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REVIEW ARTICLE

MICRO FINANCE INSTITUTIONS IN INDIA- AN EFFECTIVE RISK MANAGEMENT

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ABSTRACT

Risk is an integral part of financial services. When financial institutions issue loans, there is a risk of borrower default. When banks collect deposits and on-lend them to other clients (i.e. conduct financial intermediation), they put clients' savings at risk. Any institution that conducts cash transactions or makes investments risks the loss of those funds. Development finance institutions should neither avoid risk. Like all financial institutions, microfinance 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 begin to dry up.

INTRODUCTION

Managing risk is a complex task for any financial organization, and increasingly important in a world where economic events and financial systems are linked. Global financial institutions and banking regulators have emphasized risk management as an essential element of long-term success. Rather than focusing on current or historical financial performance, management and regulators now focus on an organization's ability to identify and manage future risks as the best predictor of long-term success. For the financial institutions, effective risk management has several benefits: Early warning system for potential problems: A systematic process for evaluating and measuring risk identifies problems early on, before they become larger problems or drain management time and resources. Less time fixing problems means more time for production and growth.

Concept

The following definitions for risk management:

Risk is the possibility of an adverse event occurring and its potential for negative implications to the MFI.

Risk management is the process of managing the probability or the severity of the adverse event to an acceptable range or within limits set by the MFI.

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Risk management is the process of managing the probability or the severity of the adverse event to an acceptable range or within limits set by the MFI.

A ***risk management system*** is a method of systematically identifying, assessing, and managing the various risks faced by an MFI.

A ***risk management framework*** 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. Integrates into MFI operations a set of systematic processes for identifying, measuring, and monitoring many different types of risk to help management keep an eye on the big picture;

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 exacerbate one another 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.

As described further in the risk management feedback loop has six key components:

1. To Identifying, assessing, and prioritizing risks
2. To Developing strategies and policies to measure risks
3. To Designing policies and procedures to mitigate risks
4. To Implementing and assigning responsibilities
5. To Testing effectiveness and evaluating results
6. To Revising policies and procedures as necessary

- More efficient resource allocation (capital and cash): A good risk management framework allows management to quantitatively measure risk and fine-tune capital allocation and liquidity needs to match the on and off balance sheet risks faced by the institution, and to evaluate the impact of potential shocks to the financial system or institution.
- Better information on potential consequences, both positive and negative. A proactive and forward-thinking organizational culture will help managers identify and assess new market opportunities, foster continuous improvement of existing operations, and more effectively align performance incentives with the organization's strategic goals.

For MFIs, better internal risk management yields similar benefits. 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.

Why is Risk Management Important to MFIs?

As MFIs play an increasingly important role in local financial economies and compete for customers and resources, the rewards of good performance and costs of poor performance are rising. Those MFIs that manage risk effectively – creating the systematic approach that applies across product lines and activities and considers the aggregate impact or probability of risks – are less likely to be surprised by unexpected losses (down-side risk) and more likely to build market credibility and capitalize on new opportunities (up-side risk).

- The core of risk management is making educated decisions about how much risk to tolerate, how to mitigate those that cannot be tolerated, and how to manage the real risks that are part of the business.
- For MFIs that evaluate their performance on both financial and social objectives, those decisions can be more challenging than for an institution driven solely by profit.
- A risk management framework allows senior managers and directors to make conscious decisions about risk, to identify the most cost-effective approaches to manage those risks, and to cultivate an internal culture that rewards good risk management without discouraging risk-taking.
- More sophisticated approaches to risk management are important to MFIs for several reasons. 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.
- Second, 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.
- Third, 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 perations, making effective risk management essential to achieving better capital and cash management without undue risk.
- The key risk management concepts and demonstrate the range of how they can be applied. The following microfinance providers contributed to the content of this document:

Microfinance Risks and Challenges

Microfinance institutions face many risks that threaten their financial viability and long-term sustainability. 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 their likelihood of occurrence. Once risks are identified, the MFI can design strategies and control mechanisms to deal with them and assign responsibility to key individuals and teams to address them.

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

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.

Most microfinance institutions have put most of their resources into developing a methodology that reduces individual credit risks and maintaining quality portfolios. Microfinance institutions that use savings deposits as a source of loan funds must have sufficient cash to fund loans and withdrawals from savings. Those MFIs that rely on depositors and other borrowed sources of funds are also vulnerable to changes in interest rates. Financial risk management requires a sophisticated

Credit risk

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

Transaction risk

Transaction risk refers to the risk within individual loans.

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

Effective approaches to managing credit risk in MFIs 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 (e.g., by loan product, by branch, etc.).The importance of a "credit culture" in minimizing problems and increasing operational efficiencies cannot be overstated.

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.

Some principles of liquidity management that MFIs use 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.

Market risk

Market risk includes interest rate risk, foreign currency risk, and investment and portfolio risk.

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. Interest rate changes can also affect fee income,

Below are two common approaches to interest rate risk management among financial institutions.

* 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 longterm loans at existing fixed rates, and shorten the term of the MFI’s liabilities.

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.

Principles in practice by MFIs to reduce 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.

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. It transcends all divisions and products of a financial institution. This risk includes the potential that inadequate technology and information systems, operational problems, insufficient human resources, or breaches of integrity (i.e. fraud) will result in unexpected losses. This risk is a function of internal controls, information systems, employee integrity, and operating processes. For simplicity, this section focuses on just two types of operational risk: transaction risk and fraud risk.

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 high level of cross-checking. Since MFIs make many small, short-term loans, this same degree of cross-checking is not costeffective, 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.

For MFIs, key steps to reduce 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 reporting information is providing the most accurate information, and reduces 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.

Fraud risk

Effective internal controls play a key role in protecting against fraud at the branch level, since line staff handle 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: i) the use of preventive measures to reduce fraud, and ii) the importance of client visits to verify branch information, as described below.

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. This section focuses on three critical strategic risks: Governance Risk, Business Environment Risk, and Regulatory and Legal Compliance Risk.

Governance risk

One of the most understated and underestimated risks 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.

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. Most successful MFIs cultivate their reputations carefully with specific audiences, such as with customers (their market), their funders and investors (sources of capital), and regulators or officials.

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. In Bolivia, for example, many microfinance institutions have lost 20 Anita Campion, Current Governance Practices of Microfinance Institutions:

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 non conformance 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.

MFIs use this risk management strategy to manage regulatory risk:

* 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 of the MFI and provide an opportunity to defuse any potential problems.

Additional Challenges for MFIs

Microfinance institutions face several additional challenges that are unique and relevant to the microfinance industry's current level of development. While every MFI is unique, they share some common challenges including rapid growth and expansion, management succession, and new product development.

Rapid growth and expansion

Rapid growth places several strains on an MFI's operations. For many MFIs, growth has strained their capacity to groom new managers from within the ranks, forcing rapid promotions to fill management positions. The pursuit of growth to improve financial viability can also lead to "mission drift," resulting in a loss of focus on serving low-income clients. The pressure to expand the loan portfolio and maintain low delinquency can encourage loan officers to select wealthier clients with larger loan requests

MFIs use several risk management strategies when faced with rapid growth:

- Careful attention to staff recruitment and training. The MFI can reduce operational risk by carefully growing staff and ensuring that employees' interests are aligned with those of the goals of the organization.
- Control growth to allow time to develop internal systems and prepare staff for changes resulting from the expansion.

* Carefully monitor loan growth and portfolio quality to better understand growth (e.g., number of loans per client, average loan size, growth in number of borrowers) and to not let growth mask increases in delinquency.
* Good communication from senior managers to reinforce the MFI's culture and commitment to quality service and integrity. These efforts should motivate new employees, as well as existing employees who are being asked to do more.

Effective Risk Management

Classic risk management requires an organization to take four key steps:

(1) Identify the risks facing the institution and assess their severity (either frequency or potential negative consequences)
(2) Measure the risks appropriately and evaluate the acceptable limits for that risk;
(3) Monitor the risks on a routine basis, ensuring that the right people receive accurate and relevant information; and
(4) Manage the risks through close oversight and evaluation of performance. Managing risk is a continual process of systematically assessing, measuring, monitoring, and managing risks in the organization. Effective risk management ensures that the "big picture" is not lost to the urgent demands of day to day management.

Risk management has only recently become a hot topic among financial institutions. Regulation and supervision historically have focused on past performance and current financial condition as predictors of future financial safety and soundness. In the mid 1990s, after several "surprise" bank failures, US regulators shifted the focus of their reviews to place greater emphasis on an institution's internal risk management capabilities in each area of operations, since those are better predictors of the bank's ability to withstand internal or external uncertainties.

Implementing Risk Management

As MFI's become larger and more sophisticated, risk management should become a more conscious part of their management and governance. The goal of good risk management is to reduce uncertainty and qualify potential financial losses as “reasonable,” in other words to eliminate surprises. Implementing risk management, however, is both art and science.

Guidelines for Implementing Risk Management

This section presents ten guidelines for microfinance institutions to follow when developing their risk management framework. Collectively, these guidelines help a microfinance institution systematize risk management and integrate it into all levels of operations. These guidelines are simple suggestions that should apply to most MFIs.

Ten Guidelines for Risk Management

1. Lead the risk management process from the top
2. Incorporate risk management into process and systems design
3. Keep it simple and easy to understand
4. Involve all levels of staff
5. Align risk management goals with the goals of individuals
6. Address the most important risks first
7. Assign responsibilities and set monitoring schedule
8. Design informative management reporting to board
9. Develop effective mechanisms to evaluate internal controls
10. Manage risk continuously using a risk management feedback loop

Key Roles and Responsibilities

While it is important that risk management permeate all levels of the MFI, responsibility for the system starts at the top of the organizational hierarchy. The board and management develop the system and set the tone, but other employees also play a part in risk management. When possible, senior management assigns other managers the responsibility for overseeing and managing specific risks.

Finding and Recommendations
Obstacles

- There are several reasons that microfinance institutions have not thoroughly integrated risk management into their culture and operations. The primary reason has been a lack of a framework and understanding of the need to do so, which this publication works to overcome.
- However, several obstacles remain that impede the microfinance industry’s ability to maximize its risk management potential. This chapter addresses the remaining obstacles to effective risk management on both an institutional and industry level and discusses some of the resources needed to overcome them.
- Successful microfinance institutions often become over-confident of their future based on their past successes. However, few microfinance institutions have been in existence for more than ten years.
- Despite short-term successes, MFIs need to prepare for worst case scenarios, such as a downturn in the world economy, 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.
- The effective risk management begins at the top of the organizational chart, the board must play an active role in communicating the importance of risk management to the rest of the institution.
- Therefore, the real starting point for effective risk management is for the MFI to have an active and effective board of directors.
- Donors are seeking to support new initiatives and are pushing MFIs to reach further down market to reach lower income and rural borrowers and to create new products to accommodate a wider client base.
- These initiatives represent high risks since they are new to microfinance institutions and have been unexplored by the financial service sector

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.

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