Archives of Business Research – Vol., No.5
Publication Date: October. 25, 2016
DOI: 10.14738/abr.45.2216.
Appiah-Konadu, P., Churchill, R.Q., Agbodohu, W. & Frimpong, H.K. (2016). Evaluating the Credit Risk Management Practices of Microfinance Institutions in Ghana: Evidence from Capital Line Investment Ltd. And Dream Finace Ltd. *Archives of Business Research, 4(*5), 72-80.

Evaluating the Credit Risk Management Practices of Microfinance Institutions in Ghana: Evidence from Capital Line Investment Ltd. And Dream Finance Ltd.

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Abstract

Several factors are constraining the continuous growth of the microfinance sector in Ghana among which are high risk of defaulting loans and how to ensure effective management of credit risk so as to simultaneously maximize returns on assets and minimize defaulting loans. Using a survey approach and convenience non–probability sampling technique, we applied the Risk Management Feed-back Loop concept proposed by GTZ (2000) to evaluate the credit risk management policies employed by microfinance firms in their quest to manage credit risks in order to minimize defaulting loans. The results of the descriptive analysis indicate that credit risk is the most significant risk that poses a great threat to the overall survival of microfinance firms. The study also revealed that ineffective client information verification system increases the rate of bad loads in microfinance companies. Based on our findings, we recommend that in order to ensure improvement in the performance of microfinance institutions, measures that seek to reduce credit risks should be strengthened. More so, in order to reduce the level of bad debts in the loan portfolios of microfinance firms, we recommend that the system for verifying client information before loan disbursements should be strengthened. Specifically, a detailed scrutiny of the client should be made before making loan disbursements.

Key Words: Credit Risk, Capital Line Investment Ltd., Ghana, Microfinance

INTRODUCTION

Microfinance institutions serve some of the world's most financially challenged population and informal sector enterprises that otherwise would be denied access to banking services owing to the stringent requirements of commercial banks in granting credit facilities to their clients. In a developing country like Ghana where small and medium scale enterprises contribute significantly to GDP and employment generation, microfinance institutions play a critical role in the economic development process by providing credit facilities to finance both capital investments and short term liquidity needs of the unbanked business units. According to

Mawuko-Yevugah (2013) there has been a tremendous growth in the number of microfinance institutions operating in most developing countries around the globe, including those in Africa, serving as a vital source of credit for individuals, small and medium-scale businesses in need of small loans and financing options but not served by the large commercial banks. Ghana in particular has seen a significant growth of the microfinance industry in the last few decades with the number of registered institutions reaching about 90 as at February 2013 (Bank of Ghana, 2013)

In the view of Asiamah and Osei, (2007) microfinance has been an integral part of Ghana's finance history through the practice of people saving and/or taking small loans from individual lenders and corporative organization to start businesses or farming ventures. In the last three decades, Ghana's microfinance sector has grown to become an important arm of the country's financial sector with the help of various financial sector policies and programmes undertaken by different governments since independence. Notable among these financial sector reforms are: (1) the establishment of the Agricultural Development Bank in 1965 specifically to meet the financial needs of the fisheries and agricultural sector; (2) the establishment of Rural and Community Banks (RCBs), and the introduction of regulations such as commercial banks being required to set aside 20% of total portfolio, to promote lending to agriculture and small scale industries in the 1970s and early 1980s; (3) shifting from a restrictive financial sector regime to a liberalized regime in 1986; and (4) the promulgation of PNDC Law 328 in 1991 to allow the establishment of different categories of non-bank financial institutions, including savings and loans companies, and credit unions (Asiamah&Osei, 2007).The above policies among others have culminated into the emergence of three broad categories of microfinance institutions in Ghana. These are: (1) formal credit providers such as savings and loans companies, rural and community banks, as well as some development and commercial banks; (2) semi-formal financial intermediaries such as credit unions, financial non-governmental organizations, and cooperatives; and (3) informal credit suppliers such as susu collectors and clubs, rotating and accumulating savings and credit associations such as traders, moneylenders and other individuals (Bank of Ghana, 2008).

Small and medium scale enterprises (SMEs) contribute between 23% and 30% to the annual GDP of Ghana and accounts for more than 40% of the country's labour force (Asiama and Osei 2007). Majority of these businesses derive their investment capital and short term financial needs from microfinance institutions. The rapid growth of SMEs over the years have necessitated an increased demand for credit and financial services to which the microfinance sector has responded appropriately and thereby seen a significant growth in their loan asset portfolios over the last few years. This notwithstanding, several factors are constraining the continuous growth of the microfinance sector in Ghana among which are high risk of defaulting loans and how to ensure effective management of credit risk so as to simultaneously maximize returns on assets and minimize defaulting loans. Steel &Andah, (2003) assert that one critical problem militating against the growth of microfinance enterprises is the difficulties pertaining to the recovery of credits granted. In as much as many microfinance enterprises in Ghana experience rapid growth after their establishment; serving more customers in larger geographic areas and offering a wider range of financial services and products, the key problem is that their capacity to effectively manage risk and their risk management systems are often behind the scale and scope of their activities (GTZ, 2000).

In order to reduce Ghana's poverty incidence to the barest minimum, the country's microfinance sector is regarded as a critical financial anchor and expected to expand its services to promote universal access to credit and a range of financial services to a significant segment of the unbanked population and informal sector enterprises. From the foregoing,

some concerns that arise are: how does the mounting expectation and expansion in credit of microfinance institutions impact on risks faced by the sector itself? And how are these purported risks managed to minimize their negative effects on the country's microfinance sector? To address these concerns, the present study seeks to investigate the different types of risks and credit risk management practices of microfinance institutions in Ghana through the lens of Capital Line Investment limited and Dream Finance Limited.

LITERATURE REVIEW

The term microfinance has been broadly defined as the provision of small scale financial services to the people who for one reason or the other lack access to traditional banking services offered by large commercial banks. The concept of microfinance is often related to very small loans to low-income clients for self-employment, with repayments usually structured into periodic fixed installments over a predetermined loan period (Gyamfi, 2011). According to Greenberg (2009) microfinance is the provision of financial services to deprived and low-income people with the ultimate objective of eradicating poverty particularly in the developing world. Murdoch (2000) also contends that "Microfinance Institutions (MFIs) refer to financial institutions which provide financial services to poor economic agents who are typically excluded from the formal banking system for lack of sufficient collateral". From the above definitions it is evident that the essence of microfinance as contended by Brandsma and Chaouli (1998) is to provide financial services to low-income groups and individuals who are not able to meet the collateral and other requirements of the traditional banking system and hence denied credit and other financial services by these banks.

GIZ (2000) defines risk as the possibility of an adverse event occurring and its potential for negative implications to an individual, a project or institution. Like all other financial institutions, microfinance institutions (MFIs) face risks that they must manage efficiently and effectively to be successful. Risks are significant if the probability of occurrence or the severity of the potential impact is high. Many risks are common to all financial institutions. From banks to unregulated MFIs, these include credit risk, liquidity risk, market or pricing risk, operational risk, compliance and legal risk, and strategic risk. According to GIZ (2000) Most risks can be grouped into three general categories: financial risks, operational risks and strategic risks.Mawuko-Yevugah (2012) defines credit risk as the potential that a borrower or counterparty will fail to meet its obligations in accordance with the terms and conditions of a loan contract. GIZ (2000) also defines credit risk as the risk to earnings or capital due to borrowers' late or non-payment of loan obligations. From the above definitions, it can be deduced that credit risk encompasses both the loss of income emanating from the MFI's inability to collect anticipated interest earnings as well as the loss of principal resulting from loan defaults. Since most loans advanced by MFIs are unsecured, these loans are usually exposed to a great deal of credit risk. In the literature, credit risk has been adjudged to be the most prevalent risk faced by microfinance institutions. As MFIs compete for customers and resources, the risks associated with their activities tend to rise. Those MFIs that manage risk effectively by developing systematic approach that applies across product lines and activities and considers the aggregate impact or probability of risks – are less likely to be taken aback by unexpected losses (down-side risk) and more likely to build market credibility and capitalize on new opportunities (up-side risk) (GIZ, 2000). The adoption of a risk management framework by an MFI makes it feasible for senior managers and directors to make well thought-out decisions about risk, to identify the most suitable approaches to manage those risks, and to develop an internal mechanism that rewards good risk management without discouraging risk-taking. According to GIZ (2000) effective risk management demands that an organization adopts four key steps: (1) Identify the risks facing the institution and assess their

severity (either frequency or potential negative consequences), (2) Measure the risks appropriately and evaluate the acceptable limits for that risk, (3) Monitor the risks on a routine basis, ensuring that the right people receive accurate and relevant information; and (4) Manage the risks through close oversight and evaluation of performance.

Risk management is generally considered as the identification, assessment, and prioritization of risks followed by an organization and the economic application of resources to reduce, monitor, and check the likelihood and effects of unfortunate events or to maximize the realization of opportunities (Mawuko-Yevugah, 2012). In the context of financial institutions, an established system that checks repayment of loans by borrowers is very critical in averting asymmetric information problems and minimizing the rate of loan defaults (Basel, 1999). A workable credit risk management (CRM) framework entails the development of an appropriate credit risk (CR) environment; working under a healthy credit lending process; maintaining an appropriate credit administration that necessitate the monitoring process and adequate controls over credit risk (Greuning & Bratanovic, 2003). According to Siegel & Alwang (2001) risk management strategies are adopted to minimize risk problems ex ante whereas risk coping strategies address risk problems ex post. Risk management in microfinance is the process of managing the probability or the severity of the adverse event (e.g loan defaults) to an acceptable range or within limits set by the MFI (GTZ, 2004). A comprehensive approach to risk management reduces the risk of loss, builds credibility in the market place, and creates new opportunities for growth.

Armendariz and Morduch (2000) have highlighted several important mechanisms that allow MFIs to generate high repayment rates from poor borrowers without requiring collateral. These mechanisms include the use of group lending contracts, non-refinancing threats, regular repayment schedules, collateral substitutes, and the provision of nonfinancial services among others. One of the major mechanisms that most MFIs employ is group lending. Group lending refers specifically to arrangements by individuals without collateral who get together and form groups with the aim of obtaining loans from a lender. According to Kono and Takahashi (2010), in the typical group lending scheme: (a) each member is jointly liable for each other's loan, (b) if any members do not repay, all the members are punished (often in the form of denial of future credit access), and (c) prospective borrowers are required to form groups by themselves. Group lending model has attracted an enormous amount of public and academic attention mainly after the success of group lending program in Grameen Bank. In addition, joint liability in group lending reduces the problem of moral hazard by increasing borrower's incentives to monitor each other and then to repay the loan. In sum, group-lending mechanism can potentially deal with information asymmetry, and therefore reduces risk-taking and improves the lender's repayment rate.

Field and Pande (2008) reported that regular payment schedule provide clients a credible commitment device, which enables them to form the habit of saving regularly. They noted also that frequent meetings with a loan officer may improve client trust in loan officers and their willingness to stay on track with repayments. According to Ibtissem and Bouri (2013), this early regular repayment schedules may exclude potential borrowers who have a single source of income from the market. These borrowers are mostly present in areas focused sharply on highly seasonal occupations like agricultural cultivation. The income generation of agriculture areas is unstable and regular repayment schedules are difficult to respect.

From the review, we note that the three major categories of risks faced by MFIs are financial risk, operational risk and strategic risk; and that the prime function of any financial institution is to manage financial risks, which consist of credit risks, liquidity risks, interest rate risks,

foreign exchange risks and investment portfolio risks. However, credit risk stands tall among the list of financial risks as the most prevalent and threatening risk faced by microfinance institutions. More so, the review has brought to light that the most common credit risk management practices adopted by MFIs to mitigate credit risk are: group lending contracts, institution of dynamic incentives, collateral substitutes and repayment schedules.

METHODOLOGY

The underlying framework for the study is The Risk Management Feedback Loop concept proposed by GTZ (2000). The feedback loop integrates several different areas of management: policies from the board, specific guidelines and procedures for operations, management information reporting, internal controls, and overall financial management (e.g. capital adequacy, liquidity, and resource allocation). The risk management feedback loop has six key components:

1. Identifying, assessing, and prioritizing risks
2. Developing strategies and policies to measure risks
3. Designing policies and procedures to mitigate risks
4. Implementing and assigning responsibilities
5. Testing effectiveness and evaluating results
6. Revising policies and procedures as necessary

The study uses the components of the risk management feedback loop to measure and analyze the effectiveness of the credit risk management practices of the MFIs.

The study employs both primary and secondary data for its analysis. The population for the study comprised of staff members, specifically credit analyst and loan officers for each institution. For the primary data collection, questionnaires were administered to selected credit analyst and loan officers from three branches of each of the two firms (Capital Line Investment Ltd and Dream Finance Ltd) in Accra. A sample size of 15 (loan officers and credit analyst) were selected from each of the two firms for the study. 13 of the respondents from Dream finance returned the completed questionnaire. This gives a response rate of 86%. 10 from Capital Line returned the completed questionnaire representing a response rate of 66%. Convenience non – probability sampling technique was used in selecting the respondents. We visited the three branches of each of the two firms at random time periods and questionnaires were administered to staff members from the credit department (credit analyst and loan officers) who were around during the visit. Gyemibi et al (2011) argues that this sampling technique helps to reduce bias in sampling as the researcher has no a priory information of the respondents who will be selected. We also held interviews with the management of the two firms to get information on managerial decisions pertaining to credit risk management. Secondary data was sourced from the annual reports and the official website of the two firms.

The study employs descriptive statistics (graphs, charts and tables) to analyze the risk factors associated with the operations of the two firms and to help identify the most significant risks factors for each firm. The effectiveness of the risk management policies of the firms are measured by the extent to which they conform to the six components of the risk management feedback loop concept proposed by GTZ (2000).

RESULTS AND DISCUSSION

Types of Risks

The responses to the question on the types of risk faced by Capital line investment revealed that the different risked faced by the institution in its operation in order of importance are

credit risk, liquidity risk, and market or interest rate risk among others. It is worth noting that all the 10 respondents (100%) stated that credit risk is the most significant risk that poses a great threat to the overall survival of the company. For Dream Finance Ltd., the risks the institution commonly faces in order of significance are credit risk, liquidity risk and operational risk. More specifically, all the 13 respondents who, participated in the survey asserted that credit risk has been the most prevalent risk in the day-to-day operations of the company.

The overwhelming significance of credit risk in the operations of Capital line investment and Dream Finance Ltd. is in line with the general trends in the literature. Credit risk has been adjudged to be the most prevalent risk faced by microfinance institutions particularly in developing countries such as Ghana (Mawuko-Yevugah, 2012). This is probably due to the fact that lending has been, by far, the core business of most microfinance institutions including Capital line investment and Dream Finance Ltd., and the high incidence of bad loans and losses suffered by financial institutions in developing countries owing to the existence of unfavourable business environment in most of these countries (GIZ, 2000).

The Effectiveness of credit risk management policies

According to GIZ (2000) the first step in assessing the effectiveness of a credit management policy is the system's capacity to identify and prioritize the different types of risk faced by a Microfinance Institution (MFI). From the analysis so far, it is seen that the two institutions have been able to identify and prioritize the various risk that they face in their operations. Specifically, credit risk has been identified as the most significant risk faced by both Capital line investment and Dream finance ltd.

Microfinance institutions usually measure the intensity of credit risk by the size of loans that are in default (loans going bad and likely to be written off) within a specified period of time. A question was therefore posed to respondents (loan officers and credit analyst) of the two institutions to find out whether the levels of bad debt in their loan portfolios are threatening or not.

From the analysis presented in figures 4.3 and 4.4 in the appendix, only 10% of the respondents from Capital line investment stated that the level of bad debt in the loan portfolios that they manage are threatening whilst 90% claimed that it is not threatening. On the other hand, 61.54% of the respondents from Dream Finance Ltd. agreed to the fact that the levels of bad debt in their loan portfolios are high and threatening to the survival of the company. Judging from the respondents' view on the level of bad debt faced, one can opine that capital line investment has a relatively more effective credit management policy than Dream Finance Ltd., which faces a relatively high rate of loan defaults (see GIZ, 2000).

The risk management feed-back loop concept proposed by GIZ (2000) emphasizes on the effectiveness of credit risk assessment done on loan applications before loans are granted to clients of MFIs. Central to the effectiveness of credit analysis is the quality of information provided by a prospective client and the efficacy of the systems put in place by a microfinance institution to duly verify client information (credit history, evidence of active business owned, cash flow, etc.) before loan disbursements are affected. A question was therefore posed to respondents to find their views on the systems put in place by Capital line investment and Dream Finance Ltd. to verify client information before granting loans to clients. The analysis of the responses is presented as tables 4.7 and 4.8 in the appendix. From the analysis, it is clear that the respondents do not have much confidence in the systems put in place by the management of the two MFIs to certify information supplied by prospective clients during loan

applications. For Capital line investment, 50% of the respondents stated that they have confidence in the system whereas 50% stated that they do not have confidence in the client information verification system in the company. For Dream Finance Ltd. only 46.2% of the respondents have confidence in the system for verifying client information whereas 53.8% claim they do not have confidence in the information verification systems put in place by management. The use of fabricated information for credit analysis most likely has an adverse effect on the quality of loans granted. The ineffective systems for verifying client information could be a contributing factor to the high rates of bad debt in the overall loan portfolio of Dream Finance Ltd.

CONCLUSIONS

Several factors are constraining the continuous growth of the microfinance sector in Ghana among which are high risk of defaulting loans and how to ensure effective management of credit risk so as to simultaneously maximize returns on assets and minimize defaulting loans. The study mainly investigates the different types of risks faced by microfinance institutions in Ghana using Capital Line Investments Ltd and Dream Finance Ltd as a case study. The study also analyses the credit management policies that Capital Line Investments Ltd. and Dream Finance Ltd. have employed in their quest to manage credit risks in order to minimize defaulting loans.

Using the primary survey and convenience non – probability sampling technique, the study applied the Risk Management Feed-back Loop concept proposed by GTZ (2000). The feedback loop integrates several different areas of management: policies from the board, specific guidelines and procedures for operations, management information reporting, internal controls, and overall financial management. The study uses the components of the risk management feedback loop to measure and analyze the effectiveness of the credit risk management practices of the two MFIs- Capital Line Investments Ltd and Dream Finance Ltd.

The study has revealed that the different risked faced by Capital line investment in its operation in order of importance are credit risk, liquidity risk, and market or interest rate risk among others. All respondents from Capital Line Investment stated that credit risk is the most significant risk that poses a great threat to the overall survival of the company. On the other hand, the risks that Dream Finance Ltd. commonly faces in order of significance are credit risk, liquidity risk and operational risk. In general, all the 23 respondents who, participated in the survey asserted that credit risk has been the most frequent risk in the day-to-day operations of the company.

In terms of the level of bad debts in the two institutions, the results show that only 10% of the respondents from Capital line investment stated that the level of bad debt in their loan portfolio is threatening whilst 90% claimed that it is not threatening. On the other hand, 61.54% of the respondents from Dream Finance Ltd stated that the level of bad debt in their loan portfolio is high and threatening to the survival of the company. The findings brought to light that capital line investment has a relatively more effective credit management policy than Dream Finance Ltd., which faces a high rate of loan defaults. Furthermore, in terms of the effectiveness of the system for verifying client information before loan disbursements are effected, we found that 50% of the respondents from Capital Line Investment have confidence in the system whereas 50% do not have confidence in the client information verification system of the company.For Dream Finance Ltd. only 46.2% of the respondents have confidence in the system for verifying client information but 53.8% claim they do not have confidence in the information verification systems put in place by management. Lastly, the ineffective

systems for verifying client information could be a contributing factor to the high rates of bad debt in the overall loan portfolio of Dream Finance Ltd.

POLICY RECOMMENDATIONS

The results of the descriptive analysis indicate that all respondents from both Capital Line Investment and Dream Finance Ltd stated that credit risk is the most significant risk that poses a great threat to the overall survival of the two companies in their day-to-day operations. Therefore, based on this finding, we recommend that in order to ensure improvement in performance of microfinance institutions, measures that seek to reduce credit risks should be strengthened. More so, in order to reduce the level of bad debts in the loan portfolios of microfinance firms, the study recommends that the system for verifying client information before loan disbursements should be strengthened. Specifically, a detailed scrutiny of the client should be made before making loan disbursements.

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