IJARR, 5(4), 2020; 20-31

International Journal of Advanced Research and Review

www.ijarr.in

EFFECT OF CREDIT POLICY ON LOAN PERFORMANCE OF MICRO FINANCE INSTITUTIONS IN MOGADISHU, SOMALIA

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ABSTRACT

The general objective of this study was to examine the effect of credit policy on loan performance of microfinance institutions. The specific objectives were; to determine the influence of Credit Procedures on loan performance of microfinance institution in Mogadishu Somalia, to find out the influence of Credit Standards on loan performance of microfinance institution in Mogadishu, Somalia, to establish the influence of Credit Information on loan performance of microfinance institution in Mogadishu, Somalia and to establish whether there is a significant relationship between credit limit and the loan performance in microfinance institutions in Mogadishu - Somalia. In Somalia the MFI sector has been growing rapidly which may have been caused by internal and external factors. Sound credit management is a prerequisite for a MFIs stability and continued profitability while credit delinquency is the cause of poor financial performance and condition. carefully documented credit policy should be able to able to serve the purposes of defining the organizations objective on credit extension, define the authority and responsibilities credit granting, specify training policy for credit professionals, monitor activities for credit staff and give performance targets and create a customer – company culture. Microfinance business is a new growing sector in Somalia and not much study that have been conducted to study the effect of credit policy on loan performance. The study addressed this gap by assessing the effect of credit policy on loan performance in microfinance institutions. This study took a descriptive survey design using a comprehensive questionnaire prepared by the researcher to help to obtain data in order to answer the research questions. The researcher used descriptive analysis, percentages and frequencies to analyze the results from the questionnaires using Statistical Package for Social Science (SPSS version 22). According to the findings, it was clear there was a positive correlation between the independent variables, credit policy procedure, Credit Policy Information, Credit Policy Standards, Credit Limit and dependent variable Loan Performance. The correlation analysis between each of the independent variables with the dependent variable (loan performance) produced the correlation coefficients of 0.833, 0.547, 0.704 and 0.785.704. . From the findings it was established that loan extension is one of the primary sources of profitability to microfinance institutions however with high risk of having non performing loans if care is not taken before giving out loans. From the study findings it was concluded that microfinance institutions need to formulate credit policies to enable the management of credit risks and increase loan performance.

Key words: Credit policy, microfinance, institutions, loan

1. INTRODUCTION

Microfinance institutions intended to simplify provision of micro financial services to low income households and self-employed individuals (Tonney, 2015). In order to continue serving their clients with microcredit facilities, the lending institutes need to effectively manage their loan portfolios. Microfinance portfolio management is the driving force to enable sustainable financial performance. Globally, the credit policy is the blue print used by microfinance or rather a lending institution in making its decision to extend credit to a customer. A credit policy helps to avoid extending credit to customers who are unable to pay their accounts. Credit policy for some larger businesses can be quite formal; involving specific documented guide lines, credit checks and customer credit applications, the policy for small businesses tends to be quite informal and lacks the items found in the formal credit policy of larger businesses. Many small business owners rely on their business instinct as their credit policy (Kluwer, 2018).

The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country, accounting for 12-14% of GDP. With about 70% of such enterprises located in Urban and others in rural areas, a sector has a high potential for contributing to rural development. Yet the majority of entrepreneurs in this sector are considered not credit worthy by most formal credit institutions (Amelia, 2015).In Somalia, the sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country (TFG Report, 2010). With about 70% of such enterprises located in urban areas, a sector has a high potential for contributing to rural development. Yet the majority of entrepreneurs in this sector are considered un credited worthy by most formal credit institutions (UNCTAD, 2018).

Credit policy has direct effects on the cash flow of any business. Hence, a credit policy that is too strict will turn away potential customers, reduce sales and finally lead to a decrease in the amount of cash inflows to the business. On the other hand, a credit policy that is too liberal will attract slow paying (even non-paying) customers, increase in the business average collection period for accounts receivables, and eventually lead to cash inflow problems. A good credit policy should help management to attract and retain customers, without having negative impact on cash flow. Credit management is the executive responsibility of determining customer's credit ratings as part of the credit control function. Increased demand for high working capital and cash for expansion has made most institutions and enterprises having to resort to borrowing of fund from financial institutions like banks, microfinance institutions and other lending agencies like insurance companies and mortgages (PATRICK, 2015). The importance of a credit policy is to maximize the value of a firm.

2. RESEARCH PROBLEM

In Somalia, Microfinance Institutions are predominately used to help recipients with immediate needs, but they also play an important role in business development in Somalia. There is an ongoing challenge for MFIs in Somalia is the absence of a financial sector, which complicates the process of getting loans given to the clients back (Rachidi, 2018). The sustainability of microfinance institutions depends largely on their ability to collect their loans as efficiently and effectively as possible. In other word to be financially viable or sustainable, microfinance institutions must insure high portfolio quality based on 100% repayment, or at worst low default, cost recovery and efficient lending. However of late, there have been complains by the microfinance institutions regarding high rate of default by their clients which is a problem to the loan performance; which presupposes that most of microfinance institutions are not achieving the internationally accepted standard portfolio at risk of 3% which is a cause for concern because of its consequences on businesses, individuals, and the economy of Somalia at large (Rachidi, 2018).

3. GENERAL OBJECTIVE

The general objective of this study was to examine the effect of credit policy on loan performance of microfinance institutions.

3.1 Specific Objectives

1. To determine the influence of Credit Procedures on loan performance of microfinance institution in Mogadishu Somalia.
2. To find out the influence of Credit Standards on loan performance of microfinance institution in Mogadishu, Somalia.
3. To establish the influence of Credit Information on loan performance of microfinance institution in Mogadishu, Somalia.
4. To establish whether there is a significant relationship between credit limit and the loan performance in microfinance institutions in Mogadishu - Somalia.

4. REVIEW OF LITERATURE

4.1 Theoretical Framework

The theories discussed in this section are credit risk theory management models and KMV credit monitor model.

4.1.1 Credit Risk Theory Management Models

A number of credit risk systems have been developed based on an organizations line of business to aid in the aspect of quantifying and managing risk across the product lines. These models also play an important role in measuring performance and credit risk management including performance based compensation, risk based pricing, client profitability analysis and active portfolio management. Credit risk modeling may prove to be a better way of internal risk management and oversight for setting a credit policy on regulatory capital requirements. To produce a more precise information the model has to be validated empirically, conceptually sound and be comparable across the microfinance organizations. Credit scoring models use data from the borrowers' observable characteristics to enable it calculate the probability default or group the borrowers into different risk classes (JACKLINE B., 2016).

4.1.2 KMV credit Monitor Model

The KMV model is a creditor monitor model that helps to solve the lending problems of financial institutions and look at the incentive repayment problem. To try to resolve the problems, the KMV model uses the structural relationship between the volatility of firm's assets and the volatility of the firm's equity. It used to determine the expected default frequency that reflects the probability that the market value of the firm's assets will fall below the promised repayments on debt liabilities in one year. If the value of the firm's assets falls below its debt liabilities, it can be viewed as being economically insolvent. Simulations by the KMV has shown that the model outperforms both S & P ratings and accounting based models (Saunders & Cornett, 2015).The relevant net worth of a firm is therefore the market value of the firms asset minus the firms default point. A firm will default when its market net worth reaches zero. The KMVs empirical expected default frequency is an overall statistics that can be calculated for every possible distance to default using data either aggregated or segmented by region or industry. As a firms distance of default fluctuates so does the expected default frequency. The model has been criticized on the basis that there are no true probabilities of default .For firms that are actively traded; it would be possible in theory to update the expected default frequency in order to replicate risky bond prices (Weinberg, 2016).

4.2 Conceptual Framework

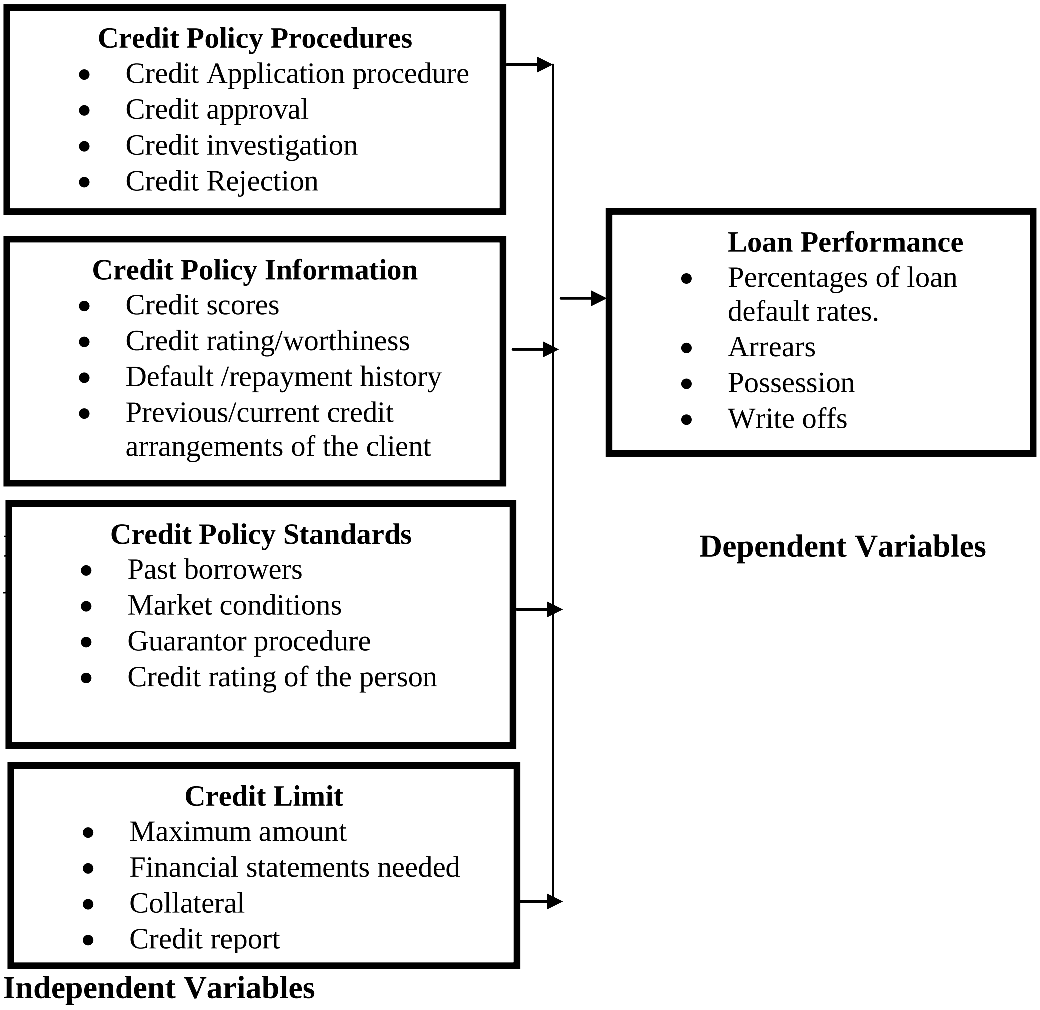

Figure 1 Conceptual Framework

4.3 Review of Study Variables

4.3.1 Credit policy procedures

A firm following a stringent credit policy sells credit on a highly selective basis only to those customers who have power credit worthiness and are financial strong and those firms will always have a high profit margin. Therefore the firm uses its credit policy variables to influence its investments in accounts receivables and to grantee profits. Collateral security, it is the pledged asset in case of default. Should easily be marketable, safe or free from nay claims and it is the last thing to consider in the credit evaluation, condition general economic, social legal, political conditions of the business prospects/futures conditions of the business that may affect the customer's ability and willingness to pay. If the environment assessment does not show good results, then granting unrestricted credit would be wrong decision (Jackline, 2016).

Achieving and maintaining repayment discipline is crucial to the sustainability of any micro credit program. Lending institutions must make good loans because default without sanctions will damage the people's commitment and the whole program may collapse. Generally, the conventional theory of rural development finance shows that rural finance in low-income countries has many inherent failures, including low levels of loan recovery, insufficient savings mobilization, high transaction costs, and distribution bias to relatively wealthier customers (Kone, 2017). Lenders prefer known clients to avoid default. People on a loan committee will give preference to an applicant with whom they have dealt previously. Hence, lending institutions will give money based on previous banking experience with the client (Moti, 2015). The same study also showed that institutions lend to profitable business that have cash follow available to pay back the loan. Another strategy for dealing with default is lending to groups. The collective coming together of individuals is useful in a number of ways, including peer pressure that obliges the members to work within agreed norms. Although studies indicate that such schemes work well if groups are homogeneous and jointly liable for defaults, the practice of denying credit to all groups members in case of default is the most effective and least costly way to enforce joint liability (Moti, 2015).

4.3.2 Credit Policy Information

Credit Policy Information before extending credit to any of its operators, sufficient information should be collected about the customers. This is done in a bid to minimize losses, reliable and timely information is critical to managing the credit process. If timely and useful information is available, management is much better equipped to direct and control prudent credit processes (Mulema, 2015).Two major sources of external information are available. The first is the work of the credit associations, which are local groups that meet frequently and correspond with one another to exchange information on credit customers. These local groups have also banded together to create credit interchange, a system developed by the National Association of Credit Management for assembling and distributing information about debtor's past performance.

Although a great deal of Credit Policy Information is available, it must still be processed in a judgmental manner. Computerized information systems can assist in making better credit decisions, but, in the final analysis, most credit decisions are really exercises in informed judgment. Even credit scoring systems require judgment in deciding where to draw the lines, given the set of derived scores (Kipkiru, 2018).

4.3.3 Credit Policy Standards

Credit Policy Standards involves application of techniques for determining which customers should receive credit (Masambu & Antony, 2018). This process involves evaluating the customer's credit worthiness and comparing it to the finance institution's Credit Policy Standards, its minimum requirements for extending credit to a customer (Masambu & Antony, 2018).These are the criteria, which the firm follows in selecting customers for credit extension. This is a very fundamental credit policy variable that requires intensive analysis. According to (PANDEY, 2015), A credit standard is one of the controllable decision variables that directly influence investment in trade credit. Credit Policy Standards provide guidelines for determining whether to extend credit to a customer and how much credit should be extended (Kipkiru, 2018). Noted that it is important that Credit Policy Standards be set basing on individual credit applicants by considering Credit Policy Information, credit analysis, and credit limit, and default rate.

Credit Policy Standards influence organizational profit depending on how they are administrated, Credit Policy Standards might be tight or loose. Tight Credit Policy Standards make a firm loose a big number of customers and when Credit Policy Standards are loose, the firm gets increased number of customers. But this does not mean that there will be the same increase in profitability because the increased number of customers leads to increased costs in terms of checking the added accounts and services added accounts of bad debts losses (Pandey, 2015).A collateral security is a general term for the assets that are pledged as security for payment of debt. Also refers to the extra security provided by the borrower when the lender feels that initial security provided by the borrower is not sufficient to recover the debt very smoothly. Collateral security helps the lender to recover its money in case of failure on the part of borrower (Ingermann, 2016).

Normally it means that if you are a day late on payment that you are subject to a late fee. If you have to make payment by a certain time of day (probably indicated in your loan papers) if you are one minute late they can late charge you. You may also be subject to penalties like an increase in the interest rate. The loan would not be in default until you are 10 days late. At default they can call for the full amount of the loan to be immediately due. They can also make you responsible for all fees (like collection, court & legal) if you default so your balance could suddenly be double what it was. Loan periods vary according to the category of client and the type material borrowed. The basic general loan period for all client categories is two weeks. Two week renewed materials may be recalled and loan periods shortened if requested by another client. Some client categories may be entitled to longer loans but these materials may be recalled and loan periods shortened if requested by another client. If clients are planning on being away for an extended period of time please make arrangements for someone to return recall materials by the recalled due date. Primary clients may renew university for Alberta books a maximum of four times and NEOS books a maximum of two times. For details on client categories and privileges, inquire at a service desk (Ingermann, 2016).

4.3.4 Credit Limit

Credit limit; This is the maximum amount of credit, which the firm can extend to customers at any point in time, as this limit is decided the analysis should carefully scrutinize the amount of contemplated sales and the customer's financial strength. There is need to lower amount of credit where slow paying tendencies crop up (Kluwer, 2018).Credit limit describes the maximum amount that a borrower can borrow. The maximum loan amount is based on a combination of different factors involving the specific loan program, the value of the property that secures the loan and the borrower's qualifying ratios and credit history. Lenders typically offer various loan programs with maximum loan amounts tailored for different classes of borrowers (Masambu & Antony, 2018).

A borrower's credit limit may be raised after he or she exhibits timely and full repayments. However, having a high credit limit and multiple lines of credit may hurt a person's overall credit rating. In these cases, new potential lenders can see that the applicant has access to a large amount of debt, which may lower the chances that this person will be able to repay his or her debts in the future. As a result, new potential lenders might be less likely to offer an additional source of debt (Kone, 2017).Credit/customer analysis is a procedure to determine the likelihood a customer will pay its bills. There are a number of ways to find out whether customers are likely to pay their debts, that is, to carry out credit analysis. The most obvious indication is whether they have paid promptly in the past. Prompt payments are usually a good omen, but beware of the customer who establishes a high credit limit on the bases of small payments and then disappears, leaving you with a large unpaid bill. If you are dealing with a new customer, you will probably check with a credit agency. Dun & Bradstreet, which is by far the largest of these agencies, provides credit ratings on several million domestic and foreign firms. In addition to its rating service, Dun & Bradstreet provides on request a full credit report on a potential customer. Credit agencies usually report the experience that other firms have had with your customer, but you can also get this information by contacting those firms directly or through a credit bureau. Your bank can also make a credit check. It will contact the customer's bank and ask for information on the customer's average bank balance, access to bank credit, and general reputation (Miki, 2016).

4.3.5 Loan Performance in Microfinance Institutions

This refers to when a debtor has not met his or her legal obligations according to the debt contract, for example has not made a scheduled payment, or has violated a loan covenant (condition) of the debt contract (Kipkiru, 2018). A default is the failure to pay back a loan. Default may occur if the debtor is either unwilling or unable to pay their debt. This can occur with all debt obligations including bonds, mortgages, loans and promissory notes (Hong Kong Monetary Authority, 2002).

The collateral serves as protection for a lender against a borrower's default that is, any borrower failing to pay the principal and interest under the terms of a loan obligation. If a borrower does default on a loan, that borrower forfeits (gives up) the property pledged as collateral and the lender then becomes the owner of the collateral (Miki, 2016). In a typical mortgage loan transaction, for instance the real estate being acquired with the help of the loan serves as collateral. Should the buyer fail to pay the loan under the mortgage loan agreement, the ownership of the real estate is transferred to the bank.

5. RESEARCH METHODOLOGY

This study took a descriptive survey design. The target population of this study was Sa'id foundation micro credit department and Salam Bank. The target population consisted of 85 employees in Sa'id foundation micro credit department and Salam Bank loans department in Somalia. This number included junior finance staff, senior finance staff and operational staff of the organizations. The study selected a sample of 70 respondents from Sa'id foundation micro credit department and Salam Bank loans department Mogadishu Somalia to determine the effect of credit policy on loan performance in microfinance institutions in Mogadishu, Somalia. The populations from which the sample was drawn constituted a homogeneous group and so simple random sampling technique was used to select the respondents. Simple random sampling method is none biased because each member of the subset has an equal probability of being chosen. Primary data was collected by use of self-administered structured questionnaires which were distributed through the drop and pick method. Secondary data collected from annual and published financial statements, in national newspapers, during annual general meetings and in-house magazines, important business disclosures in journals, manuals and the various firm's documents were used to cross validate the primary data information collected.

6. DATA ANALYSIS AND RESULTS

6.1 Correlation Analysis

Table 2 Pearson Correlation

		Credit Policy Procedure	**Credit Policy Information**	**Credit Policy Standards**	**Credit Limit**	**Loan Performance**
Credit Policy Procedure	Pearson Correlation	1				
	Sig. (2-tailed)					
Credit Policy Information	Pearson Correlation	. 630**	1			
	Sig. (2-tailed)	.000				
Credit Policy Standards	Pearson Correlation	.612**	.847**	1		
	Sig. (2-tailed)	.000	.000			
Credit Limit	Pearson Correlation	.707**	.738**	.614**	1	
	Sig. (2-tailed)	.000	.000	.000		
Loan Performance	Pearson Correlation	.833**	.547**	.704**	.785**	1
	Sig. (2-tailed)	.000	.003	.000	.000	
**. Correlation is significant at the 0.01 level (2-tailed).						

1n trying to show the relationship between the study variables and their findings, the study used the Karl Pearson's coefficient of correlation (r). This is shown in Table 2 above. According to the findings, it was clear there was a positive correlation between the independent variables, credit policy procedure, Credit Policy Information, Credit Policy Standards, Credit Limit and dependent variable Loan Performance. The correlation analysis between each of the independent variables with the dependent variable (loan performance) produced the correlation coefficients of 0.833, 0.547, 0.704 and 0.785.704**.

The correlation analysis between loan performance and Credit Policy Procedure produced a coefficient of 0.833, the correlation analysis between loan performance and Credit Policy Information produced 0.547, while that between loan performance and Credit Policy

Standards produced 0.704 and the correlation analysis between loan performance and Credit Limit produced 0.785.

6.2 Coefficient of Determination (R^2)

The study used multiple regression analysis to determine the effect of the independent variables on the dependent variable. The regression analysis produced R squared results of 0.831, this indicates that the independent explain are 83.1% of the variations in the dependent variable while the remaining 17% is explained by other factors. R squared is used to explain the percentage of variations or changes in the dependent variable that are explained by the independent variables.

Table 3 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.911[a]	.831	.910	.197
a. Predictors: (Constant), Credit Limit, Credit Policy Procedure, Credit Policy Standards, Credit Policy Information				

6.3 Analysis of Variance

This was used to determine whether the relationship between the dependent variable and independent is statistically significant in order to use the model for predicting. The model was considered significant if the p-value was less or equal to 0.05. From the study analysis it was indicated that the relationship between dependent variable and independent variables is statistically significant because it produced a p-value of 0.026 which is less than 0.05. This is shown in the table below.

Table 4 ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	12.460	4	.115	2.957	.026[b]
	Residual	2.526	65	.039		
	Total	14.986	69			
a. Dependent Variable: Loan Performance						
b. Predictors: (Constant), Credit Limit, Credit Policy Procedure, Credit Policy Standards, Credit Policy Information						

6.4 Regression Analysis

The regression analysis was carried out and it produced the following results as represented in table 4.15 below. The regression analysis showed that there is a significant relationship between Loan Performance and Credit Policy Procedure, this represented by a p-value of 0.000 which is lower than 0.05. The regression analysis also indicated that there is a significant relationship between Loan Performance and Credit Policy Information. This is shown by a p-value of 0.003 which is lower 0.05.

The regression analysis also revealed that there is a significant relationship between Loan Performance and Credit Policy Standards. This is shown by a p-value of 0.001 which is lower than a p-value of 0.05. The regression analysis further revealed that there is a significant relationship between Loan Performance and Credit Limit. This is indicated by a p-value of 0.000 which is lower 0.05.

Table 5 Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.320	.285		11.632	.000
	Credit Policy Procedure	.320	.064	.001	5.0	.000
	Credit Policy Information	.451	.086	.101	5.24	.003
	Credit Policy Standards	.731	.111	.024	6.58	.001
	Credit Limit	.572	.079	.031	7.24	.000
a. Dependent Variable: Loan Performance						

$Y=\beta+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4 X_4 + \mu$

$Y= 3.320+0.001X_1+0.101X_2+0.024X_3 +0.031X_4$

Where Y is the dependent variable (Loan Performance), X_1 is the effect of Credit Policy Procedure, X_2 is effect of Credit Policy Information, X_3 is effect of Credit Policy Standards and X_4 is the effect of Credit Limit.

7. CONCLUSIONS AND RECOMMENDATIONS

7.1 Conclusions

The study investigated the effect of credit policy on loan performance of microfinance institutions in Somalia. From the findings it was established that loan extension is one of the primary sources of profitability to microfinance institutions however with high risk of having non performing loans if care is not taken before giving out loans. From the study findings it can be concluded that microfinance institutions need to formulate credit policies to enable the management of credit risks and increase loan performance.

7.2 Recommendations

Given the findings of the study, Microfinance institutions need to have a strong credit management policy in order to reduce credit risks and promote loan performance. Microfinance institutions need to enhance their client appraisal techniques to avoid having clients who cannot repay back the loans. This will enable improvement of financial performance by having credits being paid and having a positive performing loan portfolio in terms of recovery. Micro-finance institutions suffer loan losses through relaxed lending standards, inadequate client evaluation and unguaranteed credits. The study therefore recommends that MFIs enhance their credit risk controls by creating profile assessment database of prospective and current borrowers and guarantors that can be used to help minimize non-performing loans. This will help in improving their financial performance

Management need to be cautious in order to avoid setting up a credit policy that will negatively affect profitability and also they need to know how credit policy affects the operation of their institutions to ensure judicious utilization of loans and maximization of profit. Poor credit risk management reduces profitability and increase loan losses and non-performing loan which may eventually lead to financial distress.

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