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A critical evaluation of credit risk management and loan performance in microfinance institutions: A case of a leading microfinance company, Lusaka, Zambia

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Abstract
The purpose of the study was to conduct a critical evaluation on how credit risk management practices impacts on loan performance in selected microfinance companies of Lusaka district, Zambia. The study used client appraisal, credit terms and collection policy as the dimensions of the credit risk management practices. A case study research design was employed in order to obtain a deeper insight on the subject under investigation. The target population included Management and clients from one of the leading microfinance company which was studied in detail as a case study. Questionnaires, structured interviews and observations were used to collect both qualitative and quantitative data. Qualitative data was analysed using themes derived from the research objectives and quantitative data was analysed using SPSS. The findings of the study revealed that client appraisal showed a strong correlation ($r = 0.896$) impact on the performance of the loans. It was further revealed that the company's implementation of the 5C's model (Character, collateral, capacity, capital and condition) was done in isolation. The study furthermore unearthed that there was no link among the 5Cs in the appraisal process at the organisation under investigation. The study findings also indicated that the credit terms such as high interest rate which the company was charging lead to loan default. It also came to light that the charges of other fees on loans reduced the loan amount which the client got; that lead to diversion of funds to unintended purposes. The study furthermore revealed that, the company's failure to stringently follow the recovery process caused clients to default on their loan repayment obligation. Based on research findings, the following recommendations emerged: 1.Management of Entrepreneurs Financial Centre should ensure that implementation of the appraisal process model strictly follow the 5Cs (character, collateral, capacity, condition and capital) model without compromising on any element. 2. Management of the entity should prioritize the training of staff doing the appraisal process. 3. The management and board of the company should explain interest rate charged on the loans to clients and they should ensure that borrower's accept to pay both the interest and principle. 4. Management of the entity under review should reduce the interest rates by reducing other loan cost. 5 The board through management of the company should make sure that the collection process is implemented stringently.

Keywords: loan performance, credit risk management, credit policy, loan appraisal

1. Introduction

The roles of microfinance institutions remain central in financing economic activities. Therefore, its Failure can disrupt the economic development of the country as individuals in the country will be denied access to financial services to develop themselves (Athanasoglou, *et al* 2005) [4]. Zambia's financial sector is currently facing challenges from 2015 to date this has led to the closure of one bank and three microfinance institutions. BOZ Annual Supervision Report (2015) [6] indicated high incidence of credit risk for microfinance institutions (MFIs) reflected in the high levels of losses in earnings and on profitability. This is partly as a result of poorly managed credit risks which lead to donors, investors, borrowers and savers to lose confidence in the institutions and closure for some institutions. This can hinder MFIs to meet its social objective of providing services to the poor and can go out of business (Modurch, 2001) [16]. The measures which microfinance institutions have put in place to mitigate credit risk are credit risk management (BOZ, 2015) [6]. Credit risk management offers a viable solution to such challenges. It offers restrictive credit control system to be put in place so as to restrain from unnecessary lending, default on loans thus, improving MFIs (Kakuru, 2000) [13].

However, Exposure to credit risk continues to be a significant source of problems for lending businesses at both national and international levels. This problem is even more important to MFIs since they are involved in lending to the low-income earners in the society. This group is considered as riskier in terms of the exposure to credit risk. Credit risk management is therefore a critical element in the success of these financial institutions which face a myriad of challenges in enhancing easy and affordable access to financial resources by the less fortunate of the societies (Modurch, 1999) [16].

Credit risk management is a structured approach to managing uncertainties through risk assessment, developing strategies to manage it and mitigation of risk using managerial resources. Credit risk is the financial exposure resulting from a microfinance institution's dependence on another party (counterparty) to perform an obligation as agreed. It is the risk to earnings or capital due to borrowers late and non-repayment of loan obligation. Credit risk encompasses both the loss of income resulting from the MFI's inability to collect an

anticipated interest earnings as well as the loss of principal resulting from loan defaults (Ahmed & Malik, 2015) [2].

1.1 Statement of the Problem

A well-functioning financial system for MFIs is essential for development. It mobilizes foreign and domestic resources and channels them to high-return investments, intermediate between savers and investors to reduce and allocate risk, and provide broad access to financial services, including for people on low margins of the economy. In so doing it facilitates competition, market integration, broadly based growth, and poverty reduction (World Bank, 2000) [26]. Additionally, MFIs play an important role in the financial sector by complementing the commercial bank through provision of financial services to the under-served rural consumers and small businesses often ignored by the traditional banking channels. (BOZ, 2004) [7]. Therefore, its failure can disrupt economic development of the country as the marginalised individuals in the country will be denied of access to financial services to develop themselves.

BOZ Annual Supervision Report (2015) [6] indicated high incidence of credit risk for MFIs thereby posting high levels of losses in earnings and profitability. Among the measures which financial systems have put in place to mitigate credit risk is credit risk management. However, credit risk is one aspect facing MFIs that has proven difficult to hedge. Despite the critical role credit risk management plays on loan performance, it has remained unclear on the impact it has on loan performance in microfinance institutions in Zambia.

1.2 Research Objectives

1. To ascertain causal relationship between client appraisal model and loan performance,
2. To evaluate the effect of credit terms on loan performance
3. To assess the extent to which loan performance is influenced by the loan collection policy.

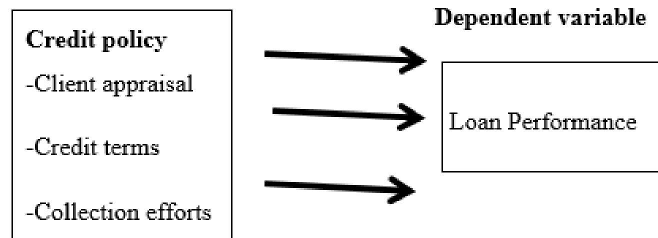
1.3 Questions

1. How does client appraisal model affect loan performance?
2. What effects do credit terms have on loan performance?
3. To what extent does collection policy affect loan performance?

1.4 Conceptual Framework

The conceptual framework (Ahmed & Malik, 2015) [2] below illustrate how different variables interact and are interrelated; client appraisal, credit terms and collection policy. Client appraisal helps MFIs to improve loan performance, as they get to know their customers. The use of 5Cs used in client appraisal is character, capacity, collateral, capital and condition. Credit Terms refers to the conditions under which a microfinance institution extends credit to its customers. These include; credit period and interest rates. These have an effect on the performance of loans. Collection policy is needed because not all customers pay in time some customers are slow payers which some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses, the policy affects timely repayments and decrease in default rate.

Independent variable



Source**:** Ahmed & Malik (2015) [2]

The conceptual frame work above have shown the relationship that exists between the variables and highlights the indicators for credit policy and loan Performance.

2. Literature Review

Relevant literature was reviewed according to themes generated from research objectives.

2.1 Client Appraisal Impact on loan performance

Client appraisal involves gathering adequate information about a client before granting a credit facility. It primarily ensures that the loans are granted to the right people and the capital and interest income is relatively secured and it is a basic stage in the lending process. Client appraisal follows a specific procedure to maintain proper credits. It involves gathering, processing and analysing of quality information as a way of discerning the client's creditworthiness and reducing the incentive problems between the lenders as principals and the borrowers as agents (Horne, 2007) [11].

Orua (2009) [20] conducted a study on the relationship between loan applicant appraisal and loan performance for 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. However, concluding that short term loan alone is the only factor which influence default rates on loan is not enough. Besides, it is not clear on how short term loans effects loans performance. This study therefore assessed how client appraisal influences loan performance.

Mureithi (2010) [18] in his study on the Relationship between credit appraisal process and the level of non-performing loans found out that client appraisal is carried out for various reasons, these are; "as a selection tool, to quantify risk, to aid in decision making, and to ensure good quality business with excellent credit worthiness". This makes the credit appraisal process an important activity among the MFIs.However; it has remained unsearched if client appraisal has an impact on loan performance in microfinance sector in Zambia.

Fidrmuc *et al*, (2007) [8] found out that before lender extends credit to customers should recognize the possibility that customers will be unable to pay or unwilling to pay as his objective. The study adopted a survey research design targeting all types of lenders. He found out that lenders must establish policies for determining who will receive credit for how long and how much. He also found out that lender should build their credit policy around 5Cs of credit, character

capacity capital collateral and conditions for them to be successful.

The mostly used model of client appraisal by microfinance Institutions in Zambia is the 5Cs model. These 5Cs are: character, capacity, collateral, capital and condition (Abedi, 2000) [1]. It can further be argued that the use of client appraisal of 5Cs model should involve linking of all the 5Cs to each other to qualify the client for credit consideration. This implies that MFIs should only extend a loan to borrowers whose Character, Capacity, Capital, Collateral and Conditions are up to expected standard. One may furthermore claim that MFIs should base their credit analysis on the basic principles of lending which are Character, Capacity, Capital, Collateral and Conditions which should be linked together''. This implies that they should be correlation in the elements of the 5Cs. However, most MFIs use the 5Cs in their appraisal in loan granting process, but this has not reduced the number of non-performing loans. This study will establish the extent to which the uses the 5Cs as client appraisal model.

2.2 The 5Cs of Client Appraisal Model

As already alluded, the 5Cs stand for Character, Capacity, Capital, Collateral and Conditions are key variables in determining loan appraisal and they are highlighted hereunder:

2.2.1 Collateral

This is the borrower's asset pledged in exchange for the receipt of a loan. Lenders request for collateral before extending loans to customers. The collateral is always higher in value than the loan taken to ensure that the loan is paid back. When one member fails to pay, the guarantors will pay on their behalf. Thus, this system makes it possible for guarantors to monitor one another thus leading to improved loan repayment. Collateral helps align borrowers' intentions with those of the lenders and provides a security in case of loan defaults. Lenders also need timely and accurate information and continued updating of accounting records (Kakuru, 2005) [13]. However, the low-income households and individuals are the primary clients of microfinance institutions. These do not have assets to offer as collateral to guarantee their loans. They do not normally have a credit history. As such they are excluded from the formal financial sector. Moreover, if collateral is offered it's usually not in good shape compared to the loan amount. Additionally, Inkumbi (2009) [12] argues "that capital and collateral are the major stumbling blocks for entrepreneurs trying to access capital". This is especially true for young entrepreneurs or entrepreneurs with no money to invest as equity; or with no assets they can offer as security for a loan. This study will assess how one of the Zambia's microfinance institution implements client appraisal as credit risk management on collateral and how it influences loan performance.

2.2.2 Character

Character is a tool used by microfinance institutions to provide them with weighting values for various characteristics of a credit applicant and the total weighted score of the applicant is used to estimate his/her credit worthiness. Ouma, (1996) [21] states "factors that influence a client character can be categorized into personal, cultural, social and economic factors". According to Kurui and Kalio (2012), [15] they assert that psychological factor is based on a man's inner worth rather than on his tangible evidences of accomplishment. MFI's consider this factor by observing and learning about the individual. In most cases it is not considered on first application of credit by an applicant but from the second time. Under social factors, lifestyle is the way a person lives. This includes patterns of membership groups, consumption and entertainment. A lifestyle typically also reflects an individual's attitudes, values or worldview. Personal factors include age, life cycle stage, occupation, income or economic situation, personality and self-concept. The loan officer must be convinced that a customer has a well-defined purpose for requesting a credit and has a serious intention to repay. However, it is very difficult to assess the character of a client in a short period. Most clients pretend to have a good character when they want to access a loan. Besides, loan officers may be motivated to extend a loan to a bad character in order for them to meet targets. This study will assess the influence of client appraisal as credit risk management on loan performance.

2.2.3 Capacity

MFI's takes into consideration the cash flow from the business, the timing of the repayment, and the successful repayment of the loan by tracking and monitoring loan borrowers. Cash flow enables MFI to determine if the borrower business net cash flow will enable her/him to repay the loan (Anthony 2006) [3]. It is more than simply comparing income and expenses. MFI's determines cash flow by examining existing cash flow statements and reasonable projections for the future ratios. However, it is difficult to appraise the repayment capacity because the clientele for MFI do not keep records of their income and their expenses. This study will assess how a leading microfinance company in Zambia uses capacity as a client appraisal process as credit management tool.

2.2.4 Capital

Capital is measured by the general financial position of the borrower as indicated by a financial ratio analysis, with special emphasis on tangible net worth of the borrower's business. Capital is the money a borrower has invested in the business and is an indication of how much the borrower has at risk should the business fail (Anthony 2006) [3].

2.2.5 Condition

Condition refers to the borrower's sensitivity to external forces such as interest rates, inflation rates, economic cycles and competition. They focus on the vulnerability of borrowers (Pyle, 1997) [23].

2.3 Credit Terms

Ringtho (1998) [24]. observes "that credit terms are normally looked at as the credit period terms of discount and the amount of credit and choice of instrument used to evidence credit". Credit terms may include; Length of time to approve loans, this is the time taken from applications to the loan to disbursement or receipt. It is evaluated by the position of the client as indicated by the ratio analysis, trends in cash flow

and looking at capital position. When borrowers are given small amount of money it will not be sufficient for business operations yet given too much money it is spent on non-productive activities causing high non - loan repayment. The credit manager should check on the amount the customer is demanding for, whether it is too much or little. Several previous studies have noted that the time period for which credit is advanced is affected by credit risk, collateral value, competition in the market and size of client's account (Ross *et al*., 2008) [25].

Other studies such as those done by Moti, *et al* (2012) [17] 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. However, it is unclear on how clients should be engaged in the formulation of credit terms. Besides, most clients for MFI do not understand credit terms they just sign the terms without asking. This study will seek to assess how credit terms affect loan performance.

Godquin, (2004) [9] in his study on microfinance repayment performance. The findings were that; credit terms such as interest rates charged by a credit institution have a dual role of sorting potential borrowers and affecting the actions of borrowers. The question of how credit terms such as interest rate can affect the actions of borrowers has remained answered.

2.4 Collection Policy and loan performance

Collection procedure is a systematic way required to recover the past due amount from clients within the lawful jurisdiction (Boldizzoni, 2008) [5].

According to Pandey, (1995) [22] in his study on Exploring public sector communication performance asserted that, prompt collection is needed for fast turnover of working capital; keeping collection costs and bad debts within limits and maintaining collection efficiency. A collection policy should lay down a clear cut collection procedure. The procedures should be followed with tact to avoid losing some customer to other competitors by covering overdue accounts. Firms should start early enough to collect his accounts from customers and it should be known that it is the duty of the firm to remind debtors to pay their due accounts. Well administered collection is needed for better performance of the loan. If financial institutions do not follow well administered collection procedures, this would results in loan defaults (Boldizzoni, 2008) [5]. However, it is unsearched if collection procedure have an impact on the performance of loans. This study will bridge this knowledge gap.

Kariuki (2010) [14] conducted a study on Effective Collection Policy. Found out that an institution should put in place a collection policy to ensure recovery is done effectively. Nevertheless, the question on whether collection policy can improve loan performance in microfinance sector in Zambia has remained unanswered. This study will assess the impact of credit risk management on loan performance.

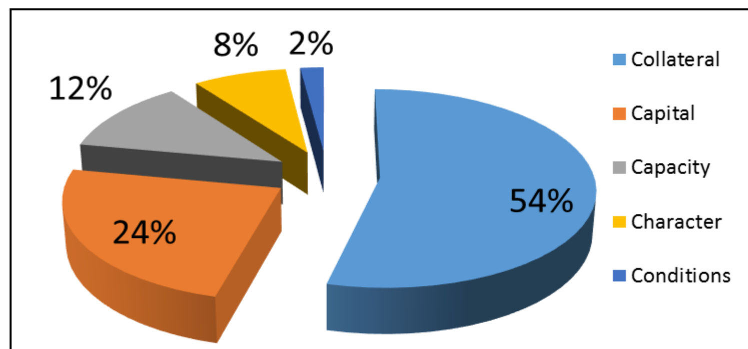
3. Methodology

The study used both qualitative and quantitative methods. A case study research design was used in order to have a deeper insights and better understanding on how credit risk management impact on loan performance. Target population included all clients of one of Zambia's microfinance institutions and staff. Sample of 50 respondents consisted of 40 clients and 10 senior credit managers. Purposive sampling was used whereby credit and debt collection department personnel were considered to ensure relevant people with the required skills in the study were included.Simple random sampling was used to select clients. Data Collection Instruments included questionnaire, interview schedule and observation. The study used both primary and secondary data. Primary data was collected using semi- structured questionnaires. The questionnaires were self-administered. Secondary data information was collected from articles, books, newspapers, and internet and magazines. Quantitative data was analysed using SPSS version 16.0 in order to generate simple descriptive statistics in form of percentages in tables while qualitative data was analysed according to themes derived from the research objectives. Note that the name of the company has been withheld for ethical reasons.

4. Presentation and Discussion of Research Findings

The study findings were presented and discussed according to the themes derived from research objectives.

4.1 Appraisal Process Model Followed by one of Zambia's microfinance institution



***Source*:** Field Data 2017

Fig 1: Respondents' Views on how 5Cs appraisal model Help Loan Performance

Collateral accounted for 27(54%) loan performance appraisal. It included household goods, cars, and houses. Second was capital 12(24%) calculated from the bank statements provided by clients. Capacity 6(12%) is another critical variable considered when appraising loan facility. The policy requires the client to have at least twice the capacity of the required installment. Character 4(8%) and conditions 1(2%) came last respectively. The latter are determined by prevailing economic situations or situations existing in particular sectors of the economy. The study shows that EFC dwells more on collateral than other elements of the 5Cs. Further, the study reveals that most default problems EFC is facing would be avoided if they ensured that the appraisal lending processes was conducted correctly. An inefficient credit appraisal process is one of the causes of non-performing loans. The use of client appraisal model using the 5Cs should involve linking of all the 5Cs to each other to qualify the client for credit consideration. An inefficient credit appraisal process is one of the causes of non-performing loans of various lending institutions

This can lead to institutional failure as a result of bad lending decisions made with wrong appraisals of credit status. Goodhart (1998) [10] states that poor credit risk management results in undue credit risk.

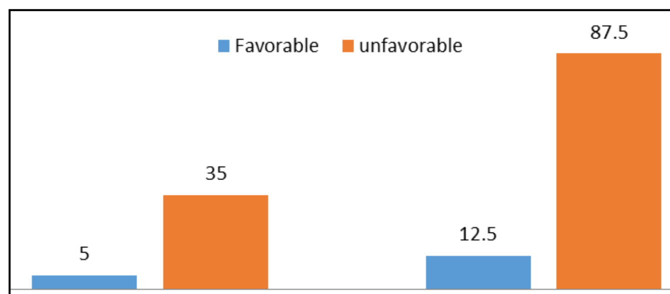
4.2 Credit Terms and Loan Performance

Managements' responses on Credit Terms and Loan Performance

One of the senior managers revealed the follows:

…The interest rate for EFC is at 78% per annum…Our Repeat Loans have a payback period of 3 years maximum…If the loan has pledged collaterals they have to be insured and this cost is recovered from the client before disbursement of the loan…There is compulsory savings of at least 10% on all loans collected from the client before disbursement of loan…

Another front line manager tabulated some of the fees that clients pay in order to access loan facility as follows:*…ledger fees (K150.00), processing fees (14%), and life assurance (2.5% for 1 year, 3% for 2 years, 4% for 3 years)…*



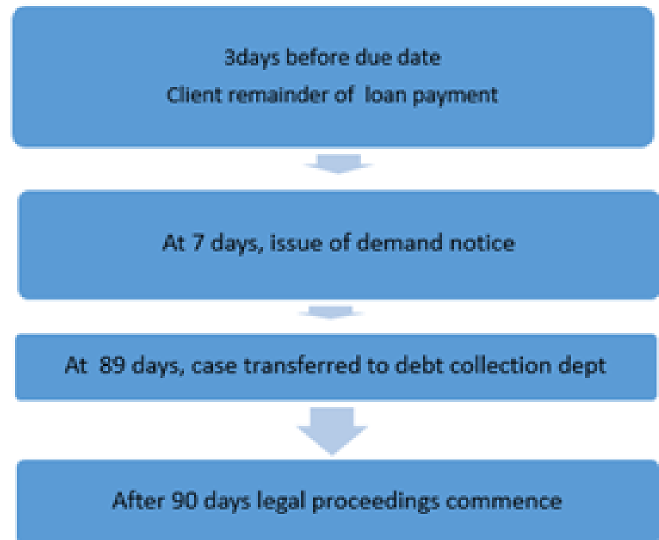
Source: Field Data 2017

Fig 2: Clients' Views on Interest Rates

- Out of 40 respondents 35(87.5%) firmly indicated that interest rates are unfavourable while 5(12.5) were of the view that interest rates at EFC are within competitive margins. Clients felt that high interest rates discouraged them from meeting monthly loan repayment obligations. It reduces the client's capital and businesses are ineffectively conducted thereby leading to poor loan recovery rate.
- The implication of this is that the interest rate which the institution charges causes poor loan performance. This is supported by the views of God quin, (2004) [9] who argued that "interest rates charged by a credit institution have a dual role of sorting potential borrowers and affecting the actions of borrowers".

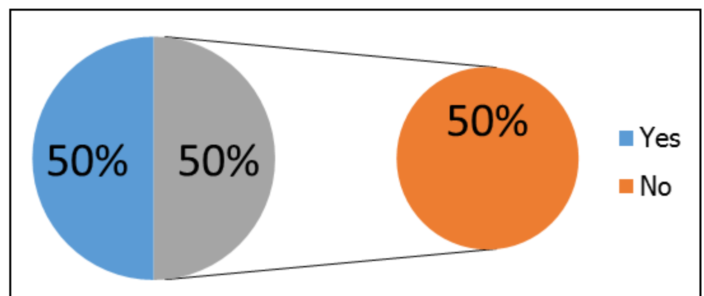
4.3 Debt Recovery Process

As regards to debt collection or recovery process, one of the debt collection manager during an interview gave the loan recovery process as follows:



- The policy document provides stringent implementation guidelines on debt collection.
- The debt collection manager stated that lenience is sometimes exercised depending on the nature of the case.
- When asked whether the loan collection policy is followed by 12(30%) of the respondents agreed while 28(70%) did not agree.

4.4 Loan Recovery Rate



Source: Field Data 2017

Fig 3: Loan Recovery Rate at one of Zambia's microfinance institution

Based on this outcome, the company generally is making losses. The findings show low recovery on loans. The default rate is at 50%. This is supported by Pandey (1995) [22] who asserts that return on equity indicates the performance and strength of an institution in maximizing profits to benefit the shareholders. The findings further reviews that the institution

does not charge penalties on loan defaulters. This has also increased the poor performance rate on loans. This is against the view of Nigarajan, (2001)[19]; who stated that legal proceedings and penalties provides risk protection and enable the lender to follow up the borrower in case of failure to honor monthly obligation.

5. Conclusion and Recommendations

In conclusion, firstly the study findings have revealed that the appraisal process model of the 5Cs causes poor loan performance because the appraisal of the 5Cs is done in isolation there is no link among the five elements in the analysis process. Secondly it can further be deduced that the credit terms which the institution offers are not favourable because in most cases it causes loan default. For Instance, the high interest rate which is charged cause clients to default, the charges of other fees on loans also reduces the amount of the loan amount which the client get. Hence, causing them to divert the money on consumption. Thirdly the recovery process is not followed stringently. This causes clients not to take their monthly obligation serious which causes poor loan performance. In view of the above and based on the study findings, the following recommendations emerged:

1. The board and management at the entity under study should ensure that the implementation of the appraisal process model strictly follow the 5Cs without compromising on any element.
2. Management at the organization should prioritize the training of staff doing the appraisal process.
3. The Board through the Management and staff should sensitize and explain interest rate charged on the loans to clients before an agreement or consent form is signed.
4. Management in consultation with the Board should explore other cost reflective loan management models which would help reduce the interest rates by reducing other loan cost.
5. The Board and management should introduce stringent and competitive processes of debt collection and implementation.

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