

**Weathering the Storm:  
Hazards, Beacons, and Life Rafts**  
Lessons in Microfinance Crisis Survival  
from Those Who Have Been There

—Case Studies—

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## The Run That Wasn't

### Artemis, Ghana

#### Risk Categories

- Methodological flaws
- Systematic fraud (mgmt)
- Loss of focus

#### Turnaround Factors

- Client confidence
- Staff confidence
- Replace management and board
- Address collections

Artemis is among the first generation of microfinance lenders in Africa. It was originally founded in 1988 as an NGO that provided training and bank loan guarantees to women business owners in Ghana. In 1996, it registered with the Ghana Central Bank as a savings and loan institution operating under the non-banking financial institution (NFBI) framework. It focused

primarily on women customers – and continues to today, even if not exclusively so.

Through much of its existence, Artemis has struggled to gain control of its operations. From at least 1999 to 2002, its PAR30 ranged between 40-50 percent, and through at least 2004, it was operating with negative equity. It was able to repair its portfolio for a few years, but by 2006, it was again struggling. By some accounts, the organization was strategically adrift with insufficient governance to help get it back on track.

The first hope of bringing the organization on track came in late 2006. Artemis recruited new investors – foreign and domestic – bringing in capital, replacing the prior board, and appointing new management. The new CEO had substantial experience, having served as CEO of another large MFI in Ghana for some years. Coming in, he brought new energy, orientation towards growth, and professional staff. But it did not prove to be the turnaround investors had hoped for.

### The Non-Turnaround

From the beginning, there were a number of mistakes made by the new investors that allowed the company

and the new management to go off course. First, they constituted a board with several directors based outside Ghana. They participated in meetings mostly via conference call and remained out of touch with events on the ground. The board also instituted an oversight mechanism that made the CEO its sole reporting channel, with no mechanism for receiving direct reports from division managers. The effect was to give the CEO full power to shape communications with the board, allowing him to stifle any dissenting perspectives from other company executives.

The board also effectively delegated all power to make and approve company policies to the CEO. The result was that no policies that could limit the CEO's authority were ever approved. For that matter, very few policies were approved at all – the CEO preferred to run the organization by fiat, making decisions as he saw fit, with little regard to process or consistency. At first, this meant that division heads and branch managers were left to operate at their own recognition, with no clear guidance or direction.

#### 1988–1999

- Founded as NGO
- Restructured as NBF

#### 1999–2002

- PAR30 ~50%
- Negative equity
- \$1m total assets

#### 2003–2004

- Portfolio quality improves
- Equity still negative

#### 2006

- Receive foreign equity
- New management & staff
- \$5.6m total assets

#### 2007–2008

- 100% CAGR
- Operating losses erodes equity
- More equity invested
- \$21.9m total assets

#### 2009

- Losses continue
- PAR30 at 44%
- Large equity injection

#### 2010

- Board & mgmt replaced
- Complete restructure
- Reduce op. deficit
- \$15m total assets

However, the absence of policies eventually resulted in a free-for-all environment. There was no HR policy, so new hires came in without any clear background checks or verification. In practice, that also meant that executives could staff the company with friends and relatives. This was an insidious way of undermining staff morale and institutional hierarchy. One employee recalled the new employees as being essentially untouchable, due to their “godfathers” in the executive suite. New hires, whether family or not, also tended to be better paid, and many saw themselves as superior to existing staff. Part of this was also cultural, with new staff focused on growth and individual rewards, while older staff retained a more non-profit and team-oriented mindset (though Artemis was organized as a limited liability company back in 1996). Even the hiring of unrelated personnel was sloppy – in one case, Artemis hired a few field officers from a competing institution. They had in fact been the competitor’s weakest performers, were suspected of fraud, and were already on their way out, but due to its weak background checks, Artemis never learned this information.

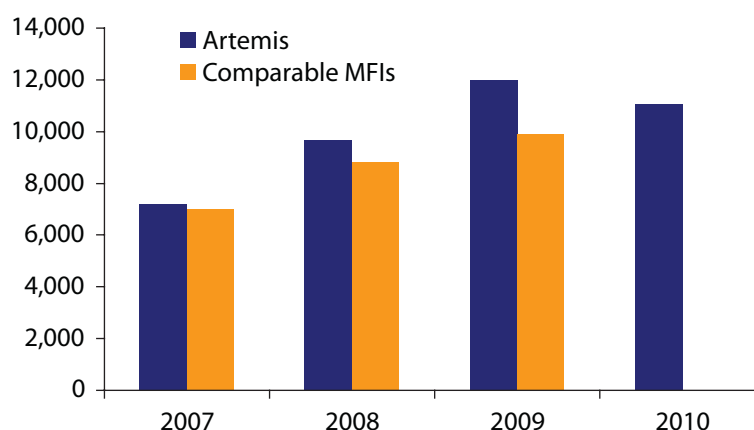
Artemis executives rewarded themselves with compensation far above that of its competitors (Figure 1). To make matters worse, Artemis also had more managers. Some positions were created for no clear reason – for example, for a significant period, the deputy CEO (a well-qualified executive) had no direct reports at all. This pattern was reflected in the field: The ratio of field officers to staff was an unusually low 53 percent. The net result has been an

extremely high operating cost for Artemis – its operating expense ratio of 50 percent is far above the 36 percent averaged by the top six NBFIs microfinance institutions in Ghana.

However, the most serious issue was the absence of a credit policy, meaning no specific guidance or consistency in how loans were to be approved and who had the authority to issue those approvals. Each branch manager was left to devise whatever system he or she felt comfortable with. Moreover, this also meant that any one of the executives at the headquarters could instruct the branch manager to issue loans to designated persons. This was especially the case for large loans over \$15,000, some of which went as high as \$50,000. In these cases, it was the senior executives themselves who were responsible for the credit evaluation – without any oversight. As of June 2010, Artemis had 128 loans above \$14,000 on its books.

Over 60 percent of these loans were issued without collateral, and of those that had collateral, it often proved worthless: For example, a business would use its stock as collateral, and if Artemis collectors attempted to claim it, the owner would simply sell his stock, thus eliminating the collateral. Not surprisingly, many of these loans were issued to management’s friends and family, including the wife of the CEO himself. Indeed, many of these loans were never intended to be paid back at all – the total PAR30 for this cohort is 80 percent, nearly double the overall portfolio PAR30 of 45 percent.

**Figure 1: Average staff salary outpaces competitors (GH¢)**



Sources: M-CRIL rating, MIX

Given the example set from the top, it is also unsurprising that repayments from the traditional client base of small entrepreneurs also suffered. In some cases, customers posed as business owners by renting or borrowing market stalls, and thus qualified for a loan. And because residence verification was spotty, some of these customers disappeared outright, with no means to trace them.

These issues did not arise suddenly. For three years, starting in late 2006 when the new investments were made, Artemis financials repeatedly raised several flags, any one of which should have given the board of directors cause to delve deeper. It's not clear that they ever did. Throughout this period, despite a portfolio yield that is comparable to its competitors, the company continued to report losses (Figure 2). The investors' apparent reaction was to inject new capital in 2008 and 2009, only to see it completely eroded within a year. No significant changes were made by the board, and existing executives continued to hold their jobs. It is possible that the board was too focused on growth to notice what were admittedly small numbers at the time. With the loan portfolio growing by over 20 times in 2006-08, issues of cost basis and sustainability could have been harder to notice.

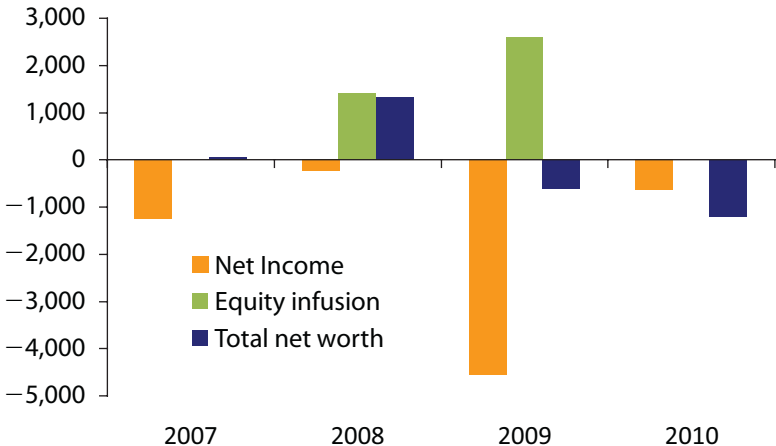
To make matters worse, heavily delinquent loans were rolled over from year to year and never written off. These accumulated, and by June 2010, PAR365 stood at 37 percent, with a significant number of those loans having been delinquent since 2007.

Throughout this time, Artemis inflated its revenues by claiming the unpaid interest from these loans as accrued interest, that is, as future income. By December 2009, such accrued interest amounted to 23 percent of gross loan portfolio, severely distorting the company's balance sheet.

Besides the problems with the loan portfolio and the high staff pay, Artemis was also profligate in its approach to fixed assets. It owned a 16-car fleet – a small luxury for a microfinance institution with fewer than 300 staff. A more serious case was its 2008-09 project to roll out branchless banking, which involved leasing 15 premises on 20-year terms. In the end, only three of them were put into operation, with the rest remaining unused through 2010, adding further to Artemis' high cost basis. But instead of being asked questions, Artemis management was collecting rewards – Artemis' branchless banking project won the 2009 innovation award from its global network.

Such lack of focus was a reflection of executives' overall approach to strategy. One manager called it "organized chaos," while another recalled the executives' "brainwave" memos she would receive on a weekly basis as the primary means of communicating strategy. On one occasion, the management held a strategy meeting offsite that generated plenty of seemingly brilliant ideas, yet no implementation plan ever made it to the desks of department heads.

**Figure 2: Deficits persist despite equity infusions (000s GH¢)**



Source: M-CRIL rating

## The Stop Sign

Naturally, this could not continue forever. In January 2010, Artemis' regulator, the Bank of Ghana, recognized that trouble was brewing. With 87,000 depositors holding some \$14 million in savings at an institution that was already insolvent, the central bank had to act.

And act it did. In February 2010, the Bank of Ghana fired the existing management at Artemis, including the CEO, CFO and COO, and forced the replacement of its board of directors. It also assigned one of its staff to act as conservator, overseeing the institution as it attempted yet another turnaround. However, this was a mid-stream correction – the Bank of Ghana never ordered Artemis to shut down, stop collecting deposits or stop making new loans. It took this strategy despite the fact that some 20 percent of the company's liabilities (most of them public deposits) were backed by delinquent loans.

The immediate step was to bring in an experienced external consultant that same month to evaluate the situation and develop a turnaround strategy. He reported that though the situation was very serious, it was not hopeless. He was consequently brought in as interim CEO in May 2010, and the company entered into another turnaround phase.

## Turnaround 2.0: Invisible Revolution

The turnaround approach was multi-pronged: 1) reduce cost basis, 2) improve internal processes, 3) develop a sustainable strategy, 4) focus on delinquent collections, and 5) recapitalize the company. However, above all, the number one priority for Artemis during this stage was to ensure that as all this change was being introduced, its depositor base continued to retain full faith in the institution.

Importantly, this depositors' faith couldn't even be slightly eroded, for with no deposit insurance in place, the tipping point for a run is relatively low. When faced with even a somewhat small possibility that their money might disappear, depositors are not likely to take a wait-and-see approach. The choice is made still easier when there are other reliable savings options – exactly the situation for Artemis clients,

nearly half of whom continue to maintain savings accounts with other institutions. The challenge facing Artemis was thus akin to performing invasive surgery on a moving train – a single mistake could have been deadly. Thus far, Artemis is still very much alive.

### **1) Reduce cost basis (and maintain deposits)**

For reducing cost, the first basic steps were relatively easy – sell most of the company's car fleet and sublease many of the unused offices that had been leased for the branchless banking project. The next steps proved more difficult. One the most risky actions taken by Artemis was to cut allowances (but not salaries) by 38 percent for managers and 19 percent for lower-level staff, while also rescinding the previously promised 40 percent pay hike (Ghana has a near-20 percent inflation rate).

The company also sought to reduce staff numbers, relying mostly on attrition, terminations for cause, and suspension of new hires. The numbers were substantial, but not so high as to undermine the operational capacity of the organization, which, by many measures, was overstaffed: During the course of 2010, the number of Artemis staff shrank by 22 percent. However, one major downside of this approach is that Artemis exposed itself to losing some of its best and most motivated employees. Already, at least a few competitors have mentioned hiring Artemis staff dissatisfied with the changes, though to-date there has not been a major employee exodus.

One of the ways Artemis addressed the issue of low staff productivity without layoffs was through extensive retraining. For example, after selling 13 cars, Artemis was left with 13 excess drivers. Instead of laying them off, the company retrained these individuals to mobilize borrower groups. After all, the drivers themselves come from the communities Artemis serves and thus have much relevant expertise. This step allowed Artemis not only to jump-start a group lending strategy, but also to save the extensive cost of both severance pay and new hiring.

Nevertheless, staff morale has suffered. In reaction to the rescission of salary increases and allowance cuts, Artemis staff lodged a complaint with the country's union commission. However, management was also

*Instead of laying off its drivers, Artemis retrained them to mobilize borrower groups, taking advantage of the common background they shared with target clients.*

proactive in managing staff morale – the cuts have been promised as temporary until the company completes the turnaround. Extensive efforts were also used to make sure that

disaffected staff did not spread negative news about Artemis to their customers. The company used frequent communication to emphasize the importance of maintaining a positive company image among clients, thus giving staff direct control over the success of the restructuring. This helped most staff come to terms with the fact that they faced the choice to either stay and work to help the company turn around, or seek their future elsewhere. Nevertheless, despite these efforts, staff disaffection regarding pay has persisted and remains a risk.

However, aside from low staff morale, the main risk still remained – the clients perceived major changes, and managing those perceptions became critical. During the first half of 2010, lending was heavily curtailed. Some types of loans were eliminated, loan sizes reduced, and credit requirements raised. Naturally, this caused substantial client consternation; however, by continuing to make new loans to its good clients, Artemis insured that the perception was that of change and not decline. In this respect, a stronger emphasis on collections also improved the company’s image to that of a more “serious” lender.

The efforts to maintain the company’s image also involved active communication. Continued advertising ensured that Artemis’ name remained in public view. When customers raised questions or mentioned rumors, they were visited by the branch manager, who would allay their fears. Large depositors were visited one-on-one by executives, taken to lunch, and otherwise made to feel valued. Meanwhile, the Bank of Ghana provided its support by maintaining stability in the public sphere and avoiding any statements that might undermine the depositors’ confidence.

Finally, Artemis maintained one more tool in its arsenal – a large amount of cash on hand, enough to withstand all but the largest of runs. As of Decem-

ber 2009, the ratio of liquid assets to demand deposits was 66 percent (Figure 3). Interestingly, this was partly the result of an 11<sup>th</sup>-hour deal by prior management, in which they negotiated a \$1.1 million fixed-term deposit with a client. The cost was high – 30 percent per annum – but it singlehandedly increased the company’s cash and securities position by 20 percent. And given that Ghana government securities at the time were yielding in the high-20 percent range, the net cost for maintaining this deposit has been limited.

The success of the strategy is undeniable. Artemis was able to significantly lower its cost basis, and at the same time maintain its deposit base. In fact, during 2010 deposits actually grew by 17 percent, and even the number of depositors increased by a significant amount. Whatever their complaints, there is little trace of any client concerns regarding Artemis’ sustainability or any unusual risk to their savings.

## 2) Improve internal processes

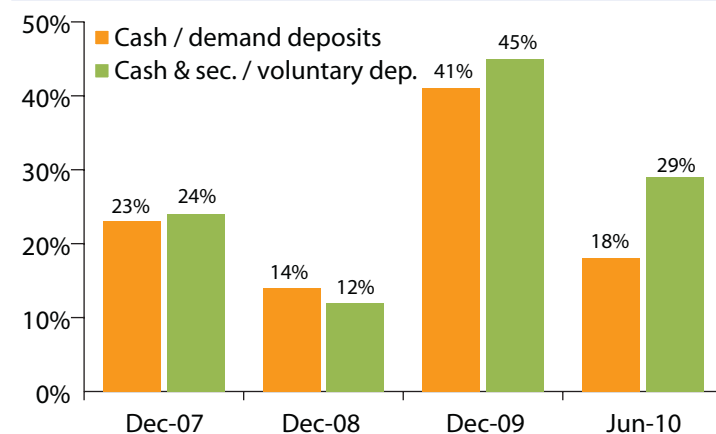
With the “organized chaos” that was Artemis operations until 2010, there has been plenty of work to do in addressing processes.

The new management has taken a wholesale approach – developing policies for each division, simplifying and standardizing loan

*To instill a culture of accountability, staff were shifted to three-month performance contracts.*

products, establishing clear authorizations for loan approval based on amount, implementing standard and regular reporting to the board of directors,

**Figure 3: High liquidity in Dec 09 could buffer bank runs**



Sources: M-CRIL rating, MIX

improving transparency in decision-making, expanding staff training, and instituting performance targets; in short, a total revamp of the organization's processes.

Most of these at their core reflected shifts to "best practice" standards, but in some cases management instituted rather innovative solutions. For example, to instill a culture of accountability, staff were shifted to three-month performance-based contracts. Failure to meet assigned targets could thus result in dismissal. This move also had the added opportunity of allowing the company to dismiss weak performers without having to pay expensive severance benefits, though naturally it caused staff consternation.

In another effort at rapid improvement, Artemis encouraged friendly inter-branch competition through a system of ranking branches according to performance on multiple metrics. Moreover, each department head was given a branch to "adopt," thus providing a further element of competition between department heads. At the same time, it provided each branch with the benefit of a mentoring relationship with a senior executive.

During the turnaround period, Artemis has also benefited from closer interaction with the newly reconstituted board, which has been meeting monthly to provide oversight and advice.

### **3) Develop a sustainable strategy**

Given that Artemis had previously been run without any visible strategy (except for its efforts to focus on branchless banking), the new management had to focus on developing a long-term strategy for the institution. For some time, one of the difficulties was

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*Friendly inter-branch competition was encouraged, based on several performance metrics; each department head was given a branch to "adopt."*

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that Artemis was the 4<sup>th</sup> or 5<sup>th</sup> MFI in the Ghanaian market, without much of a niche to claim as its own. The earlier focus on branchless banking may in part have been driven by the desire to find such a niche.

The new management faced a similar problem. It settled on something quite unusual for Ghana –

group lending. This is more unusual still, given that Artemis' primary area of operations is urban. However, since mid-2010, the company has actively pursued group lending, which currently comprises some 50 percent of disbursements, compared to less than 2 percent previously. This strategy also brings the company back to its original roots of serving low income women.

The push for group lending has faced a fair amount of resistance from staff, many of whom see it as unworkable in Ghanaian urban environments, given a culture that is perceived to be more individualistic than in countries where group lending is practiced widely. Thus far the strategy has been reasonably successful, though it is far too early to tell if it will succeed in the long run. However, if it does, it would mean that Artemis will have carved out a unique niche for itself in the competitive microfinance sector in Ghana, and should presumably allow it to serve lower income individuals and do so more efficiently than its competitors.

### **4) Focus on delinquent collections**

Given the very high level of delinquency, Artemis has been forced to focus seriously on collections to reduce what will inevitably be very large losses. The approach has been three-pronged: 1) for the most collectable loans, Artemis has relied on its own staff to ramp up collections efforts. Performance targets and inter-branch competition is used to motivate these efforts, which previously had not been pursued with much determination. 2) For more difficult cases, Artemis has outsourced collections to outside agents who are paid strictly on the basis of how much they collect. 3) The most difficult cases, where borrowers have the ability to pay but simply refuse, are being pursued through the courts. These are mostly large loans, many of them made to former executives' family and friends.

The efforts thus far have been reasonably successful. Between February and December 2010, Artemis collected a little over \$800,000, representing over 20 percent of overdue loans outstanding at the start of the year. The same pace continued through the end of the year, and the company projects to collect another 40 percent of overdues in 2011, though given the unpredictability of court decisions and other unknowns, the forecast represents only a weak estimate.

## 5) Recapitalize the company

Despite being deeply insolvent and having made extensive progress, Artemis has not yet been recapitalized. However, it does seek to increase its capital base by some \$8.5 million, which represents nearly 60 percent of its assets. More than half of the new equity would go to fill the negative equity gap and meet the minimum capital requirements of the Bank of Ghana. The remaining amount would fund future growth.

What is perhaps most surprising is that Artemis has now been in the turnaround phase for a full year, with no new capital having been injected. The Bank of Ghana has allowed it to continue operating normally and increase its deposit base. However, with much of the turnaround having been completed, it is unclear how much longer Artemis will be allowed to continue in its current state. Whatever the case may be, it needs to find new equity soon. It's difficult to imagine that Artemis could continue operating in the same negative equity state for years, as it had done a decade ago.

## Lessons from Artemis

The lessons from the mistakes made at Artemis are many, and most are rather obvious. Hiring friends and relatives is a bad idea. Giving them loans is worse still. Making large loans with no collateral can be ruinous. Then there are the organizational problems – unclear lines of authority, absence of policies and procedures, and cliques among management and staff all contributed to a culture of lax standards and no accountability. Finally, weak governance and supervision by the board of directors allowed the CEO to run Artemis as a personal fief for much too long. And investors' readiness to twice inject capital into a clearly struggling company without forcing major changes suggests that the shareholders were not fully carrying out their fiduciary responsibilities.

In short, the faults were many. But besides the faults, Artemis also offers many specific examples of turnaround strategies described above. In addition, it provides some general lessons to consider during a turnaround.

## Avoiding a Run on Deposits

The most immediate threat facing Artemis during the course of the turnaround was that it would lose depositors' confidence, thus triggering a potentially devastating run. The risk was all the more elevated, given the extensive changes: a full revamp in product offerings and outright elimination of several loan products, changes in client eligibility criteria, and rollback of staff compensation. There was a serious risk that disgruntled clients and staff could have started rumors of bank closure, which could also have prompted a run.

Artemis took a number of proactive steps to head off this possibility by focusing on minimizing employee resentment through innovative approaches (e.g. retraining drivers for group mobilization); regularly communicating with staff to build buy-in and ownership of the restructuring; continuing to work with select clients in all markets, so as to maintain influential positive voices on the ground; proactively communicating with clients; and quickly responding to budding rumors or client resentments.

## Replacing Management and Board

In Artemis' case, replacing management was a no-brainer, given the level of corruption of former management. In any case, the replacement of both management and board was mandated by the Bank of Ghana. However, reconstituting a new board and bringing in outside management gave the organization the opportunity to start fresh. Had there been no corruption and former management remained on board, a turnaround of this magnitude simply would have been far harder, and its chances of success likewise much reduced.

## Sources

MIX Market ([www.mixmarket.org](http://www.mixmarket.org))

M-CRIL rating

Individual interviews and company documents



## Tale of the Shrinking Star

### FuegoNord, Nigeria

#### Risk Categories

- Methodological flaws
- Financial instability
- State intervention (weak regulatory regime)

#### Turnaround Strategies

- Liquidity
- Client confidence

FuegoNord was founded in Lagos, Nigeria in 2006, anticipating the microfinance rush that took the city by storm just a few months later. Its founder and managing director (MD) was a serial entrepreneur of Nigerian background who had spent much of his adult life in Europe.

Burnished with a recent successful startup in the technology sector, he made his way back to Nigeria to apply his entrepreneurial skills towards making a difference for the poor of his country.

FuegoNord was founded as a for-profit deposit-taking institution, tapping into the broad popularity of rotating savings clubs that have been a staple in the bustling markets of Lagos for many decades.

A substantial sum of the initial capital for FuegoNord came from the founder himself, along with additional amounts raised from local investors. The founder recruited his initial team from the banking industry, though none of them had microfinance experience. Likewise, the company's initial board of directors, composed largely of local investors with a banking or financial background, also did not include anyone with microfinance experience.

Another element that complicated FuegoNord's administration was the founder and MD's concurrent ownership and active involvement in another MFI. While there were no direct conflicts of interest (the other MFI was in a different part of the country), and there are no credible allegations of serious improper dealings, it nevertheless divided the MD's attention and resulted in his frequent and extended absences from Lagos.

## The Early Days

In February 2007, FuegoNord was among the first to receive a microfinance bank (MFB) license – a new institutional structure created by the Central Bank of Nigeria (CBN) as part of its focus on developing the microfinance industry in the country. Though early, it was by no means alone. Within two years, some 800 institutions in Nigeria were licensed as MFBs, with over 200 of them in Lagos alone. Many were not new institutions, but community banks that were mandated to convert to MFBs by the new regulations. However, Lagos featured an especially large number of start-up commercial institutions, and FuegoNord was one of the leaders in that circle.

Many of them were either founded or staffed by former bankers. The reason for this was not entirely accidental. In 2004-2005, the Nigerian banking sector had undergone extensive mergers in response to increased capital requirements from the central bank, reducing 89 commercial banks

### 2005–2006

- FuegoNord founded

### 2007

- Receives MFB license
- Receives \$1.2m grant
- \$2.1m deposits
- \$.5m loans

### 2008

- \$2m from US investor
- PAR30 hits 40-60%
- Restructuring: layoffs, salary cuts, suspend lending

### 2009

- Resume lending, peak at:
- \$.5m deposits
- \$1.1m loans
- Financial crisis
- Shrink operations, layoffs, salary cuts
- At year-end
  - \$388,000 deposits
  - \$373,000 loans
- Sr. managers depart

### 2010

- MD resigns (March)
  - \$275,000 deposits
  - \$175,000 loans
- Company closed (Jun-Jul)

to just 24. The resulting shakeout left a number of former executives without the top positions they had previously held, and the emerging field of microfinance banks provided just the opportunity to regain these coveted top spots.

Given the background of the senior staff, FuegoNord mirrored a number of its competitors by borrowing the trappings of the Nigerian banking world, and the Nigerian business world generally – flashy offices, a car fleet, conspicuous dress. Executive salaries were similarly set to compete with those of banks. This significantly increased the cost base of the organization. Long-term office leases also proved to be a costly and illiquid investment that absorbed capital, essentially vitiating the buffering role that equity is supposed to play. These decisions to invest in real estate were supplemented by even more questionable choices: Sometime in 2007, FuegoNord invested \$360,000 in the Nigerian stock market, which proved particularly painful, given that in 2008 the Nigerian stock market lost some 60 percent of its value.

In 2007, FuegoNord received a \$1.2 million grant from a development support facility created in collaboration between the Nigerian government and an international development organization. The initial \$360,000 disbursement provided for technical assistance from a well-established microfinance organization in Africa, including on-site training for senior executives. Meanwhile, FuegoNord kept growing, and by year-end 2007, it had a portfolio of over \$0.5 million and a deposit base of \$2.1 million, serving a total of over 4,000 clients.

Besides funding technical assistance, the development support facility grant had an important catalytic role, spurring investment by other institutions, both local and international. Within months, FuegoNord was able to borrow from a local bank. Soon after, in early 2008, a large U.S.-based microfinance organization agreed to invest \$2 million in equity and convertible debt, along with a \$400,000 technical assistance grant.

For the U.S. investor, this was part of an active microfinance investment strategy, which included taking a board seat and using its own technical assistance

grant to improve the company's operations. Unfortunately, transparency wasn't what it ought to have been, and soon after the deal, FuegoNord invested \$350,000 in long-term leases for three buildings, tying up 18% of the new equity in illiquid assets. The board and the new investor were informed of this only after the fact.

## A Walk on the Shrinking Path

Unfortunately, the foundations underpinning FuegoNord's growth had serious weaknesses. At the end of 2007, PAR30 as officially reported by the organization stood at 11 percent, which was not considered unacceptably high in the West African environment. However, there are credible suggestions that true delinquencies may well have been higher.

Through the first half of 2008, FuegoNord continued to grow and hired a large number of new staff. Meanwhile, the recruitment and orientation process had not been seriously evaluated and resulted in many field officers and even mid-level managers with insufficient background or training. Moreover, the organization's approach to field staff was to treat them as an easily replaceable resource, rather than focusing on staff development.

The result was a combination of low competence and little loyalty that left the company exposed to weak client evaluation. The weakness of field staff was further exacerbated by especially weak oversight. FuegoNord's internal audit appears to have been largely ignored. At the same time, the unit in charge of sales was also responsible for credit approval and risk management – not a combination that could assure a sound portfolio, especially in the context of a country where fraud is a routine part of life.

One common practice to get around the issue of establishing client reliability was to approach clients of a competitor whose client evaluation process was believed to be reasonably strong. FuegoNord's offer was to provide double the loan amount – without doing any verification of the client's repayment capacity for the larger loan.

By spring 2008, FuegoNord broke even, on the basis of which management approved a salary in-

crease. Unfortunately, the break-even proved to be an illusion. Many of the loans soon turned out to be fraudulent or otherwise non-paying. Based on differing recollections, by July 2008, PAR30 had hit 40-60 percent. FuegoNord took action – it stopped lending altogether and began a round of restructuring. This involved extensive layoffs, salary cuts, and eventually, substantial writeoffs. After 1.5 years of fast growth, FuegoNord began to shrink.

While it shrank, the company also embarked on completely redeveloping its policies and procedures. In this, it received substantial support from its U.S. investor, which extended its consultant presence. The technical assistance provided covered nearly all areas, from operations, to credit evaluation, to financial management. In some cases, new personnel with extensive microfinance experience elsewhere in Africa were brought in and became permanent staff. Other areas were covered by temporarily assigned consultants from the West. However, some of the latter proved not entirely up to the task, with one independent observer suggesting that they seemed to have been picked off the street. Nevertheless, their cost proved substantial, given the months of expatriate salaries and expensive hotel housing.

Besides bringing in consultants, serious efforts were made to provide quality training to senior management. One such training exercise proved particularly promising. It resulted in the implementation of a new performance management system that rewarded employees based on a three-pronged criteria : deposits collected, loans disbursed, and portfolio quality maintained, with each employee's results posted daily.

By early 2009, the organization resumed lending operations. They appeared to work well, and executives were hopeful that the company had finally turned the corner. With the implementation of the new performance management system in April 2009, the pace of disbursements increased slightly.

## **Second Walk on the Shrinking Path**

Unfortunately, there was a destabilizing undercurrent in this new rollout. In revising its operations, FuegoNord's board was less focused on getting the

lending process right, and more focused on becoming profitable quickly. Thus, many of the investments one might make for healthy lending operations, such as developing a borrower base on the basis of introductory – and thus often unprofitable – loans were out of the question. More critically, the relentless focus on cutting costs entailed low staff salaries and, consequently, low morale. In this respect, the performance management strategy and its monetary incentives went against the broader focus on profitability, and did not gain full support from management. In the end, it lasted but a few months.

The company's efforts to achieve profitability were undermined by another concern unrelated to lending. For much of 2009, FuegoNord had been dealing with a persistent liquidity crunch, with incoming deposits barely meeting outflows. The fact that many of its assets were still locked up in illiquid real estate and by-then essentially worthless stock market holdings made the struggle a knife's-edge dance. More problematically, the situation directly undermined any efforts towards achieving profitability, since efforts to raise deposits could not generate revenue on their own. After all, revenues can only come from the asset side of the balance sheet, and in FuegoNord's case, that meant lending operations – which, in times of difficulty, were the ones that management invariably cut first.

Whatever efforts FuegoNord was deploying to achieve profitability were soon upended by a factor outside its control. In July 2009, the financial crisis came ashore in Nigeria. It hit FuegoNord from two directions: On the one hand, it reversed any efforts aimed at maintaining a reliable deposit base, as outflows began to exceed inflows; on the other hand, it hurt the repayment ability of existing borrowers. The company's liquidity position, already unstable in the months prior, quickly went downhill. To manage withdrawals, the company stopped all new loan disbursements, thus eliminating its only source of revenue. And to minimize the resulting operating loss, it carried out yet another round of belt-tightening, laying off a quarter of its field staff and instituting across-the-board salary cuts of 40 percent. FuegoNord was back on its shrinking path.

Some of the laid-off and highly demotivated staff spread the word to their clients that FuegoNord was on

the brink of closing, thus exacerbating delinquencies and encouraging further deposit outflows. In the context of a highly unstable market environment, where other MFBs were already closing their doors, this lent further weight to client concerns.

By September 2009, FuegoNord's portfolio stood at \$350,000 – a quarter of what it had been 6 months before, and some 30 percent below where it had stood back in December 2007. The remaining customers, pressed themselves by the economic crisis and seeing that new disbursements were not forthcoming, began to withhold payments. Delinquency climbed again, with PAR30 hitting 30 percent (PAR0 stood at 60 percent).<sup>1</sup>

Despite the impact on revenue, shrinking the portfolio enabled FuegoNord to manage the deposit outflow. To help with this, the company adopted a strategy of scheduled withdrawals. Depositors wishing to make withdrawals were given a date in the future – usually within a week's time – to come back and receive their funds. Although these were demand deposits, by applying a scheduled withdrawal timetable, FuegoNord was thus able to forecast cashflow and insure that deposits were paid out when promised. And because FuegoNord made sure to honor all scheduled withdrawals, it was able to maintain the minimum threshold of confidence with its clients. In fact, the confidence was sufficiently high among some clients that even during this time, FuegoNord was able to raise some new deposits that helped offset a part of the outflow. This was also a key factor that enabled FuegoNord to avoid the outright savings runs that felled other Lagos MFBs.

The portfolio shrinking wasn't meant to be indefinite. FuegoNord was once again seeking new capital – this time not to fund growth, but to keep the company alive – and shrinking the portfolio was meant to be a short-term solution to meet depositors' withdrawal demands. The plan was promising, as the U.S. investor was willing to inject an additional \$3.5 million provided a local investor joined as well. Talks with a local investor were in fact going well, and the deal was to be consummated in November

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1. Part (but not all) of the high PAR can also be attributed to delinquent loans growing in proportion to the total, as current loans pay off. This is a regular pattern for shrinking portfolios.

2009. FuegoNord went so far as to sell loan products with a 2-month initial savings period (thus also bringing in some deposits), banking on the fact that by November, the newly raised capital would be available to fund the disbursements.

## End of the Road

But it was not to be. The deal fell through when the local investor backed out, and the company continued on its shrinking path, now without any real hope of new equity. Over the next few months, most of the senior staff left, and by March 2010, when the MD resigned, FuegoNord's portfolio stood at just \$175,000 and deposits at \$275,000 – just 1/10<sup>th</sup> of what it had been two years before.

In early summer 2010, FuegoNord was closed by the Lagos tax authority. Some months before, the company had negotiated an agreement with the state tax authority; however, with most of its senior management gone, no one was left to carry out the agreement and the company had lapsed on its tax payments. Its flagship office, a gleaming glass building designed by its founder, was chained shut.

As a postscript, in September 2010 – after FuegoNord had already been shut for three months – the Central Bank of Nigeria revoked the company's MFB license in a single action that saw the revocation of 224 other MFB licenses, including 62 in Lagos.<sup>2</sup> Many were small institutions that never got off the ground. However, some had been leading MFBs, including FuegoNord. Thus, the three-year period that signified the first phase of the microfinance industry in Nigeria ended exactly as it began – with the CBN pulling the trigger, though this time instead of the starting gun, it was holding the executioner's rifle.

## Lessons from FuegoNord

There were a number of internal and external weaknesses that both led to the crisis and that undermined the company's ability to survive it.

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2. The CBN subsequently reinstated about half of these on a provisional basis a few months later. However, FuegoNord and its new breed of compatriots in Lagos were not among them.

## **Rapid Growth Built on Weak Operations and Lending Methodology**

Despite the founder's and original management's lack of microfinance experience, FuegoNord never took the time to develop working microfinance lending operations, embarking on fast-track growth essentially from day one. Training of field staff was minimal. Evaluation of repayment capacity and attention to fraud – a constant in Nigerian society – were not given sufficient attention. Credit approval was under the sales team, and oversight was minimal. These issues persisted despite multiple rounds of technical assistance, though there is reason to believe that towards the end, FuegoNord may have developed a sufficiently well-functioning set of policies. The irony is that by then it had no capital to support lending, as it had wasted it all on bad loans and investments.

## **Weak Regulatory Oversight Enabled a Hyper-Competitive Environment**

The microfinance market in Nigeria took off only after the MFB structure had been created by the CBN. However, very low entry requirements (only \$150,000 starting capital) led the CBN to sanction some 800 MFBs in a very short timeframe – far beyond its regulatory capacity to manage. Moreover, CBN itself was still learning microfinance, and often approached regulatory reviews like it did those of banks. Tellingly, CBN even began publishing the *Nigerian Microfinance Newsletter*, where the heads of many of Nigeria's leading MFBs contributed their articles. It was essentially the kind of publication a national microfinance association might put out, but it is not clear that this was an appropriate role for a regulator charged with prudential oversight of those same organizations.

The result was perhaps predictable – a whole breed of MFIs pursuing reckless policies oriented exclusively towards growth and profitability, without due focus on the attendant risks. It has also been suggested by several market observers that the CBN proved to be a poor judge of the business models of the leading MFBs in Lagos, too taken in by their ostentatious offices and car fleets to dig deeply into

their less-than-sound business practices. In 2008, it honored two of the most flamboyant MFBs with the Best Microfinance Bank award. Within two years, both organizations had failed.

## **High Cost Structure; Capital Tied Up in Illiquid Assets**

FuegoNord maintained large and expensive offices, owned a car fleet, paid generous executive salaries, and provided numerous executive perks. This is well outside the traditional norms of moderately sized MFIs. Moreover, doing so before the company had established reliable lending processes further undermined its efforts to attain profitability.

The choice of investing capital in illiquid assets was especially problematic. When the market situation changed and FuegoNord was faced with declining deposit base, the inability to tap its equity forced the company to curtail lending, thus cutting off its revenue base and undermining the quality of the loan portfolio.

## **Excessive Focus on Near-Term Profitability and Growth**

From a very early period, FuegoNord was focused on pursuing growth and rapidly achieving profitability. In many respects, this came at the expense of establishing well-functioning operations and processes. The result was a roller-coaster ride, whereby the company would grow during one period, run into major delinquencies, retrench, and then grow again. The emphasis on profitability also resulted in multiple rounds of layoffs and salary cuts, which seriously undermined staff quality and morale. The cycle also caused the company to erode much of its capital base.

## **Ineffective Governance**

The governance issues at FuegoNord were both numerous and serious. Until the entry of the U.S. investment company, the board did not have anyone with microfinance expertise – a significant issue given that the company's MD himself had no microfinance background.

In early 2008, investment by a U.S. microfinance investor added a different dimension of oversight, though it wasn't able to get past managerial obfuscation. The early example where FuegoNord invested a large chunk of newly received equity in three expensive branch buildings without board approval should have been a serious warning flag. Similarly, this investor allowed FuegoNord to continue fast growth for several months after its entry, only to find a few months later that many of the loans made during this period had weak repayment evaluations or were outright fraudulent.

Part of the problem may have also stemmed from infighting among investors, much of it over disagreements regarding ownership. A number of board meetings were thus consumed with issues unrelated to actual management of the company, with little time left for oversight. And at least one local institutional investor had an agenda that was narrower than the company's overall well-being. This investor warehoused the deposits raised by FuegoNord, and thus paid relatively little heed to the loan portfolio that had been the cause of so much difficulty for the company.

### **Managing Orderly Outflow of Deposits**

Among one of the positive examples at FuegoNord, the institution, though severely crippled, managed

to carry out an orderly outflow of deposits during its slow-motion collapse. Given the background of widespread depositor runs on other MFIs at the time and significant mistrust of microfinance banks, FuegoNord's achievement in avoiding an outright run is indeed notable.

One of the techniques employed by FuegoNord was to set daily withdrawal limits for each branch, and schedule withdrawal dates with requesting customers, which FuegoNord made sure to always honor. In an environment where borrower expectations already factor into banking crises, such responsiveness in the face of a visibly difficult situation was an important differentiator for clients. By essentially slowing the bank run to a walk, while simultaneously shrinking the portfolio, FuegoNord was able to unwind its balance sheet over the course of several months and repay most of its depositors.

### **Sources**

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## The Dangerous Race

### Phaethon, Morocco

#### Risk Categories

- Risk Categories
- Uncontrolled growth
- Methodological flaws
- Systematic fraud (field-level)

#### Turnaround Strategies

- Last rites

Microfinance in Morocco has a bright history. Following the Grameen Bank model, the sector was developed with the participation of people who were themselves former microcredit clients in the late 1990s. Among the numerous organizations that began operations, the market was dominated by four

MFIs (dubbed the “Big 4”), of which Phaethon was one, having been one of the first MFIs established in Morocco in 1995.

Morocco’s particular characteristics as compared to other countries across the region allowed microfinance to take root and develop: fairly advanced infrastructure (access to rural areas), political stability, and legal, regulatory and financial support from the government.

The legal framework was developed in 1999 to provide institutional support to the sector, with transparency, licensing and monitoring provided by the Ministry of Finance. While it did not allow MFIs to become deposit-taking institutions, it did lay the foundations to allow the sector to launch in an organized fashion. The new sector was also supported with funding from both the government and development finance institutions, including a joint venture fund that brought the two together.

After the first few years of foundation-building, the sector experienced strong growth between 2003 and 2007, multiplying loan portfolios by 11 times and client outreach by four.<sup>1</sup> The “Big 4” professionalized

1. CGAP Brief, The rise, fall and recovery of the microfinance sector in Morocco, Xavier Reille, December 2009, with figures from MIX

to various degrees during this time, while growth continued to attract foreign and domestic financing.

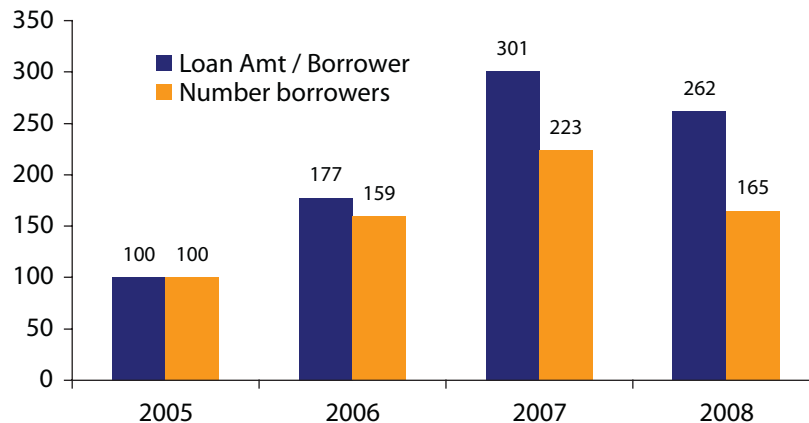
### Picking Up the Reins

The feverish competition that developed among the major MFIs in the spirit of exuberant growth was especially strong between Phaethon and another market leader. Phaethon’s owners and management felt they were in a race with this leading MFI. Until 2004, Phaethon was indeed leading in number of clients, but due to smaller loans sizes had the 2<sup>nd</sup> largest portfolio. Then in 2005, Phaethon saw its rival pull ahead in both metrics. So in 2006, it responded: Over the next two years, it increased the average loan size by 200 percent and grew its client outreach by 123 percent (Figure 1). The result was 570 percent growth in Phaethon’s portfolio during 2006-2007.

For an already-established MFI (Phaethon had a \$30 million portfolio at year-end 2005), achieving such growth should be as worrying as it is impressive. In Phaethon’s case, it was paralleled and in many ways spurred by increasing lenience in lending terms and practices. Managers and loan officers were offered their own branches if they could grow the business in new towns and villages. Moreover, all this took place in an environment of loose internal controls, with weak verifications and oversight. In effect, the body grew more than the

- 1995** – Phaethon established; early leader among MFIs in number of clients
- 1999** – National legal framework for microfinance is set up
- 2005** – Loses lead by number of clients to another MFI
- 2006** – Undertakes rapid growth to retake its market leadership position
- 2007** – MIS system is installed
- 2008** – Huge delinquencies and fake loans are discovered. Phaethon writes off 36% of its portfolio
- 2008** – Requests permission to declare bankruptcy
- 2009** – Government orchestrates a merger with Eridanos

**Figure 1: Fast growth through larger loans (growth index=100 in 2005)**



Source: MIX Market

head, and the growth was extensive, with nearly 400 branches and over 500 new staff (mostly loan officers) added in 2006 alone, reflecting an increase of 400 percent and 75 percent, respectively.

This growth took place as part of another major shift: Phaethon was moving away from its initial model of group lending and adopting individual lending. The latter involved offering larger loan amounts and longer tenures, and did so by focusing on men instead of women, who had been Phaethon's traditional base. However, the changes were not introduced with sufficient oversight, which meant that many clients were not properly screened or monitored. The larger loan sizes and longer tenures only served to increase the organization's exposure to bad lending.

During this time, Phaethon's organizational culture was still that of a non-governmental organization, where the emphasis was on the good faith of employees, with less focus on explicit monitoring and controls. Unfortunately, the organization's rapid growth made it difficult to transmit this culture of shared responsibility to the new recruits. The problem was further magnified by Phaethon's disbursement process, with loan officers themselves carrying cash into the field and disbursing directly to clients, without oversight or follow-up.

The combination of high growth targets and lax oversight, along with large numbers of new recruits, had a predictable effect on loan officer behavior. Many did not have the time to conduct analyses of their portfolios or the clients they were lending to. They were not making the required visits to follow up and

verify loan utilization. It was not unusual for loan officers to resort to various methods to create false performance metrics, such as "curing" delinquent clients with new or even fictional loans. In some cases, loan officers simply created fictional clients for the purpose of taking the money themselves. In many respects, they were simply distributing money.

To boost growth, Phaethon's loan officers also engaged loan agents – clients who took on the duties of forming and even administering groups, but without formal recognition or supervision. Some of the agents would take a portion of the loans for themselves as a reward and give smaller amounts to the other group members. The result was higher indebtedness on the part of the agent, and a weakening of the other group members' relationship with the MFI. It is probable that the agents also mirrored the fraud committed by loan officers by creating ghost group members and taking the designated funds for themselves.

Problems during disbursement were followed by problems during collections. As with former, repayment funds were also handled by loan officers, some of whom took advantage of the cash they were carrying at the expense of their clients. Matters were made more difficult by the fact that there were no controls or receipts or other proof of payment aside from the amortization table that clients signed.

The issues at Phaethon were magnified by the heavy competition among the MFIs, which often operated in the same urban spaces and rural areas (in some cases one could find branches of three or four dif-

ferent MFIs in the same village) and offered similar products. This eventually led to multiple lending. According to a study conducted in 2008 by the central bank, 40 percent of microfinance clients had more than one concurrent loan from multiple MFIs. Most of this was funded by domestic banks, whose loans accounted for some 85 percent of total MFI assets by the end of 2008.<sup>2</sup> If the MFI was large, banks could be counted on to provide funds, despite any apparent weaknesses.

And Phaethon’s weaknesses in comparison to its competitors were clear. While all were growing fast, during the crest years of growth in 2006-2007, Phaethon’s growth was double that of its competitors. Internal controls also lagged substantially. An area where Phaethon stood out in particular was its management information system (MIS), which was not only weaker than that of its competitors, but also was woefully not up to the task of supporting operations of the size Phaethon was undertaking. During this critical growth phase, Phaethon continued to operate its portfolio on the basis of three separate systems, one for each level of reporting: loan officers, branches and central management. Unfortunately, their numbers likewise remained separate and irreconcilable.

Phaethon itself knew that its systems were inadequate, and in June 2007, towards the end of its accelerated

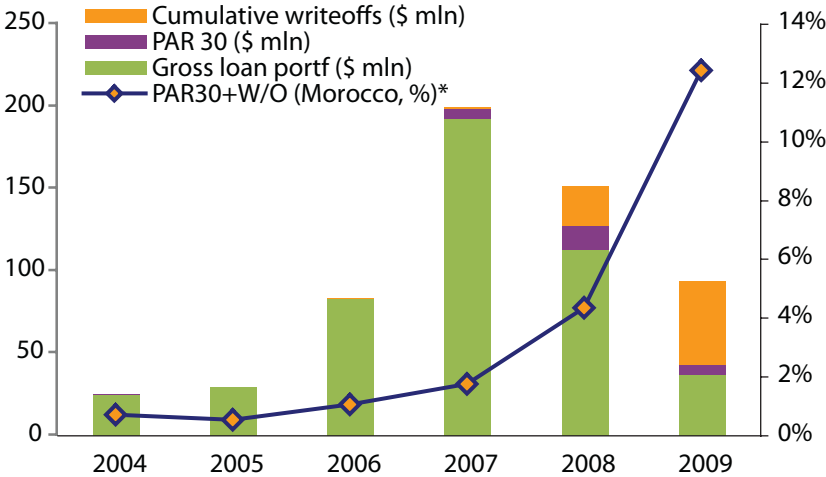
growth phase, it installed a new MIS. The new software was intended to not only increase efficiencies, but also to reinforce controls. However, the effects of the MIS did not appear immediately. Installation was slow and it took a year before implementation was completed. But when the system was finally in place, Phaethon discovered that its portfolio was not as healthy as it thought. The software helped uncover many nonexistent clients, unreported delinquencies, and indications of fraud committed by loan officers and clients alike. The dangers previously hidden in its portfolio became suddenly and painfully evident.

**Runaway Carriage**

Unfortunately for Phaethon, it was too late to change course. The market had reached breaking point, and in 2008 the sector went into crisis. Delinquencies rose across the board, with combined PAR30 and write-offs reaching 12 percent of outstanding portfolios in 2009. And these numbers don’t even include Phaethon, which suffered a far more serious blow. As growth slowed abruptly across the sector, Phaethon began to shrink, shedding nearly 80 percent of its 2007 portfolio over the two subsequent years, with nearly half of that shrinkage accounted for by write-offs (Figure 2).

There are many elements to Phaethon’s crisis. The main cause was uncontrollable growth which, as

**Figure 2: Delinquencies and losses follow rapid growth**



Source: MIX  
\* Excluding Phaethon

2. Chen, Greg, Rasmussen, Reille. “Growth and Vulnerabilities in Microfinance.” CGAP, Washington DC, 2010.

briefly described above, was partly due to the general euphoria and exuberance of the times, and partly due to insufficient checks and balances.

In reality, most of the participating actors had become complacent and did not recognize the signs of stress until it was too late. The commercial banks, rating agencies and managers considered this an easy business that was not subject to the risks of other investments. According to one of the actors, “In a nascent industry in a country that was the best in class [in the region] there was little humility.”

Nevertheless, the scale of its subsequent problems does raise the question: Why did Phaethon not realize it was in trouble earlier? Besides the fact that the control systems in place were weak, the shift in business practice was an important factor. In the early days, the average loan size was small. The rapid increase in loan size (Figure 1) was not accompanied by a change in client evaluation. This was part of a broader phenomenon, as many MFIs started giving out bigger loans, in many cases to the same clients. The issue of multiple lending had not been a significant focus of the MFIs, and the absence of a credit bureau meant that warning flags were not seen until crisis had already hit the sector. When, in late 2008-early 2009, the larger institutions informally started sharing information, they found multiple lending to be extensive, with 40 percent of clients borrowing from two or more MFIs.

### Too Big to Fail

By late 2008, the full scope of the problem was clear. In that first year of crisis, Phaethon had already shrunk its portfolio by 36 percent and reported 25 percent of the remainder as either delinquent or written-off altogether. In reality, the figure was even higher, due to still-undiscovered fraud. After careful analysis and cross-checking, Phaethon found its portfolio to be approximately 1/3 healthy, 1/3 delinquent and 1/3 consisting of fictional clients. Such a high delinquency level is difficult under any circumstances. But Phaethon’s dominant position and the extent of multiple borrowing in the market was beginning to undermine the portfolios of other institutions. To make matters worse, Phaethon, unable to manage its rapidly deteriorating situation, requested permission from the authorities to declare bankruptcy.

It was not a step the government was prepared to take. Phaethon’s failure threatened to bring down the entire market. While suffering, other MFIs had far slower growth in the two years leading up to the crisis, as well as stronger internal controls and MIS that helped them manage the crisis in their books. Nevertheless, a bankruptcy by one of the country’s largest MFIs, serving one-third of all microfinance clients, could well have overwhelmed these efforts.

The risk was that a declaration of bankruptcy threatened to quickly raise Phaethon’s delinquency to near-100 percent, as its good clients would have stopped making repayments. Seeing the country’s largest and most visible MFI fail, other MFI clients could well have stopped their repayments to all MFIs, even if on a temporary, wait-and-see basis. But that, of course, would have been a self-fulfilling prophecy, as MFIs faced with such high delinquencies would have been forced to take actions, such as suspending disbursements, which would only have confirmed their clients’ suspicions. On the funding side, it is likely that commercial banks would have taken the same approach as borrowers, and refused to keep financing the MFIs. The resulting liquidity squeeze could well have brought down a number of other MFIs.

Besides the disaster that was threatened by the prospect of Phaethon’s bankruptcy, there was also another perspective that militated against allowing it to go under. Phaethon had a strong and positive reputation in international microfinance circles, and was seen as one of the country’s main microfinance ambassadors. The public collapse that bankruptcy entailed could have undermined international support for the microfinance sector in Morocco.

The government’s solution was to orchestrate a merger with another large MFI, Eridanos, which was announced in May 2009. Since both organizations were associations/NGOs, the law did not provide for an acquisition, so the “merger” was essentially a transfer of assets from Phaethon to Eridanos and a merging of the two organizations’ operations through a ministerial decision.

Eridanos was the only big Moroccan MFI that could possibly clean up and integrate Phaethon’s operations into its own. Despite high growth, Eridanos

had a conservative financial structure with equity exceeding debt and PAR30 of only 6 percent during the height of the crisis. There was also strong support from Eridanos' mother company, a state-owned bank, and as the merger decision was a state decision, there was no room for maneuver. A number of those familiar with the situation have asserted that no other options existed for Phaethon at the time. According to some, an acquisition by a commercial bank was initially discussed, but no agreement was found.

### **Merger: Clean-up and Integration**

The merger uncovered many of Phaethon's operational weaknesses. Eridanos discovered many clients who had in fact paid back their installments, but which the MFI never received. It was assumed that the loan officers had retained a portion of these payments. Eridanos also suspended further disbursements in order to find out which clients really existed. This and other methods helped Eridanos uncover the extent of the fraud and corruption affecting its portfolio.

A large operation was set up to purge Phaethon's portfolio and integrate the two organizations. Eridanos hired a consulting firm to oversee the process. It also put together two study groups to evaluate two critical objectives: limiting the bleeding from Phaethon's portfolio and integrating the processes of the two organizations. The working groups were mixed, including people from both organizations. These groups focused on HR issues, finance, information systems, resources and network. Over a period of 8-9 months starting in May 2009, they sorted out the situation. The first two months were exhausted in emerging from the state of urgency (quick win actions to stop the bleeding by establishing special procedures for each client case, whether delinquent or fictional); the next three months were spent in assessing the merger (looking for synergies); and the last three months in merging operations by establishing permanent procedures and organizational structures.

On the ground, branches were evaluated and consolidated on a case-by-case basis. The main challenge was the difference in structure between the branches of the two organizations. Phaethon's network, which

was 2.5 times bigger than Eridanos', included principal branches, secondary sites and single-loan-officer branches, each with a different level of internal structure. In contrast, Eridanos' branches were all constructed to perform similar functions and were equipped with uniform information systems and internal organizational structures. Four resolution paths were taken towards network integration, according to each branch's profitability indicator and other measures: 1) unsustainable or otherwise non-performing Phaethon branches were closed, 2) where both organizations had branches, Phaethon branches were closed or merged with Eridanos branches, 3) some Phaethon branches were kept open to continue the process of loan recovery before eventually being closed and, 4) some Phaethon branches were fully retained.

In terms of human resources, Eridanos first fired the loan officers who were guilty of fraud and began training others who remained. For some fraud cases, it pursued legal action against the perpetrators. Many other loan officers left on their own, either because they were afraid of getting caught or because they did not like the new system and controls instituted with the merger. By early 2010, the remaining loan officers had been fully trained in Eridanos' processes, and placed in apprentice positions to learn the new systems.

A unified MIS was put in place nearly 1.5 years after the merger (early October 2010). However, for the moment, Phaethon and Eridanos are keeping their existing portfolios separate so as to manage the clients and loans more easily, while new activities have been merged.

A new strategic vision for the future of the unified organization has not been fully developed yet. The most likely scenario is that Phaethon's mission and targets will be adapted to fit those of Eridanos. There is a discrepancy here as to the characteristics and organizational culture of the two, which were quite different in the past. Eridanos was created by a state-run bank that already served SMEs, artisans and cooperatives. The intent was for Eridanos to cater to populations who had the potential one day to become bank clients, but who were not eligible for bank loans or had special characteristics and needs that required tailored services. Some of Eri-

danos' clientele already held savings accounts at the bank. Phaethon, on the other hand, targeted poorer populations, specifically women, rural, and young entrepreneurs and provided non-financial services as well. However, some elements of Phaethon's approach will likely be beneficial for Eridanos and are expected to continue, such as non-financial services and rural development.

## What the Future Holds

The depths of crisis that hit Moroccan MFIs has now passed, but Phaethon's near-bankruptcy and subsequent merger with Eridanos has shaken up the industry. MFIs have been pressed on both sides of the balance sheet, with demands for loans dropping off at the same time as banks have pulled back on their funding. The DFI and Moroccan government joint venture refinancing fund has moved in as a stabilizing factor. It has also imposed strict conditions for investing in MFIs in terms of governance, structures, and processes, making it a safer channel for commercial bank investment.

The experience of Phaethon and the subsequent merger has had a positive effect on the other players and the sector at large. The example has helped MFIs internalize the importance of gradual and sustainable growth. And Eridanos' use of legal action against those clients and staff who had committed fraud provided a useful deterrent to others.

Regulation of the microfinance sector has also been transferred to the central bank, which has more expertise and regulatory resources at its disposal than the Ministry of Finance, which previously held that responsibility. The development of a credit bureau will also enhance MFIs' and regulators' ability to evaluate and monitor client indebtedness levels. Already, the rate of multiple indebtedness has been reduced from the 40 percent found in 2008 to approximately 12 percent in late 2010.

As for Phaethon and its legacy, it is now more a historical memory than a present reality. It is important to recognize that the new organization's management came from Eridanos, with few individuals having been transferred from Phaethon. It is also unclear

how much of Phaethon's operations have really been transferred – elimination of competing branches and closure or planned closure of branches whose portfolios are especially weak has greatly reduced the scope of Phaethon's remaining operations.

The name of the merged organization reflects this reality. Initial plans had been to retain Phaethon as part of a combined name of the merged organization, but this was rejected when market research showed that doing so would only undermine client relationships given the low market credibility Phaethon held at the time. Moreover, the name is associated with a particularly difficult period in the sector's history, and a break with the past was deemed an important objective. Thus, Eridanos continues to use its own name without changes, and the name Phaethon, for years indelibly linked with Moroccan microfinance, has been consigned to history.

## Lessons from Phaethon

The case of Phaethon's failure and its subsequent merger holds several useful lessons for the microfinance community. In part, the organization's fate was a reflection of a market struggling with the consequences of hyper-growth and unhealthy competition. But even in that environment Phaethon stands out, both in terms of the pace of its growth and the weaknesses in its internal controls, as well as the sheer scale of its subsequent portfolio problems. At the same time, the resolution of the problem – through merger – also holds useful lessons, especially for an organization whose bankruptcy could have had very serious consequences for the rest of the sector.

## Unsustainable Growth

Of all the lessons from the 2009-2010 global microfinance crisis, unsustainable growth has emerged as one of the foremost risks. And Phaethon is one of its early standout examples. The heavy emphasis on being number one in the market in the lead-up to the crisis was itself a clearly inappropriate goal. Pursuing it

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*At its most basic, a sales target in a lending institution is nothing more than a directive to hand out a certain amount of money.*

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without taking care of the necessary processes and systems to support not only the growth, but also the larger-scale operations it brought, was yet more questionable. Moreover, the nature of Phaethon's growth highlighted a number of elements that are often associated with unsustainable growth and that also vastly increase portfolio risk:

- Large numbers of inexperienced field staff. An MFI never lends – its field staff does. And in the context of an organization that trusts its staff to embody the culture of client service, but without providing sufficient oversight to monitor staff behavior, the large number of new staff can be especially damaging, since they simply do not have the time to assimilate institutional norms.
- Reliance on loan agents to spur growth removes yet another layer of control over client selection. The large number of ghost clients should be seen as the logical and fully expected result of such lending.
- Pursuing growth through larger loan sizes without due attention to clients' debt capacity and existing indebtedness levels showed an inherent lack of appreciation of credit risk. There should be no place for such lending in a \$200-million credit institution, regardless of whether the lending is based on group or individual methodologies.
- Growth or sales targets, especially when combined with lax supervision and monitoring, can be especially damaging. At its most basic, a sales target or incentive in a lending institution is nothing more than a directive to hand out a certain amount of money. Absent serious controls over where that money actually goes, it becomes just that – an exercise in handing out money. It is not difficult for motivated employees to generate the required paperwork to demonstrate that it is something more.

## Merger as Crisis Management

Phaethon is especially important in highlighting how the use of mergers can protect the broader market. When a failure of a financial institution threatens to spread contagion to others, it is critical that its collapse be handled appropriately. The practice was

perhaps best highlighted recently by U.S. regulatory authorities at the height of the financial crisis in 2008-2009, when shotgun mergers between ailing institutions and their stronger counterparts emerged as one of the core strategies for maintaining market stability. However, this practice has been rare in the world of microfinance.

In the case of Phaethon, the merger has been highly successful from the perspective of protecting the market. The non-payment contagion from Phaethon to other MFIs, which had already started to spread prior to the merger, was successfully stopped and reversed, giving the remaining MFIs room to deal with their own portfolio problems. A full stop in microfinance funding that would likely have resulted from Phaethon's bankruptcy did not happen, thus avoiding a potentially devastating liquidity crunch for the sector. Most importantly, the merger provided the most important element needed during crisis: time. Instead of fighting an existential battle, which would have caused serious and possibly permanent damage, the Moroccan microfinance sector was able to take the time to restructure and refine its operations, and thus set itself up for more sustainable growth going forward.

Besides avoiding the worst, the merger also generated some positive outcomes. Eridanos was clearly a beneficiary – it was able to take the most useful parts of Phaethon and leave the rest. Meanwhile, Phaethon's clients and staff had the benefit of an orderly resolution. As for Phaethon's creditors, it's unclear what the merger agreement provided, but it could not have been worse than the bankruptcy option, since that would have entailed nearly full losses for the creditors in any case.

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MIX Market ([www.mixmarket.org](http://www.mixmarket.org))



## The Invisible Pyramid

### Loki, Europe/C.Asia

#### Risk Categories

- Systematic fraud (mgmt and field-level)
- Uncontrolled growth

#### Turnaround Strategies

- Address collections
- Debt restructuring

Loki began its existence in a country in the Europe/Central Asia (ECA) region in 1998 as a micro-finance project sponsored by a humanitarian organization to help internally displaced persons (IDPs) start entrepreneurial activities, in an effort to reduce and eventually eliminate their dependence on humanitarian aid. In 2002, it was registered as a limited liability company and became a non-banking credit organization (NBCO), licensed to perform micro-lending activities.

Between 2003 and 2006, Loki grew into a respectable, albeit small, microfinance organization. It attracted commercial funds from local and international institutions and consequently developed commercial objectives alongside its social mission. Loki's portfolio consisted of group and individual loans to IDPs (who comprised about 45 percent of clients) and other vulnerable, low-income populations in the capital and other provinces.

Between 2003 and 2006, Loki grew into a respectable, albeit small, microfinance organization. It attracted commercial funds from local and international institutions and consequently developed commercial objectives alongside its social mission. Loki's portfolio consisted of group and individual loans to IDPs (who comprised about 45 percent of clients) and other vulnerable, low-income populations in the capital and other provinces.

In fall 2006, Loki began implementing improvements in its metrics and indicators in order to become more transparent and attractive to investors. That September, it commissioned a rating assessment, and a few months later the original owner transferred Loki to a specialist microfinance equity investor for a largely symbolic price of about \$50,000. The new investor's focus on promoting MFIs that had already achieved sustainability was deemed more suitable for the path Loki was intending to pursue and would better position it for raising additional funds from creditors.

The new owners did not have experience in the region and early on made the decision to delegate significant decision-making to the branches, despite the absence of a centralized reporting system. The effect

was to significantly reduce their oversight ability, and was at odds with the reputation of corruption in the country, which ranked in the bottom quartile on the Transparency International Corruptions Perception Index.

### Growth Period

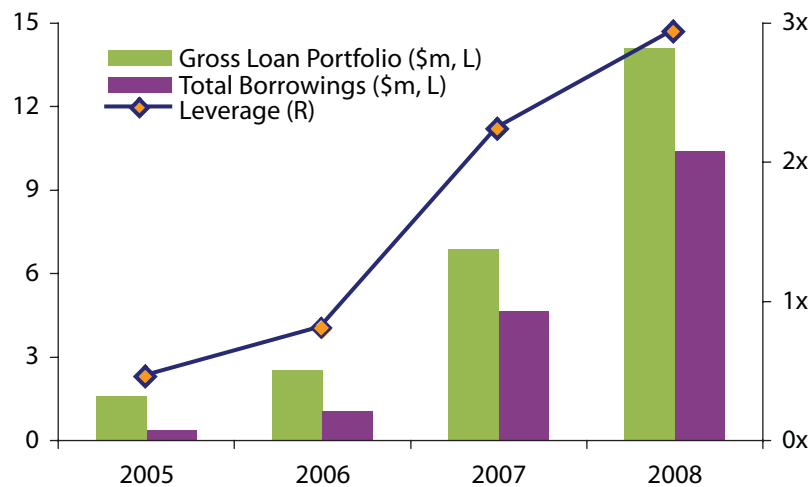
The change in ownership and subsequent growth happened at a time of rapid expansion of the micro-finance sector worldwide, as well as in the country where Loki was operating. Loki's growth was jump-started by a \$1 million loan from a development finance institution (DFI), whose due diligence process found the institution's control processes to be sufficiently strong to warrant the investment. Since Loki's total assets at the end of 2006 stood at \$2.6 million, a \$1 million loan was certainly a very substantial amount.

The participation of the DFI in turn inspired confidence and triggered interest in Loki's future potential by private international funds, which soon followed suit with additional financing.

Indeed, foreign loans were the sole source of Loki's growth, which came to an exceptionally high 215 percent on a cumulative annual basis during 2007-2008. To justify this level of investment, and to be able to repay its lenders, this growth

- 1998** – Loki founded to provide financial assistance to internally displaced persons
- 2002** – Licensed as non-banking credit organization
- 2006** – Sale to specialist MF equity investor
- 2007** – First big loan from a large multinational bank
- 2008** – Portfolio growth to \$14m with the participation of new investors
- 2009** – Independent auditors brought in to investigate suspicions of fraud. Four rounds reveal only low-level corruption
- 2009** – Largest branch found to be 80% fraudulent
- 2009** – Board decides to liquidate company
- 2010** – Prosecution and recovery of loans
- 2011** – CEO is arrested

**Figure 1: Rapid growth driven by debt**



Source: MIX

had to be mirrored on the loan portfolio side. As it happens, Loki found a way to achieve that growth, though perhaps not in the way the investors might have expected.

By mid-2008, Loki was operating out of nine branches with a portfolio of \$8 million and had received an investment-grade rating, an improvement from its previous rating. This second rating provided a further boost and played its part in encouraging more investors to take notice. Soon thereafter Loki opened two more branches, and brought its portfolio up to \$14 million (Figure 1) to reach a total of 14,000 clients.

During this period, Loki proved so efficient at deploying the new lender funds that during the two high-growth years of 2007-2008, its loan portfolio never fell below 98 percent of total assets – a highly unusual distinction, given that only a select few MFIs consistently carry a portfolio/assets ratio of above 95 percent. In both years it also reported return on assets (ROA) above 11 percent, placing it in the rarefied group of just 20 MFIs worldwide. And the fact that it achieved this level of profitability on a reported portfolio yield of 38 percent is nothing less than extraordinary.

### **Madoff Microfinance**

Or perhaps it wasn't extraordinary at all. Like the infamous Bernie Madoff hedge fund, the returns were just too good to be true. The more prosaic facts sim-

ply did not align with such performance. Loki did not have strong enough internal policies and structures to handle the large amounts of funding it received from international investors. For example, there was no centralized management information system (MIS) in place or connectivity between the branches. Staff at headquarters could not see at the end of each day the amount of loans disbursed or installments collected, as the information was manually entered into an Excel file and sent to the headquarters once a month. This fact made fraud easy to perpetrate since checks and balances were minimal. Even when Loki bought a software system to improve its accounting process and comply with legal requirements, implementation was haphazard.

In addition, most employees did not have the required education and qualifications to perform their duties. Many were hired based on their relation to the CEO (at least 27 employees were his relatives) or to other persons outside the company who had an important role to play in Loki's operations (for example, police officers or city administrators who might be useful in helping Loki collect loans or sell collateral). It appears that the branch managers were not in a position to refuse such hires. In the eyes of Loki's CEO, this was a good business deal – building relationships. At the same time, investment in employee training and development was a piffling 1 percent of the operating budget. The result was that unqualified persons, some of whom could not even properly write a simple letter but had to evaluate business plans,

were put in charge of handling funds. During a staff review conducted in 2009, out of the 172 employees, some 100 were deemed unqualified or otherwise inadequate for the positions they held.

As it happens, the weaknesses in internal control and human resources had been identified as areas presenting substantial risk in Loki's last rating report, even as the rating agency found the institution as a whole meeting investment grade requirements. Likewise, investors were well aware of these issues, but kept the money flowing.

According to several testimonies, suspicions and rumors about fraud in Loki had already surfaced in 2007. However, the personal involvement of the former CEO came as a complete surprise to everyone. His manners were initially very professional and his work was consistent and compatible with the social orientation of the organization. He was very well liked and respected, but eventually some small details did not quite fit with his overall image and slowly the façade began to fall apart. Some consider him to have "foolishly gone for the easy money"; others reacted to the revelations with deep regret, pity and disappointment both with him, and with their own failure to recognize his faults. Unfortunately, none of this is inconsistent with the marks of an especially capable con man. Without successfully projecting such an image, the CEO would not have been able to accomplish the fraud in the first place.

The mechanics of the fraud were many and are still emerging. One scheme was perpetrated as follows: After receiving a disbursement from an investor, Loki's headquarters would withdraw from its bank account a given amount, say \$100,000, to transfer to one of its branches. But instead of wiring the money through the bank, headquarters withdrew cash, of which only \$70,000 was actually transferred to the branch, while the rest was pocketed by those involved in the scheme – especially the CEO. To cover the shortfall, the branch office would issue fake loans for \$30,000, thus hiding the cash mismatch in both accounting and the MIS systems.

Another important vehicle for fraud was consumer lending, which Loki commenced during 2007, without prior experience and without any change in

its methodology or introduction of control mechanisms. Very few of these loans were collateralized. In practice this turned out to be a perfect vehicle for embezzling funds. In one scheme, Loki would sign contracts with small consumer goods shops to allow customers to buy on credit. Loki would pay the shops for the goods and the customers/clients would pay the loans back to Loki. In reality, the shopkeepers didn't sell any goods. Instead, they issued fake receipts to fake customers who were issued fake loans. Meanwhile, the very real proceeds went to the schemers. The fake loans were then dealt with the same way as other fraudulent loans, with repayments covered by the disbursement of new loans.

The fraud pervaded the organization – even in its legitimate business. In another instance, the government decided in 2008 to disallow private minibuss services and businesses, thus leaving their owners with no income source and with collateral (busses) that could no longer be sold in the country for any reasonable price. When these clients started defaulting on their microfinance loans, Loki's managers and loan officers had the option of trying to sell these busses outside the country, but it proved far easier to simply cover the losses with new, fake loans. They took the easy road.

While the extent of the fraud was an institutional anomaly, it was based on widespread cultural acceptance of corruption. It was standard practice in the country for clients to "thank" their lenders for approving their loan application. In the banking sector, this would amount to 5-10 percent of the loan amount. In the microfinance sector, where options for clients are more limited, the price was higher, at least in those MFIs that tolerated such activity. But here again, not willing to let a good opportunity go to waste, Loki's CEO in 2008 asked the branch managers to use these kickbacks to cover some of the losses incurred by bad loans. This of course only further legitimized the client kickbacks and increased the practice, with much of the proceeds going into the pockets of the branch managers and loan officers. Central management was unable to control the consequences of this scheme as it could not control the amounts the officers were taking home – 10, 30 or even 50 percent of the loan amount. On the other hand, the clients were still re-

quired to pay back the full amount, which became unsustainable for many.

## Discovering the Invisible Pyramid

Throughout this time, Loki was being continuously monitored. It was evaluated by a rating agency – twice. Its financials were being regularly audited. Many of its numerous creditors had conducted on-site due diligence prior to disbursement and most of them continued to follow up with annual due diligence – again, conducted on-site. None of these examinations turned up anything untoward. In the words of one investor, Loki’s management and personnel proved highly responsive – they gladly cooked up whatever reports were requested.

However, by early 2009, apparently based on reports from internal whistleblowers, Loki’s foreign owners began to suspect fraud and informed their counterparts at the DFI. Together, they brought in an independent auditor to review the organization and its operations. They also turned to an international consulting agency, which conducted three separate portfolio audits over a period of 3 months. Combined, these audits involved review of over 1,500 loan files and personal interviews with over 500 clients.

The audits uncovered serious fraud in several of the smaller branches, and while the findings raised concerns about significant potential losses, the losses were not considered critical. Much of the fraud uncovered by the audits appears to have been low-level corruption committed by loan officers and branch managers. None of it implicated senior management or the CEO.

Most notably, the final portfolio audit (which was also able to rely on prior audit findings) found Natix – the institution’s largest branch, responsible for 1/4<sup>th</sup> of the total portfolio – to be essentially free of fraud. As would be revealed later, Natix was the very heart of the pyramid; 80 percent of its loans were entirely fraudulent. And yet, the different auditors conducted personal interviews with 65 of its clients, making it a statistical near-impossibility that a large number of the loans randomly chosen for interview would not have been fraudulent.

It is a testament to the sophistication of the scheme that the auditors failed to uncover the fraud through these interviews. There is no reason to assume bad faith on the part of the auditors themselves, so the likely case is that the sample selection process wasn’t random (e.g. someone involved in the fraud was able to influence the sampling process), or someone at Loki knew which files had been selected, and coached the borrowers prior to the interviews.

Interestingly, of the 30 site visits conducted at Natix during the final audit, there were a few clues that borrowers may in fact have been coached. Of the 30 visits, four borrowers apparently didn’t know how much they’d borrowed, and two of them called a 3<sup>rd</sup> party on the phone to find out the information directly in front of the auditors. This was the only branch where such a problem had occurred. Unfortunately, the auditors failed to note the significance of this fact and submitted their report, concluding that the institution was on the whole healthy and viable.

With this finding in hand, Loki’s shareholders and creditors decided to pursue a workout. The former CEO was let go, replaced by an interim CEO, who began a general overhaul of the organization that included risk analysis, HR training and branch evaluation. The broad understanding shared by owners, investors and new management was that Loki was already in the process of managing the storm and had the potential to emerge from it successfully within the next few years.

It was not to be, for the pyramid was about to be revealed. In September 2009, two months after the final portfolio audit, the new management and consultants were conducting a branch evaluation at Natix, when they stumbled upon a suspicious pattern: the branch’s portfolio turnover was always being done on the same date (repayment of one loan and disbursement of another). It was particularly odd, given that all other indicators did not suggest anything amiss – repayments were excellent, loan documents were in order, client visits were being made on time.

After multiple audits and client interviews, there was just one thing to be done. To determine what lay beneath Natix’s perfect veneer, Loki’s board de-

cided to stop issuing new loans. The result was staggering. What they found was a bank within a bank. The small loans issued to clients were never actually delivered, and were instead being used to fund bigger loans to management's own clients. The fraud amounted to \$2.4 million out of the \$3 million the branch was handling.

When disbursements were suspended at the Natix branch and the fraud was uncovered, the branch manager quit. His employees, all but one of whom were his relatives, protested. This prompted the new interim CEO to fire everyone. But the branch manager had yet more surprises up his sleeve, and upon leaving, took the fraudulent loan files with him – all 688 of them, amounting to \$2.4 million. He then brought busloads of refugees and gave them small amounts of money to sign new loan documents. These “new loans” were meant to hide the fraud from previous fake loans, as refugees cannot be prosecuted for loan default.

For the investors, finding fraud at Natix was the final straw. In December 2009, Loki's board voted unanimously to liquidate the company (bankruptcy was not chosen due to a void in the legislation), as it would have been virtually impossible and too expensive to continue with a turnaround strategy. And given that this scheme was discovered after several detailed examinations had failed to recognize it, a number of investors recognized that the possibility of yet more undiscovered fraud still loomed large. The board voted to give the interim management a period of six months to recover as much money as possible from clients and employees.

### **Aftermath and Future...**

Surprisingly, the recovery rate has been higher than expected, prompting the board to allow the new CEO to continue the process until summer 2011. Since then, recovery has reached 65 percent of outstanding portfolio. However, it is not an effortless task. Client reactions have understandably not been positive, while fired employees have spread word that the company is closing and that clients will not suffer consequences if they do not repay. In one impoverished region in the country, clients connected through strong social networks have collectively de-

cided not to repay their loans. Moreover, the absence of collateral in its microfinance portfolio leaves Loki few options for convincing clients to repay. Additionally, Loki does not have the resources to continue pressuring all of its clients (visiting clients and guarantors, etc). In other regions, the recovery process is somewhat easier due to the existence of collateral, different social dynamics, or because of cooperation from the local authorities (law enforcement and state registries) wishing to preempt prosecutors and higher officials from stepping in.

Concurrently, the shareholders and investors undertook legal action against those employees and clients who committed the biggest frauds or who are not paying back their loans. The prosecutor and government (Ministry of Finance and central bank) are similarly intent on putting people behind bars to set an example for the industry and signal that corruption will not be tolerated. The process has been slow, but it moved forward in a major way with the arrest of the former CEO in January 2011.

Cooperation between the lenders and owners has been generally good, though there was some tension between a few creditors during the phase when workout discussions were taking place. To guide the liquidation process, investors appointed a steering committee comprised of three lenders, though generally the liquidation team has been relatively free to conduct its affairs.

Furthermore, Loki has been cooperating with other MFIs in the country to transfer its good clients. Taking notice of Loki's experience, many MFIs have become mistrustful of lending without collateral and using consumer loans. The central bank has also created a database of suspects to make sure that former Loki employees charged with fraud are not being employed by other MFIs.

In the aftermath of the crisis, reputation has been a major concern, not only of Loki and its lenders, but also for the sector as a whole. Those active in the country's microfinance sector have been particularly concerned that the earlier prominence of Loki's CEO could tarnish the sector. But given that the liquidation process has been conducted with full respect for the law and with appropriate collection practices,

the reputational damage that Loki has caused to the country's microfinance industry should not be serious or long-lasting.

## Lessons from Loki

### The Limits of Risk Detection

Much of risk management – investor due diligence, audits, external ratings, and so on – relies on an institution's own data in evaluating its state at a given point in time. While they may include some element of verification, such as a few conversations with randomly chosen clients and staff, these are at best a minor part of the evaluation. A reasonably well-conceived fraud would have little trouble passing undetected by most such examinations. The most independent tool available for evaluating an MFI's performance is a portfolio audit, which can normally detect fraud, as well as inconsistencies in reporting and other risk factors. However, as with any investigative tool, portfolio audits are not fool-proof and may still fail to detect the best-conceived frauds, as was demonstrated repeatedly in the case of Loki.

If there was an indication that something suspicious was happening, it's perhaps the fact that the organization's stellar performance – unmatched efficiency in deploying borrowed funds into the loan portfolio, as well as its exceptional profitability – were simply inconsistent with the visibly subpar capabilities of the organization, from the quality of staff to the quality of the MIS. These issues were not hidden and were even raised in Loki's most recent rating report. But of course, matching capabilities with performance is not fool-proof either – a better con artist could simply cook slightly less spectacular numbers. Luckily for investors, such capable criminals are a remarkably rare breed, so investors can always rely on their own portfolio diversification as the last line of defense.

### Ineffective Governance

The main conclusion reached by Loki's internal and external observers is that had Loki's shareholders been closer to the ground and been more involved, the fraud might not have happened. Naturally, even

a closely involved board could not have hoped to catch the sophisticated deceptions of the CEO and his associates. However, such a board might have prevented the situation from developing in the first place.

First, the level of corruption in the country is such that without direct and constant supervision at all levels of the organization, including close supervision by the shareholders, fraud should be the expected outcome. It is thus unlikely that an investor with a better understanding of the local market would have approved the decentralized model adopted by Loki's shareholders, which delegated extensive decision-making to the branches without providing for sufficient monitoring. A different shareholder might have also chosen to appoint an expatriate individual as CEO or other senior officer, strengthen internal audit, provide anonymous channels for whistleblowers, institute stricter hiring policies to prevent nepotism, and taken any number of other steps that were absent in the case of Loki.

Finally, it is important to recognize that Loki's shareholders had only the smallest of stakes in the company – \$50,000 – and had not injected additional equity while the MFI was growing. From the perspective of better aligning the interests of shareholders and creditors, this was a notable weakness.

### Excessive Funding

One of the common elements during the recent growth period in microfinance has been super-charged growth as a facilitating factor for other risks.<sup>1</sup> Loki certainly falls into that category.

A key aspect of pyramid schemes is that they require rapid growth to generate "returns." In the high-yield world of microfinance, the growth required is even higher than for a fund like Madoff's. It's not clear whether the scheme is even possible with an institutional growth-rate of less than 30-40%, but certainly it would be more vulnerable to early collapse and much more difficult to sustain for a significant period. Thus, the super-charged growth funded by

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1. Greg Chen et. al., Growth and Vulnerabilities in Microfinance, CGAP, Feb 2010.

Loki's creditors was an important enabling factor to the fraud.

This is not to say that rapid growth is never justified, but for investors pursuing it, the requirement for all the other areas of risk to be well-covered becomes all the more critical.

## Sources

Individual Interviews with interim management, investors, and other Loki stakeholders and observers

Company documents shared on a confidential basis

Microfinanza rating

Data from [www.mixmarket.org](http://www.mixmarket.org)



## Sailing the High Seas

### Caravela, Kazakhstan

#### Risk Categories

- Design flaws
- Macroeconomic shock
- Financial vulnerability

#### Turnaround Strategies

- Strategic redirection
- Address collections

Caravela is a small-sized MFI in Kazakhstan, founded as an NGO in the late 1990s by an international aid organization. For the first decade of its life, its primary focus was to provide credit to emerging small enterprises, with the goal of “expanding employment”

written directly into its mission. Until recently, it was largely an urban lender, with most of its operations based in the capital, Almaty, as well as a handful of other urban areas around the country.

Despite several changes to the company’s legal structure (it is currently a non-banking financial institution), the founding aid organization continues to be the nearly exclusive shareholder of Caravela. The company’s managing director has been with the organization from the start, and served as the organization’s first loan officer.

### Alone and Proud

By the end of 2007, Caravela was serving 617 borrowers with an average loan size of \$7,237, or around 150 percent of the gross national income per capita. The typical borrower profile was that of a small business owner, whether in trade, services or manufacture. In many respects they represented the “missing middle” segment – too big for microloans, but many still either too small or too risky for banks.

At the time, the bulk of Caravela’s loans were lent to individuals and secured by collateral, which in most cases meant real estate. And though the real estate collateral was used across the board, the purpose of the loans was divided nearly evenly between business and housing loans, plus some 10 percent of the remaining portfolio consisting of loans to wage-earners.

In positioning itself in the “missing middle” market, Caravela faced a challenge. During the long boom period in the Kazakhstan economy, many banks increasingly sought to go downmarket, attracting many of Caravela’s best and most established customers with lower interest rates and longer terms that the MFI simply could not match. This attrition at the top had the effect of increasing the risk profile of Caravela’s portfolio. Nevertheless, some clients who were eligible to borrow from banks still chose to stay with their long-term partner, valuing both the ease and speed of the approval process. The direct, personal relationship mattered too – such clients found it preferable to be the VIPs at Caravela, instead of being one of the masses at the banks.

Those clients who were not eligible for bank loans came to Caravela due to its flexible approach to collateral, which allowed the use of relatively illiquid property, such as residential housing in a village, for example. For the most part, they tended to be owners of smaller businesses, but not microenterprises – in Almaty’s many markets, retailers with permanent market stalls would make up Caravela’s customer base, but not those selling from portable table-tops. Caravela also had some customers who were at the top end of the small business category, running enterprises with several dozen employees. Often, these were clients who had started small and grew into larger enterprises, all the while continuing their relationships with Caravela.

#### 1997

- Founded as NGO

#### 2007

- \$6m portfolio
- Nearly all loans secured by real estate
- Half are specifically purposed for housing

#### 2008–2010

- Major economic crisis
- Both client incomes & housing collateral are hit
- Refocuses portfolio on group loans
- By 2010, nearly all loans are group-based

This market positioning of Caravela differed greatly from that of the rest of Kazakhstan’s large and mid-sized MFIs. Taken as a whole, most of the microfinance market in Kazakhstan focused on rural rather than urban lending, group over individual loans, and far smaller loan sizes; the average loan size among Kazakh MFIs in 2007 was \$1,624 – nearly five times lower than Caravela’s. And although using real estate as collateral for enterprise loans was a common practice among MFIs doing individual lending, none appear to have made as strong a foray explicitly into housing finance as Caravela had done. To a significant extent, Caravela was in a market of its own. That was about to end.

### Storm Winds Rising

In 2008, the Great Recession arrived in Kazakhstan. The effects were impossible to miss: After eight years of averaging 10 percent economic growth, in 2008 Kazakhstan GDP grew by only 3.2 percent, sliding further to 1.2 percent the following year (Figure 1). The construction industry collapsed, with a 54 percent drop in investment during 2007-2009, after averaging annual growth of 89 percent over the prior four years. The resulting unemployment hit hard many families in Almaty and elsewhere.

The collapse of the construction industry was paralleled by an equally large decline in real estate prices, especially in Almaty, which had enjoyed a massive increase, averaging 73 percent annual

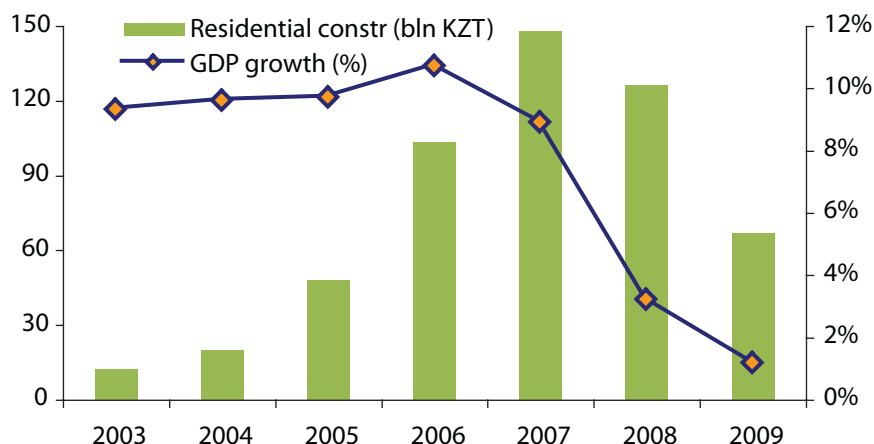
growth during 2003-2007 (Figure 2). By the end of Q3 2009, home prices in Almaty had slid 40 percent from their peak two years earlier.

The declines in construction and real estate prices had a direct and rapid effect on the local economy. According to the Kazakhstan statistical agency, small business production in Almaty declined by 33 percent in 2008 alone. Meanwhile, the drop in commodity prices in 2008 – a key economic driver in the country’s resource-dependent economy – forced the central bank to devalue the national currency, the tenge, by some 20 percent in early 2009.

Caravela’s exposure to these market downturns couldn’t have been greater. At the start of the downturn in Q1 2008, the vast majority of its clients were in the heavily-affected small business sector, and their situation tended to be more precarious than average, due to Caravela’s loss of the most established clients to competition from banks. A 50 percent decline in income was hardly unusual among many of Caravela’s clients, and as their incomes fell, they generated a rapid increase in Caravela’s portfolio delinquency rate.

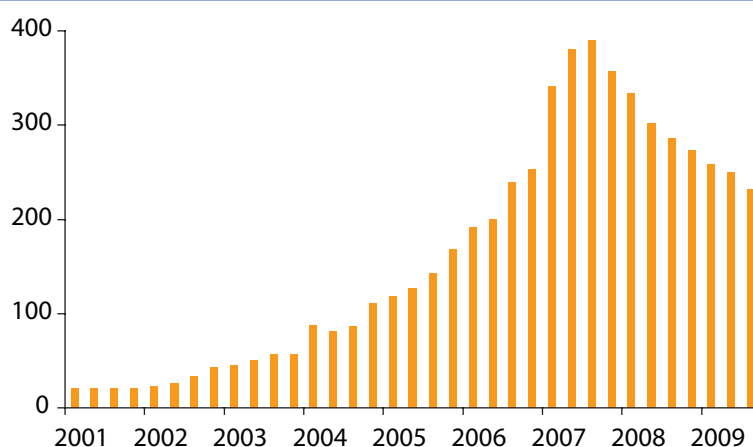
The effect was profound. In Q1 2008, PAR30 hit 13.4 percent, compared to 2.4 percent in the previous quarter, with all but a negligible amount coming from Caravela’s portfolio of individual business and housing loans secured by real estate. And as the borrowers began to default, the concurrent crash in

**Figure 1: GDP growth and construction decline in 2008-09**



Sources: IMF, Kazakhstan Statistical Agency

**Figure2: Almaty home prices (KZT 000s/m<sup>2</sup>)**



Source: Kazakhstan Statistical Agency

housing prices made recovery through the sale of collateral highly problematic. Many of the properties that backed Caravela’s loans proved unsellable in a real estate market that had simply frozen up. The crisis would continue to buffet Caravela for the next two years.

The impact of the economic downturn was felt by many MFIs in Kazakhstan, though far more severely by Caravela than by the rest (Figure 3). This is largely the result of Caravela’s different market positioning relative to its MFI competitors’ – more urban lending, individual instead of group loans, and larger loan amounts. Indeed, those MFIs that had some of these features (though not to the same extent as Caravela) also appear to have done more poorly than average. At the same time, as one might have

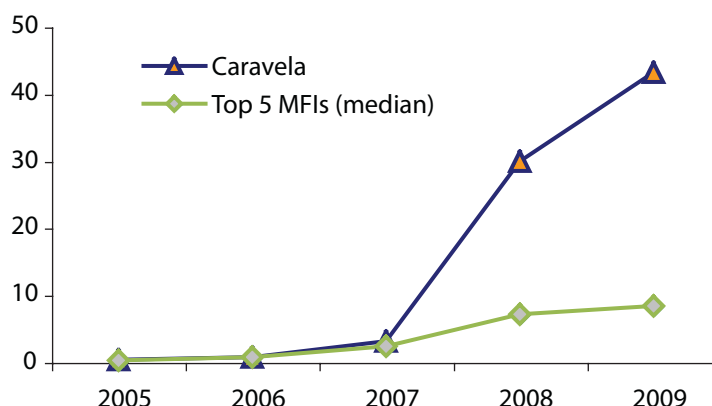
predicted, one large Kazakh MFI that had focused mostly on group lending in rural areas also displayed the lowest impact from the crisis.

### Riding the Waves

As a small MFI with little diversification in its portfolio, Caravela was especially susceptible to the buffeting of the waves, yet it proved equally capable in altering its course to avoid the worst of the storm.

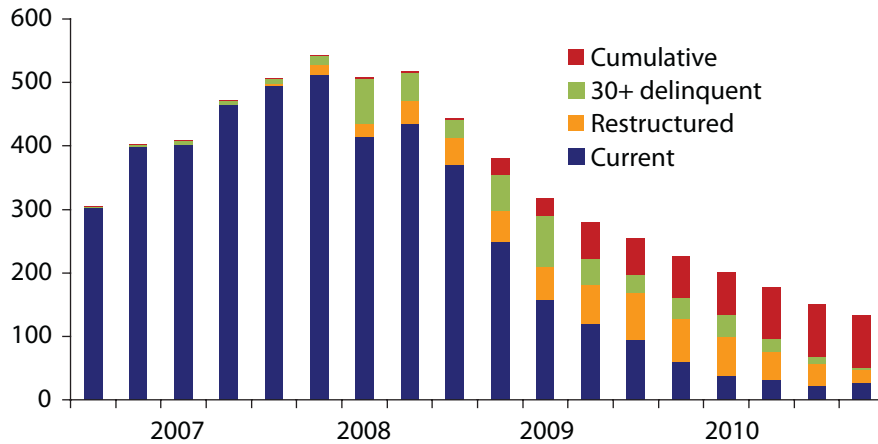
As the situation unfolded in late 2007 and early 2008, Caravela took immediate action. Realizing that its secured portfolio could ultimately sink it, Caravela’s management began to dump it overboard. It suspended issuance of new secured loans. It also engaged in an especially active restructuring effort, not

**Figure 3: PAR30 + writeoffs (%)**



Source: Mix market

**Figure 4: Crisis in secured loan portfolio (KZT mln)**



Source: company data

letting delinquent loans linger for too long. Write-offs began in earnest in Q4 2008, after nearly a year of battling the storm. By the end of 2010, Caravela had written off 15 percent of its peak secured portfolio (Q4 2007), with another 4 percent continuing to hobble along in restructuring (Figure 4).

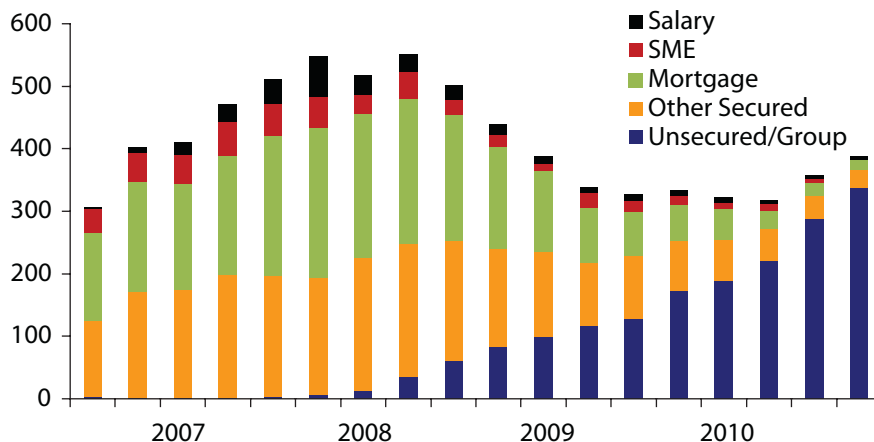
However, besides focusing on managing delinquencies, Caravela simultaneously embarked on a new lending initiative that would create the basis for its survival. The initiative in question was the launch and rapid scaling of a group lending product – a decision taken in a matter of months following the onset of the crisis (Figure 5).

Group lending was not uncommon among MFIs in Kazakhstan, but it was largely new to Caravela, which, up to that point, had only experimented with

methodology. In some respects the timing was fortuitous, as Caravela had just recently made the decision to begin expanding its group lending operations, having increased this portfolio from 9 loans in June 2007 to 107 by the end of the year. That was nevertheless minimal, accounting for just 1.1 percent of portfolio outstanding.

Caravela’s primary owner – an international aid organization with extensive microfinance experience – proved another source of advantage. Besides Caravela, the organization also owned a group-lending MFI in a neighboring country. Thus in early 2008, staff from the sister MFI was brought in to Caravela to help set up group lending operations, retrain staff, and hire the new loan officers needed for the staff-intensive group lending program. This also entailed a major geographic shift, in which

**Figure 5: Group loans replace individual (KZT mln)**



Source: company data

Caravela moved its urban operations to peri-urban and rural ones and established two new branches in a more rural part of the country.

But while the timing of the crisis may have had its advantages, it also had a serious downside. At the time of the crisis, Caravela’s managing director (MD) was outside the country, serving as an interim manager of this same sister MFI, whose own MD had recently departed. This meant that Caravela’s most experienced manager was absent at a time that the MFI badly needed her leadership. Back in Kazakhstan, the board had asked the deputy MD to fill in, despite the fact that the deputy did not have the same level of executive experience and had just returned from an extended leave. This decision was indeed questioned by some of Caravela’s creditors.

When the first delinquency reports started coming in, it was a matter of some concern to the MD. And as the numbers continued to increase the next month, the concern became serious. She requested an early transfer back and returned to Caravela in February. By March, PAR30 for its secured portfolio had hit 14 percent, and precious months had been lost without a full-scale response effort to reach out to borrowers in the early days of their delinquency. But there was an important silver lining: During those few months, Caravela’s MD had the opportunity to see group-lending operations in action, picking up experience that would prove crucial when she returned to her MFI.

She did not have to wait long to put her newly learned experience into practice. Upon returning, she put

Caravela’s group lending operations into overdrive. By the end of Q1 2008, the group-lending portfolio had doubled from the prior quarter. The next quarter the pace quickened further, to nearly three-fold. By the end of the year, Caravela’s group loans had grown by 680 percent, to comprise some 25 percent of the total portfolio outstanding (Figure 5).

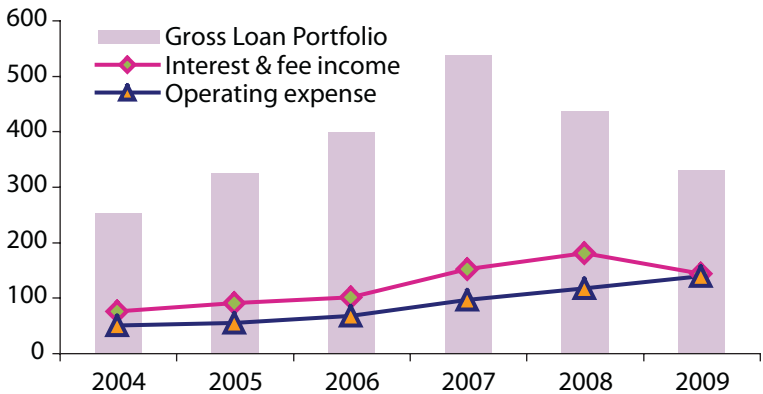
The shift to group lending proved critical to Caravela’s survival. As the crisis unfolded, it provided a much-needed income stream that proved all but immune to the macroeconomic crisis. Indeed, the highest level of PAR30 recorded on the group loan portfolio during three years of crisis was 3.4 percent. No less importantly, group loans carried a significantly higher yield than individual ones, which allowed Caravela to maintain a relatively stable revenue stream, even as its portfolio shrank by over 40 percent peak-to-trough (Figure 6). That also helped avoid staff layoffs, which would have seriously affected morale and imperiled the shift to group lending.

While holding steady on the revenue side, Caravela was recording large losses due to provisions for its failing portfolio of secured loans: In the first two years of the crisis, loss provisions eroded nearly half of its capital base (Figure 7). And loss provisions were not the only problem hurting its capital.

**The Hedge(hog)**

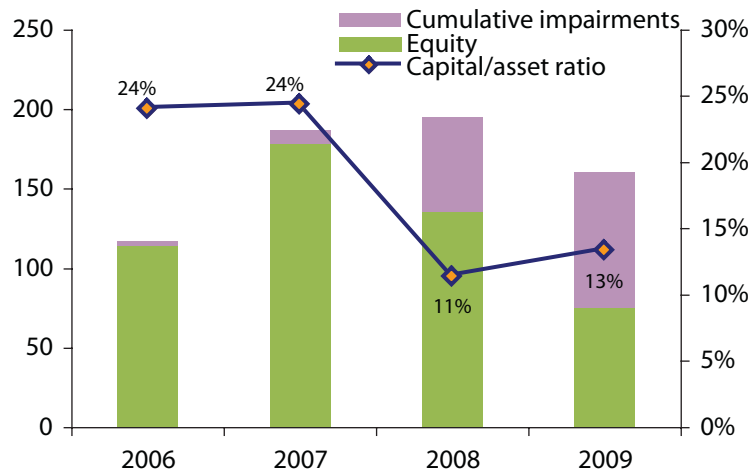
At the start of the crisis, Caravela was carrying an outstanding foreign currency loan with covenants stipulating that its combined foreign currency

**Figure 6: Revenue less affected than portfolio (KZT mln)**



Source: Mix market

**Figure 7: Capital eroded due to loss provisions (KZT mln)**



Source: Mix market

exposure not exceed more than 50 percent of equity. Since this loan was not the sole source of foreign currency debt, in practice it meant that Caravela had to hedge the entire covenant-clad loan. It fulfilled this through a back-to-back loan arranged with a local bank, which initially agreed to provide the foreign currency hedge for a fee of 2.5 percent, raising it to 4 percent in early 2008. In 2009, after the tenge was devalued, the bank quadrupled Caravela's hedging fee to 16 percent.

As it happens, by that time, Caravela was already in violation of multiple covenants, and recognizing that the situation was likely to last for the foreseeable future, the lender had by then waived all covenants, include the hedging requirement. This allowed Caravela the choice of accepting the higher hedge fee or going unhedged for some period.

Caravela's MD did not see the 16 percent fee as in any way a fair price, recognizing it as the bank's attempt to recoup its losses, rather than a genuine offer for a new product. But there were no other hedge options available, and the idea of going unhedged entirely seemed too big a step to take, not only in the immediate period, but also going forward. There was no guarantee that Caravela would be able to find another bank to provide a hedge in the foreseeable future. So it accepted the bank's terms. A year later, after carrying the 16 percent fee for a year, Caravela was finally able to secure a hedge from another local bank for a price of 4.5 percent.

In advance of the devaluation, the hedge did what it was supposed to do – it protected Caravela from a foreign currency loss. Yet in the end, the combined cost of maintaining the hedge during the 4-year period was 27 percent of the loan amount – well above the cost of the actual devaluation. It's a rare case when insurance, after having paid for the catastrophe it was meant to cover, turns out to still cost more than the coverage it actually provided.

### Emerging from the Storm

There is no question that Caravela has survived the storm, though it did so largely by entirely reconstructing the ship in mid-voyage. With its portfolio now consisting almost entirely of group loans, its earlier life as a “missing middle” lender has now been reduced to a total of 88 loans and one loan officer to oversee them.

But the new ship appears sound. As of year-end 2010, Caravela's PAR30 was once again below 1 percent, while restructured loans had shrunk to 5.5 percent of portfolio. Nevertheless, Caravela has been badly battered. Its equity, having stood at 25 percent of assets at the start of the crisis, has been knocked down to below 10 percent, a gap that Caravela will have to rebuild.<sup>1</sup> It also faces

1. Data unaudited, and equity may yet be revalued, as the loss reserve of 5.2 percent may be too large given the low current delinquency rate. Depending on the revaluation, it is also possible that Caravela may even break even for the year.

new obstacles, including a proposed law to cap interest rates at 56 percent, which is well below the 67 percent effective rate it currently charges on its group loan portfolio.

No doubt, difficulties remain, but having proven its seaworthiness, Caravela will likely continue to play an important part in Kazakhstan microfinance as it sails into the future.

## Lessons from Caravela

Caravela is a rare case. When the economic crisis hit Kazakhstan, it found itself in a sector that was no longer viable. Thus, survival was only possible by diversifying into a new market, all the while dealing with the collapse of its existing portfolio. It was also highly fortunate that it could realistically adopt a new business model – group lending – by relying on the expertise of its sister organization. Nevertheless, other MFIs in similar situations could benefit from many of Caravela’s lessons.

## Some Markets Require Diversification

Diversification is generally a truism for any market, and the more volatile the market, the more critical diversification is. In Caravela’s case, it was dealing with a double hit – both the incomes and the real estate collateral of its individual borrowers were seriously undermined by the economic crisis. Meanwhile, group loan portfolios in rural areas proved nearly immune to the crisis, and MFIs with that profile did very well. There were some MFIs in Kazakhstan that combined both approaches, and while they reported substantial increases in PAR and write-offs, it was at far lower levels than Caravela.

Caravela has also shown that diversification can also work as a response to a market crisis. Caravela’s ability to reposition itself as a rural group lender is an example of in-crisis diversification that works –while it could not protect itself from the losses in its legacy portfolio, building up a new, high-yield portfolio provided critical cashflow that allowed the company to survive. Certainly, diversification during crisis is a risky maneuver, as there is no time for experimentation, pilots, and product adjustments along the way. But for those MFIs that find themselves

operating in a market that is no longer viable, diversification may be the only realistic option.

Implementing such repositioning can be difficult – Caravela was lucky to have the backing of an investor with a wealth of experience in group lending and a group-based sister organization in a nearby country. However, other MFIs still have the option of hiring external consultants – the key is to be open-minded and be willing to assess the situation early enough to give such a repositioning a chance. And having relevant expertise on the board of directors to facilitate the transition can only help.

## Appropriate Loan Products

Caravela’s strong emphasis on housing was not an accident or a temporary deviation. Provision of housing loans is part of its stated mission. The question is whether Caravela had the appropriate institutional capacity to serve that mission. Its mortgage loan product marketed for real estate purchases had a term of just three years.

This is an unusually short period for the large loans an outright purchase requires, and it seriously exacerbates the impact of short-term swings in home prices on both the borrower and the lender. By contrast, bank mortgages in Kazakhstan during this period were available for terms of up to 20 years. Indeed, Caravela’s terms were not ones it would have chosen itself, but were dictated by its own funding structure, which featured loans of similar terms.

In truth, these were not so much specialized housing loans as simply business loans repurposed for housing. And in truth, in some ways it’s but a formal recognition that business owners can and do regularly divert loan proceeds for non-business purposes, including housing. The majority of Caravela’s housing loans were in fact quite small, averaging some \$10,000 at the inception of the crisis, which was only slightly higher than the rest of its secured portfolio. Half of them were used for construction and renovation, which is very much along the lines of traditional housing microfinance practice. However, in this portfolio was also a sizeable contingent of housing loans upwards of \$30,000, many of them intended for home purchase.

Finally, Caravela's housing loans were substantially higher-priced than bank equivalents, at about 25 percent vs. 18 percent commonly seen in the market. And Caravela, being small and not a bank, was also outside of the traditional mortgage market, which made it ineligible for the support the government provided to banks in response to the crisis.

Given these complications, it is worth asking whether the type of mortgage lending Caravela was undertaking was really appropriate for either the lender or its clients. In the end, the housing loan portfolio performed almost exactly the same as the rest of its secured loans – housing did not sink the boat, but neither did it provide the kind of diversification Caravela could have gained had it sought out other opportunities.

### **The Risks of Hedging**

The hedging problem at Caravela, whereby the MFI effectively had to compensate the hedge provider for the outlay after the fact, is an important example

for foreign currency lenders. It is already well-recognized that foreign currency poses a serious risk to MFIs. Perhaps what is less recognized is that the hedges purchased to mitigate this risk may themselves prove to be highly inadequate instruments that can undermine an MFI in much the same way as an open currency position.

This is an area where foreign currency lenders should bear more responsibility, by helping the MFI evaluate the terms of the hedges they take on, and assisting the MFI to find more appropriate hedging options when necessary. Lenders should recognize that a hedge is an instrument whose complexity and innate risks may not be fully understood or appreciated by most MFIs.

### **Sources**

MIX Market ([www.mixmarket.com](http://www.mixmarket.com))

Kazakhstan Statistical Agency ([www.stat.kz](http://www.stat.kz))

Company and other documents shared on a confidential basis

## When Agents Strike<sup>1</sup>

### Hestia, Pakistan

#### Risk Categories

- Uncontrolled growth
- Methodological flaws
- State intervention

#### Turnaround Factors

- Client confidence
- Strategic redirection

Hestia was created in 1996 with a business model that combined the examples of two leading Bangladesh MFIs: Grameen Bank, from which Hestia adopted the group lending methodology, and ASA, from which it borrowed the lean branch management model. Since its inception, Hestia has been a pioneer in Pakistan's microfinance sector. It was the first specialized MFI in the country, the first to offer a pro-women consumption loan, the first to offer micro-insurance services, and the first to become financially sustainable and obtain an investable credit rating.

### Growth: 1999–2005

In 2001, the government declared microfinance a “key poverty alleviation tool”<sup>2</sup> and set about creating a regulatory framework, with the central bank as supervisor. The new framework also facilitated microfinance investments. This set the stage for the sector's expansion.

At the same time, Hestia began growing by developing efficient, viable and financially sustainable policies and structures, while securing funding from international foundations and government development funds. By year-end 2001, it served more than 5,000 urban and semi-urban clients out of five branches in the region's capital.

The support of the government and international organizations provided an important boost to the industry, and a number of MFIs were established dur-

ing this period. Clients became fairly evenly split between urban and rural areas and the group methodology became the dominant lending method, accounting for 90 percent of loans disbursed.

During this period, Hestia built on its successful policies and structures by improving its credit assessment tools, establishing a zero-tolerance policy against delinquency, and introducing a pilot project to collect deposits, all the while maintaining a high portfolio growth rate. Based on clients' needs and feedback, it created new products and non-financial offerings, such as leadership training, reproductive health sessions, and gender training to socially empower its female client base.

### Overheating: 2005–2008

While growth in the earlier period was rapid – 59 percent annually for the overall microfinance market and 79 percent for Hestia specifically – the pattern shifted in 2006-2007. The overall market continued to grow at a similar pace, but Hestia accelerated to 100 percent annually for these two years (Figure 1).

Much of this growth took place in the Punjab region. In early 2006, the region was still somewhat under-represented in terms of microfinance penetration, accounting for 43 percent of the microfinance clients

**1996** – Hestia is founded

**2001** – Government declares microfinance a key poverty alleviation tool

**2000–2005** – Hestia grows 79% annually on average

The loan agent system develops

**2006–2007** – Acceleration to 100% annual growth

**2008** – Hestia Bank is launched. Lending begins in November

**October 2008** – Non-payment revolt in Tehsil-Muridke province

**December 2008** – Increase loss allowance to 36% of portfolio

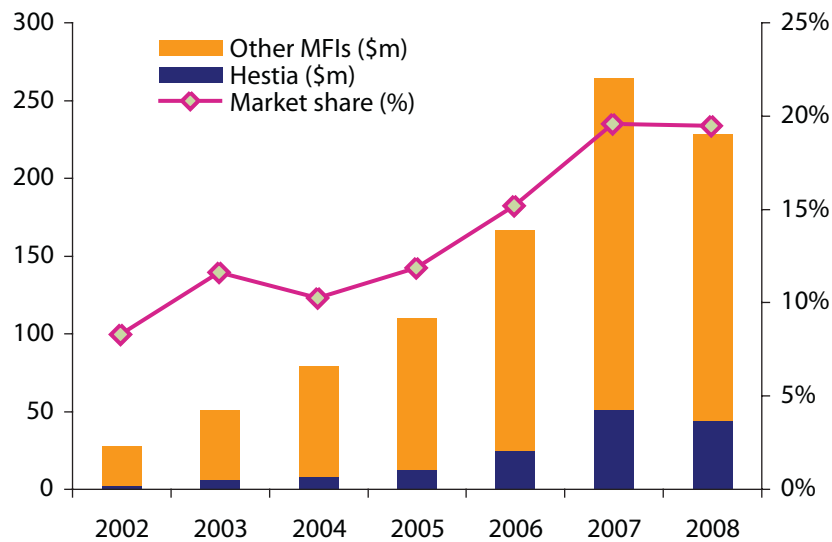
**April 2009** – PAR30 is estimated at 80%

**May 2009** – Hestia Bank launches deposit services; its own PAR levels fall to 4% by year-end

1. Much of this case is drawn from Hussan-Bano Burki, “Unraveling the Delinquency Problem (2008/2009) in Punjab – Pakistan,” Pakistan Microfinance Network, October 2009.

2. Poverty Reduction Strategy Paper (PRSP-I) p. 40. GoP 2001 <http://www.imf.org/external/np/prsp/2001/pak/01/113001.pdf>

**Figure 1: Growing share of a growing market**



Source: MIX Market

in Pakistan, while comprising 55 percent of the country's population. Just two years later, the number of microfinance clients in Punjab accounted for 68 percent of the country's total.<sup>3</sup> Moreover, this growth was being achieved through a worrying practice in which MFIs set up branches in areas where there was already a microfinance presence.<sup>4</sup> By 2008, the situation had become so dire that the best way to find a given MFI's branch was to look for its competitors' branches.

The resulting market saturation and rise in multiple borrowing was a natural consequence of these growth trends. In some communities, 70 percent of clients were multiple borrowers.

A key factor that contributed to this growth and facilitated the rise of multiple borrowing during this period was MFIs' increasing reliance on loan agents. An important part of the group lending methodology used throughout South Asia, group and center leaders had the advantage of local knowledge and gradually took over loan officer responsibilities, such as client verification and group formation.

3. Pakistan Microfinance Network website (<http://www.microfinancepakistan.com/application.html>), retrieved April 20, 2011.

4. This clustering followed the previous clustering of international aid organizations and NGOs in the region. Existing infrastructure, funding and access to poor populations made it fairly easy for the newly established MFIs to set up and provide services there.

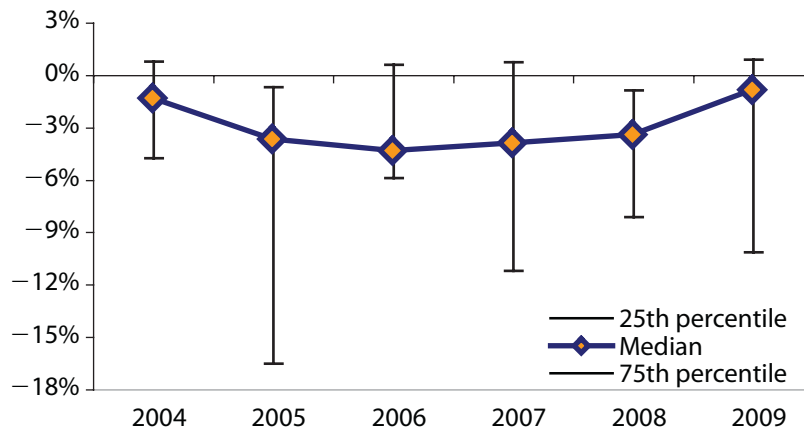
But the benefits provided by these group leaders came with a price. In effect, their expanded role became that of a gatekeeper, serving as intermediaries between the MFI and the client. With full control over determining loan eligibility and responsibility for loan recoveries, these additionally empowered group leaders, acting effectively as agents of the MFI, seriously eroded the MFI's connection with its clients. It was as though the MFIs had outsourced a major portion of their client interaction to an unofficial, unverified and unmonitored group of individuals.<sup>5</sup>

The perversity of this system became evident when these local agents began charging commissions to clients seeking to join a group, or in some cases, forming ghost groups for the purpose of taking loans for themselves. Since they worked simultaneously for many MFIs, they contributed to the spread of cross-borrowing. In some cases, the commission agent/group leader's role was so dominant that many borrowers perceived them to be the actual source of credit, instead of the MFI.

Despite rapid growth and proliferation of agents, profitability remained elusive for most institutions

5. For more on agent/group leaders in South Asia, see Ramesh Arunachalam, *The Centre Leader as A Micro-Finance Agent: Some Insights Into The Operational Model...*, blog 27 Jan 2011 (<http://microfinance-in-india.blogspot.com/2011/01/centre-leader-as-micro-finance-agent.html>)

**Figure 2: Pakistan MFIs struggling to reach profitability (ROA, assets >\$1m)**



Source: MIX Market

(Figure 2). During this period, MFIs continued to enjoy an inflow of funds (equity and debt) from local commercial banks and from abroad, including both public and private socially oriented investors. As the regional pioneer and with unconstrained access to funding, Hestia raced to achieve ever-larger numbers of borrowers, growing its portfolio by 96 percent in 2006 and doubling its branches (from 33 to 69), while its PAR remained essentially at zero. It was also consistently among the most profitable of all Pakistan MFIs.

To diversify their funding, MFIs were also beginning to turn to alternative sources, mainly deposits. Two of the leading non-banks in Pakistan transformed into banks, while Hestia was also preparing to launch its subsidiary, Hestia Bank. In short, the market was booming, and few questioned MFIs' lending practices.

### **Crisis: 2008–2009**

In October 2008, borrowers in Tehsil Muridke, a province in the Pakistani region of Punjab, approached a local politician and requested his support for having their debts to Hestia waived. The borrowers were solidarity-group members who had incurred microloans with Hestia and now, with the incitement of their activist group leaders, claimed they were unable to repay them. The politician's support encouraged other borrowers to follow this example. Soon, rumors began to spread that Hestia's founder and president had died and all outstanding loans had

been waived. The rumor spread quickly throughout the region via borrowers' social networks.

The rumors were also fanned by commission agents who perceived an opportunity to have their own loans written off, politicians who saw an easy way to burnish their populist credentials, and lawyers and others who found an opportunity to profit by selling fake documents – court stay orders withholding repayment, news announcements of Hestia's president's death and waiver, and so on.

Hestia was thus faced with a serious delinquency problem that had rapidly built momentum and that caused PAR30 to soar from less than 1 percent in October 2008 to more than 20 percent four months later. By April 2009, client feedback suggested a delinquency rate of some 80 percent, which was confirmed when Hestia inadvertently released a figure of 83 percent in May 2009. The situation was dire – having impaired 36 percent of its portfolio and generated a return on equity (ROE) of negative 59 percent, Hestia found itself on a fast track to insolvency.

Hestia had to take drastic and urgent measures to contain the repayment strike that was also threatening to spill over to other microfinance providers in the region.

### **Dealing with the Crisis**

Hestia's first response was to send senior staff out to the field to try to contain the crisis. However, as

management believed this to be a politically motivated movement, they focused much of their effort on convincing the politicians to change their rhetoric, instead of communicating directly with the clients. They were at least partly successful, and the politicians adopted a neutral stance. Yet that was no longer enough to reverse the movement – the nature of which had changed. Hestia’s failure to begin immediate discussions gave clients the opportunity to gain confidence in their stance, at times going so far as to personally harass and even attack Hestia’s loan officers when they attempted to make collections. The situation had become quite dangerous – in a neighboring country, a similar situation ended in tragedy as some MFI staff were killed by angry crowds.

One issue that affected Hestia’s response was the company’s relatively weak middle management. The difficulty here was that Hestia was headed by a founding visionary who in many ways dominated the organization. As a result, management that was physically close to the events on the ground was either too inexperienced or unable to make the quick decisions the situation required. Reliance on leadership at the top slowed the process, and when Hestia finally did start to respond, the borrowers’ position had already hardened.

Some of Hestia’s responses proved effective – most notably, getting politicians to tone down their rhetoric. Others were in fact counterproductive, such as freezing the disbursement of installments and new loans in order to persuade clients to repay their existing ones. This tactic backfired, as borrowers perceived the cessation of disbursements as a sign of organizational weakness, which only strengthened their unwillingness to make repayments. Hestia also revised its group lending methodology. To reduce the power of the commission agents, Hestia limited groups to five persons or less, restricted group leaders’ responsibilities to no more than one group, and eliminated their authority to collect loan payments.

By mid-2009, Hestia’s borrowers appeared to largely accept that rumors of the debt waiver were untrue. However, the situation had by then developed into a more intractable problem. When asked, many clients claimed to support ending the repayment strike. The trouble was that, with so many borrowers not paying, non-payment

had acquired its own inertia – put simply, borrowers didn’t want to restart payments until they saw others doing so first. The social cohesion and peer pressure that is responsible for keeping delinquencies at minimum levels during normal times had in fact flipped and was actually preventing the borrowers from repaying.

To what extent Hestia has been able to overcome this obstacle is unclear – the organization has not reported any portfolio or financial data since 2008. Some familiar with the situation have suggested that repayments were very low and most of the loans that fell delinquent in the winter of 2008-2009 remain that way to this day, that is to say, they have become permanent losses. It appears that the primary turnaround path adopted by the institution was to focus its attention on its subsidiary organization, Hestia Bank.

The delinquency crisis that hit Hestia also threatened to spill over into other MFIs, whose borrowers sporadically tried to replicate the actions of Hestia’s clients. These efforts proved largely unsuccessful. Other MFIs moved quickly to ring-fence the repayment strike affecting Hestia. Some of the practices they adopted include strengthening client documentation and using post-dated checks as collateral. They also took measures to maintain the image of stability and strength among their clients, using the credible threat of legal action in the event a borrower defaulted on a post-dated check, and placing greater effort on collections, including approaching male relatives of female borrowers to guarantee the repayments.<sup>6</sup>

### **Turnaround: The Rise of Hestia Bank**

As a non-banking institution, Hestia could only provide micro-lending services and was prohibited from gathering deposits. A pilot project launched in 2006-2007 by which it accepted savings from existing customers was not perceived favorably by the authorities, as the legislation determined that a bank license was necessary. Wanting to go one step further

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6. In the context of the highly patriarchal Pakistani society, where women are routinely subjected to domestic abuse and violence, the practice of visiting borrowers’ male relatives as a collections technique constitutes an implicit MFI endorsement of such abuse. As such, it is a violation of the Smart Campaign principle of appropriate collections practices and cannot be condoned.

and broaden its financial offerings, Hestia looked to the possibility of creating a banking institution.

In June 2008, Hestia Bank was launched. The decision to make it a separate entity was born partly out of necessity, since transforming Hestia Foundation into a banking institution would have required a massive investment in infrastructure, IT, human resources and other areas – an investment that was simply unfeasible at the time. However, Hestia also wanted to retain its focus on the population segments that it was already serving (i.e. poor women) and on the group methodology. The bank would instead cater to individual, urban-based micro-entrepreneurs and small businesses with working capital loan needs beyond the foundation's limit of approximately \$475.

However, the bank would also serve Hestia's traditional borrowers, poor women, by providing them with affordable deposit services. Its goal was to reach 1 million savers by 2012. These deposits would be used to fund the loans for entrepreneurs and small businesses, and would be supported by equity provided by a group of foreign investors.

The new entity began lending operations in November 2008 – only weeks after the outbreak of the repayment strike. It also received an inheritance of a portfolio of individual loans from Hestia, which had already successfully introduced the product for its entrepreneurs. As a result, the bank's initial clients came from the same communities and had similar profiles to those of Hestia, thus its portfolio was also affected by non-payment. By the end of 2009, its first full year of operations, the bank had to write off some 13 percent of the loans it had on the books as of December 2008. Nonetheless, it was in May 2009 – during the height of the repayment crisis – that the bank launched its deposit service and achieved a good response, reaching its declared targets for the year. By the end of the year, the bank reported PAR30 of only 4 percent.

In 2010, Hestia Bank renewed its efforts to become financially viable. Portfolio growth was small, but loan quality improved as many of the earlier troubled loans matured and new ones were disbursed. However, the focus has been on deposits, which continued to grow and exceeded the bank's portfolio by a factor of nearly two times by year-end 2010. It cur-

rently covers 70 percent of its costs from revenues and aims to break even in 2011.

According to some persons familiar with the institution, Hestia Bank would have been much better off starting from scratch instead of inheriting non-performing loans, thus infecting its portfolio right at the start. However, contamination from the delinquency crisis, compounded by macroeconomic difficulties, affected other MFIs in Punjab, as well as Hestia. Thus it is not clear to what extent the bank's problems were directly related to it being the offshoot of Hestia.

Despite initial portfolio difficulties, Hestia Bank appears to be heading towards a successful future. However, it has not yet emerged from its predecessor's shadow. As of 2009, the bank's assets came to \$14 million. A year before, in the first months of the repayment crisis, Hestia had counted its assets at \$63 million.

## Lessons from Hestia

### Role of Commission Agents

This case highlights the high degree of risk that commission agents present to MFIs. In truth, the presence of an unofficial, unverified, and unaccountable commission agent in an MFI's loan process is in itself a testament that the organization has failed in its prudential lending responsibility. Such agents insert two critical risks into the process. First, they irreparably undermine the credibility of the borrower evaluation process, including greatly increasing the possibility of fraud through ghost borrowers. Second, in times of crisis, agents can amplify non-payments and sometimes even cause them in the first place.

At a basic level, there is nothing wrong with employing client recruiters or other local facilitators – as long as their role is formally recognized, they are appropriately compensated, and they are monitored and held accountable. And any agent role should be limited to either the client identification/evaluation process or the loan repayment process, but never both. MFIs using the group-lending model should maintain clear procedures and appropriate monitoring to insure that the role of group leaders does not morph into that of agents.

## Groups in Crisis

Group lending relies explicitly on social cohesion to keep repayment rates high. But while this is highly effective in normal circumstances, it can become a major liability during times of crisis. First, groups provide a natural vehicle for spreading the contagion of delinquency. And the joint liability aspect adds an additional factor by strongly incentivizing all group members to default once the unit has reached a delinquency threshold at which the joint liability becomes untenable.

The other risk associated with group lending is that once mass delinquency has been established, the social cohesion factor starts to act in reverse by discouraging individual borrowers from making their payments. The case of Hestia featured a number of borrowers with just a few payments remaining who wished to repay their loans, but nevertheless felt compelled by group solidarity to default. Other borrowers voiced related concerns, stating that they would restart payments only if everyone else did. It is for these reasons that group-based microfinance has regularly experienced crises where delinquency rates moved very rapidly from a very low level to 70 percent, 80 percent or even higher. Indeed, at the local level, 100 percent delinquency can and does become the norm. Put simply, in such situations, the near-perfect repayment rate for which microfinance is often known becomes inverted, becoming the near-perfect delinquency rate instead.

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***Group-lending MFIs facing repayment strikes would do well to borrow from epidemiology.***

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Such situations place MFIs in a nearly impossible position, forcing them to break social cohesion in order to

collect payments. Worse still, to reverse a repayment strike, they must peel off a sufficiently large number of individuals willing to make payments such that they reach the reverse tipping point, where repayment once again becomes the path of least resistance for most borrowers. This is extremely hard to do.

What this means for crisis management is that MFIs facing such situations would do well to borrow from epidemiology. First, mass delinquencies must be identified early. Then, because quarantine is not available,

infected groups must be treated intensely by a combination of positive and negative incentives, so as to reduce their effective “contagiousness.” The primary objective of such treatment is not necessarily to restart client repayments quickly, but rather to make their non-payment stance less appealing to others. Finally, surrounding areas must be subjected to a broad campaign of inoculation – by heavily strengthening lending and collection processes (the path taken by Hestia’s competitors), and by taking proactive measures to head off delinquency, such as PR campaigns, enhanced field presence, and more careful screening of clients.

## Multiple Borrowing

Multiple (or cross-) borrowing is an issue that gained much prominence during the microfinance downturn in 2009-2010. It clearly played an important role in the case of Hestia, especially by reducing the clients’ dependence on Hestia for their credit needs.

However, there has been no evidence to suggest that over-indebtedness – a risk often identified with multiple borrowing – was a major factor in this case. If it had been, then one would have expected the other MFIs to also have been substantially affected by non-payments. And yet for the most part, they weren’t.

Nevertheless, the standard solution to multiple borrowing – a credit bureau – would have helped greatly in this situation. If clients knew that their borrowing opportunities from other MFIs would be compromised as a result of defaulting on their Hestia loans, they might well have been less willing to participate in the repayment strike. Unfortunately, for Pakistani MFIs, the lesson has not yet been learned – a pilot credit bureau has been operational there since summer 2010, but many MFIs are still not participating.

### Sources:

Hussan-Bano Burki, “Unraveling the Delinquency Problem (2008/2009) in Punjab – Pakistan,” Pakistan Microfinance Network, October 2009.

Pakistan Microfinance Review 2008, Mainstreaming Microfinance: Progress, Opportunities and Challenges, PMN

MIX Market ([www.mixmarket.com](http://www.mixmarket.com))

Confidential interviews

## The Crowded Kitchen

### Belavoda, S.E. Europe

#### Risk Categories

- Financial vulnerability
- Methodological flaws

#### Turnaround Factors

- Liquidity
- Creditor confidence
- Address collections

Belavoda was founded in a country in South East Europe in 2003. With initial equity coming from the local subsidiary of a large international foundation, a pilot for the provision of microloans began. Belavoda's mission was to lend to micro-, small- and medium-size

enterprises (MSMEs), and while it expanded to consumer loans in 2008, its focus has remained on helping entrepreneurs grow their businesses.

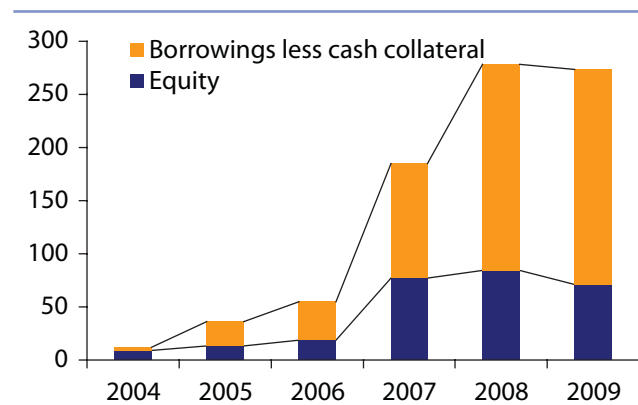
In 2007, Belavoda entered a rapid scaling phase, gaining a full 129 percent in cumulative annual growth (CAGR) during 2007-2008, compared to 53 percent growth in 2006. This was partly aided by a medium-high rating in 2006, which ranked the institution near the top for all indicators except efficiency. The rating specifically cited its relatively small scale as a significant roadblock – a clear signal to potential creditors that Belavoda was a good investment.

Late in 2007, Belavoda brought in a set of shareholders, thereby increasing its equity base four-fold. This positioned the company to take on further debt, which grew three-fold that same year (Figure 1). The year 2007 was also the first year that Belavoda posted a profit.

Growth continued in 2008 – another profitable year, during which its rating was upgraded by another notch. Though portfolio quality was showing signs of deterioration, by the end of 2008 Belavoda had a combined PAR30 + write-off ratio of 4.5 percent – up from 2.2 percent in 2006, but still not at a level of special concern. By all appearances, Belavoda was a well-run, growing MFI.

The high levels of funding helped Belavoda deliver on its mission to provide start-up or investment

**Figure 1: Growth through both debt and equity (mln local curr)**



Sources: MIX, company documents

capital to businesses. Thus, medium (over \$6,000) and large-size (over \$50,000) loans made up the bulk of its portfolio: In 2008, 53 percent of the portfolio consisted of loans over \$14,000 – a distribution that was significantly more heavily weighted to large loans than in years prior (Figure 2). Some recipients of large loans were the small Savings and Credit Associations (SCAs) that were widespread throughout the country.

The success of MFIs and SCAs in the country, as well as global optimism about microfinance during this

#### 2003

- Belavoda founded

#### 2006

- Positive rating report cites small scale as biggest impediment

#### 2007

- New shareholders enter, increase equity by 4x
- Debt grows by 3x
- First profitable year

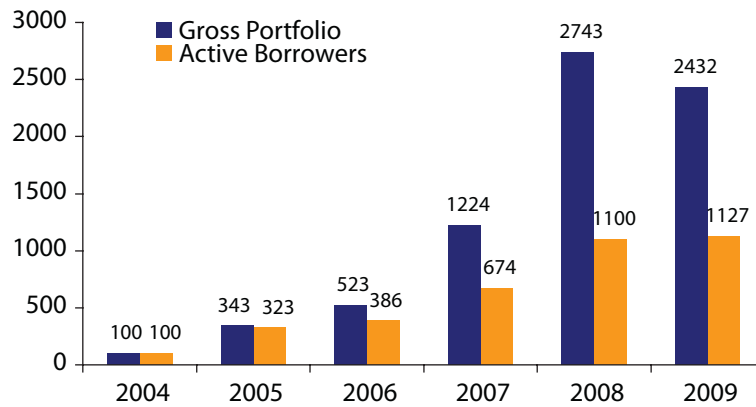
#### 2009

- Economic crisis in country
- PAR30 at 15%; write-offs at 10%
- Multiple loan covenants broken

#### 2010

- Offer of \$5 million loan, if creditors waive covenants; withdrawn when one creditor refuses
- Proceeds with negotiations to restructure loans
- Loans extended by 1 year

**Figure 2: Rapid growth through growing loan sizes (index = 100 in 2004)**



Sources: MIX, company documents

period, resulted in an influx of capital to the country from international investors. During the year leading up to the crisis, \$50m in foreign funding was placed in the local microfinance market, a large sum for both the country and the sector, given the small size of both. The recipients were not only MFIs, but also to a large extent commercial banks that realized there was an opportunity in microfinance and started downscaling, offering micro-loans with competitive terms.

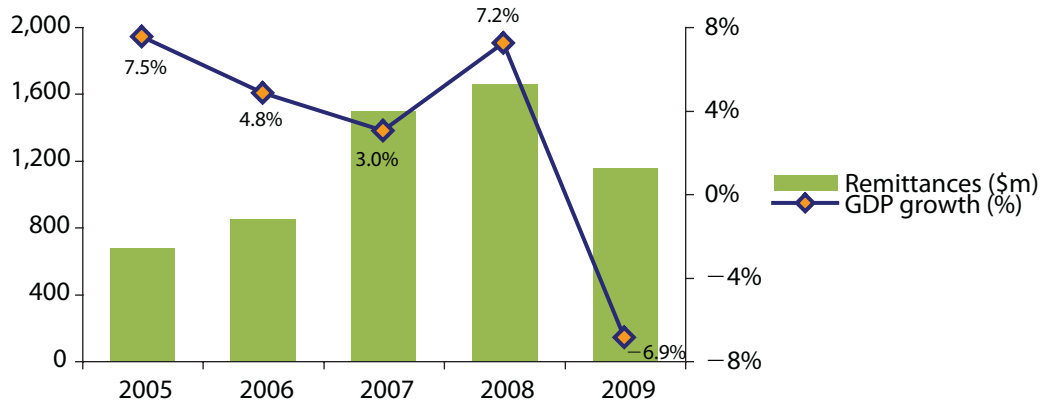
### Crisis on the Street, Crisis in the Books

The first signs of the crisis became clearly visible in Belavoda's financial results within a very short period of time. During the first two months of 2009, PAR30 rose from less than 3 percent to approximately 15 percent, as the country fell into a very difficult economic year with GDP contracting by 6.9 percent

in 2009 vs. 5 percent average annual growth during the prior three years (Figure 3). During the height of the global financial crisis the country suffered from a dramatic 37 percent drop in remittances, one of its main income sources (30 percent of GDP – one of the highest in the world). This had a cascade effect on Belavoda's clients, who saw their incomes drop, either directly as relatives stopped sending money back home or indirectly as demand for goods and services slowed.

At the same time, the value of the local currency remained high, while other governments in the region started depreciating their currencies. Devaluation was not a desirable option for the country's political elites, who were facing elections and did not want to upset the electorate. However, partly as a result, agricultural and other exports ultimately dropped by 19 percent, which also affected Belavoda's clients.

**Figure 3: Economic growth: reversal of fortune**



Source: World Bank

Another aggravating factor was the presence of multiple borrowing, which allowed borrowers to over-extend themselves. Part of this was the result of increased competition from downscaling commercial banks that had discovered new growth opportunities in microfinance.

The resulting delinquencies and low demand for new loans and products proved difficult for Belavoda. The large loans that it had been relying on for a significant part of its growth proved to be especially susceptible to the downturn. Thus, in mid-2009 just seven loans, averaging approximately \$75,000, accounted for 21 percent of portfolio loans overdue (PAR30), even though they constituted only 2.2 percent of the total portfolio outstanding. However, the major contributor to delinquency was the traditional small-loan microenterprise loan portfolio. Interestingly, consumer credit loans actually fared substantially better.

By the end of 2009, Belavoda's PAR30 stood at 15 percent, with another 10 percent having been already written off. Even these high numbers understated the severity of the problem, as 19 percent of portfolio had been rescheduled, with the expectation that thus treated loans would start performing. Belavoda's portfolio was clearly in serious distress.

Nevertheless, though serious, the high level of delinquency was not on its own an existential problem. At the end of 2008, that is, at the inception of its crisis, Belavoda had a large equity buffer, comprising 30 percent of total assets.<sup>1</sup> By the end of 2009, this had eroded significantly, but still stood at 25 percent of assets – a strong buffer for all but the worst of scenarios.

## The Monster in the Books

A greater problem was quietly lurking in Belavoda's books. During its growth phase, Belavoda had placed heavy emphasis on raising debt, and its strong organizational foundation and financial performance insured that the effort was a successful one. By the end of 2009, Belavoda had relationships with 15 separate

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1. Excluding foreign lender funds held as cash collateral for local-currency loans issued by local banks. The result of this funding structure was to inflate accounting assets, without any increase to the actual funds invested in the organization.

creditors, not counting local banks that provided it with back-to-back local currency loans secured by these foreign funds. Such diversity of funding was seen as a positive factor, mitigating Belavoda's re-financing risk – a point explicitly noted in its most recent rating report.

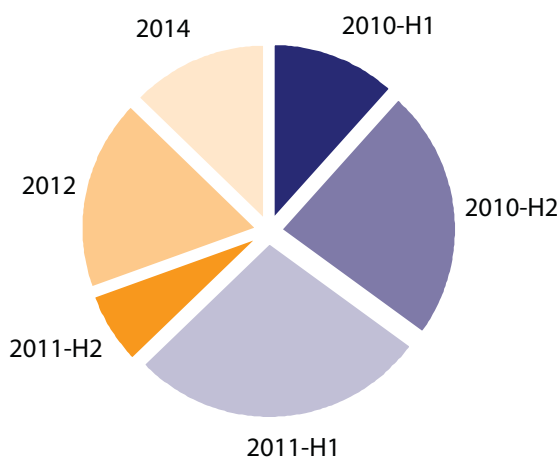
As it happens, the security provided by so many relationships proved not only a mirage but a destabilizing factor on its own. As is standard practice, most of these loans came with various financial covenants attached, requiring minimum profit margins, maximum delinquency ceilings, minimum liquidity, and so on.

These covenants worked as intended. When the storm started brewing in Belavoda's portfolio, it tripped the covenants. Theoretically, that put creditors in the position to accelerate the repayment of their loans. None took such drastic steps, realizing that it would amount to essentially a run on the bank. However, they took the next logical step: freezing new disbursements.

But not all saw things so bleakly. One large lender saw promise in Belavoda, and sanctioned a \$5 million loan in late 2009, when problems were already clearly evident. However, given the circumstances, it added an unusual covenant requiring that other lenders' financial covenants be waived before its loan could be disbursed. The intent was reasonable – a breach of covenants constitutes technical default, allowing creditors to call their loans, that is, to demand immediate repayment of principal. And lending to an organization in a state of technical default could well mean seeing its newly disbursed funds channeled right back out to pay off other lenders. It was this outcome that the waiver requirement was meant to avoid.

By agreeing to sanction a \$5 million loan, this lender was making a clear statement that despite the difficulties it faced at the time, Belavoda's future was a bright one. Unfortunately, that message got lost along the way. Instead, the requirement for covenant waivers from each of Belavoda's existing creditors gave those same creditors effective veto power over the loan's disbursement. It also highlighted what was becoming quickly obvious to Belavoda's manage-

**Figure 4: The monster in the books—debt maturity schedule (as of Dec 2009)**



Source: Company documents

ment and board: They needed to proactively reach out to the lenders and begin to build a consensus for a way forward.

The problem was exacerbated by a slowly building wave – the legacy of rapid growth in 2007-08 financed with short-maturity foreign debt. Over the next 18 months, nearly 2/3<sup>rd</sup>s of its outstanding debts would be coming due, with over half of those maturing by the end of the year (Figure 4). With cash flow already constrained by large non-payments and liquidity woefully insufficient to meet the payments on its own, Belavoda faced a tough decision. It had the choice of either suspending disbursements altogether – tantamount to institutional suicide, given the negative effect that would have had on current repayments – or it had to find a way to get its lenders to agree to a loan rescheduling package. And all 15 lenders would have to sign off on the plan.

### Herding cats

On the bright side, by the time the company started reaching out to its lenders in spring 2010, some loans had already come due, shrinking the number of creditors to 12. The bad news was that the remaining 12 lenders were independent entities scattered around the world, each with different financial requirements, a broad range of concerns with their own portfolios, and most importantly, each with its own sense of urgency. Yet all decisions had to be unanimous.

Initial signs were not positive. Belavoda's first attempt was to get the lenders to agree to waive their covenants, thus clearing the way for the disbursement of the \$5 million loan. Achieving that may have proved sufficient by itself – the loan would have covered most of the repayments for the remainder of 2010. And from the creditors' perspective, it was the most logical step – what lender would refuse to see new funds be put into an ailing investee? At a minimum, it would help dilute some of the risk. The downside of waiving covenants was small, *given the alternative*. And besides default, there was truly only one other alternative – loan rescheduling.

Most lenders saw the logic and readily agreed to the request. Others agreed, on the condition that remaining lenders would waive their covenants. And yet, one lender clearly saw things differently, and decided to exercise its veto.

Seeing the disagreements among creditors, along with continuing portfolio deterioration, the prospective lender reassessed the situation and chose to take its \$5 million offer off the table. The easy path was closed off.

With the day of reckoning drawing closer, Belavoda's shareholders were becoming increasingly concerned. To understand their position, it's worth recalling that throughout this time, the company's capital was never in any serious danger of being excessively eroded. At year-end 2009, when the discussion with lenders began and after 10 percent of the portfolio had already been written off, its capital/assets ratio stood at 25 percent.<sup>2</sup> Among the sea of tripped covenants, those controlling for capital adequacy had not been breached. For Belavoda, liquidity – not solvency – was the issue.

Nevertheless, Belavoda and its largest shareholder redoubled their efforts. In March 2010, at a conference where most lenders were already present, both the CEO and Belavoda's chairman (representing the largest shareholder) called a meeting to discuss restructuring the company's loans. They laid out the situation: Belavoda had no more than six months before it would run out of cash. The Chairman also put on the table his own fund's offer to inject \$3 million

2. After excluding cash collateral – see earlier footnote.

in equity as a demonstration of good faith – if creditors agreed to reschedule their loans.

The creditors present at the meeting recognized how limited their options were. They agreed that rescheduling would have to be done. A steering committee was formed to move the matter forward.

But the agreement at the meeting proved to be fleeting. When the creditor representatives took the issue back to their respective headquarters, the matter hit a wall at a number of institutions. One problem was simply the change of personnel – those present at the meeting were mostly relationship managers who knew Belavoda well. The risk managers who took charge of the matter from there had much less familiarity with the company. Having already gone through disastrous experiences with other MFIs, some risk managers were also far less likely to trust Belavoda’s management.

And some creditors had additional difficulties – closed-end funds, for example, had far less flexibility to reschedule than did others. Then there was the range of maturities – some lenders’ loans were due in 2010, others in 2014. Finding unanimity among such complexity was challenging.

In the end, all creditors agreed to the restructuring, though some held out until essentially the last minute. In the final weeks of negotiations, the chairman even went so far as to increase his proposed equity injection by another 10 percent to bring around the most recalcitrant parties.

Interestingly, the final deal was surprising as much in its simplicity as in its egalitarianism. Each lender agreed to extend 80 percent of the outstanding loan balance by 12 months. It didn’t matter whether the creditor was a closed-end fund, a development finance institution (DFI), or a socially driven fund. It also didn’t matter whether loans were due in two months or in four years. The same rule was applied across the board.

## Road to Recovery

While the lender negotiations were taking place, Belavoda continued making disbursements to existing

customers, a practical decision by the management to continue its work so as to maintain client confidence, as well as to ensure future income. In summer 2010, Belavoda even launched a new product to retain valued customers and give them the opportunity to borrow higher amounts to improve their businesses.

However, this lending was taking place in the context of completely redesigned operations. Belavoda had split the previous integrated lending process in two: sales and risk management. New loans now had to pass through a credit approval committee that no longer included the loan officer who recommended the loan applicant. A risk manager was now required to be present at all times, and the committee (three members minimum) would have to reach unanimous agreement to approve a loan instead of the previous simple majority. These new guidelines effectively excluded loan officers from the loan approval decisions – a major departure from a time when loan officers were able to independently approve loans of up to \$7,000. Unsurprisingly, the new policy generated some resentment among loan officers, who saw a large part of their responsibilities being taken away.

The underwriting itself was also tightened, with the maximum debt repayment ratio lowered to 35 percent of borrower income, compared to 50 percent prior to the crisis. Increased attention was devoted to risk indicators, such as liquidity ratios and existing leverage. At the same time, more importance was given to historical cash flows rather than to pro forma analyses, while collateral valuation became more conservative.

Internal and external communication was also revamped. Inside the firm, top-bottom and bottom-top communication between management and loan officers was improved, with greater discussion of products and services that incorporate feedback from the field. Externally, Belavoda began to use local agents familiar with the local micro-economy to pay visits to potential clients. This was instituted to avoid pitfalls of clients hiding or falsifying information, a phenomenon that had become apparent during the crisis.

In the absence of a credit bureau, Belavoda has also become creative about sourcing its information on potential client liabilities. Besides financial analysis and

required documentation, Belavoda now utilizes the country's central real estate database and the Ministry of Justice's moveable property database to determine if an applicant is disclosing all information about their property, and whether it may already be pledged as collateral for another loan. In addition, Belavoda informally exchanges information with its competitors.

The result of these changes has been positive. Loans disbursed under the new guidelines have performed far above those issued previously, despite the continuing economic slump.

Besides revamping its lending process, Belavoda also introduced major changes to its collections system. Belavoda's first internal action was to establish a collection unit of 19 members subdivided into "soft" collections and "hard" collections groups, plus a lawyer for the most difficult cases. Trainings were organized with outside consultants, drawing on the responses of other Eastern European MFIs with similar problems. Loan officers now report those clients who are more than 15 days in arrears to the soft collections unit. If after this group's gentle but persistent reminders the client still refuses to pay, the case then goes to the hard collections personnel, and if there is still no repayment, the lawyer can then initiate the foreclosure process or take other legal action. If the arrears are paid, the client's file is sent back to the loan officer.

Some of the techniques employed by the collections unit include the use of a call center (SMS reminders and phone calls), client relationship management (CRM) software for tracking calls, and voice-over-IP (VOIP) technology for registering calls based on an integrated MIS. These replaced an Excel-based tracking of events and recovery reports that had been used previously. The reorganization of collections has had a clear and rapid impact on portfolio quality.

### **What the Future Holds**

By successfully negotiating a one-year extension on its debt, Belavoda bought itself time. However, the future, while promising, is still uncertain. Overall PAR30 remains at 15 percent, stabilized but not going down quickly, with old loans still a serious problem (2009 vintage loans still show a PAR30 of

24 percent). According to some stakeholders, it will take Belavoda another 2-3 years to lower these levels to a safe 3-5 percent, if positive economic trends continue.<sup>3</sup> This situation reflects a larger trend in the region and systemic problems and risks that are beyond the control of Belavoda or any individual MFI. For instance, remittances, though somewhat recovered, are still far below historical levels, while Belavoda's portfolio continues to have significant exposure to agriculture, exports, and other sectors that have not yet recovered.

Looking ahead, the biggest concern for Belavoda is increased competition from non-traditional players, i.e. commercial banks, as well as international lenders themselves (some of Belavoda's shareholders are direct competitors that lend to micro-entrepreneurs in the country). The ability of banks to lend at more competitive interest rates (currently the lowest ever) is difficult to counter due to Belavoda's higher cost of funds. Moreover, Belavoda does not benefit from the support of the central bank, whose role as lender of last resort could have been extremely helpful to Belavoda during its liquidity crisis.

Belavoda is responding to this challenge by going upmarket towards medium-sized entrepreneurs, and thus coming into direct competition with banks. Some portion of this is simply a matter of maintaining a lending relationship with its small clients that have grown to become "bankable." In this market, Belavoda competes by bringing faster loan approval and more flexible repayment schedules. According to the company, clients are also responding to its more personable approach compared to that of banks, feeling that Belavoda's officers "speak the same language" and better understand their needs and circumstances.

Whether this will be the path that takes Belavoda out of its crisis remains to be seen. Moreover, the underlying liquidity problem still looms – it may be farther away, but 12 months pass quickly. Ultimately, it remains a race between portfolio performance and liquidity, and at this point, it's not yet clear which will win.

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3. Belavoda itself has more ambitious targets: PAR30 at 5 percent in 2011 and 2-3 percent in 2012.

## Lessons from Belavoda

The case of Belavoda is by no means unique. In the past couple of years, restructuring of microfinance debt has become downright commonplace – one recent study found that over \$400 million in debt has been restructured since 2007.<sup>4</sup> That same study highlights the presence of a large number of creditors as a significant complication in restructuring efforts.

### Reconsider the Multiple Creditor Strategy

When it comes to managing crises, microfinance institutions are unique. Unlike other financial institutions, most MFIs do not have the option of suspending new lending as a means of preserving liquidity or capital – doing so is very likely to undermine its still outstanding portfolio. While MFIs can successfully shrink their portfolios through attrition and other techniques, some lending to existing clients must nevertheless continue.

For debt-funded MFIs, this structure presents an inherent conundrum – if funding is to be maintained, debt must be rolled over. But when the MFI is underperforming, few lenders are willing to extend new loans. Debt rescheduling is thus often the only realistic option for MFIs under such circumstances. Unfortunately, rescheduling can also be particularly difficult, since it by nature requires unanimous consent from all creditors, or put otherwise, it puts the power of veto in the hands of any one creditor. And those vetoes get exercised more often than one might imagine – countless stories exist of “uncooperative” lenders derailing agreements, including the one in Belavoda’s case that inexplicably refused to waive its covenants.

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4. Charting the Course: Best Practices and Tools for Voluntary Debt Restructurings in Microfinance, IAMFI and Morgan Stanley, 2011.

For this reason, MFIs should be more selective when they establish funding relationships, and keep those relationships to a manageable number. Not only is it easier to work out agreements with fewer parties, but also, creditors with larger funds at stake are also far more likely to attend to the matter with the seriousness it deserves.

The flipside of this is that individual creditors must be willing to extend larger loans, thus insuring that an MFI will not require a dozen or more creditors to meet its funding needs.

### Active Shareholders Make a Difference

A point only briefly mentioned above is the close involvement of Belavoda’s chairman in the inter-creditor negotiations. However, not only was he able to directly support the efforts of Belavoda’s CEO as an experienced financial professional himself, but his presence in the negotiations also brought an important level of credibility. This was especially critical, given that it was his fund that was proposing the capital injection package.

While one cannot know what the outcome would have been without the chairman’s participation, the importance of his presence was specifically mentioned by several creditors.

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Charting the Course: Best Practices and Tools for Voluntary Debt Restructurings in Microfinance, IAMFI and Morgan Stanley, 2011.

Individual interviews

Company and other documents shared on a confidential basis

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