

**LOAN PORTFOLIO MANAGEMENT AND FINANCIAL PERFORMANCE OF  
MICRO FINANCE INSTITUTIONS IN UGANDA: A CASE OF BRAC UGANDA  
MICROFINANCE LIMITED HEAD OFFICE KAMPALA**

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**DECLARATION**

I, LUVUMA STEPHEN do declare to the best of my knowledge that this piece of work is my original work and has not been presented to this University or any other Institution of Higher Learning for the award of a Degree or any other academic award. Throughout the work, I have acknowledged all the sources used in the compilation.

**Signature**.....

**LUVUMA STEPHEN**

**Date of Submission**.....

**APPROVAL**

I certify that LUVUMA STEPHEN has carried out this research under my supervision and the work is now ready for submission and examination for the award of Master of Business Administration of the University of Kisubi.

Signature of Supervisor.....

**DR. KIZZA JAMES (PhD)**

Date.....

## **DEDICATION**

This dissertation is dedicated to my dear wife for the great care and love showed to me during the course and to my children in compensation of the fatherly love missed and as a sign of encouraging them to study passed this level of education.

## **ACKNOWLEDGEMENT**

I would like to acknowledge God the Almighty, for enabling me to reach this accomplishment. This dissertation has been a product of many supporters who provided the guidance, comfort, courage and love towards my studies. Special thanks go to my supervisor Dr Kizza James for the tireless efforts in reading the work, the constructive criticisms, timely feedback and all the necessary psycho social support, may God bless you.

Sincere thanks to my family members who accorded me all the necessary the support during this strenuous period. To all my classmates and colleagues in struggle, thank you for being there for me. To the University management and staff of the University of Kisubi, thank you for all the essential guidance and mentorship accorded to me during my studies.

All glory and honor be to God now and forever

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## **ABSTRACT**

This study set to investigate the relationship between loan management and the financial performance of microfinance institutions, using BRAC as a case study. The study followed a quantitative approach and adopted a Case study design. The key respondents of the study were the relationship officers that deal directly with identification and recommendation of prospective loan borrowers. The study findings revealed the existence of: a significant relationship between loan portfolio planning and financial performance ( $r=.27$ ,  $p<.05$ ); the existence of: a significant relationship between client screening and financial performance ( $r=.34$ ,  $p<.01$ ); and the lack of a significant relationship between credit risk control and financial performance. The study concluded that loan portfolio planning and client screening are very key to MFIs financial performance. Credit risk control plays an insignificant role in MFIs financial performance as explained by the key objectives and the inherent nature of the type of clients served by MFIs. It is recommended that MFIs strengthen their portfolio planning and client screening policies, and continue to improve on their credit risk control policies in line with their key objectives. Further research is recommended to cover more MFIs, and a study on the role of insurance as hedge to MFIs inherent risk is highly recommended.

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.0 Introduction**

This study examined the effect of loan portfolio management on financial performance of non-deposit taking micro finance institutions in Uganda using a case of BRAC Uganda Microfinance Ltd. The independent variable for this study was Loan Portfolio Management, and the dependent variable was financial performance. This is an introductory chapter that discusses the study's history, problem statement, purpose, study objectives, research questions, study scope, and importance.

### **1.1 Background of the study**

The background of the study is presented in four different perspectives namely; historical, theoretical, conceptual and contextual.

#### **1.1.1 Historical Perspective**

Lending is the primary business activity for most financial organizations. The loan portfolio is often the greatest asset for microfinance firms and is the most common source of revenue. According to Boateng (2011). The loan portfolio is often the greatest asset for microfinance firms and is the most common source of revenue. In the United States, effective credit risk management of the loan portfolio necessitates that the board of directors and management understand and oversee the bank's risk profile and credit culture. To do so, they must have a solid understanding of the portfolio's makeup as well as its inherent risks (Matovu & Okumu, 2013).

For decades, good loan portfolio managers have focused their efforts on properly authorizing loans and closely monitoring loan performance. Despite the fact that these operations remain the backbones of loan portfolio management, prior credit problems, such as those linked with

oil and gas lending, agricultural lending, and commercial real estate lending in the 1980s, have shown that portfolio managers should do more (Laurence, 2013).

In Europe, in the view of Nwankwo (2000), “credit constitutes the largest single income-earning asset in the portfolio of most financial institutions. This explains why banks spend enormous resources to estimate, monitor and manage credit quality”. This is understandably, a practice that impact greatly on the lending behavior of banks and other financial institutions as large resources are involved. In UK, Chodechai (2004) while investigating factors that affect interest rates, degree of lending volume and collateral setting in the loan decision of banks, says: Banks have to be careful with their pricing decisions as regards to lending as banks cannot charge loan rates that are too low because the revenue from the interest income will not be enough to cover the cost of deposits, general expenses and the loss of revenue from some borrowers that do not pay (Chodechai, 2004).

In Africa, in most of the developments that improve the loan portfolio’s liquidity have implications for price risk. Traditionally, the lending activities of most banks in Ghana were not affected by price risk. Because loans were customarily held to maturity, accounting doctrine required book value accounting treatment. However, as banks develop more active portfolio management practices and the market for loans expands and deepens, loan portfolio has become increasingly sensitive to price risk (Nnanna, 2005).

The banking industry has suffered massive losses over the last decade. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, The Reserve Bank of Zimbabwe (RBZ) pointed out what it terms “imprudent loan portfolio management practices” as being one of the major causes of the banking crisis of 2004. Commercial banks have nearly uniformly upgraded their loan portfolio management and control systems as a result of this (Gieseche, 2004). Portfolio theory provides a foundation for

understanding the interaction of systemic risk remand in Ugandan financial institutions. It has influenced how institutional portfolios are managed and encouraged the adoption of passive investment strategies. As more and more organizations move toward a management by projects approach, portfolio management is being used in a variety of other fields, particularly project management (Okorie al., 2007).

Microfinance institutions are an important instrument for boosting financial inclusion and alleviating poverty in developing countries. It has received widespread recognition as a tool from its humble origins with Professor Muhammad Yunus is the founder of the Grameen bank experiment, which began in 1979. Russell, cabrieal, and singh are three words that come to mind when I think about Russell (2006). The Grammen bank was established as a result, laying the framework for microfinance institutions (MFLS) (Armendariz & Murdudch, 2009).

At the start of the 1990s, Uganda had no specific formal financial institutions providing microfinance, although there were a few non-governmental organizations (NGOs) and government initiatives doing so. During the past 15 years, the industry grew at a dizzying pace. There were about 750 MFIs in operation by December 2005, with the bulk of them being savings and credit cooperatives (SACCOs) (MOFPED, 2006). In 2004 and 2005, four previously non-bank of Uganda (BoU) registered MFIs or Tier 4 MFIs, namely Finca – Uganda, Uganda Microfinance Union, Pride Uganda, and Uganda Women's Finance Trust (UWFT), became BoU regulated MFIs following the enactment of the Micro Finance Deposit-taking Institutions (MDI) Act, 2003. Furthermore, the industry is undergoing significant reorganization, with some MFIs putting in place the required prerequisites to become MDIs, while others changing their legal status and restructuring operations to comply with the new legal environment.

BRAC began its journey in 1972 in the newly independent Bangladesh, dedicating itself to poverty eradication through empowering the underprivileged and those in need. BRAC has played a vital role in reducing poverty in communities and society as a whole throughout its history. With approximately 110,000 devoted and motivated personnel, BRAC currently reaches an estimated 138 million people. BRAC first ventured outside of Bangladesh in Afghanistan in 2002, when it began to develop programs tailored to the needs of different countries. BRAC has expanded its operations across Asia and Africa over the years. BRAC is active in five African countries: Uganda, Tanzania, South Sudan, Liberia, and Sierra Leone, as well as five Asian countries: Afghanistan, Pakistan, Nepal, Myanmar, and the Philippines (Ndiritu, 2006).

BRAC started working in Uganda in June 2006 because it saw an opportunity to make a significant difference in a post-conflict country with high poverty and fertility rates, as well as to demonstrate the potential of its "microfinance multiplied" approach to others in the African microfinance industry (BRAC Uganda report, 2014).

The organization was incorporated as BRAC Foundation in January 2006 and it commenced business in June 2006. In March 2007, the name was changed to BRAC through the registry of Companies. Later the Microfinance and Non-Microfinance Programs got incorporated as independent companies in August 2008 and September 2010 respectively but were still trading during the year under the umbrella of BRAC (Charles, 2010).

On 30th day of September 2010, at a duly convened meeting of the Governing Board, BRAC transferred all Assets and Liabilities that relate to or are in any way connected with the Microfinance activity it has been operating in Uganda to BRAC Uganda microfinance limited and all Assets and Liabilities that relate to or are in any way connected with the Non-

Microfinance activities it has been operating in Uganda to BRAC Uganda (BRAC Uganda Report, 2014).

BRAC Uganda effectively commenced operations as an independent entity on 1 January 2010. BRAC's business model strongly reflects its philosophy, the core elements of the business model are BRAC's community outreach -based delivery methodology and its unwavering focus on borrowers at the poorer end of the poverty spectrum. These two principles which distinguish BRAC from other microfinance operators in Africa are apparent in the way BRAC has designed its operations (BRAC Uganda Report, 2014).

BRAC Uganda runs a branch network which covers virtually all districts. In 2015, it served more than 230,000 clients. Around 75% of the branches are located in rural areas. BRAC works with the group lending methodology, which is mainly used by women (Andrew, 2014).

#### 1.1.2 Theoretical Perspective

Various theories have been proposed by various scholars to explain loan management, one of which is the Theory of Credit Market, which postulates asymmetric information as the reason of poor financial market functioning in developing nations. Adverse selection and moral hazard are two consequences of incomplete information. The concept has two primary features: lenders allocate funds to projects that are hazardous and may not be bankable, and credits are issued at charges that are equal to the opportunity cost of funds, such as the supply price paid to savings or fixed depositors (Stiglitz & Weiss, 2013). The adverse selection component of interest rates, according to the idea, is the result of various borrowers having varied chances of repaying their loans.

The Portfolio Theory is the second theory, and it governs the creation of portfolios that maximize projected returns while maintaining individual acceptable levels of risk. The theory provides a framework for calculating and quantifying speculation risk, as well as making

linkages between risk and expected profits. Its core premise is that financial investors typically need to optimize returns on their investments while assuming a certain level of risk. Because the profits from each of these speculations are intertwined, the complete spectrum of undertakings must be addressed. As a result, the link between the earnings for each resource in the portfolio is critical (Reilly and Brown, 2011).

Portfolio theory administration is a fundamental theory in investment. The theory seeks to find the most effective combinations of advantages for the best portfolio anticipated returns for a given degree of risk. Limit risk for a certain amount of expected return, on the other hand. According to this theory, the level of hazard in a portfolio is determined by the risk of each benefit, the amount of assets dispersed on each benefit, and the link between the benefits that make up the portfolio. The major suspicions in portfolio theory when it comes to risk management are that the investors are objective and the market is skilled, and that they will eventually come together (Chijoriga, 2007; Mutua, 2016)

The credit market theory was used in this research. This is because the theory is pertinent to this research in that it explains how loans might be handled to increase profitability and reduce loan defaults in microfinance firms.

### 1.1.3 Conceptual Perspective

Microfinance is a term used to describe small-scale financial services that primarily provide lending and savings to the poor (Robinson, 2001). Microfinance has expanded to encompass insurance, housing, and investment services for low-income individuals. It is giving a way for the impoverished around the world to improve their livelihoods and have a greater impact on their countries' economic growth.

A loan portfolio is defined by Business Dictionary (2014) as the total of all loans held by a bank or finance company on any particular day. As a result, individual loans at a bank or



other MFI constitute a loan portfolio. Furthermore, the size of a loan portfolio is determined by the size of each individual loan, which is impacted by the borrowers' economic position in a given place.

According to the IACPM(2005), “loan portfolio management is the process by which risks inherent in the credit process are managed and controlled”. Loan portfolio management, according to Wise Geek (2014), is the act of creating a series of investments based on credit connections and managing the risks associated with these investments. As a result, loan portfolio management entails evaluating the risk associated with each loan and then reviewing the total amount of hazards associated with all loans. The main goal of portfolio management is to lower the number of defaulted loans. MFIs lower the risk of loan portfolio default by taking into account both individual and corporate credit repayment histories.

Loan portfolio management includes customer screening, credit risk management, and loan portfolio planning (Karekaho, 2009). Loan portfolio planning in microfinance institutions (MFIs) refers to procedures for segmenting, estimating, and determining the quantities and risks of loans. This is done in such a way that loans are profitably stretched out to a group of low-pay people in order for them to comprehend their anticipated business or growth goals (Kasibante, 2001). Customer screening is looking into and analyzing the financial soundness of loan applicants in terms of their ability to benefit from and repay the loan. Credit risk management is a pressing concern and a hot topic among MFIs. To reduce the risk of bad debt and over-holding, MFIs must have a better grasp of crucial variables such as customer financial strength, credit score history, and changing payment habits (Moti et al., 2012).

Loan portfolio planning, customer screening, and credit risk management are all geared at achieving desired performance in microfinance institutions, which is represented in loan interest installments, loan reimbursement, realized profitability, and client satisfaction

(Martin, 2016). As a result, when MFIs fail to meet their performance targets, dealing with loan portfolio management becomes inescapable.

Financial performance, according to Gibson (2012), can be defined as how well a financial institution's financial goals and objectives have been refined or achieved. Financial performance is the degree of a company's performance over a given period of time, expressed in terms of total earnings and losses (Gbolagade et al., 2013).

Financial performance is defined as how well a company utilises its assets from its major business mode to generate revenue over a specific time period. The term "financial performance" refers to financial indicators such as profit margin and return on investment.

Financial performance refers to the measure of a company's ability to collect revenue from its primary way of operation (Keown, Martin, Petty & Scott, 2002). This expression is also active as a broad assessment of a company's overall financial strength over time, and it is a key indicator of organizational performance. Financial performance (profits, return on assets, return on investment, and so on); product market performance (sales, market share, and so on); and shareholder return are three distinct categories of company outcomes (total shareholder return, economic value added, among others). Profitability, higher sales margin, and increased return on investment were all considered strong financial performance in this study.

#### 1.1.4 Contextual Perspective

In Uganda, BRAC now has 159 branches spread across 80 districts. BRAC presently has over 213,072 microfinance members and 102 small enterprise program branches. BRAC helped to alleviate poverty in 2017 by launching an ultra-poor graduation initiative for youth. BRAC helps young people in financial difficulty by providing assets and training to help them better

their livelihoods and achieve their economic and social goals, allowing them to escape extreme poverty (Ndiritu, 2006).

BRAC devised a strategy known as "Microfinance multiplied," in collaboration with the MasterCard Foundation, to increase poor clients' ability to use micro loans to supplement their incomes, build assets, and stimulate economic and social development in their communities (Marketwire – March 30, 2011).

BRAC and the MasterCard Foundation intended to extend their network to 129 outlets, which would serve over four million Ugandans. By 2011, the initiative has provided microfinance loans to over 110,000 borrowers, training and access to high-quality agricultural supplies to 50,000 farmers, productivity-enhancing services to 124,000 poultry and animal producers, and basic health services to over 1.5 million individuals. Fazle Hasan Abed, the founder and chairwoman of BRAC, announced this during the opening plenary of the 2011 Skoll World Forum on Social Entrepreneurship, held on March 30th in Oxford, United Kingdom (Marketwire, 2011).

However, amidst this, BRAC Uganda continues to make losses and struggle with sustainability since its concern to provide financial services to the economically challenged segments of the society undermine the drive to profitability just like the drive to profitability undermines the mission to serve many clients in this segment (Bugonzya, 2005).

## **1.2 Problem Statement**

MFIs' survival is largely dependent on the performance of their loan portfolios. This is because MFIs make the majority of their money through interest on loans to small and medium-sized businesses. The loan performance of these institutions, however, is determined by the loan portfolio management strategies used by the institution, including BRAC Uganda Microfinance Ltd (Mbabazi, 2012).

Loan default rates were high at BRAC Uganda Microfinance Ltd. For example, in order to comply with Bank of Uganda requirements, BRAC Uganda Microfinance Company took a more stricter approach to loan write-offs totaling USD 1.1 million in 2017. (BRAC International Report, 2017). In 2017, authorities in Kabale district detained BRAC employees for illegally detaining consumers who had failed to pay their bills.

This issue has had a negative influence on BRAC Uganda's loan portfolio and financial performance. This trend jeopardizes the institution's financial viability and sustainability, obstructing the attainment of the institution's intended goals of providing services to the rural unbanked population and alleviating poverty by bridging the financing gap in the mainstream financial sector (Kiplimo and Kalio, 2012). This report lays the groundwork for a study to fill a knowledge gap by examining the impact of loan portfolio management on the financial performance of microfinance institutions in Uganda.

### **1.3 Purpose of the study**

The study focused on inspecting the effect of loan portfolio management on performance of non-deposit taking Micro Finance Institutions (MFIs) in Uganda.

### **1.4 Objectives of the study**

- i. i. To determine the impact of loan portfolio planning on BRAC Uganda's financial performance.
- ii. ii. To investigate the impact of customer screening on BRAC Uganda's financial performance.
- iii. To investigate the relationship between credit risk control on financial performance of BRAC Uganda

## **1.5 Research Questions**

- i. What is the relationship between loan portfolio planning on the financial performance of BRAC Uganda?
- ii. What is the relationship between client screening on the financial performance of BRAC Uganda?
- iii. What is the relationship between credit risk control on the financial performance of BRAC Uganda?

## **1.6 Scope of the study**

### **1.6.1 Geographical Scope**

The study was conducted at BRAC Uganda Microfinance Ltd head offices located at Plot 90 Busingiri Zone off Entebbe road Nyanama Kampala, P.O Box 31817, Kampala.

### **1.6.2 Content Scope**

The study was restricted to investigating the relationship between loan portfolio planning, client screening, credit risk control and financial performance of BRAC Uganda Microfinance Ltd. Financial performance was measured using constructs like profitability, sales margins and return on investment.

### **1.6.3 Time Scope**

The study covered BRAC Uganda Microfinance Ltd for the period from 2012 up to 2017. This time was chosen because it is during this period that BRAC wrote off many bad loans amounting to USD 1.1 million according to BRAC International Report, 2017).

## **1.7 Significance of the study**

### **BRAC Uganda Finance Ltd**

The study's significance stems from the hope that its findings will assist BRAC Uganda Finance Limited managers in identifying the weaknesses in loan portfolio management and

the level of loan portfolio performance, providing a foundation for appreciating and devising means and ways to address the weaknesses in order to improve loan portfolio performance.

**Researchers**

This study's results and conclusions make a contribution to the body of knowledge in the subject of microfinance. It could serve as a catalyst for more research to refine and expand the current study, particularly in Uganda.

**Government**

The findings could be used by the government to develop and implement more effective Micro Finance policies in Uganda, either to replace or augment existing policies, in order to better manage non-deposit taking MFIs and their consumers.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 Introduction**

Literature is reviewed under the study objectives. Included in this chapter is; the theoretical review and conceptual framework, depicting the relationship between the variables of the study.

#### **2.1 Literature Survey**

The goal of Karekaho (2009)'s study in Wakiso, Uganda, was to establish a link between loan portfolio management and execution of Microfinance Institutions (MFIs). The research revealed that sophisticated portfolio arranging, customer screening, portfolio control, and MFI execution all had significant connections. While this study looks at non-deposit taking microfinance institutions' financial performance, it does so using financial indicators that apply to all MFIs.

Loan portfolio planning, client screening, and credit risk control are all necessary for any MFI to achieve any level of loan portfolio performance, according to Kagwa-Pafula (2002). The process of conducting all of these loan management processes determines all of the metrics that represent loan portfolio performance.

Murrinde (2002) observed loan repayment, which is another measure of loan portfolio performance, as a variable whose terms and conditions are all determined through portfolio planning and client screening, and then enforced through portfolio control as exercised by CEOs and loan officers. It is through portfolio planning that the periods for loan repayment, the installments to be paid and when to complete the payment, are all set.

Customer target attainment is also determined by loan portfolio management, which represents client loan performance. Loan repayment schedules and values are determined by



management, which have an impact on the client's capital base and, as a result, the level and capacity of business operations (Micro Finance Forum, 2001; Martin, 2001).

To summarize, the literature reveals that loan portfolio management influences the performance of any MFI's loan portfolio. Several research have been conducted to demonstrate how loan portfolio management affects MFI performance. However, none of these research focused primarily on non-deposit accepting MFIs; instead, they looked at all microfinance institutions as a whole. As a result, the research reveals that there is still a gap in understanding of how this management affects loan portfolio performance in Uganda's non-deposit accepting MFIs. It is in the light of this gap that such a manner is being given attention.

## **2.2 Theoretical Review**

The poor functioning of financial markets in underdeveloped nations is attributed to asymmetric information, according to the Theory of Credit Markets. Incomplete information has two consequences: adverse selection and moral hazard. Lenders allocate cash to projects that are risky and may not be bankable, and credits are issued at rates corresponding to the opportunity cost of funds, such as the supply price paid to savings or fixed depositors. (Stiglitz & Weiss, 2013) published a groundbreaking study that ushered in attempts to explain credit rationing in credit markets. In this argument, credit institution interest rates are thought to play a dual role in selecting potential borrowers (leading to adverse selection) and influencing borrowers' actions (leading to the incentive effect). Interest rates influence the nature of the transaction as a result, but they do not always clear the market. Both effects are assumed to be driven by a lack of information in the credit markets. Because lenders' expected returns are predicated on the likelihood of repayment, they use adverse selection to find the most probable borrowers to repay their loans. In order to discover borrowers with a

high possibility of repayment, banks are likely to use the interest rates that an individual is willing to pay as a screening technique.

Interest rates have an unfavorable selection component since different borrowers have differing chances of repaying their loans. Because the bank's expected profits are dependent on the likelihood of repayment, the bank would like to be able to identify borrowers who are likely to repay. It is difficult to identify reputable borrowers, which necessitates the employment of a number of screening procedures by the bank. One such screening mechanism is the interest rate that an individual is willing to pay: people who are willing to pay high interest rates are likely to be poorer risks; they are willing to borrow at high interest rates because they believe their chances of repaying the loan are slim. The average riskiness of those who borrow increases when interest rates rise, potentially diminishing the bank's earnings. Similarly, the borrower's behavior is likely to alter as the interest rate and other contract parameters change. Raising the interest rate, for example, lowers the return on projects with lesser chances of success but bigger payoffs if they succeed. In a world where knowledge is perfect and free, the bank would specify all of the activities that the Borrower could take (which might affect the return to the loan). However, because the bank cannot directly oversee all of the borrower's actions, the conditions of the loan contract will be written in such a way that the Borrower is enticed to perform behaviors that benefit the bank, as well as to attract low-risk borrowers.

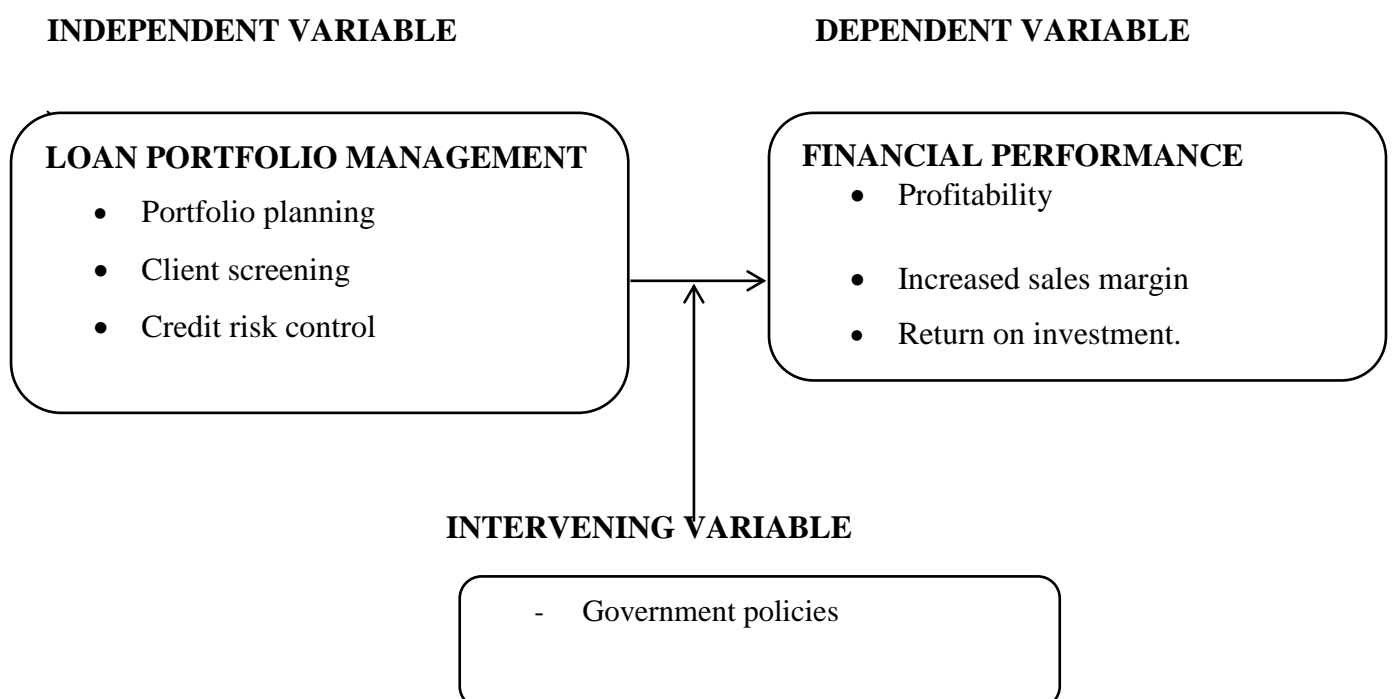
The following is an explanation of Adverse Selection: Ex ante, it is considered that money lenders have a greater understanding of the risks involved with their initiatives. A person with a high-risk project may be able to obtain credit at a high interest rate. At this high rate of interest, a less risky project may be denied financing since it will not make the firm sustainable and will jeopardize the borrower's ability to repay the loan. If the interest rate is

hiked and a higher-risk borrower is favored and defaults, the lender's capital base will be jeopardized. Lenders that seek to reduce risk will lend their money at a lower rate of interest rather than a greater rate. If the average quality of the lender's loan portfolio is realigned, the interest rate mechanism may not achieve market rate equilibrium, but rather rationing of credit at a lower interest rate. Interest rates will climb faster if lenders do not keep separate portfolios.

Moral hazard phenomenon is part of the problem of imperfect information concerning borrower's actions. It is the misapplication of borrowed funds that shifts the risk to the lender, especially, if the project does not succeed. Borrowers may be tempted to divert approved loans to other projects with high risk, thereby reducing loan repayment possibility. Lenders may refuse to take actions that will enhance loan repayment due to incentives and reinforcement problems (Amonoo et al, 2003). If the moral hazard phenomenon occurs, solution advocated by the model is credit rationing.

### 2.3 Conceptual framework

A conceptual Framework is a diagrammatic representation of the breakdown of the variables of the study. The framework depicts the study's variables in relation to one another.



*Figure 2. 1: Conceptual Framework*

**Source:** *Adopted from Mehta, (2010) and modified by the researcher 2019*

The conceptual framework above depicts the relationship between the independent variable, Loan Portfolio Management, which consists of portfolio planning, client screening and credit risk control; while the dependent variable financial performance is measured in terms of; profitability, increased sales margin and return on investment. It assumes that once the dimensions of the independent variable mentioned above are in place, then the outcome will be better loan performance of non deposit taking MFIs. However, the study recognizes that there are variables such as government regulations that intervene in loan portfolio management, thereby affecting loan portfolio performance

## **2.4 Review of Related Literature**

### **2.4.1 Loan Portfolio Planning and financial performance**

Loan portfolio planning, according to Loan Analytics (2004), involves portfolio policies such as loan segmentation, risk detection, cost allocation, and profit maximization. Loan portfolio segmentation focuses on segmenting the loan portfolio into homogeneous sub-portfolios, with each sub portfolio having customers and loans with similar risk characteristics. The goal is to build a risk-adjusted portfolio that maximizes return at a given level of risk.

However, the way Uganda's MFIs are vulnerable to risk of default, failing to recover loaned money from those they lend and to realize expected returns as pointed out by Bohnstedt (2000) casts doubts on how that their portfolio segmentation is conducted. Questions regarding how they come up with sub portfolios that do not support their stay in business remain unanswered; hence the need for this study to provide empirical answers.

Portfolio planning also involves the identification of sub-portfolio risk. The idea behind is that the foundation of effective loan portfolio performance is rooted in the probability of default and loss as estimated in accordance with the type and capacity of the businesses of customers in a given sub portfolio. Many sub portfolio risk estimation methods exist such as migration and sub portfolio stress testing, but for MFIs, the method usually employed to identify sub-portfolio volatility considers group guarantees determined according to the level of trustworthiness and cooperation that the MFI has with the customers in a particular sub portfolio.

Kagwa-Pafula (2000) observes that the use of this method is based on the rationale that most clients targeted by MFIs are poor people expected not to have the collateral required to secure loans under conditions of minimized risks. Antonio (2000) adds that the method facilitates a decrease in portfolio risk through better risk identification and risk diversification, and increases portfolio profitability through the reduction of portfolio volatility and the increase in customer profitability.

Portfolio planning also involves the identification and allocation of loan origination costs, fixed overhead and servicing costs, and variable servicing and marketing costs over the total loan portfolio. These costs are allocated by loan type, loan size, and probability of default and loss given default. This step involves loan pricing, which itself focuses on setting or fixing the interest rate or the price a customer has to pay for using the loan extended by any lending institution and a MFI in particular (Ditcher and Kamuntu, 1997; Garber, 1997; Kasekende and Aleema, 1999).

Another aspect of portfolio planning is the maximization of stockholder value by creating a risk-efficient portfolio, which according to Meeker (1998), is that portfolio that maximizes the expected return for a given level of risk. From the above policies, it can be concluded that

loan portfolio planning is a very critical process in the business life of a lending institution and a MFI in particular.

Loan portfolio planning has an impact on portfolio performance because of the outcomes of the loan portfolio planning policies used. Indeed, the portfolio segmentation planning policy tries to create a risk-efficient portfolio and optimize portfolio return at a given risk level (King & Levine, 1994). The goal is to keep or increase portfolio risk-adjusted returns while lowering portfolio risk and volatility. As a result, it assesses the risks associated with extending certain loans, forecasting the level of expected default and loan payback, both of which are important components of portfolio performance. As a result, when portfolio performance falls short of expectations, particularly in terms of loan payback, as Kagwa-Pafula(2002) reported for Ugandan MFIs, the situation, as Bohnstedt (2000) noted, raises questions about how portfolio segmentation is carried out. Failure to recover loaned funds and realize promised profits necessitates determining how MFIs create sub portfolios.

In addition, Getubig (1987) regarded risk identification, which is also a loan planning policy, as the foundation of effective loan portfolio performance. He noted that this policy centres on minimization of risk through accurate estimation of probability of default and loss in view of the type and capacity of the businesses of customers in a given sub portfolio. Antonio (2000) added that the method facilitates a decrease in portfolio risk through better risk identification and risk diversification; that it also increases portfolio profitability through the reduction of portfolio volatility and the increase in customer profitability. Clearly, all the variables the policy focuses are performance-indicator variables. Determining them is therefore the same as determining loan portfolio performance.

Furthermore, the planning policy involving identification and allocation of costs is essentially about loan pricing. It focuses on setting or fixing the interest rate or the price a customer has

to pay for using the loan extended by the MFI (Hartmut, 1997). This way, this policy affects on loan performance since the interest rates it comes up with determine the extent of loan servicing.

#### **2.4.2 Client Screening and financial performance**

Client screening, according to Van Horne (1996, 2002), entails gathering information about loan applicants and then analyzing and determining the applicants' creditworthiness in order to make credit choices. The information is collected through the applicants' financial statements, credit ratings and reports, trade checking, and business experience, according to Van Horne (1996, 2002). He pointed out that this information aids in determining not just the applicant's creditworthiness and capacity to meet the minimum requirements for the loan being sought, but also the likelihood of bad debts.

All of this is done in order to make an informed choice about whether or not to extend a loan. Van Horne, on the other hand, was dealing with the management of financial policy in general, not with micro finance organizations specifically. His observations, however, can help inspire a study into how these institutions conduct client screening and how this affects portfolio performance.

Hartmut (1997) looked at client screening from the perspective of loan demand and potential to repay. Client screening is the process of determining credit demand based on the repayment ability of loan applicants Hartmut (1997). It focuses on the applicants' repayment capacities based on the credit worthiness, trustworthiness, kind of company, and level of faith that the MFI gets from the information supplied by the MFIs.

According to ACCA (2005), historical financial indicators can be used to screen clients. These indicators can be generated from historical financial statements and used to measure liquidity, solvency, profitability, efficiency, and debt repayment capacity in the past. Lenders

need this information to assess the borrower's present financial situation and how well the borrower has fared in recent years. These signs should then be compared to the lender's underwriting guidelines to determine the creditworthiness of each individual borrower. ACCA (2005) added that if an applicant's balance sheet shows that the applicant has more loans than assets, that is, if the applicant's equity to assets ratio is low, lending the applicant is at a greater risk of not recovering the loan extended. This is because low equity to assets ratio indicates that the applicant is at a greater risk of collapsing any time. On the other hand, a high equity to assets ratio indicates that the applicant is in a sound position and can service and repay the loan, regardless of whether the applicant has made profits or not. ACCA (2005) was however dealing with general assessment of the financial position of a firm but not how this assessment impacts on portfolio performance of MFIs.

Martin *et al* (2006) observed that many potential or targeted clients of MFIs do not always have the financial statements necessary to assess their credit worthiness and potential to repay. These authors therefore suggested that other parameters have to be considered. For MFIs to remain competitive in the market, MFIs must assess the changing business features and needs of loan applicants on a regular basis. Sound customer screening systems that clearly perceive and grasp the changing nature of applicants' businesses are the cornerstone for their success. They have to look at issues like: Is the applicant a full-time business operator; is he in a sustainable business; and if the applicant wants startup capital, is the business likely to succeed and continue in operational existence until the loan is paid? A clear understanding of these issues can help a great deal in identifying successful and less risky applicants. Martin *et al* (2006) concluded by noting that based on the answers to these questions, successful MFIs tend to group loan applicants according to their business characteristics, and to extend loans to only those whose likelihood of default is very low. In



view of these observations, it is important to establish how MFIs in Uganda go about their client screening.

Even when most MFI clients do not have financial records to support their applications for essential loans, sensible screening should not be based on verbal explanations, according to the Ministry of Finance, Planning and Economic Development (MFPED) (2005). Applicants for loans must provide information about why they require the funds. These details are typically given in the form of project proposals that clarify the nature of the business for which a loan is sought, according to Martin et al (2006). As a result, an applicant's creditworthiness is assessed based on the project plan that he or she has presented. There are many different types of analysis, such as viability and reliability analysis.

According to Meeker (1998), the problem with most of the MFIs, especially those dealing in lending to farmers is that their client evaluation process is still rigid, despite all the more realistic considerations available to these institutions from the market conditions of agricultural outputs.

Every commercial lender, including MFIs, establishes and maintains a basic credit decision-making procedure. Their analysis of the five key credit variables, frequently referred to as the "five Cs of credit," for capacity, capital, collateral, character, and condition, has traditionally been used to evaluate agricultural loans. These institutions often assign a relative weight to each of these elements for analytical purposes, based on the specific circumstances of each individual borrower.

Meeker (1998) added that while the foregoing five-factor-analysis model is a useful tool, credit analysis should increasingly emphasize the evaluation of the applicant's future debt repayment capacity. This analysis should be based on various sources of information about the borrower that become more reliable and sophisticated as the complexity and size of business operation increase. This information can be accessed from historical financial

indicators, credit bureau reports, an assessment of the borrower's managerial abilities, and a demonstrated willingness to repay the loan. In general, client screening ensures that only those applicants with the least likelihood of defaulting are considered for loans. The question to pose here is therefore whether the MFIs in Uganda consider all these details when screening loan applicants before extending loans to them.

Client screening, according to Berger and Gregory (2004), is done to ensure that the borrowed funds would be repaid with minimal default. They went on to say that efficient customer screening necessitates management having sufficient understanding about loan applicants. This information is used to determine if applicants will be able to service and repay the loans. In essence, effective client screening is the only way to determine a client's ability to service and repay the loan and reduce the risk of default. The MFI will be able to accomplish its anticipated loan portfolio performance if it is done correctly. These findings imply that if portfolio performance isn't attained as expected, Indeed, Kasibante (2001) observed that proper client screening establishes which client is worthy lending, since it is based on financial statements that show not only the financial position of a client but also his/her state of income, inflows and outflows. In any case, ACCA (2005) noted that when a client's financial position indicates that his business is more financed by loans, extending more loans to such a client is tantamount to making him more indebted, thereby increasing his likelihood of failure to service and repay the loans.

In addition, Martin *et al* (2005) noted that the success of any MFI depends on how best it carries out client screening regarding the market potential and characteristics of the business for which the loan is sought. Poor client screening leads to poor portfolio performance and vice-versa.

### **2.4.3 Controlling credit risk and achieving financial success**

The method of managing the risks associated with a certain loan portfolio is known as credit risk control. The risk of the loan portfolio is reduced when the credit quality of the potential borrowing company and the collateral given are properly assessed. Credit risk analysis involves the strict scrutiny of the potential borrower's financial statements, default profitability or machine learning which may not be easily assessed basing on the targeted clients of MFIs. Loan portfolio control, according to Kagwa-Pafula (2000), entails loan monitoring, loan review and supervision in order to compel loan servicing and payback, as well as additional follow-up activities. Credit control in MFIs, according to Oketch (1998) and UNDP (1997), also entails ensuring that loans are disbursed in compliance with the approved terms for each designated sub portfolio.

In managing credit risk, most financial institutions tend to rely on the five Cs of credit control: credit history, capacity to repay, capital, the loan's conditions, and the provided collateral. The proper identification of a firm's credit risk enables it to manage its risks and reduce possible revenue losses. Credit risk assessment involves the estimation of the probability of loss resulting from a borrower's failure to repay the loan advanced to him/her. The literature identifies several reasons as to why some financial institutions end with high default rates. Some of the reasons provided include: the limited institutional capacity, inappropriate credit policies, interest rate volatility, poor loan underwriting, lack of caution while advancing loans, low capital and liquidity levels.

The Uganda Micro Finance Union (2001) indicates that the disbursed loans differ in size and charged interest rates from one sub loan portfolio to another and from one MFI to the next. Loan disbursement is also based on the guarantees availed to the MFI by the clients and on the agreed terms regarding loan repayment and servicing (Meeker, 1998). When all this is

well catered for, it is bound to lead the MFI to its planned loan portfolio performance. Otherwise, disbursement has to be brought into question.

Credit risk management aims to reduce the risk of default caused by improper usage of disbursed loans. It also serves as a resource for clients seeking advice and information on how to best put borrowed funds to work for them. Credit risk management is thus required not only to benefit the lending institution, but also to ensure that clients succeed in the commercial endeavors for which they seek loans. As a result, control should ideally ensure that loans are serviced, recovered, and repaid in a way that helps clients avoid going out of business. The Uganda Micro Finance Union (2001) claims that this is done in compliance with the interest and payback terms.

According to MFPED (2005), loan repayment and grace periods, especially for micro finance institutions that lend to agricultural clients, should be set and enforced in accordance with the period taken to get the first harvest of the crops invested in. It is unfair to expect a farmer of a crop that takes a year to be harvested to start servicing and repaying the loan before a year ends. Any lending institution that does not take this into consideration simply exists to exploit but not to help farmers and itself to survive in profitable business. These observations imply that prescriptive, concurrent and post facto forms of control have to be based grace and repayment periods set in accordance with the gestation periods.

To minimize credit risk, MFIs take actions aimed at ensuring timely loan recovery. Since MFI have no collateral to seize, they usually recover their loaned money by sharing out the defaulted amount of loan to all the members in the group that guaranteed the defaulter, and it is by effectively doing this that they can recover the money (Garber, 1997). Mullineux and Murrinde (2002) define optimal portfolio control as the goal of avoiding bad loans while making the appropriate ones. Good portfolio control, in particular, aims to reduce risk while

boosting growth and profits by focusing on high-quality loan volume. Credit applications can be evaluated against underwriting guidelines to help reduce risk.

These writers also stated that efficient communication of board direction through plans, rules, processes, and underwriting standards, as well as adequate checks and balances over lending operations, is the most common way to maintain a consistent control mechanism.

There must also be an internal control policy that offers enough direction for creating effective controls over the institution's operations, activities, and resources, as well as accountability for them. This policy should be thorough and provide direction for all operations. Because of the inherent risk in lending operations, the rule particularly requires for an internal control program to evaluate and appraise the Institution's assets on a regular basis, according to Mullineux (1996). The board's policy and system of internal controls, if correctly planned and implemented, create an effective framework for achieving management objectives, safeguarding assets, and maintaining accurate financial reporting. If an internal control policy or system is weak or lacking, risk exposure increases substantially, and the chances for effective performance and desired results are significantly reduced.

Mullineux (1996) went on to say that a lending institution's operations should be monitored by a number of internal control components, which should typically comprise a mix of "preventive" and "detective" controls. Preventive controls in portfolio management guarantee that transactions and operations are carried out in accordance with established goals. Working within existing policies and procedures; risk parameters; loan underwriting standards; risk identification and categorization systems; performance standards and assessments; management information and reporting systems are all examples of how they might be implemented.

The focus of detective controls, on the other hand, is on completed transactions (Keirungi, 2006). The goal is to detect actions or activities that are outside of policy, procedure, or risk parameters and, as a result, are not in line with the portfolio management objectives or direction. Conditions discovered through detective controls usually require management attention in the form of corrective measures or strategies to address flaws. Supervisory and operational reviews; internal loan review and categorization systems; independent internal audit, appraisal, and credit reviews; external audits or examinations; management audits or examinations are all examples of detective controls.

Antonio (2000) observed that portfolio control is intended to minimize the risk of default resulting from misuse of the disbursed loans. To Yunus (1996), it is intended to advise clients and give them information regarding how best they can put loaned money to business use required to service, recover and repay the loan without having to run out of capital. This way, control helps to ensure that loan servicing and repayment are achieved in a manner that does not overwhelm clients (Martin, 2016).

According to the Uganda Micro Finance Union (2004), control follows the interest and loan repayment terms agreed on earlier between the MFI and the client. The terms are based on periods ranging from a weekly, bi-weekly, monthly, or quarterly arrangement (Loan Analytics,

2004). It also involves enforcing ways and means of loan recovery in case a client begins to show signs of defaulting or late repayment. Since MFI have no collateral to seize, they usually adopt control measures that recover loaned money by sharing out the defaulted amount of loan to all the members in the group that guaranteed the defaulter, and it is by effectively doing this that they can recover the money (Garber, 1997). All these observations indicate that when loan portfolio control is well carried out, the desired portfolio performance

is realized. Therefore, when there is failure to realize this performance, it is in order to investigate the enforcement of loan servicing and repayment.

#### **2.4.4 Loan portfolio management and financial performance**

According to Pyle (1997), unless a seller has built into his selling price additional costs for late payment, or is successful in recovering those costs by way of interest charged, then any overdue account will affect his profit. In some competitive markets, companies can be tempted by the prospects of increased business if additional credit is given, but unless it can be certain that additional profits from increased sales will outweigh the increased costs of credit, or said costs can be recovered through higher prices, then the practice is fraught with danger. According to Koch and MacDonald (2000), a bank's profitability is directly proportional to the riskiness of its portfolio and operations. As a result, banks must understand which risk variables have a higher impact on profitability, which ultimately leads to bank financial performance, in order to increase return. Credit risk is the most important aspect for commercial banks, as we indicated in the previous section. This indicates that there is a high likelihood that credit risk will have an impact on profitability.

The mark to market book used for active portfolio management, according to James (2005), should be subject to suitable market risk restrictions, and its P&L should be maintained and monitored daily. Portfolio rebalancing actions should be carried out by a qualified team. The execution function for credit portfolio management should be separate from the institution's own trading areas and have its own execution capacity. The performance measurement targets for the portfolio management function should be clearly specified. To establish consistency with broader institutional objectives, senior management should agree on performance measurement targets. The portfolio management function's mandate should be aligned with the performance assessment targets. In a financial institution, the credit portfolio management function evolves with time. Indeed, its mandate frequently broadens beyond

defensive actions such as credit risk management to more offensive aspects of portfolio management, such as the adoption of more return-oriented methodologies. Senior management must be unambiguous in its support of such a mandate shift, both in terms of its commitment to the transition and in terms of its shown willingness to reward personnel commensurately for taking more risks. The scope of credit portfolio management activities varies widely across organizations may involve any or all of these goals: Improvement of the risk-adjusted return of a retained credit portfolio; Mitigation of event risk(headline risk) by reducing single-name and industry concentrations.; reduction of exposure to deteriorating credits; minimization of the economic capital required to support the extension of credit and increase in velocity of capital so that it may be redeployed in higher-margin activities. Because these goals can conflict at times and must be achieved within budgetary constraints, the mandate of portfolio management should be transparent and well communicated James (2005).

Risk management is crucial for both banks and policymakers, according to Tafri et al. (2009), because a strong banking system may support financial stability in a country and increase the economy's resilience in the face of economic crises. As a result, studying and measuring the impact of risk management on bank performance is critical for commercial banks. Bad debts, customers going into liquidation receivership, or bankruptcy are all losses that most businesses can easily observe. The Profit and Loss Account is noticeably reduced when bad debt losses are written off.

The interest cost of late payment is less evident, and as a cost impact, it can go unreported. It is infrequently measured separately because it is mixed in with the total bank charges for all activities. The borrowing cost saved by paying bills late also reduces overall bank interest. Credit managers can calculate this interest cost separately for debtors, and the findings are often surprising, given that the cost of waiting for payment beyond terms is typically 10 times



that of bad debt losses. Designing and documenting a credit policy is essential for effective accounts receivable management. Due to low credit criteria and unsuitable loan regulations, many businesses are experiencing liquidity and working capital issues.

According to Pike and Neale (1999), a sound credit policy is the blueprint for how the company communicates with and treats its most valuable asset, the customers. Myers and Brealey (2003) propose that a credit policy creates a common set of goals for the organization and recognizes the credit and collection department as an important contributor to the organization's strategies. If the credit policy is correctly formulated, carried out and well understood at all levels of the financial institution, it allows management to maintain proper standards of the bank loans to avoid unnecessary risks and correctly assess the opportunities for business development.

## **CHAPTER THREE**

### **METHODOLOGY**

#### **3.0 Introduction**

This chapter describes the methodology used in the research. The research design, target and accessible population, sampling size, data collection methods and instruments, data collection procedure, data analysis methodologies, ethical issues, and study limitations are all highlighted.

#### **3.1 Research Design**

Orodho (2000) defines a research design as the scheme, outline or plan that is used to generate answers to the research problems. A research design can be regarded as an arrangement of conditions of data collection and analysis in a manner that aims to combine relevance with the research purpose. This study adopted a case study design as it involved the in-depth study of a single microfinance institution. According to Kothari (2005), a case study design not only enables the attainment of in-depth first hand information but also allows the use of several research methods. The study basically followed a quantitative research approach.

#### **3.2 Study Population and Study Sample**

Population refers to the entire group of entities (the universe) to which the findings of the sample are to be generalized (Cooper & Schindler, 2007). The study targeted staff mainly in credit department, more specifically, the relationship officers who deal directly with the potential borrowers and carry out the primary risk assessment of a given borrower.

### 3.3 Sampling techniques

A sample is a subset of the target population that has been carefully chosen to reflect the entire group. The participants in the study were conveniently chosen based on their availability and willingness to participate.

**Table 3. 1: Respondents' Gender**

<b>Gender</b>	<b>Frequency</b>	<b>Percent</b>
Female	24	47.06
Male	27	52.94
<b>Total</b>	<b>51</b>	<b>100</b>

24 (47%) of the respondents were female while 27 (53%) of the respondents were males.

Table 3.1 indicates that BRAC (Uganda) offers equal opportunity in employment to both males and females.

**Table 3. 2: Age of Respondents**

<b>Age bracket</b>	<b>Frequency</b>	<b>Percent</b>
20-29 years	24	47.06
30-39 years	23	45.1
40-49 years	4	7.84
<b>Total</b>	<b>51</b>	<b>100</b>

47 (92%) of the respondents were between 20 and 39 years. We describe this as a youthful working force that is suited for the type of work involved in searching for potential clients from the field.

**Table 3. 3: Respondents' level of Education**

<b>Education level</b>	<b>Frequency</b>	<b>Percent</b>
Diploma	13	25.49
Degree	32	62.75
Masters	2	3.92
Professional qualification	4	7.84
<b>Total</b>	<b>51</b>	<b>100</b>

The majority of the respondents were graduates with a first degree 32 (63%) while very few of the respondents possessed a Masters 2(4%) or a professional qualification 4(8%). This is not surprising given the nature of our target population who are basically classified as lower cadre employees (relationship officers)

**Table 3. 4: Respondents' length of Tenure with BRAC**

<b>Length of Tenure</b>	<b>Frequency</b>	<b>Percent</b>
Less than a year	13	25.49
2-5 years	38	74.51
<b>Total</b>	<b>51</b>	<b>100</b>

The majority of the respondents had worked with BRAC in between 2-5 years 38 (75%). This means they were better placed to comment on the portfolio performance for the period studied.

### **3.5 Data sources**

Data was collected using both primary and secondary sources.

#### **3.5.1 Primary Sources**

Primary data was obtained in the field from respondents using a closed-ended self-administered questionnaire tailored to the study's goals.

#### **3.5.2 Secondary Sources**

Secondary data involved the review of accessible literature on microfinance and available documents from BRAC

### **3.6 Data collection methods and instruments**

The data was collected from the intended respondents using the researcher's self-created questionnaire. The survey was closed-ended, with items ranging from strongly disagree (5) to strongly agree (1) on a five-point Likert scale (1). There were five key sections to the

questionnaire. Section A wanted to know about the respondents' demographics, whereas Section B wanted to know about loan portfolio planning, Section C wanted to know about client screening, Section D wanted to know about credit risk management, and Section E wanted to know about financial performance.

### **3.7 Data management and Quality control**

In order to ensure that quality and relevant data is collected, the researcher estimated validity and reliability of the main instrument used in the study.

#### **3.7.1 Validity**

According to Amin (2005), both content and face validity can be used to assess validity. Face validity refers to the ability of a test to accurately measure something. If a test appears to be measuring what it claims to measure, it is said to have face validity. The content validity of an instrument is determined by how closely the content of the instrument matches the content of the study's theoretical framework. It is concerned with how appropriate and comprehensive the instrument is. The validity of the instrument was obtained by requesting the researcher's supervisor and an employee at a senior level in the credit department to help rate the items included in the questionnaire. Items rates 3 or 4 by both raters were obtained and divided over the total items of the instrument. Their agreement was on 30 of the 37 items in the instrument which gave us a content validity index of 0.8. Theory provides that an instrument with a cut off of at least 0.6 is good enough. Our instrument was rated to be valid in accordance with the issue under investigation.

#### **3.7.2 Reliability**

To ensure reliability of quantitative data, the researcher ensured that during data collection exercise, actual facts and responses. Given the nature of main instrument that had items

constructed on a Likert scale, the Cronbach alpha coefficient method of internal consistency was used to test the reliability of the study instruments.

**Table 3. 5: Reliability analysis**

<b>Variable</b>	<b>Alpha Coefficient</b>
Loan portfolio planning	.6553
Client screening	.5340
Credit risk control	.5894
Financial performance	.8471
Instrument Reliability	.8296

### **3.8 Data Analysis**

Data analysis, according to Sekaran (2005), involves a number of closely related operations, which are performed with the purpose of summarizing the collected data and organizing them in such a manner that they answer the research questions. The operations include editing, coding, classifying and tabulating. It also entails categorizing, ordering, manipulating and summarizing data, to find answers to the research questions. The obtained data was checked, edited, coded and entered in excel mark sheet from where it was imported into Stata 12 for analysis. Both descriptive and inferential analysis were conducted and the results presented in Table formant. Under descriptive statistics, all items with mean value above 3 were considered unfavorable.

### **3.9 Ethical Considerations**

The research observed all the necessary research protocols. Specifically, the privacy of respondents and confidentiality of the information provided has been observed. All respondents have been kept anonymous and their participation was voluntary.

### **3.10 Study Limitations**

The Covid-19 pandemic made it hard for the researcher to access the sample as had been planned. The researcher overcame this by turning to convenience sampling of respondents' in the targeted category

Fear of giving confidential information was overcome by the researcher constructing the questionnaire in such a way that the required information could be obtained without eliciting much suspicion from the targeted group. The questions were constructed in such a way that they relate directly to what the respondents are expected of as part of their job description on a daily basis.



## CHAPTER FOUR

### PRESENTATION OF DATA, ANALYSIS AND INTERPRETATION OF FINDINGS

#### 4.0 Introduction

The overall purpose of the study was to investigate how loan management affect the financial performance of microfinance institutions. This chapter presents the major findings as per the research objectives and the corresponding analysis and result interpretations. The study was guided by three major objectives: 1) To establish the relationship between loan portfolio planning on financial performance of BRAC Uganda 2) To examine the relationship between client screening on financial performance of BRAC Uganda 3) To look into the impact of credit risk management on BRAC Uganda's financial performance.

#### 4.1 Descriptive Statistics

##### 4.1.1 Loan portfolio planning

*Table 4. 1: Descriptive statistics on loan portfolio planning*

Item	Obs	Mean	Sd	Min	Max
Repayments set by BRAC Uganda Microfinance Ltd at each interval are fair to the clients	48	2.29	1.24	1	5
The interest rate charged by BRAC Uganda Finance ltd is fair to clients	51	2.92	1.26	1	5
The grace period allowed to clients is enough to make them payback	49	2.55	1.37	1	5
The loan repayment period is determined when putting the client's business payback period in consideration	48	2.60	1.43	1	5
It is mainly portfolio administration costs that are considered when determining the interest on loans	47	3.45	0.95	1	5
BRAC Uganda Finance ltd considers client's guarantors before it extends a loan	50	3.12	1.22	1	5
BRAC Uganda Finance ltd considers the nature of the client's guarantors	51	3.39	1.11	1	5
BRAC Uganda Finance ltd takes all clients to be of the same risk characteristics	50	3.36	1.31	1	5
Size of loans disbursed is enough to help clients achieve business goals	51	2.73	1.23	1	5
<b>Overall</b>	<b>51</b>	<b>2.94</b>	<b>0.59</b>	<b>1</b>	<b>4</b>

Source: Primary source

Table 4.1 reveals that the existence of un satisfaction on the part of portfolio panning with the overall mean of 2.94. Specifically Table 4.1 indicates that portfolio administration is not among key essentials when considering a loan disbursement and neither are the guarantors. This may be explained given that key mission of microfinance institutions is to serve the poor and what may be essential requirements to acquire a loan in the mainstream financial institutions rarely applies in most MFIs. The results also revealed that the repayment terms set for the clients are fair which is in line with the main objective of MFIs.

#### 4.1.2 Client screening

*Table 4. 2: Descriptive statistics on Client screening*

Item	Obs	Mean	Std. Dev.	Min	Max
The BRAC Uganda Finance ltd establishes the creditworthiness of a client before advancing a loan	51	2.31	1.39	1	5
The BRAC Uganda Finance ltd considers client experience in business before approving the loan applied for	50	3.30	1.40	1	5
The company considers what the guarantors of loan applicants do	50	3.42	1.23	1	5
BRAC Uganda Finance ltd ensures that loan applicants have reliable guarantors before advancing a loan	51	3.20	1.25	1	5
The company extends loans according to business capacity of clients	50	2.34	1.24	1	5
BRAC Uganda Finance ltd can extend a loan to a client without guarantors	50	2.70	1.40	1	5
The company puts attention on the type of business of the loan applicants	50	2.36	1.17	1	5
Applicants of loans submit all the information as required by BRAC Uganda Microfinance Ltd	51	1.61	0.96	1	5
<b>Overall</b>	<b>51</b>	<b>2.66</b>	<b>0.62</b>	<b>2</b>	<b>5</b>

Source: Primary source

Table 4.2 posts positive scores on client screening in the areas of: establishment of credit worthiness before advancing a loan, consideration of capacity, type of business and

submission of requested details. However, does not fare well when it comes to the advancing loans based on the borrower’s experience, what the guarantor of the loan applicant does and the reliability of the guarantors.

### 4.1.3 Credit risk control

*Table 4. 3: Descriptive statistics on Credit risk control*

<b>Statement</b>	<b>Obs</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Min</b>	<b>Max</b>
BRAC Uganda Microfinance Ltd carries out regular internal audits of portfolio performance	51	1.59	0.98	1	5
BRAC Uganda Microfinance Ltd carries loan monitoring	50	1.80	1.11	1	5
BRAC Uganda Microfinance Ltd carries Loan review/appraisal	51	1.39	0.60	1	3
BRAC Uganda Microfinance Ltd makes follow up actions to find out whether the money borrowed is being used correctly.	51	3.24	1.38	1	5
BRAC Uganda Finance ltd follows the set guidelines when disbursing loans to clients	51	1.78	1.14	1	5
<b>Overall</b>	<b>51</b>	<b>1.96</b>	<b>0.65</b>	<b>1</b>	<b>4</b>

Source: Primary source

Table 4.3 posts a positive overall performance when it comes to credit risk control with the overall mean of 1.96. The institutions posted positive scores on all the five aspects tested expect one where the institution is scored as lacking when it comes to follow up on the use of borrowed money. This may not be very surprising given that most financial institutions do loan monitoring from their designed monitoring software and only make strict follow up of customers when the advanced loan is threatening to become delinquent.

#### 4.1.4 Financial performance

*Table 4. 4: Descriptive statistics on financial performance*

<b>Statement</b>	<b>Obs</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Min</b>	<b>Max</b>
The portfolio quality has improved over time	51	2.37	1.27	1	5
The number of people seeking loans has grown over time	51	3.02	1.29	1	5
BRAC ROI over the years has at least been over 7% per annum	51	2.37	1.27	1	5
The loan portfolio has grown over time	51	2.94	1.24	1	5
The loan repayment has improved over time	51	2.61	1.52	1	5
There has been an increase in the number of disbursements over time	51	2.76	1.26	1	5
The default rate has reduced over time	51	2.33	1.21	1	5
BRAC has achieved its sales targets over the years	51	2.55	1.30	1	5
The portfolio at risk over 30 days has reduced over the years	51	2.24	1.12	1	5
Loan write-offs have reduced over the years	51	2.02	1.22	1	5
Over 90% of our clients have active accounts	51	2.61	1.46	1	5
Our loan recovery rate has greatly improved over the years	51	2.86	1.34	1	5
We have come up with new products offering over the years	51	2.35	0.93	1	5
We pride in increased customer referrals over the years	51	2.88	1.34	1	5
Most of our clients have recorded improvements in their welfare	51	2.37	1.31	1	5
<b>Overall</b>	<b>51</b>	<b>2.62</b>	<b>0.73</b>	<b>2</b>	<b>5</b>

Source: Primary source

Table 4.4 reveals what can be described as an average general financial performance with the overall mean of 2.62. The findings revealed an improvement in the quality of the loan portfolio over the years, improvement on the rate of return on investment, reduction in the default rate, increase in product offerings and a general improvement in client welfare.

## 4.2 Inferential Statistics

### 4.2.1 Correlation results

The Pearson correlation coefficient was run to test the relationship between the study variables as per the research objectives

*Table 4. 5: relationship between the study variables*

<b>Variables</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
1.Loan portfolio planning	1			
2. Client screening	0.32**	1		
3. credit risk control	0.17	0.19	1	
4.financial performance	0.27*	0.34**	0.07	1

\*P <10%

\*\*P<5%

#### **Relationship between loan portfolio planning and financial performance**

There is a significant relationship between loan portfolio planning and financial performance (r=.27, p<.05)

#### **Relationship between client screening and financial performance**

There is a significant relationship between client screening and financial performance (r=.34, p<.01)

## Relationship between credit risk control and financial performance

There is no significant relationship between credit risk control and financial performance

### 4.2.2 Regression analysis

A multiple regression was run to test the extent to which the study variables explained the response variable.

*Table 4. 6: Model Summary*

	<b>Coef.</b>	<b>Std. Err.</b>	<b>t</b>	<b>P&gt;t</b>	<b>[95% Conf.</b>	<b>Interval]</b>
Loan portfolio planning	0.22	0.18	1.26	0.21	-0.13	0.58
Client screening	0.34	0.17	2.01	0.05	0.00	0.68
Credit risk control	-0.02	0.15	-0.14	0.89	-0.33	0.29
_cons	2.11	0.60	3.54	0.00	0.91	3.31
Source	SS	df	MS	Number of obs	=	51
				F( 3, 47)	=	2.680
Model	3.844	3	1.281	Prob > F	=	0.057
Residual	22.452	47	0.478	R-squared	=	<b>0.146</b>
				Adj R-squared	=	0.092
Total	26.296	50	0.526	Root MSE	=	0.691

14.6% of the variance in financial performance can be explained for by our construct variables: loan portfolio planning, client screening and credit risk control.

## CHAPTER FIVE

### DISCUSSION OF RESULTS, CONCLUSIONS AND RECOMMENDATIONS

#### 5.0 Introduction

The research findings on the relationship between the construct variables and the response variable are discussed in this chapter. The findings of the study were used to draw conclusions, make recommendations, and identify areas for future research.

#### 5.1 Discussion

The discussion relates to the findings of our key study variables.

##### **Relationship between loan portfolio planning and financial performance**

There is a significant relationship between loan portfolio planning and financial performance ( $r=.27, p<.05$ ). The results revealed the key mission of the institution is being served by the fair repayment terms set for the clients by the institution. The institution has flexible terms to enable a person access loans, as guarantor quality is not overemphasized while carrying the lending function. This however explains the high interest rates charged on the monies advanced which may jeopardize the key objective of lifting the poor out of poverty. The hedge against the risk of default employed by many MFIs of group lending thus serves as a major security against risk. The results are also in line with Antonio (2000) where he stresses the key role of portfolio planning as a means of increasing portfolio profitability.

### **Relationship between client screening and financial performance**

There is a significant relationship between client screening and financial performance ( $r=.34$ ,  $p<.01$ ). When potential clients are thoroughly screened, this minimizes the risk of loan default and improves the quality of the loan portfolio. BRAC is credited by its thoroughness in client screening. Before a loan is advanced, the assessment of the five Cs is given due diligence. The only undoing stated was the failure to follow up as to whether the client was putting the money to the cause advance while applying for the loan. This emphasis on client screening augurs well with many authorities on prudent financial management as it is credited with improving the client's payment potential (Hartmut, 1997; Martin et al. 2006; Berger and Gregory, 2004)

### **Relationship between credit risk control and financial performance**

There is no significant relationship between credit risk control and financial performance. Much as the institution scored positively on the descriptive of this variable, the inferential statistics revealed the existence of a positive but non-significant relationship between credit risk control and financial performance. This may be explained by the very nature of the loans advanced to MFIs clients, which are highly risky being lent to the very poor and even with no collateral requirement! This may be in contradiction with Oketch (1998) and UNDP (1997) that stress the need for strict credit control. However, this finding seem to be in line with MFPED (2005) argument of the need to structure the loan depending on the targeted sector. For example, they recommend agricultural loans instalment repayment and maturity to coincide with the harvesting period.



## **5.2 Conclusion**

There was a significant relationship between loan portfolio planning and financial performance ( $r=.27$ ,  $p<.05$ ). The proper planning of a financial institution loan portfolio is associated with improvements in its financial performance.

There was a significant relationship between client screening and financial performance ( $r=.34$ ,  $p<.01$ ). Thorough screening of potential clients is associated with a reduced risk of loan default

There was a positive but none significant relationship between credit risk control and financial performance. This may be explained by inherent nature of the type of clients MFIs serve. The results however still being positive point to key role played by credit risk control in a financial institution's financial performance.

## **5.3 Recommendations**

Managers of financial institutions need to devise a loan management policy that lays emphasis on loan portfolio planning. Such a policy should answer the 4Ws and 1H of a loan portfolio. For example, who to lend, when, for what and how much

Managers needs to integrate the key objectives of their institutions in their client-screening tool. Parameters that appeal more to their core objectives should be given a higher score in relation to other scores that may appeal more to the mainstream financial institutions. For example, a loan intended to serve the rural poor should be given more weight compared to a business loan to expand one's business in an urban setting.

Much as MFIs target to serve a high-risk group, they should not lose focus on the need to manage key stakeholders and policy makers to enable them access low sources of loanable

funds and where possible bargain for tax waivers on loans advanced to high risk deserving poor populations

The issue of insurance to hedge against possible default should be earnestly sought after.

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## APPENDICES

### Appendix i: Questionnaire

#### Dear Respondent,

I am Luvuma Steven, a student pursuing a Master of Business Administration at the University of Kisubi. I am conducting a research on “Loan portfolio management and financial performance of non deposit taking Microfinance institutions, a case study of BRAC Uganda Microfinance Ltd head office Kampala” in Partial Fulfillment of the Requirement for the Award of a Master’s degree in Business Administration of the University of Kisubi. You have been scientifically sampled to participate in this study. The information got from you will be kept confidential and will be used strictly for academic purposes only.

Please do not provide any form of identity on this questionnaire.

#### SECTION A: BACK GROUND INFORMATION

(Please tick where appropriate)

##### 1. Gender

(i) Female  (ii) Male

##### 2. Age

(i) 20-29 year   
(ii) 30-39 years   
(iii) (iv)40-49 years   
(iv) 50 years and above

##### 3. Education levels

(i) Diploma  (ii) Degree   
(v) Masters  (iv) Professional qualification

##### 4. How long have you worked with BRAC Uganda Microfinance Ltd?

(i) Less than a year  2-5 years   
(ii) 6-10 years  above 10 years



For the questions below, tick the number that best indicate your opinion on the question using the following scale.

<b>SCALE</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
	Strongly Disagree	Disagree	Not sure	Agree	Strongly Agree

## SECTION B

### Loan portfolio planning

Statement	5	4	3	2	1
Repayments set by BRAC Uganda Microfinance Ltd at each interval are fair to the clients					
The interest rate charged by BRAC Uganda Finance ltd is fair to clients					
The grace period allowed to clients is enough to make them payback					
The loan repayment period is determined when putting the client's business payback period in consideration					
It is mainly portfolio administration costs that are considered when determining the interest on loans					
BRAC Uganda Finance ltd considers client's guarantors before it extends a loan					
BRAC Uganda Finance ltd considers the nature of the client's guarantors					
BRAC Uganda Finance ltd takes all clients to be of the same risk characteristics					
Size of loans disbursed is enough to help clients achieve business goals					

### Client Screening

Statement	5	4	3	2	1
The BRAC Uganda Finance Ltd establishes the creditworthiness of a client before advancing a loan					
The BRAC Uganda Finance Ltd considers client experience in business before approving the loan applied for					
The company considers what the guarantors of loan applicants do					
BRAC Uganda Finance Ltd ensures that loan applicants have reliable guarantors before advancing a loan					
The company extends loans according to business capacity of clients					
BRAC Uganda Finance Ltd can extend a loan to a client without guarantors					
The company puts attention on the type of business of the loan applicants					
Applicants of loans submit all the information as required by BRAC Uganda Microfinance Ltd					

### Credit risk control

Statement	5	4	3	2	1
BRAC Uganda Microfinance Ltd carries out regular internal audits of portfolio performance					
BRAC Uganda Microfinance Ltd carries loan monitoring					
BRAC Uganda Microfinance Ltd carries Loan review/appraisal					
BRAC Uganda Microfinance Ltd makes follow up actions to find out whether the money borrowed is being used correctly.					
BRAC Uganda Finance Ltd follows the set guidelines when disbursing loans to clients					

**Financial Performance (Rate the performance in relation to the last five years)**

<b>Statement</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
The portfolio quality has improved over time					
The number of people seeking loans has grown over time					
BRAC ROI over the years has at least been over 7% per annum					
The loan portfolio has grown over time					
The loan repayment has improved over time					
There has been an increase in the number of disbursements over time					
The default rate has reduced over time					
BRAC has achieved its sales targets over the years					
The portfolio at risk over 30 days has reduced over the years					
Loan write-offs have reduced over the years					
Over 90% of our clients have active accounts					
Our loan recovery rate has greatly improved over the years					
We have come up with new products offering over the years					
We pride in increased customer referrals over the years					
Most of our clients have recorded improvements in their welfare					