# An economic investigation of risk management and governance systems in microfinance institutions

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**Keywords**
Governance, Risk Management and Portfolio Management.

**Abstract**

*From the onset, one of the most leading factor posing a high risk in management of a microfinance is failure to have proper governance systems in place. This paper investigates the variables that best explain management of risks basing on the governance systems perspective in microfinance institutions. The methodology adopted was an explanatory and survey research design. The data was gathered from questionnaires that were distributed to 114 participants drawn from 50 MFIs. Data was also extracted from published sources of Bank of Uganda annual reports and Uganda Bureau of Statistics.*

*The study makes use of Principle Component Analysis (CPA) to identify variables that best explain the governance of MFIs basing on orthonormal loadings and Eigen values, and conclusion on each variable was drawn basing on mean values of descriptive statistical analysis. the study has revealed that effective management of risks in a MFI cannot be precisely explained by one variable in the governance but one has to consider a number of actors within the governance systems that couldn't be overlooked. Under governance the focus should be on board selection basing on the procedure taken to select the board, periodical evaluation of loan officer's performance, the process of decision making, predefined board roles, management style that is transparent, the character of manager in terms of managing human resources, manager that respects employees which is so paramount and board performance in terms of service delivery, controls and strategic issues that address the needs of a financial Institution.*

## Introduction

In Uganda, Micro Finance Institutions (MFI) came into being to bring financial services to people who have been excluded by big financial institutions because of lack of collateral security. The sole aim of the MFIs is to extend credit to under privileged group. The government of Uganda is using MFIs as agents of its program "*Prosperity for All*". In order for these MFIs to survive, to fulfil their obligations properly and to flourish in a robust business environment, they have to manage risks effectively. One indicator of the performance of a MFI is its financial sustainability on how well can the institution meet its financial obligations like meeting its clients' demand on credit facility (Buwule, 2011).

Besides financial sustainability MFI should also focus on risk management as this has received much attention in both developed and developing countries as a result of the increasing recognition that a firm's corporate governance affects its ability to access long- term, low- cost investment capital (Organization for Economic Co-operation and Development [OECD], 2004). According to the Financial Institution Regulation, 2005, "Institutional governance means the process and structure used to direct and manage the business and affairs of a financial institution with the objective of ensuring its safety, soundness and enhancing of shareholder value, and shall cover the overall environment in which the financial institution operates, comprising a system of checks and balances which promotes a healthy balancing of risk and return.

Not only that MFIs are still facing a problem lack of proper governance systems and these revolve around four core principles, i.e. fairness, accountability, responsibility and transparency. Specific challenges of upholding these principles depend on the ownership structure of the corporate sector because challenges can be easily mitigated if their systems within an institution to be followed. In recent years, corporate governance has received increased attention because of high- profile scandals involving abuse of corporate power and in some cases alleged criminal activity by corporate officers. An integral part of an effective corporate governance regime includes provisions for civil or criminal prosecution of individuals who conduct unethical or illegal acts in the name of the enterprise (http://www.businessdictionary.com).

**Literature review**

**Organization Systems**

In order to have a clear understanding of governance in MFIs, there is need to recall one of the renowned organization systems like Ludwig von Bertalanffy's systems theory (1969) which asserts that an organization is a combination of components that are interrelated and continued to state that in order to understand an organization as a whole we must know both the parts as well as relations between as cited in Chandra (2005). Ludwig's systems theory idea was propagated through his publication of "General Systems Theory" in 1969.

This systems theory was based on the ideas of Chester I Barnard (1938) affirms that an organization is characterized with cooperative system; he defines such a cooperative system as a complex of physical, biological, personal and social components which are in specific, systematic relationship by a reason of cooperation of two or more persons for at least one definite end (Barnard, 1938) cited in (Chandra, 2005). Based on these ideas, a system may be looked at as an orderly grouping of separate but inter dependent components for purpose of attaining some pre- determined objective. This reveals that every individual within institutions has a special part in the management of the risk associated with institutional asset portfolios.

Besides that, all organizations transform input into output. In the case of MFIs, the inputs may be information on applicants for loans, and by applying certain conversion processes, these inputs can be transformed into outputs of loans, services and information. In the process of conversion, the organization must take in to consideration the dynamics of the outside environment and must continually interact with both the internal variable and external variables in this case loans. Therefore, this can only be achieved if at all there proper systems of governance in the first place to be followed, the following section presents a review of the related literature on the governance systems in organization.

**Microfinance Governance**

Economists have tried to define corporate governance in different ways in the 21st century. According to the OECD Secretariat (2004), corporate governance refers to the way in which an organization is directed and controlled, including the mechanisms, processes and relations. The wise stewardship of the firm's total portfolio of assets and resources, with the objective of maintaining and increasing stakeholders' value, is the cornerstone of corporate governance. Corporate governance further focuses on building a system by which businesses are managed by different participants in the corporation, such as the board, managers, shareholders and other stakeholders. Meredith and Clough (2008) contend that corporate governance entails a relationship between corporation and stakeholders in the private sector, but in fact corporate governance is required in every business entity, be it private or public, for the business to be run in an ethical manner.

According to Itzhak (1998), corporate governance is a multi-dimensional aspect of authority that covers the political set-up of formal and informal institutions for efficiency, effectiveness and accountability. The aim is to achieve sustainable development, personal freedom and the welfare of the population, through an emphasis on planning and resource allocation. Ledgerwood and White

(2006) see corporate governance as a system of checks and balances, in terms of which a board of directors is established to oversee the management of the MFI. According to Otero and Chu (2002), governance is:

> *"the process by which a board of directors, through management, guides an institution in the fulfilment of its corporate mission and protects the institution's assets over the course of time. The board of directors provides oversight, gives direction to managers of the institution, and carries out its functions on behalf of the third party. Shareholders constitute the third party in a profit corporation; in a non-profit making corporation, the third party is not as easily defined because they are not owners and can include clients, staff, donors and government".*

MFIs should address the governance systems in order to minimize risks associated with finance loss, asset mismanagement and loss of reputation from the public as Otero and Chu (2002) argue that governance has assumed increasing importance in microfinance, because as MFIs grow in their outreach, the size of their assets (measured by their loan portfolio) also grows to a considerable size. Ensuring effective management of this growth requires added input and involvement on the part of the board so as to minimize risks associated with over-expanding. Therefore, building a public image can be enhance if at all MFIs can adopt the measures as laid down in King III report (2009) which defines the roles of the board which helps in shaping the governing body of an institution in achieving its long-term goals. The section below presents a review of risk management in MFIs

**Risk Management in MFIs**

Management of risks is a very important aspect for the survival and effective management of business enterprises in Uganda. Coleman (2011), state that *"Risk management is the art of using lessons from the past in order to mitigate misfortunes and exploit future opportunities, in other words the art of avoiding mistakes of yesterday while recognizing that nature can always create new ways for things to go wrong"*. The recognition that risk management is fundamentally about communicating risk upwards from the line managers to the top management of the MFIs. In most financial firms, different risks are managed by different departments requiring very different metrics. However, there must be a comprehensive and transparent aggregation of risks and an ability to disaggregate and drill down through an effective communication to the lower level managers. As Coleman et al (2007), points out that, *"Consistency and transparency in this process are key requirements. It is essential that all risk takers and risk managers speak the same language when describing and understanding their risks"*. This will act as a driving force to mitigate risks in financial institutions.

Therefore, risk management is about taking advantage of opportunities: "controlling the downside factors like using institutional assets for personal gains at the expense of the institution and exploiting the upside through extending credit to those in need. There for the success of any MFI is putting into consideration of how to effectively manage risk and at the same time increase performance as many MFI in Uganda have been pushed out of business solely due to poor management of risks for instance, clients at the former Teffe Trust MFI could take loans without valid collateral security.

Furthermore, Feed the Children Uganda, too has of recently closed its doors because it incurred huge losses when its clients failed to pay back the loan extended to them. Some had provided collateral security in form household items like chairs, cups animals etc, which could not yield any return. Some clients moreover threatened loan officers with death, if they do not lend them money. By the closure of 2014 financial year over 10 MFIs have closed due to poor management of risks leading to increased debt to equity ratio UBS (2014). All these risks of failure to recover the loans would have been mitigated if at all there was proper governance systems in place

Studies to date have examined various risk management basing on large financial institutions (Aspacks et al, 2005, Anas and Mounira, Vodova 2011, Chickoko 2012,). All these studies focused on commercial banks liquidity management and in particular to large financial institutions and most of them are in advanced economies only after the financial crisis. The current study examines portfolio management amidst high risks of failure to pay back the loan and mismanagement of MFIs resources and emphasis is put on having governance systems in place.

Besides risk management, Ogule (2005) in his article on the importance of promoting internal checks and balances to enhance corporate governance, states that effective corporate governance relies on interrelation and interaction of all checks and balances within an organization namely, internal controls, risk functions, policies and procedures, government and regulating agencies, audit and board independence which are a key issue management of MFIs.

**Purpose of the study**

The purpose of the current study is to identify and profile strategies of minimizing risks through proper management of MFIs portfolios, if they are to achieve their intended objectives. The various studies conducted focused on extension of credit to business enterprises and identified social-economic factors that affect loan repayment rate of rural households and Small and Medium Enterprises (SMEs). However, in the literature review, there is no indication of studies specific to governance and risk management in MFIs.

**Research methodology**

To be able to understand governance and risks management by MFIs in different operating environments, a highly structured approach is necessary. Accordingly, the researcher used explanatory and survey research designs. The study used an explanatory research design by using correlation analysis to estimate risks and to establish causal relationships between variables that best describes proper governance in MFIs whilst risk management strategies. An explanatory approach is considered appropriate because of its ability to study situations or problems in order to explain the relationship between variables (Creswell, 1994; Creswell, 2003).

At present, the majority of the microfinance institutions concentrate around Kampala metropolitan region located in the central of the country. The central region tends to hold the largest population in Uganda. The parent population comprised of participants from three categories of Microfinance institutions in Kampala and that is credit taking, Deposit taking and Credit taking and Deposit taking. The target population from the three categories of MFI included the administrative staff and credit officers and the members served by the MFIs.

Besides that, secondary data used in this research was obtained from reports, budget speeches and researches (surveys) from Bank of Uganda publication and Ministry of Finance, Planning and Economic Development (MFPED 2006). Another useful source of data was the National Bureau of Statistics Entebbe and World Bank offices in Kampala. From these sources, the researcher obtained tabulated information from their reports. Additional information was obtained from Association of Micro finance Institutions of Uganda (AMFIU 2009) publications. Internet based sources like online journals from Nelson Mandela University Library and various text books.

Lastly, a bulk of data used for analysis was obtained from various publications of MFIs. The researcher on several occasions held detailed telephone conversation (interview) with MFIs personnel to obtain more data from verbal expressions and responses to the questions posed. This technique provided more critical data that was missing in existing literature and other sources. It also helped the researcher to gain more insight and knowledge about the operation of the object of study.

**Discussion of Findings**

The researcher employed principle component analysis basing on Eigen values to identify variables above mean-scores and the nodes on the scree plot (ordered eigenvalues) denotes the total number of variables that best explain the governance basing on those above 1 mean score. Furthermore, the orthonormal loadings display of the variables is employed in order to identify the names of variables above 1mean score. The analysis is based on Governance and Risk Management.

Governance is the first dimension that relates to selection of the board, board decision, board roles, management style, and board performance basing on services, controls and strategy and risk management dimension focused on, collateral security, Management Information Systems (MIS), and loan repayment.

The following section presents the analysis of variables that explains governance in the MFIs basing on principle component analysis (PCA). The table below shows the total number of variables that were observed under governance using Principle Component Analysis (PCA) to ascertain the crucial areas MFIs should put emphasis as a way of mitigating risks.

The researcher used the orthonormal loadings to identify the names of the variables that best explain the criteria for selecting the board. The variables identified are Board_ Bank on (Someone whom the institution can bank on and is professional), Board _Shrewd (A person knowledgeable), Board_ Track (values and integrity) and Board_ Inst (owns shares in the institution).

***Eigen values and orthonormal loadings on governance dimension***

Board Selection

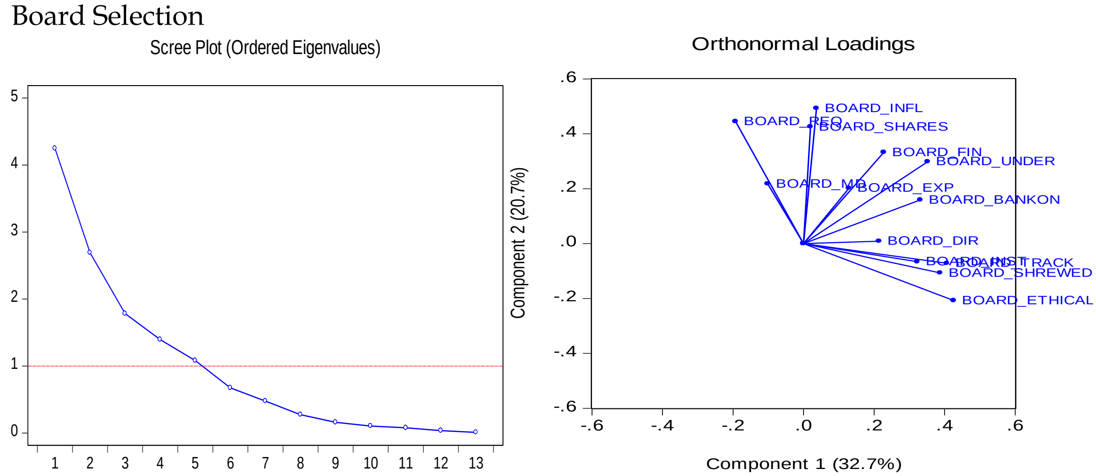


Figure 1: Board Selection

The above diagram shows that under board selection, a number of variables were investigated over 13 under this criterion but the screen plot showed 5 variables were identified as the strongest point of emphasis on board selection and last the names of the variables are displayed using orthonormal loadings.

Loan officer performance

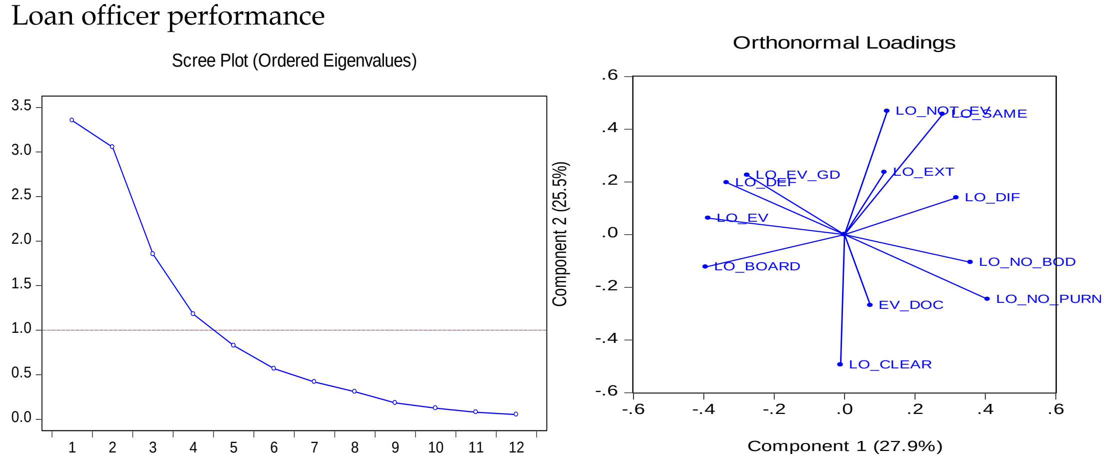


Figure 2: Loan officer performance

Under loan officer performance only 4 variables were identified as the one that best describes loan officer performance.

**Board Decision**

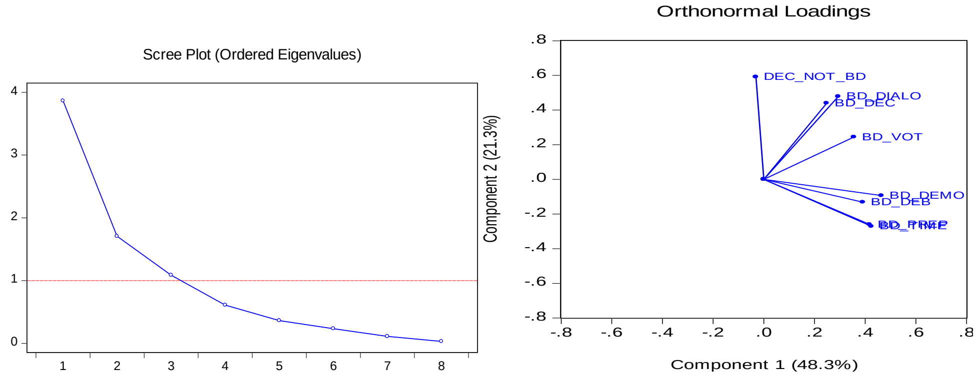


Figure 3: Board Decision

For the purposes of having an effective decision making in MFI, there was need to investigate more in board decision and basing on the above diagram, 3 variables were identified as the best practice of decision making in MFIs

**Board Roles**

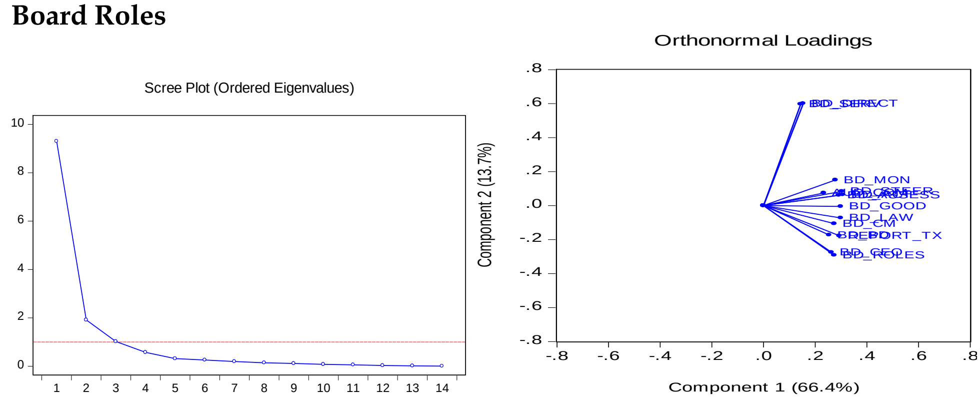


Figure 4: Board Roles

The respondents were asked to give their subjective views regarding board roles in their institutions and basing on the principle component analysis 3 variables were identified and these are Bd_ Roles (Roles of the board members defined), Report_tx (Filing tax returns), and Bd_ Assess (Assessment of top managers). Proper management of MFIs can only be enhanced when there is some clear defined roles of the board and the above diagram depicts 2 variables that best describes board roles out of 10 that were examined.

**Management style**

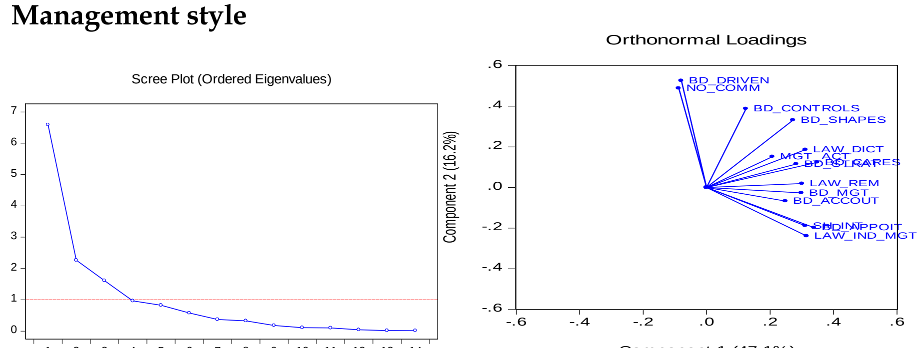


Figure 5: Management style

The subjective views of the respondents regarding management style whether it best explains governance within the MFIs. In this regard 4 variables were identified and the variables include the following Bd_Appoit (Board effectively monitors management), Bd_Mgt (Use of management committees), Bd_Cares (Strategies are implemented as planned) and Bd_Mentor (Mentoring and coaching managers).Board performance

Service

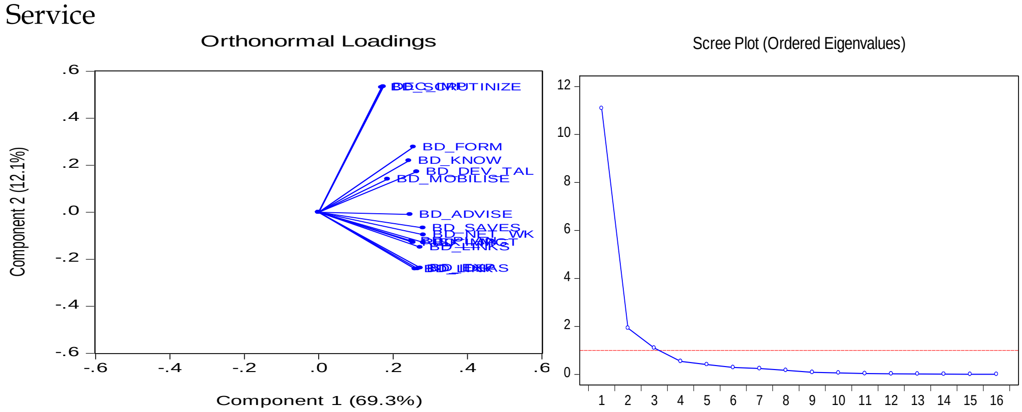


Figure 5: Service

Under this attribute in figure 5 above, there are 3 variables that explain the board performance; they are categorized under service, control and strategy. The analysis as per each category is presented in the following sections

Control

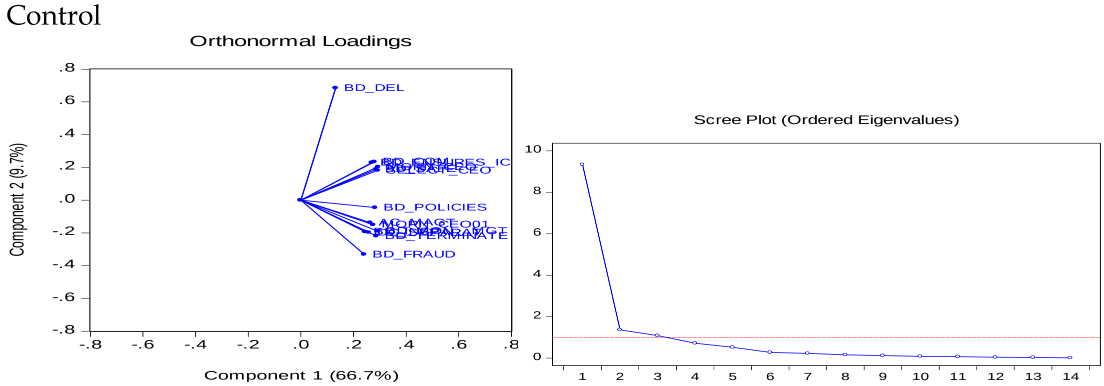


Figure 6: Control

Board control curtails on safeguarding the interest of the shareholders and the institution at large, therefore basing on the PCA, 3 variables were identified from 15 observations. they are Bd_Policies (Internal control procedures), Bd_Terminate (Monitoring Management), Bd_Mon_Mgt (Avoiding fraud).

Strategy

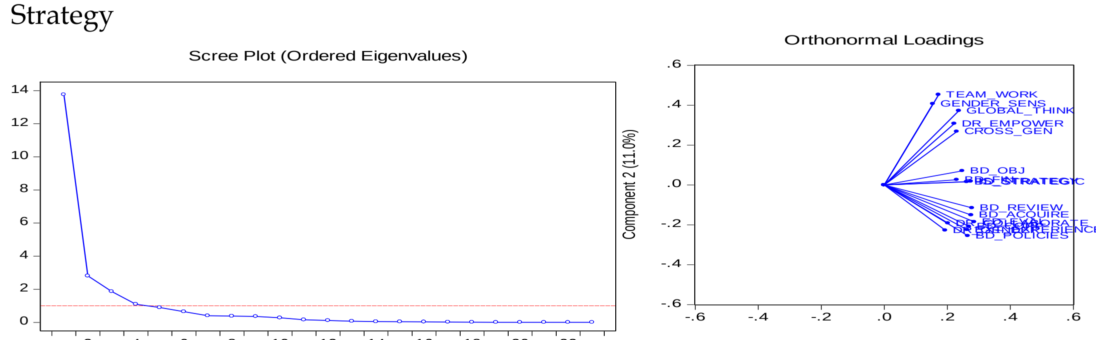


Figure 7: Strategy

This variable relates to the various strategies employed by the board to effectively manage the institution and according to the PCA out of the 23 observations 4 variables were identified as being the one that best describes the board strategies, the first 4 variables with values above 1 score were identified. The variables are Ed_Eval (Carrying out SWOT analysis), Bd_ Acquire (Acquisition of resources), Ext_Experience (Board experience) and lastly Bd_ Vision (Determining the vision and mission).

The table below shows that by employing descriptive statistical analysis basing on mean scores, the researcher has identified among the 29 variables identified by PCA on governance dimension, 19 variables on average have mean scores above 3 signifying good performance in that areas.

| No. | Dimensions | Variables | Attributes | Mean scores < or = 3 | Mean scores > 3 |
|---|---|---|---|---|---|
| 1 | Governance | Board selection | Board_Bank On | | 3.807018* |
| | | | Board_Ethical | | 3.368421* |
| | | | Board_Inst | 2.833333 | |
| | | | Board_Shrewed | 2.900901 | |
| | | | Board_Track | | 3.464912* |
| | | Loan officer performance | Lo_Dif | 3.026316 | |
| | | | Lo_No_Bod | 1.675439 | |
| | | | Lo_No_Purn | 2.061404 | |
| | | | Lo_Same | 1.921053 | |
| | | Decision Making | Bd_Demo | | 3.254386* |
| | | | Bd_Init | 3.000000 | |
| | | | Bd_Style | 3.000000 | |
| | | Board Roles | Bd_Assess | | 3.298246* |
| | | | Bd_Roles | | 3.333333* |
| | | | Report_Tx | | 3.438596* |
| | | Management style | Bd_ Appoit | | 3.228070* |
| | | | Bd_ Cares | | 3.570175* |
| | | | Bd_ Mentor | 2.763158 | |
| | | | Bd_ Mgt | 2.973684 | |
| | | Board performance-Services | Bd_Ideas | | 3.201754* |
| | | | Bd_Net_Wk | | 3.298246* |
| | | | Bd_Links | | 3.090909* |
| | | Board performance-Control | Bd_Mon__Mgt | | 3.570175* |
| | | | Bd_Policies | | 3.473684* |
| | | | Bd_Terminate | | 3.649123* |
| | | Board performance-Strategic | Bd_Acquire | | 3.175439* |
| | | | Bd_Vision | | 3.473684* |
| | | | Ed_Eval | | 3.157895* |
| | | | Ext_Experience | | 3.228070* |

Table 1: Descriptive Statistics on Mean Scores of Variables Identified by PCA

Therefore, the strength of MFIs under governance is seen in the following areas;

The MFIs surveyed have strong board that is professionally ethical and knowledgeable in the area of managing financial institutions. They are performing better in the area of decision making, they do make timely decisions, and the board keeps on monitoring management and making sure that strategies agreed upon are properly implemented. The board is well committed in filing tax returns which is a legal requirement to all taxpaying institutions.

However, 10 variables showed sign of weakness because they have mean scores on average below 3. Management of MFIs need to strengthen its self in the area of allowing individual initiative in decision making, recognition of management committees in place, this smoothen the operations of the institution and lastly the board need to mentor the management, most of the personnel managing these institutions lack skills in managing the entity calling for immediate attention from the board to intervene.

The study revealed that in selecting the members of the board the directors of the institutions focus on a person whom management can rely on in case of difficulty, a person saves the institution and bears the knowledge about operations of financial institutions, someone who has ethical values and exercises professionalism in his way of conduct, a person who is knowledgeable in business affairs that will help to give constructive ideas that makes the organization move forward, a person with clean background in terms of values and integrity and lastly member who owns shares in the institution, it is revealed that owning shares in the institution is a sign of total commitment to that institution.

In general, the number of variables observed under the governance systems in MFIs were 131 however by employing the PCA the researcher was in position to come up with those that best explain the governance systems in MFI shows that 29 out of 131 variables were identified by the PCA that best describes governance, 17 out of 72 variables were extracted that best explain what is taking in place in human capital whilst 5 out of 24 variables were extracted in relation to risk management.

Furthermore, conclusions are drawn by employing descriptive statistical analysis basing on mean scores of the variables identified by the PCA. Therefore, out of the 29 variables identified by PCA on governance dimension, 19 variables on average have mean scores above 3 signifying good performance in that areas. Therefore, the strength of MFIs under governance is seen in the following areas;

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On the side of human capital management, 17 variables identified by PCA, basing on their mean scores, 13 have mean scores above 3 showing good performance of MFIs. In this case the strength of MFIs lies in having educated human resources in place; MFIs gave the ability to exploit the available opportunities more especially targeting low income earners that for long have been neglected. However more is needed under human capital dimension more especially in those areas where on average mean scores was below 3 such as training programs where the respondents revealed that the type of training obtained does not match with the job requirements therefore they do not benefit from these programs.

There is still a lot of bureaucracy within the management that slows the operations of the MFIs. This is further explained by having directors commuting as loan officers. Failure to accept risk exposes the entire institution to a vague of collapse; risks have to be taken into account with possible strategies to mitigate them.

**Conclusion**

The study has revealed that the governance of an institution plays a big role in risk management. Institution fails because of lack of proper governance systems. In this research emphasis has been placed on key important issues like board performance, controls, strategy, management style, board roles and loan officer's performance.

MFIs are performing better in terms of governance and according to the subjective views of the respondents basing on PCA, 29 variables best described the governance of the MFIs but among these variables there is still a weakness related to the activities of loan officers, whereby they are not evaluated, no serious punishment in place for non-performing officers, most of them play a pivotal role of directors and at the same time loan officers.

MFIs need to strength the corporate governance principles especially on dimensions of board size, Gender diversity and timelines of delivering the financial reports to the regulators i.e. Association of microfinance Uganda and Bank of Uganda and presenting the details of loan Advances.

Microfinance institutions have got to establish mechanisms to enforce proper governance practices such as board composition which includes other elements like gender diversity and others. These will automatically build a bond of trust with their customers and stakeholders who are providers of capital to the institutions. Microfinance institutions operating in Uganda, like any form of business organisation in today's dynamic financial landscape should focus on proper governance practices and principles not only to boost and enhance their financial performances but as path to gaining a better public image, thus recognized by society in which the microfinance institutions operate as socially receptive microfinance institution which may augment the microfinance institutions operations and survival.

**Areas for Further Research**

Due to resource and time constraints some issues could not be studied and these constitute areas for further research. I therefore recommend further studies in the following:
Longitudinal study on Human capital and risk management in Microfinance Institutions Uganda
Longitudinal study on the clients of the microfinance performance in order to detect the impact of microfinance on the client's livelihoods.

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