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ABSTRACT

The general objective of the study was be to investigate the effect of credit management on financial performance of Micro Finance Institutions (MFIs) in Kenya. The study specific objectives were to establish the effect of client credit appraisal, credit risk monitoring, credit granting and credit terms on financial performance of MFIs in Mombasa County. The theories guiding the study were asymmetry information theory, 5 Cs client appraisal model, motive theory and balanced score card theory. The study found out that credit appraisal, credit risk monitoring, credit granting and credit terms affect financial performance of MFIs in Mombasa County, Kenya. The study concluded that client credit appraisal, credit risk monitoring, credit granting and credit terms influences the performance of MFIs in Mombasa County. The study recommended that management of MFIs should improve on client credit appraisal, credit risk monitoring, credit granting and credit terms so as to improve on the performance of MFIs in Mombasa County.

Key Words: *Credit Appraisal, Credit Risk Monitoring, Credit Granting, Credit Terms*

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INTRODUCTION

Financial performance is a crucial aspect of measuring the effectiveness of microfinance institutions (MFIs) in providing financial services to the underserved population. According to a study by Obaidullah & Masud (2019), the financial performance of MFIs in developing countries is affected by various factors such as funding sources, interest rates, and operational efficiency. MFIs that rely on multiple sources of funding, including grants and loans, tend to perform better financially than those that rely solely on deposits or borrowing from banks. Furthermore, MFIs that charge higher interest rates are more likely to experience higher levels of profitability, although this may have negative implications for the clients they serve. Another important aspect of financial performance for MFIs is operational efficiency. This refers to the ability of MFIs to manage their costs and generate revenue effectively. According to a report by the Consultative Group to Assist the Poor (CGAP), operational efficiency is particularly important for smaller MFIs, as they may not have the same economies of scale as larger institutions. Small MFIs can improve their operational efficiency by leveraging technology, streamlining their processes, and focusing on core activities that generate revenue. Financial performance is an essential aspect of evaluating the effectiveness of MFIs in providing financial services to underserved populations. Funding sources, interest rates, and operational efficiency are critical factors that can impact the financial performance of MFIs, and institutions must carefully manage these to ensure their sustainability and ability to serve their clients effectively.

Globally, in Eastern Europe and Central Asia, Microfinance Institutions recorded a loss of 1.1 percent on Return on Assets (ROA) in 2017 (Microfinance Barometer Report, 2018). In Finland, the provision of microcredit is considered as a financial activity and falls in the scope of general applicable laws on financing, which is regulated by the Crowd Funding Law (2016). Despite the weak economic situation and the challenging market environment, the Finnish financial sector maintained good results and further strengthened its capital adequacy in 2015 (Global Findex, 2017). In South Asian, MFIs showed a Return on Assets of 3.5 percent in 2017 with low portfolio quality (Microfinance Barometer Report, 2018). In India, the pressure for growth has led some MFIs to offer IL to new clients or to clients who have only completed one loan cycle and thus have no substantive credit history. Credit discipline of such clients is also suspect. This, in the absence of a thorough cash flow analysis significantly increases the programmes credit risk. Further, there is a general tendency to approve larger amount loans to mature clients irrespective of their business, even when their cash flows are not adequate to repay the loan (MicroSave, 2018).

Microfinance institutions (MFIs) have been important players in expanding access to financial services in Africa and promoting financial inclusion. A study by the Consultative Group to Assist the Poor (CGAP) found that the average return on assets (ROA) for African MFIs was 1.5% in 2018, which is higher than the global average of 0.9%. Additionally, the gross loan portfolio of African MFIs increased by 12% in 2018, indicating growth in their outreach and impact. This suggests that MFIs are making progress in achieving their social mission of providing financial services to underserved populations in Africa (CGAP, 2019). However, MFIs in Africa also face challenges that can impact their performance. For instance, limited access to funding, inadequate regulatory frameworks, weak institutional capacity, and poor infrastructure are some of the major challenges faced by African MFIs. Political instability and poor macroeconomic conditions can also affect the performance of MFIs, especially in countries where they operate (Nyangena & Njeru, 2019)

Microfinance institutions (MFIs) in Kenya have played a crucial role in providing financial services to the unbanked and under banked population, especially in rural areas. Despite facing various challenges such as high operating costs and limited access to funding, MFIs in Kenya have managed to maintain a strong presence and continue to expand their outreach. Oketch & Mutswenje (2019) found that MFIs in Kenya have contributed significantly to poverty reduction, women's empowerment, and financial inclusion. However, there is still a need for better regulation and support from the government to address issues such as over-indebtedness and ensure the sustainability of the microfinance sector. The sector has experienced significant growth from the period 2013 to 2018 (Kinyua, 2017). There has been a lot of transformation in terms of an increase in innovations of new services, growth in the number of customers, and diversity in the range of services and products offered (Central Bank of Kenya, 2020). According to AMFI (2021), net loan portfolio in the MFI sector increased by 13.3% in 2018 however, there was a decrease before tax that decreased by 19% between 2017 and 2018. In a survey conducted by AMFI in late May 2020 MFIs faced constrained working capital due to low repayment hence affecting the liquidity levels. According to AMFI (2021) as at 31st December 2020 the loan loss reserve stood at Ksh4.75B and write offs stood at Ksh395.91M with 6,998 number of loans written-off during the period. In the same period there was Ksh65.99B total liabilities. In Mombasa, there are 16 fully-fledged branches with an outstanding loan portfolio of Kshs. 2,031,554,311.77 (AMFI, 2021).

Statement of the Problem

According to the MFIs quarterly financial report there is an increase in the loan default rate (16%) and the non-performing rate increased by 15% from Sh70.3 billion in March 2017 to Sh77.3 billion in 2018 which is as a result of the practices used for credit management in the sector among other factors (Kinyua, 2017). Despite MFIs taking measures of credit scoring and client appraisal, the institutions still have high default rates (20%) that have a negative effect on the financial performance of MFIs (AMFI, 2021). Further, despite the importance and reforms in the growth of microfinance institutions in Kenya, Microfinance institutions have reported poor financial performance (Central Bank of Kenya, 2019). In Mombasa MFIs have continued to record high rate of non-performing loans with an outstanding loan portfolio of Kshs. 2,031,554,311.77 as of December, 2020 (AMFI, 2021). Non-performing loans directly leads to poor financial performance of the MFIs.

Kipkirui & Omwaga, (2018) found out that that credit risk control, client appraisal, and collection policy and affects financial performance of MFIs. Mburu, Muathe & Mwangi (2020) found out that debt collection policy and lending policy affected loan performance of commercial banks in Kenya while client appraisal had no significant effect. Murigi (2018) found that there was a positive statistically significant relationship between credit risk environment, credit appraisal process, credit administration, measurement and monitoring, internal control over credit risk and loan performance in the microfinance banks. It is against this background that this study investigated the effect of credit management on financial performance of Microfinance Institutions in Mombasa County, Kenya.

Objectives of the Study

The general objective of the study was to investigate the effect of credit management on financial performance of Microfinance Institutions in Mombasa County, Kenya. The study's specific objectives were;

- To establish the effect of client credit appraisal on financial performance of Microfinance Institutions in Mombasa County, Kenya
- To determine the effect of credit risk monitoring on financial performance of Microfinance Institutions in Mombasa County, Kenya
- To examine the effect of credit granting on financial performance of Microfinance Institutions in Mombasa County, Kenya
- To establish the effect of credit terms on financial performance of Microfinance Institutions in Mombasa County, Kenya

The study was guided by the following null hypotheses;

- $H_{01:}$ Client credit appraisal has no significant effect on the financial performance of Microfinance Institutions in Mombasa County, Kenya.
- $H_{02:}$ Credit risk monitoring has no significant effect on the financial performance of Microfinance Institutions in Mombasa County, Kenya.
- $H_{03:}$ Credit granting has no significant effect on the financial performance of Microfinance Institutions in Mombasa County, Kenya.
- $H_{04:}$ Credit terms has no significant effect on the financial performance of Microfinance Institutions in Mombasa County, Kenya.

LITERATURE REVIEW

Theoretical Review

The theoretical framework introduces and describes the theory which explains why the research problem under study exists (Kothari, 2014). The study was guided by asymmetry information theory, 5 Cs client appraisal model and the balanced score card theory.

Asymmetry Information Theory

In lending, information asymmetry exists when a client usually the borrower who applies for loan usually poses superior knowledge on the potential risks and returns regarding the business or investments for which the loan is being applied for (Arora & Kumar, 2016). The lender usually doesn't have complete of information about the borrower and the intended project. In the context of financial institutions, information asymmetry problems are generally categorized into two, that is, moral hazard and adverse selection (Rukwaro, 2017). Commercial banks encounter challenges in addressing these dominant problems because it is not rational to commit financial resources for monitoring and appraisal of small amounts of loans. This is because the data needed to screen applicants and monitor borrowers may have some costs attached to it (Ali, 2015). Therefore, MFIs face a problem of information asymmetry in their operations. The theory is associated to credit terms variable.

The 5 Cs Client Appraisal Model

The 5Cs model is an instrument used by financial organizations in credit management in evaluating a potential customer (Abedi, 2016). The 5Cs include collateral, character, condition, capital and capacity. Character is used in estimating the credit worthiness of a customer, it is usually used in weighting values for the different characteristics of the customer (Njanike, 2016). Economic, cultural and personal factors are believed to influence a customer (Migiri, 2016). Similarly, the psychological factor is not dependent on an individual's visible evidences of achievement but on his inner worth. These factors are considered by banks by enquiring and studying about the customer (Kibor *et al.*, 2015). The 5 C's Model relates to this study as it explains that financial institutions' performance is enhanced by their loan performance of financial institutions. Client appraisal is used to minimize default which in turn enhances loan performance. The theory is linked to client appraisal variable.

Motive Theory of Credit

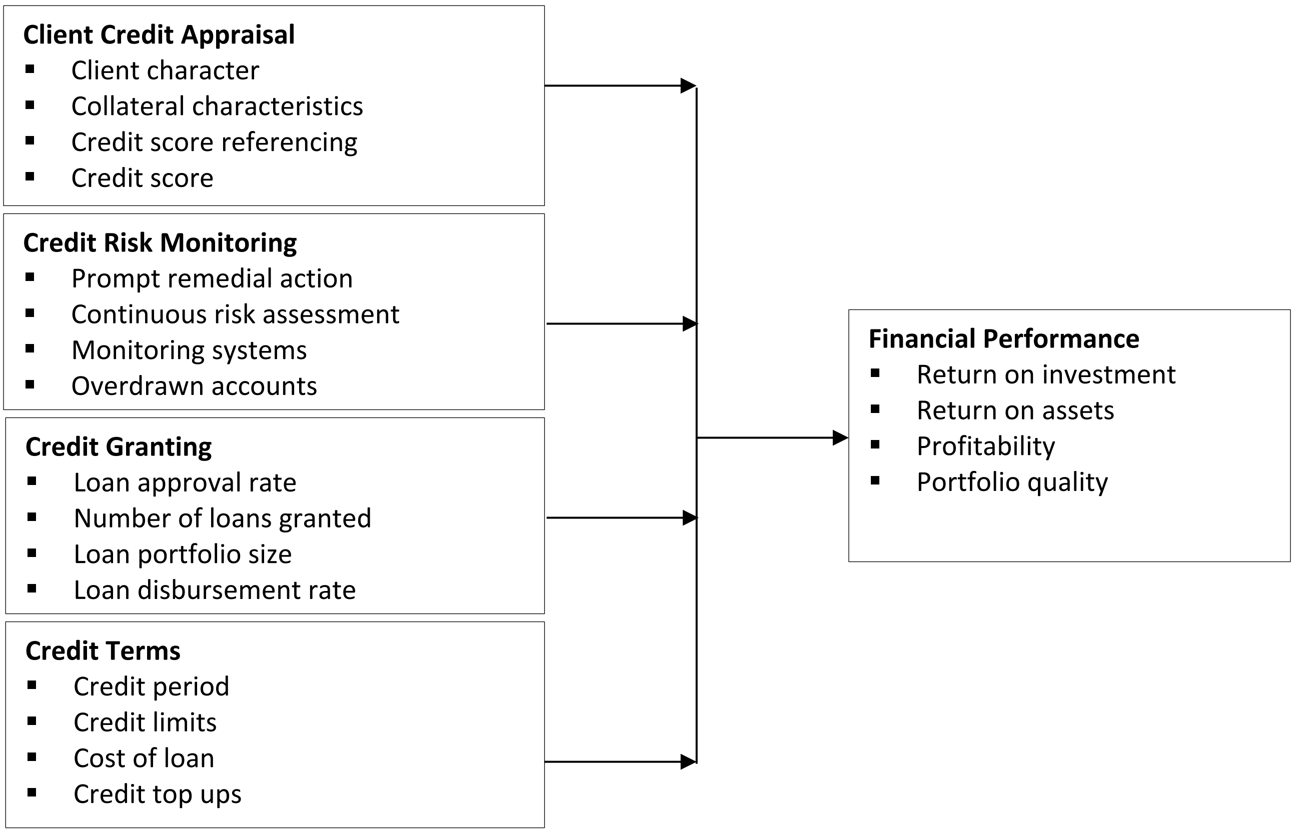
This theory was proposed by Schwartz (1974) and views trade credit from supplier firm's motives for offering trade credit which is classified as financial, operational and commercial. Schwartz (1974) developed the financial motive for the use of trade credit. He suggests that when credit is tight, financially stable firms will increasingly offer more trade credit to maintain their relations with smaller customers, who are "rationed" from direct credit market participation (Emery, 2014). The seller firm acts as a financial intermediary to customers with limited access to capital markets, financing their customers' growth. Petersen and Rajan (2017) find empirical evidence that firms with better access to capital markets offer more trade credit. Larger firms are thought to be better known and have better access to capital markets than smaller firms, in terms of availability and cost, and should therefore face fewer constraints when raising capital to finance their investments (Faulkender and Wang, 2016). According to the financial motive of trade credit, we expect a greater effect of trade credit on firm profitability for the subsample of larger firms (Mian & Smith, 2012). This theory supports credit risk monitoring variable and the credit terms variable.

The Balanced Score Card Theory

Developed by Robert Kaplan and David Norton, the balanced scorecard method translates an organisation's strategy into performance objectives, measures, targets and initiatives. It is based on four balanced perspectives, and links them together with the concept of cause and effect. It refers to a strategic management performance metric used to identify and improve various internal business functions and their resulting external outcomes. BSCs were originally meant for for-profit companies but were later adapted for nonprofit organizations and government agencies. The balanced scorecard model reinforces good behavior in an organization by isolating four separate areas that need to be analyzed. These four areas, also called legs, involve: Learning and growth, Business processes, Customers and Finance. The theory is useful in this study as it supports financial performance variable which is the depended variable of the study.

Conceptual Framework

Conceptual framework is a structure of variables that the researcher operationalizes so as to accomplish the set objectives (Kothari, 2014).



Independent Variables **Dependent Variable**

Figure 1: Conceptual Framework

Review of Variables

This part reviewed credit appraisal, credit risk monitoring, credit granting, credit terms and measurement of financial performance.

Client Credit Appraisal and Financial Performance

Client credit appraisal 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 the default risk is evaluated and eliminated or reduced to the least manageable levels, hence assurance that the customer will be able to pay for the products delivered or the services rendered. According to Armendariz et al., (2016), credit appraisal is a method by which a lender approximates the soundness of a loan request from the financial and technical feasibility or liability point of view. Banks must assess the credit worthiness of a borrower which is summed up in numerous Cs. These Cs constitute: capacity, character, collateral, cash flow, commitment, collateral, condition, credit history and common sense. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting.

Credit Risk Monitoring and Financial Performance

Credit risk monitoring is the heart of account management. It's what lets credit managers know when it's time to perform a periodic credit assessment and account review. Credit administration is a critical element in maintaining the safety and soundness of financial institutions. An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and preparing various documents such as loan agreements.

Credit Granting and Financial Performance

Credit granting is a critical activity for microfinance institutions (MFIs) as it enables them to fulfill their mandate of providing financial services to the underserved population. The credit granting process involves several stages, including loan application, appraisal, approval, disbursement, and recovery. The efficiency and effectiveness of each of these stages can significantly impact an MFI's financial performance. The loan appraisal stage is particularly important as it involves assessing the creditworthiness of borrowers and determining their ability to repay the loan. A comprehensive credit appraisal process can help reduce credit risk and loan default rates, which can positively impact an MFI's financial performance. On the other hand, poor credit appraisal practices can lead to high loan default rates, resulting in increased credit risk and lower profitability. Therefore, it's crucial for MFIs to manage credit granting effectively to maintain a sustainable financial performance.

Credit Terms and Financial Performance

Credit terms are terms that indicate when payment is due for sales that are made on credit, possible discounts, and any applicable interest or late payment fees. Credit terms is defined as the payment terms and conditions made by the lending party in exchange for the credit benefit. A sound credit terms is the blueprint for how the company communicates with and treats its most valuable asset, the customers. Scheufler (2016) 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.

Measurement of Financial Performance

Financial performance is a complete evaluation of a company's overall standing in categories such as assets, liabilities, equity, expenses, revenue, and overall profitability. It is measured through various business-related formulas that allow users to calculate exact details regarding a company's potential effectiveness. Return on Assets is the measure of efficiency which determines how well the banks use its scarce resources to generate profits. It is the ratio of net income to the total asset. A higher ratio is an indication of a better financial performance. This ratio has been used in similar studies by Athanasoglou, Brissimis and Delis (2016); Perera, Skully and Chaudhry (2016). This is because the business of banking is risky due to the possibility that loans may not be paid back leading to financial losses to the bank. Banks are therefore required to have adequate capital, not only to remain solvent, but also to avoid the failure of the financial system. Non-performing loans are used to measure the positive and fitness of a bank's credit risk management. Nonperforming loans have a fundamental effect on how banks set rates, and the problem has been the fact that those who pay their loans then have to pay for those who do not.

METHODOLOGY

Research Design: The study employed explanatory research design as it allows researchers to establish cause-and-effect relationships between variables and to determine which variables are most important in explaining a particular phenomenon (Creswell, 2014).

Target Population of the Study: The target population of the study was the 27 MFIs operating in Mombasa County and from each MFI, the branch manager, the credit manager, the marketing manager and the operations manager were studied. This made a total of 108 staff.

Sampling Frame, Sample Size and Sampling Technique: The sampling frame was the MFIs operating in Mombasa County as at December, 2022 and the sample size was 85 staff arrived at by using Slovin's formula. Simple random sampling method was used to select the 85 respondents. The unit of analysis was the MFIs while the unit of observation was the branch manager, the assistant branch manager, the operations manager, the credit manager and the marketing manager.

Data Collection Instruments and Procedures: Primary data was collected using a 5 point Linkert scale structured questionnaires using drop and pick method.

Data Processing, Analysis and Presentation: The collected data was edited, cleaned, coded and tabulated to sieve it and ensure it is free from errors and omission. Analysis was using Statistical Package for Social Sciences (SPSS) software version 25. Descriptive statistics (mean and standard deviation) and inferential statistics (multiple linear regression, Pearson's moment correlation, ANOVA and model summary) were generated. The regression equation was as follows;

$$\mathbf{Y_1 = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon}$$

Where;

Y= Financial Performance

$\boldsymbol{\beta_\theta}$ = Regression intercept

$\boldsymbol{\beta_1}$-$\boldsymbol{\beta_4}$ are the coefficient of the regression model

$\mathbf{X_1}$= Client Appraisal

$\mathbf{X_2}$= Credit Risk Monitoring

$\mathbf{X_3}$= Collection Policy

$\mathbf{X_4}$= Credit Terms

$\boldsymbol{\varepsilon}$= Error term

FINDINGS

Descriptive Statistics Results

The maximum mean values obtained was 4.3100 (SD=1.2449) for credit terms. The minimum was 3.8100 (SD=.87560) for client credit appraisal. These mean values shows presence of credit Management in the firms. The respondents indicated that to a great extend (mean =4.0), client credit appraisal, credit risk monitoring, credit monitoring and credit terms affects financial performance of MFIs in Mombasa County. This is important for MFIs because literature shows sound credit management enable customers pay their loans and ensures customers comply with company's credit policy. This leads to increased loan collection, which leads to an improvement on financial performance of the MFIs.

Table 1: Descriptive Statistics Results

	N	Mean	Std. Deviation	Skewness		Kurtosis	
Variables	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
Client credit Appraisal	58	3.8100	.87560	.223	.687	-1734	1.334
credit risk monitoring	58	4.0100	.97183	.454	.687	-.516	1.334
credit granting	58	3.9000	.99443	-.237	.687	-.300	1.334
credit terms	58	4.3100	1.24491	.280	.687	.663	1.334
Financial Performance	58	4.220	1.25167	.419	.687	.641	1.334

Correlation Analysis Results

Correlation analysis was conducted to test the relationship between credit management and financial performance of MFIs and the results were presented in table 2.

Table 2: Correlation Analysis Results

Correlations						
		Client appraisal	Credit monitoring	Credit granting	Credit Terms	Financial performance
Client Credit appraisal	Pearson Correlation	1				
	Sig. (2-tailed)					
Credit risk monitoring	Pearson Correlation	.583**	1			
	Sig. (2-tailed)	.000				
Credit granting	Pearson Correlation	.459**	.381**	1		
	Sig. (2-tailed)	.000	.003			
credit Terms	Pearson Correlation	.482**	.443**	.577**	1	
	Sig. (2-tailed)	.000	.001	.000		
Financial performance	**Pearson Correlation**	**.260***	**.295***	**.397**	**.203**	**1**
	Sig. (2-tailed)	**.048**	**.025**	**.038**	**.127**	

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).
c. Listwise N=58

The correlation results shows that credit client appraisal (r=.260, p=.048), credit risk monitoring (r=.295, p=.025), credit granting (r=.397, p=.088) all positively and significantly affect financial performance of MFIs in Mombasa county. This implies that an improvement in client credit appraisal, credit granting and credit risk monitoring increases financial performance of MFIs in Mombasa County. However, credit terms (r=.203, p=.127), showed positive but insignificant association with financial performance in MFIs in Mombasa County. This implies that an improvement on credit terms may increase insignificantly the financial performance of MFIs in Mombasa County.

Multiple Linear Regression Results

The effect of credit management on financial performance of MFIs was modeled using Ordinary least squares estimation method in a multivariate framework. The estimation method results to a model with minimization variance. The model summary results shows the fitness of the fitting a linear relation to the data. The four independent variables account for 75.7 percent of financial variations in MFIs in Mombasa.

Table 3: Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.870[a]	.757	.739	.494

The ANOVA results shows the significance of the model in predicting credit management and the financial performance of MFIs in Mombasa county. The results showed that credit management was a significant predictor of financial performance (F=41.365, p<.001).

Table 4: ANOVA

ANOVA					
Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	40.442	4	10.110	41.362	.000[b]
Residual	12.955	53	.244		
Total	53.397	57			

Table 5: Multiple Linear Regression Coefficients

Coefficients						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	T	Sig.
1	(Constant)	.162	.197		.822	.415
	Client Credit Appraisal	.319	.119	.338	2.671	.011
	Credit risk Monitoring	.301	.121	.380	2.494	.016
	Credit Granting	.425	.168	.375	2.523	.015
	Credit Terms	.182	.136	.177	1.343	.186
	Financial performance	.603	.121	.629	4.993	.000

The multiple regression results shows that client credit appraisal (β =.338, p=.016), credit risk monitoring (β =.3380, p=.016), credit granting (β =.375, p=.015), all positively and significantly affect financial performance of FMIs in Mombasa county. This implies that an improvement in client credit appraisal, credit risk monitoring and credit granting increases financial performance of MFIs in Mombasa County. Credit terms (β =.177, p=.186), was positively but not significantly related to financial performance of MFIs in Mombasa county.

CONCLUSIONS AND RECOMMENDATIONS

From the findings, the study concluded that client credit appraisal positively and significantly affect the performance of MFIs in Mombasa County. Through client credit appraisal, a lender approximates the soundness of a loan request from the financial and technical feasibility or liability point of view. The credit worthiness of a borrower is important as it indicates the ability to repay the loan. Further, credit monitoring positively and significantly affect the performance of MFIs in Mombasa County. Internal risk ratings are an important tool in monitoring and controlling credit risk and the bank's internal risk rating system should be responsive to indicators of potential or actual deterioration in credit risk as deteriorating ratings should be subject to additional oversight and monitoring to ensure credit is not advanced to financially overburdened borrowers.

On credit granting, the study found out that credit granting positively and significantly affect the performance of MFIs in Mombasa County. A high loan approval rate can lead to increased loan disbursements and portfolio growth, while a low loan approval rate can lead to reduced portfolio growth and lower profitability. Therefore, it's crucial for MFIs to set appropriate loan approval criteria and to ensure that loan approvals are based on sound credit appraisal practices. Lastly, the study found out that credit terms positively and but insignificantly affect the performance of MFIs in Mombasa County. When a 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. Credit terms, such as interest rates, repayment periods, and collateral requirements, have a significant impact on the financial performance of MFIs.

The made the following recommendations;

Managerial Recommendations

- Management of MFIs in Mombasa County should improve on client credit appraisal so as to issue loans to credit worthy customers so that their performance can increase.
- Management of MFIs in Mombasa County should improve on credit monitoring so as to ensure all loans are paid in time so as to improve their performance.
- Management of MFIs in Mombasa County should increase credit granting so that their performance can increase.
- Management of MFIs in Mombasa County should improve on credit terms so that their performance can increase.

Policy Recommendations

- Stakeholders in the MFI sector should come up with policy on credit appraisal and credit terms and so that performance of the MFIs can be increased.

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