Risk Management in Microfinance Banks
April, 2011

Question 1

Write short notes on any five of the following:
1. Risk Event
2. Social Collateral
3. i. Default Rate
4. ii. Delinquency Rate
5. Response to fraud
6. Single Obligor in MFBs
7. ALCO
8. Liquidity Ratio

Answer

a) **Risk Event** can be defined as “the undesirable outcome”. A desired outcome not happening can also be a risk event. Examples of risk events include the following;
   i. Loans falling delinquent;
   ii. Capital becoming inadequate to run operations;
   iii. Investors/Funders withdrawing their funding requirements;
   iv. Not having liquid funds to meet maturing obligations;
   v. Fraud and forgeries.

b) **Social Collateral**: This is a guarantee or commitment of a group to be held accountable for the default of the loans granted to its members. Such groups include co-operative societies, trade associations and other multipurpose groups. The following are the elements of social collateral:- i) Group Guarantee; ii) Peer Pressure.

c) i. **Default Rate**: This rate measures the amount declared as non-receivable in any given period of time. It shows the part of a loan portfolio that cannot generate income any longer. It is considered as the part of assets lost and likely to be written off. It also reveals the past performance of the loan portfolio of an MFB.

   ii. **Delinquency Rate**: This is the measure of the rate at which the loans or portfolio of a lending institution becomes past due. It measures or reveals the health of a lender’s most important asset. It is also a measure of the risk of loans not being paid as and when due. The longer the date of the past due, the higher the risk of being lost.

d) **Response to Fraud**: This is a damage control measure adopted by an MFB whenever a fraud is identified. It is also part of a contingency plan which includes the following elements:
   i. The process for termination, review of the policy, legal proceedings and efforts to recoup losses;
   ii. The process of approaching/communicating with clients affected or impacted negatively;
   iii. How to protect the brand image;
   iv. How to develop public relations and rebuild trust;
   v. What changes in the internal control policies need to be made to prevent future occurrence.

e) **Single Obligor Limit in MFBs**: In line with regulatory and supervisory guidelines for MFBs in Nigeria, Section 9.2 (g), defines single obligor limit as “the maximum loan by an MFB to any individual borrower or director; related borrowers shall not exceed one per cent (1%) while a group borrower is restricted to a “maximum of 5% of the MFB shareholder’s funds unimpaired by losses or as may be prescribed by the CBN from time to time. Any contravention will attract a penalty of =N=1m on the MFB and a fine of =N=100,000.00 on the director/manager who fails to comply.

f) **ALCO**: This means Asset and Liability Management Committee. The following are its functions:
   - Sets policies and guidelines in relation to;
     i. Risk identification,
ii. Risk assessment/measurement,
iii. Monitoring and management.
- Periodically reviews risks faced by the bank;
- Establishes risk tolerance limits for the bank.

Its membership cuts across key departments and units like Operations, Credits, Treasury and Risk Management.

ii. **Liquidity Ratio:** This is a measure of the sufficiency of cash resources to pay/meet the short-term obligations to depositors, borrowers and other creditors. It is represented thus:

\[
\text{Liquidity Ratio} = \frac{\text{Cash} + \text{Trade Investments}}{(\text{Demand Deposits} + \text{Short-Term Deposits} + \text{Interest Payable on Funding Liabilities} + \text{Accounts Payable} + \text{Other Liabilities})}
\]

All MFBs are required to maintain a minimum rate of 20% of their Deposit Liabilities, including 5% compulsory investment in Treasury Bills as part of their liquid assets.

**Comments**

This is a standard and straightforward question calling for a sound knowledge of the “Study Manual” and CBN issued Regulatory and Supervisory Guidelines for MFBs in Nigeria. Any five out of seven were required. It was well attempted by students with over 85% of them passing it. Questions 1 (d), (f) and (g) were not properly attempted due perhaps to poor preparation by students.

**Question 2**

Poor risk management framework was identified by CBN Examiners as the reason for the recent regulatory sanctions on 224 MFBs in Nigeria. Major issues were large non-performing loans or portfolio at risk. Identify the risk practices that were most ignored by these MFBs that led to their failure.

**Answer**

With so many MFBs licensed by the CBN in 2007/2008, the market was saturated with competition. Each MFB was striving to have a foothold in the marketplace. This intense competition for market share and profitability made many operators to overlook or ignore a number of risk management practices which may include;

a) **Poor Credit Appraisal** – With field officers’ rush to book credits, insufficient customer data were obtained, thereby leading to wrong appraisal recommendations and therefore poor credit decisions.

b) **Inadequate Customer Screening** – Due to inadequate customer information on clients’ businesses as well as no visits to their residences, credits were inadvertently advanced to ghost customers and those without good business/credit reputations.

c) **Poor KYC Compliance** – Having failed in due diligence at the account opening stage, the banks opened themselves to fraudulent loan disbursements as monitoring and recovery became a problem from the loan disbursement.

d) **Poor Quality/Quantity of Manpower** – Due to the evolving nature of microfinance operation in Nigeria, knowledgeable, skilled and experienced staff were sparsely distributed, thereby leaving loan decisions in the hands of inexperienced staff. This deficiency led to wrong credit decisions and poor recovery actions leading to high volume of portfolio at risk.

e) **Poor Customer Relationship** – Loan/field officers were not properly trained and were not able to build cordial relationship with customers. As such, they did not understand the customers’ businesses, thereby making follow-up and recovery difficult as some clients could not be traced. Such loans invariably fell into bad debts.

f) **Poor Loan Monitoring** – After disbursement of loans, most loan officers went to bed or continued to pursue new accounts. Loans became delinquent due to lack of close monitoring and follow-up to collect due instalments and compulsory/voluntary savings.
g) *Incomplete Loan Documentation* – Proper loan documents were not executed by clients prior to disbursements, security pledged were not site-visited and/or not obtained at all.

h) *Insider-Related Loans* – Some managers and directors extended loans to themselves without adequate collaterals and they failed to pay back as and when due.

i) *Non-Compliance with Single Obligor Limits* – Some of the MFBs were found to have lent beyond the authorised 1% or 5% of their shareholders’ funds to individual customers and groups respectively.

The foregoing and others were responsible for the large volume of non-performing loans that led to the recent sanction by the CBN.

(Any five valid points for 20 marks)

**Comment**

A practical current issue and relevant question. About 59% of the students attempted it while 41% avoided the question. The regulatory action of the CBN on these MFBs was still fresh at the time of the examination with the topic hot in the media; one expected a 100% attempt by students. Of those that attempted it, 68% recorded a pass while 32% failed. It is important for candidates to note that this is a professional certification meant for daily application on the job; therefore, theories must be practicalised on the field.

**Question 3**

You are required to define risk management in the context of a microfinance institution. List at least five types of risks you can remember.

**Answer**

Risk Management in the context of microfinance bank/institution can be defined as:-

a) The process of controlling the likelihood and the potential severity of an adverse event; it has to do with systematically identifying, measuring, limiting and monitoring risks faced by the bank.

b) Types of Risks:
   i. Credit risk;
   ii. Liquidity risk;
   iii. Operational risks;
   iv. Market risks;
   v. Fraud/Integrity risk;
   vi. Legal and Compliance risk;
   vii. Reputation/Institutional risk;
   viii. Governance risk (Any five types)

**Comments**

This is a simple and straightforward question. About 96% of the students attempted this question. Performance was also high, recording about 88% pass rate while only 12% failed it. It certainly cannot be simpler than this. Expectation would tilt in the direction of how these risks impact the industry.

**Question 4**

a) What is Operational Risk?

b) Outline at least four strategies to minimise these risks.

**Answer**

a) Operational risks arise from the possibility of human or system-related errors during the delivery of products and services. It is the potential that inadequate information systems, operational problems, insufficient human resources, inadequate staff skills, or breaches of integrity (fraud) will result in unexpected financial losses.

Managing these risks require a combination of an effective internal control system, appropriate information technology platform, employee integrity and streamlined operating processes and procedures.
The most obvious source of operational risks lies in the customer/loan officer interactions where financial transactions take place (transaction risks). When a traditional bank transacts, the staff carrying it out are usually trained professionals and there are multiple levels of cross-checking put in place. Since loan officers in MFBs usually handle numerous short-term loans, this same degree of cross-checking is not cost-effective; this therefore increases opportunities for both errors and frauds (fraud risk).

(8 marks)

b) To minimise operational risks which manifest in the form of transaction and fraud risks, the following strategies can be adopted;

1) **Use of a Daily Collection Board:** The monies due to be collected on any given day/week (both loan instalments and savings collections) are posted against the names of each loan officer on a large board placed in the cash centre, meeting point or branch. This enhances transparency, sets daily collection targets for the loan officers and helps prevent the scope for misappropriation.

2) **Collections in Group Meetings:** All savings and loan instalments are collected in group meetings in full view of all group members present. This ensures that the clients will witness all financial transactions and helps prevent misappropriation as well as increase clients’ confidence in the organisation.

3) **Rotation of Loan Accounts:** Every six months, the client’s accounts managed by one loan officer are transferred to another within the same branch. This ensures transparency and accuracy in record keeping, performs an ad hoc six-monthly audit and helps in dictating fraud or errors.

4) **Periodic Review of Passbooks:** All clients’ passbooks must be checked at least once every quarter by the respective Branch Heads/Managers to ensure that transaction details noted in clients’ passbooks agree with the Bank’s records or system. This allows for early identification of fraudulent or erroneous transactions. Random checks can also be carried out by Head Office audit staff and field managers when they visit clients.

5) **Disbursements are made from Head/Branch Offices:** Loans should be disbursed in the Branch or Head Office in the presence of all loan officers, branch manager/head of credit and marketing; and all of them signing the loan application form indicating that they have verified disbursement of the sum approved on the application form. This helps to avoid misappropriation by ensuring that the entire loan amount is handed over to the client and not part of it.

6) **Peer-Group Cross-Checking:** Peer-based cross-checking should be instituted and made a continuous process within the Bank. Loan officers cross-check each other’s books weekly and branch managers cross-audit each other’s branches on monthly basis. This would help in timely identification of irregularities in the Head Office/Branches.

7) **Cash Book Duty Rotated:** For cost-effectiveness, no employee should be dedicated as accountant or cashier. This duty should be rotated on a regular basis to ensure that no single person keeps custody of the cash book for a long period of time: It helps identify errors or frauds while building versatile manpower.

8) **Internal and External Audit Reports:** Internal Audit Unit should carry out snap checks, spot checks and full audits, and issue reports recommending corrective actions/policy changes while external audit carries out
annually the statutory audit for Board of Directors’
review and actions, thereby forestalling frauds or errors.
(Any correct four strategies earn 12 marks)

Comments

A straightforward, practical and relevant core risk management
question. About 72% of the students attempted this question and
84% of them passed it thus recording a very good performance.
Only 16% of the candidates failed it. Majority understood the
question and gave their best. They should, however, broaden their
knowledge for better performance in future.

Question 5

What role does effective internal control systems play in managing
operational risks in MFBs?

Answer

Effective internal control systems are the whole system of controls,
financial and otherwise, established by management/board of
directors in order to carry on the business of the enterprise in an
orderly and efficient manner, ensure adherence to management
policies, safeguard the assets and secure as much as possible the
completeness and accuracy of the records. (5 marks)

From the foregoing, the systems play the role of identifying,
analysing and recommending corrective actions for operational
risks and this role include:

i. Detection of errors, frauds and irregularities;
ii. Prevention of errors, frauds and irregularities;
iii. Instituting and enforcing corrective actions/measures to
    address identified errors or frauds;
iv. Safeguarding the assets of the bank from all risk factors;
v. Ensuring that operational, statutory and regulatory
    requirements are complied with;
vi. Ensuring adherence to established management policies and
    procedures;

vii. Ensuring that the Internal Control Guidelines of the Bank
    respond proactively to the changing operating environment;
viii. Ensuring, as much as possible, the viability of the business
    while taking advantage of business opportunities to increase
    profitability. (15 marks for any five points)

Comments

A standard and relevant question for this subject. About 55% of the
students attempted it while 45% avoided it. It is a question at the
core of risk management and was expected to attract a higher percentage
of students attempting it. This poor figure might be attributable to inadequate
preparation and vague knowledge of practical issues in the Industry. About 58% of those that attempted
it recorded a pass while 42% failed.

Question 6

It has been observed that most MFBs are reeling under the burden
of huge non-performing loans and managements are at their wits’
end as to how to tackle the problems associated with debt recovery.

a) What are the causes of bad debts?
b) What strategies can be adopted for debt recovery?

Answer

a) Causes of bad debts in MFBs include:-

i. Lack of Sound Lending Policy: MFBs may start to incur
   bad debts as a result of inadequate planning from
   inception. Failure on the part of the board of directors to
   establish a sound lending/credit policy as well as
   good credit manual to give clear direction to the credit
   function may lead to the booking of bad credits which
   ultimately become bad debts.

ii. Lack of Experienced and Trained Manpower: Use of
    inexperienced/untrained personnel in the credit granting
    process leads to wrong credit decisions which would
    result in bad debts ultimately.
iii. **Complacency/Weak Monitoring:** Most MFBs hardly pay attention to the quality of their credit records and credits monitoring once loans are disbursed. Consequently, loan officers allow arrears to accumulate, thereby making credit facilities that would ordinarily have been a good asset to become sticky. Weak or no monitoring at all is a major cause of bad debts.

iv. **Insider Abuses:** Substantial parts of the non-performing loans in the books of most MFBs are director/shareholder-related. Most non-performing insider-related loans are characterised by poor appraisal, weak monitoring and bad collateral. At times, some were granted clean, thereby making recovery difficult and therefore becoming bad debts.

v. **Wrong Market Niche:** Most MFBs were unable to determine their market niche. Majority of them abandoned the active poor/SMEs and got busy operating/lending like commercial banks. As a result, most MFBs have sticky loans in their books granted to individuals in large amounts which are proving difficult to recover.

vi. **Anxiety for Income and Growth:** Concern for earnings and growth of the balance sheet is another factor that pushes operators to book credits which later turn bad. Competition among MFBs for size/core business area and community influence may have resulted in the compromise of credit principles and consequently the creation of bad loans.

vii. **Failure to Adopt Group Lending Methodology:** Failure of MFBs to adopt group lending methodology is a major factor contributing to the large volume of bad loans. Group lending is one of the keys to less defaults in credit. It has been observed that the importance of group lending methodology is a function of three factors: namely, screening out bad credit risks based on joint liability, reduction of administrative cost for MFBs and peer pressure influence.

viii. **Prevailing Economic and Financial Crises:** The economy has been facing serious crises and financial system meltdown that has affected many active poor, SMEs and individual borrowers due to business failures, thereby making recovery difficult and increasing bad debt provisioning and write-offs.

(Any correct five for 10 marks)

b) Strategies that can be adopted for debt recovery include the following:

i. **Rebuild Customer Relationship:** Field/Loan officers must reach out to clients with a view to reviving their interest in running their accounts as well as starting to pay back their outstanding loans. These visits should identify the challenges hindering repayments and solutions proffered while encouraging clients to pay up missed instalments. Re-establish daily and weekly visits for collection of due instalments and savings.

ii. **Visit to Solidarity Groups:** Visit their leaders - chairmen and secretaries at their business and home addresses to solicit their support, peer pressure and cooperation in your recovery drive.

iii. **Enlist the Support of Guarantors/Business Associates:** Visit/call upon their guarantors, business associates and family members to impress it upon the debtor to pay up.

iv. **Introduce Some Incentives for Early Repayments:** Introduce new incentives as well as rehearse existing incentives for early repayments and compliance with existing terms.

v. **Implement Existing Penalties for Defaults:** Review the offer letters and ensure that agreed penalties for default are applied as pressure for repayment as at when due.

vi. **Restructure Loan/Facility:** Loan repayment schedule can be restructured for longer tenor to allow for more flexible/convenient repayment terms in agreement with client’s present realities. An overdraft can be restructured to a term loan repayable over an agreed number of months/weeks, etc.
vii. **Reschedule Repayment:** New repayment schedule can be agreed to accommodate recent changes in the business operation or cash flow realities, as the case may be.

viii. **Agree/Offer Waivers/Concessions:** Waivers and concessions can be agreed with clients to extract repayment of principal and part of the accrued interest and charges instead of losing out completely.

ix. **Appoint External Recovery Agents:** Some part of the bad debts can be outsourced to external recovery agents to pursue and recover on behalf of the Bank at an agreed commission rate.

tax. **Involvement of Law Enforcement Agents:** The NPF and EFCC can be engaged to assist the Bank’s recovery efforts, especially the recalcitrant ones.

xi. **Realisation of Security Pledged:** This is a last resort where all efforts to recover fail.

(Any correct five points for 10 Marks)

**Comments**

A mix of theory and practice question. It was well attempted by 89% of the candidates. Performance was good with 77% recording a pass while 23% failed. As credit portfolio of any MFB is the most important earning asset as well as the most risk-exposed, students are advised to pay particular attention to all that pertains to it.

**Question 7**

Double/Multiple borrowing is a risk that can lead to default in repayment. How can this risk be mitigated?

**Answer**

The problem of double/multiple borrowing by clients of MFBs is a risk that industry players must put in check to avoid/reduce default in loan repayments. This risk can be mitigated by adopting the following steps before and during account opening process/credit appraisal process.

1. **Ensure Strict Compliance with KYC Rules:** At the account opening stage, all Know-Your-Customer (KYC) procedures must be complied with. This would afford good background information at the loan application stage. It would lead to obtaining complete and accurate data (both business/personal) on the clients, thereby forestalling extending credit to a fraudster.

2. **Thoroughly Review Customer Data:** A thorough review of customer data as supplied by him/her to ascertain if he/she has other accounts with other banks, especially any other MFB. Verify if the customer has integrity based on the data/information supplied.

3. **Make Independent/Discrete Enquiries from Business Peers/Associates:** This is to ascertain his/her credit history and character as perceived by those around his/her business environment.

4. **Involve Spouse/Family Members:** Their involvement at the credit appraisal level and their commitment would serve as peer pressure to ensure compliance with agreed terms and conditions. Their disagreement would be a red flag to the loan officer.

5. **Seek and Obtain Credit Reference Reports from at Least Two Credit Reference Bureaus as required by CBN:** This is to assist the credit officers in arriving at a good credit decision. Such reports would give the client’s credit history and rating, as the case may be.

6. **Identify their Suppliers:** Obtain from them independent opinions on their customer’s payment records/habit and if there had been defaults in payment in the past, this would assist you to form an opinion as to either lend or decline application.
7. **Send out Status Enquiries to Other Banks/MFBs and Suppliers:** This is to ascertain if he/she is indebted to them and the extent of such indebtedness.

8. Seek and obtain information from household members during household visits and interviews.

Taking the foregoing steps would greatly put double/multiple borrowing risks in check and avert the havoc it has caused within the industry.

**Comment**

This is a practical industry question. Only about 33% of the students attempted the question while 67% avoided it. Of the number that attempted it, 55% did well while 45% failed. Majority did not understand the question due to lack of awareness of practical day-to-day activities in the industry. It is important to keep abreast of practical events in the industry as part of education in preparing for this examination. This is what makes the examination a professional one.