Effects of strategic risk management on the growth of microfinance sector in Kenya

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Full Length Research Paper

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Growth of Microfinance Sector (MFIs) in Kenya is exposed to various risks which originate from both the internal and external environment. Strategic risks threaten their financial viability and long-term sustainability of MFIs. The purpose of this study was to establish the effect of strategic risk management strategies on the growth of microfinance sector in Kenya. A sample of seventeen (17) MFIs was selected using the random sampling approach from the population of fifty seven (57). The study adopted a correlation survey research design. A questionnaire and an interview schedule were the main data collection tools. The preferred statistical tool for quantitative data analysis was Statistical Package for Social Sciences (SPSS) computer software. Qualitative data was analyzed using content analysis. The study utilized descriptive and regression analysis to determine the relationship between strategic risk management strategies and growth of MFI. The study results were that strategic risk management strategies were a significant determinant of growth in MFIs. The findings indicated that there were several strategic management measures that had been put in place by MFIs to promote growth which include the existence of board members with the skills and ability to lead the MFI strategically in addition to independent directors who agreed on the MFIs mission and strategic direction. Based on the findings, the study recommended that the MFIs should continue practicing effective strategic risk management practices such as good governance measures.

Key words: Strategic risk management, growth, MFI

INTRODUCTION

Omino (2005) puts emphasis on sound development of microfinance institutions as vital ingredients for investments, employment and to spur the economic growth. As a result of their flexibility and the way they operate, they are exposed to various risks which include financial risks, operational risks and strategic risks. As competition increases and the sector mature, the MFI sector must mitigate the risks in order to sustain the business and remain relevant in the long run (Omino, 2005).

Kombo et al., (2011) assert that strategic risk, credit risk and liquidity risk are the most frequent risks; whereas reputation and subsidy dependence risks occur at a very low incidence. The authors argue that 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.

To ensure that the growth in the banking sector does not jeopardize its stability, risk management is crucial. In view of this, the Central Bank (CBK) carried out a risk management survey on the Kenyan banking sector in the year 2004 (CBK, 2010). The survey’s objective was to determine the needs of the local banking sector with regard to risk management. The survey was necessitated by the drive to fully adopt Risk Based Supervision and to incorporate the international risk management best practices envisioned in the 25 Basel Core Principles for Effective Banking Supervision. The survey culminated in the issuance of the Risk Management Guidelines (RMGs) in 2005 and the adoption of the Risk Based Supervision approach of supervising financial institutions in 2005 (CBK, 2010).
Given the ever dynamic and challenging business environment, a Micro Finance Institution is bound to be exposed to various risks. The problem is that Micro Finance Institutions that don’t adapt and/or institutionalize strategic risk management strategies are likely to witness poor growth patterns compared with those that adapt strategic risk management strategies. The threat that MFIs may experience stunted growth or collapse as a result of poor risk management is not without any basis. The threat is so real such that some well-known MFIs have collapsed in the past. In 2005, for example, government regulators in Kenya closed Akiba Micro Finance on the grounds that it had unlawfully taken customers’ deposits and reneged on the repayments (Ellie et al., 2007). The report by the Task force on Pyramid Schemes (2008) was formed to investigate the collapse of pyramid schemes in Kenya (pyramids are a form of microfinance). The taskforce found that Kenyans lost more than Sh34 billion to schemes such as Developing Enterprise Community Initiative (DECI).

The closest research to the current study is from Kombo et al., (2010) who asserted that strategic risk, credit risk and liquidity risk are the most frequent risks; whereas reputation and subsidy dependence risks occur at a very low incidence for Micro Finance Institutions (MFIs) located in Kisii area. The authors argue that to tone down these risks, the Micro Finance Institutions (MFIs) employ various management strategies, which include risk avoidance, transferring of risk and mitigating risks and also regard mitigation of risks as the most effective risk management strategy. Mokoro et al., (2010) in an investigation of the various challenges facing the transition of informal MFIs into formal MFIs recognize the existence of risks emanating from both the external and internal stakeholders.

The current study notes that the reviewed studies, Mokoro et al., (2010), CBK (2010) have gaps in terms of generalized conclusions due to a tendency to research on all factors that affect the growth of MFIs and the absolute disregard of the role of strategic risk management strategies on the growth of MFIs. On the other hand, those studies that focus on strategic risk management in MFIs are purely descriptive (for instance, Kombo et al., (2010)) and lack the statistical rigour that is supposed to accompany such studies. The current study differs significantly from the above reviewed studies as it will build a case for adopting strategic risk management strategies and the effect such adoption would have on the growth of MFI sector. The current research hopes to bridge all these research gaps by analyzing the effect of strategic risk management on the growth of MFI sector.

Mango (2007) asserts that the concept of strategic risk is not well defined and therefore not well understood. The source of confusion regarding strategic risk may be that two loaded terms - “strategic” and “risk” are combined in one phrase, without clear grammatical demarcation. The definition offered by the Office of the Comptroller of Currency (OCC) in its 1998 document Emerging Market Country Products and Trading Activities:

“Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility between an organization’s strategic goals, the business strategies developed to achieve those goals the resources deployed against these goals and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks and managerial capacities and capabilities. The definition of strategic risk focuses on more than an analysis of the written strategic plan. Its focus is on how plans, systems and implementation affect the franchise value. It also incorporates how management analyzes external factors that impact the strategic direction of the company” Mango (2007).

Strategic risks arise when a MFI has inadequate governance structure in place (governance risks) or if its market reputation suffers due to mismanaged operations or client interactions (reputation risks) or due to external market factors (external business risks). Ekka et al., (2011) asserts that a number of good practices have emerged that not only promote responsible and inclusive lending, but are also crucial in managing strategic risk. The specific strategies relate to several aspects of institutional management and governance, which MFIs need to implement as part of effective operational risk management. These include: (a) Implementing the Client Protection Principles to safeguard against reputation risk; (b) Client education for strategic development of client relationships; (c) Tracking and analyzing exit rates for strategic analysis of changing competitive business environment; (d) Assessing whether clients’ enterprises have negative environmental or social effects so as to safeguard against reputation risk; (e) Communication and transparency to enhance strategic client relationships; and (f) Governance in form of effective board systems to safeguard against mission drift. Lack of strategic risk management strategies may impact negatively on the growth of MFIs. This is because an MFI risks losing future business if customers issues are not addressed strategically. Changing business environment such as stiff competition may also affect the growth of MFIs if the MFI don’t assume strategic positions to counter the competition.

METHODOLOGY

This study used a correlational survey research design. The choice of correlational survey research design was because it was used to explore relationships between variables and to predict a subject score on one variable on given his or her score on another variable. The target
population of this study comprised of all micro finance institutions in Kenya who are members of Associations of Micro finance Institutions (AMFI). The total number of the firms that were registered members of AMFI were fifty seven (57) as at 23rd August 2011. The population comprises of two types of categories or strata of MFIs. The first stratum included all MFIs which are licensed by CBK. Census was used to identify the number of licensed MFIs. The number of licensed MFIs was 6. The second stratum comprised MFIs that were not licensed by CBK. The 11 MFIs selected using simple random sampling technique as recommended by Cooper and Schindler (2006).

Primary data was collected by using the questionnaire as the main research instrument. A semi-structured interview schedule was also used. Since this study involved relationships between variables, the study utilized correlation and regression analysis to determine the relationship between risk management strategies and growth of MFI. To address the research question, the study checked whether the regression coefficient of strategic risk management strategy ($\beta_4$) was positive (+) and significant (p value of < .05) in line with theory and study expectations.

The Statistical Package for the Social Sciences (SPSS) was used to effectively process the data collected. The relationship in the research questions was determined using the following regression model.

$$Y = \alpha + \beta_4 X_4 + \varepsilon$$

Where $Y$ = Growth of MFIs

$\alpha$ = constant (intercept)

$\beta$ = slope (gradient) showing rate dependent variable is changing for each unit change of the independent variable.

$X_4$, Strategic risk management strategies

$\varepsilon$ = Error/disturbance

**FINDINGS AND DISCUSSION**

The study sought to find out the strategic risk management strategies the MFIs. The specific elements that the study addressed were: board skills, board roles, board members agreement on the MFI’s mission and strategic direction, existence of independent directors, frequency of board meetings, board committees, board term limits and rotation, guidelines preventing conflicts of interest among board members, guidelines prohibit related-party (insider) lending, investment in organizations owned by board members, criteria for awarding Loans to board members, outstanding debts for board members on their loan repayment, role of organizational structure in ensuring staff accountability, role of organizational structure in enhancing the MFI’s efficiency and productivity.

Descriptive results revealed that majority 85% of the respondents agreed with the statement that the board has the skills and ability to lead the MFI strategically. The findings concur with those in Tseng (2007) and Ekka et al., (2011), which assert that organizations should put in place a board with diverse skills and leadership abilities as a way of enhancing corporate governance and ensuring that strategic risks are easily monitored. The findings imply that the MFIs under study their board members had the skills and ability to lead strategically.

A majority (65%) agreed with the statement that the board members roles extend beyond governance and into management of the MFI. The findings concur with those in Fraser and Henry (2007), The Basel Committee (2004) and Chorafas (2001) who asserted that the board roles should be such that they extend beyond governance to management of the MFI so as to facilitate the management of strategic risks. The findings imply that the board members roles extend beyond governance and into management of the MFI.

Results revealed that a majority (70%) agreed with the statement that all board members agree on the MFIs mission and strategic direction. The findings concur with those in Kirckpatrick (2009) and Tseng (2007) which asserted that board members should agree on the MFI mission and strategic direction in order to ensure fruitful working relations and effective monitoring and mitigation of strategic risks. The findings imply that all board members agree on MFIs mission and strategic direction.

In addition, a majority (65%) agreed with the statement that the board has adequate independent directors. The findings also agree with those in Arkolakis (2011) which assert that MFIs should engage independent directors so as to bring continuous productivity improvements. The findings imply that the MFIs under study had independent directors and this may have reduced the probability of exposure to governance risks.

Results also indicated that majority (75%) agreed with the statement that the board meets often. The findings further concur with those in Mokoro et al., (2010) which asserted that financial organizations should hold frequent board meetings in order to identify any risks and offer solutions for them in good time. The findings imply that the MFIs under study have frequent board meetings. This further implies that MFI have effective corporate governance systems.

Moreover, majority (77.5%) agreed with the statement that the board has set up various committees. The findings concur with those in Mokoro et al., (2010), Chorafas (2001), Kimball (2000) and Morris (2000) which assert that organizations should ensure that the board has set up various committees which are supposed to ensure that the work of the board is properly distributed. The findings imply that the MFIs under study have set up various board committees.

Results reveal that a majority (70%) agreed with the statement that the board has policies stipulating term limits and rotation for its members. The findings concur...
with those in Kombo et al. (2011), GTZ (2000) and CBK (2010) which assert that good governance requires that the board members should be subject to term limits and rotation. The findings imply that the MFIs under study have policies stipulating term limits and rotation for its members.

Results further indicate that a majority (82.5%) agreed with the statement that the MFI has guidelines preventing conflicts of interest among board members. The findings concur with those in GTZ (2000), Kimball (2000) and Gilbert (2007) which asserted that an effective strategy to safeguard against conflicts is for MFI to establish a good working relationship based on open communication thus ensuring full understanding of the board transactions and provide an opportunity to defuse any potential problems. The findings imply that the MFIs under study had guidelines preventing conflict of interest among board members. This in effect ensures that board members act in the best interest of the MFI. The guidelines preventing conflict of interest may have influenced the growth of MFIs.

Results indicate majority (85%) agreed with the statement that the MFI guidelines prohibit related-party (insider) lending, require full disclosure of all conflicts of interest, and require arm’s length business transactions. The findings concur with those in Gilbert (2007), CFSI (2011) and CBK (2010) which asserts that the MFIs guidelines prohibit related party lending require full disclosure of all conflicts of interest and require arms length business transactions. The findings imply that the MFIs guidelines prohibit related party (insider) lending, require full disclosure of all conflicts of interest and require arms length business transactions. A majority (60%) agreed with the statement that the MFI doesn’t have some of its invested funds in a financial institution or other company in which a board member has significant ownership. The findings concur with those in Kombo et al., (2011), CBK (2010), Ekka et al., (2011), who asserted that the MFIs don’t have some of its invested funds in a financial institution or other company in which a board member has a significant ownership. The findings imply that the MFIs do not have some of its invested funds in a financial institution or other company in which a board member has significant ownership.

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Findings also indicate that majority (72.5%) agreed with the statement that all board members are current on their loan repayment. Meanwhile 17.5% of the respondents neither agreed nor disagreed and another 5% disagreed with the statement. The findings are in line with those in GTZ’s (2000), Ndulu (2010) and CBK (2010) which asserted that transparent operations facilitate effective risk management. The findings imply that the all boards’ members with outstanding debts are current on their loan repayment.

Further, results indicated that majority (85%) agreed with the statement that the MFI’s organizational structure ensures staff accountability. The findings agree with those in Pandey (2007), ACCA (2012) who asserted that the MFI should put in place organizational structures that ensure staff accountability. The findings imply that the MFIs organizational structure ensures staff accountability.

Finally, the results also indicated that a majority (72.5%) agreed with the statement that the organizational structure enhance the MFI’s efficiency and productivity. The findings concur with those in Tseng (2007) which asserted that MFIs should enhance implementation of an organizational structure that can enhance strategic firm performance. The study findings imply that the MFIs organizational structures ensure accountability, efficiency and productivity in all processes.

Regression analysis was conducted to empirically determine whether strategic risk management strategies were a significant determinant of growth in MFIs. Regression results indicated the goodness of fit for the regression between strategic risk management strategies and growth is satisfactory. R squared of 0.251 indicates that 25.1% of the variances in growth are explained by the variances in the strategic risk management strategies.

The overall model significance is also presented in table 1. An F statistic of 12.720 is larger than the tabulated statistic of 4.08 (df1; 1, df2; 38, p value; 0.05). This is also supported by a probability value of 0.00. Since F calculated > f critical and the reported probability of 0.001 is less than the conventional probability of 0.05 (p value calculated < p value critical), the overall model was significant. This also means that the independent variable (strategic risk management strategy) does a better job in predicting MFI growth compared to predicting MFI growth through its mean.

The relationship between strategic risk management strategies and growth is positive and significant (b1=0.169, p value, 0.001). This implies that an increase in the effectiveness of strategic risk management strategies by 1 unit leads to an increase in growth by 0.169 units. The regression equation is as follows:

\[\text{Growth} = 4.439 + 0.169 \times \text{Strategic Risk Management Strategy}\]

<table>
<thead>
<tr>
<th>Parameter estimate</th>
<th>Coefficient</th>
<th>P value</th>
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<tbody>
<tr>
<td>Constant</td>
<td>4.439</td>
<td>0.00</td>
</tr>
<tr>
<td>Regulatory Risk Management Strategy</td>
<td>0.169</td>
<td>0.00</td>
</tr>
<tr>
<td>R Squared</td>
<td>0.251</td>
<td></td>
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<tr>
<td>F statistic (ANOVA) (df ; 1; 38; 0.05)</td>
<td>12.720</td>
<td>0.00</td>
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CONCLUSION AND RECOMMENDATIONS
From the findings of this study, the following conclusions were reached:
- MFIs had effective risk management strategies that enabled the effective management of reputational and governance risks;
- Strategic risk management strategies have a positive effect on growth of MFIs;
  - The MFIs had constituted boards with the skills and ability to lead the MFIs strategically;
  - The board members roles extended beyond governance and into management of the MFI;
  - The board had policies stipulating term limits and rotation for its members;
  - The board had independent directors who agreed on the MFIs mission and strategic direction;
  - The MFI had guidelines for preventing conflicts of interest among board members;
  - The MFI guidelines prohibited related-party (insider) lending, required full disclosure of all conflicts of interest, and required arm’s length business transactions and;
  - The MFI’s organizational structure ensured staff accountability and enhanced MFI’s efficiency and productivity.

Following the study results, it is recommended that the MFIs should continue practicing effective strategic risk management practices such as implementing the client protection principles, client education, tracking and analyzing exit rates, assessing whether clients' enterprises have negative environmental or social effects, communication and transparency and governance in form of effective board systems.

The study further recommend that institutions manage should test the strength of risk management strategies through internal audit, monitoring and analyzing trends and ratios to check the key indicators in the results.

REFERENCES
Pandey HS (2007). MicroSave. Briefing Note # 72. Internal Controls in Small/Medium MFIs