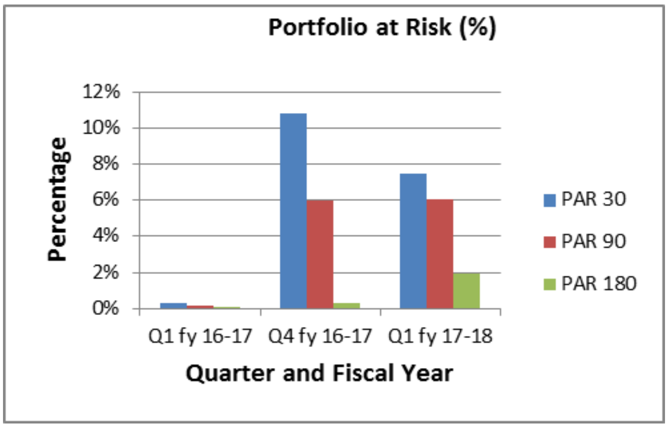
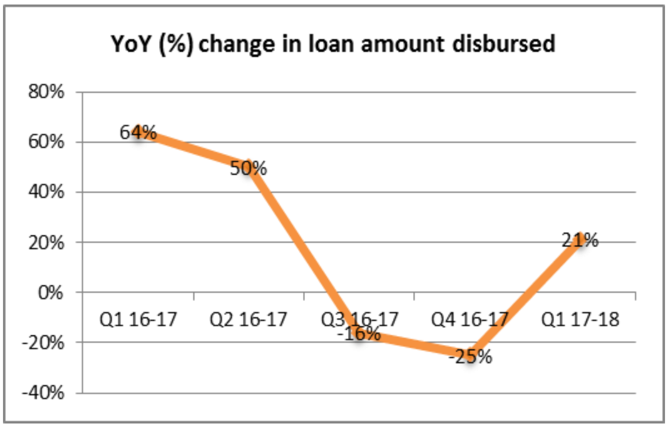
Prone to Multitude of Risks: What's the Ability of MFI sector manage these?

Risk events: A new normal?

In the last 10 years an increasing number of commercial and semi-commercial banks have joined in the operational process of this sector. This has not only led to an increase in clientele but has also led to a graver need to upgrade the operational process. Apart from customer satisfaction there needs to be more emphasis on risk management. Over the past decade this sector witnessed the unfolding of various types of risks ranging from staff and management frauds, regulatory risks and political interferences, adverse implications of government policies, ethical issues, fraudulent & unscrupulous institutions, unauthorized agents, system failures, robberies, client revolts and liquidity constraints.

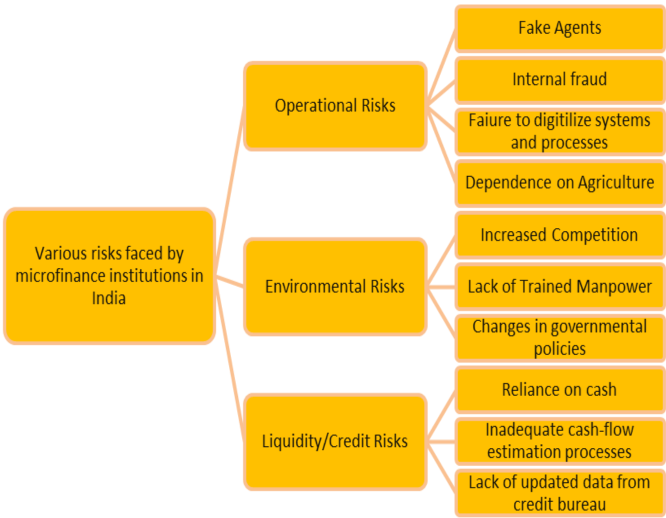
In Jan 2010, 9.2 million borrowers in Andhra Pradesh defaulted on loans from Microfinance Institutions (MFI). This was the largest number of defaulters in any single location in the world[1]. The Andhra Pradesh crisis began as a localized event whose genesis went on for a few years before the widespread crisis hit. In contrast, in November demonetisation happened and again the microfinance industry was put under tremendous stress. This time the crisis was a macro-political risk with stark unintended consequences for the Indian microfinance sector[2]. As **the figure below** shows, the latest crisis had impacted the sector immensely with PAR scores increasing tremendously over the last quarter of 2016-17. The situation still appeared poor in the first quarter of 2017-18 despite the fact that the percentage growth (YoY) in terms of loan amount disbursed has been picking up **(see figure below)**.





Source: MFIN Micrometre Report, August 2017

Risks in microfinance industry: Are we ready to manage them?



The flowchart on the right lists the type of risks faced by the microfinance industry. Even after the Andhra crisis the MFIs are still vulnerable in terms of their market position. Majority of them still suffer from a range of risk management problems. Common problems as seen before the Andhra crisis like increased competition, operational risk and managerial inability, lack of understanding of risk management, lack of board members engagement and poor management response to internal fraud still exists as seen during the demonetisation exercise. Explaining the operations of a majority of such institutions, Bharat Microfinance (2016) pointed towards the lack of vision in terms of risk management, lack of control on the risk culture and resources to implement risk mitigation techniques. This report also states that there is evidence of pockets with concentration of several MFIs in a limited

[1] Shifting trends in microfinance system report 2016.
[2] Livemint, "Demonetisations-blow-to-microfinance-sector." Updated on October 10, 2017

geographical area which has the potential to lead to over-indebtedness and other undesirable practices. There is also evidence of some unauthorized agents acting on behalf of the MFIs and unscrupulous organisations posing as MFIs. The report further goes on to state that in a rush to grow, the MFIs overlook the importance of having good internal controls and training their field staff . There are numerous factors like government policies, economic and environment aspects and political dynamics that lead to such problems and therefore the microfinance industry needs to be better prepared to manage such risks.

Status of Risk Management Techniques: Individual MFI and Industry level

Institutions	Risk Management Techniques	Motivation
Microfinance Institutions	• Group Lending • Progressive lending • Collateral substitutes • Portfolio diversification • Strict schedules for repayment • Cash-flow estimation	MFIs carry out credit risk management techniques as they are concerned with reviewing the portfolio of the customers completely. The ultimate aim of such techniques is to minimize the loan losses. This motive is achieved by the banks by the way of following accurate customer scrutinizing process and its close monitoring.
Self-Regulatory Organisations (SROs)	• Industry code of conduct • Client protection guidelines • Institutional conduct guidelines for MFIs • Monitoring and surveillance of the sector in line with regulatory framework. • Training and awareness programs for member MFIs.	The SROs play an important role in risk management by facilitating improved regulation of the sector by undertaking responsibilities such as formulating and administering a Code of Conduct, having a grievance and dispute redressal mechanism for the clients of NBFC-MFIs, responsibility of ensuring borrower protection and education, monitoring compliance by NBFC-MFIs with the regulatory framework put in place by the Reserve Bank of India[3] in order to ensure a smooth functioning of the sector.
Government Agencies	• Reserve Bank of India (RBI) regulations.	A government agency like the Reserve Bank of India (RBI) has a promotional function in microfinance. Since microfinance covers a broad range of financial services including loans, deposits and payment services and insurance to the poor and low-income households and their micro enterprises. Therefore, it is imperative for the RBI to ensure proper risk management in the sector through regulation.

Way Forward

- It is important that the MFIs ensure their products are mapped and individually assessed for risks. Additionally, products' risks also need to be classified based on their type - individual versus group lending products. Individual loan products tend to have lower co-guarantees than group lending products; thus, facing a different risk portfolio.
- Another important aspect of risk management is a robust classification resulting in prioritizing of risks across products. A risk management matrix is usually deployed for the purpose of this. A well-functioning risk management matrix will rank risks across the quality or severity of risks, quality of existing risk management protocols, the aggregate risk profile for the specific risk, and the trend that the risk profile is displaying i.e. if it is stable, decreasing or increasing.
- Furthermore, geographical diversity of these institutions increases the probability of fraud by their staff and increases vulnerability towards repayment of loans. This is because most of the clients take agricultural loans. Therefore, emphasis should be more on the need to further diversify their portfolio by providing different services like micro-insurance and micro-pensions, providing non-loan services like business development guidance.
- The risk management in these micro finance institutions is of concern as there are several loopholes present in their management. Similarly, any event similar to the Andhra crisis and demonetization will again reduce the pace of growth in this industry. There is definitely a need for developing a mechanism to mitigate the risks and take the advantage of the opportunities that will come ahead of the microfinance institutions.

[3] Sa-dhan-Regulatory Framework of Microfinance Institutions: vol 3, issue 3, 2016. Available at: [http://www.sa-dhan.net/Resources/flyer%20option%201.pdf]