

ASSESSMENT OF CREDIT RISK MANAGEMENT PRACTICES ON FINANCIAL PERFORMANCE AMONG DEPOSIT TAKING SACCOs IN NAKURU EAST SUB COUNTY, KENYA**¹Joash Kiplagat Tanui, Corresponding Author****P.O BOX 2982-20100, Nakuru Kenya****Jomo Kenyatta University of Agriculture and Technology****Email:kiplagatjoash@yahoo.com****²Dr. Daniel M. Wanyoike, Co-Author****Jomo Kenyatta University of Agriculture and Technology****P.O BOX 1063-20100, Nakuru Kenya****³Solomon Ngahu****Jomo Kenyatta University of Agriculture and Technology****P.O BOX 1063-20100, Nakuru Kenya****ABSTRACT**

Savings and Credit Co-operative Societies (SACCOs) in Kenya have been investing over the years with the objective of maximizing their wealth. Studies have shown that lack of sufficient growth of SACCOs' wealth has made it difficult for them to absorb their operational losses, which has threatened their sustainability. This study examined the effect of credit scoring and credit administration on financial performance of deposit taking SACCOs in Nakuru East Sub-county. The study was based on a descriptive survey design and targeted credit officers and credit managers in deposit taking SACCOs in Nakuru East Sub-County. Data was collected using questionnaire from a sample of 90. The sampling units was picked using census. The results indicated that there existed a strong association between credit scoring and financial performance of the deposit taking SACCOs with a chi-square value of 86.76 and p-value of .00. Credit administration in deposit taking SACCOs also had a strong association with financial performance, with chi-square value of 89.68 and p-value of .00. The study recommends that SACCO's should improve on their credit scoring and credit administration as credit management practices so as to improve on their financial performance.

Key Words**Credit Scoring, Financial Performance, Credit Administration, Nakuru East Sub County, Credit Risk Management Practices****1.1 INTRODUCTION**

Credit risk has become a major concern of many financial intuitions in the world (Jennifer, 2008). This has lead to commitment to prudential lending in financial institutions. However, Ahmed (2002) has noted that without the provision of credit, no meaningful development can be achieved in any country in the world. As a result many financial institutions are looking into ways of managing their credit in a way that can help to alleviate credit crisis and loan losses. Therefore effective credit management is very essential to achieving economic objectives and to optimizing the performance of financial institutions. According to Santomero (2007) credit risk is one of the main risks that seriously affect micro financial institutions' viability. Credit risk can arise when a borrower' ability to repay their loans is impaired resulting in economic loss to the financial institutions (Santomero, 2007). Therefore these institutions required to design sound credit risk management practices that entails the identification of existing and potential risks inherent in lending activities.

In Savings and Credit Corporative Societies (SACCOs are not different from other world micro finance institutions. In Kenya, some SACCOs have designed sound credit risk management practices in order to achieve their desired financial objectives. However, it may be difficult to establish an optimal credit management practices in SACCOs due to the frequent changes in economic conditions. According to Pandey (2008) SACCOs must develop credit management practices to govern their credit management operations and since SACCOs generate their revenue from credit extended to low income individuals in the form of interest charged on the funds granted from whom loan repayments may be uncertain. Studies show that many lending decisions by SACCOs are frequently based on their subjective feelings about the risk in relation to expected repayment by the borrower (Fayman & He, 2011). In SACCOs commonly used credit risk management practices incorporates decision making process and on the financial data and judgmental assessment of the market outlook, borrower, management and shareholders.

Moreover, different empirical studies have been conducted internationally in regard to credit risk management practices in SACCOs. Nawai and Shariff (2010) in their study found that close and informal relationship between SACCOs and borrowers helped in monitoring and early detection of credit loss. Laurentis and Mattei (2009) in their study of Lessors' recovery risk management capability shows that the development of modern and reliable systems of risk management practices like credit scoring can enhance effective management capabilities. Chua's (2000) study on risk management in microfinance found that the relationship between risks to the client and risks to the loan portfolio has been largely important to the microfinance industry.

Bhatia (2004) in his study of mitigating currency risk for investing in SACCOs in developing countries found that there is a clear tradeoff for investors to mitigating currency risk in least developed countries in the form of contract fees for the benefit of protection against currency fluctuations. Wenner (2007) conducted a study and on managing credit risk in financial institutions in Latin America and found out that donors and governments can assist in the capture and dissemination of relevant information that would serve to reduce asymmetries that contribute to credit risk. Factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of credit risk management.

In Kenya SACCOs have adopted different credit risk management practices such as credit scoring systems, SACCO's regulatory environment and effective general management of SACCOs. However, SACCOs may have the best credit management policies but may not necessarily record high profits. Although there are industry standards on what a good credit policy is and what is not, the market may be seen to regard an individual SACCO's performance when the entire financial sector has been hit by an adverse shock such as a financial crisis. Looking at the emphasis that is laid on credit risk management by SACCOs, the level of contribution of this to the profits has not been analyzed.

1.2 Statement of the Problem

Credit risk challenges are implicit in financial institutions activities because credit risk events are typically uncertain (Laurentis, 2009). Therefore as Nancy (2001) has noted an effective credit risk management process is required to help SACCOs establish rules to prevent operating losses due to human error, employee carelessness, technological malfunction or fraud. However, SACCOs may put into place internal controls and procedures as well as periodic internal audit reviews to ensure that employees comply with the rules when performing duties in credit management. Empirical studies have focused on the different challenges that affect the performance of SACCO's (Achou & Tengoh, 2008). In addition, prior studies regarding credit risk management tried to examine the possible methods to manage credit risk including the use of credit risk rating and the impact of borrower's financial positions on credit risk

management and the impact of relation of borrower and lender on credit risk management. Although there have been a number of studies on credit risk management and related issues both in developed and developing countries, it is difficult to believe that these studies exhaustively examined the effect of credit risk management practices of SACCOs specially in Kenya. As a result, this study examined the effects of credit risk management practices on the financial performance of deposit taking SACCO's in Nakuru East Sub County.

1.3 Objectives of the Study

- i. To determine the effect of credit scoring on financial performance among deposit taking SACCOs.
- ii. To find out the effect of credit administration on financial performance among deposit taking SACCOs

2.0 LITERATURE REVIEW

2.1 Theoretical Review

The study was guided by the credit management theory propounded by Woolcock(2000). According to Woolcock (2000) credit markets are shaped by lenders strategies for screening potential borrowers and by addressing opportunistic behavior encouraged by the inter-temporal nature of loan contracts. Transactions in the credit markets involve heterogeneous goods since the qualities of credit contracts vary due to differences in the credit worthiness of borrowers. The transactions are inter-temporal since credit is exchanged for a promise to repay later. It is influenced by the level of risks and profitability of projects. Accordingly, lenders tend to raise the price of the credit to a level where they expect returns to be maximized. This often excludes small, risky and costly borrowers. The consumption of credit tends to be inversely related not only to interest rates but also to collateral requirements. This theory was chosen to guide this study since SACCOs just like other financial institutions usually tend to have in place mechanisms of monitoring and managing credit especially by adopting appropriate credit risk management practices.

2.2 Empirical Review

2.2.1 Concept of Credit Risk Management

According to risk management framework in SACCOs, risk is an integral part of financial services. When financial institutions issue loans, there is a risk of borrower default. When SACCOs collect deposits and lend them to other clients they put clients' savings at risk. According to GTZ frame work any institution that conducts cash transactions or makes investments, risks the loss of those funds. However, finance institutions should neither avoid risk nor ignore it. Like others financial institutions, SACCOs face risks that they must manage efficiently and effectively to be successful. If they do not, they will likely fail to meet their social and financial objectives.

As Nancy (2001) noted when poorly managed risks begin to result in financial losses, donors, investors, lenders, borrowers and savers tend to lose confidence in the organization and funds begin to dry up. When funds dry up, SACCOs may not be able to meet their social objective of providing services to the poor and quickly go out of business. Therefore SACCOs are supposed to be aware about risks particularly credit risk they face and the way to manage these risks.

Credit risk Management policies comprise those decision-making structures associated with the reduction of exposures to credit asset classification and loan loss provisioning. According to the Basel Committee on Banking Supervision (BCBS) (2003), management of risk relates to the minimization of the potential that a borrower will fail to meet its obligations in accordance with agreed terms. In a bid to maximize shareholders wealth and ensure safety of depositors' fund, SACCOs act as delegated monitors on behalf of members using various innovations, technologies and procedures to enforce credit contracts. These measures notwithstanding, SACCOs are still exposed to some inherent risks including

borrowers' outright default, unwillingness or inability to meet credit commitment due to the vagaries of business activities or other environmental dynamics (Bidani, 2004). Credit management frameworks therefore become imperative tools in decision-making that relates to loan-pricing, mitigating or migrating as well as managing incidences of credit scoring on credit portfolios.

2.2.2 Credit Scoring

The credit score, commonly referred to as a FICO score, is a proprietary tool created by the Fair Isaac Corporation (Brown & Reilly, 2009) and is most commonly used by lenders to determine the risk involved in a particular loan. Its calculation is broken into five major categories with varying levels of importance. These categories include payment history, amount owed, and length of credit history, new credit and type of credit used. It is important to understand that credit score only looks at the information contained on your credit report and does not reflect additional information that your lender may consider in its appraisal.

Credit scoring is based on a level analysis of a person's credit files to represent the credit worthiness of that person. Buck, Liu and Skovoroda (2008) argue that credit scoring has been regarded as a core appraisal tool by different institutions including SACCOs. Financial institutions use credit scores to evaluate the potential risk posed by lending money to consumers and to mitigate losses due to bad debt and to determine who qualifies for a loan, at what interest rate, and what credit limits; to determine which customers are likely to bring in the most revenue. The use of credit scoring to identify creditworthy clients for granting credit has been found to be a reliable system which may result into increased financial performance (Gay, 2002).

According to Ditcher (2003) credit scoring is not limited to banks; other organizations such as SACCOs can employ the same technique to manage credit risk. Different scoring techniques are being used in areas of classification and prediction, where statistical techniques have conventionally been used. There is no overall best statistical technique used in building scoring models and the best technique for all circumstances does not yet exist. Also, the applications of the scoring methodologies have been widely extended to include different areas, and this subsequently can help financial decision makers. According to Brown and Reilly (2009) credit score has a three-digit number generated by a mathematical algorithm using information in credit report. It is designed to predict risk, specifically, the likelihood that an individual will become seriously delinquent on his or her credit obligations in the 24 months after scoring.

2.2.3. Appropriate Credit Administration

According to Jones (2002), prudential financial advice is about managing risk by designing an investment portfolio that is highly diversified and exposed to risks associated with higher expected returns. In other words, prudent investors only take on an amount of risk they feel is appropriate for them, and try to limit their exposure to those risk factors for which there is not a reasonable expectation of higher returns. Prudential financial advice is about structuring an investment strategy that is right for the investor, not one that reflects what an advisor is trying to sell, or what will earn the advisor the most fees and commissions. It should be designed to match each client's appetite for risk, while helping them reach their financial goals with broad diversification and excellent personal service (Richard, 1984). It is believed that investors and their advisors should follow the six (6) elements of prudent financial advice namely, recognize that markets work, manage investment risk, focus on education, elevate fiduciary responsibility, retain transparency and integrity and, maintain investment principles (Ahmed, 2002).

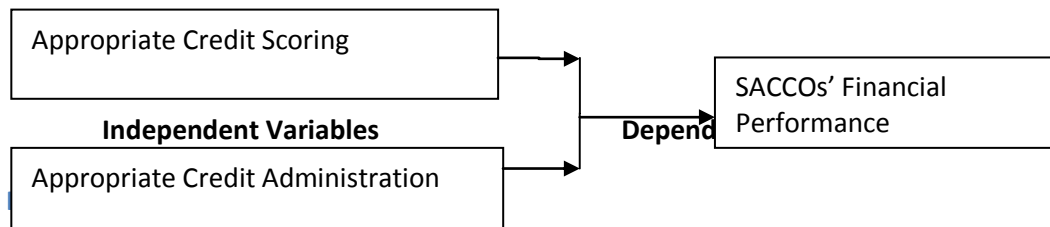
Credit administration system provides the relevant information for senior management to make its experienced judgments about the credit quality of the loan portfolio and provides the foundation upon which loan losses or provisioning methodology is built. Establishing an efficient effective administration system would help senior management to monitor the overall quality of the total credit portfolio and its

trends. Consequently the management could fine tune or reassess its credit strategy or policy accordingly before encountering any major setback (Onaolapo, 2007).

Consequently the management could reassess its credit strategy policy accordingly before encountering any major setback. The SACCOs credit policy should explicitly provide procedural guideline relating to credit scoring monitoring (Onaolapo, 2007). Credit analysis is geared toward generating profitable loan that do not expose the lender to excessive amount of risk. The reason for the acceptance or reject decision should be clearly documented and the decision should be in accordance with the SACCOs stated loan policy.

2.3 Conceptual Framework

The study adopted a conceptual framework that shows relationship between independent variables (credit risk management practices) and the dependent variable (financial performance) as indicated in Figure 1.



3.0 METHODOLOGY

The study was based on a descriptive survey design. The study targeted credit officers and managers in 10 SACCOs in Nakuru East Sub-County. Census sampling was used to select the sampling units from the 10 deposit taking SACCOs. This gave a sample size of 90 respondents. Both primary and secondary data were used where the primary data was obtained from Credit Officers and managers using questionnaires. The secondary data was obtained from deposit taking SACCOs and Central bank of Kenya records. Data was analyzed using descriptive and inferential statistics. Descriptive statistics included frequencies, percentages and means. Data was analysed at 95% significance level. Data analysis was done with the aid of Statistic Package for Social Sciences (SPSS). The results of the data analysed was presented in form of tables.

4.0 RESULTS AND DISCUSSIONS

4.1 Appropriate Credit Scoring

This section presents the results on the effect of credit scoring on financial performance among deposit taking SACCOs.

Table 1: Ratings of Appropriate Credit Scoring

Indicators of Credit Scoring	SD	D	NS	A	SA
Board of directors approve and review periodically the credit scoring strategy and significant credit scoring policies of the Sacco's	7%	9%	15%	38%	31%
Credit scoring strategy reflects the Sacco's tolerance for credit scoring and the level of profitability	9%	18%	6%	29%	38%
Senior management implements the credit scoring strategy approved by the board of directors	6%	16%	12%	47%	19%
Credit scoring addresses all of the Sacco's activities and at both the individual credit and portfolio levels	6%	18%	8%	23%	45%
Sacco's should identify and manage credit scoring in all products and activities	11%	12%	14%	27%	36%

Table 1 shows that 31% of the respondents strongly agreed that the board of directors approved and reviewed periodically the credit scoring strategy and that significant credit scoring policies of the Sacco's compared to 38% who agreed, 15% who were indifferent and 9% and 7% who disagreed and strongly disagreed respectively. Similarly 38% of the respondents strongly agreed that credit scoring strategy reflected the SACCO's tolerance for the level of profitability while 29% agreed. It is also evident that 6% were indifferent compared to 18% who disagreed and 9% who strongly disagreed. It is also evident that 19% of the respondents strongly agreed that the senior management implemented the credit scoring strategy approved by the board of directors while 47% agreed. 12% were indifferent while 16% and 6% disagreed and strongly disagreed respectively. On whether credit scoring addressed all of the SACCO's activities at both the individual credit and portfolio levels, 45% of the respondents strongly agreed compared to 23% who agreed. In addition, 8% were indifferent, 18% disagreed while 6% strongly disagreed. Finally 36% of the respondents strongly agreed that SACCO's should identify and manage credit scoring in all products and activities. This is in comparison to 27% who agreed, 14% who were indifferent, 12% who disagreed and 11% strongly disagreed. Table 2 presents the descriptive results on the factors influencing credit scoring.

Table 2: Descriptive Analysis of the Factors Influencing Credit Scoring

Factors	N	Mean	Std. Dev
Board of directors approve and review periodically the credit scoring strategy and significant credit scoring policies of the Sacco's	85	3.75	1.19
Credit scoring strategy reflects the Sacco's tolerance for credit scoring and the level of profitability	85	3.68	1.38
Senior management implements the credit scoring strategy approved by the board of directors	85	3.56	1.14
Credit scoring addresses all of the Sacco's activities and at both the individual credit and portfolio levels	85	3.84	1.32
Sacco's should identify and manage credit scoring in all products and activities	85	3.67	1.36

As shown in Table 2, the respondents' mean rating on credit scoring addressed all of the SACCO's activities at both the individual credit and portfolio levels was higher (3.84) compared to other factors. This was followed by a mean rating of 3.75 in favour of the Board of directors approving and reviewing periodically the credit scoring strategy and significant credit scoring policies of the SACCOs.

4.6 Credit Administration

The results on effect of credit administration on financial performance among deposit taking SACCOs are presented in table 3.

Table 3: Rating of Credit Administration Factors

Statements	SD	D	NS	A	SA
The SACCO has put in place a system for the ongoing administration of their various credit management bearing portfolios	37%	31%	16%	9%	7%
There is system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.	37%	28%	14%	9%	11%
SACCO has developed and utilized an internal risk rating system in managing credit management.	37%	30%	8%	13%	12%

SACCO rating system is consistent with the nature, size and complexity of a Sacco's activities.	38%	26%	14%	8%	14%
There is adequate information on the composition of the credit portfolio and identification of concentrations of risk	31%	33%	10%	13%	13%
SACCO has in place a system for monitoring the overall composition and quality of the credit portfolio.	35%	32%	12%	12%	9%
SACCO take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios	42%	26%	9%	14%	9%

The results presented in Table 3 point out that deposit taking SACCOs employees rated how the SACCO manage their credit administration. The researcher asked the respondents to rate seven (7) factors that contributed towards proper credit administration in the deposit taking SACCOs. It is evident that there were higher positive ratings for each of the factors indicating that deposit taking SACCOs put in place ensured proper credit administration thus improving the financial performance of SACCOs.

Table 4: Mean ratings of Credit Administration Factors

Credit Administration Factors	N	Mean	Std. Dev
The SACCO has put in place a system for administration of various credit management bearing portfolios	85	3.80	1.23
Sacco has in place a system for monitoring the condition of individual credits and determining the adequacy of provisions and reserves.	85	3.68	1.37
Sacco has developed and utilized an internal risk rating system in managing credit scoring	85	3.67	1.39
Sacco rating system is consistent with the nature, size and complexity of a Sacco's activities.	85	3.65	1.42
Sacco management information system provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk	85	3.55	1.38
Sacco has in place a system for monitoring the overall composition and quality of the credit portfolio.	85	3.72	1.32
Sacco take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios	85	3.75	1.37

The mean values in Table 4 shows that mean ratings of the factors that influence credit administration. The results indicate that the respondents on average positively rated all the credit administration factors. The respondents highly rated that deposit taking SACCOS have put in place a system for the ongoing administration of their various credit management bearing portfolios with a mean rate of 3.80. This was followed by a mean rating of 3.75 in favour of SACCOs taking into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios.

4.8 Test of Independence between the Dependent Variable and Independent Variables

To test the independence between the dependent variable and independent variables, the researcher ran a Crosstab procedure. The calculated Pearson Chi-Square values, degree of freedoms and the significant values were tabulated as shown in table 5.

Table 5: Relation between Dependent Variable and Independent Variable

Independent Variable	Dependent Variable	Pearson Chi-Square (χ^2)	df	p-value	Gamma (γ)
Credit Scoring	Financial Performance	86.76	16	.00	.66
Credit Administration	Financial Performance	89.68	16	.00	.79

The results show that with chi-square value of 86.76 and p-value of .00 credit scoring and financial performance are dependent of each other. In other words credit scoring in deposit taking SACCOs contributed to a large extent to better financial performance. It can also be observed that credit administration and financial performance in deposit taking SACCOs and financial performance are dependent of each other with a chi-square value of 89.68 and p-value of .00. The association can be described as strong. These results mean that proper credit administration in deposit taking SACCOs lead to better financial performance.

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

The study shows that deposit taking SACCOs in Nakuru East Sub-County have put in place proper credit management strategies that are contributing towards their effective financial performance as indicated by positive rating, improved profits, increased workforce and membership and increased assets. SACCOs in Nakuru East Sub-County have embraced proper credit scoring procedures as a credit management strategy. It is evident that credit scoring and financial performance are dependent of each other. In other words credit scoring in deposit taking SACCOs contributed to a large extent to better financial performance. Credit administration has also contributed to success in achieving high financial performance in the deposit taking SACCOs in Nakuru East Sub-County. The results also show that SACCOs have put in place a system for the ongoing administration of their portfolio management. It is conclude that credit administration and financial performance in deposit taking SACCOs are dependent of each other with a chi-square value of 89.68 and p-value of .00. These results mean that proper credit administration in deposit taking SACCOs lead to better financial performance.

5.2 Recommendations

Based on the results, it is recommended that the deposit taking SACCOs should have continuous improvement strategies in their credit management practices so that they may improve their financial performance. It is also recommended that appropriate credit scoring mechanisms be implemented to in all loan products. Moreover, deposit taking SACCOs need to improve the system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves and enhance an internal risk rating system in managing credit scoring. It is also recommended that SACCOs seed to enhance an internal risk rating system in managing credit scoring and ensure SACCO rating system is consistent with the nature, size and complexity of Sacco's activities.

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