

The Relationship between Credit terms and Financial Performance of Microfinance Institutions in Kericho County, Kenya

¹Gladys C. Kimeto, ²Dr. Isaac Naibei, ³Dr. Alfred Bett

University of Kabianga, Kericho, Kenya

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Abstract: Credit control is one of the key aspects that can be used to create sound financial performance within any microfinance institution. Although numerous prior studies have pointed out the relationship between credit controls and performance of commercial banks, there has been limited focus on credit controls and financial performance of Microfinance Institutions (MFIs), particularly in Kericho County. The purpose of this research was to establish the relationship between credit terms and financial performance of KWFT Kericho. The study was grounded on information asymmetry theory and transaction cost theory. The research adopted a correlational and cross-sectional research designs. Structured questionnaire was the main source of data collection. To ascertain validity of the research instruments, researcher used the research supervisors since they were experts in the field of study to assess the content and face value of the instrument and their feedback were incorporated in the final instruments before the actual study. Internal consistency method was used to find out the reliability of the quantitative data by finding Cronbach's alpha (α) values where a score of 0.881 was achieved which was above 0.70 hence the research instrument was deemed appropriate. The population of the study was 200 employees working at the MFI. Data was collected from 119 respondents from a sample of 133 giving a response rate of 89.5%. The findings indicated that credit terms had a positive and significant relationship with financial performance ($R=0.478$). The results further revealed that 45.8% of variation in financial performance is related with credit terms ($R\text{ Square} = 0.458$). The study recommends that microfinance institution need to sensitize their staff on the credit terms used in issuing loans. The findings may be useful to industry players in their quest to establish the effectiveness of credit controls being employed.

Keywords: Credit terms, Microfinance, Performance.

1. INTRODUCTION

Background of the Study

The concept of loan product began slowly in 1840s and became a wide spread institution of about 300 branches all over Ireland in less than one decade. The principal purpose was to advance small loans with interest for short periods. Herrmann (2008) shows that when looking for improved operational execution and benefit, firms are looking for approaches to improve their exhibition in tasks in an offer to expand gainfulness rivalry has ascended as new advancements and new firm structures yield up. This has made firms look for better approaches for bringing down their operational expenses to improve their productivity. Similarly, small scale money establishments' financial execution is resolved as far as the benefit and their arrival on speculation.

Herrmann (2008) further established that firm gainfulness is normally dictated by the association profit contrasted with its business/proprietors and resources speculation or the incentive in offers. This prompt regular proportions of productivity including return on value (ROE), Income explanations, Earnings per share (EPS), Return on all out resources (ROA) and Price/Earnings proportion or P/E proportion.

Credit terms is a credit control practice for any firm that takes part in the provision of credit facilities to its stakeholders. The procedure when done in the correct way guarantees that the client pays on administrations conveyed. According to Myers and Berkley (2013) credit control practices are the procedures utilized by an association to guarantee that the dimension of credit in the firm is worthy and it is overseen viably. It is a piece of financial control that includes the examination of credit, rating of credit, order and detailing of credit.

Nelson (2012) characterizes credit control as the practices utilized by an association to deal with the business they make on credit. It is a fundamental practice for every one of the associations that have credit exchanges since some have dealt with their credit exercises so well that they have zero credit chance. Firms are enticed to give credit when they think about the likelihood of expanded business tasks. In any case, organizations must be sure that there will be more income from the high deals that will exceed the expense of credit to” maintain a strategic distance from misfortunes.

As indicated by the Kenyan Central Bank Supervision Annual Report (2016), the net advance portfolio in the MFI area expanded by 13.3% be that as it may, there was a decline before expense that diminished by 19% somewhere in the range of 2014 and 2015. The decline in benefits was because of more arrangements for advances that were none performing which are a credit hazard in itself.

Kenya women finance bank Limited (KWFT) previously known as Kenya Women Finance Trust Deposit Taking Microfinance Institution (KWFT) is a subsidiary of Kenya Women Holding Company Limited (KWH). The institution traces its roots to Kenya Women Finance Trust (KWFT), Microfinance Institution established in 1982 to offer access to women entrepreneurs to enable them to expand their economic status and livelihood. With the rise in insolvency rates, the likelihood of incurring losses has increased. Economic pressures and business practices are forcing organizations to slow payments while on the other hand resources for credit control are reduced despite the higher expectations.

Sound credit control measures are essential in any enterprise that its key goal is to continue generating profits. The profits is key to growth and continued survival of enterprises thus the need to ensure all amount that is issues in form of credit is fully recovered by the lending institution (KWFT, 2020).

Nelson (2002) views credit terms as simply the means by which an entity manages its credit sales. It is a requirement for any entity dealing with credit relations since it is hard to have a zero credit or default risk. The higher the amount of accounts receivables and their age, the higher the finance costs sustained to maintain them. If these receivables are not collectible on time and urgent cash needs arise, a firm may result to borrowing and the opportunity cost is the interest expense paid.

Nzotta (2004) argued that credit control impacts on the success or failure of commercial banks and other financial institutions. This is because the failure of deposit banks is inclined to a large extent by the quality of credit decisions and thus the quality of the risky assets. He further notes that, credit control provides a leading indicator of the quality of deposit banks credit portfolio. A prerequisite for effective credit control is the ability to intelligently and efficiently manage customer credit lines. In order to reduce exposure to bad debt, over-reserving and bankruptcies, companies must have better understanding of customer financial strength, credit score history and changing payment patterns.

Statement of the Problem

Many financial institutions are driven by wealth maximization objective which can be achieved when products and services offered to customers generate good returns to the investors. Given that loans are the main product of MFIs, the firm can only realize its objective if the customers are able to take up the products and pay back with interested as per the contractual agreements. However, the current situation facing MFIs is that most of the loan products issued out are not recovered in full or sometimes not repaid within the stated agreed period of recovery. This tends to slow down operations since it limits realisation of certain set objectives. The MFIs can reduce default risks by adopting different control measures one of them being credit terms. However, it is not clear which controls are more suited for MFIs as they endeavour to strike the delicate balance of getting clients and having them to repay. There was need therefore to examine if credit terms as a control has been put in place by MFIs in Kericho County before issuing loans.

Ho: There is no significant relationship between credit terms and financial performance of microfinance institutions in Kericho County.

2. REVIEW OF RELATED LITERATURE

The following literature have been reviewed as per the research variables;

Microfinance Institutions

Microfinance institutions are well-defined as institutions whose major business is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their microenterprises.

The concept of microfinance is not new for instance, Savings and credit groups that have operated for centuries include the susus of Ghana, chit funds in India, tandas in Mexico, arisan in Indonesia, cheetu in Sri Lanka, tontines in West Africa, and pasanaku in Bolivia, as well as numerous savings clubs and burial societies found all over the world. Formal credit and savings institutions for the poor have also been around for decades, providing customers who were traditionally neglected by commercial banks a way to obtain financial services through cooperatives and development finance institutions.

According to Aghion and Morduch (2003), the African experience suggests that MFIs have built on pre-existing informal sector mechanisms (among the many examples are susus and tontines) to create viable channels for capital infusions from formal sector banks, donors, and governments. As a result, deposit taken from MFIs, informal microfinance institutions and credit- only MFIs have all developed increasingly close ties with full-fledged commercial banks and other non-bank financial institutions in the formal sector (Nelson, 2012).

Banks and MFIs complement each other well by servicing substantially different client bases. Banks lend and collect deposits mostly from a limited formal private sector in Africa and to the government, while MFIs service poor and rural households, and small entrepreneurs often in the informal sector. MFIs reap benefits as clients - depositors and borrowers of commercial banks. First, as observed in Guinea and Benin, commercial banks typically manage MFIs' deposit accounts, and sometimes, provide them with liquidity control services, for example emergency credit lines to cover cash shortfalls, hence reducing the risks associated with irregular cash flows. Second, extended credit facilities also allow MFIs to expand their services, (Jackson, 2011).

MFIs and commercial banks work together in providing financial services. In a number of African countries, banks and MFIs have successfully cooperated in extending their outreach and achieving economies of scale. Branch network sharing is seen as effective in servicing a larger client base while containing costs. In Guinea, banks are looking at possibilities to use the network of MFIs to expand credit to large rural clients. In Tanzania, the example of the CRDB developing banking relationships with savings and credit cooperatives to channel funds for micro-lending is illustrative. Cooperation also entails channelling credit from banks and MFIs to clients with obvious business synergies (Furletti, 2002).

With MFIs linking up with banks, the supply of loan able funds to previously underserved areas of the economy and the number of small borrowers with access to credit are likely to increase. Some might argue that this would lend to increased competition and better terms for loans to small borrowers. Unfortunately, however, this may not necessarily happen. The expansion of credit to new borrowers may entail increases in default risk, loan administration and monitoring costs, strategic collusion among informal lenders and contamination of the pool of borrowers for lenders who are poor at screening out the risky ones. All these potential risks suggest that the cost of borrowing may not fall, at least in the early stages of growth in the microfinance sector. This being said, the cost of credit provided by formal MFIs is generally much less than that provided by informal lenders (such as money lenders) (Nsambu, 2014).

Credit terms and Financial Performance

The first step in limiting credit risk involves screening clients to ensure that they have the willingness and ability to repay a loan. Microfinance Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower (Abedi, 2000). The 5Cs help MFIs to increase loan performance, as they get to know their customers better. These 5Cs are: Character - refers to the trustworthiness and integrity of the business owners. This is an indication of the client's willingness to repay and ability to run the enterprise; Capacity assesses whether the cash flow of the business (or household) can service loan repayments; Capital - Assets and liabilities of the business and/or household. Collateral - Access to an asset that the applicant is willing to cede in case of non-payment, or a guarantee by a respected person to repay a loan in default; Conditions - A

business plan that considers the level of competition and the market for the product or service, and the legal and economic environment.

The 5Cs need to be included in the credit scoring model. The credit scoring model is a classification procedure in which data collected from application forms for new or extended credit line are used to assign credit applicants to either good or bad credit risk classes (Constantinescu *et al.*, 2010). Inkumbi (2009) notes that capital (equity contributions) and collateral (the security required by lenders) as major stumbling blocks for entrepreneurs trying to access capital. This is especially true for young entrepreneurs or entrepreneurs with no money to invest as equity; or with no assets they can offer as security for a loan. Any effort to improve access to finance has to address the challenges related to access to capital and collateral. One way to guarantee the recovery of loaned money is to take some sort of collateral on a loan. This is a straightforward way of dealing with the aspect of securing depositor's funds.

Financial Performance

According to the business dictionary financial performance involves measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firms return on investment, return on assets and value added. Stoner (2003) as cited in Turyahebya (2013), defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. Hitt, *et.al* (1996) believes that many firms' low performance is the result of poorly performing assets. MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income.

Today, Microfinance institutions are seeking financial sustainability. Many MFIs were restructured in order to achieve financial sustainability and finance their growth. Sustainability is defined as the capacity of a program to stay financially viable even if subsidies and financial aids are cut off (Woolcock, 2009). It embraces generating sufficient profit to cover expenses while eliminating all subsidies, even those less-obvious subsidies, such as loans made in hard currency with repayment in local currency (Tucker and Miles, 2004). Tucker and Miles (2004) studied three data series for the period between March 1999 and March 2001 and found that self-sufficient MFIs are profitable and perform better, on return on equity (ROE) and return on assets (ROA), than developing-world commercial banks and MFIs that have not attained self-sufficiency. In order to optimize their performance, MFIs are seeking to become more commercially oriented and stress more on improving their profitability; therefore self-sustainability.

Theoretical Framework

Previous works has shown that there is information asymmetry in assessing bank lending applications (Binks and Ennew, 1997). Information asymmetry defines the condition in which relevant information is not known to all parties involved in an enterprise (Ekumah and Essel, 2003). Studies on transaction costs have revealed that transaction costs occur when a good or a service is transferred across a technologically separable interface. Consequently, a transaction cost occurs every time a product or service is being moved from one stage to another, where new sets of technological skills are required to make the product or service.

Asymmetric Information Theory

Information asymmetry discusses a situation where business owners or manager knows more about the prospects for, and risks facing their business, than do lenders (PWHC, 2002). It defines a condition in which all parties taking part in an undertaking do not know important information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has more information about the potential risks and returns related to the investment projects for which the funds are reserved. The lender on the other hand does not have adequate information regarding the borrower (Edwards and Turnbull, 1994).

Binks *et al.* (1992) idea is that perceived information asymmetry poses two problems for the banks, moral hazard (monitoring entrepreneurial behavior) and hostile selection (making errors in lending decisions). Banks will find it challenging to overcome these problems because it is not efficient to devote resources to appraisal and monitoring where loaning is for relatively small amounts. This is because data desired to screen credit applications and to monitor borrowers are not freely accessible to banks.

Micro finance institutions go through a situation of information asymmetry when assessing lending applications. The information necessary to measure the capability and commitment of the customers who are loaned, and the prospects of the business is either not available, uneconomic to acquire or difficult to interpret. The threat of adverse selection of who to lend which occurs when microfinance institution advances to businesses which subsequently fail, or when they do not advance to businesses which go on to become successful, or have the potential to do so hence this theory will be used to establish the relationship between credit terms and financial performance of microfinance institutions in Kericho County.

Transactions Costs Theory

Economists have classified transactions among and within organizations as those that (a) support coordination between buyers and sellers, i.e., market transactions, and those (b) supporting coordination within the firm. Williamson pointed out in 1981 that the choice of transaction depends on a number of factors, including asset specificity, the parties' interests in the transaction, and ambiguity and uncertainty in describing the transaction. Transactions may be broken down into production and coordination costs. In this context, coordination costs include the transaction (governance) costs of the information processing necessary to coordinate the work of people and machines performing primary processes. Transaction costs may be viewed as the economic equivalent of friction in a physical system; i.e., if friction is too great, no or at least impeded movement will occur, suggesting that if transaction costs are high, no or little economic activity is likely to occur.

Conceptual Framework

The conceptual framework spells out the relationship between the credit terms and financial performance of MFIs in Kericho County, Kenya.

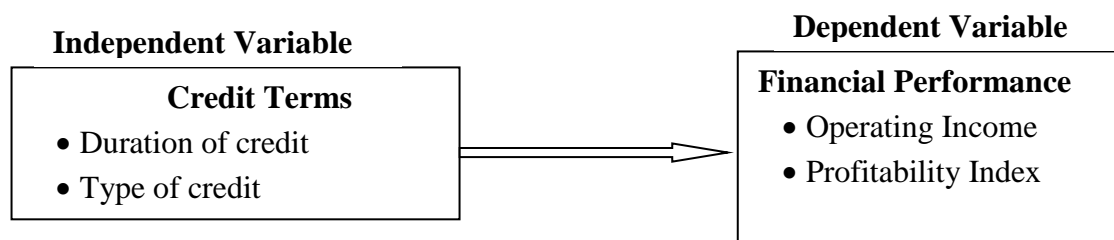


Figure 1: Conceptual Framework

Source: Research Data (2022)

Figure 1.0 shows the conceptual framework in which the relationship between the credit control and financial performance is laid out with their various dimension. The independent variables are credit terms measured by capacity and capital; client appraisal measured by loan product design as well as credit committee; and credit collection policies measured by collateral and loan signoff form. The dependent variable is financial performance measured by operating income and profitability index.

3. RESEARCH METHODOLOGY

The research adopted a correlational and cross-sectional research design. Correlational research design is used to obtain information where the researcher measures two variables, understands and assess the statistical relationship (Creswell, 2012). This particular technique was relevant as it involved detailed study without interference of any variable while Cross-sectional research design on the other hand was utilized since the study falls under observational research that analyzed data of variables collected at one given point in time across a sample population. The study was conducted in Kericho County which is located in the South Rift of the Great Rift Valley, about 256kms from Nairobi, the Capital City of Kenya. The population of study consisted of 200 employees based in Kipkelion East, Kipkelion West, Belgut, Ainamoi, Buret and Soin-Sigowet Sub-Counties of Kericho County. Purposive sampling was used to select 133 staff working under credit control section. Data was collected using a structured likert scale questionnaire where descriptive statistics were generated using mean and standard deviation while inferential analysis was carried out using correlation and regression analytical models. The findings were presented using tables and graphs.

4. RESEARCH FINDINGS

Credit terms and financial performance

The objective was to establish the relationship between credit terms and financial performance of microfinance institutions in Kericho County.

H₀₁: There is no significant relationship between credit terms and financial performance of microfinance institutions in Kericho County.

Multiple regression model was used to assess the relationship between credit terms and financial performance of microfinance institutions in Kericho. The findings are presented in Table 1.1.

Table 1.1: Model Summary for Credit Terms and Financial Performance

R	R Square	Adjusted R Square	Std. Error of the Estimate
.478 ^a	.458	.452	1.091

a. Predictors: (Constant), Credit Terms

Source: Research Data, (2022)

Table 1.1 revealed that credit terms had positive significant relationship with financial performance ($R=0.478$). The results showed that 45.8% of variation in financial performance is related with credit terms ($R\text{ Square} = 0.458$). However, other factors not in the study accounted for 54.2% variation of financial performance.

The relationship between credit terms on financial performance was tested using ANOVA analysis at 5% significant level.

Table 1.2: ANOVA Table for Credit Terms and Financial Performance

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	47.975	2	47.975	54.772	.000 ^b
Residual	331.389	117	1.261		
Total	379.364	119			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Credit Terms

Source: Research Data, (2022)

Table 1.2 revealed that there existed significant relationship between credit terms and financial performance ($F_{(2,117)} = 54.772$, $P < 0.05$). The findings showed that the significance value is 0.000 which is below 0.05. This imply that there is a statistically significant relationship between credit terms and financial performance.

Table 1.3: Table of Coefficients for Credit Terms and Financial Performance

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	2.246	0.113		19.939	0.000
Credit Term	0.604	0.601	0.627	1.408	0.028

a. Dependent Variable: Financial Performance

Source: Research Data, (2022)

As presented in Table 1.3, it was established that there exists a significant positive relationship between credit terms and financial performance $\beta = 0.604$. The results were statistically significant since p was 0.028 which was less than 0.05. The beta coefficient of 0.604 means that when credit terms increase by an additional unit, financial performance of microfinance institutions in Kericho County increases by 0.604.

The study therefore concludes that the hypothesis **H₀₁**: “There is no significant relationship between credit terms and financial performance of microfinance institutions in Kericho” is rejected since the findings showed that there exists a significant positive relationship between credit terms and financial performance $\beta = 0.604$ and that results were statistically significant since p was 0.028 which was less than 0.05.

5. SUMMARY

The objective of the study was to establish the relationship between credit terms and financial performance of microfinance institutions in Kericho. The findings showed that respondents control credit as well as monitor financial performance in microfinance institutions. The respondents were not aware of credit terms used by the microfinance institution they were working for. Respondents disagreed that their microfinance had adopted use of credit terms in issuing loans. The findings revealed that the respondents had not adopted the use of credit terms yet it affect issuance of loans by the microfinance and that the use of credit terms will affect performance of loans in future.

6. CONCLUSION

The study concludes that respondents were not aware of credit terms used by the microfinance institution they were working for. Microfinance had not adopted use of credit terms in issuing loans and that credit terms affect issuance of loans by the microfinance and that the use of credit terms will affect performance of loans in future. The study concludes that there exists a statistically significant positive correlation on credit terms and financial performance.

The study recommends that microfinance institutions need to sensitize their staff on the credit terms used. They need to adopt use of credit terms in issuing loans. Secondly, employee of microfinance institution need to adopt client appraisal in issuing of loans since it affects loan performance.

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