INVESTIGATIVE CHALLENGES OF FRAUD IN MICROFINANCE INSTITUTIONS

by

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Abstract

Globally, two billion people suffer from financial exclusion including 90% of the population in least developed countries. The microfinance industry with over $60 billion in assets was created to address the institutional void within the financial market found in at least 168 countries. There is a fundamental lack of existing empirical research on the topic of investigative challenges of fraud in microfinance. The data collection methodology was a systematic review of existing academic documents. Key terms were defined to create a uniform approach to industry-specific verbiage in microfinance. It was established that investigators work in dangerous environments, operate amongst complex legal issues, contend with limitations in infrastructure, with inadequate training inside an organizational structure that does not optimally support their role. Recommendations and future research considerations were provided regarding the antifraud program, security protocols, client education, cooperation, collaborative databases, power outages and surge protection, transportation needs, training and development, and organizational structure. Microfinance institutions play a critical role in helping the world's poor meet their basic needs. When acted upon, these recommendations will make a positive impact on their efforts towards poverty alleviation.

Keywords: Financial Crime and Compliance Management, Dr. Kyung-Seok Choo, financial inclusion, developing countries, Islamic microfinance

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Introduction

Approximately half of the world's adults (2 billion) do not use financial services (World Bank, 2014) due to barriers such as physical access, affordability, and eligibility (Beck, Demirgüç-Kunt, & Peria, 2008, pp. 413-414). In least developed countries (LDCs), "90% of the population is excluded from the formal financial system" (Shehu, 2012, p. 306). Similar to what is observed with financial exclusion, low-income individuals also lack access to clean water, adequate healthcare, good nutrition, and other basic needs are left unmet. Microfinance institutions (MFIs) attempt to address that unmet need. They primarily offer small loans to groups or individuals who often make less than $2 per day (Addae-Korankye, 2012, p. 141; Chakrabarty and Erin Bass, 2015, p. 489). MFIs are found in the most economically depressed geographies and typically operate in the most challenging environments in the world impacted by war (active or recent post-conflict). The operating goal of an MFI is to provide financial services to people who otherwise would not have them. Thus, MFIs are most often found in developing economies where the need to address poverty is the greatest.

Many MFIs acknowledge they have a problem with fraud[1], yet fail to see the entire risk landscape. Focused on a daily barrage of small frauds involving the loan origination and distribution processes, MFIs are typically blind to the risk of a devastating blow from less frequent, higher impact fraud schemes. As a result, their focus has become myopic around the four or five most common schemes they see every day. Little to no resources are allocated to address the ninety-six other fraud schemes that pose fraud risk to the organization (Bell, 2015). These unaddressed risks in their blind spot translates into inadequate resources allocated towards antifraud efforts meaning lack of training for investigators, resulting in under-detection of fraud

[1] According to Black's Law Dictionary (2004), *fraud* is defined as "A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment" (Bell, 2015, p. 5).

events, creating incomplete and inaccurate data analysis, driving management decisions made on partial information. Ultimately, this compounding cycle of shortcomings results in increased overhead and fewer funds finding their way to the intended clients.

Originality and Value

This research contributes to the existing literature in several ways. Insights into some of the challenges faced by fraud investigators within MFIs have been provided by reviewing the macro influences and interplay of security concerns, legal aspects, and the governmental impact as well as the micro factors of training, development, and organizational structure. Increased antifraud program effectiveness allows the overall MFI organization to be more successful and more closely aligns it with its mission and purpose. MFIs endeavor to lift individuals, families, and ultimately entire communities out of the cycle of poverty. Every dollar stolen due to fraud is one less dollar that could have been used to help someone in need. Similarly, dollars invested through poorly informed risk management strategy only serve to frustrate their objectives and create risks of a catastrophic loss endangering the entire organization. By reviewing several macro and micro factors affecting the fraud related investigative process within MFIs, the goal of this research paper is to advocate more effective antifraud program practices that assure funds can remain within (prevention) or return to (recovery) the organization and are used for the original intended purpose of aiding in the alleviation of poverty.

Key Terms

Microfinance has many unique terms with wide variations in spelling and definition. These variations are due in part to the nascency of the industry. Microfinance lacks the standardization observed with traditional types of finance, which have been in existence much longer. Another factor contributing to the variation is language differences due to geography where the primary native languages vary by region. Similarly, cultural differences impact the interpretation and ultimate understanding of those terms.

The vocabulary of microfinance has continued to evolve over time through the filter of language, the perspective of local culture, and the variation in commerce across the globe. Key terms and definitions have been included for relevant terms. This serves as an aide in familiarizing the reader with the terms commonly used within MFIs as well as provides relevant search terms for further research opportunities. (See Appendix A for a glossary of terms).

Spelling variations. Spelling variations of key terms have been found throughout the literature reviewed. For the purpose of consistency, the term "microfinance" has been used to equally represent "MicroFinance", "micro finance", and "micro-finance". Likewise, "microcredit" also stands for "MicroCredit", "micro credit", and "micro-credit". Therefore, when identifying relevant search terms for further research opportunities, consider word variations which include one word ("microborrowers", "MicroCredit"), two words ("micro borrowers"), and hyphenated words ("micro-borrowers").

Institutions and organizations. The overall mission and purpose drive the difference between a microfinance component being considered as an institution or an organization. The Oxford dictionary defines an *institution* as "an organization founded for a religious, educational, professional, or social purpose". An *organization* is defined as "an organized group with a particular purpose, such as a business or government department".

Microfinance is the supply of financial services to low-income people, e.g. loans, savings, transfer services, and insurance (Lafourcade, Isern, Mwangi, & Brown, 2005; Dwivedi, & Sharma, 2015, pp. 2, 6). Microfinance institutions (MFIs) offer financial services to "people who have been excluded from the mainstream financial system" (Canales, Karlan, & Sheldon, 2013). Ahmed, Brown, and Williams (2013, p. 211) propose a formal definition of "a 'social enterprise', whose primary mission is to improve the lives of poor people through [the] provision of financial services". However, Chakrabarty and Erin Bass (2015, p. 487) imply services provided by MFIs reach beyond just financial services because risk in MFIs can be categorized by either financial (loans and other financial services) or non-financial (training and social services). Therefore, a *microfinance institution* (MFI) is a social enterprise, whose primary mission is to improve the lives of poor and low-income communities without access to the mainstream financial system through the provision of financial services often augmented by non-financial services.

Ahmed, Brown, and Williams (2013, p. 211) further define a microcredit institution as a MFI which issues small, uncollateralized, non-recourse loans to poor people where the organization cannot recover the loan balance if the client is unable to pay. Although they argue organizations that lend collateralized loans would not be considered a microcredit institution, nor by their definition would it be a MFI, the sentiment is not universally accepted. In practice, there are microcredit institutions that offer collateralized loans. (See figure 1 for an illustration of microfinance.)

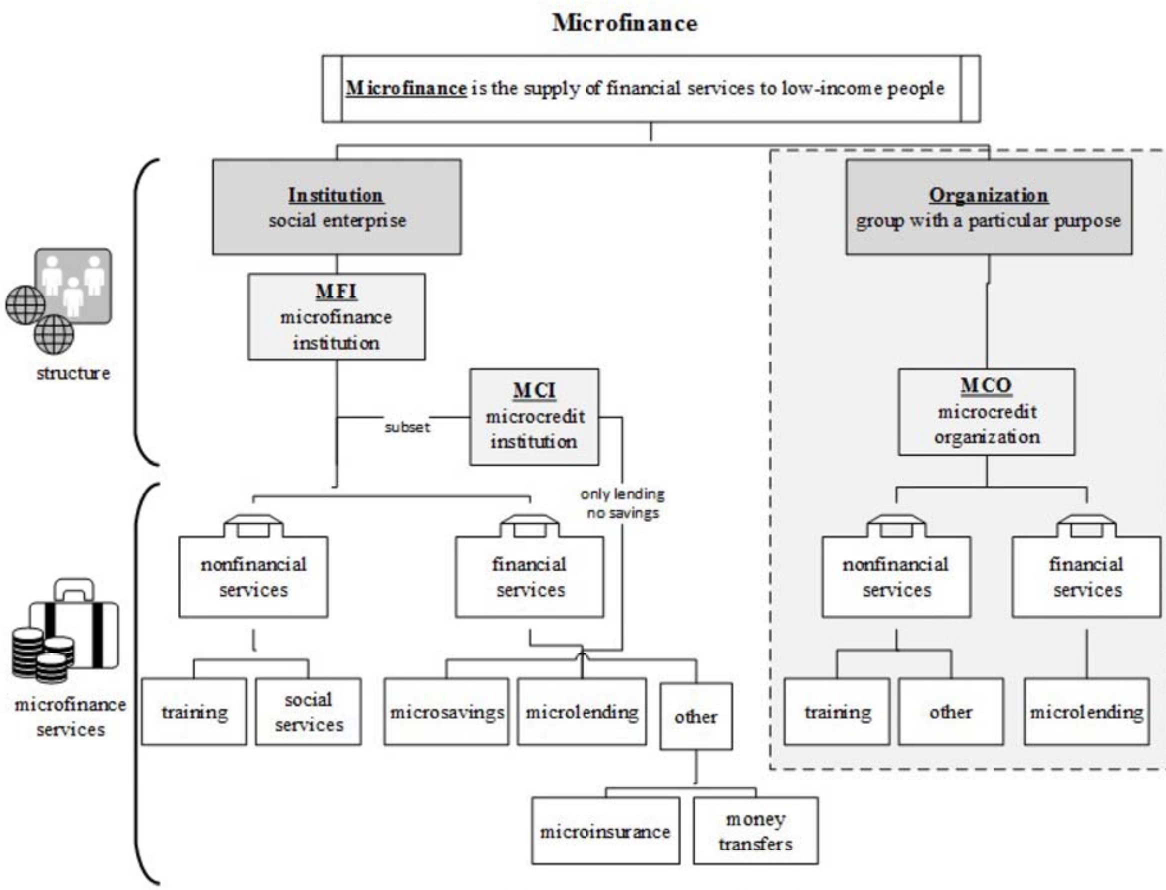

Figure 1. Microfinance illustrates the relationship amongst structure (institution versus organization) and nonfinancial versus financial microfinance services.

Zivko (2006, pp. 878-879) differentiates between microfinance institutions (MFIs) and microcredit organizations (MCOs). Microcredit organizations are "non-deposit institution[s] that offer[s] microcredits to the very poor". Microfinance institutions offer a wider range of services to low-income clients beyond just microlending.

It appears as though the microcredit institution as defined by Ahmed, Brown, and Williams (2013, p. 211) and the microcredit organization (MCO) as defined by Zivko (2006, pp. 878-879) are one and the same. The only difference being an institution requires the loan to be both uncollateralized and non-recourse while an organization allows for some collateralized loans with implied recourse while additionally clarifying they do not offer savings services. Microcredit activity meets the Oxford dictionary definitions of institution and organization,