FIRST+

Financial Institution Resilience & STrengthening

Proactive strategies to prevent non-performing loans

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Young Africa Works

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GHANA MICROFINANCE INSTITUTIONS NETWORK

Session Objective

By the end of this session…

Participants will be able to appreciate strategic steps to prevent non-performing loans in MSME lending, such as how to:

- Better understand and segment the MSME market
- Develop and offer tailor-made products and services for specific target segments
- Develop and follow simple but effective credit policies and manuals
- **Focus** on effective loan monitoring and arrears and loan recovery management

Session Objective

Share a model work plan for FIs that guides how to strengthen the basis of MSME lending:

- MSME lending as an institutional priority
- The devil of MSME lending is in the detail
- NPL do NOT happen at the end of the MSME credit cycle

1. MSME Market Segmentation

1. 70 percent of businesses in Ghana belong to the informal sector (Total: 160,000 MSMEs)
2. Micro, Small and Medium enterprises – different definitions, different shades of grey
3. Various relevant sectors: Service, trade, industry, agriculture, etc.

The Purpose of Market Segmentation

1. Improved FOCUS (e.g. most promising (profitable) subsets of clients)
2. Competitiveness and client retention (client loyalty)
3. Potential expansion (cross-selling as well as *efficient/effective* growth)
4. Pricing optimization (win-win)

→ Better define and control risks by designing methodology, processes and procedures for specific parts of the market as well as designing products to fit better to the needs of specific types of clients.

→ Better set up operations in terms of organizational structure and personnel requirements, so that effective segmentation allows you to optimize how you do business in principle

Benefits of MSME Market Segmentation

1. **Market segmentation** → results in an **optimized strategy**, organizational structure, staffing, business processes and product range as the entire approach, product offer, etc. can be tailored to fit the ***specifics of respective segments***
2. The goal is to make processes, etc. **as lean as possible (but as elaborate as necessary)** for a respective segment, tailoring product parameters and conditions to meet the needs and possibilities of typical clients of a certain segment and designing your marketing approach and measures in a targeted manner
3. Experience shows: many FIs start looking into market segmentation **only** when they start getting under pressure – high NPL, high operating costs, decreasing margins due to increasing competition, etc.

   → FIs underestimate the need for collecting, storing and analysing **client data**.
4. **Client data** → Socio-demographic, Geographical, psychographics, behavioral data

MSME Market Segmentation Approach

Note:
Market segmentation needs regular review and fine-tuning over time as markets and clients, and client needs and behaviours change

Basis for market segmentation: INFORMATION

Step 1:
Analyze client base and identify homogenous groups

Step 2:
Determine priorities in line with mission, basic business goals, etc. and compare to available resources

Step 3:
Define strategy in detail, i.e. focus segments and goals, resources and timelines to reach goals, etc.

Instruments and data availability:

- Quantitative and qualitative research: surveys, FGDs
- CBS/MIS data queries and analysis

Typical Indicators Used by Financial Institutions

Quantitative	Qualitative	Socio-demographic	Behavioural
Annual turnover	Economic sector	Gender	Types and frequency of product use
Total assets	Ownership structure	Age	Motivation for using certain products
Annual profit	Degree of formality	Education	
Number of employees	Purchasing behaviour	Marital status	

2. Develop and offer tailor-made products and services for specific target segments

Twelve key elements of a MSME product/service design/development process:

1. **Purpose** – Does everybody involved in product dev. understand why a product is changed or designed?
2. **Simplicity** - If a LO/RM can't explain a product in three sentences or less, it's too complicated.
3. **Positioning** – Client/Market segmentation and differentiate from competitor's offerings
4. **Speed** – Hit the market quickly & take the first mover advantage. One can't keep on designing a product forever!

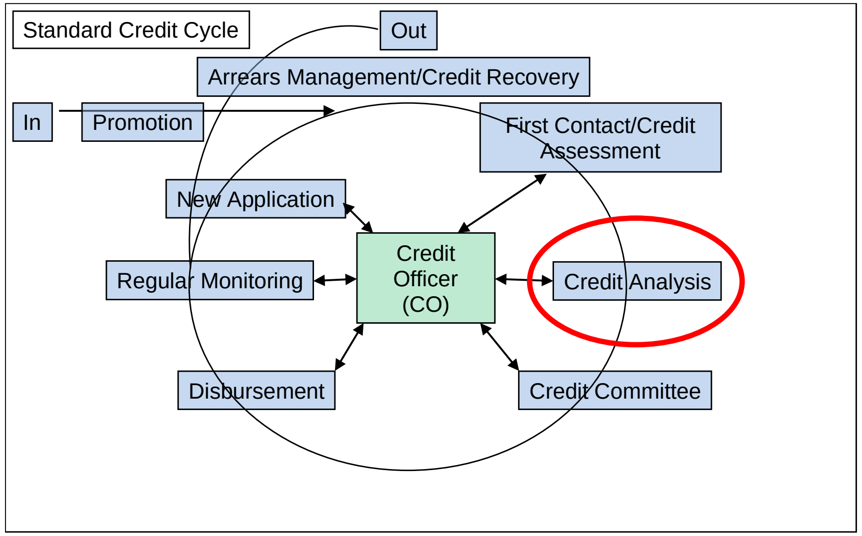
   STEPS: Market study→1st product design → Mgmt contributions → Refining the design → Seeking approvals from senio mgmt./board → Piloting → 2nd refining → Roll out
5. **Return expectation** – Profit maximization vs. other motives
6. **Risk management** – A suitable risk mitigating structure needs to be created (per product)
7. **Operational ease** – Ops processes need to be aligned with the specific objectives/target group
8. **Scalability** – Volumes/portfolio growth vs. testing the market
9. **Marketing /delivery (channels)** – Sometimes less is more. Look into innovative, target-group relevant ways
10. **Delinquency** - Risk profiling to assure that the probability of default (PD) falls within an acceptable range
11. **Expected loss** – Collateral, high filters to control delinquency, guarantee/insurance cover
12. **Competitor's products/services** – Innovation, distinctiveness from market

3. Develop and follow simple but effective credit polices and manuals

Credit policies and manuals must be aligned with the type of lending

Main Elements of Credit Policy / Credit Manual	
Objectives and FI's strategy and credit culture	Portfolio Management
Governance, Authorities, Responsibilities	Monitoring and credit control
Credit approvals and limits	Arrears management and loan recovery
Target markets / client groups	Loan portfolio quality
Credit products and services	
Credit process and analysis methodology	
Collateral & Guarantors	

Importance of credit appraisals to reduce NPLs



Credit Analysis

Qualitative vs. Quantitative

↓ ↓

Willingness vs. Capacity

Collateral

Creditworthiness & Credit risk

Still "state-of-the-art":

- **Cash flow based MSME credit analysis -** but risk analysis, trend analysis, ratio analysis and financial projections (depending on sector/segment))
- Credit risk assessment per **segment** ← standardized approach
- Credit risk analysis means (1) identifying and presenting risks, (2) assessing risks, (3) managing & mitigating risks
- ***Digital solutions?***

4. Focus on effective loan monitoring and arrears and loan recovery management

There are three stages in proper credit risk management and the prevention of Non-Performing Loans (NPLs).

1st Line of Defense	Early Warning Signs	Recovery Process

• Credit Approval
• Credit Structure
	• Monitoring
	  • Financial
	  • Non-financial
		• NPL Management
		  • Restructuring
		  • Collection

"First Line of Defense" comprises the approval and analysis processes according to the FI's credit policy (as discussed earlier).

Focus on effective loan monitoring and arrears and loan recovery management

Second stage: Monitoring of loans / credit lines after loan disbursement.

- After disbursement monitoring to ensure that the debtor has complied with the lending conditions (e.g. purchased the item specified in the loan agreement for the amount quoted).
- Regular monitoring to ensure that the business continues to be creditworthy and to have the capacity to repay the loan.
  - Monitor customer's compliance, financial position, cash flow, collateral, profitability

Third stage: Recovery process – consisting of arrears management, loan structuring, and recovery management.

NOTE: If these stages are carried out in a professional & timely manner, it is possible to significantly reduce the money lost through NPLs.

Reasons for arrears

- Poor product design
- Poor service delivery
- Poor client selection
- Poor loan analysis and management
- Poor loan monitoring and supervision (e.g. lack of early response to a problem and appropriate action)
- Insufficient definition of FI’s risk appetite & credit policy
- Lack of customer orientation / service
- Lack of understanding the clients (i.e. why do people default, etc.)
- Lack of internal capacity and knowledge

Incentive schemes and performance evaluations – key to lower NPLs?

- Well-designed staff incentive schemes can have positive and powerful effects on the productivity, efficiency and **quality** of FI's operations.

Main rules:

- Transparent ("rules of the game"), fair, achievable,
- Objective factors (few subjective variables)

Factors (*examples*):

- **Portfolio quality**: OLP, No. of clients, LLP, PAR 30, PAR 90, Write offs, Repayment rate
- **Portfolio growth**: OLP, No. of clients, new client acquisition, cross-selling, etc.
- "8-step approach" to designing a performance-based staff incentive scheme

1. Objectives	**3. Mechanism**	**5. C/B analysis**	**7. Explanation/Sale**
2. Staff members → $	**4. Technical design**	**6. Pilot**	**8. Monitor → Adjust**

Model work plan to strengthen MSME lending

- Embed MSME lending within the FI's strategy
- Align organizational structure & HR (staffing) to strategy
- Develop dedicated training & capacity building scheme(s)
- Develop and incorporate dedicated PPPs & business approach/methodology
- Incorporate MSME finance activities in the FI's general risk management framework
- Conduct a comprehensive market segmentation
- Develop, test, finetune and roll out dedicated MSME products & services
- Transversal topic: Ongoing capacity building schemes
- Manage operations & review, update and amend relevant steps

THANK YOU FOR YOUR ATTENTION!

QUESTIONS…?

Upcoming Events

22 June **1:30 – 2:45**	***Gender Finance is a Win-Win-Win!*** **Webinar**
21- 22 July	***Credit Risk Management*** Workshop in Takoradi

GHAMFIN is also currently providing workshops for its member associations as part of FIRST+. Please check with your association to learn what workshops are available to you.

For more information on FIRST+, contact

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