MicroRate Research



# GROUP METHODOLOGY, MAIN RISKS AND THREATS

Analysis Team

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While the placement of microcredits in a group expresses the essence of microfinance by its attention to the base of the pyramid, it may be the placement mechanism that is most exposed to operational as well as reputational risk.

In the experience of MicroRate, the operational risk in group methodology is furthered when the regulation of the group's operations is imprecise. There is a high level of manipulation of cash (in disbursement and collection sessions), a relaxation of credit policies and, in general, insufficient control. To this is added a comparatively higher turnover of loan officers, which is explained, in part, by the challenge they face to serve groups in dispersed and inaccessible localities.

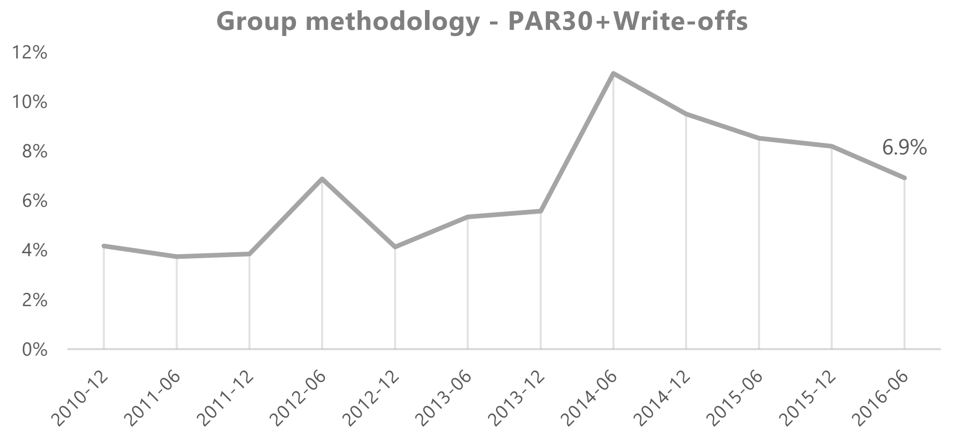
If the rules are not clear from the formation of the group, the effectiveness and implementation of the operating norms loses relevance. When the members of the group are practically unknown (a fundamental aspect), the estimation of individual payment capacity and sufficient knowledge of the character of the borrower are weakened. If the minimum rules of assistance are also not respected, understandably, few members will internalize the sense of solidarity required.

Each institution that generates exceptions to the rules, however, gains importance and generates confusion among the borrowers and leaves the door open to bad practices. Some of these include tolerance of absenteeism, late delivery of payments, the reformation of groups without mutual knowledge of their members, an excess of family members in groups (which affects objectivity in the collection process) and the limited renewal of the leadership, among others.

In the face of this scenario, the deterioration in the management of credit risk can be expected. In fact, the indicators of the MicroRate Benchmark for group methodology show higher levels of total portfolio risk (PAR 30[1] + write-offs) than those registered 5 years ago.

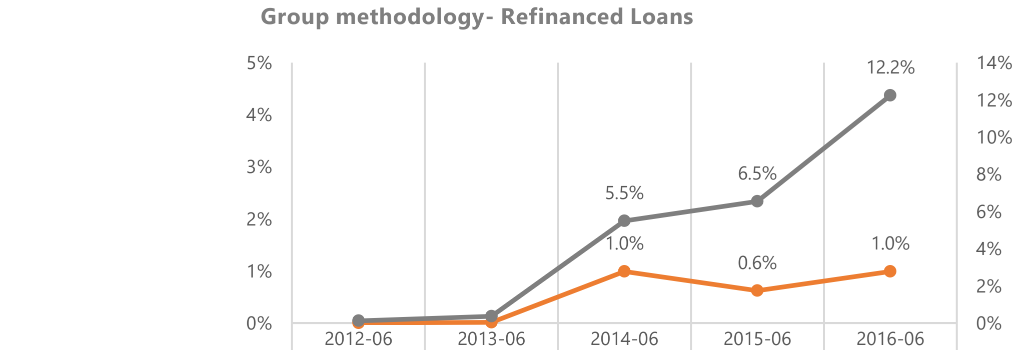


[1] Balance of portfolio at risk more than 30 days plus refinanced operations




Source: Benchmark MicroRate

Likewise, the trend of its refinanced portfolio compared to the total loan portfolio is also increasing, while this type of restructuring operation is exceptional in the face of the strength of the pressure and the group support. According to the data analyzed, in June 2016, the refinanced total is 1 percent of the total gross portfolio and contributes 12% of its loan portfolio at risk result.




| | 2012-06 | 2013-06 | 2014-06 | 2015-06 | 2016-06 |
|---|---|---|---|---|---|
| Ref. / Gross Loan Portfolio | 0.0% | 0.0% | 1.0% | 0.6% | 1.0% |
| Ref. / Portfolio at Risk | 0.1% | 0.4% | 5.5% | 6.5% | 12.2% |

Source: Benchmark MicroRate

The improper or fraudulent use of the money collected in the groups adds not only to the credit risk (to the unpaid amount of the "missing" money) but also to the reputational risk for its high and immediate impact on the desertion of borrowers, as well as their adverse effect on the MFI's financial profile.

The systematization of the operational process (disbursements and repayments) in a world in which information technology is proactively evolving is helping MFIs to mitigate the risks associated with the handling of cash, the discrepancy in records, the loss of payment documents and occasional assaults.

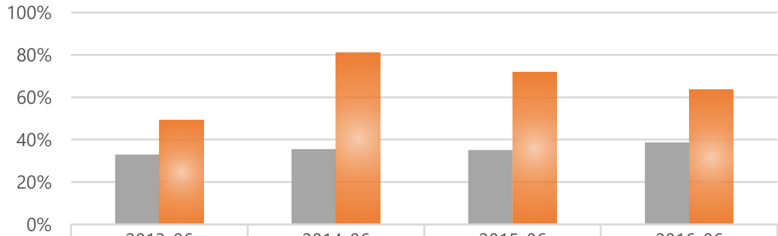
Bad practices in the management of money, in MicroRate's long experience, have involved not only credit officers or solidarity group leaders, but even entire branches in an apparent collusion.

What is worrisome at this level is insufficient control from the entity that, under best practices, is usually promoted by the highest levels of management. More than high-level sophistication in monitoring, it has been observed that random and recurrent technical monitoring during the year is sufficient, efficient and effective, even to prevent the risks mentioned above.

One of the factors that constantly threatens the operability and results under this type of methodology is the high turnover rate of the credit officer, which is higher than in entities that focus on individual methodology. Some reasons include an overload of manual processes (even more so when connectivity and technological access are limited); arduous field work and dishonest practices, but above all, MicroRate notices an inadequate management of the human resource.

Processes such as selection, promotion (absence of a well-defined and widespread career path), compensation (with personnel not valuing monetary and non-monetary incentives) and retention mechanisms are often inadequate or non-existent for a challenging job position.

**Benchmark MicroRate - Credit officer turn-over according credit methodology**



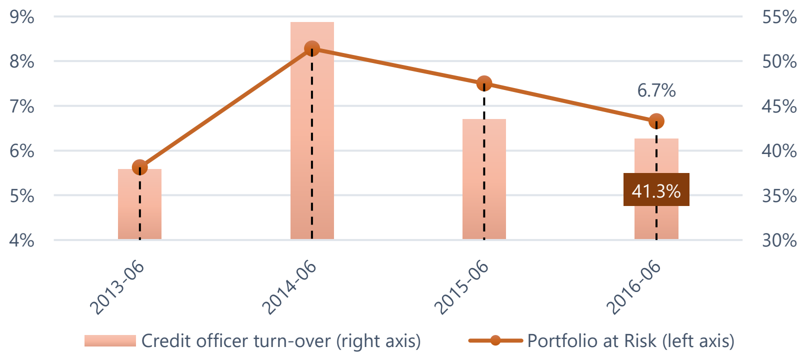

| | 2013-06 | 2014-06 | 2015-06 | 2016-06 |
|---|---|---|---|---|
| Individual Lending MFIs | 33.0% | 35.6% | 35.1% | 38.6% |
| Group Lending MFIs | 49.3% | 81.2% | 71.9% | 63.7% |

Source: Benchmark MicroRate

If the instability among the operating personnel is not brought under control, the deterioration of credit risk increases and becomes threatening.

Based on data analyzed by MicroRate, there is a high correlation between staff turnover and portfolio at risk. Thus it continues to be important to have a team of employees that, with a profile in line with the institutional mission, remains as stable and committed as possible.

**Benchmark MicroRate - Relationship between Credit officer turn-over and Crédito and Portfolio at Risk**




Source: Benchmark MicroRate