Keeping a Stumble from becoming a Fall: Lessons Learned from Global Workouts for Microfinance Institutions

For the last twenty years, IFC has invested in microfinance projects, committing $3.5 billion to 215 clients across 400 projects in 73 countries. During this time, IFC’s microfinance team has learned several lessons from our projects with microfinance institutions (MFIs) that we can apply to help propel our partners to financial success. Many such lessons can be drawn from cases in which IFC had to undertake workouts, or deal restructuring, for projects that faced significant challenges in the start-up phases. In most cases, this involved delays in reaching financial and operational sustainability. In all cases, IFC portfolio teams, in conjunction with the sponsors and other shareholders, had to provide very proactive supervision and onsite monitoring.

Background

IFC’s microfinance portfolio has been protected from complete failures such as bankruptcy or the collapse of a MFI. Instead, problematic investments have featured significant losses in capital or the inability to reach financial sustainability or break even. Another tendency is for MFIs to experience minimal growth and development. MFIs that have suffered these issues usually face heavy deterioration in capital that jeopardizes financial solvency. When this occurs, management and shareholders must evaluate options to recapitalize, merge, restructure, or sell the MFI in a process called a workout. There are several common overarching themes that emerge from MFIs that have faced a workout as a result of these issues. These themes are helpful to examine as they have also manifested to varying degrees in institutions throughout IFC’s portfolio.

Lessons Learned

Lesson 1: The role of the sponsor is essential in providing leadership and resources.

In microfinance investment projects, the sponsor is a lead investor (whether NGO or corporate owner) in a nascent MFI. The sponsor is often an experienced microfinance operator, bringing a combination of capital, microfinance expertise, and strategies for operational improvement. IFC has participated in several microfinance workouts that illustrate the importance of the NGO or corporate owner’s role in providing leadership and strategic resources to fledgling MFIs. In some cases, the sponsor’s inability to recapitalize
the MFI when times were tough led to insolvency. In other cases, the sponsors failed to provide adequate technical assistance to the MFI, leading to managerial and operational problems.

One microfinance bank found itself undercapitalized as a result of operational challenges and bank regulatory changes. The cohort of social investors that supported this institution was unable to recapitalize the bank when need for a capital injection arose. Another internationally-sponsored microfinance NGO faltered as a result of the sponsor’s inability to provide on-the-ground financial intermediation expertise. A management crisis led to high staff turnover and operational failures such as fraud and high portfolio at risk (PAR). As funders saw this occurring, they pulled commitments, leading to a liquidity crisis.

These examples illustrate how effective strategy and governance are crucial for rapid intervention and infusion of capital when a MFI faces issues. Unfortunately for these MFIs, they were the main sponsor’s first experience in new markets. These were particularly difficult market environments, and the sponsors were unable to play the needed role of a deep-pocketed and technical sponsor. In other cases, financial resources were not the issue, but rather the staff deployed did not have the managerial depth or expertise to deal with a tough new operating environment. For instance, in some cases management selected branch location in areas that had significant security concerns. One clear lesson from this is to work alongside local partners and staff to develop proper knowledge and understanding of the local environment.

IFC’s experiences with greenfield MFIs, new local institutions set up by a regional or international network or holding company who act as the main sponsor, are especially illustrative of the importance of leadership. Generally speaking, a greenfield can be considered a type of franchise, where the holding company can be expected to guide strategy, backstop operations, and provide standards for policies and procedures, among other duties.

However, in some cases this expectation has not been fulfilled. One greenfield in the Latin America and Caribbean (LAC) region, for instance, did not have the strategy and management structure to control growing operations in a very competitive market. Although strategic plans had called for opening only four branches in the first year of operations, instead six were opened, and PAR without write-offs soon reached 25 percent. Weak managers and young, inexperienced staff proved unable to successfully achieve the aggressive growth strategy with a quality loan portfolio.

Other factors that can affect workout situations are “key man risk,” or the effect of losing a focal team member, and weak governance. Both of these factors can also result in ineffective board guidance through crises. In another example, a workout scenario occurred with a MFI with a strong network that had moved into a post-conflict environment and learned the hard way that the transfer of a credit methodology from one country to another is not always a successful strategy.

In this case, the board was comprised of different institutional investors but dominated by the lead foreign sponsor and strategic investor, which had neither the resources nor the ability to facilitate a turnaround. The sponsor was in a foreign market with no ‘on-the-ground’ presence, as well as an insufficient ability to grasp key cultural understandings required to operate...
a credit company in that market. They were unable to offer adequate management support, which led to high turnover, fraud, and other operational issues that could have been avoided by partnering more closely with local experts and implementing stronger credit risk management.

**Lesson 2: Look out for flaws in the business model and technology, as these can lead to significant failure.**

As touched upon above, in some of the projects that IFC has undertaken, our partners have entered new market segments by using the same principles, methodologies, and practices of existing loan products, without any tailoring to the new segment. This pitfall has occurred in particular when MFIs that IFC worked with tried to upscale from micro to MSME or SME lending, or from group to individual lending. For instance, two MFIs in LAC and the Middle East and North Africa (MENA) had been highly successful with their original methodology for the micro sector, but then stumbled when they changed their target clientele.

In the LAC region, the MFI’s leadership was very keen to meet the demand of clients for larger individual loans and so used the same principles to serve larger micro enterprise loans without adequate risk management procedures in place. In a short span of time, the portfolio went from being 100 percent microfinance to 60 percent SME loans. Little attention was given to the fact that the risk profile of a portfolio with larger loan sizes was higher, as each default has a greater impact on the portfolio at risk. This showed a lack of understanding of the different client segments within the market and resulted in an increase in PAR and write-offs, and an eventual need for recapitalization as a result of poor operational performance, which was then compounded by unanticipated contemporaneous regulatory changes.

**Lesson 3: Avoid the peril of uncontrolled growth.**

In some of these cases, the start-up entities that we have worked with did not have a corporate control structure which could effectively curb loan losses. In these situations, there was rapid growth in branch network or loan approvals without appropriate or effective risk assessment, audit, monitoring of loan officers, or internal controls. The management instead focused on growth in portfolio and profitability over short time horizons and sacrificed the quality of their loan book as a result.

This situation is clearly exemplified by the previously mentioned greenfield MFI in LAC, which involved an international sponsor entering a highly developed and competitive microfinance market, with an aggressive growth plan and insufficient human capital to manage this growth. By opening six branches within the first year while relying on a poorly trained loan officer workforce and foreign interns, this MFI ran into inevitable operational issues that could have been avoided by employing qualified managers and properly trained loan officers.

The example of the LAC MFI that aggressively pursued the SME market segment also illustrates the risks of uncontrolled growth in the microfinance industry. Poor credit appraisals and subsequent defaults were the result of the MFI’s rapidly shifting focus to the SME segment while still utilizing microcredit technology and microcredit loan officers. Such cases showed clearly that rapid growth without attention to strong credit and underwriting criteria are not sustainable and can rapidly erode a MFI’s equity.

**Lesson 4: Safeguard against adverse government intervention by engaging proactively.**

In certain cases, government intervention has also led to operational challenges for MFIs. In South Asia, political interference in one rural region where a MFI operated led to fraudulent letters being distributed among clients announcing a loan waiver program. This led to a sudden wave of defaults among customers who believed falsely that they no longer had to repay their loans. Premature or restrictive regulations can stifle innovation, especially in a nascent sector: overly prescriptive conditions on maximum loan size, interest rate restrictions, or subsidized lending programs have also hampered some of our microfinance clients from time to time.

IFC, together with other commercially oriented donors and partners such as Consultative Group to Assist the Poor (CGAP) – a global partnership of 34 leading organizations which are working to improve financial
inclusion, has played an effective lobbying role to share best practices and to prevent market distortions.

**Conclusion**

In most of these cases, IFC responded by working with the main sponsor and other minority shareholders to effect a resolution—whether trying to make the sponsor accountable in terms of providing more resources, or changing management to avoid failure. IFC often deployed in-house technical microfinance experts to conduct on-the-ground assessments in order to fully understand where missteps had taken place, and create action plans to quickly resolve any short-term crises and prevent further spiraling losses on a medium-term basis. Though some of these conversations were difficult, particularly working with network partners in multiple countries, the main lesson was that if the sponsors were unable to play a role in turning around the institutions, it was time to find a new sponsor who could. Ultimately, all was not be lost as with a change in strategy, along with stronger credit procedures, many of these MFIs were able to recover in their local markets.