How can microfinance investors contribute to prevent over-indebtedness
The case of responsAbility Social Investments

Presentation for
Savings and Credit Forum, SDC

"Over-indebtedness of individuals or households can be defined as the inability to repay all debts fully and on time. Over-indebtedness only occurs if this situation occurs chronically, i.e. in several periods in a row, and against the borrowers' will."

Haas 2006 and Wisniwski 2010

An Investment Manager's responsibility
Optimizing multi-stakeholder interests

respons**A**bility

Over-indebtedness ...

- ... is negative for all long-term oriented stakeholders

- ... benefits only short-term oriented stakeholders

- ... being tackled as an issue with a 'social' focus only is not reaching far enough

Over-indebtedness – some thoughts
Over-indebtedness / risk of over-indebtedness …

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- … is a 'natural' part of any credit market
  and not a MF phenomenon

- … cannot be avoided entirely – it needs to be managed

- … it is not stable but fluctuating

- … an acceptable price to pay for the benefits of financial inclusion?

- … a 'sign of success' for the achievements of the MF industry
  considering what the worries were a few years back?
  (*Water, water everywhere, but not a single drop to drink!*)

Over-indebtedness – only a symptom
What are the root-causes?

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- Too many providers – lack of market order – consolidation difficult

- Unhealthy competition (also from outside MF market!)

- Too much (cheap) funding

- Weak information basis of lenders – information asymmetry

- Weak regulation - weak infrastructure

- Low financial literacy rate and level of experience of clients

- Irresponsible behaviour of lenders

➔ Most causes are on **market level**, not on institution level

Mitigating over-indebtedness
Levels of intervention for an investor

responsAbility

responsAbility acts on different levels

- attract right **investors** / align investor expectation

- appropriate **product** design and management

- in-depth **research** and market understanding

- risk management and **allocations**

- adequate investment **process**

- investment **behaviour**

- initiatives and **sector development**

responsAbility's investors

Align expectations

Investors and investment vehicle design

Technical features influence investor attraction and behaviour

- Risk/return/liquidity profile

- Currency

- Distribution channels used

- Return requirements/promise/indication

- Client suitability

- Legal set-up (e.g. open/closed-ended)

- Minimum investment/unit size

- Benchmark

- Valuation methods

- Manager (know-how, style, purpose, mission, professionalism)

responsAbility's investment process
Selection on different stages

Questions an Asset Manager has to ask
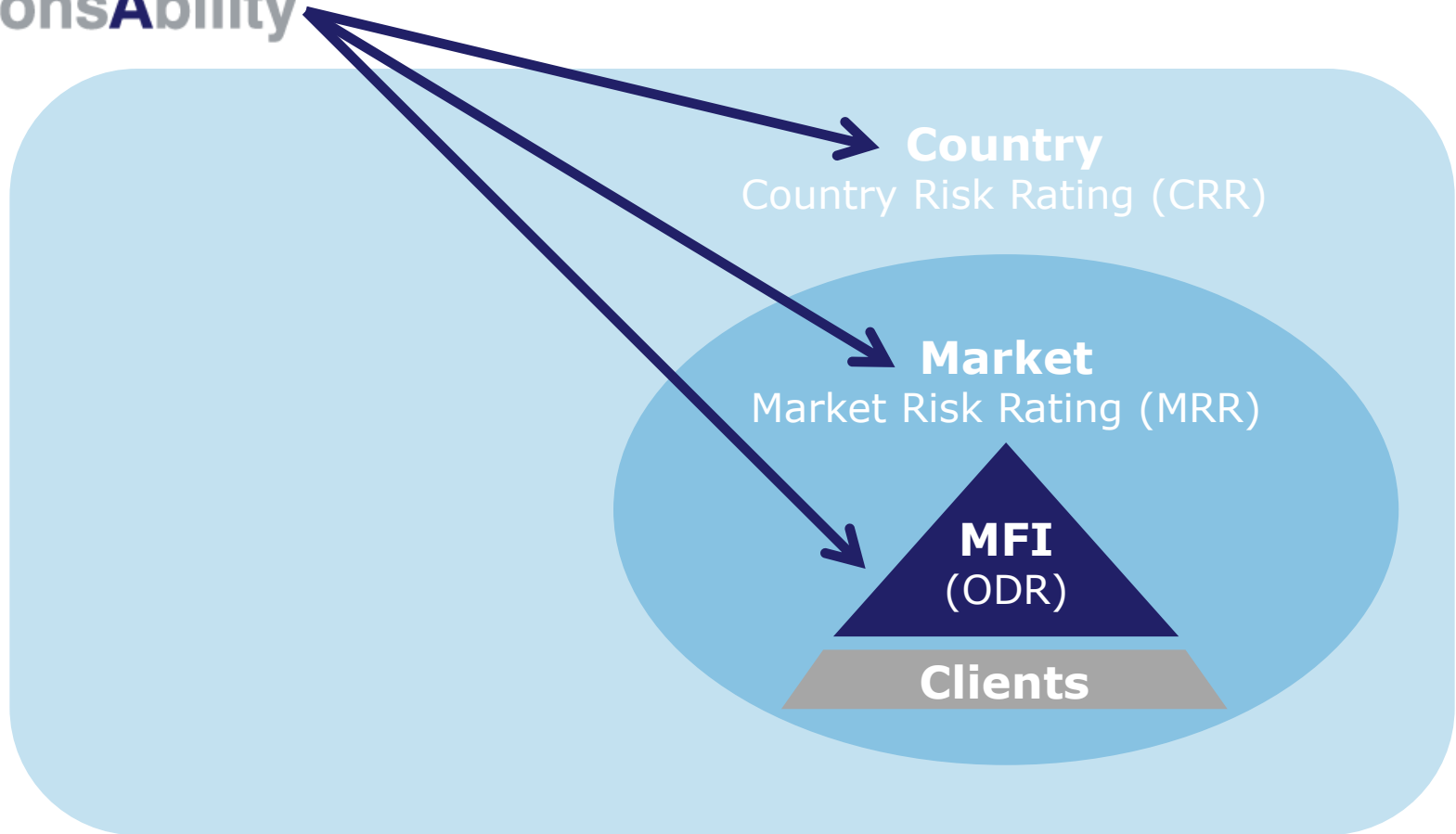## In-depth market understanding is key

responsAbility

- To whom

- How much

- At what price

- When and for how long

- For what purpose

- Under which conditions

- In which market environment

- With what kind of money

- From which source

- With which strategy

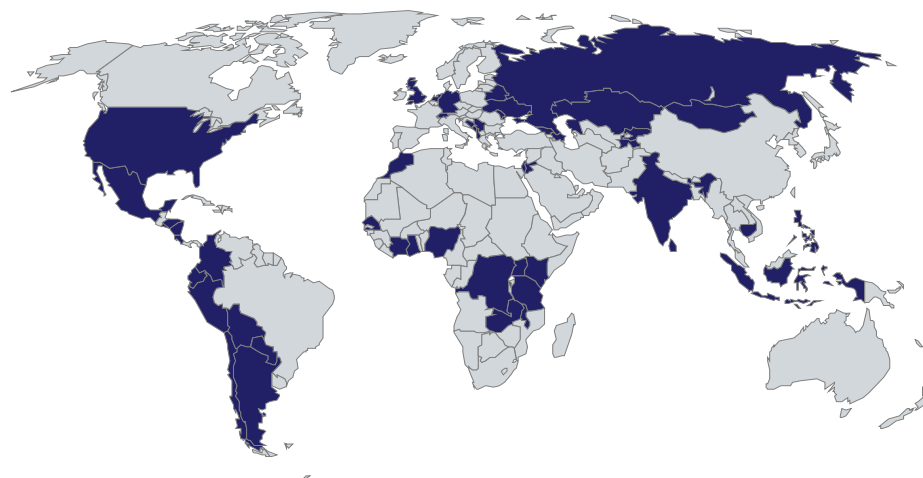# responsAbility's investment process
Overview

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Country
Country Risk Rating (CRR)

Market
Market Risk Rating (MRR)

MFI
(ODR)

Clients

Country level
Country Risk Rating (CRR)

- Comprehensive country risk assessment

  - Political risk

  - Economic risk

- High diversification

  - 68 different countries

➔ **Implication: CRR is part of every investment decision and influences country exposure and maturity limits**

Market level
Market Risk Rating (MRR)

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- The MRR accounts for the risk of over-indebtedness and for other drivers/mitigating factors of over-indebtedness

  - Over-indebtedness: How large is the risk of over-indebtedness?

  - Market Potential / Saturation: How large is the unbanked population that could be reached by microfinance?

  - Competition: How intense is competition and what are the consequences? (taking into consideration non-MF players)

  - Credit Information / Credit Bureaus: Are there effective, reliable credit bureaus for microfinance and what is the scope, access and quality of credit information available?

- **Implication: MRR is part of every investment decision and influences country exposure and maturity limits**

MFI level
Eligibility criteria as selection instrument

- MFI selection according to our Eligibility criteria

√	**Sustainable business model**
√	**Sustainable legal / supervisory form**
√	**Targeted lending**
√	**Adequate client analysis**
√	**Use of credit bureau**
√	**Fair client treatment**
√	**Reasonable owner and management compensation**
√	**Owner and management integrity**
√	**Real financing need**

- Prioritization

- in-depth on-site DD for each new investment (ODR)

> 10'000 MFIs

Selection
(Eligibility)

500 MFIs

Prioritization

300 MFIs

on-site DD
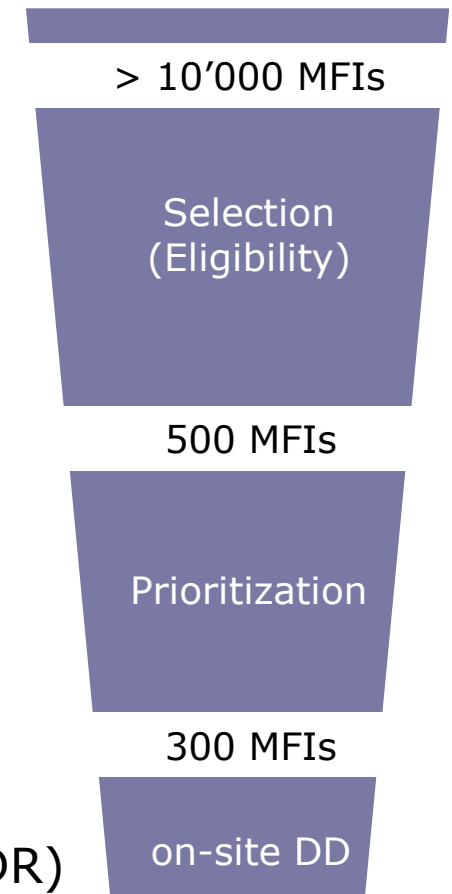
Initiatives and sector development

responsAbility Research Study:
Over-indebtedness and Microfinance

Over-indebtedness and Microfinance
An early warning index

A logo reads "responsAbility" in the top right.

University of Zurich UZH

responsAbility
leading social investments

Center for Microfinance – University of Zurich

Over-indebtedness and Microfinance
Constructing an Early Warning Index

Council of Microfinance Equity Funds
Triodos Investment Management

Goal

- Establish early warning indicators and OID index

- Apply OID index to a number of countries

Benefit

- Help the industry in preventing future OID crises

- Further develop responsAbility's market risk assessment system

Over-indebtedness and Microfinance

Methodology

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1. Analyse past crises: which indicators have a (lagged) correlation with Portfolio-at-risk & Write-offs?

2. Define ‚leading indicators' out of a set of 57 possible indicators

3. Supporting data:

   ▪ Extensive survey of ~120 MFIs

   ▪ Academic literature

   ▪ Expert interviews

   ▪ Country studies

   ▪ Quantitative market data & responsAbility data

4. Define OID index

5. Apply OID index to 13 countries

Over-indebtedness and Microfinance
The leading indicators

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1. Remittances
2. Market penetration
3. Growth rates of total volume of loan portfolios
4. Quality and use of credit information sharing systems
5. Perceived commercial bank involvement
6. Perceived level and trends in competition
7. Perceived investment flows
8. MFI liquidity
9. Average loan balance per borrower
10. Loan requirements and lending methodologies
11. Productivity (borrower per staff member)
12. Growth and market targets
13. Multiple lending
14. Consumer lending

Over-indebtedness and Microfinance
Application

OID Early Warning Sign Index value	Meaning	Countries
Dark green OID index	Lowest level of early warning signals for over-indebtedness	
Light green OID index	Relatively low level of early warning signals for over-indebtedness	Bolivia, Ecuador , El Salvador, Georgia
Yellow OID index	Medium level of early warning signals for over-indebtedness	Armenia, Paraguay, Tajikistan
Orange OID index	Medium to high level of early warning signals for over-indebtedness	Colombia, Ghana, Kosovo
Light red OID index	Relatively high level of early warning signals for over-indebtedness	Bosnia and Herzegovina, Cambodia, Peru
Dark red OID index	Highest level of early warning signals for over-indebtedness	

Involvement in Market initiatives
Initiatives and working groups

- UNPRI

  - Principles for Investors in Inclusive Finance (PIIF)

- Smart Campaign Client Protection Principles

- Social Performance Task Force

  - Social Investors Working Group for Over-indebtedness (Draft: Microfinance Investment Managers' Code of Practice on Over-indebtedness)

Conclusion

Conclusion

Investors must intervene on various levels

- Too many providers – consolidation difficult - Eligibility

- Unhealthy competition (also from outside MF market!) – CRR/MRR

- Too much (cheap) funding - Eligibility

- Weak information basis of lenders – information asymmetry- MRR

- Weak regulation - weak infrastructure – MRR/CRR

- Low financial literacy rate and level of experience of clients - ODR

- Irresponsible behaviour of lenders – Eligibility/ODR