Microfinance and Disaster Management

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Abstract

Most Microfinance Institutions (MFIs) cannot ignore the possibility of being impacted by natural disasters. Many operate in communities and regions where natural disasters are an annual event. Natural disasters such as those caused by flood, storm, earthquake, Tsunami, fire, etc. are a harsh fact of life for many poor households and therefore, for the microfinance institutions (MFIs) that target them.

Natural disasters have a severe impact on the income and assets of poor households. This paper discusses financial coping strategies of poor households and highlights a range of financial products that MFIs can offer to assist these households to manage their finances through difficult times.

This paper enunciates policies and strategies to help MFIs prepare for the impact of natural disasters. MFIs will be better placed to respond effectively when a disaster strikes if they has worked through the issues, designed policies and products, and negotiated collaboration with Disaster Management Agencies (DMAs), *before* disaster strikes rather than in the midst of it.

Introduction

Phnom Penh, the capital of Cambodia, experiences an annual flood every year during September/October, when monsoon rains to the north swell the rivers of the lower Mekong delta. For many, the high waters are a refreshing sight, as they signal cooler weather to come. They also help to flush out the river systems, and the silt deposited on the flood plains helps to keep the soil fertile. The annual flood is, for many, a potent symbol of life and renewal. It is not a "disaster" but an "event".

Many of the city's poorest people live in slum communities to the south-east of the city, along the banks of the *Tonle Bassac*. One such community is a commune called *Chbar Ampeou*, which literally means "Sugarcane Garden". At one time it would have been a perfect place to grow sugarcane, as the soil is rich and moist thanks to the annual inundation. However, *Chbar Ampeou* is now home to many thousands of Phnom Penh's poorest households. The poorest tend to live closer to the river and lower down, as rent is generally proportional to distance from the riverbank. With an average income of less than $1 per day, 50 per cent of children malnourished, few children attending school, domestic violence rife, many women forced to survive through prostitution, an AIDS epidemic, and no sanitation services, this community is a microcosm of failed Millennium Development Goals!

For many people of *Chbar Ampeou*, the annual flood is a severe hindrance. The paths leading to their homes are covered by water, sometimes metres deep. They have to construct narrow plank walkways to give access to their homes. It becomes so much harder for people to get to their places of work, and some have to relocate their shops or stalls. Any belongings stored at lower levels need to be lifted higher. Small children are at constant risk of drowning. When the river slows the water stagnates and becomes so toxic that it is a very serious health hazard. All of this adds to the already high relative cost of living for these households. Nevertheless, these long-suffering people have learned to cope with it, one way or another.

In financial terms, these households employ a number of tactics to cope with the extra demands of flood season. Many households consume less, reducing their food intake significantly. They liquidate savings they might have accumulated, either by selling physical items or withdrawing cash if they were one of the few people fortunate enough to have access to cash deposit services. Some seek loans from various informal sources or from the microfinance initiatives of NGOs. Some default on repayments of existing loans. Others are forced to sell productive assets.

In September 2000, the rains were heavier than usual and the river swelled to its highest level in many decades. Many homes in *Chbar Ampeou* were completely submerged, some collapsed, and it was too dangerous to remain

in those dwellings that remained. Thousands of people were rendered homeless and all personal belongings except those they could carry were lost. With the assistance of Disaster Management agencies (DMAs), they were able to set up temporary shelters along roadsides or in local *Wats*. A cholera epidemic added to their woes. The physical, mental and financial stress faced by many of these families lasted many months and for some, there was no recovery.

Natural disasters such as those caused by flood, storm, earthquake, tidal waves, fire, etc. are a harsh fact of life for many poor households and therefore, for the microfinance institutions (MFIs) that target them. The current literature on "Microfinance and Natural Disasters" tends to focus on relief and reconstruction activities (including non-financial and financial services) that immediately follow a natural disaster. However, disaster management is much more than this. It includes pre-disaster activities such as risk mitigation and early warning systems, as well as long-term post-disaster rehabilitation. This paper argues that there are numerous opportunities for collaboration between MFIs and DMAs that go beyond emergency relief and reconstruction. This collaboration can be mutually reinforcing, allowing MFIs and DMAs to concentrate on their core competencies and to leverage their particular expertise for the ultimate benefit of their clients – poor households that are particularly vulnerable to natural disasters.

Introduction to Microfinance

Microfinance is the provision of relevant and affordable financial services to poor households that do not have access to the services offered by 'traditional' financial institutions. The 'micro' prefix refers to the size of the financial transactions; it does not imply that the MFIs themselves are small.[2] Microfinance is primarily concerned with credit and savings although, in recent times, allied services such as insurance, leasing, payment transfers and remittances are being introduced to the mix of services. Demand for microfinance services usually comes from 'microentrepreneurs'; people who survive by generating income for themselves in very small business activities.

Providing microfinance services to poor clients requires innovative operating methods to manage risk and reduce transaction costs. Poor households do not usually have physical assets to offer as collateral for loans, so microfinance providers have developed substitutes. The most common form of substitute collateral has been the formation of groups of borrowers and the establishment of joint-liability procedures, where loan group members effectively guarantee one another's loans. To reduce transaction costs, microfinance providers primarily deal with these loan groups rather than with individual clients, and they outsource various administration tasks to the groups.

Some MFIs have developed from existing community-based savings and loans cooperatives. In India, for example, these are often referred to as village "self-help" groups. Other MFIs have evolved out of the revolving loan programs of charitable non-government organisations, which offered loans to help beneficiaries develop income-generating activities. Other MFIs have been established by commercial banks or government-owned development banks, either as a response to their observation that providing financial services to the poor could be a suitably viable business opportunity, or as a response to government edict that they provide financial services to all segments of the community, including the poor.

Since the early 1990s, a major emphasis within the microfinance sector has been on institutional development, including building the quality and capacity of the governance and management of MFIs. This institutional development is necessary for a number of reasons. First, if MFIs accept client deposits, they are generally required to meet the prudential and regulatory requirements as defined in local banking laws. Essentially, they are required to become licensed banks. Second, institutional maturity is needed to enable growth in client outreach. Growth in the client base allows the MFI to reap advantages of scale, thereby achieving a greater degree of financial sustainability. (Financial sustainability for an MFI means that it is generating enough revenue from interest charges and fees to cover all direct and indirect costs, including operating expenses, provision for loan losses, and adjusted cost of capital).[3] Third, institutional maturity is necessary to attract capital investment, whether concessionary or commercial, from external sources.

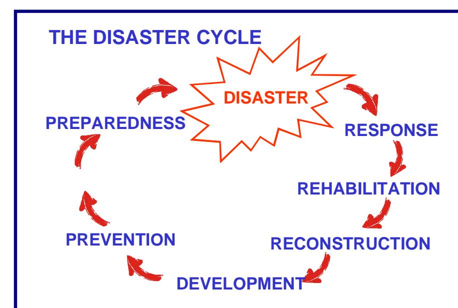
The overriding mission of an MFI is to provide financial services to poor households on a sustainable basis. While most MFIs have a pro-poor, development-oriented emphasis, they are more correctly understood as banks rather than as charitable development organisations. Indeed, many MFIs are licensed banks.

Natural Disasters, Disaster Mitigation and Disaster Management

> A **Natural Disaster** is *"a natural event, sudden or progressive, with such severity that the affected community or country has to respond by taking exceptional measures"*.
>
> **Disaster Mitigation** is *"measures aimed at reducing the impact of a natural or man-made disaster on the nation or community; and the application of these measures to moderate or reduce the effects and impacts of current, or future disasters"*.
>
> **Disaster Management** is *"an applied science that seeks by systematic observation and analysis of disasters, to improve measures relating to prevention, mitigation, preparedness, emergency response and recovery"*.
>
> (Silver, 2001)

Severe natural events include flood, cyclone (or typhoon/hurricane), fire, blizzard, earthquake, tsunami, volcanic eruption, etc. Some of these are "rapid-onset", some are "slow-onset", some are seasonal, some are predictable, and some are restricted to specific geographic areas.

Disaster management is a complicated, on-going concern, involving far more than the immediate distribution of emergency relief in the wake of a natural disaster. There is a cycle of activities that are in progress long before a natural disaster strikes and continue long after the causal event has passed.



It is important to note that use of the term "disaster" is not an indication of the severity of a natural event but of the severity of its impact on people and the environment. Therefore, all aspects of disaster management including mitigation and preparedness, emergency response, rehabilitation and reconstruction can all serve to reduce the impact of a severe natural event.

While natural events are indiscriminate, their impact is usually more devastating for poor households because they have fewer options for coping with them. Poor households are also more likely to be located in "danger" zones, for example, below the flood line. This is why natural disasters appear to strike the poor more often – because, in fact, they do.

Most recent discussions regarding "Microfinance and Natural Disasters" focus primarily on the relatively short period of immediate emergency relief. This is understandable because the period immediate following a severe natural event is often a point of "discontinuity" for microfinance activities, requiring specific measures. This paper, however, also addresses some broader issues of "Microfinance and Disaster Management", in recognition of the need for MFIs to take a more responsive (and less reactive) approach to disaster management and mitigation. There are numerous opportunities for collaboration between MFIs and DMAs that go beyond emergency relief activities to pre-disaster risk mitigation, longer-term post-disaster rehabilitation, and disaster research. This collaboration can be mutually reinforcing, allowing MFIs and DMAs to concentrate on their core competencies and to maximise the efficacy of their interventions.

The Economic Impact of Natural Disasters on Poor Households

The impact of a natural disaster is rarely uniform across all households in a community or region, and the specific impacts depend on the nature of the disaster. Nevertheless, natural disasters typically impact the finances of poor households in a number of ways.

First, the disaster might affect the household's ability to earn income. It might be difficult or impossible for income-earners to reach their customers or for customers to reach them. There might be reduced demand for the products or services that the household offers. Trading stock might have been destroyed and replacement stock might not be immediately available. Even if replacement stock is available, the household might not have funds to purchase it.

Second, poor households might face increased expenditure. Prices of essential commodities such as food or fuel might have increased dramatically due to high demand and/or short supply. Health crises or epidemics are common features of post-disaster environments and this may result in increased expenditure for health care. Also, if income-earners are injured or become sick, it might not be possible to work. Similarly, income-earners might need to take time out to care for the sick or injured. Children may be taken from school to do this.

Third, the disaster might have caused damage to, or destruction of, income-generating assets such as crops, livestock, tools-of-trade or other equipment. Loss of productive assets can have a long-term impact on the ability of the household to generate income if the household does not have funds to replace these assets.

Finally, the disaster might have caused damage to, or destruction of, household assets. The household might be faced with significant expenditure to replace household necessities.

The Economic Coping Mechanisms of Poor Households

Following a natural disaster, poor households will make adjustments to cope economically. "Low-stress" strategies include ceasing regular saving, reducing consumption, short-term migration of one or more family members for the purpose of obtaining paid labour, and calling in debts from neighbours and relatives. "Medium-stress" strategies include using up savings, selling non-essential household assets and obtaining loans. "High-stress" strategies include selling productive assets and loan default. The difference between these strategies is that low-stress strategies are easily reversed whereas high-stress strategies are difficult to reverse. To protect their long-term economic position, poor households need to avoid high-stress coping strategies.

There are limits to the low and medium-stress adjustments a household can make. Reduced consumption over long periods can negatively impact physical health and this can affect earning capacity. Migration of family members can be disruptive and result in a less coherent family unit. Even if a household has debts to call in, it is often the case that their debtors are facing similar hardships and might not be able to repay. Medium-stress adjustments are not always easy either. Typically, poor households will "deposit" savings by investing in physical items that might be difficult to liquidate in a time of emergency need. Markets are distorted in the wake of a natural disaster: the trade of essential commodities favours sellers whereas for non-essential items the balance is firmly in favour of buyers. Finally, loans obtained from informal sources are likely to be even more expensive than usual.

The Impact of Natural Disasters on MFIs

Given that the clients of MFIs are the poor households described above, it is common for MFIs to be impacted financially as well. First, there will be an immediate decline in inflow of cash. Clients are likely to stop depositing savings and they may opt to reduce loan repayments to the minimum required. Second, there will be an increase in outflow of cash. Clients are likely to withdraw savings and they may request additional loans. Note that each of these actions is one of the low or medium-stress coping strategies described above and, from the client's point-of-view, they are entirely sensible (and necessary) actions to take. In the medium term, there may be a significant loss of capital if large numbers of clients are forced into loan default. Furthermore, while group-lending methodologies can ensure high repayment rates under normal conditions they can also serve to magnify capital losses in times of widespread economic stress.

The result of all of the above is that MFIs may face a liquidity crisis in the wake of a natural disaster. Since MFIs pride themselves on their ability to deliver financial services to poor households, it would be both ironic and unfortunate if an MFI was unable to maintain these services at a time when their clients need them most.

The Role of MFIs in Disaster Relief

Most MFIs cannot ignore the possibility of being impacted by natural disasters. Many operate in communities and regions where severe natural events are seasonal and, to some extent, predictable. It behoves such an MFI to make preparations for the impact of natural disasters on their clients and on the MFI. Even if a natural disaster never occurs, many MFI clients will face their own "personal" disasters at some stage, and many of the strategies outlined in this paper would be beneficial to these clients in overcoming their financial difficulties.

Regarding the role of MFIs in emergency relief, one debate revolves around whether MFIs should engage in general (non-financial) disaster relief activities, or whether they should concentrate on providing financial services that support clients to manage their household finances through the difficult post-disaster period. At stake is the good standing of the MFI in the diaster-affected community. On the one hand, the MFI wants to protect its identity as a member of the community that gives priority to the needs of its clients. On the other hand, the MFI wants to protect its identity as a long-term, professional financial intermediary as distinct from charitable aid organisations. There is a creative tension that it not easy to resolve, especially in the context of human suffering in the wake of a natural disaster. The argument presented in this paper is that MFIs will be better placed to respond effectively when a disaster strikes if it has worked through the issues, designed policies and products, and negotiated collaboration with DMAs, *before* disaster strikes rather than in the midst of it.

In September 2003, FDC and World Vision International conducted a workshop in Hyderabad, India entitled "Microfinance and Disaster Management". The workshop brought together 27 microfinance and disaster management practitioners from eight countries in Asia. Seven microfinance initiatives, at various stages of institutionalisation, were represented. Each one of these MFIs operates in areas where natural disasters are a regular fact of life. The policies and strategies discussed in this paper are an output of the workshop. The author acknowledges the inputs and contributions of each one of the workshop participants that informed and/or confirmed much of what is written here.

Collaboration between MFIs and DMAs

Disaster management and microfinance are each specialist fields and, as such, it is important that there remains clear demarcation between the activities of each. There are, however, numerous opportunities for strategic collaboration that are mutually reinforcing, allowing MFIs and DMAs to concentrate on their core competencies and to leverage their particular expertise for the ultimate benefit of affected communities.

Disaster preparedness
With the assistance of DMAs, MFIs should develop a disaster management plan and integrate it with existing disaster management arrangements. Where possible, MFIs should formalise relationships with DMAs and negotiate a Memorandum of Understanding with them. MFIs and DMAs should ensure that, with respect to early warning systems, two-way lines of communication are clearly defined and open. Furthermore, there should be a clearly defined external communication strategy to ensure that communities and clients receive early warnings.

With the assistance of DMAs, MFIs should conduct risk mapping to better understand the vulnerability of communities to natural disasters and to reduce risk to the MFI through the geographic diversification of clientele. Similarly, MFIs should facilitate an external risk assessment of its office, its physical assets, and especially its client records.

It is helpful if MFI personnel are aware of the basic principles and practices of disaster management and of the disaster relief plans that are in place for the areas in which they work. DMAs can be invited to deliver awareness-raising workshops for this purpose. Similarly, it might be helpful if relevant DMA personnel are aware of the MFI's policies for disaster-related financial products and services that might be offered following a natural disaster. MFI personnel can offer to deliver awareness-raising workshops for this purpose.

Emergency relief
Under the direction of DMAs, the MFI and its field staff are part of the overall relief effort. Nevertheless, the priority of the MFI is the economic needs of communities, and the initial focus is on its existing clients.

MFIs should never provide cash grants. Wherever the community has access to in-kind grants from Government or other agencies, due to the disaster situation, the MFI can enable the community to obtain and share these resources.

Post-disaster rehabilitation
With DMAs, MFI personnel may be involved in detailed disaster assessment activities (e.g. livelihood analysis, asset loss, psychological study, design of innovative products, etc.). The MFI's primary focus is on assessment of its existing clients. As the focus of disaster response moves from emergency relief to rehabilitation, the MFI needs to re-orient both its personnel and its clients, and to disengage from emergency response activities and to focus on rehabilitation.

Disaster-related Financial Products and Services

The following policies can be regarded as "good practices" for microfinance in the wake of a natural disaster. Details need to be developed for each specific context. In the interests of transparency, these policies should be communicated to clients when loans are provided and included in loan contracts.

Savings

Households that have accumulated cash savings will be better placed to cope financially following a natural disaster. Many MFIs, however, are not able to accept deposits from the general public because they are not licensed to do so. Furthermore, some MFIs decide that they will not offer deposit services, irrespective of their legal position, because this adds a level of prudential complexity and cost which they do not wish to accept.

Whether they collect deposits themselves or not, MFIs should encourage their clients to accumulate savings as a buffer against disaster events. They might achieve this by educating clients about the advantages of accumulating savings, designing and applying incentives, and providing an effective savings service, for example, by employing a peripatetic deposit taker. Savings must be available for withdrawal at disaster times.

Loan measures

As a general rule, MFIs should not make "blanket" changes to the structure of loan products following a natural disaster. However, it will sometimes be advantageous to offer temporary concessions, as it is better to forgo some income for the sake of maintaining the goodwill of clients and protecting against loan default. However, MFIs should be wary of implementing concessions that might become a recurring general expectation. Concessions should be applied in *exceptional cases* only, such as when the region has been officially declared a "natural disaster" area by an authority external to the MFI.

MFIs should try to keep its response reasonably simple, otherwise it may be difficult and costly to administer. Following are examples of the type of concessions and products that an MFI might offer. Normally, the MFI would not employ every one of these options.

As a general rule, MFIs should expect continuing full repayment. However, in some instances, it will be appropriate to offer options for temporarily reducing repayments. Repayments might be made "interest only", or they might be suspended completely for a period.

MFI personnel should consider loans for rescheduling on a case-by-case basis (by individual or group). The decision to reschedule loan repayments should be based on a detailed assessment of the clients' temporary loss of income. The "grace" period should be specified at the time of rescheduling and clients should return to the normal repayment schedule as soon as possible. Interest accrues on the full balance of the loan during this period. Clients should be fully aware of the cost implications of rescheduling.

At the end of the grace period, the client might choose to make increased payments or lump sum catch-up payments, so that the loan can be completed as per the original schedule. Alternatively, the MFI might offer to extend the term of the loan. If this option is taken, the MFI will need to consider carefully how the loan will be treated in the loan portfolio, either as a loan in arrears or as a refinanced loan (see "Loan Portfolio Management Issues" below).

MFIs might consider a temporary reduction of interest rates. However, without also reducing the requirement to repay capital, this option is usually of little significance.

Emergency loans may be offered for the purpose of restoring productive assets and essential household assets. The decision to offer an emergency loan should be based on a detailed assessment of the client's asset loss. Standard cost structures should apply. An important aspect of emergency loans is that assessment and disbursement should be made at the earliest possible time.

Group lending methodologies were designed to discourage borrowers from deliberate default but not to cover unforeseen disasters and tragedies. While group-lending methodologies can result in high repayment rates under normal conditions they can also serve to magnify losses in times of widespread economic stress. To reduce risk

associated with this phenomenon, MFIs can design and implement "insurance" policies that reduce the impact of disasters on the group culture of the MFI (see "Insurance" below).

No grants or loan cancellation

Loan cancellation is essentially the provision of cash grants to indebted clients. Writing-off loans has a number of negative impacts. First, it benefits different people to different degrees (those with larger loans receive greater benefit) and this can cause disharmony among clients. Second, experience has shown that writing off loans is likely to cause "repayment apathy" on future loans. Third, writing off many loans can cause serious decapitalisation of the loan fund. Loan cancellation should not be considered.

Insurance measures

All but the simplest insurance measures are beyond the capacity of most MFIs. First, it is difficult to achieve sufficient scale (there needs to be zero chance that all clients will be affected by a disaster at the same time). Second, defining procedures for determining when a payment should be made, for what losses and for how much, are very difficult. Third, cost is usually prohibitive because premiums are proportional to risk. Since poor households generally face greater risk, it is difficult to offer affordable premiums. Therefore, it is usually best if the MFI acts as a link between clients/groups and reputable insurance companies who can provide general insurance.

Loan Portfolio Management following a Natural Disaster

Accounting of restructured loans

The occurrence of a natural disaster can significantly increase the level of risk in the loan portfolio. Some of the financial concessions employed, particularly loan restructuring, might require special accounting treatment to reflect the true level of risk. MFIs need to develop a clear policy regarding how these loans are to be treated in the accounting system. If the MFI considers that there is no additional risk inherent in the restructured loan than was present prior to the disaster event, the loan might be refinanced and recorded in the balance sheet as a "restructured" loan (i.e. as a separate item to "current" loans and "past-due" loans). In doing this, the loan will not contribute to the aging of arrears report and there will be no future loan loss reserve allocated, unless the loan falls into arrears in the future.

BALANCE SHEET			
ASSETS			
…			
Loans Outstanding:			
Current	540,000		
Past-Due	53,000		
Restructured	27,000		
Loans Outstanding		620,000	
(Loan Loss Reserve)		(14,000)	
Net Loans Outstanding			606,000
…			

Alternatively, if the MFI considers that there is increased risk inherent in the restructured loan than was present prior to the disaster, then there might be no change to the way the loan is treated; it will be treated simply as a "past due" loan.

Overuse of the refinance option will result in the portfolio appearing healthier than it is in reality. If no refinancing occurs, it will result in the portfolio appearing less healthy than it is. The latter option carries less risk than the former.

Loan loss reserves, write-off policies, loan recovery policies

Provided restructured loans are treated appropriately, there need not be any alteration to the accounting policy on arrears ageing and delinquent loan write-off. All effort should be taken to ensure that delinquent loans are recovered, either through the client, the loan group, an insurance mechanism, or combination of these.

Availability of loan capital

When a significant proportion of the clients of an MFI are severely impacted by a natural disaster, the resulting drain on cash reserves can result in a serious liquidity crisis. MFIs might not be able to offer much needed emergency loans and might need to restrict the withdrawal of savings. Such actions could have a disastrous impact on the credibility of the MFI as a long-term financial intermediary. Therefore, MFIs need to ensure that they have access to sufficient capital, especially when a natural disaster strikes. MFIs should prepare financial models for estimating the amount of additional capital that may be required in the context of a natural disaster, and they should ensure that they have access to sufficient capital, through keeping emergency reserves and/or negotiating a line of credit that can be drawn on at short notice.

Conclusion

An MFI that is weak under "normal" conditions will struggle to survive a serious natural disaster. Strong MFIs are better placed to provide relevant and helpful services to their clients. Successful MFIs have effective governance, strong human resource management, accurate and flexible management information systems, and effective portfolio management. They offer services that fit the preferences and needs of poor households, they are efficient, and they operate on a business-like basis. If an MFI wishes to prepare for a disaster event, then its first commitment should be to on-going institutional strengthening.

Most MFIs cannot ignore the possibility of being impacted by natural disasters. Many operate in communities and regions where natural disasters are an annual event. It behoves such an MFI to make preparations for the impact of natural disasters on their clients and on the MFI itself. MFIs will be better placed to respond effectively when a disaster strikes if it has worked through the issues, designed policies and products, and negotiated collaboration with DMAs, *before* disaster strikes rather than in the midst of it.

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[1] The mission of the Foundation for Development Cooperation (FDC) is to strengthen partnerships for sustainable development and poverty reduction through action research, policy dialogue, advocacy and capacity building. Since 1991, FDC's microfinance program has aimed to explore, demonstrate and publicise the scope for increasing the access of the poor to microcredit, savings services and other financial services on a sound commercial basis.

[2] In Bangladesh, for example, a number of MFIs – ASA, BRAC, Grameen and Proshika - each have in excess of one million clients.

[3] The adjusted cost of capital refers to the cost of maintaining the value of the institution's equity relative to inflation and the cost of accessing commercial funding rather than concessional loans.