Risks in Nepalese Microfinance Institutions (MFIs): A Review of Best Practices

Basudev Lamichane
Saraswati Multiple Campus, Tribhuvan University

Abstract

This article aims to analyze possible risks in microfinance institutions (MFIs) in Nepal during the loan disbursement decision. Effective risk management allows MFIs to capitalize on new opportunities and to minimize threats to their financial viability. MFIs consciously take a risk to fulfill their dual mission of sustainability and outreach to the poor. Consequently, they are exposed to a spectrum of risks which include institutional risk, operational risk, financial risk, and external risk. MFIs need to manage these risks for their survival and sustainability. They take risks every day by lending money to people without credit histories, without business records, and often without collateral. Each MFI takes risks to operates as a successful microfinance institution. But it is important to take calculated risks. Risk Management is always focused on the process of taking calculated risks. It includes both the prevention of potential problems and the early detection of problems. Risk management is an ongoing process of systematically identifying, measuring, monitoring, and managing risks in MFIs. It is important to ensure that MFIs operate in a safe, responsible, and sound manner towards their mission.

Keywords: credit default, institutional risk, loan delinquency, operational risk, recognition test.

Introduction

Nepalese microfinance institutions have been adopting different modalities of lending. Such modalities are group lending, solidarity group lending, individual lending, and village banking lending. Among them, solidarity group lending is a widely used model of microfinance. The Group lending model is known as the Grameen model. This model is one of the best practices in the Nepalese microfinance sector. Under this model minimum of five to ten individuals formulate a solidarity group. They are the same age group, same economic status, and simply work in the same market from the same community for mutual benefits. They make a demand for a loan in the same group meeting and collect a small deposit amount in the same place during the period of the group meeting. Such a group takes responsibility for the repayment of the loan installment. Such a group would help lending money for long-lasting. It is the very simplest method of lending money but it may arises delinquent risk due to collateral-free and inadequate information i.e. how to know members, how to invest money they have, and how to fulfill physical needs. This is a fact scenario that arises loan delinquent, and default in microfinance institutions.

Microfinance is the provision of financial services to low-income clients or solidarity group lending includes consumers and the self-employed who are deprived of formal financial and related services. Microfinance programs have been playing a vital role in the social, psychological as well as economic empowerment of women. Members of MFIs have more control over saving and generating income from the business. They have a greater role in

the family decision, greater freedom in family, participation in social and political activities, and increased participation in outside activities. The purpose of microfinance is to provide financial services to needy people in remote areas who do not have access to modern physical facilities.

Risk is a potentiality that both the expected and unexpected events may harm the bank's capital or earnings. The expected loss is to be borne by the borrower and hence taken care of adequately by pricing the products though risk premium. Banks have provided different products as banking instruments in the banking business. These products help banks in diversifying their risk by spreading credit widely among individual customers.

Risk-taking is an inherent element and an integral part of financial services. Microfinance Institutions (MFIs) are no exception. For microfinance institutions, risk management is a daily part of business whether the institutions having larger outreach or smaller. Microfinance institutions (MFIs) essentially act as financial intermediaries, bridging the gap between mainstream financial institutions and low-income households for a specific type of credit need. Effective risk management allows MFIs to capitalize on new opportunities and to minimize threats to their financial viability. It is necessary to take risks to achieve worthy and meaningful goals. This is especially true in microfinance where credit officer/loan managers take a risk every day by lending money to the client without any fixed collateral, business records credit history, and cash flow statement. MFIs consciously take the risk to fulfill their dual mission of sustainability and outreach to the poor.

Risk management reduces the likelihood of the loss and minimizes the scale of loss it occurs. It includes both the prevention of potential problems and the early detection of actual problems when they happen. So, risk will always be there. It will also come in different sizes and shapes.

Literature Review

The literature review is a major component of this conceptual framework. The purpose of the literature review in research is to situate the proposed research in the context of what is already known in the field. It should be able o provide the theoretical basis for the current work on the one and helps to narrow down the proposed topic.

Idma, Arongo & Nayor (2014) find that credit risk is a threat to Microfinance sustainability and conclude that Microfinance credit risk will be reduced to the minimum degree when the practical approaches to controlled loan defaults is strictly followed. They suggested building relationships with customers, engaging in Group lending then individual lending, verification of customers information, product standardization, and regular tracking through indicators are some important practical approaches to avert loan default risk.

Ahamad shows that the quality of the loan portfolio is directly concerned with the mechanism of credit management through effective credit appraisal of the borrower. Ahamad (2015) also describes the relationship between credit risk management and the positive performance of the loan.

Credit risk management is judgmental and statistical forecasting as a screening mechanism

of selection of target borrower of microfinance for the future sustainability of MFIs according to Lbtiseem and Bouru (2013). However, Desta, Tahir (2016), has conducted an assessment of “credit risk management performance of microfinance institutions” (In the case of hashemite Town microfinance institutions). The main objectives of that study were to assess and examines credit risk performance of hashemite Town microfinance institutions. He mentioned the failure of borrowers product, lack of qualified employee in credit appraisal, unsuitable repayment period, lack of evaluating collateral periodically and lack of giving training to borrowers how they use and invest loan for productive purpose and using a manual system for recording and posting transaction are the major problems that affect the credit risk management performance of MFIs. In this research, they collected data from employees, clients of microfinance, credit managers of each institution through structured interviews. He applied and uses descriptive analysis methods.

Njeru, & B.W, (2012) Analyzed internal and external factors of loan delinquency related problem in Kenya. Both factors significantly impact loan delinquency performance. They found there is a positive and significant relationship between loan delinquency and the performance of microfinance institutions. They concluded that internal and external environmental factors significantly affect the loan delinquency performance of microfinance institutions in Kenya. Njeru, & B.W, also further recommend that MFIs portfolio management strategies focus more on the internal factors of loan delinquency which they have more control over and seek practical and achievable solutions to readdress delinquency problems.
Karn (2018), Shows some challenges and opportunities in the Nepalese microfinance sector. In his study, he also found some problems of microfinance which need to be reform regarding targeting. According to Karn, there are problems in social awareness in the Nepalese microfinance sector. Along with that, he suggested a lot of opportunities in microfinance such as: stimulating the growth of the economy, increasing volume, accessibility, and outreach.

A pioneer apex wholesale lending microfinance institution in Nepal called RMDC Nepal, conducted an impact study of microfinance program in 2009 on the socio-economic dimension of the clients of the partner organization (PO’s). The study focused on the impact of microfinance on loan transaction, income and saving, living and non-living assets, food self- sufficiency, clothing and housing, health care, education for children, participation in social and political events, and empowerment of women and disclosed that there was a positive impact in investment, income, saving, and increase in both living and non-living assets. Remarkable improvements in housing, health care, and education of children were observed. The study also observed in participation in social and political events and found significant positive changes in the empowerment of women on the whole after involvement in the microfinance group compared before status. RMDC (2009) also highlighted the positive financial performance of clients of RMDC’s through systematic capacity development.

Research Gap

The result of the above-mentioned literature review illustrates that social and economic empowerment through financial services to needy people in rural areas is not only the function of MFIs but it also acts as a bridge in linking the knowledge transformation through the financial literacy program.

Currently, MFIs faced delinquent risk due to collateral-free loans and inadequate information about members, financial character, loan paying capacity, and history**.** This is a fact scenario that arises loan delinquent, and default in microfinance institutions.

Objective of the Study

The main objective of the study is to highlight the risks in the Nepalese microfinance institution (MFIs). The secondary objectives are to examine and explore the current challenges of microfinance faced by the Nepalese MF sector.

Methodology

To establish a conceptual framework to explain the causational relationship between risks and social performance of Nepalese microfinance institutions (MFIs) and the knowledge-based view of current risks in Nepalese microfinance institutions and challenges faced by the MF sector. In analyzing the risks in Nepalese MFIs, we take into consideration the following issues:

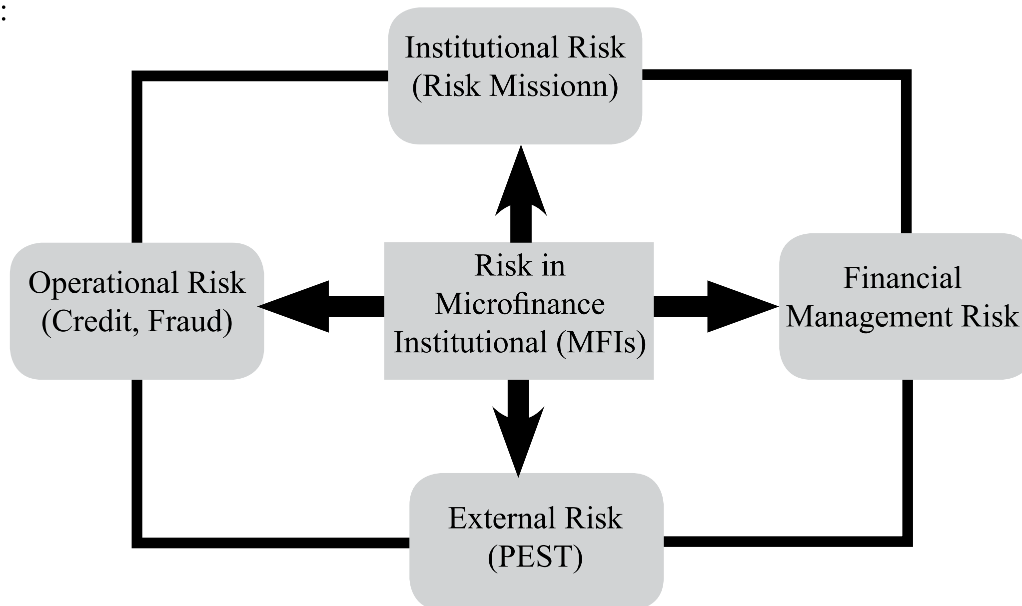

Figure 1. Possible risks in microfinance.

Institutional risk: Microfinance institutions have a dual mission: a social mission and a commercial mission (considering its sustainability). One can evaluate the MFIs success as an independent organization providing financial service to a large number of low-income people over the long - term. There are two categories of institutional miareion :

Social mission: Social mission is are to provide financial services to the low-income household for their upliftment.

Commercial mission: MFI needs to be existing for the long term as a sustainable organization for providing financial services constantly. Sometimes social and commercial missions are

conflicted with each other. But MFI's success is depending open the balance between these two missions.

Operational risks: MFIs complete the series of tasks on their daily transactions. So MFIs should look out on the following risks :

Credit risk: Credit is a major component of any financial institution. MFIs' biggest risk is lending money getting it back. Most of the loans are collateral-free. Credit risk can be classified into two categories: internal and external. The impact on loan delinquency performance significantly. External factors can not be controlled but it can prepare for their future impact. Similarly, internal environmental factors can be managed internally.

Internal environmental factors of credit default risk:

- Inefficient credit policy, operational manual, and lack of proper implementation of organizational credit lending policy.
- Poor client identification practices of MFIs despite their client's enrolment manual.
- Inappropriate debt analysis of borrowers.
- Inadequate counseling to borrowers on how to invest money.
- Poor clients' orientation mechanism to select suitable enterprises/businesses.
- Poor credit handling mechanism related to credit recovery issues.
- Untrained and Demotivated staff in credit program management.
- Top management pressure in invisible areas.

External environmental factors of credit default risk:

- Natural climates factors such as flood, drought, landslide, and heavy snowfall.
- Government wavers policy for the loan.
- A political situation such as client union, and trade union.

Fraud risk: Fraud is an inherent risk with any financial transactions which is done intentionally. Any organization that deals with a large volume of money is at a high risk of fraud. Fraud has occurred with manipulation, falsification, or alteration of records or documentation. MFIs need to establish the following systems to reduce fraud:

- Excellent loan portfolio quality
- Clearly defined policies and procedures
- Management information system (MIS)
- Internal control and internal audit
- Staff retention
- Transparency
- Smooth and steady growth
- Efficient supervision and monitoring

c) Security risk: Security risk is related to the safety of cash and the safety of office assets. Cash is always riskier than other assets. The level of security risk always depends open the

working environment of MFIs. To prevent security risk:

- Apply security measures (Vaults, door lock, alarm, etc.)
- Cash limit and cash denomination book
- Asset register

Financial management risk: Financial management risk is one of the important and very serious risks which arises along with financial transactions. The major risk areas in financial management risk are:

a) Interest rate risk: Nepalese microfinance institutions have been facing one of the big challenges of interest rate risk. The composition of the balance sheet reflects the assets and liabilities of the institution. Credit is high productive assets in microfinance institutions and liability is the external borrowing amount of institutions. Microfinance institution needs to minimize the gap between assets and liability. A high gap directly affects the financial position and sustainability of microfinance institutions if there is a significant change in the interest rate. Successful MFIs should control over:

- Interest rate risk
- Liquidity risk

b) Inefficiency risk: Inefficiency management is the major challenge for Microfinance institutions. MFIs efficiency is reflecting the inability to manage costs per unit of output. Inefficiency wastes the time and resources. As a result, it provides poor products and services to the client and ultimately inefficiency cost transfer to the clients as interest and transaction costs. To improve efficiency:

- Increase the level of outreach
- Reduce the cost
- Improve productivity (Time & HR Management)

System integrity risk: Another risk in financial management is the integrity of the information system. Microfinance institutions require various reports based on accounting, portfolio management, and other fields. MFIs should ensure the quality of the information input system. If the system is processing the information correctly, then it can produce a useful report. MFIs can find the root cause of the risks using this report and can apply the corrective measures on time.

External risks: External risks are quite different from other sets of risks. MFIs have less control to overcome this risk. External risks represent challenges that management and the Board of Directors need to identify and respond properly. These challenges are as follows:

Regulatory: Microfinance institutions provide financial services to low-income household people who are excluded from mainstream financial services. Regulation is needed to strengthen and monitor the sector which encourages MFIs to serve the deprived people. Sometimes new policy or policy amendment may affect the MFI adversely.

Competition: Nowadays microfinance is going towards a competitive business with its players. The entrance of a large number of new MFIs in the same market brings high competition between MFIs. The market can change very quickly. If a new competitor arrives with more attractive products, rival MFIs can collect information about the same product, price, and delivery systems. MFIs should respond to these risks by refining the existing product, offering new products providing an incentive for retention, or improving access.

Demographic: Low-income people are the targeted clients of MFIs. But MFI managers need to be aware of the characteristics of this target market to identify the demographic risk level. MFIs should consider the mobility of the population, socio-culture of the communities, experience of credit programs, and education.

Another environment: MFIs should be aware of the possible natural calamities (floods, landslide, cyclone, etc.) of working area which affect the microfinance service delivery, repayment systems as well as political influence in lending, and interest rate.

National economy: Microfinance institutions are vulnerable to change in the national economy such as inflation and deflation. It affects directly to MFIs, client's business, and their ability to repay their loans.

6. Challenge of Microfinance: Based on the approach mentioned in section 5, the challenges of MFIs in Nepalese are:

Less focus on the client's protection: Nepalese microfinance institutions give less priority to the client's protection. There are globally recognized seven principles of client protection in microfinance. So they need to consider appropriate product design and delivery, prevention of over-indebtedness, transparency, responsible pricing, fair and respectful treatment of clients, the privacy of client data, and mechanisms for complaint resolution.

Overcrowd in a certain geographical region: Nepalese microfinance sectors are overcrowded in certain geographical regions where there is easy access to road, transportation, communication, market, education, and electricity. Whereas some regions are deprived of formal financial institutions due to basic infrastructure problems.

Multiple banking: Multiple banking is one of the serious challenges in the microfinance sector. Multiple banking arises due to easy access to formal financial institutions. It is related with over financing of loans to clients of microfinance by two or more than two microfinance financial institutions without analysis of any records, paying capacity, and financial parameters. They borrow loans from one institution and repay the loan to another institution through a rolling basis that arises loans default risk in the upcoming future.

Deterioration in group liability: Group liability is going to deteriorate day by day due to inappropriate and ineffective approaches of pre-group training (PGT) and group recognition test (GRT). Group liability is the most important part of the Grameen classical system (GCS)

microfinance program. In Grameen model microfinance, a minimum of five to ten people formulates a solidarity group of the same age group, and same economic status, which usually works in the same market from the same community for mutual benefits. They make the demand for the loan in the same group meeting and appraise loan. They also check whether a loan is utilized in a productive sector or not and convince people to repay their loan installment on time. So, group liability plays a significant and vital role in maintaining credit discipline. But nowadays, MFIs give less priority to the importance of solidarity group formation, management, and liability.

Unhealthy competition: Unhealthy competition among microfinance institutions is also another challenge in the microfinance sector. For profit-making objectives, there is high competition between the microfinance institutions on keeping members or borrowers of microfinance who are already affiliated with one or more than one MFIs.

Mission drift: Microfinance is the provision of small scales financial services such as credit, deposit, remittance, money transfer, insurance, and other basic financial services to the poor or low-income people. So, it is the provision of financial services to low-income clients or solidarity group lending who are deprived of formal financial services. In this way, the primary objective of microfinance institutions is poverty reduction through greater and depth outreach in deprived areas. But nowadays, microfinance institutions (MFIs) have mission drift by focusing on profit maximization rather than their original mission.

A high rate of member dropout: The dropout rate of microfinance members is increasing day by day due to migration from rural to semi-urban to urban areas in search of new business opportunities. Another reason for member dropout is the inadequate products and services of microfinance institutions offered to their clients.

A high rate of employee turnover: The employee turnover rate is also another challenge of microfinance institutions. Due to the presence of a high number of microfinance institutions, employees of microfinance jump from one MFI to another MFI to fulfill their high ambition for even a minimum change in financial benefits and status.

An increasing trend in loan overdue: The overdue amount of microfinance and cooperative microfinance institutions is increasing day by day due to inappropriate client education, loan analysis, loan supervision, and client visits. Past two decades, the microfinance institutions had achieved a 100 percent loan recovery rate which is a successful history of microfinance. Nowadays, non-performing loan (NPL) of the whole microfinance industry level is 2-5 percent which is a very challenging situation not only for particular MFI but also for the whole industry, too.

Poor efficiency of employee: The efficiency of field level staff of microfinance is very poor in the areas of client selection, loan appraisal, business development, coaching, delivering skills of organizational rules and regulation which deteriorates loan portfolio quality and increases non- performing loan.

High-interest rate: Nepalese microfinance institutions have been suffering from high-interest rate and irregular interest rate fluctuation of borrowing amount from the commercial banks (CBs) and wholesale lending microfinance institutions such as RMDC Laghubitta Bittiya Sanstha Ltd. (Kathmandu), First Microfinance Laghubitta Bittiya Sanstha Ltd. (Kathmandu), and RSDC Laghubitta Bittiya Sanstha Ltd. (Rupandahi) that's directly affecting the profitability, viability, and sustainability of newly licensed MFIs from Nepal Rastra Bank.

7. Results

7.1 Proposed Conceptual framework/Risk management processes

The classical view of risk is negative, representing loss, harm, and adverse condition. But some guidelines and standards include the possibility of future opportunities i.e. uncertainty that could have a beneficial effect on gaining organizational objectives. It is an ongoing process because of risk changes over time. It is a regular function of the top-level management of the organization. The proposed risk management framework/processes are as shown in figure 2.

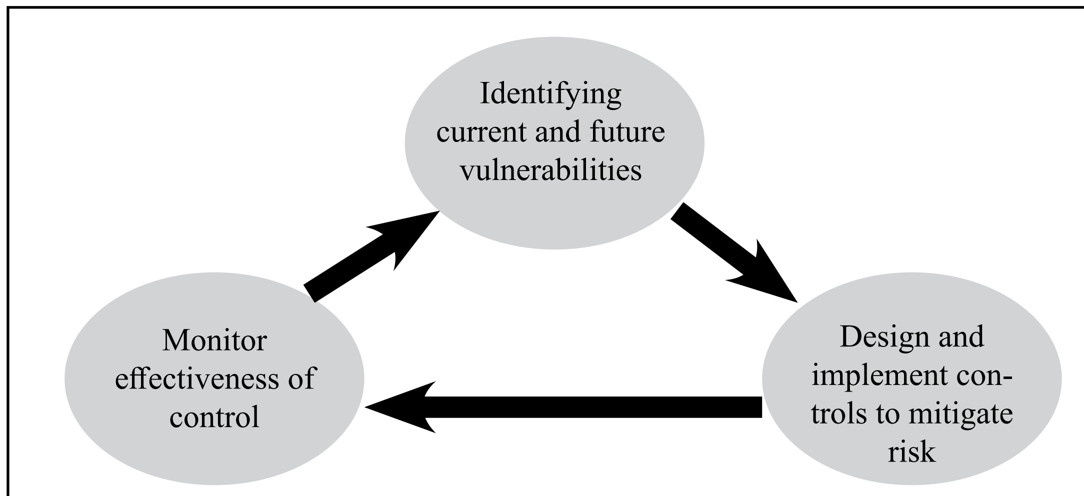

Figure 2. Proposed conceptual framework/processes.

Identifying current and future vulnerabilities: Before managing risk, it is necessary to identify the risk event and what drives it. Risk drivers should be addressed to mitigate the risk involved. It can be measured quantitatively and qualitatively. Both types of measurements are necessary to provide balance.

Design and implement controls to mitigate risk: When risks are identified and measured, microfinance institutions can design and implement controls to mitigate those risks. It is a primary management function to balance expected rewards against risk. Microfinance institutions need to establish and communicate risk control mechanisms through policies, standards, procedures, responsibility, and authority.

Monitor effectiveness of controls: When the controls are in place, then the MFI needs to monitor their effectiveness. It is more important to establish proper reporting systems (MIS)

to identify adverse changes in the risk profile of significant products, services, and activities. Consequently, effective monitoring systems will minimize the adverse impact of risks.

Proposed relationship

Building upon the proposed conceptual framework and the literature, this study postulates that, the original four levels of risk management framework/processes which has a contributory relationship between identifying current and future vulnerabilities, design, implement controls to mitigate risk, and monitor the effectiveness of risk management processes.

Additionally, this study also suggests two propositions on the relationship between the grater dimensional constructs of the proposed conceptual framework as below.

Proposition 1 Microfinance institutions (MFIs) with high-level risk management capabilities and a high level of strategic activities will likely have high social performance and productivity.

Proposition 2 Microfinance institutions (MFIs) with a high level of risk management strategy and capabilities and low level of activities will likely have a low performance with high delinquent risk.

High

High level Risk Management skills and capabilities

Low

Medium-Low Performance	High Social Performance
Low Social Performance	Medium-High Performance

Low Level of Strategic activities High

Conclusion and Discussion

Risk management reduces the likelihood of a loss that will occur. It minimizes the scale of loss when it occurs. It includes both the prevention of potential problems as well as early detection of actual problems. Microfinance institutions are vulnerable to various risks just like other financial institutions. MFIs cannot avoid all the risks but it can manage the risks and minimize the adverse effect. The CEO and the Board of Directors of the MFIs are responsible to maintain the health of the institution, establishing proper operation, management information systems, supervision, and internal control to mitigate the above risks. They need to be preparing their plans, and programs while considering the current challenges of microfinance. One of the board's key responsibilities is to analyze the internal and external risks and to ensure that the institutions are, implementing appropriate controls to minimize its vulnerability depending upon the MFIs governance, system, and transparency.
This study is Addis to the body of knowledge of the structural relationship between risks

and social performance of MFIs. Practitioners could also benefit from this study's finding by utilizing the proposed conceptual framework to establish their proposed conceptual framework to establish risk management mechanism, Since this study is still in the very early stage of research and much more important is vastly needed, there could be many limitations such as generalization ability of the proposed conceptual framework of highlighting the risks in Nepalese microfinance institutions (MFIs) when applied to the microfinance sector.

This study proposes a synergetic conceptual framework on the causational relationship between risks in microfinance and performance based on the original mission rather than profit maximization. This study is based on the theoretical lenses, past literature, the logical explanation, and my working experiences. The next step is to test if the proposed conceptual framework and the propositions are academically legit and empirically supported.

One major challenge is to properly operationalize variables and collect necessary data to statistically represent the proposed construction in the empirical study. To further explore the conceptual framework, the authors of this study suggest mixed-method research. The interested researcher could use it to refine and reconstruct the proposed conceptual framework. Seeking assistance from a panel of experts, professionals in the areas of microfinance, or financial inclusion before conducting a further study is also highly recommended.

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