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EFFECT OF LENDING POLICIES ON FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS IN KISII COUNTY, KENYA: A CASE STUDY OF KENYA WOMEN FINANCE TRUST

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Abstract

Microfinance loans, savings, and other basic financial services are important to the poor. Microfinance differs in key concepts from conventional banking in that it employs different collateral substitutes to deliver and recover loans. Such collateral substitutes are anchored on lending policies and dynamic incentives which allow the loan size to increase over time upon satisfactory repayment, mandatory savings, and regular repayment schedules. Joint liability constraints the group borrowing ability as individuals; interest fees, penalties and commissions on these loans further affect the customer; this calls for prudent credit management from microfinance institutions to minimize the default. This study sought to establish the effect of lending policies on financial performance of microfinance institutions in Kisii County, Kenya with a specific interest on KWFT. The findings will also help the microfinance bank to make effective credit risk policies that will protect its financial performance. The study adopted a descriptive case study research design

with a target population of 116 KWFT loan officers. The study found out that financial performance has strong correlation with lending policies which include joint liability (0.754), loan monitoring policies (0.859) and regular loan repayments (0.758). Lending policies explain 76.8% of variance in financial performance. Financial performance improves when lending policies are complimented with other credit risk management approaches as shown on regression model; between financial performance and lending policies $Y = -0.158 + 0.298X_1 + 2.265X_2 - 1.062X_3$. The study concludes that lending policies namely; group liability, monitoring policies and repayment frequency improves the financial performance of MFIs. The study recommends that these policies be reviewed regularly to fit them to the dynamic lending business.

Keywords: Group monitoring, Group lending, Repayment schedules, microfinance, Risk management

INTRODUCTION

Background of the Study

Microfinance is the supply of loans, savings, and other basic financial services to the poor. Micro Finance means providing very poor family with very small loans to help them engage in productive activities and grow their tiny businesses over the time (Gonzalez, 2008). Today, MFIs have spread around the world, not only in developing countries but also in many richer western countries. Microfinance schemes have been found to reduce poverty and positively impact nutrition, health and education as well as gender empowerment (Littlefield *et al.* 2003). In 2006 microfinance institutions reached around 130 million customers around the world (Daley-Haris, 2007).

Microfinance differs in key concepts from conventional banking in that it employs different collateral substitutes to deliver and recover loans. Such collateral substitutes include group lending, dynamic incentives which allow the loan size to increase over time upon satisfactory repayment, mandatory savings, and regular repayment schedules. These collateral substitutes are important for both the poor borrowers who usually lack enough collateral and available credit history and for lenders operating in countries with weak law enforcement (Fischer, 2010).

Microfinance institutions are in operation in East Africa under different models. In this region, provision of microfinance services is a function of Savings and Credit Cooperative Organizations (SACCOS). The SACCOS are formed with respect to a particular economic activity (Kiiru, 2007). Access to microfinance loans and other services is limited in Kenya and other East African nations due to lack of collateral and high interest rates (Simeyo, et al., 2011).

The single biggest contributor to failures and or distress in Kenya's lending system is poor management of lending. Credit appraisal, evaluation and approval, loan monitoring and follow-up, as well as well loan recovery and repayment play a big role in determining the net interest income to be earned on various investments as an indicator of financial performance. However, according to (Karanja, 2009), most of the larger local financial institutions failures in Kenya involved poorly analyzed lending.

In Kenya there is a growing concern on the loan default among microfinance and other non-banking financial institutions. This has created problems to both the MFIs in Kenya and their clientele (Thuo & Juma 2014). This is caused by existence of high levels of loan delinquency problem in microfinance industry which negatively affect the level of private investment and constrain the scope of MFI credit to borrowers as these firms have to compensate for loan delinquency losses. Loans given out end up become non-performing loans which adversely affect the profitability and overall financial performance of the lending institutions (Warue, 2011). Many lending institutions in Kenya are confronted by the challenge of rising nonperforming loan portfolios, which eventually end up as defaulted loans. Loan default will affect the microfinance's maximization of returns and portfolio growth.

Statement of the Problem

Sound credit management 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. The probability of bad

debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective (Gitman, 1997). The sustainability of microfinance institutions depends largely on their ability to collect their loans as efficiently and effectively as possible. In other words to be financially viable or sustainable, microfinance institutions must ensure high portfolio quality based on 100% repayment (Addae-Korankye, 2014). However, (Thuo & Juma, 2014) observes that in Kenya there is a growing concern on the loan default among microfinance and other non-banking financial institutions. This has created problems to both the MFIs in Kenya and their clientele.

Financial institutions face enormous credit risks and MFI's are not exempt from this. Financial institutions particularly microfinance banks are very important not only in providing financial assistance to the low income earners in the society, but also in granting of credit facilities to them. However, just like other financial institutions, microfinance banks experience numerous cases of credit risk (Nsobila, 2015). The Institutional investor (May 2009), observed that Russian, corporate and retail non-Performing loans (NPLs) are steadily growing, with some banks recording NPLs at over 10% of the balance sheet in 2009. Non-performing loans explain 64.6% of the variance in profitability in microfinance institutions in Kenya and the variance continued to rise from 2008-2012 (Mombo, 2013). These risks negate the profitability of the microfinance banks. Nonperforming loans are argued to harmfully affect the financial performance of rural microfinance banks, (Nsobila, 2015)

Recent theoretical work, however, has begun to cast a skeptical eye on peer group lending, suggesting that a range of simpler borrowing schemes (from greater lender monitoring to

regular repayment schedules) offer more effective repayment techniques than peer group liability (Armendáriz de Aghion et al., 2000). (Diagne, 2000) indicate that even those with favorable views towards peer group lending, acknowledge that peer group pressure may generate conflicts, which may negate the positive benefits associated with group liability. (Kendi, 2013) conducted a comparative study of the preference of MFI's individual lending versus group lending and found out that MFI's in Kenya prefer lending to individuals.

Microfinance differs in key concepts from conventional banking in that it employs social collateral to deliver and recover loans in group lending and joint liability. Such collateral substitutes are anchored on lending policies and dynamic incentives which allow the loan size to increase over time upon satisfactory repayment, mandatory savings, and regular repayment schedules. Joint liability constraints the group borrowing ability as individuals; interest fees, penalties and commissions on these loans further affect the customer. Studies indicate that there is a rise in non-performing loans which in turn affect financial performance of microfinance institutions. For this reason, this study seeks to establish the effect of lending policies on financial performance of microfinance institutions in Kisii County, Kenya a case of KWFT.

Objectives of the Study

This study sought to establish the effect of lending policies on financial performance of microfinance institutions in Kisii County, Kenya a case of KWFT.

Specific Objectives

The specific objectives of the study included

1. To determine the influence of joint liability on the financial performance of microfinance institutions in Kisii county
2. To establish the effect of monitoring policies on the financial performance of microfinance institutions in Kisii county
3. To determine the influence of repayment schedule on the financial performance of microfinance institutions in Kisii county

Research Gaps

The reviewed analysis between group lending and individual lending, A study of the effect of emerging trends in group lending among MFIs: A study on the challenges affecting group lending in MFIs.

RESEARCH METHODOLOGY

This study’s target population was 116 loan officers of Kenya Women Finance Trust Bank in Kisii County. The study used questionnaires to collect data. With a target population of 116 loan officers of Kenya Women Finance Trust Bank in Kisii County the study undertook a census approach where all the units were considered in the research. The questionnaire comprised of questions whose response was related to the study objectives. The data collected was cleaned, coded, tabulated, translated into specific categories, record them appropriately and computing them using appropriate statistical techniques.

RESEARCH FINDINGS AND DISCUSSION

Reliability Analysis

The reliability of an instrument refers to its ability to produce consistent and stable measurements. (Bagozzi, 1994) explains that reliability can be seen from two sides: reliability (the extent of accuracy) and unreliability (the extent of inaccuracy). The most common reliability

coefficient is the Cronbach’s alpha which estimate items on a test relate to all other items and to the total test - internal coherence of data. The reliability is expressed as a coefficient between 0 and 1. The higher the coefficient, the more reliable is the test.

All the 3 constructs representing the independent statistics scored more than 0.8 individual items. Loadings which represent squared multiple correlations of 0.80 or greater imply that the indicator shares more variance that the data collection is reliable (Sekaran, 2003). The reliability statistics are presented in Table 1.

Table 1 Reliability Test

	Cronbach’s	No of Items	Comments
1. Joint Liability	0.964	9	Accepted
2. Monitoring Policies	0.845	8	Accepted
3. Repayment Schedule	0.801	8	Accepted

Group Liability and Financial Performance

The first objective of this study was to determine the influence of group liability on the financial performance of microfinance institutions in Kisii County. The respondents who were loan officers at KWFT were asked to the respond on the influence of group liability. Their responses were analysed and presented in table 2

Table 2 Group Liability and Financial Performance

Statement	Agree		Neutral		Disagree		Total	
	F	%	F	%	F	%	F	%
Group liability creates social collateral security for loaned money	63	61.2	10	9.7	30	29.1	103	100
Group leader regularly visits the other group members, the risk of moral hazard is reduced	54	52.4	13	12.6	36	35	103	100
Strong social ties in joint liability increase peer monitoring and peer pressure	63	61.2	11	10.7	29	28.2	103	100
Group liability ensures that borrowers exercise prudence in use of the funds hence the likelihood of repayments	30	29.1	21	20.4	52	50.5	103	100
Group-based lending delegate monitoring activities to group members, reducing the loan management problem	59	57.3	12	11.7	32	31.1	103	100
Group members repay loans better due to a further refinancing	86	83.5	4	3.9	13	12.6	103	100
Group liability reduces the cost of loan management	40	38.8	19	18.4	44	42.7	103	100
Joint liability leads to higher repayment performance	80	77.7	6	5.8	17	16.5	103	100
social collateral ¹¹ induced by group lending is not a sufficient condition to ensure high repayment rates	52	50.5	14	13.6	37	35.9	103	100

Table 2 reveals that 61.2% of the respondents agreed that group liability creates social collateral security for loaned money. 9.7% of the respondents were neutral while 29.1% disagreed. On regularity of visits, 52.4% agreed that Group leader regularly visits the other group members; the risk of moral hazard is reduced. 12.6% of the respondents did not commit themselves any opinion while 35% disagreed. 61.2% of the respondents admit that Strong social ties in joint liability increase peer monitoring and peer pressure while 10.7% were noncommittal and 28.2% disagreeing. Whether Group liability ensures that borrowers exercise prudence in use of the funds hence the likelihood of repayments, 29.1% agreed, 29.4% were neutral and 50.5% disagreed. 57.3% of the respondents agreed that Group-based lending delegate monitoring

activities to group members, reducing the loan management problem, 11.7% were non-committal while 31.1% did not agree. Whether the possibility of refinancing loans increased repayments of the current loans, 83.5% agreed, 3.9% did not commit themselves to an opinion while 12.6% did not agree. Respondents were asked whether group liability reduces the cost of loan management. 38.8% of them agreed, 18.4 were neutral and 42.7% disagreed. 77.7% of the respondents were of the opinion that Joint liability leads to higher repayment performance, 5.8% remained non-committal, while 16.5% disagreed. The respondents were asked if they considered the social collateral insufficient to guarantee higher repayments 50.5% agreed, 13.6% were neutral while 35.9% disagreed.

These findings agree with the findings of previous studies such as the Theoretical models of Stiglitz (1990), Varian (1990), Banerjee and Guinane (1994) and Aghion (1999). They demonstrated that peer group schemes induce higher levels of repayment effort due to intra-group monitoring and greater peer pressure. Group-based lending programs delegate costly monitoring activities to group members, reducing the costs of lending, which can be translated into lower interest rates for the borrowers (Varian, 1990) and/or larger loan contracts (Stiglitz, 1990). The findings of this study also agree with (Ahlin & Townsend ,2003) who noted that if the group leader regularly visits the other group members, the risk of moral hazard is reduced; (Gine & Karlan, 2008) who also found out those strong social ties may increase peer monitoring and peer pressure. It is believed that due to these ties members are better able to monitor and may more easily pressurize others into repaying and Hermes, (Lensink & Mahrteab,2013) who found out that when compared to an individual liability contract,

entrepreneurial effort will be strictly higher under peer group lending with joint liability, assuming, of course, that monitoring costs are low and social sanctions are effective.

However, these findings differ with the findings of Conning (2000) who found out that group liability makes it limited liability thus inducing borrowers to take risky decisions. (Che, 2002) also disagrees with these results as he noted that joint liability creates a free riding problem from bad clients. (Che, 2002) also points out that group liability increases the cost of loan management in contrast with the findings of this study.

Monitoring Policies and Financial Performance

The second objective of the study sought to determine the influence of monitoring policies on the financial performance of microfinance institutions in Kisii County. The responses collected from the respondents were analyzed and presented in Table 3.

Table 3 Monitoring Policies and Financial Performance

Statement	Agree		Neutral		Disagree		Total	
	F	%	F	%	F	%	F	%
KWFT has policies that guide it in loaning	103	100	0	0	0	0	103	100
KWFT has policies that evaluate the customer before advancing loans to them (KYC)	100	97.1	1	1	2	1.9	103	100
KWFT has policies that help monitor the customers as they repay their loans	103	100	0	0	0	0	103	100
KWFT has policies that guide in the recovery of funds from non-performing loans	94	91.3	0	0	9	8.7	103	100
The lending policies developed by KWFT are adequate and effective	70	68	4	3.9	29	28.2	103	100
Good lending policies increase loan repayments	78	75.7	8	7.8	17	16.5	103	100
Stringent credit policy minimize the cost of collection, bad debts and unnecessary legal costs	71	68.9	10	9.7	22	21.4	103	100
The lending policies ensure timely allocation of asset investments to the market	70	68	11	10.7	22	21.4	103	100

From table 3 100% of the respondents agreed that KWFT has policies that guide it in loaning. 97.1% agreed that KWFT has policies that evaluate the customer before advancing loans to them (KYC). On this 1% were neutral while another 1% disagreed. On whether KWFT has policies that help monitor the customers as they repay their loans, 100% of the respondents agreed. 91.3% of the respondents agreed that KWFT had policies that while 8.7% didn't agree. He respondents were further asked if they thought that the lending policies developed by KWFT are adequate and effective; 68% agreed, 3.9% were neutral and 28.2% disagreed. However, 75.7% of the respondents agreed that Good lending policies increase loan repayments, with 7.8% neutral while 16.5% disagreed. Further, 68.9% of the respondents agreed stringent credit policy minimizes the cost of collection, bad debts and unnecessary legal costs. On this 9.7% did not commit themselves to an opinion while 21.4% dissented. When asked if the lending policies ensure timely allocation of asset investments to the market, 68% of the respondents agreed; 10.7% were neutral while 21.4% dissented.

Since lending is a risky venture, this research found out that having adequate and effective credit appraisal, monitoring and loan recovery. This agrees with Pandey, (2001) who noted that stringent credit policies minimize the cost of collection, bad debts and unnecessary legal costs. Mraba (2009) also found out that lending policies are employed to increase efficiency and coordination of asset investment operations thus better financial performance. However, this study found out that while KWFT has such policies they not adequately sealed all loopholes of non-repayment of delayed repayments. These findings, however, differ with the finds of (Ahlin and Townsend 2003) who found out that some of the

predictions of group lending, such as strong social ties, group monitoring, and group cooperation, are sometimes negatively related to repayment.

Repayment Schedule and Financial Performance

The third objective of the study sought to determine the role of regular repayment schedule on the financial performance of microfinance institutions in Kisii County. Respondents who were loan officers at KWFT were asked on the influence of regular repayment on financial performance of MFIs. The data collected was analyzed and presented in Table 4.

Table 4 Repayment Schedule and Financial Performance

Statement	Agree		Neutral		Disagree		Total	
	F	%	F	%	F	%	F	%
Regular repayment schedules makes borrowers committed to repayment	60	58.3	19	18.4	24	23.3	103	100
Regular repayment schedules can function as screening device against undisciplined borrowers	66	64.1	10	9.7	27	26.2	103	100
Frequent repayments pressure borrowers to prioritize repayment before cash is consumed or diverted	62	60.2	8	7.8	33	32	103	100
Repayment schedule flexibility jeopardizes repayment quality.	70	68	12	11.7	21	20.4	103	100
Regular repayment schedules make credit contracts look like arrangements for saving	30	29.1	14	13.6	59	57.3	103	100
Less frequent repayment should increase neither default nor delinquency	20	19.4	10	9.7	73	70.9	103	100
Regular repayment schedule increases interactions with loan officers, which may help build trust between clients and banks	76	73.8	14	13.6	13	12.6	103	100
Collecting weekly installments is costly for MFIs.	69	67	14	13.6	20	19.4	103	100

Table 4 has responses on the influence of regular repayment of loan and financial performance of KWFT. The responses reveal that 58.3% of the respondents agreed that Regular repayment schedules makes borrowers committed to repayment; 18.4 % were non-committal while 23.3% didn't agree. 64.1% agreed that Regular repayment schedules functions as screening device © Omuteyi, Muturi

against undisciplined borrowers; 9.7% didn't commit themselves to this question while 26.2% dissented. Further, 60.2% agreed that frequent repayments pressure borrowers to prioritize repayment before cash is consumed or diverted, 7.8% were neutral while 32% disagreed. On the effect of flexible repayments, 68% of the respondents agreed repayment schedule flexibility jeopardizes repayment quality. On this, 11.7% were neutral while 20.4% didn't agree. Asked whether Regular repayment schedules make credit contracts look like arrangements for saving 29.1% agreed, 13.6% were non-committal while 57.3% disagreed. Further, the respondents were asked whether less frequent repayment should increase neither default nor delinquency. 19.4% agreed, 9.7% were neutral while 70.9% disagreed. However, 73.8% of the respondents said that Regular repayment schedule increases interactions with loan officers, which may help build trust between clients and banks, 13.6% were neutral and 12.6% didn't agree. 67% of the respondents agreed that weekly installments are costly while 13.6% did not give an opinion while 19.4% disagreed.

This study found out that regular and fixed repayment schedules makes borrowers to be committed and prioritize repayments. This agrees with (Jain & Mansuri, 2003) who observed that frequent repayment can increase the maximum incentive compatible loan size and perhaps account for the low default rates realized by MFIs and (Morduch, 1999) who noted that regular repayment schedules can function as screening device against undisciplined borrowers and as an early warning to the program about potential repayment problems. They also pressure borrowers to prioritize repayment before cash is consumed or diverted. Regular repayment schedules also help screen out undisciplined (Zia

2010), however, small regular, daily or weekly, increases transaction costs incurred by both borrowers and lenders. This includes direct costs to the lender as well as the opportunity cost of meeting attendance, both of which can be substantial. Activity based costing exercises suggest that weekly collection meetings account for as much as one-third of direct operating expenses as also found out by (Shankar (2006). However, the findings of Giné and Karlan (2010) & Attanasio et al (2011) differ with these findings, that is, there is no significant difference in repayment increase in group liability when compared to individual liability.

Table 5 Correlations

		Financial Performance	Joint Liability	Monitoring Policies	Regular Repayments
Pearson Correlation	Financial Performance	1.000			
	Joint Liability	.754	1.000		
	Monitoring Policies	.859	.893	1.000	
	Regular Repayments	.758	.942	.943	1.000

Table 6 shows that financial performance has a 0.754 correlation with joint liability, 0.859 correlations with loan monitoring policies, and 0.758 correlations with regularity of repayment schedules. The correlations are strong for all the independent variables meaning an increase in joint liability approach with sufficient monitoring policies and regular repayment schedules will increase financial performance due to higher loan repayments in MFIs.

Coefficient of determination

Table 6 Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.880 ^a	.775	.768	.36473

The Adjusted R² is the coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable. From the table 6 the value of adjusted R² was 76.8% indicating the variability of financial performance caused by its relationship to lending policies in MFIs. R is the correlation coefficient which shows the relationship between the study variables. From the findings shown in Table 7, there was a strong positive relationship between the study variables as shown by R= 0.880 which is lending policies and financial performance.

Table 7 Regression model

Model		Un-standardized Coefficients		Standardized Coefficients	Sig.
		B	Std. Error		
1	(Constant)	-.158	.153		-1.028 .307
	Joint Liability	.298	.141	.300	2.115 .037
	Monitoring Policies	2.265	.250	1.304	9.054 .000
	Regular Repayments	-1.062	.271	-.755	-3.925 .000

From the table 7 the regression model of the relationship between lending policies and financial performance was $Y = -0.158 + 0.298X_1 + 2.265X_2 - 1.062X_3$. The Y-intercept was -0.158 meaning that if there was no group liability, monitoring policies and regular repayment schedules financial performance will be affected by -0.158. The negative value indicates a negative financial performance in the absence of lending policies. Joint liability accounts for 0.298 of financial performance, monitoring policy accounts for 2.265 of financial performance, while regular and fixed repayments negatively account 1.062 of financial performance. This finding on negative effect of regular and fixed repayments agree with other studies such as (Karduck and Seibel, 2004) who also found out that frequent repayments in not unambiguously good for repayment performance.

It increases transaction costs incurred by both borrowers and lenders.

SUMMARY

Group Liability and Financial Performance

The study found that group liability creates a social collateral for loaned money, which coupled by regular meetings and visits by their leaders and strong social ties help reduce the moral hazard of borrowing. Also, group based lending delegate loan management to the group and thus reducing the loan management effort by the bank. The promise of further refinancing based on repayment coupled with, peer monitoring, and regular visits creates fairly sufficient social collateral that induces higher loan repayments. However, group lending does not ensure prudence of the use of the loan and does not reduce the cost of loan management.

Monitoring Policies and Financial Performance

The study established that KWFT has adequate and effective monitoring policies that help evaluate customers before advancing loans, monitor repayments and recover non-performing loans. The findings as well revealed that good credit management policies increase loan repayment rates well as minimize the cost of collection, bad debts and unnecessary legal costs as well as ensuring timely allocation of resources. Loan monitoring policies has a positive correlation of 0.859 with financial performance of MFIs and a significant regression coefficient of 2.265.

Repayment Schedule and Financial Performance

The study established that regular repayments make borrowers committed to repayment, prioritize the repayments, and acts as screening device for undisciplined borrowers. Regular

repayment schedule increases interactions with loan officers, which may help build trust between clients and MFIs. The study also found out that repayment schedule flexibility will greatly jeopardize repayments leading to loan delinquency. As well, the common weekly repayments raise loan management costs. Regular repayment policies has a positive correlation of 0.758 with financial performance of MFIs and a significant regression coefficient of -1.062.

Conclusions

From the study findings it can be concluded that:

While lending to low and inconsistent income earning population, group liability is a successful approach because it creates a social capital or collateral to loaned money, regular meetings creates strong ties which help screening undisciplined borrowers, delegates' loan management to the group thus creating pressure to prudently use the loan and prioritize repayments. This results in minimal cases of loan delinquency, thus improving the financial performance of MFIs.

KWFT has adequate and effective credit policies that appraise customers before loaning, monitor repayments and oversee recovery of delinquent loans. With them in place, they have helped increase loan repayment rates, minimize the cost of loan management.

Regular meeting regular repayment schedule increases interactions with loan officers, which help build trust between clients and banks. As a result, this practice commits borrowers to prioritize loan repayments. However, small regular, daily or weekly repayments increase transaction costs incurred by both borrowers and lenders.

Lending policies namely; group liability, monitoring policies and repayment frequency

improve financial performance of MFIs as shown in the regression model;

$$Y = 0.158 + 0.298X_1 + 2.265X_2 - 1.062X_3$$

Recommendations

The researcher as per the finding of this study suggests the following recommendations for this study:

Group liability policy of loaning is successful. However, this study recommends that MFIs should educate customers on selection of group members, group management dynamics to avoid the challenge of 'free riding bad' clients

Though KWFT has effective policies that evaluate clients before loaning, monitor repayments and help in loan recovery, they are not yet perfect. Thus, this study recommends that they should be reviewed to identify any weakness in them. Further this study recommends that these policies should be regularly reviewed and updated to take care of emerging dynamics of lending.

Regular repayment schedules increase loan repayment rates. However, they increase loan management cost to both lender and borrower. The study recommends that MFIs should strike a balance between repayment rates and the cost of loan management so as make the loaning a good experience to both lender and borrower.

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