CREDIT MANAGEMENT AND PERFORMANCE OF SELECTED HOUSING FINANCE BANKS, KAMPALA, UGANDA

A Thesis

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In Partial Fulfillment of the Requirements for the Degree

Master of Business Administration

By:

ACEN CATHERINE BOKELLO

MBA/42973/91/DU

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DECLARATION

"This thesis is my original work and has not been presented for a Degree or any other academic award in any University or institution of higher Learning".

ACEN CATHERINE BOKELLO

Name and Signature of Candidate

6th/09/2011

Date

APPROVAL BY THE SUPERVISOR

"I confirm that the work reported in this thesis was carried out by the candidate under my Supervision".

PROF. Ohwor Fundang

Name and Signature of Supervisor

5/9/2021

Date

APPROVAL SHEET

This thesis entitled "An Assessment of Credit Management and Performance of Housing Finance Bank, Kampala, Uganda" prepared and submitted by **Acen Catherine Bokello** in partial fulfillment of the requirements for the award of a Master of Business Administration; has been examined and approved by the panel on oral examination with a grade of **PASSED**.

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Name and Sig. of Chairman

_______________________ _______________________

Name and Sig of Supervisor Name and Sig. of Panelist

_______________________ _______________________

Name and Sig. of Panelist Name and Sig. of Panelist

Date of Comprehensive Examination: _______________

Grade: _______________

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Name and Sig of Director, SPGSR

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Name and Sig of DVC, SPGSR

DEDICATION

To Almighty God who gave me life and wisdom right from birth up to now, may his name be glorified.

To my mother Mary, my daughter Achieng Naomi, my sisters, Sarah Okello Moses and Grace Awany who not only funded me but also encouraged me to expand my horizons and be what I may be in future.

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ACRONYMS/ABBREVIATION

HFB	-	Housing Finance Bank
MFI	-	Micro-Finance Institutions
FI	-	Financial Institutions
CT	-	Credit Terms
CD	-	Credit Delivery
CC	-	Customer Care
FM	-	Financial Markets
IR	-	Interest Rate
MS	-	Market Share
UCB	-	Uganda Commercial Bank
UDB	-	Uganda Development Bank

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ABSTRACT

This study investigated credit Management and Performance of the Selected Housing Finance Banks. Kampala, Uganda.

Objectives of the study: To determine the profile of Housing Finance Bank, To determined the level of credit management, To determined the level of performance of Housing Finance Bank, To determined relationship between credit management and performance of Housing Finance Bank.

The methodology of the study: A case study research design was conducted to capture qualitative and quantitative data.

The research population was 300 subjects which were included in the study. The sample size of 110 general respondents participated in the study. The main instruments for data collection included questionnaires and Observation. The research employed both qualitative and quantitative methods to analyze the data collected.

The study showed that there was positive significant relationship between credit policy and loan repayment, market share, overall bank performance, However the results indicated that a positive and insignificant relationship between credit policy and customer care and a negative and insignificant relationship with number of clients, The PLCC results also indicated that the bank's interest rate policy is positively and significantly correlated with loan repayment, market share. The same result shows a negative significant relationship between interest rate policy and number of client and a negative insignificant relationship with customer care.

The researcher concluded that, there is no significant relationship between credit management and performance in Housing Finance Bank.

CHAPTER ONE

THE PROBLEM AND ITS SCOPE

Background of the study

Financial institutions provide service as intermediaries of the capital and debt markets. They are responsible for transferring funds from investors to companies in need of those funds. Financial institutions facilitate the flow of money through the economy. Such is the primary means for depository institutions to develop revenue. Financial institutions include banks, credit unions, asset management firms, building societies, and stock brokerages, among others. These institutions are responsible for distributing financial resources in a planned way to the potential users according to Pierre (2001).

Financial institutions can be categorized as follows:

Deposit Taking Institutions, Finance and Insurance Institutions, Investment Institutions, Pension Providing Institutions, Risk Management Institutions. At the same time, there are several governmental financial institutions assigned with regulatory and supervisory functions. These institutions have played a distinct role in fulfilling the financial and management needs of different industries, and have also shaped the national economic scene Pilbeam (2010).

Deposit taking financial organizations, are known as commercial banks, mutual savings banks, savings associations, loan associations and so on. The primary functions of financial institutions of this nature are as follows:

Accepting Deposits, Providing Commercial Loans, Providing Real Estate Loan, Providing Mortgage Loans, Issuing Share Certificates. Finance companies provide loans, business inventory financing and indirect consumer loans. These companies get their funds by issuing bonds and other obligations. These companies operate in a number of countries. On the other hand, there are insurance companies that provide coverage for a variety of risk factors and they also provide several investment options. Insurance companies provide loans for a number of purposes Metron, R & Z. bodies 1995).

The functions of financial institutions, such as stock exchanges, commodity markets, and futures, currency, and options exchanges are very important for the economy. These institutions are involved in creating and providing ownership for financial claims. These institutions are also responsible for maintaining liquidity in the market and managing price change risks. As part of their various services, these institutions provide investment opportunities and help businesses to generate funds for various purposes Boland, Vincent, (2009-6-12).

The functions of financial institutions like investment banks are also vital and related to the investment sector. These companies are involved in a number of financial activities, such as underwriting securities, selling securities to investors, providing brokerage services, and fund raising advice Boland, Vincent, (2009-6-12).

According to Kairu (2009), Credit Management has therefore established itself worldwide as a vital management function with a major contribution to make to the economic well-being of organizations. Efficient credit management, with its critical impact on cash flow, can make all the difference between survival and insolvency in the private sector or between cost effective and wasteful administration in the public sector.

Historical background of Housing Finance Bank (Uganda)

Housing Finance Bank Limited was incorporated as a private limited company under the Companies Act in December 1967 as Housing Finance Company of Uganda Limited, carrying on the business of non banking financial institution (credit institution) in Uganda with focus on providing mortgage finance for the construction of residential houses and also to accept deposits from the public. To date, the company is the leading mortgage financial institution in Uganda. In November 2007, the company acquired a license to operate as a commercial bank from Bank of Uganda. The company' status was changed from a private limited company to a public limited liability and the name accordingly changed from Housing Finance Company of Uganda Limited to Housing Finance Bank Limited on November 9th, 2007, (Annual report 2009)

Ownership

The current shareholders of Housing Finance Bank are National Social Security Fund, Government of Uganda and National Housing & Construction Company with authorized and paid up capital of UGX. 61,000,040,000 (Sixty One Billion Forty Thousand Uganda Shillings, (HFB Annual Report 2009).

Housing Finance Bank in Uganda is one of the Commercial Bank in Uganda involved primarily in mortgage banking, Fixed deposit Account, Business loan, Corporate Pension Account, Super Saving Accounts, Swift loan, Toto's Treasure Account, Ware House Receipting. Current Account, Over Draft, Foreign Exchange and money transfers. This bank was founded in 1967 as a housing Finance Company. Housing Finance became fully licensed in January 2008. The bank is the leading mortgage lender in the country, with approximately 60% of all Ugandan Mortgage accounts. As of April 2010, Housing Finance Bank is the 10th largest commercial bank in Uganda with an asset based estimated at US $ 130 Million, representing about 3% of all bank assets in the country.

Housing Finance Bank maintains its corporate headquarters at its newly constructed building on Wampewo Avenue, on Kololo Hill. The bank's main branch is located in Investment House on Kampala Road. Other Branches within Kampala Central Business District, located in Nakasero, across from the Nigerian High Commission, Two other branches in Kampala, one each in the suburbs of Namwongo and Ntinda. In February 2009, the bank opened a branch in Mbarara in Western Uganda, in March 2009 it opened its 6th branch in Kampala Kikubo, in June 2009, the bank opened its 7th branch in Mbale and the 8th branch was opened in July 2009 in Arua.

In September 2010 the bank maintains branches in the following locations:- Arua Branch, Bugoloobi Branch-Kampala ,Garden City Branch – Kampala, Main Brach, Kikuubo Branch – Ben Kiwanuka, Mbarara Branch, Mbale Branch, Nakasero Branch, Nakawa Branch, Namwongo Branch, Ntinda Branch, Owino Branch, Kisenyi Branch, Branch+Up country branches, Lira Branch, Gulu Branch, Arua Branch, Mbarara. Housing Finance Bank is governed by a ten (10) person Board of Directors of whom three are Executive Directors and seven are Non-Executive. Housing Finance Bank has a population of about 300 workers (HFB Annual Report 2009).

According to Ledgerwood (2001), prior the 1980s government agencies were the predominant avenue for providing productive credit to those with no previous access to credit facilities. Their services had and still have limited access, because they need collateral as a requirement for getting a loan and the transaction cost are so high.

Governments and international donors assumed that the poor required cheap credit and see these as a way of promoting agricultural production by small landholders. In addition to providing subsidized agricultural credit, donors set up credit unions inspired by the Rainffeinsen model developed in Germany in 1864.

In Uganda, the health of the Financial Sector has been impaired by political and social turmoil, according to Kasekende (2004) indicates that the troubles of the 1970s and early 1980s produce a severe contraction of Uganda Monetary economy, a decline in financial intermediation and a loss of financial depth. In addition to that, the concentration of financial services lay in the hands of a few commercial banks, of which two banks; Uganda Commercial Bank and Cooperative Bank controlled 70% of the banking business. During the same year, the two big banks mentioned above became insolvent, and significant risks posed by a weak banking sector began to emerge.

In order to address weaknesses in the economy and the financial sector in particular, the government of Uganda embarked upon the Economic Recovery Program (ERP), It put in place to improve the incentive structure and business climate so as to promote savings, mobilization and investment as well as the rehabilitation of the country's economic, social and institutional infrastructure.

In respect, kasekende (2001) indicates that BOU developed a policy on micro-finance business in the country, which supports approaches that will increase access to financial services by the majority of the poor but in a state, sound and sustainable way. Recognizing all these financial sector constraints, and in particular credit constraints, and in particular credit constraints donors and government agencies have sought to make credit available to small borrowers and have committed millions of dollar to micro credit activities (Sarno, 2002).

Given the above background, and the need to create viable institutions, and credit being an essential financial service to finance institutions, it ought to be managed in a business approach that will keep credit institution sustainable. But one wonders whether this is the case with credit institutions in Uganda especially Housing Finance Bank and whether the manner in which credit is managed has an impact on the performance of finance institutions. Therefore there is need to examine credit management and its performance on finance institution, focusing on Housing Finance Bank Kampala.

Statement of the Problem

Small credit institutions as an economic development approach intends to benefit low-income people especially people within the rural areas. In Uganda, Housing Finance Bank has spread across new market areas including the city suburb and all-over the country. Despite their importance and growth, their credit management is questionable as shown by a high drop out rate, and high delinquency rate that has even forced some finance institution to jail defaulters (clients), poor financial management that is prone to risk, continued reliance on donors and minimal operational efficiency below 100%. This therefore raises concern as to whether finance institutions will fulfill their campaign, and even become sustainable so as to meet the future demands of their clients Kalungi, K, Olanya, & Odeyek, I (1999).

Despite these efforts, the financial sector remained weak and the government sought more funding from the World Bank and international Monetary Fund (IMF) Bank of Uganda (BOU) also embarked on a number of measures to review the entire financial system in the country, which include among other, promoting growth of micro-finance institutions.

Due to poor credit management by most commercial bank, BOU closed International Credit bank (ICB), Green Land bank, Corporative Bank, Teefe Commercial bank and Uganda Development Bank in 1990, (BOU report 1990).

Therefore, there is need to examine credit management and performance of finance institutions in Uganda.

Purpose of the study

The general objective of the study is to assess credit management and the performance of finance institutions in Uganda with reference to Housing Finance Bank.

Research Objectives

1. To determine the profile of Housing Finance Bank respondents.
2. To determine the level of credit management
3. To determine the level of performance of Housing Finance Bank
4. To determine the significant relationship between the credit management and the performance of the Housing Finance Bank.

Research Questions

1. What is the profile of Housing Finance Bank respondents?
2. What is the level of credit management in Housing Finance Bank?
3. What determines the level of performance of Housing Finance Bank?
4. What is the significant relationship between credit management and performance of Housing Finance Bank?

Null Hypothesis (H_0)

There is no significant relationship between credit management and performance in Housing Finance Bank.

Geographical, Theoretical Context

The research was carried at Housing Finance Bank, Kampala Road Branch located at Investment House and Namwongo branch located opposite Kisugu Police post. The Study focused on an assessment of credit management and the performance of Housing Finance Bank in Uganda. It covered the period between 2007 -2010. This was period when the bank was licensed and started involving itself in credit management.

Significance of the study

This study may be of great importance to the communities around and out side Kampala who would like to acquire Housing Mortgage and other banking services from Housing Finance.

At the macro level, informed decisions in policy formulations and in the building of the institutional regulatory framework may be made basing on the findings from the research.

The study will also help in policy formulation within the banking sectors or Financial Institutions in Uganda and even worldwide.

At the micro-level, a number of finance institutions may adopt the recommendations put forth, and use the findings to address issues pertaining to credit management so as to attain sustainability.

The study may also open up areas for further research on sustainability of finance institutions.

Operational definitions of key terms

Credit Management A critical requirement for effective revenue and receivables management is the ability to intelligently and efficiently manage customer credit lines or credit limits. In order to minimize exposure to bad debt and bankruptcies, organizations are to have greater insight into customer financial strength, credit score history and changing payment patterns. Likewise, the ability to penetrate new markets and customers hinges on the ability of a company to quickly make well-informed credit decisions and set appropriate lines of credit.

Performance: The accomplishment of a given task measured against preset known standards of accuracy, completeness, cost, and speed. In a contract, performance is deemed to be the fulfillment of an obligation, in a manner that releases the performer from all liabilities under the contract.

Credit delivery and payment process: The key to responsive, successful programs is rapid, simple and efficient procedures in credit extension. Poor women entrepreneurs operating in the informal sector applying for a loan need it now-not several months from now when the Micro Finance Institutions completes a lengthy and involved loan processing procedure. These procedures should be carefully established and the level of staffing should be adequate so that clients receive a prompt response to their request. Successful finance institutions are those that are able to disburse a loan with in few days.

Interest rate: The interest rate will be arrived at based on the weighted average cost of funds, risk premium, other cost such as administrative expenses and profit margin. The base interest rate is reviewed periodically. The interest rate applicable to each loan accounting will be assessed based on multiple parameters like tenure borrower profile, borrowers repayment capacity based on the cash flow, loan to value of the Asset Financed, type of collateral security provided by the borrower and past repayment track record of the borrower.

CHAPTER TWO

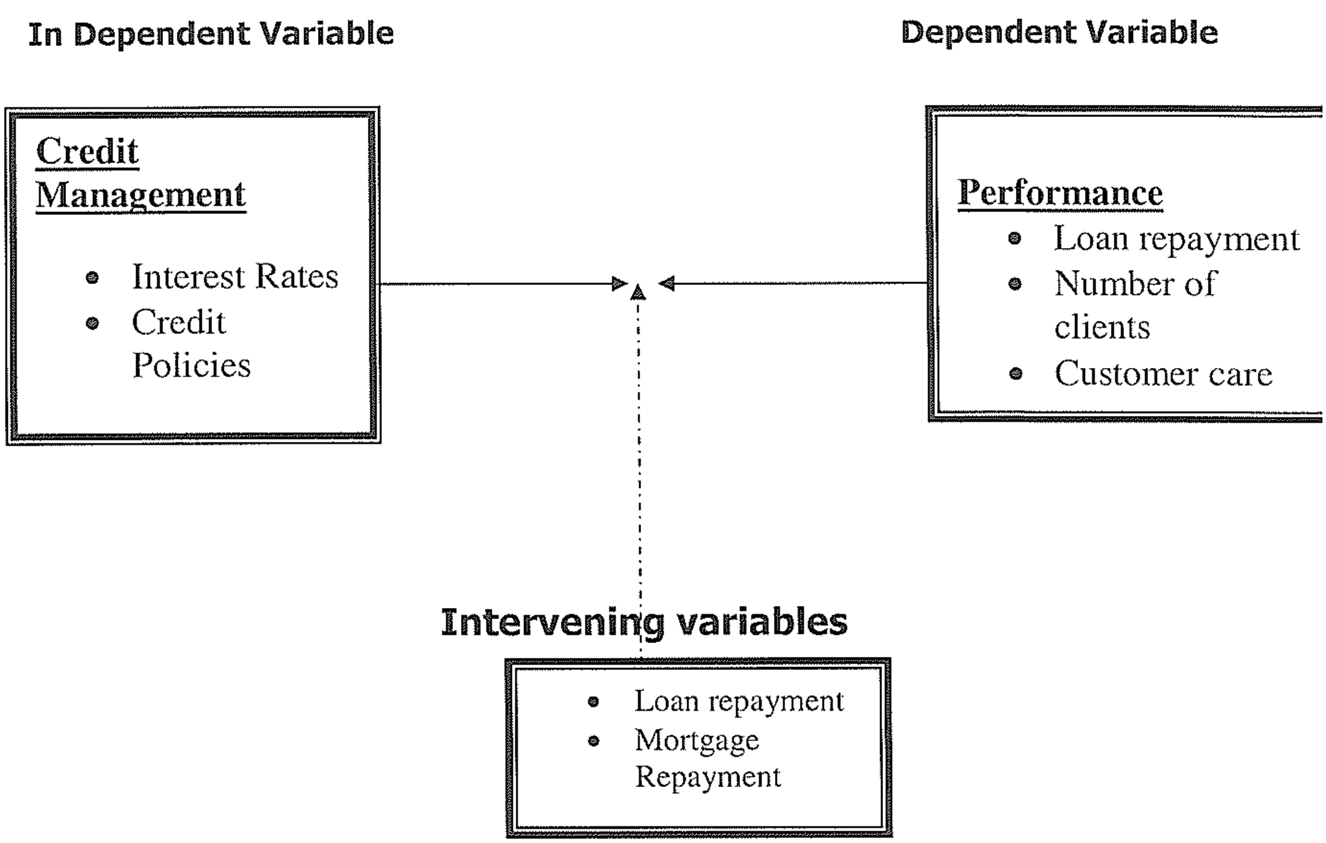
REVIEW OF RELATED LITERATURE

Concept Opinion

This chapter is all about the review of the related literature and scholars' and researchers' views and ideas else where in the world about the problem under study. It is concerned with the conceptual frame work of the study and the definition of the concepts. The literature review is very vital because it helps to investigate further. The literature will be mainly taken from other secondary sources of data as text books, internets and others.

Schema of the study

Figure 1



Source: adopted from (Kairu 2009)

Credit Management

Credit Management is the critical requirement for effective revenue and receivables management is the ability to intelligently and efficiently manage customer credit lines or credit limits. In order to minimize exposure to bad debt and bankruptcies, organizations are to have greater insight into customer financial strength, credit score history and changing payment patterns. Likewise, the ability to penetrate new markets and customers hinges on the ability of a company to quickly make well-informed credit decisions and set appropriate lines of credit.

Prior to Uganda's independence in 1962, Government-owned institutions dominated most banking in Uganda. In 1966 the Bank of Uganda, which controlled the issue of currency and managed foreign exchange reserves, became the Central Bank. Uganda Commercial Bank (UCB), which had 50 branches throughout the country, dominated commercial banking and was wholly owned by the government. The Uganda Development Bank was a state-owned development bank, which channeled loans from international sources into Ugandan enterprises and administered most of the development loans made to Uganda (Ating – Ego 2001).

The East African Development Bank, established in 1967 was jointly owned by Uganda, Kenya and Tanzania. It was also concerned with development of finance. It survived the break-up of the East African Community in 1977 and received a new charter in 1980. In 1960s, other commercial banks that had started local operations included Bank of Baroda, Barclays Bank, Bank of India, Grindlays Bank, Standard Chartered Bank and Uganda Cooperative Bank.

During the 1970s and early 1980s, the number of commercial bank branches and services contracted significantly. Whereas Uganda had 290 commercial bank branches in 1970, by 1987 there were only 84, of which 58 branches were operated by government-owned banks. This number began to increase slowly the following year, and in 1989 the gradual increase in banking activity signaled growing confidence in Uganda's economic recovery.

In the late 1990s and early 2000, the Ugandan banking industry underwent significant restructuring. Several indigenous commercial banks were declared insolvent, taken over by the central bank and eventually sold or liquidated. These included Cooperative Bank (Kalunji, Olanyo & Odyek 1999), Greenland Bank (Juko & Tolit, 1999) International Credit Bank (Malaba, 1998), Teefe Bank and Gold Trust Bank which were wind up.

Uganda commercial Bank was initially privatized through a sale of its majority shares to a purported company from Malaysia. However it later came to light that the actual buyer was a partnership between Greenland Bank (which itself was insolvent) and some politically connected individuals (Mugisha & Nakyinga, 2001). This was as a result of the financial reforms that started in 1993 which saw the passing of the Bank of Uganda Act and Financial Institution Act.

A substantial progress was made in regard to reforms of government reducing its direct involvement in the regulation and ownership of financial institutions and government divested its interest in foreign banks and remained fully committed to sale of UCB to strategic investor (Mutebile, 2001). The privatized Uganda Commercial Bank was merged with the former Grindlays Bank which Standard Bank already owned and renamed it Stanbic Bank. The combined new bank is now known as Stanbic Bank (Uganda) Limited.

As 0f 2008, Stanbic Bank (Uganda) Limited was the dominant commercial bank in Uganda, with about 27% of all bank assets and about 20% of all bank branches. According to Juko (2006), Nile Bank Limited, another indigenous institution, was acquired by the British conglomerate and finally in January 2007 the Ugandan saw the exit of the local bank and became known as Barclays Bank (Uganda).

Not only was the closure of banks in Uganda but also in the neighboring Kenya the East Africans saw the closure and exit of Delphi Bank in Kenya (New vision, 2001). In Nigeria at the same time depositors lost at least worth N13 billion resulting in to closure of 26 commercial and mercantile banks. The banks whose licences were recalled included Allied Bank, Amicable Bank of Nigeria, High Land Bank, Lobi Bank, North South Bank, Pan African Bank, Pinnacle Commercial Bank, Abacus Merchant Bank, ABC Merchant Bank to mention but a few (Jospini 1998). In Zambia United Bank was not exceptional; the bank had its license revoked in May 2002 because of unsound banking practices (Chama, 2002).

Despite the closure of some banks in Uganda, there is successful existence of other banks in the country both local and international, religious based and non religious based and they include Standard Chartered Bank, Barclays Bank, DFCU Bank, Centenary Bank, Bank of Baroda, Tropical Bank, Diamond Trust Bank, Cairo International Bank to mention but a few.

Early researchers have done a lot of work in the field of banking. These include at regional level works of Yadav (2005) who carried out a Viability study of Commercial banks: A case of banking industry in East Africa, Wawera and Kithinji (2006) looked at the Merger Restructuring: Is it attractive among Commercial Banks in Kenya, Githuku (2002) concentrated on Electronic Commerce and its challenges for Banks in East Africa, Kamuntu (2004) carried out study on the role of banking on regional integration, Amanya (2002) looked at the On- line banking vs. traditional banking: what prospects for Africa and others.

All these fore mentioned studies have tackled some aspects of technological environment (but not ATMs and CRB) and did not tackle the issue of service quality as a means of performance of some selected international commercial banks especially in the Central Region. For this reason indeed this study is to fill the gap and generate knowledge on the technological environment (ATM and CRBs) and service quality as means of performance of some selected international commercial banks in Central Region.

At local sphere, works in the banking industry has been done tremendously. It includes the contributions of Kibirango (2002) who carried out research in Professional Code of conduct for Bankers: Is it dispensable, Kamulegeya (2002), contributed knowledge on On- line Banking and Taxation: Implication for Uganda, Mutebile (2002) posited work on the Challenges and Success in the Effective Management of Monetary Policy in Uganda, Mulira (2003) did nice work on Information Technology its role in changing Banking Environment, Ochieng (1998) looked at the Commercial Banks failure in Uganda: Causes and remedies, Ating-Ego (2004) looked on Product/Service Innovation in Financial Sector and others.

Other local studies included Chemonges (2003), carried out research on Business for Consumers e-commerce: Trends, Lessons for Banks in Uganda, Mbuvi (2004), did some work on Management of Change and Innovation: Risks and Fraud. More work was done by researchers like Umoh (2004) on Today's banking Risks and Regulatory frame work, Odoki (2004) on Customer satisfaction as a bench mark for quality service in Uganda's financial sector, Muwanga (2004) did some work on E-banking in Uganda: Benefits and Challenges, Mutebile (2006) worked on the Current State of Financial Sector and others.

Looking at all these fore going studies, they have tried to tackle issues of banking like service provision, like e-banking, customer satisfaction, change management, monitory policy management, causes of failure of commercial banks and remedies for the commercial banks, innovations in product and services provided by the financial sector, lessons learnt from e-commerce, challenges and benefits of information technology in banks.

None of these studies looked at what factors are responsible for the performance of international commercial banks in the stiff competitive environment in Central Region. This study therefore will establish the relationship between technological factors (ATMs, and CRBs) and service quality as means of performance of some selected international commercial banks in Central Region.

A critical requirement for effective revenue and receivables management is the ability to intelligently and efficiently manage customer credit lines or credit limits. In order to minimize exposure to bad debt and bankruptcies organizations must have greater insight into customer financial strength, credit score history and changing payment patterns. Likewise, the ability to penetrate new markets and customers hinges on the ability of a company to quickly make well-informed credit decisions and set appropriate lines of credit.

A cording to Kairu (2009), many organizations have suffered in the hands of bad debts simply because of the trend of doing business in most third world countries has been, sell first and the rest will take care of itself. Volatile business conditions of the recent years have created problems of cash flow and interest charges never before encountered in the industrial post-economies. Companies, large and small, have closed down as a result of non-performing debts. The survivors are now beginning to accept that in total, trade debtors represent and investment that cannot be taken for granted anymore and hence the need for professionalism in credit management

Consumer

In consumer credit the grantors will give credit with a view of increasing their sales and hence maximize their profits, grantors will include banks, credit card companies and building societies. Consumers use credit as a method of making a purchase earlier than they could if they had to save to accumulate sufficient cash from earnings. The reasons why consumer credit grantors lend money is that they believe that they can charge more for monies borrowed than the cost of the money to them after deducting the overall costs of bad debt and administration.

Trade credit

Trade credit is the act of a manufacturer allowing time for a trader to sell the goods. The time given reflects the likely period between delivery of the goods to the trader and the trader affecting a sale to a consumer. In trade credit, the supplier retains the ownership of the goods until such time when they are sold. This is known as reservation of title and it gives the manufacturer an element of security.

Export Credit

When a manufacturer supplies goods outside the country he is operating in, there are additional risks to contend with in addition to the credit risk of trusting the importer to make the repayment. Such risks will include:

- Exchange risks as a result of the fluctuating nature of the currencies.
- The risk of failure to deliver the goods safely.
- Risk of passing title to the goods over at the right time.
- Political risks that arise from time to time as a result of government intervention or war.

Acording to Kakuru (2009) It is easy for anyone to lend money or grand credit. However, the skill lies in getting repaid on time. This means that credit must only be extended to people or business that can be trusted. Usually a specialist function is created within a company to mange credit. The result is a commercial tool between the natural enthusiasm of a sales department and more rigid disciplines of a finance department. A credit policy and procedures should be agreed with both departments.

Principles for the Management of Credit Risk

According to Basel Committee on Banking William 1990. Stated the followings:

While financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both G-10 and non-G-10 countries.

Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation.

For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet. Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred. The Basel Committee is issuing this document in order to encourage banking supervisors globally to promote sound practices for managing credit risk. Although the principles contained in this paper are most clearly applicable to the business of lending, they should be applied to all activities where credit risk is present.

The sound practices set out in this document specifically address the following areas:

(i) Establishing an appropriate credit risk environment; (ii) operating under a Sound credit-granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk. Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk, all of which have been addressed in other recent Basel Committee documents.

While the exact approach chosen by individual supervisors will depend on a host of factors, including their on-site and off-site supervisory techniques and the degree to which external auditors are also used in the supervisory function, all members of the Basel Committee agree that the principles set out in this paper should be used in evaluating a bank's credit risk management system. Supervisory expectations for the credit risk management approach used by individual banks should be commensurate with the scope and sophistication of the bank's activities. For smaller or less sophisticated banks, supervisors need to determine that the credit risk management approach used is sufficient for their activities and that they have instilled sufficient risk-return discipline in their credit risk management processes.

The Committee stipulates in Sections II through VI of the paper, principles for banking supervisory authorities to apply in assessing bank's credit risk management systems. In addition, the appendix provides an overview of credit problems commonly seen by supervisors.

A further particular instance of credit risk relates to the process of settling financial transactions. If one side of a transaction is settled but the other fails, a loss may be incurred that is equal to the principal amount of the transaction. Even if one party is simply late in settling, then the other party may incur a loss relating to missed investment opportunities. Settlement risk (i.e. the risk that the completion or settlement of a financial transaction will fail to take place as expected) thus includes elements of liquidity, market,

Operational and reputational risk as well as credit risk. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses.

Credit score

Credit score is a numerical representation of your credibility related to debt and your financial responsibilities. The credit score is used by lenders, credit card issuers employers etc to judge your willingness to repay a particular loan that you have availed.

Factors that can make your credit score nosedive miserably:

Late payments

Your payment history makes up 35% of the credit score. Making late payments regularly affect your credit score negatively. The creditors usually notify the credit bureaus, the rate of interest you are being charged now escalates and so do the interest rates of other credit cards, you will be required to pay late fees etc. To avoid such hassles, it is better to be regular with payments.

Making no payments at all

Still worst is not paying heed to the credit card bills. In due course your account gets charged off.

Charging off an account

If the lenders are convinced that you are not willing to pay your credit card bills, they usually charge off your account. Having an account charged off makes your credit score backslide miserably.

Sending an account to collection agencies

Lenders may sell debt accounts to collection agencies if they have failed to collect credit card payments from you. Creditors usually do this either before or after the account has been charged off. Once this is done, collection agencies harass you to no end to collect the dues that you are supposed to pay.

A loan default

A loan default indicates that you failed to comply with the terms and conditions of the contract that was agreed upon between you and you lender. This sends wrong signals to the lenders.

Filing for bankruptcy

Bankruptcy should be the last option to get out of debt. Filing for bankruptcy not only hurts your credit score but it also causes a lot of mental agony. There are various other alternatives to bankruptcy. Some of the alternatives to bankruptcy include -credit counseling, debt consolidation, debt settlement, debt management program etc.

Foreclosure of your home

If you do not make regular mortgage payments, it ultimately leads to foreclosure. This affects your credit score to a large extent. You not only lose your property but also lose the opportunity of having a good credit score.

A judgment

A judgment indicates that since you did not pay your bills, the court had to intervene in making you pay the debts. This is one of the factors that hurt your credit score.

Having high credit card balances

If your credit card balances are high as compared to the credit limits, it leads to higher credit utilization thereby decreasing your credit score.

Having credit cards which are maxed out

Credit card balances that have maxed out or exceeded the permissible limit causes credit utilization to be 100% and this makes your credit score drop to a great extent.

Closing credit cards still having balances

If you close credit cards that still have a balance, the credit limit becomes zero while you still have some balance left in the account. This gives the impression that your credit card has maxed out. It makes your score get lowered.

Closing down older credit cards

Duration of your credit history makes up 15% of your credit score. It is always desirable to have credit histories which are longer. If you close your older credit cards it may give an impression that you actually have a shorter credit history.

Applying for multiple loans or credit cards

Credit inquiries make up 10% of your credit score. Applying for credit several times within a short time span actually ruins your credit score. It is best to keep applications to a minimum.

Credit policy

Clear, written guidelines that set (1) the terms and conditions for supplying goods on credit, (2) customer qualification criteria, (3) procedure for making collections, and (3) steps to be taken in case of customer delinquency.

A credit policy is the document that unites the internal departments of a company by setting standards of credit practice that would be implicit throughout the organization. As credit managers, we should know what we are empowered to undertake and achieve although the reasons for the empowerment is not always clear to the people outside the credit department. Most of the people regard the credit department as perhaps at the best a necessary evil, but all worst an unnecessary overhead.

Types of credit policies

Conservative credit policy

A conservative credit policy is one applicable in a monopolistic business environment. The organization is not overly worried about competition.

Liberal credit policy

A liberal credit policy is one applicable in a competitive business environment. Its function is to protect the investment in the debtors of the company as well as maintaining the lowest level of receivables.

Though most consumers expect to pay cash or use a credit card when making a purchase, commercial customers typically want to be billed for any products and services they buy. You need to decide how much credit you're willing to extend them and under what circumstances. There's no one-size-fits-all credit policy--your policy will be based on your particular business and cash-flow circumstances, industry standards, current economic conditions, and the degree of risk involved. As you create your policy, consider the link between credit and sales. Easy credit terms can be an excellent way to boost sales, but they can also increase losses if customers default. A typical credit policy will address the following points:

Credit limits: You'll establish dollar figures for the amount of credit you're willing to extend and define the parameters or circumstances. Credit terms. If you agree to bill a customer, you need to decide when the payment will be due. Your terms may also include early-payment discounts and late-payment penalties.

Deposits you may require customers to pay a portion of the amount due in advance. Credit cards and personal checks. Your bank is a good resource for credit card merchant status and for setting policies regarding the acceptance of personal checks.

Customer information: This section should outline what you want to know about a customer before making a credit decision. Typical points include years in business, length of time at present location, financial data, credit rating with other vendors and credit reporting agencies, information about the individual principals of the company, and how much they expect to purchase from you.

Documentation: This includes credit applications, sales agreements, contracts, purchase orders, bills of lading, delivery receipts, invoices, correspondence, and so on. For assistance, ask your particular industry's trade or professional association for guidelines. Part of your research should include finding out what your competitors' terms are and taking them into consideration when determining your own requirements.

An often-overlooked element in setting a credit policy is the design of invoices and statements. The invoice is the document that describes what the customer is being billed for; the statement is the follow-up document that indicates the status of the account. One collection and creditor rights expert says that invoices and statements that are clear, easy to read, and allow the customer to quickly identify what is being billed are likely to be paid faster. Here are several points to include on the invoice: An invoice number, an invoice date, a customer number or other identifying code, a complete and clear description of the product or service and item numbers, if appropriate. Avoid abbreviations your customer may not understand. The customer's purchase order, job order or other reference information that will make identifying the invoice easier. The total dollar amount due, clearly indicated Payment terms and due date (and specify any early-payment incentives or late-payment penalties).

Components of credit policy

Component under which a firm sells its goods and services for cash or credit. The period for which credit is granted the cash discount and discount period.

Types of credit instruments

Factors that influence credit period

There are a number of factors that influence the credit period. Many of those also influence customer operating cycle

Perdurability

It has relatively rapid turn-over and relatively low collateral value credit periods are shorter.

Consumer demand

Seller may choose much longer credit periods for off season sales

Cost, profitability and standardization

Standardization product have shorter credit period

Credit risk

The greater the credit risks of the buyer the shorter the shorter the credit period.

Credit Analysis

Refers to the process of deciding whether not to external credit to particular customer. It usually involves the steps, financial statement, credit agency, banks and good will

Collection policy

Collection policy is the finance element in credit policy collection policy involves monitory receivables to spot the trouble and obtaining payment on past due account.

Credit delivery and payment process

The key to responsive, successful programs is rapid, simple and efficient procedures in credit extension. Poor women entrepreneurs operating in the informal sector applying for a loan need it now-not several months from now when the Micro Finance Institutions completes a lengthy and involved loan processing procedure. These procedures should be carefully established and the level of staffing should be adequate so that clients receive a prompt response to their request. Successful finance institutions are those that are able to disburse a loan with in a few days of the application, (Ketenria Simon 1995).

Presto, 2005 notes that credit delivery and payment process involves tow categories of methodologies. The individual lending where loans are given to individual guaranteed by collateral and the peer group lending where loans are given via groups who secure loan payments. The individual lending methodology necessitates the credit officer to have frequent and close contact with the individual clients, while in the peer group lending methodology the functions typically performed by the credit officer are delegated to the borrowing group.

However in both methodologies, W.WB, 2007 notes that the same steps are followed and they include notification, calculation of repayment schedule, fulfillment of preconditions and then disbursement.

Interest rate

According to Wooford Michael 2003, the base interest rate will be arrived at based on the weighted average cost of funds, risk premium, other cost such as administrative

Expenses and profit margin. The base interest rate is reviewed periodically. The interest rate applicable to each loan accounting will be assessed based on multiple parameters like tenure borrower profile, borrowers repayment capacity based on the cash flow, loan to value of the Asset Financed, type of collateral security provided by the borrower and past repayment track record of the borrower etc.

The company intimates the borrower loan amount; annualize rate of interest and method of application at the time of sanction of the loan along with the tenure and amount of monthly installment. The company also offers variable and equated monthly installments schemes. The other charges such as processing fees, additional interest charged on delayed payments and cheque bouncing charges and mentioned in the schedule which is part of the loan agreement.

Zero Percentage

Zero percent interest rates it sounds like free money, or may be a promotional deal from general motors to get people buy hummers are zero rate to the

Federal Reserve

In practice, the actual Federal Funds rate fluctuates slightly around its target as the fed carries out its open-market operations in the money markets. And because banks and financial institutions have been so frightened about lending in the past, the actual fed funds rate has been below 1 percent for the few years according to (Edmund L. Andrew 2008).

Performance

The accomplishment of a given task measured against preset known standards of accuracy, completeness, cost, and speed. In a contract, performance is deemed to be the

Fulfillment of an obligation, in a manner that releases the performer from all liabilities under the contract.

Metrics and key performance indicators

Some of the areas from which bank management may gain knowledge by using business performance management include:

customer-related numbers: new customers acquired, status of existing customers, attrition of customers (including breakup by reason for attrition), turnover generated by segments of the customers - possibly using demographic filters, outstanding balances held by segments of customers and terms of payment - possibly using demographic filters, collection of bad debts within customer relationships, demographic analysis of individuals (potential customers) applying to become customers, and the levels of approval, rejections and pending numbers. Delinquency analysis of customers behind on payments; profitability of customers by demographic segments and segmentation of customers by profitability. Campaign management, real-time dashboard on key operational metrics, (Vom and Rosemann, 2010; Frolick and et al., 2006).

Key Performance Indicators

The term KPI has become one of the most over-used and little understood terms in business development and management. In theory it provides a series of measures against which internal managers and external investors can judge the business and how it is likely to perform over the medium and long term. Regrettably it has become confused with metrics – if we can measure it, it is a KPI. Against the growing background of noise created by a welter of such KPI concepts, the true value of the core KPI. The KPI when properly developed should be provide all staff with clear goals and objectives, coupled with an understanding of how they relate to the overall success of the organisation. Published internally and continually referred to, they will also strengthen shared values and create common goals. Only Key when it is of fundamental importance in gaining competitive advantage and is a make or break component in the success or failure of the enterprise. For example, the level of labour turnover is an important operating ratio, but rarely one that is a make or break element in the success and failure of the organisation. Many are able to operate on well below benchmark levels and still return satisfactory or above satisfactory results.

Only relating to Performance when it can be clearly measured, quantified and easily influenced by the organisation. For example, weather influences many tourist related operations – but the organisation cannot influence the weather. Sales growth may be an important performance criteria – but targets must be set that can be measured. Only an Indicator if it provides leading information on future performance. A considerable amount of data within the organisation only has value for historical purposes – for example debtor and creditor length. By contrast rates of new product development provide excellent leading edge information.

Obviously KPI's cannot operate in a vacuum. One cannot establish a KPI without a clear understanding of what is possible – so we have to be able to set upper and lower limits of the KPI in reference to the market and how the competition is performing (or in the absence of competition, a comparable measurement from a number of similar organisations). This means that an understanding of benchmarks is essential to make KPI's useful (and specific to the organisation), as they put the level of current performance in context – both for start ups and established enterprises though they are more important for the latter. Benchmarks also help in checking what other successful organisations see as crucial in building and maintaining competitive advantage, as they are central to any type of competitive analysis.

Key Performance Indicators are quantifiable measurements, agreed to beforehand, that reflect the critical success factors of an organization. They will differ depending on the organization.

- A business may have as one of its Key Performance Indicators the percentage of its income that comes from return customers.
- A school may focus its Key Performance Indicators on graduation rates of its students.
- A Customer Service Department may have as one of its Key Performance Indicators, in line with overall company KPIs, percentage of customer calls answered in the first minute.
- A Key Performance Indicator for a social service organization might be number of clients assisted during the year.

Whatever Key Performance Indicators are selected, they must reflect the organization's goals, they must be key to its success, and they must be quantifiable (Measurable). Key Performance Indicators usually are long-term considerations. The definition of what they are and how they are measured do not change often. The goals for a particular Key Performance Indicator may change as the organization's goals change, or as it gets closer to achieving a goal.

Key Performance Indicators Reflect The Organizational Goals

An organization that has as one of its goals "to be the most profitable company in our industry" will have Key Performance Indicators that measure profit and related fiscal measures. "Pre-tax Profit" and "Shareholder Equity" will be among them. However, "Percent of Profit Contributed to Community Causes" probably will not be one of its Key Performance Indicators. On the other hand, a school is not concerned with making a profit, so its Key Performance Indicators will be different.

KPIs like "Graduation Rate" and "Success In Finding Employment After Graduation", though different, accurately reflect the schools mission and goals.

Key Performance Indicators Must Be Quantifiable

If a Key Performance Indicator is going to be of any value, there must be a way to accurately define and measure it. "Generate More Repeat Customers" is useless as a KPI without some way to distinguish between new and repeat customers. "Be The Most Popular Company" won't work as a KPI because there is no way to measure the company's popularity or compare it to others.

It is also important to define the Key Performance Indicators and stay with the same definition from year to year. For a KPI of "Increase Sales", you need to address considerations like whether to measure by units sold or by dollar value of sales. Will returns be deducted from sales in the month of the sale or the month of the return? Will sales be recorded for the KPI at list price or at the actual sales price?

You also need to set targets for each Key Performance Indicator. A company goal to be the employer of choice might include a KPI of "Turnover Rate". After the Key Performance Indicator has been defined as "the number of voluntary resignations and terminations for performance, divided by the total number of employees at the beginning of the period" and a way to measure it has been set up by collecting the information in an HRIS, the target has to be established. "Reduce turnover by five percent per year" is a clear target that everyone will understand and be able to take specific action to accomplish.

Credit Terms

Terms are conditions offered or agreed to by somebody, Ashornby, 2005. In this case, Holt 2007, indicate that credit institutions must take into account credit conditions which must be agreed upon by clients before lending.

Water field and Duval, 2006 indicate that there are four key terms to be taken into account in the structuring of loans. The loan period, the loan size, loan security and the effective interest rate.

The pre-credit Disbursement process

This is the period before money is lent out to clients. If entails all activities done to determine whom to lend, what to lend and how to lend effectively before credit is given to clients. The design at this stage has a strong bearing on the success of the micro-credit institution. Therefore management of activities should be stringent. The activities include program frame work, promotion and client selection (W.W.B)

The program framework

This comprises activities done at the designing of finance institutions. In the design, most finance institutions replicate successful one else where and use the individual lending and the peer lending methodologies to deliver services to clients (water field, 2006) Where as replication is good, Water field (2006), emphasizes that programs should not be replicated , but rather should be appropriately designed for every context. "if replication means doing something in the same way as it has been done else where, regardless of local circumstances, it is almost certainly doomed to failure, but there is now a wider appreciation of the need to design an appropriate credit delivery system for every market".

According to Harper 2003 emphasizes that credit is a service, and it has to be marketed like any other. It is easy but probably wrong merely to imitate what is done in a particular model case (W.W.B, 2007) outlines a number of issues to be considered in the programe framework. They include the mission and objective the target group to serve, defining core products and services, staffing, and mutual stake in successful financial means and organization means. According to (W.W.B), these lay a strong foundation in the success of micro finance institution.

Customer Care

Customer service is the provision of service to customers before, during and after a purchase. According to Turban et al. (2002) "Customer service is a series of activities designed to enhance the level of customer satisfaction – that is, the feeling that a product or service has met the customer expectation."

Its importance varies by products, industry and customer; defective or broken merchandise can be exchanged, often only with a receipt and within a specified time frame. Retail stores will often have a desk or counter devoted to dealing with returns, exchanges and complaints, or will perform related functions at the point of sale; the perceived success of such interactions being dependent on employees "who can adjust themselves to the personality of the guest.

From the point of view of an overall sales process engineering effort, customer service plays an important role in an organization's ability to generate income and revenue (Selden, 1998). From that perspective, customer service should be included as part of an overall approach to systematic improvement. A customer service experience can change the entire perception a customer has of the organization.

Some have argued that the quality and level of customer service has decreased in recent years, and that this can be attributed to a lack of support or understanding at the executive and middle management levels of a corporation and/or a customer service policy. To address this argument, many organizations have employed a variety of methods to improve their customer satisfaction levels, and other KPIs (Alisa and et al, 2009). Customer service may be provided by a person (e.g., sales and service representative), or by automated means. Examples of automated means are Internet
sites. An advantage with automated means is an increased ability to provide service 24-hours a day, which can, at least, be a complement to customer service by persons (Solomon, 2010).

Recently, many organizations have implemented feedback loops that allow them to capture feedback at the point of experience. For example, National Express, one of the UK's leading travel companies invites passengers to send text messages whilst riding the bus. This has been shown to be useful as it allows companies to improve their customer service before the customer defects, thus making it far more likely that the customer will return next time (Alisa and et al, 2009).

Technology has made it increasingly easier for companies to obtain feedback from customers. Community blogs and forums give customers to give detailed explanations of both negative and positive experiences with an organization.

A challenge working with customer service is to ensure that you have focused your attention on the right key areas, measured by the right Key Performance Indicator. There is no challenge to come up with a lot of meaningful KPIs, but the challenge is to select a few which reflects your overall strategy. In addition to reflecting your strategy it should also enable staff to limit their focus to the areas that really matter. The focus must be of those KPIs, which will deliver the most value to the overall objective, e.g. cost saving, service improving etc. It must also be done in such a way that staff sincerely believes that they can make a difference with the effort.

One of the most important aspects of a customer service key performance indicator is that of what is often referred to as the "Feel Good Factor." Basically the goal is not to only help the customer have a good experience, but to offer them an experience that exceeds their expectations. Several key points are listed as follows:

Know your product – Know what products/service you are offering back to front. In other words be an information expert. It is okay to say "I don't know," but it should always be followed up by "but let me find out" or possibly "but my friend knows!" Whatever the situation may be, make sure that you don't leave your customer with an unanswered question.

Body Language/Communication – Most of the communication that we relay to others is done through body language. If we have a negative body language when we interact with others it can show our lack of care. Two of the most important parts of positive body language are smiling and eye contact. Make sure to look your customers in the eye. It shows that we are listening to them, not at them. And then of course smiling is just more inviting than someone who has a blank look on their face.

Anticipate Guest needs – Nothing surprises your customer more than an employee going the extra mile to help them. Always look for ways to serve your customer more than they expect. In doing so it helps them to know that you care and it will leave them with the "Feel Good Factor" that we are searching for.

However, Customer care involves putting systems in place to maximize your customers' satisfaction with your business. It should be a prime consideration for every business - your sales and profitability depends on keeping your customers happy. Customer care is more directly important in some roles than others. For receptionists, sales staff and other employees in customer-facing roles, customer care should be a core element of their job description and training, and a core criterion when you're recruiting.

But don't neglect the importance of customer care in other areas of your business. For instance, your warehousing and dispatch departments may have minimal contact with your customers - but their performance when fulfilling orders has a major impact on customers' satisfaction with your business.

A huge range of factors can contribute to customer satisfaction, but your customers - both consumers and other businesses - are likely to take into account: how well your product or service matches customer needs, the value for money you offer, your efficiency and reliability in fulfilling orders , the professionalism, friendliness and expertise of your employees, how well you keep your customers informed, the after-sales service you provide and Training courses may be useful for ensuring the highest possible levels of customer care.

Promotion

When the program frame work is in place, the Micro-Finance Institution needs to think about how to let prospective clients know about their services. New finance institutions will have a particular need to advertise their services to their target clients. Once finance institutions begun to make loans and mobilize savings, clients themselves become promoters and promotion largely takes place by word of mouth. "A strong program offering efficient services to its clients is the best kind of promotion" Mutual el al (2005)

MMC, 2001 emphasizes that promotion in finance institutions is largely by word of mouth and this is by speaking in public meetings or directly in the finance institution offices. Once on ground and offering the efficient services the clients themselves become promoters. When promoting "do not create expectations that can not be met because this results in loss of credibility and always plan your promotion carefully in order not to create business you can not handle ("MCC2001).

Mutual el al (2005) further note that finance institutions use a variety of means to promote their credit programs. They include, news paper advertisements, sports on television, videos, information packets, including brochures and public meetings. It is important that the means chosen to reach potential clients is appropriate.

Clients selection

There is a direct relationship between successful lending and appropriate client selection and loan analysis. A low payment rate is as likely to be a result of poor client selection on the part of the finance institutions and on willingness to repay on the part of the clients (MCC, 2001). There are two principle elements of the client selection process. The collection of information necessary to make a loan decision, and the analysis of this information. W.W.B, 2007 notes that the key to any effective client selection process is a good understanding of the client group and its needs, and tailoring of the process to this client group.

REVIEW OF RELATED STUDIES

The economic literature posits that a well-functioning economy needs a financial system that moves funds from people who save to people who have productive investment opportunities. In other words, a sound financial system acts as a conduit for sustainable economic growth. The link between financial development and growth was first demonstrated in the literature by Walter Bagehot (1873) and John Hicks (1969), who pointed out that industrialization of England was possible because of the use of the financial system to mobilize productive financial capital.

The argument made by Bagehot, Hicks and also by Schumpeter (1912) was that well-functioning financial institutions such as banks enhance technological innovation by supporting entrepreneurs with the best chances. of successfully introducing innovative products and production processes. Levine (1997) provides a review of the literature that clearly shows that the development of financial markets and institutions plays an important role in the growth process of a country and in predicting the future rates of economic growth, capital accumulation, technological change and economic development.

However, Economic theory indicates that the main role of financial markets and institutions is to minimize the costs of information and transactions. Consequently, savings rates, investment decisions, technological innovation, and long-run growth rates depend crucially on the level of financial development. In the next section, we summarize the views in the literature on how the financial system supports economic growth Levine (1997).

The section also focuses on the role of financial systems in economic growth and examines the links between growth and the functions of the financial system.

These functions include facilitating the trading of risk, allocating capital, monitoring managers, mobilizing savings, and easing the trading of goods, services and financial contracts.

The functional roles of the financial Institutions

Financial markets and institutions minimize the costs of acquisition of information and transactions. In the classical perfect world of Arrow-Debreu state-contingent claim framework, there is no need for financial markets and institutions, because there is full information and transactions costs are absent. Hence, resources do not have to be spent to assess risks embedded in projects and behaviors of managers, and there is no need for a mechanism to reduce transaction costs. It is only when the assumptions of the Arrow-Debreu framework are relaxed and fiction introduced that the role of financial systems becomes very important. In a bid to minimize transaction and information costs, Merton and Bodie (1995) demonstrate that financial markets and institutions emerge to facilitate the allocation of resources across space and time, in an uncertain environment.

Following Levine (1997), the chapter presents five functional roles of financial markets and institutions: management of liquidity risk; information acquisition and resource allocation; monitoring of investment projects; mobilization of savings; and the facilitation of the exchange of goods and services. These functions affect economic growth through capital accumulation and technological innovation. The impact of capital accumulation either alters the savings rate or reallocates savings among different capital-producing technologies. With regards to technological innovation, the financial system affects steady-state growth by altering the rate of technological innovation. In the following sections, we look at how market frictions motivate the emergence of financial contracts, markets and intermediaries and their contributions to economic growth.

- *Management of liquidity risk*

The complexity of economic structures gives rise to information and transaction costs. Financial markets and institutions emerge to minimize the risks associated with these costs through the trading, hedging and pooling of risk. Risk could be divided into: liquidity and idiosyncratic risk.

The literature defines liquidity as the ease and speed at which an asset is converted into purchasing power (or currency) at agreed prices. By this definition, real estate is less liquid than equities, and equities in developed economies are more liquid than those traded in less developed economies. Liquidity risk therefore emerges because of uncertainties associated with converting assets into a medium of exchange. Informational asymmetries and transaction costs impact negatively on liquidity and consequently raise liquidity risk. That is why the liquidity risk of a less developed country is higher than that of a G-8 country. Financial markets and institutions therefore evolve to mitigate the frictions associated with liquidity risk.

Levine (1997) suggests that liquid capital markets are therefore markets where financial instruments are traded relatively easily and uncertainty about the timing and settlement of trades is limited. The relation between liquidity and economic development emerges because even though some economic projects may have high returns, they require long gestation periods and therefore demand capital commitments for a longer time period than what savers are prepared to commit. Financial markets and institutions therefore emerge to provide the liquidity to savers for long-term investments.

Which it has been argued by Hicks (1969) that it was the capacity of capital markets to manage liquidity risk that spurred the industrial revolution in England. Hicks points out that most of the products produced during the first decade of the industrial revolution were invented much earlier, through technological innovations. However, the inventions needed a large capital infusion that had to be committed for a long period. He contends that the catalyst responsible for growth in eighteenth-century England was capital market liquidity.

The emergence of well-functioning liquid capital markets in the eighteenth century allowed the English to hold assets such as equity, bond or demand deposits as savings. The capital markets then converted the liquid financial instruments into long-term capital investments (or loans) to support the production processes.

Bencivenga and Starr (1966), suggest that the industrial revolution would not have occurred had there not been improvements in the capital markets that allowed manufacturers to obtain long-term loans. The theoretical explanation for the link between liquidity risk management (or financial markets) and growth has been well explained in the literature.

Diamond and Dybvig (1983) present a model of the link between liquidity and growth where the economic environment is hit by shocks after savers make a choice between two investment projects: an illiquid, high-return project and a liquid, low-return project. In the absence of financial markets in such a risky environment, capital funds are only committed to liquid, low-return projects.

However, the emergence of stock markets allows equity holders to freely sell their shares, giving investors access to capital. Hence, financial markets and institutions reduce liquidity risk through banking intermediation and the trading of equities. As the costs of transactions in the stock market fall, there is more investment in illiquid, high-return projects and consequently higher growth.

In the same vein, financial intermediaries enhance liquidity and reduce liquidity risk by offering liquid deposits to savers and undertaking a mix of liquid, low-return investments and illiquid, high-return investments to satisfy demand. By receiving deposits from savers and investing in a mix of liquid and illiquid assets, banks provide insurance to savers against liquidity risk while facilitating long-run investments in high-return projects. Thus, by eliminating liquidity risk, banks foster investments in high-return, illiquid projects and by so doing accelerate growth.

As pointed out, financial markets and institutions facilitate the minimization of liquidity risk and the diversification of risk, factors which contribute to economic growth through the lending channel. In addition, risk diversification enhances technological change and economic growth. Innovators in the economy are constantly in search of new and profitable technological advances. However, research into innovations that would advance technological changes is a very risky proposition.

King and Levine (1993) suggest that financial markets and institutions allow economic agents to diversify risk by supporting investment in a portfolio of innovative projects. By so doing, financial systems facilitate risk diversification and in the process accelerate technological change and economic growth.

Information acquisition and resource allocation

Without financial markets and institutions, savers are not prepared to commit their savings to investors who are engaging in long-term risky projects, because it is difficult and costly to monitor and evaluate such projects. In addition, savers may not have the time, capacity or means to collect and process information on a wide array of enterprises, managers and economic conditions. Savers therefore withhold their savings and do not invest in projects for which they have very little or reliable information. Financial systems therefore emerge to minimize the costs of acquiring information on projects and to monitor and evaluate their performance (Diamond, 1984).

Levine (1997) demonstrates the role of the banks in acquiring information with this example. Consider a situation where there is a fixed cost to acquire information about a production technology. In the absence of intermediaries, each investor must pay the fixed cost. This information cost structure creates an avenue for a group of individuals to form (or join or use) financial intermediaries to economize on the costs of acquiring and processing information about investments. The emergence of the intermediaries therefore minimizes of the cost of acquiring information about risky investment projects and improves the allocation of resources.

However, the capacity of financial intermediaries to gather and process information has significant growth implications. As argued by Greenwood and Jovanovic (1990), many firms and entrepreneurs are searching for capital to support their investment projects. Hence, financial markets and institutions that are better at screening viable firms and managers will induce a more efficient allocation of scarce financial capital and resources and consequently faster growth as pointed out in Levine (1997), Bagehot (1873) explains the economic success of England in the mid-1800s by pointing out that England's financial system at the time was very good at identifying and funding profitable projects than most countries.

In addition to identifying the best production technologies through the acquisition of information, financial intermediaries also boost the rate of technological innovation by identifying entrepreneurs with the best chances of successfully introducing new goods and production processes. Stock markets may also play an influential role in the acquisition and dissemination of information about investment projects. The size and liquidity of stock markets create an incentive for economic agents to acquire information about firms.

Groosman and Stiglitz (1980) explain that larger and more liquid markets allow agents with private information to profit from the information. Stock markets reduce resources that economic agents must spend to acquire information. Generally, stock markets aggregate and disseminate information through the publication of prices of financial instruments.

As economic theory suggests, asset prices contain all pertinent information and therefore agents do not have to undertake the costly process of evaluating firms, managers and market conditions. This public-good aspect or public disclosure by the stock markets means that economic participants would direct resources that would otherwise be used for acquiring information to other productive activities.

Thus, stock markets stimulate the acquisition of information and as a consequence substantially improve the allocation of resources. By facilitating the acquisition of information for projects and the efficient allocation of resources, stock markets influence substantially long-run economic growth.

- *Monitoring of investment projects*

Another role of financial markets and institutions is to reduce the cost of acquiring information and monitoring investment projects. In general, business owners design financial contracts to ensure that their firms are managed in their best interests. At the same time, creditors such as banks, equity and bond holders create financial arrangements to force owners and managers to run firms in accordance with the interests of the creditors. Financial contracts are very important because they ensure that the flow of mobilized savings (or capital) to profitable investments is not impeded. They also ensure that markets and institutions improve monitoring and corporate control of investment projects, the accumulation of capital and the efficient allocation of resources to ensure long-run growth.

To understand the linkage between monitoring of projects and growth, let us consider an investment environment where it is costly for outside investors in a project to verify its returns. This creates the need for the development of financial markets and institutions, because the inside owners have incentives to misrepresent project returns to the outsiders, and the cost of verification prevents the outside owner from monitoring the project. Under this condition, outsiders would not be prepared to invest in the project, since they cannot ascertain the true return on the project due the cost of verification. Hence, verification costs impede investment decisions and reduce economic efficiency. They also imply that outsiders constrain firms from borrowing to expand investment because higher leverage means greater risk of default and higher verification expenditures by lenders. To address the issue, a financial institution would lend to the inside owners of the project if they post a collateral and allow for the monitoring of the project. Financial intermediaries reduce information costs even further because they can mobilize the savings of many individuals and lend these resources to project owners.

As a result, financial intermediaries are able to economize on aggregate monitoring costs because a borrower is monitored only by the intermediary and not by all individual savers. In addition, financial markets and institutions facilitate the efficient separation of ownership from management of the firm.

Furthermore, with time, financial intermediaries and firms cultivate strong relationships that further reduce the cost of information acquisition. Less information asymmetries can in turn ease external funding constraints and facilitate better resource allocation. Financial markets and institutions therefore improve corporate control and promote faster capital accumulation and contribute to economic growth by improving the allocation of capital.

- *Mobilization of savings*

Financial markets and institutions function to mobilize savings for investments. Without access to capital, many production processes would be constrained to economically inefficient scales. Furthermore, through the mobilization of capital, financial markets and institutions create small denomination instruments that provide opportunities for households to hold diversified portfolios, invest in firms, and increase their asset liquidity.

Sirri and Tufano (1995) suggest that, without pooling, households would have to buy and sell entire firms. Hence, by mobilizing financial capital, households are able to enhance their risk diversification and liquidity, and promote the productive sector of the economy through the efficient allocation of resources. Mobilization of savings is very costly. There are transaction costs associated with collecting savings from different individuals, and informational asymmetries have to be overcome so that economic agents are comfortable parting with their savings. As pointed out in

Carosso (1970), in the mid-1880s, some American investment banks used their European connections to raise capital abroad for investment in the United States.

Other investment banks used the ties with major banks and industrialists in the United States to mobilize capital, while others placed advertisements in newspapers, used pamphlets and travelled from state to state, selling securities to individual households. Carosso's example shows that the mobilization of resources entails a range of transaction costs, including the non-monetary cost of assuring savers of the soundness of their investments.

De Long (1991) points out that, in addition to other transaction costs, financial institutions have to spend resources to establish stellar reputations so that savers feel comfortable about entrusting their savings to them.

Financial markets and institutions also mitigate the high transaction and information costs associated with the mobilization of financial capital from savers. Mobilization involves multiple bilateral financial contracts or arrangements between productive capital-raising units and savers. To minimize the transaction and information costs, financial institutions pool the multiple bilateral contracts together, ensuring that investors entrust them with their wealth to invest in hundreds of firms. Financial systems that are more effective at pooling the savings of households affect economic development, since better savings mobilization improves resource allocation and consequently boosts technological innovation. Thus, by effectively mobilizing resources for projects, financial markets and institutions play a crucial role in promoting the use of better technologies, thereby encouraging growth.

- *Facilitation of the exchange of goods and services*

In addition to mobilizing savings and thereby expanding production technologies, financial markets and institutions minimize transaction costs and promote specialization, technological innovation and growth. The financial system promotes specialization and productivity movements because its activities lead to lower transaction costs, thereby facilitating the exchange of technology in the market and allowing creative individuals to specialize in innovations that strengthen economic growth.

Greenwood and Smith (1997) demonstrate the links between exchange, specialization and innovation when they argue that more specialization requires more transactions and because each transaction is costly, financial arrangements that lower transaction costs facilitate greater specialization and consequently promote productivity gains. These productivity gains in turn spur financial market development, implying that economic development can spur the development of financial markets.

The linkage between financial markets with specialization and growth is evident through technological advancement. As pointed out earlier, lower transaction costs of financial contracts tends to stimulate the invention of new and better and cost-effective production technologies. Thus, the development of financial markets and institutions is crucial for the promotion of economic growth, provided the proper economic environment is created.

- *Financial structure and growth*

In the previous section, the relationship between finance and sustainable economic growth was discussed. In this section, we examine if the financial structure (that is, the degree to which the financial system of countries is intermediary- or market based) matters for long-run economic growth, concentrating on the relative merits of intermediary versus market-based financial systems. The literature has debated this issue for a long time, beginning with reference to Germany and the United Kingdom in the late nineteenth and early twentieth centuries.

Gerschenkron (1962) and Goldsmith (1969) indicate that the intermediary-based system in Germany permitted a closer relationship between intermediaries and firms than was possible in the market-based system in the United Kingdom. The United States is a financial-market- based economy, while Japan, like Germany, is a dominant intermediary-based system. Porter (1992), in explaining the economic performance of Japan, claims that close relationships between intermediaries and firms increase the availability of capital to borrowing firms and thereby boost economic growth.

There are four competing views in the literature to explain the relationship between financial structure and growth: the intermediary-based view, the market-based view, the financial services view, and the law and finance view. The first two views suggest that financial markets and intermediaries are substitute sources of financial services, while the last two suggest that financial markets and intermediaries are complements in the provision of financial services.

The intermediary-based view suggests that intermediaries have the capacity to identify good projects, mobilize resources, monitor managers and manage risk. It is further suggested that financial intermediaries are very effective at financing projects that are characterized by substantial asymmetric information (for example, adverse selection and moral hazard), because they have built the capacity to separate "good" borrowers from "bad" ones. Intermediary-based systems are noted to be effective at supporting economic growth of countries at the early stages of economic development than market-based financial systems.

The market-based view emphasizes the role of markets in diversifying and managing risks. In environments where the financial markets are developed, some firms at a certain point of their life cycle rely mostly on market financing, such as equity or bond financing.

Allen and Gale (1999 and 2000) argue that industries that are faced with continuous technological advances (and where information is scarce and diversity of opinion persists) should turn to financial markets (bond and stock markets) for their capital needs. Market-based systems are seen as encouraging long-run economic growth.

The financial services view points out that financial intermediaries do provide complementary services to those provided by markets, insisting on the importance of the overall level and quality of financial services rather than the channels through which those services are provided. It focuses on the creation of an environment conducive to better-functioning intermediaries and markets.

The law and finance view, which is an extension of the financial services view, stresses that the distinction between intermediary- and market-based systems is of secondary importance. What matters most is the legal environment and the enforcement of contracts. Proponents of this view suggest that the legal system plays a crucial role in determining the growth-stimulating nature of financial services.

Empirical investigations of these views of financial structure and long-run economic growth are inconclusive. Levine (2000) and Demirguc-Kunt and Levine (2001) find that the distinction between intermediary- and market-based systems is not as important as a country's legal system and the quality of its financial services in explaining economic growth, while Tadesse (2001) takes the opposite view. He argues that for countries with underdeveloped financial sectors, intermediary-based systems outperform market-based systems, while the opposite is the case for countries with developed financial sectors.

In contrast, Levine and Zervos (1998) argue that higher stock market liquidity, irrespective of the development of intermediaries, leads to higher growth. On balance, the literature suggests that financial structure - the mixture of financial markets and intermediaries - is not important in explaining differential growth rates across countries. Countries do not grow faster and firms' access to finance is not systematically easier in

either market- or intermediary-based systems. Germany and Japan - major intermediary-based systems - and the United States and the United Kingdom - the foremost market-based systems - have had similar growth rates over time. This implies that what a country needs is a sound legal system that effectively protects the rights of investors and enforces contracts efficiently.

Accordingly, countries developing their financial markets should focus on legal, regulatory and other policy reforms that encourage the proper functioning of both markets and intermediaries, rather than the degree to which their national financial system is market-based or intermediary-based.

However, the rest of this section focuses on the relationship between financial structure and growth, examining the relationships between financial intermediaries and markets and how they facilitate savings mobilization, information acquisition and risk management, and also examines the financial services view and the law and finance view and how either of them promotes economic growth.

Services of financial intermediaries

- *Mobilization of savings*

Financial intermediaries play an important part in mobilizing savings in the economy.

Through their activities, intermediaries lower transaction costs associated with savings mobilization and mitigate the ill effects of moral hazards and adverse selection that make savers reluctant to relinquish control over their savings. By alleviating asymmetric information problems and reducing transactions costs, financial intermediaries facilitate savings mobilization and thereby increase economic growth.

Dolar and Meh (2002) suggest that financial intermediaries influence long-run growth because by mobilizing savings, they encourage capital formation and increase the national savings rate. Furthermore, by exploiting economies of scale and consequently reducing costs per unit of transaction as the size of a transaction increases, financial intermediaries improve the allocation of savings.

- *Information acquisition*

Since borrowers hold private information about the quality of their projects ex ante (Adverse selection), the screening of projects by intermediaries is crucial to provide agents with incentives to accurately report whether the project is bad or good. In the absence of screening, "bad" borrowers would pretend to be "good" and this could lead to underinvestment in good projects, since lenders cannot verify the true type of borrowers.

Stiglitz and Weiss (1981) and Boyd and Prescott (1986), in their independent contributions to *credit rationing theories,* argue that because it is costly to screen projects, it is optimal to delegate the acquisition of information to intermediaries to avoid the duplication of costly information acquisition and resource wastage. Financial intermediaries also have to verify and monitor the "true" realization of projects, as borrowers tend to keep information on their projects private (moral hazard). This verification is carried out by intermediaries as an incentive to get borrowers to truthfully report the outcome of their projects. Without the monitoring by intermediaries, lenders would receive lower returns. Townsend (1979) demonstrates that since it is costly to assess the actual state (costly state verification) of a project, it is more efficient to have the intermediary do the assessment on behalf of lenders.

Diamond (1984) also shows that the costs of monitoring decline as the intermediary deals with an increasing number of borrowers. In other words, financial intermediaries exploit economies of scale in the monitoring of firms, improving the assessment of investment opportunities (screening) and the exertion of corporate control once those investments have been financed. Through this action, the intermediary improves capital formation and allocation, which in turn boosts economic growth.

- *Risk management*

One of the functions of financial intermediaries is to facilitate risk sharing and ultimately reduce transaction costs. Standard risk diversification requires that individuals, at a given point in time, diversify their portfolio of assets in order to minimize financial losses. Financial intermediaries, by taking advantage of economies of scale, reduce the costs of holding a diversified portfolio of assets.

In addition, Allen and Gale (1997) and Levine (2000) note that intermediaries also facilitate *inter-temporal smoothing* of risks that cannot be diversified at a given point in time, such as oil-price shocks and other macroeconomic shocks, by averaging those shocks over time in a way that decreases their adverse effects. Under the framework of inter-temporal risk smoothing, investors enter into financial contracts such that they receive lower returns than what the market offers in good times in return for higher returns relative to the ones offered by markets in bad times, such as during recessions. Financial intermediaries are well suited to provide inter-temporal risk sharing, because it requires the accumulation of large reserves in safe assets.

However, financial markets also facilitate the diversification of risk, including liquidity risk, because they allow for cross-sectional risk sharing among individuals holding a portfolio of assets. Cross-sectional risk sharing requires the availability of numerous financial instruments, which are generally available in market-based systems.

Financial markets can reduce liquidity risk with positive impacts on long-run growth because, in general, most high-return projects are long-term investments that require the commitment of long-term funds. Savers, however, are often reluctant to give up control of their wealth for extended periods. Financial markets circumvent the challenge by allowing savers to convert their securities (equities in firms) readily into liquidity whenever they so desire. At the same time, capital raised through security issues allows firms to have continuous access to capital. By boosting long-term and high-return investments, financial markets allow for an efficient allocation of capital and thereby increase economic growth.

To illustrate the inter-temporal risk-sharing activity, we could consider the sharp increase in oil prices in the early 1970s as "bad times," and the stock market boom in the 1980s as "good times." Dolar and Meh (2002) suggest that in the former case, given that claims on intermediaries were constant in value, households in Japan and Germany (both intermediary-based systems) did not experience a decline in wealth like those in the United States and the United Kingdom, and as a result they did not face substantial fluctuations in their consumption.

This implies that intermediary-based financial systems were able to smooth the oil price shock rather than pass it on to households. On the other hand, during the stock market boom of the 1980s, households in the United States and the United Kingdom (that have most of their wealth in stock markets) obtained higher returns and used those returns to finance a higher consumption profile. German and Japanese households did not profit from the market boom because their savings were mostly in intermediaries, where they received fixed returns. Financial intermediaries also mitigate liquidity risk.

Many high-return investments require a long-term commitment of capital, but risk-averse agents are generally hesitant to relinquish their savings for long periods. Financial intermediaries emerge to provide long-term investments by pooling savings, which can be made liquid whenever needed. Financial intermediaries use part of the mobilized savings to support long-term capital projects and invest the balance in short-term assets to satisfy clients with liquidity needs.

However, Kose and Lang (1990) further argue that intermediaries, particularly banks, are more effective at providing external finance to new firms that require staged financing, because they can commit to make additional funding available to investors as the project advances. Thus, by facilitating the operation of high-return investment projects, financial intermediaries improve the allocation of capital and thereby enhance economic growth.

- *Services of financial markets*

Like financial intermediaries, financial markets also provide financial services by influencing savings mobilization, information acquisition, corporate control and risk management, activities that all have a positive impact on economic growth.

Savings mobilization and allocation

Well-developed financial markets also facilitate savings mobilization. As noted in the previous sections, transaction costs and asymmetric information (adverse selection and moral hazard) make the mobilization of savings very costly. Contributing to transaction costs is the fact that, in the presence of asymmetric information, risk-averse agents are reluctant to entrust their savings to others. Financial markets provide a vehicle for savers and give investors access to capital. In order to attract savers as well as investors, it is important for well-functioning markets to efficiently disclose their relevant information procedures, contracting systems and accounting standards. The laws in most market-based systems, such as the United States and the United Kingdom, require publicly listed firms to fully disclose their activities.

This implies that a great deal of information is revealed, thereby reducing the difficulties associated with savings mobilization. Financial markets also facilitate the mobilization of savings by providing the environment for "market makers" (multi-period players) to build up their reputation. Diamond (1991) suggests that reputation forces market makers (dealers) to manage the savings of agents properly.

Furthermore, Chemmanur and Fulghieri (1994) argue that reputation provides individuals with incentives to entrust their savings to market makers, and thereby encourages savings mobilization. As pointed out by Levine (2000), financial markets that are more effective at pooling or mobilizing savings from several agents can have strong positive effects on economic development by boosting capital formation and improving resource allocation.

- *Information acquisition*

Sound financial markets promote the collection and processing of information. Since individuals or firms have the potential to receive high returns from the trading of information in well-functioning markets, they devote greater resources to researching innovative projects. Allen and Gale (2000) note that new technologies are hard to assess, either because little information is available about their potential returns, or because the analysis of the information requires the assistance of experts.

Investors who can potentially finance these new technologies have different opinions on the outcomes. Financial markets ensure that only innovative projects for which enough information is available receive financing. Consequently, the development of new technologies and improved information about firms enhance resource allocation substantially, with corresponding implications for long-run economic growth.

Holmstrom and Tirole (1993) also argue that sound financial markets assist with corporate control after funding has taken place, because the market induces better corporate control by facilitating mergers and acquisitions of companies. The market also structures compensation such that managerial remuneration is conditioned on firms' performance. In other words, proper-functioning markets facilitate takeovers so that outsiders can buy poorly managed firms, fire managers, and transform those firms into productive enterprises. The markets also exercise corporate control by tying managerial compensation to the stock price of the company, thereby ensuring that the interests of managers are aligned with those of firm owners.

- *Which financial structure is better?*

The previous sections examined the operations of financial intermediaries and markets, particularly in facilitating the mobilization of savings, information acquisition and risk management. The relative contributions of intermediaries and financial markets in promoting long-run economic growth were not thoroughly examined. The next section examines whether intermediary- and market-based systems are substitutes in the provision of financial services that stimulate economic growth.

- *Intermediary-based argument*

As pointed out earlier, financial intermediaries facilitate the mobilization of savings, acquire and disseminate costly information, and facilitate risk management. These financial services are crucial for the efficient allocation of capital to firms, thereby encouraging long-run economic growth. Whereby the ability of intermediaries to promote economic development stems from their capacity to gather information on lenders and monitor their activities. In well functioning markets, information is instantly revealed to the public, providing less incentive for free riders and other individual investors to acquire information. As a result, competitive financial markets may be characterized by underinvestment in information.

Consequently, Boot, Greenbaum and other and Thakor (1993) suggest that well-developed markets could have a negative impact on the identification of innovative projects and thereby impede efficient resource allocation. Financial intermediaries have better incentives to gather information and monitor firms and can efficiently internalize the fixed cost of doing so. The free-rider problem is less severe in intermediary-based systems, since banks can make investments without revealing their actions instantaneously in public markets.

Advocates of the intermediary-based system stress that liquid financial markets can create an environment in which individual investors behave as if they were myopic. Because individual investors are able to readily sell their shares in liquid markets, they have fewer incentives to monitor managers thoroughly. This implies that greater market development may hinder corporate control and economic performance.

Another view is that financial markets are not able to provide corporate control because insiders have better information about the firms than outsiders. This informational asymmetry has the tendency to moderate the potential effectiveness of takeovers, given that well-informed insiders will more likely outbid less-informed outsiders. Proponents of the intermediary-based view argue that although markets can potentially provide products for diversifying risk, they are unable to diversify aggregate shocks because they are incomplete. Due to problems of adverse selection and moral hazard, contracts for the delivery of financial services are contingent only on states whose occurrence can be verified to the satisfaction of all counterparties.

Allen and Gale (1997) stress that the incompleteness of markets gives rise to the development of institutions such as financial intermediaries that fill in the blanks of "missing markets." Dolar and Meh (2002) also suggest that, over time, financial intermediaries are better at providing risk-improving services than market-oriented systems, particularly in cases involving inter-temporal risk sharing, where intermediaries accumulate reserves in safe assets and are able to average out aggregate risks over time.

Rajan and Zingales (1999) further argue that intermediaries have advantages over financial markets in most institutional environments, noting that even in countries with weak legal and accounting systems, powerful intermediaries can still make firms reveal information and pay back their debts, thereby facilitating expansion and long-run growth.

- *Market-based argument*

Proponents of the market-based system essentially counter the intermediary-based system argument by focusing on the problems caused by powerful banks. In the process of financing firms, financial intermediaries get access to vital information that is not available to other lenders. Intermediaries can potentially use such inside information to extract rents from firms. They also have enormous power over a firm's future profits during the process of financing new investments or debt renegotiations.

Rajan (1992) argues that powerful intermediaries can obtain a disproportionately large share of the profits, so that firms will have fewer incentives to undertake high-risk and profitable projects. The preference of intermediaries when negotiating with firms on financial debt contract is to choose low-risk projects that have a high probability of success. The drawback, however, is that low-risk projects are generally low-return investments. Hence, intermediary-based systems have the potential of curtailing technological innovation and long-run economic growth.

Weinstein and Yafeh (1998), studying the Japanese environment, find that while close relationships between intermediaries and firms increase the availability of capital to borrowing firms, they may not necessarily lead to profitability or growth. They observe that the cost of capital for firms with close intermediary ties is higher than that of their peers, which suggests that intermediaries appropriate most of the benefits from these relationships. Compared to financial market-based systems, clients of intermediaries grow at a slow rate, such that intermediaries discourage firms from investing in risky but profitable projects.

Another argument made by Hellwig (1998) against intermediary based-systems is that powerful intermediaries have the potential of colluding with managers against outsiders, which in turn impedes competition, corporate control, the creation of new firms and long-run economic growth. Wenger and Kaserer (1998) have also found that some intermediaries misrepresent the balance sheets of firms to the public, thereby encouraging some firm managers to underreport their balance sheets. Such activities do not enhance or promote economic activities.

Allen and Gale (1999) also point to a deficiency of the intermediary based-system by arguing that, despite the efficiency of intermediaries in eliminating the duplication of information gathering and processing, they can have less success in dealing with uncertainty, innovation and new ideas. The wide array of possibilities and the lack of pertinent information mean that there is often substantial diversity of opinions on the future of the projects seeking financing. Generally, intermediated financing requires delegation of the decision regarding the financing of a project to a relatively small number of decision-makers. The delegation is very effective when there is no disagreement, resulting in substantial cost savings.

However, when diversity of opinion persists, then there is a challenge. Although managers do everything they possibly can to choose projects they believe are worthwhile (i.e., apart from the principal-agent problem), diversity of opinion suggests that some of the providers of funds would disagree with those decisions. Investors may have fewer incentives to supply funds if the likelihood of disagreement is very high, resulting in underfunding of new technologies. This would not occur in financial markets-based systems, where coalitions of investors with similar views can join together to finance projects. Financial markets are therefore very effective in financing industries that are new, or where there is little information and a diversity of opinions on the future outcome of the projects.

Another comparative advantage that market-based systems have over intermediary systems is the capacity to provide cross-sectional risk sharing (i.e., diversification of risk at a given point in time). As pointed out in the previous sections, markets are well suited to achieve cross-sectional risk sharing because of the enormous variety of financial products available. All these factors help support the market-based system in boosting economic growth.

However, Arestis, Demetriades and Luintel (2001) find that intermediary-based financial systems may promote growth more than market-based financial systems. They studied the systems in Germany, the United States, Japan, the United Kingdom and France and found that while stock markets in these countries may contribute to long-run output growth, the influence of the stock market is much smaller than that of banks. Demirguc-Kunt and Levine (1996) studied 44 countries and concluded that countries with a well-developed stock market also have well-developed banks and non-bank financial intermediaries, implying that markets and intermediaries are complements in providing growth-promoting financial services.

Interest rate

The interest rate is the profit over time due to financial instruments. In a loan structure whatsoever, the interest rate is the difference (in percentage) between money paid back and money got earlier, keeping into account the amount of time that elapsed. If you were given 100$ and you give back 120$ after a year, the interest rate you paid was 20% a year (Valentino Piana, 2002).

Nominal interest rate is laid down in contracts between involved parties. Real interest rates somehow adjust the nominal ones to keep inflation into account. For instance if inflation was 15%, in the previous example the real interest rate can be said to be 20%-15% = 5%, in a simplified way of computation (Valentino Piana, 2002).

There exist several nominal interest rates, depending on the following elements: the institution offering the credit; the organization receiving the loan, which can be more or less trustworthy; the funds' use and the aims of the financed plan (consumption, investment, working capital); the time length of the loan with the broad difference between short-term interest rate and long-term interest rate; the ex-ante flexibility of the contract with the alternative between a fixed interest rate or a variable interest rate; the number, the frequency and the amounts of reimbursement actions; the conditions under which the loan is agreed, for example regarding guarantees and collateral; the presence or absence of a market for converting loan conditions and for changing the parties involved in the contract (Valentino Piana, 2002).

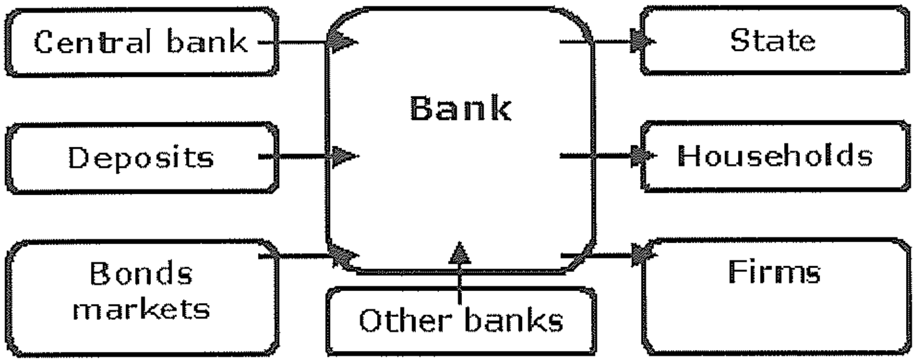
For instance, the fixed interest rate paid to a bank by private firms for financing an industrial investment, characterized by a payback period of 3-7 years, exerts a crucial importance in the economy. In fact, it may influence overall investment, thus the business cycle.

As the typical lending institution, the bank finances its credit activity in several ways: 1. by collecting money from households deposits (and pay to them an interest rate on deposits), 2. By issuing its own obligations, characterized by a bonds interest rate, 3. By taking short-term loans from other banks, paying the inter-banking interest rate, 4. By borrowing money from the central bank, this requires an interest rate for refinancing operations. When establishing the interest rate to the public, banks all over the world make reference to these rates (e.g. "1.5% more than EURIBOR" - the famous interbank interest rate for loans in Euros) (Valentino Piana, 2002).

If the firm is a sound primary firm with excellent trustworthiness, the bank would agree an interest rate only slightly higher than the rate the same bank would be requested to pay in the inter-banking market from other lending institutions. By contrast, for smaller industrial firms, the rate usually would be significantly higher because of the worsened credit risk. Apart from bank loans, a key interest rate in the economy is that paid on Treasury bonds. Similarly, private, public and state-owned firms issue bonds as well, expressing further nominal interest rates. Both state and firm bonds can be continuously exchanged in public markets, making their effective interest rate dependent on the price at which it has been bought. A bond, whose nominal price is 100 and interest rate is 5%, will in reality give a 10% yield if it is bought at a price of 50 in the public market (Valentino Piana, 2002).

Households receive interests on their bank accounts; usually higher if they block money for a certain period (savings account) and lower if it is an "a vista" account (current account). Conversely, households pay an interest when taking loans for consumption purposes. Following picture summarizes most of what we said, with an arrow for each kind of interest rate:

Banking model



Source: www. Banking model.com

Many other interest rates could be found on the light of the fact that any negotiation can produce a specific rate. In term of comparison among their mutual relationships, in some cases it is known which rate is higher and which is lower but differences (the so-called "spread" between two rates) can widely vary over time and among countries.

Which is the leading interest rate, in parallel to which all the others move? Does it exist such an interest rate? Well, in some analysis it may be easier to consider just one interest rate, but in reality there is no guarantee that all the others will move exactly in parallel. Still, the IS-LM model makes usually reference to one interest rate, influenced by the central bank and having an impact on investment (Valentino Piana, 2002).

Determinants

Changes in interest rates structure depend on reasons that are both internal and external to financial markets: 1. Different types of interest rate are linked and influence each others, so that the functioning of the financial markets and their international relationships explain a good deal of interest rate fluctuations. 2. Economic performance, perspective and expectations of potential loan receivers as well as in the overall economy play an important role. To keep things easy, we could say that interest rates are determined in negotiations, which are more or less public, binding a larger or narrower number of contrahents, more or less depending on publicly available benchmark rates. In a sentence, interest rates are set within institutional agreements. Central bank policy is one of the most powerful factors impacting on these agreements, for example through the instrument of direct determination of official discount rate or the rate for refinancing operations. An increase of money offered in the interbank market by the central bank is conducive to a fall in the interbank rate, upon which many contracts are based. To the extent the Ministry of Treasury influences the interest rates on its own bonds; it provides an important reference point for the economy (Valentino Piana, 2002).

Since for many banks the risky commercial loans to firms are alternative to safe Treasury bonds, there are paradoxically situations in which the interest rate policy in the hands of the Treasury not less than of the central bank. International tendencies exert an important influence on domestic conditions as well, since financial markets are now global in scope and there is a growing co-operation among central banks. Still, domestic commercial bank policies say the last words on loan agreements and conditions (Valentino Piana, 2002).

In general, an increase of interest rates may be provoked by the following factors alternatively or cumulatively: 1. an anti-inflationary policy of the central bank, based on restrictions to the growth of the nominal money supply and on rising discount interest rate; A policy by the central bank aimed at revaluating the currency or defending it from devaluation, 3. The attempt of the Treasure of covering public deficit by issuing more bonds in an unwilling market, 4. An attempt of banks of widening their margins, possibly as a reaction to losses, 5. any increase in other interest rates, also foreign rates arisen for whatsoever reason (Valentino Piana, 2002).

Market share

Market share, in strategic management and marketing is, according to Carlton O'Neal, the percentage or proportion of the total available market or market segment that is being serviced by a company. It can be expressed as a company's sales revenue (from that market) divided by the total sales revenue available in that market. It can also be expressed as a company's unit sales volume (in a market) divided by the total volume of units sold in that market. It is generally necessary to commission market research (generally desk/secondary research) to determine. Sometimes, though, one can use primary research to estimate the total market size and a company's market share (Carlton O'Neal, 2010).

Increasing market share is one of the most important objectives of business. The main advantage of using market share as a measure of business performance is that it is less dependent upon macro environmental variables such as the state of the economy or changes in tax policy. However, increasing market share may be dangerous for makers of fungible hazardous products, particularly products sold into the United States market, where they may be subject to market share liability (Carlton O'Neal, 2010).

However, the percentage of an industry or market's total sales that is earned by a particular company over a specified time period. Market share is calculated by taking the company's sales over the period and dividing it by the total sales of the industry over the same period. This metric is used to give a general idea of the size of a company to its market and its competitors. Investors look at market share increases and decreases carefully because they can be a sign of the relative competitiveness of the company's products or services. As the total market for a product or service grows, a company that is maintaining its market share is growing revenues at the same rate as the total market. A company that is growing its market share will be growing its revenues faster than its competitors. Market share increases can allow a company to achieve greater scale in its operations and improve profitability. Companies are always looking to expand their share of the market, in addition to trying to grow the size of the total market by appealing to larger demographics, lowering prices, or through advertising. This calculation is sometimes done over specific countries such as Canada market share or US market share. Investors can obtain market share data from various independent sources (such as trade groups and regulatory bodies), and often from the company itself, although some industries are harder to measure with accuracy than others.

However, Market share is the portion or percentage of sales of a particular product or service in a given region that are controlled by a company. If, for example, there are 100 widgets sold in a country and company A sells 43 of them, then company A has a 43% market share. You can also calculate market share using revenue instead of units sold. If company A sold widgets for a total cost of $860 and the people in the country spend a total of $2,000 on the same widgets, then the market share is $860/$2,000 or 43%. The two different methods of calculating market share won't always provide the same answer, because different companies may charge slightly different prices for the same type of widget.

Market share is used by businesses to determine their competitive strength in a sector as compared to other companies in the same sector. It also allows you to accurately assess your performance from year to year. If you only use sales to measure your performance, then you don't take into account the market conditions that may have improved or decreased your sales. Your sales may have gone up because of increased popularity of your type of widget, or they may have gone down because of a drought or recession. Since those factors are beyond your control, they don't give you meaningful information about how you are actually doing as a company in terms of improving your business. By measuring market share, you can see if you are doing better or worse compared to other companies that are facing the same challenges and opportunities that you are.

There are four basic ways you can improve your market share. You can improve your product so that it is better than your competitors or you can change the price or offer special incentives for buyers, such as discounts or sales. Alternatively, you can find new methods to distribute your product so people can buy it in more places. Finally, you can advertise and promote your product. Using these techniques in any combination may improve market share. Increased market share is not always the best solution for businesses. It might not be profitable if it is associated with expensive advertising or a big price decrease. A company may not be able to meet the demand of an increased market share without huge investments in new equipment and employees. In some cases it can be to a company's advantage to decrease market share, if the lower costs of lower market share can improve profitability. Managing market share, therefore, is a very important aspect of managing a business.

- *Financial services argument*

In the previous sections, we examined the merits and demerits of the financial markets and intermediaries systems, noting that these systems reduce transaction and information costs, in addition to the key financial functions they perform: savings mobilization, information acquisition and risk management. Proponents of the financial services view focus on these functions and emphasize the important role of a well-functioning financial system (both financial markets and intermediaries) in providing these services. They argue that the central question is the overall quantity and quality of financial services, and not the specific organization of the financial system (market- or intermediary-based). In other words, the issue of market- versus intermediary-based systems is of less relevance.

Boyd and Smith (1996) suggest that financial markets and intermediaries perform more or less the same functions, but in different ways and possibly with different degrees of success. Allen and Gale (1999) support this position by arguing that financial markets mitigate the adverse effects of powerful intermediaries by encouraging competition for corporate control and by creating alternative ways of funding investment opportunities.

Rajan (1992) also demonstrates that intermediaries and markets have a comparative advantage at dealing with different types of information, and intermediaries can benefit from higher returns to mitigate the effects of asymmetric information.

Demirguc-Kunt and Levine (1996) show that stronger securities markets tend to encourage the use of bank finance in developing countries, implying that intermediary-based and financial markets systems are complementary to one another in the development process.

Loan payment

The most typical loan payment type is the fully amortizing payment in which each monthly rate has the same value overtime.

The fixed monthly payment **P** for a loan of **L** for **n** months and a monthly interest rate **c** is:

$$P = L \cdot \frac{c\,(1+c)^n}{(1+c)^n - 1}$$

Source: banking payback model

Repayment of the loan is not gross income to the lender. In effect, the promise of repayment is converted back to cash, with no accession to wealth by the lender.

Repayment plans

The Direct Loan Program offers loan repayment plans designed to meet the needs of almost every borrower. Direct Loans are funded by the U.S. Department of Education through your school and are managed by a loan servicer, under the supervision of the Department. The Direct Loan Program allows you to choose your repayment plan and to switch your plan if your needs change. To find out more about repayment options before receiving a Direct Loan, borrowers may contact their school's financial aid office or the Federal Student Aid Information Center at 1-800-4-FED-AID (1-800-433-3243). If you currently have a Direct Loan and would like the exact payment amount on your loan, you can find it out by contacting your loan servicer. Parent Direct PLUS Loan borrowers may only choose from the standard, extended, or graduated options, but student Direct PLUS Loan borrowers may also choose the income contingent repayment plan or the income-based repayment plan.

Standard Repayment

With the standard plan, you'll pay a fixed amount each month until your loans are paid in full. Your monthly payments will be at least $50, and you'll have up to 10 years to repay your loans. The standard plan is good for you if you can handle higher monthly payments because you'll repay your loans more quickly. Your monthly payment under the standard plan may be higher than it would be under the other plans because your loans will be repaid in the shortest time. For the same reason—the 10-year limit on repayment—you may pay the least interest.

Extended Repayment

To be eligible for the extended plan, you must have more than $30,000 in Direct Loan debt and you must not have an outstanding balance on a Direct Loan as of October 7, 1998. Under the extended plan you have 25 years for repayment and two payment options: fixed or graduated. Fixed payments are the same amount each month, as with the standard plan, while graduated payments start low and increase every two years, as with the graduated plan below. This is a good plan if you will need to make smaller monthly payments. Because the repayment period will be 25 years, your monthly payments will be less than with the standard plan. However, you may pay more in interest because you're taking longer to repay the loans. Remember that the longer your loans are in repayment, the more interest you will pay.

Graduated Repayment

With this plan your payments start out low and increase every two years. The length of your repayment period will be up to ten years. If you expect your income to increase steadily over time, this plan may be right for you. Your monthly payment will never be less than the amount of interest that accrues between payments. Although your monthly payment will gradually increase, no single payment under this plan will be more than three times greater than any other payment.

Income Contingent Repayment (not available for parent PLUS loans)

This plan gives you the flexibility to meet your Direct Loan obligations without causing undue financial hardship. Each year, your monthly payments will be calculated on the basis of your adjusted gross income (AGI, plus your spouse's income if you're married), family size, and the total amount of your Direct Loans. Under the ICR plan you will pay each month the lesser of:

1. the amount you would pay if you repaid your loan in 12 years multiplied by an income percentage factor that varies with your annual income, or
2. 20% of your monthly discretionary income.

If your payments are not large enough to cover the interest that has accumulated on your loans, the unpaid amount will be capitalized once each year. However, capitalization will not exceed 10 percent of the original amount you owed when you entered repayment. Interest will continue to accumulate but will no longer be capitalized. The maximum repayment period is 25 years. If you haven't fully repaid your loans after 25 years (time spent in deferment or forbearance does not count) under this plan, the unpaid portion will be discharged. You may, however, have to pay taxes on the amount that is discharged.

Income-based Repayment

Under this plan the required monthly payment will be based on your income during any period when you have a partial financial hardship. Your monthly payment may be adjusted annually. The maximum repayment period under this plan may exceed 10 years. If you meet certain requirements over a specified period of time, you may qualify for cancellation of any outstanding balance of your loans (U.S. Department of Health and Human Services, 2011).

CHAPTER THREE

Research Design

Study involved Descriptive correlation design, and the reason for this is because it was aimed at describing the current situation so that it can be understood clearly so the gaps identified in it can be addressed in order to foster effective financial management systems in the banking sectors. Since it would be impossible to carry out research in all banking sector, particularly the Housing Finance Bank, and the information obtained from there is hereby treated as representative of the entire banking sector and country at large. The design was appropriate because it involves drawing small samples in order for in depth analysis to be made.

The study was both qualitative and quantitative. The quantitative data was obtained using closed ended questionnaires and observation from different Top management and credit officers of the bank.

Research Population

The population of the study in this research was comprised of 152 people. These included official of the bank at the main branch at Kololo, near the Air strip, such as Directors, Accountants, Auditors, Budget officers, Credit Officers, Public Relations officers. Population in this area is composed of all the tribes in Uganda and the most common language here is Luganda and English. The choice of this area is that, the study is typically Urban based. The study was relatively easy for the researcher since the researcher also understands one of the languages spoken within that area of study that is English. The population under the study was in the categories of top management, and credit managers.

Sample Size

The respondent was drowned from the all staff of Housing Finance Bank in Kampala road and Namwongo branches. The respondents fall in the categories of top management, and direct-service providers (staff), the population and sample size are determined according to solven's $n = \frac{N}{1+N \times (0.05)2}$ where N is the sample population

and n is the sample size. Table 1 is the summary of population and sample size.

Table: 1 Respondent of the study

Categories of Respondents	Population of the study	Sample
Top management	55	55
Staff	97	55
Total	**152**	**110**

$$n = \frac{N}{1 + N(0.05)^2}$$

Where

N=Samples size

N=Population

0.05^2 Level of significance

Sampling Procedure

To get the respondents size to participate in the study, purposive sampling method was used, and a sample of 110 respondents was selected. These were selected using purposive sampling technique in order to attract respondents who are capable of providing the most appropriate information on the subject matter.

Research Instruments

The researcher used the closed ended questionnaires to collect the data. The questionnaire was designed to be answered by two sections: managers, and credit officers. The researcher also used observation. This enabled the researcher to observe certain variables that could not be reflected in the questionnaire.

Validity and reliability of the instrument

The research instruments that the researcher used were questionnaires and observations. The researcher carried out a pre-test of the questionnaire before using it in the research. The questionnaire were cross examined for approval by a research expert, to ensure that the information they would generate is appropriate and consistent, before going out to carry out the study, the researcher first consulted her supervisor, to make sure that these instrument would generate relevant information during the study. To improve the validity of the data collection instruments, mainly the questionnaire.

It was therefore, be dependable that the response was got from top management, it can be proved to be reliable through the lower management that is credit officers that accepted that indeed such policies are in existence and be implemented by them

Data Gathering Procedure

The researcher collected both primary and observation through questionnaire. The data collection process was organized and conducted in three stages:

Before the administration of the questionnaires

1. An introduction letter was obtained from the school of Post Graduate Studies and Research at Kampala International University, for the researcher to solicit approval to conduct the study from respective officials of the ministry of Education and its affiliate departments.

2. When approved, the researcher secured a list of the qualified respondents. This involved seeking permission by the researcher from the senior officials of the ministry to protect qualified respondents from harm or harassment and their confidentiality and superior's sensitive information.

3. The respondents were explained about the research study and enough questionnaires were reproduced for distribution.

4 The researcher selected assistants who would assist in the data collection; brief and orient them in order to be consistent in administering the questionnaires.

During the administration of the questionnaires

1. The respondents were requested to answer completely and not to leave any part of the questionnaires unanswered.
2. The researcher and assistants emphasized retrieval of the questionnaires within ten days from the date of distribution.
3. On retrieval, all returned questionnaires were checked if all are answered.

After the administration of the questionnaires

The data gathered was collected, encoded into the computer and statistically treated using the Statistical Package for Social Sciences (SPSS).

Data Analysis

The data was obtained through questionnaires and observations. And in analyzing the data, frequency counts, percentages and means were used to answer the research questions.

To interpret the response of respondents, on Credit Management and the performance of Selected Banks of Housing Finance, the following quantification and value were used. Data analysis using SPSS's descriptive statistic for means and standard deviations, answer research question (i).

PLCC was used to show positive significant relationship between credit policy and loan repayment, and this was used to answer research question (ii) and iii).

In order to interpret the level of credit management and bank performance, the following values were used:

Mean	Interpretation
3.25-4.00	Very High
2.51-3.25	High
1.76-2.50	Medium
1.00-1.75	Low

Ethical Considerations

To ensure that the ethics is practiced in this study as well as utmost confidentiality for the respondents and data provided by them, the following was done (1) coding of all questionnaires; (2) the respondents was requested to sign the informed consent; (3) authors mentioned in this study were acknowledged within the text; (4) findings were presented in a generalized manner.

Limitations of the study

1. It was hard to get clearance from Human Resource persons who kept on postponing the appointments.
2. It was also not possible for some targeted respondents particularly key informants such credit officers who seemed to be so busy because they were having a lot of commitments.
3. This made the researcher to make several visits to their offices, hence, costing time and money resources. However, the researcher made sure that, the appointments were made and thereafter, the necessary information obtained. Some respondent did not respond to the questionnaires.
4. Instrument: the research tools are no standardized hence a validity and reliability test were done to arrive at the reasonable measuring.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTERPRETATION OF DATA

Description of Respondents' Profile

Respondents in this study were described according to sex, level of education, profession and year of service in Housing Finance Bank where the research was carried out. In every case, respondents were asked through closed ended and open ended questions to provide their respective profile information which enabled the researcher to classify and compare them accordingly. Their responses were analyzed using frequencies and percentage distributions as summarized in table 1 below.

Table 1: Profile of Respondents

Category	Sub-category	Frequency	Percentage
Respondent	Top Management	55	50
	Credit Officer	55	50
	Total	**110**	**100**
Sex	Male	63	57
	Female	47	43
	Total	110	100
Level of Education	Degree	55	50
	Post Graduate	55	50
	Total	110	100
Profession	Economist	24	22
	Accountant	12	11
	Banker	74	67
	Total	110	100
Year of service in HFB	0-5 years	76	69
	5-10 years	34	31
	Total	110	100

Table 1 shows that there were two categories of respondents that is Top Management, represented by 50% percent and Credit officers represented by 50%. The table shows that, most respondents in the study sample were male (57%), indicating that the area of the study was dominated by men as compared to the women (43%).

Regarding level of education, degree holders were represented by 55 or 50% and post graduates by 55 or 50%. Looking at the professionals, Economists were represented by 24 or 22%, accountants by 12 or 11% and Bankers by 74 or 67%, indicating that the sample was dominated by bankers.

About the year of service in Housing Finance Banks, respondents who served between 0-5 years are represented by 69% and between 5-10 years were 31% making a total of 110 or 100%. According to the findings, the respondents who have served in Housing Finance Bank from 0-5 years were higher with 69% and people who had served between 5-10 years were less and represented by 31 %.

Description of the level of Credit Management

The independent variable in this study was bank policy, operationalised into two components namely credit policy and interest rate policy. Each of these was measured using qualitative items or questions in the questionnaire and each item was Likert-scaled between one to five, where 1=Strongly Agree, 2=Agree, 3=Not Sure, 4=Disagree and 5=Strongly Disagree. Respondents were required to rate the policy of the bank by indicating the extent to which they agree or disagree with each item. Their responses were analysed using SPSS's means as summarised in table 3 bellow:

Table 2: Level of Credit Management (n=110)

Item	Mean	Interpretation	Rank	Rank
Credit Policy				
It is important to visit client's businesses before lending	2.22	Moderate	Good	1
It is important to visit client's businesses before lending	2.13	Moderate	Good	2
Does Housing Finance Bank offer fair interest rate to customers?	1.81	Moderate	Good	3
The mission of the organization is clear and related to the credit scheme	1.75	Low	Good	4
The credit policy requires that borrowers must have an account with the bank	1.61	Low	Good	5
Clients are comfortable with the interest	1.13	Low	Very Good	6

charged				
Average Mean	1.77	Moderate	Good	
Interest rate policy				
The credit policy requires that borrowers are savers	2.72	Moderate	Fair	1
It is important to visit clients' business before lending	2.13	Moderate	Good	2
Overall mean	2.42	Moderate	Fair	

Table 2 shows that, most respondents rated the credit policy of Housing Finance Bank as good (overall mean ≈ 2) for all the six items in the questionnaire, except on the question of whether clients are comfortable with the interest charged, where majority of respondents rated the level of interest charged as very good, (mean ≈ 1) which is equal to strongly agree on the likert scale. The overall mean for credit policy was approximately 2, which corresponds to Agree and ranked as good, suggesting that the respondent rated the credit policy as good.

Finally about interest rate policy, there were only two items asked on it, where, on whether importance to visit clients business before lending, was rated as good (mean 2.13=). But on whether the credit policy requires that borrowers are savers, majority of respondents rated their bank (mean ≈ 2) which is equal to not sure on the likert scale. The overall mean for interest rate policy was approximately 2 which correspond to fair on the scale suggesting that respondents rated the interest rate policy as fair.

Description of the level of Performance

The Dependent variable in this study was bank performance, operationalised into four components namely loan repayment, number of clients, customer care and market share. Respondents were required to rate the performance of the bank by indicating the extent to which they agree or disagree with each item. Their responses were analysed using SPSS's means as summarized in table 3 bellow:

Table 3: Level of Bank Performance (n=110)

Item	Mean	Interpretation	Rank	Rank
Loan Repayment				
Clients always repay their loans in time before expiry of payment date	3.04	High	Medium	1
Clients who paid more than half of their loans	2.88	High	Medium	2
Clients who have paid less than half of their loan	2.68	High	Medium	3
Bad debtors has decreased in the last 3 years	2.24	Moderate	High	4
Clients who have fully paid back loans has increased in the last three years	2.20	Moderate	High	5
Average Mean	2.61	High	Medium	
Number of Clients				
client for medium loans	2.56	High	High	1
Clients for big size loans	2.40	Moderate	Low	2
Number of clients for small loans	2.32	Moderate	Low	3
Number of savings account holders	2.28	Moderate	Low	4
Number of fixed account holders	1.96	Moderate	Low	5
Number of account holders	1.88	Moderate	Low	6
Average Mean	2.23	Moderate	Low	
Customer Care				
Feedback to customer's requests	2.32	Moderate	Good	1
Attention to customer problems and complaints	2.28	Moderate	Good	2
Training or educating client on how to use loans	2.16	Moderate	Good	3
Assistance to clients on how to pay loans quickly or easily	2.16	Moderate	Good	3
Responds to customers concerns	2.04	Moderate	Good	4
Your bank's customer care compared to other banks in Kampala	2.00	Moderate	Good	5
Assistance to clients on steps to get a loan	1.96	Moderate	Good	6
Average Mean	2.13	Moderate	Good	
Market Share				
Non-Discrimination policies about employees	2.72	High	Average	1
Organisation ensures employees are given	2.44	Moderate	Good	2

safe working environment				
Assistance to customer regarding social responsibility	2.36	Moderate	Good	3
Organisation earning per share	2.28	Moderate	Good	4
Tameness, quality, accuracy of Financial reporting	2.08	Moderate	Good	5
Organisation performing in terms of profit	1.92	Moderate	Good	6
Market share	1.92	Moderate	Good	6
Average mean	2.13	Moderate	Good	
Overall Mean	**2.275**	Moderate		

Table 3 shows that regarding loan repayment, most respondents rated the level of their bank's performance as medium (most means ≈ 3) which falls under not sure on the Likert Scale. The total mean for all the five items on loan repayment was 2.61, which is approximately 3, falling under average, indicating that respondents rated loan repayment to be at a medium level.

Regarding performance in terms of number of clients, respondents on average rated their bank as a low performer (means ≈ 2), which falls under no increase on the Likert scale. However regarding the number of clients for medium loans, respondents rated their bank as a high performer, indicating that the bank issues more medium loans compared to other types of loans. The overall mean for all the six items on number of clients turned out to be 2.23, which is approximately 2 falling under no increase on the rating scale, which confirms that the performance of Housing Finance Bank in terms of number of clients is low.

Concerning customer care, respondents rated Housing Finance Bank performance as good for all the seven items in the questionnaire (all means ≈ 2), which falls under good performance on the Likert Scale.

Finally about market share, respondents on average rated the market share of the bank as good (means ≈ 2) for all items the seven items in the questionnaire, except on the question of whether the bank has non-discrimination policies about employees, where majority of respondents rated their bank as an average performer (means ≈ 3), which is equal to average on the Likert scale. The overall mean for market share was approximately 2, which corresponds to good on the scale, suggesting that respondents rated the bank's market share as good.

Relationship between credit policy and Bank performance

The fourth objective in this study was to determine whether there is a significant relationship between credit management and performance of Housing Finance Bank, for which the researcher hypothesized that the two variables are not significantly correlated. To test this hypothesis, the mean indices computed in table 2 and 3 were correlated using the Pearson's Linear correlation coefficient (PLCC), results of which are indicated in table 4.

Table 4: Pearson's Linear Correlation Coefficient results correlating Credit Policy and Bank performance

Variables Correlated	r-value	Sig-value	Interpretation	Decision on Ho
CREDIT POLICY Vs REPAYMENT	0.383	0.034	Positive and significant	Rejected
CREDIT POLICY Vs CLIENTS	-0.341	0.061	Positive and insignificant	Accepted
CREDIT POLICY Vs CUSTOMER CARE	0.318	0.082	Positive and insignificant	Accepted
CREDIT POLICY Vs MKT SHARE	0.481	0.006	Positive and significant	Rejected
CREDIT POLICY Vs PERFORMANCE	0.457	0.010	Positive and significant	Rejected

***(Level of significance = 0.05) when the sig value is less than the value of significance 0.05, showing positive and significance results, you reject the results but when the sig value is more than the level of significance 0.05, showing positive and insignificant, you accept the result.)**

Results in Table 4 indicate that Credit Policy (first component of credit management) affects differently the different components of bank performance. For

Example, credit policy is positively and significantly correlated with loan repayment (r=0.383, sig=0.034), indicating that as the bank improves its credit policy, the loan repayment also improves. Basing on these results, the sub component of the null hypothesis is rejected and the researcher concluded that Credit Policy and Loan repayment are significantly correlated. However results in table 4 indicate that credit policy and the number of clients are negatively related, although this relationship is not statistically significant (r=-0.341, sig=0.061). This implies that as the bank improves its credit policy, the number of clients reduces. This may be the case due to the fact that in trying to improve credit policy, strict rules are put up by the bank, which result into more prospective clients being pushed out or fail to go through, hence reducing the number of clients of the bank. Basing on these findings, the null hypothesis is accepted, leading to a conclusion that strict credit policy and the number of clients in a bank are negatively correlated; however it does not significantly reduce clients for a bank.

Results in Table 4 further indicate that credit policy and customer care are positively related, however the relationship is not significant (r=0.318, sig=0.082). Basing on these results the null hypothesis is accepted and conclude that the bank's credit policy does not significantly affect (increase) customer care results indicate also that credit policy and the bank's market share are significantly correlated (r=0.481, sig=0.006). Basing on these results, the null hypothesis is rejected and a conclusion is made that an improvement in the bank's credit policy, significantly increase, the bank's market share and vice versa and these results are significant at a 0.05 level of significance.

On the overall, the credit policy of the bank is significantly correlated with the overall performance of the bank (r=0.457, sig=0.010), indicating that an improvement in the credit policy significantly improves the banks performance.

Relationship between interest rate policy and Bank Performance

The fourth objective in this study was to determine whether there is a significant relationship between interest rate policy and performance of Housing Finance Bank, for which the researcher hypothesised, that the two variables are not significantly correlated. To test this hypothesis, the mean indices computed in tables

2 and 3 were correlated using the pearson's Linear correlation coefficient (PLCC), results of which are indicated in table 5 below:

Table 5: Peason's Linear correlation coefficient results correlating interest rate policy and Bank Performance (n=110)

Variables Correlated	r-value	Sig-value	Interpretation	Decision on Ho
Interest Rate Policy Vs Repayment	0.296	0.023	Positive and significant	Rejected
Interest Rate Policy Vs Clients	-0.38	0.004	Negative and significant	Accepted
Interest Rate Policy Vs Customer Care	-0.070	0.702	Negative and insignificant	Accepted
Interest Rate Policy Vs Mkt Share	0.557	0.001	Positive and significant	Rejected
Interest Rate Policy Vs Performance	0.385	0.030	Positive and significant	Rejected

***(Level of significance = 0.05) when the sig value is less than the value of significance 0.05, showing positive and significance results, you reject the results but when the sig value is more than the level of significance 0.05, showing positive and insignificant, you accept the result.)**

Result in Table 5 indicates that interest rate policy (second component of credit management) affects differently the different components of bank performance. For example interest rate policy is positively and significantly correlated with loan repayment (r=0.296, sig=0.023) indicating that as bank improves its interest rate policy, the loan repayment also improves. Basing on these results, the sub-component of the null hypothesis is rejected, and the researcher concludes that interest rate and loan repayment are significantly correlated. However the results in Table 5 indicate that interest rate policy and number of clients are negatively related, and this relationship is statistically significant (r=0.38, sig=0.004). This implies that as the bank improves its interest rate the number of clients reduces, this may be the case due to the fact that in trying to improve interest rate policy, strict rules are put up by the bank, which results into more prospective clients being pushed out, hence reducing the number of clients of the bank. Basing in these finding the null hypothesis is rejected, leading to a conclusion that strict interest rate policy and the number of clients in the bank are negatively correlated.

Results in Table 5 further indicate that, interest rate policy and customer care are positively related, however the relationship is not significant(r=-0.070, sig=0.0702). Basing on these results, we accept the null hypothesis and conclude that the bank interest rate policy does not significantly affect (decrease) customer care. Results also indicate that interest rate policy and bank's market share are significantly correlated (r=0.557, sig=0.001) basing on these results, the null hypothesis is rejected and a conclusion is made that an improvement in the bank's interest rate policy, significantly increases the bank's market share and vice versa and these results are significantly correlated with the overall performance of the bank (r=0.385, sig=0.030), indicating that an improvement in the interest rate policy significantly improves the banks performance.

CHAPTER FIVE

SUMMARY OF THE MAJOR FINDINGS, CONCLUSION AND RECOMMENDATIONS

The first objective was to determine the profile of Housing Finance Bank, according to the study, there were two categories of respondents that is Top management, and Credit Officers, were by they were all represented by equal number of frequency of 55 and 50% each which means there were equal number of Top Management and Credit Officers. The respondents in the study were distributed by gender, 57% male and 43% females. Concerning the level of education, most respondents were degree holders and master holders and they were represented by 50% each, which means most of the respondents in the Bank, were professionals. Looking at the professionals, the bank was dominated by bankers with 74%. About the year of service in Housing Finance Bank, according to the findings, the respondents who have served between 0-5 were higher with 69%.

The second objective was to determine the level of credit management; most respondents rated the credit policy of Housing Finance Bank as good for all the six items in the questionnaire. Concerning interest rate policy, there were two items asked on whether it is important to visit clients business before lending, most respondents rated their bank as good with the mean of 2 but on whether the credit policy requires that borrowers are savers, with the means of 3 most respondents rated their bank as fair, The overall mean for interest rate policy was approximately 2 which corresponds to fair on the scale. Thus it can be concluded that these findings are contrary to the findings of William 1990, which stated that financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management , or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of the bank's counterparties. It is recommended that the bank or financial institutions should maintain the status quo and work towards improving the quality service.

The third objective was to determine the level of performance; there were four items, about the loan repayment most respondents rate their bank with an average means of 3 rated the level of their bank's performance as medium which falls under not sure on the likert scale. Regarding performance in terms of number of clients, respondents rated their bank as a low performer, however regarding the number of clients for medium loans, most respondents rated their bank as a higher performer with (the means 3), the respondents rated their bank in terms of number of clients as low, Concerning customer care, respondents rated Housing Finance Bank performance as good performer, and finally about the market share most respondents rated their bank as good. Therefore it is recommended that the bank should improve on their performance rate in all aspects of loans management operations.

The fourth objective was to determine the relationship between credit management and performance of Housing Finance Bank, According to the findings, the null hypothesis was rejected; therefore, there was a relationship between credit management and the performance of the Bank. Thus it can be concluded that the bank or financial institutions should carefully monitor the two variables, simply because any negative change in one can course problem to another.

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APPENDIX III A QUESTIONNAIRE FOR TOP MANAGEMENT/CREDIT OFFICERS

School of Post Graduate Studies and Research
Kampala International University, Uganda
January, 2011

Dear Sir/Madam

I am carrying out a survey in Housing Finance Bank, whose purpose is to find out Credit Management and Performance of Selected Housing Finance Banks, in Uganda. The questionnaire below is for bank officials, since your bank has banking services including Credit Management, it is therefore imperative that you help me answer the questions herein. It could thus be very helpful if you assist me by answering the attached questionnaire as per the instructions provided at the beginning of each situation. You should provide the most appropriate answer in your own opinion by ticking or cycling in the given space as the case may be. The success of this part of the research will entirely depend on your positive cooperation. Your response will be kept confidential. In any case the questionnaire is anonymous. Please endeavour to fill the questionnaire within two weeks and return it to reception in your bank .

Thank you.
Yours faithfully

Acen Catherine Bokello (Researcher)
0779450805

A. Personal Data: (Tick in the appropriate boxes bellow)

1. Sex
   a) Males ☐
   b) Female ☐

2. Level of Education
   a) Diploma ☐
   b) Degree ☐
   c) Post Graduate ☐
   d) Others ☐

3. Profession
   a) Economist ☐
   b) Accountant ☐
   c) Banker ☐
   d) Others ☐

4.Year of Service in Housing Finance Bank
   a) 0-5 years ☐
   b) 5-10 years ☐
   c) 10-20 years ☐
   d) Over 20 years ☐

Questionnaire on Credit Management **Loan Repayment:** Rate your bank's performance in terms of loan repayments by ticking the right number on each of the following item. Your answer should between 1. Strongly Agree 2. Agree 3. Not sure 4. Disagree 5.Strongly Disagree					
The number of clients who have fully paid back loans has increase in the last three years.	1	2	3	4	5
The number of bad debtors has decreased in the last 3 years	1	2	3	4	5
There are many clients who have paid just less than half of their loan	1	2	3	4	5
Most /many clients who paid just less than half of their loans	1	2	3	4	5
Most of your clients always repay their loans in time before expiry of payment dates	1	2	3	4	5
Number of Clients Indicate the extent to which the following aspects have increased or decreased in the last three years. Answer key 1.Little increase 2. No increased 3. Much increase 4. Little decrease 5. Much decrease					
The number of clients for small loans	1	2	3	4	5
The number of clients for medium loans	1	2	3	4	5
The number of client for big size loans	1	2	3	4	5

The number of savings account holders	1	2	3	4	5
The number of current account holders	1	2	3	4	5
Customer Care How would you rate your bank on the following aspects? Answer Key 1=very good 2=Good 3=Average 4=Poor 5=Very poor					
The way you respond to customers concern	1	2	3	4	5
Your bank's customer care compared to other banks in Kampala	1	2	3	4	5
Your support to clients in terms of training or educating clients on how to use loans	1	2	3	4	5
Your assistance to clients on steps to get a loan	1	2	3	4	5
Your assistance to clients on how to pay loans quickly or easily	1	2	3	4	5
Your feedback to customer's requests	1	2	3	4	5
Your attention to customer's problems and complaints	1	2	3	4	5

Questionnaire on Performance **How would you rate your bank on the following aspects? Answer key 1.Very good 2.Good 3.Average 4.Poor 5. Very poor**					
Your organization performance in terms of profit	1	2	3	4	5
Your market share	1	2	3	4	5
Assistance to your customers regarding corporate social responsibility	1	2	3	4	5

Your organization has a non-discrimination policies about employees	1	2	3	4	5
Your organization ensures employees are given safe working environment	1	2	3	4	5
Your organizational earnings per share	1	2	3	4	5
Timeness , quality, accuracy of Financial reporting	1	2	3	4	5

KAMPALA
INTERNATIONAL
UNIVERSITY

Ggaba Road, Kansanga * PO BOX 20000 Kampala, Uganda
Tel: +256 (0) 41 266 813 * Fax: +256 (0) 41 - 501 974
E-mail: admin@kiu.ac.ug * Website: http://www.kiu.ac.ug

ADMINISTRATOR'S OFFICE

SCHOOL OF BUSINESS AND MANAGEMENT

Date: 31/03/2011

The Human Resource Director
Housing Finance Bank
Head Office
P. O. Box.............
KAMPALA.

RE: REQUEST TO CONDUCT A RESEARCH WITH YOUR BANK

I am a Master student of Kampala International University, offering Masters of Business Administration (**Finance and Accounting**), **Reg. No.** MBA/42973/91/DU. My Research Topic is **"An assessment of Credit Management and Performance of Commercial Banks in Uganda , Case study of Housing Finance Bank, Kampala.**

I am requesting to request your Bank, to allow me conduct my research with your Bank in order to allow me analyse my final thesis. I have developed interest in your Bank, among many Financial Institutions in Uganda, since 2009 when I got to know about your Bank and the service you are offering.

I have also gain personal interest in your Bank, within two months time, I will be one of your customer in Namwongo Branch, where I live.

I am also an Administrator in the School of Business and Management of Kampala International University Main Branch, Kansanga, Kampala.

Your positive response towards this matter shall be highly appreciated.

Yours faithfully,

KAMPALA INTERNATIONAL UNIVERSITY
SCHOOL OF BUSINESS MANAGEMENT STUDIES
P.O. BOX 20000, KAMPALA

Acen Catherine Bokello
Tel: 0779450805

Housing
Finance
Bank

Ref: HRA/11

30th May 2011

The DVC,
School of Postgraduate,
Kampala International University,
P. O. Box 20000,
Kampala

Dear Madam,

TO WHOM IT MAY CONCERN

This is to inform you that Ms. Catherine Acen Bokello, a student at KIU pursuing a Masters of Business Administration (Finance & Accounting) conducted her research *("Credit Management and performance of selected Housing Finance Banks' in Kampala, Uganda)* at Housing Finance Bank.

Any assistance rendered to her related to her field research shall be appreciated.

Yours faithfully,

Housing Finance Bank
30 MAY 2011
DEPT. OF HUMAN RESOURCES ADMINISTRATION

Benedict Makanga
Manager, Human Resources

Investment House, Plot 4 Wampewo Avenue - Kololo, P.O. Box 1539 Kampala
T +256 414 259651/2, 0312 262614, F +256 414 341429/4236676, info@housingfinance.co.ug, www.housingfinance.co

CURRICULUM VITAE

Kampala International University
P. O. Box 20000, Kampala, Mobile:0779450805

Name : Miss. Acen Catherine Bokello
Date of Birth : 24th August 1974

EDUCATION AND TRAINING

2009-2011	Kampala International University, MBA Finance and Accounting
2004-2007	Kampala International University, Bachelor of Business Administration (Accounting Option).
2002-2004	Kampala International University, Higher Diploma in Secretarial and Office Management.
2004-April	Bugema University, Administrative Professional Seminar, Certificate of Participation.
1995	Computer Training with ADS, Analogue and Digital System(Sponsored by GTZ Project MFCA).
1991-1993	Uganda College of Commerce, Pakwach
1983-1986	St. Katherine Senior Secondary School, Lira ("O") Level Certificate
1982	Masindi Barracks, Primary School, P.L.E.

EMPLOYMENT

August 2011	**Ag. Head of Department**, Department of Accounting and Finance, Kampala International University, School of Business and Management.
August 2009 – September 2011	Kampala International University, **Administrator**, School of Business and Management/Teaching Assistant under the Department of Tourism and Secretarial.
October 2004-July 2009	Kampala International University, **Administrative Assistant**, School of Business and Management/Teaching Assistant under

	the Department of Tourism and Secretarial.
1993-2009	Uganda Wildlife Authority, Murchison Falls Conservation Area/GTZ Rehabilitation Project (Para – Masindi), **Secretary/Radio Call Operator,** handling in and out-going mails, handling Project work for example (filling documents, typing letters, compiling Law-enforcement reports and many others.
2000-2002	**Secretary /Cashier** ,Cotton Product Ltd., Kibira Road, 6th Street, Kampala **,** handling factor sales, Reception Duties, Petty cash and many others**.**

Administrative Duties
Management and organization of all administrative/Clerical/Secretarial services in the School, ensuring provision of appropriate support for all academic staff, maintenance of high standards of services in accordance with customer service agreements and quality assurance standards, supervision of the day to-day activities of any clerical and secretarial staff in the School, provision of administrative support in arranging occasional board meetings, conferences, workshops, symposia and guest lectures, in liaison with other University departments as necessary, monitoring of students/lecturers attendance and many other stipulated in my appointment letter.
Administrative Duties
Monitoring of Lecturers, Registration of students, managing filling systems with the School, arranging meeting, managing school Data Bank (Examination Officer), handling results complains, receiving visitors and many others. Under Secretarial Department, I have been handling keyboard skills I and II, Document Production, Office Management, Secretarial Duties and customer care, Interpersonal skills.

Referees:

Mrs. Jolly Byarugaba
Makerere Business School
Mobile: 0772417440
P. O. Box 7062

Prof. Sunday Olwor
Kampala International University
Mobile: 0703208190/0782960495
P. O. Box 20000
KAMPALA.

Dr. Bosire Josephat
Kampala International University
Mobile: 0783686146
P. O. Box 20000
Kampala.