Credit Risk Management Practices of Micro Finance Institutions in Ethiopia– A Brief Literature Review

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Abstract

In this study an attempt has been made to gather relevant literature in the area of credit risk management practices of micro finance institution with special reference to Ethiopia. Micro finance provides financial help to the unbanked sections of the society. Since microfinance is a system that distributes small loans to poor people in order for them to generate income and start their own small businesses, it has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities. At the same time microfinance portfolios are exposed to various kinds of risks due to their inherent characteristic especially credit risk. The Ethiopian Microfinance sector is one of the fastest growing financial institutions in the world today serving about 2.7 million borrowers with portfolio of Birr 9.2 Billion(AEMFI performance analysis report, 2014). The sustainability of Micro Finance Institutions(MFIs) that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime element of the new development strategy of Ethiopia (Wolday 2010). With this scenario as a background, the currents study attempts to bring together available literature on credit risk management in microfinance institutions with special reference to Ethiopia.

Key Words—*Credit risk, Credit risk management, Microfinance*

I. INTRODUCTION

Micro finance provides financial help to the unbanked sections of the society. Since microfinance is a system that distributes small loans to poor people in order for them to generate income and start their own small businesses, it has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities especially in fast developing countries like Ethiopia.

Microfinance refers to small scale financial services for both credits and deposits that are provided to people who farm or fish or herd; operate small or microenterprise where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries in both rural and urban areasRobinson (2001).

In addition to distributing loans, MFIs also offer a wide range of financial services, such as savings and insurance options (Premchander 2009). Microfinance is a provision of financial services like savings, credit, insurance, remittance, etc. in a very small quantity generally to the poor people (Dasgupta, 2001).

It is broadly recognized that lack in credit risk administration and management policies by monetary establishments have helped altogether to the financial downturn around the world (Fraser &Simkins, 2010) As fallout to this emergency, orders including credit risk administration are currently being given more imperativeness, particularly in monetary related areas (Horne, 2007) like banks and other financial institutions. Micro finance institutions operate in an environment where customers are without credit histories or necessarily predictable borrowing behaviors(Vincent et al 2014)making it more necessary to deal with credit risk management.

The Ethiopian microfinance sector is unique. It is relatively young compared to the sector in the rest of the world. The average age of Ethiopian MFIs is 10 yrs. However it has witnessed rapid growth, has aggressive drive to achieve scale, broad geographic coverage, dominance of government backed MFIs, focus on rural household, provision of both credit and saving services and emphasis on sustainability (AEMFI performance analysis report, bulletin 10)This basic characteristic of the sector makes it vulnerable to a variety of risk categories especially credit risk.

II. MICROFINANCE IN ETHIOPIA

The Ethiopian Microfinance sector is one of the fastest growing financial institutions in the world today. They serve 2.7 million borrowers with portfolio of Birr 9.2 Billion(Association of Ethiopian Microfinance Institutions (AEMFI) performance analysis report 2014).The sustainability of Micro Finance Institutions(MFIs) that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime element of the new development strategy of Ethiopia (Wolday 2010).

The development of formal microfinance institutions in Ethiopia is a recent phenomenon that gained momentum after the establishment of micro fiancé institutions proclamation (40 /1996) that made it obligatory for all such institutions to be registered with National Bank of Ethiopia.

The Ethiopian financial sector comprises of Formal financing by banks, insurance companies and microfinance institutions (www.nbe.gov.et) and informal financing by Iddir, Iquib, private money lenders, friends and family. Ethiopia has a strong tradition of informal community based financial institutions (Al-Bhagdadi and Bruentrup, 2002) which are known as Iddir and Iqub.

Iddir is an indigenous institution in which members regularly contribute to a common goal with a view to supporting a needy member. WhereasIqub is an arrangement in which members contribute to a common pool on a regular basis and collect the money by ballot among themselves or by some other means. Membership to Iqub is based on pre-established relations among members. It is temporary association for the purpose of raising funds.(Dejene, 1993)

As of 2016, 33 MFIs are registered with AEMFI, serving more than 3.5 million active borrowers with a portfolio of Birr 19.2 billion(AEMFI outreach data for the 3rd quarter, September 2016)(This is the latest possible figure and stands for correction as it is not a published figure as yet). The total savings of these MFIs (including voluntary and compulsory borrowings) amounted to about Birr 13.5 billion. The total assets stood at Birr 27 billion and liabilities at Birr 19.7 billion. The total capital of these MFIs accounted to about Birr 7.2 billion.

The National Bank of Ethiopia (NBE), which is the supervisory authority for the entire financial sector has proposed certain Risk management guidelines for microfinance institutions operating in Ethiopia (Risk management guidelines for micro finance institutions, 2010).As per these guidelines. NBE provides a risk management framework to all licensed microfinance institutions operating in Ethiopia. This framework sets out the minimum risk identification, measurement, monitoring and control system that shall be put in place by microfinance institutions.

As such NBE identifies common risks in microfinance institutions namely, Strategic Risk, Credit Risk, Liquidity risk, Interest Rate Risk and Operational Risk and requires each microfinance institution to prepare a comprehensive Risk management Program (RMP) tailored to its needs and circumstances under which it operates(RMG, 2010). Likewise, Risk management entails four key processes, Risk identification, Risk measurement, Risk control and Risk monitoring.

III. CREDIT RISK MANAGEMENT

A. Meaning of Credit risk

Tony & Bart (2009)state thatCredit risk is the risk that a borrower defaults and does not honor its obligation to service debt.

Nikolaidou&Vogiazas (2014) define credit risk management as the combination of coordinated tasks and activities for controlling and directing risks confronted by an organization through the incorporation of key risk management tactics and processes in relation to the organization's objectives

Generally, the greater the credit risk, the higher the credit premiums to be charged by banks, leading to an improvement in the net interest margin (Hanweck and Ryu, 2004). . However, a broader definition of credit risk also includes the risk of default by other financial institutions, which have payment obligations to MFIs (Bruet,2004).

According toTony & Bart (2009)Credit risk consists of pre-settlement and settlement risk. Pre-settlement risk is the potential loss due to the counterpart's default during the life of the transaction (loan, bond, derivative product One is exposed to settlement risk because the payment or the exchange of cash flows is not made directly to the counterpart, but via one or multiple banks that may also default at the moment of the exchange.

B. Factors effecting credit risk

The study conducted by Alex Addae, (2014) found the causes of loan default to include; high interest rate, inadequate loan sizes, poor appraisal, lack of monitoring ,and improper client selection.

Inadequate financial analysis according to Sheila (2011) is another cause of loan default. This is when in the loans department the officers do not take a careful study of the applicants to ensure that he/she has a sound financial base such that the risk of loss is mitigated in case of default. Sheila (2011)also points out that in Uganda; the issue of inadequate loan support is another cause of loan default.

The study conducted by Nguta, and Guya (2013) in Kenya showed that one of the causes of loan default is the characteristic of the business. It was revealed that high cases of default of loan repayment were common (67.9%) in the manufacturing sector. This was followed by the service industry (64.0%) then by the agriculture (58.3%). The trade sector recorded the least (34.9%) cases of loan repayment defaults.

Faizan& Malik (2015), has taken The credit terms and policy (CTP), client appraisal, collection policy (CP) and credit risk control (CRC) as the dimensions of the credit risk management practices.

According to Jappelliet.al(2008) information sharing is related to improved accessibility of appropriate information and results to reduced costs of acquiring the information thus lowering cost of credit to firm.

Lemieux (2003) observed that due to internet connectivity the size of financial institutions including microfinance institutions do not indicate the level of risk exposure for the financial system. Outsourced processing technology worldwide is often provided by the same service provider who link locations with weak internal controls as well s those with adequate controls occasioning potential risks of resilience of the entire financial system

C. Credit Risk Management of Financial Institution

It is broadly recognized that lack in credit risk administration and management policies by monetary establishments have helped altogether to the financial downturn around the world (Fraser &Simkins, 2010) As fallout to this emergency, orders including credit risk administration are currently being given more imperativeness, particularly in monetary related areas (Horne, 2007) like banks and other financial institutions. Micro finance institutions operate in an environment where customers are without credit histories or necessarily predictable borrowing behaviors(Vincent et al 2014) making it more necessary to deal with credit risk management.

Basel (1999a) guided that effective credit risk management requires establishing an appropriate credit risk environment where board of directors approves credit policy and strategy and senior management implements these; operating under sound credit granting process by establishing well defined credit granting criteria; maintaining an appropriate credit administration of credit portfolio; measurement and monitoring process and ensuring adequate control over the risk

Credit risk management in the banking industry involves the process of identification of risk issues, assessment of risks by using borrowers financials and sophisticated models, monitor the activities of defined risk issues, and implementation of controlling measures by senior management to avoid or reduce the undesirable consequences of risks; and the process is implemented within the operational and the strategic structure of the bank (Basel, 2000; Rechard et *al*., 2008, Tafri et *al*., 2011).

Credit management, or more precisely credit risk management, refers to the systems, procedures and controls, which a company has in place to ensure the efficient collection of customer payments thereby minimizing the risk of non-payment (Mokogi, 2003).

An effective credit risk management (CRM) requires building an appropriate credit risk (CR) environment; working under a healthy credit lending process; maintaining an appropriate credit administration that necessitate the monitoring process and the adequate controls over credit risk (Greuning&Bratanovic, 2003)

Nieman et al (2009) opine that long term sustainable financial performance is attributable to non-financial factors like internal processes, employee satisfaction as well as brand and customer loyalty. This view is shared by Ittner et al (1998) who states that the investment in intangible assets, that is, customer satisfaction, is not accommodated in the accounting data.

The same argument applies to the risk of an institution that is difficult to understand if attention is solely directed at the financial statements. Through the integration of non-financial information, the challenges associated with the manipulation of financial statements are minimized. By following a systematic approach and by taking into account both financial and non-financial information related to the institution, an improved understanding of MFI risks can be achieved **(CGAP, 1999).**

D. Practices of Credit risk management

In a study conducted by Oguntoyinbo M. (2011), titled “Credit risk assessment of the microfinance Industry in Nigeria: An application to Accion Microfinance Bank Limited”, Use of a ‘Daily Collection Board , Collections in Group Meetings, Rotation of Loan Accounts, Periodic Review of Passbooks, and . Disbursements Made from Branch Offices are methods adopted by Microfinance Banks to meliorate risks inherent to their mode of operations. In a study titled ‘factors affecting microfinance institutions credit risk management practices in Kenya’, the researcher Daniel .L.Mwangi studied the credit risk management practices in micro finance institutions in Kenya using market concentration , portfolio quality and market infrastructure as independent variables and credit risk management practices as dependent variables”. This study used descriptive analysis and correlation.

Nagarajan (2011) in his study of credit risk management practices for microfinance institutions in Mozambique found that risk management is a dynamic process that could ideally be developed during normal times and tested at the wake of risk. The study concluded that financial institutions needed to minimize risks related losses through diligent management of portfolio and cash-flow by building robust institutional infrastructure with skilled human resources and inculcating client discipline, through effective coordination of stakeholders.

In study on Credit risk management strategies for Malaysian financial institutions Fun Ho and Yusoff(2009) found that loan diversification, risk mitigation, credit reminder, credit criteria, credit culture and staff training are the most popular strategies.

Matu (2008) carried out a study on sustainability and profitability of microfinance institutions and noted that efficiency and effectiveness were the main challenges facing Kenya on service delivery.

Orua (2009) conducted a study on the relationship between loan applicant appraisal and loan performance of microfinance institutions in Kenya. The study revealed that short-term debt significantly impacted MFI outreach positively. Long term debt however showed positive relationship with outreach but was not significant with regard to default rates. This study is different since the focus is exclusively on short term debts.

Sindani (2012) in her study on effectiveness of credit management system on loan performance based on empirical review established that credit terms formulated by microfinance institutions affected loan performance. The study recommended that both credit officers and customers should be involved in formulating credit terms. Further another study conducted by Armendariz and Morduch (2000) highlighted several important mechanisms that allow MFI to generate high repayment rates from poor borrowers without requiring collateral and without using group lending contracts. These mechanisms include the use of non-refinancing threats, regular repayment schedules, collateral substitutes, and the provision of nonfinancial services.

A study conducted by Sufi Faizan Ahmed and Qaisser Ali Malik titled “" Credit Risk Management and Loan Performance: Empirical Investigation of Micro Finance Banks of Pakistan” Credit Risk Management and Loan Performance: Empirical Investigation of Micro Finance Banks of Pakistan”examined Credit risk management and loan performance with Credit terms, Client appraisal, Collection policy, Credit risk control as independent variables and Loan performance as dependent variable. The results of the analysis showed that the credit terms and client appraisal have positive and significant impact on the Loan Performance, while the Collection Policy and Credit Risk Control have positive but insignificant impact on Loan Performance.

In the study titled “Influence of Credit Risk Management Practices on Loan Performance of Microfinance Institutions in Baringo County” conducted by Kurui Samuel Kiplimo1 &Aquilars M. Kalio,(2012) the researchers investigated the effect of credit risk management practices on loan performance in MFIs in Baringo County. The study employed a descriptive research design based on a survey of MFIs in Baringo County. Descriptive and inferential statistics (Pearson correlation and regression analysis) were used in data analysis. The study concluded that there was a strong relationship between client appraisals and loan performance in MFIs. Thus the study concludes that credit risk management practices significantly influenced loan performance of M FIs. The study recommends adoption of a more stringent policy on credit risk management practices in MFIs so as to improve their financial performance

A study conducted by Sifunjo E. Kisaka1* Robert SilikheSimiyu,(2014) titled “A Survey of Credit Risk Management Techniques Used by Microfinance Institutions in Kenya” established that most microfinance institutions use 6C techniques of credit risk management. The study results also revealed that understanding the organizations exposure to credit is treated as critical by the microfinance institutions. To avoid loan losses, the microfinance institutions used follow ups. The results also show that MFIs take loan review analysis as crucial aspects of risk management by doing proper documentation and analysis. The institutions also use litigation in situations where the borrower’s financial situation and structure have been altered and the original promised value of collateral differ. The study established that a majority of the institutions used Credit Matrix to measure the credit migration and default risk. The results also show that the microfinance institutions are faced with the challenge of strict operational regulations from the Central Bank of Kenya. The government had not put any policy in place to govern the operations of the MFIs. Loan recovery is a major challenge to the majority of the institutions.

In another study titled “Causes and Control of Loan Default/Delinquency in Microfinance Institutions in Ghana” by Alex Addae-Korankye**,** the causes and control of loan delinquency/default in microfinance institutions in Ghana was analyzed. The study found the causes of loan default to include; high interest rate, inadequate loan sizes, poor appraisal, lack of monitoring, and improper client selection. Measures to control default were found to include training before and after disbursement, reasonable interest rate, monitoring of clients, and proper loan appraisal. It was recommended among others that MFIs should have clear and effective credit policies and procedures and must be regularly reviewed. It was concluded that the government and hence Bank of Ghana should regularly monitor and supervise the MFIs so as to ensure safety of clients’ deposits and customers’ confidence.

A study titled “Influence of credit risk management practices on loan delinquency in savings and credit cooperative societies in Kenya”, Justus, Dickson & Harrison Mwangi,(feb, 2016) revealed that there exist a strong relationship between credit risk controls, collection policy and loan delinquency. In this study Multiple linear regression was used to link the relationship between loan delinquency and the independent variables (credit risk control and collectionpolicy). This study used the regression equation LD= $\beta 0 + \beta 1CRP + \beta 2CP + \varepsilon$, Where, LD is the dependent variable (Loan Delinquency), CRP is the independent variable Credit Risk control and CP is the independent variable Collection Policy.

In a study titled 'factors affecting microfinance institutions credit risk management practices in Kenya', the researcher Daniel .L.Mwangi studied the credit risk management practices in micro finance institutions in Kenya using market concentration , portfolio quality and market infrastructure as independent variables and credit risk management practices as dependent variables". This study used descriptive analysis and correlation. Results of this study indicated that portfolio quality and market infrastructure were positively and significantly related with credit risk management of microfinance institutions. It also concluded that low levels of market concentration contributed to poor credit risk management of MFI studied.

Navajas et al.(2003) studied competition in the Bolivian microfinance market by focusing on two major MFIs (Casa Los Andes and BancoSol), which collectively have around 40 percent market share. The results suggest that outcome of competition is ambiguous since competition leads to innovation there by expanding outreach. However, it reduces the ability of lenders to cross-subsidize less profitable smaller loans. In a similar study, Vogelgesang (2003) examines how competition affects loan repayment performance for Caja Los Andes. The analysis indicates competition is related with multiple loan taking and higher levels of borrower indebtedness. The probability of default is also shown to be high with higher levels of indebtedness.

According to a study conducted by Anayo D. Nkamnebe, Ellis I. Idemobi, (2011) titled "Recovering of micro credit in Nigeria: Implications for enterprise development and poverty alleviation", the researchers examined the factors that are responsible for the poor credit recovery among micro-finance institutions (MFIs) that disbursed a United Nations Development Programme's micro credit in Anambra State, Nigeria.A total of 97 MFIs were surveyed out of a total of 129 MFIs in Anambra State in 2007. A ten- item researcher developed questionnaire on a four- point Likert scale was used to measure MFIs' staff assessment of factors that were responsible for poor credit recovery .it was revealed that multidimensional factors contribute to low credit recovering by the MFIs. These factors can be summarized under borrowers' wrong attitude to credit repayment, MFIs' staff weak skill and corrupt tendency, and poor infrastructural provision by the government. Arguably, these factors have direct effect in encumbering genuine effort at alleviating poverty in Nigeria through the instrumentality of micro credit and calls for a change in strategy especially on the part of the MFIs in reducing the incidence of low credit recovery.

E. Credit Risk Management In Microfinance Institutions In Ethiopia

Ethiopia is a fast developing country in the horn of Africa. The available literature on micro finance institutions is mostlycenteredaround outreach, sustainability and profitability. There is limited literature on risk management, especially credit risk management, most of it being unpublished masters thesis. An attempt is made to document available literature on credit risk management practices of micro finance institutions in the following section.

TinishuMeshesha(2014) in a study titled 'Microfinance Credit Rationing and Loan Repayment Performance:A Case of Omo Microfinance Konso Sub Branch' compared before and after performance of credit schemes and found that credit schemes have positive impact in improving the income, education,health and nutritional status of the borrowers. This is an unpublished masters thesis

Aminaet.al(2015)in their study oncredit risk management of MFIs in ethiopia used the Morgan Stanley approach (adopted from Ayayi, (2012) with some modification). There are seven rating factors which were used to rate the microfinance institutions in accordance to their credit risk management level. -Loan portfolio, Profitability, sustainability, operating efficiency, Asset and liability management, Management and strategy,. Systems and reporting, Internal and operational controls and Growth potential. Accordingly the overall credit risk management of these MFIs is ranked as follows ACSI (1st), DECSI (2nd), Wasasa (3rd), PEACE, OCSSCO,and BUSSA (4th), ADCSI (5th), SFPI(6th),OMO(7th),and Wisdom (8th). This study used mostly secondary data.

Another study conducted by Pasha and Negese(2014), on Performance of Loan Repayment Determinants in Ethiopian Micro Finance, by taking Sidama Micro Finance Institution as a case study and using Binary logistic model found that age of respondents, education level, time lag between loan application and disbursement, complicated loan processing procedures, Repayment period, and Loan diversion are essential and significant determinant of loan repayment rate.

In a study conducted by Goshim, 2011, on "performance of micro finance institutions in credit risk management: the case of five micro finance institutions in Addis Ababa". By using mixed approach he found that the failure to effectively manage credit risk contributed to a greater extent to the micro finance institutions crisis

Wale (2009) conducted a study on performance of microfinance institutions in Ethiopia and found that they have poor GLP to assets ratio, allocating a lower proportion of their total assets in to loans. They also are not using their debt capacity properly. The large and small MFIs are allocating more loan loss provision expense than the industry average and the related PAR is high for these MFIs. All these indicate distorted credit risk management practices.

In another study by Abafita (2003) microfinance and loan repayment performance was discussed in relation to a single MFI , Oromia Credit and Savings Share Company (OCSSCO) as a case study. He found that the overall repayment performance of the borrowers and the screening technique is sound and the credit scheme has contributed positively in terms of improving the incomes, access to education, access to health facilities and nutritional status of the borrowers.

IV. CONCLUSION

Micro finance provides financial help to those persons in the society who are unable to get assistance from bank. Most of these loans are small in size and distributed to poor people in order for them to generate income and start their own businesses. It has the ability to lessen poverty as well as promote entrepreneurship, social and economic development in poor communities, However at the same time microfinance portfolios are exposed to various kinds of risks due to their inherent characteristic especially credit risk. The Ethiopian Microfinance sector is one of the fastest growing financial institutions in the world today. The study concludes that available literature on credit risk management practices of Microfinance institutions in Ethiopia is mostly contributed by unpublished masters thesis with very few in-depth studies being done. Thus there is a huge potential for further empirical research in the area of practices of credit risk management of MFIs.

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