

## **Influence of Business Characteristics on Microcredit Default in Kenya: a Comparative Analysis of Microfinance Institutions and Financial Intermediaries**

Muturi Phyllis Muthoni<sup>1</sup>, Prof. Lewa, Peter Mutuku<sup>2</sup>, Dr. Riro, G. Kamau<sup>3</sup>

<sup>1</sup>*Department of Business Administration and Management, School of Graduate Studies and Research, Dedan Kimathi University of Technology, P.O Box 657-10100 –Nyeri, Kenya*

<sup>2</sup>*Chandaria School of Business United States International University-Africa, P.O Box 14634-00800, Kenya*

<sup>3</sup>*School of Business, Dedan Kimathi University of Technology, Kenya, P.O Box 657-10100 –Nyeri, Kenya*

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**Abstract:** *This study sought to investigate causes of loan default within MFIs and Financial Intermediaries (FIs) in Kenya. The specific objective addressed was to evaluate the influence of business characteristics on loan default in MFIs and FIs. A target population of 48 MFIs institutions and 76 Financial Institutions was used. A multistage sampling procedure and a sample of 48 MFIs and 48 FIs were selected. Random sampling was used to select the respondents since each participant had an equal opportunity to be selected. Primary data was collected by use of a questionnaire and analyzed by quantitative methods by use of SPSS; Version 21. Descriptive statistics and inferential statistics were employed to make generalizations. Data was presented in form of frequency tables, bar charts and pie charts for easy interpretation of results. A multiple regression model and Pearson correlation were used to establish relationships among the variables. The findings of the study indicated business characteristics were significant among MFIs and FIs but with some differences in the parameters measured. The findings are of significance to policy makers, MFIs, FIs, small businesses, universities and the general public as a source of knowledge for future reference.*

**Key Terms:** *Loan Default, Microcredit, Portfolio at Risk (PAR), Microfinance Institutions (MFIs), Financial Intermediaries (FIs)*

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### **I. Introduction**

Microcredit is an important strategy being used to reduce poverty among many countries across the globe. The world has over 10,000 Microfinance Institutions (MFIs) that serve 150-200 million clients (Etzensperger, 2014). Ruben (2007) defines it as a ‘grant loan to the poorest of the poor without requiring collateral’ with an assumption that the beneficiaries have the survival skills that facilitate for credit worthiness. Sinha (1998) as sighted by Wrenn (2005) gives a distinction between microcredit and microfinance and states that ‘credit refers to small loans, where microfinance is used where the small loans are supplemented with other financial services such as insurance and savings. Microcredit, therefore, is small loans provided to low income individuals without collateral and includes other financial services.

Microcredit brings about interaction between the lenders and the borrowers for the purpose of starting and developing micro enterprises that benefit individuals and the community in fighting poverty (Buss, 2005). However there is a widespread global concern over the countries that offer microcredit funds. Micro credit though has a positive effect on improving peoples’ livelihoods in many parts of the world, has experienced several hardships over the years. Default is a major concern in many countries in the world. Pachico (2009) highlights a numbers of cases that have been greatly affected for instance; the microfinance sector in Nicaragua in 2009 - 2010 suffered major crisis as a result of both financial downturn and the domestic No Pago (No payment) movement that was fuelled by political activists. The portfolio at risk in these MFIs was at 19 percent despite many write offs while the No Pago group advocated for a moratorium law that allowed debtors a 10 year amortization period with a very low interest rate (less than 8 percent). This greatly reduced the total portfolio granted by MFIs to the poor in Nicaragua. Similarly Kolar Microfinance in 2009 found itself in a similar crisis on delinquency as a result of multiple borrowing by clients facilitated by ‘overheated lending environment created by competition amongst the many registered MFIs and unknown number of unregistered lenders’.

A similar crisis was experienced from Andhra Pradesh (India) in 2010 where a number of borrowers committed suicide over indebtedness as a result of rising debt stress among thousands of clients which led to high default rates and the government had to step in and regulate the MFI sector. Likewise Pakistan in 2010 experienced difficulties in loan recovery in the sector after heavy monsoon rains caused havoc in the country that resulted in people losing property, raw materials, tools and work spaces which was affected means of livelihood and experienced difficulties in meeting their loan obligations. In a similar fashion, Bosnia and Herzegovina microfinance sector experienced a rapid rate of growth from 2006 – 2008, but later suffered high

indebtedness among the borrowers due to global financial crisis caused by competition, advanced loans given without following the laid down procedures (increasing maximum loan amounts and widening loan purposes and introducing new products). These actions eventually led to 'high levels of cross-and over-indebtedness among MFIs to clients.' In due time the loan arrears rose from 1 percent to 6 percent as a result of low remittances over a period of 3 years.

Globally many countries have come up with microcredit initiatives to start small businesses especially to empower women and the youth. Globally, youth enterprise fund is a widely used initiative by many governments to promote youth employment and a key driver to the economic growth. For example, the Royal bank of Scotland came up with support services that helped the youth to access funds, to do mentorship and networking program and startup capital for businesses. Similarly, the Canadian Youth Business Foundation established in 1996 was meant to design youth business loan program specifically tailor made for the unemployed and underemployed (Karlan & Morduch, 2009). In South Africa, a program called Umsobomvu Youth Fund has gone a long way in alleviating poverty and unemployment with a nationwide support (Million, Nyikal & Wania, 2012). However the fund faced numerous challenges especially in monitoring and evaluation (ibid). The same challenges were experienced in Uganda's government programs on the number of loans disbursed and very little attention given over the effectiveness of those loans borrowed by entrepreneurs (ibid).

The fiscal health of MFI sector in Sub Sahara Africa (SSA) is a cause of concern due to the increased portfolio at risk (MIX, 2010). The region records a Portfolio at Risk (PAR 30 ) greater than 5 percent, coupled by poor reporting, poor control systems, poor information systems and poor credit management (ibid). Despite the high potential of MFIs in Africa serious and closely related problems in microcredit debt payment have been noted (Buss, 2005). As a result most MFIs are likely to have unreliable financial and portfolio information in addition to a poorly equipped system in managing their credit portfolio or protecting customers' savings (CGAP, 2013). Most of these MFIs in SSA, the financial performance recorded showed high outstanding loans, high transaction costs and rising managerial costs (ibid). Ethiopia has 27 MFIs registered by National Bank of Ethiopia and massive default has been reported among small-scale holders which threatened Development Bank of Ethiopia until provision of inputs for credit by government was eventually stopped (Sileshi et al., 2012). According to Sileshi et al., (2012), loan default in Ethiopia is said to be a "tragedy as it leads to system failure in implementing appropriate lending strategies and credible credit policies".

The MFIs provide microcredit through group lending to the rural smallholders to narrow the gap between the demand and supply of credit (CBE, 2010). In Ghana, MFIs provide financial assistance to cooperative groups organized by farmers since groups have common goals and interests (Ayogyam et al. 2013). For the last three decades, these MFIs have been successful in granting loans but the trend has been worrying due to high default rate (ibid). Udoh (2008) observed that in Nigeria, 75 percent of government sponsored loans disbursed by Akwa Ibon State Agricultural Loan Board to farmers, 59 percent were loan defaulters. In Tanzania most rural SACCOs suffer from 'weak internal control systems and high non-performing loans because of ineffective loans management' (Maghimbi, 2010 and Bibi, 2006).

The Government of Kenya has put a lot of emphasis on accessibility and suitability flow of financial services to the low income earners in order to alleviate poverty (Murathe & Weda, 2015). The government of Kenya has introduced various support initiatives for provision of credit to Micro and Small Enterprises (MSEs). These initiatives include provision of Public Entrepreneurial Funds (PEFs) which include; Women Enterprise Funds (WEF), Youth Enterprise Development Fund (YEF), Agricultural Finance Corporation, Kenya Industrial Estates (KIE) Fund and Uwezo Fund. These funds are disbursed by some Financial Intermediaries (FIs) partnering with the government. The key objectives are to; improve competition of MSEs, promote social-economic development, reduce poverty among entrepreneurs, increase financial accessibility, productivity and innovation (Gitau and Wanyoike, 2014). The funds are disbursed to promote economic empowerment among youth and women. It involves mobilization of poor or disadvantaged sections of the population by increasing accessibility of resources and opening opportunities for income generation (SLE, 2010). Microcredit is therefore a tool that enhances economic development to the poor in the society.

Kenya is rated the best in Africa and also the second best in provision of a conducive business environment for MFIs and the top ten in the world (EIU, 2010). Kenya's borrower's rate is rated the second largest (Mix and CGAP, 2010). However, the case of default is still raising concern in the MFIs and FIs sectors. The default rate among MFIs' sector is relatively higher compared to commercial banks with default rates ranging from 10% -20% while commercial banks have a less than 5% default rate (Kiraka et al., 2013). According to Kiraka et al. (2013), the constituency women enterprise recorded 20-30% default rate in 2013. Youth Enterprise Development Fund (YEDF) in 2009, disbursed funds to 8586 youth groups totaling Ksh 376,923,810 and only 83,732,085 (22.2%) was repaid while the outstanding balances of 293,191,724 (77.8%) was not paid (YEDF, 2009). A report from Pamoja (2010) indicated that in Kerugoya District loan default advanced to groups increased from 7.17 percent to 28.22 percent. This eventually affects the sustainability capacity of MFIs.

Microfinance Institutions include microfinance banks, wholesale MFI's, development institutions and insurance companies (AMFIK, 2014). Microfinance has been viewed by developing countries as a strategy for poverty alleviation and human enhancement (Halvoet, 2006). Halvoet (2006) argues that in order to reach the unbankable poor and reduce costs on transaction, use of groups to intermediate is paramount. This increases chances of repayment through peer pressure and reduces time consumed on loan proceedings. According to World Bank (2006), the developing economies especially Asia, Africa and Latin America organizations deliver microfinance services that are either formal or informal. The organizations are categorized as either traditional or alternative depending on the level of community participation. The traditional microfinance is characterized by; lending of funds to the poor, external donor funding, use of Grameen bank model and less participatory and community driven.

According to Farhodova et al., (2008), these traditional MFIs do not sustain financial services due to; poor mobilization of savings, high external dependence on foreign capital that leads to less accountability and responsibility over the funds, high default rates, poor perception by community that loans provided are handouts and do not require repayment and also limited managerial skills. The alternative MFIs unlike the traditional MFIs are characterized by; saving mobilization, money lenders to members depending on their savings and follow the village bank model (Farhodova et al., 2008). The village Bank model has an objective of mobilizing members to save and have self-financing groups between 15 – 30 members who form semi-formal banks in the village (Murdoch, 2000; Holt, 1991). These MFIs are more participatory and driven by community. These alternative MFIs face several challenges namely; low savings, small loans available to members, savings not released to the member until one gets a loan, high possibility of loan default among members and lack of a legal framework (Schreiner, 2000).

In Africa, poverty is a multi-faced problem caused by low literacy levels, limited resources, low health and education services, high unemployment and lack of adequate incomes to provide basic needs to the poor (Mwaniki, 2006). Many people in Africa, about 50 per cent mostly women, live below the poverty line (less than 1 dollar per day), despite efforts made by various governments and development partners (ibid). Financial assistance is therefore considered as an anti-poverty reduction tool (Mwaniki, 2006; Chowdbury, 2009; Sjomsoeddin, 2010). In Kenya, social and economic developments are strongly affected by high poverty and unemployment rates (Lagat et al., 2012). Further, the issue is aggravated by high dependency, unemployment and under development of the youth which is challenging to the country (ibid). The government has come up with initiatives to promote entrepreneurship as an alternative strategy for creating employment through Youth Enterprise Development Fund (YEDF). At the same time women have received microcredit through the Women Enterprise Fund (WEF) by the government. These funds are channeled through Financial Intermediaries and constituencies to create small businesses.

Majority of microcredit borrowers invest their funds in small businesses. Therefore the importance of these businesses in job creation cannot be overemphasized. Small business development is effective for assisting the poor in developing economies (Zeller and Sharma, 2000). The management and running of these businesses is done by private and social entrepreneurs who play a key role in any community as “primary contributors, mobilizers of resources to develop the economy, a provider of employment for others and a stabilizing factor in society” (RoK, 1992). The government has an obligation to establish strategies to develop an entrepreneur and create conducive environment for him to use his outstanding ideas and innovations. In Kenya, since the enactment of the Microfinance Act of 2006, the microfinance industry has been vibrant in its growth, for example, Faulu and Kenya Women Finance Trust gave a total of Kshs. 14.9 billion which was granted as loans and advances and mobilized deposits that rose up to 7.2 billion (RoK, 2011).

In Kenya, MFIs are supervised by Association of Microfinance Institutions in Kenya (AMFIK) which was registered in 1999 to ensure quality service provision to the low income people and assists MFIs in building their capacity (AMFIK, 2014). These institutions are rated internationally by an agency called Microfinanza Rating. AMFIK has four strategic pillars namely; policy advocacy and lobbying, capacity building, networking and linkages, research and knowledge management. These institutions have registered a gradual growth for the last three years amounting to 298.4 billion by December 2013 (AMFIK, 2014). The active clients in the sector stand at 8,809,543 and excluding banks clients' total is 1,062,621 (ibid). The dominant banks are Equity bank which consists of 72 per cent total assets, the rest are K-REP, Post Bank and Jamii Bora Bank. 2014. Some still Deposit Taking Microfinance (DTMs) such as Kenya Women Finance Bank (KWFT) SMEP, Uwezo, REMU, Rafiki, U&I, SUMAC, Century and Faulu and others Credit-only MFIs. The microfinance institutions have received substantial support from both bilateral and multilateral donors (Chowdbury, 2009). By December 2014, a report showed that MFIs had 698 branches across the country. According to the report, Rift Valley has the highest (160), Nairobi (145 branches) followed by and Central region (102) and the least branches are found in Western (104) and North Eastern (6) branches. The sector had employed 12,377 staff and the sector without the banks has 4,856 (AMFIK, 2013). There are various policies and legislation that regulate MFIs namely: MFI Act (2006), Kenyan Banking Act(2012), Central Bank of Kenya, SACCO Act (2008), Kenya Union of Savings and

Credit Cooperatives (KUSCCO), SACCO Societies Regulatory Authority (SASRA) and Credit Referencing Bureau (CRB) Regulation of 2008 (Warue, 2012).

Microcredit and other innovative programs reduce poverty by enhancing people’s potential (Yunus, 2003) and give opportunities to the poor and unemployed, promotes their self-respect and self-esteem through self-employment. Being employed boosts the creditworthiness of those who pay back the small loans granted and therefore reduces poverty in the long run (Chowdbury, 2009). MFIs employ workers in their institutions which have great multiplier effects (Roodman and Qureshi, 2006) therefore improving peoples’ standard of living (United Nations, 2006). MFIs provide financial services such as credit, savings and other social services such as group formation, training in financial literacy and development of management capabilities (ibid). Chowdbury suggests that some of these programs include management and entrepreneurial training to entrepreneurs. Microfinance is important in building a global financial system for the needy poor (Wrenn, 2005). However despite the outlined benefits of microfinance institutions default rate is a major threat to their suitability, profitability and operations.

According to Centre for the Study of Financial Innovation (CSFI) (2011), the microfinance industry has experienced a number of challenges namely; low funding, loan default rates increasing and therefore needs sustainability in poverty eradication. According to Association of Chartered Certified Accounts (ACCA) (2011), management of information asymmetry to detect early signs of those who are likely to default is paramount in avoiding serious cases of delinquencies. This calls for proper investment in resources such as; management skills, human and capital. This in return facilitates the growth of microfinance industry. A report by Financial Sector Deeping(FSD) Kenya (2009) indicated that despite the growth of Microfinance Industry, still 33% of Kenya’s population cannot access finance, hence the need to campaign to this population through education to the unbankable population.

Microcredit is disbursed through groups or individuals. By December 2013, the group lending model had a better portfolio than the individual lending model as shown in Table 1.1. Portfolio at risk (PAR) shows all arrears of outstanding loans. Portfolio at risk 30 (PAR 30) are outstanding balance on loans with arrears greater than 30 days/gross outstanding portfolio. It is an indicator to the financial institution on the current losses likely to incur and also in the future if no payments are made at all (Warue, 2012). This implies that loan default among the individuals at 13.7% is quite high compared to groups at 5.9%, any amount over 5 percent calls for concern (United Nations, 2011).

**Table 1.1: Portfolio at Risk 30 per Category**

PAR30 per credit methodology	Sector without banks	Whole sector
Individual lending	8.1%	13.7%
Group lending	5.9%	4.2%
Individual and group lending	14.6%	N/A

**Source: AMFIK, (2013)**

Table 1.2 presents the geographical coverage of MFIs in Kenya by regions, amount of loans borrowed, the numbers of active borrowers in each region and the average outstanding loans. The regions with the highest outstanding loan amounts were; North Eastern, Nairobi, Rift Valley, Central, and Eastern regions in that order. Nairobi also had the highest loan portfolio amounting to 25.8% of the whole sector’s GLP, followed closely by Rift Valley (24.6%) and the least was North Eastern with 0.3% despite its high outstanding loan balance.

**Table 1.2: MFI and Entrepreneurs Geographical Coverage by Regions**

Regions	Gross Loan Portfolio(GLP) (Ksh billion)	% of the Whole Sector’s GLP	Number of active borrowers	Average Outstanding LoanAmount(Ksh million)
Nairobi	13.6	25.8	150,246	90,793
Rift Valley	13.04	24.6	183,966	70,874
Central	7.77	14.7	122,479	63,473
Eastern	5.74	10.8	97,607	58,799
Nyanza	4.26	10.9	94,502	46,429
Coast	5.00	9.4	91,152	54,803
Western	2.36	4.5	50,544	46,768
North Eastern	0.14	0.3	1,417	98,664

**Source: AMFIK, (2014)**

Table 1.3 presents the recent data on PAR of various MFIs in Kenya per AMFIK (2014). Some of these MFIs indicated very high PAR such as; Jamii Bora, Milango Financial Service Ltd, AAR Services, SISDO, Jitegemee Credit, Mosoni Kenya, Letshego and Uwezo have had their PAR 30 at high levels consecutively for three years. It is evident from the averages PAR that since 2011 the default rate has gradually increased from 8.8 percent (2011), 9.4 percent (2012) and 9.9 percent (2013). This trend is of great concern

since PAR 30 has continued to deteriorate compared to previous years as a result of portfolio management and therefore the need to examine this phenomenon of high default rates in these institutions. In the same year 2013 according AMFIK, (2014), the write off ratios in Credit –only MFIs rose from 0.9% (2011), 0.9% (2012) to 1.5% (2013). This is an indicator that MFIs losses have continued to increase due to the write offs and this threatens their sustainability.

**Table 1.3: Portfolio at Risk (2014)**

MFI	2011 (%)	2012 (%)	2013 (%)	Loan outstanding portfolio USD
RAFIKI DTM	-	30.8	10.0	22,036,556
MILANGO FINANCIAL SERVICE LTD	7.7	17.2	29.7	969,854
SMEP	8.9	17.2	14.8	22,826,154
K-REP BANK	16.6	15.8	na	107,555,913
JAMII BORA BANK- Whole	44.8	15.2	15.8	45,358,853
-MFI	31.0	14.7	46.3	5,042,063
CENTURY DTM LTD.	-	14.5	6.6	1,025,181
REMU DTM LTD.	6.8	14.2	9.3	1,916,464
ECLOF – KENYA	10.9	10.9	5.8	6,958,860
SPRING BOARD CAPITAL LTD	11.8	10.3	na	
AAR SERVICES	5.1	8.6	19.4	6,074,124
PAWDED	7.8	7.8	7.5	8,423,205
SUMAC DTM LTD.	7.1	7.3	6.5	1,056,587
SISDO	9.6	7.1	12.7	3,217,094
EQUITY BANK - WHOLE	3.5	6.4	na	
- MFI	7.4	10.6	7.5	153,028,977
YEHU	3.4	6.2	3.6	4,151,212
KADET LTD	11.2	5.8	na	102,727,685
KWFT	6.1	5.7	6.6	
FAULU KENYA DTM	5.2	5.2	5.3	4,934,759
MICRO AFRICA LTD	3.6	4.9	na	5,865,217
JITEGEMEE CREDIT SCHEME	2.6	3.5	6.0	2,779,347
JUHUDI KILIMO LTD	4.1	3.2	3.9	452,425
KEEF KENYA	-	1.9	1.8	6,097,262
SAMCHI CREDIT LIMITED	-	1.8	15.7	285,980
OPPORTUNITY KENYA LTD	0.8	1.4	3.4	
RUPIA MICRO-CREDIT LTD.	2.1	1.3	1.8	2,781,435
TAIFA OPTION MFI LTD	-	1.2	na	
MOSONI KENYA	4	1.1	3.2	2,781,435
GREEN LAND FEDHA	-	0.6	0.1	19,111,251
BIMAS	6.1	7.5	9.1	5,0005,225
LETSHEGO	3.6	4.9	5.8	9771,101
VISION FUND	11.2	5.8	5.1	5,909,817
U&I MFI Bank	22.4	7.1	10.2	446,963
UWEZO	10.2	12.0	29.1	924,100
<b>AVERAGE PAR</b>	<b>8.4</b>	<b>9.6</b>	<b>9.9</b>	

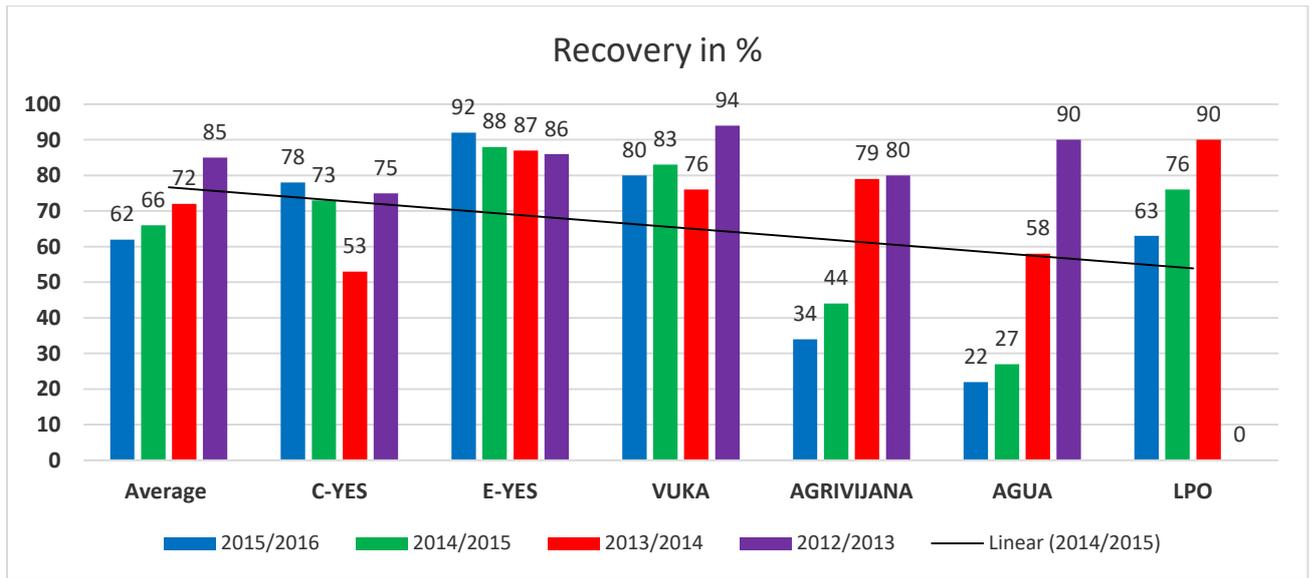
Source: AMFIK, 2014

Public entrepreneurial funds (PEFs) disbursed by Kenyan government have faced serious challenges in loan recoveries hence recording high default rates. The Youth Enterprise Development Fund has various products that are disbursed to group and individuals and Table 1.4 presents the loan recoveries since 2012 in percentages for six loan products and also their averages per year. It is evident that the recovery rates have continued to deteriorate over the years. In 2012/2013 year the recovery rate for each product ranged from 75 % (C-YES) to 90% (AGUA). This implies the default rate ranged from 10% to 25%. But in 2013/2014, the recovery rates went down from 53% (C- YES) to 90 % ( LPO) hence recording default rates from 10% to 47 %. In the period 2014/2015, the recovery rates went further down from 27 % (AGUA) to 76 % (LPO). This is well presented in Figure 1.1. This therefore implies that default rates went higher from 73% and 24 % respectively. The situation further deteriorated in the period 2015/2016 in that AGUA recorded a recovery rate of 22 % and hence recording a default rate of 78% which is quite high threatening the sustainability of the fund. AGRIVIJANA recorded a recovery rate of 34 % implying that 66 % was not paid back.

**Table 1.4: Loan Recoveries 2012/2013 to 2015/2016 in Percentages**

Financial Year	Average %	C-YES %	E-YES %	VUKA %	AGRIVIJANA %	AGUA %	LPO %
2015/2016	62	78	92	80	34	22	63
2014/2015	66	73	88	83	44	27	76
2013/2014	72	53	87	76	79	58	90
2012/2013	85	75	86	94	80	90	-

Source; YEDF, 2017

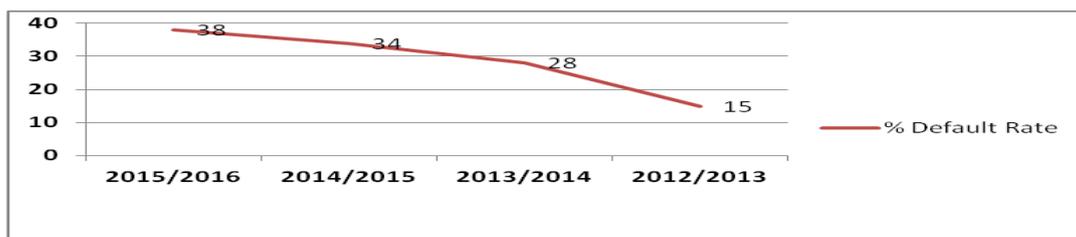


**Figure 1.1** Fund's loan recovery trend from 2012/2013 – 2015/2016

The Table 1.5 presents the average rates and default rates of YEDF for the last 5 years of from the period 2012/2013 to 2015/2016. The default rates have continued to increase over the years as presented in Figure 1.2

**Table 1.5:** Average Default Rate for YEDF (2017)

Financial Year	Average Recoveries (%)	Default Rate (%)
2015/2016	62	38
2014/2015	66	34
2013/2014	72	28
2012/2013	85	15



**Figure 1.2:** Average Default Rate Trend for YEDF (2012-2016)

The average default rate of the YEDF in 2012/2013 was 15%, increased to 28 % in 2013/2014, a further increment was recorded in 2014/2015 up to 34% and finally in 2015/2016, it raised to 34 % (YEDF, 2017). This can be attributed to lack of official loan recovery strategies on loan defaulters and scanty documentation on portfolio of groups and individuals (ibid). This trend should be reversed and therefore the need for the study. A study by Kiraka et al., (2013) reported that poor dissemination of information and misconception of the fund caused high default rates. Among the C-WES the default rates were between 20-30 percent compared to 10-20 percent among MFIs while in commercial banks recorded less than 5 percent (ibid).

Similarly, Uwezo Fund has faced numerous challenges just like YEDF in loan repayment. Uwezo Fund was established in February 2014, in order to address the issue of unemployment of youth and empower women and people with disabilities. The 6 billion fund has faced a number of challenges namely; refusal by groups to repay their first loans, since they believe it's a gift from the members of parliament (MPs), blame game between the MPs and Funds Oversight Board and the fact that the law does not give provisions for recovery of that cash (Gisera, 2016). According to a report from the funds oversight board 99 percent of the money had not been revolved as at June 30<sup>th</sup>, 2016. The board indicated that 5.34 billion was disbursed to 36,000 groups in Kenya and only 947 million has been recovered leaving 4.393 billion unpaid (representing 82%). The report further says that 32 constituencies out of 290 constituencies had revolved the funds (11%) while 258 constituencies have not revolved the funds which constitute 89 percent. This puts the sustainability of the funds into jeopardy. The default rates are very high especially in some constituencies as shown in Table 1.6. The Table presents 31 constituencies in Kenya that received over 430 million shillings. The default rate recorded on average is 68.4 percent with over 294 million unpaid. This amount is quite high being in mind that the fund was

meant to be a revolving fund. This therefore calls for immediate intervention by the government/oversight board to put in place measures to revert the trend to avoid its collapse since its sustainability is at stake. Some constituencies had default rates recorded as 99 % to 100% such as; Mandera North, East and South, Turkana West and North, Lafey, Banissa ,Moyale and Dadaab. Some of the groups that received the loans did not invest as planned, others disintegrated and stopped payments halfway (Chanji, 2016). Table 1.6 presents the loan status of WEF in 2017 as per some constituencies in Kenya.

**Table 1.6** Uwezo Fund’ Default Rates (2016)

Constituency	Allocated Kshs.	Unpaid Kshs.	% unpaid
Mandera South	31,795,213	31,531,713	99.9
Turkana West	29,449,686	29,449,186	100
Mandere West	24,838,046	24,838,046	100
Lafey	24,255,564	24,255,564	100
Banissa	24,661,127	24,661,127	100
Mandera North	25,589,527	25,421,542	99.9
Turkana North	24,334,336	23,749,336	97.6
Dadaab	19,000,000	18,996,940	99.9
Mandera East	19,800,000	19,795,000	99.9
Moyale	18,000,000	17,977,800	99.9
Tongaren	7,860,417	3,582,516	46
Kaloleni	8,477,883	4,222,336	50
Teso North	7,867,917	3,615,607	46
Manyatta	9,101,667	4,880,895	54
Matungulu	8,272,083	4,058,011	49
Lurambi	9,251,667	5,050,442	55
Alomui	8,539,167	4,356,691	51
Seme	8,202,083	4,038,668	49
Buretti	8,529,167	4,600,205	54
Nyakach	8,615,000	4,769,836	55
Sirisia	9,650,833	5,972,278	62
Sigowet/Soin	8,063,750	4,247,660	53
Vihiga	8,135,000	4,465,267	55
Ndhiwa	9,781,458	6,456,735	66
Mt Elgon	11,708,125	8,471,934	72
Kapenguria	8,300,000	5,444,176	66
Konoin	6,403,750	3,592,997	56
Rarienda	6,442,500	3,718,078	57
Kangundo	8,000,000	5,294,226	66
Kasarani	6,537,500	3,859,000	59
Igembe North	5,983,333	3,304,462	55
<b>TOTALS</b>	<b>430,809,715</b>	<b>294,673,845</b>	<b>68.4</b>

Source: Uwezo Fund Oversight Board, 2016

The Women Enterprise Fund suffered high default rates just like the Uwezo Fund and YEDF. Table 1.7 indicates the WEF loan status of some FIs as released from the Credit Department by April 2016. It is evident from the table that funds released to these FIs indicate high outstanding balances on average 49.06%. This raises concern why such default rates are witnessed and therefore the need to carry out a research to examine this phenomenon.

**Table 1.7:** FIs WEF Loans (2016)

WOMEN ENTERPRISE FUND (WEF)					
Credit Department					
FIs loans as at 26.04.2016					
Loan Amount (in ‘000,000’ Kshs)					
FIs	Total Allocation	Total Released	Amount Repaid	Balance Outstanding	Outstanding Balances in %
African W.Foundation	4	2	0.9	1.1	55
ARDESC SACCO	8	4	0.95	3.05	76.25
Chase Bank	50	50	30	20	60
Gusii P.SACCO	1	1	0	1	100
Jisaidie	13	7	3.1	3.9	55.7
Jihahidi	4	3	1.8	1.2	40
Kia -Mokama	15	13.5	10	3.5	35
Kijito	3	3	0	3	100
OLmarel Lang	5	5	0.472	3.528	9
Pambazuka Merinaoh	2	2	1.303	0.697	34.9
Tetu women	1	1	0.45	0.55	55

Uchumi Bora	4.5	1.5	0	1.5	100
UWESO	8	8	5	3	37.5
Webuye Devpt Coop	1	0.64	0.048	0.592	92.5
Wells Community	11	11	2	9	81.8
WAADI	10	10	6.45	3.55	35.5
<b>Total</b>	<b>140.5</b>	<b>122.64</b>	<b>64.473</b>	<b>60.167</b>	<b>49.06%</b>

Source: WEF, 2016

The provision of microcredit in most developing countries depends on various assumptions; firstly borrower’s willingness to repay the loan, secondly capital is the only way to finance the microenterprise, and lastly the borrowers become creditworthy by being disciplined in loan repayment (Pretes, 2002). Pretes further noted that micro credit programs experience a serious default problem of borrowed funds. Nawai (2010) suggested that microcredit is geared towards the growth of entrepreneurship among the poor people to help them out of poverty. These are people who lack collateral, stable employment and lack credit history hence not able to meet the conditions of the traditional financial institutions (ibid). According to Robinson (2002), microfinance is a developed approach that involves financial assistance and social intermediation. The financial aspect provides services such as savings, credit and insurance while in social intermediation, citizens are organized in groups that facilitate policy makers to attend to them and meet their aspirations and concerns.

Loan default appears to be a major problem everywhere. Loan default is generally said to be a serious problem in Africa and has been experienced in some cases in many countries. According to Okorie (2004), “poor loan repayment in developing countries has become a major problem in credit administration to smallholders who have limited collateral capabilities”. Financial Institutions are discouraged from giving more credit to the defaulters; therefore defaulters find themselves in the same problem of low productivity (ibid). Handling loan repayments effectively ‘reduces distress and shaky foundation for the establishment of MFI’s (Olagunju and Adeyemo, 2007).

A report from Pamoja (2010) indicated that in Kerugoya District loan default advanced to groups increased from 7.17 percent to 28.22 percent. This adversely affects sustainability capacity of MFIs. The default rate among MFIs’ sector is relatively higher compared to commercial banks with default rates ranging from 10% -20% while commercial banks have a less than 5% default rate (Kiraka et al., 2013). In their study, the constituency women enterprise recorded 20-30% default rate in 2013. Youth Enterprise Development Fund (YEDF) in 2009, disbursed funds to 8586 youth groups totaling Ksh 376,923,810 only was 83,732,085 (22.2%) repaid while the outstanding balances of 293,191,724 (77.8%) was not paid (YEDF,

A study by Mungai, Maingi and Murathe (2014) in Muranga county indicated that government funded micro-credit registered high default rate due to the fact that there was high snow balling among the borrowers who argued that ‘if others do not pay’ why should one pay, others treat the fund as a gift from the government and therefore not intended to be paid back (ibid). The study also reported that the fund was coupled with high risk and high cost of borrowing, limited capacity for the normal borrower to repay and also borrower’s irregular incomes and therefore there is need to come up with policies to ensure constant incomes among the borrowers. It is evident from the averages PAR 30 observed in MFIs that since 2011 the default rate has gradually increased from 8.8 percent (2011), 9.4 percent (2012) and 9.9 percent (2013) as presented. This trend is of concern since PAR 30 has continued to deteriorate compared to previous years as a result of portfolio management and therefore the need to examine high default rates in these institutions. In the same year 2013 according AMFIK, (2014), the write off ratios in Credit –only MFIs rose from 0.9% (2011), 0.9% (2012) to 1.5% (2013). This is an indicator that MFIs losses have continued to increase due to write offs and threatening their sustainability. The average default rate of the YEDF in 2012/2013 was 15%, increased to 28 % in 2013/2014, a further increment was recorded in 2014/2015 up to 34% and finally in 2015/2016, it raised to 34 % (YEDF, 2017). Uwezo Fund reports indicate that 5.34 billion disbursed to 36,000 groups in Kenya, 4.393 billion remain unpaid (representing 82%).The report further says that 258 constituencies out of 290 constituencies (89 percent) had not revolved the funds. This implies that the funds have not been repaid.

Bichanga and Aseyo (2013) carried out a study on microcredit and examined three parameters; supervision, shrinking economic growth and diversion of loan default. Ngahu and Wagoki (2014) explored the influence of group lending management on loans among MFIs, Moti et al., (2012) concentrated on the effectiveness of credit management on loan performance in MFIs and Warue (2012) examined the external factors and group factors on loan default in MFIs. From these studies much has been done on economic factors and group factors and their influence on loan default. Delinquency is a case of concern to both MFIs and FIs since it increases risk of losses, sign of operational problems and helps to predict the amount of portfolio that is likely to be lost if not paid (Warue, 2012). According to Stearns (1991), delinquency of loans affect MFIs and FIs programs in both measurable and immeasurable ways; it causes postponed or loss of income, rotation of portfolio eventually slows and reduces asset productivity, increases costs of follow-ups on delinquency cases, image of the programme in diminished and increases loan loss and reserve costs. It is believed that every

borrower is willing to repay the loan borrowed but there are factors that hinder or frustrate his intentions. This study sought to assess the influence of business characteristics on microcredit default rates both in MFIs and FIs disbursing public entrepreneurial funds in Kenya.

### **1.1 The Statement of the Problem**

Both Microfinance Institutions and the Kenyan Government have initiatives to reduce poverty among the poor through provision of microcredit and disbursements of funds to youth and women respectively. The issue of loan default is a major concern in Kenya. When loans are disbursed, it is not clear how the money is utilized and the follow up by lenders is a challenge. Many credit institutions have registered heavy losses as a result of loan default. Women Enterprise Funds by June 2016 recorded on average 49.06 percent as outstanding loans while Uwezo Funds in 2016 indicated that 5.34 billion was disbursed to 36,000 groups in Kenya and only 947 million had been recovered leaving 4.393 billion unpaid (representing 82%). However literature review and information from focus groups indicate that though credit is available to MSEs, entrepreneurs have challenges refunding the total credit borrowed and many questions therefore have arisen in this regard. Causes for delinquency and probable default are argued to include; poor appraisal and risk assessment systems, ineffective training on proper funds management, untimely disbursement of funds applied for, irregular loan supervision and follow-up during the loan period to check on delinquency among others. Loan default causes the defaulter to lose chances of accessing more credit in future while the lender increases losses and non-performing loans which consequently reduce funds to advance to more businesses and risks institution's sustainability. The success of credit institutions largely depends on management of credit advanced and therefore the need to minimize loan default rates. This study therefore sought to examine causes of high loan default rates in both MFIs and FIs as a result of business characteristics with an aim of reducing portfolio at risk in these institutions and making recommendations to MFIs, FIs and policy makers.

### **1.2 Objective of the Study**

The study sought to examine the influence of business characteristics on loan default in MFIs and FIs in Kenya.

### **1.3 Research Hypothesis**

The research sought to address the following hypothesis;

$H_{01}$ : Business characteristics are not significant in influencing loan default within MFIs and FIs in Kenya

### **1.4 Significance of the Study**

The study aimed at examining the influence of business characteristics on loan default in MFIs and FIs in Kenya which is a comparative study. The results will be beneficial to small businesses, financial institutions, policy makers and scholars.

## **II. Literature Review**

Globally microfinance fulfills one objective of facilitating accessibility of financial services to the "poor and marginalized sections of the community" (Reserve Bank of Zimbabwe, 2012). MFIs provide small loans and at times also expand their products to include micro-deposit and micro-insurance products (Orrick et al., 2001). Microfinance has been a channel through which the poor alleviate poverty by adopting some strategies as outlined by Dadzie et al., (2012) such as; engaging the informal economy whereby 50 percent of people derive their source of livelihood, mobilization of micro-saving therefore expanding the MFIs deposits and increase the capital base of these institutions, investing in women hence increases economic equality and improves the life of women and their households, facilitating national and international money remittances, facilitating development of local private sectors and helps to invest in, promoting slum conditions for slum dwellers such as homes and income generation activities and finally promoting rural areas and food production. Microfinance services have three sources namely; formal MFIs, semiformal institutions such as NGO's and informal sources (Atieno, 2001; Dadzie et al., 2012). MFIs collaborate with some commercial banks to provide financial services (Dadzie et al., 2012). Microfinance has four features namely; group lending method, targets women, offers graduated loans and their interest rates are higher than traditional banks (Ruben, 2007). Microfinance programs deal with small groups who receive loans. Each member is liable and takes responsibility of a member who defaults on a particular loan. Joint liability is normally taken as the collateral (Ruben, 2007). Group lending enhances enforcement and reliable repayment (Ruben, 2007). The group lending model uses social collateral rather than material collateral (Schurmann and Johnson, 2009). The model at times discourages people who must take responsibility when their members default. Microfinance targets mostly women because women are better in loan repayment than men (Proscovia, 2013; Magali, 2013 and Yegon et al., 2013). Reuben (2007) noted that women are better managers in loans' utilization in businesses and therefore improve their livelihoods. The number of women entrepreneurs has continued to increase worldwide and their representation is one third of all entrepreneurs (GEM, 2004). MFIs target women to give them a voice to make decisions at home, in the local community and society at large (Farhodova, 2008). Chen and Mahmud (2003)

argue that women need to exercise agency by formal schooling, active involvement in labour force and gaining capabilities for change. Mayoux (1999) argues that targeting women in microfinance to empower them in three ways through financial assistance, poverty alleviation and feminism while Chen and Mahmud (1995) introduced four elements of empowerment namely; material, cognitive, perceptual and relational.

Kabeer (1999) suggests that empowerment of women depends on their ability and determination to make choices and improper decision is disempowering. MFIs usually have a policy of graduated loans whereby the beneficiary of the loan starts small loans after which she/he gets another high amount when the repayment is done (Ruben, 2007). Interest rates charged by MFIs are relatively high, Grameen bank charges 20 percent due to overhead and transaction costs (Ruben, 2007). According to Orrick et al., (2012), interest rates charged by MFIs are higher than other banks in order to cover costs. It is expensive to provide small loans to many customers than larger amounts to few clients. Ruben compared other regions in the world and noted that Asia charged 18.9%, Europe 20%, Latin America 23.3% and Africa 38.2% (ibid). Interest rates charged depend on amount of loan, possibility of default and labor involved in loan follow up. A study in Bolivia revealed that high interest rates deterred economic development as sighted by Ruben (2007) and women who had taken loans sold some of their household items to make payments; others had to reduce food quantity and quality at home, others borrowed money from friends and others had to do manual jobs to pay the loans. Wanambisi and Bwisa (2013) noted that many MSEs had 'closed their stores due to inability to repay loans and also interests'.

Goetz and San Gupta (1996) argued that though microcredit empowers the poor, it still poses challenges in that; it may lead to worsened gender relationships and women disempowerment; it causes a burden of debt collection to the women through timely payments that may cause family problems, it also causes loan diversion, increases women's labour and insists of getting social collateral through groups to reduce loan defaults.

### **Public Entrepreneurial Funds**

MSEs are faced with changes of growth and long term survival. The government of Kenya has introduced various support initiatives on MSEs. These initiatives include provision of entrepreneurial funds such as; Women Enterprise Funds (WEF), Youth Enterprise Development Fund (YEDF), Kenya Industrial Estates (KIE) Funds and Uwezo Fund. These funds are aimed to; improve competition of MSEs, to promote social-economic development, reduce poverty among entrepreneurs and increase financial accessibility, productivity and innovation (Gitau and Wanyoike (2014). The government has also tried to come up with support systems on MSEs which include; incubation and development services and therefore established KIE as an institution to offer "financial, incubation and business development services to MSEs in the whole country" (ibid). KIE plays a key role in ensuring MSEs survive. According to Smilor (1987) incubators are beneficial in four ways; ensuring that the entrepreneurial learning curve is shortened, offering fast solutions to businesses, ensuring businesses are accessible to other entrepreneurial networks and to facilitate business development. Incubators are used for accelerating entrepreneurial process systematically and help overcome uncertainties at the early stage of a business development.

The Youth Enterprise Development Fund (YEDF) was introduced by government in June 2006 as a strategy to address the alarming youth unemployment in the country (YEDF, 2014). The fund was supposed to address the problems faced by youth owned enterprises and its objectives include; provision of loans, facilitate and attract investors to establish industrial parks, incubators and markets' facilitation, to facilitate business linkages for youth enterprises, facilitate domestic and international marketing of youth products /services, creation of job opportunities in the international labour market and provision of enterprise development services (ibid). These funds are disbursed to youth groups and individuals and are available in all constituency offices in Kenya. The loans occur in various forms namely; E-Yes (for individual), Vuka (for business expansion), Agrivijana (for green house), Anguka Chicks (for poultry incubators), Take 254 (for films) and Credit Guarantee Scheme. By the end of December 2013, a total of 260,533 enterprises had benefitted from the fund with a total disbursement of Ksh 9,306,385,519/90 through 76 financial intermediaries in Kenya (ibid).

Women Enterprise Fund is a unique program initiated by the government to empower women economically, socially and politically (SLE, 2010). This is because majority of Kenyan women are in the informal sector and generate little income and therefore the need to boost their incomes, reduce poverty, increase efficiency and hence increase their national output (ibid). It was initiated to meet the MDGs on gender equality and women empowerment through provision of affordable credit to women for starts up and business expansion. This was to facilitate wealth creation and employment (Machira et al., 2014). The main objectives of the fund is to; provide affordable credit to women for enterprise development, build women's capacity, promote market for the products locally and internationally, promote networks for SMEs and invest in infrastructure in support of women enterprises (KIPPRA,2010). The funds channeled through constituencies as C-WES i.e. Tuinuke Loan (for self-help groups) and through intermediaries partners as Jimarisha Loan (for women self-help groups and individuals at 8% interest rate (WEF, 2014). The WEF provides the following graduated loans for a

grace period of 1 – 2months in Table 2.2: The C-WES loan is given at zero interest rate. The graduated loans help to build the credit history of the borrower.

**Table 2.1: Loan Amounts for C-WES Loan**

New Cycle Amounts	Grace Period	Administration Fee	Interest Rate
100,000	2 months	5%	0%
200,000	1 month	5%	0%
350,000	1 month	5%	0%
500,000	1month	5%	0%

**Source: Women Enterprise Fund (2014)**

### Theories

The study was based on Pecking Order theory and Solidarity Group Theory. Pecking order emphasizes the need for business funding preference by considering internal funds first after which a business can go for external funding while Solidarity Group Theory examines group lending as an appropriate method of reaching many poor people that use social collateral.

### Business Characteristics

Several studies have been carried out on the relationship between business characteristics and loan default. Munene and Guyo (2013) conducted one on the influence of business characteristics as a variable on the loan default in Imenti North District, Kenya. They used a sample of 400 borrowers and 37 loan officers and measured parameters such as; age, type, location, profit, business management and the number of employees to measure business characteristics. The results showed that loan default was high in the manufacturing sector at 67.9%, followed by the service industry and thirdly agriculture. It was noted that businesses that had operated between 5-11 years had the highest loan default and those located within the municipality recorded high default cases. Out of the parameters measured the following factors considered significant; type of business, age of the business, number of employees and business profits.

The types of business that entrepreneurs engage determine the possibility of generating high incomes to pay loans. Most businesses involved in agriculture, animal husbandry and fisheries have a possibility of loan default than others as a result of weather changes that affect production (Mokhtar et al., 2012). Magali (2013) noted that the main occupation of microcredit borrowers in Tanzania was agriculture (83.3) percent, the rest 12.5 percent were in business, 3.2 percent in permanent employment and 0.9 percent in technical work. He noted that default rate of 13 % was recorded for those in agricultural activities while the rest registered 9 percent. Agricultural activities that depend on rain fed farming demonstrated an increase riskiness since the farmer has no control over production and marketing elements (Wrenn, 2005). Sileshi et al., (2013) in their study in Ethiopia established that adequate rainfall in agro-ecological area reduces the probability to default by 22.73 percent and increases the rate of loan repayment by 12.69 percent. According to Proscovia (undated), no significant difference was found between trade and agriculture in his study, however he found formal agricultural performance better than trade especially the animal husbandry sector which contradicts a study by Ledgerwood (1998), who noted that agricultural business credit demonstrated higher risk due to fluctuations in production causing differential loan performance. Findings from Majeed Pasha and Negese (2014) revealed that 75% of clients involved in non-agricultural businesses paid their loan better than those in agricultural businesses.

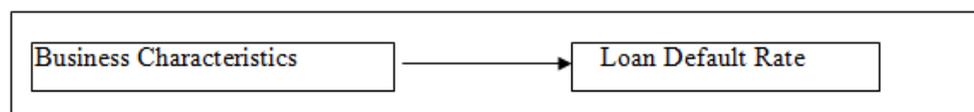
Addisu (2006) in Ethiopia noted that the amount of monthly sales are directly related to loan nonpayment, businesses mainly finance their loan repayments by use of cash flow that is created by the firm (Wang and Zhou, 2011). According to Chen (2004) in China, the following factors are important in determining capital structure of the firm: profitability, size, growth opportunity, asset structure, cost of financial distress and effects of tax shields. Mashatola and Darroch (2003) in their study on loan status of sugarcane farmers in Kwazulu-Natal, South Africa revealed that business size and liquidity are major factors in determining loan repayment. Acquah and Addo (2011) used multi regression model to explain loan repayment among on fishermen in Central Region, Ghana and revealed in his findings that loan default depends on; fishermen's' income, loan size and amount of investment. The model explained 77% of the variation in the loan repaid. This implies that there are more factors excluded in the study that explain the remaining 23% that the model did not address which needs to be tested. The study revealed that 70.1% of the fishermen had delayed repayment due to 'low catch and high debts from fish mongers' (ibid). Weele and Markowich (2001) in their study on how to manage high and hyperinflation, a case of Bulgaria and Russia, pointed out that high or hyperinflation economic conditions contribute significantly in reducing businesses' ability to repay loans. Tundui and Tundui (2013) in Tanzania revealed that multiple enterprises are negatively and significantly related to loan repayment. This implies that, the more businesses the borrower has the less the problems of loan repayment. This is because the borrower is able to use profits generated from those other businesses to pay the microcredit granted to the firm.

Magali (2013) in Tanzania noted that more years in business experience reduces loan default as a result of skills accumulated by the individual over time. Skills help one to manipulate business environments and hence able to prevent loan default. Addo and Twum (2013) argued that substantial business experience improves productivity and capital base which in return reduces the possibility of loan default. According to Tundui and Tundui (2013), the numbers of years one operates a business is not significant in determining the capacity of the borrower to repay loans, however the number of years one has been a member of microcredit programme increases business experience which translates into good business management which eventually improves efficiency and better loan repayment.

Business location is another factor to consider in loan default. According to Proscovia (undated), in Uganda, business location was found to relate to loan default considering the business income and assets. They argued that a favorable business location improves business sales and subsequently its profit and income. Studies done by Tundui and Tundui (2008), Ledgerwood (1998), Adoyo (2013), Munene and Guyo (2013), Olagunju and Adeyemo, (2007), Magali (2013) and Addo and Twum (2013) addressed a number of MFI factors that influence loan repayment, however some parameters have not been raised. Parameters location and age of business were done in FIs in Kenya by Munene and Guyo but not in MFIs. This current study addressed the same factors in MFIs and in addition, other parameters that were not included in their model which include; borrowers experience in business, size, business' portfolio and market competition. The loan officers were used as a population in the current study both in MFIs and FIs while Munene and Guyo used borrowers as their population which raises different perceptions on loan default. Studies done outside Kenya did not examine factors in FIs which the study addressed. This will help to test the results and check whether they can be duplicated in other places in Kenya.

### **Conceptual Framework**

The conceptualization of this research attempted to link loan default, the dependent variable and loan characteristics, the independent variable. This relationship is illustrated in Figure 2.1.



**Figure 2.1:** Conceptual Framework

Loan characteristics are factors relating to loan accessibility and its repayment which include; loan size, repayment mode, repayment period, type of loan and loan interest. Loan characteristics were measured in terms of amount of loan, repayment mode, repayment period, type of loan and loan interest.

### **III. Research Methodology**

Research methodology involves procedures used for examining the research objectives (Oso & Osen, 2009). Leedy and Ormrod (2001) define research methodology as “the general approach a researcher takes in carrying out a research project”. There are mainly two types of philosophies used in research namely positivism and phenomenological. Positivism is basically a scientific or empirical method, and objective while phenomenological is qualitative in nature, humanistic or interpretative (Sedgley, 2007). Descriptive survey was used in order to thoroughly investigate the population through the sample in relation to loan factors that contribute to loan default in MFIs and FIs in Kenya. Both quantitative and qualitative methods were used to address the stated objectives. The study targeted a finite population of all 48 MFIs registered and operating in Kenya as per AMFIK (2013) and 76 FIs registered as per WEF (2014). These institutions have various branches across the country. The sample consisted of 48 MFIs selected from 4 counties and 48 FIs.

In order to investigate the research objectives in chapter one, both primary and secondary data were used. A questionnaire with closed and open questions was used to balance the quality and quantity of data collected. The data collection process involved training of research assistants, after which they were sent to the selected counties in the sample to collect data. An authority letter from the university granting permission for data collection was used and introductory letter to the respondent by the researcher was used. A pick and drop method was used and each respondent was given 2-3 days to fill the questionnaire which was then collected. A pilot study to measure validity of the instrument which was not included in the analysis was done. Prior to launching a full-scale study, the questionnaire was pre- tested in MFIs and FIs in Mukurweini Town to ensure its workability in terms of: structure, content, flow and the time it takes to complete it. The opinion of research experts was also sought to proof read the instrument to check on the quality of the questionnaire and enhance validity. Reliability was tested by use of Cronbach Coefficient Alpha to confirm internal consistency of each variable measured.

Descriptive statistics were used and also inferential statistics used to draw conclusions about existing relationship and differences in the research results already found. Factor analysis was used to estimate the most significant variables which were tested in the model. A multiple regression model and Pearson correlation was used to establish relationship among variables. Data was presented by use of tables, bar graphs and pie charts and the sample statistics were used to make conclusions about the population. In order to determine the extent of loan default among MFIs and FIs, SPSS Version 21 was used to analyze data. Descriptive statistics were used to find the means and standard deviation of each variable. Standard deviation gives the distribution of scores around the mean of the distribution.

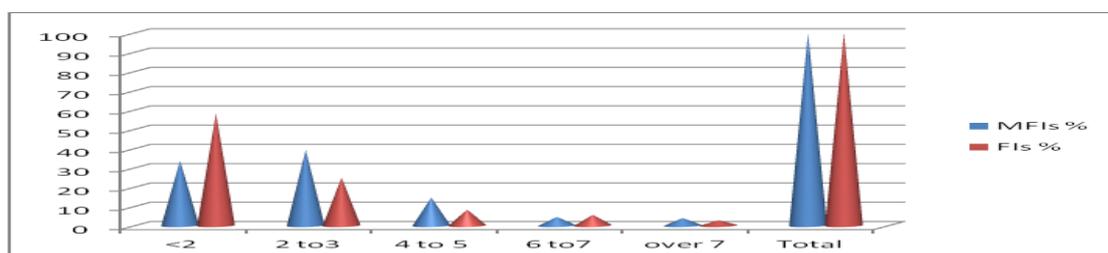
Business characteristics parameters used were; type of business, operating multiple businesses, age of business, size of business, product diversification, competition. Each parameters was measured by 5 -point Likert scale (1 –strongly disagree,2-disagree, 3- Neutral, 4-agree and 5- strongly agree). Loan default was measured by use of portfolio at risk. Factor analysis was performed on all parameters that measured each independent variable to examine the extent of correlations, and summarize and reduce the less important variables as per their factor loadings.

Exploratory Factor Analysis was performed to measure internal consistency /reliability of the measuring instrument (questionnaire) by calculating Cronbach alpha coefficients. The Kaiser-Meyer-Olkin (KMO) Measure of Sampling Adequacy and Bartlett’s Test of Sphericity were used to test the suitability of the data and number of factors to be extracted. The correlation statistical technique was used to explain the degree of association between the variables. Multiple regressions were performed on all the parameters of each parameter against the dependent variable in order to test the following null hypothesis;  $H_{01}$ : Business characteristics are not significant in influencing loan default within MFIs and FIs. Regression analysis is formed from correlation coefficients of independent variables that is expressed in form of  $Y = \beta_0 + \beta_1X_1+ \beta_2X_2+ \beta_3 X_3 +\beta_4X_4+e$  which is an equation for the best line of fit.

#### IV. Data Analysis, Presentation And Discussion

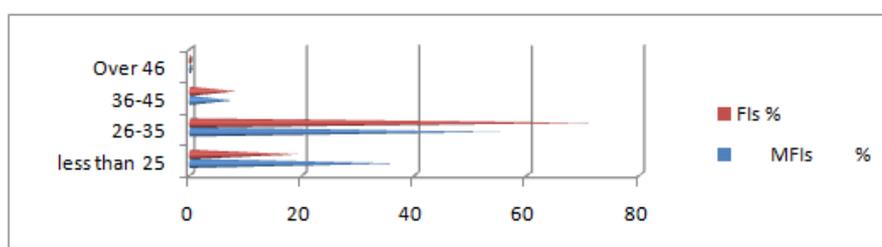
The researcher distributed 48 questionnaires to MFIs and 48 to FIs. Out of the total distributed in MFIs 36 were returned fully filled and 38 for FIs. The response rate was therefore 75 percent and 79 percent respectively. This response rate was considered adequate for the study and therefore the responses could be used for the comparative study. According to Mugenda and Mugenda (1999) response rate above 70% is considered good in a survey research. The study revealed gender parity in MFIs and FIs. In MFIs 68.5 % were males while in FIs the males constituted 63%. This implies that majority of the loan officers were men. Loans approved by male officers increase loan default by 0.35 % within one year compared to females (Agarwal and Itzahak, 2012).

Majority of clients were individuals accounting for 54.1 % in MFIs and 41.7 % FIs .The type of clients served was important in the study since people receiving loans as groups have peer pressure to pay unlike the individuals. This explains that default rate is likely to be high since individuals of microloans do not use collateral unlike self-help groups that use social collateral. This implies that members are used as guarantors against any loan given to a member. These credit institutions should lay more emphasis on group funding other than individual funding to reduce defaults. This concurs with Tundui and Tundui (2008) who observed that group lending model has various advantages in that it assists MFIs to classify and identify risks, tests cases of diversion and facilitates loan enforcement in members’ repayment. In MFIs, the respondents with less than 2 years’ experience constituted 33.7% and 2-3 years 39.3 % and 23% above 3 years as presented in Figure 4.1. Therefore those with less than 3 years’ experience constituted 73 % while in FIs majority of the respondents had less than 2 years’ experience (58.3%), 2-3 years was 25% and over 3 years was 16.7%. Therefore 83.3% had worked as loan officers for less than three years in FIs. This implies that the experience of handling clients is limited and therefore scrutinizing clients and their credit history may be a challenge. This study concurs with Gatimu et al., (2014) that majority of loan officers are less experienced in handling loans and possibility of tracking the clients’ history may be a challenge and therefore the need for institutions to place officers who are well exposed to loan procedures to manage the credit section which eventually may reduce loan default.



**Figure 4.1:** Respondent’s Experience

Age of respondents in MFIs indicated that less than 25 years was 37.1%, 26-35 years was 55.1% and over 35 presented 7.9 % as presented in Figure 4.2. These first two groups constituted 92.1% while the same groups in FIs had the following percentages; those with less than 25 years were 19.4% and 26-35 years were 72.2%, both groups constituted 91.6 % and those over 35 % presented 8.4 %. This implies that most loan officers are less than 35 years which is a clear indication that most loan officers offering microcredit in MFI and FIs are the youth Onyeagocha, et al., (2012) concluded that the higher the loan officer’s experience, the higher the possibility of recovering greater amount of loan. This argument disagrees with Agarwal and Itzhak (2012) who suggested that older loan officers approve more loans than medium- aged officers by 3.1% which eventually raises the default rate by 27.9 percent.



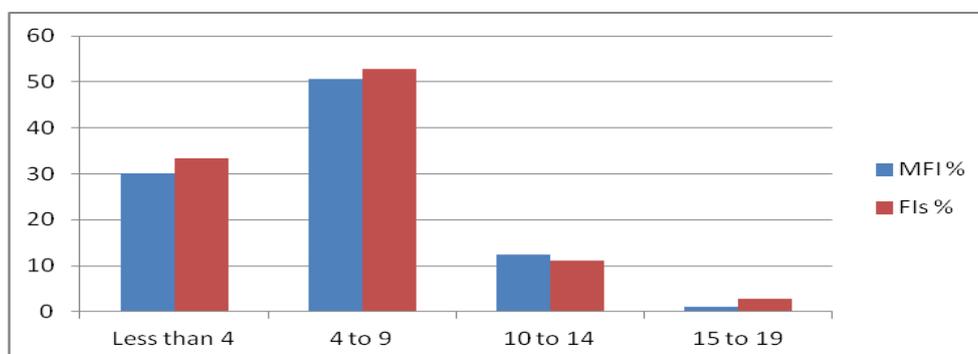
**Figure 4.2:** Respondent’s Age

It was observed from that majority of the borrowers as shown in Table 4.3 default during the “first disbursement” (42.7%) and “beyond the second disbursement” (47.2%) for MFIs and 36.1 % and 52.8 % respectively the most defaulted disbursements. It is important that MFIs do not assume that the client is able to pay any loan; the due screening process should always be followed at all times. This is consistent with Pollio and Abuodie (2010) in his study in Ghana that loan repayment among repeat borrowers deteriorate with time compared with new borrowers.

**Table 4.3:** Most Defaulted Disbursements

Number of Disbursement	MFI %	FIs %
First Disbursement	42.7	36.1
Second Disbursement	10.1	11.1
Beyond Second Disbursement	47.2	52.8
<b>Total</b>	<b>100.0</b>	<b>100.0</b>

The average default rate for MFIs in the year 2014 was 6.91% which is relatively high while that one for FIs was at 6.25. This was slightly lower than for MFIs. Figure 4.3 shows the average loan default among the MFIs for the last three years (2012-2014). The highest number of institutions had a default rate between 4 -9% consisted of 50.6 % and 10-14 were 12.4 % while those in FIs had 52.8% and 11.2 % respectively. According to United Nations (2011), the accepted world default rates is less than 5%, this implies that the credit institutions need to take critical measures to reduce this trend.



**Figure 4.3:** Distribution of MFIs and FIs Loan Default Rate

**Business Characteristics and Loan Default**

The second objective of the study was to explore the influence of business characteristics on loan default in MFIs and FIs and therefore test the null hypothesis that stated;  $H_01$ : Business’ characteristics are not significant in influencing loan default within MFIs and FIs. In business characteristics, independent variables

were regressed against the dependent variable separately for MFIs and FIs and their results shown in Tables 4.4 to 4.6.

The regression results in Table 4.4 presented the R Square and adjusted R square. In MFIs independent variables produced Adjusted R Square was 0.643, which imply that the independent variables accounted for 64.3% variation in the dependent variable. In FIs, business characteristics produced an adjusted R square of 0.450 accounting for 45% of variation in loan default. This was slightly lower than MFIs whose variation was 64.3%. This means that in FIs, 55% of the variables are unaccounted for in the model.

**Table 4.4: Business Characteristics Model Summary**

	Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
MFIs	1	.802 <sup>a</sup>	.643	.577	1.76386
FIs	1	.452 <sup>a</sup>	.204	.450	0.880

Table 4.5 presents the overall model after performing an F test was significant with F = 9.728 and p value= 0.000 which implies that independent variables strongly influence on loan default and FIs, F test was significant with a p value of 0.000 at 5% significance level (P<0.05) shows that the model was good in predicting loan default.

**Table 4.1: Business Characteristics -ANOVA<sup>b</sup>**

Model		Sum of Squares	df	F	Sig.
MFIs	Regression	151.331	5	9.728	.000 <sup>a</sup>
	Residual	84.002	30		
	Total	235.333	35		
FIs	Regression	5.557	7	4.626	.000 <sup>a</sup>
	Residual	21.666	30		
	Total	27.222	37		

Table 4.6 shows the variables that were statistically significant at 5% significant level for both MFIs and FIs. In MFIs significant parameters were; BS-business size (p =0.000), BE-borrower’s experience in business (p = 0.022), BF-business portfolio (p =0.010), FI- firm’s industry (p = 0.037) and BL-business location (p = 0.020). MC- market competition (p = 0.041). Business operation period had a p value of 0.356 therefore insignificant. In FIs, a t test indicated three significant variables whose p values were less than 0.05 namely; BS-business size (p = 0.015), BE-borrower’s experience in business (p = 0.018) and MC-market competition (p = 0.040). This confirms that loan default has some relationship with business size, borrower’s experience in business and market competition.

**Table 4.2: Business Characteristics -Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients				Standardized Coefficients		t		Sig.	
		MFIs B	FIs B	MFIs Std. Error	FIs Std. Error	MFIs Beta	FIs Beta	MFIs	FIs	MFI	FIs
1	(Constant)	.281	-2.294	.672	1.994			.419	-.151	.678	.260
	Business size (BS)	6.135	5.326	.098	.319	.757	.786	10.377	7.023	.000	.015
	Borrower’s experience in business (BE)	4.503	.207	.148	.252	.439	.153	5.146	.822	.022	.018
	Business’ Portfolio(BF)	5.062	.385	.077	.265	.515	.753	9.801	.522	.010	.450
	Firms’ Industry(FI)	3.085	0169	.115	.165	.334	.180	3.737	.950	.037	.360
	Business Location (BL)	4.327	.162	.136	.275	.437		4.725		.020	.560
	Market Competition (MC)	.136	.138	.176	.184	.152	.187	.754	.751	.041	.040
	Business Operation Period (BOP)	.168	.148	.170	.167	.189	.685	.952	.826	.356	.380

a. Dependent Variable: Loan default

A multiple regression model derived from individual co-efficient of these variables was generated as follows;  $Y = 0.281 + 0.6135 BS + 4.503 BE + 5.062 BF + 3.085 FI + 4.327 BL + 0.136 MC$  in MFIs and in FIs;  $Y = -2.294 + 5.326 BS + 4.207 BE + 0.138 MC$ . In summary, it is clear that there are more parameters causing loan default in business characteristics in MFI’s than in FIs. In MFIs firm’s industry, business location and business portfolio are significant while they are insignificant in FIs. It is evident from the findings in both MFIs and FIs that the overall model is statistically significant after F tests were performed. This implies that there exists some relationship between business characteristics and loan default within MFIs and FIs. From the two models generated  $Y = 0.281 + 0.6135 BS + 4.503 BE + 5.062 BF + 3.085 FI + 4.327 BL + 0.136 MC$  for

MFI<sub>s</sub> and  $Y = -2.294 + 5.326 BS + 4.207 BE + 0.138 MC$  for FI<sub>s</sub> none of the  $\beta$  coefficients is equal to zero therefore we reject the Null hypothesis

### V. Discussions of Results

Borrower’s business experience was statistically significant in both MFI<sub>s</sub> and FI<sub>s</sub> as discussed in Section 4.2.9.4 on business characteristics. Experience in business gives the entrepreneur opportunities to seize in generating income as supported by Tundui and Tundui (2013) in Tanzania. Tundui and Tundui found out that experienced business people are likely to have less repayment problems. This concurs with Magali (2013) who pointed out that a borrower with some business experience accumulates skills that help him to manipulate business environments and hence able to prevent loan default. This is in line with Addo and Twum (2013) who argued that substantial business experience improves productivity and capital base which in return reduces the possibility of loan default. Pollio and Abuodie (2010) also suggested that increased business operation period decreases loan default by 28% since borrowers are able to increase productivity and consequently lowers default rate. Market competition is a major cause of loan default among FI<sub>s</sub>. This is supported by a study done by Ijaza et al., (2014) who suggested that recipients of government funds face stiff market competition as a result of selling homogeneous products that lack differentiation and diversification.

Business size is a key factor in influencing loan default both in MFI<sub>s</sub> and FI<sub>s</sub>. Credit officers’ should consider the size of business in terms of stock and turnover before credit approval as this is important. This is consistent with Moti et al., (2012) who suggested that business size is an important predictor of loan default. Mashatola and Darroch (2003) in their study on loan status of sugarcane farmers in Kwazulu – Natal supports the finding in that business size and liquidity are major factors in determining loan repayment.

The type of activities a business engages in greatly determines the extent to which a loan is repaid. A study done in Tanzania (Magali, 2013) indicates that crop failure caused by rain shortages, deaths of the animals as a result of diseases led to high default rates to farmers who had loans. Udoh (2008) also argues that business failure as result of agricultural activities “increases the risk of portfolio default”. Ledgerwood (1998) concurs with those findings and reported that agricultural businesses are risky due to fluctuations in production causing poor loan performance. Findings from Majeed Pasha and Negese (2014) revealed that 75% of clients involved in non-agricultural businesses paid their loan better than those in agricultural businesses which contradicts Proscovia (undated) who noted that there was no significant difference between trade and agriculture. This was affirmed by Munene and Guyo (2013) that businesses in manufacturing sector recorded the highest default cases, followed by service industry and agriculture and trade in that order. Sileshi et al., (2013) in their study in Ethiopia established that adequate rainfall in agro-ecological area reduces probability to default by 22.73 percent and increases rate of loan repayment by 12.69 percent. Technological advancement in Kenya is equally rendering some business outdated and obsolete and therefore one must keep abreast with the relevant technology.

The location of the business is positively related to loan payment as a favorably located business attracts more customers hence able to enhance loan effectiveness. This concurs with Proscovia (undated) in Uganda who argues that a favorable business location improves business sales and subsequently its profit and income.

### Summary of Levels and Units of Analysis

The results presented in Table 4.7 outline the summary of the significant factors in both MFI<sub>s</sub> and FI<sub>s</sub> as per the findings. Some are common to both institutions and others are different.

**Table 4.7:** Summary of Levels and Units of Analysis

Factor	Significant Parameters		
	Similar parameters in MFI <sub>s</sub> & FI <sub>s</sub>	Different Parameters in MFI <sub>s</sub> & FI <sub>s</sub>	
		MFI <sub>s</sub>	FI <sub>s</sub>
Business characteristics	Business size, business experience market competition	Firm industry, business portfolio	

### VI. Summary, Conclusion And Recommendations

The second objective of the study was to explore the influence of business characteristics on loan default in MFI<sub>s</sub> and FI<sub>s</sub> and therefore test the null hypothesis that stated;  $H_{02}$ : Business’ characteristics are not significant in influencing loan default within MFI<sub>s</sub> and FI<sub>s</sub>. In business characteristics, independent variables were regressed against the dependent variable separately for MFI<sub>s</sub> and FI<sub>s</sub>. The regression results in MFI<sub>s</sub> produced indicated that the parameters measured accounted for 64.3% variation in the loan default while in

those in FIs, accounted for 45% of variation in loan default. This therefore implied a positive relationship between business characteristics and loan default in both MFIs and FIs hence the null hypothesis was rejected.

The results indicated that various variables were statistically significant at 5% significant level for both MFIs and FIs while others were insignificant. In MFIs significant parameters were; BS-business size ( $p = 0.000$ ), BE-borrower's experience in business ( $p = 0.022$ ), BF-business portfolio ( $p = 0.010$ ), FI- firm's industry ( $p = 0.037$ ) and BL-business location ( $p = 0.020$ ). MC- market competition ( $p = 0.041$ ). A multiple regression model derived from individual co-efficient of these variables was generated as follows;  $Y = 0.281 + 0.6135 BS + 4.503 BE + 5.062 BF + 3.085 FI + 4.327 BL + 0.136 MC$ . In FIs, a multiple regression model was generated for FIs as;  $Y = -2.294 + 5.326 BS + 4.207 BE + 0.138 MC$  and three significant variables whose  $p$  values were less than 0.05 namely; BS-business size ( $p = 0.015$ ), BE-borrower's experience in business ( $p = 0.018$ ) and MC-market competition ( $p = 0.040$ ). This confirms that loan default has some relationship with business size, borrower's experience in business and market competition. In summary, it is clear that there are more parameters causing loan default in business characteristics in MFI's than in FIs. In MFIs firm's industry, business location and business portfolio are significant while they are insignificant in FIs. Borrower's business experience was statistically significant in both MFIs and FIs. There is need to provide loans to MSEs that have been in operation for at least one year. Business operational period and the clients' experience in business are important factors to consider when disbursing loans. This acts as an assurance to the financial institution continuity for some time. The size of business and its location are important factors to consider when appraising loans and therefore there is dire need to physically visit the premises to assess business capability to repay loans.

### 5.1 Areas for Further Research

The researcher recommends the followings areas for further study that were not covered by this study:

- i) Explore the impact of public entrepreneurial funds on MSEs
- ii) There is need to do a comparative study on loan performance among MSEs that receive public funds and those receiving microcredit from MFIs.
- iii) Examine the influence of the business characteristics in causing loan default commercial banks.

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