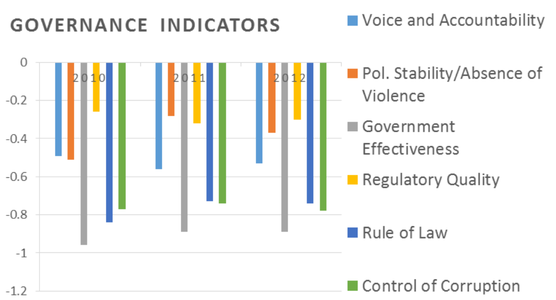
SCBF #2011-08 August, 2014

Building Risk Management Capacity with FINCA to Increase Outreach in Nicaragua

1. Development relevance

Economic and Poverty Context: After decades of political instability, and vulnerable to natural hazards, Nicaragua's economy has improved, with 3,2% annual average GDP growth between 2008 and 2012, and 4,6% in 2013. Inflation fell from a high of 25% in mid-2008 to an average of 8,8% from 2008 to 2012 and 5,7% in 2013. Export production has been a key engine of growth, notably non-traditional products, like textile, apparel, gold, seafood, and new agricultural products such as peanuts.[i] Nevertheless, traditional products (mainly coffee, meat, and sugar) still lead the list of exports and agriculture remains the most important sector. The strong economic ties with Venezuela (e.g. promotion of mixed business initiatives, owned by the Nicaraguan and Venezuelan state oil firms) could take a negative turn due to the ongoing crises in Venezuela.

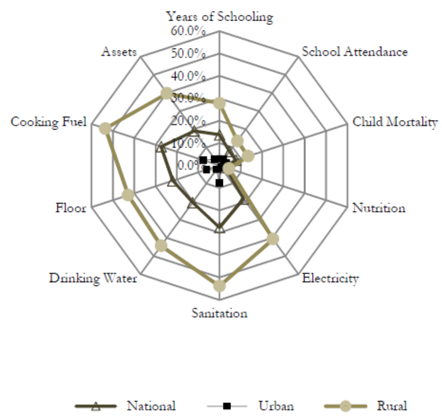
Population and Economic indicators	
Population (in thousand, 2011)	**5'997**
GDP growth (average: 2008-2012)	**3,2%**
Inflation (average: 2008-2012)	**8,8%**
Trade balance (% of GDP, 2011)	**46%**
Foreign Direct Investment (net) (% of GDP, 2011)	**10%**
Net ODA & official aid received (% of GDP, 2011)	**7%**
Workers' remittances (% of GDP, 2011)	**9%**
Economic Freedom Index[ii] (Rank among 185)	**58,8**



Despite of recent macroeconomic improvements, Nicaragua remains the second poorest country in Latin America after Haiti with a 42,5% national poverty ratio in 2009 (World Bank) and roughly 45% underemployment (CIA Factbook, 2011).[iii] Natural disasters and distortion of commodity prices in the international market led to an increase in poverty in several regions. Poverty is largely a rural problem and close to half of the people live in rural areas. Off-farm activities are an important source of income and at least one member of most rural families works off the farm.[iv]

Poverty indicators	
GDP per capita (current USD, 2011)	**1'631,7**
Gini Index (0= equality 100= inequality) (year)	**N/A**
Multidimensional Poverty Index (1=poor 0=not poor) (2009)	**0,128**
National Poverty Ratio (World Bank)	**42,5**

Percentage of Population MPI Poor and Deprived[v]



Financial Sector Context: The Nicaraguan microfinance industry suffered a profound crisis in 2009 and 2010 as a result of the global financial crisis and the domestic *no pago* (no payment) movement led by over-indebted clients. Heightened by political interference, these events left the microfinance institutions (MFIs) both illiquid and unpopular. MixMarket statistics show a loss of more than 200'000 clients across MFIs between 2007 and 2010. Total loan portfolio dropped from USD 420 million in 2008 to USD 170 million in 2011. Despite heavy write-offs, portfolio-at-risk (PAR30) was still at 19% in late 2010.[vi] The Nicaraguan Bank Superintendence (SIBOIF) adopted a very cautious attitude in allowing MFIs to diversify their products, notably to accept deposits, following the liquidation of BANEX, the then largest microfinance bank. A new microfinance law became effective in 2012 allows for the transformation of NGOs into a regulated financial company.

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In June 2013, the Nicaraguan MFIs served 232'242 clients through 189 branches across the country,[1] with Pro Mujer Nicaragua, Financiera FAMA, FINCA Nicaragua and Prodesa being the leading institutions in terms of number of active borrowers and ProCredit Nicaragua, Financiera FAMA and FUNDESER (Fundación para el Desarrollo Socioeconómico Rural Nicaragua) in terms of gross loan portfolio (GLP).[vii] Between 2004 and 2012, the total number of commercial bank branches has grown from 157 to 277. Automated teller machines went from 112 to 462 in the same period, and deposits accounts at commercial banks per 1'000 adults from 163 to 253. All these indicators show a positive trend for financial inclusion over the last decade.[viii] However, one in ten of the country's roughly 3,1 million adults only has currently a loan from a MFI.[ix] Only 12% of microenterprises can access a loan with MFIs as the main source.

Partner financial intermediary (data in USD)					
	2008	**2011**	**2012**	**2013**	**2015**
Total assets (´000)	8'827	10'058	14'061	24'470	45'458
Gross loan portfolio (´000)	6'783	7'640	11'543	19'119	37'490
Total deposits value*	N/A	N/A	N/A	N/A	N/A
Total staff/women	160	127	150	187	243
Total office	**256**	**218**	259	321	**427**
Total clients	22'573	15'483	27'561	41'588	54'810
Total branches	14	13	12	14	18

Financial Partner: FINCA Nicaragua was established as a not-for-profit MFI in 1992. Its mission has been to offer financial services to the lowest income entrepreneurs so that they can create jobs, build assets and improve their standard of living. In 2009, it has transformed into a regulated financial institution (*financiera*) in order to be able to offer a wider range of services to its clients, including savings products. It received its banking license in April 2011 and transferred its assets from the not-for-profit to the *financiera*. FINCA Microfinance Holding Company (FMH) has a 98,8% equity stake in FINCA Nicaragua. In turn, FINCA International, Inc., has majority ownership and control of FMH with 61,06% equity ownership and maintains veto power over any changes to the mission. FMH was created to facilitate access to socially responsible capital to deepen FINCA's presence in existing markets and enter new, underserved markets in a sustainable manner.

In 2009, the microfinance sector was adversely impacted by domestic political instability, the negative effects of the global economic crisis, and the development of the *no pago* movement. As a consequence, FINCA Nicaragua decreased its client base by 22% and its loan portfolio by 4% in 2010. As of August 2011, it had total assets of USD 8'820'681, equity of USD 2'346'215, and served 14'602 clients, thereof 74% women. It employed 207 staff in 14 branches (indicated in the map).[2]

FINCA Nicaragua offers several credit products, including individual loans and village banking loans (a type of group loan), ranging from USD 250 to 10'000 with an average loan size of USD 412. Its competitive advantages are its range of products and quick response to loan applications. It also offers a credit life insurance product linked to the client's credit account as well as money transfer services through a partnership with Western Union. In June 2013, it had a market share of 8,4% in GLP (USD 13,5 million) and 14,7% in outreach (34'294 clients) having the 4th rank in GLP and the 3rd rank in outreach.[x]

2. Intervention approach and additionality

Capacity Building Needs: Despite obtaining its banking license in 2011, FINCA first needed to fulfilled specific regulatory requirements - notably a bank-like risk management system - prior to regulatory authorisation to accept deposits planned for 2015. Therefore, SCBF has supported the development of a state-of-the-art risk management system in compliance with regulatory requirements that addresses the following three major impediments to scaling up lending services and introducing savings services:

- To automate and professionalise reporting to increase efficiency, reduce errors and meet regulatory requirements, as FINCA Nicaragua created manually more than 60 reports previously.
- To build disaster recovery and business continuity plans in line with regulatory requirements, as

[1] Excluding Financiera FAMA, which is not part of the network.
[2] During 2013 FINCA opened two new branches in Jalapapa (north) and Somotillo (west).

FINCA Nicaragua had previously an insufficient business continuity management system for ensuring operation under adverse conditions.

- To develop procedures to systematically manage risks of fraud and money laundering in its operations so as to safeguard its funds and to comply with specific regulatory rules.

Intervention Approach: External consultants were hired to support the in-house development of the risk management system with focus on asset-liability management and being supervised by the risk manager with back-up support from FINCA international staff. FINCA had originally anticipated purchasing risk mapping software, however the consultants developed the tools and risk matrix which eliminated the need for acquiring this software. Work on the risk management system addressed the key impediments of (1) pre-dominantly manual reporting capabilities. Furthermore, it allowed (2) the development of a Disaster Recovery and Business Continuity Plan, and (3) the development of a system for the analysis of loan repayment data on a real-time basis.

Additionality: By addressing high priority risk management issues and build sustainable, best practice solutions more rapidly, FINCA Nicaragua has made a big step forward in obtaining its deposit taking licence and in up-scaling its lending services faster and more effectively. Equally importantly, the SCBF support has allowed replicating the risk management systems developed and lessons learned throughout FINCA's subsidiaries in Latin America.

3. Results achieved

3.1. Client level

The 'state-of-the-art' risk management system will enable FINCA Nicaragua to safely expand its borrowers' clientele as projected in the table below. Furthermore, it constitutes an essential precondition for obtaining a deposit-taking licence in 2015. The offer of savings products will likely meet strong client needs.

Outreach	2008	2011	2012	2013	2015
Number of borrowers	22'573	15'483	27'561	41'588	54'810
% of female borrowers	77	77	77	76	74
Average loan balance per borrower	300	493	419	460	684
Rural Borrowers as % of Urban	35,9	49,0	64,7	86,4	90,5
Clients according to income level					
-below 2 USD/day	N/A	N/A	53%	N/A	N/A
-between 2-4 USD/day	N/A	N/A	41%	N/A	N/A

3.2. Partner financial institution level

The new risk management system was successfully implemented by the end of December 2013 when FINCA had:

- **Improved operational oversight and automated reporting to comply with regulatory requirements**: Special attention was put into correcting inconsistencies in the Credit Bureau Report. The following are some of the products developed for risk management:
  - Models and tools for Credit Risk Management: Analysis of contagious default for credit risk, portfolio concentration risk, indicators of portfolio efficiency.
  - Models and tools for Liquidity Risk Management: Tools for analysis of the asset/liability match and volatility of liabilities.
  - Models and tools for Market Risk Management: Tools for the analysis of interest rate risk and currency exchange risk, including stress analysis.
  - Models and tools for Country Risk Management: Tools to evaluate country risk, reports for monitoring the risk of commercial partners and macroeconomic indicators.
  - Models and tools for Integral Risk Management: Methodology of early alerts, reports for monitoring all indicators of all the risks to which FINCA Nicaragua is exposed.

- **Built Disaster Recovery and Business Continuity Plan and** set up of an alternate data center in the city of Juigalpa.[3] Related products were (1) methodology and tools for generating the business impact analysis, and (2) methodology and tools for generating contingency, continuity and disaster recovery plans.
- **Developed procedures to prevent and control for the risk of fraud and money laundering:** This included the purchase of Anti-Money-Laundering software, which allows for the monitoring of all suspicious activities and accurate record keeping.

Two members of the FINCA Nicaragua staff received training in the use of the tools, and also manuals, procedures and guidelines for risk management activities (improved operational oversight and automated reporting). Two staff members responsible for risk management were trained in DS/BCP as well as the risk management tools. 73 staff members were trained in the BCP and 36 staff members were trained in integral risk management. Training in anti-money-laundering has been provided to all existing staff members and is provided to new employees as well.

As a regulated financial institution, FINCA Nicaragua has become stronger compared to non-regulated competitors. This has been reflected in receptivity by lenders even when the market had not as a whole proved to have overcome the 2009-2011 crisis. Since early 2012, FINCA Nicaragua was able to attract funding while other competitors were still struggling with liquidity issues.

Key performance indicators*				
	2011	**2012**	**2013**	**2015**
ROA[4]	-7,3%	1,5%	2,2%	1,8%
ROE	-28,4%	4,3%	7,6%	7,8%
Operating Self-sufficiency	79,3%	98,2%	103,1%	107,4%
Capital adequacy ratio (SIBOIF)	32%	18,0%	17,6%	14,1%
Client per staff	71	106	130	128
Borrower per loan officer	172	238	325	349
PAR>1	2,6%	1,4%	2,8%	3,5%
PAR>30	1,5%	0,8%	1,4%	2,0%

3.3. Financial sector level

FINCA Nicaragua will share the learnings from the implementation of the risk management system with other FINCA Latin American subsidiaries via the FINCA International staff who was involved in the risk management exercise. In fact, some of the dissemination has already taken place, like the sharing of process maps with all subsidiaries. Risk management reports generated with the new tools have been shared with FINCA Honduras to use as a model.

Learnings from Nicaragua will have regional relevance as MFIs across Latin America seek to build the system to gain regulatory approval for new product lines. To date, in Nicaragua there are only two regulated financial institutions specializing in microfinance: FINCA and Financiera FAMA. In 2012 and 2013 FINCA Nicaragua held meetings with its larger competitors FUNDESER and FDL (Fondo de Desarrollo Local) in order to share the experiences and lessons learned through the transformation process into a regulated financial institution.

4. Lessons learned and further challenges

- A person was required to monitor, co-ordinate and follow up on the technical assistance received from different consultants so as to avoid delays.
- Implementing a Business Continuity and Disaster Recovery Plan requires involvement of all key areas of the organization, and takes a period of preparation to set the basic conditions needed (e.g., mapping all processes, building evacuation routes at branches, implementing an alternate data center that is ready to use by the time the plan will be implemented). This process took more time and was more complex than originally anticipated.
- Ensuring regulatory compliance is a continuous process. Operational and reporting flexibility is needed to adapt to revisions of main regulatory topics.
- Based on the successful implementation of the project, FINCA Nicaragua had planned to introduce savings by early 2014, assuming that FINCA was able to secure regulatory approval. However, FINCA decided to postpone the request to get a deposit taking license until 2015. This

[3] Juigalpa is located 139 km from Managua, Nicaragua's capital and FINCA's Nicaraguan headquarters.
[4] The calculation of ROA, ROE and OSS does not include income from donations or subsidies.

decision was made in order to:

- Accommodate the implementation of a new Management Information System (MIS; after December 2014), which is being put into place throughout the FINCA network. Implementation takes resources and management focus. With its completion, FINCA Nicaragua's capability to broaden its product offerings to client will be enhanced. The risk management framework as well as the DR/BCP and the Anti-Money-Laundering programs will not change with the introduction of the new MIS.
- FINCA management felt there was the need to develop better and more efficient client attention processes (e.g., reduce the time of response at a branch, reduce the time of disbursement, and properly address client complaints) before introducing more products.

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[i] The CIA World Factbook, https://www.cia.gov/library/publications/the-world-factbook/geos/nu.html (Mai 2014).
[ii] Heritage Foundation, 2013. Index of Economic Freedom, http://www.heritage.org/index/ranking (Mai 2014).
[iii] Where not indicated differently, the source of the indicators is: www.worldbank.org/en/country/nicaragua/overview (April 2014).
[iv] www.ruralpovertyportal.org (Mai 2014).
[v] Oxford Poverty and Human Development Initiative OPHI.
[vi] Center for Financial Inclusion Blog, January 24, 2011.
[vii] MixMarket, December 2013.
[viii] Financial Access Survey, International Monetary Fund.
[ix] FINCA analysis based on figures from MixMarket.
[x] Based on a market comprised of the MFIs that are part of the Nicaraguan microfinance network ASOMIF.