ASSESSING THE NIGERIAN MICROFINANCE BANKS' COMPLIANCE WITH PRUDENTIAL REQUIREMENTS

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Abstract

Microfinance Banks (MFBs) operate like deposit money banks except that they are restricted from carrying out general banking activities in order to focus on micro finance transactions. The activities of MFBs are spelt out in the prudential guidelines developed by CBN. One of the major activities is granting of micro loan to those customers, but with attention on the poor that cannot easily have access to the conventional banks. However, the peculiarity of the micro loan becomes difficult both for MFBs and the customers to operate because of the contents of the prudential guidelines that must be adhered to. The problem area is default often referred to as non-performing classification that may be due to the inadequate loan period and day(s) period involved in the default recognition and classification. The study therefore focuses on the problem of non-performing loan with the objective to find out whether it is possible for the MFBs to strictly comply with the guidelines on them. To achieve this objective, relevant questions were formulated and used for oral interview with the management staff of 15 MFBs from three states selected at random. The responses with the literature reviewed were analyzed and the summary of findings revealed that the prudential guidelines were forced on these banks and the expected results could not be achieved. The study recommends that the existing prudential guidelines should be studied with a view to discovering the weaknesses for solution by the CBN and MFBs.

Introduction

The activities of microfinance banks (MFBs) are like those of commercial banks often referred to as deposit money banks except for few transactions that are not allowed by the MFBs guidelines. The restriction could be due the nature of its structure, share capital, required personnel and mainly having to focus on micro activities rather than the general banking. MFBs are unit banks except for some that were permitted to expand beyond unit banking.

These banks have regulatory and supervisory guidelines developed and approved by the Central Bank of Nigeria (CBN). The guidelines are expected to be fully complied with as deviation from it could amount to violating the prudential regulations. MFBs are expected to adhere to regulations and they have a responsibility to provide the services that customers expect to improve the living conditions mainly of the poor. However, there may be possibility that some MFBs could not completely adhere to or comply with the prudential requirements either because they are not implementable or have no resource to implement. CBN (2005) construes microfinance bank to be any company licensed to carry on the business of providing microfinance services, such as savings, loans, domestic funds transfer, and other financial services that are needed by the economically active poor, micro, small and medium enterprises to conduct or expand their business. This meaning is elaborate and directly appears to include an explanatory role of the MFBs.

CBN (2005), states that microfinance is about providing financial services to the poor who are traditionally not served by the conventional financial institutions. The features of microfinance are i) the smallness of loans advance and or savings collected ii) the absence of assets based collateral and iii) simplicity of operations. One of the objectives is to make financial services accessible to a large segment of the potentially productive Nigerian population usually the poor which otherwise would have little or no access to finance services. This however, could be a policy statement because the poor will lack regular information and knowledge about having access to financial services; they are ignorant and are not represented at the implementation level for their interest to be defended.

One of the major objectives of the permissible functions of the MFBs is the provision of credit to its customers, including formal and informal self-help groups, individuals and associations and the promotion and also the monitoring of the loan among its customers by providing ancillary capacity building in such areas as record keeping and small business management. According to the 2005 guidelines, micro loan is a facility granted to an individual borrower or a group of borrowers whose principal source of income is derived from business activities involving the production or sale of goods and services. The maximum principal amount shall not exceed N500,000, or as may be reviewed from time to time by the CBN.

Usually this loan is given to the operators of micro-enterprises, such as peasant farmers, artisans, fishermen, rural women, senior citizens, salaried and non-salaried workers in the formal and informal sectors. The guidelines are silent about big men and contractors; however, a study of the loans beneficiaries of any MFB may reveal this group. One greatest characteristic is that the loan is usually unsecured, but typically granted on the basis of the customer's character, recognition and the combined cash flow of the business and household. This may not be practicable with these banks, as their risk assets must have to be protected because the CBN will not serve as a guarantor.

One crucial worry on the part of customer is the repayment period which is a maximum of 180 days (6 months). However, the period would be extended to twelve months in the case of crops with a longer gestation. The fret becomes inevitable considering the usage of the loans to yield results before the repayment. The 180 days represent maximum, meaning that the repayment period of a micro loan and accrued interest can only be 15 days or less. Another controversial matter in the micro loan is the loan size restriction to a customer which stands at a maximum of 1 % on the positive shareholders' funds. A group borrower could however, take a maximum amount of 5% on the MFB's shareholders' funds unimpaired by losses or as may be prescribed by the CBN from time to time.

A contravention of these restrictions will attract a penalty of N1.0 million on the MFB and a fine of N100,000 on the director/manager who fails to comply. This clause indicates that once the shareholders' fund is negative, a MFB cannot give out any facility irrespective of the size of the deposits in place. Another serious question that will obviously demand for solution is what happens to those loans that are already granted before negative shareholders' funds. Should they be treated as violating the prudential requirement?

One significant area that anchors on the micro loan including the size and repayment period is the default of repayment of the principal and interest thereof. Once a customer

fails to meet up the repayment period of the loan, such loan will cease to be active or standard and would best be described as *non-performing loan*. The non-performing loan (NPL) is the focus of this study and the assessment is to find out whether the Nigerian MFBs are complying with the prudential guidelines on classification of non-performing or having any reservation on the prudential classification for improvement and sustainability.

The Prudential guidelines have a classification for performing, pass and watch, substandard, doubtful and loss with accompanying provision rates of 1%, 5%, 20%, 50% and 100% respectively. The default period for pass and watch is between 1 and 30 days, for substandard is between 31 and 60 days; for doubtful is between 61 and 90 days while loss classification is for 91 or more days. It is also expected that MFBs review all their loans on monthly basis for ensuring that all the credit facilities are properly classified and reported accordingly. The prudential guidelines are very clear that the required non performing loan (that is, portfolio-at-risk) shall not exceed 2.5% at any given time.

Emphasis is on NPL because when such default has gone beyond a reasonable threshold, obviously they begin to threaten the health condition and viability of the bank by becoming toxic. Another motivating factor for focusing on NPL is that a number of studies (Enyi, 2007; Hesse, 2007 and Afrivest, 2008) identify NPL as a major cause of banks' distress in Nigerian banking industry. This therefore becomes necessary to study the compliance of MFBs with the prudential guidelines on this variable. Based on the envisaged restriction and difficulty in allowing the researcher having access to the financial records of these banks for secondary data, the following questions were developed in order to collect primary data to arrive at the objectives of the study:

i. Generally, are the prudential guidelines on classification of micro loan implementable?
ii. Will you say that the periods allowed for micro loans to customers and classification of non-performing loans adequate?
iii. What will be your comment on the practicability of 2.5% of NPL on total loans?
iv. What is the average rate in percentage of your bank's NPL on total loans?
v. Are there alternatives to the existing guidelines that could stabilize and sustain the performance of MFBs?

Concept of Loans and Advances in Banks

Creation of credit facilities is one of the most important functions of banks including MFBs. The creation of credit is accompanied by the lending and investing activities of banks in compliance with the CBN's circulars and directives. The power of the banking system to create credit is of great economic significance because it results in the elastic credit system that is necessary for economic progress at a relatively steady rate of growth. CBN Banking Supervision (1990) defines credit facilities to include loans, advances, overdrafts, commercial papers, bankers' acceptances, bills discounted, leases, guarantees, and other loss contingencies connected with a bank's credit risk. Almost all the credit facilities are granted from the deposits liabilities mobilized.

When a bank grants loans, it could therefore be deduced that it has actively created a claim against itself and in favour of a borrower. The claims a bank takes from its customers in exchange for its deposits are the banks' assets. This is the main reason to state that, the standard assets of a microfinance bank are the loans and overdrafts.

investments and cash. Banks can thus directly affect the level of economic growth of a country through the granting of credit facilities. It therefore follows that the greater the percentage of a bank's total resources placed in loans. the better the bank's performance (Bruker. 1970). Thus. an important function of the banking system is to provide financial intermediation. and this is reflected in the loans and advances provided by the banks. Consequently. the amount of loans and advances outstanding and the loans and advances to deposits ratio can be used to evaluate the intermediation function of the Nigerian Banking System. The loans and advances to deposits ratio gives an impression of the extent to which banks used the resources available to them and thus considered a positive index of performance of the bank system (Jat. 2006).

Characteristics and Riskiness of Loans in Banks

Literature on banks' regulation is found to be generally biased against banks' ability to manage risk. If there is somewhere a mistrust that is left to them. banks will embark on so much risky business as to endanger the interest of depositors. Hence. regulatory intervention is required to force the banks to manage risk. Ironically. the business of the bank is to trade risk. Banks have been managing risk since their inception. Scholtens and Wensveen (2000) rightly questioned whether risk management in banks is really a new phenomenon emerging in the 1960s or 1970s as some authors tend to suggest (Allen and Santomero. 1998). Banks have shown from historical evidence that risk management in banks existed in the distant past. They see risk as the root of financial intermediation and as its main reason.

Bhattacharya (2006) having emphasized that risk management as the core or central function of the banking business has shown how banks as delegated risk managers could mitigate the bankruptcy risks of the borrower and thereby reducing the riskiness of banking business. Risk is a commodity in which a bank deals. It is too much to assume that an institution with such a long history does not know the commodity in which it deals and that someone else must tell them about it (Bhattacharya. 2006). The risk management represents management of credit facilities or simply management of loans and advances.

Banks trade and generate interest on risk assets; because they form the largest portion of a typical bank's balance sheet. They also generate the highest income as well. The risk of these assets is the potential that events. expected or unanticipated have an adverse impact on the bank's capital and earnings (Carse. 2001). As banks generate these risk assets through credit creation. the most important risk the banks are expected to identify. measure. control and monitor is credit risk (Toor. 2006). Contributing to this. Koch (1991) defines risk assets as earning assets.

According to van Greuning and Brataonovic (2003). banks are characteristically exposed to a variety of risks in the course of their day-to-day operations. The risks are broadly defined as financial. operational. business and events risks. These risks can result in loss to the banks or affect their liquidity if they are not properly identified. assessed and managed.

Carse (2000) opines that banking involves risks and no amount of care and prudence will prevent the occasional problem from arising. However. good banking involves the judicious taking of risks. managing and pricing them properly. rather than avoiding or hiding them. and in the process making the banking system work for the economy and to the benefit of all stakeholders. Sharing the same opinion. Chemielewski (2005) asserts

that the existence of risk is not necessarily a problem; even the existence of high risk is not necessarily a concern, so long as management effectively manages that level of risk. The New Capital Accord II (2001) issued by Basel Committee on Banking Supervision (BCBS) is risks-based and it ties the risk assets banks create to their capital. This has generated controversies among researchers on whether this will increase the risk profiles of the banks by making them risk averse. According to Ahmad (2004), while early literatures on banks' capital regulations explain that the imposition of stringent capital requirements may encourage banks to take more risk, a study he conducted on Malaysian banks shows that these requirements did not motivate the banks to take more risks.

On the other hand, Jeitschko and Jeung (2003), in their study, find that a bank's risks can be either negatively or positively related to capitalization, depending on the relative forces of the shareholders. However, Gup (2004) and Hassan and Hussain (2006) opine that the 8% requirement for capital adequacy is too low for banks in a country like the U.K. They argue that this is because the risk profile of the banks is higher in most countries and this will encourage the banks to take excessive risks.

Relevance of Provisions on Loans as Risk Assets

Provision on classified facilities is of great importance for bank and its regulators. Provisions here represent the expected losses on a portfolio of impaired and good loans. They constitute a contra-account, which is deducted from the value of gross loans in a balance sheet (Basel Committee, 2003).

As bank loans are, by their economic nature, have no much market-based information to estimate their current value, loan-loss provisions must be estimated. Several countries including Nigeria have provided a provisioning schedule for non-performing loans that takes into account the number of days since the default date and the quality of collateral support.

A segment of the academic literature has studied whether or not loan-loss provisioning is used to manage or smooth reported earnings and capital. The accounting and finance literatures have analyzed three main provisioning issues related to private information held by banks on loans as one of the fundamental characteristics which explain the economic role of banks (Diamond, 1984).

A number of studies have analyzed the extent of earnings and capital smoothing through a pro-cyclical loan-loss provisioning with high provisions in good times and lower provisions in bad times. For instance, Hasan and Wall (2004) report empirical evidence throughout the world consistently with the earnings smoothing hypothesis. It is argued that the Basel Accord cannot achieve a level playing field if it does not adequately address the loan-loss provisioning practices around the world.

However, two approaches have been suggested to measure credit risk and provisions on a loan portfolio: a *mark-to-market* model and a *default* model. In a mark-to-market mode, the value of loans (both performing and non-performing) is estimated, either with actual market prices or with an estimate of their fair value, which will integrate the probability of default over time, of losses-given-default, and a risk-adjusted discount rate. In the default-mode approach, provisions are estimated only for non-performing loans.

With the exception of cases with readily available market prices, one notices that, in both the mark-to-market mode and the default-mode, one must estimate the expected losses-

given-default. It is an important issue as, according to the above literature, bank managers use discretion in loan-loss provisioning. Berger, Herring and Szego (1995), in their critical review of market value accounting, suggest that value adjustment for credit risk should be based on a loan-loss reserve on nonperforming loans. According to regulators (Basel Committee, 1998), these reserves should be prudent and conservative, falling within an acceptable range of expected losses.

Categories of Provisions on Banks' Loans as Risk Assets

The practical literatures classify risk assets into five categories. According to van Greuning and Bratonovic (2003), the importance of asset classification is to assign credit risk grades, which is determined by the likelihood of default. It is also assigned credit risk management tool which considers loan service performance and the borrower's financial condition. The standard international asset classification rules as adopted by van Greuning and Bratonovic (2003) are summarized below:

1. Standard /Pass: Standard loans are those that service capacity considered to be beyond any doubt. In general, risk assets that are fully secured, including principal and interest, are usually classified as standard or pass, regardless of arrears of other adverse credit factors. These assets are reflected as "performing" in the balance sheets of the banks and a provision of 1% is set aside for them.

2. Watch: These are risk assets with the potential of drifting into the substandard category if not checked or corrected. They pose the danger of jeopardizing the borrower's repayment capacity and the income budget of the bank. This category of risk assets is merely used as a risk management monitoring tool and is not reflected in the bank's balance sheet. The provision on this category is 5%.

3. Substandard: Substandard credit facilities indicate credit weaknesses that jeopardize debt service capacity, in particular when the primary sources of repayment are insufficient and the bank is forced to recourse to secondary sources for repayment. Non Performing Assets (NPAs) that are at least 90 days past due in principal and interest are normally classified as substandard. These assets are recorded in the balance sheet and a provision of 10% is set aside for them.

4. Doubtful: These loans have the same weaknesses as substandard, but their collection in full is questionable on the basis of existing facts. The possibility of these assets deteriorating to loss category is present but certain factors that may strengthen the asset deter its classification until a more exact status may be determined. NPAs that are at least 180 days past due in principal and interest are classified as doubtful. They are also reflected in the balance sheet with a provision of 50% on them.

5. Loss: These facilities that are assumed to be irrecoverable. This does not, however, mean that these assets have absolutely no recovery or salvage value; rather they have neither practical nor desirable to defer the process of writing them off. The recognition of this NPA will take at least one year default in principal and interest and are classified as loss. Such facilities are also reflected in the balance sheet with 100% provision them.

In the Nigeria DMBs, only four categories are recognised. They are performing, substandard, doubtful and loss, but the percentage rate and the period of defaults attached to each category are the same. For the Nigerian MFBs, van Greuning and Bratonovic (2003) classification of loans and other risk assets are similar in categorisation, but differ in the provision rates and period/days of default.

The quality of any bank's risk assets is measured by the ratio of its NPA relative to its total credit risk. By extension, the health and robustness of a country's financial system is measured by the level of NPA in its banking system, since banking is the dominant sub-sector. So long as banks will continue to extend credits, NPA are inevitable in their books. What should be of concern is the level of such NPA in the books of the banks. According to Chakrabarti (2005), default risk is an essential feature of all lending and most banks have had "bad" or unrecoverable loans in their portfolios.

There is no controversy in the literature on the standard definition of NPA as most agreed on overdue repayment of principal instalments and accrued interests (Altman and Saunders, 1998 and Toor, 2006). However, the "past due" period of classification varies from one country to the other. The study of Toor (2006) also reveals that while in the US default period is 90 days, in countries such as India and UK, default period for consumer loans and residential mortgage loans vary from as short as 30 days to as long as 180 days. In Nigeria, Non-performing Assets (NPA) are not new and have been in operations since late 1980 but became more effective in 1990 as they were the single most devastating cause of banks' failure. For example, in 1998 when 26 banks were liquidated in one fell swoop, CBN reported that the NPA for the banks was N101 billion. The distressed banks' outstanding credits alone was N33 billion, or 7.8 percent of the total credits, while provision for NPA stood at N64.5 billion. The NPA ratio in the industry then was 24.4 percent (CBN, 2000). According to CBN (2005), the assets quality of the banking sector deteriorated in 2005. Their NPA increased from N316 billion in 2004 to N356 billion in 2005, giving a ratio of about 24 percent.

A number of studies (Asogwa, 2002; Otu, 2005; Adeyemi, 2006; Enyi, 2007; Hesse, 2007 and Afrivest, 2008) identify NPL to be the major cause of banks' distress in Nigerian banking industry. Other direct causes identified are poor credit administration, insider abuse, pressure to meet risk assets and income budgets and harsh economic environment are identified (Altman and Saunders, 1998).

According to Morgan (2008), although the NPA ratio of Nigerian banks dropped significantly from 22 percent in 2003 to 8.5 in 2007, it is still considerably worse than the better performing emerging markets such as Brazil, Russia and South Africa. They conclude that even though there has been a marked improvement in the banks' assets quality in the post-consolidation, the risk of a sharp increase in NPA increased as private sector credit increased by 98.7 percent in 2007.

In a recent study on Nigerian banks, Fitch Ratings (2009) confirms the drop in the NPA ratios of the banks as investigated by Morgan (2008) but expressed concern on their exposure in share backed loans and margin lending, in addition to oil and gas, and communication.

Methodology

The instrument used in data collection was oral interview. The sample size was drawn from fifteen (15) operating microfinance banks from three states selected at random. 75

(seventy five) management staff comprising of the managing director, head of credit and marketing department, head of operations, internal auditor and head of computer and management information system were interviewed. The responses from the interview questionnaire were analysed.

Results and Discussion

The analysis of the oral interview is provided one after the other below:

Possibility of implementing the prudential guidelines on classification of micro loan

About 86 percent of the respondents believe that the prudential guidelines on loan classification especially on non-performing loan are harsh for efficient operations of the MFBs. The guidelines should have been used for at least three years as a pilot for evaluating the possibility of implementing them rather than outright enforcement on MFBs. If from the pilot test, they become implementable, the CBN can therefore draw policy on full implementation on the MFBs. However, the minority are of the view that the guidelines are necessary, at least for providing a framework to follow and to avoid abuse of position and office in manipulating transactions on loans. In general, the banks are trying to implement the guidelines, only that they cannot be totally implemented as they are.

The outright enforcement to implement the guidelines could be injurious to the operations of these banks. This is because the players or operators of the banks were not given the opportunity to study and test the guidelines for implementation, comments/feedback. Imposition or hasty enforcement of the guidelines may not yield the expected results.

Adequacy of periods allowed for micro loans to customers and classification of non-performing loans

Not less than 89 percent of the officers interviewed willingly agreed that the maximum period of 180 days allowed for the micro loans is grossly inadequate for a good customer to invest in any viable project to produce returns with which to service the loan and its interest. They are of the strong opinion that the inadequate period allowed for loan usage and repayment is the main factor responsible for loan default. On part of the classification of non-performing period, the respond is simple, that one will not expect output to be better than the input. Since the loan period is not adequate, the classification of non-performing loan will be a replica, and ordinarily one should expect high classification of non-performing loans. The reason is that, once a customer is desperate to get a loan, he would not mind any condition that will be attached even though it is not workable. The expected honouring of the loan agreement from the customer is with a default.

The responses show that both the maximum 180 days for average period is not enough for any good business to materialize for positive returns and that in turn responsible for the high classification of non-performing loans and other risk assts. However, the responses did not make reference to interest as a factor for non-performing loan.

The practicability of 2.5% of NPL on total loans?

Almost all the respondents laughed at this question; they believe that it is funny for the regulatory authority to come up with a percentage that can never be achieved except by new MFBs in their first three to six months in operations. Another positive condition that 2.5% could be achieved is for the MFBs to refuse granting loans to the customers and in that respect are violating the functions of intermediary role of MFBs.

The debatable issue from the loan classification especially on non-performing loan is the subjective nature of the classifying officer or bank examiner. For instance, different officer/examiner may come up with different classification of non-performing results from the same loans information on the same date and time. This is because of each officer/examiner's perception on the loans' status, amount of the repayment compare with total amount outstanding, frequency of repayment and vis-à-vis the repayment period.

Average rate in percentage of your bank's NPL on total loans
About 91 percent of the respondents to this question have common view that the rate at any point in time can be estimated to be more than the prudential guidelines of 2.5% and is adversely affecting the shareholders' funds. Their reason is that the 2.5% is not practicable as far as the business of MFBs is concern. The 91% is as good as 100%, if the players of these banks are of the common view that the 2.5% NPL on total risk assets is not achievable, the CBN cannot turn back on it, in means something is actually wrong with that prudential rate.

Alternatives to the existing guidelines that could stabilize and sustain the performance of MFBs
56 or about 86 percent of the respondents suggested two alternatives to the existing prudential guidelines on the micro loans. First, the CBN should allow at least three years of operational period for the MFBs to properly implement the existing guidelines on loans and other risk assets to come up with all operational and financial lapses. The banks should equally be allowed to analyse these weaknesses and then suggest what the prudential or operational guidelines should be. During the period of this test, penalty shall not be imposed because it is a solution finding exercise. The second alternative suggested is for the CBN to carry out a study sampled monthly returns and financial statements of MFBs from years 2005 to 2010 to draw up a proposed guidelines for the banks study, provide input, finalise before implementation.

The two suggested alternatives call for a rethinking on the prudential guidelines on the loans by the CBN to enable the MFBs take the guidelines or operational document seriously in the implementation.

The inferences from above are that:

1. Imposition or hasty enforcement of the guidelines on MFBs may not yield the expected results because the players of the banks were not given the opportunity to study and test the guidelines for implementation.
2. The inadequate period allowed for loan usage and repayment is the main factor responsible for loan default that gives rise to classification.
3. Classification of loan into non-performing and its sub classifications is always subjective because of the perception of classifying officer/examiner.
4. The 2.5% NPL on total risk assets at any point in time is not prudentially practicable.
5. In addition to 1. above, the CBN should conduct a study based on the mandatory returns and financial statements received from the MFBs to develop an operational policy after a satisfactory test.

Conclusion and Recommendations

The study concludes that the existing prudential guidelines were imposed on MFBs and therefore would not achieve much result. Based on the findings, the following recommendations are put forward for implementation:

1. The existing prudential guidelines should be studied with a view to discovering the weaknesses for solution by the CBN and MFBs rather than ordinary imposition.
2. In the study, proper attention should be given to the following:

    i. adequate loan period, size of the loan and sufficient repayment period.
    ii. which loans are to be classified as non-performing with clear criteria.
    iii. reasonable and implementable percentage rate of NPL on total loans and on shareholders' funds.

3. The CBN should further analyze and conduct a study on the MFBs' returns and financial statements with a view to complementing the recommendation in 1 above for the purpose of developing implementable prudential guidelines on loan and other risk assets.

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