Effectiveness of Credit Management System on Loan Performance: Empirical Evidence from Micro Finance Sector in Kenya

Haron O. Moti
Public Procurement Oversight Authority
P.O Box 58535-00200 Nairobi, Kenya

Justo Simiyu Masinde
Lecturer in Finance
Chuka University College
Kenya

Nebat Galo Mugenda
Lecturer in Finance
Chuka University College
Kenya

Mary Nelima Sindani
PhD Student
Jomo Kenyatta University of Agriculture and Technology
Kenya

Abstract

Microfinance institutions in Kenya experience high levels of non-performing loans. This trend threatens viability and sustainability of MFIs and hinders the achievement of their goals. This study was aimed at assessing the effectiveness of credit management systems on loan performance of microfinance institutions. Specifically we sought to establish the effect of credit terms, client appraisal, credit risk control measures and credit collection policies on loan performance. We adopted a descriptive research design. The respondents were the credit officers of the MFIs in Meru town. Collection policy was found to have a higher effect on loan repayment with x^2*=12.74, P=0.000 at 5% significance level. Further research is recommended on the effectiveness of credit referencing on loan performance of MFIs. This study is informative in terms of public policy adjustments and firm level competences required for better operation of MFIs and it also contributes to credit management literature.*

Key Words: *Credit management system, Loan Performance, Loan Performance, Index Microfinance*

1. Introduction

1.1 Background of the study

The concept of credit can be traced back in history and it was not appreciated until and after the Second World War when it was largely appreciated in Europe and later to Africa (Kiiru, 2004). Banks in USA gave credit to customers with high interest rates which sometimes discouraged borrowers hence the concept of credit didn't become popular until the economic boom in USA in 1885 when the banks had excess liquidity and wanted to lend the excess cash (Ditcher, 2003). In Africa the concept of credit was largely appreciated in the 50's when most banks started opening the credit sections and departments to give loans to white settlers. In Kenya credit was initially given to the rich people and big companies and was not popular to the poor.

In 1990s loans given to customers did not perform which called for an intervention. Most suggestions were for the evaluation of customer's ability to repay the loan, but this didn't work as loan defaults continued (Modurch, 1999). The concept of credit management became widely appreciated by Microfinance Institutions (MFI's) in the late 90s, but again this did not stop loan defaults to this date (Modurch, 1999).

A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected.

It may be difficult to establish an optimal credit policy as the best combination of the variables of credit policy is quite difficult to obtain. A firm will change one or two variables at a time and observe the effect. It should be noted that the firm's credit policy is greatly influenced by economic conditions (Pandey, 2008). As economic conditions change, the credit policy of the firm may also change.

Microfinance Institutions and other finance institutions must develop a credit policy to govern their credit management operations (Pandey, 2008) and since microfinance institutions generate their revenue from credit extended to low income individuals in the form of interest charged on the funds granted (Central Bank Annual Report, 2010) the loan repayments may be uncertain. The success of lending out credit depends on the methodology applied to evaluate and to award the credit (Ditcher, 2003) and therefore the credit decision should be based on a thorough evaluation of the risk conditions of the lending and the characteristics of the borrower.

Numerous approaches have been developed in client appraisal process by financial institutions. They range from relatively simple methods, such as the use of subjective or informal approaches, to fairly complex ones, such as the use of computerized simulation models (Horne, 2007). Many lending decisions by Microfinance institutions are frequently based on their subjective feelings about the risk in relation to expected repayment by the borrower. Microfinance institutions commonly use this approach because it is both simple and inexpensive.

While each company would have its own method of determining risk and quality of its clients, depending on the target group, the following client evaluation concepts are useful for most occasions. These concepts are referred to as the 5C's of credit appraisal (Edward, 1997). These elements are Character, Capacity, Collateral, Capital and Condition (Edward, 1997).

1.2 Statement of the Problem

The success of MFIs largely depend on the effectiveness of their credit management systems because these institutions generate most of their income from interest earned on loans extended to small and medium entrepreneurs. The Central Bank Annual Supervision Report, 2010 indicated high incidence of credit risk reflected in the rising levels of non- performing loans by the MFI's in the last 10 years, a situation that has adversely impacted on their profitability. This trend not only threatens the viability and sustainability of the MFI's but also hinders the achievement of the goals for which they were intended which are to provide credit to the rural unbanked population and bridge the financing gap in the mainstream financial sector. A Study on microfinance credit recovery systems is a topic of considerable interest by many researchers. However, most studies undertaken in the past few years have focused mainly on credit models used by MFI's and their impact on profitability (Migiri, 2002). Absence of empirical studies on credit recovery systems and recognition of the critical role that MFI's play in the economy are the principal motivation behind this study which sought to find out the effectiveness of credit management systems on loan performance among microfinance institutions.

1.3 Objectives

The overall objective of the study was to assess the effectiveness of credit management systems on loan performance in microfinance institutions.

1.3.1 Specific Objectives

i. To establish the effect of credit terms of microfinance institutions on their loan performance.
ii. To determine the effect of client appraisal on loan performance of microfinance institutions.
iii. To evaluate the effect of credit risk controls measures adopted by microfinance institutions on their loan performance.
iv. To evaluate the effect of credit collection policies on loan performance of microfinance institutions.

1.3.2 Hypotheses

The following hypotheses were developed for empirical testing:

H_{01}: There is no significant relationship between credit terms and loan performance of microfinance institutions.
H_{02}: There is no significant relationship between client appraisal and loan performance of microfinance institutions.
H_{03}: There is no significant relationship between the credit risk control and loan performance of microfinance institutions.
H_{04}: There is no significant relationship between credit collection policies and loan performance of microfinance institutions.

2. *Review of Literature*

2.1 The 5 C's Model of Client Appraisal

Microfinance Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower (Abedi, 2000). The 5Cs help MFIs to increase loan performance, as they get to know their customers better. These 5Cs are: character, capacity, collateral, capital and condition.

Character basically is a tool that provides weighting values for various characteristics of a credit applicant and the total weighted score of the applicant is used to estimate his credit worthiness (Myers and Forgy, 2005). This is the personal impression the client makes on the potential lender.

The factors that influence a client can be categorized into personal, cultural, social and economic factors (Ouma, 1996). The psychological factor is based on a man's inner worth rather than on his tangible evidences of accomplishment. MFI's consider this factor by observing and learning about the individual. In most cases it is not considered on first application of credit by an applicant but from the second time. Under social factors, lifestyle is the way a person lives. This includes patterns of social relations (membership groups), consumption and entertainment. A lifestyle typically also reflects an individual's attitudes, values or worldview. Reference groups in most cases have indirect influence on a person's credibility. MFI's try to identify the reference groups of their target as they influence a client's credibility. Personal factors include age, life cycle stage, occupation, income or economic situation, personality and self concept. Under life cycle stage for example older families with mature children are not likely to default since it's easier to attach collateral on their assets since they are settled unlike the unsettled young couples.

The MFI's will consider the cash flow from the business, the timing of the repayment, and the successful repayment of the loan. Anthony (2006) defines cash flow as the cash a borrower has to pay his debt. Cash flow helps the MFI's to determine if the borrower has the ability to repay the debt. The analysis of cash flow can be very technical. It may include more than simply comparing income and expenses. MFI's determines cash flow by examining existing cash flow statements (if available) and reasonable projections for the future (ratios

Orlando (1990) posits that lenders review the borrower's business plan and financial statements, they have a checklist of items to look at one of the being the number of financial ratios that the financial statements reveal. These ratios are guidelines to assist lenders determine whether the borrower will be able to service current expenses plus pay for the additional expense of a new loan. Collateral is any asset that customers have to pledge against debt (Lawrence & Charles, 1995). Collateral represents assets that the company pledges as alternative repayment source of loan. Most collateral is in form of hard assets such as real estate and office or manufacturing equipment. Alternatively accounts receivable and inventory can be pledged as collateral. Lenders of short term funds prefer collateral that has duration closely matched to the short term loan

According to Weston and Eugene (1966), Capital is measured by the general financial position of the borrower as indicated by a financial ratio analysis, with special emphasis on tangible net worth of the borrower's business. Thus, capital is the money a borrower has personally invested in the business and is an indication of how much the borrower has at risk should the business fail. Condition refers to the borrower's sensitivity to external forces such as interest rates, inflation rates, business cycles as well as competitive pressures. The conditions focus on the borrower's vulnerability.

2.2 Credit Terms

This refers to the conditions under which an MFI advances credit to its customers. The credit terms will specify the credit period and interest rates. Credit period refers to the period of time in which the credit is granted. The length of the credit period is influenced by Collateral value, Credit risk, the size of the account and market competition (Ross, Westerfield & Jordan, 2008). Debt in a particular class will have its own interest rate in accordance with the theory of term structure. The interest rates charged is a cost on borrowed funds and may affect the loan performance.

2.3 Credit Risk Control

Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Another term for credit risk is default risk. Investor losses include lost principal and interest, decreased cash flow, and increased collection costs. Credit risk can be mitigated using risk based pricing, covenants, credit insurance, tightening and diversification (Ross et al, 2008).

2.4 Collection Policy

There are various policies that an organization should put in place to ensure that credit management is done effectively, one of these policies is a collection policy which is needed because all customers do not pay the firms bills in time. Some customers are slow payers while some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses (Kariuki, 2010).

2.5 Economic Cycles

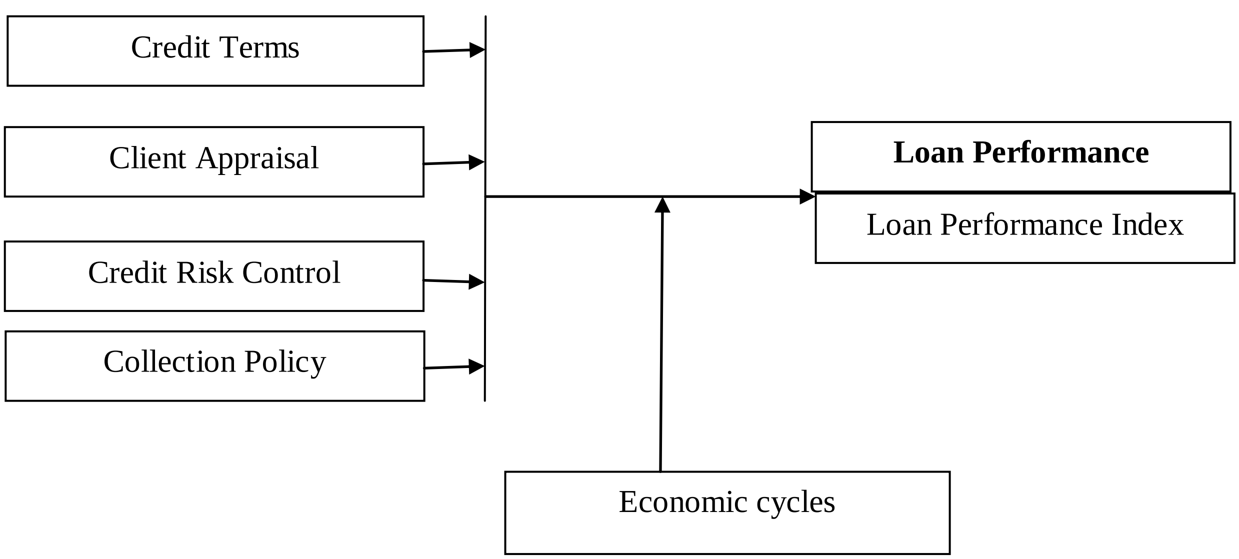
The term economic cycle (or business cycle) refers to economy-wide fluctuations in production or economic activity over several months or years. These fluctuations, according to Pandey (2008) occur around a long-term growth trend, and typically involve shifts over time between periods of relatively rapid economic growth (an expansion or boom) and periods of relative stagnation or decline (a contraction or recession)**.** The economic cycles also play an important role on MFI's choice of issuing or not issuing loans.

2.6 Theoretical Framework

The conceptual base for this study was drawn from the theory of self-efficacy postulated by Bandura (1995). It "refers to beliefs in one's capabilities to organize and execute the courses of action required to manage prospective situations". Self-efficacy affects people's thoughts, feelings, actions, motivations, efforts, and determinations to confront the obstacles faced in life. High self-efficacy means that people are more likely to participate in activities in which they believe they can succeed. It promotes the premise that individuals have the potential to mitigate and improve their situations. Finally, the theory identifies factors that affect the success or failure of individuals, including their collective or group actions.

2.7 Conceptual Framework

Figure1. **Relationship between Credit Management Systems and Loan Performance**



2.7.1 Variables Interconnectivity

Credit Terms refers to the conditions under which a microfinance institution extends credit to its customers. If a microfinance institution extends credit to a customer, then the credit terms will specify the credit period and interest rates, this therefore will have an effect on the performance of loans since it stipulates the time of loan repayments hence creating a timely repayment and decrease in default rate. Client appraisal helps MFIs to improve loan performance, as they get to know their customers. These 5Cs considered in client appraisal are character, capacity, collateral, capital and condition. Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default, credit risk controls has an effect on timely repayments and decrease in default rate. They are risk based pricing, covenants, credit insurance, tightening, and diversification. Collection policy is needed because all customers do not pay the firms bills in time some customers are slow payers which some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses, the policy affects timely repayments and decrease in default rate.

3. Research Methodology

We adopted a descriptive survey design. This design investigates the current status and nature of the phenomena. Orodho (2003) defines descriptive survey as a method of collecting information by interviewing or administering a questionnaire to a sample of individuals.

The study location for this research was Meru Town, in Meru County of Eastern Province, Kenya. The target population was 70 credit officers of the 14 microfinance institutions registered and operating in Meru town.

Table 1: Target Population

Micro Finance Institution	CREDIT OFFICERS
Faulu Kenya	8
BIMAS	7
Eclof	4
Jamii bora	5
KWFT	8
KIE	3
Tusaidiane Kenya	4
SMEP	3
K – REP	4
SISDO	4
Jitegemee Trust	4
Kenya Post office Savings Bank.	5
Equity Bank	8
Mwananchi Credit	3
TOTAL	**70**

(Source: *Association of Microfinance Institutions 2010 – Kenya*)

A census survey of all the 70 credit officers in 14 microfinance institutions in Meru town was conducted. This study made use of a questionnaire as the research instrument for data collection. Before the actual data collection, pilot testing of the questionnaire was done. Galloway (1997) suggests that a population of 5-10% of the final sample is a considerably appropriate in any pilot study.

Table 2: ***Data Analysis Matrix***

Hypothesis	Independent	Dependent	Statistics
H01: There is no significant relationship between credit terms and loan performance in microfinance institutions.	Credit Terms	Loan Performance	Frequencies Percentages Chi – Square
H02: There is no significant relationship between client appraisal and loan performance in microfinance institutions.	Client Appraisal	Loan Performance	Frequencies Percentages Chi – Square
H03: There is no significant relationship between credit risk control and loan performance in microfinance institutions.	Credit Risk Control	Loan performance	Frequencies Percentages Chi – Square
H04: There is no significant relationship between the collection policies and loan performance in microfinance institutions.	Collection Policy	Loan performance	Frequencies Percentages Chi – Square

4. Results and Discussions

The study sought to establish whether there exist a relationship between loan performance and involvement of top management in formulating credit terms. From the computed chi- square value (0.837) at 2 degrees of freedom found no significant relationship since the computed p- value (0.356)) was greater than 0.05 at 95% confidence level. This therefore means that top management involvement in formulating credit terms does not affect loan performance. The non performance of the loans can be attributed to the fact that management are busy in day to day operation of MFI's and therefore do not understand the best credit terms in the ever changing microfinance environment.

A high involvement of credit officers in formulating credit terms was found to have a significant relationship with loan performance. This is supported by the computed chi- square value (10.130) at 1 degree of freedom and the computed p- value (0.0001)) which was less than 0.05 at 95% confidence level. Burt (2004) agrees with the findings of this study which are that credit officers' involvements in formulation of credit terms do affect the performance of loans. This can be attributed to the fact that credit officers are professionals who are in touch with customers and understand their needs.

From the computed chi- square value (33.959) at 3 degree of freedom, we found a significant relationship between involvement of customers and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. The findings of this study are consistent with Ross et al (2008). This can be attributed due to the fact that customers are key stakeholders in loan contracts and as such their involvement would greatly impact on performance.

An analysis of the relationship between debt portfolios of different maturities against loan performance was tested for significance. From the computed chi- square value (5.718) at 3 degree of freedom, we found a significant relationship between maximum loan duration in months and loan performance since the computed p- value (0.126) is more than 0.05 at 95% confidence level. According to Lidgerwood (1999), loan duration is an important aspect of loan management; this therefore contradicts the findings of this study which are that loan duration does not affect the performance of the loan. The results can be attributed to the changing inflation rates and performance of the economy which can never be predicated accurately.

The analysis on the relationship between interest charged and loan performance revealed an inversely proportional relationship. From the computed chi-square value (29.663) at 7 degree of freedom, there is a significant relationship between interest charged and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. The results of this study are in agreement with the finding of Fernando (2006). Therefore interest rate affects the performance of loans in microfinance institutions and the relationship is inversely proportional.

To determine whether the character of the borrower has an effect on loan performance, we analyzed the responses on a five point scale of importance. From the computed chi-square (x^2 =13.689) at 3 degree of freedom, there is a significant relationship between character of the client and loan performance since the computed p- value (0.003) is less than 0.05 at 95% confidence level. According to Myers and Forgy (2005), character of the client is important in client appraisal, this therefore makes the findings of the study to concur that character has a significant relationship with loan performance. This can be attributed to the fact that the success of any individual greatly depends on the character.

In line with the findings of Anthony (2006), this study found significant relationship between capacity of the client to repay and loan performance as supported by the computed chi-square value (x^2 =10.868) at 3 degree of freedom. The computed p- value for this variable was 0.012 less than 0.05 at 95% confidence level. This therefore means that capacity to repay is critical in client appraisal and microfinance institutions should consider the capability of the customers they are awarding loans to repay.

From the computed chi-square value (3.373) at 2 degrees of freedom, the study did not find a significant relationship between loan conditions and loan performance since the computed p- value (0.185) is more than 0.05 at 95% confidence level. This therefore means that conditions of loans do not influence the performance of loans in microfinance institutions in Meru town which does not agree with the findings of Abedi (2000) who found loan conditions to be important in client appraisal.

Consistent with the findings of Gitman (1991) we found a significant relationship between collateral attached as security and loan performance since the computed p- value (0.000) was less than 0.05 at 95% confidence level and the computed chi-square value was (21.888) at 3 degree of freedom. Microfinance institutions therefore should evaluate the collateral used as security when appraising the clients, this is because incase of any default the MFI’s will recover the collateral in order service the loan. The study further tested whether there was any significant relationship between capital invested in the business and loan performance. From the computed chi-square value (3.893) at 2 degrees of freedom, we did not find a significant relationship between capital invested in the business and loan performance since the computed p- value (0.143) was more than 0.05 at 95% confidence level. This finding is however contrary to the findings of Westorn (1966).

The computed chi-square value (29.872) at 2 degrees of freedom indicated a significant relationship between history of repayment of the customer and loan performance since the computed p- value (0.000) was less than 0.05 at 95% confidence level. The findings of the study are consistent with those of Anthony (2006). This suggests the need for Credit officers to consider the history of repayment of the customer when appraising a client.

A five point scale of importance was used to test for existence of a relationship between cashflow statements of the business and loan performance index. From the computed chi-square value (0.746) at 3 degree of freedom, the study failed to find a significant relationship between cashflow statements of the business and loan performance since the computed p- value (0.862) is more than 0.05 at 95% confidence level. contrary to our findings, Abedi (2000) recommends that cashflow statements be evaluated when appraising clients. The variance in the findings could be as a result of the business strategies on investing, financing and operating activities.

We further tested whether there was any significant relationship between size of business and loan performance. From the computed chi-square value (33.959) at 2 degree of freedom, there is a significant relationship between size of business and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. Macharia (2000) similarly found out that the size of the business of the client is an important factor that should be when appraising clients. This is therefore to suggest that size of the business should be an important consideration in client appraisal.

The importance of signing of covenants was compared with the loan performance index on a five point scale of impotance. The study found a significant relationship between signing of covenants and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. In a similar study, Ross et al (2008) recommended signing of covenants as a useful strategy for reducing default risk.

We tested for a relationship between diversification and loan performance. From the computed chi-square value (31.837) at 3 degree of freedom, we found this relationship to be significant at computed p- value (0.000) less than 0.05 at 95% confidence level. Diversification of loan portfolio by microfinance institutions would help to mitigate the risk attributed to the loans.

The study further tested whether there was any significant relationship between credit rating and loan performance. From the computed chi-square value (33.959) at 2 degree of freedom, there is a significant relationship between credit rating and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. The study found out that credit rating affect loan performance which made the findings to be consistent with those of Butterworths (1990). Therefore microfinance institutions should rate the credit in order for their loans to perform.

The importance of reports on financial condition was compared with the loan performance index. From the computed chi-square value (31.837) at 3 degree of freedom, there is a significant relationship between reports on financial condition and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. Therefore reports on financial condition of the business do affect loan performance and microfinance institutions should ask clients to supply them with reports on the financial performance of the businesses.

The study established that 100.0% of the institutions had arrear monitoring systems in place. Arrear monitoring systems are an effective aspect of loan collection policies. The study also revealed that when stringent policy is adopted, the loan proportion below the LPI was 58.1% and that above the LPI was 41.9%, this therefore implies that stringent policy has an impact on loan performance. When lenient policy is adopted, the loan performance below the LPI was 100 % and that above the LPI value was 0 %. This implies that loan do not perform when lenient policy of collections is adopted.

The study tested whether there was any significant relationship between collection policy adopted and loan performance. From the computed chi-square value (12.736) at 1 degree of freedom, there is a significant relationship between collection policy adopted and loan performance since the computed p- value (0.000) is less than 0.05 at 95% confidence level. This therefore implies collection policy adopted do influence loan performance, with stringent policy being the best policy for adoption since the percentage of performance obtained when its adopted is relatively high compared to that of lenient policy, this therefore makes the findings of the study to be consistent with those of Pandey (2004).

5. Recommendations, Conclusion & Scope for Further Research

5.1 Recommendations

Based on the findings of this study, the following recommendations have been suggested:

i. Microfinance institutions should involve to a great extent credit officers and customers in formulating credit terms, because they are the people in the field and therefore have a good understanding of better terms which should apply.
ii. Microfinance institutions should consider the interest rates they charge on loans; this is because interest rates have a negative effect loan performance to a great extent.
iii. The 5'cs model of client appraisal is important when appraising clients, therefore microfinance institutions should take a greater consideration on character of the client, capacity of the customer to repay, collateral attached as security,history of repayment, need assessment and size of the business
iv. Microfinance institutions should consider credit insurance, signing of covenants, credit rating, reports on financial condition, refrain from further borrowing and diversification this is because they have a great impact on loan performance.
v. Microfinance institutions should adopt stringent policy as a method of collecting loans as compared to lenient policy. This is because stringent policy yields high loan performance compared to lenient policy.

5.2 Conclusion

Credit terms formulated by the microfinance institutions do affect loan performance; the involvement of credit officers and customers in formulating credit terms affects loan performance. Interest rates charged had a negative effect on the performance of the loans, the higher the interest rates the lower the loan performance. Credit risk controls adopted by microfinance institutions have an effect on loan performance, credit insurance, signing of covenants with customers, diversification of loans, credit rating of customers, reports on financial conditions, refrain from further borrowing had an effect on loan performance. Collection policies adopted by microfinance institution had an effect on loan performance, stringent policy had a great impact on loan performance, and the lenient policy had an effect but was not as great as that of stringent policy

5.3 Scope for Further Research

This research indicated that there is a relationship between effective credit management systems and loan perform ance within microfinance institutions. The researchers therefore suggests further researcher on the following:

i. Reasons for loan defaults from clients' perspective in microfinance institutions.
ii. The effect of Credit Referencing of customers on loan performance in microfinance institutions.

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