Micro Finance and its Risk Management Practices in India

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ABSTRACT
Micro Finance is discussed from ages and the Micro Finance Industry has experienced the exponential growth during last two decades. It is observed that the need and action-based service of MFIs were very much felt and they catered significantly from both the side that is from the people who required the finance and the industry which is able to provide the amount of finance and financial services. However, in pursuit of growth—in terms of breadth, depth, and scope of outreach—does not mean that MFIs can ignore risk management. In contrast, risk management has become more important now than it was ten years ago, and its importance will continue to grow in the future. Other factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of microfinance risk management.

Keywords-- Micro Finance, Risk Management, MFIs.

I. INTRODUCTION

Micro finance institutions (MFIs) providing microfinance services can no longer afford to focus only on credit and liquidity risks and consider other types of risk on an ad hoc basis, often in a reactive manner. Risks in microfinance must be managed in a systematic manner and the importance of risk management will further increase as the industry matures further and microfinance markets become more competitive (Powers 2005).

At the initial stages of growth in the microfinance industry, most MFIs were concerned only about financial risks. Even in the financial risk category, their focus was almost exclusively on credit risk. When the demand for loans began to rise exponentially, MFIs also began to be concerned about a particular type of liquidity risk wherein the MFIs would run out of enough cash to meet the demand for loans. The industry evolution has brought additional risks.

In a publication released in 2000, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) cited three major risk categories: financial, operational, and strategic. GTZ also listed subcategories of risk under each main category. More recently, Churchill and Frankiewicz (2006) listed four risk categories, namely: institutional risks, operational risks, financial management risks, and external risks.

II. RISK MANAGEMENT

Risk management is the process of controlling the likelihood and potential severity of an adverse event: it is about systematically identifying, measuring, limiting, and monitoring risks faced by an institution. Risk management is important simply because “risk pervades finance as gravity pervades physics” and to “survive and prosper in financial markets, participants must manage risk in ways that increase their wealth” (Von-Pischke 1991, p. 25).

An MFI may adopt certain elements of risk management although it may not have a comprehensive risk management system. According to the Federal Reserve Bank (quoted in GTZ 2000, p. 5), comprehensive risk management includes practices designed to limit risk associated with individual product lines and systematic, quantitative methods to identify, monitor, and control aggregate risks across a financial institution’s activities and products. A comprehensive approach to risk management reduces the risk of loss, builds credibility in the market place, and creates new opportunities for growth (GTZ 2000, p. 5). Because effective risk management ensures institutional sustainability and facilitates growth, it has significant implications for MFIs with a social mission to serve an increasing number of poor households.

With the increasing level of maturity in the industry, many microfinance stakeholders seem to realize more now, than was the case about 10 years ago, that risk management is at the heart of the microfinance industry as it is in the broader banking industry. If an MFI is keen to continue its operations, it must take risk management seriously and put in place systematic measures for the purpose. However, it appears that comprehensive risk management has not yet become the norm in the microfinance industry of most countries. GTZ (2000, p. 7) noted, although 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.”
Most MFIs do not yet have comprehensive risk management systems. The norm in the industry appears to consist largely of efforts to manage certain types of risk but not the overall risk of the institution in a systematic manner. Surprisingly, many MFIs seem not to have made a systematic effort to manage even credit risk. This is evident not only in the lack of reliable, accurate, and timely data on many MFIs’ loan collection rates and portfolio quality, but also in the absence of systematic efforts to analyze their loan portfolios from a credit risk management point of view.

The microfinance industry has also not made much progress on disaster risk management. According to Pantoja (2002, p. 30), “disaster risk is one of the most critical yet neglected external risks faced by MFIs, which for the most part, continue to deal with it in an ad hoc manner.” As a result, in disaster situations, MFIs become “organizations in distress as well as potential instruments of recovery” (Nagarajan 1998).

III. GENERAL PRINCIPLES ON MICROFINANCE RISK MANAGEMENT

Most MFIs pay more attention to crisis management than to risk management, and the attention to risk management is highly uneven across and within MFIs. Given this, MFIs must make concerted efforts to put in place comprehensive risk management systems appropriate to their institutions. Although institutional variations make general recommendations less relevant, it is possible to outline a number of general principles that MFIs need to follow in developing risk management systems and procedures (GTZ 2000, p. 36; Campion 2000, p. 8).

1. Risk management must be an integral part of the institutional culture, whether an institution is an NGO, a nonbank financial institution, a specialized MFI, or a cooperative. Otherwise, many employees would be prone to take risk management lightly. It is important to inculcate the realization that it would be far wiser and more prudent to manage risk than to cope with risk, and that risk management is a collective and continuous activity which engages everyone in an organization in varying degrees. However, risk management should essentially be a top-down activity: it should begin at the top of the organization and systematically go down to embrace all other layers of the organization.

2. The one-size-fits-all approach is inappropriate for microfinance risk management. In the microfinance industry, many MFIs tend to adopt measures that other more successful or larger MFIs have adopted. While such strategies seem to have partly worked in developing or introducing new products and services and even some delivery models, the same strategy cannot be effectively adopted for overall risk management primarily because of the institution-specificity of the overall risk profiles. Hence, each institution must develop tailor-made risk management systems and procedures appropriate to its own risk profile, organizational type, the applicable legal and supervisory requirements, scope, scale, and complexity of the products and services, service delivery modalities used by the institution, and the liability structure, among other things.

3. A comprehensive approach that covers all types of risk to which the institution is exposed, or likely to be exposed, is indispensable. The system, at a minimum, has to be sufficiently forward-looking to accommodate institutional growth and social mission objectives for the short to medium term. The main rationale for a comprehensive approach stems from the fact that most risks are interrelated. For example, the liquidity risk of an MFI could easily lead to credit risk if borrowers begin to lose confidence in the MFI’s ability to serve their demand for loans on a continuing basis. The chief executives and board of directors of MFIs must explicitly recognize the potential impact of cognitive biases and organizational pressures on risks.

4. Risk management should not be seen as something that must be put in place merely to meet the regulatory and supervisory requirements of financial authorities. Risk management needs to be seen more as a critically important way to ensure financial soundness, operational efficiency, growth, and stability of the institution to achieve its mission. Thus, those MFIs that are not subject to prudential regulation must also have an appropriate risk management system and procedures.

5. It is important to recognize that risk management is not the management of financial ratios based on balance sheets and income statements. While such ratios play an important role in an effective risk management system, a comprehensive system goes well beyond those.

6. MFIs need to consider risk management not as an activity to which attention needs to be paid periodically but as a continuing process to which unbroken and unwavering attention is required as an integral part of their daily operations.

7. The primary responsibility for putting in place an effective risk management system and procedures must rest with the board of directors and the chief executive officer of an MFI; the board and the chief executive, in addition to others, must also share implementation responsibilities. The direct link between governance and risk management must also be recognized.

8. Some elements of risk management in microfinance must go well beyond one’s own institutional boundaries and must include, to the extent possible, measures that would help the MFI clients to manage their risks more
effectively. This is one of the fundamental differences between risk management in conventional financial institutions and MFIs. For some MFIs, such measures may include financial literacy programs and basic health education for the clients. Three factors justify such wider measures: (i) poor households suffer from multiple disadvantages which prevent them from fully utilizing their access to financial services, (ii) most MFIs provide loans without collateral and run greater risk if their client households’ economic activities do not perform as expected, and (iii) MFIs have a social mission.

9. Risk management practices should be market-oriented. For example, some MFIs have attempted to manage their credit and competition risks through a memorandum of understanding with their potential competitors while others have asked their borrowers/members for a commitment not to shift to the competitors. These are not market-oriented practices.

10. A comprehensive risk management system must include a “feedback loop” (Figure 1) from the highest to the lowest levels of the MFI, often including the board of directors, among others.

IV. 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.

V. 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; they are financial risks, operational risks and strategic risks, as given in the table - 1 below.

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Financial institution managers (and regulators) review these risks in light of i) the institution’s potential exposure to loss, ii) the quality of internal risk management and information systems, and iii) the adequacy of capital and cash to absorb both identified and unidentified potential losses. In other words, management determines 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.

1. 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 treasury function, usually centralized at the head office, which manages liquidity risk, interest rate risk, and investment portfolio risk. As MFIs face more choices in funding sources and more product differentiation among loan assets, it becomes increasingly important to manage these risks well.

1.1 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 MFI’s 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.

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

2. Portfolio risk: Portfolio risk refers to the risk inherent in the composition of the overall loan portfolio. Policies on diversification (avoiding concentration in a particular sector or area), maximum loan size, types of loans, and loan structures lessen portfolio risk.

Effective Credit Risk Management

- 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.).

1.2 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. Efficient liquidity management requires maintaining sufficient cash reserves on hand (to meet client withdrawals, disburse loans and fund unexpected cash shortages) while also investing as many funds as possible to maximize earnings (putting cash to work in loans or market investments).

Effective liquidity risk management:

It 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.

1.3 Market risk

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

1.3.1 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, since most fee income is associated with loan products that are interest rate sensitive. Interest rate risk management is most important to MFIs that make longer-term loans and rely on capital markets for a large percentage of their funds.

Effective Interest Rate risk Management:

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

1.3.2 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. For example, MFIs that offer dollar savings accounts and lend in the local currency risk financial loss if the value of the local currency weakens against the dollar. Alternatively, if the local currency strengthens against the dollar, the MFI experiences a financial gain. 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.

1.3.3 Investment portfolio risk

The investment portfolio represents the source of funds for reserves, for operating expenses, for future loans or for other productive investments. Investment portfolio risk refers mainly to longer-term investment decisions rather than short term liquidity or cash management decisions.

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.

Effective Investment portfolio risk management:

- To reduce investment portfolio risk, treasury managers stagger investment maturities to ensure that the MFI has the long-term funds needed for growth and expansion. In addition, they consider the credit, inflation, and currency risks that might threaten the value of the principal investment. Short-term investments, for example, carry less risk of losing value due to inflation.
- Most financial institutions have policies establishing parameters for acceptable investments within the investment portfolio, and they range from very conservative to more aggressive for a portion of the investment portfolio. These policies set limits on the range of permitted investments as well as on the degree of acceptable concentration for each type of investment.

2. 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.

2.1 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. 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 are not cost-effective, 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. As more MFIs offer additional financial products, including savings and insurance, the operational risks multiply and should be carefully analyzed as MFIs expand those activities.

Effective Management of Transaction Risk:

- 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 reduce the occurrence of problems.
- Using computer systems and minimizing the number of times data has to be manually entered reduces the chance and frequency of human error.

2.2 Fraud risk

Until recently, fraud risk has been one of the least addressed risks in microfinance to date. Also referred to as integrity risk, 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, kickbacks, and phantom loans.
Effective internal controls play a key role in protecting against fraud at the branch level, since line staff handles 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).

Preventive measures to reduce fraud:

Fraud prevention should be built into the design of operational policies and procedures and then tested and checked by thorough internal audits. The use of client visits to reduce fraud. Experience has shown that while a small number of staff is often inclined to be dishonest, most avoid unethical behavior if their internal sense of right and wrong is reinforced by suitable external controls and sanctions. The best way to discover fraud (and deter loan officer abuse) is for someone other than the loan officer to visit the client to verify account balances. This person should have a sound understanding of the lending process and know how fraud can occur.

2.3 Regulatory and legal compliance risk

Compliance risk arises out of violations of non-conformance with laws, rules, and 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. Many non-government organizations that provide microfinance are choosing to transform into regulated entities, which exposes them to regulatory and compliance risks. Even those microfinance NGOs that are not transforming are increasingly subjected to external regulations.

3. 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 i.e. Governance Risk, Business Environment Risk, and Regulatory and Legal Compliance Risk.

3.1 Governance risk

One of the most understated and underestimated risks within any organization are 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 (investors, borrowers, and institutional partners). 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.

3.2 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. A comprehensive risk management approach and good management information reporting helps an MFI speak the “language” of financial institutions and can strengthen an MFI’s reputation with regulators or sources of funding.

3.3 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. MFIs need to check the validity of their assumptions against reality on a periodic basis, and respond accordingly. A risk management framework establishes a discipline in which those questions are encouraged and asked frequently (e.g., compare actual results to budget and assess the reasons for variances). While external business risks are out of an MFI’s direct control, the MFI can still anticipate them and prepare for their impact.

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

Risk Management Feedback Loop

The steps in the risk management process are not static; they are part of an interactive and dynamic flow of information from the field to head office to senior management and back to the field. These steps are part of a continual risk management feedback loop that consistently asks whether the assumed risk is reasonable and appropriate, or whether it should be reassessed.

In a nutshell, the risk management feedback loop includes the identification of risks
to be controlled, the development and implementation of strategies and policies to control risk, and the evaluation of their effectiveness. If results indicate that risks are not adequately controlled, then policies and strategies are redesigned, re-implemented, re-tested, and reevaluated.

Figure – 1 Risk Management and feedback loop (Source GTZ 2000, p.36)

VI. 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 microfinance institution systematize risk management and integrate it into all level sof operations. These guidelines are simple suggestions that should apply to most MFIs.

Ten Guidelines for Risk Management Guidelines for Implementing a Risk Management Framework:

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

VII. 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.

VIII. CONCLUSION

The microfinance industry has experienced dramatic growth during the last two decades, in general, and the last decade, in particular. The next decade will most probably see a continuation of this growth. Such growth is not only sought by many MFIs but also needed in most countries because the unserved and underserved markets continue to remain large. However, pursuit of growth—in terms of breadth, depth, and scope of outreach—does not mean that MFIs can ignore risk management. In contrast, risk management has become
more important now than it was ten years ago, and its importance will continue to grow in the future. Other factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of microfinance risk management.

However, it is disturbing to note that systematic risk management is still not as widespread as it should be. The increased emphasis on microfinance risk management at the level of international promoters of microfinance has not yet had its full impact on most institutions at the retail level.

Many MFIs do not seem to pay adequate attention to systematic risk management. Many continue to seek growth without much attention to attendant risks. Even basic credit risk management, upon which the industry’s growth prospects have been built historically, is neglected by many MFIs. The tendency to attribute institutional setbacks to external factors appears to continue. Many small- and medium-scale MFIs tend to focus their resources on crisis management partly on the assumption that it is the same as risk management.

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