Vol. 6 No. 2 April 2018 ISSN: 2320-4168 UGC Approval No: 44120 Impact Factor: 4.118

RISKS FACED BY MICROFINANCE INSTITUTIONS

Article Particulars

Received: 11.04.2018 Accepted: 19.04.2018 Published: 28.04.2018

B.RAMANA REDDY
Assistant Professor in Commerce, GFGC, HSR Layout, Bangalore, Karnataka, India

Abstract

There are number of risks that an MFI has to face these risks could be of delinquencies, frauds, staff turnover, interest rate changes, liquidity, regulatory etc.
But all these risks can broadly be classified into four major categories;

1. *Credit risk.*
2. *Operationalrisk*
3. *Market risk and*
4. *Strategic risk*

Of the above four categories Credit risk and Market risk are directly of financial nature and hence are called Financial risks while Operational risk and Strategic risk are of non-financial character and result mainly from human errors, system failures, frauds, natural disasters or through regulatory environment, weak board, poor strategy, etc. However, it must be remembered that operational and strategic risk, as and when materialize will also translate into financial losses for the organisation.
Keywords: *Risk, Organization, Microfinance, Institution*

Risks faced by Microfinance Institutions

Credit Risk

Credit risk is directly related to the portfolio of the organisation and is one of the most significant risks from an MFI perspective. Whenever an MFI lends to a client there is an inherent risk of money not coming back, i.e. the client turning into a defaulter, this risk is called the Credit risk. Credit risk is simply the possibility of the adverse condition in which the clients does not pay back the loan amount. Credit risk is the most common risk for the MFI. The risk is of greater significance for MFIs as it has to deal with large number of clients with limited literacy. Further, MFI provides unsecured loans, i.e. loans without any collateral. In case a client default the MFI does not have any asset to meet its loss, which makes the credit even riskier.

MFIs fund their portfolio through external borrowings, through their own capital and through client savings that the MFI has mobilized. By giving a loan, an MFI also attracts risk to these sources of funds. It is therefore said that an MFI deals in public funds, acquired through banks, clients savings or through donors who trust the MFI to carry out its activities effectively. If an MFI loses money it may not be in a position to meet its own financial obligations to its depositors or lenders thereby becoming a defaulter itself. This

results in loss of confidence of the funders and the direct financial loss for the MFI as the organisation loses not only interest but also its principal amount.

Credit risk emanates from internal as well as external factors. GTZ, a German development agency with a strong financial sector department, in its Risk Management Framework has classified Credit risk into two broad categories.

a. Transaction risk: which is related to the individual borrower with which the MFI is transacting. A borrower may not be trustworthy and capable of repaying loan which will result in loss of loan. All loss of loan related to delinquency of individual clients which can be because client's migration, willful defaulting, business failure etc. is called transaction risk.

b. Portfolio risk: Portfolio risk is related to factors, which can result in loss in a particular class or segment of portfolio. For example, an MFI may lose a portfolio with a particular community, locality or a particular trade due to some external reasons. These reasons could be political, communal, failure of an industry /trade, etc.

Indicators of Credit Risk

Although credit risk is inherent to all loan of the MFI, it materializes in the loans which start showing over dues. An amount is called 'overdue' if it is not received by the MFI on its scheduled time. Every loan that an MFI provides have fixed schedule for repayment. This is called Repayment schedule, which provides the schedule of payment and acts as the reference point for the MFIs to estimate their over dues.

At the time of loan disbursement every client is given a repayment schedule, which shows the amount to be paid in each installment and the date of payment. If the amount is not received on or before the schedule date it is called overdue. If any loan has any amount overdue it is termed as a Delinquent loan or a case of delinquency.

MFIs try to have an objectives view of their credit risk and want to measure the extent of credit risk, which is the risk on their portfolio. There are various indicators, which help in measuring the credit risk profile of an MFI. Of these indicators portfolio at risk or commonly known as PAR is considered to be the most effective and is now very common indicator across MFIs. Apart from PAR, Repayment rate and Arrear rate are other ratios, which also provide information about the portfolio quality of an MFI.

PAR; Portfolio at risk or PAR tries to measure the amount of loan outstanding that the MFI stands to lose in case an overdue client does not pay a single installment from the day of calculation of PAR. PAR is the proportion of loan with overdue clients to the total loan outstanding of the organization.

PAR% = (Loan outstanding on overdue loans/Total loan outstanding of the MFI) x 100

PAR is further refined by MFIs to make it meaningful by including ageing in it. So MFIs often calculate PAR30, PAR 60, and PAR 90 etc. PAR30 means outstanding of all loans,

which have over dues greater than 30 days as a proportion of total outstanding of the MFI, similarly PAR60 means outstanding of all loans, which have over dues greater than 60 days as a proportion of total outstanding of the MFI and so on and so forth.

One thing noticeable here is that overdue amount is not used anywhere in the formula. Over dues are simply taken as indicators to identify risky loans. Loan outstanding is used in the formula, as it is the maximum amount an MFI stands to lose if a client defaults. For example, an MFI has five clients, each has taken 10,000 loan and have to repay on monthly basis and loan term is 10 months.

Therefore each month each one of them makes principal repayment of Rs 1,000. After five months of loan disbursement, it is necessary than 5 installments had to be paid which means each client should have paid back Rs 5,000 of principal amount. But

Say the actual repayment was as shown in the table below

Clients	Disbursed	Due	Principal paid	Principal overdue	Principal Outstanding
1	10,000	5,000	2,000	3,000	8,000
2	10,000	5,000	3,000	2,000	7,000
3	10,000	5,000	5,000		5,000
4	10,000	5,000	4,000	1,000	6,000
5	10,000	5,000	5,000		5,000
Total	**50,000**	**25,000**	**19,000**	**6,000**	**31,000**

To calculate PAR, we have to take the following steps;

- Identify loans with over dues; in the given example loan 1, 2 and 4 have over dues Find outstanding on overdue loans and add; in example outstanding on overdue loans (1, 2 and 4) are 8,000 7,000 and 6,000. On adding them we get 21,000
- Divide sum of outstanding of overdue loans by total outstanding
- Arrear rate; Arrear rate is the principal overdue as a proportion of the total loan outstanding of the MFI.

Arrear rate = (Total overdue/Total loan outstanding) x 100.

In the given example it is Rs 6,000/Rs 31,000 = 19.35%

This ratio tells the proportion of loan portfolio the MFI is currently losing, i.e. the principal amount that should have been recovered out of the total portfolio but has not been recovered.

Repayments rate; Repayment rate on the other hand is the ratio of the amount received by the organization against the total amount due.

Repayment rate ;((Total principal collection during a period – prepayments)/Total amount due for the period) x 100

Prepayments, if any have to be deducted from the collections, as this amount was not due for the period. Prepayment is the principal amount paid by clients before it was due. As mentioned earlier, all these ratios, MFIs and financial institutions lay maximum emphasis on PAR and consider it as the best indicator for risk. This is because PAR is a forward looking ratio and provides an estimate of the total loss that an MFI is likely to make should the risky clients default. While arrear rate and repayment rate only

provide information of current loss and indicate the past performance. Arrear rate and repayment s rate are not able to capture the future risk.

Causes of High Credit Risk and Managing them

Now that we know that MFIs have to undertake the credit risk, the question is why different MFIs have different degrees of credit risk indicated by their different values of PAR? Even in the same geographic location with similar client profiles, different MFIs have different values of PAR, reflecting different degree of credit risk they are exposed to. Some of the major reasons for delinquencies observed in MFIs are discussed below.

Poor MIS – MIS on loan outstanding, collection etc plays a critical role in generating reports and making them available in minimum time to the right people. If an MFI does not have a good MIS, it may not know how much to collect, it may not know its over dues or age-wise over dues. A with weak reporting system on overdue will result in delayed input on over dues to the top management and consequently result in delayed action by the top management. Sometimes weak MIS also results in generation of inaccurate report. If the correct and timely information is not generated and report the problem cannot be dealt with resulting in delinquencies getting aggravated.

Poor screening of borrowers – Poor choice of clients results in delinquencies. If client with bad reputation or history of defaults are selected, then it can result in delinquencies

Weak appraisal – Poor or weak appraisal of loans is one of the major reasons for delinquencies. Before giving any loan, client's repaying capacity, status of business and cash flows must be assessed. This helps in taking loan decision that whether a client should be a given a loan and about appropriate volume of loan. Poor appraisal can lead to loans going to unworthy clients or disbursement of higher amount loans. Loans given beyond repaying capacity puts clients in stress situation as they do not have sufficient income to repay installments resulting in delinquencies.

Unclear communication about product and methodology- Clear communication of policies and procedures is very important. If the clients do not know the policies and procedures it can result in confusion and delinquencies even if clients are capable of paying

No immediate follow-up – MFI having strong overdue follow up system can control over dues to a large extent. It also gives clear message to the clients that the MFI is serious on repayments and thus prevents the future occurrences. MFIs which are weak in overdue follow up give a signal that it is not serious in overdue collection resulting other clients to imitate. Also if the over dues are immediately followed up the chances of recovery are quite high but if the case becomes old then the chances of recovery also goes down.

Mixing other social activities with micro-finance – Sometimes delinquencies may also result if MFIs carry out grant based activities along with micro-finance with the

same set of clients and with same staff. Mixing activities of two different nature confuses the client wherein one activity is being provided free while repayment is asked on micro-finance. This confuses the clients who may think that loans to be given to them may also be grants for them and they need not return it. Also enforcing repayments and discipline through a staff who is involved with the community in other social activities also will be very difficult and hence results in delinquencies.

Poor product – Delinquencies occur if the product is not suitably designed. If the repayments do not match with the cash flow of the client, then it may result in delinquencies. Client cash flow means that when do the clients receive income and when they need to spend. In agriculture economy, clients may need to spend during sowing season and hence need money. While they may receive income during harvest. Other important point is if the repayment period is too long or too short or frequency of payments and installments size are not well thought off, it can all lead to delinquencies.

Natural disasters – Delinquencies can also happen as an aftermath of a natural dis aster such as flood, drought, earthquakes or epidemic.

Corruption – Corruption at field staff level such as taking bribe for loans or frauds can result in delinquencies. A staff taking favor from clients cannot enforce discipline or strict repayments. If the staff is committing fraud it will also show up as delinquency.

De-motivated employees – If the working conditions or incentive systems are not good, it will result in staff de-motivation and ultimately delinquencies. Motivated staff can make a lot of difference in enforcing policies in the field but of staff is de-motivated then they will not put sufficient efforts to enforce polices with the clients resulting over dues.

Conclusion

Thus we see that delinquencies do not occur, exclusively on account of client related reasons. Much of it can be attributed to internal systems and policies of the MFIs. It also means that if internal reasons related to the organization are taken care of then delinquencies can be controlled to a large extent. It is also important to understand why MFIs, investors and assessment agencies give so much importance to delinquencies and portfolio quality. This is one of the most (if not 'the' most) critical parameter for investors and assessors to rate and MFI and taking lending decisions. This is because portfolio is the most o important asset for the MFI and the only or the main source of its income. Any problem with the portfolio can adversely affect the MFI in a number of ways.

References

1. http://indiamicrofinance.com/types-risks-faced-microfinance-institutions.html
2. https://www.microworld.org/fr/node/37547