RISK MANAGEMENT STRATEGIES AND FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS: A SURVEY OF SELECTED MICROFINANCE

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Abstract

Micro Finance sector in Kenya is affected by multiple risks from both internal and external business environments.Risk avoidance is a strategy where by an organization refuses to accept any exposure and loss from any activity. The study assessed on relationship between risk avoidance strategy and financial performance of Microfinance Institutions in Nairobi City County, Kenya. The study adopted descriptive research design in conducting the research. The targeted population was 51 MFIs in Nairobi which are registered under Association of Microfinance Institutions. A sample of 90 respondents was selected from 45 sampled MFIs. The collected data was analysed using SPSS (The Statistical Package for Social Sciences).Findings were that MFIs use risk avoidance strategyandthere was a weak positive mutual relationship between the strategy and the financial performance of MFIs. The study concluded that, riskavoidance strategy leads to some improvement in the financial performance of MFIs in Nairobi City County.

Key words: Risk Avoidance Strategy, Financial Performance, Risks, Micro-finance Institutions.

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Introduction

The main objective of the study was to evaluate relationship between risk avoidance strategy and financial performance of Microfinance Institutions in Nairobi City County in Kenya. Financial performance of an institution is, the ability to survive, being able to grow and operating efficiently, surviving and reacting to the threats of the environment and opportunities in which it operates in. A firm's financial performance is usually measured by return on sales, return on assets, return on investments, and return on equity, sales on growth and return on capital employed in the organization (Crane1998).

Micro-finance institutions are those financial institutions that are formed and based on a commitment of assisting the poor households and small-medium enterprises to gain access to financial services. Besides this agenda they may have other public or private intentions such as maximizing on shareholders' money for their investment, changing direction of investment into priority sectors, and mobilizing funds for financing the government projects.

Cull, Demirguc-Kunt and Morduch (2007) stated financial performance of microfinance institutions in the whole world continuously attracts the scholars hence need to do research to understand it. They are trying to understand the continual existence of MFIs more so them being special form of financial institutions that operate under the aims of outreach and financial sustainability. With this in mind their performance also needs to be measured according to these objectives.

When microfinance institutions started analysing the risks, their major concerns were about the financial risks since the management did not have much knowledge about other risks that MFIs would face. Their major attention was drawn to categorically credit risks since this was touching the heart of their core business. People started to know more about microfinance institutions and this created more demand for micro loans. On the hand MFIs had not promoted savings mobilization initiatives and therefore there were liquidity issues that started cropping up due to funding gap. The MFIs shifted their concerns to the liquidity risks caused by the cash shortfall.

New developments in the industry have posed new risks to the microfinance institutions. There are now institutional, operational, financial management, and external risks that MFIs have to deal with over and above the traditional ones. These new risks have been triggered by

the changes happening the market place. MFIs have been forced to change the traditional mode of operations because of evolutions in both internal and external environments. More competitors have joined the business, there are more expectations from clients, new rules and regulations for financial institutions, financial technology and innovation advancement, and system integrity have brought additional risks. The most unfortunate thing is that MFIs are not aware of some of the risks and managers tend to overlook them. When most attention in MFIs is directed to credit risks and timely loan repayments, loopholes are created and other types of risks creep in affecting financial performance.

Risk may also be caused by various factors in the financial mix that include stalling of projects, court cases and liabilities, business competitions, natural disasters and eventualities from unforeseen eventualities. Different organizations have made deliberate efforts to develop risk management standards that may be adopted to mitigate risks. ISO standards also has stipulated guidelines on risks management and principles under ISO 31,000.The risk management process differs depending with the organization's area of specialization, type of business it does, the type of clientele, goals and objectives. There are various risk management strategies that can be adopted to mitigate risks which include; risks transfer, risks avoidance, risks acceptance and risks sharing. When risks are effectively managed, the organizations tend to have more benefits despite the size or the type of the organization. These benefits are evident in the financial performance, when laying down the business strategies, there are better and improved service delivery, and an organization enjoys higher competitive advantages, efficient and effective problem solving processes, lesser unwelcome surprises and flexible chances of floating initiatives and business ideas. There is also efficient use of available resources, reduction on wastage, reduction on theft and frauds, better uses of funds, adoption of new technology and improved innovation (Wenk, 2005). Management is able to make effective decisions since from beginning they understand the type of risks they are dealing with and the best way to handle them.

Unmanaged risks may have negative effects on the stakeholders' value. Good governance is more often than not enhanced through good risks management. An organization is able to make cost effective use of risk management strategies when the management creates an approach that is made up of well-defined risk management procedures that are adoptable to the MFIs. These strategies have to take in to consideration all the other functions and departments. It cuts across the financial risks management, operational risk management,

governance risk management, and strategic risk management. Arguably, the main objective of managing inherent risks is to understand in advance the impacts of each alternative on future performance of an organization.

Risk avoidance is a strategy where by an organization refuses to accept any exposure to a loss from any activity. Vaughan (1997) sees it, as recognition that there is no risk management strategy that can reduce the risk to below the limit acceptable for the organization in economic terms. This strategy is used by an organization when the probability of the risky happening is high, the ripple effect to the financial performance is high and there are insufficient resources to cushion the impact. This is carried out by adopting a different ways of solving the problem and avoiding the risks by all means. MFIs would achieve this through terminating all activities which relate to the risk. Risk avoidance can be achieved by removing the risky threat more so by eliminating the cause and putting in place measures to stop the risk and its effects from happening in the first place.

In the Risk Management for MFIs Toolkit, Kumar and Kumar (2009) suggests a few examples of risk avoidance in MFIs. These measures may include not disbursing loans to farmers located in the drought prone areas and without irrigation schemes to supplement the rain shortfalls.Insights from Dittmann, Yu and Zhang (2015), indicate that the effect of the risk-avoidance strategy to any organization's financial performance is vague since there is no any relationship between it and return on assets (ROA) and return on equity ROE. Oldfield and Santomero (1997) described some applicable risk avoidance strategies that organizations can use including underwriting standards, diversification, hedges or asset-liability matches, reinsurance or syndication, and due diligence investigation. The main objective is to protect the institutions from unnecessary risks that do not be bring forth any benefits despite the financial employed. Audu (2014) stated risk avoidance may be seen as an aggressive and a solution on all risks that firms may encounter, but it is not a practical scenario since financial institutions have to venture in risky businesses in order to obtain financial return.

The financial performance indicators usually fall in different categories notably; portfolio quality, efficiency and productivity, financial management, profitability and liquidity. Portfolio quality analyses the loan book of an MFI, and forms a very crucial part of financial performance. It can lead to the largest source of risks to MFIs since the largest part of the microfinance institutions' assets resides in the loan book. With this in mind, the risks it poses

to an MFI can be quite difficult to assess and measure. This is typically so since MFIs mostly offer loans to the un-bankable clientele whom mostly do not have collateral to back up the loans in-case of default. Microfinance institutions fortunately have learnt the art of maintaining high portfolios and huge loan books as they practice co-guarantee and group lending mechanism. This reduces the default effects as the group members are individually and summarily liable when default occurs. The MFIs uses portfolio-at-risk (PaR) ratios to measure the quality of their loan book. This measures that part of running loan facilities that has fallen due but the client has not paid the required loan instalment. It's usually a percentage of the whole portfolio the MFI has at a certain period of time. MFIs may have other methods to measure portfolio quality but PaR is the most appropriate one. Microfinance loans are considered risky if they have been running in arrears for 30 days.

To show how well Microfinance institution is streaming its operations, it uses the efficiency and productivity indicators. Productivity indicators at best reflects the quantity of efforts and resources employed and the results gained from the resources. Efficiency indicators often takes in to account the cash outlays and cash inflows from any investment. Financial efficiency evaluates the extent in to which, manpower financial resources and management is utilised. It analyses the relationship between inputs and outputs. Since inputs can be measured in both physical and financial terms, most of the efficiency measures in addition to financial measures can be formulated. It's hard for the management decisions to influence these indicators hence making them easier for comparison across the whole organization. Productivity and efficiency indicators measures are less comprehensive indicators of financial performance compared to those of productivity. In this regard MFIs usually have much lower rates of efficiency when compared to other commercial banks.

Financial management takes care of the financial obligations of the MFIs by ensuring that the organization is liquid enough to settle the financial obligations as they arise. The obligations includes loans disbursements to the MFIs' clients, paying interests on savings as well as paying off loans from creditors. Financial management is usually seen as a back office function but decisions in this area may have direct effects to financial status of an organization. For an MFI to have adequate liquidity, more efforts have to put in savings mobilization from depositors. More intentionally and sound decisions have to be made regarding how the liquid funds are invested. Financial management also includes managing the foreign exchange risks and matching the maturities of assets and liabilities.

Profitability indicators in MFIs summarizes the organization's performance. It measures among others the return on equity, return on assets, and indicates profits made from utilising factors of production like loans facilities. Profitability is derived from comparing revenues generated like when loan facilities disbursed are repaid, and expenses like interest on savings repayable to depositors or loan write-off on defaulted loans. Four useful measures of the MFIs' profitability are the rate of return on assets (ROA), the rate of return on equity (ROE), operating profit margin and net firm income. The ROA measures the return to all MFI's assets and is often used as an overall index of profitability, and the higher the value, the more profitable the MFI's business. The ROE measures the rate of return on the owner's equity invested by the MFI's shareholders. It's important to compare the ROE in relation to ROA and establish if the MFI is generating profits from the borrowed funds. Profitability is affected by all the other indicators, like poor portfolio quality and low efficiency. It's usually harder to interpret since it's an aggregate of so many other factors. In MFIs profitability cannot be looked into in isolation hence any analysis has to take in to consideration all the other indicators that illuminate the operational efficiency and portfolio quality.

Conceptual Framework

A conceptual framework forms a main structure or skeleton that gives a shape to the whole system, while supporting and holding together all the other elements in a logical configuration.The study had the following independent variables ; Risk Avoidance Risk Acceptance, Risk sharing and Risk transfer while the dependent variable included financial performance measured by Portfolio quality, Financial Efficiency and Liquidity. The intervening variable was the external environment factors that would affect the MFIs, financial performance either directly or indirectly characterized by financial policies and reforms, change in business environment, and technology and innovation
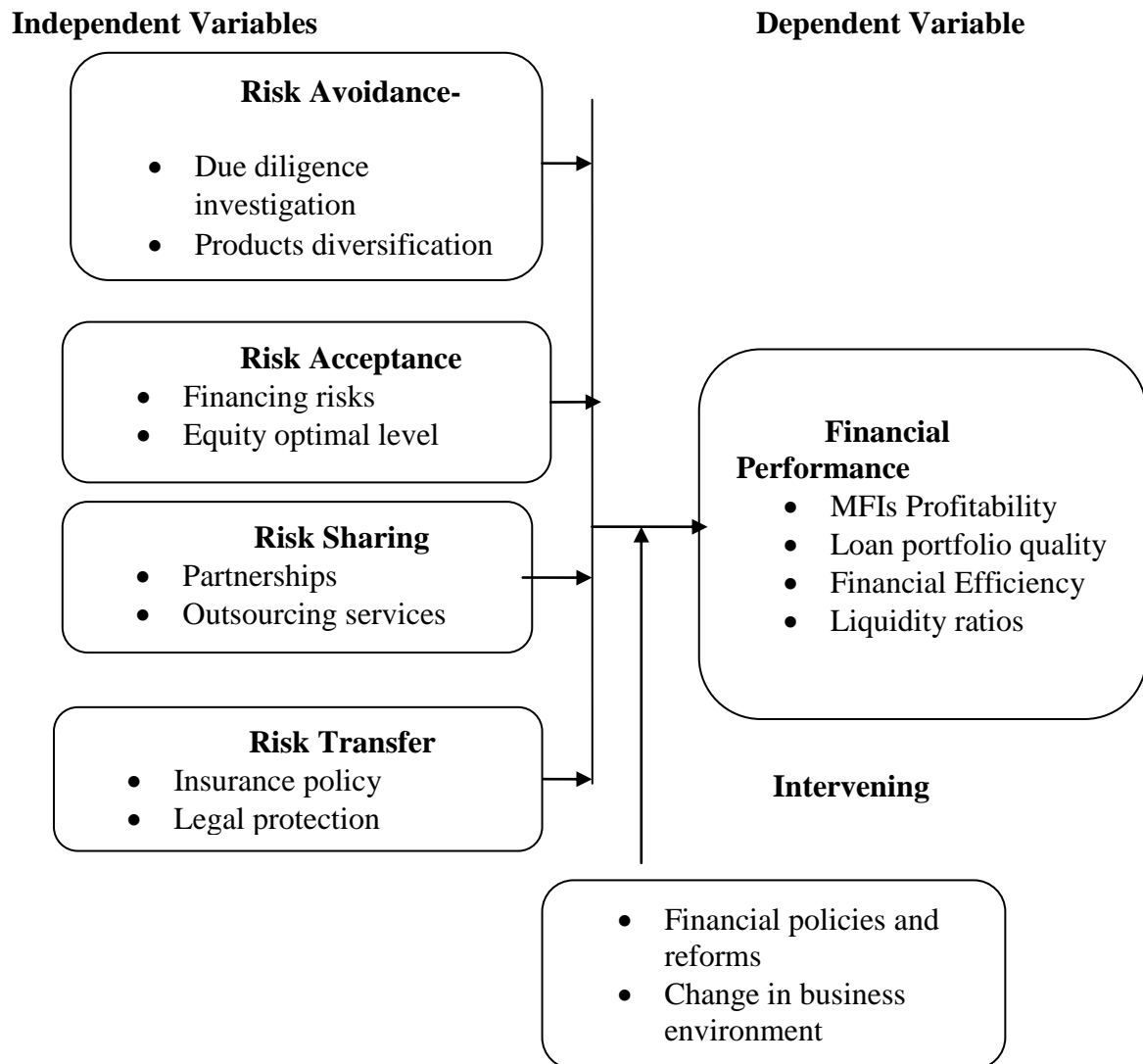
Independent Variables   **Dependent Variable**

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┌──────────────────────────┐
│      Risk Avoidance-      │
│                          │
│   • Due diligence        │
│     investigation        │
│   • Products diversification │
└──────────────────────────┘

┌──────────────────────────┐
│      Risk Acceptance     │
│   • Financing risks      │
│   • Equity optimal level │
└──────────────────────────┘

┌──────────────────────────┐
│      Risk Sharing        │
│   • Partnerships         │
│   • Outsourcing services │
└──────────────────────────┘

┌──────────────────────────┐
│      Risk Transfer       │
│   • Insurance policy     │
│   • Legal protection     │
└──────────────────────────┘
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Financial Performance
- MFIs Profitability
- Loan portfolio quality
- Financial Efficiency
- Liquidity ratios

Intervening

- Financial policies and reforms
- Change in business environment

Figure 1.1 Conceptual Framework

Source: Author, 2018

Methodology

The study used a descriptive research design and adopted survey methods to gather information from the Microfinance Institutions. The data analysis methodology was the quantitative approach and was supported by qualitative approach that shed more insights to the research for better understanding of the research results. The study was carried out in Nairobi City County. The population under study consisted of all Microfinance Institutions operating in Kenya and registered under Association of Microfinance Institutions (AMFIs). According to AMFIs reports currently there are 51 registered MFIs and operating in Kenya. All the 51 MFIs formed the targeted population.The study used purposive stratified sampling method to get a sample. The sample size for this study was determined using the Krejcie & Morgan (1970) sample size table. In a population of 51MFIs the corresponding sample size is

45 MFIs hence the study selected a sample of 45 MFIs. The 45 MFIs under study were grouped into 3 strata based on the AMFIs classification. Simple random sampling was then used to select required samples from each stratum. The strata groups were not be homogeneous since they were be based on the number of MFIs registered under each category. The first stratum comprised of 5 MFIs, the second one had 11MFIs and the third one had 35MFIs. The sample size from each stratum was 4, 9 and 32 MFIs respectively. The targeted respondents were 90 staff from the 45 sampled MFIs. Two employees were selected from each MFI sampled as respondents. One of the respondent was be selected from finance department while the other from any other department in the organization.

To test validity and reliability, a pilot testing was conducted. The researcher used 10% of the sample size to conduct pilot studychecking the appropriateness of the language used in the questionnaires, to determine if the instrument will be easy to administer and it's appropriateness to collect data it's meant to. To measure reliability, the study used Internal Consistency Reliability Method on questionnaires administered to carry out pilot survey to measure the consistency of response from respondents. Data analysis for the study was done using SPSS (The Statistical Package for Social Sciences) where descriptive and inferential statistics were used to analyse relationships, differences, trends and comparisons from collected data. Inferential statistics comprised Pearson's correlation to establish the linear relationship between risks management strategies and financial performances of MFIs.

Findings and Discussions

A total of 90 questionnaires were distributed and 79 of them were duly filled and returned. This comprised 87.8% return rate of the questionnaire administered. According to Mugenda and Mugenda (2003), a return rate of above 60% is considered adequate for data analysis. Therefore, the return rate of 87.8% in this study was adequate for data analysis.

Table 1: Risks avoidance strategy

Risk avoidance strategy	Strongly disagree (%)	Disagree (%)	Neutral (%)	Agree (%)	Strongly agree (%)	Mean	Std Dev
Documented procedures	1.3	0	15.2	53.2	30.4	4.11	.751
Due diligence	0	0	11.7	58.4	29.9	4.18	.725
Different products, services and policies diversification	1.3	0	6.3	41.8	50.6	4.41	.725

Source: Research data, 2018

Findings from the analyzed data indicates that (53.2%) of the respondents agreed with the statement that MFIs have documented procedures to handle risk. 30.4% of the respondent strongly agreed, (15.2%) were neutral and 1.3 % strongly disagreed with the statement. From the findings none of the respondents disagreed with the statement. These findings indicate that most of the MFIs at 83.6% and with a mean of 4.11 have documented procedures to handle risks, as a part of risk avoidance strategy.

Analyses on the statements regarding MFIs carrying out due diligence on its operations to avoid risks indicated that majority of the respondents (58.4%) agreed with the statement, 29.9% of the respondents strongly agreed 11.7% of respondents were neutral. These findings with an aggregate of 88.3% and a mean of 4.18 show a high level agreement to the statement that the MFIs staff carry out due diligence when carrying out their operations as one way to avoid risks.

The presented results indicated that 41 respondents constituting 50.6% strongly agreed that their institutions have different products and services, and their policies allows products diversification, as a part of risk avoidance strategy. This was followed by 41.8% who agreed to the statement while 6.3% respondents were neutral. None of the respondents disagreed while1.3% strongly disagreed with the statement. The aggregate results of the 92.4% of respondent in agreement, confirmed that most MFIs in Nairobi City County have different products and services for their clientele and their policies allows products diversification as a part of risk avoidance strategy. This confirms Vaughan (1997) statement that risk avoidance is carried out by adopting a different way of doing things and removing risk where it is

possible to do so. MFIs would achieve this through terminating those activities which relate to risks. Prevention can be achieved by removing the specific threat more so by eliminating the causes and putting in place measures to stop the threat or problem from occurring in the first place. This may include dropping one product or service and introducing a different one on the other hand.The analysis from risk avoidance strategy confirms the statement by Audu (2014) which states that risk Avoidance is considered as an aggressive and a solution on all risks that firms may encounter, but it is not a practical scenario since financial institutions have to venture in risky businesses in order to obtain financial return. The effect of the risk-avoidance measure on firm's performance is ambiguous, as there is no significant relation found with return on assets (ROA) or return on equity (ROE) (Dittmann, Yu & Zhang, 2015).

Table 2: Correlation between risks avoidance strategy and financial performance

			Our profits for 3 years performance been high	Portfolio quality on our loan records has been 95%+	Our policy docs incorporates resources maximization for financial efficiency	We monitor liquidity ratio to ensure financial stability	Savings mobilization to encouraged to curb funding gap at any time
Spearman's rho	Different products, services and open policy on products diversification	Correlation Coefficient	.037	.105	.295**	.359**	.385**
		Sig. (2-tailed)	.746	.355	.008	.001	.000
		N	79	79	79	79	79
	Documented procedures	Correlation Coefficient	.266*	.393**	.464**	.434**	.511**
		Sig. (2-tailed)	.018	.000	.000	.000	.000
		N	79	79	79	79	79
	Due diligence	Correlation Coefficient	.348**	.298**	.450**	.616**	.558**
		Sig. (2-tailed)	.002	.009	.000	.000	.000
		N	77	77	77	77	77

*. Correlation is significant at the 0.05 level (2-tailed).

Source: Research data (2018).

According to Table 2 the data indicates the type and strength of mutual relationship between risk avoidance strategy and the financial performance of Microfinance Institutions in Nairobi City County using two-tailed tests. The analysis indicated a positive strong relationship (r) value of 0.746 between the risk avoidance strategy variable on having different products & services, policy being open on products diversification and financial performance variable on profits for the 3 years performance being high. The implication is that when this independent variable on the risk avoidance strategy increases then dependent variable on financial performance increases with the same proportion. The analysis showed a weak positive correlation r value of 0.355 between dependent financial performance variable about portfolio quality on our loan records having been above 95% and risk avoidance independent variable on having different products & services and policy being open on products diversification. Further the analysis shows insignificant correlation value r of 0.008 between this risk avoidance variable and financial performance variable on MFIs' in Nairobi County having policy documents that incorporates resources maximization for financial efficiency. With the financial performance variable that MFIs in Nairobi County, encourage savings to curb funding gap, and variable that the MFIs monitor liquidity ratio, this risk management strategy variable recorded a very insignificant r value of less than 0.001. The implication is that there was no relationship between these variables.

Analysis on correlation coefficient between risk avoidance independent variable about MFIs in Nairobi having a documented procedure to handle risks and dependent variable on MFIs performance for 3 years having been high, recorded a weak positive relationship of r = 0.018. When this independent variable was correlated with dependent variables portfolio quality of MFIs in Nairobi having been above 95% it had r value of r=0 hence no correlation between the two variables. The was no mutual relationship of r=0 between the independent variable on the policy documents incorporating resources maximization for financial efficiency and the two financial performance variable on monitor liquidity ratio to ensure financial stability and Savings mobilization is encouraged to curb funding gap at any time.

The relationship between carrying out due diligence variable and Portfolio quality on our loan records has been 95% and above variable has a very weak r value of r= 0.002 and r= 0.009 with our profits for 3 years performance have been high variable. These values of r indicate there is almost no correlation between due diligence and the two financial performance variables. When carrying out due diligence variable is correlated with three dependent variables which are MFIs policy documents incorporates resources maximization

for financial efficiency; MFIs monitor liquidity ratio to ensure financial stability and Savings mobilization is encouraged to curb funding gap at any time, the r value of r=000 indicates that there is no correlation between the variables.

These findings agree with insights from Dittmann, Yu and Zhang (2015), who indicated that the effect of the risk-avoidance measure on firm's performance is ambiguous since there is no significant relationship found with return on assets (ROA) or return on equity (ROE). Oldfield and Santomero (1997) described some common risk avoidance actions, to include underwriting standards, diversification, hedges or asset-liability matches, reinsurance or syndication, and due diligence investigation. In each case, the goal is to protect the organization from some risks that are not essential to the financial service provided or to absorb only the optimal quantity of a particular kind of risk.

Conclusions

It's evident that the MFIs in Nairobi County have adopted risk avoidance strategy to enhance financial performance. However, there are positive but weak mutual relationships between adopted risk avoidance strategy components (having documented procedures; due diligence in institution and having different products, services and policy on products diversification) and the financial performance of the MFIs in Nairobi County. Risk acceptance strategies (absorbing risks with no adverse effects; have different type of investments with other organizations and maintaining low MFI owner equity) have great effects on financial performance of the MFI institutions in Nairobi County

Recommendations

The MFIs in Nairobi County should put more emphasis on adopting the risk avoidance strategies that have positive impact on their financial performance. The strategies implemented should be realistic and tested within the MFIs to see if they are adoptable and economical to use. The staff should be made aware of these risks by continually enlightening them on risks and risk handling procedures.

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