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Risk Management in Microfinance Institutions of India

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Abstract

The micro finance sector in India today is on a path of steady growth and is undergoing substantial change building on regulatory support and the common shared industry infrastructure. The main challenge of microfinance is to create social benefits and promote low income households by providing financial services without any suitable guarantees. It is in this context that the issue of risk management in microfinance institutions becomes increasingly relevant. The study uses a descriptive research design with the main objective to study the most significant risks (with the most potentially damaging consequences for the MFI), how they interact, and current challenges faced by Microfinance Institutions (MFIs) and the risk management practices adopted by them. Like all financial institutions, MFIs face risks that they must manage efficiently and effectively to be successful. If the MFI does not manage its risks well, it will likely fail to meet its social and financial objectives. When poorly managed risks begin to result in financial losses, donors, investors, lenders, borrowers and savers tend to lose confidence in the organization and funds dry up. While MFIs with effective risk management systems are far better prepared for the unexpected and this can be the difference between growth, stability, or bankruptcy. By instilling a culture of risk management throughout the institution, from the board of directors to loan officers and internal operations staff members, the MFI and its clients should be able to manage unexpected events—and even thrive.

Key words : *Microfinance Institutions, Risk Management, Risk Management Practices.*

Introduction

Micro finance Institutions operate in the economy with the ultimate objective to serve the financially poor section of the society, by providing them with financial support and credit services. Very often, the task of managing both financial stability and long term viability becomes a bothered grindstone for such micro finance institutions. The reason behind the same is that the unprivileged section, to which the loans are provided, lacks a stable income to provide the collateral and repay the loan amount. Many a times, to fulfill the object of generating regular cash flows in the institution, proper credit risk analysis is ignored. As such, the objective of maintaining the sustainability of the institutions is not given due attention and failure follows. Like all financial institutions, microfinance institutions (MFIs) face risks that they must be managed efficiently and effectively to be successful. If the MFI does not manage its risks well, it will likely fail to meet its social and financial objectives. When poorly managed risks begin to result in financial losses, donors, investors, lenders, borrowers and savers tend to lose confidence in the organization and funds begin to dry up.

Microfinance institutions face many risks; some of the most serious risks come from the external environment in which the MFI operates, including the risk of natural disaster, economic crisis or war. A simple way to begin the process of thinking about risk management in an MFI is first to identify, understand and assess the risks that can

have a severe impact on the organization and the frequency of their occurrence. Once risks are identified, the MFI can design strategies and develop a control mechanism to deal with them.

Risk management has undoubtedly emerged as one of the most important tools for mitigation of anticipated risks or failures for a financial institution. However its importance in micro finance institutions has not been realized by many, except the large scale ones. Many medium and small scale micro finance institutions still find themselves with no systems to protect them; they rely on traditional forms of analysis like subjective judgment or no analysis at all. In such situation they are extremely vulnerable to debt. The problem aggravates further when a large number of individuals or groups default on their loans, causing a huge dent on their financial returns.

Advantages Offered By Risk Management Tools

1. Institutions are growing in size and reach. So to stay in the market, they need to upgrade their internal management and risk management systems. It helps manage credit and liquidity risks, market risks, pricing and operational risks, etc. Only the proper analysis of credit risk can help them to avoid facing the failures of financial losses.

2. The risk management tools and techniques can help in cultivating the culture of good risk management and helps in mitigating the losses with cost effective approach.

3. Micro finance institutions in India, are struggling to stay financially stable by looking for cost-effective solutions. Risk management methods can ensure that their capital and cash are managed better with minimal risk to business.

4. The micro finance institutions are funded by the way of debt or savings that are deposited by the clients. In order to maintain a position in the economy and to obtain more funds by the way of debt, the application of credit risk mitigation techniques becomes an obligation.

As MFIs continue to grow and expand rapidly by serving more customers and attracting more investment capital and funds, they need to strengthen their internal capacity which could help them identify and anticipate potential risks to avoid unexpected losses. Creating a risk management framework and culture within an MFI is the next step after analyzing the fundamentals of individual risks, such as credit risk, treasury risk, and liquidity risk.

Risk Management Framework

It is a guide for MFI managers to design an integrated and comprehensive risk management system that helps them focus on the most important risks in an effective and efficient manner. It helps them integrate a set of systematic processes for identifying, measuring, and monitoring many different types of risk to help management keep an eye on the more important facts which:

1. Uses a continuous feedback loop between measurement and monitoring, internal controls and reporting, and involves active oversight by senior managers and directors, allowing more rapid response to changes in internal and external risk environments;

2. Considers scenarios where risks interact and can worsen in adverse situations;

3. Elevates responsibility for risk management and preparedness to senior management and the board;

4. Encourages cost-effective decision-making and more efficient use of resources;

5. Creates an internal culture of "self-supervision" that can identify and manage risks long before they are visible to outside stakeholders or regulators.

More sophisticated approaches to risk management are important to MFIs for several reasons. 1 Many MFIs have grown rapidly, serving more customers and larger geographic areas, and offering a wider range of financial services and products. Their internal risk management systems are often a step or two behind the scale and scope of their activities.

2 To fuel their lending growth, MFIs increasingly rely on market-driven sources of funds, whether from outside investors or from local deposits and member savings. Preserving access to those funding sources will require maintaining good financial performance and avoiding unexpected losses.

3 The organizational structures and operating environments of MFIs can provide unique challenges. They may be very decentralized or too centralized (both can be a risk), tend to be labor- and transaction-intensive, have concentration risk in certain regions or sectors (e.g., agriculture) due to their mission, and often operate in volatile and less mature financial markets.

Finally, MFIs are striving for financial viability through cost-effective and efficient operations, making effective risk management essential to achieving better capital and cash management without undue risk.

Research Methodology

In this paper the existing records relevant to the subject matter was used. Using deductive approach, the research is able to draw conclusion and having critically reviewed salient issues in existing records. This method was adopted because time would not permit the use of questionnaire which ordinarily has to be administered to a sizeable number of micro finance banks across the country. However, reviewing related works by other researchers gave a deeper insight to the researchers which enabled us to draw reasonable conclusion.

Objectives

1) To understand the importance and value of risk management to MFIs, and

2) To design a framework for systematically managing risks to the institution.

3) To study the approach to identify, anticipate, and respond to the major risks that threaten MFI.

4) To understand challenges and current issues for risk management in MFIs.

Major Risks to Microfinance Institutions

Many risks are common to all financial institutions. From banks to unregulated MFIs, these include credit risk, liquidity risk, market or pricing risk, operational risk, compliance and legal risk, and strategic risk. Most risks can be grouped into three general categories: *financial risks, operational risks and strategic risks,* mines whether the risk can be adequately measured and managed, considers the size of the potential loss, and assesses the institution's ability to withstand such a loss The section discusses the most significant risks (with the most potentially damaging consequences for the MFI), how they interact, and current challenges faced by MFIs.

Financial Risks

Because an MFI's loan portfolio is its most valuable asset, the financial risks—credit, market, and liquidity— are of greatest concern. Financial risks begin with the possibility that a borrower may not pay the loan on time with interest (credit risk). They include the possibility that the MFI might lose a significant part of the value of its loan portfolio as a result of an economic downturn, hyperinflation, and other externally generated causes (market risk). Financial risk can also include changes in interest rates of government lending programs or the possible enforcement of old usury laws. Market risks include lower prices for borrowers' products and services, which could directly affect their ability or willingness to repay an outstanding loan.

The business of a financial institution is to manage financial risks, which include :

i) Credit Risk

ii) Liquidity Risk

iii) Interest Rate Risk

iv) Foreign Exchange Risk and

v) Investment Portfolio Risk.

i) Credit Risk: Credit risk is the risk to earnings or capital due to borrowers late and non-payment of loan obligations. It encompasses both the loss of income resulting from the MFI's inability to collect anticipated interest earnings as well as the loss of principle resulting from loan defaults.

Credit risk includes both transaction risk and portfolio risk.

Transaction Risk

Transaction risk refers to the risk within individual loans. MFIs mitigate transaction risk through borrower screening techniques, underwriting criteria, and quality procedures for loan disbursement, monitoring, and collection.

Portfolio Risk

Portfolio risk refers to the risk inherent in the composition of the overall loan portfolio. Management must continuously review the entire portfolio to assess the nature of the portfolio's delinquency, looking for geographic trends and concentrations by sector, product and branch. By monitoring the overall delinquency in the portfolio, management can assure that the MFI has adequate reserves to cover potential loan losses. MFIs have developed very effective lending methodologies that reduce the credit risk associated with lending to microenterprises, including group lending, cross guarantees, stepped lending, and peer monitoring. Other key issues that affect MFIs' credit risk include portfolio diversification, issuing larger individual loans, and limiting exposure to certain sectors.

Approaches to manage Credit Risk include:

- Well-designed borrower screening, careful loan structuring, close monitoring, clear collection procedures, and active oversight by senior management. Delinquency is understood and addressed promptly to avoid its rapid spread and potential for significant loss.
- Good portfolio reporting that accurately reflects the status and monthly trends in delinquency, including a portfolio at- risk aging schedule and separate reports by loan product.
- A routine process for comparing concentrations of credit risk with the adequacy of loan loss reserves and detecting patterns.The importance of a "credit culture" in minimizing problems and increasing operational efficiencies cannot be overstated.

ii) Liquidity Risk

Liquidity risk is the possibility of negative effects on the interests of owners, customers and other stakeholders of the financial institution resulting from the inability to meet current cash obligations in a timely and cost-efficient manner. Liquidity risk usually arises from management's inability to adequately anticipate and plan for changes in funding sources and cash needs. Effective liquidity management protects the MFI from cash shortages while also ensuring a sufficient return on investments. *Cash management* refers to the mechanics of consolidating cash at the head office and investing it at the local bank in interest bearing accounts. Effective liquidity risk management requires a good understanding of the impact of changing market conditions and the ability to quickly liquidate assets to meet increased demand for loans or withdrawals from savings.

Approaches to manage Liquidity Risk include:

- Maintaining detailed estimates of projected cash inflows and outflows for the next few weeks or months so that net cash requirements can be identified.
- Using branch procedures to limit unexpected increases in cash needs. For example, some MFIs, such as ASA, have put limits on the amount of withdrawals that customers can make from savings in an effort to increase the MFI's ability to better manage its liquidity.
- Maintaining investment accounts that can be easily liquidated into cash, or lines of credit with local banks to meet unexpected needs.
- Anticipating the potential cash requirements of new product introductions or seasonal variations in deposits or withdrawals..

iii) Interest Rate Risk

Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest

rates. Also known as asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets). In MFIs, the greatest interest rate risk occurs when the cost of funds goes up faster than the institution can or is willing to adjust its lending rates. The cost of funds can sometimes exceed the interest earned on loans and investments, resulting in a loss to the MFI.

Approaches to manage Interest Rate Risk include

* To reduce the mismatch between short-term variable rate liabilities (e.g. savings deposits) and long-term fixed rate loans, managers may refinance some of the short-term borrowings with long-term fixed rate borrowings. This might include offering one and two-year term deposits as a product and borrowing five to 10 year funds from other sources. Such a step reduces interest rate risk and liquidity risk, even if the MFI pays a slightly higher rate on those funding sources.

* To boost profitability, MFIs may purposely "mismatch" assets and liabilities in anticipation of changes in interest rates. If the asset liability managers think interest rates will fall in the near future, they may decide to make more long-term loans at existing fixed rates, and shorten the term of the MFI's liabilities.

iv) Foreign Exchange Risk

Foreign exchange risk is the potential for loss of earnings or capital resulting from fluctuations in currency values. Microfinance institutions most often experience foreign exchange risk when they borrow or mobilize savings in one currency and lend in another.

Approaches to manage foreign exchange risk include:

* Due to the potential severity of the downside risk, an MFI should avoid funding the loan portfolio with foreign currency unless it can match its foreign liabilities with foreign assets of equivalent duration and maturity

* Some MFIs have used interest rates swaps or futures contracts to "lock-in" a certain exchange rate, which protects the MFI from uncertainty.

v) Investment Portfolio Risk

The investment portfolio must balance credit risks (for investments), income goals and timing to meet medium to long term liquidity needs. An aggressive approach to portfolio management maximizes investment income by investing in higher risk securities. A more conservative approach emphasizes safer investments and lower returns.

Operational Risks

Operational risk arises from human or computer error within daily product delivery and services. Like liquidity risks, operational risks are within the MFI's control. They include the risk of loss through faulty internal processes, poorly trained personnel, and inadequate information systems, operational problems, insufficient human resources, or breaches of integrity (i.e. fraud) will result in unexpected losses.

There are majorly two types of operational risk:

i. Transaction Risk and

ii. Fraud Risk.

i) Transaction Risk

Transaction risk exists in all products and services. It is a risk that arises on a daily basis in the MFI as transactions are processed.12 Transaction risk is particularly high for MFIs that handle a high volume of small transactions daily. When traditional banks make loans, the staff person responsible is usually a highly trained professional and there is a very highlevel of cross-checking. Since MFIs make many small, short-term loans, this same degree of cross-checking is not cost effective, so there are more opportunities for error and fraud. The loan portfolio usually accounts for the bulk of the MFI's assets and is thus the main source of operational risk.

Approaches to manage Transaction risk include

- Simple, standardized and consistent procedures for cash transactions throughout the MFI.
- Effective ex-ante internal controls that are incorporated into daily procedures to reduce the chance of human error and fraud at the branch level (e.g. require dual signatures, separate lines of reporting for cash and program transactions).
- Strong ex-post internal controls (i.e. internal audit) to test and verify the accuracy of information and adherence to policies and procedures. These internal controls help ensure that management reported information is the most accurate information, and reduce the occurrence of problems. The GTZ/Microfinance Network's technical guide, Improving Internal Control, describes in detail the process for developing an internal control system linked to risk management.
- Using computer systems and minimizing the number of times data has to be manually entered reduces the chance and frequency of human error.

ii) Fraud Risk

Effective internal controls play a key role in protecting against fraud at the branch level, since line staff handles large amounts of client and MFI funds. While fraud risks exist in all Financial Institutions, if left uncontrolled, they inevitably increase as fraudulent behaviors tend to be learned and shared by employees. Internal controls should include *ex-ante* controls that are incorporated within the methodology and design or procedures (prior to operation), as well as *ex-post* controls that verify that policies and procedures are respected (after operations).

Two principles are paramount:

- The use of preventive measures to reduce fraud, and
- The importance of client visits to verify branch information.

Strategic Risks

Strategic risks include internal risks like those from adverse business decisions or improper implementation of those decisions, poor leadership, or ineffective governance, as well as external risks, such as changes in the business or competitive environment (caused by new entrants, new laws, and new regulations).

The three critical strategic risks:

i) Governance Risk,

ii) Business Environment Risk, and

iii) Regulatory and Legal Compliance Risk.

i) Governance Risk

One of the most understated and an underestimated risk, within any organization is the risk associated with inadequate governance or a poor governance structure. Direction and accountability come from the board of directors, who increasingly include representatives of various stakeholders in the MFI. The social mission of MFIs attracts many high profile bankers and business people to serve on their boards.

Unfortunately, these directors are often reluctant to apply the same commercial tools that led to their success when dealing with MFIs. As MFIs face the challenges of management succession and the need to recruit managers that can balance social and commercial objectives, the role of directors becomes more important to ensure the institution's continuity and focus.

ii) Business Environment Risk

Business environment risk refers to the inherent risks of the MFI's business activity and the external business environment. To minimize business risk, the microfinance institution must react to changes in the external business environment to take advantage of opportunities, to respond to competition, and to maintain a good public reputation. In Bolivia, for example, many microfinance institutions have lost 20 Anita Campion, Current Governance Practices of Microfinance Institutions:

iii) Regulatory and Legal Compliance Risk

Compliance risk arises out of violations of or non-conformance with laws, rules, and regulations, prescribed practices, or ethical standards, which vary from country to country. The costs of non-conformance to such practices range from fines and lawsuits

to the voiding of contracts, loss of reputation or business opportunities, or shut-down by the regulatory authorities.

Approaches to manage Compliance Risk include:

* Establishing a good working relationship with the regulatory authorities. Regardless of its formal regulatory status, an MFI should encourage open communication with regulators to ensure their full understanding and provide an opportunity to defuse any potential problems.

Successful MFIs employ several risk management strategies.

- They develop strong internal information systems to allow managers to understand and mitigate the risks related to liquidity, internal fraud, and new product development.
- They ensure better information on the cash flow, productivity, and other characteristics. Their credit management systems keep a watchful eye on portfolio quality issues, allowing for swift responses to willful default.
- They recognize the value of micro insurance to protect borrowers from insurable risks.
- They consistently enforce the loan contract. Finally, their incentives for loan officers are linked directly to portfolio performance.

Risk management systems are, in effect, the wings needed before taking the leap of faith of lending to large numbers of informal micro businesses. MFIs with effective risk management systems in place are far better prepared for the unexpected, and this preparation can be the difference between growth, stability, or bankruptcy. By instilling a culture of risk management throughout the institution, from the board of directors to loan officers and internal operations staff members, the MFI and its clients should be able to manage unexpected events—and even thrive.

Conclusion

Instead of encouraging all MFIs to enter new niches and explore new products, donors should focus their efforts on those institutions that have demonstrated effective risk management strategies in the provision of traditional microfinance services. Donors should promote effective risk management in microfinance NGOs by supporting their development of more effective systems and procedures to manage risks, such as the implementation of an enhanced management information system or the start-up of an internal audit department. Furthermore, donors should support research and training efforts that address risk management topics and ensure that they are discussed in a comprehensive format rather than in isolation. While regulators increasingly apply a risk management approach to regulation and supervision of financial institutions, few understand how risk management of MFIs is different from that of traditional financial institutions.

In some cases, regulators will need to apply more conservative policies to microfinance institutions. Leading microfinance institutions, donors, and practitioner networks can all play a role in helping to educate and inform regulatory authorities on the appropriate ways to measure and monitor microfinance risks. By including regulators in discussion forums, inviting them to conferences and sending them the latest research findings, microfinance practitioners can work to improve regulators' knowledge and understanding of MFIs and will simultaneously gain an understanding of their perspectives and limitations.

An MFI that develops an early warning system can respond before the risks become larger and more costly. The early warning system will evolve with the changing risks confronting the institution, thereby protecting its short-term solvency and long-term viability. The management team is responsible for periodically assessing the MFI's exposure to risk and determining its risk management strategy. For instance, the assessment will be based on the institution's particular circumstances—the legal and

regulatory context, inflation, the sources of funds (such as the mix of loans and grants, grace period, rates of interest, repayment terms), client location (rural or urban) and activities (agriculture, animal husbandry, commerce, services or production).

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