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Good Money' Chasing 'Bad Money': Implications for MFIs Management and Governance in Ghana

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Abstract

Despite the conviction that microfinance is able to reduce poverty among low income groups, one challenge that still remains in the sector is high default rate. One of the major causes of this situation seems to be the involvement of management, staff and board in loan processing and approval. The current study seeks to explore the cost of retrieving bad loans as a result of taking court actions against clients. The study adopts the qualitative approach to analyze the data from selected MFIs in Ghana. The use of good money for chasing bad money is unprofitable for MFIs. At least MFIs spend about 10.7% of their good money to chase bad money. This has the effect of minimizing the value of shareholders' wealth and as a consequence reduces profitability. In all the institutions interviewed, there is no code of ethics on loans for the board and management. Among the recommendations include the sale of outstanding debts to debt collection agencies (DCA) which is uncommon in Ghana at a fee less than cost of court actions. Board, staff and management are strongly encouraged to desist from the practice of influencing loan application and approval processes for friends and relations. There should be a high level of trust between board members and that board members should be ethical and have high level integrity.

Key words: MFIs, good money, bad money, management, board,

Introduction

The financial sector is a sector that utilizes productive resources to facilitate capital formation through the provision of a wide range of financial services to meet the different requirements of borrowers and lenders. Thus, the financial system plays a crucial role in mobilizing savings, and ensuring that these resources are allocated efficiently to productive sectors (Ang, 2007). In Ghana the financial system comprises formal, semi-formal and non-formal institutions that mobilize savings and grant loans to the public. The emergence of the informal financial system has become very crucial due to the inability of formal and traditional commercial banks to serve the wide range of needs of low income groups. In this regard and to serve the financial needs of the rural and urban poor, low income groups in society and micro-entrepreneurs, microfinance has been identified as a powerful way of serving the unserved, the under-served and reaching the unreached. Even though microfinance programmes have contributed immensely to poverty reduction among their clients as claimed by most authors, there remain significant challenges. While the provision of credit is by far the most important product of financial services, much progress has also been made by many MFIs offering a range of savings and insurance products, which has great potential for alleviating poverty and reducing vulnerability (Nourse, 2001; Robinson, 2001; Churchill, 2002; Zeller and Meyer, 2002; de Aghion & Morduch, 2005).

Despite the above conviction that microfinance is a powerful tool for reducing poverty, there remain several challenges in the sector. One of the biggest challenges facing the sector is default arising from loan delinquency. As registered legal financial institutions, MFIs have the legal right to prosecute defaulters and compel them to pay all outstanding loans. This process has some cost implications to the institutions. In doing this, institutions use 'good money' to chase 'bad money'. In this paper good money refers to funds that the MFIs have in their coffers to process court actions against defaulters and 'bad money' refers outstanding loan balances. These outstanding loan balances are described as bad because one cannot measure with precision whether they will be retrieved or not even after court action. Bad loans more often than not generate 'bad monies' thus compelling MFIs to take court actions against defaulting clients with their 'good monies'. Two main costs are associated with chasing bad monies: money cost and opportunity cost. The money involves the amount of money involved in taking defaulting clients to court including court fees, processing fees, transport and travelling expenses of staff to and fro court premises. The opportunity cost involves the time spent in chasing clients who have defaulted.

It is usually possible to estimate that after the institution has used good resources (such as monies in the safe) to follow-up bad loans; all efforts to retrieve them prove futile due to many factors. Some clients sensing danger in re-payment may re-locate, change their addresses, and cannot be traced at all. Clients are compelled to re-locate in times of default and sensing dangers associated with their arrest. In connection with this, one of the main challenges facing MFIs in Ghana is that many clients give false information about themselves making it difficult for the institutions to chase them in times of default. It also appears that the traditional principle of 'know your client' (KYC) is not being followed well by many MFIs because they want more clients. In another development, it is also believed that since most clients are in the communities that these institutions operate, vital information about clients are ignored or taken for granted. Another prominent factor is high cost of loans which make it difficult for clients to pay the principal and accumulated interest on their loans. It is philosophical to conclude that at times, there are bad loans and not bad clients because some MFIs having the sole mission of making profits poach clients to take loans at extremely high interest rates. Bad loans refers to loans that are not properly screened before approval, loans given to clients just because institutions want to make their profits, as well as loans that carry high interest rates. One can therefore not blame clients who default because some MFIs just want to supply credit in order to make profits.

Another side of the coin is that the influence of management and board of directors may generate bad loans because loan officers are sometimes not given the opportunity to appraise loan applications well before approval. Management and the board have the responsibility for ensuring that the goals of the MFIs are achieved and also depositors' interest is protected. The fundamental goal is to contribute to institutional sustainability and one way of ensuring this is to ensure that there is high repayment rate. This involves reaching out to more clients and economically active population strata, the so-called main outreach 'frontier' of microfinance (Helms, 2006; Johnson et al., 2006). Secondly, there is the need to achieve financial sustainability, preferably independence from donors. While Rhyne (1998) considers these two main goal areas to be a 'win-win' situation, claiming that those MFIs that follow the principles of good banking will also be those that alleviate the most poverty.

Woller et al. (1999) and Morduch (2000) believe that the proposition is far more complicated. This is because in most cases management and the board influence the loan application processes thus creating more outstanding loans which directly affect the achievement of MFIs objectives. It is important however to recognize that the theory of corporate governance is based on the assumption that the objective of firm is to maximize the market value of the company's wealth translated into shareholders' wealth maximization. In this regard the onus is on board to discharge good internal governance strategies to achieve this.

The role of internal corporate governance in microfinance cannot be underestimated. Corporate governance is concerned with ways in which all parties in the well-being of the firm attempt to ensure that managers and other stakeholders take measures or adopt mechanisms that safeguard the interests of the stake holders. Such measures are necessitated by the separation of ownership from management, an increasing vital feature of the modern firm (Sanda, Mikailu & Garba, 2005). The corporate governance procedures and the actions of the board members should be such that they create accountability and enable the stakeholders to trust one another. Governance gives shareholders confidence that managers are being supervised. It creates checks to prevent management from serving its own interests. Governance engenders trust that allows a financial institution to attract depositors and investors. Governance provides assurance to government officials and, in the case of financial institutions, to bank superintendents. In these directions it is the responsibility of the board and management to ensure that loan portfolios do not go bad to the detriment of equity holders. More often than not, MFIs do not have proper governance structures to ensure this and as a result many MFIs unfold causing high level of systemic risks.

In Ghana the issue of using 'good money' to chase 'bad money' has not been recognized by researchers in the microfinance sub-sector. In most cases attention has been focused on why clients default and constraints in assessing credit from the formal financial institutions. It must be emphasized however that the use of good money to chase bad money is of critical implications for MFIs in Ghana. The issue of whether it is profitable to use good money to chase bad or not has not also been dealt in the Ghanaian microfinance landscape.

The issue of governance (internal and external) and management relationship with regards to loan application and disbursement has not been given much attention in the literature of microfinance in Ghana. The board has the responsibility to approve certain threshold of loan amount at board meetings. Unfortunately, the situation where a board member may solely influence or 'fast track' a client's loan application is common in Ghana. In the same way a situation where management personnel may also influence the credit to recommend a client's loan for approval is also not uncommon. Any of these two situations can generate bad loans at the cost of the institution. This is what the paper attempts to explore and proposes measures of dealing with them. In this regard, the main question that the paper addresses is that in the face of increasing default among MFI clients and using good money to chase bad money, what are the implications for managers and those who govern (the board) MFIs in Ghana? Is it worthwhile to use 'good money' to chase 'bad money'? The rest of the paper is organized as follows: the next section takes a look at the management and governance issues in the Ghanaian microfinance sub-sector. Section three reviews some literature related to the current study; section four discusses the study methodology and data; section five presents results of the study and section six concludes.

Management and governance of MFIs in Ghana

Overview of MFIs in Ghana

On the basis of different levels of regulation and licensing, five main types of MFIs can be identified in Ghana. These institutions have been classified into formal, semi-formal and informal. Table 1 is skewed to the bottom suggesting that the microfinance industry is predominantly in the informal sector. The last category 'susu' is made up of either individual collectors or companies. The presence of individual collectors makes it difficult to track the actual number of 'susu' operators in the sub-sector. However based on the average number operating at a particular point in time researchers are of the view that about 1000 individuals and companies have been operating since 2000 but with a slight increase in the number of companies in 2009. Table 1 shows that the number of credit unions increased by almost 15 times between the 2006 and 2009. Among the number of reasons attributed to the increase in the number are under reporting in previous years and reorientation of the unions mandate and engagement in microfinance activities. While these reasons are unfounded, the geographical spread of credit unions as a result of its mode of evolution adds to its increasing relative advantage over the other categories.

Table-1: Number and Trend of MFI Categories in Ghana

Type of Microfinance Institution	2000	2006	2008/2009
Rural and Community Banks	115*	121	131
Savings and Loans Companies	8	12	17
Not-for-Profit NGOs	225	273	350*
Credit Unions	8	29	409
'Susu'	1000	1000	1259

Compiled from Ministry of Finance and Economic Planning Bulletin, 2008

The external environment of microfinance in Ghana is shrouded with several stakeholders including government agencies, regulatory and supervisory bodies, networks, associations, development partners and researchers. The complexity heightens given the undefined functional role of each of the stakeholders. This inevitably has led to functional role overlaps, market fragmentation and distortions and increasing cost of interventions. For instance, momentarily, the role of the Government of Ghana in microfinance can be identified from two perspectives; (1) providing an enabling environment such as the commissioning of the Ghana Microfinance Policy (GHAMP) document through the Ministry of Finance and Economic Planning (MoFEP) and (2) engaging in direct finance activities based on the mandate of the Microfinance and Small Loans Centre (MASLOC). Anecdotal evidence indicates that the latter functional role of the government has contributed to distortions in the microfinance market as a result of the wide differential interest rate charges created by its engagement in retail financing. In addition to Ghana Government's functional role of retail financing distorting the microfinance market, sustaining this responsibility is currently grappling with operational hurdles such as monitoring and loan recovery.

In another instance, while the mandate of the Bank of Ghana transcends any other body in terms of prudential regulations, the social mission of microfinance and MFIs dominance in the informal sector has sparked capacity related challenges for the Bank of Ghana (BoG). Thus for the government to successfully regulate MFIs it should incorporate social monitoring indicators into the periodic reports submitted for assessment. This by no means is daunting and an initial national level benchmarking of social indicators and extra capacity (financial and human) is imperative. Among the attempts to combat this challenge is the institutionalization of mini-central banks (Apex bodies) and reliance on networks (Ghana Microfinance Institutions Network (GHAMFIN)) and or associations (Association of Financial Non-governmental Organization (ASSFIN)). While this initiative is commendable, clear exclusivity of responsibilities of each of the institutions and hierarchical definition of functional roles in the event of overlaps between financial and non-financial issues is lacking in Ghana. Among the obvious reasons for initiating the GHAMP was to deal with the issue of conflicting responsibilities and mandates. However, for reasons including the above mentioned issues and bureaucracies, launching of the GHAMP since 2006 is still expected.

The financial sector (and microfinance industry) in Ghana, has made modest strides in the area of financial electronic service delivery and linkages among and between MFIs, other financial institutions and support agencies. Only a couple of years ago, Ghana joined the league of countries pioneering the use of national platforms of electronic service deliveries to expand financial services to remote and deprived segments of the population. The launch of EZWICH in 2008 was intended to create a common platform for both formal and semi-formal financial institutions and to issue a biometric card for users to facilitate both online and offline payment. Also in 2009, Mobile Telecommunication Network initiated mobile phone banking which added to the evolving financial ESDs in Ghana. While the expected benefits of these interventions are overwhelming, issues of security, risk-sharing and consumer education and confidence require careful consideration. However, Ghana can escape these challenges by learning lessons from neighbouring countries such as South Africa, Kenya, Uganda and La Cote d'Ivoire.

Institutional linkages in the microfinance industry that have emerged in recent past in Ghana were between: Barclays Banks and Susu Companies; Rural and Community Banks (RCBs) and Financial Non-governmental Organizations (FNGOs) and between the government and MFIs. The former could not survive because the Susu Companies could not mobilize the retailed funds back to Barclays Bank. The underlying factor was basically high default among clients. Barclays, realizing this abrogated the contract between the bank and the Susu Companies. The latter has predominantly taken the shape of MFIs (RCBs) disbursing funds on behalf of the government. This kind of collaboration is not consistent with the form described above since in most instances MFIs have acted in the capacity of exigent in contrast to collaborators. As agents MFIs do not have the mandate to examine their operational market and package financial products (pricing, determining duration, targeting and establishing other conditions) that will enhance repayment and sustainability. Collaborations between financial institutions have been comparative advantages of each institution. Susu companies are well known for their exquisite client relationship and targeting, hence collaboration between Barclays Bank and susu companies will foster synergies in the area of expanding outreach and mobilizing deposit.

State of management and governance of MFIs: Ghana's perspective

Rural and Community Banks (RCBs) are managed by Chief Executive Officers (CEOs) and governed by Board of Directors (BoD). The board as usual is elected by shareholders during Annual General Meetings (AGM). The management committee is headed by the CEO who is appointed by the board. In Ghana RCBs are community based and the rule is that the CEO and the board members must come from the community. Since the CEO and the board members are from the community, they are not likely to be independent in dealing with clients from the community. The Apex bank regulations (2006), L.I 1825 section 35 stipulates the role of the board of directors of RCBs in Ghana as follows:

1. The board shall ensure that any application for financial accommodation is dealt with and considered strictly on financial and economic merit to ensure that the bank: (a) performs its functions and conducts its affairs in accordance with sound business, financial and administrative standards and practices, and (b) takes measures that are necessary to ensure that any financial assistance rendered by the bank is utilized for the intended purpose.
2. The board shall formulate borrowing and lending policies for the bank;
3. The board may propose to any RCB or the Bank of Ghana, measures for efficient and profitable management or operation of a rural bank and the proposals may include mergers, acquisitions, amalgamations and reconstruction.

There is no statutory duty therefore for a board member to influence in the loan application or disbursement at the banks. Unfortunately, in Ghana, some board members have been involved in the loan application and disbursement processes for some clients who they have relations with. Such actions are tantamount to fraud, dishonesty or moral turpitude (Section 33) of the Apex Bank Regulations (2006), Legislative Instrument (L.I) 1825.

The law governing credit unions in Ghana is the Non-Bank Financial Institutions Law (NBFL) 1983. Management of credit unions (CUs) is governed by Credit Union bye-laws formulated by the Credit Unions Association (CUA) of Ghana. CUA is the Apex body mandated by the BoG to regulate and supervise the activities of all credit unions in Ghana. All credit unions in Ghana are required by law to constitute a board. Management is supposed to be independent of the board in its functions. In a like manner loan officers are to be independent of management. The Credit Union Bye-Laws govern the operations of all credit unions in Ghana. With regards to loans, the bye-law states among others that:

1. Loans shall not be disbursed to clients for a period exceeding 2 (years);
2. No individual member shall be given a loan amount more than 20% of total savings of the society;
3. Application for loans shall be in writing and on prescribe forms

Are these by-laws adhered to strictly? The answer may be NO. This is because some clients are given the loans before they even apply. Again, a scan through the books of selected credit unions showed that there some loan aged more than two years going contrary to the bye-laws. In another development, some clients take individual loan that is more than even 25% of the institution's total assets. All these undermine the essence of good governance thus generating bad loans hence bad money. In recent times, in Ghana, anonymous bank managers have had themselves to blame, sacked, imprisoned and sanctioned for condoning and conniving with clients to take loans that should have been approved through the entire board. In some instances too some employees of banks in Ghana have been black-listed just because they involved themselves in one way or the other in granting loans.

Until July, 2011, the microfinance sector did not have any regulatory guidelines even though the Ministry of Finance and Economic Planning (MoFEP) had made strenuous efforts to document Ghana Microfinance Policy (GHAMP) document. Effective 1st August, 2011, the BoG issued regulatory guidelines to be followed by all existing and new MFIs. This is but one of the plethoras of proposals aimed at reducing risks in banking and in taming the excesses that some MFIs and financial service providers have caused over the past decade or two. This has brought the microfinance sector into a new perspective. In the past and before the introduction of the guidelines, some MFIs have folded up not because of mismanagement of funds but also high default rate among clients due to bad loans. The new regulatory guidelines have classified MFIs into four categories namely tier 1, tier 2, tier 3 and tier 4. In Ghana tier 1 MFIs include Rural and Community Banks (RCBs) and Savings and Loans Companies (S&Ls). These institutions are typical formal financial institutions and are governed by the Banking Act 2004. Tier 2 MFIs include Susu companies and other financial service providers, including Financial Non-Governmental Organizations (FNGOs) that are deposit taking and profit making and Credit Unions. However, credit unions are not regulated under this Notice. A Legislative Instrument (LI) under the Non-Bank Financial Institutions (NBFI) Act, 2008 will soon be passed to regulate their activities. Tier 3 activities are those undertaken by money lenders, non-deposit taking Financial Non-Governmental Organizations (FNGOs). Tier 4 institutions consist of Susu collectors whether or not previously registered with the Ghana Cooperative Susu Collectors Association (GCSCA) and individual money lenders. The new bank of Ghana guidelines specify that all tier 2 entities shall require not less than GHS100, 000.00 (One hundred thousand Ghana cedis only) as minimum paid-up capital and all tier 3 entities shall require not less than GHS 60,000.00 (Sixty Thousand Ghana cedis) as minimum paid-up capital. These new guidelines are to ensure that in times of crises institutions will be able to absorb the shock and also have enough funds to carry on their businesses.

Microfinance in Africa

The mix market (MIX) collects and validates financial, operational, product, client, and social performance data from MFIs in all regions of the developing world, standardizing the data for comparability. The information is made available on MIX Market (www.mixmarket.org), a global, web-based, microfinance information platform, which features financial and social performance information for more than 1,900 MFIs as well as information about funders, networks, and service providers. Table 1 shows the performance of selected African MFIs that report on the MIX.

Table-2: Selected African MFIs on Mix Market

Country	No. of MFIs	Loan portfolio (US$)	Active borrowers	Deposits (US$)	Depositors	Deposit / depositor (US$)	Loan per borrower (US$)
Ghana	**54**	**131.8m**	**360,910**	**140.2m**	**1.3m**	**107.8**	**365.2**
Kenya	26	1.1b	1.5m	1.2b	6.5m	923	733.3
Malawi	4	36.2m	119,385	31.5m	307,043	102.6	303.2
Egypt	16	216.9m	1.1m	1.1m	11,373	96.7	197.2
Gambia	19	87.6m	172,234	71.3m	516,887	137.9	508.6
Cote d'Ivoire	11	62.7m	47,409	175.3m	973,213	1322.5	180.1
Nigeria	16	64.2m	503,196	41.4m	413,547	100.1	127.6
Niger	6	10.6m	48,894	4.5m	139,352	32.3	216.8
Benin	19	117.8m	143,473	104.9m	920,177	114	821.1
Togo	10	139.3m	152,736	160.6m	756,373	212.3	912.0
Cameroun	23	220.6m	205,117	340.1m	513,961	661.7	1075.5
Gabon		686,038	483		372		1420.4
Congo, Republic	4	72.4m	75,036		257,352		964.9
Liberia	3	2.3m	28,471	697,638	20,438	34.1	80.8
Uganda	25	313.6m	431,926	306.6m	1.7m	180.4	726.1
Zimbabwe	4	474,406	12,777	N/A	N/A		37.1
Tanzania	13	591.3m	233,341	1.2b	357,105	3360.4	2534.1

Source: Compiled from MIX Market, 2010

Across Africa, Ghana has the largest number (54 institutions) of MFIs that report on to the MIX market as of 2010. One interesting thing about the Ghanaian microfinance sector is that despite its highest number of institutions, total loans and deposits are far less than Kenya which has halve of the number of institutions in Ghana. The country with the least number of MFIs is Liberia. With the exception of Kenya, all MFIs have higher average loan sizes per borrower than average deposit per borrower.

The implication is that default among clients could cause serious problems for MFIs because deposits cannot cover loans in times of default. Again, it is even not proper to use deposits to defray default loans.

Literature Review

The theoretical framework upon which this study is based is the agency theory. The theory posits that in the presence of information asymmetry, the agent (managers and board members) is likely to pursue interests that may hurt the principal (in this case the depositors whose monies are being used for on-lending and investors).

Information asymmetries are important in economic theory. Stiglitz and Weiss (1981) sparked a large theoretical literature on the role of asymmetric information in credit markets that has influenced economic policy and lending practice worldwide (Bebczuk, 2003; Armendariz de Aghion and Morduch, 2005). Theories show that information frictions and ensuing credit market failures can create inefficiency at both the micro and the macro level, via underinvestment (Mankiw, 1986; Gale 1990; Banerjee & Newman, 1993; Hubbard 1998), overinvestment (de Meza & Webb, 1987; Bernanke & Gertler, 1990), or poverty traps (Mookherjee & Ray, 2002). In addition, when borrowers and lenders do not share common information, optimal financial contracts often involve agency costs, which are costs required in monitoring investment projects (Williamson, 1986; Bernanke & Gertler, 1989, 1990). While borrowers typically possess inside information about the investment projects, they have little incentive to disclose such information. Efforts made by a third party to obtain additional information are often costly. Furthermore, since lenders cannot distinguish between honest and dishonest borrowers prior to issuing loans, the incorporation of a lemons premium into the market interest rate discourages honest borrowers. Given that the necessary information is not available, credit rationing by way of limiting loan size arises in the market (Jaffee & Russell, 1976). As such, without proper information transfer, credit markets will perform poorly as loans are given to "wrong" borrowers while genuine borrowers with good characteristics may sometimes be turned down. Two main theories that information asymmetry produces are adverse selection and moral hazards which affect repayment rates among microfinance clients in the credit market.

There are several reasons why clients default thus generating bad loans. Finance theorists' view of access to credit exists due to adverse selection, moral hazard and contract enforcement problems can be used to explain why most clients default. Stiglitz and Weiss (1981) originated the adverse selection theory (AST) in which they explained why the interest rate could not equate the supply and demand in the credit market. As discussed by Stiglitz and Weiss borrowers have inside information about the nature of the project they want to finance and may reap substantial rewards from talking up their projects. Moreover, while the lender gains if the loan is repaid with interest, it is not a beneficiary of any upside gain in the client's performance; it is, however, a victim of any downside losses in the case of default. Lenders, like MFIs, therefore face difficulties in discriminating between good and bad credit borrowers and simply increasing the price of credit to all potential borrowers can lead to adverse selection; rather than driving potential non-payers out of the market (Pollard, 2003).

Moral hazard can also arise when lenders are unable to discern borrowers' actions that would affect the distribution of returns from an investment. This means that after a lender has extended finance to a client they are exposed to moral hazard, the risk that the client will not perform in a manner sufficient to meet the contract in order to repay the loan in future. For example, once a loan has been secured, a borrower could use the proceeds of the loan for a higher risk purpose or a non-income generating activity, necessitating costly ex-post monitoring of the financial contract which may also lead to default. In ex-ante, moral hazard refers relates to the idea that unobservable actions or efforts are taken by borrowers after the loan has been disbursed but before project returns are realized. These actions affect the probability of a good realization of returns. Ex-post moral hazards refers to the difficulties that emerge after the loan is made and the borrower has invested the funds. Armendariz and Morduch (2007) argue that even if those steps proceed well, the borrower may decide to take the money and run away once project returns are realized. These problems indicate that it is not only high interest rates that may cause borrowers to default.

If the moral hazard occurs, the solution advocated by the model is credit rationing. Mushinski (1999) argued that credit market imperfections in developing countries derive not only from moral hazard and adverse selection problems but also from increased cost of monitoring and contract enforcement. In contrast, countries characterized by well functioning legal systems, these problems are not as pronounced as in those where the mechanisms for enforcement of contracts are weak. Hence, the main reason for the contract enforcement problem is the poor development of property rights. Although this argument is not specifically drawn at small and medium scale businesses (SMEs), these problems are more associated with SMEs and individuals than large companies and corporate institutions. The worse scenarios are observed in sub-Africa and most less developed countries in Latin America and Asia. In developing countries however where contract enforcements are weak, lenders resort to court actions against notorious clients.

Empirical evidence suggests that microfinance clients default for many reasons. For example in Ghana high interest rates charged by MFIs have contributed to high default and client exit. Okorie (1986) shows that the nature, time of disbursement, supervision and profitability of enterprises which benefited from small holder loan scheme in Ondo State, contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans. Loan default thus contaminates the quality of loans.

The quality of credit is a known critical issue in the literature where it is recognized that three different aspects, relating to macroeconomic, competition and MFI supervision issues, matter for its relevance. As for the first aspect, one needs to recognize that the financial structure of an economy plays a key role in the allocation of resources and MFI credit is a main connection with the real sector. Furthermore, bank MFI is still considered special in gathering information and monitoring borrowers, so that financing through financial markets cannot be seen as a perfect substitute for it. Moreover, the cost and the availability of MFI credit affect heavily investment choices both with respect to firms' financial structure and in relation to the structure of household financial portfolios and banking liabilities. This point is particularly important and relevant for bank-based economic systems, such as in many European continental countries (Gambacorta, 1998; European Central Bank, 2003).

Part of the problem is attributed to management and governance of MFIs. Good management practices and governance are therefore critical to MFIs operations. Using panel data from RCBs in Ghana, Kyereboah-Coleman and Osei (2008) shows that governance plays a critical role in the performance of MFIs and that the independence of the board and a clear separation of the positions of a CEO and board chairpersons have a positive correlation with performance measures. This in part emanated from high recovery rates since the board and management were both independent and credit officers have the power to decide who qualify for loans and how much by critically appraising the loan applications. When this is absent, it means management and board are contributing to the default among clients thus causing corporate governance problems. Chaffai, Dietsch and Godlewsky (2007) used a database of around 2154 banks located in 29 emerging countries in Eastern Europe, Asia and Latin-America for the period 1996-2000. They found that corporate governance problems occur whenever the bank's owners or the regulators lose control of the decisions of banks managers, so that the latter can adopt too risky lending policies.

Problem loans may pose problems at the micro and macro levels. At the macroeconomic level then, problem loans may be a signal of a wrong allocation of credit which may cause a decrease of the funds available for good and safer investments. Moreover, problem loans influence expected losses and so they may influence the state of the economic cycle causing a reduction in the supply of loans or changing the perception of depositors about the risks that banks take (Bernuer & Kubi, 2004).

Berger and DeYoung (1997) find that the relationships between loan quality and cost efficiency run in both directions. Their results provide support for the 'bad luck' hypothesis – high level of NPL oblige banks to devote efforts and suffer costs to working out and selling off these loans -, as well for 'bad management' hypothesis – lower cost-efficiency is followed by an increase of NPL. In short there is a bi-directional relationship between loan quality and cost efficiency in financial institutions including MFIs.

Bad loans sometimes occur due to the due to maturity and cost and terms of the credit such as repayment arrangements. For example Rajan and Dhal (2003) utilise panel regression analysis to report that favourable macroeconomic conditions (measured by GDP growth) and financial factors such as maturity, cost and terms of credit, banks size, and credit orientation impact significantly on the NPLs of commercial banks in India. The literature discussed so far show that bad loans are always likely to exist and financial institutions including MFIs need to make enough provisions for that. Fair provisioning on bad and doubtful loans is therefore of great importance for bank managers, board and regulators. This is because at the global level there has recently been intense discussion on the merits of Basel 2, the revised capital accord that would much better capture the actual risks taken by banks (Basel Committee, 2003). The Basel Accord is keen on making all provisions that will capture anticipated bad debts but with MFIs, it will be prudent for management and board to reduce the occurrence of bad loans because of the small size nature of their capital.

Study Methods

Data for the study comprises both secondary and primary data. The secondary data comprises financial reports of the selected MFIs. In addition structured questionnaires were used to collect information from selected MFIs in Ghana including Credit Unions (CUs), Rural and Community Banks (RCBs) and Savings and Loans Companies (S&Ls). In all 4 credit unions, 4 rural banks and 2 savings and loans companies were interviewed for the study. The institutions were selected from Central, Ashanti and Western Regions of Ghana. Selection of these institutions was done randomly and according to institutions that were prepared to give out the information for the study. The questionnaires captured information on outstanding loan balances, reasons for default among clients, management opinions on credit approval, board involvement or otherwise in loan approval. An examination of loan books was done to confirm information provided by the interviewees. A descriptive approach was used to analyze the data. For the sake of anonymity, the respondent institutions are to be held anonymous as the Ghanaian data protection law requires. In this paper therefore the names of the institutions are withheld for the sake of anonymity.

Results and Discussion

Reasons why clients default-Loan Officers' Responses

Clients default for several reasons. In this study loan officers were asked questions about their perceived level of reasons for client default (Table 3). With exception of lack of monitoring and late disbursal of loans, loan officers perceive that apart from management and board involvement, some of the causes of loan default among clients are: high interest rate, wrong use of loans, insufficient screening and less frequent repayment schedules. The factor that ranks first is wrong use of loans (65%). Whether someone influences the loan approval or not, as loans are misused they generate bad money. The second on the list is poor repayment schedules. For example, Armendariz and Morduch (2005) report that in Bangladesh microfinance contracts with less frequent repayment terms are associated with higher default among clients. This finding collaborates with the result current study (see table 3).

Table-3: Level of perceived reasons for default

Other reasons why clients may default	**RANK**	**Perceived Level**			
		VERY STRONG	STRONG	WEAK	TOTAL
High Interest rate	3rd	58%	23%	19%	100%
Lack of monitoring	5th	40%	40%	20%	100%
Wrong use of Loans	1st	65%	30%	5%	100%
Late disbursal of Loans	6th	20%	25%	55%	100%
Insufficient loan screening	4th	54%	40%	10%	100%
Less frequent repayment	2nd	60.5%	30%	9.5%	100%

Source: Survey data, 2011

Again, frequency of repayment is associated with client delinquency which is also a correlate of loan default among MFI clients. Loan officers perceive that less frequent repayment arrangements is a very strong factor (60.5%) in contributing to client default. Here too this finding is consistent with Rosenberg (1999). Again the result confirms Rajan and Sarat (2003) that term of the loan agreement correlate with NPLs. The assumption is that if repayment is frequent, clients do not feel the pinch of the repayment since amounts involved are usually small. Traditionally, high interest rates have been identified as a major cause of loan default and for that reason; high interest rates can generate bad money.

The cost of overdue loans

Smith (1998) has noted that the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan. Table 3 shows the costs associated with default. The money cost is defined in terms of cost of court actions and is expressed as a percentage of amounts retrieved. On the average selected MFIs in Ghana spend 10.7% of their good money on court actions in their quest for chasing the bad money. This is consistent with Smith (2003) since all parties involved as per the study bear some costs.

On the average, it costs an MFI GHS 3,863.3 (equivalent of US $2476.47) to process court actions against defaulters. The average loan portfolio aged more than one year is estimated at 104,409.78 (equivalent of US$ 66,929.35) meaning MFIs in Ghana have high non-performing loans (NPLs) on their balance sheet. It is also interesting to note that on the average 52 clients were sent to court between 2006-2010. These were clients whose loans were influenced in one way or the other by a board member, CEO or a key staff of the organization.

Table-4: Overdue loans, court actions and amount retrieved 2006-2010

MFIs	No. of clients sent to court	Overdue loans (GHS)*	% of loan aged>1year	Cost of court actions (CoCA) GHS*	Amount retrieved (AR) GHS*	(CoCA/AR) %
RB1	165	9,026,037.77	(451,301.9)5	9,499	96,360	9.9
RB2	21	1,761,574.36	(140,925.7)8	2,520	26,800	9.4
CU1	20	177,513.85	(44,378.5)25	5,889	32,298.2	18.2
CU2	N/A	56,062.57	(11,212.5)20	N/A	N/A	N/A
RB3	N/A	N/A	N/A	N/A	N/A	N/A
CU3	N/A	N/A	N/A	N/A	N/A	N/A
RB4	N/A	N/A	N/A	N/A	N/A	N/A
CU4	31	36,916.95	(18,458.48)50	1,282	15,274.5	8.4
SL1	37	49,520.69	(19,808.28)40	2,790	19,339.0	14.4
SL2	56	89,568.0	(44,784.0)50	1,200	32,000.0	3.75
Average	**52**	**1,574,240.05**	**(104,409.78)24**	**3,863.3**	**37,011.95**	**10.7**

***GHS=Ghana cedis (1.54 Ghana cedis is equivalent to $1 as of 2010).**

Source: Survey data, 2011

Another cost to the MFIs is the unpaid amount (principal plus accrued interest) that remains with the clients. Even though defaulters may be ordered by the courts to pay, the court cannot guarantee the full payment of all outstanding loans. It has been observed from the study that clients only pay less than 50% of the bad loans after which they relocate or cannot be located at all. Thus the second part (relocation) of the cost to the bank is even greater than the cost of court actions. The third aspect of cost to MFIs is the time spent in chasing clients for court actions. It takes on the average 30 days for the court to give hearing to a client. Even though this cannot be quantified in monetary terms, the opportunity cost is high. A member of staff who follows the court actions could have worked at the office instead of chasing bad money and attending to court to represent the bank since most MFIs do not have lawyers. Even when there are lawyers, a staff still has to represent the MFI as the secondary prosecutor to provide evidence that the clients owe the institution. Going by the Basel Accord (Basel Committee, 2003) therefore means that irrespective of the nature and size of the organization, full provision should be made for all doubtful debts.

Board, management and staff involvement-right or wrong?

Fiducially, it is not right for the board to be involved in loan application and disbursement processes even though the board has the right to approve certain thresholds of loans. The board owes a duty of care to shareholders and they are to protect innocent depositors from loss of their hard earned savings. In the same vein, management are entrusted with owners' resources and they are to make sure that loans go into the right hands for the sake of timely repayment. Table 4 shows the level of board, management and staff involvement in granting loans in selected MFIs in Ghana. The table also shows whether or not there exists code of directors on loans for directors and management. Within eight of the MFIs there is management, staff and board influence in loans to clients. The involvement comes as a result of blood relations. This practice is against ethics of business and does not make loan officers independent.

Table-5: Board and Management involvement in loans

ISSUES	RB1	RB2	CU1	CU2	RB3	CU3	SL1	RB4	CU4	SL2
BOD influence	**Y**	**N**	**Y**	**N**	**SH**	**SH**	**Y**	**Y**	**Y**	**Y**
Staff influence	**Y**	**Y**	**Y**	**Y**	**Y**	**Y**	**Y**	**Y**	**N**	**SH**
Independence	**N**	**N**	**N**	**Y**	**N**	**N**	**N**	**N**	**N**	**Y**
Loan Process followed	**N**	**SH**	**N**	**N**	**SH**	**N**	**SH**	**N**	**SH**	**SH**
Mgt influence	**Y**	**Y**	**Y**	**Y**	**N**	**SH**	**N**	**Y**	**Y**	**SH**
Directors' code of ethics	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**
Management code of ethics	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**	**N**

Y=Yes, N=No, SH=some how

Source: Survey data, 2011

The influence starts at the loan initiation process. In another development, some management and key staff commented that their remuneration does not commensurate their effort. They therefore push clients' loans to receive 'tips'. The practice in the Ghanaian banking sector has been 'help me to get the loan for a reward'. In most cases when client's loan is approved, the officer who assisted in getting the loan is promised 10% which is unethical. This is usually referred to as 'kick-back'. This is common not only in banks and MFIs but even in most government institutions where contracts are awarded to contractors for the execution of government projects.

Even though loan officers are supposed to be independent, are they allowed to be seen so? They might be independent in theory but not in practice. In almost all the MFIs there is board involvement in loan processes apart from the usual board meetings to discuss the approval or otherwise of certain loan thresholds. Two institutions believe that there is somehow board involvement. In the same way, four institutions indicate that management influence is common in loan processes where in some cases there is some level of partial involvement (somehow) by management personnel. In almost all the institutions loan officers seem to be independent but their independence is undermined by board and management involvement.

In almost all the MFIs interviewed, there is no code of ethics for directors and managers with regards to loans. We are not sure if such a document exists elsewhere but ideally there should be such a document to guide the board and management on loans. This probably has given chance to some board members and CEOs to do what they are not supposed to do creating serious conflict of interest.

Implications for management and board of directors

In the face of the proposed regulatory guidelines for MFIs in Ghana

(BG/GOV/SEC/2011/04), there is a strong need to protect the interest of depositors. This stems from the fact that any loose structures in granting loans to otherwise incredible clients will mean some depositors losing their hard earned money. To safeguard the interest of the poor depositor there is the need for proper internal governance. This will ensure the avoidance of agency cost. Bad loans have the potential for generating high agency cost in that management, board or employees may pursue a selfish objective at the expense of owners of the resources since the core asset of banking is the protection of the loan portfolio. The finding is consistent with Chaffai, Dietsch and Godlewsky (2007) that the when owners are not able to exercise control over management, the latter will pursue actions to their advantage.

Management and staff involvement in loan disbursement that generates bad loans are sometimes subject to sanctions such as firing, repayment by the personnel involved, forfeiture of all employment benefits, and sometimes police arrest of the personnel involved. The implication is that the personnel whose involvement causes liability to the institution is held severally and jointly liable with the client. The board quickly meets to take any appropriate decisions to sanction the offenders. Unfortunately, when a board member is involved in causing liability, management is unable to take any such actions against the board member because the board members are able to influence shareholders to retain them. In most cases where the board chairman is in close contact with the CEO, the situation becomes different. The two team up to retain their positions in order to gain their selfish interests at the cost of shareholders.

Board influence in loan application and disbursement process comes in different forms. A board member may encourage a close friend or relative to apply for loan. The board member then makes a follow-up to ensure that the loan officer recommends the application for consideration either by the CEO or the board depending on the loan threshold. In some cases, the CEO directly influences loan officers and compel them to approve some loans. The implication is that, in MFIs, most board members play the 'diffused role' by engaging themselves in the operation of the MFIs. Another implication is that in most cases the MFI was started as sole proprietor (by the CEO) and latter became public thus giving the CEO the greater control in the institution. Even after going public, the spirit of the sole proprietorship is can still be seen in the CEO.

Conclusion and Recommendations

The paper examines some of instances that make MFIs generate 'bad money' and the rationale behind using 'good money' to chase 'bad money'. Data for the study is obtained by interviewing CEOs and credit officers of selected MFIs. An examination of MFIs loan books is done to confirm information provided by the interviewees. The paper concludes that the use of 'good money' for chasing 'bad money' is unprofitable and contaminates the entire portfolio of MFIs. Again, improper screening of loan applications also contributes to loan default. It is also concluded that management and board involvement in loan disbursement has serious negative implications for loan repayment and recovery. This can contribute to high level of non-performing loans (NPLs) on the balance sheet of MFIs.

Without board or management involvement, clients are likely to default. Prominent among the causes are wrong use of loans, high interest rates, less frequent repayment, and lack of monitoring activities from the MFIs. It is recommended that board and management need to price (realistic rates) loans that will not hurt clients because poor clients might be insensitive to high interest rates but might be sensitive to repayment which will produce bad money and NPLs of MFIs balance sheet. Flexible repayments schedules can reduce bad monies since they give clients some breathing space. Among poor clients, repayment can be on daily basis in small amounts since clients will not feel the payment. This can be done through the ***susu*** system.

It is obvious that MFIs have debt collection problems or they are incapable of collecting debts that go bad. It is recommended that it will be more profitable to sell outstanding debts to debt collection agencies at a fee. Instead of incurring on the average cost of 10% in enforcing legal actions to retrieve bad loans, it will be more economical to sell these debts to collection agencies at a fee less than 10% of monies retrieved. This proposal is consistent with Berger and DeYoung (1997) hypothesis. There is also the need to re-emphasize training, monitoring and evaluation of MFI clients in order to make good use of loans contracted since aside the influence form either board or management, clients themselves might not use the resources well.

Instead of the board influencing loans that go to clients, there is the need to strengthen the board's capacity to facilitate provision of up-to-date loan repayment statements to loanees and enable early detection of potential slow loanees and defaulters. This will facilitate appropriate action including, follow-up, counseling or serving demand notices to potential defaulters. There is the need to document code of ethics for the board and management with regards to loans. This will ensure that neither the board nor management get involved in what they are not supposed to do. This will ensure the protection of deposits and sound banking practices. There should be a high level of trust between board members and that board members should be ethical and have high level integrity. Better executive remuneration is one more mechanism that can be refined to improve corporate and management governance.

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[1] Work and religious based credit unions have led to the presence of this category of MFIs in almost all localities in Ghana.

[2] Some Loans disbursed by MASLOC as at 2007 had a nominal annual interest rate of 10 per cent compared to the average 40 per cent microfinance industry interest rate.