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RISK MANAGEMENT PRACTICES OF MICRO FINANCE INSTITUTIONS: A BRIEF EMPIRICAL LITERATURE REVIEW

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ABSTRACT

In this study an attempt has been made to gather relevant literature in the area of risk management practices of micro finance institutions. Micro finance provides financial help to the unbanked sections of the society. Since microfinance is a system that distributes small loans to poor people in order for them to generate income and start their own small businesses, it has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities. At the same time microfinance portfolios are exposed to various kinds of risks due to their inherent characteristics. As such the risk management practices of Micro finance institutions plays a vital role in the success and continuation of micro finance business. This study therefore makes an attempt to present meaning and types of microfinance, History of microfinance and micro finance in India and finally empirical literature on risk management practices of microfinance institutions.

KEYWORDS

micro finance, micro credit, risk management practices.

1. INTRODUCTION

The concept of micro credit – extension of small loans without collateral, based on Joint liability was pioneered by Dr. Muhammed Younus in 1976 in Bangladesh. Ever since nations look towards microfinance as a means to alleviate poverty. 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 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 (such as credit information system, publicly available industry information/ data analysis and self-regulatory among others). During financial year 2014/2015, the NBFC-MFI industry has shown strong growth and strengthened its position to provide much needed credit to the under/ unbanked population in the country. In the year 2014/2015 NBFC-MFIs with a branch network of 9894 branches, and employee base of 75, 085 provided credit to over 2.85 crore clients with loan outstanding of Rs. 37,988 crores and Par 30 under 1 % **(Microscape, FY 2014-15**)

2. MEANING OF MICROFINANCE

Microfinance is defined as the attempt to improve access to small deposits and loans for poor household neglected by banks **(Schreiner and Colombet 2001)**.

According to **Robinson (2001),** microfinance refers to small scale financial services for both credits and deposits that are provided to people who farm or fish or herd; operate small or microenterprise where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries in both rural and urban areas.

According to **Otero (1999)** Micro finance is 'the provision of financial services to low income poor and very poor self-employed people. Since microfinance is a system that distributes small loans to poor people in order for them to generate income and start their own small businesses, it has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities (**Lazar 2008}**

In addition to distributing loans, MFIs also offer a wide range of financial services, such as savings and insurance options (**Premchander 2009**). Microfinance is a provision of financial services like savings, credit, insurance, remittance, etc. in a very small quantity generally to the poor people (**Dasgupta, 2001)**

Microfinance **(Investopedia.com**) is a type of banking service that is provided to unemployed or low-income individuals or groups who would otherwise have no other means of gaining financial services. Ultimately, the goal of microfinance is to give low income people an opportunity to become self-sufficient by providing a means of saving money, borrowing money and insurance

Today however microfinance is referred to more generally as the provision of financial services to those excluded from the formal financial system (**UNCDF, 2002)**

Microfinance institutions have emerged as an alternative solution by targeting the poor through innovative lending approaches, including group lending, progressive lending, regular repayment schedules, and collateral substitutes (**Thapa, 2006**). Micro-finance institutions (MFIs) offer loans and/or technical assistance in business development to low-income community in developing countries. Therefore, MFI should be an effective development agent and alleviate poverty (OECD, 1996).

The **Reserve Bank of India (RBI) and National Bank for Agriculture and Rural Development (NABARD)** define microfinance as Provision of thrift*, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and in improving living standards.

Micro finance and Micro credit: It is common to find the terms microfinance and micro credit being used interchangeably however, these two are distinct terms. **Sinha, 1998)** states that "Micro credit refers to small loans whereas micro finance is appropriate where NGOs and MFIs supplement the loans with other financial services such as insurance, savings etc. Therefore, microcredit is a component of microfinance and micro finance is a broader term and includes pensions and payment services (Okiocredit, 2005).

3. TYPES OF MICRO FINANCE

There are different categories of microfinance institutions as numerated by different authors. **Lafourcade et al. (2005)** has identified three categories of that is regulated (banks, regulated non – bank financial intermediaries, and regulated NGOs), cooperatives (financial cooperatives and credit unions) and unregulated (NGOs, Non-bank intermediaries, MFI projects and others).

Udeaja and Ibe (2006) used the consideration of formality to classify microfinance institutions. They identified three categories of MFIs, a. Formal MFIs are institutions such as development banks, savings and loans, and Non – bank institutions that are governed by general company laws, regulations and guidelines, b. Semi- formal MFIs are those MFIs that are subject to commercial and general company laws but which are not subject to banking regulations such as NGOs and cooperatives (thrift and credit societies) c. Informal MFIs are those that are non – registered groups

Ayayi (2008) has conducted a study on MFIs of Vietnam and categorized MFIs into three main categories, formal, semi formal and informal based on the type of institution, regulations and strategies involved.

Greuning et al. (1999) categorized MFIs into three broad categories (i) MFIs which depend on other people's money, (ii) MFIs which depend on member's money and (iii) MFIs which leverage public money

Crisil (2008) discusses the grouping of microfinance institutions with respect to the legal structure into Not for profit MFIs, Mutual benefit MFIs and for profit MFIs.

Yvonne Mawuko (2013) introduced five key structures or categories of microfinance institutions identified: these are Rotating Savings and Credit Associations (ROSCAs); the Grameen Solidarity Group Model; the Village Banking Structure; Microfinance Integrated with Social Services (MFISS) and Credit with Education.

4. HISTORY OF MICRO FINANCE

Micro finance is not a new finance phenomenon found in 20th century. It has its roots in the medieval Europe especially in Ireland and Germany. In fact, many years before it got formalized through the efforts of Professor Muhammed Yunus of Bangladesh (**Guntz, 2011**)

As early as in the 15th century, the catholic church founded the so called pawn shops in order to protect people from shady loan sharks and money lenders who gave out loans at usurious interest rates. These shops later spread though out Europe (**Helms, 2006)**

Formal credit and savings institutions for poor were established in Ireland by 1720 by the Irish loan fund system, using peer monitoring to enforce weekly installments of initially interest free loans from donated resources **(Seibel, 2003)**

In the early 1800s a new variety of financial organization based on cooperative principles was founded by Friedrich Wilhelm Raiffeisen in Germany which quickly expanded to Europe, North America and other developing countries. Raiffeisen created credit associations of farmers which later came to be known as Raiffeisenkassen and later Raiffeisenbanken **(Seibel, 2005)**

History of microfinance saw another milestone the history of micro finance through the opening of the Indonesian People's Credit Bank in 1895 that became the largest micro finance system in Indonesia (**Helms, 2006**)

Literature often conveys microfinance as a recent concept introduced in the 1980s. Microfinance is in fact a rediscovery or renaissance of existing practices. It has become more institutional and formal benefitting from innovative approaches and findings of modern research in some areas (**Digefe, 2009)**

5. MICROFINANCE IN INDIA

The **Reserve Bank of India (RBI) and National Bank for Agriculture and Rural Development (NABARD)** define microfinance as Provision of thrift*, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and in improving living standards.

The Micro Finance Institutions (Development and regulation) Bill, 2012 of India, defines Micro Finance Institution as

- a society registered under the Societies Registration Act, 1860; or
- a company registered under section 3 of the Companies Act, 1956; or
- a trust established under any law for the time being in force; or
- a body corporate; or
- any other organization, as may be specified by the Reserve Bank,

The object of which is to provide micro finance services in such manner as may be specified by regulations. Further, **"micro finance services**" means any one or more of the following financial services provided by any micro finance institution, namely:

(*A*) micro credit facilities involving such amount, not exceeding in aggregate five lakh rupees for each individual and for such special purposes, as may be specified by the Reserve Bank from time to time, such higher amount, not exceeding ten lakh rupees, as may be prescribed;

(*B*) collection of thrift;

(*C*) pension or insurance services;

(*D*) remittance of funds to individuals within India subject to prior approval of the Reserve Bank and such other terms and conditions, as may be specified by regulations;

(*E*) any other such services, as may be specified.

As per The **Directory of Microfinance institutions (MFIs) in India (2014),** Micro finance refers to thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and improve living standards and Microfinance institutions are those organizations, other than banks providing micro- financial services.

Micro credit in India is synonymous with microcredit. This is because savings, thrift and micro insurance constitute a miniscule segment of microfinance space. In India most microfinance loans are in the range of Rs. 5000 and Rs. 20,000 (the development and regulation bill, 2007, defines micro finance loans as loans with amounts not exceeding Rs. 50,000 in aggregate per individual/ small enterprise).

As per Crisil report **(Crisil, 2008**), MFIs usually adopt the group based lending model which are of two types, the Self-help group (SHG) and the Joint liability group (JLG)/ solidarity group model.

Under SHG model an MFI lends to a group of 10 to 20 women. Under SHG –bank linkage model an NGO promotes a group and gets banks to extend loans to this group.

Under JLG model loans are extended to and recovered from each member of the group (unlike the SHG model where the loan is extended to a group as a whole). The most popular JLG models are the Grameena bank model (developed by grameena bank of Bangladesh) and ASA model developed by ASA, a leading Bangladeshi based NGO- MFI. Most of the large MFIs in India follow a hybrid of the group models **(Crisil, 2008).**

Most MFIs following the JLG model adopt weekly and fortnightly repayment structure. Those under SLG model have a monthly repayment structure. MFIs lending to traders in market place also offer daily repayment while MFIs extending agricultural loans have cash repayment structures depending on crop patterns.

MFIs following JLG model charge flat interest rates of 12 – 18 % on their loans while MFIs following SHG model charge 18 – 24% interest rate per annum based on reducing balances method. Most MFIs in India are solely engaged in extending micro credit; a few also extend savings, thrift, insurance, pension and remittances facilities.

With respect to the legal structure, Microfinance institutions can be classified as **(Crisil 2008):**

- Not for profit MFIs – Societies, public trusts, Non profit companies
- Mututal benefit MFIs – Co-operatives registered under state or national acts, mutually aided co-operative societies
- For profit MFIs – Non banking finance companies, producer companies, local area banks.

Further, **Crisil** estimates that around 120 million households in India continue to face financial exclusion translation into a credit demand around Rs. 1.2 billion.

As per the **Directory of Microfinance institutions (MFIs) in India (2014),** incorporation of MFIs under different acts of the country determines the legal form. The common legal forms include Society, trust, Cooperative, section 25 company, Non banking finance company (NBFC).

Once the world's leader, India's microfinance industry went through a severe crisis, when the state of Andhra Pradesh witnessed a mass default of microfinance borrowers in 2010. Combined with allegations of over-indebtedness and coercive recovery practices, this reflected poorly on microfinance institutions (MFIs) and the industry at large, undermining investor and consumer trust in the sector (**IFC world bank group, 2013**)

Andhra Pradesh was the most penetrated state for microfinance loans during FY 95 – FY 10. Even under SHG – Bank linkage model, AP had over 50% share in a number of credit SHGs. In 2010, MFIs exposure to AP was 29% (INR 52.1 bn on 31st March 2010). A poor household in AP in FY10 held about INR87,728 as debt, out of which about INR 27,000 was borrowed from MFIs. Considering the average outstanding of INR 8,270(Bharat Microfinance Reports, FY10,FY11 –Sa-Dhan), each average poor household borrowed from at least three MFIs at a time. **(Jindal Haria & Cyrus Dadabhoy, 2015)**

After AP crisis the Reserve Bank of India (RBI) set up a committee called the Malegam committee to investigate the various activities and impact of MFIs across the country and to make relevant recommendations on improving their performance. After Malegam committee report, RBI issued a set of guidelines to cover the operations of NBFCs functioning as MFIs in 2012. As a result of these new guidelines a new category NBFC-MFI was created. Further capitalization of 5 crores and having 85% or more of their exposure in microfinance portfolio should immediately apply for NBFC – MFI

(http://rbidocs.rbi.org.in/rdocs/notification/PDFs/49010713MFIFL.pdf)

An analysis of six international and three domestic microfinance crises in the last 15 years suggests that rapid growth and high return expectations were precursors to almost every crisis. Indian microfinance institutions (MFI) have clocked a 50% AUM CAGR over FY13-FY15 and interactions with a cross-section of MFIs operating across the country suggested that they have ambitious expansion plans in newer, unknown markets. At the same time, massive PE/VC investments in the sector have led to unduly high return expectations from investors. (**India micro finance sector report, 2015)**

6. RISK MANAGEMENT PRACTICES OF MICROFINANCE INSTITUTIONS

RISK CATEGORIES

Risk in financial terms is usually defined as the probability that the actual return may differ from the expected return (**Howells and Bain, 1999**)

Smith (1999) defines risk as a decision expressed by a range or possible outcomes with attached probabilities. When there are a range of possible outcomes with attached probabilities, it is risk and when there are a range of possible outcomes but no assumed probabilities there is only uncertainty.

Risk can be considered as "a systematic way of dealing with hazards" (**Beck 1996).** If it is assumed that there is uncertainty associated with any prediction of a hazard occurring, then there is only uncertainty because there is only ever a prediction of the likely occurrence.

MICRO FINANCE RISK CATEGORIES

There are various risk categories that an organization can be exposed to, **Vedpurshwar (2001)** classifies these into three categories. Firstly, there are the hazard risks, which refer to natural hazards, which include accidents, fire etc. Secondly, there are operational risks that cover systems, processes and people. Thirdly, there are financial risks, which include market risks, liquidity risks, solvency risks etc

In a publication released in 2000, Deutsche gesellschaft fur technische zusammenarbeit (GTZ) cited three major risk categories for micro finance institutions that is financial risk, operational risk and strategic risk.

GTZ (2002) the three risk categories can be subdivided into Financial risk as Credit risk, Liquidity risk and Market risk, Operational risks as Transactions risk, Fraud (integrity risk), Legal & compliance risk, Strategic risk as Governance risk, reputation risk, and External business risks.

Churchill and Frankiewicz (2006) listed four categories of risk namely Institutional risk, operating risk, financial management risk and external risk.

The typical categories of risk faced by a Microfinance institution according to Yvonne **Mawuko (2013)** are Liquidity risk, Interest rate volatility, Cash management risk, Operational risk and Credit risk.

A study of literatures in general shows that there are seven main areas of institutional-level risks facing MFIs. These are Credit Risk, Liquidity risk, Market risk, Operational risk, Interest risk, Foreign exchange risk, and Environment Compliance & Regulatory risk

RISK MANAGEMENT

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. (**Mokni et al)**

Risk management refers to a systematic process of identifying and analyzing of risks and selecting the most appropriate method to treat the risk has been acknowledged to minimize losses and at the same time increased profitability **(Aris et al, 2009**).

Risk management is very essential in financial sector as the main objective is to maximize shareholders value. Therefore, risk management is essential to achieve the goal of wealth maximization (**Al-Tamimi and Al-Mazrooei (2007**).

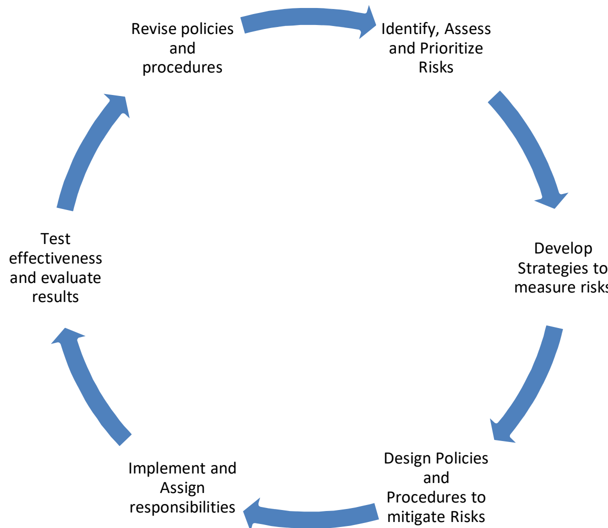
In investigating banking risk management, **Ouamar (2013**) articulates the requirement of a sound risk management structure in order to reducing banking risk and improving performance.

Risk management is a systematic approach to identifying, measuring, monitoring and managing the various risks faced by an institution. In short, risk management is an integral part of a financial institution's strategic decision-making process which ensures that its corporate objectives are consistent with an appropriate risk return trade-off. (**Akwasi et al. 2014**)

GTZ (2000), provides a risk management framework for microfinance institutions and states that the steps in risk management process are not static; they are part of an interactive and dynamic flow of information from the field to head office to senior management and back to the field. These steps are part of a continual risk management feedback loop that is cyclical in nature.

Risk management feedback loop includes the identification of risk to be controlled. The development and implementation of strategies and policies is to control risk and the evaluation of their effectiveness. If results indicate that risks are not adequately controlled then policies and strategies are redesigned, re-implemented, retested and reevaluated.

RISK MANAGEMENT FEEDBACK LOOP



Source: Risk management framework for microfinance institutions by GTZ (July 2000)

GTZ (2002) in its report discusses the risk management strategies of MFIs and argues that MFIs thrive on reasonable risk. Successful MFIs incorporate risk management into their organizational design. Lending methodologies, savings services, and operational procedures. MFIs need to form a Risk management feedback loop in order to mitigate risk arising from their operations.

7. EMPIRICAL LITERATURE ON RISK MANAGEMENT PRACTICE OF MICROFINANCE INSTITUTIONS

Waweru and Spraakman (2012) carried out a case study on the use of performance measures in three Microfiance institutions and found that the commercial or bank like nature of microfinance institutions suggests that techniques used in banking can also apply to microfinance sector

A comprehensive approach to risk management reduces the risk of loss, builds credibility in the marketplace, and creates new opportunities for growth. As MFIs continue to grow and expand rapidly, serving more customers and attracting more mainstream investment capital and funds, they need to strengthen their internal capacity to identify and anticipate potential risks to avoid unexpected losses and surprises. Creating a risk management framework and culture within an MFI is the next step after mastering the fundamentals of individual risks, such as credit risk, treasury risk, and liquidity risk. (**GTZ, 2000**)

In the study titled" **An Appraisal of Risk Management Practices of Microfinance Institutions in Ghana"** conducted by **Akwasi A. Boateng & Gilbert O. Boateng(2014),** It was discovered that the barriers to microfinance institutions success includes numerous and varied obstacles. Studies conducted confirmed microfinance institutions managements are ignorant pertaining to the risks their organizations face with risk management techniques deployed reactively and ineffectively. By embedding a structured approach to enterprise risk management within MFIs, potential benefits such as reducing the over-management of risks and organizational alignment towards the microfinance institution's mission can be realized. This study used secondary data sources for drawing these conclusions.

Rosman (2009) has proposed a research framework on RMPs and the aspects of risk management processes. This framework observes the relationship between RMPs and the four aspects of risk management process i.e.: (1) Understanding risk and risk management (URM). (2) Risk identification (RI). (3) Risk analysis and assessment (RAA) (4) Risk monitoring (RM). This framework has been extensively used in several studies.

Another study titled "Risk management practices among commercial banks in Ghana", conducted by **Seyram Pearl Kumah1* Yakubu Awudu Sare (2013)** studied the determinants risk management practices among commercial banks in Ghana using a multiple regression model with risk management practices as the dependent variable and Understanding risk, risk identification, risk assessment and analysis and risk monitoring as the independent variable.

In the study "Risk management practices: A comparison of conventional and Islamic banks in Pakistan", conducted by **Mian Sajid Nazir, Adeel Daniel, Muhammad Musarrat Nawaz** (2012) Descriptive analysis, Pearson correlation were used to examine and compare risk management practices of conventional and Islamic banks in Pakistan. This study used a regression model to examine the impact of independent variables of understanding risk and risk management, risk identification; risk assessment and analysis, risk monitoring; and credit risk analysis on the dependent variable risk management practices

The study titled "Banks risk management: A comparison of UAE national and foreign banks" by, **Hussein A. Hassan Al-Tamimi & Faris Mohammed Al-Mazrooei (2007)** tried to examine the degree to which UAE banks use risk management practices and techniques in dealing with different types of risk. This study has used Cronbach's alpha, descriptive statistics, regression analysis and one-way ANOVA

Hassan, (2009), made a study "Risk Management Practices of Islamic Banks of Brunei Darussalam" to assess the degree to which the Islamic banks in Brunei Darussalam implemented risk management practices and carried them out thoroughly by using different techniques to deal with various kinds of risks including liquidity risk.

In a study titled **"Risk management practices of conventional and Islamic banks in Bahrain", by Hameeda Abu Hussain and Jasim Al-Ajmi (2012)**, it was observed that Banks in Bahrain are found to have a clear understanding of risk and risk management, and have efficient risk identification, risk assessment analysis, risk monitoring, credit risk analysis and risk management practices. In addition, credit, liquidity and operational risk are found to be themost important risks facing both conventional and Islamic banks. Furthermore, the risk management practices are determined by the extent to which managers understand risk and risk management, efficient risk identification, risk assessment analysis, risk monitoring and credit risk analysis. Islamic banks are found to be significantly different from their conventional counterparts in understanding risk and risk management. The levels of risks faced by Islamic banks are found to be significantly higher than those faced by conventional banks. Similarly, country, liquidity, and operational, residual, and settlement risks are found to be higher in Islamic banks than in conventional banks. The purpose of this paper was to report empirical evidence regarding the risk management practices of banks operating in Bahrain.

Koziol and Lawrenz (2008) conducted a study where they assessed the risk of bank failures. They said that assessing the risk related to bank failures is the paramount concern of bank regulations. They argued that in order to assess the default risk of a bank, it is important considering its financing decisions as an endogenous dynamic process. The research study provided a continuous-time model, where banks chose the deposit volume in order to trade off the benefits of earning deposit premiums against the costs that would occur at future capital structure adjustments. Major findings suggested that the dynamic endogenous financing decision introduced an important self-regulation mechanism.

Daniel Onyebuchi Okehi (2014), found that, by adopting effective risk management, improving corporate governance practices, and adhering to regulations, Nigerian banks can improve their performance. His research was aimed to determine why there have been persistent bank failures in Nigeria and to investigate whether ineffective risk management in banks, coupled with poor corporate governance practices and non-adherence to regulations (independent variables), play a significant role in the banks' performance (dependent variable).

Siddiqui (2008) found that Islamic banks in Pakistan were more liable towards considering projects with long-term financing and better performance in terms of assets and return established improved risk management with keeping safe liquidity

In the study titled "**Risk management tools practiced in Tunisian Commercial banks**" **conducted by Selma Abdelghani and Rajhi** the current risk management practices and techniques used by Tunisian banks were explored. It was found that the Tunisian bankers are aware of the importance and the role of effective risk management in reducing costs and improving bank performance. Furthermore, the Tunisian banks have implemented some effective risk strategies and risk management frameworks. In addition, the credit risk exposure methods are still underused by the Tunisian banks. Similarly, collateral and guarantees continue to be the most commonly used risk mitigation methods to provide support to credit facilities in Tunisian banks.

In a study titled '**factors affecting microfinance institutions credit risk management practices in Kenya'**, the researcher **Daniel. L.Mwangi** studied the credit risk management practices in micro finance institutions in Kenya using market concentration, portfolio quality and market infrastructure as independent variables and credit risk management practices as dependent variables". This study used descriptive analysis and correlation. Results of this study indicated that portfolio quality and market infrastructure were positively and significantly related with credit risk management of microfinance institutions. It also concluded that low levels of market concentration contributed to poor credit risk management of MFI studied.

8. CONCLUSION

The study concludes that micro finance provides financial help to the unbanked sections of the society. Since microfinance is a system that distributes small loans to poor people in order for them to generate income and start their own small businesses, it has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities. At the same time microfinance portfolios are exposed to various kinds of risks due to their inherent characteristics. As such the risk management practices of Micro finance institutions plays a vital role in the success and continuation of micro finance business.

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