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# Microcredits Management Practices: A Critical Success Factor for Rural and Community Banks

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***Abstract***

*Microcredits are the largest assets and the main sources of income to rural and community banks in Ghana. That notwithstanding, microcredit is relevant to rural and community banks in Ghana but it is risky and expensive to manage. Based on a review of extant literature, this study aims to demonstrate how microcredits are managed in rural and community banks. This was achieved by examining literature on the criteria used in managing credit worthy clients, the effectiveness of the loan disbursement procedures, the extent to which the banks educate and supervise the customers and problems encountered in recovering bank loans granted. The review indicates that the bank had higher default rate as a result of the high interest rate and time of making credits available to the beneficiaries, hence, operating far below the expected recovery rate. It was recommended that banks should be mindful of the time they give out credits to the clients to meet the purpose for which loans were taken by the clients. It was also recommended that banks should adopt innovative lending methodologies such as group lending and dynamic lending to joint-liable group to solve the problem of high default rate.*

***Key words*** Microcredit, rural community banks, Ghana, lending

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## 1. Introduction

Asiedu-Mante (2011), credit management involves establishing formal legitimate policies and procedures that will ensure that proper authorities grant credit to the right people for the productive activities or for businesses which are economically and technically viable. Savings mobilization and lending are the major operating activities and life-blood of all banking institutions. The mission of the rural bank is an instrument to help turn around the community it serves to foster.

Ampah (2010), said that rural banks in Ghana are grappling with huge challenges in managing their loan loss reserves due to bad loans and poor management systems applied by the banks. As a result, majority of these Rural and Community banks have been rendered insolvent and could soon fold up if austerity measures are not taken to reverse the trend. Ampah (2010) further indicated that the poor performance of Rural and Community Banks stemmed from both unfavorable operating environment and capacity constraints. Rural banks have unfavorable environment to mobilize scattered rural incomes at a high cost into saving, and lend to the people with virtually no collateral to support such credits. Rural and community banks are one of the banking sectors which are the main source of funding to business activities especially the small scale businesses as well as other capital intensive projects in rural Ghana. In spite of the significant contribution of loans to the financial health of banks as a whole through interest income earnings, huge bad loans could negatively affect banks' operating performance. It is therefore imperative to assess how such credits are managed to meet the overall objectives of both banks and their clients.

This paper is based on secondary data from published studies to establish the relevance of credit control in Rural Banks in Ghana. The objective of this paper is to emphasize on how microcredits management can contribute to the success of rural banks in Ghana. It is therefore necessary to consider the following specific objectives:

i. To explain credit management practices
ii. To identify the effects of credit management on profitability of rural banks.
iii. To establish how the rural banks could use credit policy to curb credit risk.

## 2. Literature review

### *2.1. Credit Management Practice*

Asiedu-Mante (2010), credit management involves establishing formal legitimate policies and procedures that will ensure that: the proper authorities grant credit, the credit goes to the right people, the credit granted for the productive activities or for businesses which are economically and technically viable, the size of credit is granted, the credit is recoverable and there is adequate flow of management information with the organization to monitor the credit activity.

Credit management practice refers to the efficient blend of the four major credit policy variables to ensure prompt collection of loans granted to customers and the same time boost their confidence and loyalty to the bank (Van Horne, 1995). The first variable is the assessment of the quality of the customer account. This examines the ability of the customers to repay on time. The second policy variable is that of setting the credit period. Such period must not be too long to put the bank at a disadvantage. The third variable is the enticement to credit beneficiaries to repay credit on time. Such enticement must be motivating enough before the aim can be achieved. The last variable considers the expenditure level that could be incurred in the collection exercise. To blend these variables into an efficient workable system requires careful planning, controlling and co-ordination of all available human and material resources. Moti, Masinde, Mugenda and Sindani (2012), said that a key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. The authors further stressed that in order to minimize exposure to bad debt, over-reserving and bankruptcies; companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. This implies that rural and community banks must not grant credit where the amount to be expended on collecting the debt is likely to be greater than the debt itself. Anjichi (1994) also lamented that, many of the agonies and frustrations of slow and distressed credits can be avoided by good loan supervision which helps in keeping a good loan. This is done by visiting the borrowers' business premises to unearth the general state of affairs, checking on the state of borrowers' morale and physical wellbeing as well as their inventories.

### *2.2. Risk Associated with Lending*

Kay (2002), credit risk is distribution of financial losses due to unexpected changes in the credit quality of counterparty in a financial agreement. The author also sees it as the probability of default or any type of failure to honour a financial agreement. Kay (2002) indicated that the probability of default is estimated by specifying a model of investor uncertainty: a model of the available information and its evolution overtime; and a model definition of the default event.

Smook (1997), views risk assessment as the overall process of risk identification, quantification, acceptance, aversion and management. The author indicated that risk management practices include risk assessment and risk control. Smook (1997) again indicated that risk evaluation is a complex process for developing acceptable levels of risk to individuals, groups, or the society as a whole. It involves the related processes of risk acceptance and risk aversion. The author further indicated that risk acceptance implies that a risk taker is willing to accept some risks to gain or benefit, if the risk cannot possibly be avoided or controlled. If the determined risk level is below the acceptance level, the risk is deemed acceptable. If it is deemed unacceptable and avoidable, steps may be taken to control the risk or the activity should be ceased .The perception and the acceptance of risks vary with the nature of the risks and depend upon many underlying factors. The risk may involve a "dread" hazard or a common hazard, encountered occupationally or non-occupationally, which has immediate or delayed effects and may affect average or especially sensitive people or system (Andrews, 1999). Rose and Kolari (1995) view credit risk as the possibility that borrowers will default in repaying loans taken. Balogun and Alimi (1988) also identified the major causes of loan default as loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes. Vandel (1993) and Okpugie (2006) in separate studies found that high interest rate charged by microfinance institutions is a major cause of default among the microfinance clients.

### *2.3. Lending*

Lending in general term is the temporary giving of money or property to another person with the expectation that it will be repaid at a later date. But Gaurav (2010) identified general principles of good lending which every banker should follows when appraising an advance proposal:

- Safety**:** The banker ensures that the money advanced by him goes to the right type of borrower and is utilized in such a way that it will not only be safe at the time of lending but will remain so throughout, and after serving a useful purpose in the trade or industry where it is employed, and should be repaid with interest.
- Liquidity: The borrower must be in a position to repay within a reasonable time after a demand for repayment is made by the borrower.
- Purpose; the purpose for which loans were acquired should be productive so that the money not only remain safe but also provides a definite source of repayment.
- Profitability: the bank must make profit from the loan.
- Security; Security is considered as an insurance or a cushion to fall back upon in case of an emergency.
- Spread; the diversification of advances.
- National Interest, Suitability: Compliance with all local legislation.

The authors further explained that in the changing concept of banking, factors such as purpose of the advance, viability of the proposal and national interest are of importance than security, especially in advancing credits to agriculture, small industries, small borrowers, and export-oriented industries. It is therefore worthy of note that lenders must observe these aforementioned lending principles before granting loans to clients.

### *2.4. Credit Analysis Techniques*

Maness (1988) credit analysis is the process of deciding whether or not to extend credit to a given customer. The author outlined certain individual traits that must be used for such analysis, which he referred to as the 5Cs, namely, the customer character, capacity to pay, collateral to support the loan, capital or asset-base of the customer, and the general economic condition under which the customer operates. Andrews (2004) believes that Credit analysis includes financial and non-financial factors, and these factors are all interrelated. These factors include the environment, the industry, competitive position, financial risks, management risks, and loan structure and documentation issues.

Rural bank must operate within a sound and well-defined criteria for new credits as well as the expansion of existing credits. Credits should be extended within the target markets and lending strategy of the institution. Before allowing a credit facility, the bank must make an assessment of risk profile of the customer or transaction. Stiglitz (1990) argues that group members have better access to information on reputation, creditworthiness and an intended purpose of peer borrowers than the bank official. Fundamentally, the problem arises because lenders are imperfectly informed about the characteristics of potential borrowers, and it may be impossible for lenders to distinguish between 'good' borrowers from 'bad' ones (Fraser, 2004). Ahmad (2001), there is no guaranteed procedure for ensuring that loans do not go bad as certain circumstances can go against the best of borrowers.

### *2.5. Credit Appraisal Techniques using 5Cs Model*

The 5Cs model used in a credit appraisal is: character, capacity, collateral, capital and condition. The 5Cs help rural and community banks to increase loan performance, as they get to know their customers better. Abedi (2000) posits that Microfinance Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower. Myers and Forgy (2005) said character basically is a tool that provides weighting values for various characteristics of a credit applicant and the total weighted score of the applicant is used to estimate his or her credit worthiness. This is the personal impression the clients make on the potential beneficiaries of the loan. Ouma, (1996) pointed out that factors which influence a client can be categorized into personal, cultural, social and economic factors. But Moti, Masinde, *et al*., (2012) also stressed that the psychological factor that influence clients is based on a man's inner worth rather than on his tangible evidences of accomplishment. Rural and community banks consider this factor by observing and learning about the individual. And in most cases it is not considered on first application of credit by an applicant but from the second time, (Moti *et al.,* 2012). Under social factors, lifestyle is the way a person lives. This includes patterns of social relations (membership groups), consumption and entertainment. A lifestyle also reflects an individual's attitudes, values or worldview. Moti *et al.* (2012) again said that reference groups in most cases have indirect influence on a person's credibility. Rural and community banks endeavour to unfold the reference groups of their target as they influence clients' credibility. The authors further stressed that personal factors including age, life cycle stage, occupation, income or economic situation, personality and self-concept also influence clients' credibility. Under life cycle stage for example older families with mature children are not likely to default since it's easier to attach collateral on their assets since they are settled unlike the unsettled young couples (Moti *et al.,* 2012). The rural and community banks consider cash flow from the business, the repayment schedule, and the timely success of loan repayment. Anthony (2006) defines cash flow as the cash a borrower has to pay to the client. Cash flow helps the rural and community banks to determine if the borrower has the ability to repay his or her debt as and when the debt fall due. The analysis of cash flow can be very crucial and technical. It may include more than simply comparing income and expenses. Cash flow in the rural and community banks is determined by examining existing cash flow statements (if the client has) and reasonable projections for the future ratios. Orlando (1990) stated that lenders review the borrower's business plan and financial statements, they have a checklist of items to look at one of them being the number of financial ratios that the financial statements reveal. These ratios are yardsticks to assist lenders to determine whether the borrower will be able to service current expenses and also settle the additional expense of a new loan. Lawrence and Gitman (2007), said that collateral is any asset that customers have to pledge against debt. Collateral represents assets that the loan beneficiaries' pledge as alternative repayment source of loans acquired. It is obvious to unfold that most collaterals are in the form of hard immovable assets and/or non-current assets such as property plant and equipment (real estate and offices or manufacturing equipment). Alternatively, current assets such as accounts receivables and inventories can be used to pledge as collateral. Lenders of short term funds prefer collateral that has duration closely matched to the short term loan (Moti *et al.* 2012). 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, (Weston and Brigham, 1982). Capital is the money that borrowers have personally invested in their businesses and are indications of how much the borrowers have at risk should their businesses fail (Moti et al, 2012). Capital is therefore the quantum of resource that will be lost to that borrower first should the businesses of the loan beneficiaries fail. Condition refers to the borrower's sensitivity to external forces such as interest rates, inflation rates, business cycles as well as competitive pressures. It is therefore obvious to note that such conditions focus on the borrower's vulnerability.

### *2.6. Credit Policy and Administration*

Seid (1998) lamented that it is the Government policy to empower the rural people economically by making credits easily available to them through rural banks to improve their standard of living and contribute to the development of their community. In addition, District Assemblies are to devote part of their common fund to assist the rural people to embark on income generating activities. Guidelines of rural bank (1993) indicate that senior management of the bank should develop and establish credit policies and credit administration procedures as a part of overall credit risk management framework and get those approved from board. Such policies and procedures shall provide guidance to the staff on various types of lending including corporate, consumer, agriculture, etc. At minimum, the policy should include detailed and formalized credit evaluation, credit approval authority at various hierarchical levels including authority for approving exceptions, roles and responsibilities of staff involved in origination and management of credit.

According to Effah (1998), although, it was the aim of the government to help the rural banks to find their feet economically through World Bank package, it is only viable and hardworking rural banks in the country that will benefit from the schemes. Effah (1998) further said that, despite the government assistance to rural banks, small-scale farmers and shareholders of the rural banks should not neglect their responsibilities in helping the peasant farmers whose interest is the prime objective for the establishment of rural banks in Ghana.

Guidelines for rural bank (2005) indicate that the on-going administration of the credit portfolio is an essential part of the credit process. Credit administration function is basically a back office activity that support and control extension and maintenance of credit. A typical credit administration unit performs following functions such as documentation, credit disbursement, credit monitoring, and maintenance of credit files, collateral and security documentation, and loan repayment.

### *2.7. Rural Banks and Credit Schemes*

Andrews (2009) indicates that credit arose as a response to the fact that banks were not extending credit to the rural poor of developing countries, and as a result people were forced to endure the usurious practices of moneylenders. Though several microfinance programs came into being in different parts of the world at around the same time, the most celebrated of these -The Grameen Bank-traces its origin to 1974-1975, when famine raged in the countryside of Bangladesh. Yunus (2003) indicated that bankers continue to refuse to grant credit to the poor without collateral. The author decided to start his own bank: a Grameen (village) Bank.

Yunus (2003) realized however that he had to develop a system that would guarantee that, those who had received a loan would pay back. To ask for collateral was difficult as these poor people have hardly anything to offer as security. The author devised a system of “social collateral”. Those women who wished to receive a loan needed to organize themselves in groups from 5 – 10 persons. One of the group members receive a loan, and upon repayment the next one, and so on. If one member has problem of repayment, the others need to assist. Thus, solidarity, cooperation and social control replaced the traditional collateral. Employees of the Grameen Bank go out to their clients – on foot, by bike or by bus – to become acquainted with them in the surroundings of their own businesses. It turns out that poor borrowers in general are very faithful and repay their debts right on time. The emergence of microfinance in Ghana is not a recent phenomenon. Traditionally, people have been saving and taking loans from local lenders or group of people with the aim of starting their own businesses or for farming purposes (Asiama 2007). The author confirmed that the Canadian Catholic missionaries in 1955 first established a credit union in northern Ghana. This was the first in Africa. However, Susu which is another form of microfinance scheme in Ghana is thought to have originated from Nigeria to Ghana in the early twentieth century. Asiama (2007) has broadly categorised micro finance institutions that normally grant microcredt in Ghana into three. That is the formal suppliers such as rural and community banks, semi-formal such as credit unions and informal suppliers like “Susu” collectors. Frimpong (2007) asserts that rural and community banks offer both financial and non- financial services to the communities they serve. The financial services include lending, savings and other banking services such as cheque clearing for cocoa farmers. Non-financial services include supply of agricultural input to farmers. The rural banks grant loans that are payable within 4-12 months, and accept flexible payments on weekly, bi-weekly and monthly bases. In some loan applications, the banks often require the beneficiaries to be already involved in some economic activity and to deposit about 25 percent of the intended amount before the loan is approved.

The following factors were found to be those affecting granting of microcredit and profitability of rural and community banks. These factors include high interest rate, inadequate loan sizes, late disbursement of loans, business failure, unfavourable payment terms, unforeseen contingencies, (such as illness and death of a family member), lack of training the clients before and after disbursement. These were confirmed by the findings of the study by a number of researchers. Late disbursement of credits normally disallows the clients to timely use the money on projects they intended to do. Since clients therefore apply their credits on unplanned ventures, they fail in such ventures thereby leading to the default of their credits and hence negative effect on the banks' profits. This revelation confirms what Okorie (1986) stated, that time of disbursement is a major cause of loan default among rural and community banks. It is obvious to note that if credits are granted timely to the clients, all things being equal, clients are able to apply them appropriately to increase their wealth, and hence repay their loans, thereby helping the bank to meet their objective. Balogun and Alimi (1990) also lamented that major causes of loan default are delay in time of loan delivery, loan shortages, small farm size, high interest rate, age of farmers, non-profitability of farm enterprises, poor supervision and undue government intervention with the operations of government sponsored credit programmes. But Vandel (1993) and Okpugie (2006) in separate presentation posit that high interest rate charged by microfinance institutions is a major cause of default among the microcredits clients.

As part of the rural and community banks credit management practices are proper appraisal, adequate or proper monitoring, proper client selection, willingness of clients to repay their loans, conduct periodic training for the clients. These factors, if well managed would pave the way for the clients to be able to repay their loans. These are consistent with the findings of the studies conducted by Anjichi (1994) who lamented that, many of the agonies and frustrations of slow and distressed credits can be avoided by loan supervision which helps in keeping a good loan. This is done by visiting the borrowers' business premises to unearth the general state of affairs, checking on the state of borrowers' morale and physical wellbeing as well as their inventories. This was the confirmation of the findings of the study conducted by Ahmad (1997), who declared that lack of willingness to repay their loans coupled with diversion of funds by borrowers, wilful negligence and improper appraisal by credit officers are some of the causes of loan default and hence loss of interest income by the clients. Bigambah (1997) also observed that frequent visits/monitoring help to ensure that clients maintain the business and intend to repay the loan. It is therefore obvious to say that frequent visits allow the loan officer to understand the clients business better.

## 3. Conclusions and recommendations

It was revealed through the study that, the bank has put in place policy guidelines which they follow in performing their lending functions. The policy has played a crucial role in the profitability and survival of the bank. The findings from the study have convinced the researcher to conclude that, the bank has placed much emphasis on monitoring and collection of loan granted to borrowers.

In rural areas where banks have high individual credit defaulting rate, group lending could improve repayment rate. The most innovative lending methodologies that could be used by the bank are group lending, social intermediation and dynamic lending to joint-liable groups. These methodologies would solve the problem of inadequate appraisal, loan monitoring and high default rate. Group members have better access to information on reputation of their members. It was noted that creditworthiness of the group members could put pressure on other members to repay the loans as the failure of any member to pay the loan would affect the whole group.

The researcher recommended that the loan policy of the bank must be customer oriented. To be able to solve numerous problems of the bank, it is recommended that management must be proactive in credit delivery. It is further recommended that bank official must make sure that they get the necessary information about the loan customer before any credit is granted to the customers. In addition to physical asset as collateral the bank can adopt group lending where social collateral and trust are sufficient for economic active poor to repay the loan. Customer should also receive the loan as and when needed to avoid possible loan diversion. As much as possible the bank must avoid staff and board influence to allow institutional procedures to work.

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