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FACTORS AFFECTING PROFITABILITY IN MICROFINANCE INSTITUTIONS: A CASE STUDY OF SELECTED MICROFINANCE INSTITUTIONS IN NAIROBI

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ABSTRACT

In Kenya, Micro Finance has roots that can be traced back to the mid-1950s when the Joint Loan Board Scheme was established to provide credit to indigenous Kenyans with small trading businesses. The main objective of this study was an analysis of factors affecting profitability in microfinance institutions. Specific objectives included to analyze the extent to which debt collection process affects profitability in MFIs, to establish the effect of central bank regulations on profitability in MFIs and to find out the effect of credit vetting on profitability in MFIs. The research adopted a descriptive research design and focused on selected micro finance institutions to analyze the factors affecting profitability in micro finance institutions. However this study was limited to Nairobi CBD with specific focus on Faulu Kenya, Micro Kenya and Kenya Women Finance Trust with a total population of 188. Stratified sampling method was then used to sample out 94 respondents. Data collection was through questionnaires. Qualitative analysis involved summarizing the responses from open ended questions. From the findings, respondents (74%) indicated that the debt collection process in the micro finance sector affects credit risk management and consequently profitability,70%) that legal policies had effect on profitability of MFIs and 69% that credit rating affects lending. The study came up with various recommendations that micro finance institutions should have a set of regulations, lenders should focus on the key business issues quickly and that electronic commerce application such as mobile banking, online loan processing among others should be incorporated to improve the services, speed, and convenience. Also, organizational lending policies should be in line with the existing legal policies.

Keywords: Microfinance Institutions, profitability, banking, loans

INTRODUCTION

Over the years, microfinance has evolved as an economic development approach intended to benefit the low income population. It is not just banking, it is a development tool commonly used by donors. The history of microfinance dates back to about three decades when in 1976, Mohammed Yunus, who is believed to be the founder of formal microfinance, founded Grameen-Bangladesh. Grameen-Bangladesh, began assessing micro finance service to poor women in South Asian Villages. Grameen is a Bengali name which means village. Its evolution, however, dates about 30 or 50 years from the late 1960s with efforts made towards the reduction of poverty through the promotion of income earning activities among the poor. It is thus an up growth of the small enterprise development initiative (Greuning, 2003).

Micro finance however, has a number of roots. For hundreds of years, poor people in Africa and Asia had formed savings and lending groups. Moneylenders and the informal curb market had provided quick services at very high costs to poor households who had no access to mainstream financial institutions. In the last century, cooperatives and credit unions in developing countries have focused on savings mobilization and lending with rural households, many of which are poor. Over the years, governments have created lending programs for poor entrepreneurs and producers; most of these programmers have suffered from subsidized interest rates, political patronage and low repayment (Janson, 2007).

In Western Africa, the credit unions were set up on the basis of European or North American experiences. Although they have been in existence since 1960s, they only started to expand rapidly in the 1980s following the collapse of most of the rural development banks in the sub-region. Significant credit union systems were developed in Benin, Burkina Faso, and Togo. In Eastern Africa, micro-finance has harbored some success stories, especially in Kenya and Uganda; credit unions have not experienced the successful growth and reputation of their counterparts in Western Africa. Moreover, the state control over the cooperative sector which prevailed for a long time in several Eastern Africa countries created a very different dynamics in the evolution of these systems. In fact, similar types of micro-finance organizations in Eastern/Central and in Western Africa show contrasting achievements, on a number of indicators (Charitoneko, 1998).

The emergence of the Savings and Credit Cooperative Organizations (SACCOs) dates back to the years 1965-1970. They grew out of the credit systems of the old farming cooperatives which were common in cash crop areas, particularly where coffee was produced. At that time, the state controlled the production of coffee from farm to market. Farmers were organized into cooperatives and financial services were provided by "banking sections" (in Kenya, the Union Banking Sections) where farmers could save and obtain advances that were repaid using the income earned from the harvest. In Tanzania, the SACCO movement, is legally autonomous but closely linked to the farming cooperatives, experiencing mixed fortunes because of change in government policy (Altman, 2002).

In Kenya, these banking sections were progressively converted into SACCOs in order to formalize the separation between economic and financial functions, but not without generating a certain amount of resistance. The process took nearly 20 years, and is not complete even today. During the 1980s, Kenya witnessed the emergence of micro-finance NGOs which adopted the Grameen Bank model. These NGOs focused on providing micro-credit to solidarity groups, operating in urban areas and targeting micro-enterprises. Five of these NGOs are noteworthy, with K-REP (Kenya Rural Enterprise Program) taking the lead and transforming itself recently into a commercial bank. (Greuning, 2007).

K-REP introduces a new type of member-based institution in Kenya known as Financial Service Associations (FSAs) in order to diversify its client base and broaden its national coverage. These FSAs started operating two years ago in poor rural areas that were not covered either by the K-REP type solidarity group systems or by the SACCOs. Although they are still at the experimental stage, FSAs seem to be quite popular especially in areas neglected by other MFIs. Their low start-up and operating costs suggest that they might achieve autonomy despite the difficult economic environment in which they operate. Under pressure from donors, certain banks in Kenya have initiated micro-finance activities simply by using concessional lines of credit or external guarantee funds to refinance MFIs. Only the Cooperative Bank seems seriously interested in pursuing this course of action despite this polarized situation these two types of MFI know little about each other (Altman, 2002).

Thus, it can be said that although the sector has evolved over the last few years and is still undergoing significant change today, this evolution seems to be more strongly influenced by change in the local environment than by meetings or confrontations between the different approaches or the impact of increased competition among MFIs (MicroSave, 2000).

In Kenya, Micro Finance has roots that can be traced on the mid-1950s when the Joint Loans Board scheme was established to provide credit to indigenous Kenyans with small trading businesses. Since then, there has been a gradual shift in interest and resources toward providing micro-credit to micro and small enterprises (MSEs). In the 1970s the main organizations providing credit to the MSE sector were church based organizations like National Council of Churches (NCCK) and other smaller church based NGOs. These programs were heavily subsidized and were ad hoc additions to other social welfare programs offered to the poor. Outreach was extremely limited. (Kariuki, 1995)

Interest in the informal sector in Kenya can also be traced to the early 1970s after seminal International Labor Organization (ILO) report on employment was issued in Kenya in 1972. This report for the first time identified the informal sector as a potentially important contributor to employment and to economic growth in Kenya and other developing countries. Urban poverty had not reached crisis levels. Development finance was not concerned about poor target groups. The main thrust was to transfer capital to developing countries in order to fill what was believed to be a structural gap in capital formation. Multilateral and bilateral funding was directed towards large industrial and infrastructural projects in the belief that there would be a trickle-down effect through which the poor would benefit.

The three main lending methodologies used in microfinance are individual lending, solidarity group lending and group of groups. Individual lending is defined as the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment. It requires frequent and close contacts with the individual client. It is most successful for larger urban based production oriented businesses and for those who have some form of collateral or a willing cosigner or with small scale farmers in rural areas. Normally clients are those who require working capital and/or fixed assets. Loan amounts and forms are based on careful analysis by credit officer (Auronen, 2003).

Detailed financial analysis and projections are often included with the loan application. The amount and terms are negotiated with the clients. Visits are often made to the clients' place of business as specified in the loan contract. Savings may or may not be provided depending on the institutional structure of the Micro Finance Institutions. Training and technical assistance may be provided by the credit officers. Sometimes training is provided on a per-fee basis or is mandatory (Haron, 2007).

Solidarity Group lending model makes loans to individual members in groups of four to seven. Clients are mostly urban and include men and women and are typically informal sector micro businesses such as traders who need small amounts of working capital. Group members collectively guarantee loan repayment; access to subsequent loans is dependent on successful repayment by all group members. The repayment is made on a weekly basis. The model also incorporates minimal technical assistance to the borrowers such as training and organization/group building. Loan applications are simple and are reviewed quickly. Savings are usually required but often deducted from the loan amount at the time of disbursement rather than requiring the clients to save prior to receiving a loan. Savings serve primarily as a compensating balance, guaranteeing a portion of the loan amount. Loan approval is often by credit officers based on minimal economic analysis of each loan request. Loan disbursement to individual members is by group leaders. In addition, members normally receive equal loan amounts with some flexibility provided for subsequent loans. Interest rates are often high and service fees are also charged (Haron, 2007).

Group of Groups methodology is based on the premise that the poor (the target) requires small quantities of financial services and they lack collaterals of signatories-hence, the necessity of groups. Also the approach reaches and empowers many clients by totally involving them even at the management of these financial services and it attains financial self-sufficiency by cutting down loan processing costs and minimizes loan losses (Auronen, 2003).

Statement of the Problem

The MFI sector operates in a dynamic competitive environment and as such institutions continually reinvent themselves for survival. This means that for them to survive they must come up with ideas that have a competitive advantage against their main competitors. The main competitors of MFIs in Kenya are commercial banks. The competition has become rather fierce in the last 5 years with commercial banks targeting the hitherto unbanked population that had been the preserve of the MFIs.

The major risk exposure in MFI is the risk of loss of income from loans due to processing errors, inadequate information, non-compliance with loan policies and excessive concentration of credit risks, counterfeit collateral and employee fraud. One of the biggest control issues comes from the fact that the loan tracking system operates separately from the accounting system. For each loan that an MFI makes, it exposes itself to credit risk with the client's inability to repay the loan. This risk increases when employees collect inadequate information on the clients or when loan decisions do not comply with the stated policy. Common errors by employees include transposed numbers e.g. changing Kshs 39 into Kshs 93, miscalculations e.g. Incorrect calculations of interest for loan payments, poor business analysis by loan officer e.g. overestimation of growth to result from loan.

Zeller and Mayer (2005), in their study of Microfinance objectives indicated that there is what is called "Critical Micro-finance Triangle" that we need to look at to evaluate Micro-finance institutions based on their objective. The three corners of the triangle represent outreach to the poor, financial sustainability and welfare impact. And Performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance. The inner circle in the triangle represents

MFI innovations in technology, policies, organization, and management that affect how well each objective is met

Kealhofer (2007) did a research study on risk-adjusted performance measures in commercial banks. The measures, however, focus on risk-return trade-off, i.e. measuring the risk inherent in each activity and charge it accordingly for the capital required to support it. Kabiru (2009), studied sound credit granting process; maintaining an appropriate credit administration that involves monitoring process as well as adequate controls over credit risk. Clear established process for approving new credits and extending the existing credits has been observed to be very important while managing credit risk.

The above studies have focused mainly on objectives and roles of Microfinance . There is no known study that has been done on profitability of microfinance institutions in Kenya. This study aims at establishing factors affecting profitability in microfinance institutions.

This research study is motivated to bridge the gap by investigating strategic credit policies and debt collection for risk profitability in microfinance institutions. It shall aim at finding out whether the lending practices that the MFIs have adopted are good enough such that bad debts are avoided and also the loan tracking is done efficiently to enhance profitability.

Objectives of the Study

The study was guided by the following objectives:

- To analyze the extent to which debt collection process affects profitability in MFIs
- To establish the effect of central bank regulations on profitability in MFIs.
- To find out the effect of credit vetting on profitability in MFIs.

LITERATURE REVIEW

Debt Collection Procedure

An effective debt collection strategy starts with a clearly thought out credit policy and credit management tools to enforce this policy. Success comes from the overall performance of the whole credit value chain. The collection function within financial organizations can make the difference between a good performance for the business and an excellent performance. By making use of opportunities to make the collection processes strategically effective, operationally efficient and customer orientated, an organization can expect the collection function to add significant value to the business (Benveniste, 2002).The debt collection process can be defined as a legitimate and necessary business activity where creditors and collectors are able to take reasonable steps to secure payment from consumers who are legally bound to pay or to repay money they owe (Kitua,2002).Once a loan or credit agreement has been granted and paid out to a consumer, the next phase of the credit provider's tasks will start. The credit agreement has to be actively managed over its life cycle as payment dates on which the consumer should pay fall due. As a result of various reasons, the payment of agreements does not always occur as anticipated, and some of the payments may become overdue (Benveniste, 2002).

According to Janson (2002), the services offered by investment banks play an important role in the development of Kenya's economy and general infrastructure. This development has been achieved through lending to prospective customers in private investments, as well as those in the corporate sector. However, funds acquired from customer deposits – the main source of lending funds – have long since become a commodity, bought and sold for the highest possible profit by financial institutions. These institutions review their loan agreements in a manner which has worried investors, which sometimes have no option but to raise capital by borrowing from banks in the form of mortgages. Small-scale borrowers usually repay the loans with income from employment and the net effect to the lenders is an increase in profit margins. However, recently many borrowers have defaulted by failing to meet the contractual obligations set out in the loan agreements – many of which include clauses allowing the banks to adjust interest rates with or without notice to the borrower. Risk management is a practice by which a firm optimizes the manner in which it takes financial risk. It includes monitoring of risk taking activities, upholding relevant policies and procedures, and distributing risk-related reports. For the Bank, transactions involving credit risk are a key source of earnings, in line with its business strategy. In addition to assessments of individual credit risk assets, including loans, the Bank conducts comprehensive risk management from the perspective of its overall credit risk portfolio. In this way, the Bank seeks to generate earnings commensurate with its level of credit risk. Also, as a financial institution whose base consists of agricultural, forestry and fishery cooperatives, the Bank aims to promote these industries through cooperative lending while carrying out due risk management as a private financial institution (Bryant, 2002).Overdue payments will have a negative impact on the credit provider's financial performance since cash flow targets cannot be met and collection cost increases. Risk is also indicated by overdue payments, taking into account that overdue payments may become payments that cannot be collected and inevitably resulting in losses and bad debt. As a result of all of these negative consequences, the collection of overdue accounts is extremely important to any credit provider (Harvey, 2005).

Central Bank Regulations

The services offered by investment banks play an important role in the development of Kenya's economy and general infrastructure. This development has been achieved through lending to prospective customers in private investments, as well as those in the corporate sector. However, funds acquired from customer deposits – the main source of lending funds – have long since become a commodity, bought and sold for the highest possible profit by financial institutions. These institutions review their loan agreements in a manner which has worried investors, which sometimes have no option but to raise capital by borrowing from banks in the form of mortgages. Small-scale borrowers usually repay the loans with income from employment and the net effect to the lenders is an increase in profit margins. However, recently many borrowers have defaulted by failing to meet the contractual obligations set out in the loan agreements – many of which include clauses allowing the banks to adjust interest rates with or without notice to the borrower (Jonathan,2005).

According to Charitoneko (1998), current job market is quite uncertain and inflation rates continue to rise. However, lenders have been unwilling to understand the reasons why borrowers are defaulting on their mortgages, choosing instead to raise interest rates in order to keep pace with rising inflation. This behaviour is contrary to the 'duplum rule' which states that interest on debt stops running when unpaid interest equals the outstanding capital. Credit institutions have always assumed that individuals who have good credit scores on assessment and reliable jobs are capable of paying back their mortgages. The default factor has been a great problem to both lenders and borrowers, in that the majority of the loans advanced have ultimately performed to the detriment of the lenders in terms of profitability. Borrowers, on the other hand, have lost their securities as the lending institutions exercise their statutory powers of sale on charged properties because the borrowers' investments failed to generate a return sufficient to service these loans and accrued interest.

The Ministry of Finance has enacted regulations intended to give greater protection to the lending institutions. The Banking (Credit Reference Bureau) Regulations 2008 set out a framework for the establishment and operation of credit reference bureau in order to facilitate credit information sharing among all credit providers licensed under the Banking Act. The regulations were expected to enhance the credit risk appraisal process by providing banks with improved access to information on prospective borrowers. Despite these efforts towards the enactment of various protective measures, lending by most investment banks has slowed, while others have heightened their provisions on bad and suspect debts in order to tackle cases of default brought about by the upward adjustments in interest rates on borrowed funds. As a result of the increases in interest rates, prospective investors have generally reduced their investments. Small-scale borrowers have opted to shun bank loans altogether for fear of default and the ensuing consequences. It is clear that there is a need to review the existing legislation and lending policies in a manner that restores confidence among borrowers. Certain changes are to be recommended (Rosenberg, 2004)

The supervisory role that was allocated to the Banking Supervision Department of the Central Bank of Kenya under Kenyan legislation includes the vetting and licensing of all institutions in addition to issuance of guidelines. Currently the department's hands are tied as a result of the powers conferred upon the minister of finance by Legal Notice 34/06. The notice gives the minister the power, through the governor of the Central Bank, to approve applications from banks to adjust interest rates. These approval powers must be transferred to the Central Bank's Banking and Supervision Department in recognition of its supervisory jurisdiction over all commercial banks (Microsave,2000). The 'duplum rule', which restricts banks from loading interest onto debts where a customer is unlikely to pay, has greatly worked to the disadvantage of lending institutions. A review of those clauses which empower the lender to adjust interest rates with or without notice to the borrower is necessary to allow banks to include clauses in loan agreements which leave room for the downward adjustment of interest rates when the economy improves, in order to protect the interests of borrowers (Microsave,2000).

According to Klaehn (2002) Section 44 of the Banking Act (Cap 488) must be amended for purposes of empowering the Supervisory Department in the Central Bank. This section states that: "No institution shall increase its rates of banking or other changes except with the approval of the minister". Such increases should be approved by the Central Bank, rather than the minister of finance, who may be directly affected by any adjustment in bank rates as an investor, shareholder or individual. Court decisions have also confirmed that the courts will not interfere with contractually agreed rates of interest between lenders and borrowers. This was so in High Court case of Desai vs. Fina Bank Ltd (2004), where the issue before the court was whether bank rates ought to comply with the Banking Act. It is recommended that any attempt to adjust interest rates on borrowed funds be subject to the borrower's approval. The existing regulations are unhelpful to lending institutions, since they have always assumed that lending is the basis for growth and profitability. The blame for the current situation lies neither with borrowers nor with lending institutions, but rather with Parliament – the body concerned with the enactment of legislation in Kenya. It is now up to Parliament to review the existing lending policy and accordingly close the gaps in the Banking Act. (Klaehn, 2002).

Credit Vetting

Banks need to monitor carefully the risk-return profile of their lending portfolio to meet capital adequacy guidelines and to ensure long-term survival. The objective of the bank is to maximize profits thus maximize the shareholders wealth. If the primary objective of all bank lending is to make trouble-free advances, the financial capacity and previous borrowing experience of a loan applicant and their determination to repay their debts is all-important (Greuning, 2003)

Greuning (2003) defines credit risk as the chance that a debtor or a financial instrument issuer will not be able to pay interest or repay the principal according to the terms specified in a credit agreement. It means that payments may be delayed or ultimately not paid at all, which may cause cash flow problems and affects banks liquidity. Credit risk is the most important area in risk management. More than 80% of all banks balance sheet relate to credit (Kabiru 2003). All over the world exposure to credit risk has led to many banks failure.

According to Basel (2004) credit risk exposure particularly to real estate led to widespread banking problems in Switzerland, Spain, The United Kingdom, Sweden, Japan and others. Here in Kenya Obiero (2002) found out that credit risk was only second to poor management in contributing to bank failures. On perception, Idarus (2005) found out that credit risk was the most important area of risk management in Kenya.

Report of Securities and Exchange Board of India (SEBI) committee on Corporate Governance defines corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company." The definition is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution. Corporate Governance is viewed as business ethics and a moral duty. Corporate Social Entrepreneurship regarding employees who are driven by their sense of integrity (moral conscience) and duty to society is also viewed as corporate governance. This notion stems from traditional philosophical ideas of virtue (or self governance) and represents a "bottom-up" approach to corporate governance (agency) which supports the more obvious "top-down" (systems and processes, i.e. structural) perspective.(Ledger wood and Victoria,2006)

Managers' accountability to shareholders and corporations' responsibility to society are two important objectives of corporate governance. Some scholars argue that managers who are accountable to shareholders must neglect society's interest. But loosening this accountability leaves managers free to serve themselves, thereby increasing agency costs. This makes three main contributions to the debate on the appropriate roles of accountability and responsibility. First, it shows how modern markets cause managers who are accountable to shareholders also to attend to society's interests. Second, it shows that the debate is actually less important than it might first appear because the logistics of publicly held corporations substantially free managers from accountability to shareholders irrespective of whether society's needs should compel that freedom. Third, it shows that the debate may be joined over whether partnership-type devices compelling distributions and allowing owner cash-out should be imported into publicly held firms. These devices would provide for more managerial accountability to shareholders, and therefore less flexibility to serve society's interests, than standard corporate governance mechanisms. The main impediment to use of these devices is the double corporate tax, which provides tax benefits for earnings retention and thereby encourages managerial control over corporate earnings. The future of the corporate tax may depend at least on the part of the debate over accountability and responsibility in corporate governance. (Helms, 2006)

Management is the process of planning, organizing, leading and controlling the use of resources to accomplish performance goals. According to Schermerhons (2002), Management is concerned with the accomplishment of organization objectives through the efforts of other people. Objectives or goals are the final results expected. The objective of most business firms is to make profit by providing goods and /or services to customers. In order to achieve this, the management must consider the following; determine what is to be achieved (planning), allocate resources and establish the means to accomplish the plans (organizing), motivate and lead personnel (influencing or directing) and compare the results achieved to the planned goals (controlling).

Planning involves setting performance objectives and determining what actions should be taken to accomplish them. Desired work results are identified and means of achieving them are also identified. Organizing involves assigning tasks, allocating resources and arranging activities to implement plans. Leading is the process of arousing enthusiasm and directing efforts towards organizational goals. Leading is a way of building commitment to a common vision and encouraging activities that support goals. Controlling is the process of measuring performance and taking action to ensure desired results. Through controlling, managers maintain active contact with people in the course of their work, gather and interpret reports on performance and use this information to plan constructive actions and change. (Schermerhons, 2002)

Policies according to Harvey (1988) are rules or guidelines that express the limits within which action should occur. This will often take the form of contingent decisions for solving conflicts among specific objectives. They are broad guidelines for making decisions. A sound business policy is of great value in harmonious functioning of an organization.

Conceptual Framework

Conceptualization therefore is the idea of inventing or contriving a notion or explanation and formulating it mentally. The figure 1 illustrates a conceptual framework for this study which formed the basis for the literature review.

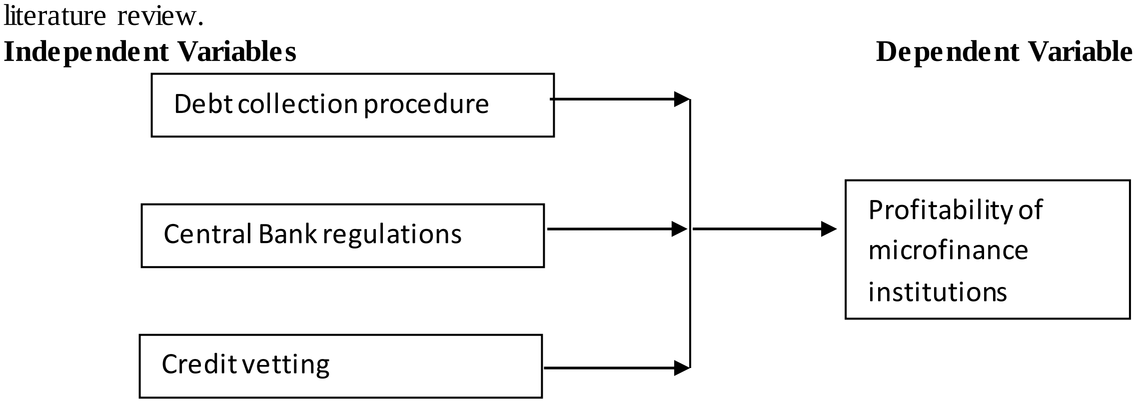

Fig. 1: Conceptual framework

RESEARCH METHODOLOGY

Descriptive research design was the best because it is a design that is concerned with answering the questions who, what, which, when, or how much (Cooper and Scheduler, 2001). A descriptive study is appropriate if description is informative. Secondly descriptions are the starting point for identifying variables and building hypothetical constructs that can be tested using other methods. Thirdly, description is the only way to study a behavior or situation, because it is either physically or ethically impossible to produce it in an experiment (Mugenda, 1999). Descriptive design is able to give a detailed description of how one variable explains another or one variable is explained by another variable.

There are over 500 registered microfinance institutions in Kenya. However this study was limited to Nairobi CBD with specific focus on the most popular and fast growing microfinance institutions. In this study, the population consisted of three selected microfinance institutions in Nairobi CBD.These included Faulu Kenya, Micro Kenya and Kenya Women Finance Trust with a total population of 188. Stratified sampling method was then used to sample out 94 respondents which constitute 50% of the population

The researcher used questionnaires to collect data from the general managers of each company. The reason why this tool was selected was because questionnaires are easy to distribute, it confined the respondent to only areas the researcher needed and data collected can easily be analyzed both quantitatively and qualitatively. This being an academic research and with limited resources and time, this was the most appropriate instrument to use. The researcher used the letter of introduction from KCA University to reserve appointments with respondents.

Data Analysis Technique

The data received from the duly completed questionnaires was edited, coded, described, tabulated and interpreted in relation to the research objectives. The analysis of quantitative data was carried out using descriptive statistics. The purpose of descriptive statistics is to enable the researcher to meaningfully describe a distribution of scores or measurement using a few indices or statistics. Excel computer package was also applied in this study .Qualitative data was analyzed textually since the response received from the respondents was diverging.

RESULTS AND DISCUSSION

The findings from the study showed that respondents (74%) indicated that the debt collection process in the micro finance sector affects credit risk management and consequently profitability. Respondents indicated that their microfinance institutions made use of credit management principles. They gave examples as substantial security criteria, context of taking the loan, credit history and general character of the loanees. They also explained that when loans are issued documentation on the mode of payments, amount of installments and number of installments is done. The rate of interest is also indicated and the security property stands in incase of default

Respondents (70%) indicated that legal policies had effect on profitability of MFIs. First, the requisites of the normal contract such as contractual capacity, offer, and acceptance, evidence must exist in the contract between the loaner and the loaned. The other principles of lending such as payment mode and interest rates then follow. The loan officer must assemble and evaluate information and then determine what the entire picture looks like. Legal policies are aimed to create legal relationship and thus ability to take the necessary measures in case one of the parties to the contract defaults. Organizational lending policies should be in line with the existing legal policies.

Respondents (69%) indicated that credit rating affects lending. Corporate skills of the loanee determines whether the individual can obtain a loan or not. It thus calls for good management history to obtain loans from financial institutions. Corporate governance refers to the skills and abilities of the person obtaining the loan. It is important for the person to have a good loan history and be of sound character. Respondents pointed out that they had experienced cases where the loaned defaulted their loans with many giving the reason of financial constraints. Mechanisms such as substantial security and client vetting can minimize loan defaulting.

CONCLUSION

On the basis of the findings, respondents indicated that their micro finance institutions made use of credit management principles. They gave examples as substantial security criteria, context of taking the loan, credit history and general character of the loanee. Also central bank policies have effect on profitability of MFIs. First, the requisites of the normal contract such as contractual capacity, offer, acceptance, and evidence must exist in the contract between the loaner and the loaned. The central bank is also extensively involved in formulation of micro and macroeconomic financial policies such as determination of interest rates and authorization of lending. Again the researcher was convinced that credit vetting affects MFI profitability .The credibility of the loanee determines whether the individual can obtain a loan or not. It thus calls for good management history to obtain loans from financial institutions. The researcher then came up with the four Cs" of lending which include Credit, Capacity, Collateral, and Character which should form part of the microfinance institutions lending policies and that legal policies are aimed to create legal relationship and thus ability to take the necessary measur1es in case one of the parties to the contract defaults.

RECOMMENDATIONS

Micro finance institutions should have a set of regulations regarding obtaining and analyzing the facts of a loan request and making judgments about that information, the feasibility of the business, and the credibility of the borrower. Lenders should focus on the key business issues quickly, determine what information is needed, and then make prompt decisions based on that information.

In the modern business environment, technology is indispensable. Microfinance institutions should therefore embrace the technologies that support financial transactions. Electronic commerce applications such as mobile banking, online loan processing among others should be incorporated to improve the services, speed, and convenience.

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