

RISKS AND MITIGATION MEASURES

1. Microfinance has proven to be a critical element of an effective poverty reduction strategy and the term “microfinance” refers to a range of financial services for low-income people, including credit, savings, insurance, and money transfers. Microfinance institutions (MFIs) could comprise licensed and unlicensed financial institutions that include non-government organizations (NGOs), commercial banks, credit unions and cooperatives, and agricultural and postal saving banks. Given this, the credit risk that ADB will undertake will be on (i) the underlying MFIs; (ii) the participating financial institutions’ (PFIs) ability to select strong and sustainable MFIs; (iii) the PFIs’ internal credit and risk management processes; (iv) the quality of management information systems (MIS); and (v) the management team. ADB’s due diligence process will cover all of these areas for each PFI considered under the program.
2. In addition to the inherent risks associated with emerging markets investments and in particular to the microfinance sector, risks embedded in the transaction, and potential mitigants, will include those listed below.
3. **Risks related to MFIs.** There are risks associated with the creditworthiness of the underlying MFIs. These include the level of demand for microfinance borrowing, liquidity and financial sustainability, and operational and governance risks. Credit risk at the MFI level can also be influenced by over indebtedness among microfinance borrowers, given the lack of credit data available in the microfinance sector and the absence of credit bureaus in many countries. There also tends to be inconsistencies in the method of financial reporting by MFIs. ADB will utilize internal ratings performed by PFIs that are mapped to the default frequency and external rating scale of international rating agencies where available to assist in comparing MFI standing and performance. However, in certain instances where PFIs do not have an internal rating scale, a more rigorous approach will be followed in assessing the credit risk of individual MFIs. Some MFIs have also experienced difficulties in managing growth and expanding into new product lines, which will be carefully assessed during the credit review process.
4. The risks associated with individual MFIs and their operations are best managed through in-depth knowledge of the institution and the environment in which the MFI operates. Through their regional network, personnel on the ground, and close borrower contact, PFIs are best positioned to assess and manage this risk. ADB will therefore rely to a large extent on the PFIs’ experience in their markets, and the PFIs’ rigorous underwriting and monitoring standards to mitigate risks related to the individual MFIs. ADB’s due diligence of the PFIs’ internal standards and systems therefore forms a critical component of ensuring MFI risks are managed appropriately.
5. **Partner financial institution performance risk.** As stated, ADB will substantially rely on the operational and business judgment of PFIs given their industry experience and expertise. The PFI remains the loan originator and servicer, so adequate credit quality of the PFI is important for continued maintenance of the facility. Financial difficulties with the PFI could impair its ability to process and manage the MFI loan portfolio. The ability of PFIs to maintain acceptable ongoing performance levels may therefore be impacted by such issues as changes in risk appetite, staffing and recruitment, maintenance of credit underwriting and monitoring procedures, and market forces. With these concerns, ADB will endeavor to select PFIs with sound MFI assessment and monitoring systems, a solid track record of building an MFI portfolio and one that has an acceptable credit profile as determined by the selection criteria for PFIs

(Table 1). Further, through equal sharing of risk between ADB and the PFI in most cases, the PFI will be sufficiently incentivized to maintain high loan origination and monitoring standards.

6. **Regulatory and reputation risk.** The MFI industry in many DMCs may not yet operate within a robust regulatory framework, and MFIs may therefore be susceptible to political interference. MFIs have also been criticized for charging high interest rates, leading to calls in some countries for interest rate caps and requests for debt forgiveness to distressed borrowers. Politicians have also questioned the practices and collection methods of certain MFIs. There is potential reputation risk for ADB if the MFIs selected under the program are engaged in illegal and unethical lending practices. In consultation with PFIs, ADB will assess the suitability of each MFI client, and take into account the local regulatory and political environment in ADB's review process. Furthermore, to ensure that the portfolio meets the above standards, ADB will conduct stringent due diligence on PFIs to ensure that each PFI has an appropriate screening mechanism for MFIs. The due diligence will, amongst other areas, evaluate that in selecting the MFI, the PFI has ensured that the underlying MFIs are legitimate and indisputable, are respected and well reputed and have an outreach and social agenda that they are able to report on and monitor.

7. **Geographical concentration of the reference entities.** The MFIs conduct their business in limited countries throughout Asia. The geographical concentration of the MFIs may therefore result in a greater risk of loss than if such concentration had not been present. This risk can be managed through analysis of the reference MFI portfolios when new PFIs are considered under the program, and through reaching agreement with PFIs on new target countries and new MFIs for participation under the program. Eligibility criteria can also be built into terms agreed with PFIs to ensure underlying exposure does not become overly concentrated in particular geographic locations, or to specific MFIs being funded by more than one PFI. Furthermore, geographic concentration risk will be safeguarded by internal reviews of exposure limits for MFIs in each country.

8. **Credit risks of micro-loans.** All of the loans covered under the program will be to MFIs that extend credit to micro-entrepreneurs and microenterprises in developing countries. Most of these micro-borrowers have low incomes and little or no previous credit history. History has shown that risks associated with microloans can be managed through features such as group lending models and taking certain types of collateral. MFIs have also started to lend to microenterprises based on enterprise cash flows. Therefore, selection of MFIs with an ability to assess these risks is important for PFIs. The PFIs' own standards for underwriting and managing their MFI lending portfolio are therefore critical to ADB in the context of the program.