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THE EFFECTS OF CREDIT RISK MITIGATION STRATEGIES, ON PROFITABILITY OF MICROFINANCE INSTITUTIONS IN NAKURU TOWN

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ABSTRACT

Credit risk is on an increasing rate and is becoming an area of concern to many people and institutions in the lending business globally. This kind of exposure leads to instability and poor financial performance of microfinance institutions. Microfinance institutions are exposed to credit risk and therefore it is important for them to come up with mitigation strategies. The current study sought to find out the effects of credit risk mitigation strategies on the profitability of microfinance institutions in Nakuru town. The objectives of the study were to determine the role of loan appraisal procedures, debt recovery policies, credit risk monitoring and diversification of credit products on the profitability of microfinance institutions in Nakuru town. The study used a sample size of 75 respondents who were drawn from selected microfinance institutions in Nakuru town. The target population for the study was 500 respondents drawn from various microfinance institutions in Nakuru town. The sample size comprised of respondents drawn from various microfinance institutions drawn in Nakuru. Questionnaires were the main data collection tool that was used. Secondary data was obtained from reports by microfinance institutions. Data was analyzed using the Statistical Package for Social Sciences (SPSS) and was presented in form of frequency tables, charts and graphs. The results revealed that credit risk monitoring was negatively correlated with profitability. However, this correlation was not statistically significant hence the null hypothesis 3 was retained and concluded that there was no evidence based on the sample to suggest that credit risk monitoring as associated with profitability. The results revealed that credit risk monitoring was negatively correlated with profitability.

KEYWORDS: Credit Risk, Debt Recovery, Diversification, Loan Appraisal

INTRODUCTION

Financial institutions are pertinent to economic growth through the financial services they provide. Their intervention role can be said to be a catalyst for economic growth. The efficient and effective performance of the financial institutions overtime is an index of financial stability in any nation. The extent to which a financial institution extends its operation to the public for productive activities accelerates the pace of a nation's economic growth and its long-term sustainability (Kolapo, Ayeni & Oke, 2012). In the 21st century, business environment is added multifaceted and intricate than ever. The majority of businesses have to trade with uncertainties and qualms in every dimension of their operations. Without a doubt, in the present-day's unpredictable and explosive atmosphere all the financial institutions are in front of a hefty risks like: credit risk, liquidity risk, operational risk, market risk, foreign exchange risk, and interest rate risk, along with others risks, which may possibly intimidate the survival and success of the financial institution's Corporate Performance.

Risk is an inevitable phenomenon which has lived with mankind since time immemorial. In our domestic and especially in our business life, we find ourselves in situations where risk taking becomes the solution to our break through. Nevertheless, one should find a way to minimize or manage this risk in order not to affect the expected result from a given investment. In the financial sector, risk mitigation is seen as one of the most essential internal itineraries upon which decisions are made by financial institutions (Aureliju, Jinkens, Mahmud & Briggs 2014).

As illustrated by Aduda and Kalunda (2012), Kenya is known as one of the African countries at the forefront, in the discovery of the significance of MFIs as a poverty eradication tool, thus more efforts have been directed in the development and promotion of the MFI sector. Microfinance industry in Kenya has evolved and is carried out in diverse institutional forms, which include the semi-formal, formal and non-formal providers (Muriuki, Maru, & Namusonge, 2015). In relation to the performance of MFIs, AMFI report (2013) indicated a gross portfolio increase in 2012 because of the raise of interest rates on loans in the perspective of elevated inflation. The report also indicates that profitability and sustainability levels of the sector dropped dramatically because of high operating costs that resulted from expensive lending rates and high-risk exposure. In addition, Operations self-sufficiency (OSS) decreased in the year 2012 and the decrease was because of decreased performance of the Deposit taking microfinance as their Operations self-sufficiency dropped from 114% to 104% as of December 2011. Further, higher operating costs led to decreased levels of efficiency and profitability. The funding costs increased to 8.6% while operating costs shot up to 26.7%. In terms of operational costs associated with staffing ration increased to 53.3 percent as more MFI operation called for more field staff. This shows that on overall, the operational self-sufficiency and sustainability of microfinance institutions in Kenya have been decreasing over the years (AMFI, 2013).

Statement of the Problem

Sound credit mitigation policy is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. According to Gitman (1997), the probability of bad debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective. Such delay on collecting cash from debtors, as they fall due has serious financial problems, increased bad debts, which affect customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good business to put credit management at the front end by managing it strategically. As with any financial institution, the biggest risk is lending money and not getting it back. Credit risk is a particular concern for MFIs because most micro lending is unsecured. The people covered are those who cannot avail credit from financial institutions and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many financial institutions do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principle amount itself. Therefore these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities. Matu (2008) carried out a study on sustainability and profitability of financial institutions and noted that, efficiency and effectiveness were the main challenges facing Kenya on service delivery, Orua (2009) did a study on the relationship between capital structure and financial performance of financial institutions in Kenya, Gitau (2010) did a study on assessment of strategies necessary for sustainable competitive advantage in the financial industry in Kenya with specific focus to Faulu Kenya. Achou and Tenguh (2008), also conducted a research on financial institution performance and credit risk management found that there is a significant

relationship between financial institutions performance and credit risk management. The purpose of this study was to understand the effect of credit management on their financial performance.

Objectives of the Study

The general objective of this study was to investigate the role of credit risk mitigation strategies on profitability of micro-finance institutions in Nakuru town. The study was guided by the following specific objectives:

- To determine the role of loan appraisal procedures on profitability of microfinance institutions in Nakuru town.
- To assess the role of debt recovery policies on the profitability of microfinance institutions in Nakuru town.
- To examine the role of credit risk monitoring on the profitability microfinance institutions in Nakuru town.
- To establish the role of diversification of credit products on the profitability of microfinance institutions in Nakuru town.

LITERATURE REVIEW

Achou and Tenguh (2008), there is a significant relationship between financial institution performance (in terms of return on asset) and credit risk management (in terms of loan performance). Better credit risk management results in better financial institution performance. Thus, it is of crucial importance that financial institutions practice prudent credit risk management and safeguarding the assets of the financial institutions and protect the investors' interests. Many scholars use the Return of Assets (ROA) or Return on Equity (ROE) as a measure of MFIs or financial institutions' profitability (Rosenberg 2009). Moreover, they use Non Performing Loans (NPL) ratio as the measure of credits risks management.

Loan Appraisal Procedures and Profitability

Three sources of cost advantage were classified by Petersen and Rajan (1997) as follows: information acquisition, controlling the buyer and salvaging value from existing assets. The first source of cost advantage can be explained by the fact that sellers can get information about buyers faster and at lower cost because it is obtained in the normal course of business. That is, the frequency and the amount of the buyer's orders give suppliers an idea of the client's situation; the buyer's rejection of discounts for early payment may serve to alert the supplier of a weakening in the credit-worthiness of the buyer, and sellers usually visit customers more often than financial institutions do. In market- based countries where capital market dominates economic activities, financial institutions have suffered a severe shock in their capital and liquidity status due to the unanticipated downturn in the financial market and a credit crunch experience in the financial industry. This made a number of financial institutions go illiquid and some even closed down operations (Omotola, Roya & Safoura 2012). It is a common practice that profit-maximizing firms, including financial institutions, consider operational miscalculation which could be as a result of macroeconomic risks, such as the effect of interest rates, inflation or even business cyclicality. Further, microeconomic risks like new competitive threats are inevitable and should be dealt with adequately. Financial institution-wide issues such as technological failures, commercial inefficiency of a supplier or customer, political manipulation, X-inefficiency and natural disaster are possible risks faced by financial institutions and other financial institutions. In addition, the debacle in financial and non-financial sector as a result of the contagious subprime crisis indicates a strong need for risk management.

Debt Recovery Policies and Profitability

Credit Policy can be viewed as written guidelines that set the terms and conditions for supplying goods on credit, customer qualification criteria, procedure for making collections, and steps to be taken in case of customer delinquency. This term can also be refers to as collection policy. It is also the guidelines that spell out how to decide which customers are sold on open account, the exact payment terms, the limits set on outstanding balances and how to deal with delinquent accounts. Lawrence (2003), the objective of managing accounts receivable is to collect receivable without losing sales from high-pressure collection techniques. Accomplishing this objective encompasses; credit selection and standard which involve the application of technique for determining which customer should receive credit. Debtor management means the process of decisions relating to the investment in business debtors. In credit selling, it is certain that we have to pay the cost of getting money from debtors and to take some risk of loss due to bad debts. To minimize the loss due to not receiving money from debtors is the main aim of debtor management. Credit and collection policies encompasses the quality of accounts accepted, the credit period extended, the cash discount given, certain special terms and the level of collection expenditure. In each case, the credit decision involves a trade-off between the additional profitability and the cost resulting from a change in any of these elements. Receivable management begins with the decision of whether of whether or not to grant credit. Where goods are sold on credit, a monitoring system is important, because without it, receivable will built up to excessive levels, cash flow (liquidity) will decline and bad debts will offset the profit on sales. Corrective action is often needed and the only way to know whether the situation is getting out of hand is to set up and then follow a good receivable control system. Eugene, (1992), states that optimal credit policy, hence the optimal level of accounts receivable, depends on the firm's own unique operating conditions.

Diversification of Credit Products and Profitability

Loans and advances can be arranged from financial institutions in keeping with the flexibility in business operations. Traders may borrow money for day to day financial needs availing of the facility of cash credit, financial institution overdraft and discounting of bills. The amount raised as loan may be repaid within a short period to suit the convenience of the borrower. Thus business may be run efficiently with borrowed funds from financial institutions for financing its loans and advances working capital requirements, are utilized for making payment of current liabilities, wage and salaries of employees, and also the tax liability of business. Loans and advances from financial institutions are found to be economical for traders and businessmen, because financial institutions charge a reasonable rate of interest, on such loans/advances (Khrawish, 2011).

Credit Risk Monitoring and Profitability

Risk management is a systematic process of understanding, evaluating and addressing risks to maximize the chances of objectives being achieved and ensuring organizations, individuals and communities are sustainable. It also enables the organization to be aware of new possibilities. In effect, risk management requires an informed understanding of relevant risks, an assessment of their relative priority and a rigorous approach to monitoring and controlling them. It is indeed the practice of identifying potential risks in advance, analyzing them and taking precautionary steps to reduce or curb the risk. In finance and business term, when an organization makes an investment decision, it exposes itself to a number of financial risks. The quantum of such risks depends on the type of financial instrument. The financial risks might be in form of high inflation, volatility in capital markets, recession and

financial institutions bankruptcy and so on. In order to minimize and control the exposure of investments to such risks, financial institution managers and investors resort to the practice of 'risk management' (Tsevisani, 2007). Risk mitigation strategies are measures employed by lending institutions, to avoid or minimize the adverse effect of risk. This includes the identification, analysis, assessment, control and avoidance, minimization or elimination of unacceptable risks. As a strategy, an organization may use risk assumption, risk avoidance, risk retention, risk transfer or any other strategy (or combination of strategies) in effective management of future events. Therefore a sound risk management framework is crucial for commercial financial institutions to enhance their profitability and guarantee survival. The key principles in credit risk mitigation process are sequenced as follows: establishment of a clear structure, allocation of responsibility, prioritized processes, discipline and responsibilities should be clearly communicated and accountability assigned.

RESEARCH METHODOLOGY

The study adopted a explanatory research design. Explanatory research design involves measuring a set of variables as they exist naturally (Saunders, Lewis & Thornhill, 2011). It attempts to answer immediate questions about a current state of affairs (Matthews & Kostelis, 2011). It is designed to provide in-depth information about the characteristics of subjects within a particular field of study. The target population comprised all 500 management and staff members of microfinance institutions within Nakuru town. Using the statistical formula, a sample size of 75 respondents was obtained. The study utilized simple random sampling technique which ensured that the target population was representative, reliable, flexible and efficient. In this study an appropriate method to collect the primary data was a questionnaire survey. For the purposes of this study, quantitative data was collected using a closed-ended questionnaire. The primary data was sourced from the answers the participants gave during the survey process. The data collected from the questionnaires was analyzed with Statistical Package for Social Sciences.

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

According to the findings, the gender distribution among respondents showed that majority 59% were female while 41% were male. The study revealed that 36% of the respondents were between 20 and 30 years, 23% between 41 and 50 years, 15% were between 31 and 40 years while 13% were above 60 years and 13% were between 51 and 60 years. Furthermore, the researcher was also interested in finding out the highest education level attained by the respondents which yielded the following results. According to the study, the majority (53%) had attained college education while 47% were university graduates. This implied that the credit institutions employed highly educated individuals.

Loan Appraisal Procedures

The researcher was interested to determine the loan appraisal procedures carried out by the institutions. The table below reveals the responses to the likert scale on loan appraisal 0= Not at all, 1=To a little extent, 2= To a moderate extent, 3= To a great extent, 4=To a very great extent. When asked to what extent review of credit history of the member or borrower is done, 33.3% said to a very great extent, 26.7% said to a moderate extent, 24% to a little extent and 16% said to a great extent. On analysis of credit risk based decisions, 44% to a very great extent, 33% to a great extent and less than 20% to a moderate extent. Screening of clients before advancing credit, 46% to a great extent, 40% said a very great extent, while 13% said to a moderate extent.

On credit risk information sharing, 40% said to a very great extent, 31% to a great extent, less than 20% said to a moderate extent and to a very little extent. The results revealed that the majority (92%) did not have challenges determining which clients are viable for loans and which are not while 8% said yes. The results revealed that the majority (75%) said that loan appraisal strategies were effective while 25% said they were not always effective.

Table 1: Loan Appraisal Procedure

	n	0	1	2	3	4
Review of credit history of the member or borrower	75	0(0%)	18(24%)	20(26.7%)	12(16%)	25(33.3%)
Analysis of credit risk based decisions	75	0(0%)	6(8%)	11(14.7%)	25(33.3%)	33(44%)
Screening of clients before advancing credit	75	0(0%)	1(1.3%)	10(13.3%)	34(45.3%)	30(40%)
Credit risk information sharing	75	0(0%)	8(10.7%)	14(18.7%)	30(40%)	23(30.7%)
Weighing and prioritizing risk events and clients	75	0(0%)	10(13.3%)	15(20%)	20(26.7%)	30(40%)

Debt Recovery Policies

It was in the interest of the researcher to determine the extent which organization undertakes on various risk control measures to ensure that credit risk control is done well to prevent it from failing in its obligations and meeting it objectives. The table 2 revealed the frequency response rate. Key: 0= Not at all,1=To a little extent, 2= To a moderate extent, 3= To a great extent, 4=To a very great extent

Table 2: Debt Recovery Strategies

	n	0	1	2	3	4
Training financial institution staff on risk control	75	0(0%)	1(1.3%)	19(25.3%)	26(34.7%)	29(38.7%)
Ascertaining the value of collateral	75	0(0%)	3(4%)	23(30.7%)	24(32%)	25(33.3%)
Secure loan financial institutional system	75	0(0%)	7(9.3%)	20(26.7%)	23(30.7%)	25(33.3%)
CRB listing upon default	75	0(0%)	5(6.7%)	18(24%)	20(26.7%)	32(42.7%)
Penalties upon default	75	0(0%)	6(8%)	14(18.7%)	22(29.3%)	33(44%)
Ensuring the loan is used for intended purpose	75	0(0%)	11(14.7%)	14(18.7%)	28(37.3%)	22(29.3%)

The results revealed on training financial institution staff on risk control, the majority (50%) said to a very great extent, 35% to a great extent while 14% said to a moderate extent. Value of collateral is ascertained according to the study. This was evidenced by 34% of the respondents who said to a very great extent and 32% who said to a great extent. In regard to secure loan financial institutional system, the respondents held the view that this is carried out to a very great extent (33%), 31% said to a great extent while 27% said to a moderate extent. Listing in CRB for loan defaulters revealed that 43% agreed to a very great extent, 26% to a great extent, while 24% opined to a moderate extent. Penalties are imposed on loan defaulters to a very great extent (46%), 29% were of the view to a great extent, 18% to a moderate extent while 8% said to a little extent. Is to whether the institution ensures that the loan is used for the intended purpose, 38% said to a great extent, 30% said to a very great extent, 18% to a moderate extent while 14% said to a very little extent. According to the results, 57% said bad debts do not affect profitability of the institution while 43% said it does affect profitability. 77% said they do not encounter challenges in bad debt recovery while 23% said they encounter some challenges. 76% said that the strategies used by the institution are effective in debt recovery while 24% opined that they are not as effective.

Credit Risk Monitoring

The researcher also sought to determine the extent that the organization undertakes on a number of credit risk monitoring measures to ensure that credit risk monitoring is properly done. The table 3 shows the frequency rate of the responses

Table 3: Credit Risk Monitoring

	n	0	1	2	3	4
Continuous monitoring of cash flows of borrower	75	0(0%)	8(10.7%)	13(17.3%)	15(20%)	39(52%)
Constant contact with borrowers	75	0(0%)	3(11%)	23(18%)	24(27%)	25(43%)
Review of clients loan repayment pattern	75	0(0%)	7(9%)	20(12%)	23(28%)	25(51%)
Supporting distressed borrowers and	75	0(0%)	5(9%)	18(23%)	20(19%)	32(48%)
Frequent loan classification/provisioning	75	0(0%)	6(13%)	14(25%)	22(29%)	33(32%)
Revising credit risk control and appraisal measures	75	0(0%)	11(10%)	14(14%)	28(34%)	22(42%)

52% agreed to a very great extent that the institution continuously monitors of cash flows of borrower, 18% said to a great extent while 17% said to a moderate extent. As to whether there is constant contact with borrowers, 43% of the respondents said to a very great extent, 27% to a great extent, and 18% to a moderate extent. Fifty-one percent agreed to a very great extent that clients loan repayment pattern is reviewed, 28% said to a great extent while less than 15% said to a moderate extent. The respondents agreed to a very great extent that there is support of distressed borrowers, 23% said to a moderate extent, while 19% said to a great extent. On the issue of frequent loan classification/provisioning, 32% said to a very great extent, 29% opined to a great extent, 25% said to a moderate extent while 13% said to a very little extent. In addition, the researcher wanted to establish whether revising of credit risk control and appraisal measures is done. The results revealed that 42% said to a very great extent, 34% said to a great extent while 14% said to a moderate extent.

Diversification of Credit Products

The researcher also sought to determine the extent that the organization undertakes on diversification of credit products. The table 4 shows the frequency rate of the responses.

Table 4: Diversification of Credit Products

	n	0	1	2	3	4
There are a number of credit products available in the organization	75	0(0%)	8(10.7%)	13(17.3%)	15(20%)	39(52%)
Diversification of products has kept profitability constant	75	0(0%)	1(1.3%)	19(25.3%)	26(34.7%)	29(38.7%)
Diversification of products has increased profitability	75	0(0%)	3(4%)	23(30.7%)	24(32%)	25(33.3%)
Diversification of products has decreased profitability	75	22(42%)	28(34%)	14(14%)	11(10%)	0(0%)

52% agreed to a very great extent that the there are a number of credit products available in the organization, 20% said to a great extent while 17.3% said to a moderate extent. As to whether diversification of products has kept profitability constant, 38.7 said to a very great extent, 34.7% to a great extent, and 25.3% to a moderate extent. 33.3% agreed to a very great extent that diversification of products has increased profitability, 32% said to a great extent while 30.7% said to a moderate extent. 42% disagreed that diversification of products has decreased profitability, 34 disagreed to a little extent, while 14% said to a moderate extent.

Regression Analysis

The model summary revealed a coefficient of determination (r square) of 0.642 (64.2%). This meant that a change in profitability could be explained by 64.2% change in the explanatory variables (credit risk monitoring, loan appraisal procedures, debt recovery policies, and Diversification of credit products).

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.801[a]	.642	.622	.306

Regression standard error (Std. Error of the Estimate) is the average forecast error (difference between actual and values predicted by the estimated equation). Small values indicate that the estimated model fits the observed data closely. The Std. Average error (difference between actual and predicted values) was about 0.30.

Table 6: ANOVA[a]

Model	Sum of Squares	df	Mean Square	f	Sig.
Regression	11.785	4	2.946	31.434	.000[b]
Residual	6.561	70	.094		
Total	18.347	74			

ANOVA for the explanatory variables was used to describe whether these variables were significant and whether they could be used in the model to predict profitability as shown in table 6. Study revealed an f statistic of 31.43 that was associated with a p value of p <.01 and significant at 0.01 alpha level. This meant that the regression model could be used because the explanatory variables' impact on the dependent variable was statistically significant. The results showed the unstandardized beta coefficients that could be used to predict the single outcome of profitability.

Table 7: Coefficients

Model	Un standardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-.337	.268		-1.258	.212
appraisal	.078	.044	.130	1.786	.079
debt recovery	.083	.062	.098	1.329	.188
credit risk	-.030	.046	-.047	-.638	.526
Diversification	.771	.072	.776	10.730	.000

The predicted multiple regression equation from the model above becomes:

Y (profitability) = - 0.337 +0.078(loan appraisal procedures) + 0.083(debt recovery policies) - 0.030(credit risk monitoring) + 0.771 (diversification of credit products).

Based on the model, findings revealed that loan appraisal procedures, debt recovery policies, and diversification of credit products were positively associated with the dependent variable (profitability). However, loan appraisal procedures, debt recovery policies as included in the model were not statistically significant at 5% significance level (β1= 0.078, t= 1.786, p=0.079; β2=0.083, t= 1.329, p=0.188). According to the model, only resource availability could be used to estimate capacity building since it was statistically significant at.05 alpha level (β_1 = 0.497,t= 2.572, p=0.014). The null hypothesis that there is no clear link between loan appraisal procedures and the profitability of microfinance institutions in Nakuru town was therefore, retained and concluded that, there is no relationship between loan appraisal procedures and the profitability.

Similarly, the study found no clear link between debt recovery policies and the profitability of microfinance institutions in Nakuru town hence, the decision was to fail to reject the null hypothesis. In terms of the relationship between diversification of credit products and the profitability of microfinance institutions in Nakuru town, the model revealed a test statistic of 10.73 associated with a p value of $p<.01$. The decision to reject the null hypothesis 4 and conclude that there was sufficient evidence to suggest that diversification of credit products is associated with profitability ($t= 10.73$, $p<.01$). The results revealed that credit risk monitoring was negatively correlated with profitability. However, this correlation was not statistically significant hence the null hypothesis 3 was retained and concluded that there was no evidence based on the sample to suggest that credit risk monitoring as associated with profitability.

CONCLUSIONS

The major conclusion from this study is that microfinance institutions in Nakuru town are faced with credit risk, as depicted by the significant negative relationship between the profitability and credit risk. Secondly, changes in the lending CBK interest rates greatly affect the profitability of the Microfinance institutions in Nakuru town. Loan appraisal procedures, debt recovery policies, and diversification of credit products were positively associated with the dependent variable (profitability). This means that all these factors affected the profitability of microfinance institutions in Nakuru town. It is therefore important that, microfinance institutions come up with ways of mitigating the effects of these factors. The major policy recommendation is that the MFIs in Kenya, must constantly pay attention to the credit risk being a major risk affecting its performance. For instance, it needs to come up with a ceiling on its non-performing loans beyond which, it should shift its major focus towards thoroughly investigating and recovering the non-performing loans.

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