

Effect of Risk Management Practices on the Growth of Microfinance Banks in Nigeria

¹Aliu, John Nma & ²Auwal, Jibo Samira

^{1&2}*Department of Banking and Finance,
College of Business and Management Studies,
Kaduna Polytechnic, Kaduna*

Article DOI: 10.48028/iiprds/ijsrsmms.v7.i1.11

Abstract

Risk management practice in microfinance banks is vital for the sustainable growth of the vulnerable financial institution in Nigeria. Accordingly, the study focused on economic and human risks. Data for this study was sourced from annual observations of ten (10) microfinance banks between 2010 and 2019; These were obtained from annual reports and financial statements of the microfinance banks. Questionnaires were also administered to assist in data collection. A panel data estimation technique was used for ease of statistical analysis. The finding indicate that credit risk had profound effects on the growth or otherwise of the MFBs. Market and reputation risk also had significant impact on the sustainable growth of MFBs. The study concludes that management and regulators of the MFBs should focus more attention to the identification and treatment of risks.

Keywords: *Risk management, Risk appetite, Microfinance banks, Credit risk, Reputational risk, and Liquidity risk.*

Corresponding Author: Aliu, John Nma

Background to the Study

Effective management of risk is a complex task for all banks and financial institutions. Risk management has also assumed increasingly significant position in a world where financial activities are inter-linked. Operators and regulators of microfinance banks are now placing greater emphasis on risk management as an essential element for long term sustainability of these banks. Rather than only paying attention to the historical performance of the banks, the regulators are now focusing on the Microfinance banks' ability to identify existing and future risks as the predictor of their sustainable growth. As emphasized by Owozori et al (2011), Central Bank of Nigeria introduced measures aimed at ensuring the safety and soundness of banks in a stable financial service environment such that will enhance public confidence in the system. Adeusi, Akeke, Adebisi and Oladunjoye (2014) reports that although, the Nigerian banking sector has been undergoing continuous reform since 1999, the first major exercise was the assessment of risk quality of banks resulting in the removal of eight (8) Chief Executive officers of banks and the injection of N600 billion into banks. These reforms were carried out to mitigate the risks faced by banks in Nigeria and improve their capacity and health (Owojori, Akintoye & Adida, 2011).

Banks face series of risks, which include credit risk, operational risk, market and liquidity risk, compliance risk, strategic risk; and reputational risk (Omiagbo & Daniel, 2021). The primary role of Risk Management is to minimize the divergence between expectations and outcomes, thus ensuring the realization of more predictable results. This can only be achieved through a robust framework and clearly defined and transparent processes for the identification of all factors that may lead to the said divergences (“Risk Identification”); estimation of likelihood of their occurrence and the extent or severity of their impact in the event of occurrence (“risk assessment/measurement”); design of effective controls to minimize both the likelihood and the impact of risk events “Risk Control”); establishment of procedures to ensure that these controls are effective and are being complied with (“risk monitoring”); regular reporting of risk events and controls (“Risk Reporting”); and provision of sufficient capital to absorb the adverse impact of expected and unexpected losses. (Owojori, Akintoye & Adidu, 2011). Risk is an integral part of the Microfinance Bank's business. The microfinance bank (MFB) will not only seek to avoid risk, but to understand it properly, manage it effectively and evaluate it in the context of the reward that is being earned. Our focus in this paper is to examine the effects of economic and human risks on the growth of microfinance banks in Nigeria.

Risk Management Processes

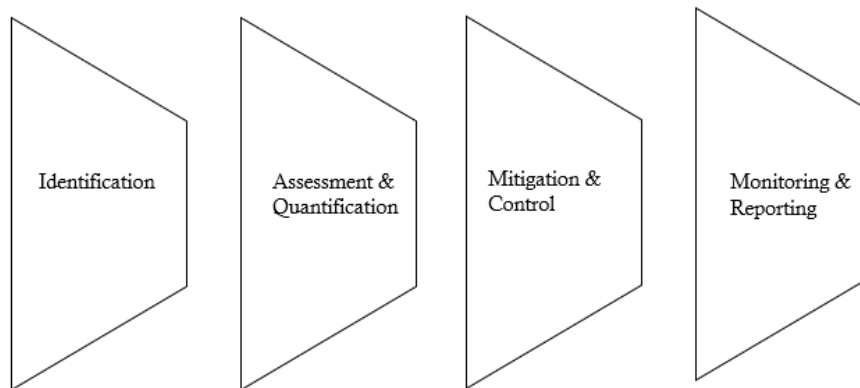
The risk management processes refer to the steps embarked upon by the MFB's management in identifying, assessing, mitigating, and treating the risk faced by the MFB (Aliu, 2014). The process will guide the MFB's senior officers in the management of risks at their level.

According to Greuning and Bratanovic (2009), the aim of process is to ensure proper corporate governance practices in banks. Also, this will assist to:

1. Ensure effective and holistic integration of sound risk management practices across the MFB;

2. Enhance the consolidation of business units' risk profile into integrated risk profile for the MFB's and
3. Create a common basis for managing risks across the MFB.

The risk management process/flow is divided into four cyclic activities shown below:



As shown in the flow above, the risk management process commences with the risk identification activity, followed by the Risk Assessment and quantification. Thereafter, the Risk Mitigation and control commence with the Risk Monitoring and Reporting concluding the interactive cycle.

Risk Definition

Risk is the level of exposure-opportunity, threat and uncertainty that the MFB must identify measure, understand and effectively manage as it executes its strategies to achieve its business objectives and create value (Crouhy, Galai & Mark, 2006). As an opportunity risk refers to the relationship between risk and return. The greater the risks, the greater the potential returns and necessarily, the greater the potential for loss. In this context, risk means using techniques to optimize the upside within the constraints of MFB's business environment. This definition is in agreement with the views of Micolis and Shaw (2000). As a threat, risk refers to the potential for negative events such as financial loss, fraud, damage to reputation or public image, loss of key staff and loss of competitive advantage. Managing risk in this context means introducing management techniques to reduce the probability of these negative events occurring without incurring excessive costs or affecting the initiative, innovative and entrepreneurial flair of the MFB. This was supported by Tandelilin, Kaaro, Mahadwartha and Supriyatna (2007) in their working paper on corporate government, risk management and bank performance.

The CBN considers risk management philosophy and culture as the set of shared beliefs, values, attitudes and practices characterizing how the Bank considers risk in everything it does, from strategy development and implementation to its day-to-day activities. In this regard, the Bank's Risk Management philosophy is the moderate and guarded risk attitude that will ensure sustainable growth in shareholder value and reputation.

As noted by Colquitt (2007), banks generally believe that effective risk management will provide the superior capabilities to identify and assess the full spectrum of risks and to enable staff at all levels to better understand and manage risks.

This will ensure that:

1. Risk acceptance is done in a responsible manner
2. The executive and the board of the Bank has adequate risk management support
3. Uncertain outcomes are better anticipated and accountability is enhanced

Risk Appetite

Risk appetite is defined as the level of risk the Bank is prepared to accept (tolerate) to achieve its objectives. The MFB's risk appetite can be expressed in terms of how much variability of return the Bank is prepared to accept in order to achieve a desired level of result. It is determined by considering the relationship between risk and return. (Cebenoyan & Strahan (2004). The MFB would also need to consider its risk capacity which is the level of risk the bank is not prepared to exceed. This can be assessed by estimating the maximum loss the Bank can endure in the short run without endangering the survival of the Bank. This estimate can serve as a proxy for the Bank's risk capacity. The MFB's risk appetite shall always be set at a level that minimizes erosion of earnings or capital due to avoidable losses in the banking and trading books or from frauds and operational inefficiencies. This is in line with views expressed by Nocco and Stulz (2006).

The factors that govern an MFB's risk appetite include among others, financial, reputational and credit factors.

1. Losses due to fraud and operational lapses as a percentage of shareholders' fund; and
2. Maintenance of sustainable returns

Reputational

Bank's performance is closely linked to their reputation (Santomero, 1995). The following are important in discussion reputational risk of MFBs.

1. Favorable reports from the auditors, regulatory bodies and external rating agencies
2. Top five market position based on all rations
3. Financial and prudential rations at a level more conservative than regulatory requirements and better than the average of benchmark banks
4. Minimal reputational damage from adverse publicity in local press; and
5. Zero appetite for association with disreputable elements

Credit

Credit is considered vital in considering bank's rating.

The Bank's appetite for credit risk shall be governed by high quality risk assets measure by the following key performance indicators:

1. Ratio of non-performing loans to total loans
2. Ratio of loan loss expenses to total revenue
3. Ratio of loan loss expenses to interest income

4. Ratio of loan loss provision to gross nonperforming loans; and
5. Concentration of portfolio by industry, product and defined sectors

Methodology of the Study

This study is a pilot study in Kaduna and its environs on the effect of Risk management practices in Nigerian Microfinance banks. Kaduna is located on latitude 10°30'N and longitude 9°24'E in Nigerian Northern region. It covers about 65km South of the famous Zazzau city popularly known as Zaria city. It is made up of four (4) local government areas. The bulk of the study was conducted with the aid of questionnaires.

Data for this study consists of annual observations of 10 Microfinance banks between 2010 and 2019. Data was also obtained from annual reports and financial statements of the MFBs. Since the data contains information on observed MFB over time, a panel data estimation technique is appropriately used in this study. Therefore, statistical analysis is possible. The model is as follows:

$$y_{it} = a_0 + B_{it}X_{it} + e_{it}$$

Where $i = 10$ MFBs and time $t = 2010 - 2019$.

y_{it} as a dependent variable represents MFB's growth measured by Return on Asset (ROA) and Return on Equity (ROE), while X_{it} represents a vector of the independent variables of liquidity, financial and reputational risks. These variables include cost of past/watch and doubtful loans, non-performing loans as well as liquidity position. The a_i differs in effects on each microfinance bank.

Results and Discussion

Results of the estimation are presented in the following tables (1 and 2). From the correlation matrix of the variables in table 1 below, it can be seen that all the variables show considerable variances between the microfinance banks. This significantly justify the adoption of panel estimation technique. Even the f-statistics and likelihood ratio indicates that the model is fit. In model one where the return on capital employed (ROCE) was adopted as dependent variable, cost of non-performing loan was discovered to be a significantly negative factor (5%) affecting the growth of MFBs. This means that there is an inverse relationship between growth of MFBs as measured by ROCE and cost of non-performing loans. But the capital asset Ratio (CAR) measured by debt equity ratio was discovered to be positively significant at 5%. This is an indication that there is a direct relationship between these two variables. In MFBs, loans are expected to be repaid as at when due in order to minimize the risk of loan losses. The MFBs must ensure that loan accounts are closely tracked and conscious efforts should be made to collect repayment as they fall due.

Also, reputation of the MFBs as depicted by their levels of investment was found to be positive and also significant at 5%. This is suggestive of the fact that the more the careful investment by MFBs, the higher the growth of the MFBs. Even when both return on Asset (ROA) and return on equity were used as dependent variables, similar results were obtained.

Table 1: Correlation matrix of the variables

roe	1	1.0000																	
roa	1	0.7237	1.0000																
roaa	1	0.2194	0.3236	1.000															
cost of non perf	1	-0.2234	-0.2143	-0.2546	1.000														
PW&d	1	0.3234	0.2544	0.2101	0.3562	1.000													
liquidity	1	0.2464	0.3211	0.3310	-0.0134	0.4321	1.0000												
Caeql	1	0.2212	0.2288	0.3509	-0.1032	0.4023	0.5727	1.000											
carder	1	0.4501	0.5445	-0.0408	0.1367	0.3601	0.1720	0.674	1.0000										
careqta	0.0141	-0.0531	0.1203	0.3420	0.1564	0.4087	0.2810	0.5604	-0.2101	1.0000									
invest	0.5475	0.4461	0.2464	-0.1752	0.2274	0.1521	0.1712	0.2436	0.0117	1.0000									

Table 2: Risk and Growth of MFBs

ITEM	ROCE		ROA		ROE	
	Amount (N)	Standard error	Amount N	Standard Error	Amount N	Standard Error
Cost of non-performing loan	-1.73342	.4368221	-1.42234	.5001123	-1.310122	.4868602
Past / watch and doubtful	.5614104	.644132	.6418331	.6651261	-.1604424	.620344
Liquidity position	-.0023441	.02344601	.042601	.0460131	.0261302	.0370221
CAR						
Equity / loan asset	-2.442131	6.1132312	-2.12302	6.606262	-1.688213	7.4314135
Debt equity ratio	1.1126212	.2317248	1-664761	.2214321	1.868211	.3446212
Equity – Total Asset	14.45652	20.24846	25.04444	22.40414	30.323123	22.745381
Investment level	2.142424	1.214066	4.722142	1.224011	1.764201	1.244433
Constant	.522121	2.02555	-.5372421	2.140031	1.03456	2.111201

Conclusion and Recommendations

From the results, it is clear that there is significant relationship between growth of microfinance banks and risk management. The more effective risk management strategies are, the higher the sustained growth of microfinance banks. Effective risk management in terms of credit, reputation and liquidity are all important for the enhanced growth of microfinance banks in Nigeria. In order to safeguard depositors fund, protect investors / shareholders' interest and ensure enhanced reputation of the MFBs, the operators must ensure prudence in the management of the MFBs. Efforts should be intensified to ensure that loans are adequately secured and recovered as at when due. Members of staff of the MFBs should be constantly trained and retrained to ensure efficiency. The Central Bank of Nigeria (CBN) and Nigeria Deposit Insurance Corporation (NDIC) should focus attention on the identification of risk and its mitigation in their regulatory role.

References

- Cebenoyan, A. S. & Strahan, P. E. (2004). Risk management, capital structure and lending at banks. *Journal of Banking and Finance* 28, 19–43.
- Colquitt, J. (2007). *Credit risk management: How to avoid lending disasters & maximize earnings*. 3rd Edition. USA: McGraw-Hill.
- Crouhy, M.; Galai, D. & Mark, U. (2006). *The essentials of risk management*. USA: McGraw-Hill.
- Cumming, C., & Mirtle, B. (2001). The challenges of risk management in diversified financial institutions. *Federal Reserve Bank of New York Economic Policy Review* 7, 1 – 17.
- Greuning, H. V. & Bratanovic, S. B. (2009). *Analyzing banking risk: A framework for assessing corporate governance and risk management* 3rd Edition. Washington, USA: The World Bank.
- Miccolis, J. & Shaw, S. (2000). *Enterprise risk management: An analytic approach*. New York: Tillinghast- Towers Perrin,
- Nocco, B. W. & Stulz, R. M. (2006). Enterprise risk management: Theory and practice. *Journal of Applied Corporate Finance*, 18, 8-20.
- OwoOwojori, A. A., Akintoye, R. I. & Adidu, A. F. (2011). The challenge and risk management in Nigeria banks in the post consolidation era. *Journal of Accounting and Taxation*, 13(2), 23 – 31.
- Santomero, A. (1995). Financial risk management: The whys and hows. *Journal of Financial Markets, Institutions and Investments*, 4,
- Tandelilin, E., Kaaro, H., & Mahadwartha, P. A., Supriyatna, E. (2007). Cooperate governance, risk management and bank performance: Does type of ownership matter? EADN Working Paper No. 34.
- The Obasanjo Economic Reforms Banking Sector (2005). Abuja Federal Ministry of Information and National Orientation.