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EFFECT OF CREDIT RISK CONTROL ON FINANCIAL PERFORMANCE OF MICRO FINANCE INSTITUTIONS IN KENYA

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ABSTRACT

Credit management systems play a crucial role in determining the success of microfinance institutions in Kenya. Interest received on initial monies granted to small and medium-sized enterprises who subject the institution to credit risk accounts for the vast majority of the income generated by these banks. Risk of not getting back principal plus interest is what credit risk is all about. For Kenya's microfinance industry, the link between credit risk Control and bottom line results is murky. The banking industry produces the majority of the available literature. That's why we decided to look into it; it's clearly a promising field. While the majority of academics agree that credit risk management strategies have an impact on financial performance, some have cast doubt on this finding. This study's objective was to explore on the effect of Credit Risk Control on Financial Performance of Micro Financial Institutions in Kenya. The study adopted a descriptive survey research design. The target population consisted of credit managers of all 52 Microfinance Institutions operating in Kenya as captured in the Micro Finance Institutions in Kenya (AMFI) data base. Census technique was applied on all the targeted institutions. Primary data was collected using a questionnaire as the data collection instrument and secondary data was collected from financial reports of the respective Micro Finance Institutions in Kenya, published journals and association of Micro Finance Institutions reports. Descriptive statistics and inferential statistics analysis were used. Credit Risk Control had a direct good impact on Financial Performance according to the survey under descriptive analysis. Credit Risk Control was found to have a positive correlation with Financial Performance using inferential statistics. In conclusion, the survey found that Credit Risk Control practice was critical to the effective financial performance of Micro Finance Institutions firms. As a result, the study recommended that the management of different Micro Finance Institutions adopt Credit Risk Control Practice. The research relied solely on information collected from the database of the Association of Micro Finance Institutions in Kenya (AMFI). Therefore, additional study in this field should concentrate on expanding the size of the census to encompass a greater number of unregistered micro finance institutions not in AMFI database across the country using comparable variables and different technique.

Key words: *Credit Risk Control, Credit Risk Management, Financial Performance*

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INTRODUCTION

Microfinance institutions rely heavily on the production of credit, which has substantial dangers for both the lending institution and the borrower. There is always a chance that a loan recipient won't pay back their debt to a financial organization. Ahmed and Malik (2015) conducted research in Islamabad and Rawalpindi on the credit risk management (CRM) and loan performance of MFBs of Pakistan. Client appraisal was found to significantly affect loan outcomes in a favourable way.

Murthy and Mariadas (2017) investigated what causes borrowers to default on their loans to MFIs in Shah Alam, Selangor, Malaysia. Defaulting on a loan was linked to factors such as the borrower's age and the type of company being conducted, they discovered.

Kargi (2011) conducted research on the impact of credit risk on bank performance in a Nigerian setting. The research looked at the years 2004 through 2008. According to the data, commercial banks' success was greatly impacted by their risk management practices. Results showed a negative correlation between commercial bank performance and how well they handled credit risk. Wanja and Jagongo (2017) investigated the loan policies and economic results of commercial banks in Kenya. Based on their research, they concluded that a bank's ability to compete is heavily influenced by the quality of its credit information, that banks place substantial weight on a borrower's credit history, and that credit policy has a favorable impact on the performance of commercial banks.

Credit risk management (CRM) is the process through which a business plans for, implements, and monitors the systems, procedures, and controls necessary to collect payments from its customers in a timely manner while reducing the likelihood of nonpayment (Mashoko, 2020). It is an integral aspect of a business's overall approach to managing risk. Companies often collapse because of poor handling of their credit risk. Muturi (2016) suggests that a company uses CRM to cut down on the number of clients who don't pay back the money they borrowed. Finance Profits, revenues, Return on Equity (ROE), Return on Assets (ROA), sales revenue, losses, or even the market value of assets can all be used as performance indicators to gauge a company's success.

According to Olalere and Wan's (2016) research on credit management, Credit Risk Control is the process by which a company ensures that it extends credit only to creditworthy clients and that those customers pay on time when they do. Companies, especially those in the manufacturing sector, implement financial controls like credit control to guarantee that sales are converted into cash or liquid resources as soon as possible. Salike and Ao (2017) claim that lending institutions give greater weight than ever; to the institution's values, traditions, and ideologies when making credit or loan choices. Naeem et al. (2017) asserts that credit control encompasses all the elements linked to credit quality, credit extension, and recurring cyclical patterns and sequences. This is important to keep in mind given the complicated and vast nature of the banking industry. In addition, all credit and termination decisions should be guided by rigorous and strong credit control, making it the backbone of CRM.

Financial products and services, such as loans, savings accounts, insurance, and money transfer services, are all part of microfinance because they are designed to help people with low incomes manage modest amounts of money. Micro finance institutions (MFIs) are crucial to any economy because they provide financial services to people who lack access to larger financial institutions. These people include those who live in low-income homes, run micro businesses, and farm on a small scale (Serwadda, 2018). According to Bawuah (2014), expanding relationships between MFIsand the banking system in Africa are mutually advantageous, as MFIs rely on banks for a number of services, such as deposit facilities, liquidity management services, and, in certain

circumstances, emergency credit lines to address cash shortfalls.

Kenya's microfinance business is relatively advanced when compared to the rest of Sub-Saharan Africa. It is made up of businesses whose mission is to provide various forms of affordable financial aid to people at the lowest levels of society. Microfinance has been subject to particular regulation since 2006, when the Microfinance Act was drafted. This environment has been crucial to the growth of Kenya's microfinance industry (Darko, 2013) K-rep was founded in 1984 as a non-governmental organization (NGO) and later morphed into a microfinance institution (MFI). The necessity to increase capacity to mobilize public savings for onward lending drove the change. 52 microfinance institutions (MFIs) are currently registered with the Association of Microfinance Institutions (AMFI). Muturi (2016) claims that a number of MFIs have emerged in Kenya to meet the unmet need for financial services among small businesses and people with low incomes.

Statement of the Problem

Microfinance organizations rely on interest payments from lent money; therefore how well they handle credit risk is crucial to their financial health. The rising rate of non-performing loans (NPLs) in MFIs has been identified as a major source of credit risk, according to the Central Bank Annual Supervision Report (2021). Because of this pattern, MFIs are in jeopardy of losing their ground. While numerous studies have been conducted on the root causes of subpar loan returns and their domino effect on global banking crises, too far, there have been no in-depth analyses of the impact of Credit Risk Control on the profitability of the Microfinance sector. Competition in the market, long-term product diversification, rising operational expenses, the shift to individual lending, expansion, and efforts to enhance outreach are all obstacles that microfinance institutions (MFIs) must overcome.Charles, Okaro, and Kenneth (2013) discovered no correlation between Credit Risk Control and the financial health of microfinance institutions.Most researchers among them; (Wanja and Jagongo, 2017; Ndegwa, 2016; Ahmed and Malik, 2015) came to the conclusion that Credit Risk Control practice impacted on financial performance, while some scholars disagreed.The results of this research showed where other researchers had fallen short in terms of methodology, concepts, context, and theory. By using, Credit Risk Control, as an independent variable and financial performance as a dependent variable, this study filled a knowledge gap and experimentally contributed to the existing literature. This research would also prefer to use more recent data and a more recent time frame.

Objective of the Study

The study explored the effect of Credit Risk Control on Financial Performance of Micro Finance Institutions in Kenya. The study was guided by the following research hypothesis;

- **H_0**: Credit Risk Control has no significant effect on Financial Performance of Micro finance Institutions Kenya.

LITERATURE REVIEW

Theoretical review;

Asymmetric Information Theory

Asymmetric information theory was created by Akerlof in the '70s. An Information Asymmetry exists when a market buyer uses the market mean as a yardstick for evaluating a product's quality, whereas a market seller has greater in-depth knowledge of a single item. Due to the vendor's superior knowledge of the product's quality, the seller is in a stronger negotiating position than the buyer. The term "information asymmetry" is used to describe the unequal distribution of knowledge. Since the buyer of a debt instrument already possesses insider knowledge about the market's inherent risks and potential returns on investment projects, an information asymmetry exists in this sector of the capital markets. Nonetheless, the lender does not have adequate consumer information. Several types of market institutions can help even out the distribution of benefits

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between investors and society. Derban (2010) argues that in order for microfinance institutions to undertake credit evaluation correctly, they must first do an analysis to obtain sufficient and trustworthy information about the consumer, whether that information comes from CBK or elsewhere.

The idea can be used for risk assessment, risk management, and credit scoring. Borrowers with a high debt load exposure and defaulters should be appraised by microfinance institutions using the data provided to reference bureaus throughout the credit assessment process, while only customers who can afford to make their repayments should be granted credit. Important pieces of information in credit evaluation include measures to reduce risk and proof of identity.

Accordingly, this theory is relevant to the investigation at hand since it implies that higher credit risk would emerge from the absence of a competent credit appraisal process, potentially resulting in the awarding of credit to borrowers who do not deserve it. The quality of debt repayments would inevitably suffer as a result. However, a favorable correlation exists between accurate credit evaluation and the success of a loan. The processes of microfinance institutions' credit approval, CRM, credit terms, and credit assessments will be examined.

Financial Intermediation Theory

The theory was developed beginning in the 1960s, with Gurley and Shaw's contributions (1960). This approach is grounded in the ideas of information asymmetry and the agency theory. High transaction costs, a lack of timely, relevant information, and an ineffective regulatory framework all play a role in this phenomenon.

Informational asymmetry is the one distinguishing feature of the research. These defects, or departures from the Arrow-Debreu ideal of perfectly competitive markets, are the result of the informational asymmetry that arises as a result of the existence of this asymmetry. According to the Arrow-Debreu perfect markets summary of a near heaven, financial intermediaries wouldn't be necessary for the economy as a whole if there were a heaven. However, since we're still here on earth, it's safe to assume that there have been imperfections and incomplete information that have served as a benefit-cost impact for intermediaries and markets.

In the neoclassical theory's ideal financial market model, all market participants have equal bargaining power, all prices are determined by supply and demand, all financial securities are uniform, divisible, and tradable, and there are no fees associated with accessing information or resolving bankruptcy.

Due to informational asymmetry's inadequacies, certain transaction costs arise. The emergence of financial intermediaries is a direct response to the need to reduce, if not entirely eradicate, these expenses. Diamond & Dybvig (1983) argue that banks are best understood as a coalition of depositors who protect savers from potential threats to their liquidity. Financial intermediaries are a group that coordinates the dissemination of information, according to Leland and Pyle (1977). Diamond (1984) demonstrates that financial intermediaries operate as authorized agents of savers and facilitate economies of scale. Investors place their faith in these middlemen, who then use the money to finance whatever projects they deem promising; savers can access their money at any moment, subject to the terms that have been agreed.

Research on informational asymmetry has focused on the difficulties inherent in banking interactions, particularly those between banks and their customers (the creditors and the borrowers). The role of the selection bank, the monitoring of the issued loans, the adverse selection problem, and the moral hazard issue are the primary focuses of this analysis of the bank-borrower interaction.

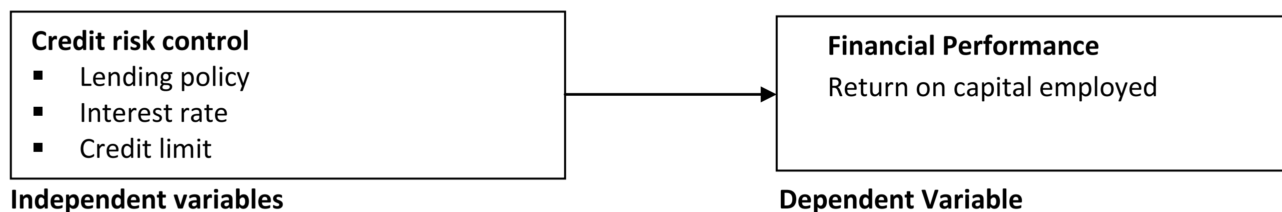
Benston & Smith (1976) and Fama (1980) established a second method of financial

intermediation based on the theory of transaction costs. This method takes into account individual variations in participant technology usage. Therefore, middlemen are seen as a group of borrowers or lenders who take advantage of the economy's size via transaction technologies. Transaction costs include, but are not limited to, those associated with transferring funds, conducting research, evaluating and monitoring, and exchanging currency. Intermediaries in the financial system play a crucial part by facilitating the transfer of funds, providing access to a wider range of investment options, and reducing the risk associated with holding large amounts of capital in a single area.

Guttentag and Lindsay (1968) and Merton (1995) suggested a third strategy for financial intermediaries based on the regulation of monetary creation, savings, and economic financing. It's important to note that the regulatory approach affects the solvency and liquidity of intermediaries. According to Diamond and Rajan (2000), rules governing the capital of intermediaries affect the "health," the capacity for refinancing, and the way of recovering loans.

The study's variables in the credit function system of financial institutions are relevant because the Financial Intermediation theory, which is a blend of asymmetry and agency theory, provides supporting literature on how investors' information is used to issue credit, manage debtors, generate savings, and so.

Conceptual Framework



Independent variables **Dependent Variable**

Figure 1: Conceptual Frame Work

Source: Author (2022)

METHODOLOGY

Descriptive research survey design was therefore used to determine an association between the conceptualized independent and dependent variables as shown in the study’s conceptual model. This study was aimed at all of the microfinance institutions in Kenya that are in the Association of Microfinance Institutions (AMFI) database. Since the population was relatively small and the institutions being studied were easily accessible, a census methodology was deemed appropriate for this study. Using this strategy, we were able to more accurately evaluate how credit risk control affected our bottom line Sample Size and Sampling Technique basing on the 52 micro finance institutions. Both Secondary and Primary data was collected by means record survey sheet and self-administered questionnaires.

Data collected from the field was coded, cleaned, tabulated and analyzed using both descriptive and inferential statistics with the aid of specialized Statistical Package for Social Sciences (SPSS).version 24 software. Descriptive statistics such as frequencies and percentages as well as measures of central tendency (means) and dispersion (standard deviation) was used. Data was also organized into tables for easy reference.

Further, inferential statistics such as regression and correlation analyses was used to determine both the nature and the strength of the relationship between the dependent and independent variables. Correlation analysis is usually used

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together with regression analysis to measure how well the regression line explains the variation of the dependent variable. The linear and multiple regression plus correlation analyses were based on the association between two (or more) variables. SPSS version 24 computer software was used to compute statistical data.

Study conceptualized Regression Model;
$y = \beta_0+\beta_1X_1 + \varepsilon$

y = Financial Performance

β_0 = Constant

X_1= Credit Risk Control

$\{\beta_1\}$ = Beta coefficients

ε = the error term

FINDINGS AND DISCUSSIONS

The study had a return rate of 96.15% (50/52 questionnaires), which is regarded appropriate and in line with the recommendation of Kothari (2004), who stated that a return rate of more than 80% is acceptable in social science research.

Descriptive Statistics

Descriptive Analysis for Credit Risk Control

The study sought to investigate the relationship between Credit Risk Control and Financial Performance. Respondents were given different factors where they were required to rate on a five point likert scale (5. Strongly Agree 4. Agree 3. Not sure 2. Disagree 1. Strongly Disagree) based on their understanding of the organization. Respondents had varying viewpoints on whether or not the board of directors accepts the MFIs' credit risk strategy and major credit risk rules, the majority (24%) agreed with the statement while 20% strongly agreed and 18% were unsure.

In addition, most respondents (78%) strongly agreed that our MFI's senior management carefully implements the credit risk strategy approved by the board of directors, whereas 28% agreed, 18% strongly agreed, 24% were doubtful, 8% disagreed, and 22% strongly disagreed.

Twenty-four percent of respondents agreed, twenty-four percent strongly agreed, twenty percent were unsure, twelve percent disagreed, and twenty percent strongly disagreed that the senior management in the MFI creates policies and procedures for identifying, measuring, monitoring, and controlling credit risk. The percentage of people who agreed or strongly agreed with this statement was considerable, especially when compared to the total number of respondents.

The majority of respondents agreed (28%), strongly agreed (16%), were unsure (22%), disagreed (16%), and strongly disagreed (18%) that the credit risk policies and procedures adopted address credit risk in all the MFIs activities and at both the individual credit and portfolio levels. In a survey, just 20% of respondents strongly agreed that the bank effectively identified and managed the credit risk inherent in all products and activities; another 30% agreed; 12% were unsure; 20% disagreed; and 18% severely disagreed.

Finally, when asked if the board of directors approved the MFIs' credit risk strategy and major credit risk rules, 32% of respondents agreed, 20% strongly agreed, 20% were doubtful, 12% disagreed, and 16% strongly disagreed. Since the vast majority of responders apparently agreed, it followed that this view was accurate.

Kisala (2014) looked into how credit risk controls affected the lending outcomes of MFIs in Kenya. This study employed a descriptive research strategy to analyze CRM and its connection to loan performance in microfinance organizations in great detail. While primary data was gathered from a total of nine MFIs, secondary data was gathered from five MFIs via questionnaires and yearly reports (2011-2017). The return on equity (ROE) served as a profitability indicator, and the CAR and NPL ratio served as CRM indicators in this study. CRM and loan outcomes were shown to have a strong association in the study's findings. According to the data, Non Performing Loans and CAR do have a considerable and negative impact on return on equity (ROE). Comparatively, the impact of the NPL

ratio on ROE was larger than that of the CAR. The results of the research established that effective management of credit risk is directly related to the financial health of microfinance institutions.

Inferential Statistics

Linear Regression of Credit Risk Control on Financial Performance

This tested the direct influence of Credit Risk Control on Financial Performance of MFIs

Table 1: Direct influence of Credit Risk Control on Financial Performance

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.753[a]	.567	.562	.80708	.567	64.303	1	49	.000

ANOVA[b]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	64.110	1	64.110	64.303	.000[a]
	Residual	48.854	49	.997		
	Total	112.964	50			

coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.921	.269		3.424	.001
	Credit Risk Control	.801	.081	.753	9.889	.000

a. Dependent Variable: Financial Performance

Table 1 showed that Credit Risk Control accounts for 56.7% of the variance, whereas other factors account for 43.3% of the variance. Coefficient analysis reveals a favorable and statistically significant effect of Credit Risk Control ($\beta = 0.801$ (0.081); $p<.01$). This results in a rise of 0.801 standard deviations. Kisala (2014) looked into how credit risk controls affected the lending outcomes of MFIs in Kenya. The study's methodology was descriptive, and it analyzed how microfinance firms manage credit risk and the profitability of their loans. Primary data was gathered from nine MFIs and secondary data was from five MFIs via questionnaires and yearly reports (2007-2011). In this analysis, we used the ROE to gauge financial performance, and CAR and NPV to gauge credit risk management. The linear regression equation is;

$$\mathbf{Y = 0.921 + 0.801X_2}$$

Where;

Y = Financial Performance of Micro Finance Institutions in Kenya.

X_2 = Credit Risk Control

CONCLUSIONS AND RECOMMENDATIONS

This study examined the effect of credit risk management on the bottom lines of Kenya's microfinance institutions. According to the results of the research, MFIs heavily employ credit risk control in Credit Management. Credit committees' participation in loan decision-making is critical to minimizing default/credit risk; regular credit checks improve credit management; penalties for late payments strengthen customers' resolve to repay loans; all of these findings were established through the study. Financial performance of commercial banks in Kenya was studied by Poudel (2012), and the results showed that Credit Risk Control was

crucial for credit management in the MFIs. According to the research, the majority of Kenyan banks employ sound Credit Risk Control policies, which has a salutary influence on the profitability of Kenya's commercial banking sector.

Financial results of Kenya's microfinance institutions are highly dependent on effective credit risk management. Based on the data, it appears that Credit Risk Control have a role in the MFIs' bottom lines.

Based on a comparison of the study's final findings and conclusions, I advise MFIs to strengthen credit risk control in order to boost their financial performance, attract more high-quality customers, and lower the percentage of their loans that go into default.

Areas for further research

First, a similar study can be done on all commercial banks in Kenya using time series analysis so as to compare study findings. Secondly, do a similar study retaining similar variables but use other methods for analysis. And thirdly include non-registered MFIs not captured by the Association of micro finance institution MFI.

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