Managing Credit Risk in Microfinance: Challenges in the Wake of the Arab Spring

Enda Inter-Arabe (ENDA), a market-leading microfinance institution (MFI) in Tunisia, was one of the first MFIs affected by a repayment crisis linked to the so-called Arab Spring. However, rather than spiral out of control, ENDA took quick steps to limit the damage while demonstrating an unwavering commitment to its clients. Today, IFC is helping ENDA remain at the vanguard of regional MFIs through the adoption of advanced risk-management practices. This SmartLesson highlights the lessons learned from the crisis, explores the nuances of effective credit-risk management, and shows how MFIs like ENDA can remain ahead of the curve in the years to come.

Background

Tunisia, where a micro-entrepreneur’s self-immolation in December 2010 set off the chain of events now known as the Arab Spring, was at the forefront of a wave of revolutions in the region that brought both promise (the evolution toward more democratic governance) and distress (socio-economic disruptions).

Despite the conventional wisdom that microfinance is countercyclical and typically more resilient in the face of macro-level shocks, the country’s microfinance sector (the MENA region’s third largest, with between 300,000 and 400,000 borrowers) was affected by the economic malaise that followed the revolution. With Tunisia’s economy in crisis, its leading MFI, ENDA Inter-Arabe (ENDA), began to accumulate loan delinquencies across its portfolio.

IFC is currently providing ENDA with an investment and advisory-services package focused on building capacity in key areas, including nonperforming loans and risk management. This support has been timely.

Box 1: ENDA Inter-Arabe

Founded in 1990 as part of the international ENDA Third World network, ENDA Inter-Arabe (ENDA) has risen to become one of the largest and most successful MFIs in the Arab World. In 2003, it became the first, and only, sustainable MFI in Tunisia. In 2011, it achieved full autonomy when it registered as a local NGO. ENDA offers an array of credit products as well as non-credit business development support and training aimed at primarily low-income households and female micro-entrepreneurs. By March 2013, ENDA had over 218,000 active clients, 68% of them women, and an active loan portfolio of US$87 million.

ENDA, which had always enjoyed exceptional portfolio quality, saw its Portfolio at Risk as of 30 Days (PAR>30) rise from 0.3% in December 2010 to over 6% by October 2011. During the revolution, ENDA had to temporarily close some branches, and many of its micro-credit clients were deeply affected by the contraction of the economy. For example, small entrepreneurs near the Libyan border were unable to continue cross-frontier trade (commerce à valise), while much of the wider population faced

1 Ministre de Finance de Tunisie “Vision Concertée pour le Développement de la Microfinance,” 2011
difficulty as inflation rose, revenues from tourism and other key sectors declined, and households refrained from spending.

Like many MFIs, ENDA finances the majority of its credit portfolio through repayments, and thus rising delinquencies—when coupled with a lack of new loan disbursements—presented not only a credit risk but operational and liquidity risks as well. Fortunately, the people, processes, and systems that ENDA had nurtured and put in place over many years proved resilient. Furthermore, before the dust had fully settled, ENDA began working with IFC to proactively implement new measures to enhance its risk management—particularly in credit and operational risk, which historically are the most serious risk areas affecting MFIs—to minimize the likelihood of such a situation recurring, and if it did, to mitigate its severity.

Lesson 1: Stand by your clients, and they will stand by you.²

As a mission-driven organization that was determined to help its clientele in a time of difficulty, ENDA did not merely adopt a reactive approach to rising delinquencies by panicking, turning off the faucet on new loans, and focusing entirely on repayment. Instead, it remained true to two tenets of (micro-) banking orthodoxy: know your client (KYC) and relationships matter. The staff held meetings with clients in all branches to better understand their problems and how best to support them.

The outcome of these meetings included the development of a new “disaster” loan product, which was made available to distressed clients at a subsidized rate, and the selective use of rescheduling and repayment grace periods. ENDA also went on the radio and television to distance itself from the former regime and reiterate its commitment to the poor. Taken together, these steps helped assuage the concerns of both clients and the broader public.

This is not to say that ENDA continued, in the aftermath of the crisis, to grow apace as it had before. Rather, it slowed its expansion and adjusted its incentive system to emphasize portfolio quality over volume. However, it did not turn away from those clients that were most in need. It continued to serve agri-entrepreneurs in at-risk rural areas, opened new branches in the south of the country, and even provided specialized services targeting refugees and returnees from Libya.

ENDA’s financial partners (including IFC) likewise stood by it and continued to make available new loan facilities and support. By 2012, as its portfolio began to stabilize and improve, it even began piloting a start-up loan product for youth entrepreneurs (Bidaya) as well as exploring new channels (mobile banking) as a way to serve clients more efficiently and cost-effectively.

Lesson 2: Develop a tailored recovery strategy.

A deliberate, well-tailored recovery strategy is a critical element of any effective response to rising repayment issues. ENDA quickly put in place a dedicated recovery team, organized high-profile campaigns to collect overdue amounts, and even instructed some of its call-center agents to follow up with delinquent clients by telephone. It also segmented its past-due loan portfolio, based on conversations with clients, into different categories, such as willful default as opposed to default due to economic hardship. This allowed the staff to better target its efforts, including negotiation of new terms and/or collection of partial payments from clients. Later, with the support of IFC, ENDA further tailored its recovery strategy to: differentiate loan officers following up on loans less than 90 days overdue from recovery agents focused on loans more than 90 days late; categorize clients by relative likelihood to repay; highlight more at-risk segments of overdue loans; and understand the effect on provisioning. To assure success, these efforts were well documented and integrated into ENDA’s management information system (MIS) to enable effective monitoring and appropriate follow-up by recovery agents or supervisors.

Lesson 3: Nurture strong relationships with your staff.

Often overlooked in a crisis is the importance of the relationship between an MFI and its staff, and consequently its staff and clients. ENDA employs over 1,000 staff spread across more than 65 branches. After the revolution, many employers in Tunisia began to face more confrontational attitudes from their employees, which challenged work environments and also led to higher turnover rates. While ENDA likewise experienced this change, the strong organizational culture it had built over the years assured it the support and loyalty of its long-time staff, many of whom

² Michael Cracknell, Measures to overcome Revolution-Induced Problems, http://www.cgap.org/blog/measures-overcome-revolution-induced-problems
whom protected branches or volunteered to assist clients in affected areas.

However, ENDA’s management also needed to take quick and decisive action with regard to its personnel. For example, it adjusted salaries to ensure employees had a stable income to offset the lower incentives that ensued from declining loan volumes. It also gave branches and staff new autonomy to resolve issues in the field, and used IFC assistance to invest in additional training on recovery strategies. And rather than give its more experienced staff the difficult task of recovering overdue loans (which was often viewed negatively), ENDA wisely shifted younger and more recently hired field employees into these roles. As ENDA fielded this new team of dedicated recovery agents (RAs), it became necessary to weigh cost against benefit. Indeed, when RAs began collecting smaller amounts than expected, ENDA reduced the fixed amount it paid RAs and increased the incentive-based portion of their monthly salaries, leading to better results. Despite challenges, ENDA’s swift human-resource interventions yielded significant dividends, including keeping staff morale high and improving recovery of overdue loans.

**Lesson 4: Go back to basics: reinforce credit underwriting.**

While much of ENDA’s delinquency was linked to the revolution, coupled with Tunisia’s subsequent economic slowdown and the closing of border with Libya, a close analysis of field activity revealed that staff often deviated from its standard loan appraisal and approval process. For example, loan officers often focused their analyses exclusively on a client’s business and failed to factor total household income and expenses in calculating loan size or a client’s ability to make monthly payments. Furthermore, it was clear that adherence to credit policy varied from branch to branch and region to region.

To address these challenges, IFC supported additional training and implementation of oversight mechanisms in the field to improve and standardize the loan-making and review processes. In addition, it helped ENDA build an automated anomaly-detection system that could be linked to the MIS. The system uses a linear-regression model that detects discrepancies between financial analyses of a client (for example, summaries of business revenue and income, household income and expenses) and the loan amount requested; any anomaly will automatically trigger further analysis. Finally, to reinforce solid credit-underwriting decisions, the institution began deploying credit analysts who helped further develop a risk culture by scrutinizing specific applications.

**Lesson 5: Harness data to create an early-warning system...**

Relying on the portfolio-at-risk metric, a conventional but lagging indicator of microfinance portfolio quality, merely permits the assessment of risk events “after the fact.” Instead, IFC helped ENDA adopt and integrate new tools into its monthly reporting system to monitor the accumulation of credit risk before a repayment problem involving a few clients becomes a portfolio issue. These include vintage curves, which graphically represent default in a given set of loans over time, allowing disbursements to be further segmented by region, product or business unit. ENDA also has adopted the use of transition matrices which monitor arrears in a tabular format by predicting the likelihood of deterioration or improvement in a given category of arrears (30-day, 90-day). Tools of this sort, which constitute leading indicators, can be used for more accurate loan-portfolio provisioning as well as to guide or monitor the effectiveness of collection and recovery strategies, and thus allow MFIs like ENDA to take proactive risk-mitigation measures in a timely fashion.

**Lesson 6: ...and a predictive credit-scoring model.**

Beyond simply measuring and monitoring risk, effective risk management should help avoid or at least mitigate the key risks facing an organization. In the case of financial institutions, credit risk is usually of primary importance. Given its already extensive database of client information, ENDA was well placed to develop a credit-scoring tool that would help it analyze and approve loans with greater sophistication and ultimately reduce losses from avoidable loan defaults.
By mid-2012, with IFC support, a credit-risk expert helped ENDA design an initial scoring model that used predictive statistical methods to analyze the behavior of previous customers and make predictions on the relative credit risk of new clients (e.g., likelihood of default). It was prudent to pilot such a tool offline for up to a year to allow for testing and adjustments to the model. Thus far, the pilot-test has shown strong results, and the tool demonstrates strong predictive ability. ENDA is currently training its staff in the implementation of the credit scoring tool, and hopes to roll it out formally by the summer of 2013. However, credit scoring should neither replace nor undermine the qualitative research typically undertaken by loan officers in the field, nor should it substitute for sound underwriting practices, adequate financial analysis, or strong customer relationships.

**Lesson 7: An independent view -- credit analysts under a risk-management unit.**

Taking a page from the playbook of banks and advanced MFIs (such as those in the Latin America and Caribbean region), ENDA took the difficult step of placing an independent check on its lending and commercial activity: the creation of a credit analyst position. In principle, a credit analyst’s role is straightforward: to focus exclusively on portfolio quality by assisting with ongoing credit scoring; to further analyze loans that meet certain risk criteria; and to assess incidents and/or default patterns.

However, implementation has been challenging, and ENDA continues to face a number of key questions. One of these is how to select the right candidates. Thus far it has begun using high-performing loan officers who have aspirations for greater responsibility and who view the role of credit analyst as a step forward career-wise. A second important consideration is how many credit analysts are sufficient vis-à-vis the portfolio or staffing size, and how to quantify their contributions vis-à-vis the costs they incur. Furthermore, should credit analysts be based in the field or at headquarters? How should they be deployed? To whom should they report?

Risk-management units typically do not insert themselves into the daily business of MFIs. They should ideally retain an independent outlook and focus on making recommendations about risk rather than getting pulled into battles with operations staff, whose commercially driven goals are at odds with their own. However, credit analysts do the opposite: they frequently curb unfettered growth and bedevil staff and managers who have portfolio targets linked to incentives. Still, these conundrums are not unusual; each MFI must find its way, taking into consideration sound practice, its own unique character, and risk tolerance.

**Conclusion**

Today, Tunisia and the wider region continue to suffer from political and social tension, rising unemployment, and slower economic growth, all of which present an elevated risk environment for MFIs. This is particularly relevant to the sector as the country’s regulatory body for microfinance prepares to enact new legislation that may transform the sector by allowing for new commercial entrants.

With the support of IFC, ENDA has absorbed the lessons of the crisis and relatively quickly returned to sustainable growth and strong portfolio quality while setting high standards among MFIs in the region in the management and handling of risk. Its success is critical: estimates put the number of micro-entrepreneurs still with limited or no access to finance in Tunisia at 1.2-1.4 million (nearly 12% of the population).

In fact, as part of its regional strategy, IFC is now providing risk-management advisory support to other MFIs to help them adopt and integrate advanced risk-management tools and systems into their operations, measure and mitigate risks, and continue to expand outreach to low-income households in a more sustainable manner. Given its achievements, Tunisia and ENDA are well placed to remain at the forefront of MFI developments in the MENA region.