EFFECT OF CREDIT POLICY ON GROWTH OF MICRO-FINANCE INSTITUTIONS

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Abstract: The purpose of the study was to determine the effect of credit policy on growth of Micro-finance institutions in Kenya. This study adopted a descriptive research design targeting all DTM extending credit facilities to their clients. The population of study consisted of 13 deposit taking MFIs in Kenya that are members of AMFI while sample size was 100 staff members of the deposit taking MFIs. Primary data was collected using questionnaires where all the issues on the questionnaire were addressed. The sampling technique for selecting the employees was stratified sampling technique. The study confirmed that the relationship between credit policy and growth of MFIs was statistically significant. This study recommended that deposit taking MFIs should have clear credit policies to avoid default of repayment of microfinance loans; this is because if microfinance does not have stringent credit policy then they stand to lose their money hence creating liquidity issues and should also improve and include new credit management strategies to enhance growth.

Keywords: Credit Policy and Growth

Introduction

Credit is one of the many factors that can be used by a firm to influence demand for its products. According to Michelle, Kingsley and Joseph (2016), firms can only benefit from credit if the profitability generated from increased sales exceeds the added costs of receivables. Myers and Brealey (2003) define credit as a process whereby possession of goods or services is allowed without spot payment upon a contractual agreement for later payment. Non-performing loans is the most obvious risk to microfinance and other financial institutions by the nature of its activity. In regards to potential losses, it is typically the largest type of risk as default of a small number of members may result in very huge loss for the microfinance (Bessis 2003). Credit risk is a situation in which a borrower is likely not to honor his or her obligation to service the credit facility extended to him. Eferakeya (2014) said a number of reasons have been identified as contributing to the spate of banking distress with one notable cause being the issue of bad loans.

Over the years, the microfinance sector has expanded its financial service offerings to better meet client needs. Along with providing more flexible loan products, business and personal development training, micro-finance institutions are seen to offer savings and insurance to help clients effectively navigate the daily hardships they face. Despite their lack of a comprehensive policy and legal provision, they have grown considerably in number and relative sizes. This growth has created need to incorporate MFI’s into the financial service industry through a streamlined registration and regulatory body, an estimated 10 percent to 15 percent of the
population relies entirely on NGOs and informal associations for financial services. A national survey given in 1999 estimated that 20 percent of the country's total employment was involved in microenterprises, contributing more than 25 percent of non-agricultural GDP. In 2007, Kenya passed the microfinance bill to regulate microfinance institutions in conjunction with the association for microfinance institutions (AMFI), based in Nairobi and funded by a large USAID grant. The aim of the bill was to protect populations who are out of the scope of traditional banking services from corrupt microfinance institutions (The Point, 2002).

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e. traditional collateral is not often used to secure microloans (Ayayi, 2008). The people covered are those who cannot avail credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principle amount itself. Therefore, these institutions need to design sound credit management that entails the identification of existing and potential risks inherent in lending activities.

In 1990s most credit extended to customers did not perform, which called for the intervention. Most suggestions were for the evaluation of customer’s ability to repay loan, but this did not work as loan defaults continued. The concept of credit management became widely appreciated by microfinance institutions (MFIs) in the late 90s, but again this did not stop loan defaults (Constantinos & Tsamis, 2014).

In the 2000’s, the microfinance sector witnessed emergence of large number of MFIs with some transforming to commercial banks and deposit taking institutions (DTI). The focus of these institutions gradually shifted from emphasis on the very poor to the enterprise poor as demands on these institutions to become financially sustainable increased. The microfinance act 2006 became operational in May 2008. The act empowered the central bank of Kenya (CBK) to license and supervise deposit taking microfinance institutions. By May 2016, the CBK had licensed Faulu Micro Finance, Kenya Women Finance Trust, SMEP, REMU, RAFIKI, UWEZO, Century, Sumac, U&I, Daraja, Caritas, Choice, and Maisha Deposit Taking Microfinance (DTM) to conduct nationwide deposit taking microfinance business. As of May 2010, non-deposit-taking microfinance institutions did not fall under the jurisdiction of the central bank’s microfinance regulations, and as such they were under either the SACCO category supervised by the SACCO Societies Regulatory Authority (SASRA), or the informal microfinance category, which is unregulated except for the licensing required of all NGOs in Kenya. The central bank is currently consulting with a variety of industry stakeholders to determine the best practices for incorporating non-deposit-taking MFIs into their regulatory framework (CBK 2015).

In Kenya, a cap on interest rates which is pushing banking institutions in Kenya to approve fewer loans despite the surge in applications of the same. Non-performing loans have shot up to KSh217 billion in the year 2016 marking the first time ever the Sh200 billion mark has been crossed with the KSh17 billion being declared bad loans within three month between June and September. Between 2012 and 2016, the total non-performing loans have risen from KSh60 billion to KSh217 billion. This is partially attributed to deep job cuts by companies hence leaving households with grim choice of either honoring loan repayment with diminishing income or defaulting on their obligations to meet basic needs. The drop in household expenditure on goods and services due to people’s purchasing power has trickled down to challenges in business
environment, leading to cash flow constraints on borrowers. On the other hand, there has to be a way of cutting back on lending and stringent credit terms to be put in place to mitigate the risks. First, there is a raise in requirements for loans. Then, concessionary lending has become impossible that is, projects that stimulated positive social impact no longer enjoy flexible lending. Interest rate viability is a risk management tool that banks have been using but since introduction of rate cap, the banks no longer have this tool hence loans with interest rates below market rates are not being awarded anymore. This has made microfinance and Saccos more attractive financing option particularly because they provide credit to members well below bank rates. This may lead to expansion in microfinance institutions but raises a need to do appraisal or supervision of loan borrower (Eferakeya, 2014).

A study on microfinance loan recovery systems is a topic of considerable interest by many researchers. However, most studies undertaken in the past few years have focused mainly on loan models used by MFI’s and their impact on profitability (Migiri, 2002). Absence of empirical studies on credit risk management and recognition of the critical role that MFI’s play in the economy are the principal motivation behind this study which seeks to find out the effects of credit risks on growth of micro-finance institutions. Muteru (2007) points out that good credit risk management practices impacts positively on financial performance of Pharmaceutical manufacturing firms in Kenya. The researcher, in his recommendations, points out that there is no known study done on the relationship between credit risk management practices and growth of MFIs in Kenya. He says extensive research needs to be done on this area noting that most of the work that has been done on this matter was done in the developed economies. This implies that there was little or no known knowledge of such kind in developing economies like Kenya. The purpose of this study was to determine the effect of credit policy on growth of micro-finance institutions. This paper is divided into the following sections; introduction, literature review, research methodology, data analysis and conclusions and recommendations.

Theoretical Review

The study was founded on asymmetric information theory. Information asymmetry refers to a situation where business owners or manager know more about the prospects for, and risks facing their business, than do lenders (Eppy, 2005). It describes a condition in which all parties involved in an undertaking do not know relevant information, in a debt market; information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with investment projects for which the funds are earmarked. The lender on the other hand does not have sufficient information concerning the borrower. Durban, Binner and Mullineux (2005) point out that perceived information asymmetry poses two problems for the MFI, moral hazard (monitoring entrepreneurial behavior) and adverse selection (making errors in lending decisions). MFI will find it difficult to overcome these problems because it is not economical to devote resources to appraisal and monitoring where lending is for relatively small amounts. This is because data needed to screen credit applications and to monitor borrowers are not freely available to MFI. MFI face a situation of information asymmetry when assessing lending applications (Masood & Fry, 2012). The information required to assess the competence and commitment of the entrepreneur, and the prospects of the business is either not available, uneconomic to obtain or difficult to interpret. This creates two types of risks for the MFI. The risk of adverse selection which occurs when MFI lend to businesses which subsequently fail (type II error), or when they do not lend to
businesses which go on to become” successful, or have the potential to do so (type I error) (Jiménez et al., 2014).

The borrower voluntarily or per force takes resource to concealing of the information for making their case as strong candidature for obtaining the external finance. In this, the efforts are done to hide uncomfortable economic information on the real risk involved in the project. It, therefore, reduces the ability of the lending institution to foresee the hazards inherent to the project. The feasibility and viability of the proposed project are miscalculated due to the imperfect information received from the borrower. The imperfect decision made on the basis of imperfect information has a cascading effect on the financial market legitimately resulting in economic crisis. Asymmetric information theory states that lenders need a score card to rate their borrowers and enable the micro-finance institutions to do credit risk analysis (Jacobs & Karagozoglu, 2011).

Credit Policy

Credit policy is clear, written guidelines that set the terms and conditions for customer qualification criteria, procedure for making collections and steps to be taken in case of customer delinquency. Written credit policy statement is beneficial as it communicate to employees in credit department what procedures they must follow and what their responsibilities are, hence credit policy helps the institutions to move towards a credit portfolio, controlling its risk exposure and satisfying regulatory requirements (Acharya et al., 2013). Any exceptions to the policy should be fully documented and reasons for it listed. While any written policy must be flexible due to continuing changes in economic conditions and regulations, violation of loan policy should be infrequent events. Credit department should consider all such changes and periodically review all credits until they reach maturity. Credit review is crucial as it help management to identify problematic loans more quickly and act as a continuing check on whether credit policy will be adhered to by credit officers. The commercial banks review credits more efficiently such that they are able to top up loans-faster using modern technology unlike institutions (Agene, 2011).

A study by Beatrice (2013) revealed that they will underscore the need to formulate a prudent credit policy for individual manufacturing firms as well as the need for a conducive macro and micro environment in order to synchronize benefits of using credit facilities to facilitate financial mobilization of firms which can be likened to institutions also. Therefore formulation of a prudent credit policy for institution is important to avoid loss of its market to its rivals and improve performance in terms of development and reduction on loan defaults. In addition, credit policies also considers credit limit (maximum amount of credit which the firm will extend at a point in time). It indicates the extent of risk to the firm by extending credit to a customer. Credit limit is also a function of the character of a customer (customer’s willingness to pay and the moral factor).

Microfinance Institutions must develop a credit policy to govern their loan management operations and since microfinance institutions generate their revenue from credit extended to low income individuals in the form of interest charged on the funds granted (CBK, 2015) the loan repayments may be uncertain. According to (ADB, 2000), the implementation of the policy is very important for savings mobilization and proper management of deposits by implementing basic minimum level of regulations. Jacobs and Karagozoglu (2011) argues that prudential requirements enable DTIs to manage resources properly which ultimately improves the
efficiency and loan costs. The success of lending out loan depends on the methodology applied
to evaluate and to award the loan and therefore the loan decision should be based on a thorough
evaluation of the risk conditions of the lending and the characteristics of the borrower. Lack of
clear credit policies can lead to default of repayment of microfinance loans; if microfinance does
not have stringent credit policy then they stand to lose their money hence creating liquidity
issues. It may be difficult to establish an optimal credit policy as the best combination of the
variables of credit policy is quite difficult to obtain. A firm change one or two variables at a time
and observe the effect. It should be noted that the firm’s credit policy is greatly influenced by
economic conditions (Agene, 2011).

Research Methodology

The study used a descriptive design. Bickman and Rog (1998) suggest that descriptive studies
can answer questions such as “what is” or “what was.” Experiments can typically answer “why”
or “how.” The research often involves collecting information through data review. This type of
research best describes the way things are (Mugenda & Mugenda, 2003).

The target population was thirteen (13) deposit taking MFIs. They included Faulu, Kenya
Women Finance Trust, Smp, Uwezo, Remu, Rafiki, Century, Maisha, Sumac, U & I, Choice,
Daraja and Caritas in Nairobi County. Mugenda and Mugenda (1999), explain that the target
population should have some observable characteristics, to which the researcher intends to
generalize the results of the study. The target respondents were 200 employees working in the
MFIs. The employees were grouped according to their levels which formed the basis of
stratification. From the population of 200 a sample size of 100 respondents was selected. The
sample size comprised of 20 credit managers, 60 credit officers and 120 credit clerks. These
groups were chosen because they comprised of individuals in charge of credit risk management.

Data collection deals specifically with the type of data to be collected and the techniques used.
The type of data that was collected for this study was both primary and secondary data for the
purpose of analyzing effect of credit policy on growth of micro-finance institutions. Primary data
was obtained through self-administered questionnaire so as to collect the required data.
Secondary data was obtained from financial statements of the MFIs. The researcher sought
clearance for this study from the University and the MFIs under study. The respondents were
assured that information accessed and secured in the course of this study would be protected
from unauthorized persons and used for the sole purpose of the study.

The data that was mostly quantitative and was analyzed using the descriptive statistical method.
Statistical Package for Social Sciences (SPSS) Software was used to describe the data and
determine the extent used. Analysis of Variance (ANOVA) was performed to determine the
impact of independent variables on the dependent variable in the regression analysis.

The Multi-regression model takes the form below:

\[ Y = \beta_0 + \beta_1 X_1 + \epsilon_i \]

Where, \( Y \) = Dependent Variables; \( X_1 \) = Independent variable; \( \beta_0 \) = the constant; \( \beta_1 \) = the
regression coefficient or change included in \( Y \) by each \( X \); \( \epsilon_i \) = error term; \( Y \) = growth of MFIs
and \( (X_1) \) = Credit policy.
Data Analysis and Findings

The data was collected from the deposit taking MFIs operating in Nairobi County. A total of 100 questionnaires were administered and 81 were received as complete, and therefore, all of them were viable for consideration. This represented 81.0% response rate. The response rate is considered excellent given the recommendations by Mugenda and Mugenda (2009), a response rate of 50% is adequate for analysis and reporting, a rate of 60% is generally good while a response rate of above 70% is excellent. This is also the same position taken by Babbie (2010) who adds that a response rate of above 70% is deemed to be very good. Based on these assertions, this implies that the response rate for this study was adequate.

Credit Policy

In order to measure this antecedent variable under Credit Policy, a 5-items Likert scale was used which ranged from (1= Strongly Disagree, 2= Disagree 3= Not Sure, 4=Agree, 5= Strongly Agree). The mean score was then computed as the average of the 5 items. The higher the score, the more the variable is important to the growth of MFIs. Factor analysis was performed and the results are shown in Appendix 1.

Table 1: Descriptive Analysis for Credit Policy

<table>
<thead>
<tr>
<th>Description</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>My department has an established clear policy that guides the staff on potential credit risks</td>
<td>81</td>
<td>4.70</td>
<td>0.254</td>
</tr>
<tr>
<td>Credit policy document outlines award and repayment regulation to be adhered to.</td>
<td>81</td>
<td>4.56</td>
<td>0.221</td>
</tr>
<tr>
<td>Credit policy management in my department effective outlines the repayment period and penalties where necessary.</td>
<td>81</td>
<td>4.70</td>
<td>0.254</td>
</tr>
<tr>
<td>Credit policy affect loan default in relation to the growth of my institution</td>
<td>81</td>
<td>4.56</td>
<td>0.221</td>
</tr>
<tr>
<td>There are clear policies and procedures in my company that guide emergency procurement credit facilities by clients</td>
<td>81</td>
<td>4.09</td>
<td>0.168</td>
</tr>
</tbody>
</table>

Note: Reliability α – Credit Policy = 0.7645

Ranked on a scale where 1=Strongly Disagree, 2= Disagree, 3=Not Sure, 4=Agree, 5=Strongly Agree

The results in Table 2 showed the respondents agreed that MFIs department had an established clear policy that guided the staff on potential credit risks and that credit policy management in the department effectively outlined the repayment period and penalties where necessary (M = 4.7). The respondents also agreed that Credit policy document outlines award and repayment regulation to be adhered to and that Credit policy affected loan default in relation to the growth of their institutions (M = 4.56).
Descriptive Analysis for Growth of MFIs

In order to measure growth of MFIs, a 5-items Likert scale was used which ranged from (1= Strongly Disagree, 2= Disagree 3= Not Sure, 4=Agree, 5= Strongly Agree). The mean score was then computed as the average of the 5 items.

Table 2: Descriptive Analysis for Growth of MFIs

<table>
<thead>
<tr>
<th>Statement</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your institution has experienced growth for the last 5 years in terms of profitability and turnover</td>
<td>81</td>
<td>4.16</td>
<td>0.174</td>
</tr>
<tr>
<td>New branches have been opened up in the last 5 years</td>
<td>81</td>
<td>4.27</td>
<td>0.170</td>
</tr>
<tr>
<td>There has been employment of new staff in your institution</td>
<td>81</td>
<td>4.57</td>
<td>0.225</td>
</tr>
<tr>
<td>Supervision of loan borrowers has affected growth of your institution positively</td>
<td>81</td>
<td>4.41</td>
<td>0.196</td>
</tr>
<tr>
<td>Credit management structure has curbed the credit risks leading to growth of your institution</td>
<td>81</td>
<td>4.33</td>
<td>0.225</td>
</tr>
<tr>
<td>The growth of your institution has been partly due to good credit policy implemented in your institution</td>
<td>81</td>
<td>4.35</td>
<td>0.203</td>
</tr>
<tr>
<td>Client appraisal on loan awarding has affected growth of your institution positively</td>
<td>81</td>
<td>4.37</td>
<td>0.182</td>
</tr>
</tbody>
</table>

Note: Reliability α – Growth of MFIs = 0.7265

 Ranked on a scale where 1=Strongly Disagree, 2= Disagree, 3=Not Sure, 4=Agree, 5=Strongly Agree

The results in Table 3 showed the respondents strongly agreed that there was employment of new staff in your institution (M = 4.57). The respondents also agreed that supervision of loan borrowers affected growth of their institution positively (M = 4.41). Further, the respondents agreed that client appraisal on loan awarding affected growth of their institutions positively (M = 4.37). The respondents also agreed that the growth of their institutions was partly due to good credit policy implementation (M = 4.35).

Regression Analysis for the Overall Model

ANOVA Analysis for the Overall Model

The ANOVA analysis in Table 5 presents the effect of credit policy on growth of Micro-Finance Institutions. The results presented a p-value of 0.000 which was less than 0.05. This indicated that the model was statistically significant in explaining the impact of credit policy independent variables on growth of MFIs under study. It is therefore concluded that the independent variable had significant combined effects on MFIs growth.
Table 3: ANOVA (b)

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>Df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>34.783</td>
<td>1</td>
<td>34.783</td>
<td>91.578</td>
<td>.000(a)</td>
</tr>
<tr>
<td>Residual</td>
<td>7.217</td>
<td>79</td>
<td>.09135</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>42.000</td>
<td>80</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a Predictors: (Constant), Credit Policy
b Dependent Variable: Growth of MFIs

The significance value is .000 which is less that 0.05 thus the model is statistically significant in predicting independent variable (Credit Policy) this shows that the overall model was significant.

**Goodness of fit model summary**

The significance of the model was reaffirmed by the goodness of fit tests in Table 2, whereby the coefficient of determination (R square) of 0.537 confirmed that the model explained 53.7% of the variation or change in the dependent variables. The adjusted R square of 0.488 did not make a significant difference since the model now explained 48.8% of the variations. The standard error of estimate was 0.87649. The goodness of fit test in Table 2 presents the goodness of fit of the model:

\[ Y = \alpha + \beta_1 X_1 + \varepsilon \]

Being the linear model involving independent variables; \( Y = \text{MFIs Growth}, X_1 = \text{Credit policy} \). The coefficient of determination (R square) of 0.537 indicated that the model explained 53.7% of the variations in the dependent variable. This meant that the linear model was a good fit in explaining the relationship between the dependent and independent variable. A further 46.3% of growth among MFIs in Nairobi County under study is attributed to other factors not investigated in this study.

Table 4: Fitness Test for the Overall Model

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>Durbin-Watson</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.733(a)</td>
<td>.537</td>
<td>.488</td>
<td>.87649</td>
<td>1.888</td>
</tr>
</tbody>
</table>

**Coefficient of Determination**

According to the regression equation established, taking credit policy constant at zero, growth of MFIs will be 0.540. A one percent (1%) change in credit policy will lead to zero point zero nine nine percent (0.099%) variation in growth of MFIs (p<0.05).
Table 5: Regression Analysis Results

<table>
<thead>
<tr>
<th></th>
<th>Un-standardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>0.54</td>
<td>0.12</td>
<td>4.504</td>
<td>0</td>
</tr>
<tr>
<td>Credit policy</td>
<td>0.099</td>
<td>0.032</td>
<td>0.197</td>
<td>3.07</td>
</tr>
</tbody>
</table>

a Dependent Variable: Growth of MFIs

The Un-standardized beta coefficients column in Table 5 above were used to obtain the overall equation as suggested in the conceptual framework. When these beta coefficients are substituted in the equation, the model becomes:

\[ Y = 0.54 + 0.099X_1 \]

where

Y = Growth of MFIs, and X1 = Credit Policy

Summary of Findings, Conclusions and Recommendations

The study established that credit policy influenced the growth of MFIs in Kenya since a one percent (1%) increase in credit policy led to an increase in the growth of MFIs in Kenya by 0.099%. Further, the study confirmed that the relationship between credit policy and growth of MFIs was statistically significant (p-value less than 0.05 at 95% level of confidence). This finding is in line with Jun, Qiuzhen and Qingguo (2010) findings from their study on the effects of credit policy on firm growth focusing on a case of China commercial banks. The study showed that there existed a significant positive relationship between credit policy and firm growth (P< 0.05). The results indicated that credit policy improves financial stability among listed MFIs in Kenya.

The study concludes that credit policy affected the growth of MFIs in Kenya, the deposit taking MFIs under study had established clear policy that guided the staff on potential credit risks and credit policy documents outlined award and repayment regulation to be adhered to. Credit policy management in the MFIs understudy departments effectively outlined the repayment period and penalties where necessary. On credit policy effect on loan default in relation to MFI growth, credit policy affected loan default in relation to institutional growth and that there were clear policies and procedures in their company that guide emergency procurement credit facilities by clients.

This study recommends that deposit taking MFIs should have clear credit policies to avoid default of repayment of microfinance loans this is because if microfinance does not have stringent credit policy then they stand to lose their money hence creating liquidity issues.

Suggestion for Further Studies

While this study successfully examines the variables, it also presents rich prospects for several other areas to be researched in future. The present study was only confined to deposit taking microfinance institutions in Nairobi County. It would however be useful to carry out a similar
study across the country. It would be useful to carry out the same type of research across East
Africa and beyond and see whether the same results would be replicated.

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**Appendix: Factor Analysis Results**

**Variable: Credit Policies**

**Component Matrix of Credit Policies**

<table>
<thead>
<tr>
<th>Statement</th>
<th>Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>CP1</td>
<td>0.578</td>
</tr>
<tr>
<td>CP2</td>
<td>0.574</td>
</tr>
<tr>
<td>CP3</td>
<td>0.521</td>
</tr>
<tr>
<td>CP4</td>
<td>0.549</td>
</tr>
<tr>
<td>CP5</td>
<td>0.597</td>
</tr>
</tbody>
</table>

**Reliability Statistics of credit policies**

<table>
<thead>
<tr>
<th>Cronbach's Alpha</th>
<th>Number of Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>.7645</td>
<td>5</td>
</tr>
</tbody>
</table>