CREDIT POLICY AND FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN KENYA

TONNEY AGOLA

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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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Signature Date

TONNEY BOLDER AGOLA

D61/81401/2012

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

………………………………….. …………………………

Signed Date

Mr. Nixon Omoro

Lecturer, department of Finance

School of Business, University of Nairobi

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DEDICATION

To my parents Mr. Joseph Agola and Mrs. Mary Agola and my brothers and sister who have always been helping me and committed to all my endeavors, encouraging me to succeed may the Lord Almighty bless you beyond measure.

ABSTRACT

This study was carried out with the purpose of establishing the relationship between credit policy and financial performance of microfinance institutions in Kenya. Credit policy is an important activity within any financial institution that cannot be overlooked in an economic organization engaged in credit irrespective of the nature of business. A well-structured credit policy is a prerequisite that is able to define the stability and continued profitability, while a poor formulated credit policy could cause a negative financial performance for any financial institution. This financial performance constitutes the risk of lending out money and not being able to get it back.

The study adopted a survey design, regression analysis to determine the relationship between variables of the study. Frequency distribution tables and percentages were used to examine the institutions branch coverage, credit terms, financial performance, credit approach, organization membership and challenges faced in practicing credit policy.

The findings revealed a positive relationship between financial performance, credit policy, credit risk controls, credit appraisal and collection policy. Credit policy was a significant predictor showing that when credit appraisal and credit policy procedures on risk management are competent, they can influence achievement of improved financial performance objective. The study recommends that microfinance institutions should adopt a more stringent policy to a lenient policy for effective debt recovery.

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LIST OF ABBREVIATIONS

AMFI - Association of Microfinance Institutions

MFI - Microfinance institutions

CGAP - Consultative Group to Assist the Poor

SHG **-**Self Help Groups

KCPA - Kenya Credit Providers Association

EBDIT **-**Earnings before interest and tax

IFC - International Finance Corporation

USAID **-**United states Agency for International Development

UNDP - United Nations Development Program

EUI – Economist Intelligence Unit

GDP – Gross Domestic Product

ROA - Return on Assets

VAR – Value at Risk Model

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Granting of credit is a powerful selling aid and is a fundamental foundation upon which all trading relationships are built. Both parties in the transaction gain advantage from the credit facilities but the risk of slow or nonpayment is borne by the MFIs and cost in the form of the interest expense incurred from the date of granting credit to payment of the funds. Credit is therefore one of the many factors that can be used by an MFI to influence demand for its products. According to Wachowicz and Horne (1998),firms can only benefit from credit if the profitability generated from increased sales is able to exceed the added costs of receivables.Brearely and Myers(2003) define credit as a process whereby goods or services possession is allowed without spot payment upon a contractual agreement for later payment. Financial access and performance has become an increasingly important metric for the advancement of microfinance institutions driven by competition and supported by changes in regulation and policy.

The biggest risk in any micro-finance institution is lending money and not being able to get it back. Credit risk or default risk is a particular theory of concern for MFIs because most of the lending is unsecured (i.e. collateral is not often used to secure small loans); Churchill and Costar (2001).The persons who are granted credit are not able to gain credit from banking institutions and other financial institutions due to lack of the ability to provide security and guarantee against the borrowed money. Banks do not extend loans to such clients because of the high default risk for repayment of interest and in other cases the principal amount itself. Therefore, the MFIs are required to design a concrete credit policy structure that entails the assessing of potential and existing risks that may arise during the lending activity. An effective credit policy will be able to help in timely identifying a potential credit default that will lead to reduced flow of cash, financial distress and lower liquidity levels. The basic financial purpose of any MFI would be to maximize its value and therefore credit management should contribute to the realization of this aim. Management decision theory has been developed to implicitly contain the risk management process so as to curb the economization of financial loss and time and accomplishment of strategic objectives.MFIs need to collect information before and after a loan is granted, including screening of loan

applications, examining the borrowers ongoing credit worthiness and ensuring that the borrower adheres to the credit terms. According to Ditcher (2003), in-depth evaluation needs to be made on the risk conditions of lending and borrowers characteristics before a credit decision is made.

The Kenya MFI sector has been growing rapidly which may have been caused by internal and external factors. Competition as a major factor is promoting efficiency within MFIs by lowering operation costs and lower interest rates while improving the welfare of borrowers. In an economic perspective, it means that there is limited market and therefore MFIs that are competing need to adjust their policies in way that is accepted from the top management to the consumers/clients. Weak policy and competition lowers borrower selection standards and may lead to a poor relation with clients hence multiple taking of loans thus a high rate of delinquency (Srinivan 2009). Kenya financial sector, which includes MFIs, continues to enjoy high levels of growth in terms of assets and profits, which is driven by need to facilitate financial access in the economy. A survey called Fin Access in Kenya and Fin Scope in other African countries notes that 65% of the population can access microfinance services due to extensive outreach. This can be explained by the rapid expansion of instititutions, Kenya Women Finance and Faulu Kenya (Cracknel 2012).

1.1.1 Credit Policy

Ahmed (2010) describes credit policy as a managerial philosophy that brings out the decision variables of credit standards, collection efforts and credit terms by which managers in microfinance institutions have an influence on their operations. The credit policy impact on the outreach of the MFIs depending on the lending of approaches used to screen clients for credit facilities, which are either liberal or stringent in nature. The approaches will be effective provided the managers are competent with the required skills, experience and knowledge to achieve the desired target (Frey 2010).According to Schueffer (2002), in today's environment of business management of risk and improvement of cash flows are very challenging. With the rise of bankruptcy rates, the probability of incurring losses has increased. Business practices and economic pressures are forcing organizations to slow payments while on the other hand resources for credit management are reduced despite the higher expectations. Therefore, it is important for credit professionals to search for credit opportunities to implement proven best practices. By upgrading the practices, five pitfalls can be avoided. A summary of these pitfalls are; under estimation of the current customer contribution to bad debts, failure to recognize potential frauds, failure to take full advantage

of technology, getting caught off guard by bankruptcy, and spending too much time and resources on credit evaluations that are not related to reduction of credit risks.

Credit risk is a situation whereby debtors fail to meet their contractual obligations on the debts they owe an organization(Modigilliani,Fabozzi,Jones 2002).According to Fabozzi et al(2002),credit risk assessment involves consideration of the following factors; credit exposure, default probability and recovery rate. Credit exposure is the size of the total outstanding balance of the obligation at default while recovery rate is the fraction of exposure during default that can be collected through bankruptcy proceedings or any other settlement form (Arnold 2003).

Default probability is the likelihood that the counterparty will default on payment or transactions either over the life of the obligation or over a specific time horizon. The process of measuring loss potentials and evaluating and assessing their impact on financial institutions and banks leads to control of credit risk and financing and a thorough risk analysis, evaluation and assessment before beginning to grant credit to customers. The effective management of the credit risk and accounts receivables involves designing and documenting a credit policy. Many MFIs face liquidity and inadequate working capital problems due to inappropriate credit policies and poor credit standards, therefore the credit policy acts as blueprint to communicate the company and how to treat its most valuable assets, the customers.Scheufer (2002), proposes that a credit policy creates a common set of goals for the organization and recognizes the collection and credit department as an important contributor to the organizations strategies.

1.1.2 Firm Performance

Financial performance is the measure of organizations achievement on the goals, policies and operations stipulated in monetary terms. It involves the financial health and can be compared between similar firms in the same industry. The main aim of every micro-finance institution is to have operations that are profitable in order to maintain stability and improve on sustainability and growth. Loan delinquency negatively affects the level of private investment and hinders financial access facilitation to the micro-finance client. Group lending is one of the best practices in Africa (Schreiner 2003).The MFI lends to self-help groups, which later lend to individual group members. The SHG are able to assist in governance and internal regulation and screening of members for loan qualification to be able to reduce loan delinquency. Micro-financial institutions earn financial revenue from other financial services loans in the form of interest fees, commissions and penalties. Financial revenue also includes

income from other financial assets such as investment income. MFIs financial activities also generate various expenses from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Appropriate loan sizes to match client needs, savings as a prerequisite, realistic interest rates regular short and immediate repayment periods and achieving scale can lead to sustainability (Havers,1996).If these measures are put in place then both the financial and social responsibility objectives can be achieved.

Micro-finance has operated for centuries and in different parts of the country with the principal purpose of advancing small loans with interests for short periods. Micro-finance also called micro-credit is the supply of loans ,savings and other basic financial services to low income clients or solidarity lending groups including consumers and self employed, who traditionally lack access to banking and related services. Many MFIs seem to have problem reaching self-sustainability at the financial level even after the set-up of subsidized credit, therefore the need of credit policy to be used as a guide to measure and assess the credit risk exposure with respect to financial performance. Meyer (2002) stated that poor financial performance in the MFIs arises due to low repayment rate or un-materialization of funds promised by donors or governments. To be able to assess the MFIs performance, one needs to observe the operational self-sustainability and the financial self-sustainability of MFIs.

Imp-Act (2004a) states that when evaluating the performance of an MFI, both its financial and social performance must be assessed for the successful running of an MFI.The microfinance sector experiences constraints in infrastructure development such as credit bureaus and credit rating which have a weak management information system and lack a strong risk management framework for microfinance practices (Nyanjwa,2008).Legislation has been introduced to enable microfinance institutions to accept deposits(MFI Act-Act No.19 of 2006).This policy has been used to support increased access to financial services, to reduce credit risk and allow for a more competitive lower risk based pricing to be introduced and for interest spreads to reduce.

1.1.3 Credit Policy and Micro-Financial Performance

A change in focus among stakeholders of MFIs requiring the institutions not only to focus on social impact but also efficiency in use of funds and sustainable operations. The focus is a result of failure of donor funded projects due to high default rate, poor fund management and lack of better management of funds (Zeller and Johansen 2009).Apart from the internal factors, MFIs also experience increased competitions for donor funds, leading to need of efficient and sustainable MFIs which do not depend on donation and which have the ability to mobilize commercial funds and still keep their social mission of outreach to the poor (Murdoch 2000; Christen et al,2004). MFIs have to place credit policies to ensure that credit appraisal or administration is done effectively. One policy is the collection policy, which ensures prompt and regular collection for fast turnover of working capital keeping collection costs and bad debts within limits hence maintaining collection efficiency. This collection policy defines clear-cut collection procedures and hence dissuades conflicts arising from loan repayment periods, amounts and loan structure (Pandey 2004).

Firms need to employ a simple discriminator analysis by using more objective methods of differentiating between good and bad customers; such as an empirical analysis may show that the ratio of earnings before depreciation, interest and taxes (EBDIT) to sales is a significant fact. People living in the underdeveloped countries are able to access financial resources through the provision of conventional loan services by microfinance institutions. Therefore MFIs fill a needed gap within the financial industry by offering small loans or micro loans .It is therefore expected that the MFI industry will play an important role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans (Central Bank of Kenya 2013).Most MFIs receive or source there funds from commercial borrowing, international NGOs and Aid agencies including; IFC, USAID, UNDP, European Commission among others who are also active in providing capacity building activities. Member's shares have also been used as a source funds for the MFIs.

The microfinance sector is becoming highly competitive with the presence of downscaling commercial banks and the growing base of microfinance service providers both in the informal and formal sector. This deepening is driven by the thriving mobile banking and payment system. Increased competition is expected with the amendment of the Microfinance Act and increase of technological innovation to increase outreach. The risk of client over indebtness is relevant to the MFI sector due to strong competition hence the need for more stringent credit policies on the overall clients to avoid non-performing of loans.

1.1.4 Micro-Finance Institutions in Kenya

The Kenya microfinance industry has come a long a way particularly since the landmark Microfinance Intermediaries Act of 2006.Kenya has the largest borrower base in the continent (Mix and CGAP 2010).The country now has five DTMs operating under the Economist Intelligence Unit (EUI) as the best in Africa (EUI 2010).Overall EUI rates Kenya as having the second best business environment for MFIs in all of Africa (and one of the top ten in the world).The total assets of the microfinance sector has registered a stable growth over the past three years with the sector being dominated by banks, in particularly Equity Bank which represents 72% of the sectors total assets. The relative market share of the different microfinance segments of Deposit Taking Microfinance Institutions, Banks, Credit Only MFIs and Insurance MFI account for the sectors total assets.

Microfinance plays a vital role in Kenya's economy. A survey done on the country's labor sector showed that MFIs contribute to an estimated 20 percent of employment contributing to more than 25percent of non-agricultural growth domestic product (GDP).The microfinance bill was passed to enable regulation of MFIs in conjunction with the Association for Microfinance Institutions(AMFI).The bill was also passed to protect populations who out of scope from traditional banking services from corrupt microfinance institutions (Foundation for sustainable development). A wide range of credit products is being offered with the formulation of the credit policy regulation in the MFI market, to enable financing of specific sectors such as business,agriculture,the consumer segment including health and education; asset finance, housing and green products. The core products are business loans whereby the terms of offer show a mix of both reducing balance and flat rate interest rates.

MFIs in both commercial and non-profit practice are facing challenges as they are operating in a competitive environment, which requires measures for long-term financial sustainability and competitive advantage K-Rep as one of the earliest NGO MFI to transform into commercial bank faced challenges of payment system adoption, commercial bank regulation follow through (i.e. savings service and reports), development of a corporate culture and governance. There is more to gain than lose in transformation although it may not be an easy process. A breakthrough in the MFI sector has brought about competition arising from expansion of self identified MFIs,entry of new commercial players, emergence of related business primarily consumer lending. The MFI sector is globally shifting to a recognized form of finance yet it is hindered by more sophisticated regulatory measures and market gaps, organizations may be overwhelmed by the demand of credit from the members keeping the

industry from operating as well as it should. The success of lending out credit will depend on the method used to assess and award the credit; hence, there should be comprehensive evaluation (Ditcher 2003).

Commercialized MFIs take deposits and offer opportunities for investment enabling them to lend more than nonprofits. Commercialized MFIs are able to mobilize the general public deposits to be used as a source for capital lending, which is risky, hence have to scrutinize the potential borrowers based on risk and paying back probability. Each microfinance institution may have its own way of determining risk and client quality towards repayment; hence, the following concepts are relevant in such occasions. These are capacity, collateral, character, capital and condition (Edward 1997).MFIs should not only be focused on the repayment of loans but also on social development of which the nonprofits are covering well. They should also strive to achieve economic development for the whole community and not just for individuals.

1.2 Research Problem

Credit policy cannot be overlooked by any economic enterprise and is an important activity in any company irrespective of the nature of business. The biggest risk in the microfinance business is lending money and not being able to collect it back, which arises to credit risk. The persons covered here are the ones who cannot gain credit from banks due to lack of guarantee or cannot provide security against borrowed money. Credit appraisal therefore is used to determine whether to accept or reject the proposal of finance for borrower.MFIs has credit policies that guide them in the process of credit awarding. The policy sets the rules on who should access credit, when and why should one obtain the credit including repayment arrangements and required collaterals. If an organization adopts a lenient or stringent credit, policy it must ensure that it does not lose its customers for they are required to enhance positive cash flow (Kalunda, Kabiru and Nduku 2012).

MFIs performance largely depends on the effectiveness of their credit management systems because the institutions generate most of their income from interest earned on extended loans. Sound credit management is a prerequisite for a MFIs stability and continued profitability while credit delinquency is the cause of poor financial performance and condition. carefully documented credit policy should be able to able to serve the purposes of defining the organizations objective on credit extension, define the authority and responsibilities credit granting, specify training policy for credit professionals, monitor activities for credit staff and

give performance targets and create a customer – company culture. The internal factor of an organization should emphasize on the sphere of creativity, knowledge and manipulation of information to enhance decision-making rather than just consider the borrowers' character that might be misrepresented (Balduino 2000).However Kenyan MFIs face many challenges. Expenses are high and on average revenues remain lower; efficiency in terms of cost per borrower is low.

A number of local studies have been conducted on micro-finance institutions.Nguta (2013) carried out a study on Loan repayment default in micro-finance institutions and noted that this could be attributed to the type, age of business, number of employees and business profit.Sindani (2012) researched on the effectiveness of credit management on micro-finance loan performance and noted that the terms and policies formulated by MFIs do affect the performance whether stringent or lenient policies.Wangechi (2008) did a study on factors influencing sustainability of microfinance institutions in Kenya with a focus on establishing the direction of such influence on financial sustainability. The study noted that MFIs face challenges of funding, repayment default and government regulations. Various scholars have also conducted studies; Mulumba (2009) conducted a study on credit policy and customer retention in microfinance institutions in Uganda; Mulema (2011) did a study on credit policy and loan portfolio performance with a specific focus on Uganda Finance Trust.

There have been attempts in the past to study microfinance institutions but much of the focus has been on loan performance and loan portfolio with regard to credit policy. Not much has been done as per the researcher on credit policy and financial performance of MFIs in Kenya and therefore this research addresses the gap. The research question of this study is: What is the relationship between credit policy and financial performance of microfinance institutions in Kenya?

1.3 Research objective

To establish the relationship between credit policy and financial performance of micro-finance institutions in Kenya.

1.4 Value of the Study

The study will be able to benefit credit professionals in the microfinance institutions in enacting credit policy that enhances microfinance outreach, and appropriate evaluation of borrowers before granting credit. The results of this study would form a basis of further

research and discussion of credit policy and financial performance. It will be of aid to MFIs under study as it will help the MFIs in appraising there credit policies and review on operations to enhance improved financial performance.

The study will benefit managers on improving on service delivery by issuing credit terms that are accommodative and merge with organization objectives. According to Korten (2009) when managers are empowered with the necessary resources then they will have the capability to transform the organization visions into objectives, which are achievable in a measurable and short period. Therefore, managerial practice through required skill, knowledge and experience facilitates in the achievement of the required performance. Membership to the Kenya credit providers association will enable full information sharing amongst all credit providers representing the interest of credit providers in policy and regulatory reform and disseminate credible credit market information on a regular basis.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews available literature from other scholars in the field of study regarding credit policy. It reviews theoretical literature and empirical review of the relationship between credit policy and financial performance of microfinance institutions in Kenya and other countries.

2.2 Theoretical Literature

Authors of literature such as (Pandey 2004), (Atkinson 2007), (Krueger 2005) have defined credit policy in a like manner as the combination of such terms as credit standards, credit period, collection policy credit terms and cash discounts.MFIs have credit policies that guide them in the process of granting credit and the policy also sets the standards or rules on who should be given credit, including required collateral and repayment period.MFIs may either decide to use lenient or stringent credit policy whereby in a lenient credit policy, the microfinance institution may decide to liberally lend to persons whose credit worthiness is questionable. This will minimize costs and losses from debts that may go bad but it might also reduce revenue earnings from loans in case of delinquency, profitability and cash flow (Huang and Borin, 2001).

Nzotta (2004) stated that credit policy greatly influences the success or downfall of microfinance institutions and other financial institutions. This is due to the failure of deposit taking institutions influence by the credit decisions quality. He further notes that a key requirement is the effective and efficient management of the customer’s credit line. If a credit policy is properly designed, understood and carried out well at all levels of management of financial institution, it will allow for proper standards of the MFI loan to avoid unnecessary risks and allow for business development. A stringent credit policy will turn away potential customers and slow the loan portfolio growth, which then lowers customer retention whereas a liberal credit policy will attract slow paying customers and increase the arrears rate. The liberal credit policy adopts liberal terms and standards such as longer period of credit ,granting credit to customers with stable financial positions, while on the other hand a stringent credit policy sells on credit to only selected customers who posses proven credit

worthiness and are also financially stable. Therefore, a good credit policy is one that brings. about equilibrium between customer retention and defection to facilitate financial performance and outreach

Riach (2010) states that the credit policy enables microfinance institutions to limit bad debts and improve cash flows. This is because the main cause of business of MFIs is loans. The credit policy also assures a degree of consistency among departments by writing down what is required of each department as well as ensuring consistence in handling clients based on predetermined parameters.Keplan (1998) noted the use of 5Cs of credit to estimate or credit score the possibility of default in order to avert default risks. Policy reforms can have a greater impact if information could be shared between MFI and the borrower. Lack of sharing information increases the MFIs credit risk and reduces the competitiveness of the MFI system. This absence of reliable information on borrower increases the adverse selection risk resulting to higher credit risk and loan loss provisions, which in turn raises interest rate spreads.

A collection policy is necessary because not all customers pay their loans the same way, while other customers may pay promptly, others are slow payers. Collection efforts should be enhanced to accelerate collection from slow payers thereby reducing loan delinquency and bad debts. Pandey (2005) notes that prompt collection is needed to ensure fast turnover of working capital; keeping collection costs and bad debts within limits and maintaining collection efficiency. The procedures under collection policy should be followed to ensure coverage of overdue accounts and avoid lose of customers to other competitors

According to Harris (2001), customers who willingly renew their loan contracts for top-ups are satisfied with the microfinance service than those who do not. The satisfied clients therefore reflect a positive response to other prospective customers, which facilitates the efforts of microfinance institutions in extending outreach, which reflects on the financial performance. Credit granting is also shorter for retained customers because loan appraisal takes a little time to conduct. This is true for clients with a good repayment track whose cost of serving results in low transaction cost leading to efficiency ,increased number of clients reached and enabling credit officers to market more about the financial products hence lowering acquisition costs for customers (Craig 2010).Dawkins (2010) states that the retained customers who are loyal and satisfied with the services issued are able to generate increased profits for the MFI over time. This is a result of reduced of acquisition costs, higher loan

balance that are used to subsidize the cost structure inform of interest rates for processing fees to new clients.

Management decision making is influential in MFIs as it involves gaining of information before and after granting of loans to borrowers. The MFI will have privileged information in the occurrence of operating the clients account and can observe flows of income and expenditure. Financing advantage theory of credit policy allows the MFI to have an advantage in investigating credit worthiness of his clients as well as to have a better ability to monitor and force repayment of the credit This may give the MFI a cost advantage over other financial institutions in offering credit to a buyer in terms of advantage in credit information acquisition, advantage in controlling the client and advantage I salvaging value from existing assets.(Schwartz 1974 and Mitchell A Petersen)

According to (Szabo 2005) for a credit policy to be effective it is supposed to be flexible and not static, it should allow opportunity for reviewing regardless of how serviceable it may be. Price discrimination through credit policy can be used to have a financing advantage. The constant reviews are important because of the dynamics in business caused by changes in both external and internal environment. The credit policy should be able to benefit both the sales and accounts receivable, which can be achieved by reciprocation between departments. Credit policies are revised and reviewed to allow management to incorporate changes on the strategic direction, risk tolerance or market conditions (Elliot 2009).The policies are revised to incorporate customer preferences so that they are served to satisfaction according to their expectations. The reviews will be then used to evaluate performance of the policy in terms of achieving the goals ranging from profitability to customer growth.

2.3 Credit Risk Theory Management Models

A number of credit risk systems have been developed based on an organizations line of business to aid in the aspect of quantifying and managing risk across the product lines. These models also play an important role in measuring performance and credit risk management including performance based compensation, risk based pricing, client profitability analysis and active portfolio management. Credit risk modeling may prove to be a better way of internal risk management and oversight for setting a credit policy on regulatory capital requirements. To produce a more precise information the model has to be validated empirically, conceptually sound and be comparable across the microfinance oeganizations.Credit scoring models use data from the borrowers observable characteristics

to enable it calculate the probability default or group the borrowers into different risk classes (Saunders and Cornett 2007).

2.3.1 Value at Risk Model (VAR)

This model commonly used by security firms, credit unions and companies involved in the energy sector and other commodities is used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities.VAR has been considered as the "new science of risk management", it is able to measure risk while it happens and is an important consideration when firms make hedging or trading decisions (Robert 2001).

There are three basic methods of calculating VAR as expounded.VAR is presented by;

VAR= (dollar value of position)(price sensitivity)(potential adverse move in yield/price)

The risk for microfinance institutions is about the odds of losing money given out as loans and VAR is based on that common fact. By assuming that MFI organizations care about the odds of a big loss of loans, VAR answers the question of "what would be the worst case scenario?"On the other, hand "How much would be lost in a really bad month or financial year". The three components of VAR are time period, loss amount or percentage and confidence level (Harper 2008).

2.3.2 KMV credit Monitor Model

The KMV model is a creditor monitor model that helps to solve the lending problems of financial institutions and look at the incentive repayment problem (Gilbert 2004).To try to resolve the problems, the KMV model uses the structural relationship between the volatility of firm's assets and the volatility of the firm's equity. It used to determine the expected default frequency that reflects the probability that the market value of the firm's assets will fall below the promised repayments on debt liabilities in one year. If the value of the firm's assets falls below its debt liabilities, it can be viewed as being economically insolvent. Simulations by the KMV has shown that the model outperforms both S & P ratings and accounting based models (Saunders and Cornett 2007).The relevant net worth of a firm is therefore the market value of the firms asset minus the firms default point. A firm will default when its market net worth reaches zero (Moody's KMV 2003).

The KMVs empirical expected default frequency is an overall statistics that can be calculated for every possible distance to default using data either aggregated or segmented by region or industry. As a firms distance of default fluctuates so does the expected default frequency. The

model has been criticized on the basis that there are no true probabilities of default .For firms that are actively traded; it would be possible in theory to update the expected default frequency in order to replicate risky bond prices (Kao Eon et al 2000).

2.3.3 Altman's Z-Score model

The Z-score model for predicting insolvency of Altman (1968) is a multivariate formula for measurement of the financial health of a company and a powerful diagnostic tool that forecast the probability of an organization entering insolvency within a two-year period with a proven accuracy of 75-80%.

$Z=1.2X1+1.4X2+3.3X3+0.6X4+1.0X5$

Where, X1=working capital/Total assets ratio, X2 retained earnings/total assets ratio, X4=Market value of equity/book value of long-term debt ratio, X5=sales/total assets ratio.

The higher the value of Z, the lower the borrowers default risk classification. Altman credit sore model states that any firm with a Z-score of less than 1.81 should be considered a high default risk,between1.81-2.99 an intermediate default risk, and greater than 2.99 a low default risk. The model has although been criticized for discriminating between borrower behavior, high, indeterminate, and low default risk. It has also been criticized for not quantifying hard factors (macroeconomic) that play a crucial role in the default or no default decision.

2.4 Determinants of Financial Performance of MFIs

Collection policy involves all strategies and processes within the MFI to ensure that all granted loans or credits have been fully paid back on time. According to Pike and Neale (1999), a good credit policy is one that has procedures that are defined clearly, communicated to clients and members.MFI should enact stringent measures to reduce the debt collection cycle as long cycles affect the cash flow and liquidity of the institutions operations. To avoid conflict between the essential departments of the organization on collection policy there must be a clear structure understood by all compatible units in the instititution. Arnold (2003) states that good administration of debtors could only be achieved through a clear, concise and well communicated. He further suggested three principles towards maintaining a good collection policy that are systematically reviewing debtors, sending invoices promptly and being strict with credit limits. Late payments can be avoided by strategies like setting strict credit limits, regular credit checks on the customer, contractual agreement for charging late payment fees or interest and if all fails involvement of a debt collection agency.

Outreach at a glance means the number of clients served. Meyer (2002) noted that outreach is a multidimensional concept that has different dimensions of measurement. Firstly is the number of persons served who previously were denied access to financial services, some measure of depth to evaluate how well MFIs reach the very poor and finally the variety of financial services provided? Navajas et al (2000) similarly indicated six aspects of measuring outreach which are depth, worth of users, cost of users, breadth, length and scope. Depth refers to "the value society attaches to the net gain associated to use of micro credit given by borrower". Worth of outreach to users refers to "how much a borrower is willing to pay for a loan".Similarly,cost of outreach to users refers to "cost of loan to a borrower". The costs might consist of prices like interest rates and various payments that they have to pay, which would be revenue to the lender. Breadth of outreach is the number of users, length of outreach is the period in which a microfinance organization produces loans and scope of outreach is the number of type of financial contracts offered by a microfinance organization (Navajas et al 2000).The higher the scope of services the greater the outreach to customers since different customers have different desires hence customer retention.

Financial sustainability is an indicator of performance for microfinance institutions. This can be defined as having an operational sustainability level of 110% or more, while operational sustainability is defined as having an operational self-sufficiency level of 100% or more. The operational self-sufficiency is defined as total financial revenue/financial expense+ operating expense. Meyer (2002) stated that the financial unsustainability in the MFI arises due to low repayment rate or unmaterializaton of promised funds by donors or governments.

In accessing MFI performance, we need to consider operational self-sustainability, which relates to when income is sufficient to cover operational costs like salaries, supplies, loan losses and other administrative costs, and financial self-sustainability, which is when MFIs can also cover the costs of funds and other forms of subsidies received when they are valued at market price. Meyer (2002) indicated, "Measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery and potential losses". Regarding an indicator of financial performance, it can be considered that loan repayment (measured by default rate) could be another indicator for financial sustainability of MFI; low default rate would help realize future lending.

2.5 Relationship between credit policy and financial performance

Management to incorporate changes in strategic direction and risk tolerance periodically revises credit policies or market conditions (Elliot 2009).The reviewing is done to allow incorporation of customer preferences so there needs can be met according to their expectations. The reviews are also to evaluate the performance of the policy in terms of achieving desired objectives that range from profitability to customer growth and outreach. The credit policy also addresses the procedure of lending and recovering loans from customers (Zeller 2010).On time loan payments encourages customer loyalty due to the limited inconveniencies, which leads to an improvement of financial performance.

Dawkins (2010) notes that retained customers who are loyal and satisfied by the services given by the MFIs generate increased profits over time for MFIs due to the lower acquisition costs, higher loan balances that are used to subsidize the cost structure inform of interest rates and processing fees to new customers. Likewise, retained customers reduce the credit risks because sufficient information is built on their cash flows and business performance that facilitates the MFI to make an optimal credit decision while modifying lending terms as the identified risks.

2.6 Empirical Literature

A number of studies have been conducted in relation to credit policy. Mulumba (2011) conducted a study on Credit policy, managerial competence and outreach of microfinance institutions in Uganda. The use of random sampling led to findings that revealed a positive relationship between credit policy, managerial competence, and outreach and customer retention in microfinance institutions. He also noted that managerial competence was a significant factor in showing that when managers are competent they can influence staff to achieve objectives and targets entailed in credit policy. The findings of the study recommended micro finance institutions to train on customer relationship management in order to increase on outreach of the services to the poor to meet the mission of microfinance lending.

Wangechi (2012) conducted a study on factors influencing microfinance institutions sustainability in Kenya and found out that the quality of service delivered influenced sustainability by attracting new clients through advertisiments, improving of institutions image, improving profitability and financial performance, reducing operational costs and increasing on customer retention, which improves on the quality of the organization. She also noted that staff competencies contributed to increased efficiency and that training motivates employees and lack of training may lead to poor performance.

A study by Nduta (2011) on the effects of credit management on the financial performance of microfinance institutions in Kenya. The study adopted a survey design and established that there is a strong relation between financial performance of MFIs and client appraisal, credit risk control and collection policy. The study established that client appraisal ,credit risk and control and collection policy had a strong influence on the financial performance of MFIs in Kenya. The study recommended adoption of a more stringent policy to a lenient policy for effective debt recovery.

Sindani (2012) conducted a study on the effectiveness of credit management system on loan performance on MFIs in Kenya. The study adopted a descriptive survey design and established that credit terms formulated by MFIs do affect loan performance so does the involvement of credit officers and customers. The stringent policy had a greater impact on loan performance than the lenient policy. The researcher recommended the MFIs to consider the interest rates on loans because interest rates have a negative effect on loan performance. Credit risk controls adopted by MFIs have an effect on loan performance, credit ratings, report on financials, signing of contracts with customers and credit insurance. The collection policies adopted by microfinance institutions had an effect on loan performance; lenient policy had an impact on loan policy but was not as great as the stringent policy.

Balogun (2012), conducted a study on performance of microfinance institutions in Nigeria and in established that the number of MFIs in Nigeria is increasing at a rapid rate, in response to the growing need for financial services to the poor. The legal framework is being developed to regulate this sector and the technological gap be bridged to enhance innovation of the unbanked population. He also noted that the MFIs in Nigeria have a structural weakness, operators lack understanding on how to run MFIs and poor state of reporting in the financial development. The remedy to the challenges would be through application of technological innovation that will include human and material resources.

Mulema (2011) conducted a research on the relationship between credit policy and portfolio performance in microfinance institutions of Uganda finance trust. The findings indicated that MFIs use customer particulars for tracking purposes as a way of credit control when issuing loans on various loan products (school fees, individual loan, salary loans or business loans).The study indicated that credit policy if not clearly designed could influence negatively on the performance of microfinance institutions.

2.7 Summary

The chapter began by providing a discussion on the theoretical foundation and studies related to credit policy and financial management. Key theoretical approaches are default risk, decision-making .Local studies have also been on the microfinance sector that does not focus on credit policy, and financial performance of MFIs in Kenya, there is therefore a gap in empirical evidence available hence, this study seeks to bridge the gap.

This chapter also simply refers to credit policy as the laid down procedures and rules which a firm has chosen to guide in the granting of credit or loans to customers. However, there are three decision credit policy variables; credit standards, credit terms and collection policy.

In order to improve the financial performance there is need to represent the interest of all microfinance institutions in the policy and regulatory reform and to undertake education and communication initiatives. The credit policy should be developed in accordance with the strategic, marketing, financial and organizational context of the business and be designed to contribute to achievement of the organizational goals. This will help build a sustainable relationship between customers, generate information about customers and their requirements interms of credit granting, credit terms and customer service. The objective is to improve on performance.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section describes research design, study population, sampling design and methods of data collection to be used in the study. It further discusses the measurement of variables that the researcher employed on analysis.

3.2 Research Design

The research used a descriptive study that adopted a survey design. This was used to capture averages and percentages derived from the questionnaires, which act as a blueprint for the collection, measurement and analysis of data. The descriptive study was able to associate how the variables are related because data is to be collected at a point in time involved with in-depth study and analysis of the \ credit policy and financial performance of microfinance institutions in Kenya. (Ataya 2009) used a descriptive study to research on factors affecting accessibility of facilities among small and micro-enterprises. Descriptive research design has been used because it allows for analysis of the variables using linear regression and enables generalizing of the findings to a larger population as long as the sampling units of the study are many.

3.3 The Study Population

The study population comprises of a sampling frame of all MFIs operating in Kenya. This is obtained from the Association of Microfinance Institutions. The sample size comprises of 59 MFIs that are registered by the member-based institution. This is to enable for a more comprehensive analysis of the MFI credit policy and financial performance. A purposive sample was used to identify the choice respondents for the study, whom are the Credit officers currently working in the MFIs. A random sample was used to select a single respondent for each MFI.This gave an equal chance of inclusion of the respondents in the sample from the purposive sample.

3.4 Data Collection

The study used both primary and secondary data. The primary data was collected using questionnaires .The questionnaires included semi-structured with both closed and open-ended questions and was administered through a purposive drop and pick method by the credit officers in the organization. Secondary data on the other hand was based on data that has gone through the statistical process. This was obtained from public reports on performance, annual profit performance gazzetements by MFIs, journals released by member bodies and final accounts from the MFIs.

3.5 Data Analysis

The search for patterns that exist among the study variables are to be measured using a five point Likert scale ranging from strongly agree, not sure ,disagree, strongly disagree responses from the respondents. The responses before being processed were edited for completeness and consistency whereby a descriptive analysis was employed. The technique of multiple regressions was used to measure the quantitative data, which was later analyzed using the SPSS.Graphical presentations, and tables were used as to present the data collected as an appropriate method of understanding and analysis of the data.

(Kothari 2009) states that multiple regression is a method of data analysis that is flexible when predicting the quantitative variables (the dependent) based on the covariance or relationship to any other factors (the independent variables).For this study the researcher is interested in measuring credit policy and financial performance of microfinance institutions in Kenya. The factors are β as the independent variables and Y as the dependent variable. The credit policy was quantified from the likert scale questions while the financial performance of the microfinance institutions were as a measure of return on assets.

The multiple regression equation is:

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

Where Y=Financial performance as measured by Return on Assets (profitability)

α= Constant term normally distributed to a mean of 0 for the purpose of computation.

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

The independent variables are below whereby the equation was solved by use of the statistical model in which SPSS was applied for analysis.

X1=credit appraisal

X2=credit risk controls

X3=collection policy

Ȩ = error terms

Null hypothesis

The credit appraisal depending on the purpose of the loan and the quantum can be measured based on the clients' income and existing liabilities. In assessing of credit risk that can affect the repayment then MFIs, use the credit scorecard model and leverage. For collection policy, measurement will be based on sales or accounts receivable considering outstanding payments.

Other variables of performance can be measured through intangible dimensions, such as public image and perception, customer satisfaction on the enacted policies, employee skill levels and training, innovations in products and services offered as investments into new value streams. Other leading indicators that serve to predict the performance of MFIs include lead-time s on recovery of credits, daily sales score of loans with regard to the right information, delivery performance and quality of performance.

The data variables will be measured using ordinal measurement scales of mean, standard deviation and percentage to know the ranking of score from the responses. The likert scale can also be used to measure subjects response according to levels of agreement (strongly agree, agree, undecided, disagree, and strongly agree).

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter contains the presentation and interpretation of the findings obtained of the study on the credit policy and financial performance of micro-finance institutions in Kenya. The study targeted 59 respondents out of which 49respondents were able to fill and return the questionnaires constituting to a response rate of 68%.The data analysis was done through SPSS (Statistical Package for Social Scientists).The results were displayed by use of frequencies and percentages whereby data was presented by use of tables and graphs.

4.2 General Information

The respondents were asked to state their position within the organization as the collection of data was purposively supposed to be from the credit officers or loan officers.

Number of branches of MFIs

Table 4.1: Number of branches by the MFIs

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0-10	5	12.5	12.5	12.5
	11-20	20	50.0	50.0	62.5
	More than 20	15	37.5	37.5	100.0
	Total	40	100.0	100.0	

Source: Research Finding

The study sought to establish the level at which microfinance institutions have gained strength in the financial market through expansion into different economic region, to enhance self-sustainability and be competitive. From the findings 12.5% of the respondents indicated 0 – 10 branches, 50% of the respondents indicated 11 – 20 branches and 37.5% indicated

more than 20 branches. This is an indication that the microfinance sector is becoming an important part of the Kenyan financial system of accessing money.

Basis of availing credit

Table 4.2: The basis of availing credit to clients

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Nationality	8	20.0	20.0	20.0
	Security	9	22.5	22.5	42.5
	Savings	12	30.0	30.0	72.5
	Employment	9	22.5	22.5	95.0
	Other	2	5.0	5.0	100.0
	Total	40	100.0	100.0	

Source: Research finding

The respondents were requested to state the basis on which there microfinance organizations were using to avail credit to clients. From the findings 20% f the respondents indicated nationality, 22.5% of the respondents indicated security, 30% of the respondents indicated that the clients has to have savings in the organization, 22.5% of the respondents indicated employment or a source of income by the client and 5% of the respondents indicated others whereby character or ability to repay could be a measure of granting credit the client. This indicates that microfinance institutions are keen on appraising a client before giving out a credit to effectively manage credit risks and defaults in loan payment.

Credit payback

Table 4.3: The period of paying back credit

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	less than 1 year	10	25.0	25.0	25.0
	1- 5 years	17	42.5	42.5	67.5
	More than 5 years	8	20.0	20.0	87.5
	Other	5	12.5	12.5	100.0
	Total	40	100.0	100.0	

Source: Research finding

The study requested the respondents to give an indication on the period to pay back loans by the clients. From the findings, it was found that 25% indicated less than 1 year, 42.5% indicated 1 – 5 years, 20% indicated more than 5 years and 12.5% indicated other. This is an indication that microfinance organizations need to collect better within the given period of 1 - 5 years so as to have a good cash flow and improved financial performance.

Type of credit policy Approach

Table 4.4: Credit policy approach adopted

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Stringent	18	45.0	45.0	45.0
	Lenient	22	55.0	55.0	100.0
	Total	40	100.0	100.0	

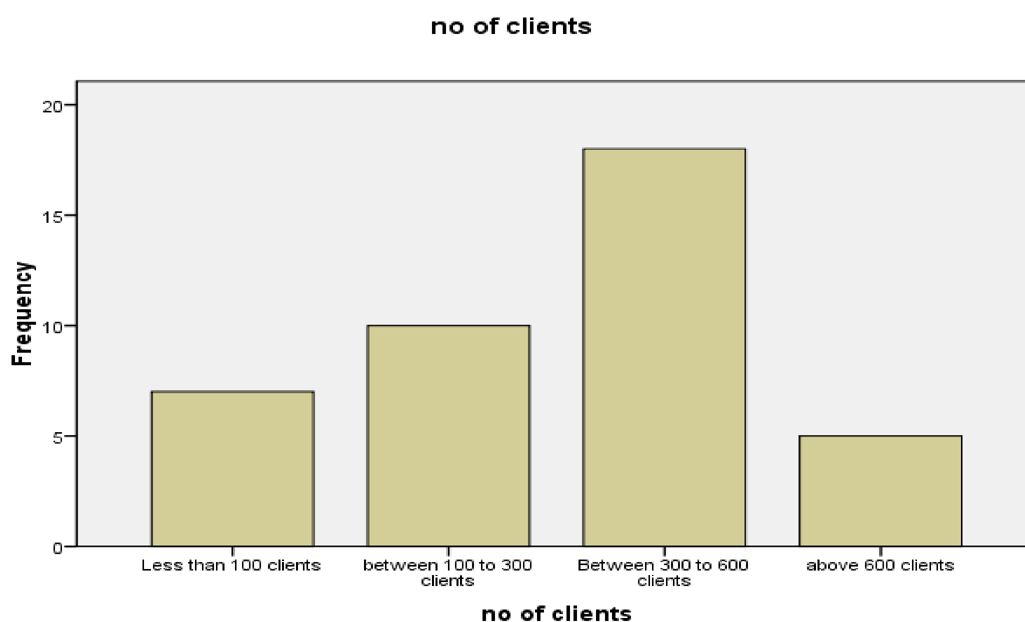
Source: Research finding

The study sought to indicate the extent to which the respondents agreed to the use of credit policy practices to enable the MFI meet set obligations. From the findings most of the

respondents at 55% indicated lenient credit policy adoption and 45% of the respondents indicated stringent credit policy. This implies that microfinance institutions are upgrading their approaches of availing credit facilities to avoid the pitfalls of credit risk and poor financial performance. It is therefore important for MFIs to implement best credit proven practices.

4.3 Credit Policy Practices

Figure 4.1: Population of clients by the MFI organization

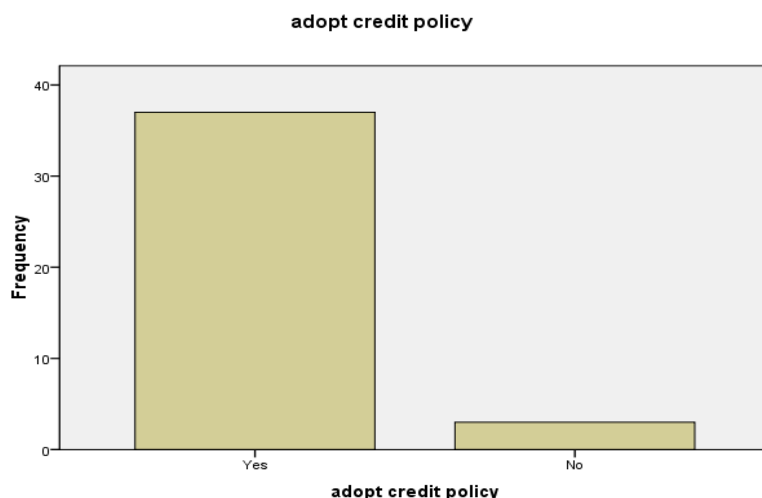


Source: Research finding

The study requested the respondents to indicate the population capacity to which the MFI was availing financial services. From the findings, it was found that 17.5% of the respondents indicated less than 100, 25% of the respondents indicated between 100 to 300 clients, 45% of the respondents indicated between 300 – 600 and 12.5% of the respondents indicated more than 600.

4.3.1 Practices of Credit Policy

Figure 4.2



Source: Research finding

The study sought to determine whether the micro finance organizations adopt the use of credit policy practices. The findings indicate that 92.5% of the respondents indicated that MFI organizations have adopted credit policy practice, and 7.5% of the respondents indicate that they have not adopted credit policy. This indicates that a huge number of organizations have defined credit policy practices to enable improvement of cash flows, collection and reduction of default delinquency on loans.

4.3.2 The Extent of Appraising Clients

Table: 4.1 Use of credit terms and standards in appraising clients.

extent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Very great extent	12	30.0	30.0	30.0
	Great extent	18	45.0	45.0	75.0
	Moderate extent	10	25.0	25.0	100.0
	Total	40	100.0	100.0	

Source: Research finding

The study sought to investigate the extent MFIs use credit terms and standards in appraising of clients. The respondents were requested to indicate their level of client appraisal. It was found that 30% of the respondents indicated very great extent, 45% of the respondents indicated great extent and 25% of the respondents indicated moderate extent. This indicated that microfinance institutions lay emphasis on improving credit policy practices to enable improving on the financial performance.

4.3.3 Level of Agreement relating to credit policy

Table 4.2 what is the level of agreement on statements relating to credit policy

level of agreement

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly agree;	24	60.0	60.0	60.0
	Agree	8	20.0	20.0	80.0
	Not sure	8	20.0	20.0	100.0
	Total	40	100.0	100.0	

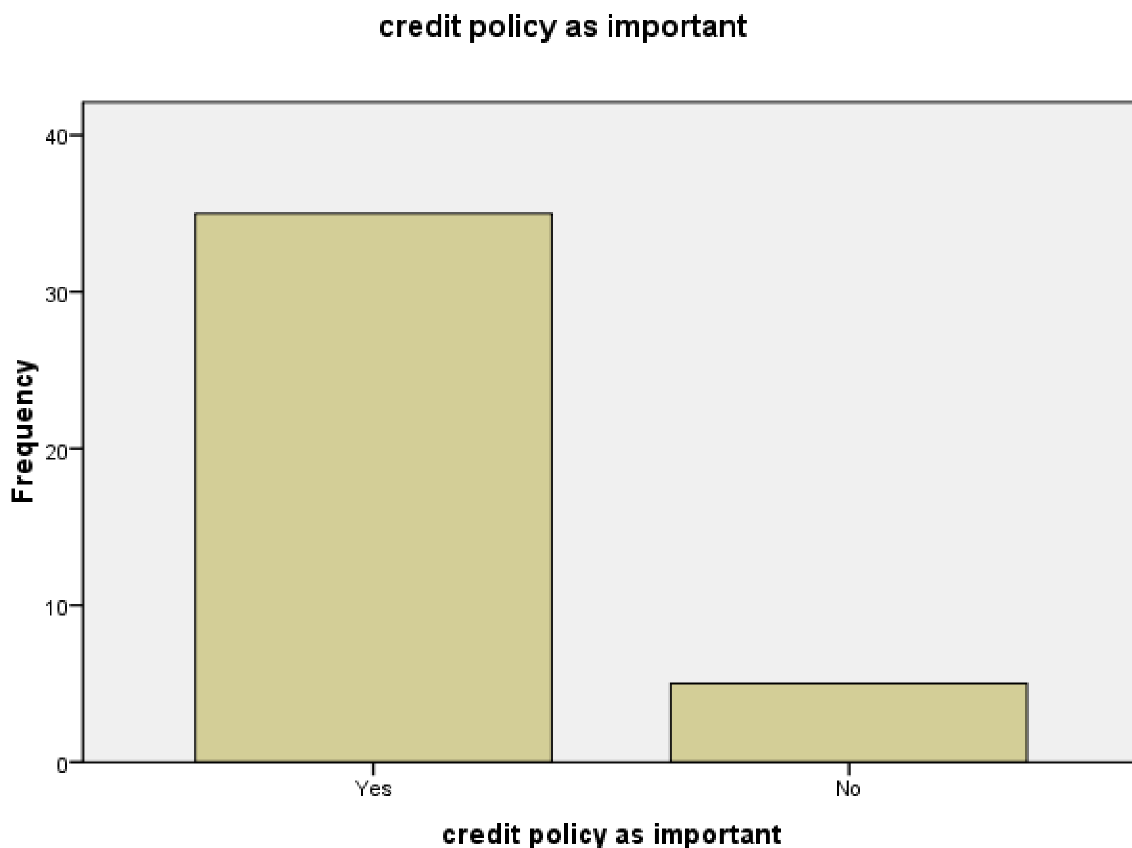
Source: Research finding

The study sought to find out the level of agreement relating to credit policy in microfinance organization. The findings from the respondents indicated that a majority of the responses strongly agreed that MFIs set and follow credit terms and that it easy to get loans from there MFI institutions with loan products increasing the profit levels.60% of the respondents strongly agreed to the statements,20% of the respondents agree to the statements of credit policy in microfinance institutions and 20% are not sure .This indicated that MFIs use and set credit policies to enable them reduce on credit risk and credit appraisal decision making to enhance on financial performance.

4.3.4 Importance of credit policy in determining performance

Figure 4.3: Is credit policy important in determining financial performance of MFIs

Source: Research finding



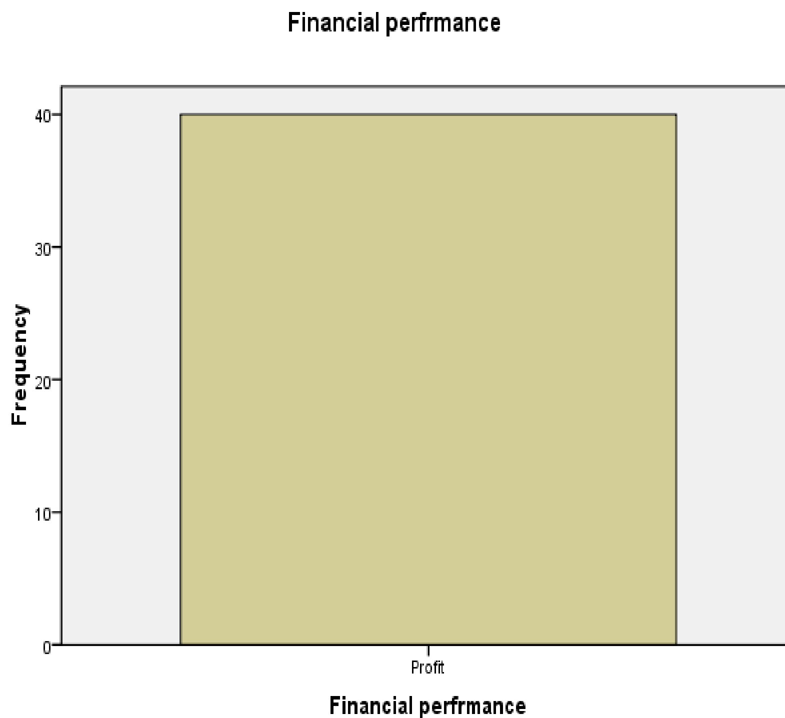
The study sought to determine the level at which the respondents agreed to the consideration that credit policy was important in determining the financial performance of microfinance institutions. From the findings, majority of the respondents at 87.5% indicated that their organization considered credit policy as an important factor in determining financial

performance, 12.5% indicated that it is not an important factor. This clearly indicates that MFIs are adopting credit policy procedures and structures. This is to enable them avoid conflicts of loan defaulters, proper timing on repayment and improvement of financial performance which may be caused by a good cash flow in the organization.

4.3.5 Financial performance

Figure 4.3: What is the financial performance of your organization

Source: Research finding



The respondents were requested to indicate whether the microfinance organization financial performance was making any profit or loss. From the findings, it indicated that most of the respondents at 100% agreed to the fact that the MFI is making profit. This indicated clearly that the MFIs are not only focusing on social performance but also efficiency in the use of funds and having sustainable operations that deliver on achieving growth in financial performance.

4.4 Regression Analysis

A multiple regression analysis model was applied to determine the relationship between credit policy and financial performance of microfinance institutions in Kenya

Table 4.3 Research variables

Mode 1		Understandardized Coefficients		Standardized Coefficients	t	Significance
		B	Std error	Beta		
1	Constant	.217	.140		1.066	.038
	Client appraisal	.238	.163	.203	1.651	.027
	Credit risk	.391	.269	.025	1.084	.031
	Collection policy	.283	.148	.409	1.0851	.012

Source: research findings

From the above table regression equation can be established as

Y = .217 + .238X1 + .391X2 + .283X3

4.5 Discussion

From the equation it was found that collection policy, credit risk, client appraisal to a zero constant, the financial performance would be .217.A unit increase in collection policy would increase the financial performance to .283, an increase of unit in the credit risk controls would lead to an increase of financial performance to .391, and an increase of unit of client appraisal would lead to an increase of financial performance to .238.

From the findings the variation of the dependent variable from the independent variable was 0.791 an indication that there was a 79.1% on financial performance of MFIs in Kenya due to the appraisal of clients, credit risk control and collection policy. The significance of the t-values whose significance was less than 0.05.This indicates that the variables were significant statistically in influencing financial performance of microfinance institutions in Kenya

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter focuses on the presentation findings of key data, drawing conclusion from the findings and making recommendations. The discussion, conclusion and recommendation follow the objective of the study drawing information from findings in chapter four. The researcher had intended to determine the relationship between credit policy and financial performance of micro-finance institutions in Kenya.

5.2 Summary

The sustainability of microfinance institutions is becoming very important with the rapidly growing supply of funds for micro-loans and increasing competition in microcredit markets. There is therefore a need for MFIs to influence financial sustainability while meeting the required social objectives. Credit policy is formulated and reviewed on a regular basis to be consistent with the decision-makings on client appraisal, advancement of loans, collection policy and be in tandem with the objectives and goals of the credit function. The study revealed that a carefully documented credit policy is a fundamental requirement able to serve the following purposes; specify performance targets and monitor activities for credit staff, define the objectives of credit granting and timing of collection actions and define objectives of credit extension in the context of corporate strategy and organization structure.

The study revealed that MFIs use credit appraisal as a viable tool in management of credit risk. Aspects of collateral, employment and savings with the MFI are considered while appraising a client of which failure to access customers potential in repayment of loans may result to loan delinquency. The timing of repayment through collection policy is also considered as a means of generating sales and profits that contributes to an appropriate cash flow and good investment relationship with the institution. The management of trade credit through the adoption of either lenient or stringent credit policy helps the MFI to build a long-term relationship with customers, generate information and customer requirements. This will help facilitate different strategies in terms of credit granting, credit terms and customer service enabling growth of profitable sales.

The study established that management should give priority to staff empowerment in terms of trainings to enhance their skills and experience on service delivery, which leads to customer satisfaction and retention. The study further established that interest rates charged on credit affect loan performance and the credit management committees involved in making decisions, regarding loans are essential in reducing credit risks. There should be regular credit checks whereby late repayment is to attract penalty therefore enhancing commitment to loan repayment.

The study further revealed form most respondents who agreed that microfinance institutions incurred many costs in terms of resources in recovering loans. This could be brought about incase the screening and analyzing of the client was not done conclusively before awarding credit. Based on the respondents responses it can be argued that the perspectives for microfinance institutions can be gauged as positive.

5.3 Conclusion

From the findings, the study concludes that microfinance institutions need to formulate credit policies to enable the management of credit risks and support in decision making by the credit management committee. This will guide the MFIs on the intended way of doing business and avoid any potential misunderstanding, minimize loan defaulters or cash loss, meet its objectives and ensure the organization performs better increasing return on assets and attaining of maximum financial performance.

The study also establishes that client appraisal, credit risk controls and collection policy all have an effect on the financial performance of microfinance institutions. A unit increase on the collection policy would lead to an increase in financial performance, an increase in credit risk control would also lead to an increase in financial performance and an increase in credit appraisal leads to improvement of financial performance. This is an indication that the MFIs need to allocate more resources on the improvement of collection policy. Credit appraisal and credit risk controls to enable attaining of maximum financial performance

From the findings, the study concludes that MFIs are involved in the management of credit policy by making credit risk decisions through a standardized procedural process, documentation, observance of credit ratings and terms and watching the degree of loan portfolio. Findings from the respondents also concludes that regular meetings with the credit officers or staff enables awareness of the risks facing the organization and the best way forward to mitigate them. This implies that when the credit officers are well trained on

customer relationship and market awareness outreach is improved. The study further establishes that financial performance is related to customer retention and improved collection policy. This means that the firm will be able to reduce the costs in getting new clients and have growth in terms of sales.

5.4 Policy Recommendation

Given the findings of the study, the MFIs management in militating against credit risks to enhance financial performance, should enhance their collection policy by adopting a more stringent policy to a lenient policy for effective recovery of debt. The credit policy structure is the key indicators of how the policy decisions will be made in various levels of MFI management.

The study also recommends that MFIs need to enhance their client appraisal techniques to avoid having un-credit worthy clients leading to loan delinquency. This will enable improvement of financial performance by having credits being paid and having a positive performing loan portfolio in terms of recovery.

Micro-finance institutions have suffered loan losses through relaxed lending standards, the borrower's perception and unguaranteed credits. The study therefore recommends that MFIs enhance their credit risk controls by creating profile assessment database of prospective and current borrowers and guarantors that can be shared among MFIs to help minimize non-performing loans. This will help in improving their financial performance.

From the findings the study recommends that the microfinance institutions should periodically review their credit policies, which will include collection policy, loan portfolio procedure, risk monitoring and analysis, credit scoring, diversification of assets to earn a higher financial performance as the study established that there is a positive relationship between management of credit risk and financial performance of microfinance institutions.

5.5 Limitations of the Study

The major limitation of the study was the inability to include more organizations. The study would have covered more institutions across the microfinance sector to provide a more broad based analysis. However, constraints in terms of resources placed the limitation. The study also faced challenges in terms of the respondents getting time to fill the questionnaires and travelling for collection of the filled questionnaires.

The respondents approached were reluctant as they held sensitive information regarding their financial institution, fearing that the information sought would be given to the public. Some respondents would turn down a request to fill a questionnaire noting different reasons as time consuming or organization confidential information. The researcher explained to the respondents that the information to be provided would be treated as confidential was only for academic purpose.

5.6 Recommendations for the Study

The study investigated the relationship between credit policy and financial performance of microfinance institutions in Kenya. The study revealed that there is a positive relationship between credit policy and financial performance, hence further study should be carried on how credit policy can be managed to have an impact of client retention and customer loyalty in microfinance institutions. Further research should also be done on the relationship between the financial scope and management of non-performing loans on microfinance institutions in Kenya and the reasons for loan delinquency from the client's point of view.

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APPENDICES

Appendix 1: QUESTIONNAIRE

Dear sir/madam

I am student of the University of Nairobi carrying out a research aiming at determining the effects of credit policy on the performance of microfinance institutions. I kindly request you to spare some minutes of your time and respond to the questions below by ticking or filling where applicable. The purpose of these is for a requirement of the award of masters' degree in finance; your answers will be treated with utmost confidentiality.

Thank you for your cooperation.

Section A: General information: (Please put a tick in the appropriate box)

1. How many branches does your microfinance institution have?

0-10 ☐ 11-20 ☐ More than 20 ☐

2. What is the basis of availing credit to clients?

Ethnicity ☐ Security ☐

Savings ☐ Employment ☐ Other……………………

3. What is the maximum period of credit payback?

Less than a year ☐ 1- 5 years ☐ More than 5 years ☐

4. What kind of credit policy does your organization adopt?

Stringent { } Lenient { } Other………………..

Section B

5. How many clients does your organization have?

Less than 100 clients { } between 100 to 300 clients { }

Between 300 to 600 clients { } above 600 clients { }

6. Does your organization adopt credit policy practices?

Yes { } No { }

7. To what extent do the MFI use credit terms and standards in appraising a client?

Very great extent { } Great extent { } Moderate extent { }

Low extent { } Not at all { }

8. What is your level of agreement to the following statements relating to credit policy in MFI?

SA=strongly agree; A= Agree; NS=Not sure; D=Disagree; SD=strongly disagree

Statement	SA	A	NS	D	SD
9. In your opinion the MFI sets and follows credit policies and terms					
10. The MFI implements these terms and policies when there is payback failure of the loan					
11. There is always training to employees and customers on the terms and policies set by the institution					
12. It is very easy to get loans from your institution					
13. The organization incurs a lot of costs in recovering loans					
14. Loan products have increased the organization profit levels					
15. In my own opinion decline in performance is attributed to inappropriate credit policy					
16. Credit policy ensure no default in loan repayment					
17. The organization sound financial performance is attributed to the enacted credit policy					

18. What other factors affect the performance level in your organization apart from credit policy?

……………………………………………………………………………………………………
……………………………………………………

19. What challenges do you face when practicing credit policy?

……………………………………………………………………………………………

…………………………………………………

20. What are the common costs incurred when administering credit policy?

……………………………………………………………………………………………

……………………………………………………..

21. What are the indicators of a good performing credit policy?

……………………………………………………………………………………………

……………………………………………………..

23. Do you consider credit policy as important in determining performance of MFI?

Yes { }　　　　　　　　　　No { }

THANK YOU

Appendix 2: List of MFIs

1) K-rep Bank Ltd K-Rep Centre, Wood Avenue
2) Equity Bank Equity Centre, Upper hill
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, Post bank House
5) Kenya Women Finance Trust-DTM Upper hill, 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 House, 2nd Floor
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 Company Ltd. Chartis House, Eden Square Complex, Chiromo Road
53) Micro ensure 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 floor 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 Westland's, Vanguard House, 6th Floor,

Source - http://www.amfikenya.com