GOOD PRACTICES - CASE IDENTIFICATION /1ST LEVEL ANALYSIS

KIZ SINNOVA Gesellschaft für soziale Innovationen gGmbH

1. Good Practice title: DMI's high-growth early warning system

Technological innovation: Risk management for fast growing portfolios. When the number of borrowers increases significantly in a rather short period of time, potential risks are hidden. The usual PAR 30 or PAR 15 indicators do not provide sufficient information to identify risky loans/borrowers.

When MFIs are fully occupied with managing their growth (coping with high case load, hiring new staff, etc.), they generally neglect their monitoring and risk management duties. In such cases a neutral supervisory body is needed that controls market risks. In Germany, DMI has taken over this function. At the end of 2011, problems and aberrations occurred within individual German MFIs due to their rapid growth (some MFIs grew more than 200% on a yearly basis). DMI wanted to draw lessons for the whole sector from this situation. The existing DMI benchmarking and risk reporting that had been scientifically developed in 2006 was already very detailed and had proven its worth in making apparent diverse inherent risks as "window-dressing". However it still had a weak point when it came to making transparent the risk concealed by growth. Therefore, in April 2012, with funding from the German Federal Ministry for Labour and Social Affairs, DMI ran a pilot project with the aim of developing and testing an early risk warning system to better control dynamically developing MFIs. Designed by a consultant in cooperation with two German MFI practitioners, this new system was subsequently built into the DMI monitoring and risk management system *Inthepro*. As of May 2012 it is available for all of DMI member MFIs.

2. Territory of implementation/application (country/region/...)]

The early warning system was developed for all accredited MFIs in Germany and was used to monitor MFI's externally from an independent organisation (DMI). It has also been available for MFI management to very potential risks.

3. Timeframe:

year of introduction: 2012 year of termination: *(leave 0000 if ongoing)*

4. **Brief description of the promoting organization:**

DMI is the umbrella organisation of German MFIs. It’s main task is to assure quality of the whole microfinance system and support MFIs with dedicated services, such as training, quality management, risk management, software, reporting etc. KIZ supports entrepreneurs setting up their own businesses with a focus on inclusive entrepreneurship. From the very beginning it was clear that in order establish a sustainable and scalable microfinance system in Germany technology is essential for efficient processes.

5. **Main objective of the initiative:**

Sustainability is one of the most important issues for MFIs. The greatest risk for German MFIs is the risk of defaults, since they have to cover 20% of the first loss of their portfolio from their own resources.

The high-growth early risk warning system has become an essential part of the German microfinance sector: (i) it can be used by all DMI members via the DMI Inthepro MIS provided by DMI for free; (ii) it has been included into the DMI accreditation and reaccreditation procedure. From a strictly cost-perspective, the system is sustainable. The cost of development and testing amounted to a total sum of approximately 6,000 euro. This means the project was covered financially after one single loan was prevented from defaulting with its help (the average loan amount in Germany is 6,000 euro). Finally, the system is also highly beneficial from an MFI point of view. A study carried out by DMI in 2012 on processing costs showed that an MFI’s total revenue for an average microloan of 6,000 euro amounts to a maximum of 1,000 euro. This means a German MFI needs to disburse six or seven loans in order to recover the revenue of only one defaulted 5,000 euro-loan.

6. **Brief explanation of the initiative:**

Due to its simple formula and relatively low costs, the early warning system can be easily adapted to other microfinance markets. It can be used by individual MFIs and programmed into their MIS system and/or operated by a national microfinance umbrella network or fund manager through a national IT platform. An essential pre-condition is the availability of reliable and complete data, which can be a challenging task, especially if there are several partners cooperating in the system such as in Germany. To sum up, there are three main tasks to replicate the system successfully:

7. **Target group and measures to involve the target group:**

Some MFIs stepped forward and discussed potential risks of defaults, reputation and sanctions at DMI's yearly assembly. As a result the early warning system has been developed and implemented to create transparency and quality.

8. Innovativeness:

The DMI high-growth early warning system enables rapidly expanding MFIs, as well as higher-level bodies, to closely monitor and control risk. Warning levels are defined and made visible via a traffic light function and concern 3 main areas:

- Monitoring directly growth-related risk: the growth rate measures the dynamics of growth indicating whether the loan volume exposed to risk grows faster than the total loan volume; in addition the delayed risk ratio shows the real risk a high-growth MFI faces.
- Managing cluster-risks: monitor the portfolio risk regarding certain characteristics such as the cooperation/sales partners who recommended them, target groups / sectors as well as loan sizes.
- Calculating expected future loss: the system is derived from the "classical" banking sector: based on the past repayment behaviour of existing clients, a prediction about future loan loss is made. A prognosis is thus made about an essential component of an MFI's sustainability.

9. Outcomes:

The impact and potential impact of the early warning system for high growth MFIs is significant. First of all, it leads to a change of focus as the system sets the focus from the beginning on a controlled and well-balanced growth with a positive impact, on both the MFI and the microfinance clients. Secondly, the system has the potential of preventing the whole German microfinance market, which is still rapidly growing (nearly 240% from 2010 to 2011 and another 75% from 2011 to 2012), from collapsing or being buried by a risk avalanche. As of December 2012, the German sector had very low risk and default rates: 10.5% PAR15 and 4.2% write-off. Thirdly, the warning system contributes to maintaining the good image of microfinance, considering that if only one MFI should collapse, all others will suffer due to negative headlines and bad reputation. Finally, the potential impact of the system is significant for microfinance markets in other EU countries.