THE EFFECT OF CREDIT MANAGEMENT ON THE FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN KENYA

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DECLARATION

This research project is my original work and has not been presented in any other University for examination for an award of a degree.

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This research project has been submitted for presentation with my approval as the University supervisor

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DEDICATION

To my parents, for your love, encouragement and support that you have given that has brought me this far.

ABSTRACT

Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. The study sought to determine the effect of credit management on the financial performance of Microfinance Institutions in Kenya. The study adopted a descriptive survey design. The population of study consisted of 59 MFIs in Kenya that are members of AMFI. A census study was used to carry out the research. Primary data was collected using questionnaires where all the issues on the questionnaire were addressed. Descriptive statistics were used to analyze data. Furthermore, descriptions were made based on the results of the tables. The study found that client appraisal, credit risk control and collection policy had effect on financial performance of MFIs in Kenya. The study established that there was strong relationship between financial performance of MFIs and client appraisal, credit risk control and collection policy. The study established that client appraisal, credit risk control and collection policy significantly influence financial performance of MFIs in Kenya. Collection policy was found to have a higher effect on financial performance and that a stringent policy is more effective in debt recovery than a lenient policy. The study recommends that MFIs should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

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LIST OF ABBREVIATIONS

AMFI	Association of Microfinance Institutions
CGAP	Consultative Group to Assist the Poor
DBN	Development Bank of Namibia
GNI	Gross National Income
GTZ	Deutche Gensellschaftfur Technische Zusammenarbeit
MFI	Microfinance Institutions

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Credit is one of the many factors that can be used by a firm to influence demand for its products. According to Horne and Wachowicz (1998), firms can only benefit from credit if the profitability generated from increased sales exceeds the added costs of receivables. Myers and Brealey (2003) define credit as a process whereby possession of goods or services is allowed without spot payment upon a contractual agreement for later payment.

Micro-finance concept has operated for centuries in different parts of the world for example, “susus” in Ghana, “tandas” in Mexico, “tontines” in West Africa and “pasanaku” in Bolivia. One of the earliest and longest serving micro-credit organization providing small loans to rural poor dwellers with no collateral is the Irish loan Fund system initiated in the early 1700”s by Jonathan swift. His idea began slowly in 1840s and became a widespread institution of about 300 branches all over Ireland in less than one decade. The principal purpose was to advance small loans with interest for short periods. However, the pioneering of modern microfinance is often credited to Dr. Mohammad Yunus, who began experimenting with lending to poor women in the village of Jobra, Bangladesh during his tenure as a professor of economics at Chittagong University in the 1970s.

Microfinance is the supply of loans, savings, and other basic financial services to the poor." As these financial services usually involve small amounts of money - small loans, small savings, the term "microfinance" helps to differentiate these services from those which formal banks provide. Microfinance institutions provide a reliable source of financial support and assistance compared to other sources for financing. Sources operating outside the microfinance industry typically form informal relationships with borrowers and have no real legal or substantial ties with their customers. As a result, loan terms tend to carry high costs with no guarantee that lenders will remain in one place for any length. In contrast, microfinance institutions typically work alongside government organizations and also have ties with larger global organizations

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e., traditional collateral is not often used to secure microloans Churchill and Coster (2001). The people covered are those who cannot avail credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principle amount itself. Therefore these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities.

Timely identification of potential credit default is important as high default rates lead to decreased cash flows, lower liquidity levels and financial distress. In contrast, lower credit exposure means an optimal debtors' level with reduced chances of bad debts and therefore financial health. According to Scheufler (2002), in today's business environment risk management and improvement of cash flows are very challenging.

With the rise in bankruptcy rates, the probability of incurring losses has risen. Economic pressures and business practices are forcing organizations to slow payments while on the other hand resources for credit management are reduced despite the higher expectations. Therefore it is a necessity for credit professionals to search for opportunities to implement proven best practices. By upgrading your practices five common pitfalls can be avoided. Scheufler (2002) summarizes these pitfalls as failure to recognize potential frauds, under-estimation of the contribution of current customers to bad debts, getting caught off guard by bankruptcies, failure to take full advantage of technology, and spending too much time and resources on credit evaluations that are not related to reduction of credit defaults.

1.1.1 Credit Management

Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. It is the process to ensure that customers will pay for the products delivered or the services rendered. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management.

It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting. Nelson (2002) views credit management as simply the means by which an entity manages its credit sales. It is a prerequisite for any entity dealing with credit transactions since it is impossible to have a zero credit or default risk.

The higher the amount of accounts receivables and their age, the higher the finance costs incurred to maintain them. If these receivables are not collectible on time and urgent cash needs arise, a firm may result to borrowing and the opportunity cost is the interest expense paid.

Nzotta (2004) opined that credit management greatly influences the success or failure of commercial banks and other financial institutions. This is because the failure of deposit banks is influenced to a large extent by the quality of credit decisions and thus the quality of the risky assets. He further notes that, credit management provides a leading indicator of the quality of deposit banks credit portfolio. A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns.

Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It follows that principles of goods lending shall be concerned with ensuring, so far as possible that the borrower will be able to make scheduled payments with interest in full and within the required time period otherwise, the profit from an interest earned is reduced or even wiped out by the bad debt when the customer eventually defaults. Credit management is concerned primarily with managing debtors and financing debts. The objectives of credit management can be stated as safe guarding the companies' investments in debtors and optimizing operational cash flows. Policies and procedures must be applied for granting credit to customers, collecting payment and limiting the risk of non-payments.

1.1.2 Financial Performance

According to the business dictionary financial performance involves measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firms return on investment, return on assets and value added.

Stoner (2003) as cited in Turyahebya (2013), defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. In agreement with this, Sollenberg and Anderson (1995) assert that, performance is measured by how efficient the enterprise is in use of resources in achieving its objectives. Hitt,et al (1996) believes that many firms' low performance is the result of poorly performing assets.

MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. An MFI's financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Profitable institutions earn a positive net income (i.e., operating income exceeds total expenses).

Today, Microfinance institutions are seeking financial sustainability. Many MFIs were restructured in order to achieve financial sustainability and finance their growth. Sustainability is defined as the capacity of a program to stay financially viable even if subsidies and financial aids are cut off (Woolcock, 1999). It embraces "generating sufficient profit to cover expenses while eliminating all subsidies, even those less-obvious subsidies, such as loans made in hard currency with repayment in local currency" (Tucker and Miles, 2004). Tucker and Miles (2004) studied three data series for the period between March 1999 and March 2001 and found that self-sufficient MFIs are profitable and perform better, on return on equity (ROE) and return on assets (ROA), than developing-world commercial banks and MFIs that have not attained self-sufficiency. In order to optimize their performance, MFIs are seeking to become more commercially oriented and stress more on improving their profitability; therefore self-sustainability.

1.1.3 Effect of Credit Management on Financial Performance

Credit management is the method by which you collect and control the payments from your customers. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting.

A proper credit management will lower the capital that is locked with the debtors, and also reduces the possibility of getting into bad debts. According to Edwards (1993), unless a seller has built into his selling price additional costs for late payment, or is successful in recovering those costs by way of interest charged, then any overdue account will affect his profit. In some competitive markets, companies can be tempted by the prospects of increased business if additional credit is given, but unless it can be certain that additional profits from increased sales will outweigh the increased costs of credit, or said costs can be recovered through higher prices, then the practice is fraught with danger.

Most companies can readily see losses incurred by bad debts, customers going into liquidation, receivership or bankruptcy. The writing-off of bad debt losses visibly reduces the Profit and Loss Account. The interest cost of late payment is less visible and can go unnoticed as a cost effect. It is infrequently measured separately because it is mixed in with the total bank charges for all activities. The total bank interest is also reduced by the borrowing cost saved by paying bills late. Credit managers can measure this interest cost separately for debtors, and the results can be seen by many as startling because the cost of waiting for payment beyond terms is usually ten times the cost of bad debt losses.

Effective management of accounts receivables involves designing and documenting a credit policy. Many entities face liquidity and inadequate working capital problems due to lax credit standards and inappropriate credit policies. According to Pike and Neale (1999), a sound credit policy is the blueprint for how the company communicates with and treats its most valuable asset, the customers. Scheufler (2002) proposes that a credit policy creates a common set of goals for the organization and recognizes the credit and collection department as an important contributor to the organization’s strategies.

If the credit policy is correctly formulated, carried out and well understood at all levels of the financial institution, it allows management to maintain proper standards of the bank loans to avoid unnecessary risks and correctly assess the opportunities for business development.

1.1.4 Microfinance Institutions in Kenya

The potential of using institutional credit and other financial services for poverty alleviation in Kenya is quite significant. About 18 million people, or 60% of the population, are poor and mostly out of the scope of formal banking services. According to the National Micro and Small Enterprise Baseline Survey of 1999, there are close to 1.3 million MSEs employing nearly 2.3 million people or 20% of the country's total employment and contributing 18% of overall GDP and 25% of non-agricultural GDP. Despite this important contribution, only 10.4% of the MSEs receive credit and other financial services. The formal banking sector in Kenya over the years has regarded the informal sector as risky and not commercially viable (Omino, 2005).

According to the Poverty Reduction Strategy Paper (PRSP) of 1999, a large number of Kenyans derive their livelihood from the MSEs. However, in spite of the importance of this sector, experience shows that provision and delivery of credit and other financial services to the sector by formal financial institutions, such as commercial banks has been below expectation. This means that it is difficult for the poor to climb out of poverty due to lack of finance for their productive activities. Therefore, new, innovative and pro-poor modes of financing low-income households and MSEs based on sound operating principles need to be developed (Omino, 2005).

Microfinance institutions fill a needed gap within the financial services industry by offering small loans, or micro-loans, to people unable to access conventional loan services. Microfinance institutions vary in size and function with some organizations focusing entirely on micro financing, while others work as extensions of large investment banks. People living in under-developed areas can access needed financial resources through the services provided by microfinance institutions. In the past, microfinance institutions (MFIs) established using either an NGO or a savings and credit co-operative societies framework have been important sources of credit for a large number of low income households and MSEs in the rural and urban areas of Kenya.

Microfinance institutions in Kenya are regulated under The Microfinance Act, 2006 and the Microfinance Regulations issued there under sets out the legal, regulatory and supervisory framework. The Microfinance Act became operational with effect from 2nd May 2008. The principal object of the Microfinance Act is to regulate the establishment, business and operations of microfinance institutions in Kenya through licensing and supervision. The Act enables Deposit Taking Microfinance Institutions licensed by the Central Bank of Kenya to mobilize savings from the general public, thus promoting competition, efficiency and access.

It is therefore, expected that the microfinance industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans (Central Bank of Kenya, 2013).

Before the enactment of this bill, the MFIs operating in Kenya (over 200) were unregulated unless they optionally entered the Association for Microfinance Institutions (AMFI), based in Nairobi and funded by a USAID grant. Under the new bill, MFIs operating in Kenya are vulnerable to the fines imposed by the CBK that can reach Kes 1 million (equivalent to USD 14,376) for every guideline to which they do not comply. According to Kimanthi Mutua, chairman of the AMFI, the new regulations will protect the 60 percent of the Kenyan population who are out of the scope of the formal banking services from bogus MFIs. (Micro capital, 2007)

Many MFIs access commercial borrowing to fund their portfolio. Other sources of funds for operational and financial activities are International NGOs and Aid Agencies including; USAID, IFC, UNDP, HIVOS, DANIDA, European Commission, OIKO Credit, World Vision, Churches and individual donors among other. Some commercial banks have also invested in microfinance institutions.MFI Members' shares have also been a source for funds for the MFIs. Donors in Kenya (such as USAID, IFC, UNDP, HIVOS, DANIDA, European Commission, Oikocredit, World Vision etc.) are active not only in funding MFIs but also in providing capacity building services.

1.2 Research Problem

Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. According to Gitman (1997), the probability of bad debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective .Such delays on collecting cash from debtors as they fall due has serious financial problems, increased bad debts and affects customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good business to put credit management at the 'front end' by managing it strategically.

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e., traditional collateral is not often used to secure microloans Craig Churchill and Dan Coster (2001). The people covered are those who cannot avail credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principle amount itself. Therefore these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities.

Matu (2008) carried out a study on sustainability and profitability of microfinance institutions and noted that efficiency and effectiveness were the main challenges facing Kenya on service delivery, Orua (2009) did a study on the relationship between capital structure and financial performance of microfinance institutions in Kenya, Gitau (2010) did a study on assessment of strategies necessary for sustainable competitive advantage in the microfinance industry in Kenya with specific focus to Faulu Kenya.

Achou and Tenguh (2008) also conduct research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (in terms of loan performance). The purpose of this study was to understand the effect of credit management on their financial performance.

There have been attempts in the past to study Micro financing and Micro lending but much focus has been on the impact of MFIs in poverty alleviation, especially in Kenya but much less has been done to investigate the effect of credit management on financial position of MFIs institutions in Kenya, therefore this research addresses that gap. The research question of this study is: What is the effect of credit management on the financial performance of Microfinance institutions in Kenya?

1.3 Research Objective

To establish the effect of credit management on the financial performance of Microfinance Institutions in Kenya

1.4 Value of the Study

The results of this study will be valuable to researchers and scholars, as it would form a basis for further research. Scholars would use this study as a basis for discussions on credit management and financial performance. It will provide the scholars with empirical studies that they will use in their studies. The study will also add to the body of knowledge in the finance discipline by bridging gaps in credit management research in general.

This study will make several contributions to both knowledge building and practice improvement in credit management and financial performance. From a theoretical standpoint, the study proposes a comprehensive framework of studying changes in credit management and financial performance.It also expected that it will aid policy makers in their effort to revamp the sector. It shall be of great relevance to the organizations under study as well as other financial institutions. The non-financial business firms, whether manufacturing or service oriented shall also benefit from the research findings. This is because the result of the study shall enable the users especially MFIs to appraise its credit policies and to review its operations critically for more result oriented approach in the dealing with its credit facilities.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from the available literature in the same field of study. It will review theories of credit management as well as empirical studies on credit management and financial performance in Kenya and in other countries.

2.2. Theoretical Review

Previous literature has shown that there exists information asymmetry in assessing bank lending applications (Binks and Ennew, 1997). Information asymmetry describes the condition in which relevant information is not known to all parties involved in an undertaking (Ekumah and Essel, 2003). Studies on transaction costs have shown that transaction costs occur “when a good or a service is transferred across a technologically separable interface”. Therefore transaction costs arise every time a product or service is being transferred from one stage to another, where new sets of technological capabilities are needed to make the product or service. Therefore, it may very well be more economic to maintain the activity in-house, so that the company will not use resources on example contacts with suppliers, meetings and supervision. Managers must therefore weigh the internal transaction costs against the external transaction costs, before the company decides whether or not to keep some activity in-house. Williamson (1981).This chapter will review the asymmetric information theory and Transaction cost theory in credit management

2.2.1 Asymmetric Information Theory

Information asymmetry refers to a situation where business owners or manager know more about the prospects for, and risks facing their business, than do lenders (PWHC, 2002) cited in Eppy.I (2005). It describes a condition in which all parties involved in an undertaking do not know relevant information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with investment projects for which the funds are earmarked. The lender on the other hand does not have sufficient information concerning the borrower (Edwards and Turnbull, 1994).

Binks et al (1992) point out that perceived information asymmetry poses two problems for the banks, moral hazard (monitoring entrepreneurial behavior) and adverse selection (making errors in lending decisions). Banks will find it difficult to overcome these problems because it is not economical to devote resources to appraisal and monitoring where lending is for relatively small amounts. This is because data needed to screen credit applications and to monitor borrowers are not freely available to banks.

Bankers face a situation of information asymmetry when assessing lending applications (Binks and Ennew, 1996, 1997). The information required to assess the competence and commitment of the entrepreneur, and the prospects of the business is either not available, uneconomic to obtain or difficult to interpret. This creates two types of risks for the Banker (Deakins, 1999).

The risk of adverse selection which occurs when banks lend to businesses which subsequently fail *(type II error)*, or when they do not lend to businesses which go on to become" successful, or have the potential to do so *(type I error)* Altman (1971).

2.2.2 Transactions Costs Theory

First developed by Schwartz (1974), this theory conjectures that suppliers may have an advantage over traditional lenders in checking the real financial situation or the credit worthiness of their clients. Suppliers also have a better ability to monitor and force repayment of the credit. All these superiorities may give suppliers a cost advantage when compared with financial institutions.

Three sources of cost advantage were classified by Petersen and Rajan (1997) as follows: information acquisition, controlling the buyer and salvaging value from existing assets. The first source of cost advantage can be explained by the fact that sellers can get information about buyers faster and at lower cost because it is obtained in the normal course of business. That is, the frequency and the amount of the buyer's orders give suppliers an idea of the client's situation; the buyer's rejection of discounts for early payment may serve to alert the supplier of a weakening in the credit-worthiness of the buyer, and sellers usually visit customers more often than financial institutions do.

2.3 Financial Performance Measures

According to Hermes and Lensink (2007), the financial systems approach, which emphasizes the importance of financial sustainable microfinance programs, is likely to prevail the poverty lending approach. The argument is that microfinance institutions have to be financially sustainable in order to guarantee a large-scale outreach to the poor on a long-term basis. Measuring and comparing the performance of MFIs has been difficult due to both a lack of publicly available financial information and differences in reporting in a mostly nonregulated industry.(Michael and Miles, 2007)

A myriad of financial ratios are available for assessing the performance of MFIs (CGAP 2003) The Seep Network and Alternative Credit Technologies,2005) Although it is difficult to synchronize the different interpretations of all the ratios, they provide alternative perspectives in assessing the performance of MFIs for each of the domains namely, profitability, efficiency, leverage and risk .In essence, interpreting the determinants of MFIs' financial performance due cognisance should be taken of the precise focus of each ratio.

2.3.1 Financial Profitability

Return on Assets (ROA) falls within the domain of performance measures and tracks MFIs' ability to generate income based on its assets. The ratio excludes non-operating income and donations.ROA provides a broader perspective compared to other measures as it transcends the core activity of MFIs namely, providing loans, and tracks income from operating activities including investment, and also assesses profitability regardless of the MFIs funding structure. ROA is expected to be positive as a reflection of the profit margin of the MFI, otherwise it reflects non-profit or loss. In banks and other commercial institutions, the commonest measures of profitability are Return on Equity (ROE), which measures the returns produced for the owners, and Return on Assets (ROA), which reflects that organization's ability to use its assets productively.

$$ROE = \frac{\text{After-tax profits}}{\text{Starting (or period-average) equity}}$$

$$ROA = \frac{\text{After-tax profits}}{\text{Starting (or period-average) assets}}$$

These are appropriate indicators for unsubsidized institutions. But donor interventions more typically deal with institutions that receive substantial subsidies, most often in the form of grants or loans at below-market interest rates. In such cases, the critical question is whether the institution will be able to maintain itself and grow when continuing subsidies are no longer available. To determine this, normal financial information must be “adjusted” to reflect the impact of the present subsidies. Three subsidy-adjusted indicators are in common use: Financial Self-sufficiency (FSS), Adjusted Return on Assets (AROA), and the Subsidy Dependence Index (SDI).

2.3.2 Efficiency

Efficiency of MFIs is measured by the share of operating expense to gross loan portfolio in most cases. The ratio provides a broad measure of efficiency as it assesses both administrative and personnel expense with lower values indicating more efficient operations.

$$\text{Operating Expense Ratio} = \frac{\text{Personnel and administrative expense}}{\text{Period-average gross loan portfolio}}$$

The debt equity ratio is a member of the asset/liability management ratios and specifically attempt to track MFIs leverage. This measure provides information on the capital adequacy of MFIs and assesses the susceptibility to crisis. Microfinance investors mainly rely on this ratio as it helps to predict probability of an MFI honouring its debt obligations. However its use should always be contextualized as high values could lead to growth of MFIs.

The Operating Expense Ratio is the most widely used indicator of efficiency, but its substantial drawback is that it will make an MFI making small loans look worse than an MFI making large loans, even if both are efficiently managed. Thus, a preferable alternative is a ratio that is based on clients served, not amounts loaned:

$$\text{Cost per Borrower} = \frac{\text{Personnel and administrative expense}}{\text{Period-average number of active borrowers [x GNI per capita]}}$$

If one wishes to benchmark an MFI's Cost per Client against similar MFIs in other countries, the ratio should be expressed as a percentage of per capita Gross National Income (which is used as a rough proxy for local labor costs).

2.3.3 Credit Risk Exposure

The credit risk exposure (CR) is measured by the sum of the level of loans past due 30 days or more and still accruing interest namely Portfolio at Risk (PAR-30). In robustness tests we include further measures of credit risk by estimating various econometric specifications for three additional different explanatory variables; the write-off ratio (WOR) which is the value of loans written off during the year as uncollectible, as a percentage of average gross loan portfolio over the year. An additional measure of credit risk is the Risk Coverage Ratio (RC) which is measured as the Adjusted Impairment Loss Allowance/PAR>30 Days and finally Loan Loss Reserve Ratio (LLR). This is measured as the ratio of loan loss reserves to gross loans or simply put as Loan loss reserve/Value of loans outstanding. It is an indicator of how much of the gross loan portfolio has been provided for but not charged off. It is important to note that only WOR and LLR are measures of default, while PAR is a measure of risk of default.

2.4 Credit Management Variables

Key Credit management variables include;

2.4.1 Client Appraisal

The first step in limiting credit risk involves screening clients to ensure that they have the willingness and ability to repay a loan. Microfinance Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower (Abedi, 2000). The 5Cs help MFIs to increase loan performance, as they get to know their customers better. These 5Cs are: character, capacity, collateral, capital and condition.

Character **-** refers to the trustworthiness and integrity of the business owners .it's an indication of the applicant's willingness to repay and ability to run the enterprise. **C**apacity assesses whether the cash flow of the business (or household) can service loan repayments. **C**apital - Assets and liabilities of the business and/or household**. C**ollateral -Access to an asset that the applicant is willing to cede in case of non-payment, or a guarantee by a respected person to repay a loan in default. **C**onditions-A business plan that considers the level of competition and the market for the product or service, and the legal and economic environment

The 5Cs need to be included in the credit scoring model. The credit scoring model is a classification procedure in which data collected from application forms for new or extended credit line are used to assign credit applicants to 'good' or 'bad' credit risk classes (Constantinescu et al., 2010).Inkumbi (2009) notes that capital (equity contributions) and collateral (the security required by lenders) as major stumbling blocks for entrepreneurs trying to access capital. This is especially true for young entrepreneurs or entrepreneurs with no money to invest as equity; or with no assets they can offer as security for a loan.

Any effort to improve access to finance has to address the challenges related to access to capital and collateral. One way to guarantee the recovery of loaned money is to take some sort of collateral on a loan. This is a straightforward way of dealing with the aspect of securing depositors' funds.

2.4.2 Credit Risk Controls

Key Credit controls include loan product design, credit committees, and delinquency management. (Churchill and Coster, 2001)

2.4.2.1 Loan product design

MFIs can mitigate a significant portion of default risk by designing loan products that meet client needs. Loan product features include the loan size, interest rate and fees, repayment schedule, collateral requirements and any other special terms. Loan products should be designed to address the specific purpose for which the loan is intended.

2.4.2.2 Credit Committees

Establishing a committee of persons to make decisions regarding loans is an essential control in reducing credit (and fraud) risk. If an individual has the power to decide who will receive loans, which loans will be written off or rescheduled, and the conditions of the loans, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, getting involved in delinquency management.

2.4.2.3 Delinquency Management

To minimize such delinquency MFIs can use the following delinquency management methods Institutional Culture: A critical delinquency management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow up on all late payments. MFIs can also remind clients who have had recent delinquency problems that their repayment day is approaching.

2.4.2.4 Client Orientation

A logical first step toward developing a zero-tolerance institutional culture is to communicate this concept to each new client before she receives a loan.

2.4.2.5 Staff Incentives

Creating staff involvement in discouraging delinquency, through a staff incentives system, can be effective. Delinquency Penalties: Clients should be penalized for late payment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance.

2.4.2.6 Loan Rescheduling

Given the vulnerability of the target market, it is common for borrowers to be willing but unable to repay. After carefully determining that this is indeed the case it may be appropriate to reschedule a limited number of loans. Only done under extreme circumstances, this may involve extending the loan term and/or reducing the installment size.

2.4.3 Collection Policy

There are various policies that an organization should put in place to ensure that credit management is done effectively, one of these policies is a collection policy which is needed because all customers do not pay the firms bills in time. Some customers are slow payers while some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses (Kariuki, 2010)

2.5 Empirical Review

Pyle (1997), in his study on bank risk management held that banks and similar financial institutions need to meet forthcoming regulatory requirements for risk measurement and capital. However, it is a serious error to think that meeting regulatory requirements is the sole or even the most important reason for establishing a sound, scientific risk management system. It was held, managers need reliable risk measures to direct capital to activities with the best risk/reward ratios. They need estimate of the size of potential losses to stay within limits imposed by readily available liquidity, by creditors, customers and regulators. They need mechanisms to monitor positions and create incentives for prudent risk taking by divisions and individuals.

Nagarajan (2001) in his study of risk management for microfinance institutions in Mozambique found that risk management is a dynamic process that could ideally be developed during normal times and tested at the wake of risk. It requires careful planning and commitment on part of all stakeholders. It is encouraging to note that it is possible to minimize risks related losses through diligent management of portfolio and cash-flow, by building robust institutional infrastructure with skilled human resources and inculcating client discipline, through effective coordination of stakeholders.

Achou and Tenguh (2008) also conducted research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (interms of loan performance). Better credit risk management results in better performance. Thus, it is of crucial importance that financial institutions practice prudent credit risk management and safeguarding the assets of the institutions and protect the investors 'interests. This is also true for micro finance institutions. Method used by the researchers is mixed research method.

Matu (2008) carried out a study on sustainability and profitability of microfinance institutions and noted that efficiency and effectiveness were the main challenges facing Kenya on service delivery.

Soke Fun Ho and Yusoff (2009), in their study on credit risk management strategies of selected financial institutions in Malaysia the majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk.

The aim of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable boundary. The efficient management of credit risk is a vital part of the overall risk management system and is crucial to each bank's bottom and eventually the survival of all banking establishments. It is therefore important that credit decisions are made by sound analyses of risks involved to avoid harms to bank's profitability. They held effective management of credit risk is an essential component of a comprehensive technique to risk management and critical to the long-term success of all banking institutions.

Orua (2009) did a study on the relationship between capital structure and financial performance of microfinance institutions in Kenya it revealed that short-term debt significantly impacted MFI outreach positively. Long term debt however showed positive relationship with outreach but was not significant with regard to default rates, both short and long term debts showed expected results but were not significant indicating that maturity may not necessarily be of essence. Generally highly leveraged MFIs were found to perform better by reaching out to more clients. It was also revealed that such MFIs also enjoyed economies of scales and therefore were better able to deal with moral hazards and adverse selections which also enhanced their ability to manage risks.

Sindani (2012) in her study on Effectiveness of Credit Management System on Loan Performance: Empirical Evidence from Micro Finance Sector in Kenya found out that Credit terms formulated by the microfinance institutions do affect loan performance; the involvement of credit officers and customers in formulating credit terms affects loan performance. Interest rates charged had a negative effect on the performance of the loans, the higher the interest rates the lower the loan performance.

Credit risk controls adopted by microfinance institutions have an effect on loan performance, credit insurance, signing of covenants with customers, diversification of loans, credit rating of customers, reports on financial conditions, refrain from further borrowing had an effect on loan performance. Collection policies adopted by microfinance institution had an effect on loan performance, stringent policy had a great impact on loan performance, and the lenient policy had an effect but was not as great as that of stringent policy.

Wangechi (2012) in her study on Factors influencing sustainability of microfinance institutions in Kenya studied Kenya Women Finance Trust and found out that that the quality of service delivered influenced KWFT Sustainability by attracting new customers through word of mouth advertising, improving on the reputation of the organization, improving financial performance and profitability, lowering operating costs and also increased customer retention rates hence boosting the overall quality of the organization.

She also found out that staff competencies contributed to increased efficiency and that training boost employees' morale hence sustainability and that that the staffs at KWFT had all the needed skills to effectively carry their duties efficiently and that lack of training attributed to poor performance of KWFT. The study concluded that the level of education of the staff contributed to increased efficiency at KWFT.

2.6 Summary of Literature Review

The chapter begun by providing a brief discussion on key theoretical approaches and findings reported in earlier related studies credit management and financial performance. Key theoretical approaches discussed are Asymmetric Information Theory andTransactions costs theory. The chapter also concentrated on empirical facets of credit management and financial performance. Local studies that have been done on microfinance sector do not focus on the effect of credit management on the financial performance of MFIs,there is therefore a gap in the empirical evidence available .This study seeks to bridge the gap.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. It involves a blueprint for the collection, measurement and analysis of data. This section is an overall scheme, plan or structure conceived to aid the researcher in answering the raised research question. This stage is about how research was executed and how respondents were approached, as well as how the research was completed. Therefore in this section the research identifies the procedures and techniques that were used in the collection, processing and analysis of data. Specifically the following subsections are included; research design, data collection instruments, data collection procedures and finally data analysis.

3.2 Research Design

The study adopted a descriptive survey design. Descriptive research is used to obtain information concerning the current status of the phenomena to describe "what exists" with respect to variables or conditions in a situation. The technique was appropriate as it involved a careful in depth study and analysis on the effect of credit management on the financial performance of MFIs in Kenya.

3.3 Population

The population of study consisted of 59 MFIs in Kenya that are members of AMFI, (Appendix 2). A census study was used to carry out the research.

3.4 Data Collection

Data collection instruments used were questionnaires, annual reports and financial statements on record and data from the Mix market. Primary data was collected using questionnaires where all the issues on the questionnaire were addressed. Secondary data was collected from annual reports and financial statements on record as at 31stDecember 2012.

The secondary data from the financial statements included the after tax profit, total assets, written off debt, and value of loans outstanding.The researcher administered the questionnaire to each respondent in the study. The questionnaire had both open and close-ended questions.

The closed ended questions were used to test the rating of various attributes and this helped in reducing the number of related responses in order to obtain more varied responses. Semi structured interview refers to the use of already prepared questions during the study (Shenghverzy, 2003). The open-ended questions provided additional information that may not have been captured in the close-ended questions.

3.4.1 Data Validity and Reliability

The reliability of a research instrument concerns the extent to which the instrument yields the same results on repeated trials. Although unreliability is always present to a certain extent, there will generally be a good deal of consistency in the results of a quality instrument gathered at different times. The tendency toward consistency found in repeated measurements is referred to as reliability (Carmines and Zeller, 1979).

One method of testing for reliability is the internal consistency method. The internal consistency method provides a unique estimate of reliability for the given test administration. The most popular internal consistency reliability estimate is given by Cronbach's alpha. It is expressed as alpha = Np/ [1+p (N-1)] Where N equals the number of items and p equals the mean interitem correlation.

Validity is defined as the extent to which the instrument measures what it purports to measure (Allen and Yen, 1979). Content validity pertains to the degree which the instrument fully assesses or measure the construct of interest. The questionnaire will be carefully designed and tested with a few members of the population for further improvements. This will be done in order to enhance its validity and accuracy of data to be collected for the study

3.5 Data Analysis

The data that was collected through questionnaires was tabulated and analyzed using the Statistical Package for the Social Sciences (SPSS) software package these includes mean and standard deviations. Descriptive statistics was used to analyze data. Furthermore, descriptions were made based on the results of the tables.

3.5.1 Analytical Model

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was coded to enable the responses to be grouped into various categories. The findings were presented using tables, percentages, and tabulations. Tables were used to summarize responses for further analysis and facilitate comparison.

For this study, the researcher was interested in establishing the effect of Credit Management on Financial performance of MFIs.The model used in the study took the form below:

$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + ę$

Where:Y= Financial Performance as measured by ROA

α= Constant Term

β= Beta Coefficient –This measures how many standard deviations a dependent variable will change, per standard deviation increase in the independent variable.

X1= Client Appraisal

X2= Credit risk controls

X3= Collection policy

ę= Error term

Null hypothesis

There is no significant relationship between credit management and financial performance in Microfinance institutions

Z test and F test were used in the study, 0.05 level of significance was used as a reference in rejecting or accepting the hypothesis.

Summary of variables and measurement

Variable	Definition	Formulae
Y	Financial Performance	ROA= Return on Assets = net operating income-taxes/ average total assets
X1	Client Appraisal	As per the questionnaire
X2	Credit Risk controls	As per the questionnaire
X3	Collection policies	As per the questionnaire

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter discusses the interpretation and presentation of the findings obtained from the field on the effect of credit management on the financial performance of Microfinance Institutions in Kenya. Descriptive and inferential statistics were used to discuss the findings of the study. The study targeted a population size of 59 respondents from which 53 filled in and returned the questionnaires making a response rate of 90.9%. This response rate was satisfactory to make conclusions for the study.

4.2 Data Analysis

4.2.1 General Information

Table 4.1: Period within which MFI had been in existence

Period of time	Frequency	Percentage
Less than 5 years	10	18.9
Between 5 to 10 years	20	37.7
Between 10 to 15 years	15	28.3
15 years and above	8	15.1
Total	**53**	**100**

Source: Research findings

The study sought to establish the length of time which the MFIs had been in existence in the organization, from the findings 37.7 % of the respondents indicated 5 to 10 years 28.3 % of the respondents indicated 10 to 15 years 18.9% of the respondents indicated less than 5 years whereas 15.1% of the respondents indicated for more than 15 years this implies that most of the MFIs had been in existence for 5 to 10 years.

Table 4.2: Adoption of Credit Management Practices

	Frequency	**Percentage**
Yes	46	86.8
No	7	13.2
Total	**53**	**100**

Source: Research findings

The study sought to determine the organizations that had adopted Credit Management practices. From the findings 86.8% of the respondents indicated that their organizations had adopted Credit Management practices, whereas 13.2 % indicated that their organizations had not, this implies that a significant number of organizations had adopted the use Credit Management practices.

Table 4.3: Clients the organization has

Number of clients	**Frequency**	**Percentage**
Less than 100 clients	10	18.9
Between 100 to 250 Client	15	28.3
Between 250 to 500 clients	23	43.4
above 500 clients	5	9.4
Total	**53**	**100**

Source: Research findings

The study sought to determine the number of clients the organization had, from the findings 43.4 % of the respondents indicated that their organization had Between 250 to 500 clients 28.3% of the respondents indicated that their organization had Between 100 to 250 Clients 18.9% of the respondents indicated that their organization had Less than 100 clients whereas 9.4% of the respondents indicated that their organization above 500 clients this implies that majority of the organizations featured in this study had Between 250 to 500 clients

4.2.2 Client Appraisal

Table 4.4: Extent to which MFI use client appraisal in Credit Management

Number of clients	**Frequency**	**Percentage**
Very great extent	19	35.8
Great extent	24	45.3
Moderate extent	10	18.9
Total	**53**	**100**

Source: Research findings

The study sought to determine the extent to which MFIs used client appraisal in Credit Management, from the findings 45.3% of the respondents indicated to a great extent, 35.8% of the respondents indicated to a very great extent whereas 18.9 % of the respondents indicated to a moderate extent, this implies that most MFIs used client appraisal in Credit Management to a great extent.

Table 4.5: Level of agreement on client appraisal in MFIs

Statements	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std deviation
Client appraisal is a viable strategy for credit management.	21	30	2	0	0	1.70	0.26
The MFI has competent personnel for carrying out client appraisal.	16	33	4	0	0	1.77	0.27
Client appraisal considers the character of the customers seeking credit facilities.	15	36	2	0	0	1.75	0.29
Aspects of collateral are considered while appraising clients.	18	32	3	0	0	1.72	0.27
Failure to assess customers capacity to repay results in loan defaults	16	35	2	0	0	1.74	0.29

Source: Research findings

The study sought to establish the level at which respondents agreed or disagreed with the above statements relating to client appraisal in MFIs, from the findings majority of them respondents agreed that Client appraisal is a viable strategy for credit management as shown by a mean of 1.70, Aspects of collateral are considered while appraising clients as shown by a mean of 1.72.Failure to assess customers capacity to repay results in loan defaults as shown by a mean of 1.74, Client appraisal considers the character of the customers seeking credit facilities as shown by a mean of 1.75 and that the MFIs have competent personnel for carrying out client appraisal as shown by a mean of 1.77.

4.2.3 Credit Risk Controls

Table 4.6: Extent to which MFI use credit risk control in Credit Management

Number of clients	Frequency	Percentage
Very great extent	15	28.3
Great extent	30	56.6
Moderate extent	8	15.1
Total	**53**	**100**

Source: Research findings

The study sought to determine the extent to which MFIs used credit risk control in Credit Management, from the findings 56.6 % of the respondents indicated to a great extent, 28.3 % of the respondents indicated to a very great extent whereas 15.1% of the respondents indicated to a moderate extent, this implies that MFIs used credit risk control in Credit Management to a great extent.

Table 4.7: Level of agreement on credit risk control in MFIs

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std deviation
Imposing loan size limits is a viable strategy in credit management	22	28	3	0	0	1.64	0.25
The use of credit checks on regular basis enhances credit management.	17	30	6	0	0	1.79	0.24
Flexible repayment periods improve loan repayment.	14	37	2	0	0	1.77	0.30
Penalty for late payment enhances customers commitment to loan repayment	20	32	1	0	0	1.64	0.28
The use of customer credit application forms improves monitoring and credit management as well	18	35	0	0	0	1.66	0.30
Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk	35	15	3	0	0	1.40	0.28
Interest rates charged affect performance of loans in the MFI	38	15	0	0	0	1.28	0.31

Source: Research Findings

The study sought to establish the level at which respondents agreed or disagreed with the above statement relating to credit risk control in MFIs, from the findings, the study established that majority of the respondents strongly agreed that interest rates charged affect performance of loans in the MFIs as shown by a mean of 1.28, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk as shown by a mean 1.40 other agreed that, The use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers commitment to loan repayment as shown by a mean 1.64 in each case, The use of customer credit application forms improves monitoring and credit management as well, as shown by a mean 1.66, Flexible repayment periods improve loan repayment as shown by a mean 1.77, and that the use of credit checks on regular basis enhances credit management as shown by a mean 1.79.

4.2.4 Collection Policy

Table 4.8: Extent to which MFI use collection policy in Credit Management

Number of clients	Frequency	Percentage
Very great extent	18	34.0
Great extent	32	60.4
Moderate extent	3	5.7
Total	**53**	**100**

Source: Research findings

The study sought to determine the extent to which MFIs use collection policy in Credit Management, from the findings 60.4 % of the respondents indicated to a great extent, 34.0% of the respondents indicated to a very great extent whereas 5.7% of the respondents indicated to a moderate extent, this implies that MFIs use collection policy in Credit Management to a great extent.

Table 4.9: Level of agreement on collection policy of MFIs

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Mean	Std deviation
Available collection policies have assisted towards effective credit management.	12	35	6	0	0	1.89	0.27
Formulation of collection policies have been a challenge in credit management.	36	10	7	0	0	1.45	0.28
Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults	33	10	10	0	0	1.57	0.25
Staff incentives are effective in improving recovery of delinquent loans.	22	30	1	0	0	1.60	0.27
Regular reviews have been done on collection policies to improve state of credit management.	15	35	3	0	0	1.77	0.28
A stringent policy is more effective in debt recovery than a lenient policy	17	36	0	0	0	1.68	0.30

Source: Research findings

The study sought to establish the level at which respondents agreed or disagreed with the above statements relating to collection policy of MFIs. From the findings majority of the respondents strongly agreed that formulation of collection policies have been a challenge in credit management as shown by a mean of 1.45 others agreed that enforcement of guarantee policies provided chances for loan recovery in case of loan defaults as shown by a mean of 1.57 , staff incentives are effective in improving recovery of delinquent loans as shown by a mean of 1.60, a stringent policy is more effective in debt recovery than a lenient policy as shown by a mean of 1.68.

Regular reviews have been done on collection policies to improve state of credit management as shown by a mean of 1.77, and available collection policies have assisted towards effective credit management as shown by a mean of 1.89.

4.2.5 Regression Analysis

Table 4.10: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.892(a)	.796	.761	.2467

Source: Research findings

Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable, from the findings in the above table the value of adjusted R squared was 0.761 an indication that there was variation of 76.1% on financial performance of MFIs in Kenya due to changes in client appraisal, credit risk control and collection policy at 95% confidence interval. This shows that 76.1% changes in financial performance of MFIs could be accounted for by client appraisal, credit risk control and collection policy.R is the correlation coefficient which shows the relationship between the study variables, from the findings shown in the table above there was a strong positive relationship between the study variables as shown by 0.892.

Table 4.11: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.896	4	.224	2.213	.012(a)
	Residual	5.184	48	.108		
	Total	6.08	52			

Source: Research findings

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.012 which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. The calculated value was greater than the critical value (1.699 < 2.213) an indication that client appraisal, credit risk control and collection policy significantly influence financial performance of MFIs in Kenya. The significance value was less than 0.05 an indication that the model was statistically significant.

Table 4.12: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	Constant	.218	.141		1.608	.039
	Client Appraisal	.239	.165	.205	1.653	.029
	Credit risk controls	.392	.271	.027	1.087	.032
	Collection policy	.284	.157	.413	1.852	.012

Source: Research findings

From the data in the above table the established regression equation was

$Y = 0.218 + 0.239X_1 + 0.392\ X_2 + 0.284X_3$

From the above regression equation it was revealed that holding client appraisal , credit risk control and collection policy to a constant zero , financial performance of MFIs would be 0.218 , a unit increase in client appraisal would lead to increase in performance of MFIs in Kenya by a factor of 0.239, a unit increase in credit risk control would lead to increase in performance of MFIs in Kenya by a factor of 0.392 and also unit increase in collection policy would lead to increase in performance of MFIs by a factor of 0.284.

The study also found that all the p-values were less that 0.05 an indication that all the variables were statistically significant in influencing financial performance of MFIs in Kenya.

4.3 Interpretation of Findings

From the findings as shown in Table 4.10, the value of adjusted R squared was 0.761 an indication that there was variation of 76.1% on financial performance of MFIs in Kenya due to changes in client appraisal, credit risk control and collection policy at 95% confidence interval.R is the correlation coefficient which shows the relationship between the study variables, there was a strong positive relationship between the study variables as shown by 0.892.

From research finding as shown on Table 4.11, the calculated value was greater than the critical value (1.699 < 2.213) an indication that client appraisal, credit risk control and collection policy significantly influence financial performance of MFIs in Kenya. The significance value was of 0.012 which was less than 0.05 an indication that the model was statistically significant.

The regression equation established from table 4.12 indicated that that holding client appraisal , credit risk control and collection policy to a constant zero , financial performance of MFIs would be 0.218 , a unit increase in client appraisal would lead to increase in performance of MFIs in Kenya by a factor of 0.239, a unit increase in credit risk control would lead to increase in performance of MFIs in Kenya by a factor of 0.392 and also unit increase in collection policy would lead to increase in performance of MFIs by a factor of 0.284.The significance of the variables was supported by the t values whose significance values were less than 0.05 which indicates that the variables were statistically significant in influencing financial performance of MFIs in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the discussion of key data findings, conclusion drawn from the findings highlighted and recommendations made there-to. The conclusions and recommendations drawn were focused on addressing the objective of the study. The researcher had intended to determine the effect of credit management on the financial performance of Microfinance Institutions in Kenya.

5.2 Summary

The study revealed that MFIs use client appraisal in Credit Management to a great extent. Further it established that client appraisal is a viable strategy for credit, Aspects of collateral are considered while appraising clients, failure to assess customer's capacity to repay results in loan defaults, client appraisal considers the character of the customers seeking credit facilities and that MFIs have competent personnel for carrying out client appraisal.

The study established that MFIs use credit risk control in Credit Management to a great extent. The study further established that interest rates charged affects performance of loans in the MFI, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk, the use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers commitment to loan repayment, the use of customer credit application forms improves monitoring and credit management, flexible repayment periods improve loan repayment and finally that the use of credit checks on regular basis enhances credit management.

The study revealed that MFIs use collection policy in Credit Management to a great extent. Formulation of collection policies have been a challenge in credit management , enforcement of guarantee policies provides chances for loan recovery in case of loan defaults, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more effective in debt recovery than a lenient policy, regular reviews have been done on collection policies to improve state of credit management, and finally that available collection policies have assisted towards effective credit management.

5.3 Conclusion

From the findings, the study found that client appraisal, credit risk control and collection policy had effect on financial performance of MFIs. The study established that there was strong relationship between financial performance of MFIs and client appraisal, credit risk control and collection policy.

The study revealed that a unit increase in client appraisal would lead to increase in financial performance of MFIs in Kenya; this is an indication that there was positive association between client appraisal and financial performance of MFIs, an increase in credit risk control would lead to increase in financial performance of MFIs in Kenya, which shows that there was positive relationship between financial performance of MFIS and credit risk control and a unit increase in collection policy would lead to increase in performance; this is an indication that there was a positive relationship between financial performance of MFIs and collection policy. Client appraisal, credit risk control and collection policy significantly influence financial performance of MFIs in Kenya.

5.4 Recommendations for Policy

The study recommends that MFIs should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

The study also recommends that there is need for MFIs to enhance their client appraisal techniques so as to improve their financial performance. Through client appraisal techniques, the MFIs will be able to know credit worth clients and thus reduce their non-performing loans.

There is also need for MFIs to enhance their credit risk control this will help in decreasing default levels as well as their non-performing loans. This will help in improving their financial performance.

5.5 Limitations of the Study

The respondents approached are likely to be reluctant in giving information fearing that the information sought would be used to intimidate them or print a negative image about them or their Micro Finance Institution. Some respondents may even turn down the request to fill questionnaires. The study handled the problem by carrying an introduction letter from the University and assuring them that the information they give would be treated confidentially and it would be used purely for academic purposes.

Employees operate on tight schedules; respondents are not able to complete the questionnaire in good time and this might overstretch the data collection period. To mitigate this limitation, the study made use of network to persuade targeted respondents to fill up and return the questionnaires.

The researcher also encountered problems in eliciting information from the respondents as some of the information required was subject to areas of feelings, emotions, attitudes and perceptions, which cannot be accurately quantified and/or verified objectively.

This might lead to lack of response due to the veil of confidentiality surrounding the Micro Finance institutions. The researcher encouraged the respondents to participate without holding back the information they might be having as the research instruments would not bear their names.

5.6 Areas for Further Research

The study sought to determine the the effect of credit management on the financial performance of Microfinance Institutions in Kenya. Further research is recommended on the effect of Credit Reference Bureaus on loan performance in microfinance institutions in Kenya. Further research should also be done on the relationship between credit management and nonperforming loans on Microfinance Institutions in Kenya and on the reasons for loan default in microfinance organizations from the clients' perspective

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APPENDICES

Appendix 1: Letter of Introduction

Letter of Introduction

Rosemary Gatuhu

P.o box 104131-00101

Nairobi

TO WHOM IT MAY CONCERN

Dear Sir/Madam,

RE: APPLIED QUESTIONNAIRE

I am a student at the University of Nairobi undertaking a Master of Business Administration; I am currently undertaking a postgraduate research project on 'The effect of credit management on the financial position of Microfinance institutions in Kenya' as a partial fulfillment of my degree requirements.

Attached herewith is a questionnaire that I am requesting to be completed. All the information you will provide will remain strictly confidential.

If you are interested in the findings of this research, it shall be mailed to you upon request. Your cooperation and existence will be highly appreciated.

Sincerely,

Rosemary Gatuhu

Appendix 2: Questionnaire

Name of MFI | |

Part A: General Information

1. For how long has your MFI been in existence

   Less than 5 years [ ] Between 5 to 10 years [ ]

   Between 10 to 15 years [ ] Above 15 years [ ]

2. Has your organization adopted Credit Management practices

   Yes [ ] No [ ]

3. How many clients does your organization have?

   Less than 100 clients [ ] between 100 to 250 Client [ ]

   Between 250 to 500 clients [ ] above 5000 client [ ]

Part B: Credit Risk Management Practices

CLIENT APPRAISAL

4. To what extent does the MFI use client appraisal in Credit Management?

   Very great extent [ ]

   Great extent [ ]

   Moderate extent [ ]

   Low extent [ ]

   Not at all [ ]

5. What is your level of agreement on the following statements relating to client appraisal in MFIs?

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Client appraisal is a viable strategy for credit management.					
The MFI has competent personnel for carrying out client appraisal.					

Client appraisal considers the character of the customers seeking credit facilities.					
Aspects of collateral are considered while appraising clients.					
Failure to assess customers capacity to repay results in loan defaults					

CREDIT RISK CONTROL

6. To what extent does the MFI use credit risk control in Credit Management?

   Very great extent [ ]

   Great extent [ ]

   Moderate extent [ ]

   Low extent [ ]

   Not at all [ ]

7. What is your level of agreement on the following statements relating to credit risk control in MFIs?

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Imposing loan size limits is a viable strategy in credit management					
The use of credit checks on regular basis enhances credit management.					
Flexible repayment periods improve loan repayment.					
Penalty for late payment enhances customers commitment to loan repayment					
The use of customer credit application forms improves monitoring and credit management as well					

Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk					
Interest rates charged affect performance of loans in the MFI					

COLLECTION POLICY

8. To what extent does the MFI use collection policy in Credit Management?

    Very great extent [ ]

    Great extent [ ]

    Moderate extent [ ]

    Low extent [ ]

    Not at all [ ]

9. What is your level of agreement on the following statements relating to collection policy of MFIs?

Statement	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Available collection policies have assisted towards effective credit management.					
Formulation of collection policies have been a challenge in credit management.					
Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults					
Staff incentives are effective in improving recovery of delinquent loans.					
Regular reviews have been done on collection policies to improve state of credit management.					
A stringent policy is more effective in debt recovery than a lenient policy					

Thank you

Appendix 3 : List Of MFIs As At December 2012

1) K-rep Bank Ltd K-Rep Centre, Wood Avenue
2) Equity Bank Equity Centre, Upperhill
3) Co-operative Bank Co-operative Bank of Kenya Ltd Co-operative Hse Building- 4th Floor
4) Post Office Savings Bank Market Lane Off 17 Banda Street, Postbank House
5) Kenya Women Finance Trust-DTM Upperhill, Kiambere Road
6) Rafiki Deposit taking Microfinance Ltd Elroy Plaza, Tom Mboya Street,
7) Faulu Kenya DTM Ngong Road, Ngong lane
8) SMEP DTM Kirichwa Road, Kilimani
9) Remu DTM Ltd Finance House, 14th Floor, Loita street
10) Uwezo DTM Ltd Park Plaza, Ground Floor, Moktah Daddah Street
11) Century DTM Ltd New Pumwani Road K K Plaza, Gikomba
12) Sumac Credit DTM Ltd Consolidated Bank Building, Koinange Street, 2nd Floor
13) Blue Limited Chester House-Koinange Street
14) K-rep Development Agency K-Rep Development Agency Ltd K-Rep Centre| 7th Flr. Wood Av. Kilimani.
15) Eclof Kenya Chiromo, Royal Offices, Mogotio Road
16) KADET Capital Hill, Cathedral Road, Community
17) BIMAS ,Bimas Complex
18) SISDO Ngong Road, Ngong lane
19) Micro Africa Ltd P.O BOX 52926 NAIROBI
20) Opportunity Kenya Geomaps Centre-Matumbata rd Upper Hill
21) Yehu Microfinance Trust Buxton, Tom Mboya Street
22) Fusion Capital Ltd ACK Garden house, Wing A, Ground Floor, 1st Ngong Avenue, Community next to ardhi house.
23) Canyon Rural Credit Ltd Studio Hse,3rd floor
24) One Africa Capital Ltd Koinange Street-Ratansi Educational Trust Building, 2nd Floor
25) Jitegemea Credit Scheme Jogoo Road, KCB building
26) AAR Credit Services Methodist Ministries Centre, 1st Floor Oloitokitok Road Agakhan Foundation
27) Microcredit Programme Mpaka plaza, Westlands 3rd floor
28) ADOK TIMO Sifa House, Ground Floor, Mission Rd. Off Kakamega Rd. Opposite Kibuye Market. KISUMU.
29) Pamoja Women Development Programme Kikinga House, Kiambu Town
30) Juhudi Kilimo Co.Ltd Mucai Road, Ngong Road
31) Musoni Kenya Ltd Cape Office Park Along Ring Road Kilimani, Opposite Yaya Centre
32) Molyn Credit Ltd Bruce House 9th Floor Standard Street
33) Renewable Energy Technology Assistance Programme(RETAP) Waumini Hse, Westlands 1st Floor

34) Rupia Ltd View Park Towers, 10th Floor
35) Taifa Options Microfinance Finance House, Kenyatta Highway
36) U&I Microfinance Ltd 1st Floor, Asili Complex,River Road/Latema Road Junction
37) Select Management Services Ltd Kenya Re towers, off Ragati Road
38) Greenland Fedha Ltd KTDA, KTDA farmers building
39) Youth Initiatives – Kenya (YIKE) Kariobangi North, Sanoda Hse, 2nd Flr
40) Biashara Factors Finance House, 11th Floor, Loita Street
41) Platinum Credit Limited 2nd floor, union towers, moi avenue
42) Ngao Credit Ltd 2nd Floor NHIF Bldg. Community
43) Indo Africa Finance Museum Hill Centre 3rd Floor, Museum Hill Road
44) Springboard Capital Kensia House along Muranga road, Opposite Kobil Petrol Station 1st Floor, suite no.12
45) Mini Savings & Loans Ltd Highway Building, Githunguri Town (Near Githunguri Post Office)
46) KEEF-Kenya Entrepreneurship Empowerment Foundation Mapa House 3rd Floor Kiambu Road
47) Women Enterprise Solutions Development House, Moi Avenue
48) Focus Capital Limited Donholm Mina Centre
49) Samchi Credit Limited Parklands Plaza
50) Fountain Credit Services Ltd Ngong Road , near Kobil Petrol Station
51) CIC Insurance CIC Plaza, Mara Road
52) Chartis insurance Chartis Insurance Company Ltd. Chartis House, Eden Square Complex, Chiromo Road
53) Microensure Advisory Services Hughes building, Kenyatta avenue, 8th floor
54) Jitegemee Trust K-Rep Centre, Wood Avenue
55) OIKOCREDIT Methodist Ministries Centre, Olitokitok road
56) MESPT 2nd flr vision towers muthithi rd, westland
57) Women Enterprise Fund NSSF Building, Eastern Wing, Block A, 14th Floor
58) Unaitas Sacco Society ltd. formerly Muramati Sacco Society Ltd Muramati Building, hospital road, Muranga
59) Swiss Contact Westlands, Vanguard House, 6th Floor,

Source - http://www.amfikenya.com