IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN:2278-487X, p-ISSN: 2319-7668. Volume 25, Issue 10. Ser. 8 (October. 2023), PP 55-60
www.iosrjournals.org

Influence Of Client Appraisal Practices On Non-Performing Loans In Micro-Finance Institutions In County Government Of Kiambu, Kenya

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Abstract:
Background: *The emergence of microfinance institutions to support the mainstream financial institutions has been a relief for most individuals especially the micro, small and medium enterprises. The main business for microfinance institutions has been to extend credit and to act as deposit taking institutions for micro, small and medium enterprises. However, the institutions have adopted poor credit management practices which have led to some experiencing problems of liquidity while others have wound up. This problem is worsened by the fact that the microfinance institutions extend credit to low income earners who are considered as riskier in credit risk exposure. Further, with their main business being credit advancement, microfinance institutions have been experiencing performance related problems with regard to non-performing loans especially in four aspects; non-performing loans ratio, provision of loan loss, ratio of cost to assets and ratio of credit to deposits due to the risky nature of their borrowers. This study therefore aims at assessing the influence of client appraisal practices on non-performing loans focusing specifically on microfinance institutions based in County Government of Kiambu, Kenya.*
Methods: *A descriptive research design was used. The study was conducted in County Government of Kiambu. The sample size for the study was 96 respondents working in the credit departments of the 48 registered MFIs in the County Government of Kiambu. A census was carried out for this investigation because the target population was quite small. A questionnaire was used for data collection in this study. After relevant authorizations, questionnaires administration was executed to the study's respondents at their places of work. Data collected for this study was cleaned, edited, coded and then entered in SPSS version 26.0 for analysis. Quantitative data was descriptively analyzed through the use of descriptive statistics such as frequencies and percentages. A simple regression model was used to present the association between NPLs and client appraisal practices.*
Results: *The findings of the study showed existence of client appraisal practices through appraising their character, capacity, collateral, capital and conditions under which credit was being advanced. The Likert scale responses were in agreement that client appraisal practices minimize default rates and thus the occurrence of non-performing loans. The regression model demonstrated that client appraisal practices had a significant positive influence on non-performing loans.*
Conclusion: *The study found that microfinance institutions employed client appraisal practices based on the 5 C's of client appraisal. Further, the performance of non-performing loans in microfinance institutions is positively and significantly influenced by credit appraisal processes.*
Key Words: *non-performing loans, appraisal, credit, microfinance*

Date of Submission: 17-10-2023 Date of Acceptance: 27-10-2023

I. Introduction

The emergence of microfinance institutions (MFIs) to support the mainstream financial institutions has been a relief for most individuals especially the micro, small and medium enterprises (MSMEs)[1]. The MFIs' main business has been to extend credit and to act as deposit taking institutions for MSMEs[2]. Their source of income is through interest collection and interest/dividend payments from their own investments such as in securities and bonds to other institutions such as government[3]. Credit advancement is therefore the major output for MFIs, but it is a risky output[4]. However, the institutions have adopted poor credit management practices which have led to some experiencing problems of liquidity while others have wound up[5]. This problem is worsened by the fact that the MFIs extend credit to low income earners who are considered as riskier in credit risk exposure[6]. The MFIs get their strength from memberships which imply that weak and wrong membership management styles leads to weak MFIs[7].

In Kenya, MFIs have emerged in order to support the mainstream financial institutions and have therefore been a great ease for most individuals and organizations that have been having difficulties partaking in the formal financial sector[8]. With their main business being credit advancement, MFIs have been experiencing performance related problems with regard to non-performing loans (NPLs) especially in four aspects; NPLs ratio, provision of loan loss, ratio of cost to assets and ratio of credit to deposits due to the risky nature of their borrowers[9]. For this reason, [4]noted that MFIs have given special emphasis on credit risk management quality in an attempt to avert the deteriorating situation of NPLs rates. However, this has not been yielding the required results as the level of NPLs in the country have been exceeding 10% as compared to the globally accepted standards of approximately 3%[10]. Founded on this scenario, this study therefore aims at assessing the influence of client appraisal practices on NPLs focusing specifically on MFIs based in County Government of Kiambu, Kenya.

II. Methods

Research Design: A descriptive research design was used.
Study Location: The study was conducted in County Government of Kiambu.
Sample Size: The sample size for the study was 96 respondents working in the credit departments of the 48 registered MFIs in the County Government of Kiambu.
Sampling Technique: A census was carried out for this investigation because the target population was quite small.
Data Collection Instruments: A questionnaire was used for data collection in this study.

Procedure Methodology

An approval from Mount Kenya University, school of postgraduate studies was obtained. A research license was then sought from National Commission for Science, Technology and Innovation (NACOSTI) authorizing the researcher to collect data from the field. Relevant authorization for data collection was sought from the top management of MFIs and the County Government of Kiambu. After relevant authorizations, questionnaires administration was executed to the study's respondents at their places of work.

Statistical Analysis

Data collected in this study was cleaned, edited, coded and then entered in SPSS version 26.0 for analysis. Quantitative data was descriptively analyzed through the use of descriptive statistics such as frequencies and percentages. A simple regression model was used to present the association between NPLs and client appraisal practices. The following regression model was used for this study.

$$NPLs = \beta_0 + \beta_1 Client\ Appraisal + \varepsilon$$

Where: β_1 is the regression coefficient while ε is the error term.

III. Results

Respondents' Profile

The findings show that 54.7% (52) of the respondents were male while 45.3% (43) were female. This is a suggestion that both male and female respondents were well represented in the study. The findings also demonstrate that the respondents worked in different sections of the credit department as shown by 38.9% (37) who worked as credit managers; 22.1% (21) who worked as loan officers; 20.0% (19) who worked as recovery/monitoring officer; 10.5% (10) who worked as credit analysts and 8.4% (8) who worked as credit directors. Further, the findings illustrate that 37.9% (36) of the entire respondents had been employed in their MFIs for 5 to 9 years, 27.4% (26) had worked for less than 5 years, 24.2% (23) had worked for 10 to 15 years and 10.5% (10) had worked for more than 15 years. When asked about the duration they had worked in the credit department, 46.3% (44) had worked for 5 to 9 years, 33.7% (32) had worked for less than 5 years, 17.9% (17) had worked for 10 to 15 years and 2.1% (2) had operated for more than 15 years. This is an indication that the duration in which they had worked would be considered sufficient enough to be knowledgeable on matters affecting their respective MFIs. The findings that majority had worked in the credit department for 5 years or more made the respondents suitable to respond on the status of NPLs in the MFIs (see Table 1).

Table 1: Profile of the Respondents

		Frequency	Percent (%)
Gender of the Respondents	Male	52	54.7%
	Female	43	45.3%
Current Position	Loan Officer	21	22.1%
	Credit Analyst	10	10.5%
	Recovery/Monitoring Officer	19	20.0%
	Credit Manager	37	38.9%
	Credit Director	8	8.4%
Duration (in years) worked in this	< 5 years	26	27.4%

organization	5-9 years	36	37.9%
	10-15 years	23	24.2%
	>15 years	10	10.5%
Duration (in years) worked in the credit department	<5 years	32	33.7%
	5-9 years	44	46.3%
	10-15 years	17	17.9%
	>15 years	2	2.1%

Client Appraisal Techniques

Respondents indicated existence of character appraisal through appraising clients in terms of loan defaults in other institutions (integrity) as shown by a repose of 81.1% (77) and whether clients had been advanced credit by other financial institutions thus evaluating their trustworthiness as shown by 67.4% (64) of the respondents. Client appraisal practices also involved evaluating the capacity of the borrower in terms of their financial ability as shown by 89.5% (85) of the respondents and the profitability/cash flow analysis of the business as shown by a response of 81.1% (77) of the respondents. Appraisal practices also entailed appraising the collateral offered as security to the credit in terms of collateral value, marketability and legibility as shown by a response of 84.2% (80), 42.1% (40) and 94.7% (90) of the respondents respectively. The MFIs also employed capital appraisal practices such as appraising the nature of the capital and exposure to risk of the client's capital as shown by a response of 31.6% (30) and 33.7% (32) of the respondents respectively. In terms of conditions appraisal, it was evident that MFIs appraised the loan purposes, industry environment and conditions, political climate and economic/financial conditions related to the business as shown by 81.1% (77), 49.5% (47), 26.3% (25) and 23.2% (22) of the respondents respectively (see Table 2).

Table 2: Client Appraisal Practices

		Frequency	Percent (%)
Character	Loan defaults in other institutions (integrity)	77	81.1%
	Loan advancement by other financial institutions (trustworthiness)	64	67.4%
Capacity	Financial capacity of the borrower	85	89.5%
	Profitability/cash flow analysis of the business	77	81.1%
Collateral	Collateral value analysis	80	84.2%
	Collateral marketability	40	42.1%
	Collateral legibility	90	94.7%
Capital	Nature of the capital	30	31.6%
	Exposure to risk of client's capital	32	33.7%
Conditions	Loan purpose	77	81.1%
	Industry environment and conditions	47	49.5%
	Political climate	25	26.3%
	Economic/Financial conditions related to the business	22	23.2%

Effect of Client Appraisal Practices on Non-Performing Loans

Respondents were further presented with Likert scale items on client appraisal practices and their effect on NPLs. Table 3 demonstrates the responses. Majority of respondents - represented by a response of 70.5% (67) – agreed that frequent appraisal of the character of the borrower ensures only creditworthy borrowers access credit thus minimizing default rates and therefore the level of NPLs; 18.9% (18) of the respondents were neutral, 8.4% (8) strongly agreed and 2.1% (2) strongly disagreed. According to the findings as reported in Table 4.3, a total of 70.5% (67) of the respondents agreed and strongly agreed that appraisal of the collateral ensures that valuable security is in place which reduces chances of default by the client in fear of losing the security; 29.5% (28) were neutral. Evidently, 64.2% (61) agreed that capital appraisal of the client ensures that the correct credit amount is advanced to the client with respect to his/her wealth which reduces default rates; 21.1% (20) were neutral and 14.7% (14) strongly agreed. The results further demonstrate that 53.7% (51) of the respondents agreed and strongly agreed that appraisal of the client's capacity ensures that the client makes regular loan repayments without major setbacks thus minimizing levels of NPLs; 42.1% (40) of the respondents were neutral while 4.2% (4) disagreed to this statement. Lastly, Table 3 depicts that 50.5% (48) of the respondents were in agreement that a proper assessment of the external conditions such as economic conditions discloses prevailing conditions that may influence loan repayment thus reducing levels of NPLs; 25.3% (24) disagreed while 24.2% (23) were neutral (see Table 3).

Table 3: Likert Scale Responses on Influence of Client Appraisal Practices on NPLs

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Frequent appraisal of the character of the borrower ensures only creditworthy borrowers access credit thus minimizing default rates and therefore the level of NPLs	2 (2.1%)	0 (0.0%)	18 (18.9%)	67 (70.5%)	8 (8.4%)
Appraisal of the collateral ensures that valuable security is in place which reduces chances of default by the client in fear of losing the security	0 (0.0%)	0 (0.0%)	28 (29.5%)	55 (57.9%)	12 (12.6%)
Capital appraisal of the client ensures that the correct credit amount is advanced to the client with respect to his/her wealth which reduce default rates	0 (0.0%)	0 (0.0%)	20 (21.1%)	61 (64.2%)	14 (14.7%)
Appraisal of the client's capacity ensures that the client makes regular loan repayments without major setbacks thus minimizing level of NPLs	0 (0.0%)	4 (4.2%)	40 (42.1%)	47 (49.5%)	4 (4.2%)
A proper assessment of the external conditions such as economic conditions discloses prevailing conditions that may influence loan repayment, thus reducing level of NPLs	0 (0.0%)	24 (25.3%)	23 (24.2%)	40 (42.1%)	8 (8.4%)

Level of Non-Performing in Micro-Finance Institutions in County Government of Kiambu

From the responses in Table 4, it can be seen that 29.5% (28), 25.3% (24), 21.1% (20), 20.0% (19) and 4.2% (4) of the respondents disagreed, strongly disagreed, strongly agreed, agreed and were neutral that the amount in Kenya Shillings of NPLs is on the increase in their respective MFIs. Further, 46.3% (44), 21.1% (20), 13.7% (13), 10.5% (10) and 8.4% (8) of the respondents disagreed, strongly agreed, agreed, were neutral and strongly disagreed respectively that the loan defaults' numbers is on the increase in their respective MFIs.

Table 4: Likert Scale Responses on Level of NPLs

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The amount in Kenya Shillings of NPLs is on the increase in this MFI	24 (25.3%)	28 (29.5%)	4 (4.2%)	19 (20.0%)	20 (21.1%)
The loan defaults' numbers is on the increase in this MFI	8 (8.4%)	44 (46.3%)	10 (10.5%)	13 (13.7%)	20 (21.1%)

Based on these responses, a decision was to be made on the overall status of responses. This was necessary so as to draw conclusion on the overall status of NPLs in MFIs in County Government of Kiambu, Kenya. The two items were subjected to a t-test, with a test value of 3. The aim was to evaluate whether the responses were significantly different from neutral (signifying that NPLs in MFIs is neither increasing nor decreasing). The t-test results are as shown in Table 5. Though the mean on Likert scale responses related to the statement "The amount in Kenya Shillings of NPLs is on the increase in this MFI" was less than the test value of 3 (mean=2.8211), it was not significantly different from neutral (p-value=0.257 was greater than 0.05 level of significance). This meant that, on overall, respondents neither agreed nor disagreed on that statement. Similarly, the mean on Likert scale responses related to the statement "The loan defaults' numbers is on the increase in this MFI" was less than 3, the test value. However, it was not significantly different from neutral since the p-value=0.593 was greater than 0.05 level of significance. This implied that respondents neither agreed nor disagreed on this statement on overall (see Table 5).

Table 5: One Sample t-Test on Significance of Likert Scale Responses on Status of NPLs

		Test Value = 3					
						95% Confidence Interval of the Difference	
	Mean	t	df	Sig. (2-tailed)	Mean Difference	Lower	Upper
The amount in Kenya Shillings of NPLs is on the increase in this MFI	2.8211	-1.140	94	.257	-.17895	-.4906	.1327
The loan defaults' numbers is on the increase in this MFI	2.9263	-.536	94	.593	-.07368	-.3464	.1990

Regression Modeling

A regression model was fitted for the data. The model summary results shown in Table 4.14 show that R-Square=0.576. This implies that 57.6% of NPLs in MFIs in County Government of Kiambu is explained by client appraisal practices (see Table 6).

Table 6: Summary of the Model

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.759[a]	.576	.581	.58355
a. Predictors: (Constant), Client Appraisal				

The ANOVA table shows that the p-value<0.05 (see Table 7). This is a sign that the regression model for the relationship between NPLs and client appraisal practices is significant.

Table 7: ANOVA Results for the Regression Model

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.288	1	2.288	6.720	.011[b]
	Residual	31.670	93	.341		
	Total	33.958	94			
a. Dependent Variable: Non-Performing Loans						
b. Predictors: (Constant), Client Appraisal						

The regression coefficient for the regression model showing the relationship between NPLs and client appraisal practices demonstrate significant regression coefficient (p-value=0.011) and constant (p-value<0.0001). The regression coefficient is positive implying that client appraisal practices have a positive effect on NPLs (see Table 8). The regression model for the relationship between NPLs and client appraisal practices is therefore presented as:

NPLs=2.846 + 0.290 Client Appraisal Practices

Table 8: Regression Model Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.846	.457		6.227	.000
	Client Appraisal	.290	.112	.260	2.592	.011
a. Dependent Variable: Non-Performing Loans						

IV. Discussion

From the findings, respondents indicated existence of client appraisal through appraising clients in terms of loan defaults in other institutions (integrity) and whether clients had been advanced credit by other financial institutions thus evaluating their trustworthiness. Client appraisal practices also involved evaluating the capacity of the borrower in terms of their financial ability and the profitability/cash flow analysis of the business. Appraisal practices also entailed appraising the collateral offered as security to the credit in terms of collateral value, marketability and legibility The MFIs also employed capital appraisal practices such as appraising the nature of the capital and exposure to risk of the client's capital. In terms of conditions appraisal, it was evident that MFIs appraised the loan purposes, industry environment and conditions, political climate and economic/financial conditions related to the business. The findings agree with[11] framework of the 5 Cs of client appraisal. According to Edward, the five important factors that lenders use in administering credit so as to lead to improved loan performance include character, capacity, collateral, capital and existing conditions. Capacity as discussed by[12] is evaluated by assessing the financial information of the borrower to determine his/her repayment ability. Character on the other hand evaluates the personality of the borrower to assess his/her integrity and trustworthiness[13]. Capital appraisal analyses the capital of the borrower to determine his/her risk to unexpected losses in the market[14]. Collateral appraisal involves assessing the alternative security which can be sold to recover unpaid loans. The collateral should be evaluated in terms of its value, marketability and should have a proper title[15]. According to[16], conditions appraisal assesses the purpose for which the loan is being taken for, the industry, the political and economic climate.

The Likert scale responses are in agreement that client appraisal practices minimize default rates and thus the occurrence of NPLs. The findings concur with a study conducted in Zambia by[17] that found a strong positive correlation between client appraisal and loan performance in terms of amount of repayments made. Further, [18]found that credit risk management practices had a significant effect on loan performance with credit appraisal being the most significant among the practices studied. A study in Kenya's Nairobi Business District by[19] found a positive relationship between appraisals of loan applicants and financial performance in terms of reduced NPLs. The study also demonstrated that the appraisal process considered the personality of the applicants, collateral presented and capacity to fulfill the repayment obligations, which if not well assessed can lead to emergence of loan defaults leading to poor performance of the MFIs. The regression model demonstrated that client appraisal practices have a positive effect on NPLs. This imply that increased client appraisal practices lead to a reduction in NPLs. [20]conducted a study on credit appraisal practices in Nairobi County, Kenya and found that deposit taking SACCOs always checked the character, capital, collateral, capacity and conditions of the borrowers thus increasing their profitability through reduction of losses in the loan portfolio.

V. Conclusion

The study found that MFIs in County Government of Kiambu employed client appraisal practices based on the 5 C's of client appraisal, that is, character, capacity, collateral, capital and conditions appraisal. Further, the performance of NPLs in MFIs is positively and significantly impacted by credit appraisal processes.

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