

CREDIT RISK MANAGEMENT PRACTICES IN SMALL AND MEDIUM-SIZED MICRO-FINANCE PROVIDERS

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Abstract

Microfinance providers play a significant role in emerging economies by providing banking-related financial services to the low income market. However, lending to the low income market is associated with high credit risk. This paper investigates the use of certain risk management practices by small and medium-sized micro finance providers in the Cape Metropolitan Area. The big difference of micro-finance is that collaterals are absent and instead, a close connection between microfinance providers and their clients come into place. And while micro-finance providers use follow up calls and penalties to avoid losses from loan overdue, the classical way to the court is not really an option. Instead, community leaders function as middlemen between the provider and the customer. Although most respondents agree that policies are in place, written risk policies exist in only half of our respondent's enterprises. We further showed that the views on risk management depend on whether the respondent is an owner or a manager of the venture.

Keywords: Microfinance, SMMEs, Credit risk Management, Sustainability

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1 Introduction

Financial exclusion of poor households, mainly those living in remote areas, is a major hampering factor for economic development. Still, lending to poor households is inherently risky as they lack collateral security and often have no formal employment. In search of needed financial support, many seek the help of informal lenders which may make relentless use of their client's desperate situation.

To break this vicious circle, micro-finance services have been hailed as a tool to ease poverty worldwide. Micro-finance providers offer financial services like small loan amounts, saving arrangements and insurance contracts to the low income market (Egyir, 2010; Hartungi, 2007). The concept was pioneered by economics professor Muhammad Yunus in 1976 who subsequently received the noble price for his engagement in poverty alleviation. In South Africa, the microfinance business gained traction in 1992 when the government set an exemption to the Usury Act which legalised small loans under R6000 to be issued with no restrictions on the interest rate (Meagher, 2005).

Since the rise of the microfinance industry, scholars and practitioners alike raised questions about the management of credit risks. Already in 1990s, intervention measures were called for as many loans were non-performing (Moti et al, 2012; Norell, 2001). The majority of the suggestions targeted the ability of the client to repay the borrowed amount. Despite the criticism, loan default continued to increase and has now become a major contributing factor to banking distress (Eferakeya, 2014).

Previous contributions concentrated on credit risk and the need to address it effectively and efficiently (Steel & Andah, 2003; Sarwar et al., 2011; Hishigsuren & Hussein, 2007; Churchill & Coster, 2001; Gstraunthaler & Cramer, 2012). Failure to manage it properly results in liquidity problems (Hishigsuren & Hussein, 2007) and high delinquency management costs (Churchill & Coster, 2001). Especially efficiency is a main topic for small and medium service providers lack the back-office support to handle elaborated risk-management procedures. This paper asks what credit risk management practices are in place within such small and medium providers of microfinance services?

Today, the approaches towards client selection are plentiful. However, due to the focus of the paper we use the following section to discuss selection and structural mechanisms a micro-finance provider has at his hand to manage risk.

2.1 The Five Cs for client selection

To assess the creditworthiness of their clients, micro-finance providers use the five Cs: character, capacity, collateral, capital and condition as suggested by Hishigsuren & Hussein (2007). Character involves looking at characteristics of the applicant which include honesty, ability to manage a business, family situation, reputation in the community and previous credit history. These characteristics are then weighted and the total score of the potential borrower is indicative for his or her credit worthiness (2005; Moti, et al., 2012). Capacity looks at the ability of the borrower to repay the loan in terms of cash flows

(Gyamfi, 2012). The cash-flow analysis involves a comparison of existing income and expenses (using available cash-flow statements) and the projection of future cash positions (e.g. using ratios). Collaterals describe assets given to the lender by the borrower as a guarantee of loan repayment (e.g. Balkenhol & Schutte, 2001). However, providers of micro-finance services target mainly the poor who mostly don't have any assets to pledge for a loan. Hence, micro-finance lenders will use non-traditional collaterals such as future harvest, personal sureties, household assets etc (i.e. character-based lending and frequent client visits) (Ledgerwood, *et al.*, 2013). Capital measures the financial position with special emphasis on the borrower's net worth (Moti, *et al.*, 2012). It also covers also stakes in businesses (Hishigsuren & Hussein, 2007) and provides an indication of financial risks the client is exposed to (Moti, *et al.*, 2012). Conditions cover economic factors like inflation rates and competitive pressures and looks at the potential borrower's vulnerability (Hishigsuren & Hussein, 2007).

2.2 Loan product design

The loan product design refers to the structure of the loan in terms of cash flow, interest rate, repayment terms and possible penalties (Pinkowish, 2011). Proper loan product design helps micro-finance providers to reduce default risk. Loan product design includes the following elements (Churchill & Coster, 2001):

- **Eligibility requirements:** The potential borrower should meet certain criteria that are perceived to reduce credit risk like a business plan, salary advice and business documents like bank statements and sales receipts.
- **Loan amounts:** Ensuring that the amount requested by the borrower is within his/her ability to repay.
- **Loan terms:** The ability of the loan repayment can be enhanced by prolonging the loan term to make installments smaller and more affordable.
- **Repayment incentives** may stipulate that early repayment gives the client access to another loan.
- **Interest rates and fees:** These require alignment with the cost of delivery and risk levels, as riskier loans require corresponding interest premiums. Rates on loans on the other hand should not be set too high in order to attract lower-risk clients and maintain a healthy portfolio.

2.3 Individual vs group lending

Money lending is a mutual agreement between lender and borrower with individual liability. Thus, the obligation to repay the loan rests with a single person. Individual lending involve the gathering of information to evaluate the willingness and capacity to pay before an individual loan application is approved. Gathering information under the individual-based

lending method greatly depends on staff visits at homes or business premises rather than obtaining information solely from documents supplied by the potential borrower (Aghion & Morduch, 2000:407-408).

However, in some instances, another person may serve as a loan guarantor (Cull, *et al.*, 2007). Group lending refers to a situation whereby loans are issued to a small group of individuals (usually between 3 to 7 members) (Aghion & Morduch, 2000). The group is jointly liable should any of the members default. Group lending methodology manages risks as it provides (Crabb & Keller, 2006):

- **Dynamic incentives:** If a group member defaults, the entire group will be denied access to future loans. This creates an incentive for group members to monitor each other and ensure repayment in order to have access to loans in the future.
- **Collateral substitute:** If one member defaults, the whole group will be jointly liable, hence, this acts as an assurance to the lender that repayment is secured.

2.4 Credit risk controls

Internal controls define processes implemented by management with the objective of providing reasonable assurance regarding the reliability of financial reporting, compliance with relevant laws and regulations and effectiveness and efficiency of operations (Shah, 2007). Such internal controls include (Campion, 2000):

- **Segregation of duties:** For example, client screening is separated from the responsibility to approve the client's request for funding.
 - **Credit policy:** specify which staff will approve loans and from which amounts additional steps are required.
 - **Regular operational checks:** This is achieved by the use of mechanisms like age analysis and delinquency management in order to maintain a healthy portfolio.
- The National Bank of Ethiopia (2010) recommends that internal audits should be performed by independent employees of microfinance providers on regular basis to give an assurance that:
- Loans have been issued in accordance with stipulated credit policies and procedures.
 - Periodic reports on various risk events are made available to senior management.
 - Risk management weaknesses are identified and timeously reported to superiors.
 - Senior management are informed of exceptions to stipulated policies and procedures.

2.5 Delinquency management

A professional delinquency management is crucial for the establishment of a sustainable micro-finance business and include the following basic elements (Office of International Information Programs, 2004; Ledgerwood, 1999):

➤ **Delinquency requires effective follow up procedures:** clients must understand that delinquency will trigger consequences. Such follow-up procedures include regular calls and meetings with clients, community leaders etc.

➤ **The consequences of the loan default must be sufficiently unappealing to the client:** The consequences may include legal action taken against the client, public announcement, entry into credit history and penalties.

➤ **Both staff and client must understand that late payment is unacceptable:** The client must understand that when he/she has accepted the loan, repayments should be made as outlined in the loan agreement. Failure to do so will result in hefty penalties.

➤ **Micro-finance providers require accurately and timely management of information:** This requires effective and efficient information systems that support the monitoring of credit-related information. Thereby, the management accurately and timely identifies payments which are due and late, and allow follow up procedures to be implemented in good time.

3 Research design and data collection

Data was collected by means of a questionnaire from microfinance providers in the Cape Metropolitan area which are registered with the National Credit Regulator (NCR). We obtained a complete list of credit providers from the NRC which included among others retailers, micro-finance providers and pawn brokers. In a first step we excluded credit providers like retailers and pawn brokers, so that only the suitable micro-finance providers remained. In a second step we introduce size-depending criteria and focus on small, medium and micro companies according to the South African SMME definition. This is especially important as large financial service providers (like commercials banks) do offer micro-finance services, but due to their financial position their approach to risk management is very different.

Furthermore, we checked for the following criteria:

➤ All respondents should not have owned/managed businesses that were regarded as large financial services providers (e.g. commercial banks).

➤ All respondents should have owned/managed businesses that provided microloans to natural people only.

➤ All respondents should have owned/managed businesses that had to be in operation for at least 3 years.

➤ All respondents should have owned/managed businesses that should have been in charge of their respective business' risk management.

➤ All respondents should have owned/managed businesses that employed 1 to a maximum of 100 people (according to South African Small Business Act No. 102 of 1996).

➤ All respondents should have been owners/managers of their respected businesses.

➤ All respondents should have been actively involved in their respective businesses for at least 2 years.

After applying these selection criteria, we identified a total of 69 micro-loan providers (credit providers) with knowledge and experience relevant to the research question. Data could not be collected from the entire sample (69 micro-loan providers) because of the following constrains:

➤ Eight entities could not be reached due to distance barrier.

➤ One entity had closed its business by the time of data collection.

➤ Four entities could not be located using the addresses obtained.

➤ Seven entities could not want to share their information with an outsider.

➤ Three entities were not giving loans by the time of data collection and were reluctant to complete the questions.

This left us with a total of 46 participants. All questionnaires were returned, but 1 questionnaire was not fully completed and 4 did not satisfy the criteria set for the survey sample (the questionnaire showed that 4 respondents had meanwhile more than 100 employees).

5 Data analysis

Our respondents were in 34.1% of the cases the owners of the venture, 43.9% of the respondents were managers, 19.5% of the respondents were both owner and manager and in one case an assistant managers completed the questionnaire (see Table 1).

Table 1. Descriptive statistics for the categorical variables

Variables	Categories	Frequency	Percentage
1. What is your position within the business?	Owner	14	34.1%
	Manager	18	43.9%
	Owner and Manager	8	19.5%
	Other = Assistant Manager	1	2.4%

The average number of years for which the businesses in this survey have been operating is 10.1 years, the average number of employees is 13 and the

average number of years that the employees who completed the questionnaires have been in their current position is 6.7 years (see Table 2). This shows

that the person who responded indeed had gained place.
experience in the business and knew the policies in

Table 2. Descriptive statistics for the continuous variables

Variables	N	Mean	Std Dev	Median	Min	Max
1. How long has your business been operating?	41	10.12	5.0606	10.00	3.00	21.00
2. How many employees does your business have?	41	12.66	10.3238	9.00	2.00	50.00
4. How long have you been in this position?	41	6.68	3.5878	6.00	2.00	17.00

Table 3: Rating credit risk management practices

Variables	Categories	Frequency	Percentage
6a Credit scoring	Never	0	0.0%
	Seldom	0	0.0%
	Sometimes	5	12.2%
	Often	16	39.0%
	Nearly always	20	48.8%
6b Customer affordability calculation	Never	0	0.0%
	Seldom	0	0.0%
	Sometimes	0	0.0%
	Often	5	12.2%
	Nearly always	36	87.8%
6c Credit Bureau information	Never	0	%
	Seldom	0	%
	Sometimes	6	14.6%
	Often	8	19.5%
	Nearly always	27	65.9%
6d Collateralisation	Never	17	41.5%
	Seldom	10	24.4%
	Sometimes	5	12.2%
	Often	7	17.1%
	Nearly always	2	4.9%
6e Surety ships	Never	10	24.4%
	Seldom	5	12.2%
	Sometimes	14	34.2%
	Often	8	19.5%
	Nearly always	4	9.8%
6f Peer monitoring through group lending methodology	Never	9	22.0%
	Seldom	0	0.0%
	Sometimes	5	12.2%
	Often	16	39.0%
	Nearly always	11	26.8%
6g Character based lending methodology	Never	4	9.8%
	Seldom	4	9.8%
	Sometimes	8	19.5%
	Often	10	24.4%
	Nearly always	15	36.6%
6h Customer orientation	Never	2	4.9%
	Seldom	3	7.3%
	Sometimes	1	2.4%
	Often	11	26.8%
	Nearly always	24	58.5%
6i Start with smaller amounts for first time borrowers and then grow the loan size as the institution builds a credit history with the borrower	Never	0	0.0%
	Seldom	2	4.5%
	Sometimes	11	26.8%
	Often	7	17.1%
	Nearly always	21	51.2%

Most respondents rely on the analysis of customer affordability and traditional credit scoring. Many also request the service of credit bureaus. Half of the providers prefer to build up trust through lending smaller amounts for first time borrowers and upon successful completion, new loans can grow in

size. Fewer lenders engage in group lending, while very few base their decision on collateralisation.

Respondents were asked to rate their usage of the certain practices to manage loans overdue (see Table 4).

Table 4. Rating loan overdue management practices

Variables	Categories	Frequency	Percentage
7a Make a follow up call to the client	Never	0	0.0%
	Seldom	0	0.0%
	Sometimes	0	0.0%
	Often	6	14.6%
	Nearly always	35	85.4%
7b Calling upon community leaders to put pressure on the client	Never	27	65.8%
	Seldom	2	4.9%
	Sometimes	2	4.9%
	Often	10	24.4%
	Nearly always	0	0.0%
7c Make a public announcement through national media like newspapers	Never	27	65.8%
	Seldom	2	4.9%
	Sometimes	3	7.3%
	Often	2	4.9%
	Nearly always	7	17.1%
7d Take a legal action against the client	Never	0	0.0%
	Seldom	2	4.9%
	Sometimes	25	61.0%
	Often	7	17.1%
	Nearly always	7	17.1%
7e Penalties	Never	0	0.0%
	Seldom	0	0.0%
	Sometimes	19	46.3%
	Often	6	14.6%
	Nearly always	16	39.0%

Most credit providers make follow-up calls to their clients and threaten them with penalties. Providers rarely take legal action, as the cost might well exceed the benefit. Very much in line with African realities, a quarter of the credit providers contact community leaders to put pressure on the client.

Respondents were asked to indicate the presence of certain risk management elements of by either choosing 'yes' or 'no' response (see Table 5).

Most providers do have a risk management plan in place and internal controls have been developed. Still, policies in writing exist only in half of the cases. Much fewer providers actively identify risks, categorise, prioritise and document them appropriately.

We furthermore studied whether the position a respondent holds in the micro-finance venture is connected with his or her perceptions of risk management. Interestingly, there is a significantly positive correlation with employee position and the perception that risk appetite is set. Especially managers believe that there is a risk appetite set that has been agreed on. Still, few owners see it that way.

Also statistically significant is the correlation between employee position and the existence of a risk management plan. However, here it is the owners that see a plan in place. Most managers agree that risk management processes are regular monitored and kept up to date shows that most managers agreed, while less than half of the owners see such processes in place.

6 Discussions of the results

Our study shows that most studied micro-finance service providers use a fine-tuned version of the 5Cs to improve their loan performance (e.g. Moti, *et al.*, 2012). The big difference of micro-finance is that collaterals are absent and instead, a close connection between microfinance providers and their clients come into place. And while micro-finance providers use follow up calls and penalties to avoid losses from loan overdue, the classical way to the court is not really an option. Instead, community leaders function as middlemen between the provider and the customer.

Table 5. Basic elements of effective risk management

Variables	Categories	Frequency	Percentage
18.a A risk appetite is set	Yes	17	41.5%
	No	24	58.5%
18.b Written risk policies exist	Yes	19	46.3%
	No	22	53.7%
18.c A risk management plan exists	Yes	36	87.8%
	No	5	12.2%
18.d Address the most significant risks first	Yes	23	56.1%
	No	18	43.9%
18.e A risk strategy is developed and implemented	Yes	13	31.7%
	No	28	68.3%
18.f All staff levels are involved in risk management	Yes	17	41.5%
	No	24	58.5%
18.g A risk management framework is developed or adopted	Yes	14	34.2%
	No	27	65.8%
18.h Effective mechanisms of internal controls are developed	Yes	32	78.0%
	No	9	22.0%
18.i Risk management is incorporated into operating process and systems design	Yes	27	65.8%
	No	14	34.2%
18.j The risk management process is regularly monitored, reported and kept up to date	Yes	24	58.5%
	No	17	41.5%
18.k Risks are actively identified, categorised, prioritised and documented before being assessed	Yes	25	61.0%
	No	16	39.0%

Most entities have a risk management plan in place, which is a central starting part for a functioning risk management. However, further analysis of the results revealed that managers confirmed that risk management procedures exist in their businesses, while respondents who were owners indicated that it doesn't. The generally different views of manager's vs owners can be explained in various ways. On one hand, the presence of managers might point to a more elaborated structure of the company and also indicate a certain size. With an increased number of employees, formal risk management approaches become a necessity. Others suggest that African SMME entrepreneurs have a generally low level of managerial skills. Hence, a formalised approach to risk management would not be high up on their agenda. This indicates the importance of skilled employees for micro-finance business owners. Similarly, the fact that owner-managers did not indicate the presence of a risk appetite and regular checks on the risk management process further supports the assumption of lacking skills among SMME entrepreneurs. Also previous research voiced similar concerns on SMME entrepreneurs regarding risk management (Smith & Perks, 2006; Smit, 2012; Rogerson, 2008; Gstraunthaler, 2010).

Although most respondents agree that policies are in place, written risk policies exist in only half of our respondent's enterprises. We further showed that only some staff is involved in risk management. Conversely, Kombo et al. (2011) stress the importance of including a great number of staff into the risk management design and execution. This is even more true for SMMEs where employees often act in various different positions and with a flexible range of

responsibilities. Therefore, risk management should not only be a responsibility of loan officers and credit managers. Instead, we suggest that all staff including data capturing clerks should work as a team in implementing and maintaining risk management practices. This research has also shown that a risk management framework which provides a holistic approach to risk management like Enterprise Risk Management (ERM) etc. is largely absent. Still, given the size of the firms, it is understandable that such elaborated concepts are not in use.

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