Failures in Microfinance: lessons learned

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TAKING THE GOOD FROM THE BAD IN MICROFINANCE:
LESSONS LEARNED FROM FAILED EXPERIENCES IN LATIN
AMERICA

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This study was made under contract with Calmeadow. The opinions hereby expressed are only the opinions of its authors.
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Prologue

It is impressive how the microcredit industry has changed since its humble beginnings in Bangladesh and Bolivia just 40 years ago!

The concept of granting loans to low-income people based on no more than a solidarity guarantee has evolved to become a multibillion dollar industry. The sector is now an integral part of the financial system of many countries. It is an industry with multiple players that goes beyond simply providing short-term, small loans (solidarity or individual) for working capital. The sector currently provides lower-income people in the “base of the pyramid” a variety of financial services, including long-term loans for the acquisition of fixed assets and home remodeling, remittances, savings, micro-insurance and electronic banking.

Those of us who have been following the industry’s evolution throughout the years have always been very diligent in promoting and sharing each of the sector’s accomplishments. We have always been ready to announce each new goal reached. We work hard to promote successes, whether it is the launch of a new product or service of another million clients.

However, as may be expected, not everything has always been perfect. Not every story has had a happy ending. Not all microfinance institutions (MFIs) have accomplished the goals proposed. In fact, some enterprises have failed. Since this is the case, we should also be ready to tell the stories where success was not achieved, in order to learn from those mistakes.

As could be expected, during times of crisis, deficiencies become more evident. Quoting Mr. Warren Buffett, “When the tide goes out, we find out who’s been swimming without a bathing suit.” In this context, given the depth of the latest international financial crisis it is not strange that we have recently seen several cases of MFIs that, far from reaching the goals proposed, have instead suffered important shortcomings in their net worth – institutions that, in short, have failed.

Because we learn from our failures, this document has been prepared as part of an effort to acknowledge, analyze, and learn from the mistakes made by MFIs. The goal is to minimize the possibility that the same errors will be repeated in the future. The purpose of this study is not to judge or stigmatize any organization and/or individual; in fact, the names of the different institutions and individuals referred to in the paper have been eliminated precisely to ensure anonymity. Instead, the study intends to reveal past
failures and identify the contributing causes and factors. The paper then derives lessons learned so that, in the future, we may take them into account and avoid making the same mistakes.

In this framework, and true to its mandate of working to strengthen the microfinance industry, the Calmeadow Foundation is proud to have promoted this project.

We are even more proud of having secured the participation of Beatriz Marulanda and her team to research and write this paper. This study was made possible thanks to her diligent efforts and to the financial support of the MIF/IDB, IAMFI, the Deutsche Bank Foundation, and the Center for Financial Inclusion at ACCION International.

Although budgetary constraints limited the scope of this study to failures at Latin American MFIs, we would like to believe that the paper’s conclusions and lessons learned can be applied globally. We expect that complementary studies covering other regions will be undertaken soon.

We thank all those who contributed to making this project a reality and trust that they will continue to work to both strengthen the microcredit industry and expand the breadth and reach of financial services to the base of the pyramid as efficiently as possible.

Alex Silva
Calmeadow, Executive Director
SUMMARY

Successful microfinance institutions (MFIs) have been widely studied to understand the reasons that drove them into the market and to extract good practices that are useful for the rest of the industry. However, the institutions that could be considered failed experiences have received very little attention. A detailed analysis of these experiences constitutes an invaluable source of lessons to continue expanding the breadth of practical knowledge in microfinance.

Based on interviews with experts and their opinion about what could be considered a failed experience, six types of common causes of failure in MFIs have been identified: (i) methodological flaws in credit technology, (ii) systematic fraud, (iii) uncontrolled growth, (iv) loss of focus, (v) design flaws in the conception of the institution itself, and (vi) a suffocating level of government intervention. Many of the institutions that were analyzed faced more than one cause of failure simultaneously, yet each case sought to identify the main cause that led to a poor situation.

Based on a deep analysis of 10 cases that exemplify each one of these causes, valuable and varied lessons have been extracted. The wide range of lessons includes, but is not limited to, the following:

- One recipe does not work for every institution
- Macroeconomic crisis does not necessarily cause bankruptcy
- Factors such as asset composition and integrated risk management strongly affect asset quality of MFIs
- Abundant and easy access to funding may have negative implications
- The role of investors and regulation is critical
- Bad governance and regulation, and exposure to political risks strongly affect the industry

The most important lesson from this study, as obvious as it may seem, is the need to understand that microfinance continues to be a financial business. In short, crises do not cause failures, but rather the way in which crises are handled by an MFI’s Board of Directors and management team ultimately determines whether or not an institution will overcome that challenge.
1 Introduction

In microfinance, best practices often refer to those practices that after a process of trial and error, as in any new industry, prove to be successful. While best practices have been quickly disseminated through the sector, very little attention has been paid to those experiences that did not yield expected results.

Indeed, a rigorous analysis of unsuccessful experiences can provide valuable information that would prevent similar mistakes in the future. While this is very useful in any context, it is even more relevant in an industry characterized by rapid evolution and permanent innovation. Understanding and documenting errors will offer valuable lessons to continue expanding the scope of practical knowledge in microfinance. This end goal was the primary motivation for Calmeeadow to undertake and fund this study, with support from the Multilateral Investment Fund of the IDB (MIF), Deutsche Bank Americas Foundation, International Association of Microfinance Institutions (IAMFI) and the Center for Financial Inclusion at ACCION International.

The study was conducted in two phases. The first phase defined a selection criterion for institutions that would be subject to further analysis. The selection ensured that these entities broadly represented unsuccessful experiences and that useful lessons could be drawn from their analysis. After an investigation of secondary sources, a series of interviews with microfinance experts were conducted to gather opinions on the most prevalent characteristics of a failed MFI and the main causes that led to various institutional failures; furthermore, interviewers sought to identify possible cases for further analysis. These experts are listed in Annex 12, and we are grateful to each of them for sharing their feedback and opinions.

Through this process, a list of 108 institutions in 19 Latin American countries was compiled, as shown in Figure 1.
From this group, and in agreement with Calmeadow, we selected the institutions to be analyzed. Given budgetary and time constraints, as well as the availability of information, we focused our efforts on six countries in the region. Based on the review of secondary sources and general assessments of a large number of the aforementioned institutions, we were able to create a typology which served the basis on which the results of this study are presented. Individual cases of the institutions that were analyzed in detail are presented in annexes 2 to 11. For these cases, we consulted the available secondary information and public financial information, and interviewed a number of the institutions’ shareholders, funders, Board of Directors, and staff. Because several of the cases draw on events from several years ago, it was not possible to obtain interviews with all the stakeholders mentioned.

In this document, the names of institutions, countries and individuals interviewed and/or involved are omitted out of respect for their trust and honesty. Several of these individuals shared their experiences and insights about a situation that represents an extremely difficult time in their careers. To all of them, we express our appreciation for the time and information shared with us.
In particular, we would like to express our gratitude to Alex Silva and Georgina Vasquez of Calmeadow for their comments, ideas, suggestions and support throughout the development of this study.

We hope this report will help to strengthen the microfinance industry in Latin America and beyond by identifying the main weaknesses and mistakes of some institutions and individuals. The lessons to be learned from the analysis of unsuccessful experiences can help pave the way for those who follow.

2 What can be understood by unsuccessful experiences?

An initial review of the industry’s literature suggests that unsuccessful experiences in microfinance have not been discussed or explored in length. The current literature focuses more on documenting the features and characteristics of successful microfinance institutions. The success of most of these institutions is undeniable, to the point that what used to be a handful of institutions now constitutes an entire industry.

While it is true that compiling MFI success stories is of enormous importance to all players in order to generate a method that can be replicated, it is also true that in the process of building this industry, there have been some unsuccessful experiences. Interestingly, although many of these cases applied aspects of good practices, they still ultimately failed despite having reached a considerable size. This demonstrates the importance of understanding the factors that prevented an MFI from succeeding and identifying which poor patterns should be prevented in order to avoid making the same mistakes.

Returning to the characteristics of a successful MFI, we can categorize them according to two groups: scope and penetration of the target market, and good financial results. The first relates specifically to the coverage achieved by an institution in terms of its achievement in the breadth and depth of its services (defined as the number of customers served and the diversity of the financial services offered), and also in terms of its impact in providing access to the poorest sectors of the population. The latter category relates to an institution’s financial sustainability, measured in terms of growth, efficiency, control of default and profitability, etc.

Although the inability to achieve one or more of these objectives could be considered a failure, such a broad definition may give rise to various
interpretations. For example, it can be argued that limited breadth and depth of coverage is not a failure, as this could depend on the target population of an institution, such as indigenous communities or sparsely populated rural areas. Likewise, the inability to provide savings products cannot be regarded as a failure because many microcredit institutions are not authorized to capture public resources.

Instead, it seems that two other scenarios may better reflect the concept of a failed experience: first, the disappearance of an entity due to a significant loss of its capital (equity), in some cases reaching negative equity, or to the inability to achieve financial sustainability; and second, the existence of entities in a "vegetative state" that remain in operation while experiencing minimal growth or development.

The lack of financial sustainability that leads to insolvency and therefore requires the injection of fresh capital is considered a failed experience in any industry, but it is even more critical in financial institutions, especially those that manage public savings. This would also include cases where lack of sustainability leads to the capital restructuring of the entity in order to attract new shareholders, but, if unsuccessful, results in the entity’s closure.

Moreover, the existence of institutions that fail to grow since its inception can also be considered failures since they do not reach sufficient scale to be profitable and self-sustaining, and consequently do not have a major impact on the industry at the country level.

During our interviews with industry experts, the two most commonly identified types of failures are MFIs that go bankrupt and those that exist in a “vegetative state”, seeing no growth in their portfolio size or in the number of clients. The latter situation is common within the region, as evidenced by a significant percentage of nongovernmental organizations (NGOs) serving between 3,000 and 5,000 customers despite being in operation for several years. This makes this problem more of a characteristic of the industry, rather than an anomaly, and goes beyond the framework of this study1. The concern expressed by both the experts interviewed and the authors of this study on this dilemma should encourage managers and funders of such institutions to reflect on the current and future role and purpose of their entities.

1 According to Mix Market, of the 327 microfinance institutions in the region that reported information in 2008, 114 had fewer than 5,000 clients (Mix Market 2009).
Again, because that is beyond the scope of this paper, we will instead concentrate on those cases in which an MFI, or a microcredit program within an institution, suffers serious deterioration in its capital (equity) that jeopardizes its solvency, forcing managers, shareholders or creditors to recapitalize, merge, restructure or close the institution. This definition includes institutions that have suffered economic afflictions of substantial importance (not inherent in the start-up process) that make it necessary for the institution to undergo major restructuring or recapitalization. While in some of these cases, the process of equity restructuring and/or strengthening may have been successful, it was often accompanied by a change in ownership.

Based on this definition of failure, it is necessary then to explore the causes of these failures, since the main objective of this study is to understand their drivers and consequences, and the context in which each of these failures arose. Doing so will allow us to draw lessons which may be useful for future decision-making by MFIs, investors, financiers, regulators and donors.

Before proceeding, it is worth emphasizing that successful microfinance institutions are clearly in the majority, and these failures, despite being more numerous than suspected, remain the exception to the rule.

### 3 Typical Causes of Failures

Financial institutions in all countries have faced different circumstances, external or internal, that have led to periods of crisis which threatened their financial sustainability. Likewise, microfinance institutions across the continent have undergone difficulties, the majority of which have been handled successfully. The institutions addressed by this study also underwent periods of severe crisis caused by external and internal factors, yet for various reasons were unable to solve them.

In order to draw lessons from these case studies, we employed the same methods that have been used in past studies to document best practices in the industry. Using these case studies and supplemental secondary information when available, we categorized the most common causes of deterioration of the capital base (equity) of the entities in question. In fact, a number of these causes were present (in varying degrees) in several of the cases studied, and this combination of factors clearly exacerbated the institutional crisis. Despite this phenomenon, in describing each cause we specifically reference a specific case that best exemplifies the experience
being described. The reader is then referred to the annex, which provides an
in-depth study into the case, including all causes that ultimately contributed
to the failure.

The main causes identified are

- Methodological flaws
- Systematic fraud
- Uncontrolled growth
- Loss of focus
- Design flaws
- State intervention

### 3.1 Methodological flaws

Perhaps the most characteristic and most analyzed element when describing
an MFI is its customer service methodology, which incorporates several
characteristics that can differentiate the institution from other MFIs. Aspects
of this methodology can include a particular design for the credit product
offered (short terms or graduated loan offerings for example); a
decentralized risk assessment methodology carried out by loan officers who
visit the client’s place of business and build the family and business’s cash
flow in order to estimate the ability of the client to pay a loan; and an
incentive system for loan officers, which incorporates a bonus for both the
granting and quality loans. Besides these characteristics, methodologies
have been developed in which the loan is not given individually, but
administered to solidarity groups out of consideration for clients’ socio-
economic profiles, the institution’s risk management, and operational costs.
And beyond solidarity groups, methodologies extend to village banking as
well, and each different lending methodology requires a unique institutional
structure.

The poor or partial implementation of these processes, which this paper has
termed “methodological flaws”, has been one of the factors that have
contributed to the failure of many microfinance initiatives in the region. This
phenomenon comes in many forms, from the non-use of proper methodology
to its partial implementation, through carelessness and neglect of essential
elements of the methodology over time, as well as the use of different
methodologies without considering the type of markets for which they were developed.

The cases that demonstrate a complete absence of specialized microcredit methodology are usually programs developed by traditional financial institutions which seek to expand their business towards other markets, and believe they can do so using mainly traditional consumer credit methodologies. In many of these cases, credit scoring programs developed for the loans aimed at salaried market segments have been used, without making adjustments to recognize the informal and unstable nature of the income-generating activities of micro-entrepreneurs. This mistake is further exacerbated by the bank’s expectation that credit scoring will predict the payment capacity of micro-entrepreneurs, despite the fact that the bank did not appropriately adjust the models to reflect the market demographic. This approach to microenterprise loans has frequently led to a profound and rapid deterioration of the quality of the portfolio of these entities, causing substantial equity losses. Indeed, the gravest mistake in confusing the microenterprise sector with the salaried sector lies precisely in the estimation of payment capacity. In the case of salaried employees estimation is done through labor certification of income, whereas in the case of microenterprises, it is an initial estimate that is confirmed empirically as time passes and the granted loan is or is not repaid².

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² As a tool for risk management, credit scoring can be successful if properly adapted to the microenterprise sector. In this capacity, it has been used very successfully by microfinance institutions in the region to more efficiently select clients, give additional loans to existing clients, as well as improve efficiency in collections practices.
This problem has been particularly evident in the case of commercial banks that make the mistake of underestimating the risk faced in microcredit and believe that their current risk assessment models are sufficient with merely "minor adjustments". When this is done, the level of risk taken on by the banks is so high that they typically conclude that the business is not feasible. Furthermore, when they leave a market, they also leave behind many over-indebted borrowers who now have poor credit reports with credit bureaus. The difficulty in adapting traditional credit scoring methods lies in the fact that micro-entrepreneurs lack payment behavior records; precisely because they operate in the underserved informal sector. Additionally, financial institutions often lack complementary methods to quantify payment capacity based on business information gathered; a potentially invaluable tool when credit scoring methods are adapted to take into consideration payment probabilities based on socio-demographical profile and economic activity.

**WITHOUT TARGET MARKET OR MICROCREDIT TECHNOLOGY... WITHOUT DIRECTION – MFI 2**

MFI 2 began operations in 1996 amid a favorable macroeconomic environment characterized by a positive trend in growth in the country which stimulated a boom in credit, particularly consumer credit. As a result of this credit boom, financial institutions reported attractive profits amongst which microfinance and consumer credit institutions stood out.

The MFI 2 began in February and, even without a clear target market, served more than 28,000 clients in less than three years. From the beginning, the entity directed its efforts both to the salaried segment with consumer credit and the micro-entrepreneurs segment, creating two separate departments to service these two market segments. The consumer credit department achieved exponential growth rates through the use of a credit-scoring system. In the opinion of executives at the time, key aspects that explained the rapid deterioration in the MFI’s portfolio only a couple of years later included (1) the ambitious goals for growth, (2) an incentive system for the sales force that rewarded quantity over quality of the prospects for credit and (3) a poorly-adjusted credit scoring system. In some cases, the absence of appropriate internal controls led to collusion between loan officers and borrowers to create cases of ghost applicants. Furthermore, exorbitant fees charged to delinquent debtors became an incentive not to adopt a culture of zero default, the usual practice in consumer credit. Without necessary care, delinquency can get out of control. Another strategy that accelerated the growth of the consumer department was the granting of loans, with the same credit scoring system, to people who had received a loan from other microfinance institutions. It was assumed that the mere fact of being a client of a microfinance institution reduced the credit risk almost automatically, thus ignoring the importance of an appropriate and correctly applied credit technology.

On the other hand, the microcredit department began offering group and individual loans in addition to a special line of credit with collateral of gold. The microcredit methodologies also had deep flaws, including: (i) there was no rigorous training process for the staff employed; (ii) the calculation of the payment capacity was somewhat subjective since the loan officer assigned a reliability margin to the
Given that some of these failed experiences were housed within commercial banks, the exact level of losses incurred is not often verifiable if not identified specifically in public financial statements. However, losses have led several banks to close their microcredit divisions and withdraw from the sector. Even if losses are not sustained, these commercial banks consistently witness higher default rates than MFIs in the same region. Tolerance for this level of default changes from entity to entity, often depending on the proportion of the portfolio aimed at microcredit and the prevailing market interest rate levels.

Perhaps the best example of indiscriminate use of consumer credit scoring models can be found in Chilean financial institutions that entered new markets in Bolivia and Peru in the mid-1990s. Both of these countries are characterized by a much higher proportion of their population earning informal income. The case of

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3 See in this regard Rhyne, 2001,

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client’s disposable income which could vary between 40% and 90%; (ii) the MIS system did not provide timely or specific information on the portfolio, which prevented monitoring of default rates; (iv) there was no rescheduling policy, which meant that many defaulted loans could be marked as current artificially; and (v) the collection policy established five stages of collection according to the time of default, each with a different responsible party, which not only diluted the degree of accountability of those involved, but encouraged the default to move from one stage to the next. However, the main problem was that many micro-entrepreneurs were served by the consumer department under a mal-adjusted model that did not take into account qualitative aspects of the applicants that are typically fundamental elements of individual micro-lending methodologies such as motivation, diligence, initiative, etc.

The arrival of the economic crisis in 1999 ended the expansive business cycle that had lasted for six years. The credit boom seen in the financial system also came to an end. In fact, one of the consumer financial entities that had penetrated the market aggressively, and as a result boasted more than 80,000 clients after only a few years, began to plummet. Its failure had an unsettling ripple effect and affected other financial institutions due to debt overhang problems in the market. MFI 2 had emulated the growth strategy of this financial entity and thus was one of the most affected institutions. During the second half of 2001, portfolio delinquency reached 35% on more than one occasion and portfolio delinquency minus provisions for bad debts rose above 80%.

Investment losses in the institution also accelerated. In 2001 its ROE was in the negative at -54%. The situation became unsustainable because the entity also favored funding through costly long-term deposits. Although the entity introduced several changes, including the reduction of borrowing rates, the effects were not visible in the short term. The entity was in a deep crisis from which it could not recover. Finally, in 2006 the entity received a capital contribution from a local financial group that decided to restructure the institution and focus fully on the microfinance business using appropriate microcredit technologies.
a finance company in Bolivia has perhaps received the most attention as it is the best illustration of the misuse of credit scoring, not just by inappropriately granting credit for microenterprise clients, but also by over-extending credit to those that already were clients of microfinance entities.

Another case is a Chilean financial group that expanded to Peru, establishing its first financial institution outside the Chilean market. In this financial institution, credit scoring technology was used both to provide consumer credit and microcredit. Through the years, adjustments were made allowing the incorporation of critical behavioral variables in the microenterprise sector, which were accompanied by a visit to the place of business to verify the payment capacity of the micro-entrepreneur. This dynamic credit scoring system, coupled with the broad financial margin in the Peruvian market, allowed the institution to operate for more than 14 years before selling to another financial group. The financial entities created by the Chilean institution in other countries within the region were not successful. In fact, two of them closed and another had to be sold to a competing bank, which then suspended the microcredit program.

The second typical case of methodological flaws arises from problems in the application of the method. Although there was an awareness of the need to use specialized methodology, implementation was piece-meal and applied only to some of its elements. This kind of flaw implies that the system of checks and balances (market incentives and risk control) is weak, typically resulting in significant deterioration of the portfolio.
Partial methodology implementation is typically characterized by only adapting the strategies and mechanisms to search for clients, such as providing bonuses for the placement of credits. Very often these bonuses are NOT accompanied by the corresponding incentives for the control of portfolio quality, and are not accompanied by the design of an appropriate credit product for serving microenterprises. In fact, the sales force searches for clients with incentives for placement but not for recovery in mind, while the product offered lacks key elements designed to control credit risk, e.g. staggered terms and increasing loan amounts based on repayment capacity. However, we recognize that if these risk-mitigating elements are in place, it can make significant portfolio increases difficult, as well as hinder bonus achievement for placement. That is why incentives for loan officers must be balanced carefully.

The above situation worsens when, as has happened in some cases, an institution experiences extremely rapid portfolio growth in a short time. New MFIs sometimes believe that the profitability of past successful

**IS THERE NO SUBSTITUTE FOR EXPERIENCE? - MFI 9**

Even though the directors appointed by the parent bank to manage MFI 9 knew about microcredit methodologies, they believed that the parameterized model with which they had extended credit to small and medium enterprises through the parent bank was suitable for use in their new microenterprise segment. Moreover, the MFI would assume only 20% of the irretrievable portfolio, taking advantage of a government program that offered a portfolio guarantee of 80%. What the parent bank did from very interesting about microfinance methodology was the potential for the sales force presence on the streets, scouring for clients, and encouraged by variable compensation dependent on loan placement.

They decided to create a new subsidiary with its own network of offices, preferring to establish an image independent from the parent bank. Given the interest rate levels, and the low risk assumed under the state guarantee provided, the business was emerging as a very interesting investment. MFI 9 also had the advantage of having unrestricted funding provided by the parent bank. Aggressive growth goals were raised, which they managed to meet. In the first year, they opened 39 offices in 21 cities, and ended with a portfolio of US$30 million serving 15,000 clients. For the second year, it continued with this strategy and increased the number of offices to 80, reaching a portfolio of US$56 million and 29,000 clients.

In the third year with a goal of serving 61,000 micro-entrepreneurs, the loan default problem became unsustainable. Inappropriate incentives for loan officers led to a very fast loan placement dynamic, but the portfolio quality was very poor, and the parametric model they originally deemed useful was not actually used to avoid bad credit risks. The default rate, which in the second year was 9%, reached 20% by the third year. The expected profitability of this business did not come to fruition; although MFI 9 claimed the government guarantee, the government put up all sorts of obstacles to avoid payment upon seeing such poor results.

After just over 4 years, with a default rate of 34% and after the entity had been capitalized for more than US$10 million, the bank decided to shrink the institution and absorbed it into the bank’s operations.
microcredit institutions can be quickly achieved. However, this perspective ignores the fact that the profitability levels achieved by successful microcredit institutions are the results of many years of work and patient development of a methodology carefully created to fit the characteristics of the target market. The desire to achieve rapid growth and profitability in the short term often leads to a relaxation of discipline and control over the sales force. As a result, it becomes increasingly difficult to maintain high standards as the volume of operations increases.

There were other cases in which methodological flaws were evident due to the search for new markets using the same principles, the same methodology and even using the same loan officers who had been trained to serve the microenterprise segment, without making the necessary adjustments in terms of the new risks involved. We pinpointed entities that did not make significant changes to distinguish different microcredit technologies, such as individual, joint and communal lending. Differences manifest themselves in various aspects such as different loan officer profiles, credit type, and recovery processes. It is necessary above all that entities that begin to venture into microcredit make a careful evaluation of the profile of the market in which they wish to operate and, based on this market, implement the most appropriate methodology.

### 3.2 Systematic fraud

Fraud at different institutional levels is another feature that has characterized many cases of failure in microfinance, to the point that the number of cases that fall into this category surprises.

The in-depth study of each case showed how fraud in the microcredit industry basically occurs on two levels and in different ways. The two levels differ by the position of the officials who commit them: fraud committed at the management level (which, in the cases studied, resulted in more serious harm), and fraud committed at the level of the sales force, typically loan officers.

At a management level, there were different forms of abuse by senior officials of the entities who abused the power granted to them as senior members of the institution and used the MFI for their own benefit through several mechanisms.
There were cases in which loans were granted to persons related to the president, CEO or general manager of the institution, in amounts and conditions that consumed the assets of the entity. This type of fraud is very well described in a book documenting cases of microfinance institutions\(^4\) that when faced with insolvency end up owing funds to or being owned by a second tier entity in the microfinance sector in the Colombian market. In the book’s case study, the management of an NGO granted loans to political supporters of his brother-in-law. Not only were these loans not disclosed in the accounts, but when they were not recovered they seriously affected the liquidity of the institution and led to its dissolution. This case was tried before the courts, and the manager was convicted and imprisoned. This case is just one of the four described in this publication.

Among the cases analyzed in greater depth, MFI 3 illustrates the traumatic experience inflicted by senior officials of the entity, not only by betraying the trust of their Board members, but also of the church that sponsored the institution. These managers allegedly appropriated resources equating almost all of the institution’s equity. This, along with other reasons, led to the delivery of assets and liabilities of the entity to another NGO in the country; it was basically the only alternative to save the operation. See Box and Annex 3.

\(^4\) See Barrera and Matiz, 2004
In several cases, managers’ greed and self-interest, combined with inadequate controls, contributed to embezzlement via contracts with entities or persons related to the directors or general manager, and/or overpayments for services rendered by companies owned by family members. In several cases, the abuse of power was discovered only when the entity faced a crisis, usually a decline in portfolio quality, and was not preemptively detected by the external directors, auditors, or by rating agencies. Detection was particularly unlikely when the entity was making profits that left all parties involved satisfied. In reality fraudulent contracts demonstrate complacency among boards of directors close to the CEOs or managers of MFIs, or lack of control around issues of fraud. See Annex 8 and Box 8.

In some cases, self-loans and loans to related parties was used in order to finance companies within the manager’s family and even led to the creation of shell companies to avoid risk exposure limits to a single person – a regulatory requirement for commercial entities. In fact, these regulations were issued in most countries after several crises were caused by fraud. We know, for example, of cases in which loans were issued to parties related to Mexican credit unions in the 1980s. These and

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5 This behavior has also been documented in the case of MFIs in other continents. See Rozas, 2010.
other similar experiences promoted the ownership of financial institutions by businessmen of any sector (although especially the agricultural sector), creating the phenomenon of weak corporate governance that has been much studied in the case of savings and loans associations. (See Annex 4 and Box).

Another fraudulent practice discovered was loans granted to persons connected to local directors and shareholders in order to provide resources for the purchase of shares of the same entity; thus generating a fictitious strengthening in equity with the same resources going back and forth in the balance sheets. This case occurred in MFIs that, due to rapid growth, required equity increases in order to maintain adequate solvency levels. The shareholders then resorted to this fraudulent mechanism so they would not have to face share dilution due to lack of capital. Such practices occur when there is a requirement for a large capital increase, in order to maintain a strong growth strategy, with no real ability among existing shareholders to meet the capital requirements of the MFI.

In many cases, different fraudulent strategies were utilized to hide the poor economic reality of the entity, often through the manipulation of financial statements. Some of these strategies were related to the activation of excessive expenditure on

**TAKING OVER A CORPORATION - MFI 4**

MFI 4 was created in 1994 in a small municipality, with the purpose of providing agricultural loans, especially to the rice sector. Initially it focused on the agricultural sector and then ventured into the consumer credit market. The entity was conceived in 1993 within the context of a group of institutions that had similar origins and purposes to respond to the need for funding in rural areas of the country. The need arose when a state-owned bank that served these sectors closed and left a void in 1992. It was created as a privately-owned financial company authorized to receive public resources, subject to specialized supervision by the state.

The original legislation defined a dispersed equity structure for these institutions to ensure shareholder democracy, but in reality a single family was the majority shareholder through various strategies, such as the consolidation of small shareholders’ participation. It was initially established with 3,000 shareholders who eventually sold their share in the secondary market and the property remained in the hands of a single family group. This created major governance problems that led to fraud and mismanagement that eventually led to MFI 4’s demise. The participation of unskilled shareholders with small equity contributions and the expectation of obtaining a loan created perverse incentives for decision-making for personal benefit vs. the benefit of the financial entity, given the confusion between the role of shareholder and borrower.

The problems of governance, that arose from having equity controlled by net debtors, led to inadequate portfolio review and inappropriate loan granting to parties related to shareholders. There were cases of loans supported by guarantees for amounts well above their real value, which financially harmed the financial situation of the entity when the superintendent demanded authentic financial statements. Moreover, several of those interviewed said that the management team purposely delayed the disclosure of overdue accounts, by granting loans with a single payment at maturity which was refinanced just before expiration or granting another loan to pay the first before its maturity.

The crisis was evident in the balance sheet of MFI 4 when the Superintendent made an inspection visit and found mismanagement, particularly in relation to the portfolio of related party loans. At that time, the very weak governance and the majority shareholder family’s abuse of power was revealed. Thus, it was discovered that the companies and individuals related to the governing family not only obtained
deferred assets, along with the existence of parallel accounting for higher value loans which were precisely those that were directed to related parties and were of poor quality. An additional fraudulent strategy granted long term loans with a single payment at maturity, which delayed the disclosure of overdue accounts until the last minute. At that precise moment, new credit was granted to pay the former, with similar term conditions so that the default was never evident on financial statements. It should be noted that these strategies are so sophisticated that they even confused the supervisory and rating agencies for some time.

The second level of fraud occurred mainly at the level of loan officers. The lack of appropriate control mechanisms and structures favored this kind of phenomenon. Indeed, in many cases we saw that fraud at this level led to the creation of fictitious loans, especially in cases where there were incentives for placing and not for recovering loans. But even with incentives for recovery, there were still cases where the consultants generated many fictitious loans, earned the bonus and quickly left the institution before the default was noticed. This practice was evident in the cases of MFIs 5, 9 and 10.

Another fraudulent method at the sales force level entails the practice of sharing with the clients the placement bonus, with the commitment to bring new clients regardless of their ability to pay. Finally, there were also cases found where there was clear collusion between the customers and loan officers to share the loan with the intention to never repay. At one MFI, all the employees a branch office joined together in such a ploy.

In the cases analyzed, fraud at the loan officer level was not really the factor that led to substantial economic losses, but rather was the result of a lack of control in the loan placement process, resulting in a deterioration of the institutional culture related to delinquency control. This type of fraud, although it is presented as a derivate of a crisis caused by other factors, undermined the ethics of the institution in general.
Fraud in financial institutions in general has been widely documented by several scholars focused on financial institutions facing economic breakdowns\textsuperscript{6}. The manner in which fraud occurred at microfinance institutions analyzed, however, is particularly painful. Firstly, it is difficult to swallow given the fact that it occurred in institutions that, in most cases, had a social orientation and advocated their altruistic purposes. Secondly, many of these cases had received equity capital that was either donated or granted on preferential terms precisely because of the MFI’s unique goals and vocation.

The fact that fraudulent activity occurred almost identically among the cases we studied illustrates an element to which we will address later; microfinance institutions should be understood as financial institutions, since they behave as such regardless of whether they are regulated and therefore are subject to the same risks, temptations and mismanagements that have characterized the bankruptcy of other types of financial institutions. Because of their relatively small size within financial markets they have not yet represented a systemic risk, but in the cases analyzed, they have demonstrated a substantial loss of equity and inability to pay debts.

3.3 Uncontrolled growth

Uncontrolled growth was another feature shared by several cases of MFI failures. Specifically, entities that experienced rapid growth and later entered a crisis had often relaxed their systems of controls for the sake of achieving rapid growth in the short term; and, in some cases, the strong portfolio strategy itself overwhelmed the institutions.

Undoubtedly, an important feature of some microfinance institutions born in the 1990s has been portfolio growth rates that outpace the financial system of their respect countries of operation. Today these MFIs are considered leaders. Why, then, did accelerated growth arguably lead to institutional failure for some of the cases studied?

\textsuperscript{6} See for example Rojas Liliana, 1997, or de Juan, Aristobulo, World Bank.
A common feature of several of the entities studied is that they were recently created. In order to achieve growth, they did not increase productivity of loan officers or improve their operational efficiency, but rather, hired a large number of loan officers from the start and expanded their branch network before achieving individual profitability at established branches. The belief was that penetrating several markets at once would give them an advantage over other competitors in the market (MFI 1, 9 and 10). In cases with entities with a large number of loan officers at the time of start-up, the experience of loan officers was limited and incentives preferred growth indicators over portfolio quality. On the other hand, when the branch network was rapidly expanded simply to pursue geographical dispersion, control was not exercised with the diligent care. Additionally, the start-up entities did not build a corporate control culture that characterized development institutions in the early days; institutions that have now matured and grow on solid foundations. In these cases, we observed the absence of the necessary controls to ensure credit risk assessment, a solid methodological audit, the monitoring of loan officer performance, the lack of internal controls, and the absence of a technological platform with adequate management information systems (MIS). In short, growth was obtained before achieving the correct adoption of microcredit methodology.

MICROCREDIT TECHNOLOGY IS NOT THE ONLY THING NEEDED - MFI 10

MFI 10 was created as a for-profit institution as a subsidiary of a holding company. A technical assistance firm with extensive experience in the field of microfinance and various multilateral institutions invested in MFI 10 as well as shareholders. Sponsors of MFI 10 were very optimistic about the potential of the institution given the market potential and the conditions in the region.

Confident, they opened 6 branches in 4 cities, hired 140 people, and accumulated a portfolio of US$1 million, serving 3,000 micro-entrepreneurs in their first year. In the next two years, due to concern regarding a 11% default rate, they slowed physical expansion with only 11 branches by the end of the second year. However, MFI 10’s portfolio did increase by 77% in the second year and 62% in the third. By the end of the third year they had 7,900 clients. Portfolio quality was achieved in part by rapid expansion and through write-offs, so that in December 2008, the delinquency indicator dropped to 7.8% for PAR >30 days. In the fourth year, it was decided that the institution was ready to grow and potentially reach the break-even point that initial projections had expected would be reached a year and a half after starting operations. For this purpose, the first local director of the MFI was hired, who proposed changing from individual credit methodology to group credit in order to expand rapidly. The institution adopted these changes in less than three months, and according to those interviewed, without enough time for it to be assimilated by the staff (who had turnover rates of over 80% for two consecutive years) or for the implementation of support business processes required by this new methodology. In the first three quarters of that year the entity increased the portfolio by 84% in value and increased the number of clients served by over 14,000, but also drove the PAR > 30 days rate to 10.4%, even exceeding 18% for more than one day at the end of that quarter. Unfortunately, the institution failed to recover from this; delinquency continued to grow and the institution was forced to suspend disbursements. At the end of the year, PAR > 30 exceeded 20%. The shareholders decided to sell rather than add more capital.
Another phenomenon seen in many of these cases was the use of a relatively unknowledgeable team of loan officers to achieve growth. This staff was mainly poached from competitor MFIs. The staff tended to be experienced in traditional financial services, but lacked true microfinance knowledge, and the ethics and institutional commitment required by any financial business, but especially microfinance. Loan officer training is particularly necessary in microcredit given its dependence the loan officer’s ability to assess capacity and willingness to pay when approving credit.

The desire to achieve outstanding growth in the portfolio and great profitability in very short periods resulted in various entities sacrificing some of the most important basic methodological principles of proper implementation of best practices in microfinance. Thus, adopting the extension of the terms, new credits are disbursed before the end of the first payment, the recurrence of installments is modified and the values and amounts of credits are extended, without appropriate adjustments to the risk assessment model and without consideration of additional guarantees that would be needed in order to venture into new business lines or new market segments. (See Annex 7, and Box). Not only are such practices common, but when appearing in

BIG IS NOT BEAUTIFUL – MFI 7

MFI 7 had transformed into a financial institution in 2002 and subsequently into a bank in 2008, maintaining its objective of financing micro and small companies in the country. Throughout the transitions, the MFI maintained the same managing director; a very charismatic and dynamic person who emerged as CEO and Chairman of the Board. Throughout the process, he had demonstrated his commitment to the institution by buying shares until he achieved a majority stake as an individual shareholder. He made clear his wish to turn MFI 7 into the largest entity in the country, and effectively adopted an accelerated growth strategy. His achievements were so impressive that at the time that the institution decided to become a regulated entity, several international funds, public international financial institutions, and MLT 1 provided capital. Institutional confidence was further strengthened when it became a bank. Both the shareholders and the funders expressed their confidence in the CEO and provided the resources for the institution to grow rapidly; this came to fruition when its portfolio grew by 340% between 2003 and 2007, boasting the largest growth in the country during that period, and reaching a portfolio value of US$ 125 million.

Resources to leverage this growth, was evident in the increase in the debt to equity ratio (which changed from 4.7 to 9.9 in the same period), and came mainly from international funders, despite the MFIs ability to mobilize public savings. Growth averaged at 55% annually and even reached 75% in one year. However, problems in performance began appearing. Indeed, even if the institution had shown excellent indicators, it had focused a large portion of resources in the livestock sector, in larger loans with increasingly longer terms, and had even contracted loans with a single payment at the end the period.

The rapid growth, accompanied by political and macroeconomic problems that affected all MFIs in the country, revealed the weaknesses of this MFI causing it to lose US$ 15 million in the first year of the crisis. One year later, the supervisory body ordered that it increase its capital by US$34 million.
competitive contexts, it increases the probability of over-indebtedness in the market, which analysts suggest also affected the performance of MFI 7.

In all these cases, it would not have been possible for institutions to grow at such a rapid pace if they had not counted on the availability of a large amount of resources to finance the portfolio. This applies to regulated institutions, who resorted to investor funding – even if they could mobilize savings – particularly international financing. In this regard, a great similarity among financial institutions is seen again; in taking advantage of liquidity conditions in the markets, institutions grow their portfolio at a rapid pace, only to ultimately conclude that they were not able to control the risk during the process and indeed achieved growth only by sacrificing assessment parameters.

### 3.4 Loss of focus

Some microfinance institutions have met their downfall when trying to meet all the needs of micro-entrepreneurs and their families, without having strengthened the basic business of microcredit. In the process, not only do they divert the attention of the Board on several fronts, but they commit substantial resources to projects that have no proven profitability or that generate losses that use up equity resources needed to strengthen the basic business of microcredit. Several of these collateral businesses also imply the freezing of assets that should be financed with equity only, but, because of this is the scarcest resource, are financed with credits or public deposits, thereby deteriorating both profitability and liquidity.

A particular MFI that faced a severe crisis in the early 1990s is a prime example of this type of failure. It was a regulated financial institution that had been the product of an NGO considered a leader at the time in the region⁷. As with all cases under analysis, the MFI suffered a series of circumstances that ultimately led to severe equity deterioration in the middle of the decade and that could only be saved through the capitalization of the debts of its largest funder at the time, a second-tier public bank in the country where it operated. The group which had been formed around the

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⁷ This case is interesting not only for the facts that arise, but the work of the Network to which it belonged. The Network led the rescue of the MFI; it also continued to support it in its new form and with new owners and tried to draw lessons from this case, which it promoted through various of studies. See in this regard HBS (1998), Lee, P.(2001), Steege, J. (1998).
original business of microcredit could not be saved. The NGO that gave rise to this MFI, which, as in several other cases discussed in this paper, had a very charismatic and enterprising CEO. After the success achieved in the second half of the 1980s, he directed the NGO to "meet the comprehensive needs of micro-entrepreneurs". This well-intentioned philosophy led to the incorporation of a wholesale market for storekeepers and a distribution company of building materials to facilitate better quality housing for micro-entrepreneurs and their families; strengthened the training offerings of the NGO; undertook rural and agricultural loans, in addition to housing loans; and acquired a financial company to which to transfer its existing microcredit portfolio. This corporate group had a sun as its symbol, with its rays symbolizing the subsidiaries that had been created. It had as equity the initial contributions from local businessmen who were very enthused with the idea of microcredit; this was further increased by the retained earnings of the financial business and by international donations, which came up quite generously thanks to the persuasive skills of the CEO.

This case best illustrates how an entity or corporate group can lose focus and embark on businesses that exceed its business and equity capacity, to the point that it leads to failure of the institution. Not surprisingly, due to this lack of focus, having frozen a large part of the Group's assets in fixed assets of all the various business without being able to consolidate the profitability of the other subsidiaries, when encountering the first difficulties in the financial business, the response capability was limited. Moreover, to save time, a series of unethical practices began, all of which ended in bankruptcy for the entire group in the mid-1990s.
The case of MFI 6 bears a striking resemblance, despite having a fairly different evolution. It is an institution that was born as a regulated financial company and took advantage of an opportunity provided by the monitoring body to become a bank without fully complying with the minimum capital requirement. Despite this, because it was a new institution, it was unable to leverage this capital efficiently with only its microcredit portfolio. Thus, management decided to enter the market of financing larger companies such as small and medium enterprises. Over the years, under the leadership of its CEO and Chairman of the Board who has been described as a visionary motivate to provide an integrated solution for microenterprise needs, the institution not only began granting long term credit, but, under the CEO’s instruction, the bank and other subsidiaries entered the real estate business. These facts were crucial in explaining the equity deterioration that was hidden until the last moment. This institution received a capitalization order from the Superintendence of Banks and had to seek new partners who had the capacity to replenish lost capital. See Annex 6 and Box 6.

The loss of focus also occurs when a microfinance institution enters

DO NOT BITE OFF MORE THAN YOU CAN CHEW - MFI 6.
MFI 6 was created as a regulated financial institution and turned into one of the pioneers in microfinance not only in its country but also in the entire region. Unlike many other MFIs that received portfolios from their founding NGOs (which immediately provided the necessary capital to turn into a regulated institution), MFI 6 had to generate its own portfolio. The elevated minimum capital required and the institution’s facilities to gain access to financing represented motivation for quick growth. However, the urgency to grow could not be channeled towards the MFI’s mission to serve micro entrepreneurs, because the operational difficulty meant expanding that portfolio quickly. The pressure to grow was channeled towards a commercial portfolio, which, after the first two years of activities represented 80% of the total portfolio, while the microcredit portfolio only represented 20%.

Despite the slow startup of the microcredit portfolio during the first few years, it showed a quick growth later, reaching 45% of the total portfolio within the first seven years of operations, and after ten years, 70%. From startup, MFI 6 implemented several credit products aimed towards its target group, among them, individual and solidarity microcredit groups, credit with jewelry guarantees, credit for migrants, credit for social housing, credit for transportation and for small businesses. At the same time, the entity designed products that were not focused on the main activity of the business, including trusts, credit for builders, credits for medium businesses, and consumer credit, among others.

The microcredit methodology used by MFI 6 was individual credit in urban areas as well as rural areas, and also solidarity groups. From the experience gained in the first years, plus the technical assistance received from international sources, and because it had been one of the first institutions to venture into the microcredit market segment, the traditional microcredit portfolio (individual and solidarity microcredit groups) grew while controlling default levels, allowing for the generation of important profits. However, many of the other products directed towards the target group had not been designed, tested or implemented in a careful way, and began generating significant losses for the institution.

Behind the impetus for growth and the desire for recognition were a very ambitious group of shareholders and a visionary leader, who aside from working as the President was the Chairman with political aspirations. The initial results that the institution had achieved, especially in terms of growth and positioning, allowed the leader to consolidate himself even more within the institution, opening a greater opportunity for the institution to continue venturing into a diverse range of activities, from businesses to develop banking software, real estate
the service of other business or population segments without making the necessary adjustments in its risk assessment model. Attempts to penetrate different credit markets without adapting products or methodologies for credit risk management can offer additional growth opportunities without much increase in back-end costs, because institutions typically enter larger business segments, and even other economic sectors, such as agriculture. It involves credits of higher value and longer term, which generate lower portfolio turnover and generally require fewer provisions because they can be supported by tangible collateral. Obviously the risk diversification when penetrating other sectors or segments of the market is not necessarily bad, as long as an adequate system for assessing payment capacity is developed, in this case from productive projects presented for consideration. However, this methodology is very different from that of microcredit and requires a microfinance institution to make just as many adjustments as a bank specializing in SME has to make when providing service to microenterprises.

Another phenomenon observed is the development of too many different products that cater to the same market, without necessarily carrying out the diagnostic studies required, or developing a business model with projections that could provide information about the financial strength of the product. Among these products, an attempt to develop a long-term mortgage credit line for real estate has proven to be one of the most difficult to develop for micro-entrepreneurs because of the challenge of estimating the stability of the long term cash generation for a micro-entrepreneur. Even when this product has a guarantee for the mortgage, the reality of the legal systems in Latin America has taught us that the period to recover a house can take several months, and even the breeding of Alpacas to sell their wool.

To operate the businesses of MFI 6, a group of companies was formed, from which some companies were full subsidiaries of the group and others had less visible relationships. The financial crisis that the country went through 5 years after the MFI was in operation exacerbated the already-difficult situation facing many of its businesses, causing a series of financial maneuvers to be carried out to elude impending disaster.

Following the crisis, MFI 6 was fragile but had survived, largely because of income from the microcredit business, which had demonstrated itself to be more resistant than other products during crises. However, MFI 6 resorted to a series of gimmicks to show a favorable financial situation, reducing transparency of the financial statements through the overvaluation of assets from the constitution of trusts, the activation of expenses, the payment of commissions for services allegedly provided by subsidiary companies. At the same time, credit to related parties started to proliferate. In addition, administrative expenses continued to rise.

The Superintendent of Banks, which until then had not exercised rigorous control, demanded that MFI 6 dismantle its real estate business, which was expressly forbidden by regulation. In addition to this decree, MFI 6 was ordered to constitute reserves for overvalued assets (portfolio and investments). Despite the fact that foreign investors were capable of injecting new capital, it was decided that the institution would be sold to a bank because the shareholders’ trust had eroded. The sale was carried out in 2006 and few months later, the person who had been the chairman quit, arguing that he desired to participate more actively in politics.
years and the probability can be low; hence, determining risk, interest rates, and tenor make this product’s design and implementation very complicated.

**3.5 Design Flaws**

During the in-depth analysis of the specific cases, the lack of a precise understanding of the market that would maximize the true potential of a start-up microfinance entity was identified as a frequent and clear cause of some of the failed experiences. In fact, in several of the cases of failed experiences, we found that some of the microcredit entities started their operations by applying microcredit best practices from other countries only to find out that they were not relevant to the market at-hand, or even that the target market simply did not exist.

This problem was detected in two very different circumstances. On the one hand, there is countless evidence in several countries where it has not been possible for a successful microcredit entity to be developed. This has to do with the regional average profit level of the families and with the degree of informality present. Broad segments of informal and small companies do not exist in all countries in Latin America. Therefore, despite having counted on the presence of the informal sector, in many cases, microcredit initiatives have failed because they could not be developed at a significant scale. The most evident case is Costa Rica, but it can be extrapolated to several Caribbean countries.

On the other hand, there are markets where there is an important microenterprise sector to cater to, but in this case, the downfall lies in failing to identify that other market operators, financial entities or other types of offerings are already solving the needs of micro-entrepreneurs; while this did not occur in the nineties, it is increasingly common today. The development of consumer credit has permeated several levels of the population in the majority of Latin American countries, be it via offers from financial institutions or retail chains. A credit card allows a client the advantage of uses on multiple things, from purchasing television sets for the home to inventory purchases for the store. Even if the card was issued to a son with a paying job, other family members often use the card, whether it be for their personal purchases or for goods that benefit the entire family. Other credit sources can even cover cases that are much closer, such as pawnshops that exist to a greater or lesser degree in several of countries within Latin America; in the case of MFI 9, pawnshops made the market penetration
difficult in the capital city and led to the opening of other offices in more rural areas.

This blindness regarding the differences that exist in the markets, where sometimes you innocently think that micro-entrepreneurs only resort to credits granted by microfinance institutions, does not lead to the bankruptcy of an institution but can cause dangerous consequences. On the one hand, at the time of creation of a new entity, it can ruin budget projections, preventing the achievement of covering its costs in the stipulated time or forcing an increase in capital in order to reach the proposed goals. In the case of institutions created with business purposes, which seek to give returns to its shareholders, this can lead to the temptation to sacrifice discipline in the implementation of microcredit principles in order to grow portfolios and break even more rapidly. This, for example, was what happened in the case of MFI 10.

The other consequence of acting blindly in a competitive market is the over indebtedness of clients and the consequent accelerated deterioration of the portfolio. This can occur for a number of reasons, including a lack of information-sharing. In many countries, the risk assessment/credit bureaus do not receive reports from non-financial entities, or data is not shared between the financial and the non-financial sectors. At the same time, irresponsible operators may dedicate themselves to buying portfolios of other institutions, extending deadlines and increasing loan amounts. If this is not corrected in time, it could cause the failure of the institution, or of several institutions in the same market.

Another of the design mistakes identified through our cases pertains to the determination of the most adequate institutional way to develop microcredit activities. In fact, some cases were found in which the problems did not arise from the lack of a target market, but rather from the initial institutional design with which the entity was created. This is the case of MFI 1, which was inspired by the franchise models employed by the mainstream commercial sector; it adapted the idea to a financial institution, so that the franchises corresponded to subsidiaries and the parent was the main branch. In this case, the employees and managers of the subsidiaries were something like the owners of the franchise and in this way, they shared the property, and in theory, the risk. This scheme was created by its manager,

8 See CGAP, Focus Note 61, Feb. 2010 and Burki, 2009.
who had ample experience in the microfinance sector and was supported not only by the managers, who were former employees of the most prestigious microfinance institutions in the country, but also by international funds. All of these stakeholders failed in the conception of the entity itself, whose franchise structure made it almost impossible to control.

In the other two cases, it seems that there was not much reflection on the institutional scheme within which a commercial bank would develop its venture into the microcredit sector. In cases MFI 5 and MFI 9, despite the adoption of a subsidiary scheme that has been effectively and successfully implemented by many commercial banks in the region, the entities’ “automatic” implementation culminated in the lack of strict control schemes, adequate incentives, and corporate governance.

3.6 State Intervention

State intervention to promote the development of microcredit and/or regulate financial activities is another of the identified factors that contributed to failed experiences in the region. In some countries, the need to promote access to credit for informal and micro-entrepreneurship sectors of the economy has led to the government making decisions regarding industry promotion that in the medium or long-term do not ensure the sustainability of the intervention.
This type of failure includes entities in which governments are shareholders, creating public development banks specialized in micro-entrepreneurship financing. This type of intervention was very common before the 1990s, with institutions typically created to grant credit to the agricultural and livestock sectors, or to offer credit with deadline conditions and preferential rates to finance “projects”. These entities seemed to have disappeared in the majority of the countries because of bad experiences stemming from the political intervention that they were subject to, and which also led to inadequate loan assessments due to political interests.

However, in recent years, linked to the successes of microfinance institutions, and to the discourse that highlights the potential that microcredit holds to reduce poverty, an increasing interest has resurfaced among governments for more direct action regarding the industry. As a result, many initiatives have been developed along these lines; this is a bit surprising because, given the considerable resources being committed, governments probably could be more effective if focused on education and health, for example.

The state’s participation through its own microfinance entities has had direct and indirect consequences. Often, loans at these types of institution tend be provided without a correct analysis of either risk or political criteria, which results in a high default level, portfolio losses, and ultimately the need to recapitalize to prevent the institution’s closure. A second common characteristic of such institutions is access to preferential pricing that does not reflect market realities; often, the true risk profile of the market is not taken into account, nor the appropriate expenses or actions needed to mitigate against these risks. Thus, loans are often granted at below-market rates, in installments and in amounts that are not consistent with the characteristics and payment capacity of the informal micro-entrepreneurship sector. In the box below, we see our most extreme example of unsustainability; the institution’s inability to recover even its operating costs not only required an annual tax to cover these expenses, but also severely limited the MFI’s reach; at its largest, the institution could only disburse 9,000 loans.
History repeats itself

Bank A was created at the end of 1999, with the purpose of promoting microfinance in the country. It was initially incorporated as a bank, and as such, it operated under the supervision of the regulatory entity that oversaw all the banks in the country. However, after five years, the bank decided to create a separate entity that would be under the supervision of the Ministry responsible for popular economy. In these first few years, the bank had 5 presidents; it was not until 2006, that its direction was stabilized in the hands of the same person.

Since the bank had the authority to offer credit at subsidized rates, its sustainability was not possible; as a result, each year, it receives budget transfers that covered the personnel and operational expenses that it could cover on its own. This is notable since the institution did not have a start-up cost, since its launch was financed with a non-cost government credit. In 2008, it received US$ 50 million for its current total capital of US$85 million. The Government is estimated to have committed $120 million to the Bank between the resources transferred at year end, taxes benefits, etc.

The bank’s portfolio has been quite volatile (see graph below), having disbursed approximately 47,000 loans over 10 years, with 30% (in number) and 42% (in sum) were distributed between 2008 and 2009. These were prominent election years (electoral processes are marked with an orange line in the graph).

As a result of the concentration of these disbursements, the portfolio saw accentuated growth from US$ 23 million in 2006 to US$ 162 million in June of 2010. Actually, the growth occurred over one single semester, the second half of 2008, when the portfolio grew from US$ 51 million to US$ 136 million.

Like the majority of financial institutions in the region, the bank demonstrates bad portfolio quality. In the first few years of operations, it was not able to control delinquency rates, which exceeded 40%. Although in the years after 2006, the Bank seemed to demonstrate a decrease, this is actually a product of portfolio growth and the massive refinancing granted in 2008. At the time, the bank was actually experiencing rapid deterioration in the quality of its portfolio, reaching levels it had in the beginning of the decade. This explains the abrupt decline in the number of loans in the first semester of this year. If the Government wishes to bring this institution back from the brink, it will have to commit additional tax resources to increase its equity stakes. And history repeats itself yet again...
These types of institutions can play havoc in the markets on a number of levels. Repayment discipline lessens since the loans technically come from public resources; clients may also take refinancing for granted, driving down their incentive to repay their loans in a timely fashion. At the same time, these institutions can crowd out competitors’ financial services, making privately-run MFIs unsustainable given the availability of a government-subsidized microloan that is offered at a lesser price to those with a more risky credit profile. The worst effect, however, is the creation of an unstable situation. The ultimate effect of these types of institutions is to delay the development of private entities and, in doing so, prevent the population’s access to broader, safer, and more dependable financial services that can help micro-entrepreneurs grow their businesses.

The state has also intervened on an indirect level, still contributing to MFI failures. Often, this comes in the form of overly-abundant, frequently-discounted government funding for MFIs. In some cases, this funding is meant to address specific deficiencies in a country’s financial markets; in others, the supply of funds can be motivated by the public bank’s need to supply credit to promote its own profitability and sustainability in the long-term. This situation can lead many entities to anchor microfinance entities excessively, regardless of the credit risk control. It is necessary to point out that this phenomenon did not appear only in the case of public banking; rather, it was also present in the case of international funders, who relaxed their analysis and control of the credit risk in order to supply resources to microcredit entities.

The second case of indirect government intervention relates to the decision to promote microenterprise through the supply of public guarantees, understanding that the lack of guarantees can cause a rationing of credit. This policy actually serves as a disincentive to assess adequately and precisely clients’ credit risk, develop a specialized credit methodology, and elevate the moral risk commonly associated with loans funded by public resources. This means that the entities that grant the credit relax their controls, and the payment discipline is lost on the part of the clients when they consider that the state is the one obligated to pay. Evidently, the guarantee level plays a crucial role in the moral credit risk produced. The weak credit management processes stimulated by these types of initiatives can lead to serious consequences for the viability of the business, and in the case of MFI 9, illustrates the harmful effects produced by public guarantees.
Other types of state interventions, whether interest rate caps or an inadequate regulatory framework for microfinance, foster an unfavorable environment for the development of MFIs and prevent the creation and sustainability of financial entities dedicated to microcredit. However, in none of our cases was this type of intervention considered the primary cause for failure.

4 Lessons Learned

When analyzing institutions that faced equity losses that ultimately led to their closure, restructuring, or changes in the ownership structure, we conclude that several of the causes that led to bankruptcy arose from the failure to implement best practices for microcredit methodology. However, even more importantly, these failures arose from two drivers that have been highlighted for many years in literature that analyzes traditional financial institutions: poor risk management and weak governance.

This causes us to reflect not only on how to manage credit risk – a major focus within microfinance already – but, perhaps more importantly, to recognize that MFIs, both regulated or unregulated, face the same risks that any other financial intermediaries encounter; this fact supports and justifies third party regulation and supervision of MFIs, particularly if these entities are administering third-party resources, from savings deposits to large loans from funders.

Please note that does not take NGOs off the hook, merely because they may not be regulated or are unable to mobilize deposits. Rather, this means that the institutions’ funders should be particularly watchful of these entities given the lack of public supervision and must implement measures to ensure that these institutions have implemented adequate controls and policies to mitigate risks.

With the above as a general framework, the facts that stand out from the analysis conducted are described below.

4.1 One size does not fit all

Many mistakes have been made when trying to replicate successful experiences without adjusting practices to take into account the specific characteristics of each case. These errors include
• Believing that ALL markets and countries MUST have specialized microfinance institutions.

It may have been true 20 years ago, but today, in markets with developed financial systems and with a high penetration of commercial banks and/or consumption financing banks, the financing problems faced by families and small businessmen have already been solved by existing institutions.

The extent of the informal sector clearly differs between countries in Latin America. Microcredit makes sense for informal businesses but requires information-gathering technology that is often more expensive than that required by banks servicing formal sectors, even of small businesses.

The products needed by a small businessman and his/her family are NOT always those offered by a microfinance institution. For that reason, several market research studies have overestimated the market’s potential and have achieved development goals only by sacrificing discipline in the risk assessment methodology. Additionally, it may have contributed to overindebtedness, which is affecting several competitive microfinance markets.

• Believing that an institutional model that worked in one country, HAS to work in another country or institution. An example would be the belief that a bank can only successfully implement a microfinance model through a subsidiary. Although this has been the most successful

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MFI 5 – One size does not fit all

The parent bank of MFI 5 decided to venture into microcredit despite operating in a country with a competitive market. It based its expansion on a model that has been successfully implemented by several banks in the region, including by its parent bank in another country. Because company executives did not know much about microfinance, they decided to associate with the ex-president of an NGO, whom they entrusted with the management of the branch. However, the bank gave its trust to the manager without enacting control systems; it took them some time to realize that the level of arrears had grown rapidly. As a result, they seized control and managed to restructure the operation successfully. Among other corrective actions, bank management decided that in order to best serve the market MFI 5 should be made into an internal division of the Bank. Management believed it would be a safer bet, which has turned out to be true.

This case adds new elements that allow us to evaluate whether there is a recipe for success applicable to all cases. Interviewees agreed that both the branch and subsidiary models can be equally successful, provided that the size and complexity of the internal process of expansion are taken in account. The experience of MFI 5 demonstrated that a quick response time is required for microcredit programs, especially in issues of technology; in the case of large banks, this kind of response time is difficult to attain. In those cases, the best suggestion is to choose the branch scheme. On the contrary, if the parent is a small bank, it is better to embrace a division within the bank, because its capacity to respond is reasonably fast and allows for the saving of considerable infrastructure costs.

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downscaling model, it must be developed under a unique framework with appropriate governance practices, risk management, aligned incentives between parent and subsidiary, and HR management. The cases of MFI 5 and MFI 9 illustrate the consequences of a poorly adapted institutional model.

- **Believing that those leaders who have been successful in microcredit or successfully managed an MFI can replicate this success.** Microfinance has spurred many people to create new MFIs, motivated either by their social mission and devotion to sustainability or an entrepreneurial bent. Leaders at start-up MFIs have sometimes mistakenly assumed that, by appointing managers or loan officers with microfinance experience at other entities, an institution will be as successful as the managers’ or staff’s last MFI; however, they are forgetting that the financial business not only depends on correct risk assessment, which is a field that these people may be knowledgeable in, but that it also requires the acquisition of outside investors capital and other third-party services. This is evident in the cases of MFI 1 and MFI 5.

### 4.2 Macroeconomic crises did not cause bankruptcies

Drawing on our cases, two of the countries in which they were based had gone through deep macroeconomic unbalances that left their mark on the institutions. In MFI 6, the losses from the portfolio’s deterioration came as a consequence of a crisis in the financial system which was evidenced by a fall in GDP and restricted availability of liquidity. In two other cases, the macroeconomic crisis faced by the country negatively affected the quality of the portfolio. At MFI 7, this was a consequence of the broader crisis on an economic sector (such as cattle farming) in which the institution had concentrated a significant portion of its portfolio; this was further worsened by the rise of a non-payment movement supported by certain politicians. In the case of MFI 8, the institution saw a rise in delinquency due to both the financial crisis and the political circumstances. However, in these three cases, we did not conclude that the macroeconomic crisis was either the most important cause or the decisive factor for the institution’s equity loss. Instead, the macroeconomic situation caused the MFIs’ weakness to surface, as these were not evident in times of growth. It is important to note that while these institutions failed, there were other MFIs in the three countries that faced the same difficulties, but were able to overcome them.
It became evident that as a result of these crises, the administrators at these institutions implemented a number of poor behavioral decisions, characteristic of financial institutions in disgrace. They employed “financial gymnastics” in order to hide the losses incurred for the greatest possible period of time. They ventured into more risky activities, in exchange for greater potential profitability. They tried to postpone the public announcement of their difficulties, buying time to see if the situation would improve.

These attitudes suggest that, even though the microcredit portfolio can be more resistant than the business portfolio due to the versatility and flexibility of the informal segments of the economy, in situations of generalized macroeconomic deterioration, the analysis and evaluation of accounting practices at MFIs must be reinforced by shareholders; at the same time, they must also verify that the entities adjust to and comply with risk management policies.

4.3 Asset quality not only depends on low default rates

The indicator commonly used to identify whether an MFI has adequate risks management is PAR>30 for its microcredit portfolio. The cases analyzed in this study show that even though this is a valid criterion, it is not the only one that may affect institutional profitability and feasibility, and that it can change rapidly.

4.3.1 The quality of the microcredit portfolio is critical

The analyzed cases in which institutions either implemented microcredit technology “in part” or inadequately implemented this methodology clearly resulted in difficulties.

Loan officer compensation through an incentive scheme is often ill applied by institutions that implement incentives programs partially. The most generalized cause for the deterioration of portfolio quality in the analyzed cases was the abuse of staff incentive plans; both by knowledgeable institution that allegedly applied microcredit methodologies in the past, and by newer institutions what adopted the scheme as an important part of their method without taking into consideration the product, terms, and even less so, the system of controls necessary to prevent abuse.
In a competitive market characterized by the frequent poaching of staff among institutions, incentives for those in charge of business operations and risk assessment demand a system of controls and strategies of retaining employees to avoid employee turnover risk, but also in order to avoid loan misplacement because loan officers may take advantage of loan placement incentives and move to another institution before suffering the consequences of a defaulting portfolio. This is especially harmful when the terms of the loans are extended in order to attract clients, a common tactic also used to defend against competition. This typically leads to lower rates for loans of greater amounts. Ultimately, this delays the recognition of a loan’s delinquency and postpones the impact on the loan officer’s income.

The “maturity” of a loan officer does not only require intensive training, but, more importantly, longevity at the institution in order for the MFI to achieve higher levels of productivity. In the 1990s, low competition in microfinance provided time for this “learning curve” and allowed loan officers to attain very high levels of productivity. Several of the new institutions that were analyzed sought to attain those same levels in much less time, creating exaggerated incentives for loan placement and sacrificing quality during the origination and assessment process. The consequences of this decision were made evident in several of our cases.

The volatility of delinquency rates at several of the analyzed institutions should make the industry reflect on a number of items: first, the negative impact of poorly-structured incentive schemes that stress growth over portfolio quality on portfolio quality, and second, the negative impact that accelerated growth may have on the portfolio of an institution. Controls that analyze rapid credit expansion must be strengthened with institutional follow-up on loan officers’ assessments and disbursements, even in high growth markets.

4.3.2 .........as well as the composition of the assets

The productivity of the assets has not drawn a lot of attention in the literature of microfinance, because the tendency of successful institutions in practice was always to maintain a very high proportion of assets exclusively dedicated to the microcredit portfolio. On the contrary, in financial institutions in general, as well as in cooperatives, this subject has been analyzed in depth, although for different reasons. In the case of cooperatives, too much attention has been given to expensive property structures of the cooperatives; expenses derived from weaknesses in
governance that, in many cases, were the actual cause of their failure. In the case of financial institutions, attention has focused on the leverage of these institutions, which base their business on administering customers’ resources, and to a lesser extent, shareholders’ resources. For these reasons, one of the most common indicators used to assess whether an entity faces equity difficulties is the level of income-generating assets relative to interest-bearing liabilities.

In several of the analyzed cases, two types of problems were identified. Entities that diversified their business tended to look toward businesses with assets with low turnover (such as real-estate assets), financed with third-party funds (either deposits from the public or third-party loans); this affected not only the profitability of the institution, but also its liquidity. Whether regulated or unregulated institutions, the greater the leverage, the greater the risk.

The fact that microfinance institutions currently enjoy increasingly easier and greater access to third party resources makes it more critical to ensure the profitability of the asset as a whole. In this sense, the shareholders of these entities must be aware of how this funding structure decreases the ability of MFIs to develop innovative products or projects in relation to what they have done historically. Even when the foundation for the greater part of these institutions came precisely from a great innovation, it was developed when the resources at stake were either equity, comprised mostly by donations or withholding of benefits, or grants specifically for the project. At present, the need for innovation continues to exist, as MFIs strive to reach new segments, develop new products or implement processes that use technology to reduce the cost of servicing customers. Multiple funds and resources have been established to finance precisely these kinds of initiatives. However, we must keep MFI 1 and MFI 6 in mind and ask whether, in the haste of performing innovations, these initiatives have clearly assessed the cost-benefit analysis, market potential, and actual ability of the institution to test or employ such innovations; for instance, regulated entities that manage the savings of the public or are highly levered have a limited capacity to experiment with technology and new products due to their accountability to regulators and third parties.
The volatility of the microcredit portfolio is surprising.

Several studies have emphasized the “resistance” of the microfinance sector to changes in the macroeconomic situation; in our cases, this affirmation was not questioned, for in the majority of cases, the portfolio’s deterioration was not due to clients’ inability to pay, but rather to bad origination of the loans. What was surprising was the speed with which the portfolio of several of the cases deteriorated, which pushed us to reflect further on this matter.

The first reason for the rapid change in portfolio quality stems from accounting practices, whether through refinancing or undisclosed re-scheduling. However, we would categorize that as fraud rather than a true change of results; the controls for this type of behavior are discussed in section 4.6.

The cases referenced in this section have to do with facts intimately associated with microcredit technology. First, during rapid growth, control mechanisms were among the first tools to suffer. Sanctions meant to be imposed on loan officers with poor portfolio quality could not be imposed fast enough because in order to avoid the delinquency limit loan officers would accelerate the speed with which they granted loans. Thus, the overall size of the portfolio would grow (the denominator of the delinquency indicator) before defaulting loans could be captured and recorded (the numerator of the delinquency ratio) which kept the ratio unrepresentative of default growth in absolute terms. In short, loan placement outpaced the controls to keep delinquency in check.

Secondly, portfolio quality was highly dependent on the relationship between the loan officer and the client. It is worrying that controls do not adequately take into account or prevent the increasing practice of “theft” by loan officers; this tends to be more common in competitive environments, for loan officers can change from entity to entity, claiming their bonuses and quitting before having to face repercussions for their bad placement practices.

Thirdly, the motive to repay depends heavily on the likelihood obtaining a new loan. When a crisis hits, institutions tend to slow their rate of disbursements in order to reassess the entities’ risk appetite and practices, or, even worse, abruptly decrease size of loans; when this occurs, portfolio quality rapidly decreases. This was demonstrated in several of the
institutions analyzed here, as well as in those cases analyzed in recent studies on the MFI liquidations\(^\text{10}\).

As a consequence of the observations mentioned above, institutional resources are used up very quickly, leaving re-capitalization as the only alternative for recovery. Raising this additional capital from shareholders can provide difficult. In some cases, the legal structure of the MFI complicated this, while in others, it was difficult to raise more capital from existing shareholders, due to lack of resources, or difficulty of rallying them because of the variety of institutions, the nature of several shareholders, or geographic dispersion. This comment does not include those institutions that were not capitalized because their shareholders and financiers lacked confidence in the entities’ future.

The reporting requirements requested by the regulators and/or funders of an MFI should be the most conservative possible, even surpassing the levels demanded by a specific country if its regulatory frame has not been adjusted to reflect microfinance. Special attention should be paid to the possibility of creating general provisions, independent of the degree of the default, against cyclical problems that may arise. In other words, increasing provisions when an institution’s macroeconomic and payment conditions are adequate and decreasing them when facing a crisis. This should be done even at the expense of the institution’s profitability in order to benefit the internal sources of capital.

Additionally, it would be worthwhile to encourage the use, in microfinance entities, of the series of “harvests” in order to evaluate the quality of the portfolio, complementing the traditional analysis made with the 30 day PAR indicator, especially within the formulas of incentives to advisers and as a more reliable predictor of the quality of the portfolio.

**4.3.4 …… and an integral system of risk management is needed for MFIs**

Microfinance institutions are becoming diversified, both in segments and by sectors. Thus, it is necessary to introduce comprehensive outlines of risk management, focused not only on the adequate implementation of microcredit technology, but also on the incorporation of a broader vision of the rest of the risks faced by the institution.

\[^{10}\text{Rozas, 2010.}\]
For that purpose, manuals must be introduced, as well as policies and procedures for the management and handling of the various risks. This should incorporate limits in regards to concentration by sectors, segments, regions and products, not only by debtor as has been the common procedure at microfinance institutions. Likewise, economic performance of the different sectors of the economy must be analyzed, monitored and incorporated into the MFIs’ activities in the same way that mainstream financial institutions do; this should encompass the most significant segments of the economy, as even large MFIs can be sensitive to changes in business cycles.

In this sense, there are already guidelines proposed by the Bank Supervision Committee of Basel, which have been incorporated in some regulatory frames in Latin American countries. These define internal policies of integral risk management, especially credit risk. For instance, they require that an executive board by appointed and that risk committees be created that include both board directors and MFI managers, in an effort to provide greater shareholder oversight, involvement, and control in their investments.

4.4 Advantages and disadvantages of easy access to funding

It is undeniable that the analyzed cases share a characteristic in common, and it is that they had, to varying degrees, funding resources to increase their portfolio at rates much greater than the growth rates that financial institutions in those same countries may have attained.

The sector’s ability to obtain millions of dollars, mainly from private international investors, has been widely analyzed and documented. It constitutes a crucial element to explain the extraordinary expansion that microcredit portfolio has shown in Latin America\textsuperscript{11}.

Nonetheless, it is useful to reflect on the role that these funds can and must play, as well as actions that they should avoid; just as at a certain moment criticisms were made to second-tier public institutions (APEX institutions) that created credit lines and financed the aggressively accelerated growth of first-tier financial institutions\textsuperscript{12}.

\footnotesize{\textsuperscript{11} For more about this, see Rhyne, 2009 and Jansson, 2001.}  
\footnotesize{\textsuperscript{12} The case of NAFIN in Mexico with the Credit Unions or that of the IFI in Colombia with the cooperatives of savings and loans.}
In the majority of analyzed institutions, besides those cases of financial institutions that downscaled, the exposure of the external funders surpassed several times the net worth of the institution and represented a very high percentage of the portfolio. This is not bad by itself, but does lead to some reflections.

In the first place, the availability of external resources allowed microfinance institutions to grow at much higher rates than their mainstream equivalents, whose key variable to growth is not the capacity to originate loans but rather to mobilize internal savings in order to be able to finance that growth. The most relevant question revolves around the rate at which financial institutions can grow without undertaking risky practices\textsuperscript{13}. Another valid question pertains to the level of financing at which additional liquidity becomes, as stated by De Juan, the “opium of the banker”\textsuperscript{14}.

In the analyzed cases, these risky practices ranged from growing without the appropriate controls, to engaging in deceitful practices.

The other question that must be asked is whether or not MFIs are actually engaging in some of the practices for which MFIs have been criticized. Namely, the extension of credit lines for larger amounts, longer terms and laxer covenants, the implementation of methods employed by other funds without adequate testing, and the propagation of institutional over-indebtedness. When observing the course of events in several of the cases studied, this seems to be an appropriate description of poor practices.

Third, the question that must be asked of (and by) funders is whether excessive leverage is exacerbating MFIs’ governance difficulties. This could generate the same problem that has been analyzed in-depth at cooperatives, which have witnessed the conflict between debtors and creditors grow drastically when a cooperative’s growth stems from third-party resources and not its own associates' resources.

The other question that arises is whether the accessibility of funding may be causing regulated MFIs to be lax in regards to the challenge of mobilizing the public’s savings. The mobilization of savings not only offers funding to microfinance institutions, but also allows them to offer comprehensive services to their customers, going beyond credit and savings to include

\textsuperscript{13} See CGAP 2010, op.cit.
\textsuperscript{14} De Juan, World Bank
purchases and payment. That means that foreign funders must push for clients’ increased access to credit, as well as other financial services.

This leads to the suggestion that international funders establish a benchmark between the capital and debt of a microfinance institution, regardless of whether it is regulated, as well as a relation between the resources received from third parties and the mobilization of savings from the public in general, and the savings collected in the lowest income segments.

4.5 Capital Contributions – The role of investors

The most important lessons that have been extracted from past financial crises involve equity deterioration; the solution requires the contribution of fresh capital. In that regard, the analyzed cases also provide some insights.

In several cases, the local promoters or shareholders faced difficulties in raising additional capital. Moreover, some shareholders, although willing to infuse funding, several restrictions, of legal nature, exposure limits or opportunity.

In several of the analyzed cases, the inability of local promoters to contribute capital at the moments when it was most needed led to unethical practices in order to avoid dissolution. These practices ranged from indirect loans to altering the financial statements, in order to generate profits that could be distributed to shareholders.

The experiences of the mainstream financial sector have led a number of regulators to believe that the minimum capital should be ensured at the time of start-up and that shareholders in the institution must have additional resources at their disposal that are not linked to the investment, that would be available in the event of an emergency.

This topic should justify a special discussion among microfinance investors and practitioners that are undergoing the transformation from an NGO to a regulated entity. The conversion should not only address the minimum capital requirement, but also the existence of additional resources and/or a mechanism to meet capital calls. For instance, this could mean that NGOs do not contribute all of their equity to the newly-transformed financial institution; instead, it would keep a portion of it to be able to contribute later in a capitalization effort.

At the same time, international funders must incorporate into their due diligence the ability of shareholders to infuse and/or repay capital.
In the case of international investors, it is a cause for concern to see the difficulties they are facing to exercise adequate control over the institutions in which they are invested. There does not seem to be a model that replicates the high level of involvement demonstrated by Board members who invest their own wealth and apply it to those investment officers who act on behalf of institutions or investment funds. Given the geographic distance and rapid pace in the investment community, Board members may actually participate in a very limited number of meetings, or, if participating, be inadequately prepared, both of which breed a series of governance issues.

Secondly, investors should consider setting up a mechanism for capital replacement in the event that the institutional hardship has not been caused by fraud and the possibility of recovery remains realistic.

Based on their track record, microfinance networks appear to have additional know-how or expertise in governance, rapid intervention, and infusion of capital. In only of the institutions analyzed for this study, did a network not support an MFI within its “family” until it was too late.

4.6 The difference that governance makes

Microfinance institutions, as the youngest segment of the financial sector in most countries will continue to face crises of different origins and dimensions. The crises are not what cause the failures, but it is the way in which they are faced by the Board, the managers and the staff of a financial entity that explains if an institution overcomes the challenge.

The clearest and strongest conclusion derived from this study is that an institution’s governance structure proved to be the primary differentiating factor between those entities that overcame a crisis and those that did not.

The main weaknesses of governance that explain the failed experiences can be grouped in the following way.

- The detrimental concentration of functions in a single person (Member of the Board and CEO)

Although we acknowledge the fundamental role that MFI leaders have and can play. Still, the excessive concentration of functions in a single person contributes to an institution’s inability to detect any failures and react quickly.
In such cases, institutions typically lacked a transparent and efficient system of accounting and checks and balances, or dual control to prevent decisions that were risky or inconvenient for the institution. The most evident problem was the manipulation of information with the intent to hide losses, but in some cases, MFI managers were also engaging in unknown or more risky business. All these elements were more serious when personal interests competed with (and won out over) those of the entity. The most frequent personal conflict was a manager’s quest for personal recognition on a local or national level with the goal of receiving political rewards or social recognition.

The excess concentration of functions in one single person, with the absence of dual control and of the healthy balance between commercial interests and risk control, proved destructive in several of the analyzed failures.

- Weakness of the boards

In several of the analyzed cases, the reaction from the Board was conspicuously absent. In some cases, the Board was manipulated by a charismatic leader, while in others it was misinformed or did not possess the information or skills needed to act.

For this reason, MFIs (regulated and unregulated) should have minimum standards of suitability and knowledge in order for individuals to qualify as board members; traditional financial institutions exercise this protocol. Additionally, the Board’s independence from the MFI’s administration should be protected. MFIs that do not practice or enforce such processes should not receive investor financing, and should receive support and guidance in order to improve their practices.

- Lack of regulating entities

The number of entities that have experienced fraud calls for a reflection on the importance of developing and implementing mechanisms of strict control. This is particularly crucial because these entities are essentially financial institutions that work with the resources of third parties (donors, governments, commercial banks), even those that are not authorized to receive resources from the public.

From this perspective, poor asset quality and systematic fraud are problems that endanger the recovery of third party resources, which can even lead to a system-wide crisis given the size and portfolio volume of
some MFIs. Microfinance’s rapid growth has been mainly financed by third party resources, which, if not recovered, could lead to a crisis in the banking system among donors and/or public resources.

In the cases where fraud was identified at the management level, it was observed that the lack of governance or the failure to apply basic principles of corporate governance and the lack of independent control structures favored the occurrence both of fraud and, more generally, of activities that promoted personal interests over those of the institution.

The multiple cases of fraud and deviation from best governance practices occurred without any suggestion by the Boards that they knew this was occurring at the time. In particular, we found that in many cases the internal auditor or tax supervisor did not report directly to the Board but to the CEO, thus making it easier to manipulate the information. Institutions should not be able to select auditors without the Board’s input and all internal auditing must report directly to the Board.

However, in some cases, despite having good auditing practices in place, the audit did not report any anomalies – sometimes even 6 months before the crisis. These failures, already denounced at the financial system level in general, should in the particular case of microfinance institutions be addressed with the work of multilateral entities and funders in order to create a framework for training audit firms about microfinance, specifically in the subjects of risk and weaknesses common to MFIs.

Additionally, it is important to acknowledge MFIs are part of the financial sector and the same perverse incentives to misuse third party money exist for MFIs. Thus, declarations should always be required, particularly regarding exposure to risk with only one group of shareholders, especially those related to managers and administrators. The formation of businesses of any kind linked to managers or administrators should also be declared.

4.7 Political Risk

Political risk sets MFIs apart from the general financial sector. MFIs run the risk of being targeted by politicians due to their high interest rates (often the highest in the market), despite serving the low-income populations.

This risk was of very little relevance when the penetration and visibility of the microfinance institutions was marginal. However, with MFIs’ growth their
inclusion in the formal financial sector, their profitability, and (for some) their regulated status, they are now subject to this risk.

This risk manifests itself in several ways. Governments can create a financial institution specialized in microcredit with the purpose of offering access to those who still do not have it, or offering loans at lower interest rates by putting forth the message that the poor cannot be lent money at higher rates than the great corporations of such country. This kind of intervention, which completely differs from some cases where financial institutions owned by the state have learned and developed the best practices of microcredit, usually generates two adverse consequences: a message to the target segment that the private financial institutions offering such products are stealing from them, and, if the institution or program is large enough, a deterioration in the culture of repayment. Additionally, in terms of public policy, given the frequency with which these programs end up being manipulated with political purposes, their permanence is limited, resulting in the squandering of public resources that could have been better used in areas such as health and education. The most worrying consequence of these institutions’ unsustainability is the lack of continuity for clients. Typically, these countries lags behind in terms of access to financial services, and the target population, instead of perceiving a benefit, suffers a loss when an institution closes. Even worse, those clients that do not repay a loan are reported to Credit Risk Bureaus, and their access to other MFIs is restricted.

Another tool used for indirect state intervention is the offering of public guarantees. If the microfinance institutions are “tempted” by these programs, there are two adverse effects. Firstly, since risk is shared with the government, MFIs often disregard the management of microcredit technology. Secondly, the repayment culture can be negatively impacted if clients know that the state will support its loan. Because these risks are under the control of the MFI, the institution must be responsible for minimizing the harmful impacts of such guarantee programs.

There are two kinds of risks that escape the control of the industry and that may be extremely harmful. The first is one that which has been thoroughly documented in several papers: the imposition of interest rate caps, whether by means of a legal standard defining them in absolute terms or through general laws that usually make reference to the limits of usury.
These caps can have a dreadful effect on the industry if the sector has developed freely and then is suddenly limited to interest rates that do not cover its costs of operation. In the case of the countries where the standard has always existed, the clear impact is on the segments of the population with lower income, who do not attain access to formal credit for it is not offered at these rates, forcing that population to solve its financial needs by turning to informal lenders who frequently turn out to be much more expensive than MFIs.

The second case of external risks derived from the actions of politicians is that of the call by politicians to clients to not repay their loans from MFIs. This risk is increased in the event of deterioration in the economic conditions of a region or country. It is not in the institution’s power to do much in relation to this kind of intervention, and it depends on the customers of the entity whether or not to follow such a proclamation.

Our cases, however, suggest that clients are less likely to participate in no payment movements if the MFIs have formed relationships with them in an adequate manner, including clarity on pricing, the collections practices, and more generally, the way in which the services have been provided; all of these factors allow institutions to build long term relationships with clients. The efforts being made to advocate for client protection shall undoubtedly have a positive effect on the industry in a better economic environment.¹⁵

With regard to this matter, it is worth reconsidering the collections practice of an industry that should prioritize customer loyalty among stable clients; the operating costs associated with reliable repeat clients are substantially lower than bringing on new customers, so, if leveraged correctly, this tactic could allow for a more reduction in interest rates.

In any case, it is clear that the discussion regarding the levels of interest rates is far from over. The great success of the microfinance industry in Latin America could also become its great weakness, precisely for the exposure to the aforementioned political interventions. It is increasingly difficult to determine adequate levels of profitability for entities dedicated to serving the

¹⁵ On this regard, an initiative such as Smart Campaign, which has been promoted by the Center for Financial Inclusion, is of the greatest possible importance. Its focus on achieving endorsements from MFIs on principles for client protection constitutes a clear example of how this kind of risk can be approached in an intelligent and preventive manner. See http://www.smartcampaign.org/.
informal, low-income demographic. Additional political attention is drawn to these entities as more of them have reached a size that results in economies of scale, yet continue to charge interest rates that generate profitability two or three times greater than the market average.

4.8 Regulation

The subject of an appropriate regulatory framework for MFIs is beyond the scope of this study. Suffice it to say, in the case of MFIs working with the savings of the public, the responsibility of regulating and supervising their actions lies squarely in the lap of the government. This does not mean that funders should be lax when overseeing their investments. Rather, they must also supervise the actions of the MFIs with whom they work in order to mitigate risk.

In this regard, several Central Banks in the region have not only produced specific standards for evaluating MFIs, but also determined the conditions and the parameters that must be met by the entities in order to benefit from public and third party resources.

International funders are in a position of great weakness in this respect, given the many funds and institutions acting in the industry at this moment. If a common front is not created, it will ultimately be impossible to implement an appropriate structure for regulation and supervision that provides proper risk management. If every fund develops its own system of monitoring its investments, a MFI will be driven mad by trying to please every individual. Moreover, a shared framework for regulation and supervision would be expensive to set up and operate, particularly given free riders who would offer credit to institutions with minimal legwork based only on the findings of the system.

It is then logical to think that the only way to regulate the industry is to encourage an agreement among funders through which the accounting standards that should be applied are compiled, as well as the best practices in the management of microcredit, and in general, the recommended integral system of risk management. Similarly, standards should be created for entities that offer savings to the public. In much the same way, specific standards that address weaknesses in institutional governance practices could be developed in order to have a common understanding and enforcement of these practices. These steps would ultimately benefit regulated and unregulated institutions alike, as well as those institutions whose regulatory framework is lacking.
Please note that these recommendations will not prevent future bankruptcies. Rather, they are suggested in order to both prevent potential mistakes made by institutions and address existing institutional weaknesses by creating a set of tools that allow an MFI to respond to crises in a more organized and efficient manner.

5 ANNEXES 1 to 10: Case Studies

The following annexes present ten case studies of institutions that were analyzed in detail by the consultant team. Their names, countries of operation, shareholders, funders, and other details have been kept confidential. For the sake of clarity and consistency, we have developed acronyms to identify a specific type of institution. In the case of an NGO, bank, credit union, or corporation, we will use the generic acronym MFI followed by an assigned number. In each case we will point out if the respective institution is a regulated or unregulated financial institution. In the case of multilateral institutions, we will use the acronym MTL followed by an assigned number, and for the funders we will use FU and an assigned number that will be used in every case study.

In order to analyze these institutions, the team traveled to respective countries and interviewed individuals with differing perspectives and stakes in the institutions such as shareholder representatives, members of the boards of directors, presidents and managers of the institutions, vice-presidents, assistant managers, and in several instances various officers working at the institutions at the time of the crisis. In all cases, we were able to consult with stakeholders. They were all very generous in sharing their time and information with us. Out of respect for them, their names are not disclosed in the following case studies.

In addition to the information collected during the interviews, the team reviewed public information available for each institution, particularly financial statements, audit reports, annual reports, and risk rating agency reports if available. This process was generally easier in the case of regulated institutions and in those in which failure was more recent. In order to put into context each institution’s unique situation, case studies of the microfinance market in their respective countries of operation were utilized.

This material provided the basis for the creation of these case studies hereby presented. We have sought to provide the most objective and balanced analysis and description possible for each case.
### 5.1 MICROFINANCE INSTITUTION 1 - COUNTRY A

#### 5.1.1 Institutional Background

MFI 1 is a private company established in Country A in early 2003 using a corporate legal structure. As envisioned by the founders, the institution was established in order to revisit the social mission that in their opinion had been abandoned by the microfinance industry partly due to commercialization in the 1990s and led to a rapid increase in the average loan size during the early part of the 2000s, despite the available data not necessarily supporting this rationale. For example, the average loan granted by one of the flagship microfinance banks in the same country, was reduced from US$1,900 to US$1,400 between 1996 and 2002.

This departure from social mission among regulated microfinance institutions, according to the founding partners of MFI 1, was also evident in an increasingly smaller share of microcredit portfolios aimed at serving micro-entrepreneurs who were at the base of the pyramid. In their opinion, this situation was exacerbated by the problems derived from the advent of debtor associations in 2000 which resulted in many micro-entrepreneurs being negatively reported to the country’s credit bureau.

MFI 1 identified the market niche of very small entrepreneurs at the base of the pyramid as having great potential and decided that its main activity should be the provision of microloans ranging from US$50 to US$3,000 without excluding individuals who were negatively reported to the credit bureau. In their opinion, those negative reports arose from the irresponsibility of some financial institutions which granted loans under conditions that did not minimize the credit risk.

#### 5.1.2 Shareholders and Sponsors

Even though MFI 1 was established in 2003, its origins date back to 1997 when the manager and founder of a local microfinance bank left and created his own independent consulting firm. During that same year, he co-founded an NGO devoted to granting loans to micro-entrepreneurs. As time went by, the consulting firm had more and more influence in the operations of the NGO, which caused governance problems that led to the 2003 creation of MFI 1 as a spin-off of the NGO.

At that time, the consulting firm had already been working on the creation of an innovative microfinance institution model based on “owner-managers”. This idea was welcomed by some officers and branch managers of the NGO,
most of whom had left the same microfinance bank once managed by the owner of this consulting firm. Their separation from that bank, in most cases, was a consequence of a crisis that emerged in the microfinance industry of that country at the end of the 90's and which had profound repercussions in 2000 and 2001, among them, lay-offs.

As the sponsor of MFI 1, the consulting firm started with a controlling interest in the shareholding package. Thanks to the excellent reputation of the originator of this idea in the microfinance world (mostly derived from his founding of a bank that became a flagship microfinance institution), MFI 1 was successful in accessing funding from private sources. Particularly, it had the support from an association composed of bankers from a European country which through a fund that we will call FU20 decided to purchase a third of the shareholding package. FU20 gave all its support to the new institution not only as an investor, but also as funder of an ambitious expansion process proposed by the institution. In 2003, FU20 made a capital contribution of US$250,000 and granted a one-year loan of US$350,000. The shareholding structure was as follows: consulting firm (46%), FU20 (34%), persons outside the institution (14%), and branch owner-managers (6%).

5.1.3 An Innovative Business Model

The business model of MFI 1, defined as a model based on franchises, proposed the creation of an institution run by its majority shareholder and several “owner-managers”, each with different but complementary duties and responsibilities. The majority shareholder, in addition to making an initial contribution of 46% of the corporation’s equity and sharing his knowledge of the business, would give the necessary support to the franchised branches through a head office. Specifically, the head office would be in charge of (i) providing technical assistance to conduct market research aimed at analyzing the feasibility of opening new branches, (ii) providing accounting and information technology (IT) services, (iii) developing credit policies, (iv) monitoring the performance of all the franchised branches, and, (v) facilitating funding from international sources (which might had been the most appealing aspect associated with being part of the franchise). In exchange for these services, the head office would charge a royalty fee of 15% which was to be included in the annual interest rate charged to the branches. This fee, which would decrease over time, would be added to the funding that headquarters would provide to its affiliates. To make the system work, each branch would have a basic system
that would enable them to record income and expenses. This data would be sent to the head office on a monthly basis for consolidation purposes.

Conversely, to be part of MFI 1, the owner-managers would make an initial capital contribution of US$3,000 and continue making contributions according to an established timetable over a five-year term, up to US$16,000. At the five-year mark, the branches would become “owners” of the franchise, a concept whose exact meaning was not always clear. Some branch managers believed they would automatically become the owners of the equipment provided by the head office to start the operation and of the portfolio generated through the branch. While there were discrepancies (as the head office view differed), the premature shutdown of the institution did not allow this potential conflict to play out nor to gauge the real implications of such a situation.

An important characteristic of the business model was that, in order for the owner-managers of each branch to have access to the financial resources obtained by the head office from different credit sources, they should make a capital contribution that kept a capital/debt ratio at or below 1:4. The main purpose of this requirement was to reduce the level of branch supervision and the resulting costs based on the premise that as long as the interests of the owners were aligned with those of the head office, since they had contributed their own capital at a significant proportion to the branches’ activities, the need for supervision and/or control would be minimal.

The idea was very appealing, particularly because decentralized management of operations had turned out to be a key factor to business success in microfinance. The franchise model was designed to remove the problems resulting from divergent interests and asymmetrical information between the branches and the head office. Some investors described the model as ahead of its time. However, as shown below, the model did not work as planned.

However, it may be inappropriate to refer to MFI 1’s model as a franchise model, whose main characteristics are the sale of technical assistance and a well-known brand (allowing the franchisee to use the image of the brand) to franchising branches which comply with a standardized processes in exchange for a royalty. In MFI 1’s case it would have been more appropriate to speak about the sale of services by the main shareholder to the operators, because there neither was a well-known brand, nor a totally standardized process, nor close monitoring to guarantee such a process.
5.1.4 The Management

The consulting firm continued performing consulting jobs, while also acting in the role of head office of MFI 1. This duality of roles, which might be deemed by most as detrimental for the institution given the multiplicity of activities performed by the main shareholder, was presented as a strategy to lower operating costs. The MFI 1 started operations staffed with employees from the consulting firm of the main shareholder who also performed administrative duties for MFI 1 in the areas of portfolio management, IT services, human resources, and accounting. Some of the staff in the home office were also minority shareholders of the institution.

During the branch network’s first year, a shareholders’ assembly delegated effective control. The assembly met on an annual basis and was represented by the owner-managers of the 17 branches, with the consulting firm representing two of the seventeen branches it owned. To work more effectively, each of the three regions of the country in which the institution operated would designate a regional director to represent his region during the monthly directors' meeting.

The Board of Directors was composed of the three elected regional directors and a representative of the consulting firm. Regarding the presence of FU20 in the Board of Directors, there are two conflicting stories: the first states that FU20 never had a seat in the Board, and the second version states that the fund granted power of attorney to the consulting firm to represent it. In any event, the Board of Directors was composed in such a way that the main shareholder, who was also the consultant and the sponsor of the institution, had a significant influence in the decision making process. Furthermore, on the day-to-day operation, all operating decisions were analyzed and decided upon by the consultants, even though there was an independent general coordinator appointed by the Board of Directors.

At the end, the strong leadership of the consulting firm was not enough to unite the group of operators/branch owner-managers. In a short period of time, the relationship among directors soured; a situation that prevented reaching the necessary consensus. For example, after establishing a maximum tolerable delinquency level of 2% for the branches as a requirement to access new funding, conflicts arose as some of the managers disagreed with such a limit. Moreover, the access to new funding was conditioned by the head office to the compliance with the established capitalization timetable of the branches; something not always well
understood by the branch managers. These types of actions caused internal friction in the organization, both regionally and nationally.

Initially, the plan was for eligible branch managers to fit a specific profile. Their main experience requirement would have been holding a job in the financial sector, preferably in microfinance. However, the pressure placed on the institution to expand led to the laxation of the selection criteria for branch managers, thus deepening the differences between directors and managers.

Faced with a lack of clarity for procedures and realizing the internal problems of the institution, some owner-managers decided to sell their shares, which led to the incorporation of new managers. Furthermore, some creditors noticed the control problems as well as back office deficiencies that meant that it was not providing the necessary support to the branch operations. Apparently, the priority was to encourage rapid expansion of the institution, despite the lack of a solid foundation. It was argued that the problems would be solved along the way, and that it was better to be prepared for a new round of funding expected from FU20 for US$15 million.

5.1.5 An Evolution Characterized by Growth

MFI 1 inherited from the NGO (co-founded by the consulting firm’s founder) an initial balance, and a portfolio of 11 branches and 100% of the corresponding liabilities. Thanks to the rapid growth, after less than one year of operations in December 2003, MFI 1 had up to 8,000 clients, assets of US$2.4 million, and a loan portfolio of US$1.4 million, of which about 40% was inherited from the NGO. Funding was obtained not only through capital infusion but also through direct loans from individuals who believed in the initiative and from international funds FU1, FU7, FU8, and FU9, who trusted the initiative because of the prestige of its sponsor and the resources that were supposedly ensured by FU20. During the first year, these funding institutions granted loans for a total of US$ 1.8 million, an amount exceeding the portfolio that the institution reported for the same period.

The original institutional purpose to meet the needs of micro-entrepreneurs at the base of the pyramid was fulfilled as evidenced by the average loan size of US$177. This was accomplished mostly through the use of group microcredit technology. Regarding operating expenses, one must take into account that focusing exclusively on granting small loans to potentially high risk clients has a negative impact on operating costs and provisions, which in turn delay an institution from reaching its breakeven point. Therefore, even
though the level of global delinquency for MFI 1 during that same year was under control with a PAR 30 equivalent to 1.0%, and the return on portfolio at about 40%, it was not enough to offset the operating costs of US$500,000 in that same year. The operating efficiency closed the first year with an indicator of 54% due to the effects of the start-up costs and difficulty to dilution of fixed costs of new branches. The ROA at the end of 2003 was -20.6%.

Operating costs were high even though most branches had a lean structure composed of a manager, a loan officer, and a cashier, and the average branch portfolio in the first year was US$84,000, with an average 380 loans per loan officer (probably mostly due to the use of group lending). The efficiency achieved by the loan officers was affected however, by a heavy bureaucratic structure reflected in the fact that in the first year of a total of 68 officers only 26 were microcredit officers. In fact, even though individually each officer had high productivity, each branch of the owner-manager model was, overall, not productive. Also, starting operations simultaneously with 11 branches prevented the model from benefiting from the economies of scale that typically results from allocating to a single branch the largest number of loan officers who can be controlled by a single supervisor, and the largest number of operations (disbursements and collection) which can be handled by a cashier.

In 2004, the ambitious expansion plan continued, with the intention of opening 21 new branches, so the branch network would reach a total of 38. However, at the end only 11 branches were opened as the incipient effects of the crisis which the institution was by then already undergoing prevented accelerated expansion.

Since the beginning of 2004, some branches started to show delinquency levels that exceeded the 2% limit approved by the Board of Directors. As agreed upon, the branches that exceeded the limit could not access new funds from the head office until they returned to the allowable level. This policy increasingly deteriorated delinquency levels because, as it is common in microfinance, the main reason for debt repayment among borrowers is the promise of access to new loans of a higher amount. However, due to lack of funding, branches with delinquency rates above 2% could not grant new loans, thus causing liquidity problems which exacerbated credit risk by eliminating borrowers’ incentives to repay. Conversely, the funding restriction became a perverse incentive because it encouraged branch managers to look for a way to “artificially” present better indicators to fund
the expansion: an expansion necessary to achieve the breakeven point. In addition, several operators had not achieved the capital contribution goals, and expected that the new business profits would be used to fulfill their obligations, business profits that were stunted by lack of funding.

Despite these inefficiencies, the financial resources from abroad were sent to the branches that met the limit, thus leading to a drive to grow based on the "healthy branches", surpassing in some cases their ability to control operations.

In an attempt to control the delinquency of the branches that did not meet the 2% limit, credit committees were created among the different regional branches. Even though the institution globally reported a controlled level of delinquency (1.2% in 2004 with a bad debt portfolio of 1.5%), the indicator was distorted by a significant volume of rescheduling which did not take into consideration quality criteria. Moreover, there were also nonstandard loan granting and collection processes, a lack of effective monitoring of branch performance, and, amid the lack of control, the discovery of loans taken out by several branch managers themselves.

In fact, as later stated by a risk rating agency, the branch control system was nonexistent. According to the 2006 report from the rating agency, the accounting system was not linked to the portfolio system, and the branches were not interconnected with the head office; in fact, most of the information flow was in Excel files.

The information problems were so serious that in 2003, an external audit firm issued a report with a qualified opinion, and in 2004 it reserved the right to issue an opinion because the financial statements did not have the corresponding back-up to verify information. It was evident that the head office had lost control of the branches.

5.1.6 The Crisis

According to some investors, at the end of the first year of operations, it was possible to foresee structural deficiencies in the owner-manager, quasi-franchise model that questioned its feasibility:

- Owner-managers were absolutely autonomous by stating that nobody could issue standards regarding the management of their branches as they had been created with their own resources and the capital provided by the managers, and the counterpart of the 4:1 debt-to-capital ratio needed to obtain the funding.
- The failure to comply with the timetable of capital contributions of several branch managers exacerbated their moral risk in the placement of loans.

- The scarce control on the branches led to cases of fraud that involved managers themselves. Some capital contributions were made based on the disbursement of loans to managers themselves.

- The loan granting and collection processes were not sufficiently standardized. Moreover, credit assessment was very superficial.

- Many owner-managers, mostly former mid-level officers from the financial institutions, were not creditworthy enough to make new capital contributions.

Despite these weaknesses, in 2004 there were still plans to continue growing. In fact, the expansion of new branches foreseen for that year was based on the promise of significant resources, allegedly promised by FU20 and amounting to US$ 15 million starting with an "assured" disbursement of US$500,000. Nevertheless, after some weeks of operations of some recently opened branches, FU20 decided not to make the allegedly promised capital contribution.

The reasons for FU20 to suspend the disbursements were based on issues related to the institution itself in addition to issues that took place within the fund. MFI 1 failed to repay a loan to FU20, and the 2003 external audit was issued with a qualified opinion regarding the accounting processes of the institution, and the reliability of the information reported. This led to suspicion about the management and about the institution itself. FU20 went through a management change and the new manager reversed several investment decisions made by the previous manager because, it was argued, such decisions were not based on technical criteria and in some cases, they conflicted with legal aspects in their country. MFI 1 was precisely one of the investments questioned by the new management. Eventually, FU20 was dissolved.

In terms of liquidity, the institution faced a dramatic situation. The fixed costs to open new branches and to manage a highly atomized portfolio consumed the institutional resources available, and due to the lack of resources, loan placement stopped. The operating efficiency during the second year deteriorated and reached a 70% ratio and the ROA worsened to -25.4%. Of a total of 8,000 clients in December 2003, at the end of 2004 it had just over 4,200.
Obviously, lack of liquidity also had an impact on MFI 1’s ability to pay its debts; therefore, the institution failed to fulfill its commitments in 2004 with FU20 and other creditors, thus seriously weakening the reputation of the founder and owner of the consulting firm. In view of the crisis faced by the institution, a general assembly of branch managers was held to request an increase in capital. Faced with the threat branch closings, only some operators attended the meeting, and in view of the failure to resolve the crisis, the recently opened branches were closed. Branch closings generated incremental costs, particularly in relation to the payment of the termination of the staff. It is estimated that these branches generated a monthly expense of US$50,000 while they were open and generated a total cost, including start-up and liquidation expenses, of about US$200,000.

In retrospect, even though it is true that the crisis was triggered by the “implosion” of FU20 as described by the owner of the consulting firm, undoubtedly the aggressive growth without a consolidated model played a major role in the ability of the institution to face a crisis, a problem exacerbated by the weak ownership and governance structure.

5.1.7 The Outcome

In view of the difficult situation faced by the institution regarding high operating expenses, liquidity problems, failure to pay overdue loans, and the difficulty to reach agreements within the organization, in mid-2004 the institution started to seek alternative solutions. In November 2004, unable to deal with the situation, and based on the guidance provided by a new consulting firm (not the shareholder of the MFI 1), a restructuring plan composed of three fundamental elements was developed: 1) redefinition of the business model aligned with the traditional model of headquarters and branches, with an independent board of directors, 2) legal recognition of creditors in the country to ensure repayment obligations, and 3) restructuring of liabilities. The plan was implemented after the main investors and creditors gave their approval.

The branches from one of the operating regions decided to buy the portfolio that was generated by MFI 1 and negotiated the repayment subject to portfolio maturities. FU20 demanded the repayment of the total loan, but after intense negotiations, all creditors accepted a 45% loss and shareholders a 90% loss. Therefore, just two years after starting operations, MFI 1 sold 35% of its portfolio and absorbed losses to the point that its capital was reduced to the legal minimum requirement according to national laws to
continue operating, US$17,000. Through October 2005, the institution had incurred accrued losses of US$1.54 million.

As a result of the restructuring plan, the main shareholder had to transfer his shares to third parties designated by the creditors thus causing a complete management turnover. The debt renegotiation allowed the institution to receive debt forgiveness of US$800,000 and decrease the interest rate from 8% to 3%, in addition to grace periods of at least one year. Currently, the institution continues to operate under a traditional model at smaller scale, although the future looks uncertain.

5.1.8 Bibliography
Assessment by the risk rating agency for 2006 and 2007 Newsletters from the Bank Superintendence of Country A. Studies and documents related to MFI 1 and the microfinance sector in country A available in secondary sources.
5.2 MICROFINANCE INSTITUTION 2 – COUNTRY A

5.2.1 Institutional Background
MFI 2 was founded in 1996 by a group of successful businessmen and entrepreneurs from the eastern region of Country A. The institution was granted an operating license to operate as a microfinance entity through a special purpose vehicle that had been created specifically for this purpose by the government. The minimum capital requirement was approximately one million dollars.

The institution opened a head office and six branches distributed in two neighboring states. During the first semester of operations, and as a prudent measure stipulated by the regulator for all the entities that received this type of operating license, MFI 2 was not able to raise funds from the public in the form of savings accounts. Only fixed-term deposits were allowed. Actually, with time, the MFI became quite good at taking this type of deposit; which eventually became its main source of funding.

5.2.2 Shareholders and Sponsors
Private investors were motivated by different factors to create MFI 2, among them a favorable macroeconomic environment within an expansion cycle that had started four years prior, an attractive rate of return on capital reported by existing microfinance institutions, a credit boom (in the form of an unusual increase in number of financial consumer institutions, most of which were subsidiaries of commercial banks), and the existence of a legal vehicle that had been created specifically to meet the needs of the microenterprise sector. This vehicle allowed for the opening of financial institutions with a minimum paid-in capital seven times lower than the requirement for a commercial bank. It also allowed for institutions to also participate in the market for consumer loans in addition to traditional microfinance markets, as was the case for MFI 2.

The founders of the institution were individuals who came from a variety of economic sectors and were all very successful in their various businesses. While this guaranteed equity support in a time of need for capital increases in the future, it was also a disadvantage because none of them had deep knowledge of the financial sector, let alone the microfinance sector. In addition to the private investors, a multilateral institution, MLT2, also invested in MFI 2 through a US$500,000 subordinated loan.

5.2.3 A Turbulent Financial Evolution
The institution experienced a fast take-off. At the end of 1998, just two years after starting operations and, thanks to new capital contributions, paid-in capital was increased to US$2.7 million. By then, and in accordance with the contemporary regulations, the institution was fully leveraged.
Consequently, its assets had reached US$24 million and its loan portfolio was at US$ 21 million. This rapid growth was made possible through the funding received from fixed-term deposits, mostly from companies owned by the shareholders, but also from a variety of companies which had invested in MFI 2 thanks to the trust placed in the shareholders. Fixed-term deposits amounted to US$20 million and were highly concentrated among no more than fifty depositors. More than half of the deposits were placed at a term longer than one year and at a higher-than-average interest rate. The high financial costs incurred by this expensive type of financial instrument, in conjunction with the institution’s emphasis on these high-interest deposits, played a major role in explaining the future crisis of MFI 2.

The institution reached the highest portfolio volume in 1998 and the largest number of clients (approximately 28,000) in 1999. However, this rapid growth, which had allowed this institution to be profitable from 1997 to 1999, was not based on a solid foundation. The end of the economic growth cycle in 1999 quickly disclosed weaknesses that the institution was carrying since its inception. For instance, the rate of delinquency at the start of the second year of operations was approximately 7%, but by late 1998 the situation was already out of control with an indicator of about 13%. Delinquency rates continued to escalate at a rapid pace as the institution started to feel the effects of the deteriorating macroeconomic environment in 1999, and in 2002 the delinquency rate was close to 40%.

5.2.4 The Achilles' Heel: Lack of a Target Market and Credit Technology

The institution had a fast start-up but all along lacked a clear target market. Due to a mandate implicit in the regulations governing special purpose vehicles, MFI 2 was supposed to be targeting mostly microenterprises. However, in an attempt to maintain its rapid growth rate, and encouraged by the apparent success of competing consumer financial institutions, the MFI quickly opened a second product line and started catering consumer loans as well.

Thus, two completely different business units were created within the company. One devoted to microfinance and the other to consumer lending. The consumer lending department operated under the traditional structure for this type of product, characterized by loan officers with variable compensation, external inspectors to confirm the information provided by applicants, a centralized and parameterized credit approval process based on pre-established criteria, and an independent collection department. On the other hand, the microcredit department utilized standard microcredit techniques: group and individual loans alongside a special credit line guaranteed by liens on assets. While the microcredit unit accounted for less than 30% of total portfolio, when it came to number of clients, it represented
more than 70%. As it usually happens in institutions that provide a variety of products, the business that attracted the most attention was the one with the highest share of assets – in this case, consumer credit.

The technology used for consumer credit, however, had various deficiencies. According to the executives at that time, the ambitious growth goals, perverse incentive system for the sales force (which rewarded credit quantity over quality), and a deficient risk assessment system (resulting from overly ambitious growth objectives), were key issues that contributed to the rapid deterioration faced by this institution. In some cases, the lack of proper internal controls also led to collusion of loan officers and inspectors to set up cases of ghost applications. The excessive fees levied on portfolio in arrears also became a perverse incentive that work against the low delinquency culture that is common in most MFIs. Also, as it is well known, in the case of consumer loans delinquency is frequently viewed as a good source of income instead of a problem. Of course, this can get out of hand if appropriate measures are not in place to ensure that the losses resulting from the high credit risks do not exceed the potential income to be derived from the fees collected from the portfolio in arrears.

The microcredit methodology itself also had serious deficiencies, among them:

- Lack of a rigorous induction process for new staff. This is of particular importance to microfinance due to the high degree of decentralization when it comes to the credit assessment and approval process.

- The calculation of the ability to pay was in some ways subjective because the loan officer rated the disposable income to a reliability margin ranging from 40% to 90%. The risk that the loan officer might manipulate the information to adjust the ability to pay of the applicant is always latent in microfinance, but even more so when the reliability margin is defined by the loan officer.

- The system did not provide timely or specific information on various decision levels. This element in order to take corrective actions proactively, especially regarding the delinquency indicator.

- A loose rescheduling policy opened the door to many loans in arrears being artificially classified as current. At a later date the regulator also noted that the rescheduling did not include a new assessment of debtors’ ability to pay.

- The collection policy established five collection stages in terms of delinquency level, each with a different officer in-charge. Consequently, this collection system minimized the degree of responsibility of those who were involved in the process, and worsened the situation by encouraging
a process in which delinquency went from one collection stage to the next.

- The internal control deficiencies resulted in part from a weak internal audit department, which had very little capacity to enforce its observations with corrective actions, despite making the Board of Directors aware of them.

Another of the institution’s growth strategies relied on the aggressive granting of loans to individuals who had received credit from other microfinance institutions. At that time, microfinance institution showed an overall historical delinquency level lower than 2%. Therefore, some consumer financial institutions, among them MFI 2, decided to grant larger loans to borrowers from well-known microfinance institutions without conducting any sort of analysis. In other words, the assumption was that being a client of a well-known MFI with a low delinquency level reduced the credit risk almost automatically, thus overlooking the importance of a proper and correctly applied credit methodology. Additionally, over 70% of the clients of consumer financial institutions were shared with other institutions, most of them microfinance institutions. Therefore, MFI 2 saw this as a sign of an existing level of dissemination of this strategy. The real problem with using this strategy, however, was that these other institutions also participated in "credit auctions," where, unlike a normal auction, the institution with the highest bid for the delinquency will lose. In some cases, consumer financial institutions created solidarity groups which gathered people who applied for loans on an individual basis. In other words, the credit methodologies became completely denaturalized due to the strong drive to grow.

Even though both departments at the institution, consumer and microcredit, operated separately, the institution had one single image. The loose practices at the consumer loan department impacted the microcredit unit as its clients became aware that the policies of MFI 2 were largely discretionary regarding the granting, collection, and rescheduling of loans; particularly the policy of zero tolerance towards delinquency. This common image was a factor in the deterioration of the portfolio, which further deteriorated with the arrival of an economic crisis and led to a chronic crisis within the institution which brought about serious negative consequences.

5.2.5 The Crisis of the Institution Arrived with the Economic Crisis

The economic crisis that arrived in 1999 ended the expansive economic cycle that began in 1993. The credit boom in the financial system, mainly consumer credit, also came to an end. In fact, one of the consumer financial institutions, which penetrated the market more aggressively and which in a few years had over 80,000 clients, started to collapse and affected the rest of the financial system. This was due not only to overleveraging problems
within the market, but also to a damaged image of all financial institutions - especially those who had recently been incorporated using the new legal vehicle, such as MFI 2.

MFI 2, which emulated the growth strategy of the aforementioned consumer financial institutions, was one of the institutions most affected by this situation. The portfolio began to shrink and demonstrate rapid deterioration. During the second semester of 2001, the portfolio in arrears (minus provisions) relative to equity was close to 80%. This situation demanded significant incremental provisions, which in 2002 were over US$2.6 million.

The decapitalization of the MFI 2 also accelerated, and in 2001 its ROE was -54%. In order to reduce administrative expenses four branches were closed. This action indeed curtailed expenses, but also increased delinquency. Particularly the delinquency of microcredit clients who, due to the lack of a nearby branch, were now discouraged to repay their debts because the loan recovery largely depended on the relationship between the loan officer and the client. Additionally, with a smaller number of branches, transportation expenses related to collection increased.

The situation became unbearable due to MFI 2’s encouragement of long-term funding at often burdensome rates. In mid-2002, the borrowing rate was 11%, three percent points higher than the average market rate. Even though, overtime, the institution was able to decrease the rates it offered to depositors, in the short run the benefits eluded the company’s bottom line. Another factor that prevented more accelerated reductions of financial expenses was the high liquidity levels that the company was required to carry. Due to a high concentration of deposits, becoming illiquid was a latent danger, a danger exacerbated by the low repayment level of the portfolio.

The interest rates of MFI 2’s credit portfolio were among the highest in the market; below only those of the consumer financial institution that was MFI 2’s benchmark, which would soon shut down operations after a gradual dismantling by the regulator in order to return all deposits to the public. In both cases, MFI 2’s and its benchmark institution, lending rates well above the average rate had an adverse selection effect. They became the preferred lenders for clients with very high risk profiles.
With the arrival of the economic crisis, and burdened with escalating delinquency, some consumer financial institutions adopted abusive collection practices. These practices coupled with the resulting overleveraging problems led to a critical situation for many debtors and to the establishment in 2000 of debtors associations. These associations voiced the clients’ displeasure regarding contracts that they had signed with financial institutions that not only over-indebted clients but also lacked transparency. All along the portfolio of MFI 2 continued deteriorating and reached a PAR 1 higher than 35% in 2002, and in 2003 it was estimated that the institution had written off US$5 million. The institution was undergoing a profound crisis.

### 5.2.6 The Outcome

While initially the institution was a follower and emulated most of the industry’s bad practices (as described above), during the crisis it made an effort to act responsibly. Several actions were taken among them, a change in management, reduction of administrative expenses and financial costs, reclassification of the loan portfolio, and curbing of consumer credit growth. However, these actions were for the most part too-little-too-late and were unsuccessful. The institution continued analyzing and implementing all available options to try to overcome this critical situation, including adopting
a governmental strengthening plan for institutions that have been hit by the crisis, selling the portfolio and accruing liquid assets with intention to leave the market, and returning liabilities as expected of consumer financial institutions.

Despite all these efforts, in 2002, the return on equity was -86%, and MFI 2 was technically bankrupt. Shareholders were not willing to increase capital, at least not in the proportions required by the regulator. Shareholders would not invest capital because they were not sure about the path the institution was going to follow moving forward. At this point, the regulator considered possible liquidation and similar solutions. However, the regulator was reluctant to push for a dramatic exit which could cause systemic problems, particularly when coupled with the difficult situation faced by various other financial institutions. Accordingly, as was the case with other institutions, the regulator chose to seek a negotiated, non-traumatic solution. In the meantime, time went by and nothing happened.

**EQUITY AND ROE**
*(Expressed in US$)*

Between 2003 and 2006 through the arrival of a new favorable economy and actions taken by the institution to stabilize its financial situation, MFI 2 started to show some signs of improvement, including a controlled delinquency indicator and an increase in gross portfolio. After having actively sought a way out of the crisis for several years, in 2006 the entity finally received a capital contribution from a local financial group. The new investors decided to restructure the institution and refocus it on the microfinance business. Currently, the majority shareholder is still this financial group which has experience with banking - an aspect that proved to be crucial in reversing the bad image of the company.
The main changes introduced by the new management included providing the entity with an executive staff experienced in financial business, training the operating staff intensively, improving internal control and information systems, and improving the quality of service based by opening of new branches and installing new ATMs. The entity finally overcame the crisis and is in the process of moving forward with its ambitious objective of becoming a world class microfinance institution and the best in the country.

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5.3 MICROFINANCE INSTITUTION 3 – COUNTRY A

5.3.1 Institutional Background
At the end of the 80s, through an initiative of a Christian church based in Europe, the foundation that gave rise to MFI 3 in Country A was created as a non-profit entity. The social mission of the foundation was to help the low income population, mainly from rural areas, by providing two types of services: technical assistance and credit financial services. To fulfill this purpose, the foundation started working on these two services in an autonomous and separate fashion, without looking for any complementary traits that might have existed between both services. Since none of the branches had their own legal structure, both were governed by the by-laws and the Board of Directors of the foundation.

From its inception, the foundation showed great interest in promoting the financial branch of MFI 3 by allocating US$1 million as loan funds, more than three times the amount allocated to the technical assistance branch which received US$300,000. MFI 3 started operations in a rural population in the plateau, which was consistent with the mission to provide financial services to small agricultural producers. After ten years, the institution had 12 branches with a presence in four regions of the country, although the initial purpose had deviated somewhat, as six of the branches were located in urban areas.

5.3.2 Evolution
MFI 3 had an enormous growth potential as it was one of the first institutions that ventured into microfinance in the country, at a time when there was little presence of other entities in rural areas. The good development conditions were accompanied with a favorable economic environment and average GDP growth rate of 4.3% between 1989 and 1998 (in 1999 this situation was reversed, and this indicator fell to 0.43%). Moreover, the active support of the church had materialized in the provision of easy access to funds.

MFI 3 did not take advantage of the favorable economic conditions, among other reasons because the administration was very peculiar. The highest authority of the foundation was the Assembly of Church members who met once a year and were responsible for choosing the members of the Board of Directors. The Board of Directors met on a monthly basis to monitor the technical assistance activities, the development of MFI 3, and evaluate the plans submitted by each of the two managements. However, the directors of the foundation, who were church members, did not necessarily have the
technical capabilities to exercise an effective control of both operations, particularly those of MFI 3. Therefore, most of the tasks were performed by the top executives, an aspect that could be somehow justified since the elected directors were Assembly volunteers who saw these duties as charitable activities.

From the start, MFI 3 showed slow growth; in fact, in 1998, ten years after it started operations, its portfolio reached a value of US$3 million and 6,500 clients with an average loan value of US$461. Other entities with similar backgrounds had reached portfolio values of approximately US$16 million. The initial rural focus of MFI 3 and its strategy of concentrating exclusively on agricultural activities had implications both for the risk taken by the entity and high operating expenses. Certainly, these elements had an impact on the institution in its goal for self-sustainability.

MFI 3 adopted both individual and group microcredit technologies, with special provisions to accommodate the special needs of the agricultural sector such as matching payment schedules with agricultural production cycles. Later, it also introduced a village banking methodology. Towards the end of 1998, it reported a delinquency level of 4% (higher than the 1.15% reported at that time by the regulated microfinance institutions); 200 loans per loan officer (less than the 450 average loans per loan officer for the industry); and a return on assets of 8% (lower than the 13% return reported by the industry). This comparison is presented solely for benchmarking purposes because we cannot ignore the fact that MFI 3 had a rural focus, unlike the regulated microfinance entities whose strategy was oriented towards developing financial activities in the urban sector.

With an aim to improve the performance of MFI 3, and with the support of MLT 1, in 1999 the directors of MFI 3 approved the initiation the process of becoming a regulated entity. To support this change and start the process of becoming a regulated entity, MLT 1 provided funding of US$300,000, while the entity contributed US$198,000. They hoped regulation would address some of the problems identified by the institution including significant deficiencies in the information technology (IT) area and information management systems, internal control deficiencies, low diversification of financial services, and inadequate levels of staff training.

However, it probably was not the best time to become a regulated institution. The imminent crisis in the financial system as a result of the plummeting GDP growth in 1999, gave rise to overleveraging problems and to the creation of debtor associations a year later. MFI 3 was not ready for the
crisis. In a short time, the main indicators, which already lagged industry averages, would confirm this. The PAR 30 of the foundation in 2001 increased to 16%, almost four percent points higher than those of the regulated microfinance institutions (12.1%). The number of clients fell to 3,100 from 6,500. All along the amount of the gross portfolio increased to US$4.7 million, financed mostly through loans received from a mezzanine fund created by the government to support non-regulated entities.

Starting in 1999, the contributions from the mezzanine fund began to exercise an increasingly important influence on the total portfolio of the institution. This resulted in a larger funding concentration, and a deterioration of the quality of the portfolio, as several loans were granted by the fund based on political motives, rather than technical justification for the loans. For instance, in 2001 and 2002 as a result of a bad harvest in one region of the country, in order to resolve farmers’ delinquency issues with their suppliers the mezzanine fund repaid loans on behalf of the farmers. As was to be expected, in a short period of time this negatively affected payment morale and resulted in portfolio deterioration at MFI 3.

The mezzanine fund also gave MFI 3 a trust portfolio created to fulfill a government promise of loans to buy tractors for small farmers in the western region of the country. Even though the bad loans of this trust portfolio did not directly affect the delinquency indicator of the institution, it did have a negative impact on payment morale and also meant an additional cost for MFI 3 which had to commit additional institutional resources to the endeavor. Through these actions, the mezzanine fund became the main creditor of MFI 3. In 2003, the obligations to the fund amounted to US$3 million – exceeding the gross portfolio value of US$2.8 million. By December 2003, the indicator of the portfolio in arrears was 18.5%, while the rest of the industry was able to control it and reduce it to 4.8%.
Chart 1

ASSETS, TOTAL PORTFOLIO, AND OBLIGATIONS TO FUNDERS

(Expressed in US$)


The deterioration of the portfolio was also the result of MFI 3’s loan decisions, not just the consequence of the bad loans in the inherited mezzanine fund’s portfolio. The entity was created at a time when credit methodologies were still evolving and improvement was achieved based on a trial and error process (which at times proved to be costly as “errors” had to be written-off). Moreover, unlike other entities in the industry, the management of MFI 3 lacked deep understanding of the financial business, and – even worse – the implicit trust the church had in the management meant the relaxation of all controls.

5.3.3 The Crisis

Towards the end of 2001, based on a report of presumed embezzlement by the general manager brought forward by one of the regional branches, the Board of Directors ordered the dismissal of the general manager. Later, MFI 3 filed a lawsuit accusing him of embezzling US$1 million. The outgoing
manager faced a legal process and it is said that he is now a fugitive of the law. The lack of proper internal controls was evident: there was no internal audit department; the accounting processes were very deficient, particularly regarding the recording and supporting of expenses; and the information systems were obsolete.

At that time and given the circumstances, the entity started to rethink its plan to transform into a regulated entity. More than three years after entering into an agreement with MLT1, and a few months before the expiration of the term to use the promised technical assistance, the entity had used just 25% of the committed amount. According to some sources, the former general manager was not necessarily helping the transformation process, presumably because this meant increased controls over the operation. Additionally, mired in a deteriorating economic environment which had negatively affected the financial system in general, and MFI3 specifically, the regulator was increasingly unwilling to issue operating licenses to set up new regulated MFIs. At the end, the transformation into a regulated entity was aborted.

The tarnished image of the institution as a result of the embezzlement had spread to other circles, including the trade association to which it belonged. Thus, in spite of its status as founding shareholder of not-for-profit NGOs devoted to financial intermediation, in an aim to safeguard the interests of the trade association MFI 3 was expelled from the association in 2001. In 2003, thanks to a change in management, the trade association decided to readmit MFI 3 into its ranks.

In view of the situation faced by MFI 3 in 2001, the Board of Directors authorized two of its directors to intervene in the institution, assuming the roles of manager and lead advisor. According to comments made by the people who later took over the institution, the new management was unfortunately not technically qualified for the positions; furthermore, both had serious personal financial problems.

After this attempt to change the management, MFI 3 was still not able to find a direction. The financial management problems, for which the former manager was fired, persisted and were later confirmed by an external audit. Loans to related parties, excessive operating expenses, and embezzlement continued, and some believe worsened. Furthermore, the new management allegedly used funds from MFI 3 to make severance payments owed to former employees of their personal bankrupt companies. According to
interviews, this embezzlement would not have been possible unless the controller of the organization was also aware of it.

In light of the bad performance of MFI 3 compared to other microfinance institutions (in terms of achieving significant credit volumes, large numbers of clients, and attractive profitability rates in shorter periods of time) and in light of the lacking ability of some directors to properly manage a financial institution, the foundation requested in 2003 an independent review of the portfolio quality. The resulting review discovered that the loan delinquency rate reported at 5% in MFI 3’s balance sheet was in fact 60%. One of the problems was of course the deteriorated portfolio, but the total lack of information transparency was an even more serious problem.

The real delinquency indicator reflected the deterioration of the portfolio given to MFI 3 by the mezzanine fund and that of their own portfolio. With respect to the loans granted by MFI 3, the respondents agreed that the worst quality loans were those granted using group lending methods, both in rural and urban areas. The economic crisis exposed the serious weaknesses of the institutional portfolio. On the other hand, the solidarity guarantee weakened significantly as a result of the systemic risk that emerged during the economic crisis.

According to individuals who later analyzed the credit operations, the institution did not conduct a rigorous credit assessment, the follow-up process was nonexistent, and the loan recovery was very weak. Moreover, the loan officers had low productivity, granting an average of two loans per month. In 2001, the total productivity of the loan officers was an average 100 loans. Exacerbating MFI 3’s financial struggles, the officers at all levels received compensation that was well above the industry average. The operating efficiency indicator (operating cost/portfolio) in 1998 exceeded 22%, well above the 16% operating efficiency indicator of the regulated microfinance system. In 2003, this indicator increased to 26%.

The portfolio deterioration required significant reserves to proceed with bad loan write-offs. This had a significant negative impact on the creditworthiness of the entity. In fact, equity became negative in 2002 and remained that way for four consecutive years. The total portfolio write-off at the end of 2003 was US$1.6 million. The audit of the financial statements of that year (conducted in 2005) established a loss of US$450,000 and accrued losses of US$2.3 million. The entity was technically bankrupt according to the existing regulations. In parallel, the numbers of clients were reduced from 6,500 in 1998 to 3,100 in 2001 and 1,700 in 2003. This was due to
several causes, including the crisis faced by the institution, the weak borrowing groups that were created, the overleveraging problems of the financial system as a whole, and a heavy reclassification of the portfolio (Chart 2).

**Chart 2**

**EVOLUTION OF THE LOAN PORTFOLIO AND THE NUMBER OF CLIENTS**

(Expressed in US$)

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5.3.4 The Outcome

The lack of qualified management was pervasive and demonstrated by the poor financial evolution of the institution, leading to a situation of technical bankruptcy. This opinion was shared by a risk rating agency at that time, pointing out in its report on MFI 3 in 2007 that the management of the entity “was not professional enough for their line of business.” The church in Europe was made aware of these problems and as it was also rumored that the new “intervention” managers had the intention of taking over the institution. Thus, in 2003 instructions were received from Europe to hire a new manager who had knowledge of financial business and was trusted by
the headquarters of the church. Moreover, there was a call to professionalize the Board of Directors.

A new manager was appointed from Europe, but the new professional composition of the Board of Directors was not completely implemented. Later, this gave rise to conflicts relating to the management of the institution. For instance, the technical proposals made by the new manager were not always understood by the Board of Directors, as the philanthropic approach was at odds with the proposed recovery plans aimed at financial self-sustainability. Moreover, some members of the Board of Directors constantly objected to the salary level of the new manager.

The new administration was able to stop the embezzlement that had taken place for a long time and, as a strategy to help the entity overcome the difficult situation it was undergoing, it started to clear the balance sheet and renegotiate funding from financial institutions, starting with its principal creditor, the government mezzanine fund.

Although ironic, the entity’s creditworthiness problems were not evident due to the portfolio provided by the mezzanine fund. According to individuals who were later in charge of the administration, this portfolio – in spite of its problems and costs – became the last resort for the institution that allowed it to continue operating due to the liquidity injection it provided.

At the end of 2003, the new manager submitted the restructuring plan to the Board of Directors, but at that time the church was already analyzing the possibility of abandoning the financial business altogether. In 2004 the church decided to exit the financial market and focus on technical assistance endeavors. They cited the poor performance of MFI 3, their lack of experience in such a specialized business and the tarnished image that was starting to affect the ecclesiastic organization as the primary reasons for this decision. Consequently, it started a process to transfer the assets and liabilities.

As a result of this decision, in 2005 an NGO specialized in technical assistance for the microenterprise sector, but lacking prior experience in financial intermediation, proposed to take over all the assets and liabilities based on an institutional recovery and strengthening project. The proposal also included a financial contribution as part of the transfer. This proposal was chosen, as it competed against another offer with very disadvantageous conditions for MFI 3.
In 2006 and after a period of co-management, MFI 3 was transferred to the NGO under an asset-transfer and management control agreement, with the approval of the main creditor. Under this agreement, the church turned over the management of the institution to the NGO. At the end of that year, continuing the strategy set forth by the former manager of MFI 3, the portfolio fell to US$2 million and the number of clients to 1,800. Currently, after completing a merger with another foundation aimed at helping small farmers, the re-organized entity has decided to reintroduce the idea of obtaining a license to operate as a regulated entity.

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5.4 MICROFINANCE INSTITUTION 4 – COUNTRY B

5.4.1 Institutional Background

MFI 4 was created in 1994 in a small municipality with the objective of granting agricultural loans, particularly in the rice producing sector. At the beginning, it focused on the agricultural sector and then on the retail credit market. The entity was created in 1993, within the context of a group of institutions that had a similar origin and purpose, as a response to meet the need to provide funding to the rural areas in the country due to the vacuum left by the public bank that closed in 1992 and which had previously granted funding to these sectors.

MFI 4 was created as a financial private company authorized to take deposits from the public and place them in small and micro enterprises in rural areas, subject to the supervision of the bank and financial institution Superintendence. While as a legal entity it was deemed a corporation, the original laws defined a dispersed equity structure for this type of institution (type 2 MFI) since a single shareholder could not own more than 5% of the capital, and the minimum required number of shareholders was 20, who should come from the region. This meant a fragmentation of capital among several shareholders. Therefore, in the opinion of some respondents, several characteristics of a corporation were combined with other characteristics of the cooperative sector even though they were not entirely compatible, and this led to governance problems, particularly in the capital structure as seen below.

5.4.2 Shareholders and Sponsors

MFI 4 was organized by shareholders from the agricultural and agro-industry sector situated in their spheres of influence. The multiplicity of non-specialized shareholders with little capital contributions and expectations of being granted a loan generated perverse incentives for a decision making process for personal gain rather than the benefit of the financial institution, given the confusion between the role of the shareholder and the borrower. According to experts, this situation led to the establishment of a board of directors that was not representative of the interests of the majority shareholders, some of which even interfered in the managers' decisions. Furthermore, various accounts of the situation agreed that there was a dominance of regional, non-qualified investors from groups whose participation in the Board of Directors was the result of influence campaigns,
outnumbering small, qualified shareholders. Moreover, the promotion of regional investment led to participants in the Board and managers who had no experience in financial services. Furthermore, they often had no clear awareness of what public fund management and use mean; they thought that deposits were their petty cash. Moreover, since the portfolio was aimed at funding agricultural production in the region, its disbursement was determined in many cases by political rather than technical criteria, which favored clients with higher economic or political clout.

This situation had damaging effects on the decision-making processes, which in turn caused institutional fragility. On the other hand, the country’s minimum capital requirements to legally take public deposits were low enough that entities with fragile equity structures and limitations to achieve economies of scale proliferated, and MFI 4 was no exception.

Although MFI 4 was created under the same regulatory environment that required a multiplicity of shareholders, according to some versions, a single family became the majority shareholder based on different strategies such as the shareholding consolidation through small shareholders. Initially it was created with 3,000 shareholders, but as time went by, these shareholders sold their shares in the secondary market, eventually putting ownership in the hands of a single group.

This caused serious governance problems that led to cases of fraud and embezzlement and to its final dissolution. Likewise, its origin as an entity whose governance was formed from the base of regional farmers lacking the knowledge to manage a public savings institution facilitated the emergence of weaknesses that in the end led to its dissolution.

The institution also had the support of international funders. First, a foreign-capital NGO, FU19, supported the entity from the beginning by funding the rice project in MFI 4’s area of origin. This funder’s interest in MFI 4 was the result of the institution’s agricultural focus. The involvement of FU19 originated when MFI 4 offered them a chance to buy a rice mill responsible for processing and selling the rice MFI 4 received as payment in-kind for the loans granted to producers. Due to a mandate received from the superintendence in 2000 suspending this type of operation, the director at that time and an executive created a company to manage the business and approached FU19 to buy the mill through a capital contribution. Therefore, FU19 was able to participate in the Board of Directors of MFI 4, and in this capacity it was able to play a major role in the MFI 4 rescue attempts before its takeover by another entity.
The other fund that had a significant interest in MFI 4 was FU1, which in some cases contributed capital and in others it funded microfinance entities. Between 2000 and 2001, FU1 supported another NGO that was working in the area. The NGO was undergoing serious liquidity problems due to the non-payment movement promoted by politicians in the region. Consequently, FU1 decided to seek a regulated entity that had a stronger financial structure that might take over the debt, and this is how it came to MFI 4. At that time, the institution was also undergoing liquidity problems severe enough that the superintendence was considering the possibility of an audit; therefore, FU1 decided to grant it only short-term resources. This support helped MFI 4 overcome its liquidity problems to such an extent that within 4 or 5 months it was already recovering public deposits and refunding loaned resources. After establishing a relationship, FU1, using one of the funds focused on rural-area institutions, decided to contribute resources in the form of preferred stock. As a shareholder, it participated in the strategies aimed at improving the institutional governance together with FU19 but always trusted the honesty of the main shareholders.

While MFI 4 relied upon the participation of third parties such as these funds in the Board of Directors and this participation was the focus of interest to donors, the control bodies were not able to fulfill their duties due to the collusion of other members of the Board and the fact that the audit was subordinated to the management of the institution. Therefore, it was not possible to expose the financial difficulties found during reviews.

In 1999, a local development bank started providing technical assistance to MLT1 in order to strengthen institutions like MFI 4 through management improvement and support for equity structure reform in order to secure higher productivity and improved financial reputations of this type of institution. The MLT 1 technical assistance process had two stages, and it was during the second stage in early 2003 when they made the decision to stop working with MFI 4 due to the serious problems that were identified in terms of governance, a lack of discipline within the entity and MFI 4’s lack of interest in undertaking a truly deep restructuring.

Afterwards, MFI 4 gained the support of a project of AT5 Technical Assistant to improve governance, but it was also suspended due to a lack of commitment by MFI 4.
5.4.3 Location in the Market

The microcredit market in Country B has been dominated by banking institutions in the last decade (at least in terms of value) despite the presence of non-banking financial entities of various types (MFIs types 1, 2, and 3) that serve the microenterprise sector. Type 2 institutions, such as MFI 4, have had market shares lower than 7% throughout the decade.

According to different available reports, type 2 MFIs like MFI 4 experienced fast development and increase in assets of 78% during the period between 1995 and 1997. However, by 1999 the financial sustainability of this group was threatened by an overdue portfolio ratio of 17.5%, with losses equivalent to 1.9% of equity in 1998. At that time, the superintendence ordered the divestment of seven of these institutions, with only 13 remaining institutions in 1999.

MFI 4 was one of the biggest institutions because when it was created in 1994, it accounted for 15% of assets of all the financial institutions of this type in Country B, and by 2000 it held 21% of total assets. By 2000, MFI 4 had an asset level of US$20.6 million, a total gross portfolio of US$12.5 million, equity of US$2.7 million, and deposits of US$6.9 million. Between
In 1999 and 2000, it already started showing significant increases in asset volume of 42%, a deposit growth of 50%, and an increase in the gross portfolio of 22%. In terms of total portfolio, MFI 4 accounted for 14% of the total in 1999 and 20% of the portfolio in 2000. Regarding the microcredit portfolio, by 2002 it was ranked first in this group of entities. Later, other institutions of the same type started showing a larger growth and market share even though MFI 4 was ranked second until 2005 when it fell into fifth place.

5.4.4 Financial Situation

A look at the performance of this entity since its foundation shows a solid growth with a generation of significant profits compared to equity, with an ROE that reached its highest level of 21% in 1998, and falling to 12% in 1999. Apparently, this resulted from the good quality of the portfolio coupled with the fact that the delinquency rates of MFI 4 were better than the rest of institutions of the same type (type 2 MFIs), as shown by the red line in the graph. However, when including restructured loans, increasing from 8% of the gross portfolio in 1995 to 18% in 2000, the delinquency rate was higher than the rest of MFIs of its type during almost the entire period (green line), which tends to support the opinion of various experts that believe the crisis had been taking place for several years before it became evident in 2006.

![Delinquency Rate of MFI 4 vs. Total Delinquency of Type 2 MFIs](image)

*Source: Bank and Financial Institution Superintendence.*
Despite its share of the microenterprise portfolio held by this type of entity, this entity did not use any specialized technology in its operations. Therefore, some donors designed projects to provide them with technical assistance aimed at the institutional strengthening and improving credit methodologies. Consequently, MFI 4 was part of the group of entities that received the technical assistance provided by MLT1 to develop new financial products and services, improve rural credit methodologies, develop a risk management system, and improve corporate governance.

The governance problems evident in an entity controlled by debtors led to portfolio disbursement without proper analysis and loans granted to shareholders’ interests. In fact, there was no proper assessment of credit risk in microenterprises; according to some opinions, loan allocation did not use methodologies to assess the ability of borrowers to pay, or valuen the pledges received. At any given time, there were loans backed with pledges that were valued higher than the real value, which had a punitive effect on the financial situation of the entity when the superintendence required accurate financial statements.

In 2001 and 2002, the management of MFI 4 made strategic decisions aimed at diversifying its markets by serving more micro-entrepreneurs. Therefore, they hired a more specialized staff, but they started penetrating markets where there were already some MFIs of this type and where competition was fierce. In this context, MFI 4 ended up with the worst clients of these markets and as a result, its portfolio delinquency increased. The overdue portfolio showed a significant growth, increasing by as much as 58% in 2003.

While the behavior of some financial indicators were a little confusing, there were no clear alarming signs (even though the deterioration seemed a well-known secret) until 2004 when the entity showed significant losses equivalent to 22.8% of equity. In that same year, the overdue portfolio was reduced, and the gross portfolio showed an increase of 20% in a year. However, in 2005 the situation seemed to reverse according to the public financial statement records because the entity made a profit again.

On the other hand, the financial income/gross portfolio ratio was not reduced significantly during those years, as expected due to lack of portfolio productivity. This was evident in the statements of several respondents who attested that the management carried out maneuvers aimed at postponing the disclosure of the overdue portfolio when granting loans with a single
payment at the end of the term, and which were refinanced just before maturity, or another loan was granted to pay the first credit before maturity.

Furthermore, it is important to point out the deposit growth until 2003, when according to some opinions the entity used high-rate deposits to cover the liquidity shortages resulting from a non-performing portfolio. As is shown, the high level of deposits was the result of MFI 4's rates that were well above the market rates. Even though this was a clear sign of liquidity problems in a financial market, investors continued making deposits because it was an institution subject to specialized government supervision and was covered by deposit insurance.

5.4.5 A Time of Crisis: A Well-Known Secret is Revealed

According to experts, the crisis had begun a long time before it was evident (some said that the deterioration lasted 4 years), considering the loans to linked companies, shareholders, and Board members who used the institution for their own benefit. The Board included three external members who at the beginning of the decade participated in the audit committee and discovered the first fraudulent loans signed by employees from the companies owned by the shareholders, a situation that was revealed to the superintendence at one time, according to some respondents. These findings even made donors try to consolidate the shares of minority investors to form a controlling group and develop a strategy to rescue the entity in 2005.

The crisis was clearly evident in the balance sheets of MFI 4 when the superintendence conducted a supervisory visit and discovered embezzlement particularly with regard to the linked company portfolio. At that time, it was evident that all operations were performed under a very weak governance structure and through the abuse of power exercised by a family who was a member of the institution. Therefore, it was discovered that the companies and people linked to the entity not only received the benefit of loans that lacked proper risk assessment or proper pledges, but also some services engaged by MFI 4 were provided by companies owned by majority shareholders. The situation escalated further because when MFI 4 exceeded the risk exposure limit with a single debtor as stipulated in the regulations, they decided to create companies (some ghost and others real) to evade the risk limit thus causing a risk overexposure to the economic group of controlling shareholders.
The indicators of the entity at the time of the crisis in 2005 and 2006 showed its deterioration. There was a decrease in the asset value by 20%, accounting for more than US$5 million, and the overdue portfolio skyrocketed, due to the adjustment process stipulated by the superintendence during the audit among other causes, and caused a reduction of 50% of equity, equivalent to US$1.4 million.

In fact, in the financial statements of 2006, the superintendence detected that they had not disclosed the real economic situation of the entity and found problems that led to a special supervision regime. During this process, the superintendence conducted monthly supervisory visits and tried to convince the Board members and shareholders to repay the capital losses when the assets became impaired. The more evident the deterioration of MFI 4 became the higher and more evident the fraud was, and this situation was so serious that, according to some respondents, the Board members went to the branches to withdraw money using fake documents, as advance payments of per diem allowances.

In 2006 when the crisis became unbearable, the superintendence started looking for exit strategies for the entity while trying to protect the resources of savers and the low value of the good assets of the entity. The decision of the superintendence at that time was to look for another entity that would accept the assets and liabilities of MFI 4 in order to keep providing the services in the area where it operated.

### 5.4.6 Exiting the Crisis

During the crisis of MFI 4 and the audit by the superintendence, another microfinance entity with a legal structure different from MFI 4, which we will call MFI 11, was developing a market expansion strategy by increasing its coverage to reach markets along the border with a neighboring country. Since these operations were still under an authorization process and because the superintendence considered the MFI 4 market to be in the same market corridor as MFI 11 and its future operations in the neighboring country, it was decided that MFI 11 would take over MFI 4. According to some respondents this was a mistake because they were not actually geographically close markets.

The solution included shrinking equity by paying off the losses shown after disclosing accurate balance sheets, in which all the shareholders who had losses were those who did not have a loan. In fact, the shareholders who had a loan and were faced with the possibility of losing their investment decided
not to pay the loans (which in the case of cooperatives is called "a silent run"), so when the "accordion" operation was performed, the people with the highest losses were the shareholders who did not have any loans with the entity.

According to some observers, the management of the crisis by the superintendence prevented the bankruptcy of MFI 4 from generating traumas in the market because public resources were not lost; however, it hindered the self-criticism and lesson-learning process that would have been necessary. From the point of view of the supervisor, the decision was to protect the public trust in the financial system and preserve the financial services provided in the sphere of influence of MFI 4 and avoid a traumatic market exit.

During the MFI 4 takeover process by MFI 11, there was legal difficulty with making a public offering (as instructed by the Securities Commission since MFI 4 was a corporation) even though MFI 11 already had the control over the shares of MFI 4. At that time, the institution had 5,000 shareholders in the area, and they needed to be located and gathered in order to buy 100% of the shares between August 2006 and December 2007.

MFI 11 took over the entity with the balance sheet supposedly disclosing its true economic situation. However, it took over not only the liabilities with the public but also the bad quality assets of the entity. In fact, the takeover process was never preceded by the writing-off and separation process of "bad" assets in order to provide the new entity with a good quality balance sheet. Instead, there was a takeover of all the good and bad assets and the respective liabilities. In fact, after the takeover process in March 2008 by MFI 11, there was an investigation conducted by an external auditor who discovered a situation that was worse than expected. Therefore, MFI 11 decided to file criminal charges against all the present and past directors of MFI 4 in order to protect itself from any contingencies.

While the financial situation of MFI 11 was good, its balance sheet was still affected by the takeover of MFI 4. Besides having to take over a worse-quality asset, it had to change the financial conditions of deposits by decreasing the deposit rates and losing the inherited liquidity.

According to reports of MFI 11 by rating agencies, its financial statements for 2008 recorded higher provision requirements to transfer the bad portfolio of MFI 4 with an increase of 41.84% in the problematic portfolio. According to these reports, and as shown in its financial statements, the merger caused
an impairment of the main portfolio quality indicators of MFI 11 since the delinquency indicator was increased from 5.3% to 6.7%, with the resulting increase in provisions. The profits in 2008 were also affected by this situation, as they were decreased by 1% compared to the profits of the previous year, as a consequence of the increase in the operating expenses due to an increase in the number of employees needed to manage a larger operation.

As a result, the inherited situation was so serious considering the frauds detected in MFI 4 that MFI 11 needed years to be able to cushion the takeover impact.
5.5 MICROFINANCE INSTITUTION 5 – COUNTRY B

5.5.1 Institutional Background

MFI 5 was created as a branch of Bank 5. It was created in November 2004 as a corporation with the purpose of granting and collecting microcredit loans to be disbursed by the bank. The former president of another successful microfinance bank in the same country, Country B, developed this idea after leaving the bank where he used to work in 2003 and started developing a microcredit granting and collecting project through his consulting firm. This consulting firm is still operating and is based in Country B. Its mission is to develop their clients’ business mission “...aimed at facilitating their sustainability, profitability, and quality of services, by combining strategic management with commercial, operational, and technological management.”

This project was presented to various financial institutions, and Bank 5 showed the most interest in what was seen as a market opportunity, considering the high level of competition in the traditional niches Bank 5 served. Bank 5 is owned by a business group from a neighboring country. Its majority shareholder is a local bank in that country and which invested in Bank 5 as a result of a strategic decision made in 1997 to expand its presence in the Andean region.

In 2003, Bank 5 started diversifying its business lines by serving other sectors besides the business sector where it had originally focused. This diversification was happening when the consulting firm proposed the development of a microcredit origination and recovery project. Bank 5 decided to expand their business to include microcredit, by implementing a specialized program through an affiliated scheme, similar to the scheme adopted by the financial group from the neighboring country. The strategy was based on technological support and a joint venture with technical assistant TA2. Given the success of Bank 5 in their country, their original idea was to adopt the same scheme of a parent company’s subsidiary serving the microcredit market in the neighboring country, with the same clear market concepts and objectives of the subsidiary, but adjusting it to the market in Country B. Consequently, they decided to accept the proposal of the consulting firm, establish MFI 5, and appoint their sponsor as the general manager. At that time, a partnership with a person who had experience and was a local market expert was deemed a guarantee for a successful project.
According to the information gathered, the project operating scheme was based on the granting and recovering of loans by MFI 5 (on an outsourcing basis), while the loan approval and further disbursement approvals were made by Bank 5. In order to serve microcredit clients who were very different from the Bank’s traditional clients, they decided to create 8 branches of MFI 5 that "mirrored" Bank 5 and where the clients’ loan applications were processed and evaluated. The client would only have to go to a bank branch to receive their disbursement. The operations of MFI 5 were based on an in-house technological platform (used by Bank 5) while their staffed was filled with commercial officers who had previously worked in other, more successful banks of Country B that specialized in the microfinance market.

The publicly available information on this case is scarce, but it was possible to find some newspaper reports explaining that the proposed medium-term, 5-year goals included the granting of US$30.2 million in loans, and the service of between 100,000 and 150,000 clients. These goals necessitated reaching up to 25,000 clients during the first year. Such goals entailed not only significant efforts for the bank (the goal accounted for 8.6% of the total portfolio as of June 2004), but also seemed quite ambitious when compared to the results shown by the local banks at that time. In fact, in June 2004, the banking sector had a total of almost 243,000 microcredit clients, whereas the bank with the most clients had 80,000 clients. The MFI 5 project implied increasing the number of clients of microcredit banks between 40% and 60% in 5 years. According to these reports, the achievement of these goals was possible only in the case of MFI 5 because it had a manager with knowledge and experience in the market and microcredit methodologies, which would have allowed the entity to achieve “…a significant distribution capacity at a national level and supported by a start-of-the-art technology.”

5.5.2 Market Position

With respect to value, the local microcredit market in Country B has been dominated by banking institutions in the last decade, in spite of the non-banking financial institutions serving the microenterprise sector, as is the case of type 2 and type 3 MFIs. Type 1 MFIs are the most important intermediaries in this market after banks. The market has been characterized as a highly developed market with a high competition level,

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16 The reduction can be seen in the graph showing the bank share by type in microcredit loans during 2009 as a consequence of the transformation of a bank into a financial institution, resulting from a change of shareholders.
particularly in the major cities in the country. When the MFI 5 project was launched, 95% of microenterprise credit was granted by regulated entities.

Bank 5 started participating in this market in late 2004 when MFI 5 began operations; by December of that year, it had 2,994 clients, and their microcredit portfolio amounted to US$6.4 million, with an average loan size of US$2,180. In 2005, the microcredit balance rose by 140%, while the number of clients tripled and reached 9,384 clients in June 2005. During the second quarter of 2005, the growth in clients stabilized and then fell in 2006 and as of the first semester of 2007, the portfolio balance shrank, clearly indicating the presence of problems. As of June 2007, the Bank reduced the portfolio targeting this segment to US$13.4 million and served more than 13,000 clients.
The following graph shows the penetration progression of the microcredit program of Bank 5, versus the microcredit penetration of the rest of the banking sector, taking into account that the objective was to achieve a significant share of this sector. Until June 2007, the penetration achieved in the number of clients was 3.7%, whereas the value was 1.5%, suggesting an average value lower than that of banking institutions. MFI 5 had been able to grow fast, which was not an easy task in such a competitive market.
In spite of the results, a growth level in terms of clients of 373% in the first year and 113% in the second year, and 302% and 32% growth in terms of the portfolio, but it still did not meet the initial budgetary goal of the project.

5.5.3 Some Performance Indicators

The financial statements of MFI 5 as an independent affiliate of the Bank were not available. Therefore, an analysis was conducted based on the microenterprise loan portfolio recorded by Bank 5. When MFI 5 started operating in December 2004 the microcredit portfolio accounted for 1.9% of the total portfolio of the Bank, but the number of clients already accounted for 5.5%. From then until December 2005, microcredit accounted for almost 5% of the total portfolio of the Bank and 18% of the total clients. According to some respondents, the crisis that almost led to the demise of the venture took place in 2006 and 2007. Additionally, according to publicly available information, the main observed impact was on the value of the microcredit portfolio, which dropped and accounted for just 3.6% of the total portfolio of the Bank, while the impact on the number of clients was not that significant, since the number of clients remained at 13,000, accounting for just 11% of the clients of the Bank.

The evidence concerning the start-up of the crisis is clearly shown in the delinquency rate. The following chart shows the behavior of the delinquency rate according to publicly available information. According to these figures, MFI 5 was growing so rapidly that portfolio delinquency reached its PAR > 30 peak of 10.5% in just one and a half years. This led to curbing growth and stabilizing the portfolio, but as of June 2007, PAR > 30 is still higher than 9%. Even though this is a very high indicator for microcredit markets, several respondents pointed out that during this period there were various branches with delinquency levels higher than 20%.
The board members of the Bank were aware that penetrating the microenterprise market required the use of a specialized and appropriate methodology to select, manage, and recover a portfolio in a market with such particular characteristics. Therefore, given the success achieved by the parent bank with the subsidiary model in the neighboring country, they not only adopted the model, but have also entrusted its management to a person who seemingly guaranteed project success due to his experience in successful microcredit methodologies. This confidence was translated into such an excessive trust that, according to some observers and available information, it led to a relaxation of the Bank controls. In fact, Bank 5’s control standards were not applied to the operations of MFI 5. Consequently, it took some time to detect problems in implementing the methodology that led to the final decision of divesting in the affiliate and adopting another strategy to remain in the market.

5.5.4 Time of Crisis

The crisis in the microcredit program implemented through MFI 5 quickly became evident. As of late 2006 it was obvious (2 years after its start-up), and could have been detected even sooner if judged by the behavior of the delinquency ratio. The results were not as expected by Bank 5 since it did not even reach 25% of the budgeted disbursements.

At that time, it was evident that even though there was supposedly a systematic implementation of the best practices of microcredit technology, the desire to grow led to implementing an incentive method for the microcredit officers that was heavily loaded towards the growth of the portfolio over its collection. It seems that the management of MFI 5 considered that this was the only way to achieve the goals proposed to Bank
5. It believed it was going to achieve a rapid penetration into the microenterprise market without taking into account that a lack of a proper growth management was a risk factor that often makes the difference between success and failure of a microcredit program.

The situation went so far that there was even collusion between loan officers and clients, which generated duplication and over-sizing of loans, document forgery, and the granting of loans based on fictitious references. The lack of controls also contributed to the rise of this kind of fraud. As an example, there was a situation at one of the branches where there was complicity among all the branch employees, causing a loss around US$185,000.

Some of the observers even stated that the microcredit officers accelerated the granting of new (actual and fraudulent) credits in order to receive bonuses and leaving the MFI in 5 months or so before delinquency became evident.

The initial goals were not only challenging, but the Bank had also short-run expectations which added strong pressure to achieve results. In order to achieve these goals, they forgot about loan officer training (some who were new and others who came from other banks) at an advance training stage, and instead threw officers immediately into generating a portfolio. This situation worsened because among the people hired by MFI 5 were a significant number of former employees of an important microfinance bank in Country B, who were feeling spiteful and wanted to damage the market of such an entity. Other versions suggest that these people were not highly trained, and their reasons for leaving their former jobs were not considered.

Some opinions agreed that the motivations that gave birth to the business were influential to the outcome. According to some responders, the motivations of leaders of MFI 5 were driven by hurt feelings, to the point that ambitious goals were aimed at destabilizing another leading financial institution in the local microcredit market. This led to a relaxed implementation of microcredit methodologies and failed attempts to align business and risks with incentives that gave more importance to loan granting rather than loan collection. Thus combining all the perverse incentives, the turnover of loan officers increased who remained in their positions just 3 or 5 months before delinquency problems became evident.

The situation in general worsened due to the excessive trust of the Bank in the management of MFI 5, which led to failure to implement the same control
scheme applicable to the rest of the Bank subsidiaries, which aggravated the situation and did not provided timely corrective actions.

Another factor that had an adverse effect on the results of the entity was a conflict between the banking culture of Bank 5 and the microcredit culture of MFI 5, whose loan officers came mostly from a microfinance bank. Not surprisingly, even if many observers have stated that a subsidiary dealt with such cultural conflicts, the institutional culture of the Bank strongly collided with the clients and officers of MFI 5; to the point that clients did not want to go to the Bank 5 branches to collect loan disbursements or pay installments because they felt discriminated and mistreated. As it was later confirmed, this situation also happened between the Bank officers and the staff MFI 5, and affected employee relations during institutional events. This might have been a reflection in the lack of clarity of the motivation of the Bank when it initially decided to accept the proposal of the sponsor of MFI 5, and did not consider the implications of such a decision.

In light of the latter, the Bank decided to change the initial management of MFI 5. The change in management led to the replacement of the manager with an officer from Bank 5 who had a lot of experience in traditional banking. According to data gathered, this change also caused a high turnover of microcredit officers, leading to an increase in the overdue portfolio that reached 25%. Based on the same information, a large part of the deteriorated portfolio was written off, which explains the resulting overdue portfolio expressed in their balance sheet.

The change in management and the replacement of the management structure of MFI 5 by Bank 5, led to a change of strategy during the period elapsing from June 2006 to December 2007.

Some observers pointed out that the new management of MFI 5 did not improve the situation either; moreover, they also indicated that as they were not familiar with market methodologies and results worsened. A review of the goals proposed initially was conducted and took into account the option of closing the institution and exiting the microcredit market. However, a diagnosis conducted at the end of 2006 ended up convincing Bank 5 about the profitability of the microenterprise market and the advantages of continuing the business. According to some observers, it wasn’t until then that Bank 5 actually made the clear and true decision of entering into the microenterprise market. At this point, the subsidiary from the neighboring country became involved through direct advice and training to new credit officers.
5.5.5 Exiting the Crisis

The strategies implemented by Bank 5 and supported by the subsidiary from the neighboring country, in addition to replacing the management team, started a cleaning process of the portfolio and refrained from granting new loans, practically throughout 2007. This also included a management restructuring of MFI 5, when most of the original officers left and new officers were hired.

At that time, the institutional crisis was so serious that it posed even a reputational risk for Bank 5, so the strategy also meant isolating MFI 5. It was even stated that the bank had such a poor image that people who had worked for MFI 5 did not mention their experiences in their resumes\(^{17}\). It was precisely because of this and the need to achieve operational savings\(^{18}\) that in late 2007 and in early 2008, the Bank decided to dispose of MFI 5 and its trade-brand, but without leaving the microenterprise market. Consequently, the Bank 5 took over MFI 5 and created an internal division for its operations. This process was somewhat hindered by the difficulty in hiring new business officers given the bad reputation of MFI 5 because nobody wanted to work for that division of Bank 5. It was necessary to open a loan officer training school to coach professionals who were new to the business, and in 2008, of the 200 officers working for the Bank, 150 had been trained at this school. Moreover, they had to improve their salaries to keep them and to strengthen mechanisms to control their activities. According to observers at that time, another problem faced by the Bank was the need to attract new clients because they lost most of them when they had to replace all the original loan officers. However, this statement was not confirmed by the publicly available figures because, in fact, the reported clients only decreased for a couple of months during the first semester of 2006.

The decision to incorporate the program in the Bank meant a change of management in 2008, starting with the recognition of the need to create an institutional culture within the bank that would allow incorporated micro-entrepreneurs as clients, within a culture of service to business clients and

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\(^{17}\) An interesting fact is that the professional background of the first MFI 5 manager described in the website of the consulting firm did not even mention this experience.

\(^{18}\) It was not only MFI 5 which accounted for the high costs of institutional infrastructure but also the billing process between MFI 5 and Bank 5 which generated sales taxes.
others from a different socio-economic level. It is important to point out that, according to some respondents, it was difficult to accept the directive of the Bank aimed at serving the microcredit market within the institutional culture of the Bank, which caused some conflicts that had to be solved, even at a branch level. According to some information, part of the success of the strategy to solve the institutional problems was to entrust the person in charge of the Bank channel network to manage the microfinance division.

Another key element of the direct training of officers was training done in a subsidiary of the Bank based in a neighboring country. This training aimed at implementing the same business model and incorporating changes in the risk model which included the monitoring of credit officers conducted by risk analysts; a practice in force at that time in the rest of the subsidiaries of Bank 5. The integration of the microfinance business into the Bank implied closing all “mirror agencies” and using instead only the Bank branches.

The decision made by the Bank consolidated even more when its long-run mission and vision was modified to incorporate micro, small and medium businesses within its target market. According to some directors of the Bank, in 2008 the growth was healthy (without any fraud), and was able to take advantage of the positive synergies of businesses done by the Bank, such as a strategic alliance with an appliance store and the collection of payments through this network. This alliance allowed for an increase in the number of branches to almost 100. For Bank 5, its microfinance division is a success story within the Bank, to the point that they are working to implement similar incentives systems to serve other segments.

The Bank acknowledged that it had underestimated the importance of implementing the best practices of microcredit methodology, including proper controls throughout the process. This experience demonstrated that microcredit business is complex and requests specialized management and knowledge of the market.

The successful recovery of the business is shown by the figures as of December 2009. The microcredit portfolio amounted to US$ 52 million, and the clients served rose to 43,000.
5.6 MICROFINANCE INSTITUTION 6 – COUNTRY C

5.6.1 Institutional Background

MFI 6 was born in late 1996 in Country C. However, its origins date back to 1991 when the Sponsor Foundation was established with the mission of finding a suitable mechanism to give micro-entrepreneurs access to credit. In 1995, the Foundation purchased a financial corporation owned by a bank thanks to the impetus of a company responsible for developing real estate projects and whose owner later became one of the sponsors of the Foundation and president of the Bank. Soon after, the Foundation became the social sponsor of the Bank. The financial corporation had a few assets and a portfolio focused on individual credits that accounted for half the portfolio – which at the end could not be collected.

In 1996 a crisis led to the bankruptcy of various non-banking institutions. In order to avoid damage to their image, the institution decided to become a Bank (from now on referred to as MFI 6). The regulations in force allowed deferring the minimum capital contributions as long as the bank emerged from the merger of two or more financial entities. Therefore, in that same year the financial corporation merged, through a take-over, with another entity that had the same legal structure but that was dragging a heavy commercial portfolio with a delinquency ratio over 40%. After filling in all the legal formalities in record time (it is said that it was just two weeks), in August 1996 the former financial corporation was granted a bank license and a three-year term to meet the minimum capital requirements. The fact that they had absorbed another financial corporation that was having problems, explains in great part, why the license was granted by the Superintendence so rapidly.

MFI 6 became one of the first regulated financial institutions in the region to be established with solely private equity, both local and international, and whose mission was to provide financial services to those sectors that were not served by traditional banks.

5.6.1.1 Shareholders and Sponsors

MFI 6 was established with local capital contributed by a dozen national shareholders, some of them traditional bankers. However, this situation changed during the first years of operation for two reasons. First, after a year the institution was able to attract foreign investors who were interested in
the target market defined by the institution in a country with little microfinance competition. It received a capital contribution from the first venture capital fund created in the region and also partnered with an international NGO that also provided TA2’s technical assistance services. Later on, TA2 contributed both capital and technical assistance to the institution for several years. At the same time, institutions such as FU21, FU22, and MLT2 became part of the shareholding structure. Second, since a small group of shareholders were internally trying to exercise hegemonic control, various local shareholders gave up the idea of staying at MFI 6, which led to their departure. As a result, most of the shares were held by the three founding shareholders. At the beginning, one of the majority shareholders was a financial institution specialized in construction with a shareholding of 15%. The fact that most shares were held by companies and people closely related to the world of construction played a major role in explaining the determination of MFI 6 to enter into the real estate business.

After the fourth year of operations, 27% of the shareholding of the institution was held by foreign investors which continued growing, and during the eighth year, reached 38%. Nonetheless, the Bank remained under the control of a small group of founding shareholders who with their shareholdings and the shares owned by their relatives and their companies had a majority interest. Paradoxically, the sponsor Foundation that played a major role in raising funds never had a controlling interest in MFI 6 since it started with a 2% ownership and reached a maximum of 6%.

Despite the shareholding structure, almost since its inception, the foreign investors had a representative in the board of directors, who were later joined by other representatives of the funds FU1, FU4, and FU23. Those funds were attracted to the good results reported by the institution and the constant innovations that were proudly boasted by its Boards of Directors. After nineteen years of operation, the list of investors included 11 international investors and more than 70 local investors, including companies and individuals. As indicated before, the ownership structure of MFI 6 was always highly atomized, which probably worked against the MFI since a few shareholders took control of the entity.

5.6.2 An Evolution Characterized by Innovation

During the first years, one of the majority shareholders who had banking experience was appointed president of the Bank. In spite of his speech in favor of microfinance, he gave MFI 6 a business oriented vision focused less on microfinance, forced partly by the fact that the institution had inherited a
highly business concentrated portfolio volume from the institution that was taken over. The president left the institution because he decided to get involved in politics and also because it was discovered that a large volume of loans were granted in his favor.

Later, the owner of the real estate developing company and also one of the majority shareholders of MFI 6 took control of the institution by simultaneously holding the position of chairman of the board and chief executive officer. In spite of the evident concentration of power and duties in just one person, who was at the same time shareholder, director, and CEO of the Bank, the decision was considered beneficial since besides his alleged commitment to microcredit, his dynamic personality and energy were deemed instrumental for the success of the institution.

MFI 6 started growing and had a lot of reasons to do it fast. First, the minimum capital of the institution, which was reached in 4 years, was significantly higher than the amount that could be absorbed by the microcredit portfolio, which was just starting its consolidation stage. Second, there was a significant amount of funds coming from international cooperation agencies. Third, there was a need to generate positive results to meet the expectations of local investors who believed in the business. These factors combined with a management led by traditional bankers, a significant volume of inherited business portfolio, and a strong orientation by various shareholders towards the real estate business, led MFI 6 to develop a strategy to avoid concentrating exclusively on microcredit. They were aware that if they had not done this, it would have otherwise taken them longer and required more efforts to leverage the institution efficiently. Consequently, the institution reached for other products; a strategy that according to some would eventually change as the institution so that it would be able to generate an adequate microcredit volume that guarantees the sustainability of the institution.

Since its inception, MFI 6 had two balance sheets; one for the commercial banking institution and the other for the microfinance institution. To illustrate, two years after its creation, 85% of the total portfolio corresponded to business credit portfolio, while the microcredit portfolio represented 15%, though even with such a low volume it was leading MFIs in the country. It was only after ten years of operation that the situation reversed, although not completely; the microcredit portfolio reached 70% of the total portfolio. Also, despite ten years of operation, the microcredit
portfolio accounted for just 42% of total assets, which meant that the institution was still managing a business based on different approaches.

The slow growth of the microcredit portfolio was influenced by the need to consolidate credit technology, which as explained before, was not easy given that the regulated entity was created prior to building a microcredit portfolio. The venture faced problems which were reflected by the fact that after just two years since its set-up, the delinquency ratio of some branches reached 20%. According to the interviewees, this was due to problems in the product design, the lack of institutional commitment towards a zero delinquency policy and the lack of a rigorous loan evaluation and management methodology. Nevertheless, as time passed, the institution gained experience and consolidated not only a portfolio but also a team that was managing a relatively successful business, using both group and individual lending technology, and thanks to the technical assistance of TA2.

During ten years of activity, MFI 6 had over 150,000 microcredit clients with a share of the microcredit portfolio of more than a quarter of the entire financial system and 40% of the clients, thus becoming the leading microfinance institution of the local market. Their market share was achieved thanks to the fact that MFI 6 structured a business that complemented productive microcredit lending. Such business consolidated, matured, proved to be very profitable for MFI 6 and also had a zero risk, gold-backed credit. In 2005, this portfolio accounted for 17% of the total portfolio and 80% of the clients. In the same year, MFI 6 was not only the first regulated microfinance in the country, but also became the most important entity.

While entering a new business, the dynamism contributed by its President with the support from TA2 and the other international shareholders, the decision to launch various products were sometimes directly related to their target market, and sometimes they were not. These new products included retail loans, builder loans, and medium-enterprise loans. Some of these products concentrated in highly atypical portfolios for a microfinance institution to such an extent that at a given point, 13% of the portfolio was concentrated in 40 borrowers, with an average loan of over US$650,000.

The growth’s momentum led to a diversification of the business units, which at that time, were deemed as visionary by the executives of MFI 6. Therefore, since it was a pioneering institution in the microfinance industry in the region, soon it was evident that one of its restrictions was the lack of a technological platform. Consequently, a subsidiary was created to develop a
banking core suitable to the needs of MFI 6, and that demanded the control of low value operations which should be also monitored in a close and efficient manner. The team of MFI 6 came soon to the conclusion that if they had such need, other microfinance institutions in the region would also have them. Therefore, they decided to create a subsidiary to develop software programs to support the business operations of MFIs. It was anticipated that the subsidiary could attract private capital, yet that never happened. The programs were likely to have limitations that are bearable when an organization develops it in-house for itself, but it does not work that way when the software is developed for other microfinance institution that has already paid for it. Besides, the needs of the institutions exceeded the capacity of the subsidiary team; therefore, it was decided to close it as a business division and leave it as a support division for the institution itself.

MFI 6 also offered new products. Given the close link and the knowledge some shareholders had on the real estate business (including the President), the evident for housing of low-income families, and the aim of MFI 6 to fulfill such needs, it was decided to venture strongly into mortgage funding for new houses. This was not only the beginning of a new experience in a product that demanded the management of a liquidity in a very different manner than the one in microcredit, but also a very different granting and credit risk management. MFI 6 was able to take advantage of a grant program that subsidized housing demand in the country at that time, and launched a credit product through which families could use their savings to access a housing grant from the Government and get a loan from the institution.

The problem was, as indicated, that the rational for participating in a more complex business was that there were not enough construction companies that could generate enough supply of houses to serve this segment of the population. Consequently the institution argued that real estate savvy players of MFI 6 could play a major role by stimulating the supply. Therefore, they approved the participation of MFI 6 in some real estate trusts, where MFI 6 would not only invest in fiduciary rights on the lands and the potential project, but it would also fund the developing and construction of houses with the intent to sell to heads of low-income households who would later become clients of the institution. At the end, the source of the real estate properties in which MFI 6 had an interest through fiduciary rights (which in 2006 accounted for over 10% of the assets), was seriously questioned, as well as deviation of important human and financial resources into the development of such projects, which did not achieve the expected success.
MFI 6 and its President always wanted to look for comprehensive solutions for the target market. During that search, the entity was one of the first institutions to understand and assess the potential that immigrant remittances had. Consequently, it ventured into a new business line aimed at channeling remittances. It set a the strategy based on alliances with foreign financial institutions that would receive the immigrants’ remittances while MFI 6, without charge for the service, would receive the funds and deposit them in savings accounts opened in the entity. How was MFI 6 going to make a profit from this business? It was argued that the remittances would provide a stable funding source and they would also facilitate the product cross-selling, particularly mortgage loans, since having a house upon their return to the country was one of the immigrants’ main goals. This project not only absorbed the availability of several officers of the institution, including the President, but it also demanded significant investments both in trips to consolidate the alliances with other institutions as well as in start-up expenses of new branches, where a MFI 6 subsidiary would operate. This project reflected the vision of its President, yet in practice it never materialized since the mobilization of savings was not significant, and sales of houses of their real estate projects were not significant.

Another innovative product developed by MFI 6 was a smart card that allowed micro-entrepreneurs to pay purchases to suppliers based on a credit limit. The card would also allow micro-entrepreneurs to collect payments that were accounted as payments to their credit balance. This product faced several problems, among them, a lack of understanding of the product by micro-entrepreneurs and suppliers (the sales terminals soon became obsolete) and difficulties to manage the credit limits that were linked to the repayment trend. Once again, the idea did not materialize into an income flow for the institution; not only were resources used and the attention of the management diverted from other products, but also in spite of the investment of millions and the management boasting about the investment, in practice it was a total failure since it was never able to operate properly and it was also technologically inferior to other products in the market.

Several of the products gave MFI 6 an innovative image in the eyes of both funders and attendants of the international events in which MFI 6 showcased its projects. This image earned the institution grants for several initiatives from the international community, which freed up MFI 6’s resources from fund-raising endeavors.
In an effort to grow, leverage the business efficiently and channel the resources obtained, MFI 6 created various business lines and products, some of them successful and others not. In parallel, at least four companies were developed under the growth of the entity and they were somehow related, but they kept an independent ownership structure that was governed by the local majority shareholders: a brokerage house, a fund manager, a real estate company, and a computer company. Even though there were more than twenty companies that were related to each other, they were not formally linked to MFI 6. The goal was really ambitious because they were trying to create a financial holding company and a comprehensive service offering to the target group.

5.6.3 The Management

The leadership of the CEO, who at the same time was the chairman of the board, his charisma, and the image he initially projected as a visionary, together with the commitment and dynamism of its executive vice-president and the good results of the institution in the early years, generated even more trust and great expectations about the institutional path to be followed by the directors, funders, executives, and officers.

The control hegemony continued even after foreign investors joined the institution and who, based on the dynamism of its main executives and a prosperous microfinance business, gave him all their approval and trust. In spite of the control concentration, there were internal control problems that were evident in the fact that the internal audit department had little independence because it had to report directly to the CEO.

The control problems worsened because even though the Board meetings were held on an annual basis, a recurrent complaint of the members was that the materials to be discussed during a morning brief meeting were sent to them a few hours before. As time went by, according to some directors, the institution established the practice of holding separate board meetings. During type A meetings, which had an off-the-record nature and were attended by the local majority shareholders, key strategic issues regarding the institutional performance were discussed, whereas during type B meetings, attended by the legally organized board including the representatives of foreign investors, the sessions focused on a fast review of the reports that pointed out the good results of the entity.

A report developed by consultants engaged by a foreign cooperation agency pointed out the existence of a disconnection between the CEO and the
different vice-presidents. The accelerated innovation pace and the product and business diversification might have prevented proper coordination among the different managers.

Even though the remuneration of executives and the fees of directors were above average, a high turnover of these positions was evident throughout the years. Some officers suggested that there was a rumor inside the institution which held that if someone opposed the CEO, the dissenter would be dismissed. There were some rumors about a vice-president who resigned a few days after being hired because he expressed some concerns about the transparency of the financial statements.

To minimize the power concentration problem detected by several directors, a concentration they were uncomfortable with after having been suspicious about some institutional operations, the Board recommended hiring a general manager just two years after MFI 6 started undergoing a serious crisis. The proposed action was implemented, but the power of the CEO was so strong that he appointed an inexperienced person as manager, but he soon became another of his subordinates who lacked independence in the decision-making process.

5.6.4 A Financial “Earthquake”

Amid the effervescence to generate business and products, and when MFI 6 was able to consolidate itself as a microcredit leader, the country where the institution operated underwent an unprecedented financial crisis in 1999 that led to the divestment of 22 entities and to auditing of 11 by the Superintendence. According to the Bank president, it was a financial earthquake that devastated the structure of an entire system. In fact, the earthquake had swept 60% of the financial institutions in the country.

There were two main causes of the financial crisis. First, there were macroeconomic problems reflected in an inflation rate of 60%, a depreciation of 190%, a tax deficit that went from -1.8% of the GDP to -5.8%, and a GDP that contracted by -7.3%. There were of course repercussions on the country’s productive activity and consequently on loan repayment. Second, the significant concessions granted by the legal framework to the financial institutions to create financial groups which in most of the cases were funded with linked loans in proportions much higher than the established limits. For instance, one of the first banks that went bankrupt in Country B had linked loans higher than 300% of the equity.
MFI 6 was severely hit by the financial crisis, but the general distrust of the population in the financial sector did not affect it. In fact, at that time it became the leader of the financial system in delivering government housing grants. Therefore, many people who withdrew their deposits from other entities deposited them in MFI 6, hoping to access government grants and the corresponding credit. Moreover, the international shareholders mobilized and were soon able to implement an emergency credit program to achieve liquidity, something that reinforced client trust in the financial institution.

Nevertheless, at that time the seed of problems was planted and it led to experiencing a major equity difficult – the development of real estate projects based on trusts. When the crisis emerged, MFI 6 had already created some fiduciary operations. The first operation since its organization was when it accepted a swap of the deteriorated portfolio of the financial institution takeover for land that would be later used for housing construction. The second operation came after the departure of some national shareholders when there were problems among the founding shareholders because they did not share the same future vision of the institution. According to one of the respondents, the properties that were included in the trusts gave rise to credit operations with linked loans that allowed one of the shareholders to buy the shares of a departing shareholder and thus claim majority shareholding. According to others, including the majority shareholder, the transformation, as instructed by the Central Bank, of some assets into real estate trusts happened as a consequence of investment freezing and reserve requirements in the financial statements submitted to the Central Bank and the government. The financial institutions received, in exchange, bonds that could only be used to purchase assets of divested entities; therefore, MFI 6 chose to buy lands using such bonds. Furthermore, the institution took advantage during those difficult years of those bonds to repay the debts with the second-tier entity that had supported its growth, a financial operation that bought bonds at a discount and paid liabilities at 100% of their value. The profits of the institution obviously benefited from this operation, obtaining something good from a situation absolutely adverse to the financial business.

The dollarization of the economy to restore the national situation to normal obviously hit the real estate business because houses that were usually sold in dollars (because in practice the agreements had become dollarized a long time ago) became inaccessible for national citizens who had savings in local currency. Even though MFI 6 initially started funding builders, it slowly
changed its direction and decisively entered the real estate business by operating as property owner and contractor funder. Consequently, MFI 6, under the legal concept of fiduciary rights ended up with lands that were hardly realizable and had to wait for the crisis to be over and try to develop them, sell the houses, and obtain a return on investment. In the meantime, MFI 6 accounted for them as investments and valued them year by year.

MFI 6 was able to overcome the crisis thanks to the strong microcredit portfolio, particularly the portfolio with gold as collateral which during times of financial distress became a useful tool to give families a break with their most pressing needs. Other factors were also very important, such as an ingenious treasury management.

The impacts of this financial earthquake were varied and had immediate consequences and other medium-term repercussions. For instance, the decline in the loan portfolio volume was immediate since it decreased by 16% in 2000 due to a lower demand for credit, but also due to the dollarization effects that liquefied a portion of the institutional assets. The crisis reduced the ability to pay of individuals, something that had repercussions on the delinquency level that was 5% in 2002. For trust operations relating to lands and construction works that proliferated due to the government housing grants, MFI 6 reported about 24% of the assets as investments during that year, an amount equivalent to US$34 million, almost three times higher than the equity of US$12 million.

The financial crisis was devastating for many financial institutions, but MFI 6 only reported losses in 2000 and 2001, when the ROE was -5.9% and -9.2%, respectively. Such a relatively positive result was surprising because the institution already faced problems before the crisis: it had products that did not generate income; it had a high level of unprofitable assets (about 30%) and its operating efficiency, in terms of operating costs as a proportion of the portfolio, was relatively high for an institution that was not entirely devoted to microcredit, i.e., 18%. MFI 6, though weak, continued growing and recorded during the year before the financial crisis, an increase of 32% in assets. The microcredit business and the gold-backed credit recovered their dynamism, with an average growth rate of 32% and a delinquency level that was not higher than 5%. This occurred even though during those years the microfinance industry in general faced a difficult situation given the Government audit of interest rate limits for microcredit, a situation that was partially solved by charging an advice fee so that operators could finally develop a business without very severe complications. The other businesses
were the ones that led to a second crisis, which left the institution with a significant capitalization and the departure of the majority shareholder.

5.6.5 Institutional Crisis

The crisis faced by MFI 6 in 2005 and 2006 was developing since its inception due to its desire to grow at any price and which led to a lack of institutional focus and multiple businesses and products that did not always achieve positive results.

The lack of focus and the absence of proper controls left the company in a fragile situation during the 1999 crisis. If the institution had stuck to the initial objective to be a microfinance institution, it would have not been affected by the crisis. As confirmed by data, the microcredit business is more resilient than other types of credit.

The actual impact of the financial crisis and of the growing share of assets linked to the real estate business was disclosed 5 years after it happened in 2004, at least to the public because several respondents stated that within the institution the difficulties were faced a long time prior. There was not only a high staff turnover, but also liquidity was affected. It seems incomprehensible that in view of all the problems faced by the Bank and just a year after the Superintendence instructed a capitalization to face essential adjustments that led to selling the Bank, the risk rating agency gave an A+ rating.

How was it possible that the situation of this institution would deteriorate so suddenly if it had continued generating profits all this time and showing a sustained profitability (with an annual average ROE of 18%) from 2002 to 2005? According to some, due to the severe financial crisis in 1999 the board members left the door open so that the executives of the institution took unorthodox actions to save MFI 6, which in some cases meant adopting accounting practices that distorted the balance sheet. According to others, the management was not transparent and hid the magnitude of the difficulties caused mainly by the real estate business. According to the president, due to the fragility of the institution, he himself asked the shareholders in 2002 to increase the capital by US$ 6million, a request that was not approved due to the difficult and uncertain national situation. According to board member this request was never implemented.

In fact, the institution needed fresh capital long ago. Upon analyzing the figures shown in the annual statements after the crisis, the simplest indicator
to detect difficulties in a financial institution, such as the unprofitable assets or interest-bearing liabilities ratio, was lower than 100% every year after the financial crisis, pointing out that the entity was taking public deposits to fund assets that did not generate a yield, a behavior that cannot be sustained and might lead to an equity difficulty, without considering the accounting adjustments that are discussed below.

The accounting distortions emerged when the external audit report of 2005 pointed out difficulties to verify operations that came from profits derived from the purchase and sale of trusts, which accounted for 15% of the equity. On the other hand, after 2005’s inspection the Bank Superintendence recommended a capital increase. At that time, some board members had already started objecting to some operations that were not considered entirely transparent, particularly relating to trust operations. The qualified opinions of external auditors significantly raised doubts regarding the transparency of the financial management. Finally, the Bank Superintendence instructed the establishment of provisions for bad loans and investments, warning MFI 6 to make a capital increase through a note issued during the first semester of 2006.

By then, it was evident that the entity had gotten into trouble by showing financial information that was not transparent. Some of the accounting artifices used by the institution was the overvaluation of assets established through the fiduciary rights that allowed valuing their properties higher than the rate of inflation, when in fact most of them were represented in millionaire projects that due to various reasons were not selling, and what they experienced was a devaluation.

Another unsuitable accounting practice was the lack of recognition of expenses, most of them related to these trusts. The explanation given was that expenses would be recorded when the real estate projects could be sold. Some respondents said that the management fees paid for the projects of companies related to the majority shareholder bled MFI 6 and can be part of the explanation for the high expenses as compared to its portfolio.

At an income level, the accounting of builder fees for their loans during the disbursement year was questioned when their term lasted more than a year and depended on their timely recovery.

Third, it was possible to verify the loans linked with companies related to the majority shareholders, which surpassed the largest loan limit established by
policy. As previously pointed out, there are people who suggest that some of these loans led to the purchase of more shares.

5.6.6 The Outcome
MFI 6 needed capital to assume the losses that were concealed in the balance sheet. However, at this point most shareholders had lost confidence in the President and his team, and even though they were interested in getting the institution going, they wanted a change in management. Finally, there was a capital increase of US$12 million, and there was a negotiation to sell a third of shares to another banking institution that showed interest in strengthening the microfinance business; consequently, its majority shareholder left the financial institution. The new shareholder, now with a controlling interest, negotiated a term with the Superintendence to gradually recognize the losses from previous operations and dismantle the real estate business that was expressly forbidden by regulations.

The change was smooth and did not affect the image of the entity, which is still operating today and is entirely focused on the microenterprise sector. The core microfinance business, which was successful in spite of all the financial problems, was sold. The President left a few months after formalizing the transaction, arguing that he wanted to be more actively involved in politics.

The new management took over and decided to make the bank specialize in microcredit and credit backed by gold. Therefore, it started improving the institutional efficiency to the point that during the first two years it was able to reduce the operating expense/portfolio ratio from 20% to 14%. The profitability derived from the two core businesses has allowed paying for the losses of the real estate businesses on the terms agreed upon with the Superintendence. The new shareholders have forged a good relationship with the international investors and together they are committed to keep the institution going. In fact, in late 2009, the institution was able to keep an important market position with 20% of the microcredit clients and 13% of the loan portfolio. Regarding the write-off process, the institution was able to ostensibly reduce the interest-bearing liabilities, and at the same time increased the profitable assets. Even though it has not been able to generate profits, based on the trends, it is estimated that in 2010 the trend will be finally reversed.

5.6.7 Bibliography
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5.7 FINANCIAL INSTITUTION 7 – COUNTRY D

5.7.1 Institutional Background

MFI 7 was founded in 2008 as a result of a transformation of a regulated financial institution, created six years prior, into a bank.

The origin of the institution dates back to 1963, when a local private enterprise association decided to promote social and business projects in the country. NGO 7 was born to fill this vacuum and started providing training and consulting services. When it felt the need to complement its services with funding services, its financial branch, fund FU7, was created. This fund was aimed at promoting and implementing a micro and small enterprise lending program initially funded by technical assistance company, TA3, which required FU7 to be sustainable. Therefore, since the beginning of its operations, the project tried to cover costs by charging market interest rates, and thus be self-sustainable. Upon achieving this objective, TA3, with the support of the Board of Directors of the financial institution, promoted the organization as a formal autonomous financial institution aimed at providing financial services to micro and small enterprises. The Board hired a qualified manager to promote the new institution. On March 13, 2002, FU7 was authorized by the Bank Superintendence to develop financial intermediation operations, except public deposit-taking activities. The authorization to take public deposits pended on the recently created institution’s ability to show organizational infrastructure, technology, and physical capacity, which was achieved one and a half years later in August 2003.

The financial institution had exponential growth since its inception. It was founded in 2002 with 10 branches in the Pacific coast and in the northeastern region in the country, and a portfolio of US$10.5 million distributed among 8,500 clients, mainly from the trade and service sectors. Five years later, in December 2007, it had US$125 million in the loan portfolio and about 55,000 active clients. In October 2008, the size of the institution and the possibility of providing a wider range of products encouraged the institution to become a bank, hereafter referred to as MFI 7.

5.7.2 Shareholders and Sponsors

In 2003, a year after the transformation of the NGO into a financial institution, it was able to easily diversify its capital. The national shareholders diluted their shareholding to allow the entry of three new international investors. The local shareholders held 70% of the shares,
among which NGO 7 and fund FU7 held, in equal parts, 40% of total capital, and the remaining 30% was held by a group of individual investors, each with an interest smaller than 3.5%. In this group, the COO of the Financial Institution held 2.3% and its CEO held 11% of the shares. The CEO had been the president of NGO7, founding shareholder, and Chairman of the Board of Directors of FUND F7. After being recognized as a successful, visionary, and dynamic businessman, besides advocating for his own interests, he had good national and international liaisons; therefore, he became the CEO, Chairman of the Board, and the main advocate of the institution, nationally and internationally.

The 30% shareholdings split among international funders was composed in equal proportions by a multilateral institution MLT1, a technical assistance company TA4, and an international funder FU1, which saw the potential of the entity in the local market and decided to promote the formalization of the institution, support innovative product development, public deposit taking, and improve corporate governance. Furthermore, the investment by TA4 was deemed significant for the Financial Institution because of its experience in mobilizing savings among cooperatives in various countries. In addition to its funding commitments and investments, MLT1 also provided a technical assistance component aimed at strengthening the entity in the area of deposit-taking and at developing the family remittance capacity. MLT1 and FU1 also granted technical assistance resources. Together they set growth goals in terms of portfolio, clients, and branches, as well as expected profitability indicators – in practice, these goals were quickly achieved and in some cases significantly surpassed. The investments of MLT1 had a pre-arranged exit commitment four years after making the investment.

The institution was growing steadily with good risk and profitability indicators, and its ratings were favorable; it was ranked as one of the best in the industry in the country.

The Financial Institution soon needed to strengthen its equity, but the profits were not enough to fund the rapid growth of the institution. The institution thus had to be capitalized. At the end of 2005, international fund FU13 granted the Financial Institution a subordinated loan. At that time, the institution already had other sources of funding that included 15 international funds and 6 local funds.

Even with all this funding, the growth of the institution still required additional permanent funding sources. The founding NGOs did not have the funding capacity. However, the possibility of diluting their shareholding,
regarding the control of the institution, caused disputes among them. The Board of Directors was divided. Fund FU7 supported by some local minority shareholders supported the individual majority shareholder (the CEO) and NGO7 was against him. There were serious conflicts between the president of the Financial Institution and the president of the NGO7 that were even in the national newspapers. These included slander and defamation between them and even death threats. The news disclosed the conflicts within the Board of the Directors of the financial institution by mentioning that one Board meeting was held without the presence of NGO7, trying to change the bylaws and the shareholding structure of the financial institution. These personal clashes however did not affect the institution from a financial point of view.

At the end of 2006, the paid-in and subscribed capital was US$8.3 million. In light of its inability to provide fresh resources, which were required by the entity, in 2007 FU7 decided to sell all its shares to the local shareholders and to a new international fund FU5, which acquired a small shareholder interest. The CEO, now the majority shareholder, bought a significant interest of 23.7% share of the capital. With a new capitalization, in late 2007 the paid-in capital increased to US$15.8 million. In 2008, new international shareholders arrived: FU14, FU15, and FU16, and at that time NGO7 decided to sell its shares and a new holding company of local shareholders arrived. As a consequence, 60% of the entity was held by national shareholders and 40% by international shareholders. Moreover, the institution's employees had the possibility of investing in shares. In an effort to show a strong commitment to the institution, they became shareholders through a corporation exclusively organized for this purpose. The Financial Institution was paying dividends to its shareholders on an annual basis, and because of its growth and position in the local market it became a very appealing entity among investors.

In parallel to changes in the shareholding structure, the transformation of the Financial Institution into a bank was progressing almost simultaneously. MLT1 and TA4, in compliance with their foreseen period as investors, started the exit process by organizing a public offering. Again, two international investors, FU8 and FU17, (included in the shareholding structure of one of the international shareholders, FU5) acquired an interest in the Financial Institution, but during this additional operation the CEO sold his shares to a third, international party, thus generating an excellent profit but still keeping his controlling interest of 26%, for a total of 52% held by local shareholders.
In October 2008, the Financial Institution was granted a banking license and became MFI 7.

In terms of corporate governance, the Board of Directors of the financial institution was initially composed of former bankers and entrepreneurs. The international shareholders were represented in the Board of Directors with two members who usually attended the meetings because they were consultants living in the area. Then, after international investment increased, the number of Board members increased to eight: four local shareholders became Board members and the other four seats were split among three international investor representatives and one international independent. After the transformation, the Board of Directors did not change its composition.

Since the CEO was the majority shareholder, the Board of Directors of the Financial Institution and MFI 7 accepted that the CEO played a dual role of chief executive officer and chairman of the Board. He had an office at the institution and was very involved in decisions relating to its general management, and he (as well as the general managers) enjoyed a good salary, an annual bonus, a car, and of course, dividends as the majority shareholder. According to some respondents, the Board of Directors was skillfully run by the Chairman. Due to its good growth results and very acceptable indicators and distribution of yearly dividends, its investors were happy; no questions were asked as long as there were not problems.

On the other hand, according to the CEO, the Board of Directors always had a good grasp of financial methods, and it became stronger after the transformation into a regulated entity, when some independent directors joined.

The CEO apparently provided transparent information to the Board of Directors and was in permanent contact with them by discussing and reporting the progress of the bank and consulting beforehand with the Board about proposals to be submitted, so that the Board meetings were made easier and more active. In spite of the crisis, some funders and investors mentioned the ability of the CEO to run the meetings and achieve prior acceptance of the agenda during the Board meetings. However, there were also accusations that the handling of information was hardly transparent. In 2008, when the Board started looking at the deterioration in the portfolio quality, in view of the general deterioration in the cattle-raising sector of the country. The CEO and bank management were required to reduce the high
portfolio concentration in this sector, but at that time it seemed too late to change the course of the bank.

5.7.3 Market Position

In June 2002, the microenterprise segment of the market was served by 278 entities with a total portfolio of US$126 million. The clients of these MFIs were distributed in micro and small enterprises, including small producers, and the number of clients was 311,000.

The NGOs were intermediaries with a larger share in the microcredit supply. Ninety-three NGOs accounted for 60% of the total portfolio and 73% of the clients. Among them, 19 institutions that were members of the Microfinance Association accounted for 72% of the total portfolio with a value of US$54 million; 180 cooperatives had a share of 28% of the granted portfolio, and only two regulated MFIs accounted for 16% of the portfolio and served 6.4% of clients.

These two regulated MFIs included MFI 7, which was becoming a regulated entity and another institution (an affiliate of an international group), and which combined, accounted for a portfolio of US$20.7 million, of which MFI 7 accounted for 50%.

These institutions were located in a Latin American country with a high poverty level and an informal economy, and seemed to have great market potential not only in the urban sector but also in the rural sector. After 2002, in general all the MFIs showed a sustained increase in the portfolio and number of clients. The most dynamic period was 2004-2007. Not only due to the dynamics of the market but also due to the larger funding source – both national and international funds. The NGOs of the microfinance association doubled the portfolio value and grew by 50% in terms of clients, with an average loan size of US$640. Due to the size of some MFIs, several transformations were encouraged. Besides MFI 7, the aforementioned affiliate became a bank in 2005, and one NGO became a regulated Financial Corporation in October 2006. MFI 7 and the competing bank grew concurrently and kept a similar portfolio volume.

In December 2006, the competitor bank had a portfolio of US$89 million and the Financial Institution US$ 87 million. A year later, by late 2007 these two MFIs had $123 and $125 million, respectively, which meant a growth of 38% and 43%, respectively. MFI 7 had the highest portfolio volume during that year among the MFIs in Country D and was ranked second among the 3
regulated MFIs in terms of clients by serving a total of 39,329, surpassed only by the competing bank that had a total of 84,000 clients.

In 2007, the share by type of institution in the microfinance market had changed. The 3 regulated MFIs were now larger than all the NGOs and accounted for 56% of the total portfolio, with MFI 7 as its leader.

Both regulated and unregulated MFIs in the region traditionally focused on funding trade and service activities. But as the competition intensified in the urban sector, MFIs turned their attention to the rural productive sector. They also considered agriculture and cattle-raising enterprises, which posed some risk, to be quite profitable – particularly due to the increase in beef prices in the export market. In December 2007, the agricultural cattle-raising sector accounted for 25% of the clients and 43% of the portfolio for unregulated MFIs that were members of the microfinance association, and for regulated MFIs it accounted for 2.5% of the clients and 10% of the portfolio.

MFI 7 was among the regulated MFIs which showed a higher concentration in the cattle raising activity, with 23% of its total portfolio invested in this sector, and it stood out as an institution that also funded medium-sized producers. This concentration allowed the highest growth record among MFIs in Country D in 2003 – 2007; a growth that was the result of the largest average loan size in the market, equivalent to US$3,190. Therefore, the finance was directed at SMEs, especially in the rural sector. It developed an in-house credit assessment methodology for SMEs, by granting loans up to US$250,000 and 24-month terms. Its closest competitor granted loans that would not exceed US$50,000 and granted 60-month terms to this sector. Regarding microcredit, MFI 7 had just about 20% of its portfolio focused on this segment, encompassing loans smaller than US$10,000. It utilized individual lending methodology, and its interest rates ranged from 20% to 55%.

In 2007, the microfinance market in Country D was generally healthy and booming. In terms of financial indicators, the operating efficiency levels were acceptable (the operating expenses as a proportion of the portfolio were 13.8% for unregulated MFIs and 15.2% for regulated MFIs), the portfolio indicators with PAR > 30 days did not surpass 2.2% in the case of regulated MFIs, and the return on equity (ROE) was 23% for regulated MFIs vs. 15% for unregulated MFIs.

The only alarming sign was rumors of clients becoming overleveraged in a fiercely competitive market.
5.7.4 Financial Information

MFI 7, as a regulated financial institution, was authorized to take public deposits in August 2003. Nevertheless, it maintained a high share of its funding from loans granted by international funders, several of which were also shareholders of the institution. Between December 2004 and 2007, deposits increased by 230%, but financial obligations also increased by 325%. Regarding deposits, there was significant concentration since the 20 largest depositors accounted for 56% of the total deposit balance. Regarding international funding, a single international fund accounted for 18% of the financial obligations of the institution in 2008. The ability to fund almost 75% of the liabilities of the institution through 25 international funds reflected the successful fundraising managed by the CEO. The results of the entity apparently justified financial support because during this period, the entity showed a sustained growth, a delinquency level lower than 2%, and a ROE at least of 25%.

![Funding Sources](source: Based on figures published by the Bank Superintendence.)

The change in 2008 and 2009 in the indicators of the institution was surprising. The increase in the delinquency level was so steep and fast that the financial indicators of MFI 7 did a 180 turn. The overdue loans went from 1.8% in 2007 to 10% in 2008 and 65% in 2009. The bank’s profit went from US$2.8 million in 2008 to a reported loss of US$15 million in 2009, and in April 2010, the annual losses were estimated at US$25 million. The banking
superintendence required an increase in provisions. An immediate capitalization of MFI 7 was planned in order to protect public savings which amounted to US$36.7 million in April 2010.

The rating agency of MFI 7 was not able to foresee the magnitude of the crisis. In December 2008, MFI 7 was rated BBB+ (for long-term debt without a specific guarantee) and F2 (short-term debt with and without specific guarantee). The risk rating agency stated that considering the complex environment, MFI 7 had an acceptable overdue loan share (2.7%)\(^{19}\), ample provision coverage and adequate portfolio atomization. At that time, the risk rating agency was not aware that there were already restructured and postponed loans of 7% of the total portfolio. There was also a foreign exchange risk in the portfolio (as loans were granted in dollars to individuals who did not generate income in such currency) and equity was too stretched to face the eventual deterioration in the loan portfolio.

5.7.5 The Crisis ... How Did the Situation Come to this Point?

In late 2007 and early 2008, there were nation-wide complaints against the microfinance industry due to its high interest rates and the use of delinquent debtor guarantees. At that time, it was said that one out of four complaints was against MFI 7. This led to its management having to design a strategy aimed at reducing the resulting reputational risk, including hiring a public relations employee to handle news and advertising matters better.

In March 2008, there were outbreaks of a non-payment movement in the northern region of the country. The riots were led by the former mayor a small town and a businessman from the area, joined by almost 400 producers. Enough to get, at the local level, a nonpayment movement – NPM— going against the microfinance industry, who were being labeled as “loom sharks”. The movement continued attracting more followers, and in July 2008, the president of the republic supported the movement, and during a speech urged debtors to occupy the buildings of the microfinance institutions to defend their rights.

At this point, the movement grew to almost 10,000 individuals, a fourth of the total clients of MFIs in the northern region, and expanded its coverage into other states in the central regions of the country (such as cattle-raising

\(^{19}\) It included only loans with arrears longer than 90 days.
regions) and in the Pacific region. The rioter demands were similar across the regions. They advocated for a debt repayment freeze (or moratorium) for thousands of producers and merchants served by microfinance institutions and banks, a suspension of legal actions, an interest rate moratorium, grace periods, and finally, a decrease in interest rates. Some NGOs and some microfinance institutions approached the representatives of the debtor groups who were followers of the NPM, seeking agreements that in the end were not implemented. In June and July of 2009, leading businesspeople and producers in the municipality where the NPM originated submitted two bills to the National Assembly: the first bill called for a “law for a moratorium for bank and financial institution clients and suspension of executive actions against borrowers in the financial system” and the second bill, for a “law on the suspension of trials and enforcement of judgments relating to debts incurred by agricultural producers with microfinance institutions.”

At the same time, the cattle-raising sector was said to have been facing difficulties resulting from a decrease in the export prices for beef, thus affecting their ability to repay loans and thus becoming a risky sector. For MFI 7 it was especially worrisome because it had about 30% of its portfolio concentrated in this sector, usually with larger loans and longer terms. The microfinance market was also affected by the overall difficult macroeconomic situation in the country (resulting from the international economic recession) combined with energy problems, an increase in oil prices, and reduced remittances.

The impact on the microfinance sector was evident in the figures of MFIs in 2009. NGOs from the microfinance industry and regulated MFIs significantly reduced their portfolio volume and the number of clients served. On average, the NGOs reduced loan portfolios by 13% and the number of clients by 10%, which meant a loss of 57,000 clients in 2009; while regulated MFIs reduced the loan portfolio by 19% and had a similar reduction in the number of clients.

Among the regulated MFIs, the situation was similar.
It has been reported that the deteriorating environment and the presence of multiple external factors, such as the international recession, the decline in the national economy, the falling prices in the cattle-raising sector, the nonpayment movements, and adverse political support negatively affected regulated and unregulated MFIs in the country. But what was happening to MFI 7 that led it to be more negatively affected by the crisis than other MFIs in the region? The difficulties could not be explained only by the aforementioned facts.
Summarizing the opinions of the respondents, an ex-post analysis listed several factors that worsened the difficulties; among them, too fast growth without proper controls, methodological weaknesses in loan placement, high loan concentration by debtor and sector without adequate provision policies, weak auditing and internal controls, and an inadequate reaction to the crisis – the implementation of a rollover policy that was not adequately designed nor managed transparently. All of the above reflected a weak management but mainly a lack of proper governance evidenced by the concentration of power in the person acting simultaneously as the CEO, the Board Chairman and its main shareholder.

First, regarding the aforementioned exponential growth, the Financial Institution had the highest growth between 2003 and 2007. The number of branches rose from 17 in 2004 and to 26 in 2007, achieving an extensive coverage nationally, thus increasing the number of clients by 77% and reaching 55,000 clients. But above all else, the portfolio value increased by 340% in local currency for a value of US$125 million. Obviously, this meant a significant increase in the average loan, which went from US$1,490 to US$3,140. In 2008, two more branches opened and the portfolio was US$139 million. This fast growth forced the institution to make a major operational effort which was clearly reflected in an increase in the number of employees from 372 employees in 2005 to 575 in 2007 and to 616 in 2008.

This growth was not apparently supported by the necessary consolidation within the institution; therefore, some weaknesses of the credit methodology were not detected at the time of the crisis. In view of the institutional growth and the presence of fraud in one of the branches, the institution closed a branch. The general manager of the Financial Institution recognized that he could not control the entire operation; therefore, the new position of regional managers was created. In late 2007 the institution implemented a decentralized loan approval process; consequently, the head office only participated in the approval of loans above certain amount, and only in certain cases, the Board approval was necessary. Therefore, regional managers were granted, during meetings with loan officers and branch managers, the authority to approve smaller loans. While this practice was common among microfinance entities, the loans granted by MFI 7 were larger, not all the loans could be assessed with the same methodology and stricter controls would have been needed. The regional managers had more responsibilities, yet controls did not strengthen. As an example, there was some fraud, which even though they did not affect the equity of the institution, did reflect a lack of control of the decentralized approval process.
Amid the crisis, it was also possible to detect that the loan officer incentive policy recognized the earnings from loans and only penalized the first days of arrears; therefore, there were loan placement errors and a lack of motivation to collect the loans, so branches achieved the growth rates but at the expense of a poor portfolio quality.

Besides uncontrollable institutional growth, the entity did not strengthen a proper analysis and assessment of credit risk for each segment served (micro, small, and medium enterprises). The respondents agreed on poor enforcement of strict use of credit evaluation and approval methodology. They also mentioned that consultation of credit unions was neglected and there was a concentration in some debtors, with the 20 largest debtors accounting for more than 50% of the equity in 2008.

On the other hand, credit analysts did not have the ability to apply different evaluation methods of micro, small, and medium enterprises, so similar parameters were used for micro enterprises and SMEs. There was no fact-checking through secondary sources of data mentioned by clients, and there was not enough sales information, particularly for SMEs. For microbusinesses, an automatic credit evaluation process was implemented but without considering the characteristics of each client. As stated by one top officer of the institution, “they lost the credit risk compass” and became disoriented regarding evaluation.

In 2006, after an investigation by the audit committee which questioned the granting of some loans and forced the former manager to quit, a new general manager joined the institution. The new general manager came from the traditional financial sector but received internal training on microcredit methodologies and interned at other South American MFIs. The manager admitted that he found some progress in some areas but some backwardness in others. Therefore, he had to restructure the technological processes and the human resources areas and implement a strategy to position the bank as the market leader. Maybe due to his lack of microfinance experience, he was not able to timely detect the weaknesses that were already affecting the entity in the area of credit evaluation methodology.

There was a credit concentration that was clearly reflected the weaknesses in credit policy compliance regarding the limits on operations and the concentration of the portfolio. MFI 7 had defined policies for risk concentration by client and amount, yet longer terms of even 10 and 12 years were granted in some cases. In the case of cattle-raising loans, there were several loans with payments at maturity, which meant that when the
other external factors affected the institution it would be overexposed to the non-payment risk.

This took place even though the institution had policies in place to limit the risk concentration. The Board of Directors approved a risk management policy which identified each of the main risks to which MFI 7 was exposed, and it created Credit and Investment Committees composed of key executives who were in charge of monitoring, controlling, and carefully managing such risks. Moreover, MFI 7 was subject to the superintendence’s regulations regarding risk concentration, liquidity, and capitalization, among others. Apparently, the institution had the governance structure needed to ensure its growth. In spite of this, the concentration in terms of value in the cattle-raising sector went unchecked despite it having caused concern among the Board members for some time. They were worried not only about risk arising from targeting the same activity, but also the profile of clients whose average loan was larger than US$ 13,000.

The final outcome was that MFI 7, as of December 2008, showed a clear concentration by sectors. By then, loans to the trade and service sector accounted for 46% of the total portfolio, the cattle-raising sector accounted for 29%, followed by the agricultural sector with 8% and personal loans with 10%. The rest of the portfolio was concentrated in industrial and mortgage loans in smaller proportions. In 2008, the cattle-raising sector portfolio was apparently hurting but not badly. At that time, of the total portfolio in arrears (including those under a court collection proceeding) cattle-raising loans comprise only 4%, the commercial sector also comprised 4%, while the sectors with a larger percentage of overdue portfolio (or under court collection proceedings) included the loans granted through a credit card which accounted for 12%, and personal loans 6%. Consequently, the cattle-raising sector was not worrisome due to the low percentages of delinquency that accounted for the total portfolio of the bank. Amid the crisis, the institution found out that a high percentage of the loans granted to the cattle-raising sector (and to the agricultural sector) were agreed with a single payment at maturity, clearly increasing the risk of the operation. Moreover, some of the recipients of the cattle-raising loans granted with a one-year term to breed cattle between 2006 and 2008 afterward became five-year mortgage debtors with a pledge on their farms. When the crisis in the cattle prices emerged, the cattle-raising sector’s portfolio delinquency was 60%. By the time the Board of Directors strongly warned about serious concentration problems, the crisis had already imposed an irreversible impact on the institution.
The traditional stability of the cattle-raising and agricultural sectors and the laxness of a guarantee made these segments an easy target for institutional growth. Nevertheless, at the time of the crisis, it was evident that for a significant number of these loans, the guarantees had inadequate support so their collection was very difficult. Furthermore, under the political support for the nonpayment movement it would have been very difficult to resort to the courts to claim a right to these guarantees. The bank implemented the standard accepted by the Superintendence of creating a provision only for the amount not covered by the guarantee. Thus the entity did not create adequate provisions for medium-sized entrepreneurs and ranchers in the years prior to the crisis because they did not consider the real guarantees supporting these loans. Therefore, the entity did not have adequate provisions, so at the time of the crisis all the required adjustments had to be covered with new capital. Between December 2008 and December 2009, the portfolio of the cattle-raising sector was reduced by 43% and its delinquency increased by 36%; with such a severe deterioration of the portfolio, there was an evident need to perform write-offs so that the provision level would be significantly reduced to cover just 27% of the total portfolio at risk.

In view of the crisis, MFI 7 started an accelerated restructuring of loans, in many cases at interest rates lower than the initially agreed-upon rates and lacking the due authorization by the relevant agencies. Upon analyzing the figures of the portfolio at risk published by the Superintendence as of December 2008, overdue loans under a court collection proceeding accounted for just 2% of the total portfolio, while 7% corresponded to extended and restructured loans and in 2009, these percentages increased to 11% and 28%, respectively. The portfolio, which in 2006 and 2007 accounted for 98% of the gross portfolio, in 2009 accounted for 61% after restructuring 23% of the total gross portfolio during that year. Subsequent analyses suggested that the rolled-over and restructured loans were higher than those recorded in the Financial Statements of the entity.

The internal control and audit weaknesses were surprising for an entity that supposedly had all the internal audit and internal control processes in place. The external audit report in 2008 stated that MFI 7 was embraced by different committees whose meetings were attended by several Board members. In spite of this, there were serious internal control deficiencies.

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20 Including overdue loans and under court collection procedures.
Some loans were granted without the corresponding supporting documentation and there were significant evaluation weaknesses and faults in the credit information and approval process and in the provision of guarantees. There were several incomplete files resulting from a poor consultation at the credit bureau.

How could the bank management not be aware of this situation? The fact is that the governance weaknesses of MFI 7 were only evident when it faced a crisis. Moreover, since the beginning there was not a separation between the Chairman of the Board and the institutional management. As long as there were not problems there were not concerns because everybody was happy with the profits and dividends; besides requesting a removal of the concentration in the cattle-raising sector and more delinquency controls, no significant changes were demanded.

This concentration of CEO duties characterized the history of this entity. At the time of the transformation of MFI 7 in 2002, the efforts were focused on developing and transforming the institution internally according to the requirements of a regulated institution, to which the Manager of the institution was devoted, while the CEO led the fund-raising efforts and was in charge of spreading the institutional achievements and keeping up to date with the daily activities of the institution. As the CEO increased his shareholding in the entity, he continued working on two levels and since the Board of Directors trusted him and his ability to manage the Board, there were no real concerns. With the arrival of the new General Manager, there was again, no segregation of duties.

Some suggested that the involvement of the CEO in the management of the institution, defending his own interests and handling the Bank’s daily decisions without being actually the general manager was the main reason for demanding the expansion of the entity. Some respondents suggested that he was obsessed with making MFI 7 the largest microfinance institution, a goal that was indeed achieved at the expense of the quality of the assets and led to a departure away from the target market. Faced with an abrupt deterioration in the results for 2009, some funders and investors even wondered if some information was concealed and tampered with, but there was not convincing evidence that this was the case.

In view of the crisis reflected in an impressive deterioration in the portfolio quality, the manager at that time and the CEO did not respond on a timely basis. The CEO played the role of judge and jury given his management role during the entire process. His main concern regarding the reduction in the
international funding was to focus his attention on the search for deposit funding sources by creating a commercial strategy to handle a smart card and to provide clients with a comprehensive state-of-the-art deposit-taking product to manage accounts because they needed to defend the liquidity of the institution. At that time, according to the CEO, it was difficult to understand how, during a growth stage, funders supported the institution and during a crisis, they abandoned it.

5.7.6 The Outcome

In late 2009, the Superintendence required investors to conduct a capitalization that meant an equity increase of 130% and recommended a change in the management of the institution. The response of national investors was to admit their inability to provide fresh fund, yet not accept a dilution. International investors had to come up with a plan to raise the missing capital on their own. Shareholders increased their contribution of fresh funds while at the same time trying to have creditors transform part of the debts into capital (or subordinated debt). At that time, the national shareholders, who could not contribute more capital, finally diluted their shares. The structure of the Board changed, giving more power to international shareholders.

In September 2009, the Bank Superintendence authorized shareholders to increase the paid-in capital by 66% in early December, an equivalent to US$4.5 million, mainly with the participation of international shareholders, and three international creditors (FU1, FU18, and FU13) accepted converting debt into capital amounting to US$2.6 million. However, in view of the continuous deterioration of the institution, this was no longer enough.

In January 2010, the bank signed a restructuring agreement with its creditors and a debt conversion and borrowing agreement to convert debt into capital for a value of US$5.3 million and the conversion of senior debt into subordinated debt for a value of US$5.2 million for a total of US$10.5 million. On the other hand, a debt conversion agreement (CCA by the initials in Spanish) was signed that allowed converting amounts of current debt as of January 15 into common stock at a specific price per share. However, only 4% of the financial obligations were converted into shares as of December 31, 2009, including 1 out of 3 national funders, and 3 out of 18 international funders. Other two international funders converted their entire debt into

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21 Audited financial statements for 2009.
senior debt equivalent to 2% of the total obligations and 3 more restructured 15% of the debt into subordinated debt. 76% of the total debt was not restructured. Nine international lenders did not accept the agreement.

The agreement was enacted as of December 1st and included a commitment by MFI 7 to comply with a series of financial indicators and other kinds of obligations. At that time, a new series of actions were requested, for instance, an independent portfolio assessment by a risk rating agency specialized in microfinance.

One of the requests was to dismiss the CEO, though not on good terms as some Board members and funders argued that the CEO during his term, and particularly during the re-capitalization, had protected his personal wellbeing over the wellbeing of the institution and its target market. The Board of Directors took control of the institution and an external consultant was brought in to conduct an analysis and planning process. His first report was scheduled to be submitted in March 2010. By December 31, 2009, MFI 7 failed to pay its obligations to 4 international funders who did not participate in the agreement, specifically, capital payments amounting to US$7.4 million. After a couple of months, the General Manager left and a new consultant was hired to conduct the requested diagnosis.

In the meantime, the political situation in the country against microfinance institutions continued worsening. The bills for a Moratorium and Suspension of Collection Proceedings were combined into a single “law on the establishment of the basic guarantee conditions to renegotiate debts among microfinance institutions and delinquent debtors”, which was signed by the president of the republic and published in the official newspaper in April 2010. The law stipulates a mandatory rollover for agricultural and commercial clients whose loans with NGOs and MFIs, regulated by the Bank Superintendence, were in arrears as of June 30, 2009. It stipulated four-year terms and a six-month period of grace for loans smaller than US$10,000; and for larger loans, the term was extended to 5 years with at least a six-month period of grace at an annual rate of 16%. The late interest and attorney’s fees were forgiven, and in case of an early repayment of the total loan, there should be a minimum reduction of 30% in the accrued current interest. When this white paper was written, no legal actions resulting from these changes affecting MFIs in the country had been reported.

On the other hand, as of April 2010, MFI 7 closed 5 branches with an accrued loss of US$25 million and the equity fell to US$325,000. The
Superintendence again required a larger capitalization and stipulated a deadline on June 30 so that creditors and investors made plans to capitalize the bank by about US$32 million. Various choices were anticipated, such as the Bank Superintendence could take over the Bank’s administration, or investors and creditors could capitalize and save the Bank. This would have depended on new capital contributions by investors or subordinated debtors, or on common debtors capitalizing the debts. The liquidity was deposited in the Central Bank to ensure a refund of savings to depositors. When this white paper was finished, the public deposits amounted to US$36.7 million and financial obligations amounted to US$86 million.

The newspapers reported the situation of IMF 7, and both the Bank Superintendence and the Manager of the Central Bank explained to the media about the equity requirements of shareholders. By the time this document was finished, the Superintendence had issued an instruction requiring a capitalization by shareholders amounting to US$34 million, and shareholders had to admit their inability to contribute new funds (besides the funds recently granted to the institution). It has been reported that the institution will close down but this would not pose a risk for depositors because all the deposits have already been entirely refunded.

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5.8 MICROFINANCE INSTITUTION 8 - COUNTRY D

5.8.1 Institutional Background

The institution was created in 1990 as a nonprofit association with the initiative of five professionals who graduated from a prestigious university after noticing a limited access to credit in the informal sector of the economy. The objective included in the articles of incorporation was to grant loans to small and medium enterprises (SMEs) in the country and render credit services. It opened in 1990 by providing only credit services. In 1996, in order to give total support to clients, both regarding funding and advice, MFI 8 promoted the creation of a training and technical assistance company of which MFI 8 held an interest of 97%.

It was created at a time when the microcredit industry was emerging in the country; therefore, it did not have a lot of competitors, thus contributing to its consolidation. It granted loans in the neighborhood of US$2,000 to US$6,000 and contributed to recovering the payment culture which was deteriorated after a severe national crisis. In the mid-1990s, the government supported the creation of some microfinance institutions, and the number of unregulated MFIs gradually increased. Nevertheless, MFI 8 was able to position itself, achieve a lot of success, and become the leader among NGOs.

Its growth was so dynamic that it operated 48 branches in 2006, which at that time accounted for the largest number of branches of regulated and unregulated MFIs in the market and a 100% coverage of municipalities. The most successful years were 2006 and 2007 when it became the second largest unregulated MFI in terms of portfolio volume, and the largest in terms of the number of clients. In the following years, it faced a severe crisis that almost led to its bankruptcy.

The size of its portfolio and the number of clients led its founder, the Chairman of the Board, and CEO to considering the possibility of authorizing a change in its legal nature to become a regulated microfinance institution. It approached the Bank Superintendence, but the approval was delayed until the institution returned some of the loans payable to individuals which were to become a funding source for public deposits. Faced with a crisis, the institution gave up and decided to keep its legal concept as an NGO.
5.8.2 Sponsors

In the beginning, the institution relied upon the labor support from the founding shareholders and the financial support from TA6 technical assistance amounting to US$150,000, to create a credit fund, and US$90,000 to cover operating expenses for two years. This funding source sought to have an impact on the development of a country that was overcoming a political crisis. As a requirement, TA6 processed the financial assistance of MLT1 and, since the institution had a good project, it easily obtained a soft loan of US$500,000 with a 40-year and 10-year period of grace under soft interest rate conditions and technical assistance funds aimed at institutional strengthening. These funding sources contributed to giving the institution the first boost, supporting the credit fund, strengthening the infant institution and making the microenterprise funding an important product within the operations of the NGO.

In 1996, it had about 10 branches, and after a rigorous evaluation by MLT4 it received a grant of US$2 million and international cooperation funds through the local Development Bank amounting to US$900,000. These important contributions helped the institution grow and strengthen. According to its founders, this contribution opened the doors to the funding from the large international funders.

The excellent results were also reflected in very good risk ratings, recognitions in international forums, and as a result it became a popular institution in granting resources from national and international credit funds.

During that time, there were excessive external resources that flooded the microfinance market in Country D, and the most prestigious NGOs were the most popular to receive funds, particularly this NGO which was considering becoming a regulated financial institution.

The main governance body was the General Members’ Meeting, composed of 9 members. The by-laws allowed the members to propose new members, who should be accepted by a majority; something that had never occurred, so the number of members was still nine with some changes in membership during the twenty years of development of the NGO.

The Board of Directors was composed of 5 members, three of them women, and all members were professionals and some of them were founding shareholders. Some of them were businesspeople with little or no experience in the financial sector. The Board secretary had been the legal advisor of the institution and was later invited to participate as a Member. The secretary
had the most experience in financial sector because he had been a legal advisor to various banks. According to most respondents, the institutional governance was weak, and some of them thought it was a Board of Directors only on paper, and in reality under the control of the Chairman who was also the CEO. The institution was always run by one of its founders and main sponsor, a strong-willed person but also a strategist, visionary, and innovator. He instilled a lot of trust among people and had a good reputation. He was a well-known person in the microcredit industry in the country; therefore, he was twice appointed as the Vice-Chairman of the Board of Directors of the microfinance institution industry association in the country, and he was also a member of the Board of Directors of the international microfinance network and of a well-known financial fund, and the president of TA7 technical assistance.

Some of the respondents mentioned that the Board of Directors received high allowances, and that the Board never questioned the large amounts of money that the CEO spent in credit cards or his salary conditions or bonuses that he received for being the CEO. Others believed that the directors who supported him always trusted his abilities and good management skills.

Nobody doubted the stability of the institution or the abilities of its founder. How could someone doubt or demand better results if MFI 8 had received excellent ratings by three top-of-the-line external auditors and by two risk rating agencies specialized in microfinance? One of them gave the institution a rating of A+ in June 2006 and June 2007.

One of the respondents mentioned that a specialized rating agency rated MFI 8 in the past and after detecting potential problems, it reduced the rating, so the contract with the agency was terminated. Other rating agencies were brought in and willingly gave the institution a high rating again.

In 2008 and 2009, the NGO started showing signs of deterioration in the portfolio quality indicators. At that time and at the request of international funders, there were changes in the governance approach of the institution which will be described later in this document.

5.8.3 Market Position

Like in other Latin American countries, the microfinance market had a major turnaround during the first decade of the new century. At the beginning of the decade, the NGOs granted 72% of the funding to the microenterprise sector, and, among them, the NGOs affiliated to the microfinance community
in the country accounted for 60% of the portfolio volume. In 2009, this percentage fell to 44%.

MFI 8 was always positioned among the largest NGOs in the market. It was the first NGO in terms of the number of clients from 2003 to 2006 and the second largest in terms of portfolio volume. This explains the lower average value of its loans, US$450, while the NGOs in the microfinance community offered an average loan of US$640.

In general, the microcredit supply grew significantly from 2004 to 2007. Even though the country had one of the highest poverty levels and was one of the most informal economies in Latin America, it had a great market potential, not only in the urban sector but also in the rural sector. Therefore, the microfinance NGOs were able to double their portfolio value and grow by 50% in terms of the number of clients. During the same period, MFI 8 increased its portfolio 2.3 times and the number of clients by 90%.

The microcredit market was initially aimed at funding trade and service activities, but as the competition intensified in the urban sector, MFIs turned their attention to the rural productive sector. For example, 25% of the clients and 43% of the portfolio for unregulated MFIs associated with microfinance institutions were located in these two sectors in 2007. Nevertheless, in December 2007, MFI 8 held 56% of the portfolio in commercial activities, 16% in agriculture, and 9.2% in consumer business. The clients were concentrated in commercial activities (41%) and in consumer lending 37%, while in agricultural activities it held just 8.6% of the total clients.

In the market, most of the credit was granted based on the individual lending methodology (18 of the 19 MFIs associated with microfinance institutions). Village Banking was offered in just 3 MFIs and solidarity lending in 11 institutions, among them MFI 8, which offered individual and solidarity lending, but the former prevailed.

The only alarming sign came from the rumors of client over borrowing in an increasingly competitive market, and MFI 8 was already deteriorating since its PAR > 30 days in arrears went from 3.5% in 2005 to 7.9% in 2007.

In 2007, there was a series of debtor movements fostered and encouraged by politicians, including the President of the Republic, which led an accelerated deterioration of the microfinance institution portfolio. For a few months, people thought that the problems faced by MFI 8 were caused by
the crisis itself, but after a while, it was evident that the crisis brought up the structural failures of the institution.

5.8.4 Microcredit Technology

The risk assessment methodology used by MFI 8 was developed in house, and it was initially aimed at individual lending in the urban sector. Some of the founding shareholders had prior experience in the financial sector that helped strengthen the credit granting processes; then they received technical assistance from MLT1 regarding the group lending methodology, which was discontinued by the institution alleging internal difficulties to implement the two lending methodologies. Instead, they specialized in the individual lending methodology and kept just a small proportion of the solidarity lending portfolio.

On the other hand, according to the information provided by several respondents MFI 8 had the best technological platform among regulated and unregulated MFIs in the country. This, together with 100% coverage of the national territory, was the one of the best advantages for the NGO and one of the reasons why it was admired nationally and internationally.

MFI 8 diversified its portfolio into different types of products. It offered the typical micro-entrepreneur loans of working capital and free investment in different activities, such as agricultural sector lending, retail loans, and a highly innovative and profitable product, a salary advance payment, which charged a 5% fee in advance. The latter was offered since 2005 when it started lending without entering into agreements with companies. Such loans had an average value of $100 and 1-month maturity and accounted for an increasing interest rate of 6%, becoming the main lending product in 2009 and a life preserve in view of the deterioration in the other loan categories.

The risk assessment methodology was never questioned, and according to external analysts, it was implemented properly. Consequently, none of the ratings granted to the entity from 2005 to 2007 mentioned this methodology as a weakness. The funders did not perceive any risks because from 2003 to 2007 the credit lines of MFI 8 increased from US$4.7 million to US$ 33.9 million as of December 2007. However, when the financial indicators started deteriorating in 2008, one of the international funders with the highest exposure requested a field trip to supervise the operation and detected serious faults that unveiled weaknesses in the credit analysis. An employee who provided wrong information trying to disguise the faults was immediately dismissed. These weaknesses were later confirmed by the
General Manager at that time that, who together with the internal auditor started studying some errors in the lending process in depth and then reported them to the Board of Directors and international funders. These officers were later dismissed by the CEO.

In fact, MFI 8 had methodological weaknesses. The analysts limited themselves to conducting an analysis of the clients' ability to pay and ensuring the granting of loans; the analysts' bonus structure was designed in terms of this variable. They had decentralized the loan approval process, but without the proper controls, such as using the required audits and supervision to avoid fraud. These control faults were obviously used by the branch officers to create ghost loans. The system promoted a series of internal frauds.

Furthermore, the collection process was managed since the first day of arrears by an outsourcing company in which, as was later confirmed, the family of the CEO and President of the institution held an interest. The outsourcing method was known by all the directors and international funders because the institution always disclosed it transparently, but shareholders were not aware of the shareholding structure of such company. The company had its own staff that reported to the management of each branch and spent 100% of the time at the offices of MFI 8 and even had a job there. One of the respondents said that during the last year, fees amounting to more than a million dollars were paid to this company.

Looking at the deteriorating delinquency indicators, this figure was reviewed because the outsourcing collection company was paid since the first day of arrears; therefore, it received quite a significant amount of money in monthly fees leading to a perverse incentive, because the longer the arrears the higher the profit for the family's company. As of 2009, they made the decision to include the collection process as part of the loan officer duties, and terminated the contract with the outsourcing company.

According to the present Manager, with the exception of the MFIs that used the village banking technology, the loans were granted under very high interest rate conditions, something that can be confirmed upon comparing the average performance of the MFI 8 portfolio with the other MFIs. The interest rate was calculated based on the disbursement, including the fees that were deducted at the time of the disbursement. This means that there was an absolute lack of transparency with the clients of the institution. Moreover, the one-year maturity loans with a single installment upon maturity were rolled over for the corresponding amount plus interest.
In 2008, other institutional deficiencies that were not obvious to the Board members or the external auditors or risk rating agencies were detected.

### 5.8.5 Financial Information

MFI 8 always showed very good portfolio and client growth indicators. In recognition of these good results, it received several awards from the microfinance industry, for instance, it was one of the 20 recipients of the Financial Transparency Award granted by MLT4 in Country D in 2006; it received the 5-diamond certificate for its information transparency in 2005; and it received the Technological Innovation 2006-2010 award granted by the TA7 network and the Microfinance Excellence award granted by MLT1.

As shown by the following graph, from 2003 to 2006, it achieved an average growth rate higher than 40% per year in the portfolio volume, even higher that the rates recorded by the average NGO and regulated MFIs, reaching US$34 million in 2007. From that time on, the trend plummeted and in 2008 the portfolio was decreased by US$12 million and in 2009 by US$5 million. The reduction faced by MFI 8 is clearly higher than that of other microfinance institutions in the region, as shown in the graph, proving that MFI 8 faced some problems that could not attributed to the crisis prevailing in the country in those years, particularly for the microfinance industry.

![Loan Portfolio Growth](image)

*Source: Microfinance institution industry in Country D and the Bank and Financial Institution Superintendence.*

In terms of the number of clients, the behavior was similar to that of the portfolio. The increase in the number of clients of MFI 8 was also higher than the regulated MFI and NGO average until 2006. In 2007, it had 70,000
clients, but in the next two years, it lost half the clients, and in 2009, it ended up with 35,000 loan clients.

Regarding branch coverage, during the boom year of 2007, it achieved the highest MFI coverage in the national system with 48 branches. Moreover, it surpassed by far the coverage of other NGOs in the microfinance sector, but this had an impact on a higher level of operating expenses which were higher than those of other institutions, reaching an average of 20% of the portfolio.

On average, MFI 8 showed a portfolio performance higher than 50%, whereas that of other MFIs was 27% in 2007. The high interest rate charged by the entity contributed to the outstanding profit indicators. Its levels from 2004 to 2006 were higher than 33%, but in 2008 it yielded -64 points. In 2008, MFI 8 ended up with a loss of US$3.8 million and a decrease in the equity of US$2.7 million.

These results led to a drastic deterioration of the portfolio quality. Consequently, in June 2007, the PAR >30 days deteriorated further by reaching a level of 5.5%, two points higher than the level in June 2006, but after adding the portfolio write-offs which accounted for 2.7% and restructured portfolio for 1.7%, the total portfolio at risk already achieved 10%. In December 2007, the portfolio in arrears had risen to 7.9%, even though in November, there was a significant write-off equivalent to 5.9% of the portfolio. This happened, as stated by the current Chairman of the Board, amid the crisis. The different accounting reviews found that the financial statements had been tampered with, mainly for delinquency.
indicators, using rollovers and extensions that were not disclosed in due time.

To fund the growth, MFI 8 found various funding sources. They had an innovative funding method called "loans payable" which are the equivalent of a time deposit from private investors which paid an interest rate. Such lenders received a duly legalized document stating the conditions of the interest rate, term, etc. It had all the characteristics of a time deposit. There was an interest rate of up to 12% a year while the average cost of the funds was between 8% or 9%, and the market offered 3% for foreign currency deposits. These deposits reached US$7 million in June 2007\textsuperscript{22} and fell to US$5.6 million in December of that year. These depositors had a typical deposit run. MFI 8 has been paying such deposits according to the agreed-upon 1 to 5 year terms and from US$ 50,000 to US$500,000.

Moreover, MFI 8 institutionalized the concept of “guarantee fund,” which was a matching fund with a mandatory underwriting by debtors. For these resources, the rate was 3% and they were underwritten for a 9-month term. As of June 2007, the rating agency reported that for its 77,000 clients, the institution had 87,000 active savers; the highest value in December 2006 amounted to US$2.5 million. It was surprising that neither the Rating Agency nor the funders found something unusual because it was common in Latin America that unregulated institutions were not authorized to manage public deposits. It was more surprising that the Rating Agency in 2005, after the institution announced its intention to start a process to become a regulated entity, considered that this was an advantage for the entity during its transformation process because of the experience it provided, even though it was clearly something illegal. It was not surprising that the existence of these deposits slowed down the authorization by the Bank Superintendence to convert MFI 8 into a regulated financial institution as long as process would resume if the deposits were totally cleared. They were suspended in 2007, and at the end of that year, they fell to US$1.6 million.

The risk of having an unregulated institution mobilizing deposits without proper supervision and a lack of deposit insurance became evident in this case and pointed out the fact that funders should be careful with this kind of situation.

\textsuperscript{22} Risk rating in June 2007.
Even though the aforementioned resources came from a lot of people, most of the volume to fund the growth of this institution came from local funders (including second-tier institutions in the country), and even more from international funds. In 2002, MFI 8 had funding from 9 sources, of which 4 were national (among them, a member of the current Board of Directors who received an interest rate that was two times the rate for the other funds). Then, the composition of the funding changed and international funds became their main source. After having just 5 international funds which funded 37% of the portfolio in 2002, in 2007 there were 15 international funds, which funded 69% of the portfolio, of which 3 had a very high exposure, accounting for 35% of the portfolio of MFI 8. In December 2007, the ratio between the portfolio and the loans from national and international funds accounted for 99% and the debt to capital ratio and increased 2.5 times in 2004 and 4.6 times in 2007. It was more surprising that in one year, from 2006 to 2007, the liabilities of the institution increased by 66% in local currency while the portfolio increased by 30% and the equity by 24%.

The 3 creditors who arrived in 2007 made the decision of supporting the transformation of the NGO and they also granted subordinated loans amounting to seven million dollars each and a seven-year maturity. In exchange they signed an agreement with MFI 8 to serve 100,000 clients in 2009, which was a strong pressure on the institution because at that time the institution had a base of 65,000 clients. According to one of its representatives, in spite of their subordination status, they did not demand to be members of the Board of Directors because of the implications since it was a nonprofit institution. After one year MFI 8 was able to increase the number of clients by 5,000, and two years later, as a consequence of the crisis, the number of clients fell drastically, and in 2009 fell to half the number (35,000) of clients it had in 2007.

5.8.6 What Drove this NGO to a Crisis?

Several factors played a role in the country's crisis. In 2007, there were frequent blackouts across the nation that together with the high oil prices and a decrease in the remittance income led to an economic recession. Micro-entrepreneurs started complaining of reduced income resulting from a sales reduction. MFI 8 was dealing with a slight deterioration in its portfolio quality. At the end of 2007 and in early 2008, specific complaints against microfinance institutions were voiced regarding the high interest rate and the execution of guarantees for delinquent debtors.
In March 2008, there were outbreaks of rebellion in the northern region of the country. The riots were led by the former mayor of the municipality and a businessman from the area, joined by almost 400 producers who were able to encourage the nonpayment movement –NPM— at a municipal level, against the microfinance institutions because they were deemed usurers. The movement continued attracting more followers, and in July 2008, the President of the Republic supported the movement, and during a speech he urged debtors to occupy the buildings of the microfinance institutions to defend their rights.

The movement grew to almost 10,000 people (a fourth of the total clients of MFIs in the northern region) and expanded its coverage into other states in the central regions of the country and in the Pacific region. The rioter demands were similar across the regions. They advocated for a debt repayment freeze (or moratorium) for thousands of producers and merchants served by microfinance institutions and banks, a suspension of legal actions, an interest rate moratorium, grace periods, and finally, a decrease in interest rates. Some NGOs and some microfinance institutions approached the representatives of the debtor groups who were followers of the NPM, seeking agreements that in the end were not implemented. In June and July of 2009, leading businesspeople and producers in the municipality where the NPM originated submitted two bills to the National Assembly: the first bill called for a “law for a moratorium for bank and financial institution clients and suspension of executive actions against borrowers in the financial system” and the second bill, for a “law on the suspension of trials and enforcement of judgments relating to debts incurred by agricultural producers with microfinance institutions.”

The impact on the microfinance sector was evident in the figures of MFIs in 2009. NGOs from the microfinance institution industry and regulated MFIs significantly reduced their portfolio volume and the number of clients. On average, the NGOs reduced the loan portfolio by 13% and the number of clients by 10%, which meant a loss of 57,000 clients in 2009, while regulated MFIs reduced the loan portfolio by 19% and similar reduction in the number of clients.

All the MFIs were facing the same risks. In the case of MFI 8, the situation was even more critical – one branch reached a delinquency level of 70%. Soon, they found out about fraud committed by branch staff. Other two smaller branches showed the same behavior. The two branches on which MFI 8 concentrated their portfolio, one in the northern region and the other
in the western region of the country, had a higher delinquency. The highest
deterioration was experienced by the agricultural portfolio, which in 2009
showed a delinquency indicator of 51% while the microcredit portfolio in
general reached up to a 17% delinquency ratio. In fact, the delinquency was
the least significant problem faced by this institution as shown below.

The crisis started affecting the liquidity of the institution, partly because one
of the international funders noticed these threats and asked for a debt
repayment, threatening to disclose the information among other funders.
The loan was repaid by MFI 8, so this situation alerted the other international
funders and cast doubts on the stability of the institution. Another funder
with a higher exposure requested a field audit. Such audit highlighted the
methodological weaknesses in the analysis and evaluation of loans and
incomplete documentation, and disclosed a lack of internal controls, audit
deficiencies, and a weak performance by the management and the CEO. At
that time, it was evident that the outsourcing of the collection of delinquent
portfolios since the first day in arrears favored the CEO and Chairman’s
family, so this led to an obvious disincentive for the entity to control
delinquency.

These anomalies were immediately reported to the Board and other
creditors. By mutual consent, in June 2008, they asked the CEO to resign as
the Board Chairman and as the CEO of the NGO. To speed up his departure,
the entity agreed on keeping him as a Board advisor and paying him the
same salary and allowing him to attend Board meetings.

Creditors requested a new composition of the Board by appointing the
secretary as the Chairman, who according to directors had better banking
background and experience. However, the governance problems of the
entity were not solved. The Board lacked cohesion because some of the
members supported the CEO and founder of the institution while others were
sure that his presence significantly contributed to the financial disaster.

The Chairman of the Board and the creditors started reviewing the
outsourcing agreements and they found out that they were executed by
parties related to the outgoing CEO. Besides the collection company, MFI 8
had worked with a training company that provided technical assistance to
entrepreneurs in strengthening their enterprises. In July 2002, this
Enterprise became a corporation, with shares held by the CEO of MFI 8 and
run by his daughter. This company was paid a lot of money. The third
linked company was related to technology. MFI 8 granted scholarships to all
the micro-entrepreneurs who wanted to learn how to use computer software.
The company was linked to another company run by the CEO’s brother in law and which provided all the computer equipment funded by MFI 8. The fourth company provided security services, and according to one of the respondents, it entered into a one-sided contract with the entity. Each branch had two 24-hour guards. In this case, it was impossible to prove the relationship with the CEO, but it was difficult for them to explain such unfavorable contracting conditions. Soon, they discovered that the Operations Manager was linked to these processes and had been aware of the entire operation and the contracts. It was also assumed that the internal audit in 2008 should have been involved. It was said that the CEO had duplicate information in his house and he manipulated and tampered with the balance sheets daily as he wished. There was a daily account closing.

The departing CEO had major conflicts with the General Manager who had disclosed these embezzlements. The General Manager left the institution and one of the ladies who had been a Board member for many years was appointed as the new manager. It was soon found out that this lady was very close to the CEO who was also the founder of MFI 8. Once again, there was a replacement, and a local external consultant expert in microfinance was appointed as a temporary manager. He started conducting a review and looking for solutions to the crisis faced by the entity. The entire process was kept confidential to avoid affecting the institution. The departing CEO, who argued that there was a ploy against him under the leadership of the Chairman of the Board to run the institution and chair its Board, detected legal faults in the new organization of the Board of Directors and filed a legal action in which he prevailed. When he was reinstated as the CEO in early 2009, he decided to take over the institution. He came to the general management office accompanied by the police and one of the Board members who had been a temporary manager. In the following 3 or 4 months, he took about US$4 million from the institution using different mechanisms. According to public information and observations made by several respondents, the reinstated CEO spent about $150,000 to pay his credit card debts and also authorized loans amounting to millions of dollars and engaged service institutions which were paid huge amounts of money. Other irregularities was the hiring of 20 people as managers, assistant managers, assistants, lawyers, and drivers with a fixed five-year term contract, but after three months, he dismissed them and paid them a compensation as if they had worked for 5 years, and with a compensation as high as US$450,000. During the CEO's trial, his attorney stated that the institution did not want to recognize his 20-year experience in microfinance.
and that the credit card payments were justified because they were used to pay for representation expenses that were part of his duties.

The leaders of the international creditors lobbied in favor of the interests of the institution and for their own interest before various legal and political authorities in the country and to which they reported what was happening; however, they did make any progress. In 2009, MFI 8 prevailed and the CEO received a sentence of four years in prison for theft and breach of trust. Nevertheless, the CEO was able to get house arrest due to his political and legal liaisons. The CEO’s children have been also legally required to testify and give evidence of their relationship with MFI 8.

It was evident that the leading NGO institution was used by its sponsor and CEO for his own benefit for many years.

**5.8.7 The Outcome**

Even though anomalies were detected and adjustment processes made some progress in spite of the interruption caused by the “retakeover” of the entity by the former CEO, the institution, with the support of the new Board and the creditors, proposed a stabilization program to save the institution and which would cause the least damage to micro-entrepreneurs and microfinance institutions in the country.

They hired a former manager of one of the NGOs which had become a regulated institution to adhere to the stabilization plan and help the new manager in the process.

The plan that was implemented in 2009 focused on a reduction of delinquency levels and on keeping an acceptable liquidity level to meet creditor commitments. A decision was made to restrict the loans and close unprofitable branches. During that period, 20 branches were closed in an effort to boost profitability indicators and adjustments were made to the microcredit technology, seeking alternatives to promote loans again.

At the end of 2009, a new general manager was hired, but she did not have any microfinance experience; however, she had technical expertise that could help solve some problems and save the institution. The local consultant who was acting as the temporary manager continued providing technical advice to the NGO in the area of microcredit methodology.

The new manager conducted a diagnosis of the institution and submitted it to the Board and creditors. She also proposed a new stabilization plan based on 2015 projections and which would include infusion of new resources and debt
restructuring. Creditors were offered a reduction in the rates by 50% for commercial loans and 70% for subordinated debt, and a change in the terms of payment from a capital payment schedule during the fourth or fifth year to one of monthly payments. The restructuring agreement was approved by 7 of the 9 creditors, including those with subordinated debt.

The new management started a reorganization process based on the implementation of controls, definition of regulations, and a review of policy and procedure manuals. The stability of the platform and the availability and clarity of the information were mentioned as key issues in the institutional restructuring.

To improve the portfolio, the portfolio of closed branches was assigned to other branches and the obligations were reallocated so that the recovery was in charge of the collection officers, a process that as of April 2010 recovered US$ 31 million. In spite of these achievements and given the reduction in the portfolio value, the delinquency was 61% in March 2010.

In the case of international funders, there were various reactions. Some got involved in the restructuring process and followed the development of the crisis very closely by participating daily in the closing of liquidity rates and a weekly follow-up of indicators and results. Some decided to record the loans as losses even though the current manager thought the agreed-upon installments were being met.

However, others decided not to modify the commitments initially agreed before 2008, applying the original covenants, for instance, a delinquency lower than 10%. Other creditors, with a debt of US$4 million, imposed a clause on MFI 8 equivalent to US$2.3 million, forcing the institution to freeze that money in an account. This led the management of the institution to question the commitment and support of these funds in times of crisis. On the other hand, international funds have argued that the legal insecurity in the country together with the political support of the nonpayment movement by top government officials, made it impossible to think of a change of attitude and to consider the possibility of granting new funds.

In fact, the political environment faced by the microfinance industry in the country was very complex. At the time of the interviews, the moratorium law had been approved by granting 30 days to MFIs so that they restructured the overdue loans by June 30, 2009. The regulation required a case-by-case renegotiation. In the case of MFI 8, the loans linked to the nonpayment movement accounted for the largest loans, in total 1,600 loans. An additional one-month term was granted in order to recover and renegotiate
the most loans. The serious internal developments faced by MFI 8 were disclosed in different media. The future of the institution was uncertain.

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5.9 MICROFINANCE INSTITUTION 9 – COUNTRY E

5.9.1 Institutional Background

MFI 9 was created as a bank with various interesting characteristics that help clarify its interest in venturing into the microenterprise credit business. The banking institution was opened in the northern part of the country by local businesspeople and had become the largest financial institution owned by national businesspeople in a market controlled by multinational banks. Its traditional niche was small and medium enterprises (SMEs), a business that was considered very successful and which allowed the institution to grow and have a national coverage.

Due to its strong background, a SME funder, a public second-tier institution devoted to fostering the development of the microcredit market (by either funding the financial institution portfolio or granting pledges to hedge the loan delinquency risks), suggested that the bank venture into the microenterprise business, offering a pledge of 80% on the loan value.

In 2004, the Bank’s Board explored the venture and appointed a Project Manager who would visit the various microfinance institutions in the region to become familiar with the business. Upon analyzing the business, the Bank decided to create an affiliate to implement the new model, particularly at the request of one of the Board members who considered that the Bank’s image could be damaged due to its involvement in granting loans to the lower-income segment at rates much higher than in the rest of the segments served by the Bank.

Therefore, in 2005 MFI 9 was created as an affiliate exclusively owned by the Bank. It used the legal concepts allowed in the financial system, which at that time allowed the MFI to be a bank affiliate while under the supervision of the regulatory entity of the country. Based on public statements from one of the commercial bank directors, the Bank considered that the potential market in the corporate segment was being depleted because the companies were relying upon the stock market, and the Bank understood that there was potential in the very small enterprises segment in which the bank had comparative advantages. They understood that it would be the first commercial bank to venture into this segment, which would be an element that could contribute to establishing its image as a bank that would meet the needs of businesspeople in the country.
5.9.2 Business Evolution

The management of MFI 9 was entrusted to an officer with experience within the Bank who had been in charge of the SME division. Therefore, the bank board was reassured that even though it was an independent Board of Directors composed of bank officers, the Board did really not meet, but it rather established a direct line between the manager and one of the vice-presidents and operated as a bank division. The manager was sent to several seminars and visited some microfinance institutions in the region to become familiar with the best practices in this area. The technical support would be provided by the Bank through its systems and human resources divisions by paying the affiliate a fee for these services. Some observed that due to this decision, the project would be weak since its inception. The Bank also decided to venture into this segment with a new independent image; consequently, the affiliate gave it a different name, but it also decided that it would operate with its own branch network in spite of the concomitant extra costs.

During the first year, the optimism for this business potential was so high that the affiliate opened 39 branches in 21 cities in the country. During the second year, this figure doubled and reached 80, serving 28 departments in the country; and during the third year, it planned to have 115 branches. The rapid expansion of the branches was also evident in the number of employees because during the first year, it already had 300 officers, which increased to 515 during the second year. During the third year, it was authorized to have 700 employees; however, it did not fill all the positions.

To support this expansion, the affiliate did not buy its own technological platform, but instead asked the Bank’s systems department for a platform. However, it did not have the required priority attention, so most controls needed to develop a specialized model began to be implemented manually.

Because microcredit was its main product, the affiliate initially focused on defining how to conduct a risk analysis. Even though the MFI 9’s board received brief microfinance training, their experience within the Bank made them consider that it was possible to combine successful microfinance elements with the know-how that the Bank developed during its time in the small enterprise area.

A model emerged that was based on this combination, which was relied upon by specialized advisors who sought after clients and were rewarded for their commercial work. The model provided information on both the borrower’s
character and capacity to pay; a model developed by the Bank to serve SMEs. According to a Bank document, the entity defines its risk policy as "the individual credit risk for the portfolio of the Corporation is identified, measured, and controlled using a parameterized system (scoring) including demographic, socioeconomic, and financial risk factors, among others". The platform and the parameterized model developed by the Bank and used by MFI 9 was quite inflexible, and it even used a microenterprise information collection form very similar to the form used by the Bank with small-enterprise loans. The information was complemented with a consultation to the Credit Bureau about the financial institutions that provided a good information database about the credit history of these businesses. Credit was granted on an individual basis, and the pledge used was the pledge offered by the national second-tier institution which hedged 80% of the risk.

Hoping to encourage growth, they also urged clients to bring referrals, and MFI 9 would pay US$18 per each client if the loan of the referral was approved.

In terms of financial conditions, the Bank also decided not to adopt the staggered term structure that was recommended as one of the best microcredit practices by granting 24-month terms; therefore, it is not surprising that the average loan value during the first year was not higher than US$2,000. Moreover, in order to compete, the Bank decided to use rates lower than the market rates; and since they only took 20% of the risk due to the pledge offered by the local second-tier institution, the business was very profitable. This distortion in the risk perception caused by this business plan explained several mistakes made by the Bank in developing this project. Even though it was decided that the affiliate would have its own branches, it was also decided that they would not manage cash; therefore, the disbursements and fee payments had to be made at the Bank branches and at the post offices that had entered into collection agreements with the Bank. Even though this minimized operating risks and allowed them to establish a few branches with more relaxed security, it contradicted the interest of the Bank to launch this project based on a totally independent image.

MFI 9 not only granted loans, but also provided insurance to serve this segment of the population, including life, house, and car insurance. Since the license MFI 9 did not allow them to collect deposits, the Bank also offered deposit-taking products. However, it was not possible to collect information about the level of penetration of these products.
During an international forum in late 2006, the manager of MFI 9 stated his concern for the high turnover among loan officers. Additionally, during another international seminar two years after the institution was founded, the vice-president in charge of MFI 9 admitted that the balancing of incentives (not only with the loans, but also with the portfolio quality) was overlooked at the beginning of the project. By then, delinquency was already at 9.4%.

5.9.3 Financial Situation

Under the financial structure chosen for MFI 9, it not only disbursed loans but also kept them in the balance sheet. Therefore, they had to comply with the minimum capital requirements enforced in the country to create a regulated financial institution. The institution made a contribution of about US$ 5 million, and after one year of operation, it had a portfolio of US$ 30 million and 15,000 clients. The funds to sustain operations were obtained through loans granted by the Bank itself at market rates. According to one of the audited reports the loans among the related parties paid an annual interest rate of 9.5%.

The penetration figures were considered successful even though at the end of the year a loss of US$1.9 million was recorded, which accounted for the start-up cost of the business; MFI 9 invested a significant amount of resources to establish 39 branches that had not achieved their productivity level goal. In fact, even though that year their recorded income accounted for 43% of the portfolio, they had hardly enough to pay the operating expenses equivalent to 42% of the portfolio. Therefore, it was not possible to meet the provisions and financial expenses corresponding to the credit lines granted by the Bank.

In 2006, MFI 9 continued growing rapidly, increasing the portfolio by 80%, the number of clients by 53%, and reaching a value of US$56 million for a total of 29,000 micro-entrepreneurs at the end of the year. Even though delinquency had risen and was higher than 9%, the MFI was able to make a profit at the end of the year because it increased institutional efficiency despite having doubled the branch network to reach 79 branches. The delinquency did not affect the profit and loss due to the pledge granted by the second-tier institution that covered up to 80% of the credit, and MFI 9 only had to provide the portion not covered by this pledge. However, if this pledge had not existed, the Bank’s Board would have paid more attention to the way the affiliate was managing its portfolio risk.
Based on these results, the institution established even more ambitious growth goals for the following year, planning to serve 61,000 clients, with an increase of 70% in the amount disbursed and a larger coverage to reach 115 branches. These goals meant that at the end of the third year, MFI 9 as a bank affiliate should have accounted for 1.06% of the clients served by a network equivalent to 11% of the Bank.

In 2007, the Bank continued to be dynamic, but the growth of the portfolio in arrears became unbearable. In 2007, the portfolio in arrears reached 20%, and the productive assets/interest-bearing liabilities ratio was 74%. The honeymoon was over.

### 5.9.4 The Crisis

During the third quarter of 2007, it was evident that the portfolio quality was out of control, even though the business of MFI 9 was growing rapidly (which allowed the board members to see the previously under-served market the institution was now able to serve). The Bank decided to change the management of the affiliate by bringing in another officer, who had a career at the Bank, in order to strengthen the management structure and regain control of the delinquency level.

Even though the new Manager had little microfinance knowledge, he decided to “tidy things up” before continuing with the growth plans; therefore, he ruled out the possibility of opening 30 additional branches out of the 65 that were budgeted for that year. Part of the total staff, which amounted to 700 authorized employees but whose positions were not entirely filled entirely, was used to reinforce the portfolio recovery tasks.

Soon after, the severity of the situation faced by the institution was fully understood, and a formal Board meeting was requested to get the support of all the bank authorities who should intervene so that the MFI continue its course. Henceforth, it continued to meet on a regular basis.

Several elements became evident in the diagnosis conducted by the new management:

First, during its rapid growth, MFI 9 was not able to train the staff properly in regards to the minimum knowledge required to perform properly as well as the organizational culture on which the Bank prided itself.
Second, even though an adjustment was made in the MFI’s second year to encourage loan officers to take more responsibility for loan disbursement, two facts prevented the incentive system from working effectively. One was the fact that the officers delegated responsibility to the parameterized model, which allowed them to justify the poor quality of the model by arguing that “the computer” approved the credit. The second was high staff turnover, which resulted from chasing incentives from allocating loans, but leaving MFI 9 before being penalized for the poor quality of their portfolios. Additionally, the policy of paying for referring clients also led to the fabrication of fictitious loans by the loan officers and their friends.

Third, after thoroughly analyzing the clients’ credit history and comparing it to their payment behavior at the institution, they found out that consultations were made using the database of “formal persons” (that is, of established businesses), and traditionally involved the clients of the Bank, instead of “simple persons” that included retail and micro-entrepreneur loans as informal entrepreneurs.

Fourth, the institution had not developed processes and procedures to control the business and prevent frauds, such as the fraud discovered when they tried to detect the reasons behind the poor quality of the portfolio. Amid the crisis, the internal control divisions of the Bank (which had not been very concerned about MFI 9) started to question the processes adopted, and the monitoring agency started also questioning the risk management policy of the institution. Even the risk rating agency of the Bank started questioning the results of MFI 9. To the surprise of the audit, it found out that the affiliate did not even have collection manuals and during the growth process, the increase in the number of employees overwhelmed the institution to the point that there were no separate job-description manuals for the different positions. After this discovery, they were then developed.

Since the diagnosis concluded that the loans were poorly evaluated since their origination, a decision was made to stop the disbursements and renew only the loans to clients who had repaid or who had a proven ability to pay. In fact, the high loan officer turnover led to a very high client turnover; therefore, lending was not easy. Due to the fraudulent operations that were detected, many officers were dismissed. The financial conditions were also
revised because due to the delinquency levels, there was no way to keep interest rates lower than the market rates that were charged up to that time.

As a consequence, the portfolio from December 2007 to June 2008 fell by 38%, and the delinquency rose to 34%, recording losses of 20% of equity. This forced shareholders to make a capital contribution of US$ 5.6 million to maintain institutional creditworthiness.

The new management decided to rely upon the pledge offered by the national second-tier institution. To file a claim, clients had to wait until the 45th day after the maturity of the loan, and after that, they had to wait another 45 days to pay. But as MFI 9 began to claim more and more, the files were refuted by the national second-tier institution which, according to officers from MFI 9, was arguing about the most insignificant problems. However, it was discovered that there were indeed deficiencies in most files (fewer than those refuted by the national second-tier institution); therefore, the institution lost the coverage of the pledge. It was concluded that the losses were clearly higher than the estimates, and that the provisions that were set apart and estimated on the uncovered portion of the loan were clearly insufficient.

In light of the failure to control the delinquency, as well as the disappointment associated with this failed effort, in late 2008 the Bank told the new management to dismantle the business in the least traumatic way possible. Although a recently conducted analysis had proposed a way to save the business, it was not revisited at this time. The analysis, conducted by a company that specialized in microfinance technical assistance, had concluded that there were serious deficiencies in the operations of MFI 9 because it was not able to adopt the best well-proven microcredit practices. The analysis went on to propose advice that would make the business feasible in a year to a year and a half; however, the Bank chose not to follow this advice.

Considering the instructions given, the deposit-taking products were reduced. At the end of that year, the current portfolio of MFI 9 was reduced to US$ 16 million, and a delinquency of 14% was recorded in spite of the write-offs that were greater than US$ 8 million. The Bank had to capitalize the affiliate again for US$ 5.5 million, leaving it ready for a merger with the Bank. This operation was finally approved in March 2009, and thus led to the demise of MFI 9.
Since the time this document was written, the Bank has maintained its decision not to venture into microenterprise credit.

5.9.5 Bibliography

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5.10 MICROFINANCE INSTITUTION 10 – COUNTRY E

5.10.1 Institutional Background
In 2006, a prestigious institution referred to as TA1, with experience in microcredit technical assistance and as a rating agency of microfinance institutions, embarked on the difficult task of building a holding company to promote the creation of 15 microfinance institutions in Latin America, Africa, the MENA region (Middle East and Northern Africa), and Asia. It was aimed at "providing an operational tool and helping the financially excluded to have access to the traditional banking system". As such, it would encourage the organization of new institutions, to which it also hoped to provide the support of the consultant team from the investor holding company, as well as the knowledge acquired by TA1 throughout its history. For the capital of the holding company, it was possible to mobilize resources from international financial institutions, and for its affiliates, it sought the support of local investors and multilateral banks.

The institution created in Country E is the first investment made by the holding company. In the annual report for 2007, the Chairman of the Board stated that it initially relied exclusively upon the capital of the holding company. The affiliate created in this country became very important, since this institution developed the processes and products that were later implemented in other institutions of the group and trained the staff who were sent to other institutions to support them in the other continents. Nonetheless, the final performance was not as expected.

5.10.2 Market Position
The market in Country E has suffered a significant transformation in the last few years, caused in part by legal reforms that had led to the creation of various legal concepts, but also by the interest rates and the high profitability levels shown by well-known institutions in the country. Therefore, according to a recent study of the industry that included unregulated microfinance institutions in the country, the microfinance institutions showed an average annual growth of 49% in their portfolios, and 44% of the served population (global) from 2005 to 2008; the estimate for the latter year was 2.2 million people. The average number of clients per institution was fifty thousand, served mainly (65%) through solidarity credit methodologies (community banking or group lending) and just 35% through individual lending, which resulted in the low average loan of US$ 497. Many institutions that
experienced this rapid growth had been created recently, precisely at a time when MFI 10 was trying to be consolidated.

There were good opportunities within the target market for a start-up because the intended region had 7 million inhabitants, of which 450,000 lived in the capital city. The same market research showed that about 1.2 million people were working at microenterprises in that state and there were about 200,000 microenterprises under operation.

Because it was a nonprofit institution, the sponsor institution as well as the rest of the shareholders who supported the venture had the goal of achieving a break-even point in 18 months. This was an ambitious goal, but it nonetheless remained due to the aforementioned good market perspectives. In retrospect, this was clearly one of the factors that motivated various decisions that went wrong with this case.

To achieve the needed scale, the institution set an ambitious expansion goal. In five years, it would aim to achieve a portfolio of US$40 million and serve 55,000 microenterprises. It is not surprising that in view of these goals, MFI 10 decided to start the operation even though the institution did not have the necessary background or enough qualified staff for 6 branches. The goal was to have 15 branches by 2010 and operate with a team of 240 loan officers.

Nevertheless, they soon found out that they underestimated two characteristics that later made the institution face severe difficulties. First, there was competition in the region, not only from microfinance institutions, but also from retail funders and cooperatives. Today, there are approximately 67 institutions granting credit in this region. The second inconvenience was the lack of information necessary to operate. This was because most entities did not report to the Credit Bureaus (excepted regulated entities), or if they did, they usually reported only delinquent cases; therefore, the market was somewhat blind to the possibility of a client with multiple loans from other sources.

5.10.3 Shareholders and Sponsors

In 2006, the company was created with US$780,000 in capital contributed by the holding company. Moreover, the technical assistance company that supported both the holding company and the affiliate in Country E made a contribution of 4%, and at the end of the first year, a local shareholder got involved and made a contribution to MFI 10 as its first contact with a microfinance institution, with an interest of 14%.
In 2007, multilateral institutions in the region were invited to participate, thus decreasing the interest of the holding company to 51% of the capital. Other institutions then followed suit, including MLT1 (US$600,000, along with a contribution of non-reimbursable resources for US$300,000), MLT2 (US$400,000), and MLT3, which supported MFI 10 with a direct contribution of US$400,000 as well as indirect exposure through an investment in the holding company. These shareholders had a positive opinion not only about the entry into the market of Country E, but also about the coaching that would be provided by an institution such as TA1, with a great amount of microfinance knowledge in the region. Furthermore, they saw a good sign in the market research conducted by the sponsor that showed the break-even point would be reached in 18 months, considering the opportunities offered by the market of the state where the institution was going to be located (its capital in particular) and the interest rate conditions prevailing in the market of Country E.

Even though the figures of the business that were used to make the investment decision were for September 2006, when there was a delinquency level of 6%, the potential shareholders were reassured that the situation was under control and that it was the logical result of the process for a new entity to enter a new market. However, as of December of that year, the 30-day PAR indicator had already risen to 14%.

As a corporation, the Board of Directors was composed of delegates for the shareholders, where the majority shareholder, given the preferred stock he held, had the right to appoint the Chairman of the Board. In fact, due to the trust derived from the presence of TA1, the dedication to the entity and the fact that it had an international board of directors, a decision was made to schedule Board meetings on a quarterly basis, as well as a requirement that two of them were held directly at the headquarters of the institution and the other two outside the country where the headquarters of the holding company were located. This frequency of meetings met the vision of the Chairman of the Board in terms of the management style they wanted to implement, as it has been done with other affiliates of the holding company, which was the delegation of responsibilities to the general management of MFI 10; this demonstrated trust in the Directors chosen. However, this was in direct contrast with the observations made by the institutional staff who reported a significant interference in the daily decisions from outside.
5.10.4 Management Structure

The first General Director of the institution had experience in a South American commercial bank and had recently started a microcredit program at such a bank. However, it was soon shown that he was not ready to consolidate an institutional microcredit methodology. In March 2007, almost one year after starting operations, the Board of Directors appointed an officer from the holding company as the Acting Director to stabilize institutional performance, in light of the high delinquency levels.

In May of that year, they brought in foreign experts to reinforce the staff with experts in microcredit technology. Each was assigned to a branch to develop recovery strategies and ensure the correct origins of new credits. In addition to this effort, the holding company sent two of its officers to reinforce the Board of Directors of MFI 10. Moreover, they created a recovery area and hired an attorney to start the collection procedures. In the final report of the year, the General Manager pointed out the success of the actions taken.

The challenge to achieve the goals proposed in the business plan explained how at the end of the first year, they hired 140 people and had a portfolio of 3,000 clients with a value of about US$1 million. Clients were served by 6 branches opened during the first year, where only two were located in the capital city, and the others in 4 additional cities with over 200,000 inhabitants each. This structure remained during 2007, and once the entity stabilized in 2008, 5 more branches were opened, totaling 11. In 2009, they added one more, resulting in 12 operating branches. This expansion was undertaken only to grant credit since in 2007 they entered agreements with two banks and a store chain to process the portfolio collections.

Maybe the most important feature to point out was the failure to stabilize the number of employees which, according to some respondents, prevented the consolidation of a business culture and the generation of knowledge at a loan officer level, which would improve their credit origination capacity. According to the annual reports of the holding company, the staff turnover was as follows:
<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff leaving the Institution</td>
<td>9</td>
<td>121</td>
<td>131</td>
<td>143</td>
</tr>
<tr>
<td>Staff hired during the year</td>
<td>0</td>
<td>109</td>
<td>163</td>
<td>172</td>
</tr>
<tr>
<td>Staff hired at the end of the year</td>
<td>139</td>
<td>127</td>
<td>159</td>
<td>188</td>
</tr>
<tr>
<td>% of staff turnover</td>
<td>6.9%</td>
<td>87.1%</td>
<td>103.1%</td>
<td>89.9%</td>
</tr>
</tbody>
</table>

This high staff turnover clearly made the goal of staff training, as expressed in the Annual Report of 2006, unfeasible: “Every new loan officer has several weeks of introductory training, together with other training courses throughout the year.” According to the staff, this training system was never implemented.

The turnover was caused by the failure to find qualified people to fill positions, particularly at the loan officer level, and by an incorrect selection of personnel, since most of them were not used to being on the street all day long. Therefore, the traditional incentives used to align loan officers with the long-term interests of the institution (particularly a healthy portfolio) were not effectively implemented, not even during the fastest growth stages. As mentioned by several respondents, the loan officers stayed long enough to receive the incentives for the loans they placed, but they left before facing the consequences of deterioration in the portfolio.

The need to incorporate people from other South American countries led to bringing in people with needed microfinance experience, but this strategy faced two major problems. These people had very good profiles as loan officers, but they also had to perform the duties of a branch manager, for which they were not qualified. They were also unfamiliar with the local market, both in terms of clients and competitors.

In 2008, after the delinquency situation supposedly stabilized, the number of loan officers was increased by 57%, rising from 47 to 74, so a new internal human resources company was used and efforts were made to improve the training structure.

In 2009, the Annual Reports indicated that it was time to "revisit" institutional growth, which was surprising because in 2008, as seen below, the institutional portfolio increased by 62%. Consequently, they hired a General Director from the country. In May, they hired a new General Director, who came from the largest microfinance institution in the country. Faced with the growth challenge (which according to most respondents
derived from a Board decision, although one of the advisors believed it was the General Director himself who set that goal), the new Director believed that he could only implement the community banking methodology, which the institution then began to devote more time to. The respondents stated that it was the beginning of the end because the change of methodology was made without a proper loan officer profile, and lacked the training time and the implementation of controls necessary to consolidate such a different risk analysis model and granting of loans.

It is surprising that during the development of analyses conducted so far, MFI 10 was coached in technical assistance from the holding company. During this initial stage, the institution received coaching from TA1, due to its experience in several parts of the world and assistance focused on the development of individual lending methodologies, the development of manuals, and the training of institutional staff. During MFI 10’s second phase, TA1 analyzed the requirements necessary to make an institution strengthen its management levels, and brought in board members from MFI 10, a team that initially included officers from the holding company, but later included staff specifically hired for the affiliate in Country E. The main funder of the company (a local fund supporting the microfinance sector) questioned the costs of this technical assistance (according to respondents estimated to be about US$ 300,000 a year), arguing that for 4 years, they had allocated US$1.2 million for this purpose. Instead, they could have allocated this amount towards covering the accrued losses of the MFI, which amounted to over US$ 5 million.

As pointed out in the beginning, MFI 10 had many elements to be a promising project. One of them was the market situation in which commercial rates were very high and led planners to think that an efficient institution with a good credit methodology could effectively reach a break-even point rapidly. Therefore, the 2008 annual report stated that "the interest rate depends on the loan size and fluctuates between 3.5% and 5% a month, calculated based on the initial loan amount. Moreover, they charged a 5% fee at the time of the disbursement, but this fee is reduced to 2% for clients who can prove an excellent repayment record or who have had a relationship with the company for at least twelve months\textsuperscript{23}, which combined exceeds 90% annual cash.

\textsuperscript{23} Annual Report 2008.
It was not surprising that nobody was concerned about such an expensive operating structure because the institution, since its inception, was obviously justified due to its plan to serve 55,000 clients in 5 years. These costs accounted for over 300% of the average portfolio during the first year of operation, 183% the second year, and 78% the third year\(^{24}\), including the items recognized for the aforementioned technical assistant. This high level of expenses and the following provisions made the institution financially unviable.

### 5.10.5 Portfolio Quality: An Unsolved Problem

As stated at the beginning, one of the characteristics (in terms of value supposedly contributed by this institution to the microfinance market in Country E) was the use of an individual credit technology. Therefore, they brought in staff from other countries experienced in this methodology since only community banking was known in the local market. Then, after 2 years, they announced the development of individual credit with a group pledge in order to improve the portfolio performance. And finally, in 2009, they relied upon a community banking scheme to increase the pace of the loan portfolio and achieve the goal of reaching the break-even point at the end of that year. However, as seen in the graph, MFI 10 was never able to have a delinquency rate lower than 5% in PAR more than 30 days. The alleged stability observed during 2008 was in fact produced by two elements: a decline in the level of the portfolio in arrears accounting for 28% in December 2007 and declining to 19% in December 2008, and write-off level of 20% of the portfolio in December 2007, which fell to 11% in 2008. The explanation for the failure of this institution to manage its portfolio risk was not easy. Several respondents mentioned the over-borrowing problem among micro-entrepreneurs in the country, particularly due to the penetration of retail loans that made one institution grant loans based on another methodology and created more flexible client payment habits. In view of this explanation, we could ask how other microfinance institutions in the country had indeed done it.

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\(^{24}\) Calculation based on indicators published by Mix Market.
The second explanation is based on the rapid growth of the institution, which as of the first year was evident not only because of its geographic expansion but also due to the portfolio growth. This growth, within an institution that had administrative and operating problems that were mentioned above, seemed to offer a more suitable interpretation of the source of the setback.

Six months after starting operations and creating two branches in the capital city, the institution expanded into two other cities within two months and two others at the end of the first year. These six branches were still operating in 2007, while it was trying to control delinquency. In 2008, it started the second stage, adding 5 more branches. Albeit these five branches had a "lighter" design since these new points of service did not include a cashier service, and branch service was provided based on an agreement entered with two banks and a store network, which in turn cut operating costs and helped clients pay their obligations. Even in 2009, two other branches were added to the network, arguing that the expansion into more rural areas allowed them to separate themselves from the retail loan competition.

Regarding the portfolio, the graph shows that it had quite a rapid growth since the beginning. In 2008, the local currency portfolio increased by 116% in 2007 and 58% in 2008, which in terms of any institution's granting of loans was deemed satisfactory. Furthermore, according to the industry indicators, the portfolio of microfinance institutions until 2007 has been growing rapidly by 40%, and in 2008, due to the economic deceleration of the country, the growth rate was reduced to 17%, thus showing how MFI 10
significantly surpassed the average. In spite of this, 2009 was defined as the year when the break-even point was achieved and, as shown in the graph, an accelerated growth stage started along with a shift in the microcredit technology from individual to community banking loans.

This growth stage "at all costs", based on a new methodology, surprised an entity which had not even been able to consolidate the individual credit method. The loan officers’ tenure at the institution was brief, as was their previous work experience at MFIs. Various institutional officers noted that this situation worsened due to the attitude of the General Director who – in view of the growth goal – accepted the unethical behavior of the loan officers, which included paying commissions to people so that they organized community banks or created fictitious loans. The institutional control system failed, showing again that the loan officers, in a spiral of disbursements, could be rewarded with new disbursements and then leave before the poor quality of the original loans had repercussions on their personal income. The portfolio quality deterioration definitely surpassed the institutional capacity, and in November a decision was made to change the General Director again and suspend disbursements. However, it was too late. The PAR more than 30 days delinquency ratio was higher than 20%. How did MFI 10 fund its growth? Throughout the first stage and using the capital contributed by the shareholders, it applied for loans from three institutions in 2008. The first was a commercial loan, but guaranteed by the holding company and supported by a government pledge program. During that same year, it was also granted a small credit line from an international fund, which had shown interest in supporting entities related to practitioners, and which considered that in this case, the shareholders and the technical assistance of the holding company provided interesting security elements. But clearly, the strong support of the institutional growth came for the local microenterprise fund, a program of the National Government which was aimed at encouraging the development of the microfinance industry. About 55% of the portfolio increase in 2008 was funded with this credit, and if we included two others, the percent spikes to 83%. The capital contributions made by the shareholders in that year, both in terms of fresh resources and debt capitalization, were allocated to covering the accrued losses and maintaining MFI 10’s creditworthiness.

If the provisions derived from the portfolio quality were added to the aforementioned expenses, it would be surprising that the institution recorded
an after-tax ROE\textsuperscript{25} of -96\% in 2006, -140\% in 2007, and -35\% in 2008, and accrued losses (without considering the tax credit) were higher than US$5 million in September 2009. The recapitalization and restructuring that the institution required did not match the plans of the shareholders, who decided to get a buyer for the institution.

5.10.6 Bibliography
Website of the holding company
Website of MFI 10
Website of TA1
MTL 1 - Documents published about MFI 10.

\textsuperscript{25} The entity reported tax credit income to be discounted in the future.
## 5.11 Annex 11: Experts Interviewed

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<td>Tomás Millar</td>
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<td>Diego Guzmán</td>
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<td>Alejandro Silva</td>
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<td>Erik Geurts</td>
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<td>Jacinta Hamman</td>
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<td>Fernando Prado</td>
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<tr>
<td>Fernando Fernández</td>
<td>DAI Mexico</td>
</tr>
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</table>
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