Credit Risk Management Practices in Microfinance: Evidence from Selected Microfinance Institutions in Togo

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Abstract: ***Since the poor - once excluded from the formal banking system- have been proved bankable, microfinance institutions were created to help save and improve the situation by offering the poor affordable financial services that could help ameliorate their living conditions. Microfinance in itself is a risky activity. The main risk it faces resides obviously in its main activity which is granting loans or credits. However with the rapid growth and expansion of the sector today, microfinance institutions face many other risks and as a matter of fact must identify and anticipate potential risks to avoid unexpected losses and surprises. The present study sought to investigate risk management practices in microfinance institutions. It focused on two major institutions in Togo namely FUCEC and WAGES. The study uses a qualitative survey research design. Data was gathered through semi-structured interviews with about 40 respondents in both institutions and was analyzed using descriptive statistics. Findings reveal that these microfinance institutions face institutional, operational, financial management and external risks but focus more on credit risk. Also the study reveals that the main threat to credit risk management in these institutions resides in the lack of training and the bad selection of staff in charge of credits.***

Keywords: Microfinance, Credit risk, Credit Risk management system, Togo.

1. Introduction

In an attempt to help the poor- once excluded from having access to financial service, emerged the concept of microfinance. Through small-scale credit and savings, money transactions, and other banking opportunities mostly given to and low and middle income people; the main idea behind the concept was simply the provision of financial services to those excluded from the formal financial system.

Since the poor can't all be satisfied in a blink of an eye, an ideal microfinance program should be one that can keep offering it services in time and permanently. Until today and regardless of the mission drift issue in microfinance;many microfinance institutions continue to work towardstheir primarily objective of trying to serve and save the poor by giving him access to finance. This continuation on a long-term of microfinance services can be somehow referred to as sustainability in microfinance. Who says long term service obviously means long time existence of the institutions. Some have survived since their creation and others failed in their exercises for diverse reasons one of which is the lack of efficient and effective risk management programs.

Every institution should manage their risks proportionately to their size and complexity of their operations and services. In fact, just like any other institution in the financial sector, Microfinance institutions also face risks. Thus risk management should be an integrated part of microfinance programs. But the observation today is that only few institutions practice risk management with a focus on only one or few risks and others even neglect it.

The recent steady growth of the microfinance industry has changed the risk profile of MFIs thus many other risks have appeared in the industry. But still, many institutions continue not taking into account this change and even have no risk management program but are looking forward to sustainability.

This paper seeks to study the risk management practices of microfinance institutions in Togo. It precisely investigates the different risks existing in credits management in these institution, identifies the characteristics of their credit risk management systems, and finally attempts to figure out failures in these systems in order to make some recommendations to improve them.

2. Statement of the problem

According to [1], first of all, risk is the biggest obstacle to overcome to reach the poor. Generally, outcomes from micro entrepreneurial activities are more volatile and sensitive to market changes. For example According to (Nasir 2013) cited by [8], the micro finance institutions are struggling for their existence in India due to their lack of initiatives in managing the credit risks. Coupled with high operational costs derived from the small size of transactions with micro enterprises, the risk will lead to the situation which was predominant prior to microfinance – poor and low-income households are tagged as by the conventional banks "too risky and too costly". Therefore, despite success at reducing poverty through the employment of a group-lending methodology, MFIs may face some risks if they are to continue operations since they may not always be able to rely on government or donor assistance. As MFIs continue to grow and expand rapidly, serving more customers and attracting more mainstream investment capital and funds, they need to strengthen their internal capacity to identify and anticipate potential risks to avoid unexpected losses and surprises. This illustrates a change nowadays in the risk profile of Microfinance institutions. Microfinance institutions should normally cope with their new environments and take into account the new risks but as mentioned by [7] it is noticed that regardless of the growth and development of Microfinance institutions, their internal risk management systems are often a step or two behind the scale and scope of their activities. Because effective risk management ensures institutional sustainability and facilitates growth, it has significant implications for MFIs with a social mission to serve an increasing number of poor households [14]. He also further that Risk management should not be seen as something that must be put in place merely to meet the regulatory and supervisory requirements of financial authorities; but should rather be an integrated part of both regulated and unregulated microfinance institutions.

Microfinance sector in Togo is supervised at both country and regional level and these supervisory authorities try to develop this sector by promoting sustainability through sound risk management procedures and institutional self-sufficiency. Despite the efforts done authorities in Togo, the reality on the field in reflects a relatively high degradation of loan portfolio, a large number of unregulated institutions and some institutions operating for a short time and disappearing after with the poor's money thus making them poorer. Just as mentioned by [10]; unsustainable MFIs might hurt exactly those whom they are meant to help. All this reflects how the sector's overall risk profile is alarming. In addition, although the microfinance sector in Togo is experiencing an increase in the volume of activities; the difficulties in loan recovery are not negligible. As mentioned by the Professional Association of banks and financial institutions (APBEF) in Togo at its recent symposium; with an additional membership of more than 88,000 members in the 2nd Quarter 2016 (+ 4.8 percent compared to 2015) the microfinance sector faces a deterioration of the loan portfolio, from 8.1 percent in 31 March to 8.3 percent in 30 June 2016, for a norm of 3 percent. This situation, according to the professionals, "is an important concern for the authorities in charge of regulating the sector". This paper then comes as an approach of solution on how to improve risk management in Togolese microfinance institutions.

3. Research Background

3.1. Definition of risk

Risk is generally defined as an event (whether internal or external), result of an action or inaction, of an opportunity, susceptible to happen and to have an impact (mostly negative) on the realization of an entity's objectives [16]. In Microfinance, Risk is defined as the possibility of an adverse event occurring and its potential for negative implications to the MFI[7]. A broader definition is given by [14] who defines microfinance risk as "the potential for events or ongoing trends to cause future losses or declines in future income of an MFI or deviate from the original social mission of an MFI."

It's quite important to mention that most of these definitions refer to risk as everything that could have a negative consequence on an institution's activities. However as mentioned by [2], risk should no longer be only perceived as something negative that should be avoided or controlled but also as something positive that could be used in a constructive manner. It is also a way for institutions to be well prepared and faster seize opportunities that show up to them. In this order of idea we can say that the risk is not taking risks but to take too much risks or not being able to manage them properly. So risk; being far from something bad; would rather help any institution who knows how to handle or manage it to be ready, never be surprised by worst cases nor miss opportunities.

In addition, for the purpose of this paper we use the following definitions of the terms risk management and risk management system: Risk management will refer to the process of managing the probability or the severity of the adverse event to an acceptable range or within limits set by the microfinance institutions and risk management system will refer to a method of systematically identifying, assessing, and managing the various risks faced by microfinance institutions.

3.2. Typology of risks in microfinance

For any financial institution offering financial services, the most important risk it faces resides in the quality of the services it offers. Giving the poor access to credits (loans) is the main activity of many MFIs thus the quality of the loan portfolio is crucial and the related risk (credit risk) has to be mitigated as to make it possible for them to keep up with their activity. However, Microfinance faces more than just credit risk, as learning how to identify and mitigate all the different risks is critical to sustainability (S. khan 2013). There are different types of risks faced by microfinance institutions. [7] cited financial, institutional and strategic risks. [4], in addition, listed four risk categories, namely: institutional risks, operational risks, financial management risks, and external risks. Similar to [4]; [9] grouped risk in microfinance into Financial Risks, Operational Risks and Strategic Risks.

A MFI must balance many different types of risk within its portfolio. For [12]Common risks include, Credit risk which originates from client's unwillingness or inability to repay their loans. Credit risk results in a deterioration of the MFI's portfolio, reduced revenues, and increased operating expenses. Interest rate risk: Any changes in the level of market interest rates during the term of a loan relates to interest rate risk. This risk originates from the mismatch of the maturities of the MFI's assets and liabilities. Liquidity risk: A MFI's difficulty in obtaining needed cash at a reasonable cost. The largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by for a largest asset of the microfinance institution (MFI). Credit risk, a financial risk faced by microfinance institutions is the risk to earnings or capital due to borrowers' late and nonpayment of loans obligations [7]. It involves both transaction risk which refers to the risk in individual loans, and portfolio risk which refers to the risk inherent in the composition of the overall loan portfolio.

To investigate the types of risks in the microfinance sector in Togo, this paper uses the typology proposed by [4] according to which risks in microfinance are grouped into institutional, operational, financial management and external risks. They explained and discussed each of the sub-categories of risks but do not provide definitions.

Institutional risks are composed of social mission, commercial mission, dependency, strategic and reputation risks. The social mission of a microfinance institution is to provide affordable financial services to a large number of low income people in order to improve their living conditions. Risk on this social mission of a microfinance institution arises when its target groups or clients are not well defined or when good follow-up mechanisms are not set up to make sure its financial services are adequately delivered and correspond to the real needs of the actual and potential clients. The commercial mission on the other hand is to provide financial services and while helping the institution become self-sufficient. Risk on this mission appears when there is a conflict between the social and the commercial mission thus when there is a trade-off between an MFI's outreach and self-sufficiency. Most of institutions supported by international organizations are faced with dependency risk. This support even though advantageous in the beginning; it could weaken institutions' endeavor towards independency on the long term.

Operational risks are composed of credit, fraud and security risks. Credit risk is simply the risk related to a loan not being repaid after it's been granted. Fraud risk arises in institutions with incoherent management and information systems. Such a vulnerable situation could cause failure in fraud detection and would result in losses of liquid assets and a loss of notoriety by these institutions. Security risk in microfinance exists due to the fact that many institutions operate in areas with a high level of poverty and where theft probabilities are rather high.

Financial management risks are composed of asset and liability risk, inefficiency risk and system integrity risk. Assets and liability risk is often linked to interest rates and liquidity and exchange rates. It arises in terms of interest rate when the interest rates of assets and liabilities are not well negotiated. Institutions located and operating in inflationist environment are faced with such a risk. When it comes to liquidity it arises when MFIs borrow money repayable on a short term in order to satisfy immediate financing needs or repay debts or grant loans for example. In terms of exchange rates, it shows up when a microfinance institution has to repay the money it borrowed in foreign currency and when the financing of this loan has been done in local currency; regardless of the fact that revenues from interests locally generated are often insufficient to cover these financial charges. A microfinance institution faces inefficiency risk when it cannot minimize its marginal operating costs with regard to service providing. Inefficient MFIs squander their resources and provide low quality services to their clients at high interest rates and high operating costs.

External risks are composed of regulatory, competition, demographic macroeconomic and environmental risks. Regulatory risks arises when an institutions doesn't know or doesn't abide by the rules and regulations defined by the sector's supervisory authorities. Such rules include for example the labor code, the usury act, deregulation and political interferences. Competition risk comes from an institution's ignorance of its competitors' services in order to properly define its marketing plan for example in terms provided services and market shares. Demographic risks are function of the characteristics market in which the MFI operates. For example information on death rates, population mobility, schooling rate, experiences of past credits programs in a market could reduce the MFI's vulnerability to demographic risks. Environmental risks are related to natural calamities such as floods, droughts etc. which affects households, companies, revenue streams and microfinance service deliveries. In addition, physical infrastructures such as transports, communication, and availability of banking infrastructures at the MFI's location could affect its vulnerability to environmental risks. Finally MFIs are particularly vulnerable to macroeconomic changes such as inflation and devaluation. These risks have a direct effect on both the microfinance itself and on its customers' loan repayment abilities.

3.3. Credit risk management system in microfinance

As previously defined; a risk management system is a method of systematically identifying, assessing, and managing the various risks faced by an MFI. This paper focuses on credit risk management system in microfinance institutions. It exposes the arrangements of a credit risk management system and the procedures credit risk management in microfinance.

Credit risk is the risk to earnings or capital due to borrowers' late and non-repayment of loan obligation. To limit losses in microfinance due to credit risk, microfinance institutions dispose of well-defined risk management policies. According to [15]; several arrangements should be made by any microfinance institution for a good control of credit risk. He cites the identification of current and future vulnerabilities, the conception and implementation of controls in order to reduce credit risks and finally the tracking of the controls' efficiency. [13] mentions an active oversight by board and senior management, well designed borrower screening, careful loan structuring, close monitoring, clear collection procedures, good understanding of delinquency, good portfolio reporting and a following up of the concentration of credit. It further stresses the need for development and implementation of clearly defined policies defining the credit risk philosophy of the microfinance institution and the parameters under which credit risk is to be controlled.

Risk management is a continued process since an institution's vulnerability changes with time. This could lead to an appreciation of credit risk management under two major aspects namely the preventive measures taken by the MFIs prior to granting credits and the encouragement measures for on-time repayments after the credits have been granted. Credit in a microfinance institution is generally managed following three main steps namely the instruction and analysis of the credit file, the follow-up of granted loans and collection of credits in arrears. [11]And[3] mention four steps to manage credits properly in a microfinance institution. They cite the planning of credits granting, the selection of clients, credit file review and the recovery of credits in arrears. We can then mention that, the steps or procedures of credit risk management in a microfinance institution generally goes through the process of granting credits, the definition of the objectives of this credits' granting process, the operations involved in credit granting process and finally the arrears management.

4. Research Methodology

This paper uses a qualitative approach to investigate the risk management systems of MFIs in Togo. As mentioned by [5] qualitative research helps obtain results without the use of statistical analysis. It can relate to the life of individuals, their behavior and their history. The choice of this qualitative approach is also supported by the lack of existing literature on credit risk management in microfinance institutions in Togo.

This study's target were the first and second largest microfinance institutions in Togo namely FUCEC and WAGES. Data has been collected through conducted interviews with a focus on Directors (from General Direction, departments of risk, department of operations and departments of audit and internal control), head of agencies, staffs in charge of credit, and risk managers. The sample used in this paper and the number interviewed people are described in table (1).

Table 1: Sample description

Interviewees	Directors	Head of agencies	Staff in charge of credits	Risk managers	Total
WAGES	2	5	10	2	19
FUCEC	1	3	15	2	21
Total	3	8	25	4	40

This paper used a semi-structured interview approach. As mentioned by [6]; Semi-structured interviews are widely used in qualitative research and this method is used most often in the social sciences. While a structured interview has a rigorous set of questions which does not allow one to divert, a semi-structured interview is open, allowing new ideas to be brought up during the interview as a result of what the interviewee says. The interviewer in a semi-structured interview generally has a framework of themes to be explored. After developing an interview guide according to our research framework we went to meet those susceptible of answering our questions and the average interview time was about 30 minutes per interviewee.

5. Research Findings

Findings will cover the typology of risk in the concerned microfinance institutions, the characteristics of their credit risk management systems and the flaws in their credit risk management.

5.1. Typology of risks in Togolese microfinance institutions

Table 2 presents the main findings on the typology of risks in FUCEC and WAGES. As we can see operational risks have the highest quotes during our interviews (about 58.87 percent in total) followed by external risks (28.21 percent), financial management risks (6.85 percent) and institutional risks (6.05 percent). In the category of operational risks; Credit risk or risk of default has been the most mentioned by our interviewees with a 61.64 percent of quotes against 38.36 percent for fraud risk. This tends to supports the fact that credit risk is effectively the biggest concern for these microfinance institution

Table 2: Frequency of quotes in terms of the types of risks

Main category	Sub-category	Number of quotes	Percentage of quotes in the main category	Percentage of quotes in total interviews	Concerned interviews
Institutional risks	Risk on social mission	10	66.67	4.03	6
	Risk on the commercial mission	5	33.33	2.02	6
Operational risks	Credit risk	90	61.64	36.29	30
	Fraud risk	56	38.36	22.58	25
Financial management risks	Asset and liability risk	10	58.82	4.03	8
	Inefficiency risk	7	41.18	2.82	7
External risks	Regulatory risk	10	14.29	4.03	10
	Competition risk	60	87.71	24.19	10

Figure 1 illustrates the findings on the typology of risks reflecting the different sub categories. We can see that in general the least concern for these institutions in terms of risk, is the risk on their commercial mission. Even though there is evidence that these institutions acknowledge the existence of this risk for their institution, it seems to be of less concern for them.

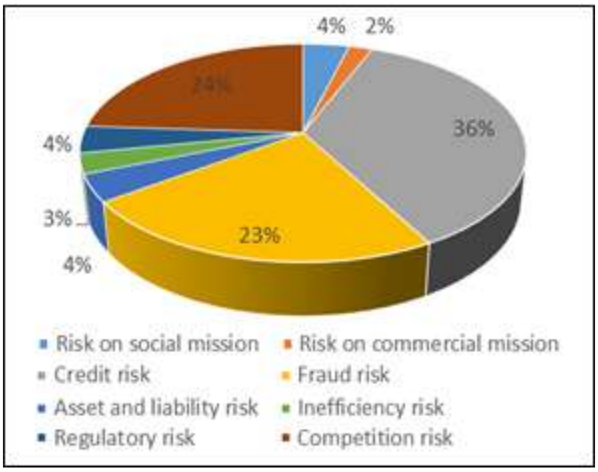

Figure 1: Typology of risks (Percent of quotes in total interviews)

5.2. Characteristics of Credit risk management systems

Findings on the characteristics of the MFIs' risk management systems cover the arrangements of their credit risk management systems and the procedures used for credit risk management in these institutions.

Table 3: Findings on the characteristics of credit risk management systems

	Characteristics	Number of quotes	Number of interviews	Percentage of quotes within category	Overall percentage of quotes
Arrangements of credit risk management system	Identification of current and future vulnerabilities	15	9	33.33	4.04
	Conception and implementation of controls	15	9	33.33	4.05
	Tracking of the controls' efficiency	15	9	33.33	4.05
Steps in credit risk management	Planning of credits granting	60	20	18.46	16.22
	Selection of clients	53	20	16.31	14.32
	Credit file review	30	12	26.77	23.05
	Follow-ups of granted loans	35	20	24.62	21.62
	Recovery of credits in arrears	45	20	13.85	12.16

Findings show that arrangements for a credit risk management systems appear to have the same level of consideration based on information provided by the interviewees. However when it comes to steps followed by these institutions to manage credit risks, there seem to be more emphasis on the review of credit files (in about 23 percent in overall quotes during our interviews). This step consists in the checking and crosschecking of the credit files. This step is considered to be a key element that participates in the credit granting decision making and focusing on it would eventually reduce risk related to credits. It is followed by an increased focus on the follow-ups after these credits have been granted. These follow-ups consist in checking if the credits obtained by the clients are effectively used to fund the activities they were claimed to be dedicated to, or if they have been used to other ends. Also they consist in the follow-up of repayments which is all about remembering due dates to clients by staff on the field. The following figure illustrates the characteristics of the MFIs' credit risk management systems taking into account how regularly mentioned they were by our interviewees.

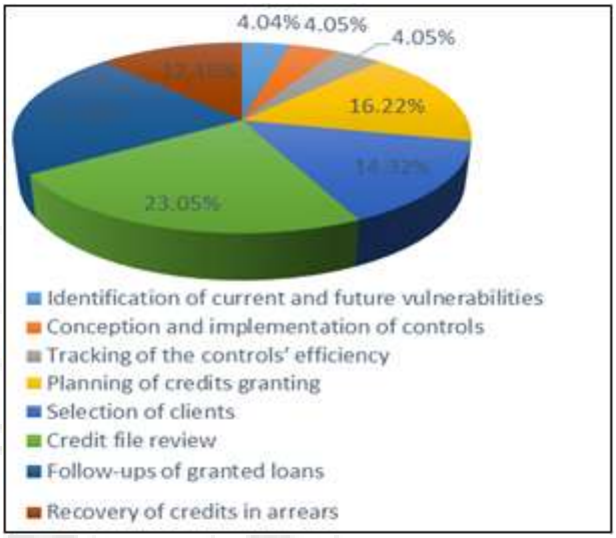

Figure 2: Illustration of MFIs' credit system characteristics

5.3. Flaws in credit risk management

After examining the characteristics of the institutions' credit risk management systems; the study attempted to figure flaws in these institutions' credit risk management. Results are presented in the following table:

Table 4: Flaws in credit risk management

Categories	Flaws	Number of times quoted	Number of interviews	Percentage of quotation in category	Percentage of quotation in overall interviews
Governance related	Bad strategic management of the MFI	16	10	44.44	8.25
	Non consideration of risks analysis in the MFIs' development decision making	20	10	55.56	10.31
Credit operations related	Bad selection of staff in charge of credits	32	25	20.25	16.49
	Lack of training for staff in charge of credits	25	25	26.58	21.65
	Lack of motivation of the staff in charge of credit	17	18	20.25	16.49
	Corruption	36	25	23.08	18.56
	Non respect of credit granting steps or procedures	8	18	10.12	8.24

As shown in table 4, the biggest flaw in the concerned MFIs' credit risk management resides in the training of their staff in charge of credits. Many this staff members lack trainings on credit risks management. As mentioned by some our interviewees, this failure is linked to the bad selection of these staffs in charge of credits. In fact not all the staff members are recruited the "formal and correct" way; thus the knowledge and abilities of some members of these staffs even on for example credit management or financial analysis are questionable. Figure 3 shows the distribution of the findings on the failures or flaws in the credit risk management and appears as an illustration of how important these mistakes appear to be for these institutions.

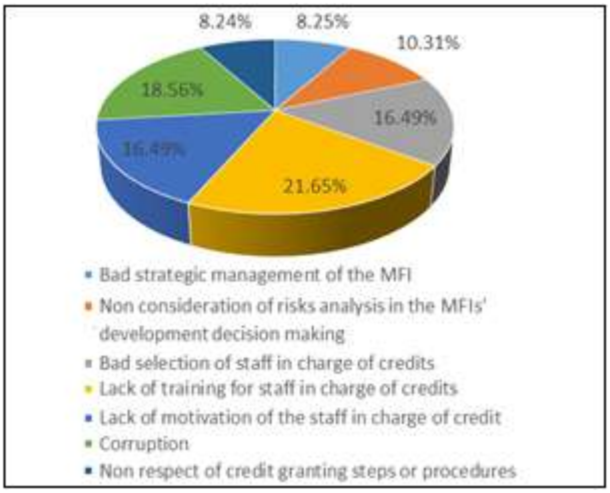

Figure 3: Illustration of flaws in credit risk management

6. Conclusion

Findings made by this study could lead to the conclusions that MFIs' in Togo effectively face a variety of risks such as institutional, operational, financial management and external risks. However they importantly focus on credit risk (an operational risk) as it is the one directly related to their main activity. In terms of their systems put in place to manage such a risk, these institutions focus more on reviewing the credit files before any credit granting and invest themselves a lot in follow-ups after the credits have been granted in order to make sure they are well used and would be repaid on time. However, the lack of training and the bad selection of staff in charge of credits appears to be the main failures and threats when it comes to managing credits in these institutions.

This could lead us to recommend that these MFIs concentrate on recruiting more and the best staff in charge of credits based on their prior knowledge and offer them proper training on credit risk management and techniques. In addition, even though credit risk appears to be the biggest concern to them, they should however not underestimate their vulnerability to other risks such as fraud risk and competition risk and thus should design proper risk management systems for those too.

7. Limitations

This paper focused on only two main institutions in Togo. Other studies could include more institutions for more insights on risk management in Togolese MFIs. Also this study used a specific typology to study risks and characteristics of credit risk management systems in Togolese MFIs other studies could use additional elements since these lists are non-exhaustive.

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