THE EFFECTS OF GROUP LIABILITY LENDING ON
PERFORMANCE OF MEDIUM AND SMALL ENTERPRISES IN
NAIROBI UHURU MARKET

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OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF
MASTER OF BUSINESS ADMINISTRATION OF KENYATTA
UNIVERSITY

APRIL, 2013
DECLARATION

This research project is my own work has not been submitted to any other University for examination.

Sign: ……………………………………... Date: ……………………………

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Supervisor’s Approval

This research project has been submitted for examination with my approval as the university supervisor.

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Sign---------------------------------------- Date------------------------

F.W Shikuku Ndede
Chairman
Department of Accounting and Finance
DEDICATON

I dedicate this research project to my supervisor, to my son Gabriel and friends.
ACKNOWLEDGEMENT

I take this opportunity to first, thank God for good health and for bringing me this far. I extend my gratitude to my supervisor for his encouragement and patience in reading, his critique, correcting, re-reading and constant demand for quality work.

I recognize the support, care and encouragement from my family members, classmates and friends. May God bless all abundantly.
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<tbody>
<tr>
<td>AMFI</td>
<td>Association for Microfinance Institutions</td>
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<td>ANOVA</td>
<td>Analysis of Variance</td>
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<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
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<td>CBS</td>
<td>Central Bureau of Statistics</td>
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<td>EU</td>
<td>European Union</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GOK</td>
<td>Government of Kenya</td>
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<tr>
<td>ICEG</td>
<td>International Congress of E-government</td>
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<tr>
<td>K-REP</td>
<td>Kenya Rural Enterprise Programme</td>
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<tr>
<td>MFI</td>
<td>Micro Finance Institutions</td>
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<tr>
<td>MSE</td>
<td>Micro and Small Enterprises</td>
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<td>MSME</td>
<td>Micro, Small and Medium Enterprises</td>
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<tr>
<td>NGO</td>
<td>Governmental Organization</td>
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<td>SME</td>
<td>Small and Micro Enterprises</td>
</tr>
<tr>
<td>SPSS</td>
<td>Statistical Package for Social Sciences</td>
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<tr>
<td>USA</td>
<td>United States of America</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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OPERATIONAL DEFINITION OF TERMS

Collateral - Security of the fund given out by a financial institution.

Default - Difficulties in repayment of credit which may lead to delays or total failure to pay back the credit.

Enterprise/business - Enterprise and business will be used interchangeably to refer to an economic unit producing goods or providing services.

Entrepreneur - An individual who launches a venture and/or significantly improves it through innovative means.

Entrepreneurship - A process of creating something new with value by devoting the necessary time and effort, assuming the accompanying financial, psych and social risks and receiving the resulting rewards of monetary and personal satisfaction and independence.

Group liability - Where members of a group co-guarantee one another in loans acquired from micro financial institution.

Growth - General increase in business determined by volume of sales, rate of capital increase, profit, management improvement and addition employee level.

Micro finance institution - Non formal financial institution that offers small loans to low income earners.

Micro lending - A system of accessing small loans from the micro finance institutions.
ABSTRACT

All over the world, conventional lending to the poor has traditionally been considered infeasible as a result of the riskiness of loans that are not secured with adequate collateral. In such circumstances joint liability institutions, step in to lend to groups of people and where the entire group is considered responsible for default by any one member. In places where group lending has been practiced there have been mixed results with some enterprises growing and repaying their loans while others did not. This study therefore sought to analyze the effects of group liability on the performance of MSEs in Nairobi, Uhuru market. This is because the market is located in the largest and fast growing urban town, therefore providing an appropriate population for the study. The objectives of the study were to establish whether adverse selection and moral hazards affect performance of MSEs in Nairobi Uhuru market, to determine the effect of cost state verification on the performance of MSEs in Nairobi Uhuru Market and to explore the relationship between enforcement of laws on loans and performance of MSE’s in Nairobi Uhuru Market. This study used both primary and secondary data. Primary data was collected using questionnaires which were administered using drop and pick later method while secondary data was obtained from MSEs strategic plans, newspapers, in-house journals, electronic journals and other internet sources. Data was analyzed using descriptive statistics and represented by measures of central tendency, that is mean and standard deviation. Descriptive statistics such as mean and standard deviation were used to measure effect of group liability lending on performance of MSEs. Inferential statistics such as the as spearman correlation coefficients and ANOVA were computed to explain and allow for drawing of conclusions. The information was then presented by use of tables, bar charts, graphs and pie charts. The study found out that most of MSEs in Uhuru market rely on funds from group lending to operate and that borrowers organized in groups were more likely to be productive and repay their loans than their counterparts in individual lending. It also found that MSEs faced the challenges of high interest rates and lengthy processes of auditing of borrowers.
CHAPTER ONE

INTRODUCTION

1.1 Background Information

Group liability in micro-credit purports to improve repayment rates through peer screening, monitoring, and enforcement. However, it may create excessive pressure, and discourage reliable clients from borrowing. Ghatak (1999), Banks and other financial institutions hesitate to lend to borrowers who cannot provide adequate collateral. The reason is simple: the collateral represents the penalty for default, which, if sufficiently high in value, discourages people with low repayment potential to apply for loans. But collateral requirements also cause credit to be inaccessible to people who are poor. This tends to perpetuate poverty and underdevelopment in societies where economic backwardness and low productivity are a consequence of the scarcity of capital.

According to Schaper (2004) there is no simple or single definition of what constitutes a medium and small enterprise and a variety of both qualitative and quantitative factors can be used from the quantitative perspective, the business has to be independently owned and operated, closely controlled and funded by the owner and principal decision-making functions must rest with the owner – manager. Also it can be defined using quantitative indicators such as the number of employees, value of assets turnover, and share of ownership retained by the owner manager.

Bolton Report (1971) suggested two definitions for small enterprise. First, he suggested a qualitative or economic approach that tried to capture the range and diversity of the smaller enterprise relative to the larger enterprise. The definition suggested that a small
enterprise is one that is independent, managed in a personalized manner and relatively small share of market.

A more uniform definition adopted by the European Union (EU) which was first introduced in 1996 but was updated in 2004 to account for the impact of inflation and productivity changes. EU considers there are three types of small enterprises: micro, small and medium sized, these three groups are known as Micro, small, and medium enterprises (MSMEs), where micro enterprises have 0-9 employees. Small enterprises can be said to be an independent firm which is usually managed, funded and operated by its owners and whole staff size, financial resources and assets are comparatively small in scale. Basically small enterprises operate independently with limited resources and one or two key individuals taking most of the responsibility, risk and rewards in the project.

A micro-enterprise (or microenterprise) is a type of small business, often registered, having five or fewer employees and requiring seed capital of not more than $35,000. The term is often used in Australia to refer to a business with a single owner-operator, and having up to 20 employees. MSEs add value to a country's economy by creating jobs, enhancing income, strengthening purchasing power, lowering costs and adding business convenience. Because MSEs typically have little to no access to the commercial banking sector, they often rely on "micro-loans" or microcredit in order to be financed. Microfinance institutions often finance these small loans, particularly in the Third World. Those who found MSEs are usually referred to as entrepreneurs. In developing countries, MSEs comprise the vast majority of the small business sector—a result of the relative lack of formal sector jobs available for the poor. MSEs in developing countries, then,
tend to be the most frequent form/size of business. As explained by Aneel Karnani in the Stanford Social Innovation Review (summer 2007).

Development Commissioner, MSMEs (2006), Micro, small, and medium enterprises (MSMEs) are defined as any business activity/enterprise engaged in industry, agri-business/services, whether single proprietorship, cooperative, partnership, or corporation whose total assets, inclusive of those arising from loans but exclusive of the land on which the particular business entity's office, plant and equipment are situated, must have value falling under the following categories: The Micro, Small and Medium Enterprises (MSME) sector has been recognized as engine of growth all over the world. Many countries of the world have established a MSME Development Agency as the nodal agency to coordinate and oversee all Government interventions in respect of the development of this sector.

According to the sessional paper no.2 of 2005 and the national baseline survey of 1999, there are different criteria used to define micro and small enterprises (MSEs) based on the number of employees, the amount of capital and the degree of legality. Criteria one defines MSEs using the number of employees in the enterprise, the survey distinguished between micro enterprises employing up to 10 employees and small enterprises employing between 11 and 50 employees in both cases the owner is included. Criteria two, defines MSEs that are basically non-primary business excluding agricultural production, livestock production, fishing, hunting and gathering and forestry. The last criterion includes farm based activities that involve some form of processing before
marketing e.g. selling sour milk. In summary this study adopted and based its definition on quantitative measures.

Schaper (2004) says that, performance of micro enterprises can be measured by the financial growth of a business. Financial growth relates to the development of a business as a commercial entity. It is concerned with increase in sales, the investment needed to achieve those sales, the resulting profits and increase in what the business owns. Growth can be strategic or organizational growth. Where strategic growth relates to changes that take place in the way the organization interacts with its environment as a coherent whole. This is concerned mainly with the way the business develops its capabilities to exploit a presence in the market place. Organizational growth relates to the changes that take place in the organization, structure, process and culture as it grows and develops.

Robert (2002) notes that for the person who actually starts his or her own business the experience is filled with enthusiasm, frustration, anxiety and hard work. There is high failure rate due to such things such as poor sales, intense competition, lack of capital or lack of managerial ability. The financial and emotional risk can also be very high. This study adopted Schapers’ way of measuring performance of micro enterprise.

According to Microcredit Summit Campaign (2005) to qualify for a loan, a person has to belong to a small group of loan applicants, all of whom must be from the same village. While each person in a group receives a separate loan, the whole group is jointly liable in case of default by any of its members. What this means is that borrowers whose projects are successful may have to pay additional amounts, over and above their own dues, if any member of their group is unable to repay his loan. Thus, even though there is no
collateral, default imposes a penalty, although this is exacted from the rest of the group rather than from the individual responsible.

It is this feature of joint liability that performs the function of screening high-risk borrowers from the pool of loan applicants. Groups are formed on the basis of self-selection by borrowers who live in the same community, and who are well acquainted with each other. In traditional societies, residents of the same village usually know of each other's productive capabilities. A person regarded as a high-risk borrower by others will not be included in a group since he is more likely to default and impose a financial burden on the rest. The terms of joint liability, appropriately determined, provides incentive to borrowers to utilize their personal information on each other to ensure membership quality. (Armend´ariz de Aghion, B. and Gollier, C., 2000). This study used group liability lending and joint liability lending interchangeably.

1.1.1 Medium and small enterprises in Kenya

The medium and small enterprises (MSEs) play an important role in the Kenyan Economy. According to Longenecker, (2006), the sector contributed over 50 percent of new jobs created in the year 2005. Despite their significance, past statistics indicate that three out of five businesses fail within the first few months of operation. According to Amyx, L. (2005), one of the most significant challenges is lending and the negative perception towards MSEs. Potential clients perceive small businesses as lacking the ability to provide quality services and are unable to satisfy more than one critical project simultaneously. Often larger companies are selected and given business for their clout in
the industry and name recognition alone. As with many developing countries, there is limited research and scholarly studies about the MSE sector in Kenya.

The 1999 National Baseline Survey conducted by Central Bureau of Statistics, International Congress of E-government (ICEG) and Kenya Rural Enterprise Programme (K-Rep) Holdings provide the most recent comprehensive picture of MSEs in Kenya. Mead, A. (1998) observes that the health of the economy as a whole has a strong relationship with the health and nature of micro and small enterprise sector. When the state of the macro economy is less favorable, by contrast, the opportunities for profitable employment expansion in MSEs are limited. This is true especially for those MSEs that have linkages to larger enterprises and the economy at large. Given this scenario, an understanding of the dynamics of MSEs is necessary not only for the development of support programmes for MSEs, but also for the growth of the economy as a whole.

1.2 Problem Statement
Generally, group liability structures create incentives for group members to monitor each other’s loans. Liability falls on all the group members who contribute in repayment incase of the member’s project fails. However, even if a project succeeds some borrowers may refuse to repay or may claim that the project failed to avoid repayment.

Besley and Coate (1995) point out in their model that if borrowers cannot repay as a group, then some group members will not find it worthwhile to contribute their share of repayment, even though they would have repaid under individual lending.
Fischer (2010) conducts a series of lab experiments and found that group liability increases risk-taking, relative to individual liability contracts, as borrowers free-ride on the insurance provided by their partners.

Group liability is often cited as a key innovation responsible for the expansion of access to credit for the poor in developing countries (Morduch 1999; Armendariz de Aghion and Murdoch 2005; Microcredit Summit Campaign 2005). This contract feature purports to solve a credit market failure by mitigating adverse selection and moral hazard problems. Under group liability, clients have an incentive to screen other clients so that only trustworthy individuals are allowed into the program. In addition, clients have incentives to make sure funds are invested properly and effort exerted. Finally, enforcement could be enhanced because clients face peer pressure, not just legal pressure, to repay their loans. Thus, by effectively shifting the responsibility of certain tasks from the lender to the clients, group liability claims to overcome information asymmetries typically found in credit markets, especially for households without collateral.

Previous studies of Diagne (1998) and Aghion (1999), which focused on joint liability considered several extensions of the role of joint liability in mitigating the problem of strategic default; Diagne (1998) proposes a peer-pressure model in which borrowers are incompletely informed about their partner’s willingness to apply or to tolerate social sanctions. He shows that peer pressure works only because of a potential defaulter’s intolerance of passive social sanctions. Murdoch (1999) studied on the increasing prominence of MSEs lending, Ojo (2009) in his research on the role of micro finance in
entrepreneurship development found out that there was a significant difference in the
number of entrepreneurs who used Microfinance Institutions and those who do not.

From this background, there is scanty systematically documented information that has
been done in Kenya on the effects of group liability lending on performance of MSEs and
more so the micro enterprises in urban areas. The researcher was motivated by the
knowledge gap that existed and investigated the effect of group liability lending on
performance of, medium and small enterprises in Nairobi.

1.3 Research Objectives
1.3.1 General objective
To analyse, the effects of group liability lending on performance of medium and small
enterprises in Nairobi, Uhuru market.

1.3.2 Specific objectives
i. To establish whether adverse selection and moral hazards affect performance of
MSEs in Nairobi Uhuru market.

ii. To determine the effect of cost state verification on the performance of MSEs in
Nairobi Uhuru Market.

iii. To explore the relationship between enforcement of laws on loans and
performance of MSE’s in Nairobi Uhuru Market.

1.4 Research Questions
i. Does adverse selection and moral hazards affect performance of MSE’s in Uhuru
Market?

ii. What is the effect of cost state verification on the performance of MSE’s in
Nairobi Uhuru Market?
iii. What is the relationship between enforcement of laws on loans and performance of MSE’s in Nairobi Uhuru Market?

1.5 Significance of Study

To the government: The findings of this study are of great use to the government of Kenya. The government policy makers can use the information to develop new policies or make reforms on the existing ones.

To medium and small enterprises: The findings of this study enable micro entrepreneurs to better understand the effect of group liability lending on the performance of MSEs.

Scholars and the academicians: The findings of this study are of great use to the scholars and the academicians as they carry out their research as it adds to the already existing literature on group liability lending and MSEs performance concepts.

1.6 Scope of the Study

This study investigated group liability lending in MSEs in Nairobi Uhuru market. Data was collected from the MSEs in Nairobi Uhuru market. The medium and small enterprises were chosen because they play an important role in the country’s economy and are highly involved in group liability lending.

1.7 Limitations of the Study

The study was influenced by availability of respondents. This forced the researcher to visit the medium and small enterprises persistently which increased the operating costs. The study was also limited to Nairobi area of which the findings could be different from other enterprises operating in other counties in the country.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter reviews the available literature on group liability and performance of medium and small enterprises. The chapter covers theoretical review, joint liability and peer monitoring and effects of group liability lending on the performance of medium and small enterprises.

2.2 Theoretical literature Review
In analyzing joint lending, economists have focused on either the effects of joint liability on the pool and behavior of borrowers, or on the fact that lending to groups as opposed to individuals is a way to reduce transactions costs. While we only discuss the joint-liability aspect of these lending programs, our argument is complementary to the transactions-costs argument. According to the transactions-costs argument, under many circumstances, it is only slightly more expensive to administer a group of loans than to administer a single loan, so group lending enables a reduction in transactions costs per loan. Aghion, (1999), if the projects to be funded are simple and similar in terms of their characteristics, the time path of their returns, and the geographic location of their activities, then coordinating the lender’s dealings with these borrowers by putting them together in a group can save on processing, screening and loan collection costs. Put this way, transaction cost-based theories and joint-liability-based theories can be combined.

2.3 Empirical literature Review
Ghatak, (1999), joint liability alleviates the four main problems faced by formal credit institutions that lend to poor borrowers who cannot offer much in the way of collateral
adverse selection, moral hazard, costly audits and enforcement. We will illustrate these benefits using a simple model of lending. Our model shows how joint liability affects group formation, induces group members to influence the way other members select their projects, helps the lender avoid costly audits, and gives encourages borrowers to repay their loans without the lender imposing costly sanctions. Joint liability alleviates the four lending problems.

2.3.1 Global perspective

Globally, microfinance has greatly helped self-employed individuals with affordable and accessible business capital. While domestic and international microfinance share a common goal, domestic micro-lending methodology has been modified to accommodate the formal economies.

In the developed countries, larger loans are necessary in the United States to accommodate a relatively high cost of business operation. Group lending has proven effective in ensuring high repayment rates for MFIs abroad by providing peer support and a form of loan collateral Accion, USA, (2012).

However, conventional lending to the poor has traditionally been considered infeasible as a result of the riskiness of loans that are not secured with adequate collateral. This risk is exacerbated by the lack of sound legal infrastructure and credit scoring mechanisms. In such circumstances, joint liability institutions, which lend to groups of people and where the entire group is considered responsible for default by any one member, have had some success in lending to the poor. The results, however, have been mixed.
As Conning (1996) states (referring to Pitt and Khandker, 1996), “group lending programs have been quite successfully implemented in the United States of America (USA), Cameroon, Malawi, South Korea, Malaysia and Bangladesh but similar schemes have had problems in India, Egypt, Venezuela, Kenya and Lesotho.” This is they lack the structure, capacity and capability to do the business for which they were licensed.

Karlan and Giné (2007) noted that in the new system of Grameen Bank, one of the changes has been to relax the joint liability aspect. The reward/punishment of a borrower now depends on both her performance and group performance as opposed to only the group performance.

Focusing on the problem of strategic default, Besley and Coate (1995) and Armendariz de Aghion (1999) suggest a possible explanation for the mixed performance of group lending. Besley and Coate (1995) argue that unless social sanctions are sufficiently strong, group lending may encourage default by members who would have repaid under individual lending.

2.3.2 Regional perspective

Countries in the East African region rely heavily on microfinance providers such as commercial banks, micro-deposit taking institutions, NGOs and ‘NGO-like microfinance for loans to boost their economy. In East Africa (EA), most of the people who seek financing from these micro-finance are women, organized in groups that actively participate in productive income generating activities women reinvest up to 90% of their income into their families, whereas men simply consume most of it Kibaara, (2006).
Group lending (whereby all group members are liable) has helped women secure loans and improve the economy of the countries over the years. If one is not able to pay his or her debt, group members impose social sanctions. Belongings like furniture, utensils, or livestock may be confiscated to pay for an amount owed to the bank. Group liability has had its effects in the finance industry in East Africa. In the late 1990’s a number of banks throughout East Africa had severe financial troubles or went bankrupt (including the Cooperative Bank and the Commercial Bank of Uganda) in part because of losses made in rural areas (including due to low repayment rates). Banks then closed rural branches to consolidate costs, and new regulations introduced after the banking crisis have curtailed the risks credit institutions take. Ssemogerere, (2004)

2.3.3 Local perspective

Microfinance- related services play a vital role in Kenya's economy. An estimated 10 percent to 15 percent of the population relies entirely on NGOs and informal associations for financial services. A national survey given in 1999 estimated that 20 percent of the country's total employment was involved in microenterprises, contributing more than 25 percent of non-agricultural GDP. In 2007, Kenya passed the Microfinance Bill to regulate microfinance institutions in conjunction with the Association for Microfinance Institutions (AMFI), based in Nairobi and funded by a large USAID grant. The aim of the bill is to protect populations who are out of the scope of traditional banking services from corrupt microfinance institutions.

During the past 15 years microfinance has gained enough support from both the Government of Kenya (GoK) and International Donors to be considered an industry in itself. An estimated USD 80 Million has been received by the micro-finance industry in
Kenya thus far. In the early 1990s, the GoK established a Structural Adjustment Program that liberalized the economy and caused the GoK to support micro-enterprises to counter possible negative effects of this liberalization. Kenya was interested in supporting entrepreneurial development, hastening economic growth, and creating employment opportunities that were all considered to be hindered by lack of credit, and limited access to financial services in rural areas.

2.3.4 Adverse Selection

Diagne, (1998), adverse selection arises when borrowers have characteristics that are unobservable to the lender but affect the probability of being able to repay the loan. A lender can try to deal with this information problem directly, by trying to assess these characteristics, or indirectly by offering loan terms that only good risk will accept. The typical method for separating good risks from bad risks is to ask the borrower to pledge collateral. Risky borrowers are likely to fail more often and lose their collateral. If the bank offers two different contracts, one with high interest rates and low collateral and the other with the opposite, risky borrowers will select the former and safe borrowers the latter. But poor people by definition to do not have assets that make useful collateral, meaning that lenders have no effective way to separate good risks from bad. Group lending deals with adverse selection by drawing on local information networks to achieve the equivalent of gathering direct information on borrowers and using differences in loan terms to separate good from bad borrowers.

Several recent papers have examined the effect of joint-liability on the selection of groups. Most of these studies use an adverse-selection framework where borrowers know the characteristics of each other’s projects relevant to their creditworthiness, but the bank
does not. From now on, we will refer to these characteristics as a borrower’s ‘type’, risky or safe. While all borrowers prefer to have safe partners because of lower expected joint-liability payments. Safe borrowers value safe partners more than risky borrowers because they repay more often, and as a result more likely to realize the gain of having a safe partner. This implies that in equilibrium, borrowers end up with partners of the same type. As a consequence, the bank can screen borrowers by varying the degree of joint liability. This is because risky borrowers have risky partners and, hence, will prefer a contract with less joint liability than will a safe borrower. Ghatak (1999), saw that this assortative matching property allows the bank to screen borrowers ‘by the company they keep’ because risky borrowers are less willing than safe borrowers to accept an increase in the extent of joint liability. If the bank offers two contracts, one with high joint liability and low interest rates and the other with low joint liability and high interest rate, safe borrowers will select the former contract and risky borrowers the latter. Thus, the repayment rate and efficiency are higher under joint-liability contracts as compared to conventional individual-liability contracts because the former exploits a useful resource that the latter does not: the information borrowers have about each other.

2.3.5 Moral Hazard
Once a borrower has taken a loan, the project’s payoff depends in part on the borrower’s actions, including levels of labour and other inputs. Ordinarily, we would expect the borrower to choose these actions such that the marginal benefit of each action equals its marginal cost. That is not necessarily the case with asymmetric information. In the absence of collateral, the lender and borrower do not have the same objectives because the borrower does not fully internalize the cost of project failure. Moreover, the lender
cannot stipulate perfectly how the borrower should run the project, in part, because some of the borrower’s actions are not costlessly observable. Theories of peer monitoring are motivated by the fact that group members have an incentive to take remedial action against a partner who misuses her loan because of joint liability. With group lending, individual borrowers are made to bear liability for themselves and for others in their group, but the savings in the form of better project choice allows the bank to pass on some benefits to the borrowers in the form of reduced interest rates. Thus, group lending increases welfare and repayment rates Besley and Coate, (1995).

2.3.6 Costly credit assessment procedures

Formal lenders sometimes cannot lend to poor borrowers because such lenders cannot easily verify whether borrowers who say they cannot repay are indeed unable to do so. We are assuming that all parties are risk-neutral, which implies that the ideal contract is one in which the borrower pays a fixed fee such as an interest rate regardless of what happens. But because of the borrower’s limited wealth there may be situations where the borrower cannot pay very much, for example, when her project fails. For the bank to accept partial repayment is like charging a lower interest rate to the borrower, and if the bank applies this lower fee to all states of the world it cannot break even. At the same time, any other option introduces some degree of state contingency in the contract. Townsend, (1979), since states are costly to verify, a state-contingent contract creates an incentive for the borrower to report those states of the world where her repayment obligations are the least, irrespective of the true state. To solve the twin problems of false reporting and costs of state verification the optimal contract takes the following simple form: as long as the borrower is willing to pay a fixed fee, the bank does not audit, but if
she reports that she is unable to pay this fee, the bank audits her and takes away all her returns. This is a standard debt contract and with this kind of contract, if the borrower claims her output was too low to repay, the bank audits her and takes all her output. But if the costs of auditing borrowers are too high, there may be no contract which allows the bank to break even on loans. This problem is especially likely for groups Townsend, (1979).

2.3.7 Enforcement of repayment of loans

The final problem, enforcement, arises not from informational asymmetries but from the lender’s limited ability to apply sanctions against a delinquent borrower. Even if the borrower’s project succeeds so that she is able to repay, she may still refuse to repay if the legal system does not work very well and if the poverty of the borrower restricts the amount of effective sanctions. Besley and Coate, (1995) address the question of how joint-liability contracts affect the willingness to repay. They saw that group lending has two opposing effects on repayment rates. The advantage of groups is that they allow a member whose project yields very high returns to pay off the loan of a partner whose project does very badly. The disadvantage is that a moderately successful borrower may default on her own repayment because of the burden of having to repay her partner’s loan. However, if social ties among members are sufficiently strong, the net effect is positive because by defaulting willfully a borrower incurs sanctions from both the bank and the community. With sufficient social capital, a borrowing group enforces repayment better than would take place with individual liability.

Recent work by Diagne (1998) and Aghion (1999), has considered several extensions of the role of joint liability in mitigating the problem of strategic default. Diagne (1998)
proposes a peer-pressure model in which borrowers are incompletely informed about their partner’s willingness to apply or to tolerate social sanctions. He shows that peer pressure works only because of a potential defaulter’s intolerance of passive social sanctions. Aghion (1999) develops a model of strategic default where a borrower’s partner can verify her true project return and impose sanctions if she defaults strategically at some cost and allows for project returns of group members to be correlated. She examines the issue of optimal design of group-lending programs in terms of optimal group size and monitoring structures.

2.4 Joint Liability and Peer Monitoring under Group Lending

Group lending has received much attention recently as an effective means of financing MSE’s that lack collateralizable assets. While differing in the ways group lending schemes work in different cases, their common feature is that a group of borrowers as a whole are liable for repayment of their collective loans. The rationales for this joint liability contract have been the subject of many recent studies. For instance, authors have recognized (1) adverse selection (see Ghatak,(2000), Armendariz de Aghion and Gollier, (2000), and Sadoulet, (1998), (2) limited enforcement Besley and Coate, (1995), Armendariz de Aghion, (1999), Rai and Sj¨ostr ¨om, (2000)) and (3) moral hazard Stiglitz, (1990), Varian, (1990), Banerjee, Besley, and Guinnane (1994), and Conning, (1996), Spagnolo,(1999), as possible reasons for the emergence of joint liability contracts.

Much of this literature, particularly in the latter two categories, has singled out peer monitoring as an important benefit arising from joint liability contracts. Besley and Coate, (1995) and Rai and Sj¨ostr ¨om, (2000) argued that peer monitoring among group
members can prevent members’ shirking in their productive efforts, their poor project selection and/or their strategic default. While this literature recognizes the connection between the joint liability feature and the incentive for peer monitoring, it does not explore whether group members will indeed have incentives to sanction their peers when necessary. It is often assumed that that the members can coordinate their project choices and productive efforts through complete contracting, which seems unrealistic in many circumstances. In particular, the peer sanction behavior is left largely unexplained. Rather, it is typically assumed that group members have access to some exogenous penalty device and that they apply it whenever it is warranted.

When the group members operate their projects repeatedly, however, the free-rider problem associated with group lending can actually alleviate the incentive problems of the agents and therefore increase their credit-worthiness. We show this result without introducing an ad hoc penalty technology for the group members (such as ostracizing members who do not perform well). Rather, the joint liability feature itself makes it credible for members to penalize others through their effort decisions. Stiglitz (1990) and Varian (1990), under group lending, a member’s shirking (the lowering of his effort) increases the payment burden of his peers, and thereby negatively affecting their payoffs. This means that a group member can be penalized by other members’ shirking. If the group members observe the effort decisions of their peers, then they can use this punishment strategy to improve their incentives and thereby to enhance their ex ante credit-worthiness. It is shown that group lending can provide (weakly) better incentives than individual lending, given a mild condition, and furthermore that group lending can eliminate the incentive problem altogether (i.e., achieves the first-best outcome) if there
are sufficiently many members who are sufficiently patient and can observe one another’s effort.

2.5 Effects of Group Liability Lending on Repayment Rates
Following the success of the Grameen Bank in Bangladesh, a large number of institutions all over the world have replicated the joint liability. During the last decade, however, some institutions have departed from group lending schemes. Even the Grameen Bank itself shifted to a new system known as Grameen II in 2002 and discarded joint liability schemes. In 2005, The Economist (2005) drew attention to recent developments in microfinance and noted that a growing number of the institutions had discovered limitations of the group-lending model. The article pointed out that the members who expanded their businesses faster and required more capital felt constrained in what they could borrow, while those whose businesses grew more slowly found themselves guaranteeing big debts for other people. Besides, as group members developed personal credit histories through their loan repayments, the need for collective guarantees disappeared.

In the 1990s, most theoretical work focused on how joint liability lending can mitigate the problems of moral hazard Stiglitz (1990), Varian (1990), Banerjee, Besley and Guinnane (1994), adverse selection Ghatak (1999), Van Tassel (1999), and strategic defaults Besley and Coate (1995), (1999)). These studies attempted to clarify why group lending had succeeded in collecting money from the poor people who had been considered too poor to repay their loans while other traditional government banks lending money to the farmers and the poor with low interest rates had suffered high default rates.
Recently, light has been shed on other factors than joint liability as contributors to the success of micro finance in maintaining high repayment rates. Aghion and Morduch (2000, 2005) argue that joint liability is just one element in successful micro finance schemes and considers other important aspects of micro finance success thus far, including dynamic incentives, frequent repayment installments and public repayments. Chow Dhury (2005) illustrates the importance of dynamic incentives in micro finance programs and shows that without dynamic incentives, group lending schemes may involve under-monitoring with the borrowers investing in undesirable projects. Che (2002) points out that joint liability schemes create a free riding problem and worsen the repayment rate, but when the projects are repeated many times over, joint liability becomes more attractive than individual lending. Rai and stress the importance of cross-reporting in achieving efficiency in Group lending. One important empirical study is Karlan and Zinman (2006), who conducted a consumer credit field experiment finding strong evidence of dynamic incentives and weaker evidence of adverse selection and moral hazard. If this result should generally, then it might be the case that even if joint liability reduces adverse selection and moral hazard, this effect on repayment rates is not critical since adverse selection and moral hazard are not so serious in reality.

Another important randomized experiment is done by Gine and Karlan (2006). They randomly assigned pre-existing joint liability centers to individual lending centers in order to purge out the adverse selection effects and found that this conversion to individual lending does not change their payment rates, which casts doubt on the myth of joint liability as a better incentive scheme than individual lending. This result, however, is a combined effect of moral hazard and strategic default. Since types of the lending
schemes influence on investment (Stiglitz, 1990), effort levels, Che (2002) and strategic
default Besley and Coate (1995), we cannot conclude how and which kinds of borrowers
behavior joint liability could affect. One attempt to disentangle this composite effect is
done by Gine, Jakiela, Karlan and Murdoch (GJKM), (2006) who focus on the effect of
joint liability on borrowers investment decision by conducting experimental surveys of
investment games in Peru, where subjects just choose risky investment or safe
investment, and found that joint liability creates a free-riding problem, inducing
borrowers to choose risky investment (moral hazard) with expectation that their partners
will repay for the min case of no investment returns. But if participants were allowed to
form groups by themselves, which is often the case with real micro finance schemes, the
moral hazard was mitigated.

Returns are determined randomly in order to exclude the moral hazard effect and measure
the effect of joint liability on strategic defaults. In this sense, our work is complementary
to GJKM. Under the joint liability, participants would have higher incentives to help the
other group members since if they don’t then they would be punished. But the fact that
other members would help them if they default would give them incentives to default
strategically. That is, the joint liability might cause a free-riding problem. If this is the
case, whether the joint liability can achieve higher repayment rates or not depends on the
magnitude of the effect of helping others and the effect of free-riding. Field experiments
to consider repayment decision have also been conducted by Cassar, Crowley and
Wydick (2005). They conducted repeated public good games, which incorporated joint
liability and dynamic incentives, in South Africa and Armenia, to investigate the role of
social ties in group lending. The structure of their game is based on Abbink, Irlenbusch
and Renner (2002), who conducted an experimental study at the University of Erfurt, Germany and found that there is little difference in outcomes between self-formed groups and randomly matched groups.

### 2.6 Conceptual Framework

#### Adverse selection
- Characteristics of borrowers (risky or safe)
- Riskiness of borrowers
- Borrowers preference on partners and joint liability

#### Moral hazard
- Inability to monitor borrowers projects
- Misuse of loans
- Liability in group lending

#### Costly credit worthiness assessment
- Formal lenders risks
- Cost of CRBS
- Costs of auditing borrowers

#### Enforcement of repayment of loans
- Legal rules on repayment
- Sanctions for defaults
- Level of repayment of loans

Performance of MSEs in CBD Nairobi

#### 2.6.1 Adverse selection

This is when the nature of the business or operations alienates some people from getting the competitive advantages in a business. The study deeply examined how characteristics
of the borrowers prevented or influenced them to get loans. This was examined to determine whether the riskiness of the borrowers, joint group and individual application affect the awarding of loans by the loan providers.

2.6.2 Moral hazard

This is the misuse or use of resources for a different purpose than the one intended for in a particular undertaking. Moral Hazard would result from the fact that the lenders do not have adequate means and measures to monitor the projects thus the loans may be misused by the loan applicants.

2.6.3 Costly credit worthiness assessment

The cost of assessing credit worthiness is a factor of consideration. The cost of assessment in checking the lenders risks, the costs of the CRBs and costs of auditing borrowers should be at a certain level so as to attract some good lending.

2.6.4 Enforcement of repayment of loans

The existing and presence of rules on repayment, sanctions and level of repayment of the loans also determine the rate of credit giving and repayment in the market. When the loan laws are well enforced, then the loan repayment is better thus increasing the lending rate. This ensures more get loaned and expand their businesses.

2.6.5 Performance of MSEs in CBD Nairobi

The performance of the MSEs is subject and is depended on the functioning of the independent factors. This is majorly affected by the capital in place. This capital is obtained from the loans. The acquisition of the loans is affected by the adverse selection factors, moral hazard, Cost of credit worthiness assessment and the enforcement of the loan laws.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter provides information on the research methodology of the study. It covers the research design, population and the data collection technique to be applied, and the methods and tools that will be used to analyze the information about the study.

3.2 Research Design
Copper and Schindler (2003) define research design as “the blueprint for fulfilling objectives and answering questions”. Accordingly, Kothari (2004) contends that the research design describes the arrangement of conditions for collection and analysis of data, bringing together the relationship and rationale of the study as a means to achieve the research objectives using empirical evidence obtained economically. Research design brings out the plan of what the researcher intends to do and how to carry out the research. Copper & Schindler (2003).

In summary, a research design can be described as the plan for the collection, measurement and analysis of data

The research design was a cross sectional research design, which involved the, medium and small enterprises operating in Nairobi, Uhuru market. This method was appropriate for study since it was descriptive and aimed at providing data on the entire population.
3.3 Target Population
Population is defined as “an entire group of individuals, events, or objects having a common observable characteristic” (Mugenda & Mugenda, 2003). It consists of all elements of study in a research. The target population for this study was medium and small enterprises operating in Nairobi Uhuru market. According to the Nairobi City Council, the total number of licensed MSEs is 1560. The information was acquired from the small joint liability group leaders and the credit officers of micro finance institutions.

3.4 Sampling and sample size
Stratified sampling method was applied to select the sample which was used to analyze the whole population of study. This is because there were MSEs which were group owned, while others were private. Therefore a representative of each group was taken for comparison purposes.

Since the population of this study was less than 10, 000, the required sample size was smaller (Mugenda and Mugenda, 2003). Thus the final sample estimate was calculated using the following formula.

\[ N_f = \frac{n}{1+n}N \]

Where:
- \( N_f \) = desired sample size (when the population is less than 10, 000)
- \( n \) = desired sample size (when the population is more than 10, 000)
- \( N \) = the estimate of the population size

\[ 100/ (1+100) (0.01) = 100/1+1 \]

\[ = 100/2 = 50 \]
This study randomly selected a sample of 50 respondents. Then purposeful sampling was used to select 10 credit officers from microfinance institutions where they obtain their loans from, who provided key information.

3.5 Data Collection
3.5.1 Data collection instruments
This study sought to use both primary and secondary data to achieve the intended objectives. Primary data was collected through structured questionnaires. The questionnaires were semi-structured. According to Mugenda and Mugenda (2003) questionnaires are commonly used to obtain important information about the population. Each item in the questionnaire was developed to address a specific objective, research question or hypothesis of the study (Mugenda & Mugenda, 2003).

3.5.2 Data collection procedure
The study sought to use both primary and secondary data. Questionnaires designed to collect primary data were administered to the respective respondents and picked later to allow the respondents ample time to internalize and fill them. This was also economical and time saving. Secondary data was obtained from MSEs strategic plans, newspapers, in-house journals, electronic journals and other internet sources.

3.5.3 Pilot study
The pilot study was conducted using questionnaires which were administered to the respondents prior to the main study. Data collected during the pilot study was used in the final data analysis. The purpose of the pilot study was to ensure validity and reliability of the questionnaires. Mugenda and Mugenda (2003) asserted that, the accuracy of data to
be collected largely depended on the data collection instruments in terms of validity and reliability.

3.6 Data Analysis
Data was analyzed using descriptive statistics and represented by measures of central tendency, that is mean and standard deviation. Descriptive statistics such as mean and standard deviation were used to measure effect of group liability lending on performance of MSEs. Inferential statistics such as the as spearman correlation coefficients and ANOVA were computed to explain and allow for drawing of conclusions. The information was then presented by use of tables, bar charts, graphs and pie charts. This was done effectively using a specific program designed for descriptive statistics known as the Statistical Package for Social Science (SPSS).
CHAPTER FOUR
DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction
This chapter presents the data analysis, presentation and discussion of findings. Each finding is accompanied by a brief explanation for easy interpretation. The findings are presented as per the research objectives.

The study established a response rate of 75%. According to Mugenda and Mugenda (2003), a response rate of 50% is sufficient, 60% is good and 70% is excellent for a study. Thus a response rate of 75% was deemed highly appropriate for the study.

4.2 Demographic Information
4.2.1 Gender

The respondents in this study were required to indicate their gender. The results are as shown in Figure 4.1.

Figure 4.1: Gender
Figure 4.1 shows the gender of the respondents. According to the findings, most respondents were female (58%), while the male respondents were at 42%. This indicates the involvement of women in MSEs.

4.2.2 Age

The respondents in this study provided their age. The findings are as illustrated in Figure 4.2.

**Figure 4.2: Age**

![Bar chart showing age distribution](image)

Figure 4.2 shows the age of the respondents who participated in the study. Most of the respondents were aged between 26 – 35 years (64%), followed by those aged 36-45 years (18%) below 25 years (12%) and lastly those over 45 years (6%). This shows that most of the respondents operating MSEs in Uhuru Market, Nairobi, are middle aged people, who are at their highest energy levels. Thus the population of the MSEs is highly productive.
4.2.3 Experience In banking

Respondents provided information on their experience in banking. The results are as illustrated in Figure 4.3.

**Figure 4.3: Experience in banking**

![Bar Chart: Experience in banking]

Figure 4.3 shows the respondents experience in banking. Most of the respondents had less than 5 years experience (60%), followed by those who had 6 – 10 years (22%) and lastly, those with above 10 years (18%). This shows that most of the respondents did not have adequate experience in same bank. This could indicate the high rate of turnover among the banks in Kenya.

4.2.4 Length of time respondents had operated MSEs in Uhuru market

Respondents who participated in the study provided information on the length of time they had operated MSEs in Uhuru market, Nairobi. The results are as shown in Figure 4.4.
Figure 4.4: Length of time in Uhuru market

Figure 4.4 shows the length of time respondents had operated MSEs in Uhuru market, Nairobi. Most of the respondents had been in the market for a period of 6 – 10 years (55%), followed by those who had been in the market for over 10 years 23% and finally less than 5 years (22%). The results indicate that most of the respondents had operated in the market for a long time and were therefore qualified to give information on the subject of study. This is because they had adequate information and experience about the place.

4.2.5 Major challenges facing MSEs, Uhuru market

Respondents in this study availed information on the challenges the MSEs face in Uhuru market, Nairobi. The results are as shown in Figure 4.5.
Figure 4.5: Major challenges facing MSEs, Uhuru market

Figure 4.5 shows the major challenges faced by the MSEs in Uhuru market, Nairobi. Most of the respondents said that market for their products and services is the greatest challenge (50%), followed by those who pointed to competition (24%), then lack of managerial training (15%) and finally poor infrastructure (11%). This shows that the major problems are the lack of market for products and services and competition. Thus the local are highly lacking the market for their products and services.

4.2.6 Sources of capital

Respondents provided their sources of capital. The results are as shown in Figure 4.6
Figure 4.6: Sources of capital

![Bar chart showing sources of capital]

Figure 4.6 shows the respondents' sources of capital. Most of the respondents stated that their capital came from loans (54%), followed by those who said that their capital was from savings (33%), then grants (7%), and finally contributions from family and friends (6%). This shows that the MSEs in Uhuru market depend mostly on loans in order to operate. The study of group lending is therefore timely, appropriate, and desirable. The idea of loan and group lending should be supported in the region to benefit more MSEs operators at Uhuru Market.

4.3 Loan lending information
4.3.1 Adverse selection

Respondents in this study provided information on the factors that affect their ability to receive loans. The results are as shown in Table 4.1.
### Table 4.1: Factors that affect respondents’ ability to receive loans

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Have you ever failed to get a loan because the bank considered you to be too risky</td>
<td>4.20</td>
<td>0.73</td>
</tr>
<tr>
<td>b) Do you prefer joint lending to individual lending?</td>
<td>3.98</td>
<td>0.62</td>
</tr>
<tr>
<td>c) Are the interest rates too high?</td>
<td>3.50</td>
<td>0.57</td>
</tr>
<tr>
<td>d) Are groups highly likely to get loans from the lending institutions than an individual?</td>
<td>2.98</td>
<td>0.65</td>
</tr>
</tbody>
</table>

Table 4.1 shows the findings on various factors that affect respondents’ ability to receive loans. The responses were recorded using a five point likert scale. The scale was calibrated into five units. Where 1 represented, Strongly disagree, 2 Disagree, 3 Neutral, 4 Agree and 5 Strongly agree. The data was analyzed using descriptive statistics such as mean and standard deviation. According to the scale, those variables with a mean close to 4.0 represented Strongly agree, those with a mean close to 3.0 represented the factors which the respondents were neutral about, and variables with a mean close to 2.0 represented the factors which the respondents disagreed with. Consecutively, standard deviation was used to indicate the extent of dispersion of the responses.

From the findings on table 4.1, the respondents cited that they failed to get loans from banks because they were considered too risky (M=4.20). The study also established that most of the respondents preferred joint lending to individual lending, (M=3.98) The
interest rates are too high, (M = 3.50), and finally groups highly likely to get loans from the lending institutions than an individual (M=4.25).

The findings of the study indicate that the problem of adverse selection has played a role in determining those who get loans and those who do not. The notion and the inability of the MSE operators to have required collaterals made the banks to consider them too risky. Due to this the idea of group lending is highly welcomed by majority since the group can get a lot of cash and is not risky according to the banks as compared to the individual MSE operators.

4.3.2 Moral hazard

Respondents who participated in this study provided information on various moral hazards that affect the performance of their businesses and ability to get loans. The findings are as shown in Table 4.2

<table>
<thead>
<tr>
<th></th>
<th>Moral hazards that affect performance of businesses in Uhuru market</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>Bank have limited ability to monitor borrowers projects</td>
<td>4.32</td>
<td>0.64</td>
</tr>
<tr>
<td>b)</td>
<td>Borrowers use loans for other purposes than the intended purpose</td>
<td>3.02</td>
<td>0.54</td>
</tr>
<tr>
<td>c)</td>
<td>Members fail to pay since the liability of repaying the loan is a joint group liability</td>
<td>2.00</td>
<td>0.76</td>
</tr>
</tbody>
</table>
Table 4.2 shows the findings on various factors that affect respondents’ ability to receive loans. The responses were recorded using a five point likert scale. The scale was calibrated into five units. Where 1 represented, Strongly disagree, 2 Disagree, 3 Neutral, 4 Agree and 5 Strongly agree. The data was analyzed using descriptive statistics such as mean and standard deviation.

According to the scale, those variables with a mean close to 4.0 represented Strongly agree, those with a mean close to 3.0 represented the factors which the respondents were neutral about, and variables with a mean close to 2.0 represented the factors which the respondents disagreed with. Consecutively, standard deviation was used to indicate the extent of dispersion of the responses.

From the findings on table 4.2, the respondents agreed that banks have limited ability to monitor borrowers projects (M=4.32). The study also established that most of the respondents agreed that borrowers use loans for other purposes than the intended purpose (M=3.02) and finally respondents disagreed that members fail to pay since the liability of repaying the loan is a joint group liability (M = 2.00).

The findings indicate that there are moral hazard problems which influence the loan acquisition by the loanees. The loans obtained by the loanees may not be all taken and used by the businesses simply because there is no valid monitoring by the loan lenders.

4.4 Credit worthiness and assessment
The respondents in this study provided information on cost and processes of ascertaining credit worthiness of the loanees. The results are as shown in Table 4.3.
Table 4.3: The cost and processes of ascertaining worthiness of loanees

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>The formal procedures are too lengthy</td>
<td>4.43</td>
<td>0.56</td>
</tr>
<tr>
<td>b)</td>
<td>The costs of CRBS is high</td>
<td>4.55</td>
<td>0.75</td>
</tr>
<tr>
<td>c)</td>
<td>Costs of auditing the borrowers are too high</td>
<td>4.32</td>
<td>0.97</td>
</tr>
</tbody>
</table>

Table 4.3 shows the findings on the cost and processes of ascertaining credit worthiness of the loanees. The responses were recorded using a five point likert scale. The scale was calibrated into five units. Where 1 represented, Strongly disagree, 2 Disagree, 3 Neutral, 4 Agree and 5 Strongly agree. The data was analyzed using descriptive statistics such as mean and standard deviation.

According to the scale, those variables with a mean close to 4.0 represented Strongly agree, those with a mean close to 3.0 represented the factors which the respondents were neutral about, and variables with a mean close to 2.0 represented the factors which the respondents disagreed with. Consecutively, standard deviation was used to indicate the extent of dispersion of the responses.

From the findings on table 4.3, the respondents agreed that the formal procedures are too lengthy (M=4.43). The study also established that most of the respondents agreed that the cost of CRBs is too high (M = 4.55) and finally respondents agreed that the cost of auditing the borrowers are too high (M = 4.32).
The findings imply that the procedures of ascertaining credit worthiness are too lengthy and costly. This has affected the efficiency of loan lending by the loan lenders which in turn affects the rate at which loans are given to the MSEs to run their businesses.

4.5 Enforcement of repayment of loans
Respondents in this study provided information on various factors that affect MSEs ability to get loans. The results are as shown in Table 4.4.

Table 4.4: Factors affecting MSEs ability to secure loans

<table>
<thead>
<tr>
<th>Factor</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>There are rules on repayment of loans</td>
<td>4.32</td>
<td>0.56</td>
</tr>
<tr>
<td>The banks sanction loan defaulters</td>
<td>4.12</td>
<td>0.68</td>
</tr>
<tr>
<td>The repayment of loans is low</td>
<td>2.22</td>
<td>0.32</td>
</tr>
<tr>
<td>The banks are serious on loan repayment on individuals than group loanees</td>
<td>4.45</td>
<td>0.97</td>
</tr>
</tbody>
</table>

Table 4.4 shows the findings on the factors affecting MSEs ability to secure loans in Uhuru market. The responses were recorded using a five point likert scale. The scale was calibrated into five units. Where 1 represented, Strongly disagree, 2 Disagree, 3 Neutral, 4 Agree and 5 Strongly agree. The data was analyzed using descriptive statistics such as mean and standard deviation.
According to the scale, those variables with a mean close to 4.0 represented Strongly agree, those with a mean close to 3.0 represented the factors which the respondents were neutral about, and variables with a mean close to 2.0 represented the factors which the respondents disagreed with. Consecutively, standard deviation was used to indicate the extent of dispersion of the responses.

From the findings on table 4.4, the respondents agreed that there are rules on loan repayment (M= 4.32). This study also found out that the banks sanction loan defaulters (M = 4.12) the respondents disagreed that repayment rate of the loans is low (2.22) and finally respondents agreed that banks are serious on loan repayment on individuals than group loanees (M = 4.45).

These findings indicated that policies on loan repayment are effective in that they have contributed to reduction in loan defaults cases. This means that loan laws have played that role of controlling loan recovery.

4.6 **Other factors that affect the ability of the MSEs to get loans**

The respondents in this study cited various factors that affect their ability to secure loans. Firstly, they cited that they failed to secure loans because of failure or lateness in repayment of previous loans. Secondly, they cited credit scores as determining factors. The higher the score the better chance of securing a loan.

Thirdly, they mentioned employment history as an aspect that determined their ability to secure loans. Financial institutions make sure that the borrower is receiving some income and will continue to receive the money so as to pay back their loan.
Lastly, they cited lack of collateral as a determining factor. Collateral is important to lending institutions because it provides some protection to the financial institution because it gives them an asset they could sell to recoup the loan and their expenses with trying to collect the loan.

**4.7 Does the accessibility of loans to the groups affect the performance of the individual MSEs?**

Respondents in this study provided information on whether the accessibility of loans to the groups, affects the performance of individual MSEs. The findings are as shown in Figure 4.7.

Figure 4.7: Does the accessibility of loans to groups affect the individual performance of MSEs?

![Pie chart showing responses](image)

Figure 4.7 shows the responses of respondents on whether the accessibility of loans to groups affects individual performance of MSEs. According to the findings, most respondents stated that the accessibility of loans to groups affects the individual performance of MSEs (67%), while others said that the accessibility of loans to groups...
does not affect individual performance of MSES (33%). This indicates that the accessibility of loans to groups really does affect the performance of individual MSEs in Uhuru market. Thus the performance of the individual business is least affected by the accessibility of the loans to the groups in Uhuru Market.

4.8 Inferential statistics
4.8.1 Correlations

The relationship of the study variables was investigated using Pearson correlations. The results are shown in table 4.5.

Table 4.5: Correlations

<table>
<thead>
<tr>
<th></th>
<th>Cost of credit</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Adverse selection</td>
</tr>
<tr>
<td>Adverse selection</td>
<td>1</td>
</tr>
<tr>
<td>Sig.</td>
<td>.001</td>
</tr>
<tr>
<td>Moral hazard</td>
<td>.247</td>
</tr>
<tr>
<td>Sig.</td>
<td>.001</td>
</tr>
<tr>
<td>Costly assessment of credit worthiness</td>
<td>.041</td>
</tr>
<tr>
<td>Sig.</td>
<td>.589</td>
</tr>
<tr>
<td>MSE performance</td>
<td>.195</td>
</tr>
<tr>
<td>Sig.</td>
<td>.010</td>
</tr>
</tbody>
</table>

Pearson correlations show the relationship among variables. The range of values ranges from -1 to 1 where a negative value indicates inverse relationship and a positive value indicates a direct positive relationship. Also the magnitude of the of the Pearson results
indicates the strength of the relationship. The significance value indicates whether there is any relationship of the variables.

From the results, adverse selection is positively related with performance (p=0.010, r=0.195). This could be because of the fact that the selection produces only the most able loanees who pay without default. Moral hazard was found to be negatively related with performance (p<0.001, r=-0.315) indicating that moral hazard lead to ineffectiveness in use of loaned funds thus leading to low performance. Cost of credit worthiness was highly negatively related with performance (p<0.001, r=-0.564). Thus if the costs are high the interest charges increase on the loans which reduces the funds used for improving the performance of the MSEs.

4.8.2 Regression

A model summary of the study regression is shown in table 4.6.

Table 4.6: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.742a</td>
<td>.550</td>
<td>.382</td>
<td>.13286</td>
</tr>
</tbody>
</table>

From the table the value of the R-squared was 0.55. This means that the variables in the study explained 55% of the total variation in the dependent variable.
4.8.3 ANOVA

The ANOVA table produced is shown in table 4.7.

Table 4.7: ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>.442</td>
<td>4</td>
<td>.110</td>
<td>6.258</td>
<td>.001a</td>
</tr>
<tr>
<td>Residual</td>
<td>.530</td>
<td>30</td>
<td>.018</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>.971</td>
<td>34</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4.7 shows that the ANOVA findings, from the results the model is statistically significant for the study (F=6.258, P=0.001). Thus the model’s goodness of fit for the study was approved.

4.8.4 Coefficients of regression

The coefficients of the regression are shown in table 4.8.
### Table 4.8: Coefficients of regression

<table>
<thead>
<tr>
<th></th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>B</td>
<td>Beta</td>
</tr>
<tr>
<td>Constant</td>
<td>3.311</td>
<td>.915</td>
</tr>
<tr>
<td>Adverse selection</td>
<td>.070</td>
<td>.085</td>
</tr>
<tr>
<td>Moral hazard</td>
<td>.017</td>
<td>.032</td>
</tr>
<tr>
<td>Cost of assessing credit worthiness</td>
<td>-.268</td>
<td>.263</td>
</tr>
<tr>
<td>Loan policies and laws</td>
<td>.203</td>
<td>.201</td>
</tr>
</tbody>
</table>

Table 4.8 shows the coefficients of regression results. From the findings, all the variables were statistically significant for in the model regression. Adverse selection (t=0.81, p=0.002), moral hazard (t= -0.515, p=0.010), cost of assessing credit worthiness (t=-1.016, p=0.018) and loan repayment policies (t=1.12, p=0.011).

The study used the following regression model.

\[ Y = a + X_1 \text{ADS} + X_2 \text{MHZ} + X_3 \text{COA} + X_4 \text{LPE} + e \]

Where \( Y \) = Performance of the MSEs

\( a \) = constant

\( X_i \) = coefficient of variables of the study
ADS=Adverse selection, MHZ=Moral Hazard, COA=Cost of assessment and LPE=Loan Policy Enforcement.
e=represents the error term.

From the regression results the variable coefficients were as follows adverse selection (0.07), Moral hazard (-0.017), Cost of assessing credit worthiness (-0.268) and loan policy effects (0.203). Thus the empirical model became

\[ Y = a + 0.07\text{ADS} - 0.017\text{MHZ} - 0.268\text{COA} + 0.203\text{LPE} + e \]

From the regression results, a unit increase in the adverse selection when all the factors are kept constant increases the performance of the MSEs by 0.07, a unit increase in moral hazard when other factors are kept constant reduces the performance of the MSEs by 0.017, a unit increase in cost of assessing credit worthiness when other factors are constant reduces the performance of MSEs by 0.268. A unit increase in enforcement of loan policies and laws leads to an increase in MSE performance by 0.203 units when all other factors are kept constant.

4.9 Suggestions on group lending in Kenya in relation to the individual MSEs

Respondents who participated in this study, offered suggestions on group lending in Kenya, in relation to individual MSEs. They stated that introduction of shorter processes of auditing borrowers in groups and reduction in the interest rates charged by lenders.
CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
This chapter presents the study’s demographic information, the discussion of the findings, conclusion of the study and the recommendations of the study on the effects of group liability lending on performance of medium and small enterprises in Nairobi, Uhuru market.

5.2 Summary of the findings
This study was motivated by the need to address the following four variables. The first variable was adverse selection.

5.2.1 Adverse selection
The findings of this study indicate that respondents failed to secure loans because banks considered them too risky, they preferred joint lending to individual lending and that the interest rates of loans were too high.

The results of this study agree with Bestly and Coate, (1995) who stated that poor people by definition to do not have assets that make useful collateral. If the bank offers two contracts, one with high joint liability and low interest rates and the other with low joint liability and high interest rate, safe borrowers will select the former contract and risky borrowers the latter. This indicates that banks generally, prefer safe borrowers and those risky borrowers are likely to fail and lose collateral. This can be attributed to the fact that high interest rates are imposed on risky borrowers.
5.2.2 Moral hazard

According to the findings of this study, members do not fail to pay because the liability of repaying the loan is a joint group liability. These findings are in agreement with Besley and Coate, (1995), who stated that group lending increases welfare and repayment rates and that efficiency is higher under joint-liability contracts as compared to conventional individual-liability contracts because the former exploits a useful resource that the latter does not, i.e. the information borrowers have about each other. This indicates that repayment rates are higher in joint liability lending than in individual lending. This can be attributed to the fact that groups have information on each other and can impose sanctions on members’ property, if they fail to repay their loan.

5.2.3 Credit worthiness and assessment

According to the findings of this study, the formal procedures of ascertaining worthiness of loanees are too lengthy, the cost of auditing borrowers too high and the cost of CRBs too high.

This is in agreement with (Townsend, 1979) who stated that if a borrower is unable to a fixed fee, the bank audits her and takes away all her returns and as long as the borrower is willing to pay the fee, the bank does not audit. This indicates that the respondents consider the formal processes unnecessarily lengthy and that something needs to be done to address the issue.

5.2.4 Enforcement of repayment of loans

According to the findings, most respondents agreed that there are rules on repayment of loans but disagreed that banks sanction loan defaulters and that repayment rates are low.
These findings agree with Besley and Coate, (1995), who stated that lenders have limited ability to apply sanctions against a delinquent borrower.

The findings also disagree with Aghion, (1999) who stated that borrowers may fail to pay when their projects succeed, if the legal system does not work very well. This indicates that lenders, mostly banks, have limited ability to impose sanctions, and that borrower, in groups may fail to repay their loans. This can be attributed to the fact that banks do not have a lot of information about borrowers and that delinquent borrowers, expect other group members to bear liability for their loans.

The findings of this study also indicate that respondents provided information on other factors that affect the ability of MSEs to secure loans, whether the accessibility of loans to groups affect the individual performance of MSEs, and also offered suggestions on group lending in Kenya in relation to individual MSEs. Respondents mentioned credit scores, employment history, and lack of collateral as the factors that affect their ability to access loans and also agreed that the accessibility of loans to groups does affect the performance of individual MSEs. The suggestions respondents offered for group lending in Kenya include shorter processes of auditing borrowers in groups and reduction in the interest rates charged by lenders.

The study findings indicate that adverse selection has lead to improvement in the performance of the MSEs simply because the selected loan applicants are mostly the elite who are able to pay. The moral hazards problem leads to low performance of the MSEs; this is attributable to the fact that less cash is used for Business performance. Cost of assessing the credit worthiness has a negative effect on the performance of the MSEs.
since the banks and the lenders take more interests in turn thus reducing the cash used for business operations. Lastly, the loan laws and policies are very effective in improving the performance of the MSEs.

5.3 Conclusions
This study concluded that group liability lending improves the productivity and repayment rates of loans. This is mainly because every group member is forced to work harder or risk losing their property (collateral) and the fact that in group lending, group members bear liability of loans of other members who fail to pay their loan. Members whose projects are doing well can also come in to pay for those whose projects have failed.

The study concludes that the problem of adverse selection is highly affecting the MSEs operators in obtaining the loans. The banks usually consider the collaterals of the loan applicants to assess their credit worthiness. This has alienated majority of the MSEs since they lack the necessary assets to support their loan applicants.

The study concludes that moral hazard has been a major problem in obtaining loans for the MSE operators. The group lending has had negative effects as some group members may take advantage of group liability and fail to repay their loans even when their projects are doing so well. Also lack of proper monitoring by the lenders leaves the loan applicants with options of deciding what do to with the money. Thus some have misused the money.

The study concludes that the processes of determining the credit worthiness of a MSEs is highly procedural. This has made it to be too high and inefficient. The services of the
CRBs are efficient but too high for the lenders causing them to only extend loans to some people and charging high interest rates.

The study concludes that loan repayment laws and policies are very effective in controlling loan repayment. Although banks have never imposed sanctions on the loan defaulters, the repayment rates are good and not low. The sound practices used by the loan lenders are highly influential and have contributed to increased loan repayment.

Since MSEs have limited access to banks and few collateralizable assets, they mostly rely on microfinance institutions that impose high interest rates on borrowers and hence affect their repayment rates. There is need for financial institution to reduce interest rates on borrowers.

5.4 Recommendations
The study’s findings revealed that group lending is an important contribution in the growth and development of MSEs in Nairobi, Uhuru market. Most of the respondents who operate MSEs in the market rely on loans. The problem arises with the high interest rates and lengthy processes of auditing worthy borrowers. It is recommended that the government of Kenya and Central bank of Kenya (CBK) set less stringent measures on interest rate charges and shorter formal processes of auditing borrowers.

The study found that credit assessment processes are too lengthy and costly which in turn increases the charges on the loans. It is recommended that the banks use computer and a universal credit information data base for quick assessment to enhance the efficiency of the loan assessment.
The study found that sound loan policies and laws prevent loan default and increase loan repayment. This increases the amount of money available for more loans to be awarded. It is therefore recommended that loan repayment policies be framed well in order to adequately effect repayment of loans to increase the lending.

The study has established that group lending is advantageous in many ways than individual loan applications. Thus the study recommends that the MSEs be sensitized about the importance of group lending so as to get loans through groups other than as individuals to reduce adverse selection problem and allow more to access the loans even without collaterals.

5.5 Suggestions for further studies
This study collected data only from the MSEs operating in Nairobi Uhuru market, which is an urban set up. It is recommended that more studies be conducted on MSEs operating in other towns and also those operating in the rural areas of Kenya so as to better understand effects of group lending on the MSEs.
REFERENCES


Che Y., (2002). “Joint liability and peer monitoring under group lending” Co


APPENDICES

Appendix I: Introduction letter

Dear Sir/Madam,

RE: REQUEST FOR RESEARCH ASSISTANCE

I am a postgraduate student at Kenyatta University, undertaking a research project as part of the requirement for the award of my master’s degree. The topic of my research is the effects of group liability lending on performance of medium and small enterprises in Nairobi Uhuru market.

Your business has been selected as my case study I therefore write to kindly request you to fill the attached questionnaire form. The information provided will be treated with confidence and will be used solely for academic purpose.

Yours Sincerely,

DORIS MOIGE MAOBE
Appendix II: Questionnaire

Section A: Demographic information

1. Indicate your gender.
   
   Male [ ]  Female [ ]

2. Indicate your age.
   
   Below 25 years [ ]
   26-35 years [ ]
   36-45 years [ ]
   Above 45 years [ ]

3. Experience in banking.
   
   Less than 5 years [ ]
   6-10 years [ ]
   Above 10 years [ ]

4. How long have been in this market (Uhuru)?
   
   Less than 5 years [ ]
   6-10 years [ ]
   Above 10 years [ ]

5. State the major challenges facing your business
   
   ……………………………………………………………………………………………
   ……………………………………………………………………………………………
   ……………………………………………………………………………………………
   ……………………………………………………………………………………………
   ……………………………………………………………………………………………
   ……
   ……

57
6. What were your sources of capital?

- Savings [ ]
- Family and friends [ ]
- Loans [ ]
- Grants [ ]
- Other (specify)

Section B: Loan lending information (Adverse selection)

7. Indicate the extent to which the following factors affect your ability to receive loans.

Tick appropriately using a likert scale of 5 where 5= strongly agree, 4= Agree 3=
Neutral and 2= Disagree and 1= strongly disagree.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you ever failed to get a loan because the bank considered you to be too risky?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you prefer joint lending to individual lending?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are the interest rates too high?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are groups highly likely to get loans from the lending institutions than an individual?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Moral hazard

8. Indicate whether the following factors on moral hazards affect the performance of your business and ability to get loans. Tick appropriately using a likert scale of 5 where 5= strongly agree, 4= Agree 3= Neutral and 2= Disagree and 1= strongly disagree.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank have limited ability to monitor borrowers projects</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrowers use loans for other purposes than the intended purpose</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Members fail to pay since the liability of repaying the loan is a joint group liability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Costly credit worthiness assessment

9. To what extent do you approve or disapprove the following factors on cost and processes of ascertaining credit worthiness of the loanees. Tick appropriately using a likert scale of 5 where 5= strongly agree, 4= Agree 3= Neutral and 2= Disagree and 1= strongly disagree.
<table>
<thead>
<tr>
<th><strong>The formal procedures are too lengthy</strong></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The costs of CRBS is high</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Costs of auditing the borrowers are too high</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Enforcement of repayment of loans**

10. To what extent do the following aspects affect the ability of MSEs to get loans.

   Indicate by a tick where appropriate.

<table>
<thead>
<tr>
<th><strong>There are rules on repayment of loans</strong></th>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The banks sanction loan defaulters</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>The repayment of loans is low</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>The banks are serious on loan repayment on individuals than group loanees</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
11. Apart from the above factors what other factors affect the ability of the MSEs to get loans

---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------

12. Does the accessibility of loans to the groups affect the performance of the individual MSEs?

Yes [ ] No [ ]

13. Any suggestions on group lending in Kenya in relation to the individual MSEs.

---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------
---------------------------------------------------------------------------------------------

Thank you
Appendix III: list of MSEs in Uhuru Market.
Miseancara Misson support Proans Ireland
Dahala Investment
Superior Design
Bontex Dyeing Centre
Lydia Knitting Centre
Tonny Enterprises
School shoes Shop
School uniform shop
Tiroro Enterprises
Business Board
Restoration Hotel
Rose Hair Saloon
Harriel Hair Dressing
Warimu Hotel
Kwa nyangwesi Matumbo Fresh
Winnie's Café
Ndegwa Photo Music
Bubble Mini Bakery
Kolwa Laundry
Kk Foto studio
Milani Enterprises
Chonjo Tailoring and Textile
Uhuru Bookshop, Exercise books and Ball pens
Jamuki enterprises
School of uniforms
Hilton ndogo shop
Enjoyable shop
Nemuma cereals General
Arri clothing
Mwikali hope hair salon
Chrisy bar and restaurant
E-moss cosmetics & M-pesa
Mashambani quality furnitures
New hunters choma zone
Centrifugal electrical
Wanga General Stores working gas and food stuffs
Flo café
Sanctuary Enterprises LTD
Super class Salon
Urifod Clinic
Senator dry cleaners
Modern lady beauty Salon
Venture computer training college and Photostudio
Neet café
CET chonjo ENT for tailoring and textile accessories
Bizfirst enterprises LTD
Sewing master for industries domestic spare parts and electronics

Jomuki knitting machine dealers for new and used machines and spare parts

School uniform and mobile services

Block A Stalls
Block B Stalls
Block C Stalls
Block D Stalls
Modern A Stalls
Modern B Stalls
Modern C Stalls
Modern D Stalls
Modern E Stalls
Modern F Stalls
Modern G Stalls
Modern H Stalls
Modern I Stalls
Modern J Stalls
Modern A Stalls

Source Uhuru Market Management.