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Problems & Prospects of Microfinance Institutions–with Special Reference to Chandigarh

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Abstract: *Microfinance is defined as any activity that includes the provision of financial services such as credit, savings, and insurance to low income individuals which fall just above the nationally defined poverty line, and poor individuals which fall below that poverty line, with the goal of creating social value. The creation of social value includes poverty alleviation and the broader impact of improving livelihood opportunities through the provision of capital for micro enterprise, and insurance and savings for risk mitigation and consumption smoothing. This research paper seeks to identify the risks and challenges facing the microfinance industry as seen by practitioners, investors, regulators and observers of the microfinance industry and others. Microfinance has undergone plenty of changes in the last decade; many trends have emerged and the service scope of many financial services has changed too (for instance, mobile banking has evolved over the last several years). Overall, the survey highlighted significant concerns about the future of microfinance and the need for critical issues to be addressed in order to ensure the long-term survival of the industry. So this survey explores the main risks and challenges facing by the microfinance industry.*

Key words: *MFIs, risks, challenges, financial services.*

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I. Introduction

Micro-Finance:

Microfinance is an economic development approach that involves providing financial services through institutions to low income clients". In India, Microfinance has been defined by "The National Microfinance Taskforce, 1999" as "provision of thrift ,credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards"."The poor stay poor, not because they are lazy but because they have no access to capital."Microfinance is the supply of loans, savings, and other basic financial services to the poor."

Emerging Risks and Challenges in Microfinance

A) Financial Risks:

Most MFIs focus on financial risks, including credit, liquidity, Interest rate, and investment risks. Mentioned under are the risks which are very critical for the MFIs.

1. Credit Risk:

Credit risk, the most frequently addressed risk for MFIs, 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 MFIs inability to collect anticipated interest earnings as well as the loss of principle resulting from loan defaults. Credit risk includes both transaction risk and portfolio risk.

2. Transaction Risk:

Transaction risk refers to the risk within individual loans. MFIs mitigate transaction risk through borrower screening techniques, underwriting criteria, and quality procedure for loan disbursement, monitoring, and collection.

3. Portfolio Risk:

Portfolio risk refers to the risk inherent in the composition of the overall loan portfolio. Policies on diversification, maximum loan size, types of loans, and loan structures lessen the portfolio risk.

4. Liquidity Risk:

Liquidity risk is the risk that an MFI cannot meet its obligations on a timely basis Liquidity risk usually arises from management's inability to adequately anticipate and plan for changes in funding sources and cash needs. Efficient Liquidity Management requires maintaining sufficient cash reserves on hand while also investing as many funds as possible to maximize earnings.

5. Interest Rate Risk:
Interest rate risk is the risk of financial loss from changes in market interest rates. The greatest interest rate risk occurs when the cost of funds goes up faster than the financial institution can or is willing to adjust its lending rates.

B**) Operational Risks:**
Operational risk arises from human or computer error within daily service or product delivery. 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.

1. Human Risks
Human risk means errors, frauds and animosity .Human resource plays a key role in success or failures of enterprises. An organization with good human resource can meet most challenges effectively whereas weak human resource enhances the operational risks at various levels. MFIs mostly transact in cash, which increases the probability of frauds, misappropriation either by employees or even by clients.

2. Transaction Risks:
Transaction risk is particularly high for MFIs that handle a high volume of small transactions daily. Since MFIs make many small, short-term loans, this same degree of cross-checking is not cost-effective, so there are more opportunities for error and fraud. As more MFIs offer additional financial products, including savings and insurance, the risks multiply and should be carefully analyzed as MFIs expand those activities.

3. **Fraud Risks:**
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 misleading financial statements, bribes etc.

4. Relationship Risks:
Clients are very valuable for MFIs. With competition more and more clients have options of choosing one MFI over another. Loss of clients or high dropout is a big cost to the MFIs. As the sector becomes more competitive importance of strong client relation and meeting client requirement will only gain more significance. Managing good client relations can help the MFIs is not only managing this risk but turning it into an opportunity to maximize profits by not losing to competition and building client loyalty and instead attract clients from the competitors.

5. Process Risk:
Lack of clearly defined process within an organization can result in confusion, conflicting actions, duplicity of work resulting in loss of time and other. Strong internal management systems such as cash planning, cash handling, disbursement procedures, internal checks – monitoring and audits help in managing process related operational risks.

6. System and Technology Risks:
As MFI becomes more and more dependent on technology such as computers, software, hand-help devices, etc. it also enhances their technology related operational risk. Hard disk crash, virus attacks, software or hardware failures, password misuse can impact MFIs to different degrees based on their extent of dependence on technology.

C) **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 two critical strategic risks: Governance Risk and Business Environment Risk.

1. Governance Risk:
Governance risk is the risk of having an inadequate structure or body to make effective decisions. The Financial crisis, described above illustrates the dangers of poor governance that nearly resulted in the failure of that institution.

II. External Business Environment Risk:

Business environment risk refers to the inherent risks of the MFIs business activity and the external business environment.

Challenges

Microfinance programs are currently undergoing a period of rapid innovation in an attempt to meet these various challenges. These include development of:

New products new loan packages, savings facilities, insurance and most recently pensions.

Methodologies for reaching new types of client particularly the poorest and most disadvantaged.

New types of institution which are capable of being flexible and innovative, including client participation, gender mainstreaming and new ways of combining cost-effective microfinance delivery with other services.

New types of partnership between MFIs and other development actors. This includes linking with the informal and formal financial sectors, other complementary service providers and linking micro-finance groups with local political processes and advocacy organizations.

III. Review of Literature

Akoijam (2013) analyzed the issues and concerns of Indian rural credit, which was a powerful tool for enhancing production and productivity and for poverty alleviation. Self Help Group (SHG)-Bank Linkage model of NABARD which creates an interface of the informal arrangements of the poor with the banking system was also analyzed in detail. The study concluded that rural credits serve as a tool for providing asustainable livelihood for millions of rural Indians.Ayuub (2013) examined the impact of microfinance on poverty alleviation. Data took through questionnaire, descriptive research and interviews from microfinance banks and some of their clients. Increase in income level and customer satisfaction level was observed but this increase was not so significant. The result showed that microfinance scheme help people to improve their living standard and provide them financial opportunity to expand their business.Beenish Ameer & Dr. Moazzam Jamil (2013) - The researcher studied the effectiveness of microfinance loans in Pakistan. The study assessed that how much the microfinance loans are effective in Pakistan from the borrower perspective. Moreover the loan which was taken by the client of Micro Finance Tamer Bank, how that loan amount has been used in the projected business and whether the income has been increased by the loans utilization. And concluded that Microfinance institution should consider the core to make the microfinance loans more effective as it for the low income households.Mago, S., Hofisi, C., & Mago, S. (2013) The paper suggested that MFIs have limited capacities in the management of operational risk. A number of factors could be responsible for the poor capacity in ORM. These may include, untrained managers, poor resources, lack of political will, among other things. the challenges found include transaction risks, fraud (for example M-CAP) and legal risks. The major recommendation is that MFIs must strengthen their operational risk management in order to survive. Vichore and Deshpande (2012) analyzed the performance and growth of MFIs in terms of cost efficiency, cash constraints and net portfolio in India providing microfinance services to low income clients. The study was an exploratory in nature. It suggested that proper training should provided to the employees of MFI's especially in disbursing loans and collection of the loan amount so that the cost per borrower could be managed efficiently.

Roy (2011) examined the delivery process and profitability of MFIs. Delivery mechanism was explained in terms of four parameters namely collateral requirement, size of the loan amount, repayment time and purpose of the microfinance loan. Profitability was analyzed ROA and ROE. This study adopted simple correlation and descriptive analysis technique and found that MFIs of Assam were enjoying higher profitability.Sarumathi, S., & Mohan, K. (2011) concluded that the rural area Self Help Groups performed well. The study concludes that microfinance brought psychological and social empowerment than economic empowerment. Impact of micro finance was appreciable in bringing confidence, courage, skill development and empowerment. The SHG members feel free to move with their groups and leaders. It led them to participate on various social welfare activities with good co operation while interacting with the respondents.McIntosh, C., A. De Janvry, et al. (2011) examined that the data from Uganda's largest incumbent Micro-Finance institution to analyze the impact of entry by competing lenders on client behaviour. We observe that rising competition does not lead to an increase in client dropout rate, but induces a decline in repayment performance and savings deposited with the incumbent, suggesting rising multiple loan-taking by clients.Easton, T. (2010) found in their study that Micro-Finance as a strategy towards poverty alleviation. Traditionally, the poor were not viewed as investment worthy and were excluded from financial services. Other barriers to developing financial services for the poor include high and volatile inflation in developing countries, incompetent governments, and a lack of necessary legal framework for financial services. McIntosh, C. and B. Wydick (2008) in their study found that Competition between Micro-Finance institutions (MFIs) in developing countries has increased dramatically in the last decade. As competition exacerbates asymmetric information problems over borrower indebtedness, the most impatient borrowers begin to obtain multiple loans, creating a negative externality that leads to less favourable equilibrium loan contracts for all borrowers. Ghosh (2005) in the research paper Microfinance in India: A critique, the evolution of microfinance in empowerment of women and poverty alleviation was studied. Microfinance was viewed as an important tool for providing self employment for the low income rural population. This paper studied the various delivery models of microfinance institutions, which contribute to women empowerment in India.Benjamin, L.et al. (2004) revealed that Community development Financial institutions (CDFIs) help to address the financial needs of under-served, predominantly low-income communities. CDFIs include community development banks, credit unions, business and microenterprise loan funds, and venture capital funds. Although CDFIs are a rapidly growing and an increasingly important area of community economic development, they have not received proportionate attention from academic researchers. Mosley, P. and J. Rock. (2004) examined a range of six African Micro-Finance institutions with a view to assessing and if possible enhancing their poverty impact. The impact of Micro-Finance loans is variable between institutions, with a tendency in particular for savings services to be taken up by people well below the poverty line, especially in South Africa and Kenya. However, many benefits to the poor from Micro-Finance programmes, in Africa at least, are likely to come via an indirect route, via 'wider impacts' or 'spin-offs', rather than by through direct impacts on borrowers.Godquin, M. (2002) in their study found that a comprehensive analysis of the performance of Micro-Finance institutions (MFIs) in terms of repayment. We focus the analysis on the impact of group lending, nonfinancial services and dynamic incentives on repayment performance. We test for endogeneity of loan size and use instrumental variables to correct for it. In the second section of the paper, we use a comparative analysis of the determinants of the repayment performance and of loan size in order to make policy recommendations on the allocation of loans by MFIs.Tsai, K. S. (2000) revealed that Banking authorities in both China and India have attempted to limit most forms of informal finance by regulating them, banning them, and allowing certain types of Micro-Finance institutions. This article suggested that the persistence of informal finance may be traced to four complementary reasons-the limited supply of formal credit, limits in state capacity to implement its policies, the political and economic segmentation of local markets, and the institutional weaknesses of many Micro-Finance programs.Morduch, J. (1999) the need of microfinance comes from the disadvantaged sections of the society - who are unable to access to services of formal sector financial intermediaries- and are typically excluded from the formal banking system

Significance of Study:

Micro financing plays vital role in India. As innovations gain momentum, some players are keen to exploit loopholes for immediate advantage which transforms the entire microfinance model into a zero-sum game. So the risks must be addressed by MFIs as quickly as possible to avoid pitfalls. It helps to study the changing perception of risk in a dynamic and moving microfinance industry. It helps to study the Institutional inefficiencies viz how well prepared are MFIs to handle these risks? Is microfinance coming to a crossroads in is evolution? If so, what should be its new direction? We come to know the possible alternatives for effectively promoting Micro-finance services. MFIs need to further strengthen their lending standards, particularly with regard to over indebtedness among borrowers.

Objectives of Study:

- To identify the risks faced by the microfinance industry.
- To identify challenges faced by the microfinance industry.

Research methodology:

Research design:

Research design is systematic procedure for collection and analysis of data. It is a blue print that guides the study to be done. The present research work is done with the **descriptive research design** method. Descriptive research has been used in this study to obtain information about the various risk and challenges emerging in micro finance industry as seen by practitioners,, investors, regulators, others and to rank the potential risks and to rate how prepared they think micro finance institution are to manage those risks. Information collected is then analyzed and tabulated thoroughly. At last the findings of the study are sorted out to present the result of the study in clear terms.

Data Collection: For this study, data has been collected from two sources:

Primary Data: In this study, data has been collected through personal contact. Questionnaire was used to collect primary data from respondents. Survey participants were given a questionnaire asking them to describe their concerns about the various risks and challenges faced by microfinance industry, to rank potential risks and to rate how prepared they think microfinance institutions (MFIs) are to manage those risks. Respondents included practitioners, investors, regulators, aid officials, academics and consultants and others. A survey questionnaire was completed by 100 respondents. The respondents were the practitioners, regulators, observers and others. The total number of completed questionnaires was 100 as the respondents were personally administered. The questionnaire has been adapted from the research papers Published by Centre for the Study of Financial Innovation (CSFI) survey of micro finance risk and the work done by David Lascelles with the assistance of Sam Mendelson.

Secondary data are those which have already been collected by someone else. In this study, secondary source data has been collected from Articles, journals, Websites and research papers.

Sampling Plan:
- Sample size : 100
- Sample area : Chandigarh ,India
- Sample unit : practitioners, investors, regulators and observers.
- Sampling design : convenience sampling

Practitioners – People who run or work in MFIs

Investors – People who invest in MFIs
Observers- observers' category included analysts, aid officials, academics, accountants, lawyers, consultants etc.
Regulators -Government officials and those who regulate MFIs. (RBI AND NABARD)
The non probability sampling has been used i.e. convenience sampling. Members of the population have been chosen based on their relative ease of access. The investors have been chosen from Chandigarh area because it was convenient.

Tools used:
Percentage method

IV. Data Analysis and Interpretations

Table 1: Type of Respondents

Type of respondents	Response	Percentage
Practitioner	35	35%
Investor	25	25%
Regulators	5	5%
Observers	15	15%
Others	20	20%
Total	100	100%

Source: Compiled from Primary Data

The above tabulated data shows that 35% of the respondents are practitioner. The data shows majority of respondents are practitioner as in India there are various micro finance institutions in which people work. Further, about 5% percent of the respondents are regulators which are least in number as there are only few bodies who regulate these institutions.

Table 2: The Main Risks and Challenges Facing by Practitioners

Risks	Response	Percentage
Competition	5	5%
Corporate governance	1	1%
Credit risk	7	7%
Fraud	1	1%
Interest rates	1	1%
Liquidity	3	3%
Management quality	2	2%
Ownership	2	2%
Political interference	3	3%
Reputation	3	3%
Too little funding	1	1%
Too much funding	2	2%
Transparency	3	3%
Managing technology	1	1%
Total	35	35%

Source: Compiled From Primary Data

The practitioners work in Micro finance institutions as it involves only 35% risk . The main risks and challenges for microfinance practitioners all relate to the impact of the economic crisis on their business: the rise in credit risk, the availability of funding, their liquidity and competition risk. New risks include threats to profitability, interest rates, foreign currency,fraud and management quality. The appearance of reputation as a rising risk is also notable at a time when financial markets are stressed and microfinance is becoming more controversial.

Table 3: The Main Risks and Challenges Facing By Investors

Risks	Response	Percentage
Competition	2	2%
Corporate governance	1	1%
Credit risk	5	5%
Foreign exchange	1	1%
Fraud	2	2%
Interest rates	4	4%
Liquidity	2	2%
Political interference	1	1%
Profitability	2	2%
Reputation	2	2%
Strategy	1	1%
Transparency	2	2%
Total	25	25%

Here Investors are bearing only 25% risk in which interest rate risk and credit risk are more prudent. The reason being more market fluctuations and amendments in government policies. The risk is less due to the ability of MFIs to manage their liquidity, and funding, the effect of currency fluctuations on cross border exposures, interest rates and the impact of credit risk on their soundness and profitability.

Table 4: The Main Risks and Challenges Facing by Regulators

Risks	Response	Percentage
Credit risk	2	2%
Interest rates	1	1%
Management quality	1	1%
Political interference	1	1%
Total	5	5%

There is the least risk to the regulators i.e. 5%.The biggest concerns for regulators centre on the institutional strength of MFIs and their ability to get through the crisis. Issues such as credit risk, management quality, transparency, profitability, depositor confidence and staffing were all in their top ten. They also saw funding, refinancing and the macro economy as rising problems for MFIs. Of respondent groups, they were the most concerned about operational issues such as the growth of fraud and reputation risk. Interestingly, they also saw political interference as a fast-rising risk for microfinance.

Table 5: The Main Risks and Challenges Facing by Observers

Risks	Response (%)	Percentage%
Competition	1	1%
Credit risk	4	4%
Interest rates	1	1%
Liquidity	2	2%
Political interference	1	1%
Profitability	1	1%
Reputation	3	3%
Transparency	1	1%
Managing technology	1	1%
Total	15	15%

Source : Compiled From Primary Data

Observers, deposit-taking MFIs shared practitioners' concerns about rising credit risk and the state of the world economy and funding, but were less worried than the sector as a whole about liquidity issues, possibly because of the protection offered by their deposit base. They showed little concern about the risk of losing depositor confidence, though they did see ownership as a growing issue. Institutional risks ranked high: management, corporate governance and staffing. Because many of them receive overseas investment, currency risk was also a growing concern.

Table 6: The Main Risks and Challenges Facing By Others

Risks	Response	Percentage
Corporate governance	2	2%
Credit risk	1	1%
Interest rates	2	2%
Liquidity	5	5%
Management quality	1	1%
Political interference	1	1%
Profitability	2	2%
Reputation	1	1%
Transparency	3	3%
Product development	2	2%
Total	20	20

Source : Compiled From Primary Data

Interpretation:

The biggest concerns for others centre on the liquidity position of MFIs and their ability to get through the crisis. Issues such as credit risk, management quality, transparency, profitability, depositor confidence and product development are all in their top ten

Table 7: The Some Areas of Risk For MFIs Which Have Been Attracting Attention And Their Level Of Risk: Low, Medium, High. Response (%)

Risks	Low	Medium	High
Back office operations	2		
Competition		10	
Corporate governance	4		
Credit risk			25
Foreign exchange		2	
Fraud			2
In appropriate regulation	1		
Interest rates			
Liquidity		15	
Management quality	1		
Mission drift		4	
Ownership	1		
Political interference			4
Profitability		2	
Reputation			7
Staffing		3	
Strategy	1		
Too little funding		2	
Too much funding		1	
Transparency		5	
Product development	1		
Macro-economic trends		2	
Managing technology		3	
Unrealizable expectation	1		

Source : Compiled From Primary Data

They were asked to rate a list of potential (main) risks: low, medium, high for MFIs which have been attracting attention. Result is that credit risk is one of the main risk areas for micro finance sector which require more concern. Reputation and political risk are both placed more highly in the rating of level of risk involved in micro finance industry.

V. Findings:

The data analysis and its interpretation lead to the following findings and conclusion:

- This survey explores the main risks and challenges facing by the microfinance industry. The biggest risks include credit risk and competition risk, liquidity risk, reputation risk, while the other risks and challenges are management quality, corporate governance and staffing.
- A breakdown of responses by type shows MF practitioners are deeply concerned about the impact of the crisis on loan quality, credit risk, and transparency and funding, while investors focused more on refinancing, interest rate, competition risk and foreign currency risk. The concerns of regulators centered on management strength, quality, inappropriate regulation.
- New risks include threats to profitability, interest rates, foreign currency, fraud and management quality, too little funding, mission drift and corporate governance.

- The study highlights the changing perception of risk in a dynamic and moving microfinance industry
- Generally, large, commercially-minded MFIs are seen to be among the better prepared. Smaller MFIs, with weak management and a heavy reliance on donor funding could be vulnerable.

VI. Recommendations:

- There is a need of trained risk managers to manage and handle the risk successfully in a volatile environment, particularly in the areas of credit and reputation.
- Riots, wars, communal problems can quite significantly impact the operations of an MFI as such situations may bring an MFI to a complete halt. Riots and other such situation are directly related to the issue of personal security of the staff as well as of the clients and hence are serious risks.
- An MFI must keep its portfolio diversified to limit its loss on account of such external factors. In cases of robberies or thefts, it is better to transfer risk through insurance, cash carrying by staff can be limited and there can be polices on cash limits at branch
- Define the Regulations and Policies
- Definition of MFI: Encompass and allow MFIs to serve poor not only as lender but as full financial service provider without increasing risk for poor customer and MFI itself.
- State should not interfere in the commerce of the sector by offering Loan waivers or bad policy interventions like Interest rate caps (even informal caps).
- Connectivity at the village level enabling growth of ATMs and other payment devices.

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