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Full Length Research paper

An Evaluation of the Impact of Risk Management Strategies on Micro-Finance Institutions' Financial Sustainability: A Case of Selected Micro Finance Institutions in Kisii Municipality, Kenya

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The main purpose of this study was to evaluate risk management strategies employed by Micro finance institutions and their impact on the institutions' financial sustainability. The study sought to: establish the Micro-Finance Institutions (MFIs) preference for the various sources of finances; determine the frequency of Microfinance Institutions' exposure to risk; identify the risk management strategies used by Microfinance Institutions in the management of risk exposures and the extent to which they have contributed to their financial sustainability. A survey design was adopted for the study. The study covered only MFIs within Kisii Municipality selected using purposive sampling. A sample of 29 respondents consisting of both the managers and the credit officers participated. The instrument of collecting data was mainly a questionnaire which had both structured and unstructured questions. Analysis of data was done using descriptive statistics such as percentages and the likert scale. Some of the findings were donor funding, revolving fund and government subsidies are the most preferred sources of funding by the sampled MFIs. Strategic risk, credit risk and liquidity risk are the most frequent risks; whereas reputation and subsidy dependence occur at a very low incidence. To tone down these risks, the MFIs employ various management strategies, which include risk avoidance, transferring of risk and mitigating risks. Mitigation of risks is regarded as the most effective risk management strategy. Specifically, reconciliation of loan accounts and loan data were considered as the most effective risk management in determining financial sustainability of the MFIs. Major recommendations are that institutions' management should test the impact of the risk management strategies through internal audit, monitoring and analyzing trends and ratios to check the key indicators in the results. Also, the institutions should practise sound financial discipline to enable them stand on their own should the donors withdraw their support.

Keywords: Micro finance institutions, risks and sustainability.

INTRODUCTION

Small scale entrepreneurs who include agriculture and rural businesses have contributed greatly to the growth of the Kenyan economy. The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low income households in the country accounting for 12-14% of GDP (Republic of Kenya, 1989, 1992, 1994).

Kenya's development challenge therefore largely remains that of identifying sustainable ways of enabling the main sectors (which include agriculture and rural business) of the rural economy. The government

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recognizes that the challenge of sustainable development in Kenya is eradication of poverty and the achievement of sustained broad based economic growth (Sessional Paper no.2 of 1992). It is for this reason that the government in the 1990's through the CBK relaxed the entry requirements of the non banking financial institutions to promote locally owned financial institutions. This was aimed at ensuring accessibility of credit facilities to Small and Medium entrepreneurs. Later, the regulatory differences led to the mushrooming of the non-banking financial institutions and this forced the government to harmonize capital requirements and interest rate regulations for both banks and the non-bank financial institutions. This led to the decline in the number of the non-bank financial institutions that were converted to commercial banks (Atieno, 2001).

However, commercial banks have their restrictions of credit to specific activities, making it difficult to compensate for losses through other forms of enterprises, and their policies have left out the majority of the SMEs accessing credit facilities. A survey conducted by FinAcces (December, 2007) found out that**,** Kenya's financial sector is probably the most advanced in East Africa, but to date, only an estimated 55% to 60% of the population has access to financial services. Unsurprisingly, the FinAccess Survey found that the key issue for access to financial services is income, driven by three determinants which are being able to afford the minimum balance and costs for a bank account, being able to afford bus fare to the bank, and finally having sufficient 'excess' cash to justify having a bank account. The commercial banks have used these criteria to categorize their customer as either being creditworthy or uncredithworthy. The uncreditworthy are risky to lend to and accessing credit facilities means exposing themselves to more risks.

On the other hand, the CBK in its policies and guidelines (CBK Prudential Guidelines Basel II) advises financial institutions on the common risks that they are exposed to. These risks include: strategic risks, credit/default risk, liquidity, currency/foreign exchange risk, interest rate risk, operational risk, regulatory risks and reputation risks. According to the CBK, it is apparent that every firm is subject to operational risks in any one of its operations that may arise from inadequate or failed internal processes, human behaviour, external / internal disasters or from the systems. The financial institutions should realize that risks are unavoidable part in their operations and the main role should be to mitigate and manage them. They should be able to minimize the probability of risks occurring and if they occur how the impact can be minimized.

If the risks are not managed well, MFIs are likely to fail to meet their social and financial objectives. Poorly managed risks results into financial losses, loss of confidence by the donors, investors, lenders and borrowers in the organization as they lead to capital erosion.

However, despite employing the risk management strategies, commercial banks have been seen to be so rigid in their policies, a condition that has prevented them from lending to SMEs. Therefore, there exists a gap as to which institutions should provide credit facilities to the SMEs.

Micro finance institutions have tried to bridge the gap mainly because they have wide recourse to credit, either donations or at concessionary interest rates from external funders. Most of these MFIs have adopted the widely known Grameen bank model that was started by Muhammed Yunus in 1976(Steinwand, 2000). These institutions have been established in Kenya and are purposely serving the very group that has been categorized as being uncreditworthy. In spite of this group being regarded as risky, they have succeeded in disbursing and recovering thousands of loans from it.

In Kisii Central District, there are three main MFIs mainly Kenya Women Finance Trust, Women Development Corporation and Young Women Christian Association. According to the Development Plan (2005), Kisii District has absolute poverty rate of 56.9% contributing 1.5% to the national poverty. Agricultural sector contributes 44% with a total of 85% of the population involved in Agriculture, 34% wage employment, 22% in other engagements, and the number of unemployed is at 9.9%. These MFIs are providing services to the people engaged mainly in agricultural activities and small scale businesses. Most of the SMEs are accessing credit facilities from these institutions, which in turn have boosted growth of small scale businesses in the town. These institutions have expanded their customer base and are expanding through opening sub branches in remote areas of the region. Their success has defied convention about financing the poor. They have shown that poor people especially women have excellent repayment ability and are willing to pay interest rates that do allow the MFIs to not only cover their costs, but also make profits.

Statement Of The Problem

Raising enough capital to either start or expand small scale businesses by entrepreneurs has been a major challenge. Though they can access credit facilities from commercial banks and other financial institutions, their lending policies and procedures are not easily met by majority of these entrepreneurs. These procedures and policies are some of the risk management strategies employed by these institutions and hence failure to meet them means that they are "uncreditworthy". To the commercial banks, this is a risky group to lend to. On the other hand, Microfinance Institutions (MFIs) have been established purposely to serve the otherwise 'uncreditworthy' group.

The study is therefore intended to examine and establish the extent to which the strategies employed by the MFIs to manage various risks have contributed to their financial sustainability.

Objectives of the Study

The general objective of the study was to examine and establish the impact of risk management strategies on Microfinance institutions' financial sustainability. Specifically, the following specific objectives guided the study:

a To establish the Microfinance institutions' preference for the various sources of finances;
b To determine the frequency of Microfinance institutions' exposure to risk;
c To find out if MFIs employ risk management strategies;
d To establish the impact of risk management strategies used by microfinance institutions;
e To determine the extent to which they have contributed to their financial sustainability.

Research Questions

a What is the MFIs' preference of the various available sources of finances?
b How frequent are the MFIs exposed to risk?
c Do MFIs employ risk management strategies?
d What risk management strategies do the MFIs employ to reduce the effects of the risk exposures?
e Do the risk management strategies have an impact on their financial sustainability?

Significance Of The Study

The financial institutions will benefit from the effective strategies suggested by the study and shall enable them to develop new products that can be accessed by the majority who are small scale entrepreneurs. The borrowers on the other hand will have a better understanding on the importance of the policies and procedures applied by MFIs. Above all, the government in its efforts to alleviate poverty shall be able to come up with better legal and operational framework that can support the MFIs.

Scope Of The Study

The study was conducted on only three MFIs operating within Kisii Municipality that offer services to small scale entrepreneurs. Only 29 respondents were selected for the study. Specifically, the respondents consisted of managers and credit officers of these institutions

Limitation Of The Study

i Financial contraints limited the researcher from covering the whole country
ii Lack of cooperation from some respondents who felt that the information might be leaked to other institutions. However, the researcher had to assure them of confidentiality of the information given.

MATERIALS AND METHODS

Research Design

The study used a survey design to evaluate the impact of risk management strategies on micro finance institutions' financial sustainability. The design was adopted because of its appropriateness in describing the current situation of phenomenon (Kothari, 1990).

Target Population

The study targeted a population of 38 respondents consisting of three branch managers and thirty five credit officers of MFIs that are operating within Kisii Municipality. The managers are policy makers while the credit officers are concerned with evaluation. This provided the relevant information for the study.

Sampling Design

Sample size determination

The sample consisted of 29 employees of the MFIs selected. A censure was carried out on managers, while a sample of 26 credit officers was used

Sampling Procedure

Both Stratified and Simple Random sampling techniques were used. The target population was grouped into two strata: managers and credit officers. The Managers were censured because each branch has one while a proportionate sample size of Credit officers was randomly selected to get a total of 29 respondents represented in the a sample.

Data Collection Instruments And Procedure

A questionnaire was used to collect data. The instrument had both structured and unstructured questions. Warwick & Linger (1975) stated that researchers should settle on instruments, which provide utmost accuracy, generalizability and explanatory power with low cost, rapid speed, and a minimum of management demands, with high administrative convenience.

Data collection procedures involved the researcher getting the introduction letter from the university administration, visiting the MFIs to do an introduction to the management giving intentions of the visit. The managers later introduced the researcher to the respondents. The questionnaires were self administered and later picked after allowing the respondents one week to complete them.

Data Analysis

Raw data collected from the field was sorted and summarised in tables and diagrams. The process of data analysis involved several stages. Completed questionnaires were edited for completeness and consistency. The data was then coded and checked for any errors and omissions. The data was analyzed using procedures within Statistical Package for Social Sciences (SPSS) _PC version 10. The responses from the open-ended questions were coded; the mean and standard deviation were used for likert-scale responses. Content analysis was also used in the analysis of some of the open-ended questions. For closed questions, a comparative analysis using distribution tables, quantiles (percentiles) and graphical analysis was done to improve the presentation of the analyzed results for ease of interpretation.

General Conclusions

The purpose of this study was to evaluate the impact of the risk management strategies on MFIs' financial sustainability.

a) The study found out that donor funding, revolving fund and government subsidies were the most preferred source of funding, whereas debt financing was least preferred as fundraising was not a preferred source of funding. Von Pische (1991) observed that, though, donors do support MFIs, they reward the successful ones as they punish failures. Similarly, Roseberg (1994) noted that successful MFIs need to be weaned quickly because donors may tire, political moods may change demanding the withdrawal of the donors. This according to his findings will lead to the MFIs hurting the same poor group that they wanted to help. Given that 71% of these institutions offer credit facilities and that they prefer donor funding, they should ensure they are financially stable so that should the donors fail to provide funds, they can stand on their own. To achieve this, the MFIs should ensure good risk management strategies are put in place and also be financially disciplined by ensuring the available funds are used for the intended purpose.

b) The study found out that like any other financial institutions, MFIs are exposed to various risks. According to the results of the study, strategic and credit risks are the very frequent risk exposures to the MFIs. Similarly, liquidity, market and management risks are frequent but legal and compliance, reputation and subsidy dependency are not frequent. Strategic, credit, liquidity and management risks are frequent risks. These risks are both internal and external. While external risks are out of control of MFIs direct control, the MFIs can still anticipate them and prepare for their impact. This should be done through integration of an effective risk management into their culture and operations. They should systematically analyze their preparedness for potential events through building in sufficient cushion for unexpected events.

c) The study revealed that MFIs employ various strategies in their risk management practices. The various strategies employed by these institutions such as risk avoidance, transferring of risks, and mitigation of risks are effective in reducing the impact of risks to these institutions and hence contributes to their financial sustainability. There is a significant relationship between the strategies and the financial sustainability of the MFIs. However, it was observed that reconciliation of loan accounts and data, larger repeat loans and prompt payment incentives ranked highly at 3.01 and 3.07 on the likert scale in their contribution to the financial sustainability.

The general conclusion therefore, is that risk management contributes greatly to the MFIs' financial sustainability. As per the results of table 4.8, mitigation of risks is more effective as the various controls put in place cut across the business.

Recommendations of the study

The management should evaluate the result through internal audit, monitoring and analyzing trends and ratios to check the key indicators in the results. They also should institute good reporting on whether the risk management strategies are yielding the intended results such as monthly loan asset quality reports and the funds management reports.

There should be a continual risk management feedback loop which should give an interactive and dynamic flow of information in the institution. This will enable the management to take necessary actions to reduce the effects of the risks as and when they arise.

Specifically, these institutions should adopt the following risk management process guidelines:

- Lead risk management process from the top
- Incorporate risk management into process and systems design
- Keep simple and easy to understand
- Involve all levels of staff
- Align risk management goals with the goals of individuals
- Address the most important risks first
- Assign responsibilities and set monitoring schedule
- Design informative management reporting to board
- Develop effective mechanisms to evaluate internal controls
- Manage risk continuously using a risk management loop (Steinwand, 2000).

Recommendations For Further Research

The researcher recommends that further research be conducted on the following areas;

i Factors influencing use of the various sources of funding for MFIs

ii Challenges faced by MFIs in the use of various sources of funding

iii Other factors that contribute to MFIs' financial sustainability.

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