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Microfinance risk management, social mission and financial performance during the Covid-19 pandemic in Uganda

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ABSTRACT

Introduction: Microfinance is an economic tool promoted to extend financial services to the vulnerable groups excluded from the formal financial institutions. The Covid-19 pandemic containment measures disrupted the economic activities of the poor and made it hard for microfinance institutions (MFIs) to reach out to poor.

Purpose: This paper sets out to investigate the relationship between microfinance institutions risk management, social mission and financial performance of MFIs during the Covid-19 pandemic in Uganda. The study objectives were to investigate the relationship between risk management and financial performance of MFIs during the Covid-19 pandemic in Uganda and to investigate the relationship between the microfinance social mission and financial performance of MFIs during the Covid-19 pandemic in Uganda.

Methodology: This was a cross sectional study that involved 53 respondents conveniently selected from six (6) MFIs from Central Uganda working in the area of credit. The data was collected during the late period of the year 2021 using a self –administered questionnaire and analysed using STATA 12 to generate both descriptive and inferential statistics.

Results: The study findings revealed the existence of a significant positive relationship between risk management and the social mission (0.88; $p \prec 0.05$); risk management and financial performance (0.91; $p \prec 0.05$); the social mission and financial performance (0.88; $p \prec 0.05$). Collectively, the predictor variables explain 85% of the variation in microfinance financial performance (Adjusted R-squared 0.85; p<0.00).

Recommendations: It is recommended that while designing risk management strategies, the focus be put on the social mission that will translate in the attainment of the financial objective. Attempts should be made by policy makers to help MFIs design strategies that integrate the dual bottom line with the triple bottom line.

Keywords: *Microfinance, risk management, social mission, financial performance, Covid-19*

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1. Introduction

Microfinance is used by many countries as a tool to promote financial inclusion (Hobden, Kovacs, & Amarger , 2021). Microfinance is an economic approach to take financial services to the excluded segments of the population from the formal financial sector mainly due to their financial vulnerability status (Foundation Grameen Credit Agricole, 2021). From the very conception of microfinance as hinged to serving the very poor, the concept of risk was inherent in microfinance and to attain microfinance sustainability, this risk has to be managed. When Professor Yunus in 1983 founded the Grameen Bank to provide microloans and microfinance to the rural poor, he held strong beliefs that this was one of the most practical ways the poor could be helped out of poverty. Through these loans, the poor could establish small businesses, earn incomes and eventually improve their welfare. This focus on the poor underpins the social mission of microfinance institutions (MFIs) that needs to be reconciled with the financial objective to ensure sustainability of the MFIs. The social and financial objective spells out the double bottom line of the MFIs.

The economic activities involved in by the poor, as any other businesses flourish in a relatively stable economic environment, which however, has been disrupted by the Covid-19 pandemic (Foundation Grameen Credit Agricole, 2021). The Standard operating procedures (SOPs) enforced by many governments characteristic of lockdowns, restricted movements and social distancing rules do not favour the smooth operation of businesses and other related economic activities (Hobden, Kovacs, & Amarger , 2021). The MFIs cannot easily access their target clients - the poor- because of restricted movement and social distancing rules. The MFIs have also found it hard to do due diligence while assessing the capacity of the clients for credit or following up on due payments for credit advanced earlier on (Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021; Foundation Grameen Credit Agricole, 2021; Dąbrowska, Koryński, & Pytkowska, 2020).

During crisis situations such as that caused by the Covid-19 pandemic, it is the poor that are greatly affected as their incomes sources are threatened and access to credit limited (Mendelson, Dassy, Erice, Rozas, & Afonso, 2020). With incomes threatened, cases of loan default are more likely and the attainment of the financial objective becomes more of a dream. The fear of a deteriorating portfolio quality makes MFIs more risk averse and adopt selective lending policies that may promote financial exclusion of the poor thereby threatening the attainment of the social objective. Research has shown that the Covid-19 containment measures threatened the deterioration of the portfolio quality of MFIs in many parts of the world like in sub Saharan Africa (Hobden, Kovacs, & Amarger , 2021), save for the MFIs in the Europe that have been able to maintain their portfolio quality (Dąbrowska, Koryński, & Pytkowska, 2020).

Whereas financial performance is occasionally measured by quantitative measures such as financial ratios (Navin & Sinha, 2021), this paper relies on qualitative indicators of financial performance. Financial performance is used to refer to the ability of the MFI to meet its financial targets at a given time. The authors posit that an MFI that has risk management as one of its core goals and prioritises the social mission through microcredit plus services is likely to experience improvements in its financial performance. This paper attempts to contribute towards the on-going debate of the effects of Covid-19 pandemic on the performance of MFIs. The paper is set to attain the following objectives; (1) to investigate the relationship between risk management and financial performance of MFIs during the Covid-19 pandemic in Uganda (2) to investigate the relationship between the microfinance social mission and financial performance of MFIs during the Covid-19 pandemic in Uganda.

2. Literature Review

2.1 Microfinance risk management and financial performance

Risk management is defined as the measures taken by an MFI to identify, measure, monitor and manage the potential risks of the institution. The mostly commonly used risk management measures employed by MFIs is the focus on social collateral where group methodologies (Navin & Sinha, 2021) are relied upon to cultivate a sense of social responsibility among group members towards the repayment of the credit acquired. The group methodology may however lead to the exclusion of the very poor due to the self-selection and peer pressure principle, where the very poor may self-isolate themselves or are excluded by their peers during group formation. If this happens, then the social mission of the MFIs may not be realised. MFIs rely heavily on the close relationship between the institution and the clients for the success of its operations which close contact was shattered by the Covid-19 restrictions (World Development Report, 2022). With restricted movements, it became very hard for the MFIs to follow up on the clients whose loans were due for repayment or appraise new loan applicants that would wish to access credit. This heightened the risks faced by MFIs.

Risk is the probability that what is actualised is different from the expectation, which can be brought about by an unexpected hostile environment such as the Covid-19 pandemic. During the pandemic, the poor that accessed microfinance credit hoping for a stable economic environment were left at crossroads, as they planned to meet their repayment schedules in a constrained and uncertain economic environment. The pandemic increased client vulnerability risk, which as well affected the activities of the MFIs.

The Covid-19 pandemic containment measures reduced the demand for credit and increased risks in the financial sector (Okumu, Kavuma, & Bogere, 2021; Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021). The MFIs have to come to contend with a new type of risk hither to unknown and perhaps unplanned for- the Covid-19 risk (Dąbrowska, Koryński, & Pytkowska, 2020). When a financial institution advances credit to a client, this creates a risk that is associated by failure of the client to pay back the loan acquired. This is worsened in the case of MFIs whose main activity is lending to the very poor, moreover without collateral. Among the financial risks that MFIs have had to endure during the Covid-19 pandemic include delayed loan repayment (credit risk) which in turn has constrained the cash flows of the MFIs limiting its ability to extend credit to prospective borrowers (liquidity risk).

The low demand for credit (Dąbrowska, Koryński, & Pytkowska, 2020) has led some MFIs to halt some of their core activities (Foundation Grameen Credit Agricole, 2021) or close some of the branches (operation risk). In a bid to mitigate these risks, MFIs create additional risks of the possibility of diverting from their mission (mission drift risk) which in the end leads to harming the target beneficiaries that are denied access to the needed finances (client protection risk). MFIs pursue a dual objective of achieving financial sustainability as well as achieving the social objective of reaching out to the very poor (Froelich, Kemper, Poppe, Breda, & Richter, 2015). This puts MFIs in a very delicate situation of balancing profitability and attaining the social mission. Achieving profitability implies charging high interest rates to recover the operational costs of the MFIs and ensure financial sustainability. This phenomenon is referred to by many in the literature as the commercialization of microfinance (Navin & Sinha, 2021). On the other hand, to achieve the social mission of microfinance, MFIs need to charge low interest rates affordable by the poor but at the same time, rates that can keep the MFI operations upfront. The balancing of these two conflicting objectives is an issue that needs attention and more research in the current period of economic and social uncertainty caused by the emergency of the Covid-19 pandemic. The study by (Navin & Sinha, 2021) attest to the possibility of the MFIs mutually attaining the dual objective of the MFI.

By devising appropriate risk management policies, possibly MFIs would ably hedge against the risks associated with lending to the poor. The MFIs attempt to manage risk associated with lending through character assessment of prospective loan applicants (Chong, 2021), strict loan monitoring schedules (Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021), regulating the loan amounts advanced that are progressively increased depending on how the group performs on its earlier repayment schedules and pre-saving requirements (Mendelson, Dassy, Erice, Rozas, & Afonso, 2020). From the case studies conducted by the Grameen Foundation during Covid-19, savings services were found to be an effective way of building the vulnerable resilience to shocks (Foundation Grameen Credit Agricole, 2021). MFIs also offer loans for varied terms, require clients to obtain Local Council recommendation and have guidelines for eligibility to access loans such as being a member of the group. During the Covid-19 pandemic, some MFIs restricted lending and concentrated on loan recovery thereby excluding the poor access to credit in the time of great need. This volatile environment has necessitated the current study on risk management and the financial performance of MFIs during the Covid-19 pandemic in Uganda. From the literature reviewed, the following hypothesis is drawn:

H1: The microfinance risk management do not lead to improved financial performance during the Covid-19 pandemic

2.2 Microfinance social mission and financial performance

The pursuit for the social mission was the very reason for the promotion of the concept of microfinance right from the times of Prof Yunus when he founded the Grameen Bank (Foundation Grameen Credit Agricole, 2021; Hobden, Kovacs, & Amarger , 2021). During a crisis, the pursuit of the social mission even becomes of more importance to the MFI than the financial objective even if this may expose the MFIs to the risk of insolvency (Mendelson, Dassy, Erice, Rozas, & Afonso, 2020). By being there in time of need however, is likely to save the MFI from the reputational risk, as the MFI will be looked at positively as being pro-client which in the final analysis may improve the financial base of the MFI and help improve the financial performance.

The Covid-19 restrictions have necessitated that MFIs come up with new ways of reaching out to their clients especially the vulnerable groups. New methods of interacting with the clients especially using digital platforms (Dąbrowska, Koryński, & Pytkowska, 2020; Hobden, Kovacs, & Amarger , 2021; World Development Report, 2022; Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021) have become more of a necessity than a luxury. In Tunisia, digital platforms were effectively utilised to provide advisory support to the vulnerable during the Covid-19 pandemic (Hobden, Kovacs, & Amarger , 2021). Unfortunately, in most parts of Africa, and Uganda in particular, the very poor are less unlikely to be in possession of these digital tools let alone having proper knowledge of their usage. It is therefore imperative that MFIs provide the necessary education and training to their clients in the use of these new forms of interactions, and integrate such training as a crucial component of their package to any form of credit to be advanced to the client. Yet surprisingly some MFIs other than strengthening client non-financial services reduced such services in a bid to reduce their operational costs.

The timely response to client needs through innovative tools like the digital platform to provide loan products and the accompanying client education plays a key role in enabling the MFIs achieve their dual objective of social and financial sustainability (Hobden, Kovacs, & Amarger

, 2021).The microcredit plus services become an essential component of MFI services to the clients as they strive to build the clients non-financial capabilities including client education on the need to observe the established Covid-19 health protocols. The concept of microcredit plus is a tool used by MFIs to use the social objective to achieve the financial objective.

MFIs have embraced the concept of microcredit plus where in addition to providing credit to the poor, clients or group members are trained on how to efficiently utilise the credit advanced and meet the agreed upon repayment schedules. The microcredit plus activities includes enterprise training, client protection policies (Kizza, 2021), training in financial literacy (Chong, 2021) and micro insurance. Financial education (Foundation Grameen Credit Agricole, 2021), which is a component of microcredit plus is positively linked with a reduction in client late repayments (Froelich, Kemper, Poppe, Breda, & Richter, 2015). The microcredit plus services increasing offered by MFIs are part of the growing effort to integrate the social lens that focus on client protection into the risk management framework of MFIs to hedge against reputation risk. Once an institution loses public trust, this may affect negatively on its operations through loss of the customer base, which once lost, may not be easy to regain. The loss of the customer base will translate in deterioration in the portfolio quality and translate in the negative financial performance of the MFI.

MFIs strive to protect their clients from harmful financial practices through the provision of client education and the putting into practice the Know Your Client (KYC) principle. It is a policy in many MFIs adequate information is obtained on the prospective loan applicant, which greatly helps during loan appraisals. Before extending credit, MFIs make an effort to educate clients on the prudent financial management practices through the financial literacy programmes (Chong, 2021); and the provision of information on what the client's rights and responsibilities are. Before the loan is advanced to the group, members are informed about the loan conditions and repayment terms, the advantages of timely meeting loan obligations, and of course the MFI have to take the responsibility of loan monitoring, loan reminders and effecting loan recovery in a way that do not threaten the reputation risk of the institution. There is emphasis on constant transparent communication and timely feedback mechanisms to handle client challenges and complaints. From the literature reviewed, the following hypothesis is drawn:

H2: The microfinance social mission do not lead to improved financial performance during the Covid-19 pandemic

3. Methodology

The current study adopted the cross sectional design and was conducted during the late period of the year 2021 towards the full re-opening of the economy that happened in February 2022. The data was collected using a self –administered questionnaire that was distributed to client relationships officers and credit managers that directly handle the management of credit from six MFIs within the Central region of Uganda. The self-administered questionnaire followed a five-type Likert scale where 1 represented disagreement with the item under consideration and 5 showed agreement with the item under consideration. The target respondents were selected basing on their availability and willingness to participate in the study. The reliability of the study instrument was obtained using Cronbach alpha coefficient where a value of 0.72 was posted. This value falls within the minimally acceptable range (Tavakol & Dennick, 2011) implying that the study instrument was reliable. The model was tested for multicollinearity using the variable inflation factor. The collinearity tolerance (1/VIF) for all predictor variables was greater than 0.1(10%) with the corresponding variable inflation factor (VIF) for all variables not less than 1 which falls within the recommended interval of 1 and 10 indicating the non-existence of multicollinearity in our data set. The estimators were thus considered reliable. The descriptive statistics, correlation tests, multiple regression, parameter estimates and multicollinearity tests were all estimated using Stata 12 software. The theoretical model that guided this study is given by: Financial performance $(Y) = \alpha + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$, where α is the intercept, $\beta_1 \beta_2$ are Coefficients, X_1 is risk management, X_2 is social mission and ε is error term.

4. Results

4.1 Descriptive statistics

In all 53 employees participated in the study where 31(58%) were males and 22(42%) were females. 37(70%) of the respondents were not married, and there was an equal number of the married eight (15%) and divorced eight (15%). The majority of the respondents 41(77%) had a bachelor's degree while 12 (23%) had a diploma qualification. 40(75%) of the respondents had worked in the field credit between 1-5 years, 10(19%) between 6-10 years and 3(6%) had worked in credit for more than ten years.

The overall means of the study constructs revealed respondents agreement with the various items under each construct. The overall means and standard deviation (SD) of the various constructs under study were: risk management 4.17 (0.85), social mission 3.51 (1.17), and financial performance 3.33(1.09). To manage risk, MFIs ensure that credit terms are clearly explained to the client (4.55), the clients ability is a key consideration in the loan advanced (4.45), there is focus on loan monitoring (4.25), performance on previous loan repayments influences the future loan size (4.23), customer complaints are timely handled (4.08), there is an office in charge of risk management (3.96), a risk management policy is in place (3.92), and various loan products are offered (3.14).

To promote the social mission of MFIs, efforts are made not to harm the clients through multiple loans (4.19), policies on client safety are in place (3.83), preference is given to female loan applicants (3.38) and rural loan applicants (3.21), clients are offered business development services (3.28) and measures to protect the environment are considered during the loan appraisal process (3.17). The financial performance of MFIs have been boosted by an increase in client referrals (3.79), increase in the number of loan applicants (3.66), an improvement in the portfolio quality (3.36), and a decline in loan write offs (3.26). The introduction of new loan products on the MFI financial performance received a neutral response (3.00) while the issue of MFIs meeting their sales targets also received a middle ground response (2.91).

4.2 Inferential Statistics

Correlation results

The correlation tests were performed to test the relationship between the independent variables and the dependent variable. The results are presented in table 1.

Table 1: Correlation matrix

Variable	Risk management	Social mission	Financial performance
Risk management	1		
Social mission	0.8881***	1	
Financial performance	0.9077***	0.8888***	1

***significant at 5%

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H1: The microfinance risk management do not lead to improved financial performance during the Covid-19 pandemic

The results indicate that microfinance risk management do lead to improved financial performance during periods of the Covid-19 pandemic (0.88; $p \prec 0.05$). The null hypothesis is rejected.

H2: The microfinance social mission do not lead to improved financial performance during the Covid-19 pandemic

The results indicate the existence of a significant positive relationship between microfinance social mission and financial performance during the Covid-19 pandemic (0.88; $p \prec 0.05$). This means that prioritising the social objective of MFIs during the pandemic greatly positively contributes towards the financial performance of the MFI. The null hypothesis is rejected.

Table 2: Regression test (parameter estimates)

Variable	Coef.	Std. Err.	T	P>t	[95% Conf.	Interval]
Risk management	0.35	0.06	5.56	0	0.23	0.48
Social mission	0.37	0.10	3.89	0	0.18	0.57
Intercept	0.22	0.86	0.25	0.8	-1.50	1.94

The estimated equation as derived from Table 2 is given as $(Y) = 0.22 + 0.35X_1 + 0.37X_2$. These findings imply that a unit increase in risk management improves the financial performance of MFIs by 35% while a unit increase focus on social mission improves the MFI financial performance by 37%.

Table 3: Regression model summary

Source	**SS**	**Df**	**MS**		
Model	5225.07	2	2612.53	F(2, 67)	Prob > F=0.0000
Residual	876.78	67	13.09	199.64	
Total	6101.84	69	88.43		
R-squared=	0.86			Adj R-squared=	0.85
Root MSE	3.62				

Source: Field survey, 2021. Values based on author's calculations using STATA 12

The regression test was performed to determine the contribution of the independent variables on the response variable, and also help to model the relationship between the independent variables and the response variable. Collectively, the predictor variables explain 85% of the variation in microfinance financial performance (Adjusted R-squared 0.85; p<0.00). The difference between the R –squared and the adjusted R- squared is only 0.01 meaning that the model fit is very good. The F-test is also significant which implies that our regression equation fits well the data set used in the analysis.

Table 4: Testing for multicollinearity of Independent variables

Variable	VIF	1/VIF
Risk management	4.73	0.211354
Social mission	4.73	0.211354
Mean VIF	4.73	

The model was tested for multicollinearity using the variable inflation factor. The collinearity tolerance (1/VIF) for all predictor variables was greater than 0.1(10%) with the corresponding variable inflation factor (VIF) equal to 4.73 for all variables which falls within the recommended interval of 1 and 10 indicating the non-existence of multicollinearity in our data set. This as well further indicates the reliability of our estimates.

5. Discussion, Conclusion and Policy Recommendations

5.1 Discussion

The paper sought to establish the relationship between risk management, social mission and the financial performance of MFIs during the Covid-19 pandemic. The results have indicated the need for MFIs to strike a middle ground in order to attain their dual objective of attaining the reaching out to the very poor while at the same time remaining financially sustainable. The two predictor variables, risk management and social mission explain 85 percent of the variation in MF financial performance underscoring the need for MFIs to design relevant policies and strategies integrating these aspects in their operations and strategic initiatives.

Risk management is significantly positively associated with the achievement of the social mission (0.88; $p \prec 0.05$) and financial performance (0.91; $p \prec 0.05$), while the social mission is significantly positively associated with MFIs financial performance (0.88; $p \prec 0.05$). The results have indicated that the pursuit of the social mission is not an encumbrance to the attainment of the MFI financial objective but rather a key complementing factor to the MFI financial performance. This finding is in direct support of earlier research studies that argued the possibility of MFIs mutually attaining their double bottom line (Navin & Sinha, 2021). The results from the descriptive statistics have revealed that MFIs studied are still focussed on the achievement of the social mission as they prioritise lending to women and the rural population. This finding also supports the argument by various authors that MF is a tool for financial inclusion (Hobden, Kovacs, & Amarger , 2021).

High on the risk management measures identified in this paper are in agreement with earlier researchers. These measures include evaluating the performance of previous loan repayments to issue new loans, which is supported in (Chong, 2021; Mendelson, Dassy, Erice, Rozas, & Afonso, 2020) and the emphasis on loan monitoring which is supported in (Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021). The offering of various loan products as a key risk management measure does not come out distinctively, and perhaps this can be subject for future research especially in the context of developing countries. Much as the Covid-19 containment measures restricted movement and slowed down many economic activities, the results have indicated that the focus on risk management and the social mission enabled MFIs to register improvements in their financial performance. This is contrary to what some researchers had posited that the MFIs especially in sub-Saharan Africa, of Uganda is part were threatened with a deterioration in portfolio quality due to the Covid-19 pandemic (Hobden, Kovacs, & Amarger , 2021; Castellani, Niño-Zarazua, Pujia, & Garofalo, 2021; Dąbrowska, Koryński, & Pytkowska, 2020).

The findings on the social mission of MFIs are supported in research works that promote complementing financial relief with the necessary advisory services (microcredit plus). The attainment of the social mission from the findings rates highly the need not to harm clients, which can be attained by the microcredit plus activities of the MF. The significant positive relationship between the social mission and the MFI performance collates with findings attributing reduction in client late payment to microcredit plus services like financial education and advisory services (Kizza, 2021; Chong, 2021; Foundation Grameen Credit Agricole, 2021; Froelich, Kemper, Poppe, Breda, & Richter, 2015). The finding on the need to integrate measures to protect the environment during the loan appraisal process is in line the Sustainable Development Goals (SDGs) emphasis on balancing the triple bottom line which can be explored further in future research.

The findings have also revealed that MFIs financial performance is greatly boosted by client referrals, which has positive contribution in the increase in the number of loan applicants. Client referrals are usually associated by client satisfaction with the services of an institution. Client referrals may also imply an improvement in the portfolio quality of an MFI and a declining imperative to make loan write offs. These referrals may be attributed to the continued focus on the MFIs studied on the social mission, and therefore in agreement with (Mendelson, Dassy, Erice, Rozas, & Afonso, 2020) that it is beneficial for the MFIs to focus more on the social objective during a crisis situation as this saves the MFI from reputation risk with its associated negative impacts on the financial performance of the MFI.

5.2 Conclusion

Risk management when designed with the focus on the social mission will improve the financial performance of the MFIs even during times of crisis like with have gone through during the Covid-19 pandemic. The results have indicate that its highly probable for MFIs to attain the double bottom line in pursuit of improvements in financial performance while at the same time achieve the triple bottom line which is one the key objectives of the SDGs. The fact that risk management and social mission explain 85 percent of the variation in MFIs financial performance points to the need for MFIs to develop a risk management framework that protects the financial mission while at the same time protects the clients from any form of harm that result in the reputation risk of the MFI.

The results have also indicated that serving the very poor and financially excluded is not as very risky as most research studies would indicate, as this study is in support of researchers that have indicated that it is indeed possible for the MFIs to attain the double bottom line. In order not to harm clients, MFIs should advance credit based on the ability to pay, clearly explain the credit terms, monitor the loan performance and offer advisory support to the clients. When clients are well served, the MFIs will benefit through client referrals, new loan applicants, reduced need for loan write offs and improved loan portfolio performance, which will translate in an improvement in the financial performance of the MFI.

5.3 Policy recommendations

It is recommended that while designing risk management measures, the focus is not put on only the financial objective but also the social mission as it may be more rewarding for the attainment of the improved financial performance of the MFIs. That is, the MFI should use the social objective to attain the financial objective.

The study has shown how conflicting goals can be mutually achieved. It is therefore recommended that the Government and Microfinance regulators enable the MFIs to design strategies that integrate the dual bottom line with the triple bottom line. Further research in how this can be achieved is recommended.

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