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Loan Portfolio Management and Firm Performance: Theoretical Paper Review

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Abstract: **Microfinance is established in the economy for the economic benefit the low income group in the society who cannot be able to access the formal institutions that have many conditions regarding access to credit facilities. It is also established for purposes of alleviating poverty in the country. This paper presents background knowledge about loan portfolio management and firm performance of MFLs. The paper further provides a problem statement which comprises of challenges being faced by the MFLS institutions in Kenya, it progresses further to reviewing theoretical literature in support of the theme and empirical literature in the same geographical reach. The paper finally rests its case through presenting findings as a benchmark case study done in Uganda in MFls with similar studies in agreement with the benchmark study under findings and conclusions. Subsequently the paper provides insight for further research to be carried out under this area through providing a platform for research under conclusion and recommendations.**

Keywords: **Loan portfolio management, firm performance, balance score card theory, loan default.**

1. BACKGROUND

Loan portfolio management comprises of loan portfolio planning, customer screening and credit risk control Karekaho, (2009). In micro financial institution (MFIs), loan portfolio planning entails strategies by which loans are sectioned, estimated, and their sizes and related risks determined. This is done such that loans are gainfully stretched out to bunch ensured low-pay people to enable them to understand their foreseen business or development goals Kasibante, (2001). Customer screening centers around investigating and evaluating the financial soundness of candidates for loans regarding their capacity to benefit and repay the loan applied for. Credit risk control is an urgent perspective and a hot issue among MFIs, to limit the danger of bad debt and over-holding, MFLs should have more prominent understanding into critical variables like, client financial strength, credit score history and changing payment patterns Moti et al., (2012).

Loan portfolio planning, customer screening and credit risk control are altogether directed with the sole target of accomplishing desired performance in micro financial institutions, which, itself is reflected in loan interest installment, loan reimbursement, realized profitability, and clients‟ objective fulfillment Martin, (1996). Subsequently, when MFIs‟ target on better performance is not attained, addressing loan portfolio management ends up noticeably inescapable. As portrayed by Gibson (2012), performance may be referred to as how much financial related goals and objectives of a financial institution have been refined or are being accomplished. To measure performance profitability ratios are used, ROE (Return-on-Equity) which is probably the most basic pointer of a bank's profitability and growth potential. It is the rate return to shareholders. ROA (Return-on-Assets), which exhibits how much net income, is generated per dollar of Assets Josiane, (2013). ROE is in the region of 15% and 30%, for ROA is no under 1%. Measuring profitability is the most basic measure of the accomplishment of the business Mishkin, (2002).

Microfinance institutions is a vital tool that facilities financial inclusion in developing countries with a view of alleviating poverty. As a tool it has now acquired universal embrace since its humble begging with professor Muhammad Yunus who started the Grameen bank project in 1979 cabrieal, Russell and singh (2006). it all began when professor Yunus who was teaching economics at Bangladesh university of Chittagong who was moved by oppressive poverty of the villagers of Jabra neighboring the university to start a series of experiments in lending small amounts of cash from income to enable the recipients to run small business but were also reliable in repaying their small loan. This led to the birth of the Grammen bank that laid the foundation of microfinance institutions (MFLS) Armendariz and Murduch, (2009).

In Kenya it has evolved since the 1970s when group lending formula was acquired by most of the institutions as a way of enriching the local rural; community both for leadership advancements and access to financial services. The idea was embraced by religious organizations and NGOs who utilized credit to start and cluster their enterprises as group projects. Due to poor formation structure and internal systems of handling credits loan defaults were in arise as a result of that AMFL association come up. In 1990s the microfinance foundation began the process of having a system to champion the enthusiasm of the quickly growing microfinance subsector. The initiative culminated with the formation of the Association of Microfinance Institutions of Kenya AMFI-K in 1999.Since its origin AMFI-K has kept on assuming a noteworthy part in the development of the sector. The broader mandate of the association is to promote a conducive environment for the development of MFIs clients and the business environment at large. AMFI-K comprehensively concentrates on triple bottom on financial maintainability, social impact on customers, environment impact and standard reporting. AMFI-K has lobbed MFIs support in credit data sharing through credit bureaus. The venture was to help the segment deal with its credit book of while supporting their customers. It is foreseen that the advance book of microfinance was to improve by distinguishing those clients' credit data, multiple loan defaulters and nonpayment of loans was to decrease altogether in this way diminishing the cost of loaning Republic of Kenya, (2013).

However as report by AMFI, (2013) shows that on overall, the operational self-sufficiency and sustainability of microfinance institutions in Kenya have been decreasing over the years thus for MFLs to be successful on decreasing loan defaults they ought to have the capacity to discover a method for overseeing loan portfolios i.e. credit risk control, customer screening, portfolio planning and internal control frameworks as a moderating variable to improve performance. Since the execution of the Micro finance act, 2006 which was to better subsector governance still defaults rates are being accounted for kibor, Ngatu and Kwasira (2015).

1.1 Statement of Problem:

The survival of MFI's depends largely on their loan portfolio performance this is because MFI's generate most of their income from interest earned on loans extended to small and medium entrepreneurs. However, the loan performance of these banks depends on the loan portfolio management practices adopted by the banks. Giving of loans to customers comes with its own risk exposure Ali, (2015). Central Bank of Kenya (2016) in its annual supervision report opined that high incidence of loan default has been reflected in the rising levels of non- performing loans by MFIs in the last 10 years. According to the report, this situation has adversely impacted on loan portfolio performance and profitability of MFIs. This trend poses a threat to the financial viability and sustainability of the MFIs which in turn hinders the provision of achievement of the goals for which they were intended, to provide services to the rural unbanked population and eradicating poverty bridging the financing gap in the mainstream financial sector.

Loan Performance of banks has attracted many researchers' minds. This is because some banks have gone under while others are facing serious default or low loan uptake (Kiplimo and Kalio, 2012). Studies carried out by Rukwaro,(2001), Kitaka, (2006), Korir (2011), Mokogi, (2003) Kisala, (2014) and Kibor *et al*, (2015) have shown a high diminishing rates among the MFIs however, loan portfolio management practices for Micro Financial institutions are not known because from literature this type of information has not yet been documented in Kenya. Studies have been done in other counties and some studies in commercial banks in Kenya and Sacco's but none of the studies has been done in MFIs given their unique nature of providing services to the unbanked population and eradicating poverty. This paper opens a platform for a study to be carried out to fill the gap in knowledge through studying the relationship between loan portfolio management and performance and the effect of internal control as a moderating variable in Micro financial institutions.

2. THEORETICAL REVIEW

2.1 Theoretical literature:

There are several theories that explain why financial institutions would select particular management activities to ensure profitability. This paper is be based on three theories balanced scorecard theory, portfolio theory and asymmetry information theory.

2.1.1 The balanced scorecard theory:

The primary balanced scorecard (BSC) was developed in 1987 by US firm Analog Devices. It's encouraging was trailed by various scholastics, with the most celebrated investigation bringing about a 1992 article in Harvard Business Review by Kaplan and expert David Norton called "The balance scorecard – measures that drive execution". On account of its rap reception, the BSC has turned into the best known model of multi-measurement execution estimation. The adjusted scorecard idea emerged out of a perceived need to quantify accomplishment on more than just money related articulations. Concentrating entirely on financial outcomes doesn't furnish an association with the data that it needs to thrive in the present condition.

Monetary outcomes give a sign of past execution; however don't furnish you with knowledge into your present status or where you'll likely be later on. For execution to be viably measured then you have to consider both monetary and non-money related pointers Kaplan, (2000). The word balanced in the term 'balanced Scorecard' is characteristic of the adjusted thought given to long term and short term destinations, money related and non-budgetary measures, driving and slacking indicators and external and internal execution viewpoints Kaplan and Norton, (1996b, 1996c), Hendricks et al., (2004).

Balance scorecard theory is the main theory the paper is benchmarking its deemed relevant because it measures performance in two perspective both financial and non-financial indicators in ensuring profitability in a firm.

2.1.2 Portfolio Theory:

Portfolio theory manages the determination of portfolios that boost expected returns predictable with the individual satisfactory levels of hazard. The theory gives a structure to determining and measuring speculation hazard and to create connections amongst risk and expected returns. Its principle essential supposition is that financial investors frequently need to maximize returns from their ventures for a given level of risk. The full range of ventures must be considered in light of the fact that the profits from every one of these speculations cooperate henceforth the connection between the profits for a resource in the portfolio is imperative Reilly and Brown, (2011).

In investment, portfolio theory administration is a basic theory. It tries to search for the most effective mixes of advantages for boost portfolio expected returns for given level of risk. Then again, limit risk for a given level of expected return. From this theory, it is apparent that the level of hazard in a portfolio relies upon danger of every benefit, extent of assets distributed on every advantage and the interrelationship between the benefits making up the portfolio. The significant suspicions in portfolio theory in overseeing hazard are that the investors are objective and the market is proficient and culminate Chijoriga, (2007), Mutua (2016)

This theory is relevant to this paper in the sense that it brings out how loan portfolio can be managed to bring about profitability in the Micro financial institutions and reduce loan defaults.

2.1.3 Information Asymmetry Theory:

The idea of asymmetric information was first presented in George A. Akerlof's 1970 Paper The Market for "Lemons": Quality Uncertainty and the Market Mechanism. In the paper, Akerlof creates uneven data with the illustration instance of vehicle advertise. His essential contention is that in many markets the purchaser utilizes some market measurement to gauge the estimation of a class of products. Therefore the purchaser sees the normal of the entire market while the dealer has more cozy information of a particular thing. Akerlof contends that this data asymmetry gives the vender a motivation to offer products of not as much as the normal market quality. The normal nature of products in the market will then decrease as will the market estimate. Such contrasts in social and private returns can be alleviated by various distinctive market organizations Auronen (2003)

According to this investigation Information asymmetry alludes to a circumstance where entrepreneurs or chief find out about the prospects for, and dangers confronting their business, than do banks PWHC, (2002) refered to in Eppy.I (2005). It portrays a condition in which all gatherings associated with an endeavor don't know important data. In an obligation showcase, data asymmetry emerges when a borrower who takes a credit for the most part has better data about the potential dangers and returns related with investment ventures for which the assets are reserved. The moneylender then again does not have adequate data concerning the borrower Turnbull and Edwards (1994).

Binks et al (1992) call attention to that apparent data asymmetry postures two issues for the banks, moral danger (checking entrepreneurial conduct) and antagonistic choice (settling on blunders in loaning choices). Banks will think that it's hard to beat these issues since it isn't sparing to commit assets to examination and checking where loaning is for generally little sums. This is on the grounds that information expected to screen credit applications and to screen borrowers are not uninhibitedly accessible to banks. Brokers confront a circumstance of data asymmetry while evaluating loaning applications Ennew and Binks (1997). The data required to evaluate the capability and responsibility of the business visionary, and the possibilities of the business is either not accessible, uneconomic to get or hard to decipher. This makes two sorts of dangers for the Banker Deakins, (1999). The danger of unfavorable choice which happens when banks loan to organizations which in this way come up short (type II mistake), or when they don't loan to organizations which go ahead to wind up" fruitful, or can possibly do as such (type I blunder) Altman (1971) Gatuhu (2013).

Asymmetry theory is relevant for this paper as it explains that borrowers may take advantage of the superior knowledge they have over lenders in this case MFI's to hide some information which is only known by them. Any information they perceive will be at their detriment in the loan application process will most likely be omitted or hidden.

2.2 Empirical literature:

As indicated by George et al (2013) whose design was to examine of loan portfolio administration on association gainfulness instance of Commercial Banks in Kenya. The sample was gotten to by utilization of both stratified and simple random sampling. The study utilized multiple regression model to discover the connection between the determinants and benefit. Measurable bundle for sociologies (SPSS) was utilized to break down essential information while the SAS v.6 of 2009 was utilized to investigate the auxiliary information accumulated from the banks. The essential information discoveries show that the four determinants of gainfulness were in reality genuine. The loan portfolio impacted the gainfulness of the banks. Non-performing credits and the new advances had distinctive effect on the productivity of the bank. The interest cost was evaluated exceptionally as a factor that attempts to lessen the benefits. The organization costs particularly pay overheads were absolutely faulted for decreasing productivity.

As indicated by Magali (2014) whose general point was to establish the viability of loan portfolio management in rural SACCOS in Tanzania. The information investigation was finished utilizing multivariate regression model, illustrative and subjective strategies. The information for this study was gathered toward the finish of May 2013. The outcomes from the regression investigation uncover that the nature of advance portfolio was decidedly affected by the loan measure while the impact of sexual orientation and area of the borrowers were not critical. The discoveries additionally uncovered that change of the cost of horticultural create undermined the nature of loan portfolio, upgrade the reimbursement of late advances and overhaul the advance classes and development so as to enhance the nature of the advance portfolio in the SACCOS.

The study led by Karekaho, (2009) whose reason for existing was to build up the connection between loan portfolio management and execution of Microfinance Institutions (MFIs) in Wakiso locale, Uganda. The study was directed as a cross sectional study including a logical outline, simple random sampling utilized. The discoveries demonstrate that there were noteworthy connections between advance portfolio arranging, customer screening, portfolio control and the execution of the MFIs. However this study only measure performance using financial indicators, therefore this paper proposes and a study on performance in two angles both financial and non-financial performance as alluded in the balances cord card theory.

Sufi Faizan Ahmed, Qaisar Ali Malik (2015) whose primary point was to assess the impact of credit risk management hones on loan execution, empirical study of Micro Finance Banks of Pakistan. For measurable assessment, the essential information in cross sectional shape was thought about. The information was gathered from the administrative level credit risk administration staff of microfinance banking sector. Multiple regression model study was utilized for experimental relationship assessment of the credit risk management rehearses on the execution of advance. The consequences of the study demonstrated that credit terms and customer appraisal had positive and noteworthy effect on the advance execution, while the Collection policy and Credit hazard control had positive however irrelevant effect on Loan execution; this study was centered on financial indicators.

Muraleetharan (2012). The study was done on 'Internal Control and Impact on Financial Performance of the Organizations in Jaffna District in India', inspected whether the inward control framework prompts expanded and better budgetary execution of the Organizations. In his examination, interior control was measured by control condition, hazard evaluation and control exercises and monetary execution was measured by gainfulness, productivity and liquidity. To test his theory, information was gathered by utilization of questionnaires, perception and individual meetings and 181 samples were chosen from workers in the workplaces. He used Chi square and regression analysis to measure the variables and the significant level indicated that there was a relationship between internal control and financial performance.

Aballey (2009) uncovered those colossal awful advances portfolio for African Development Bank (ADB) in Ghana was to a great extent caused by inadequate advance checking and poor credit choice. The investigation prescribed preparing, powerful advance checking, compelling insurance, foundation of horticulture infrastructural offices and utilization of acknowledge departments as systems for lessening the terrible credits and enhancing the nature of advance portfolio for ADB in Ghana. Haas et al (2010) uncovered that determinants of powerful advance portfolio for banks in 20 change nations were possession styles, measure and lawful insurance of loan bosses. Lagat et al (2013) found that credits' hazard distinguishing proof, examination, observing, assessment and alleviation affected the loaning portfolio for SACCOS' in Kenya.

Nagarajan (2011) did study on credit risk management rehearses for microfinance foundations in Mozambique, the study found out that hazard management is a dynamic procedure that could in a perfect world be created amid typical circumstances and tried at the wake of hazard. The examination reasoned that monetary establishments expected to limit dangers related misfortunes through persevering administration of portfolio and income by building hearty institutional foundation with gifted HR and instilling customer train, through viable coordination of partners

Keitany (2013) uncovered that there is solid negative connection between the loan default and the productivity of SACCOs in Nairobi County Kenya. The tests demonstrated that the general regression display is a solid match for the information as the free factors measurably and altogether foresee the reliant variable. The regression display is a solid match of the information. Identity sorts are inclined to advance default why credit markets may come up short. The examination prescribes that SACCO should; constantly audit credit approaches, build up irretrievable, loan provision policies and character of loan applicants.

3. FINDINGS AND DISCUSSIONS

From the study conducted by Karekaho (2009) on loan portfolio management and performance of MFLs in Uganda the study found out that loan portfolio, client screening and portfolio control significantly affect firm performance. The study was inconformity with the results obtained by loan analysis (2004), Martin (1996), and Antonia (2001). However all this studies didn’t examine the effect of internal control as a moderating variable on loan portfolio management and performance of MFls. Most of the studies review in empirical literature only concentrated on measuring performance using financial indicators and not as stated by Norton and Kaplan (2001)

4. CONCUSSIONS AND RECOMMENDATIONS

From the empirical literature review it’s evident that most of the studies done in Kenya on MFLs have been biased on one side, measuring performance only using financial indicators but Kaplan and Norton (2001) stated that for one to measure performance effectively in an organization then you need to consider financial and non- financial indicators. Most of the studies that have been conducted on loan portfolio management utilized financial indicators being the dominant denominator in the literature review, none of the studies has gone ahead to study on how to reduce loan defaults rate in micro financial institution by way of studying loan portfolio management and performance in Kenya, hence this paper opens a platform for a study to be carried out to fill this cap through studying the relationship between loan portfolio management and performance (financial and non-financial measures) in Micro Financial institution

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