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The Effect of Loan Appraisal Process Management on Credit Performance in Microfinance Institutions (MFIs): A Case of MFIs in Uganda

Ronald Aliija[1], Bernard Wakabi Muhangi[2]

[1]Mountains of the Moon University, Administrative Department of Finance, Fort Portal, Uganda

[2]Mountains of the Moon University, School of Business and Management Studies, Fort Portal, Uganda

Abstract: ***The study was carried out with the purpose of understanding the effectiveness of loan appraisal process management on the credit performance of MFIs in Uganda taking MFIs in Fort portal municipality in Western Uganda as a case study. The study objectives included; (i) analyzing the loan appraisal process by Microfinance institutions, (ii) examining the challenges faced by Credit officers at the appraisal stage of the Loan process and (iii) assessing the relationship between the loan appraisal process management and credit performance in Microfinance institutions in Fort Portal, Uganda. The researcher employed both qualitative and quantitative research approaches which involved the use of questionnaires to collect data from 44 loan officers and Credit Managers. The study revealed that MFIs use client appraisal in Credit management to a great extent. Further, it established that client appraisal is a viable strategy for mitigating credit risk. The study also established that there was a strong relationship between credit performance of MFIs and client appraisal. The researcher recommended that there is need for MFIs to enhance their client appraisal techniques so as to improve their credit performance.***

Keywords: Loan appraisal, credit performance, microfinance institutions

1. Introduction

The field of Microfinance has received a lot of attention since Muhammed Yunus received a Nobel Prize in 2006 after founding the Grameen Bank in 1976. Grameen Bank dispersed and recovered loans in Bangladesh. By 1990's lenders had learned how to increase loan repayment rates to make microfinance sustainable. Women were targeted as borrowers and they gave them money to invest in businesses that would create wealth for themselves [1] and thus improving their living standards.

The concept of credit can be traced back in history but it was not appreciated until after the Second World War when it was largely appreciated in Europe and later to Africa [2]. 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 [3]. 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.

Microfinance refers to that part of the financial sector that responds to the financial demand of low- income households. Author in [4] suggests that Microfinance refers to financial services provided to low-income earners usually people who cannot get access to formal commercial banks. Microfinance institutions provide small and short-term loans predominantly for trading, services and micro- enterprise activities [5].

In Uganda, many Microfinance Institutions provide financial services at a community level and have changed the lives of many small scale entrepreneurs. They provide their members with financial and social intermediation services to help improve their businesses. It has expanded to scores of other developing countries since its beginning in Bangladesh and even to some developed countries. However, the role of Microfinance Institutions (MFI) is a critical issue especially in financing the small and medium enterprises who find it too costly to access credit from Commercial Banks.

A loan or Credit may be regarded as 'credit' granted where the money is disbursed and its recovery is made on a later date - a debt for the borrower [6]. Credit is given for a definite purpose and for a predetermined period. Interest is charged on the loan at agreed rate and intervals of payment. Coupled with the above, a loan process is an entire sequence of steps, from the time a loan application is received or a loan offer is accepted to the time when the loan is closed, the loan proceeds are disbursed, and the aggregate amount (principal plus interest) is placed on the lender's books as an asset [7].

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Furthermore, MFIs provide unsecured loans, i.e. loans without any collateral. In case a client defaults, the MFI does not have any asset to meet its loss, which makes the credit even riskier. Credit risk is directly related to the portfolio of the Organization and is one of the most significant risks from an MFI perspective. Whenever an MFI lends to a client there is an inherent risk of money not coming back, i.e. the client turning into a defaulter. Credit is simply the possibility of the adverse condition in which the client does not pay back the loan amount. The risk is of greater significance for MFIs as it has to deal with large number of clients with limited literacy. The people covered are those who cannot avail credit from Banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principle amount itself. Therefore, these institutions are required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities [8].

Generally, Micro finance refers to the provision of financial services to those excluded from the formal financial system [9]. It therefore targets the informal sector that comprise of small and micro enterprises, which are located in urban and semi urban areas. Small and micro enterprises are loosely structured and therefore keep on changing from time to time depending on market trends and other factors that affect their businesses since most of them are privately owned [10]. However, despite the fact that Microfinance Institutions have tried their level best to offer credit facilities to the public and then reduce their Portfolio at Risk (PAR) through reducing the default rate by various techniques, it still matters a lot to evaluate the relevancy of the appraisal process on the overall performance of the loan repayment. Indeed, the appraisal stage is thought to largely determine whether a loan will be properly repaid or defaulted.

The particular credit standards applied in making loans have been accompanied by the use of special methods of credit appraisal. In extending medium-term credit, bankers look beyond seasonal or temporary business transactions of the borrower, and expand their credit investigations beyond the limits that are usually set in making short-term loans. The influence of business cycles and of long-term economic forces upon the financial position of the borrower is carefully weighed. Moreover, term credit analysis, although strongly resembling that used by investment bankers, differs from the techniques applied to public issues of corporate bonds or notes. As term loans and debt securities privately purchased from issuing concerns are not marketable assets, lenders cannot look to factors directly affecting market prices, except where the borrowing concern has a similar issue of securities outstanding in the hands of the public. Since a lending institution often cannot look to a public market for a continuing appraisal of the borrower's credit or the liquidation of a loan, it must increase its requirements with respect to quality and augment the care with which it scrutinizes such credits [11].

It is against this background that the researcher found it necessary to carry out a study on the effect of the loan appraisal process management on credit performance of MFIs in Uganda. The success of MFIs seem to largely depend on the effectiveness of their credit management systems including the Loan appraisal process because these institutions generate most of their income from interest earned on loans extended to small and medium entrepreneurs. There is a high incidence of credit risk reflected in the rising levels of non-performing loans by the MFIs, a situation that has adversely impacted on their profitability [12]. 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 [13]. Absence of empirical studies on the effectiveness of the loan appraisal process management on the credit performance in microfinance institutions was the principal motivation behind this study.

2. Literature Review

According to author [14], Micro-finance concept has operated for centuries in different parts of the world for example, "susus" in Ghana, "tandas" in Mexico, "tontines" in West Africa and "pasanaku" in Bolivia. One of the earliest and longest serving micro-credit organization providing small loans to rural poor dwellers with no collateral is the Irish loan Fund system initiated in the early 1700s by Jonathan swift. His idea began slowly in 1840s and became a widespread institution of about 300 branches all over Ireland in less than one decade. The principal purpose was to advance small loans with interest for short periods. However, the pioneering of modern microfinance is often credited to Dr. Mohammad Yunus, who began experimenting with lending to poor women in the village of Jobra, Bangladesh during his tenure as a professor of economics at Chittagong University in the 1970s.

According to [15], compared to other well-advanced microfinance countries like Bolivia or Bangladesh, the microfinance industry in Uganda is fairly new. Informal financial arrangements like ROSCAs have existed in many forms in Uganda for several decades. From the mid-1980s on, credit schemes started emerging as side components of social welfare programs. Like in all other parts of the developing world, these components usually followed a project-oriented approach, disbursed credit at subsidized interest rates, had very poor repayment rates and were therefore typically rather short-lived. The first true microfinance institutions like FINCA and Uganda's Women Finance Trust (UWFT) appeared in the early 1990s. However, they did not start to expand in terms of significant client outreach and receive recognition until the mid-1990s. With increased interest from donors and NGOs discovering that they can make a lasting impact on poverty alleviation by offering sustainable financial services, the microfinance industry began to take shape.

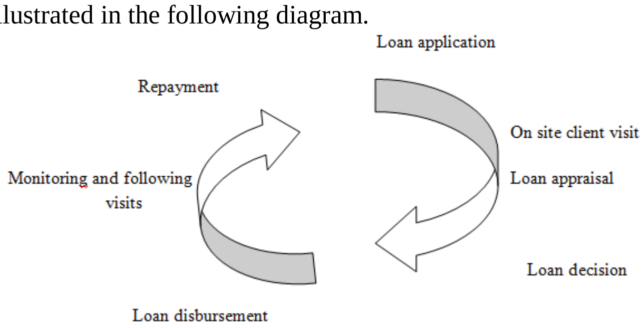
Table 1: Three main types of Microfinance Service Providers

Formal	*Semiformal*	*Informal*
Commercial Banks	NGOs	Village banks
Development Banks	Credit unions	Self-help groups
Savings banks	Savings and Credit cooperatives	Financial Service Associations
Non-Bank Financial institutions	Private companies	ROSCAs
Finance companies		ASCAs
Leasing companies		Burial societies
Insurance companies		Individual money lenders

Source: Churchill and Frankiewicz, 2006.

Most financial institutions provide credit and the success or failure of a financial institution depends heavily on its ability to manage lending well. Loan procedures must set out all the steps to be followed in selecting customers, completing applications, loan appraisal and approval, setting repayment schedules, loan contracts, disbursement, monitoring, loan collection, dealing with delinquency and loan record-keeping. Procedures need to be simple enough to be easily followed while meeting all the requirements of the institution [14].

The relationship between a financial institution and its borrowers is governed by the fact that there is a time gap between the moment when a loan is disbursed and when it is fully repaid. Because of the particular nature of loan transactions, where money is advanced in exchange for the promise of future repayment, moral hazard is a major issue and must be controlled by reducing the asymmetric information between the borrower and the lender. This is done by collecting sufficient information on which to base loan decisions, as well as by adequately supervising and monitoring loan use to ensure that it is repaid in full and on time. These steps form part of the loan cycle which is illustrated in the following diagram.



Source: FAO/FFM, 2010

Figure 1: A typical loan cycle

Appraising clients is one of the key steps in the loan cycle and it involves screening clients to ensure that they have the willingness and ability to repay a particular loan facility. When trying to analyze the client's creditworthiness, MFIs typically use the five C's i.e. *character*, *capacity*, *collateral*, *capital* and *condition* [16].

Microfinance Institutions use the 5C's model of credit to evaluate a customer as a potential borrower [17]. If any of the five Cs is poorly analyzed, the rate at which a clients' to default rate may be high. To limit this risk, institutions develop policies and procedures to analyze each component. The weight assigned to each component will vary depending on the lending methodology, the loan size and whether it is a new or repeat client [18]. The loan officers and their immediate supervisors should consider the 5C's when making credit decisions, and they should be held accountable for those decisions.

Capacity to repay is the most critical of the five factors. It is the primary source of repayment – cash. The prospective lender will want to know exactly how a borrower intends to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships – personal or commercial- is considered an indicator of future payment performance. Potential lenders also will want to know about other possible sources of repayment [19]. Assessing effective credit demand based on repayment potential therefore requires certain skills in an institution. The success or failure of a loan depends to a large degree on an accurate appraisal of the customers' repayment capacity [20].

It is commonly said that a loan can be bad at the time of appraisal meaning that once a mistake is committed at the time of loan appraisal it can have an effect on the final repayment of the loan [21].

Another challenge MFIs face at this stage is the establishment of capital of the applicants and the capacity to pay which is compounded by the poor records and sometimes by complete absence of records about the applicant's businesses. This situation causes delays as the Loans officer has to do more probing during the appraisal process [21]. In an effort to ensure good quality portfolio, MFIs try to conduct thorough loan appraisal which has been found costly as the loan applicants are dispersed in remote rural areas with poor road infrastructure [21].

In the same way, a relationship between the 5Cs and the Loan performance needs to be taken into account**.** The character of the borrower has an effect on loan performance. According to [12], there is a significant relationship between character of an individual and loan performance. Character of the client is important in client appraisal because the success of any individual may greatly depend on his/her character.

According to [22], capacity of the client to repay has a great influence on the loan performance. Capacity to repay is critical in client appraisal and microfinance institutions should consider the capability of the customers they are awarding loans to repay. Microfinance institutions should evaluate the collateral used as security when appraising the clients, this is because in case of any default the MFI's will recover the collateral in order to service the loan. The size of the business hence capital of the client is an important factor that should be scrutinized when appraising clients [12].

Based on the literature reviewed, it is evident that many researchers have done research focusing on effects of credit risk management practices on loan performance in MFIs. Researchers have paid little attention on effectiveness of Loan appraisal process on the credit performance in MFIs. These studies have been conducted in different towns and cities in Uganda and other countries at different times and used diverse methodologies. This study took different dimension by studying the effectiveness of Loan appraisal process on the credit performance in MFIs in Fort Portal municipality.

3. Methodology

The study used descriptive survey research design. The survey research design is most appropriate for use in social sciences. The research was carried out in MFIs in Fort Portal municipality in Kabarole district located in the western part of Uganda. There are a number of MFIs in Fort Portal municipality. However, for the purpose of this study, out of the 9 MFIs, only 6 MFIs in this area were used of which only the staff involved in credit (i.e. Loan officers and credit managers) were of relevance. Thus, the researcher used a census of the credit staff of these six Microfinance Institutions in Fort portal municipality to find out the effectiveness of the Loan appraisal process management on the credit performance of MFIs in Uganda. The study consisted of all the credit officers and the respective credit managers from the MFIs and these formed the census of the relevant population.

The target population was 40 credit officers and 9 credit managers drawn from nine (9) licensed Microfinance institutions in Fort Portal municipality during the study period. However, a census survey of 38 loan officers and 6 credit managers in 6 Microfinance Institutions in Fort Portal municipality was conducted. Since the target population of 38 credit officers and 6 credit managers was relatively small, the researcher included all the units of analysis. This method was suitable not only to the small target population but also it enhances the accuracy and reliability of the study because it eliminates the sampling biasness. The study used a questionnaire as the research instrument for data collection.

Both primary and secondary data were used. This study used primary data collected from MFI's credit officers using structured questionnaires to gather information relevant in achieving research objectives. Self-administered questionnaires which included both closed and open ended questions were preferred since they are suitable to survey research and that they are cheap and easy to administer. Open-ended questions were used to capture the qualitative data needed for the study. Secondary data source included a review of related literature from recognized journals, brochures, publications and the Microfinance guidelines.

Data was collected confirming to the tests of validity. The validity of the data was guaranteed because the research tools that were used in the study were designed to capture all the relevant information required to fulfill the objectives of the study. The reliability of data was confirmed by pre-testing the tools and careful choice of relevant questions used in the study. Before the actual data collection, pilot testing of the questionnaire was done. The author in [23] suggests that a population of 5-10% of the final sample is considerably appropriate in any pilot study.

The data collected was coded, organized and analyzed with the help of statistical computer package for social sciences (SPSS). The results were analyzed using descriptive statistics (frequencies and percentages). Presentation of data was done using tables and pie-charts for easy understanding and analysis. Linear regression models were used to show the strength of association between the variables.

Simple Linear regression equation:
$Y = \beta_0 + \beta_1 X_1 + \alpha$
Y is the dependent variable (credit performance)
β_0 is the regression intercept
β_1 is the slope of the regression equation

The independent variable, X_1 is Client appraisal process management and $\propto$ is Error term

A number of ethical considerations were taken into account throughout this study. A letter of consent was hand delivered to the different MFIs' head offices and some to the branch offices to request for participation of the credit staff in the research. When permission was granted, the researcher went ahead to interact with the credit team of the respective MFIs to introduce the topic to them and there after invite them to participate on a voluntary basis. Confidentiality of participants by the researcher was assured.

4. Results and Discussion

A. Study Characteristics

The study targeted a population size of 49 respondents from which only 44 who responded to the questionnaires were interviewed making a response rate of 90%. This response rate was satisfactory to make conclusions for the study.

The level of credit experience of the respondents examined the number of years in credit of the respondents. This information was necessary to obtain information on whether the respondents had work experience or not. Only twenty seven percent (27%) of the respondents had less than 1 year work experience in credit. This clearly indicates that most credit staff had work experience.

The study sought to establish the different methodologies used by the different MFIs to offer loan products to clients. From the findings, twenty three percent (23%) of the respondents indicated that they use the individual lending methodology, 18% indicated that they use the Group lending methodology and then 59% (26 respondents) offered both.

The study sought to determine the institutions that had adopted Credit Management practices. From the findings 86.4% of the respondents indicated that their institutions had adopted Credit Management practices, whereas 13.6 % indicated that their institutions had not, this implies that a significant number of institutions had adopted the use of Credit Management practices.

Research findings on information about credit techniques used in scrutinizing loan applications and loan appraisal revealed that forty eight percent (48%) of the respondents use 5C's credit appraisal model. Thirty percent (30%) of the respondents use credit scoring model and twenty three percent (23%) of the respondents use credit reference bureaus. This information implies that most microfinance institutions mainly use 5Cs credit appraisal model to scrutinize loan applications and loan appraisal. The results agree with [17] who reported that 5Cs client appraisal model is used to scrutinize creditworthiness of loan applicant. The extent of credit assessment being used to ascertain information given by client is reliable revealed that most MFIs use credit assessment techniques to ascertain information given by client as reliable.

The study sought to establish the strategies used by MFIs when appraising loan applicants. Majority of the respondents which is 32% of the respondents indicated that MFIs use "business aspects" strategy when appraising loan applicants, 18% of the respondents indicated that MFIs use "character issues strategy", 30% of the respondents indicated that MFIs use the various lending parameters and 20% indicated they MFIs use the "repayment capacity strategy" when appraising loan applicants. This clearly indicates that MFIs majorly use business aspects as a strategy when appraising loan applicants followed by the various lending parameters and rarely use the character issues as a strategy for the same purpose.

The study sought to establish how MFIs analyze character of the loan applicants. Majority of the respondents (52%) of the respondents indicated that MFIs analyze the loan applicants' character by assessing honesty through use of intuition.

The identified client appraisal factors results reveals that poor test of accuracy and credit worthiness of a client has greatest contribution to non-loan repayment. Use of false information to acquire loans also does contribute to non-loan repayment as well as falsified past business financial performance. Also, accepting collaterals whose values are overstated or impaired contributes to non- loan repayment according to the respondents. This implies that client appraisal is a crucial variable in ascertaining creditworthiness of a client. Results concur with [25] who found out that factors affecting the ability of the borrowers to repay loans are business factors, borrowers' attitude towards their loans, amount of loan received, other debt burden, business experience, family background and business formality.

The variables were rated on a 5 point Likert scale ranging from 1- greatest contribution to 5- no Contribution.

The study sought to establish the level at which respondents agreed or disagreed with the above statement relating to credit appraisal in MFIs. From the findings, the study established that majority of the respondents agreed that Credit officers have authority over the loan approval and rejection of the applicants as shown by a mean of 1.64. Respondents also agreed that MFI has developed policies and procedures for client appraisal which influence the repayments of the loan facilities offered as shown by a mean of 1.78. A sizable number of respondents strongly disagreed that developed policies and procedures are not followed by the credit department members as shown by a mean of 1.54. Those who agreed that MFI's credit department considers 5Cs when appraising loan applicants are shown by a mean of 1.48. Whereas those who disagreed that MFI offers loan facilities to Start-up businesses are shown by a mean of 1.56. Those who disagreed that there are perfect record keeping systems by clients who apply for loan facilities in the MFI are shown by a mean of 1.48 whereas those who agreed that complete absence of records about the businesses is a major constraint at the appraisal stage of the loan had a mean of 1.42. The respondents who agreed that loan applicants put a lot of pressure on the loan officers when applying for loans in the MFI are shown by a mean of 1.42.

B. Regression Analysis

Table 2: Linear regression model summary

Model	R	R square	Adjusted R square	Std. Error of the Estimate
1	0.725	0.641	0.612	0.2510

Source: Primary data

Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable, from the findings in the above table the value of adjusted R squared was 0.612 an indication that there was variation of 61.2% on credit performance of MFIs in Uganda due to changes in client appraisal at 95% confidence interval. This shows that 61.2% changes in credit performance of MFIs could be accounted for by client appraisal. R is the correlation coefficient which shows the relationship between the study variables, from the findings shown in the table above there was a strong positive relationship between the study variables as shown by 0.725 or 72.5%.

Table 3: Analysis of variance (ANOVA)

Model		Sum of Squares	Df	Sum of Squares	F	Sig.
1	Regression	0.863	4	.319	3.785	0.071
	Residual	6.985	40	.281		
	Total	7.848	44			

Source: Primary data

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.071 which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. The calculated value was greater than the critical value (1.699 > 3.785) an indication that client appraisal significantly influence credit performance of MFIs in Uganda. The significance value was less than 0.05, an indication that the model was statistically significant.

Table 4: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
1		B	Std. Error	Beta		
	Constant	.316	0.224		2.746	0.048
	Client Appraisal	.397	0.254	.301	2.851	0.041

Source: Primary data

From the data in the table, the established regression equation was $Y=0.316+0.397X_{1.}$ From the above regression equation it was revealed that holding client appraisal to a constant zero, credit performance of MFIs would be 0.316, a unit increase in client appraisal would lead to an increase in performance of MFIs in Uganda by a factor of 0.397.

The study also found that all the p-values were less that 0.05 an indication that all the variables were statistically significant in influencing credit performance of MFIs in Uganda.

From research finding as shown on Table 4.13, the calculated value was greater than the critical value (1.699 < 3.785) an indication that client appraisal significantly influence credit performance of MFIs in Uganda. The significance value was of 0.071 which was less than 0.05, an indication that the model was statistically significant.

5. Conclusion

The study revealed that MFIs use client appraisal in Credit management to a great extent. Further it established that client appraisal is a viable and necessary strategy for managing credit. Aspects of collateral are considered while appraising clients, failure to assess customer's capacity to repay results in loan defaults. Client appraisal considers the character of the customers seeking credit facilities and that MFIs have competent personnel for carrying out client appraisal and client visit is mandatory before loan disbursement. Further, the study established that there was a strong relationship between client appraisal process management and credit performance of MFIs.

From the findings, the study found that client appraisal had positive effect on credit performance of MFIs. The study established that there was strong relationship between credit performance of MFIs and client appraisal. The study revealed that a unit increase in client appraisal would lead to an increase in credit performance of MFIs in Uganda; this is an indication that there was positive association between client appraisal and credit performance of MFIs.

6. Recommendations

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

- The Microfinance Institutions need to adequately train their credit department staff to ensure that they are well equipped with the relevant and necessary information required by them to conduct their appraisal processes more effectively.
- The Microfinance Institutions also need to put much emphasis on their credit staff towards the usage of the loan policies and procedures as they work on the clients for loan facilities. Microfinance institutions should advocate for serious usage of the 5C strategy when appraising loan applicants as it is among the best strategies of assessing a client's potential and worthiness in acquiring credit.
- More so, MFIs should sensitize their clients on how helpful and good it is to maintain and keep business records as regards to credit facility acquisitions.

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Author Profile

Ronald Aliija is an Assistant Accountant-Administrative Department of Finance, Mountains of the Moon University. He holds an MBA with a major in Finance and is an accredited Bachelor's Degree holder of Banking and Development Finance. Ronald's research interests are in Banking and Finance.

Bernard Muhangi Wakabi is a PhD student at Uganda Management Institute. He is a lecturer at Mountains of the Moon University, School of Business and Management Studies. He also doubles as the coordinator of Internships and Field placement. Bernard holds a Bachelor of Commerce degree from Makerere University and an MBA from Uganda Martyrs University.