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CHALLENGES OF MANAGING CREDIT RISK IN MICROFINANCE BANKS IN PERIOD OF BUSINESS DISRUPTION

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ABSTRACT

The peculiarity of microfinance banks as financial intermediaries exposes operations to risks in their normal business activities. Business disruptions generally aggravate the level of risk is that tends to endanger the survival and sustainability of these financial institutions whose services are designed to bridge the access gap for the financially excluded productive poor. This paper focuses on the challenges of managing credit risk by the Microfinance banks in a disruptive economy to achieve corporate goals and objectives.

Keywords: Microfinance, Microfinance banks, Microcredit, Credit loans, default risk, loan delinquency, Portfolio at risk, business disruption

INTRODUCTION

The emergence of Microfinance is as a result of the financial exclusion of the economically active poor from the mainstream banking institutions and thereby depriving them of access to finance their productive and economic activities. Microfinance, that initially started as microcredit has now grown over the years into the provision of microloans, micro-savings, micro insurances, transfer payments, health services, social services and advisory services. The original concept of microfinance as mere microcredit has transformed into modern or commercial Microfinance so as to ensure its sustainability and to further attract private capital investments to the sub-sector.

Microfinance has become a veritable tool for poverty reduction and wealth redistribution across the globe today. Globally, Microfinance is being embraced by various Governments and International organizations for poverty alleviation, job creation, income generation or redistribution, improvement of the standard of living and as a means to actualize the goals of the Sustainable Development Goals (SDG). As part of public initiatives the Federal Government of Nigeria through the Central Bank of Nigeria (CBN) launched the Microfinance Policy Document in December 2005 to address the problem of lack of access to finance by the individuals and small business operators, it is also an acknowledgement of potentials of microfinance in the process of financial inclusion policy of the financial authority. This Policy introduction serves as the commencement of official regulation of the Microfinance subsector. A Policy review was further carried out in 2011 by the Apex Regulatory Body on the Microfinance Policy Document. Microfinance is globally accepted as a potent tool for poverty reduction and economic growth driver. As the practice of microfinance is recognized as a policy measure to empower the active poor, that constitute the greater proportion of the population in the developing nations who are excluded by the conventional banking institutions in terms of access to finance. The micro, small and medium enterprises which are often referred to as catalyst or agents for economic growth lack access to credit due to stringent lending conditions imposed by the commercial banks. Unfortunately, these productive units are financially excluded from mainstream banking. It is this financing gap that microfinance banks are expected to fill. The primary role of microfinance is to supply finance to this critical sector of the economy without the traditional collateral requirements that are commonly demanded by the formal financial institutions. Accessibility to financial services has been a major problem facing these economic agents especially in the developing countries of the world. It is in the process of creating access to finance for these excluded groups that led to the discovery of microfinance generally. The lending activity of microfinance bank is premised on collateral substitution against the practice among conventional banking institutions where collateral security is a cardinal requirement. The hallmark of microfinance is collateral substitution – that is loans are guaranteed by means other than conventional collateral security like lands and stocks. In the event of loan default, the lending institution has nothing to back to, to realize the loan amount. The credit risk of microfinance banks is worsened in the period of business disruptions when business activities are experiencing a downward trend with a fall in business volumes and the inability to generating earnings among the micro borrowers.

LITERATURE REVIEW

Conceptual framework

The real sector and financial sector are correlated as the financial system facilitates the flow of funds from the surplus unit to the deficit unit to stimulate productive and economic activities. Todaro and Smith (2011) argued that the six functions of the financial system include providing payment services, matching savers and investors, generating and distributing information, credit allocation, pricing and risks management, and finally asset-liability management. In all over the world, the financial sector is an integral part of the economy and plays significant roles in savings mobilisation and capital formation as well as the allocation of funds to productive sectors. However, the productive poor and economically active have been financially excluded from the mainstream banking institutions because of their inability to satisfy collateral demand for credit appraisal. Microfinance is the provision of comprehensive financial services in forms of microloans, micro-savings, micro-insurance, payments transfer, and advisory services to the active poor who has no financial access to conventional banks. Todaro and Smith (2001) defined Microfinance as financial services to include micro credits, micro-savings and micro-insurance to individuals who otherwise lack access to credit due to unfavourable terms and conditions. There had been divergent views on the definition of microfinance as authors tried to explain the goal or objective of microfinance practice. Ledgerwood (1999) defined Microfinance as rendering comprehensive financial services to low-income individuals and self- employed groups. Microfinance, according to CGAP(2002) is the category of financial services offered to lower-income people where the unit size of the transaction is usually small (Micro) typically lower than the average GDP per capita. Microfinance means microcredit, insurance, money transfers, and other financial products targeted at the poor and low-income people. Robinson (2001) stated that microfinance is the offering financial services in form of credit and savings to people especially small business owners, who farm or fish, and to other individuals and local groups in developing countries in both rural and urban areas. Adeyemi (2008) Microfinance is the provision of a full range of financial services compromising microcredit (including micro lease), micro-savings, insurance and fund transfer to low-income poor clients including consumers and the self- employed who traditionally lack access to Deposit Money Banks (DMBs) and related financial services to help them grow microenterprises or engage in other productive economic activities. Ehigiamusoe (2011) stressed that Microfinance is more than disbursement and collection of loan repayments and savings but include a set of elastic organizational structures and procedures by which appropriate financial services are delivered to low-income people and owners of microenterprises on a sustainable basis. Agene (2011) explained microfinance to mean as the provision of financial services such as loans, savings, insurance or transfer services to low-income households and small business owners who lack access to finance to do their business. The provision of microfinance services include savings, loan payments services, money transfers, and insurances to poor and low-income households and enterprises. It can be deduced that Microfinance is the provision of a range of financial services to the economically active poor and small scale enterprises. Such services are microcredit, micro-savings, micro-insurance, fund transfer to low-income clients, self- employed who lack access to formal financial institutions. The target market is those who are financially excluded from the conventional banking sector. It is estimated that over 80% of households or low-income groups do not have access to financial services due to collateral requirements by the formal banking institutions, this has resulted into socio-economic problems like unemployment, starvation, malnutrition, diseases, poverty among developing countries of the World.

The significance and sustainability of microfinance have generated debate and that has into two proponents namely Financial system approach and Poverty lending approach (Ademu,2012). The financial system school of thought, emphases large scale outreach to the economically active poor who can repay loans. The goals of the theory of the financial system are institutional self-sufficiency which is key to a regular or consistent supply of service and expansion, which implies every microfinance institution must develop products for savings mobilization and efficient funding capacity for its loan products. An efficiently managed Microfinance institution will be able to attract private capital. Hence the financial system approach is in support of the commercialization of microfinance for sustainability and wider outreach.

On the other hand, the Poverty lending approach premises their argument solely Extention or supplying loans mainly for poverty alleviation without and consideration of the ability of the borrower to repay the loan. This has been the model of Government agencies in Nigeria. The aim is to extend microcredit to the poor to overcome poverty and gain employment. The poverty leading theorist believes that loan disbursement is the primary consideration while savings mobilization is accorded less factor except where the savings is mandatory. The private sector is key to financial sustainability as profit-making is the driving force. Unfortunately, the poverty lending group are not comfortable in allowing the industry to be dominated by profits motives. Sustainability of microfinance industry is imperative and this is a function of viability, more so as microfinance business cannot survival mainly on donors and government subsidies. Often Government funding and grants are politically motivated which might further endanger the operations of microfinance institutions.

Types of Microfinance

Microfinance service providers can be classified into three categories namely (i) Formal microfinance institutions, (ii) Semi-formal Microfinance Institutions and (iii) Informal microfinance sectors. The major distinction is the level and extent of external regulation. (Churchill and Franckiewicz, 2006). Formal Microfinance Institutions are subject to both general laws and specific regulation of the Monetary Authority. Semiformal Microfinance institutions are registered entities that satisfy relevant general laws but not regulated by the financial regulatory body. On the other hand, informal microfinance services providers are typically not registered nor recognized by government bodies. They are motivated only by their members or the community they serve, like village banking self-help groups, financial Service associations, ROSCAs, ASCAs, burial societies, Pawnshops, and individual money lenders. The informal Microfinance sector has always existed to provide lending and borrowing opportunities for the low-income group and self- employed. The operators or services providers were driven by the need to provide affordable financial services to rural dwellers and were essentially poverty alleviation projects. These include non - governmental organisations (NGO), community-based organisations (CBO) and cooperatives. Many factors have accounted for the existence and growth of the informal finance operators essentially due to (i) the failure of the conventional banks to meet the loan requests of the poor, (ii) failure of government economic programmes at the rural economy,(iii) the concentration of the poor population in the rural areas, (iv) low literacy level of the rural community and (v) the poor performance of the rural branch banking programme. Noteworthy is that the informal microfinance sector operates under different names in Nigeria as esusu, daily contribution scheme, alajo, adashi, etoto etc. Prominent among the informal associations were , Farmers Development Union (FADU), Community-women and Development (COWAD), Country Women Association of Nigeria (COWAN), Lift Above Poverty Organisation (LAPO), Nsukka United Self Help Organisation (NUSHO) and Women Development Initiative (WDI)

Relevance of Microfinance

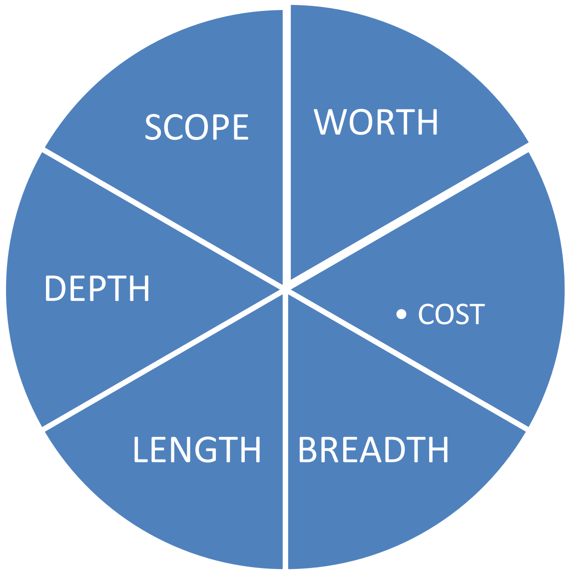
The entire globe lies in deep poverty amidst plenty as statistics reveal the level of poverty and other socio-economic challenges which is attributed to the high rate of unemployment and lack of access to finance by small business firms. The situation demands the application of the unconventional method to address this global problem of poverty and unemployment in the World. According to the World Development Report of 2000 and 2001, shows that 2.8 Billion out of the World's population of 6 Billion live below the abject poverty. The level of poverty across the globe has generated a lot of discussions as to ways of reducing poverty and financial empowerment to ensure equitable redistribution of wealth among the rich and less privileged. The goal of such discussion is how to improve the living standard of poor, by reducing poverty and human deprivation in developing nations. Microfinance has significantly provided employment opportunities, created wealth, reduce poverty levels, improve health conditions of people and had changed lives through financial empowerment of the low-income groups and small scale businesses around the globe. The proponents of microfinance believe that the importance of microfinance cannot be overemphasized as a tool to drive the economy of any nation especially with the failure of the formal financial system to give the necessary financial support to the active poor and micro-enterprises. Microfinance has been noted to contribute to the economy through (i) Job creation: microloans facilitate job creation through entrepreneurship and small business firms development and growth, (ii) Asset building: loans and savings mobilization helps low-income people to build up wealth through microfinance intermediation, (iii) Poverty reduction: it is noteworthy that microfinance has significantly reduced poverty among clients of microfinance over years thereby improving living standards, (iv)

Empowerment: through its varied services microfinance has empowered the economically active with loan disbursement and (iv) Rural economy transformation: Microfinance also helps to develop and grow business and commercial activities in the rural communities.

The microfinance services are not restrictive to the poor in terms of financial and investment provision but entails the advisory services like health services and enlightenment as well as education, training and capacity development and counsellings to manage household emergencies and to meet the wide variety of other cash needs that they encounter (Elizabeth, Murduch and Hashem, 2003). Empirical results have shown that microfinance has consistently given credit access to the economically active poor thereby improving living standard. It should be noted that access to financial services translates into better nutrition and improved health condition such as higher immunization rates for beneficiaries of microfinance services. Though it is projected that there are over 3 billion microfinance potential clients in the world, with only about 500 million customers are being served, while a significant number of potential clients remain unserved (CGAP 2003).

The impact measurement of the performance of microfinance activities resulted in controversy because of the dual mission of these financial institutions in terms of financial sustainability and social mission. An institution can only be socially relevant only if profitability is sustainable. In other assess the impact of microfinance, Schreiner (2002) adopted Six Aspects of outreach to determine the social benefit and impact of development finance institutions. This includes (i) Worth refers to the value the clients derived from purchasing the financial product. It is the willingness of the customer to pay for the services which invariably translates to profit for the lender (ii) Cost that refers to the price that the clients are willing to accept for that service including the terms and conditions for every the transaction and the opportunity costs (iii) Depth simply means the resultant effects of the usage of the product on the economic activity on the status of the clients considering the size and tenor of the loan., (iv) Breadth applies to the number of people that have benefited from the lending operations of the microfinance institution, gender spread and occupational coverage (vi) Length measures that the sustainability and continuity of the institution in the lending business over a period of time and finally (vi) Scope addresses the various financial products designed towards satisfying the peculiar needs of the microfinance clients.

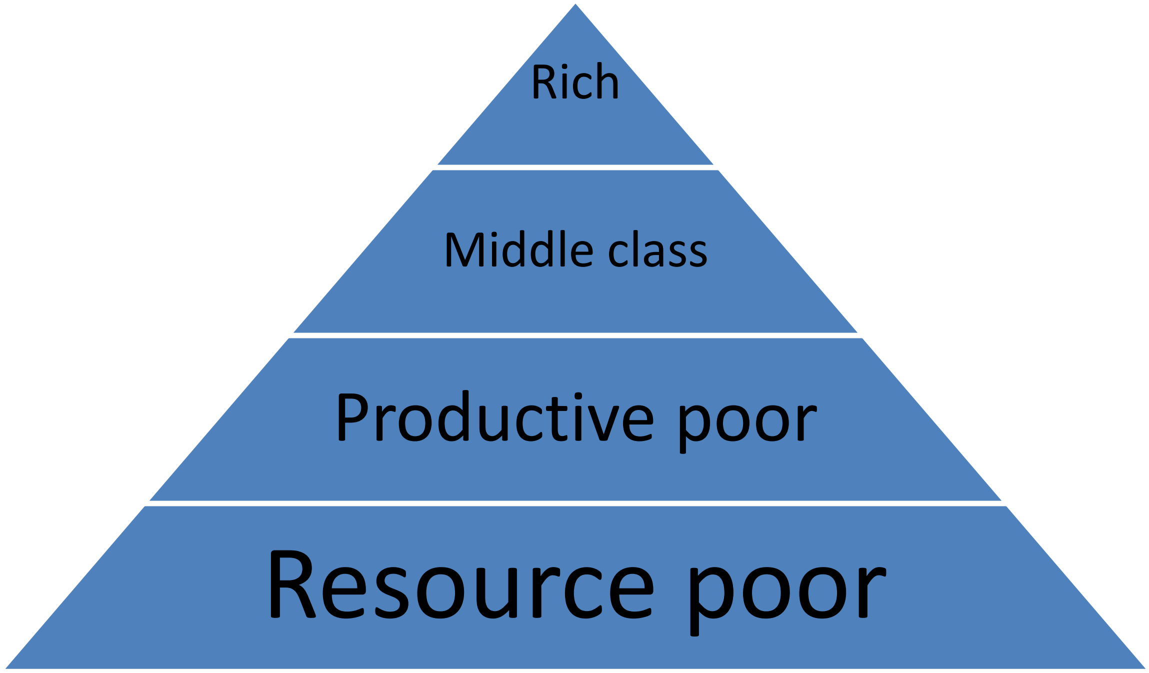
Six-degree outreach by Mark Schreiner



Microfinance clients and market

The peculiarities of microfinance clients are the same all over the world. These clients include traders, vendors, service providers, small business owners, salary or wage earners, and unfortunately, this group of customers do not have marketable or acceptable collateral, hence they lack access to finance through the formal banking sector. They have no credit history and mostly involved in multiple income-generating economic activities and extremely poor. The product and services can be categorized into financial services, social services, health services and advisory services. Microfinance institutions target market is the productive poor otherwise known as active poor that are economic active however lack access to credit to develop and promote their trades and business activities.

Microfinance clients and Market



Characteristics of Microfinance

A major identity of microfinance institution is a door - to - door delivery of services to their clients. There is a need to have personal and direct contact with the consumers of microfinance services. The uniqueness of microfinance is noticeable in its practice all over the world which distinguishes it from conventional banking practice generally. Microfinance has some distinctive features such as collateral substitution, Small units of loan sizes, High transaction cost, priority to Women, group lending, door to door service delivery, client centeredness, simplicity of operations, and access to repeat loans.

Lending Methodologies

Globally Microfinance industry has equally evolved models or approaches for outreach and sustainability over three decades. There are Individual lending and Group lending methods. Individual Lending Methodology; Loan is given on an individual basis. The challenges of individual lending include key man risk, high default rate and high cost of credit administration. Effective individual lending is premised on the following factors, appropriate selection of right clients, good knowledge of the business of the client, effective and diligent monitoring of the client after loan disbursement, adequate collateral substitution to mitigate against credit loss, Credit analysis is based on the character of the borrower. Loan approval and disbursement is based on the capacity of the borrower to repay the loan and it is advisable to start small and then scale up gradually, Collateral substitution could include social security, stocks, pieces of jewellery, personal guarantees, post-dated cheques, cash collateral, insurance and credit insurance.

Group Lending Methodology: Loan is given to borrowers on a group basis. Group lending enhances joint liability for loan repayment.

Microlending and Conventional Bank lending

	Microlending	**Conventional Bank lending**
Objective	- Social goals predominant - Stakeholders value	- Profit maximisation - Shareholders value
Target groups	- Low-income population - Mostly informal self- employed - Low solvency - Socially marginalised	- Bankable clients - Realizable collaterals - High solvency
Provider	- Specialized microfinance institutions - Non- Governmental organisations - Informal providers - Cooperatives	- Deposit-taking institutions such as Deposit Money Banks, Microfinance Banks, Primary mortgage institutions
Loan characteristics	- Small sums - Short – term (6 months to I year) - Alternative collaterals - Joint liability (group lending) - Regular meeting (group meeting) - Obligatory savings	- Individual liability - Unlimited amounts and duration depending on individual needs and solvency - Market – based interest rates
Business procedures	- Close personal contact to clients - Loan officer responsible for the	- Highly standardized (credit scoring) - Highly decentralized

	whole process	

Source: Castellani, D. (2015) and Author's modification

Risks in the financial system

Risk is the possibility of the occurrence of the undesirable occurring or the possibility of the desirable not occurring. Financial institutions generally are faced with the possibility of loss due to the role of intermediation. Nwankwo (2004) defined risk as to the possibility of loss, injury, damage or peril. Similarly, Ehigiamusoe (2009) defined risk as to the possibility or chance of a loss. Risk is the possibility of the undesirable outcome occurring or in the alternative the possibility of the desired outcome not occurring. Risk is therefore defined as the possibility or chance of a loss taking place such a loss could be financial or non- financial. In a corporate environment, risk can, therefore, be defined as the possibility of a loss. Risk is the chance or occurrence of an action that could result in any a loss that could undermine the achievement of corporate or institutional objectives. Banking risk could be summed up as financial risk, environmental risks, operational risk, management risks, and delivery risks (Hempel, Simonson and Coleman, 1994)

The intermediary roles of microfinance make their operations prone to a number of risk factors such as credit risk, liquidity risk, regulatory risk, the reputational risk among others

Impact of the crisis on microfinance

Russia, 1998	**Financial and banking crisis) default on Russia Government bonds and devaluation of the rouble**	**The collapse of most commercial banks with EBRD but the resilience of microfinance portfolios**
Ecuador 1999- 2000	Financial and banking crisis (Collapse of the national currency, freezing of banking accounts, dollarization	Near collapse of Banco Solidario, the retreat of most commercial banks
Bolivia 1999- 2001	The economic and financial crisis	Delinquency crisis in the microfinance sector, the exit of consumer lenders
Argentina 1999-	**Economic crisis, abandonment**	**Collapse of largest Argentine**

2002	**of dollar parity, the collapse of the banking system, default on government bonds**	**MFI (Fundacion Emprender)**

Source: Financial Crisis: Lessons from Microfinance, Dinos, C and Arvid, A.

Credit Risk Management

Credit risk is the risk of financial loss resulting from a borrower's late or non- payment of a loan obligation or that a guarantor will fail to redeem the obligation. Credit risk applies to lending and investing activities. Ledgerwood (2000) defined credit risk as the potential loss resulting from the poor quality of an organisation's asset especially loan portfolio. It is the chance that a borrower whether an individual or group borrower will not repay the loan amount and interests on agreed terms. Nwankwo (1991) described credit risk as to the possibility of not realizing both the principal and accrued interest. It simply means that a bank will lose both earning asset and portion or all of its expected interest income. Greuning and Bratanovic (2009) affirmed that credit risk is the principal cause of bank failures. The impact of credit risk is that it gradually erodes the capital of financial institutions through loan loss provisioning.

A credit risk management policy is critical for a sound and healthy financial institution. An effective credit risk policy would, therefore, ensure the soundness and sustainability of microfinance banking operations. The credit risk management framework should focus on reducing credit risk, loan classification, loan loss provisioning, collection and monitoring. According to (Koch,1992) loans are classified as delinquent loans (Non- performing loans) when the loan covenants are not strictly adhered to by the borrowing customer. Problem loans and loan losses are essentially credit risk issues underlying the borrower's willingness and ability to repay loan obligations as at when due. The Nigerian Microfinance regulatory guidelines (2005) provides for the classification of loans as performing loans, Pass and Watch, Substandard, doubtful and loss with appropriate loan loss provisioning. When the reserve is depleted by unanticipated losses the profit decline becomes an issue as the shareholders' fund is adversely affected that can trigger liquidity problem thereby reducing the ability of the microfinance bank to extend further credits. Loan loss provisioning usually impacts negatively on the portfolio at risk.

The quality of the loan portfolio is determined by earning capacity of the bank. A good loan asset would enhance profitability, growth and sustainability of the institution.

While a poor risk asset is inimical to the success of the bank as this might lead to bank failure and liquidation through a loan classification and loss provisioning process.

Asset classification is the basis for loan loss provisioning.

Loan classification	**Days**	**Loan Provision %**
Performing	0 day	1%
Pass and Watch	1- 30 days	5 %
Substandard	31- 60 days	20 %
Doubtful	61 – 90 days	50 %
Lost	91 days and above	100%

Source: Central Bank of Nigeria Prudential Regulatory for Microfinance banks

Problem loans are attributed to internal and external factors which are sometimes described as controllable and uncontrollable causes. Controllable factors which are internally induced such as bank credit policy, inadequate credit analysis, loan restructuring, loan approval process, loan documentation and disbursement, poor capitalisation, poor management, loan collection and monitoring, while the external factors (uncontrollable causes) include; adverse economic conditions, adverse changes in regulations, environmental changes, economic downturn, strong competition, the poor performance of customer's business and natural disasters.

Risk Management

Risk management is a significant activity in any financial institutions that aims at minimizing the impact of possible losses due to either internal or external factors. Risk management is both the duty of Board of directors and management of the institutions, all relevant stakeholders have a specific function to perform in the risk management framework policy It involves managing the negative effect of the adverse occurrence in a corporate environment. Churchill and Franckiewicz (2006) asserted that risk management includes the prevention of potential problems, the early detection of actual problems when they occur and the correction of policies and procedures that permitted the occurrence.

Adopted from Churchill and Franckiewicz, 2006)

The process of risk management can, therefore, be summed into five basic activities namely (i) risk identification (ii) risk measurement and analysis (iii) risk mitigation (iv) risk monitoring and (v) risk control.

Collection challenges

A critical challenge of the microfinance practice is the delivery model of cash collection from borrowers daily gives room for cash suppression and diversion by loan officers and poor response by loan customers especially when there is a break in the contact process. Others challenges that are attributable to the collection process, especially in terms of business disruption, are; slow repayments in a period of economic downturn, deliberate refusal by borrowers to answer or return calls, the insincerity of the borrower, failure by the borrower to keep promises to loan agreements, inability to trace the location of the borrower and where the borrower is facing family problems that could make collection difficult.

Microfinance institutions must design measures and structure to mitigate against the aforementioned problems through Institutional frameworks such as of zero tolerance loan default or penalty and sanctions late payment, rewards systems for loyal borrowers and diligent loan officers, effective loan supervision and monitoring, and internal control, strong policies and procedures, client orientation on timely repayments enforcement of penalty fees and effective management information system.

CONCLUSION

The loan portfolio essential and main income earning asset for any financial institution so it should properly and effectively be monitored and managed. The loan portfolio is the most important and largest asset of the microfinance banking institution. The loan asset or portfolio is the total amount of loans held by borrowers or all loans balances unpaid. The portfolio management process involves the formulation and implementation of policies and procedures, decisions and actions taken towards ensuring good portfolio quality. Delinquency is a deviation from the expected behaviour and in the case of credit, it starts when the amount due is not settled in full or loan is not serviced as and when due. Loan delinquency affects microfinance bank's profitability, growth and sustainability. In a situation of total economic meltdown businesses of the household, private firms and Governments are severely affected it might be necessary for creative and proactive measures to safeguard and recover the loan assets of the microfinance institutions.

Fifteen steps to take in a Delinquency crisis

1. Review credit policies and operations for their compliance with basic principles and methodology
2. Evaluate the extent to which loan officers are complying with a sound methodology, look for deviations
3. Design an incentives system that will maintain the type of performance sought by the program
4. Lay off loan officers and other field staff who have particularly poor performance and who will most likely reject the manner of improving performance
5. Separate the poorest loans from the rest and give them to a specialized collection department. Leave loan officers with an acceptable level of delinquency
6. Review your information system to ensure that it gives you adequate management information for the day-to-day control of operations and implementation of the incentives system
7. Layout the reviewed policies and operational procedures along with an incentives system to field staff
8. Set deadlines for improving performance and achieving incentives
9. Set up ex-post control capacity to measure refinancing requests, delinquent accounts and a sample of on-time accounts against new policies
10. Review the performance of new versus old loans after about six months under new policies. If it is satisfactory, proceed with the following steps, if not repeat prior steps from the beginning
11. Judiciously refinance some clients who have a genuine potential to repay loans
12. Write off the major number of loans that are more than six months late. Continue collection efforts through a specialized department (in those cases where the money involved is significant)

13. Promote strong growth both in amounts and numbers of clients
14. Move clients out who have had poor records as they pay off their loans
15. Remove loan officers who continue to perform poorly or who drag down the entire concept.

Source: Economics Institute, 1996

Delinquency management strategies

Some measures for managing problem loans could include;

(i) Loan workout refers to the entire process of mutually renegotiating the loan terms and conditions in the face of current realities. It is a process of managing the delinquent loan through review and agreeing with the borrower to ensure collection of due loan and interest outstanding. Mutual agreement on loan restructuring by both parties Loan rescheduling involves extending or altering the loan terms or repayment schedule. Loan refinancing refers a providing additional loan for the borrower to strengthen this business

(ii) Collateral liquidation where the loan was probably secured with an asset especially moveable assets with microloans.

(iii) Reducing debt to judgment – in the event, there is a collapse of the agreement between the bank and borrower a judgment can be obtained against the borrower or guarantor where the mutual resolution fails.

(iv) Loan write off – is applicable where the loan portfolio has become a regulatory issue and weight of loan loss provision is heavy on the balance sheet erosion of bank capital. However, this must be followed the plan for a fresh capital injection to ensure the microfinance bank remains in business.

(v) Cost reduction to bring down operating expenses and suspension of all capital expenditures

(vi) Establishment of wholesale Microfinance refinancing fund – this would provide a refinancing window to offer liquidity support for microfinance banks with delinquent loan assets. This would be an effective intervention tool especially in the period of general economic meltdown where the default rate would be predictably high with a negative impact on the financial sector.

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