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Influence of Credit Management Practices on Financial Performance of Savings and Credit Co-operative Societies in Kakamega County

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Abstract: **The purpose of this research is to determine the influence credit management practices on the financial performance of SACCOs in Kakamega County. The objective that guided the study was to determine the impact of credit appraisal on the financial performance of SACCOs in Kakamega County. The study employed descriptive research design. Purposive sampling technique was used to select 99 SACCOs from a target of 132 SACCOs in Kakamega County. The sampling frame consisted of credit managers and credit officers of the sampled SACCOs. Structured questionnaires were used for data collection. Validity of the instrument was achieved using content validity while reliability through Cronbach alpha with a value of 0.900. Data was analyzed with the aid of statistical package for social sciences (SPSS) and presented in form of tables and models. The findings indicate that credit appraisal has significant relationship with financial performance (R=0.702, P=0.000). Regression results revealed that up to 49.3% of the variance in financial performance of SACCOs in Kakamega County is significantly accounted for by credit appraisal (R^2=0.493, P=0.000). Some SACCOs do not have credit evaluation committee and this affected their loan portfolio quality. The study concluded that credit appraisal practices has significant positive outcome on the financial performance of SACCOs in Kakamega County. The study recommended that that SACCOs management should constitute credit evaluation committee which is composed of competent personnel to carry out credit appraisal. Management should put into consideration the process and procedures in regard to credit appraisal.**

Keywords: **Credit Appraisal, Credit Management Practices, Financial Performance, SACCOs.**

I. INTRODUCTION

Credit management is the policy formulated to regulate the issue and collection of revenue; it is the process by which customer payments are controlled and collected (Kagoyire & Shukla, 2016). It is a necessary function, and any business firm offering credit regardless of the nature of its activities cannot overlook it. Proper management of credit ensures that the organization remains stable and profitable in its operations, poor management of credit, that is, low-quality credit often results in poor financial performance (Gatuhu, 2013). According to Kargi (2011) SACCO members acquire credit that enables them to venture into viable business projects that can expand hence improving their welfare. Also, SACCOs play a vital role in the growth and stability of the economy by running profit-making entities that allow for smooth allocation of funds through the effective and efficient management of credit (Psillaki, 2010). Credit management for a loan offered does not stop until the full, and the recovery of the last instalment (Bullivant, 2016). Gatuhu (2013) notes that a sound credit management is indispensable for continued profitability and stabilization of a financial entity. Whereas, a degenerating credit quality is an established source for poor financial performance.

The greatest risk and setback for any financial institution is issuing out a loan and failing to collect it back together with the stated interest. Contrary to the prevailing opinion that non-payment rate in SACCOs is inconsequential, the demography laid out by the Industrialization and Enterprise Development Ministry indicate a substantial swell in the amount defaulted by Sacco Members each year (Mutua, 2015). SACCOs with effective strategies for managing loan defaulters are believed to have high chances of excellent financial performance while SACCOs with ineffective defaulter management strategies may prone to high financial risks (Miriti, 2014).

In financial sector, credit management is concerned with activities such as accepting application, loan appraisal, loan approval, monitoring, and recovery of non-performing loans (Olabamiji & Michael, 2018). The Banking Act (2013)

provides for the setting up of Credit Reference Bureaus and their operations. Specifically, it provides for registered CRBs to collect and disseminate prescribed credit information from clients of licensed institutions under the Banking Act (2013) the Microfinance Act (2006) and the SACCO Societies Act (2008). Resultantly SACCOs which are licensed are not barred from giving client information to CRBs but will require written consent for both positive and negative information sharing. Therefore, SACCOs need the approval to request credit information from bureaus with the aim of credit appraisal and give feedback on how the loan is performing (Saunders & Allen, 2010). According to KUSCCO (2017) SACCOs have been added in the Credit Information Sharing mechanism to help in tightening the noose on borrowers who default loan payment and for quite some time have been taking advantage of SACCOs by seeking credit from some financial institutions lack information their credit history.

According to Turyahebya (2013) financial performance is the ability to operate efficiently, profitably, survives, grow and react to the environmental opportunities and threats. The degree at which enterprise meet its financial objectives is therefore called financial performance. Further, it is the process of quantifying the results of a firm's policies and operations in monetary terms (Nkusu, 2011). How the company utilizes its assets on various operations and business activities to generate income can be measured analyzed through its financial performance. It measures the financial health of an organization using financial indicators such as return on assets, returns on investment, profits, value added and margins (Baumohl, 2012). Financial performance guides management on the strategies and policies to adopt to improve the sustainability of the organization (Almazari, 2011).

Ondieki et al. (2011) acknowledged that Kenyan Cooperatives, SACCOs have a significant role in Kenya's financial sector. A Savings and Credit Cooperative main aim is to collect savings from members and in return provide them with credit facilities (Rop, 2015). Waweru (2011) asserts that SACCOs are voluntary associations or cooperative financial institutions owned and controlled by their members to promote saving, providing credit at low-interest rates and providing other financial services to its members. The common aim of SACCOs is to foster the economic interests and general welfare of its members. According to World Council of Credit Unions 2015 Statistical report. There are 60500 Credit Unions worldwide; in 109 countries on six continents, serving 223,000,000 members, having a total penetration of 8.3%, penetration rate computed by portioning out the sum of proclaimed credit union members by the economically active population, age 15-64 years old (WOCCU, 2016). Further, the report illustrates that the largest markets in Africa by some members as of December 31st, 2015 are (Kenya, 5,432,009; Senegal, 1,767,506; Rwanda, 1,607,560; Uganda, 1,325,517; and Benin, 1,272,020) (WOCCU, 2016).

A. Statement of the Problem

A range of challenges affects SACCOs because most of their clients earn a modest income. As a result, members default paying the loans disbursed to them, thus struggling to reach a balance between their running costs and satisfying the clients' needs (Kipng'etich & Muturi, 2015). Also, there are no stringent policies set by SACCOs in the country that regulate issuing of loans and collecting payments. Besides, limited credit appraisal poses a hitch in that SACCOs in Kenya carry out an inadequate financial assessment of clients and their guarantors leading to disbursing of loans to credit unworthy members who eventually default (Hyman, 2016). All these challenges result in loss of revenue hence SACCOs collapse, and as such lose their bargaining power in the investment sector, their businesses also risk being liquidated, and they even lose potential customers (Musyoki, 2011). SACCOs should, therefore, solicit for new members who are high-income earners and should consider using liquid assets like Vehicle log books, title deeds and premises as collateral security (Olando et al., 2013). They should also formulate policies that meet the current market standards. The SACCOs should work with the Credit Reference Bureau to allowing gathering substantial information that will aid in proper credit appraisal (Banking Act, 2013). A number of studies have been done to determine financial performance of SACCOs including technology (Mosongo et al., 2013) managerial competency (Lwanga et al., 2014) dividend policy, loan portfolio and surpluses (Maingi, 2014) and thus, the studies recommend for further research on credit management while looking at SACCOs as business units aimed at benefiting their members, their profitability and ability to achieve long-term goals in a competitive market.

1.1 Research Objective

The specific objective was to assess the impact of credit appraisal on the financial performance of SACCOs in Kakamega County.

1.2 Research Question

Basing from the specific objective, the study sought to answer what is the outcome of credit appraisal on the financial performance of SACCOs in Kakamega County.

II. LITERATURE REVIEW

2.1 Theoretical Framework

The study was guided by information theory and Credit Scoring Model

Information Theory

Borrowers should be screened especially by banking organizations in the form of credit assessment (Derban et al., 2005). The Collection of reliable information from prospective borrowers becomes critical in accomplishing effective screening as indicated by similar (symmetric) information theory. Information Theory was not just a product of the work of Claude Shannon. It was the result of crucial contributions made by many distinct individuals, from a variety of backgrounds, who took his ideas and expanded upon them. Indeed the diversity and directions of their perspectives and interests shaped the direction of Information Theory.

In the beginning, research was primarily theoretical, with little perceived practical applications. Christensen says that the innovator's dilemma is that he cannot garner support for his new ideas because he cannot always guarantee an end profit (Christensen & Raynor, 2013). Fortunately, Information Theory was sponsored in anticipation of what it could provide. This perseverance and continued interest eventually resulted in the multitude of technologies we have today (Shannon, 2001). Information Theory grew out of the concepts introduced in "A Mathematical Theory of Communication." Although, the phrase "information theory" was never used in the paper, Shannon's emphasis on the word "information" probably helped coin the term. The idea that something as nebulous as "information" could be quantified, analyzed, and reduced to a mathematical formula attracted tremendous attention.

The theory of information comes in effect where the borrower has much better information about his financial state than the lender (De Meza & Webb, 1987). According to Auronen (2003) it may be difficult to distinguish between good and bad borrowers, which may result into adverse selection and moral hazards problems. The lender has difficulty knowing whether it is likely the borrower will default. To some extent the lender will try to overcome this by looking at past credit history and evidence of salary. However, this only gives limited information. The theory argues that in the market, the person that possesses more information on a particular item to be transacted (in this case the borrower) is in a position to negotiate appropriate terms for the transaction than the other party (in this case, the lender) (Richard, 2011). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction.

This approach is significant to the study since it helped in knowing members rather borrowers loan history to be able to determine if one is a can pay or is a non-payer allowing the issue of credit to modest individuals thus better-informed decisions. In this study, this theory was used to inform credit appraisal variable as SACCOs need information about client before advancing credit. The process of appraisal entail collecting relevant information about client credit worthiness and repayment information after disbursing the loan.

Credit Scoring Model

The most widely used credit measure to predict future loan performance is credit scoring model. Feldman (1997) explained credit scoring as "the process of assigning a single quantitative measure, or score, to potential borrower representing an estimate of the borrower's future loan performance. The models are statistical such as logistical regression analysis or discriminant analysis and more recently neural networks and Support Vector Machine (SVM). Credit scoring methods are used to estimate the likelihood of default based on historical data on loan performance and characteristics of the borrower. In the small business environment, if the customer statistics produce a score above the cutoff score, the application is considered for further assessment by specialized small business units and then later progresses to the small business credit department for approval or otherwise. The underlying assumption is that there exists a metric which can distinguish between good and bad credits and segregate them into two separate distributions.

2.2 Conceptual Framework

Credit Appraisal

The Credit Appraisal is a comprehensive exercise which starts from the time a potential borrower walks into the financial institution and terminates in credit delivery and monitoring with the purpose of guaranteeing and preserving the quality of lending and managing credit risk (Gatuhu, 2013). Customer loan repayments must remain monitored. Hence organizations

should avoid issuing loans to risky clients, follow up loan repayment and renegotiate loans when customers get into difficulties (Ameyaw-Amankwah, 2011). Credit appraisal is a requisition for funds, evaluated and examined by a financial institution (Boldizzoni, 2008). The areas of focus in examination include: the purpose of the client, need genuineness, repayment capacity of the borrower, quantum of the loan and collateral security.

Credit appraisal plays an important role to keep the loan losses to a minimum level; hence if those officers appointed for credit evaluation are competent, then there would be high chances of lending money to non-deserving customers. Mbuya (2009) conquer that credit-related document, including the loan contract, financial statement, business plan, documents of the lender's security interest, and other papers that are used by the lender in evaluating creditworthiness of a prospective borrower. These documents, detailing the history of a loan, are kept in the borrower's credit file, for later review by the loan review committee and by field examiners from the lender's primary supervisory agency. Proper documentation is important in lending because the quality of documentation in the loan portfolio is directly related to credit quality ratings.

Mureithi (2010) acknowledges that credit assessment is conducted out for many objects, these are; as an assortment tool, to quantify risk, to aid in decision making, and to ensure good quality business with excellent credit worthiness. Credit appraisal, therefore, remains an important activity among the lending institutions. Sheila (2011) broadly recognizes that proper and adequate examination is the key to controlling or minimizing default. The examination is a crucial stage in the loan process. The stage is the heart of a high-quality portfolio. It includes diagnosing and assessing the business as well as the customer (Korankye, 2014). For a financial institution to establish the creditworthiness, credit analysts typically use a combination of financial or accounting data. And non-financial variables as well as some different models, or analytical tools, where, some of the methods involve a personal approach; others are more systematic in that they use quantitative techniques to evaluate a credit against objective benchmarks (Mohammad, 2015).

At the start of the process of seeking information on the borrower to determine credit limits, the loan officer should have accurate information available which will guarantee the data and figures availability and that the client will have a pro-margin error (Sheila, 2011). While assessing a credit proposal, more emphasis shall of those surveyed on compensation potential of loans out of reserves produced from borrower's enterprise money stream instead of realization of the possible underlying bonds. A formal assessment of borrower's financial health and ability to repay debt obligation is known as to as credit rating which helps the bank to grade the concerned customer (Hossain & Chowdhury, 2011).

Financial Performance

Financial performance is a biased measure of the competence and effectiveness with which firms employ their assets from their fundamental forms of enterprise and create wealth (Nazir, 2010). Financial performance forms an important part of the SACCO business, and it is crucial for their survival. Successful financial results in the SACCO have an active association with the capacity to manage economic issues effectively (Thachappilly, 2011). SACCOs with powerful approaches for managing loan defalcators are deemed to have high chances of superior financial administration while SACCOs with ineffective defaulter management strategies may prone to high financial risks (Miriti, 2014).

There are two central reasons as to why organizations should have financial performance measurement. The first one is to produce financial statements at the right time. Secondly, financial statements should be analysed to generate information about the productivity of the company, which must be adopted to improve that production (Johnson & Scholes, 2007). Financial results may be measured in many various ways depending on the type of the organization and the needs of the users of the financial reports. Profitability is one of the means to measure financial performance, is the ability of management to utilize an organization's resources to create profits and cash flows measured through various ratios like Return on Assets and Return on Equity (Mbui, 2010). Return on asset (ROA) reflects the ability of management to generate profits from the property of the firm while Return on Equity (ROE) indicates the ability of the directorate to make profits from the equity employed by the company. The Essence of financial performance measurement is to provide the organization with the maximum return on the capital used in the business (Wan & Ngui, 2014).

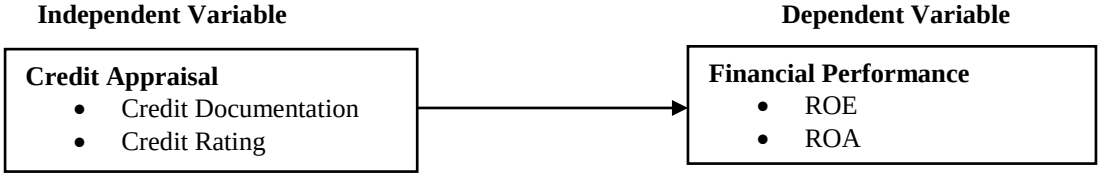

Figure 1: Conceptual Framework

III. METHODOLOGY

This study adopted descriptive survey research design. There are 5,769 SACCOs in Kenya (WOCCU, 2016) but the research targeted a population of one hundred and thirty-two (132) SACCOs within Kakamega County (KUSCCO, 2016). The sampling frame consisted of staff from credit section comprising of credit managers and credit officers. The study applied Neyman allocation sample formulae to calculate the sample size of 99 SACCOs. The study adopted purposive sampling technique by selecting SACCOs that have been in existence for more than 5 years with organized structure specifically credit section. The study used primary data collection instruments. A total of 99 questionnaires were administered to the sample population and 59 were returned having been successfully filled thus giving a response rate of 60%. The research adopted the content validity to measure the validity of the instruments. Cronbach's alpha was computed using data from the pilot study to determine the internal consistency of the research instruments. The results yield an alpha of 0.900 which was reliable as it was greater than 0.7. Data was summarized, edited and coded. Both descriptive and inferential statistics were used to analyse the data collected. The researcher used descriptive statistics that included frequency and percentage. Inferential statistics was used to determine the relationship between independent and dependent variables. This involved Pearson correlation and multiple linear regression analysis at significance level of 0.05. This was done using SPSS software version 20 and it was presented using tables and a model.

IV. FINDINGS AND DISCUSSIONS

4.1 Descriptive Statistics

The study sought to find out credit appraisal practices by asking the sample respondents to indicate their level of agreement on eight statements related to credit appraisal practices. The statements were anchored on a five point Likert-type scale ranging from SD=Strongly Disagree, D=Disagree, NA/ND=Neither Agree/Neither Disagree, A=Agree, SA=Strongly Agree. Pertinent results are shown in Table 1.

Table 1: Descriptive Statistics for Credit Appraisal

Credit Appraisal	SD	D	NA/ND	A	SA
We consider client credit history and character during credit appraisal	3(4%)	5(6%)	7(8%)	0(0%)	44(80%)
Credit related documents detailing the history of a loan are kept in the borrower's credit file	9 (20%)	8 (16%)	4 (8%)	3 (6%)	35(70%)
We have a credit evaluation committee	14(28%)	10(20%)	5 (10%)	4 (8%)	16(32%)
We have competent personnel to carry out credit appraisal	2(4%)	12(20%)	5(10%)	4(8%)	36(66%)
We have an internal credit rating system	1(2%)	5(6%)	12(20%)	17(30%)	23(42%)
Customer grading plays an important role to keep loan losses to minimum level	1(2%)	6(8%)	20(34%)	0(0%)	31(60%)
Data collected from application forms for new or extended credit line are used to assign credit applicants to right or wrong credit risk classes	7(10%)	7(10%)	12(20%)	15(28%)	17(32%)
Extension of credit to borrower is according to customer profile	11(20%)	12(24%)	3(6%)	12(20%)	21(40%)

From Table 1, in probing if SACCOs consider client credit history and character during credit appraisal 80% strongly agreed while none agreed. However, 4% and 6% strongly disagreed and disagreed respectively. Further, 70% strongly agreed that credit related documents detailing the history of a loan are kept in the borrower's credit file as 6% agreed. On the other hand, 20% strongly disagreed and 16% disagreed with the statement. The results also revealed 32% strongly agreed that SACCOs have a credit evaluation committee as 8% agreed. However, 28% strongly disagreed and 20.0% disagreed on the statement. Further, 66% strongly agreed that SACCOs have competent personnel to carry out credit appraisal as 8% agreed. On the other hand, 4% strongly disagreed and 20% disagreed on the same. In relation to whether there was an internal credit rating system 42% strongly agreed and 30% agreed. On the other hand 2% strongly disagreed and 6% disagreed on the same. The results further revealed that 60% strongly agreed that customer grading plays an important role to keep loan losses to minimum level while none agreed. On the other hand, 2% and 8% strongly disagreed and disagreed respectively.

The results also revealed that 32% and 28% strongly agreed and agreed respectively that data collected from application forms for new or extended credit line are used to assign credit applicants to right or wrong credit risk classes as 10% strongly disagreed and disagreed on the same. Lastly, 40% strongly disagreed that extension of credit to borrower is according to customer profile as 20% agreed. On the other hand, 20% strongly disagreed while 24% disagreed on the same statement. This is in agreement with Mbuya (2009) who conquer those credit-related documents, including the loan contract, financial statement, business plan, documents of the lender's security interest, and other papers that are used by the lender in evaluating creditworthiness of a prospective borrower.

4.2 Inferential Statistics

Pearson correlation analysis was used to investigate the relationship between credit appraisal and financial performance. The results are as shown in Table 2.

Table 2: Correlation between Credit Appraisal and Financial Performance of SACCOs in Kakamega County

	Statistics
Pearson Correlation	.792**
Sig. (2-tailed)	.000
N	59

In assessing the impact of credit appraisal on financial performance of SACCOs in Kakamega County, the study established a coefficient of correlation (r) as 0.702**. The objective answered what is the outcome of credit appraisal on the financial performance of SACCOs in Kakamega County. This implies that improvement in credit appraisal would results to increases in financial performance and decrease in Credit appraisal would results to decrease in financial performance. The results indicated that the relationship between Credit appraisal and financial performance is positive, strong and significant.

Simple linear regression analysis was conducted to find the proportion in the dependent variable (financial performance) which can be predicted from the independent variable (Credit appraisal). Findings were as shown in Table 3 which contains model summary, ANOVA and Coefficient.

Table 3: Regression results for Credit appraisal and financial performance of SACCOs

Model Summary					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	
1	.489[a]	.239	.220	.42280	
a. Predictors: (Constant), Credit appraisal Practices					
ANOVA[a]					
Model		**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig.**
1	Regression	2.302	1	2.302	12.880	.001[b]
	Residual	7.329	41	.179		
	Total	9.632	42			
a. Dependent Variable: Financial Performance b. Predictors: (Constant), Credit appraisal Practices						
Coefficients[a]						
Model		**Unstandardized Coefficients**		**Standardized Coefficients**	**t**	**Sig.**
		B	**Std. Error**	**Beta**		
1	(Constant)	2.577	.289		8.928	.000
	Credit appraisal	.424	.118	.489	3.589	.001
a. Dependent Variable: Financial Performance						

The results revealed a coefficient of determination (r2) of 0.493 implying that credit appraisal can explain up to 49.3% of the variance in financial performance of SACCOs in Kakamega County. The F test gave a value of F(1,58) = 55.382, P<0.01, which was large enough to support the goodness of fit of the model in explaining the variation in the dependent variable. It also means credit appraisal is a useful predictor of financial performance. The regression equation for Credit appraisal becomes:

Y = -0.316 + 0.979CA

From above regression model, in absence of credit appraisal, financial performance will be significantly at negative 0.316. Further, a unit change in credit appraisal would result to significant change financial performance by 0.979. Hence, the study concluded at 5% significance level, credit appraisal has a significant positive outcome on the financial performance of SACCOs in Kakamega County. The findings of this study is consistent with Mutua and Gekara (2017) found that credit appraisal positively affect performance of commercial banks in Kenya. Further, Kalimba et al (2016) established that credit management systems which consist of credit appraisal improved the bank return capital, asset of quality and bank management quality.

V. CONCLUSION

The study concluded that credit risk control has significant positive influence on the financial performance of SACCOs in Kakamega County as obtained from Pearson Correlation analysis. This implies that an increase in credit risk control would result to significant increase in financial performance. Regression results revealed that up to 46.5% change in financial performance is significantly accounted for credit risk. However, a unit change credit risk control led to insignificant change in financial performance of SACCOs in Kakamega County. Hence, credit risk control is useful predicator of financial performance. From these findings, it can be deduced that credit risk control practices such as credit risk exposure and credit risk monitoring are vital as far as financial performance of SACCOs is concerned. Increase in credit risk monitoring would results for decrease in non-performing loans hence increase in financial performance.

From the likert results, majority of the respondents (90.0%) were in agreement that they considered the past track record of repayment while few of them (10%) were not in agreement. The results also revealed majority (90%) of respondents were in agreement that they monitor the capability of clients to meet credit obligation while few of them (10%) were not in agreement. Further, majority (72%) of the respondents also were in agreement that they continuously monitor clients activity and credit worthiness during the time of a loan maturity while few of them (8%) did not agree on the same. Majority of the respondents (60%) confirmed that they conducted background check on clients ensuring their willingness and ability to repay loan while 8% were not in agreement while a few of them (20%) did not agreed on them same.

However, small majority of the respondents (44.0%) were in disagreement that in case of loan default, measures are taken to recover both principal amount and interest while majority of them (60%) were in agreement. Similarly, small majority (44%) of respondents also were not in agreement that there is no extension of credit to credit unworthy individuals while majority (60%) of the respondent were in agreement. The results also revealed that majority (60%) of the respondents confirmed that they have established internal guidelines to approve and review counterparty credit limits while few (20%) of them did not confirm. Lastly, the results also revealed that majority (60%) of the respondents confirmed that they conduct background check on clients ensuring their willingness and ability to repay loan while few (20%) of them did not confirm.

VI. RECOMMENDATION

The results of this study showed that credit appraisal has significant positive impact on the financial performance of SACCOs. Majority of the respondents agreed that they considered client credit history and character during credit appraisal; the study recommended that there is need for SACCOs to link up with credit bureaus for more information on client credit history. The study also concluded that majority of respondents agreed that they have internal credit rating system, therefore, the study recommended that there is need for SACCOs to improve on the capability of crediting system so as to match those of commercial banks through adoption of appropriate technology. Small majority of the respondents disagreed that they have credit evaluation committee; the study recommended that SACCOs management should constitute credit evaluation committee which is composed of competent personnel to carry out credit appraisal.

Some respondents agreed that customer grading plays an important role to keep loan losses to minimum level; the study recommend that internal risk management process must be sophisticated, proactive and adaptable handled by risk management staff and external partners, who can effectively and routinely assess, quantify, prioritize and address credit appraisals in depth. The appraisal process should identify and analyse all loss exposures, and measure such loss exposures. This should guide in selection of technique or combination of techniques to handle each exposure. The appraisal process should capture key issues like the capitalisation of the business, capacity of the applicant, value of the collateral, and repayment history and conditions that is economic, political before a project is financed.

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