GENERAL PRINCIPLES OF EFFECTIVE ASSET LIABILITY RISK MANAGEMENT IN MICROFINANCE

Principle 1) Risk management is a shared responsibility among MFIs, Investors and Donors

- Donors and Investors should understand their MFI clients ability to address balance sheet risk and provide appropriate loan products. Donors and investors should be transparent about the risks and costs of the products they are offering to their clients.

- Donors, Investors, and MFIs should not mitigate their risk by passing it on to their respective clients, who are often less equipped to address it. Failure to do so neglects client welfare while increasing regulatory and political risk for the industry.

- The microfinance industry should actively work to increase the alternatives and information available for measuring and hedging or otherwise mitigating risk.

Principle 2) Measuring risk is a central part of measuring performance

- MFIs should understand their interest rate, foreign exchange and liquidity risks in order to develop balance sheet risk objectives. MFIs should only seek out financing products that are most suitable to meeting those objectives.

- MFIs should actively monitor portfolio risk, including across loan officers, branch offices, demographic variables, loan products, credit yields etc. Such monitoring should also include forecasting and historical analysis.

- MFIs should be cognizant that concentration of credit and balance sheet risk can be masked by healthy portfolio growth during periods of favorable economic conditions, and should maintain capital buffers accordingly.

- MFIs should use technology to improve operational efficiency and adopt standard accounting practices to provide transparency to donors and investors on their exposure to these risks.

- MFIs comparing local vs. hard currency loan alternatives should consider the potential impact of additional FX risk in their decision making.

- MFIs and investors should understand the tradeoff between currency risk and credit risk, and consider that when pricing local vs. hard currency loans.

- Asset liability risk management education should be a priority and promoted throughout the industry.

- Balance sheet risk exposure data should be collected and aggregated to allow for industry level analysis on the level of risk the industry is exposed to.

Principle 3) Adopt a comprehensive approach to managing balance sheet risks

- MFIs should establish clear performance objectives, and enact polices which will guide them in achieving these objectives.

- MFIs should set up formal Asset-Liability Committees (ALCOs) responsible for creating a funding plan and managing balance sheet risk.

- MFIs should ensure that they do not compromise underwriting standards to maintain market share or origination volume in the face of market pressures and competition.

- MFIs should understand the extent of material risks they are subject to in cases where loans originated by them are sold to third parties.

- MFIs should adopt a risk management framework that includes:
  - development and execution of appropriate risk management strategies;
  - regular assessment of performance against objectives;
  - based on those assessments, feed findings back into iterative framework updates and improved strategies.

- MIVs and MFIs should seek out the most cost-effective tools to measure and mitigate risk including currency and interest rate derivatives and loan portfolio analytical tools.

- MFIs should collect data, store it in a way they can use it, analyze it, and adjust based on what they find to achieve both social and financial objectives.