THE YIELDREPORT | NEWSLETTER – JUNE 2023

Technology | Risk | Financial Inclusion

The Micro-credit Edition

Ghana’s business environment has become very volatile and uncertain given the unstable macro-economic conditions, which is undergirded by weak fiscal imbalances and inordinately expansionary monetary policy response. The adverse impact on operating performance of businesses and household incomes are felt widely across the financial sector, including Tier 3, Tier 4 NBFIs. This edition of The YieldReport newsletter, highlights certain structural risks for micro-credit institutions to consider as an integral part of a broader risk management framework. We hope you find it enlightening, and will adopt some of our recommedations.

Constructing a robust credit portfolio in an unstable macro environment

Micro-credit plays a critical role in making financial services available to excluded populations across the lower demographic strata. Notwithstanding, majority of providers (mostly Tier 4 operators), do not have the balance sheet size to absorb shocks or weather credit impairments over a sustained period without closing shop. Having a robust risk management framework therefore, is critical to building resilience in this volatile macro-economic environment. Notwithstanding inflation trending downwards from 54.1 percent in Dec 2022, to 41.2 percent in April 2023, consumer price risks remain elevated across board.

For micro-credit portfolios, the risks are even more accentuated given that food inflation constitute a greater proportion of the year-on-year changes. Majority of micro-credit portfolio assets are held by counterparties in the food sector, mostly market traders, chop bar operators, etc. The transport sector, which recorded the 5th highest year-on-year inflation in April 2023 (42.5 percent), also contsitute a sizeable portion of micro-credit portfolios. There is therefore an urgent need to rethink how credit portfolios are structured and how to mitigate exposures to various sectors, market segments or counterparties.

Useful link: Inflation report for April 2023. Click here

The first order of business is to mitigate structural risks

Since 2017, YieldRock has provided on-lending facilities and technical assistance to several micro-credit institutions across 6 regions. We have found 6 structural risks that have high correlation with poor operating performance and balance sheet vulnerability during economic downturns.

1. Fatty Cost Structure: There are currently no regulatory guidance on industry averages, but 40-45 percent cost-income ratio is reasonable for an NBFI with total asset size less than GH¢500,000. Plush offices, and incoherent business models are few of the drivers behind high capex and operating costs. Be modest. Ensure that your non-current assets is less than 25 percent of total assets.
2. Weak Business Models: Customers in remote locations are very costly to adminster, particular during loan recoveries. Geography must play a vital role in customer segmentation and targeting.
3. Risk-Adjusted Pricing: Most MCIs charge a blanket interest rate for all their customers, irrespective of counterparty risks. This increases moral hazard and adverse selection risks thereby reducing portfolio quality. Financial exposures (including loans) must be priced to reflect counterparty risks. No two customers ought to have the same interest rate unless both have similar risks profiles.
4. Portfolio-per-Employee ratio: It is inefficient to have 5 employees, for instance, with portfolio size of about GH¢500,000. Ideally, a maximum of 2 employees, if properly incentivized and trained, could manage that size of portfolio. Anything more signals a weak business model.
5. Concentration Risks: We know of at least 2 micro-credit institutions that went of out business after the COVID lockdown in 2020, due to excessive exposure to private schools. Do not put all your egs in one basket. Diversify across segments, locations, demographics, etc.
6. Information Assymetry: A thorough assessment of credit risks has a direct impact on earnings and growth. Unfortunately, some categories of information are unknowable unless disclosed by the customer. E.g., borrowing history, sundry liabilities, etc. Having a process to estimate these input drivers is central to determing a borrower's repayment capacity. In our experience, most MCIs rarely use rule-of-thumb estimates, if at all. It is always safe to assume that a prospective customer has loans or debts elsewhere. Account for it in your risk assessment by using rule-of-thumb estimates for certain unknowables that may impact the customer's expenditures in the future.

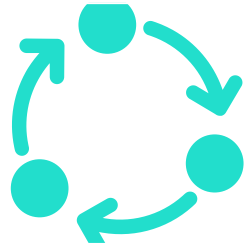
Credit Decision Automation: One useful way of mitigating structural risks is to deploy a Credit Decision Automation (CDA) system that uses a risk-weighted approach and allows for a systematic disaggregation of customers into various risk categories, i.e., high, medium and low risk customers. The CDA system, if properly designed and implemented, should tighten the controls at the 'main gate' to ensure bad customers do not enter and wreck havoc to PAR 30+.

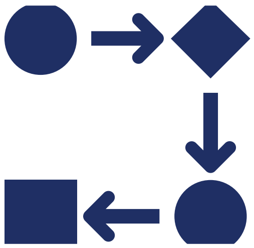
Business Intelligence Systems: Systems for ensuring continuous monitoring of counterparty risks across the entire portfolio are as crucial as blood is to the human body. This is one way to set-up early warning signals that will prompt corrective actions when necessary. Like the CDA system, a customized proprietary tool may serve a useful purpose if an MCI cannot afford a sophisticated off-the-shelf business intelligence solution on the market.

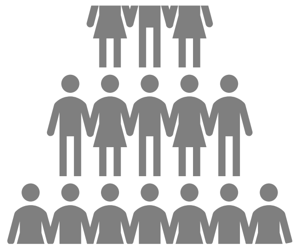
Always pay attention to…

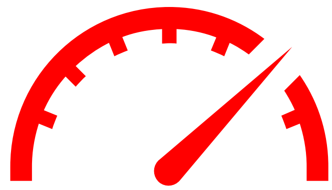

Market Risk


Credit Risk


Liquidity Risk


Operational Risk


Concentration Risk


Regulatory Risk

The next edition of The YieldReport will focus on the education sector (Basic Schools Editon). We will share how we helped a client to achieve massive growth by repurposing their school building (asset utilization) for use as a nanny care centre and playground on weekends. Don't miss it!

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