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Credit Risk Management and Loan Performance of Microfinance Banks in Nigeria

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Abstract

The concept of micro-finance in Nigeriahas evolved over the years following other well developed like Kenya in the sub-Saharan Africa. Given the importance of credit risk in microfinance operations, it is expected that the effectiveness of microfinance risk management systems, processes, procedures,activities, methods,and incentives would have a significant influence on loan performance. As a result, the purpose of this research was to examine the link between credit risk management and loan performance in Nigerian microfinance banks (MFBs), using Lagos and Ogun State as case studies. A descriptive research design was used. The target population comprised Two Hundred and Thirty Microfinance Banks and a sample size of Three Hundred and Twelve (330) respondents obtained by purposive sampling.Through the use of questionnaires, data was gathered and analyzed using SPSS, which provides both descriptive and inferential statistics. The study found a favourable and statistically significant correlation between loan performance and the internal controls over credit risk, the credit administration, measurement, and monitoring systems, and the credit risk environment of the microfinance banks.It is imperative for the boards of the Microfinance banks oversee institutions where credit policies and procedures are developed and put in place with effective monitoring mechanism and virile system of internal control, reporting and continuous process reengineering in tune with dynamic business environment.

Keywords: credit risk management, environment, process reengineering, microfinance banks, loan performance, internal control

INTRODUCTION

Some of the world's most financially underprivileged and informal sector businesses would normally be denied access to banking services due to the severe criteria that commercial banks apply when providing credit facilities to their clients. In a developing country like Nigeria, where small and medium-sized firms contribute significantly to GDP and employment creation. Microfinance institutions play an important role in the economic development process by providing lending facilities to assist both capital projects and the short-term liquidity needs of unbanked business units.

Credit risk management include identifying, evaluating, monitoring, and controlling risks linked with the probability of loan repayment failure (Coyle, 2000).

According to Olawale L. Samuel's (2014) study on how credit risk influences commercial bank performance in Nigeria, there is a substantial relationship between bank performance (measured in terms of profitability) and credit risk management (in terms of loan performance). Loans, advances, and non-performing loans are all important aspects in determining a bank's asset quality. According to the study's suggestions, management should take prudence while developing a credit policy to prevent negatively impacting profitability. They should also be knowledgeable of how credit policy influences bank operations in order to guarantee responsible deposit management and profit maximization.

Description of the Issue

Microfinance has been practiced in Nigeria from the beginning of time, mostly via unauthorized microfinance initiatives. However, no codified government regulations or supervision mechanisms for the sector's functioning have ever existed. According to the Central Bank of Nigeria (2004), the creation of microfinance firms was prompted by the inability of government financial institutions to offer financial services to both urban and rural underprivileged people. Microfinance groups may help low-income people in both urban and rural regions get loans. These organizations are classified as informal or official. Examples include self-help groups, savings organizations, cooperative societies, and other informal microfinance institutions. They often have a limited reach because to a shortage of loanable cash. Official microfinance organizations are banks (Nwanyanwu Onyinyechi 2011). Credit rules and procedures are developed to govern credit and ensure ethical lending practices.

Numerous studies on credit risk management and loan performance have been undertaken both in the United States and throughout the world. Kisala (2014) observed a significant association between credit risk management and loan performance in MFIs in Nairobi, Kenya, as part of his study. Furthermore, Kipkemboi (2013) discovered a correlation between MFIs' financial performance and their approach to credit risk management. Credit risk management and the financial performance of MFBs are substantially associated, according to Otieno and Nyagol (2016). (Murigi D. M. et al 2018)

These studies, however, do not include credit risk management or loan performance when analyzing these banks.

Overarching Research Objective

The major purpose of this research was to investigate the relationship between credit risk management and loan performance in Nigerian microfinance banks.

Specific Research Objectives

i. Determine the relationship between the loan performance of Nigerian microfinance banks and the credit risk environment.

ii. To ascertain the relationship between the loan performance of Microfinance Banks of Nigeria and the credit evaluation system.

iii. Determine the relationship between Microfinance Bank loan performance in Nigeria and credit administration, measurement, and monitoring.

iv. Determine the relationship between Microfinance Banks of Nigeria's internal credit risk controls and loan performance.

Research Issues

i. What is the relationship between the loan performance of Nigeria's microfinance banks and the credit risk environment?

What is the relationship between the credit assessment technique used by Nigerian microfinance banks and loan performance?

iii. What is the relationship between the loan performance of Nigeria's microfinance banks and credit administration, measurement, and monitoring?

iv. How do the internal credit risk controls of Nigerian microfinance banks relate to their lending performance?

SUMMARY OF THEORY

Theoretical Foundations of Credit Risk Management

Credit Risk Management

Risk management has become a critical function inside banks as a consequence of the diverse range of market and non-market threats to which contemporary banking organizations are exposed. Banks have invested in risk management due to the clear economic logic that their shareholders and creditors demand.

What exactly is credit risk?

The exposure to the prospect of danger or loss is referred to as risk. Risk is the element of uncertainty or the possibility for loss that occurs in every economic transaction. Credit risk refers to the possibility that a counterparty or borrower won't be able to fulfill their commitment in line with the terms and circumstances stated.

The likelihood of financial loss as a result of a borrower's failure to repay a loan is referred to as credit risk. The possibility that a bank debtor or counterparty may fail to satisfy its obligations in line with the conditions agreed upon is refer to as a credit risk is defined (Basel Committee on Banking Supervision, 2000).A Business Cycle Theory of Credit Risk Assessment and Pricing, The peaks and valleys

This is a theory of how risk is assessed and priced throughout the business cycle, similar to Piketty's (1995) "left-wing" and "right-wing" dynasty theory, by establishing a logical model in which it is unclear whether results are due to chance or the risk-management skills of banks. Regardless of the mystery surrounding what is generating the outcomes, during times of continuous banking profitability, all agents reasonably boost their judgments of bankers' competence levels. As a consequence, no one is concerned about bank risk, credit spreads shrink, and banks invest in riskier assets. If future unexpectedly high default rates are seen, a perspective may endogenously alter to put more weight on outcomes impacted by chance. This causes credit spreads to expand, which may be enough to spark a catastrophe. The regulatory implications of the study are discovered.

Theory of Asymptotic Information

Agency theory is the study of agency relationships and the challenges that arise from them, most notably the paradox that the principle and agent may not necessarily share the same interests, despite the fact that they are nominally working toward the same goal. Examples include lender and borrower roles, constituents and elected politicians, and shareholders and CEOs (CEO).

Because internal control is one of many strategies used in business to manage the agency problem by reducing agency costs, which have an influence on both the overall performance of the relationship and the benefits of the principal, the agency theory is relevant to this topic (Payne, 2003).

ANALYTICAL REVIEW

Credit Risk Setting

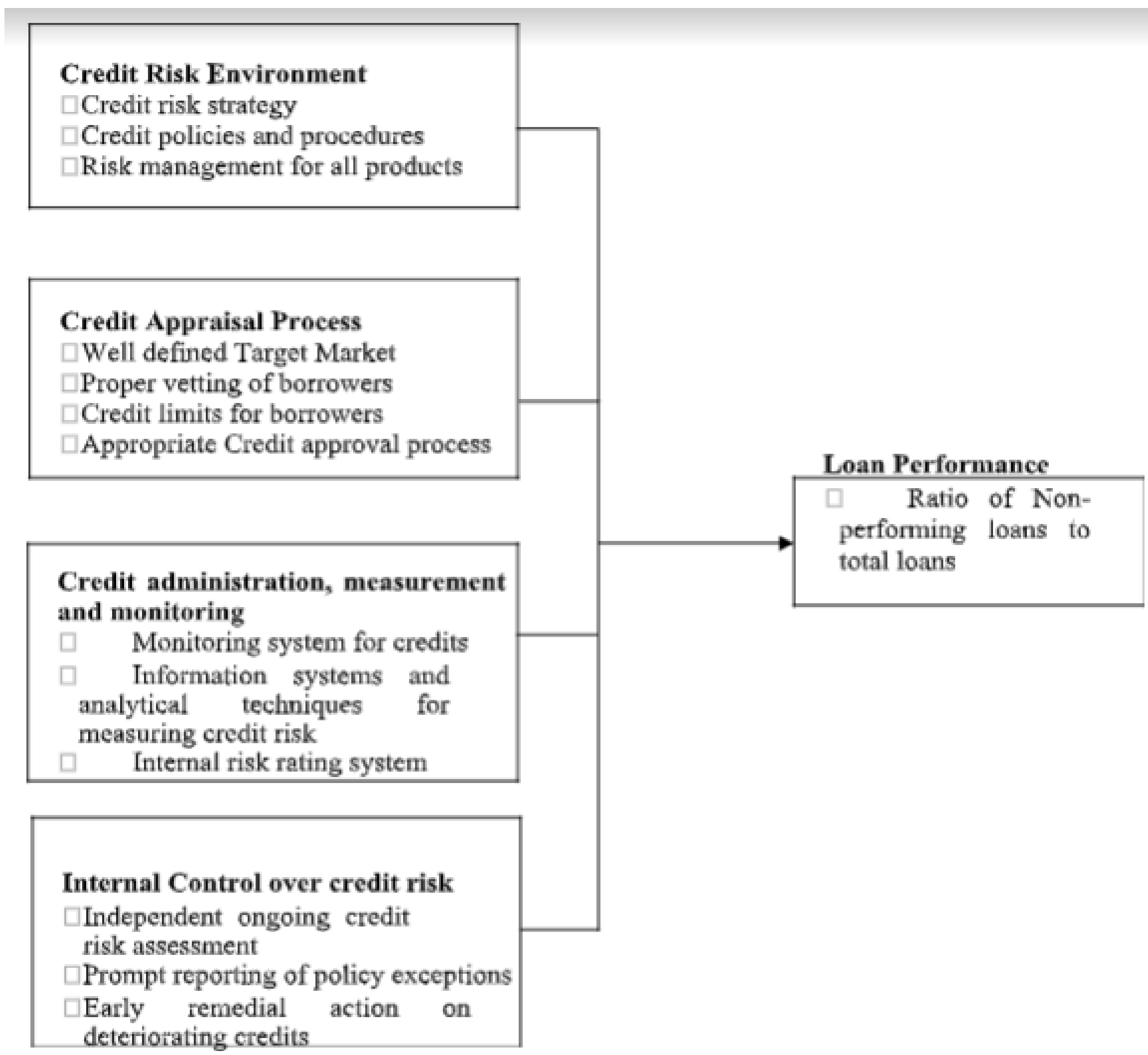
Zia Ur Rehman and colleagues performed study to assess the credit risk management techniques employed by Balochistan commercial banks in Pakistan. Commercial banks must be aware of the effectiveness of various risk management methods in order to apply them to minimizing credit risk, which is why the study's findings are important. The explanatory study investigates staff employees' perceptions on the best techniques for minimizing credit risk at various commercial banks. The study's results indicate that four elements impact credit risk management (CRM): corporate governance, diversification, hedging, and the bank's capital adequacy ratio. CRM is primarily influenced by corporate governance. This study highlights four risk management approaches that are critical for commercial banks to handle credit risk.

Addae-Korankye (2014) investigated the causes and prevention of loan default and delinquency in Ghanaian microfinance firms. Loan defaults, according to the research, may be caused by expensive interest rates, inadequate loan amounts, poor evaluations, a lack of monitoring, and poor client selection. Training before and after disbursement, an appropriate interest rate, customer monitoring, and competent loan evaluation have all been shown to decrease default. MFIs, among other things, should have clear and efficient credit criteria and procedures that are periodically examined. To ensure the security of customers' savings and their confidence, it was decided that the government, and hence the Bank of Ghana, should frequently supervise and control MFIs.

Internal credit risk management controls

Negera (2012) investigated the variables that influence non-performing loans. A mixed-methods approach was adopted for the investigation. A self-administered questionnaire was used to conduct a study of professionals holding different positions in both private and state-owned banks in Ethiopia. As part of the investigation, in-depth interviews with senior bank executives in Ethiopia's banking industry were undertaken, as well as a thorough review of bank records and paperwork. According to the study's findings, factors that contribute to loan default include ineffective loan monitoring, weak institutional capacity, a lack of credit culture, aggressive lending, compromised integrity, lax credit terms and conditions, unfair competition among banks, fund diversion for unintended purposes, willful default by borrowers and their knowledge limitations, and over/under financing by banks.

Imaginative Model
The independent variables in the conceptual model include the credit risk environment, the credit assessment process, credit administration, measurement and monitoring, and internal credit risk management. The dependent variable, on the other hand, is loan performance.
Figure 1: Conceptual Model



Source : Murigi and Thuo 2018: Credit risk management and loan performance in microfinance banks in kenya

RESEARCH METHODOLOGY

Research Design

The study adopted a cross-sectional research design which is a type of observational study design. This simultaneously measures the study participants' exposures and outcomes.

Target Population

The population of study consists of staff of the 230 Microfinance Banks operating in Lagos and Ogun State of Nigeria from list of Microfinance Banks released by Central Bank of Nigeria in October 2020. The total staff strength was estimated at an average of 10 staff per bank

Sampling Technique and Sample Size

A purposive sample frame of 400 participants from the employees of microfinance banks was selected. While each member had a chance to be chosen, the sample size of 330 was obtained using the checkmarket sample size calculator.This number was deemed representative enough to allow generalization based on demographic characteristics and was thus used to gauge credit risk management and loan performance of microfinance banks in Lagos and Ogun states of Nigeria.

Data Collection Instruments/Procedure

Questionnaires were employed as the major research instruments in this study administered on the target respondents who are members of the sampled population. The study administered the questionnaire to the entire sample online complimented by a few telephone interviews for further clarity. The study exercised care and control to ensure that all questionnaires were received by the respondents and online feedback received by auto generated delivery mechanism..

Measurement of Variables

The main research instrument for this study was primary data. This was done using a questionnaire to extract information from the respondents because they feel at ease and relaxed when using this instrument.
Credit Risk Management (Independent Variable) and Loan Performance are the variables (Dependent Variable). The questionnaire was constructed with a five-response Likert-scale option and administered to 338 professionals, with data analyzed using descriptive statistics and a One-Sample T-Test using IBM's SPSS (Version 22).

Method of data analysis

Simple percentage and frequency tables were used to analyse the distribution of responses. A summary of responses from the questionnaire was designed in the five-response option of Likert-scale and administered from 330 professionals, and data are analysed through descriptive statistics and One Sample T-Test using IBM's SPSS Statistics 22. Alpha level of 5% was set at a degree of freedom of (n-1). The formula for One sample T-Test is stated as

$$t = \frac{\bar{x} - \mu}{\frac{s}{\sqrt{n}}}$$

Where,

t = calculated value of t

s = standard deviation whose formular is

$$s = \sqrt{\frac{\Sigma X^2 - \frac{(\Sigma X)^2}{N}}{N - 1}}$$

$\bar{X}$ = sample mean whose formular is

$$\frac{\Sigma X}{N}$$

μ = population mean which is unknown.

The One Sample T-Test were computed around this expected mean and the result compared with p-value at alpha level of 5% and degree of freedom. The use of One Sample T-Test is justified in this case because the population standard deviation is unknown. A z-test in this instance will need to use the sample standard deviation to estimate population standard deviation. This will result in a little loss of accuracy when compared with the T-Test. However, since the sample size is large (n>30) the two test statistics will in this instance give the same result.

SUMMARY OF FINDINGS

According to the study, Microfinance Banks have a Board of Directors that is entrusted with developing credit risk strategies as part of the bank's policy-based governance system. Senior management implements this method by adopting rules and processes for recognizing, assessing, monitoring, and controlling credit risk. In summary, a critical credit risk environment with a favorable influence on the loan performance of Microfinance banks in Nigeria is senior management in the bank properly following the credit risk strategy agreed upon by the board of directors.

Furthermore, research revealed that banks created overall credit restrictions, acting as a motivator for strong, well-defined credit appraisal standards. Microfinance banks also have a system for monitoring the condition of individual credits, as well as a rating system that is appropriate for the type, size, and complexity of the bank's activities.

In addition, the banks have an independent internal control mechanism in place to undertake continuing assessments of the bank's credit risk management process to ensure that credit exposures remain within prudential norms and internal limits.

Conclusion

According to the study's findings, the internal controls over credit risk, the credit appraisal process, the credit administration, measurement, and monitoring, as well as the credit risk environment, all have a substantial impact on loan performance. According to the inferential statistics analysis of the research data, all of the study factors positively influenced loan performance of Nigerian microfinance banks. As a result, they are very significant in understanding the loan performance of Nigerian microfinance institutions. The main restriction of the research was the expense, particularly the requirement to contact the sample population, for which technology became a rallying point, as well as the time available for the investigation.

RECOMMENDATIONS

i. Bank executives should create policies and processes for recognizing, assessing, monitoring, and managing credit risk.

ii. In particular, the following practical procedures are advised for Microfinance banks that, if fully implemented, might lower the default rate, particularly when employing group lending technique.

iii. The Bank official should physically visit the group members, either at their shops or at their homes, to ensure that the group is real and that all members are serious business people, not simply members by name.

iv. MFBs should define general credit limitations for individual borrowers as well as counterparties, since this is crucial in credit evaluation.

v. The loan officer should convey to the group that they are jointly liable for each other's loans and reaffirm their willingness to guarantee each other.

vi. The loan officer should guarantee that each borrower receives the full amount of the loan and that other members of the group do not utilize their part of the loan.

vii. During the pre-disbursement training phase, clients should be required to save a certain amount in their bank account each week. This will assist the loan officer in determining if the customer is in business and predicting his capacity to repay the loan.

viii. To minimize diversion and impending default, the loan officer should visit the borrower's company following disbursement and check that the funds was utilized as stipulated.

ix. Clients who borrowed as part of a group must continue to meet even after the loan has been issued. In reality, each member should pay his or her loan payment to the Loan officer at the meeting, in the presence of all members.

x. Loan Officers should have solid relationships with local chiefs and opinion leaders in areas where the bank loans to customers since local chiefs have a good impact in the community and will assist to recover the money quickly.

xi. No new loan shall be provided to any member of the group if one or more of the group's prior loans have not been completely paid.

xii. Loan officers should not dismiss any early warning indications, such as the borrower being unavailable at his place of business/residence, installments not arriving, and so on.

xiii. Loan officers should not be authorized to keep borrowers' passbooks in order to prevent using or altering them.

xiv. Loan officers should avoid accepting cash or in-kind gifts from customers. Banks that enable this always have payback issues since it leads in collecting a kickback from clients after loans are made.
xv. Clients, not loan officers, should choose group members. This is to prevent bank officials forcing consumers to borrow on the group's behalf.

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