

## **Factors Influencing Loan Repayment Default in Micro-Finance Institutions: *The Experience of Imenti North District, Kenya***

**Munene, H. Nguta**

**Guyo, S. Huka**

Meru University of Science and Technology  
Kenya

### **Abstract**

*Microfinance institutions in Kenya have suffered significant loan repayment default resulting into subsequently decreased employment levels and cash flow problems in microfinance institutions. This study was carried out in order to establish the causes of such repayment defaults in Imenti North District, Kenya. Using a descriptive survey design individual microfinance loan beneficiaries and microfinance institution officials were studied. A representative random sample of 400 respondents was selected from the study population using census and cluster sampling procedures for micro finance institutions officers and loan beneficiaries respectively. Data collected using both structured and unstructured questionnaires were analyzed using descriptive and inferential statistics. The findings of the study revealed that there was significant relationship between the type of business ( $p=0.000<0.05$ ), age of the business ( $p=0.000<0.05$ ), number of employees ( $p=0.011<0.05$ ), business profits ( $p=0.000<0.05$ ) and loan repayment default. The study further indicates a strong link between technical training for loan beneficiaries and the performance of entrepreneurial businesses among the remote communities. The study therefore recommends that the stakeholders in the microfinance sector should ensure that the loan borrowers have access to adequate relevant technical training in entrepreneurial microfinance businesses.*

### **1.1 Introduction**

A micro finance is an emerging market particularly amongst the urban and peri-urban populations in Kenya. The growth of the sector is supported mainly by private micro finance institutions and government of Kenya initiatives as motivated by economic pillar enablers of the Kenya Vision 2030. Technically, micro finance is a business in which the person conducting the business holds himself out as accepting deposits on a day to day basis and any other activity of the business which is financed, wholly or to a material extent, by lending or extending credit for the account and at the risk of the person accepting the deposit, including the provision of short term loans to small or micro enterprises or low income households and characterized by the use of collateral substitutes (GoK, 2006). According to Waithera (2008), Micro Finance is way of supplying loans and small credits to finance small projects to help the poor have an income through forming their own small scale business to earn their daily bread and better their living. Micro finance is the provision of credit to the poor and low-income earners to enable engage them in productive activities.

Kiiru (2006) asserts that the Kenyan micro-finance industry is relatively a new phenomenon having begun with a few agencies about 20 years ago. Since then there has been a gradual shift in interest and resources allocation towards assisting the informal sector in a variety of ways. In the 1970's the main organization providing credit to the informal sector were church based organizations. The programs point to innovations like group lending contracts as the keys to their success. Group lending effectively make a borrowers neighbors co-signers to loans mitigating problems created by information asymmetries between borrower and lender. Neighbours will then have incentives to monitor each other and to exclude risky borrowers from participation prompting repayments even in the absence of collateral requirements (Modurch, 1999). Group lending mechanism allows a group of individuals often called solidarity to provide collateral or loan guarantee through a group repayment pledge. The repayments are made daily, weekly, monthly, or after four weeks.

Repayments for some loan products are made by one installment. A delayed installment is said to be delinquent and a repayment that has not been made is said to be in default. If one group member defaults the other group members makes up for the re-payment amount. Although there are good reasons to be excited about the micro finance promise of poverty alleviation, there are also good reasons for caution too. Poverty alleviation through provision of subsidized credit was embraced by many countries in the 1950's through the 1980's, but these experiences were nearly all disasters. Loan repayment rates often dropped well below 50 percent.

The rapid proliferation of MFIs has drawn some criticism. Some observers fear that it has outpaced the capacity of developing world governments to implement sensible regulatory measures (Howard et al, 2006). While this has contributed to the industry's flexibility and propelled its fast growth, it has also created a wild environment in which borrowers with limited financial experience may be exploited by incompetent or unscrupulous lenders (Howard et al, 2006). In 2005, for example, government regulators in Kenya closed Akiba micro finance on grounds that it had unlawfully taken customers deposits and reneged on payments (Mullei,1999). In 2006, the Indian governments cracked down on two large MFIs following suicides of at least sixty of their customers who were under pressure to repay loans at prohibitively high interest rates (Fernado et al, 2006). Poverty alleviation through provision of subsidized credit was embraced by many countries in the 1950's through the 1980's, but these experiences were nearly all disasters. Loan repayment rates often dropped well below 50 percent. (Morduch 1999). Kenya rural enterprise programme suffered default in two of its schemes while Benin, Ghana, guinea and Tanzania have also suffered a bad portfolio due to non repayment of loan issued out.

## 1.2 Statement of the Problem

Microfinance institutions offer medium amounts of loans mostly to business people who cannot afford collaterals to get loans from the main commercial banks. Despite the recent growth in the Micro-finance sector, the sector is faced with challenges of loan repayment defaults by clients. Individual groups have tried using groups equity for collaterals which is expected to ensure the revolving of money for the benefits of other individuals members of the group. However, loan delinquency have continued to causes serious challenge to most microfinance institutions. It is in this regard that this study was designed to determine factors influencing loan repayment default among the Micro-finance clients in Imenti North District.

## 1.3 Objectives of the Study

The objective of the study was to determine relationships between business characteristics and loan repayment default in micro-finance institutions in Imenti North District, Meru County.

## 1.4 Research hypothesis

H<sub>0</sub>: There is no significant relationship between business characteristics (type, age, number of employees and profit) and loan repayment default among microfinance loan beneficiaries in Imenti North District, Meru County

## Literature Review

The main aim of micro finance is to provide funds for investment in micro businesses that is expected to increase income to investor households and hence improve their livelihood. It has been observed that most borrowers use micro credit finances on food, shelter and clothing to meet their basic needs rather than investment. As Bayang (2009) put it at the time of loan disbursal, the poor borrowers are pre-occupied with pressing economic problems ranging from shortage of food, lack of seeds for planting and paying medical bills among others, a practice which makes micro finances repayment difficulty.

In order to overcome challenges of loan defaults, micro finance institutions use various credit lending models such as the Grameen (village) Bank in India founded by professor Yunus (Yunus, 2003). The bank adopted a methodology where a bank unit is set up with a field manager and a number of bank workers covering area of about 15 to 22 villages. The managers and the workers start by visiting villages to familiarize themselves with local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions and mode of operation of the bank to local population. Lending started with formation of groups of five prospective borrowers. The group is observed for a month to see if the members are conforming to the rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks (50) do other members of the group become eligible for an additional loan.

This mechanism ensured that collective responsibility of the group served as collateral on the loan. Another popular model in micro finance is rotating savings and credit associations (ROSCA). ROSCAs form groups of individuals who pay into an account on a monthly basis. Each individual then earns an opportunity to receive a relatively large loan with to invest. The group decides who receives the loan each term, often based on rotating schedule. The initial money is either accumulation of the group members' individual deposits or more frequently, by an outside donation. Loan repayment is ensured through peer pressure. Anyone who does not repay the loan amount risks the privilege to borrow in the future.

### **Business Characteristic**

The size of business relates to the amount of income obtained from it. Mpunga (2004) asserts that the level of business income is important factor that would determine the credit worthiness of a client. At low levels of income, business have little money to save while at higher levels much can be saved and even used to purchase collaterals which can be used as loan securities. Such securities can be sold to repay loans. According to Horne (2007) the excess of the security pledged over the amount of the loan determines the lender's margin of safety. If the borrower is unable to meet an obligation, the lender can sell the security to satisfy the claim. If the security is sold for an amount exceeding the amount of the loan and interest owed, the difference is remitted to the borrower. If the security is sold for less, the lender becomes unsecured for the creditor amount of the difference. The levels of incomes can also be used as an indicator to determine the credit worthiness of client. Because secured lenders do not wish to become general creditors, they usually seek security with a market value sufficiently above the amount of the loan to minimize the likelihood of their not being able to sell the security in full satisfaction of the loan. The degree of security protection a lender seeks varies with the credit worthiness of the borrower, the security the borrower has available, and the financial institution making the loan.

### **Credit Policies**

There are various policies that lenders put in place to ensure that credit administration is done effectively. One of these policies is collection policy which is needed because all customers do not pay the firms bills in time. The collection effort should, therefore aim at accelerating collections from slow payers and hence reducing bad debt losses. A collection policy ensures prompt and regular collection for fast turnover of working capital keeping collection costs and bad debts within limits and hence maintaining collection efficiency. The collection policy specifies clear-cut collection procedures and hence dissuades conflicts arising from loan repayment periods, amounts and loan structure (Pandey, 2004). The policy analyses business viability position and business Management by appraising the financial strength of the applicant, the firm's quality of management and nature of the customers businesses. The lender also conducts management audit to identify weakness of the customer's business management. If the nature of the customers business is highly fluctuating or has financially weak buyers or the business depends on a few buyers, then it is risky to extend credit to such borrower (weston, 1982).

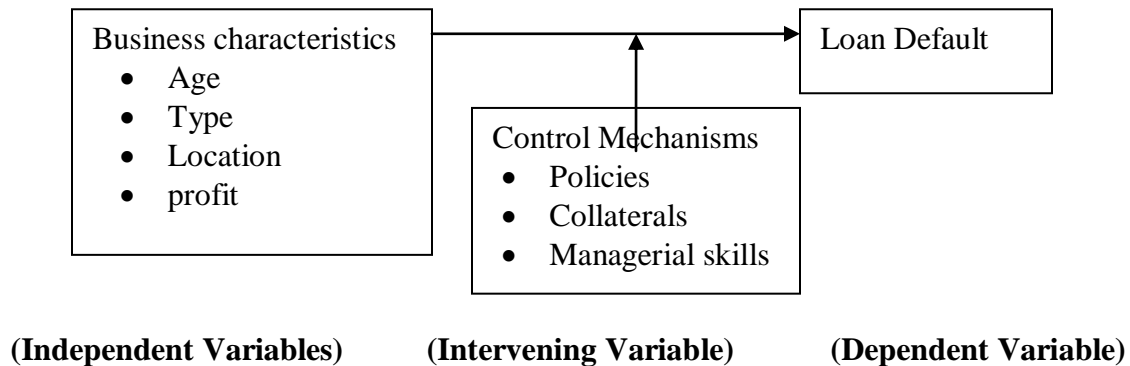
In addition, credit policies also considers credit limit (maximum amount of credit which the firm will extend at a point in time). It indicates the extent of risk to the firm by extend credit to a customer. Credit limit is also a function of the Character of a customer (customer's willingness to pay and the moral factor). There are various methods employed to analyze Credit Worthiness. The debt capacity of the applicant is reflected in cash flow projection, forming the basis for the decision on the loan conditions and the payment plan. The willingness to pay is assessed either on the basis of his credit history or, if there is none, using statement of suppliers, neighbours on the borrowers reputation and how promptly. According to Batar (2008), the lender can identify target clients' MFI's financial services needs, evaluate their needs, assess their character and capacity for repayment and determine the appropriate loan amount using financial expertise Batar et al (2008). A firm may develop its own ad hoc approach of numerical credit scoring to determine the credit worthiness of customers. The attributes identify by the firm may be assigned weights depending on their importance and be combined to create an overall- score.

Firms also employ a simple discriminant analysis by using more objective methods of differentiating between good and bad customers. For example, empirical analysis may show that the ratio of earnings before depreciation, interest and taxes (EBDIT) to sales is a significant factor in discriminating good customers from bad customer. The firm should select a cutoff point for granting credit to those customers who have EBDIT to sales ratio above the selected cut-off point.

Besides, firm can use two factors to distinguish between good and bad customers viz, EBDIT to sales and operating cash flows to sales which can give better indicator of a customer's financial health than one ratio alone. A combination of these ratios may be plotted on a graph for paying and non-paying customers. A straight line in the graph separates the two groups of customers. A firm may also use the multiple discriminant analysis to reveal , the credit worthiness of a customer which will depend on many factors that may interact with each other . The technique of multiple discriminant analysis combines many factors according to the importance given to each factor and determines a compact score to differentiate good customers from bad customers.

### Conceptualization of the Study

**Figure 1 Conceptual Framework**



Business characteristics which include the size, age , type, location of businesses and profits generated from the business may influence the loan repayment default by clients. Consequently, these are operations that ensure security of the loan such as the loan policies, proper area market analysis, proper business screening and follow-up. Without effective mechanisms in place loan defaults are inevitable and loan recovery might be a great challenge for microfinance institutions

### Methodology

The data available in the micro finance institutions as at December 2007 was used for sampling. The total population under study was 37 loan officers and 4578 clients. Using census and cluster random sampling formula for proportions (Israel, 1992), 400 sample respondents were identified. Primary data from respondents were obtained through questionnaires were analyzed and presented as findings of this study

### Discussion and Results

The study showed that high cases of default of loan repayment were common (67.9%) in the manufacturing sector. This was followed by the service industry (64.0%) then by the agriculture (58.3%). The trade sector recorded the least (34.9%) cases of loan repayment defaults. This could be attributed to the observation that trade industry deals in fast moving products on high demand which could translate into good business performance and increased revenue that accounts for low default cases.

Among businesses that had been in operation for less than two years, 52.4% had defaulted in loan repayment, 44.2% of those that had been in operation for a period of between two and five years had defaulted. It was noted that the highest (78.6%) default cases were regular in businesses that had been in operation for a period of between five and ten years. Loan repayment defaults were rare (0.0%) in business that had survived for more than 10 years. In addition, the businesses located within the municipality had high loan repayment default rates (55.7%) as compared to business outside municipality.

Businesses making monthly profits of below Kshs. 10,000 had the highest cases (62.8%) of loan repayment default followed by those that made profits of between Kshs. 11,000 and Kshs. 50, 000 (42.5%). There were 22.7% cases of loan repayment default among businesses that made profits of between Kshs. 51,000 and Kshs. 100,000. Loan repayment default among businesses that made profits of over 100,000 was minimal.

#### 4.5 Hypothesis testing

The relationship between the business characteristics and loan repayment default is examined by testing the stated hypotheses using  $\chi^2$  test at 95% confidence interval.

**Table 1: Chi-square for business characteristics**

Variable	Value (Pearson Chi-Square)- $\chi^2$	DF	Significance level
Type of business	27.558	3	0.000
Age of the business	28.646	3	0.000
Number of employees	11.070	3	0.011
Business location	3.766	1	0.55
Business manager	3.143	1	0.91
Profits	30.031	3	0.000

There was a significant relationship between the type of business ( $p=0.000<0.05$ ), age of the business ( $p=0.000<0.05$ ), number of employees ( $p=0.011<0.05$ ) and business profits ( $p=0.000<0.05$ ) and loan repayment default. We therefore accept the null hypotheses that the type of business operated, age of the business, number of employees and business profits influence the loan repayment default. However, the strength of the relationship between type of business and loan default is a fairly weak ( $\Phi=.277$ , Cramer's  $V=.277$  & Contingency Coefficient=.267). Strength of the relationship between profits and loan default and age of business and loan default was equally weak.

#### Conclusions and Recommendation

The study therefore concludes that there various factors influencing non-repayment of loans which could arise from businesses characteristics. These factors included type of business, age of the business, number of employees and business profit. The study recommends that the stakeholders in the microfinance finance sector ensure that the borrowers have access to adequate relevant training in the microfinance businesses. The current link between technical training services for entrepreneurs in the deprived communities and loan granting institutions is under-utilized. Technical training on microfinance investments and exposure to wider range of entrepreneurial environments is expected to cushion the loanees against the start-up challenges. In addition, the training will also guide the microfinance entrepreneurs on appropriate choice of types of businesses and suitable levels of man power required by the entrepreneur

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