared that these trends would be sharpened by the crisis because MFIs would be forced to take a more hard-nosed approach to their customers. Lynne Curran with ACCION International in the US, said that “given difficult financial times, the trend may be to move upmarket”.

20. Fraud (15)

Although the risk of fraud has dropped down the rankings, it has only been overtaken by more urgent concerns. It continues to be seen as a rising problem in many regions, and could be made worse by the recession.

The group that is most concerned about fraud are the deposit-taking institutions (No. 11). Investors and analysts were more relaxed about it (No. 19 and No. 24). Geographically, the top areas seem to be Africa and the Middle East (both No. 10).

The risk of fraud rises in a recession

Many respondents made the point that a downturn and fraud go hand in hand. A practitioner in Poland said that “a recession always leads to higher fraud or attempted fraud”. A regulator in the Middle East said that “a growing economy typically yields large scale financial fraud (i.e. Madoff). However, a declining economy typically yields small scale financial fraud (lying on applications, falsifying income sources, lying on insurance claims, etc.). This small scale fraud has a potential to hurt microfinance institutions”.

Others felt that MFIs were not taking advantage of modern means, technological and managerial, to combat the problem. Oluseyi Olojede, an executive with the Integrated Microfinance Bank in Nigeria, said there was “a risk of cash suppression by officers and teeming and lading [the practice of rolling cash receipts forward to conceal a misappropriation]”.

Some respondents were more upbeat. One said that growing reports of fraud were the result of better tracking rather than more crime. Another felt that this was one area that would benefit from the industry-wide drive to strengthen management and systems.

21. Depositor confidence (-)

With confidence in banks badly shaken by the financial crisis, we thought we should test the level of depositor confidence in MFIs. The results were encouraging – or complacent depending on your point of view. The loss of depositor confidence is not seen as a high level risk by any of the categories of respondents to this survey except regulators who put it No. 5.

Practitioners and deposit-taking institutions put it at No. 23 and No. 21 respectively, and investors only slightly higher at No. 20. Geographically, the region where concern was highest was Latin America at No. 12.

Many respondents could see potential for risk here: a loss of confidence in financial institutions leading to a run on deposit-taking MFIs. This could severely cripple affected MFIs and even bring them down. Keith Flintham, managing director for Eastern Europe at Opportunity International, raised this possibility in his area, and

The loss of MFI depositor confidence is not seen as a high risk

others wondered whether we were really past the worst on the banking front. A US respondent thought that "deposit-taking MFIs will be tested for their ability to manage liquidity". Some respondents pointed out that MFIs – even strong ones – might have to take on more liquidity as a precaution, which would be expensive.

Although some respondents reported incidents of deposit withdrawals in their markets, the general feeling seemed to be that MFIs were weathering the storm quite well. "No loss of deposits yet by clients," said Peter Ziwa, risk and standards manager at Opportunity International Bank in Malawi. However, a looming problem in this area is the growth of competition for deposits as more MFIs transform themselves into authorised institutions, and commercial banks step up their drive for people's savings.

22. Back office operations (18)

The quality of MFI back offices remains a source of concern, but not a pressing one. However many respondents felt that the economic crisis would expose those that were weak in this area because there were so many potential points of stress: information and control systems, risk management, fraud prevention and cost efficiency. A US MF advisor said the back office was "never a strong point among MFIs. As numbers and scope increase, [they face] increased back office problems".

Practitioners put it down at No. 24, arguing that much improvement had been made to systems and controls, particularly in Latin America. There were slightly higher levels of concern in Africa, the Middle East, Asia and the Far East.

Among those who saw risk in this area, Richard Kossi Amoussou, an MF advisor in the Congo, said that "information systems have not always kept up with the size and complexity of MFIs' operations". Other respondents also feared that back offices were suffering from under-investment and inadequately trained staff. The need to keep track of loan performance and control costs during the recession would be a key test.

But some respondents thought things were getting better. Masami Hayashi, director of MicroFinance Network in Mexico, said "The risk may decrease because of less workload". Malcolm Hayday of Charity Bank in the UK said: "As technology improves back office risk should fall".

23. Ownership (17)

Respondents identified two types of risk in ownership, one the form of ownership (was it appropriate?) and the other that MFIs are changing their ownership structures, either voluntarily or under regulatory pressure, which can be a risky process.

Ownership is a key issue because it determines the character of an MFI: is it a philanthropic organisation or one aiming to make profits for its shareholders? Many MFIs are caught between the two, which is why tensions over ownership structures are appearing. A US academic analyst said that "with the industry growing rapidly in many new directions, ownership risk is high and likely rising".

Some respondents described this dilemma as "painful". One said that "changing ownership, changing governance, especially under time pressure of a deadline, increases the risk profile of an MFI". Another said that "unfortunately this is a legacy issue that has to be worked through. International development organisations and investors could be helpful in providing resources to well-managed MFIs who need project management and other talent to drive these transformations through to completion without disrupting existing operations".

24. Product development (24)

Despite frequent calls for greater imagination in MF product development, this did not emerge as a high profile issue. It was not a big Banana Skin in the 2008 survey, and its position remains unchanged.

Most MFIs understand their clients' needs

Respondents tended to say that most MFIs are very close to their clients, and understand their needs. There are also plenty opportunities to partner with product developers and providers to keep up with new ideas. A respondent in India said: "This is a very easy area to handle if the concerns of the clientele are taken into account".

A rating analyst also said that "given funding constraints in both the MFI and banking sectors, there is less competitive pressure for MFI's to diversify into non-core activities".

25. Too much funding (21)

Everybody gets it wrong sometimes. In the last survey, this was a lowish risk (No. 21 out of 29), though it was rated as trending upwards and seen as potentially destabilising for the MF industry. This year, it is dead last: a surfeit of funding is not seen as the problem it once was. In fact, some respondents thought this was a good thing. "Many institutions may have been over-financed over the last few years", said a US loan fund manager.

To the extent that it is a problem, it is diverse and market/sector specific, for example for Tier 1 MFIs who now enjoy a disproportionate amount of what funding is available. But it's a good problem to have, and hardly a 'risk'. However, the popularity of some of the top institutions, fuelled by media profiles, case studies and ratings models, could still lead to too much money chasing too few good loans. Jessie Greene, senior investment officer at Triple Jump in the Netherlands, feared that "bad capital will crowd out good capital, in other words, reckless microfinance investors will crowd out careful investors, with the risk of causing a microfinance sub-prime crisis".

For the time being, this is not a risk. The question for the longer term is whether economic recovery will see a return to the indiscriminate funding of past years, or whether it will leave investors more cautious about their exposure to the MF sector.

New pressures of structural change

And the further outlook is...

One effect of the economic crisis could be to accelerate the pace of structural change in the microfinance industry. This may be a good thing, but it also carries the risks of uncertainty and failure.

Respondents saw a number of trends developing. One is that the pressures of cost and deteriorating loan portfolios will prompt MFIs to shift their attention to more lucrative markets, i.e. wealthier individuals, small and medium sized enterprises, which would take them away from their social goals. Respondents say this would advance the trend of commercialisation which is making MF more business-minded, but also more controversial.

A second trend is towards transformation. Funding difficulties will drive more NGO-led MFIs to become shareholder-owned authorised banks in order to attract investment and tap the deposit markets. Other MFIs are also going down the transformation route in order to grow. This need not take them away from their target markets, but it will give them heavier commercial responsibilities.

Chikako Kuno, director of small business finance at the EBRD, commented: “Accelerated growth particularly over the last two years in Eastern Europe, the Caucasus and Central Asia has pushed MFIs to a size where they are no longer small lending organisations but must put into place strong institutional frameworks to manage risk, human resources, client services, develop new products. This will require different strategies, potentially different priorities, and significant financial and human resources”.

A third is consolidation. The problems of reduced funding, bad debts and economic recession could drive smaller and weaker MFIs into mergers to avoid having to shut down. This would make them stronger. But consolidation might also take MFIs out of the countryside and other underserved areas, reducing the availability of microfinance where it is most needed. Gustavo Lasala, chief financial officer of ACCION in Texas, said that this trend “will gain speed in years two and three, bringing challenges related to the availability of skills and talent to manage consolidation and growth”.

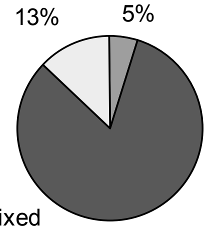
MFIs are seen to be less well prepared than before

Preparedness

We asked the question:

> **How well prepared do you think MFIs are to handle the risks you have identified?**

Five per cent of respondents answered well, 82 per cent gave a mixed reply, and 13 per cent said poorly. In 2008, 27 per cent said well, 68 per cent said mixed and 5 per cent said poorly. Among the reasons given for this more negative result, respondents said that MFIs realised too late that they would be impacted by the economic crisis, particularly by its effect on credit and funding. Respondents who gave a positive reply stressed the quality of management and the strength of institutional support.



Emmanuelle Javoy, managing director of Planet Rating in France, said that "overall, one third of MFIs have systems, procedures and performance that should really allow them to manage the above stated risks without major problems, while another half have decent systems or procedures or performance, but that might take a little time to adapt to changing situations".

A breakdown of responses by category shows practitioners to be the most optimistic, with ten per cent of them believing that MFIs were well prepared. Although 18 per cent of regulators thought MFIs were well prepared, a further 18 per cent of them answered poorly. Investors were the most pessimistic, with only 2 per cent answering well.

%	Practitioners	Investors	Regulators	Observers
Well	10	2	18	3
Mixed	77	89	64	83
Poorly	13	9	18	13

APPENDIX: The questionnaire and guide

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION
5, Derby Street, London W1J 7AB, UK
Tel: +44 (0)20 7493 0173 Fax: +44 (0)20 7493 0190

Microfinance Banana Skins 2009

This survey seeks to identify the risks facing microfinance institutions (MFIs) over the medium term (2-3 years), as seen by practitioners, investors and other close observers. 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.

Please read the accompanying guide for information on how to complete the questionnaire.

Please complete and return this questionnaire to us by May 8th.

Name ☐ **Position** ☐

Institution ☐ **Country** ☐

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

What is your perspective on the microfinance industry?

1. Practitioner ☐ **If yes, does your institution take customer deposits?** ☐

2. Investor ☐ **3. Regulator** ☐ **4. Analyst** ☐

Other (please state) ☐

Question 1. Please describe the main risks you see facing microfinance institutions and the industry as a whole over the next 2-3 years, and the reasons why.

Please turn over

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			
2	Competition			
3	Corporate governance			
4	Credit risk			
5	Depositor confidence			
6	Foreign currency			
7	Fraud			
8	Funding - too little			
9	Funding - too much			
10	Inappropriate regulation			
11	Interest rates			
12	Liquidity			
13	Macro-economic trends			
14	Management quality			
15	Managing technology			
16	Mission drift			
17	Ownership			
18	Political interference			
19	Product development			
20	Profitability			
21	Refinancing			
22	Reputation			
23	Staffing			
24	Transparency			
25	Unrealisable expectations			
26				
27				

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

Poorly ☐ Mixed ☐ Well ☐

Microfinance Banana Skins 2009

Guide to the questionnaire

The Banana Skins questionnaire is designed to find out how people see the risks facing the microfinance sector over the medium term. The sector is defined as microfinance institutions (MFIs) which operate for profit and have assets of at least US$5 million.

In **Question 1**, we ask you to describe in your own words what your concerns about the risks facing MFIs over the next 2-3 years, and the challenges they will have to meet to sustain continued profitable growth. Please identify geographies or MFI types which you feel face particular risks.

In **Question 2**, we ask you to score a list of potential "Banana Skins" by the severity of the risk on a scale of 1 to 5, and whether you see this risk as rising, steady, or falling (please mark R,S or F). There is space for you to add brief comments, for example about particular countries, markets or MFI types. An explanation of the various Banana Skins follows.

1. **Back office operations.** How vulnerable are MFIs to risks in administration, accounting, systems and controls?

2. **Competition.** Competitive pressures in microfinance are mounting with the proliferation of MFIs, new entrants and unregulated institutions. Will these push MFIs to take greater risks in areas such as pricing, product innovation and credit quality?

3. **Corporate governance.** Are there weaknesses in the corporate governance of MFIs which could damage the business, for example because of a lack of independence, low calibre, or a failure to bring in fresh blood?

4. **Credit risk.** Will MFIs be damaged by borrowers failing to repay their loans?

5. **Depositor confidence.** How safe are MFIs from the risk of a run on their deposits and funding?

6. **Foreign currency.** Many MFIs fund themselves in foreign currency, creating foreign exchange risk. Is this a risk they can manage?

7. **Fraud.** Will MFIs be damaged by dishonest staff and customers?

8. **Funding – too little.** Can MFIs maintain their access to funding for their lending activities, particularly those which are not in the deposit-gathering side?

9. **Funding – too much.** Is the problem of funding that MFIs have more funds than they can prudently employ for loans?

10. **Inappropriate regulation.** Will rules imposed by regulators constrain or damage the growth of MFIs by failing to offer an appropriate regime?

11. **Interest rates.** Will MFIs be able to protect themselves against changes in interest rates which are beyond their control, for example those set by competition or central banks? These rates apply both to their cost of funds and their loan pricing.

12. **Liquidity.** Will MFIs be able to manage their cash resources successfully, both those for whom it is in short supply, and those with a surplus? Will the current financial crisis constrain MFIs' ability to obtain cash to run the business?

13. **Macro-economic trends.** Are MFIs vulnerable to pressures in the wider economy, for example inflation, recession or volatile commodity prices?

14. **Management quality.** Will MFI management be up to the challenge of growing the business and managing the risks?

15. **Managing technology.** With technology an increasingly key part of managing and delivering microfinance, will MFIs be able to master this difficult area?

16. **Mission drift.** Are MFI missions commercially viable; will they be able to stick to their stated missions?

17. **Ownership.** Are the ownership structures of MFIs appropriate and stable for their line of business?

18. **Political interference.** MFIs may face political pressures, for example in the areas of interest rates, lending terms and subsidised government programmes. How big a risk do these pose to the business?

19. **Product development.** Will MFIs be able to develop the right products and manage them successfully?

20. **Profitability.** Will the MFI sector be able to sustain adequate levels of profitability to ensure growth and commercial viability?

21. **Refinancing.** Will investors and donors renew their financial support for the capital of the business when the time comes?

22. **Reputation.** Will MFIs be able to sustain their good reputation?

23. **Staffing.** Will MFIs be able to recruit and retain good staff?

24. **Transparency.** Do MFIs report enough good information to sustain confidence in the sector? Do they conform to international accounting standards?

25. **Unrealisable expectations**. Is the sector vulnerable to hype? Do people expect too much of microfinance, and what happens if MFIs fail to deliver?

In **Question 3**, we ask you to say how well prepared you think MFIs are to deal with the risks you mentioned. Please tick Poorly, Mixed or Well.

CSFI PUBLICATIONS

1.	**"Financing the Russian safety net":** A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors. By Peter Ackerman/Edward Balls. September 1993	£40/$65
2.	**"Derivatives for the retail client":** A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level. By Andrew Dobson. Nov 1993 (Only photostat available)	£10/$15
3.	**"Rating environmental risk":** A proposal for a new rating scheme that would assess a company's environmental exposure against its financial ability to manage that exposure. By David Lascelles. December 1993	£25/$40
4.	**"Electronic share dealing for the private investor":** An examination of new ways to broaden retail share ownership, inter alia, by utilising ATM networks, PCs, etc. By Paul Laird. January 1994	£25/$40
5.	**"The IBM dollar":** A proposal for the wider use of "target" currencies, i.e. forms of public or private money that can be used only for specific purposes. By Edward de Bono. March 1994	£15/$25
6.	**"UK financial supervision":** A radical proposal for reform of UK financial regulation, (prepared pseudononymously by a senior commercial banker). May 1994	£25/$40
7.	**"Banking banana skins":** The first in a periodic series of papers looking at where the next financial crisis is likely to spring from. June 1994	£25/$40
8.	**"A new approach to capital adequacy for banks":** A proposal for a market-based alternative, using the concept of 'value-at-risk', to the present mechanistic Basle approach to setting bank capital requirements. By Charles Taylor. July 1994	£25/$40
9.	**"New forms of Euro-Arab cooperation":** A proposal for a new public/private development finance corporation to promote employment-generating projects in the Arab world. By Jacques Roger-Machart. October 1994	£25/$40
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