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Contemporary Advancements in Commerce

Editors

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Contents

MANAGEMENT OF MICRO FINANCE INSTITUTIONS IN INDIA

*S.S.Mallikarjunaprasanna.

Abstract

Micro Finance Institutions are institutions whose major business is the provision of micro finance services. They are not banks, but they work like banks. They may be called micro finance bank, but their services and products are peculiar and targeted to the low-income earners. They provide services such as deposits, loans, payment services, money transfers and insurance to poor and low-income households and their micro enterprises so as to help them increase their income and thereby improving their standard of living. The survival of MFIs in any country depends majorly on the overall political and economic environment of such a nation. Risk is a daily phenomenon in every area of life and business. It is an integral part of financial services. Like all financial institutions MFIs face risks that they must manage efficiently and effectively to be successful. There are number of risks that an MFI has to face these risks could be delinquencies, frauds, staff turnover, interest rate changes, liquidity, regulatory etc. Very often, the task of managing financial stability and their long term viability becomes difficult for MIFs. If the MFIs does not manage its risks well, it will likely fail to meet its social and financial objectives. The management of these risks is therefore important. To fulfill these tasks risk analysis is needed. The MFIs are struggling for existence in India due to their lack of initiatives in managing the risks. There is a need to build strategies to mitigate risks. Therefore, the present study attempts to explore growth and silent features of MFIs, Identify the various types of risk categories faced by MFIs and to analyze the various strategies used to manage the risk.

Introduction

Microfinance is "small-scale financial services primarily credit and savings provided to people who farm, fish or herd" and adds that it refers to all types of financial services provided to low-income households and enterprises. In India, microfinance is generally understood but not clearly defined. For instance, if an SHG gives a loan for an economic activity, it is seen as micro finance. But if a commercial bank gives a similar loan, it is likely that it would not be treated as microfinance. In the Indian context there are some value attributes of microfinance. Micro finance is something done predominantly with the poor. Banks usually do not qualify to be MFOs because they do not predominantly cater to the poor. Micro finance grows out of developmental roots. This can be termed the "alternative commercial sector". MFOs classified under this head are promoted by the alternative sector and target the poor. However, these MFOs need not necessarily be developmental in incorporation. There a MFOs that are offshoots of

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NGOs and are run commercially. There are commercial MFOs promoted by people who have developmental credentials. We do not find commercial organizations having microfinance business.

It set up development banks, such as SIDBI, NABARD which focused on rural credit and micro-financing. NGOs and SHGs were encouraged to become the government arm in extending micro-credit to the poor. They were provided supplementary credit needed to fund the credit, paper work was reduced between them and the banks. Also, the government assisted in mobilizing funds from formal financial institutions to meet the larger credit needs of these organizations.

A lot of Micro financing schemes are now increasingly focusing on women primarily as well. There are compelling reasons for this. Among the poor, the poor women are the most disadvantaged - they are characterized by lack of education and access to resources, both of which are required to help them work their way out of poverty and for upward economic and social mobility. The problem is more acute for women in countries like India, despite the fact that women labor makes a critical contribution to the economy. Evidence shows that groups of women are better customers than men - they are better managers of resources - benefits of loans are spread wider among the household if loans are routed through women - mixed groups are often inappropriate in Indian society - record of all-male groups is worse than that of all-women groups, everywhere.

Objectives of The Study

1. To explore growth and silent features of MFIs
2. To identify the various types of risk categories faced by MFIs
3. To analyze the various strategies used to manage the risk.

Methodology

The study is based on Secondary data. The data has been collected from books, magazines and websites.

Statement of The Problem

Micro Finance Institutions provide services to poor and low income households and their micro enterprises such as deposits, loans, payment services, money transfers and insurance so as to help them increase their income and thereby improving their standard of living. The survival of MFIs in any country depends majorly on the overall political and economic environment of such a nation. Risk is a daily phenomenon in every area of life and business. It is an integral part of financial services. There are number of risks that an MFI has to face these risks could be delinquencies, frauds, staff turnover, interest rate changes, liquidity, regulatory etc. Very often, the task of managing financial stability and their long term viability becomes difficult for MIFs. If the MFIs do not manage its risks well, it will likely fail to meet its social and financial objectives. The management of these risks is therefore important. To fulfil these tasks risk analysis is needed. There is a need to build strategies to mitigate risks. Therefore, the present study attempts to explore the various types of risk categories faced by MFIs and to analyze the various strategies used to manage the risk.

Various Risk Categories

1. Financial Risks
2. Operational Risks
3. Strategic Risks

Financial Risk

The business of a financial institution is to manage financial risks, which include credit risks, liquidity risks, interest rate risks, foreign exchange risks and investment portfolio risks.

1. Credit risk

It is the risk to earnings or capital due to borrowers' late and non-payment of loan obligations. Credit risk 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.

2. 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.

3. 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. It 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).

4. Investment portfolio risk

Investment portfolio risk refers mainly to longer-term investment decisions rather than short term liquidity or cash management decisions.

5. 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.

Operational Risks

Operational risk arises from human or computer error within daily product delivery and services. It includes Transaction Risk, Human resources Risk, Information & technology risk, Fraud (Integrity) Risk, Legal & Compliance Risk

1. 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.

2. Fraud risk

Fraud risk is the risk of loss of earnings or capital as a result of intentional deception by an employee or client. The most common type of fraud in an MFI is the direct theft of funds by loan officers or other branch staff. Other forms of fraudulent activities include the creation of is leading financial statements, bribes, kickbacks, and phantom loans.

Strategic Risks

Strategic risks include internal risks like those from adverse business decisions or improper implementation of those decisions, poor leadership, or ineffective governance and oversight, as well as external risks, such as changes in the business or competitive environment.

1. Governance risk

One of the most understated and underestimated risks within any organization are the risk associated with inadequate governance or a poor governance structure.

2. Reputation Risk

Reputation risk refers to the risk to earnings or capital arising from negative public opinion, which may affect an MFI's ability to sell products and services or its access to capital or cash funds. Reputations are much easier to lose than to rebuild, and should be valued as an intangible asset for any organization.

3. External 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.

4. Regulatory and legal compliance risk

Compliance risk arises out of violations of or non-conformance with laws, rules, regulations, prescribed practices, or ethical standards, which vary from country to country. The costs of nonconformance to norms, rules, regulations or laws range from fines and lawsuits to the voiding of contracts, loss of reputation or business opportunities, or shut-down by the regulatory authorities. Many non-government organizations that provide microfinance are choosing to transform into regulated entities, which exposes them to regulatory and compliance risks.

Strategies or Tools to Mitigate Risk

Microfinance institutions are facing risks. There is a need to build strategies to mitigate risks. **Some of the major reasons include:**

- high dependency on rural population on agriculture which itself is dependent on monsoon,
- lower income of people
- less employment opportunities in rural sector

Risk management strategies are used to reduce the likelihood of the losses due to the risks explained above. General risk management strategies are in use and some examples from other microfinance institutions are

1. Quantitative assessment coupled with incentives and penalties to mitigate credit risk

In order to prevent credit risk, microfinance institutions perform

a) Quantitative assessment and screening of the customer

b) Regular monitoring of activities of client

c) Offer incentive to prevent delinquencies

d) Heavy amount of penalties is imposed in case of default and adoption of limit on the amount of the loan.

e) In case of agriculture loans, credit officers are trained for credit appraisal and management. It is now in practice that loan is preferably given to the individuals having various sources of incomes.

f) Group lending is one of the innovative tools used to mitigate credit risk. The outstanding feature of group lending is that no collateral is required to lend loans but the group is responsible for the payback of the loan.

g) Thus, peer pressure act as collateral in this case. Several microfinance institutions in India are using Self Help Group and Joint Liability Group model in the rural sector.

2. Mitigation of operational risk by focusing on recruitment process

Due to increase in diversification, geographical expansion (offices far from head office, remote area offices) and positioning of officers from a long period in microfinance institutions in India, operational risks have increased overtime. Microfinance institutions in India facing operational risk use various strategies to mitigate risks. Some of the most used strategies include

a) Standardization of policies for staff (so that there is a less chance of fraud).

b) Effective internal control on any human error.

c) Recording of fraudulent staff.

d) Background verification of staff before recruiting.

3. Diversified portfolio to mitigate market risk

Many institutions are exposed to market risks, mainly interest rate risks which arise due to two major reasons. Firstly, due to slow adjustment of institutions towards variable interest rate in the market. Secondly liquidity risk due to increase in term of loans. To reduce liquidity risk, microfinance institutions usually invest and have diversified portfolios, which attract investments for further lending.

4. Skilled and efficient board to tackle strategic risk

This arises due to lack of management skills and poor governance. This form of risk become important for complex structured financial institutions. This management can make policies, handle and guide on strategic issues and can review the implemented actions. Foreign exchange risk is not considered in study because majority of Indian microfinance institutions are not using foreign funds for lending.

Despite the adoption of strategies to mitigate risk and use of ethical practices to collect money, the microfinance industry is exposed to many risks and chances of fraud. Due to this crisis, institutions are losing their trust worthiness. Similarly, commercial banks are also refusing to disburse loans to microfinance institutions. This led to a negative borrowing trend in the industry which raised portfolio risk and made lending costly.

Risk Management

Risk management is a systematic process consisting of well-defined steps of (a) identifying risks, (b) analyzing and assessing risks, (c) risk response planning, and (d) monitoring and controlling risks. When these steps are taken in sequence, they support better decision making by contributing to a greater insight into risks and their impact. This process is as much about identifying opportunities as it is about avoiding losses/threats. It is the process of managing the risk exposures by keeping the undesirable outcomes to an acceptable minimum either by taking actions to reduce the exposure to risks to an acceptable level, or by converting one form of risk into a more acceptable risk, in a cost-effective way. Risk management includes the prevention of potential risks, the early detection of risks when they occur, and the correction of the policies and procedures that permitted the occurrence.

It is not about eliminating, avoiding or removing all risk. Risk management should be:

1. Comprehensive – covering every aspect of the organization
2. Continuous– not just a one-off exercise, but something that is maintained and updated
3. Built-in – not an add-on, but integrated into all operations and systems
4. Suitable – there is no one size fits all but principles, policies and practices that can be adapted to any kind of organization or activity
5. Proportional – keeping a sense of perspective and proportion between benefits and risks.

Findings

1. Natural calamities like Floods, fires, cyclones, earthquakes and epidemics can cause havoc to the economic and social life of the people affected.
2. Economic recessions sometime also affect client earnings, potentially reducing their loan repayment capacity.
3. A comprehensive approach to risk management reduces the risk of loss, builds credibility in the marketplace, and creates new opportunities for growth.
4. Lack of a framework and understanding is the reason that microfinance institutions have not thoroughly integrated risk management into their culture and operations.
5. Risk management is dealing with uncertainties and reducing or removing risk factors.
6. Where the client dies or is incapacitated to undertake business/ livelihoods activities will surely affect the repayment.
7. MFIs need to upgrade their internal management systems and risk management so as to manage credit and liquidity risks, market risks, pricing and operational risks, etc.
8. Proper analysis of credit risk can help the bank to avoid facing the failures of financial losses.
9. 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.
10. Risk management methods can ensure that their capital and cash are managed better with minimal risk to business.
11. Many MFIs also sanctioned loan without appraising the capacities of the client. Both this situation led to the over-indebtedness of the client. Results of the over-indebtedness are non-repayment of loan instalment, coercive method of collection and even suicide by the clients
12. Functional risk include staff fraud, inefficient staff performance, inefficient tracking system of credits or loan outstanding, over-dependent upon donors and staff dropouts.

Suggestions

1. 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.
2. MFIs need to prepare for worst case scenarios, such as a downturn in the world economy.
3. MFIs should use sensitivity analysis to determine how the institution would fare in face of unforeseen risks, given its current structure and controls, and implement additional measures to ensure its survival.
4. MFIs should have an active and effective board of directors for effective risk management.
5. Donors should focus their efforts on those institutions that have demonstrated effective risk management strategies in the provision of traditional microfinance services.
6. Donors should promote effective risk management in microfinance NGOs by supporting their development of more effective systems and procedures to manage risks,
7. Donors should support research and training efforts that address risk management topics.
8. The board must play an active role in communicating the importance of risk management to the rest of the institution.
9. The MFI must integrate risk management into the organization's culture. It is the task of the MFI's leadership i.e., the directors, CEO and senior managers to communicate the importance of risk management and install a risk management culture at all levels of the institution.
10. MFIs should incorporate risk management into the design of its systems, processes, and methodologies to reduce the frequency and scale of unwanted risk from the outset.
11. MFIs must assign operational accountability for monitoring and managing risk on a daily basis, as well as senior level accountability for oversight of specific risks.
12. Management and directors must focus on the key performance indicators they need on a regular basis and then direct staff to implement the systems to provide that information.

Conclusion

Risk management has become more important to MFIs and its importance will continue to grow in the future. Other factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of microfinance risk management. MFI's business is adequately controlled is the development of a comprehensive system of management controls, accounting and internal controls, security procedures, and other risk controls. However due to various internal and external factors, risks and losses has led to negative growth and has reduced the trust worthiness. Risk is an essential part of every business and it is not possible to avoid them. So, risk management should be considered seriously and actions toward necessary measures should be taken on time. Identification, monitoring and controlling of risk oriented steps should be done to minimize the losses. Microfinance institutions in India are present to serve rural and poor population which should work on ethical lines. Also, microfinance institutions should keep in mind the lessons from cases of failure while devising strategies at the management level. Strategies or techniques become the obligation of MFIs and are required to be followed adequately to retain the strong financial position in the economy.

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