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**A SURVEY OF FACTORS INFLUENCING LOAN DEFAULTS OF SMALL  
MICRO MICRO-ENTERPRISES FINANCED BY CO-OP BANK**

**RESEARCH PROPOSAL**

**SUBMITTED BY**

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**DECLARATION**

This project proposal is my original work and has not been submitted to any other university or Institution for examination and award.

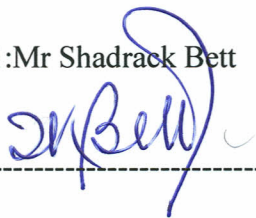
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This is dedicated to the Almighty God who has enabled me reach this far; to my loving Wife Fridah for her support ,to my dearest Daughter Kawira ,My Supervisors Mr Shadrack Bett ,Mr Robert Nzulwa ,My Dad and Mum for Support ,Family and Friends for their tireless support during this period of research. Indeed May God Bless You All Abundantly.

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## ABBREVIATIONS

MFI – Micro Finance Institution

SME- Small Micro Enterprises

Co-op Bank-Co-operative Bank

PAR-Portfolio at risk

CIS-Credit Information Sharing

CRB-Credit Reference Bureau

CRB-Africa- Credit Reference Bureau Africa

SACCO –Savings and Credit Co-operative Society

CBK-Central Bank Of Kenya

HELB-Higher Education Loans Board

KYS –Know Your Customer

ME-Micro Enterprise

N.C.B.D -Nairobi Central Business District

NPAs-Non Performing Advances

NPL-Non Performing Loans

NPA-Non-performing Asset

OECD-Organisation for Economic Co-operation and Development

U.S-United States of America

Ksh-Kenya shilling

CEO-Chief Executive Officer

TV -Television set

## ABSTRACT

The purpose of this study was to determine the factors influencing loan defaults of Small Micro Enterprises financed by Co-operative Bank

Loan default has lead to heavy losses to banks and other financial organisations, Over the years banks have been a victim of loan defaults. The borrowers also have over the past been affected by the high interest charged by banks.

The study will focus on certain factors which are likely considered cause of the loan defaults. These includes loan appraisal and follow up by the Bank, Economic factors, Business Failures, Interest rates ,Loan repayment schedules among others.

The study will be of importance to banks in dealing with loan defaults, Bankers in Understanding their clientele,The Government in formulating Policies dealing with loans ,Youth and SME,Credit firms and MFIs,The general public in understanding Good credit management ,Policy makers like CBK in dealing with rates charged by Banks, Donor bodies such as USAID,DANIDA and future researchers.

The research adopted a descriptive research design and a population size of 150 which was the total population of customers in selected areas In N.C.B.D Ngara ,Park road areas and are customers with loans at Co-op Bnak.A sample size of 10% was drawn from the population. A systematic sampling technique to select the respondents where every 5<sup>th</sup> customer was picked from the list was employed. Data was collected by use of both closed and open ended questionnaire method. Data was analyzed using descriptive statistics including frequency distribution means, mode and standard deviation. Data presentation was inform of pie charts ,tables and bar graphs.

At the end of the study the researcher was able to answer the research questions on Factors Influencing Loan defaults In Small Medium enterprises Financed by Co-op Bank.

## **Definition of Terms**

According to Coyle (2000) Default refers to inability to repay loan by either failing to complete the loan as per the loan agreement or neglect to service the loan.

Coyle (2000) states that a loan is a financial transaction in which one party (the lender) agrees to give another party (the borrower) a certain amount of money with the expectation of total repayment. The specific terms of a loan are often spelled out in the form of a promissory note or other contract. The lender can ask for interest payments in addition to the original amount of the loan (principal). The borrower must agree to the repayment terms, including the amount owed, interest rate and due dates. Some lenders can also assign financial penalties for missed or late payments. Credit therefore represents an amount of money that will be paid at a later date in return for benefits received earlier.

Credit risk can be defined as potential losses from losses or refusal or inability of credit customers to pay what is owed in full and in time. Credit risk exists because an expected payment might not occur. Credit risk is risk due to uncertainty in a counterparty's (also called an obligor's or credit's) ability to meet its obligations. (Bell, 1998; Bose, 1997; Eaton & Stiglitz, 1986 )

A credit rating estimates the credit worthiness of an individual, corporation, or even a country. It is an evaluation made by credit bureaus of a borrower's overall credit history. A credit rating is also known as an evaluation of a potential borrower's ability to repay debt, prepared by a credit bureau at the request of the lender (Black's Law Dictionary).

credit rating also means an assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities (Coyle 2000)

Portfolio at risk (PAR) is a measure of the amount of loan in arrears as a percentage of the total outstanding portfolio. PAR is used as a measure to know the rate of defaults. Central bank regulate PAR at 5%. This includes all the lending units in the bank a higher par shows that the bank has a portfolio which will not be paid hence poses a risk to the bank due to uncertainty. PAR will be useful in checking out if the book for Bank or MFI is wanting and measures to reduce PAR (Co-op Bank IPO 2008 report)

## CHAPTER ONE

### 1.0 INTRODUCTION

This chapter introduces the problem that is to be investigated by discussing the following issues; background to the problem, statement of the problem, objectives of the study, significance of the study, scope of the study, assumptions and limitations of the study.

#### 1.1 Background of the study

Strategic defaulting is associated with personal characteristics of the borrowers whereby there is a willful decision by the borrower to default- moral hazard, even when the benefiting business has yielded enough revenue to effect repayment (Poulton et al, 1998). Prevalence of strategic defaulting noted in developing economies is a condition for credit rationing by uninformed lender. Business failure increases the risk of portfolio default. Therefore, the probability of portfolio loan default is high in event of failure. Lender extends productive credit to his client under the condition of imperfection e.g. lending to farmers whose income will be dependent on price and crop yield. Therefore the lender cannot say with certainty that the borrower will repay under the agreed contract terms. Hence, repayment of loan by borrower is a probability decision: full repayment, partial repayment and no repayment when due (Bell,1998:Bose,1997:Eaton&Stigliz,1986).

Bank financing to SMEs in Africa is less significant and more short-term than in other developing countries. This is particularly the case for small firm financing. In the large group of developing countries, bank loans devoted to financing small firms average 13.1 percent, while only 5.4 percent of loans are allocated to such firms by banks in Africa. Similarly, bank approvals for loan applications by small firms in non-African developing countries average 81.4 percent, whereas only 68.7 percent of such applications are approved by banks in Africa. Furthermore, while an average of 47 percent of small business loans are used to finance investments (as opposed to working capital) in non-African developing countries, the figure only reaches 28 percent in African countries. Importantly, all these differences are statistically significant. Bank lending to SMEs in

Africa is also more costly than in other developing countries. Fees charged on SME loans in Africa ,an average of 1.97 percent of the loan value for small firms and 1.79 percent for medium-sized firms - are generally almost twice as high as in other developing economies. Interest rates on SME clients are also 5 to 6 percentage points higher on average in Africa than elsewhere in the developing world (Peria, 2009).

A 2004 survey of OECD countries revealed that SMEs accounted for over 90% of total number of enterprises in EEs. Furthermore, 60% of all companies in emerging economies are SMEs (The Economist, 13 November 2004).SMEs are responsible for 70% of foreign trade in China (Newberry, 2006).The International Finance Corporation (2007) reports that small and medium businesses comprise of 80 percent of the private sector in Africa. As a result of this, many governments have given policy priority in supporting the development of this sector. Kotler (2005) points out that relationship marketing entails that a business should go beyond meeting the needs of consumers to developing a long term mutually beneficial relationship. This theory goes beyond merely getting a customer to engage in a transaction to recognizing that marketing is a series of exchanges which are relational by nature especially in the service industry. Within a retail banking context, relationship marketing suggests the “activities carried out by banks in order to attract, interact with, and retain more profitable or high net-worth customers (Leverin and Liljander ,2006).

Small and medium business has become major source of employment in Kenya today unlike the past where these were considered jobs of the poor. It has played a major role in boosting of Kenya Economy and the world as whole. SME business loans have become major source of income to many commercial banks in Kenya today and across the world. Some of these loans are partly secured whereas others are fully secured. Security for most of these loans are legal charges on property, cash, chattels mortgage, insurance policies, debentures and hypothecations on stocks and shares of companies listed in the Nairobi stock exchange. Banks in the past had shied away from SME businesses and focused much on the large ones. Most of these loans were almost bring down

many banks in early 90s due to non payment hence Commercial had to diversify their loans to many customers to avoid giving one big loan to one company or individual(Business Daily Magazine 22/09/2009).

Over the last five Kenya we have experienced Banks targeting Micro Finance. Banks such as Equity,Co-operative Bank ,KRep and Family Bank were leading in Microfinance but The big banks found out that there is potential in this sector hence have now targeted the sector, these include banks such as Barclays ,KCB .There has been cases where banks were hit by fraud and forgeries and most banks are now using there own ways to fight this. Loans there a few cases here fraudsters take loan hence don't pay. In such cases the credit officer need to use a rule KYS (Know your Customer) whereby interacting with a client, the officer can be able to gather a lot of information on the customer. Banks entering in this emerging market are facing a lot of uncertainty about the risk s involved in lending (Business Journal 13<sup>th</sup> May 2009).

Many advisors in the commercial and financial world are advocating for more loans to people as long as the ability to pay can be proven. The question therefore is how can we prove that a person presenting himself for loan application is willing and able to honour his repayment obligations to the bank? This brings about the issue of asymmetric information as stated by Stiglitz and Weiss (1981) model on adverse selection and moral hazard. As the pressure mounts to advance these loans therefore, it is important to suggest better and more effective models for appraisal of loans to mitigate against credit risks which are currently imminent in many commercial banks.

The major challenge for most bankers is determining the possibility of default by a loan applicant. Many banks have come up with a loan appraisal system which sieves good credit risk customers and the bad credit risks. Several models have shown for instance that liquidity and profitability factors are important determinants of SME defaults. We also find that above average indebtedness significantly increases the probability of default (Donaldson, 1994). The legal framework in addition plays a role in determining the liability and hence the default rates. The current scoring system on the other hand indicates that young unmarried people are at a higher risk of default compared to older married family men. However there has not been an optimal solution to the problem of loan delays and ultimate loan defaults. This is to say that even with the use of these systems; portfolio at risk in many banks is still high.

The potential risk in theory is the full amounts of debts or loans but in practice only a small proportion of debts are unpaid. Coyle (2000) observed that the concern for credit managers therefore is the risk of bad debts from the marginal customers and the potential cost of over due payments. The potential risk is that a large proportion of the customers could be a high debt risk. A bank can increase its loan book but the new customers to whom it lends could be of bigger credit risk than its existing customer base. Banks must however give loans to make profits. Some credit risks are actually unavoidable because without risks, there are no returns. Banks can compensate themselves for the extra risk on marginal lending by demanding a higher return that is by charging higher interest rates to cover risk involved in default Coyle (2000)

According to Lipscombe (1991) the borrower who seeks to be lent money entrusted to the bank by its depositors, must be utmost integrity- somebody who will keep their word and who can be believed.

Banks need to come with precautionary measures to minimize the PAR these include though vetting ,check on turnovers, credit history ,other sources of income, The kind of business if its risky or not, what the competition is offering, is the credit officer compromised, death of the entrepreneur (Co-op Bank IPO Information Memorandum 2008).

The causes of loan defaults are perceived by many as obvious, just like one would argue about causes of motivation. If then the causes are that obvious, it would be expected therefore that banks should have taken the precautionary measures to mitigate this risk which more often than not, is a major cause of losses to the banks. Commercial banks have been seen to use a lot of their profits to write off a non performing loan book. The argument here therefore would mean that not all factors causing loan defaults are known for sure. Reasons for default could be unique to a specific market and market segment just as markets are different and unique in their own ways. (Business Journal March 2010)

Commercial banks have had bad loan books and hence incurred huge losses due to loan write offs. The research will investigate the factors that contributes to loan defaults in Small Micro Entrepreneurs Financed by Co-operative Bank in Nairobi

## **1.2 Statement of the Problem**

Lending institutions, either public or private, consider certain characteristics of potential borrowers before loan/credit of any kind is granted. These include economic characteristics (their capacity to make good use of additional capital, so as to generate funds for repayment of the loan in the time specified) and their personal characteristics (their likely reliability in repaying the loan, given the means to do so. Evaluation of the vectors of these factors forms the framework of decision by lending body to grant loan to intending beneficiaries on the expectation of full recovering. As such, the finite number of potential borrowers seeking credit from a lending body has different probabilities of either repaying or defaulting irrespective of the credit contract, which specify the condition of lending. However there are still high cases of loan defaulters even after thorough screening of the borrower by the lender.

It is against this background that the researcher aims to investigate the factors that influence loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi.

### **1.3 Research Objectives:**

#### **1.3.1 Broad objective**

To investigate the factors that contributes to loan defaults in Small Micro Entrepreneurs Financed by Co-operative Bank in Nairobi

#### **1.3.2 Specific Objectives**

The objectives of the study are:

1. To find out the extent to which loan appraisal and follow up contributes to loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi.
2. To find out whether Economic Factors contributes to loan defaults in small Micro entrepreneurs financed by Co-operative Bank in Nairobi .
3. To establish if effects of Business Failures Influence loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi.
4. To determine how Interest rate and loan repayment schedule influence loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi.

### **1.4 Research Questions**

1. To what extent does loan appraisal and follow up contributes to loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi?
2. Does Economic Factors such as Inflation contribute to loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi?
3. Does Business Failures Influence loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi
4. How does the interest rate and loan repayment schedule influence loan defaults in small Micro entrepreneurs financed by Co-operative Bank in Nairobi.

## 1.5 Significance of the Study

The results of the study will be beneficial to the following:

1. The research study will be of use to the Banks in efforts to deal loan defaults and adopt strategies to reduce loan defaults hence reduce losses.
2. The research project was aimed at helping the bankers in understanding their clientele. This will hence help the bank management in formulating accommodative policies and pricing for their products, as well as product design.
3. The Government-The youth fund mainly targets young Kenyans doing business hence will assist government implement policies that are accommodative. Also will be able to learn what affects the small micro entrepreneurs
4. The Credit firms and MFIs will find the research useful in vetting their loan applicants, sieving the good credit risk from bad credit risk.
5. The general public would find the research useful in understanding good credit management, to minimize their likelihood of default in case they borrowed from the banks.
6. The study will provide guidelines to policy makers in the Central Bank of Kenya on how to regulate the interest charged by commercial banks and Micro Finance institutions such as Faulu, SMEP.
7. The donor fund bodies targeting SMEs such as USAID, DANIDA
8. The study will be of importance to the future researchers as part of their literature Review and an opportunity to improve research in this area.

## 1.6 Scope of the Study

The Scope of the study will be focused to selected Micro Credit customers of the Co-operative Bank in N.C.B.D areas such as Ngara Market, Parkroad, Pangani, Riverroad, Tom Mboya, Moi Avenue and Kirinyaga Road who will constitute the scope of the study. The study will cover about 100 small business entrepreneurs in said Markets. There is population of about 10,000

SMES in the area who bank at Co-operative Bank but the survey will be limited to about 100 respondents. The business targeted are hawkers ,Bars, Butcheries, Shoesellers, motor- vehicles spare shops, Cafeteria, Boutiques, Car garages, Vegetable ,Hardware and fruit sellers, cereals among others

### **1.7 Assumptions of the Study**

It is assumed that all banks in Kenya Dealing with SMEs are faced with high default rate on their SME loans.

### **1.8 Limitations of the Study**

The following limitations are anticipated to be faced in this study:

#### **a) Funds**

The study is expected cost funds for copies, transport, library, research materials among others.

#### **b) Co-operation**

Respondents may not be willing to give relevant, reliable and valid information. These includes loan defaulters and banks customers whom shy off from giving the required information

#### **c) Time**

It is also expected that time will be limited; also fitting into the respondents schedule may also proof a challenge.

#### **d) Dishonesty among respondents**

Respondents especially those who defaulted may give the wrong information. They may frame the information on to what caused their loan to default

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter presents a review of literature pertinent to the study as presented by various researchers, scholars' analysts and authors. This chapter summarizes literature that has been reviewed and will be reviewed for the purpose of the study which is to find out the factors that contribute to loan defaults in small micro entrepreneurs financed by Co-operative Bank in Nairobi.

#### **2.2 Main Review**

##### **2.2.1 Loans defaulting by small and Medium Enterprises**

The SME and Micro-enterprise (ME) sector encompasses a very broad range of firms, from established traditional family businesses employing over a hundred people to "survivalist" self-employed people working in informal micro enterprises. While the upper end of the range is comparable across developed and developing countries, SMEs in the latter are concentrated at the lowest end (Berry, A. *et al.* 2003). The term SME usually refers only to firms operating within the formal (legally registered) economy, and attempts to relate the SR agenda to SMEs are likely to be restricted to these enterprises. Micro enterprises may be in either the formal or informal sector. However, it is not unusual for statistics to group these enterprises together, where data are available. The informal sector is significant in many developing countries (OIT, 2003).

According to Gorter and Bloem (2002) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of nonperformance in the form of bad loan provisions, or they may spread the risk by taking out insurance.

The central bank of Kenya defines NPLs as those loans that are not being serviced as per loan contracts and expose the financial institutions to potential losses (CBK, 1997). It is important to

note that non-performing loans refer to accounts whose principal or interest remains unpaid 90 days or more after due date. According to the Central Bank of Kenya Supervision Report (CBK, 1999), the level of non-performing loans had been increasing steadily from shs.56 billion in 1997, to Shs. 83 billion in 1998 to shs.97 billion in 1999. This high level of non-performing loans continues to be an issue of major supervisory concern in Kenya. China Daily(2002) points out that one method that has been successfully used is turning over the non-performing assets to Asset management companies. According to Reddy (2002), appropriate provisioning for non-performing assets (up to 50% of gross non performing assets) has been successfully used to cushion banks agents the debilitating effects of non-performing loans.

According to Donaldson (1994) Credit management functions are to identify high risk customers. Bankers probably would argue that the origins of bad debts happen during times when the economy is strong. In contrast, credit risk in decisions to lend when the economy is at the bottom of a recession could be much lower. Companies making profits in recession are likely to survive in the future when economic conditions improve. Poor lending decisions in a recession therefore should be much less common than during the years of economic growth. Bagchi (2006) defines NPLs assets or account of a borrower which has been classified by a bank as substandard, doubtful or loss asset in accordance with the directions or guidelines relating to asset classification issued by a Reserve bank. An asset becomes non-performing when it ceases to generate income for the bank on actual realization basis. An amount due under any credit facility is treated as "past due" when it has not been paid within 30 days from the due date. Due to the improvement in the payment and settlement systems, recovery climate, up gradation of technology in the banking system.

Coyle (2000) suggests various ways of trying to keep bad debts on loans to a tolerable low level including avoiding loans to risky customers, monitoring loan repayments and renegotiating loans when customers get into difficulties. Loans should only be made to borrowers who are likely to be able to repay, and who are likely to become insolvent. Loan payments are monitored and action

taken whenever a customer defaults for example failing to make a payment of interest on the due date. The bank in addition should be in a position to discuss the problem with the customer as soon as it becomes apparent. Where necessary, the loan can be called in.

### **2.2.2 Loan appraisal and follow up procedures**

Claim recovery and collateral realization processes are often very weak in Sub-Saharan African countries. This is a phenomenon common to developing countries in other regional areas as well.

This barrier to credit protection is aggravated by the fact that in many countries the issuance of titles, is extremely slow, due to the absence of appropriate procedures for registration of properties, and inadequate resources of property registration offices, Some countries are making efforts to address this problem, by accelerating the issuance of property titles, in particular in the main cities.

Credit recovery is hampered in many countries by the malfunctioning of the courts, and cumbersome legal and judicial procedures Enforcement of judgments with respects to loans in defaults take in many countries several years, with high recovery costs. Foreclosure and realization of security requires in many countries requires a judgment and order for sale by public auction (Sacerdoti, 2005).

Coyle (2000) and Bagchi (2006) add that banks and financial institutions should have a credit department which monitors loans after they are approved the banks should be able to do a loan follow-up to check if the loan was used as stated in the application some early signs such a loan delaying in the first payment, diversion of funds can be a sign of loan going bad. The banks officer should keep checking these micro loans for progress. If a business has increased stocks after loan is approved is a good sign that funds were utilized as agreed. He should be able to check if his clients have increased after loan is given or not. If the loan falls in arrears then it should be followed in less than five days to check why the entrepreneur is not paying. Banks classify as follows on the number of days it fall in arrears: good, watch, substandard , doubtful and losses.(Co-op Bank 2009 year End Results)..

### 2.2.3 Economic Factors

Environmental analysis concerning national economy consists of at least three factors namely, national economy and demand prospects, government policies concerning industrial development and availability of infrastructure facilities. Singh (1983)

Economic risk arises from economic instability and depressed or deteriorating economic conditions within a country. Borrowers must be able to repay loans from their sources of income

Some risks associated with this are: risk of insolvency of the buyer, risk of protracted default that is failure of the buyer to pay the amount due within six months after the due date, risk of non acceptance, surrendering political sovereignty and risk of exchange rate fluctuations.

Currency risk exists with any cross boarder lending because of the volatility of foreign exchange rates. It can be said to be a form of risk that arises from the change of price of one currency against another. Whenever investors or companies have business operations across national borders, they face currency risks if their positions are not hedged.

Currency fluctuations are simply the ongoing changes between the relative value of the currency issued by one country when compared to a different currency. The process of currency fluctuation is something that occurs every day and impacts the relative rate of exchange between various currencies on a continual basis. It is currency fluctuations that investors in currency exchange deals look to closely in order to generate a profit from their investments. Ben Benankes (2008)

Currency fluctuations may appear as both upward and downward movements. When currencies that are purchased by an investor demonstrate an upward movement in comparison to the

currencies used to make the purchase, there is opportunity to realize a significant return on the transaction. At the same time, if the rate of exchange remains somewhat flat, or if the base currency actually increases in relative value, the investor stands to realize no return or actually lose money in the deal. Ben Bernankes (2008)

There are a number of factors that can lead to currency fluctuations. One key factor is the current state of the economy associated with a given country. If the general perception is that a country is going through a phase where severe conditions will exist for an extended period of time, the currency of that country is likely to lose value in comparison to other countries. However, if an investor esteems that the currency of that country will only remained depressed for a given amount of time and can afford to hold on to the currency in the interim, he or she may realize a substantial profit when the country recovers and the relative value of the currency rises. Ben Bernankes (2008)

Political risks also exist when a country's government is under some political pressure form within and without. Some of the risks associated with this are risks of cancellation or non renewal of export or import licenses, war risks, risks of expropriation or confiscation of the importers company, risk of imposition of an import ban after the shipment of the goods, transfer risks which are associated with imposition of exchange controls by the importers country or foreign currency shortages, surrendering political sovereignty and influence of political parties in importers company (Daily Nation magazine 2009)

A credit risk could arise from the threat of invasion, preventing business customers from paying what they owe.

## 2.2.4 Business Failure

Prevalence of strategic defaulting noted in developing economies is a condition for credit rationing by uninformed lender. Business failure increases the risk of portfolio default. Therefore, the probability of portfolio loan default is high in event of failure. Lender extends productive credit to his client under the condition of imperfection. That is, he cannot say with certainty that the borrower will repay under the agreed contract terms. Hence, repayment of loan by borrower is a probability decision: full repayment, partial repayment and no repayment when due (Bell, 1998; Bose, 1997; Eaton & Stiglitz, 1986).

According to the Central Bank of Kenya (1999), Formation of a Credit Reference Agency where banks can exchange information on the bad borrowers is one method on trial. Furthermore, a private sector credit reference bureau is now in operation, but its full operation has been hampered by lack of legislation that may allow banks to exchange information. Business failure involves *many parties* and *large costs* and, therefore, research in the topic of corporate failure prediction has been stimulated both by private agents, who urge for an accurate failure prediction model so as to be able to take preventive or corrective actions (Neophytou et al, 2001).

Company failure generates various types of costs, not only for the direct (internal) stakeholders of the company – the entrepreneur, management and employees – but also for the direct environment of the firm – shareholders, equity and credit suppliers, clients and suppliers, the Government – and the economy as a whole. Due to ‘contagion-effects’, the costs of the failure of a firm with a large network of related companies may cause a downward spiral for the whole economy of a country (Doumpos & Zopoudinis, 1999; Bickerdyke, 1999)

According to Jessie Hagen (2000) Business where the business is unable to sustain itself hence closure or losses leading to Bank loans not paid.

Insufficient business planning, financial planning, marketing, and management are reasons why many businesses fail after less than two years. Jessie Hagen (2000) of the US Bank and Enterprise

Toronto, a program operated by the City of Toronto to help Entrepreneurs and Small Businesses, introduced a study about business planning. According to Hagen's study, 78 per cent of businesses fail due to lack of a well-developed business plan. "If you fail to plan, you plan to fail." Leadership and planning for success before it happens is essential for the success of planning, marketing, and management for businesses

Business rises and falls on leadership. According to business guru, (Brian Tracy (2005)

"Leadership is the most important single factor in determining business success or failure in our competitive, turbulent, fast-moving economy

Based on a study by Jessie Hagen (2000) of the US Bank, here are the main reasons why businesses fail:

- 1) Marketing
- 2) Poor Business Planning
- 3) Poor Financial Planning
- 4) Poor Management

#### **2.2.4.1 Marketing**

Marketing is defined by the American Marketing Association [AMA] as "the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large.

The Chartered Institute of Marketing defines marketing as "the management process responsible for identifying, anticipating and satisfying customer requirements profitably.

A different concept is the value-based marketing which states the role of marketing to contribute to increasing shareholder value. In this context, marketing is defined as "the management process that seeks to maximize returns to shareholders by developing relationships with valued customers and creating a competitive advantage

According to Jessie Hagen's (2005) study, Over 64% of the businesses surveyed in the Marketing category failed because of owners minimizing the importance of properly promoting their business followed by ignoring their competition. Again, as a business leader, one must be able to effectively

communicate their idea to the right people and understand their unique needs and wants. An entrepreneur should take initiative; take action, getting things done, and making decisions. If entrepreneur is not doing anything of significance to market and promote the r business, then it's most likely headed for business failure.

It's possible to create a business that sells the best product at the best price and still fail because no one knows it exists. Getting the word out about one's product is critical if the business is going to have any chance of becoming the thriving venture (Jessie Hagen's (2005).

A business can fail as a result of lack of marketing as a result it closes down. This will lead to loan arrears since if the source of loan repayment was from the business it will mean bad loan resulting to lose by the financial institutions (Jessie Hagen's (2005)

#### **2.2.4 .2 Lack of proper planning**

According to Jessie Hagen's (2005) study, in the Business Planning category, 78% of businesses fail due to lack of a well-developed plan. He also pointed out that "If one fails to plan, then one plans to fail." Leadership is about planning for success before it happens. Entrepreneurs need to take leadership in their businesses for a success.

Sun Tzu, the 6th century Chinese philosopher, in his epic work The Art of War, gave some sound business advice that still applies today: "When one's strategy is deep and far-reaching, then what you gain by your calculations is much, so you can win before you even fight. When your strategic thinking is shallow and near-sighted, then what you gain by your calculations is little, so you lose before you do battle."

A business needs to set up clear goals so that their obligations are meet. An entrepreneur needs to separate cash for personal use and business. Sometimes they take loans and end up using the money unwisely like drinking the loan or buying presents without investing the loan in the business where they will get profits. Bank loans are very expensive and an entrepreneur needs to plan well how best to use the money (Jessie Hagen's (2005.

#### **2.2.4.3 Poor financial planning**

According to Jessie Hagen's (2005) 82% of businesses failed due to poor cash flow management skills followed closely by starting out with too little money. Business leadership is about taking financial responsibility, conducting sound financial planning and research, and understanding the unique financial dynamics of one's business. Before even starting a business, one should show their plans to their accountants and get their counsel. Asking for the advice of someone who sees

the bottom-line realities of business day in and day out; someone who sees the birth certificates, successions, and autopsy reports of thousands of business entities. It just makes good business sense. But many people will ignore this advice and eventually meet with business disaster. He points out that: an entrepreneur should not rely on just one opinion. They should Get at least two or three opinions from different accountants to get a more informed view.

#### **2.2.4.4 Poor Management/ Mis management**

According to Jessie Hagen's (2005) 70% of businesses failed due to owners not recognizing what they don't do well and not seeking help, followed by insufficient relevant business experience. Not delegating properly and hiring the wrong people were major contributing factors to business failure in the Management category.

New business owners frequently lack relevant business and management expertise in areas such as finance, purchasing, selling, production, and hiring and managing employees. Unless one recognizes what they are not doing well, and seek help, business owners may soon face disaster. They must also be educated and alert to fraud, and put into place measures to avoid it.

Neglect of a business can also be its downfall. Care must be taken to regularly study, organize, plan and control all activities of its operations. This includes the continuing study of market research and customer data, an area which may be more prone to disregard once a business has been established. (Jessie Hagen's (2005)

A successful entrepreneur is also a good leader who creates a work climate that encourages productivity. He or she has a skill at hiring competent people, training them and is able to delegate. A good leader is also skilled at strategic thinking, able to make a vision a reality, and able to confront change, make transitions, and envision new possibilities for the future John Harmstron (1995)

#### **2.2.5 Interest rate and loan repayment schedule**

Interest rate elasticity reflects market power. The lower the elasticity, the greater the monopolistic power and the wider the spread. The effect is greater with an undiversified asset basket and with an underdeveloped money market. Elkayam (1996), assuming market power in both the deposit and the loan markets, concludes that interest spread depends on the elasticities of demand for credit and deposit. The higher the elasticity, the more competitive the market and the narrower the spread.

Interest rates targets are also a vital tool of monetary policy and are taken into account when dealing with variables like investment, inflation, and unemployment. Interest is a fee paid on borrowed assets. It is the price paid for the use of borrowed money, or, money earned by deposited funds. Assets that are sometimes lent with interest include money, shares, consumer goods through hire purchase, Interest is compensation to the lender, and for forgoing other useful investments that could have been made with the loaned asset. If the Rate of interest is high it means the entrepreneur will pay the bank more and can bring down the business since the entrepreneur will be working to repay the loan. It can result to loan defaults Lipscope (1991).

Demirguc-Kunt and Huizinga (1997) note that interest margin and interest spread are different unless there are zero non-interest bearing funds. However, spread is superior to margin as an indicator of the bank policy in determining the conditions and volume of intermediation. Coyle (2000) a banks lends money to make money .it must therefore consider the rate of interest it will

lend at, commissions and fees Lending policies for most banks stipulates particular rates for particular type of customer and the loan. A loan for high risk venture such as new business would carry high interest rates. This compensates the bank for the risk .A secured loan to a credit customer of good standing in contrast will be offered at a lower rate. The ability of a bank to lend is restricted by regulations that govern the minimum acceptable level of capital adequacy. These guidelines are called Basle Agreement Banks lend at higher rates to customers who are considered risky.

### **2.3 Critical Review**

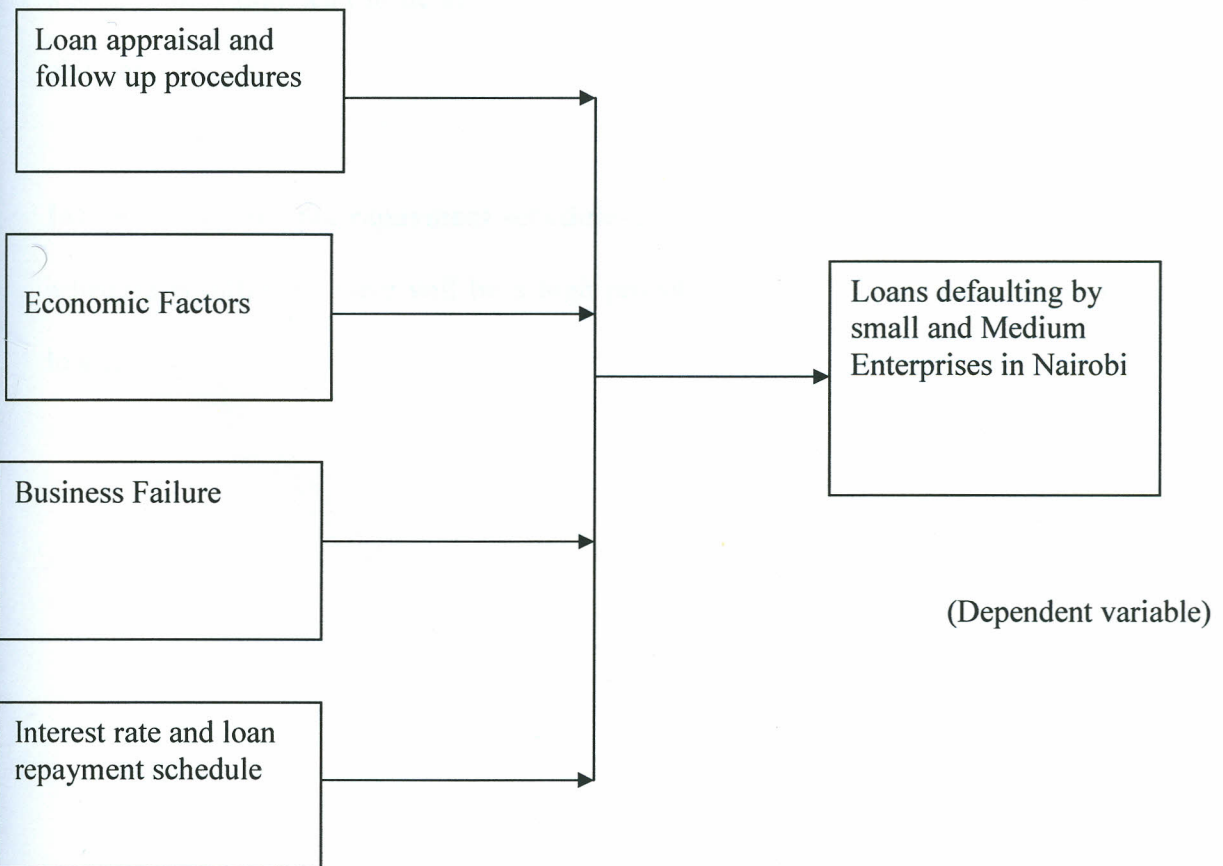
No study has been done on the factors that influence loan defaults in Small Micro entrepreneurs financed by Co-operative Bank in Nairobi, especially with the changes that have occurred in the microfinance industry since the inception of the company. Therefore the factors set in the literature may not clearly relate to the specifically to the sector.

## 2.4 Summary and gaps to be filled by the study

Many of the studies that have been done in the past have focused on the factors loan defaulting in banks. Little attention has been given to the Microfinance sector which plays a vital role of serving the public. New knowledge may be revealed or discovered thus the study will aim to improve and lift information on the topic. Given that the some of the literature is based on developed countries creates a gap that the study will aim to fill.

## 2.5 Conceptual Framework

Figure 2.1 Conceptual Framework



Independent variables

Source: Author 2010

## 2.6 EXPLANATION OF THE VARIABLES

**Loan appraisal and follow up procedures-** If loan procedures and follow up procedures are inadequate there will be leakages in revenue through defaulting as uncreditworthy individuals will be granted loans.

**Debtors characteristics-** The characteristics of the debtor will enable the lender know how reliable the creditor will and thus be able to know if the money lent will be paid. Credit history of the debtor usually aids the process.

**Business Failure-**If a business fails this will affect the ability of the individual to repay his/her loan and thus may lead to defaulting on the loan because of reduction in the debtor's financial abilities.

**Interest rate and loan repayment schedule-** if the rate of interest is high and the loan repayment schedule is inflexible there will be a high probability of default by individuals who have taken loans.

## CHAPTER THREE

### RESEARCH METHODOLOGY

#### 3.0 Introduction

This chapter describes the research design, target population, data collection procedure and data analysis procedure that will guide the study.

#### 3.1 Research Design

The research was a case study, covering the Co-operative Bank- Stima Plaza branch. A case study method was selected as the research design for this study which took place in a natural setting designated as a bounded system. Case study method focuses on what Burns (2000) contended as a bounded system, which is an entity in itself and allows in depth examination. Burns adds that the researcher can probe deeply, undertaking intensive analysis of the subject of the case study by examining the various phenomena. Study of a particular case might reveal insights, which Burns (2000) pointed that it may relate to the typical class of events from which the case has been drawn. Punch (1998) adds that case study method allows for a variety of research questions and purposes which allows the researcher to develop as full an understanding of that case as possible. Isaac and Michael (1995) contended that a case study is also exploratory in nature and the outcome of a case study may provide information and a possible hypothesis to guide future research. A case study is therefore useful to pioneer new ground which allows the researcher to bring to light important variables, processes and interactions.

The study will adopt a descriptive research design. According to Kothari (2000), descriptive research design is used when the problem has been defined specifically and where the researcher has certain issues to be described by the respondents about the problem. This is because the method is appropriate for collecting both descriptive and explanatory data concerning the topic of the study. In this case the researcher will go to the population in a bid to tackle the topic of the study.

### 3.2 The Target population

This research will focus on the SMEs loan defaulters at Co-operative bank, Stima Plaza branch. Business loans unlike any other loans of the bank pose a high risk to the bank. These are secured by movable assets Such as Motorvehicle, Household ,and Business assets, realization is tedious and more often, the proceeds from sale of such might not cover the loan adequately. Major concentration was small and medium enterprises business loan defaulters. Defaulters in this sense will be the loanees who have not honored their repayments the First day onwards. Repayments amounts which will be considered will be both principal and interest. The business loan defaulters of 120 customers from small and medium different business types will be selected. The target population will consist of selected Defaulters who are the customers of Co-op Bank Stima Plaza. This is shown in the table below.

*Table 3.1 Target Population*

<b>Number of Days in arrears</b>	<b>Frequency/Population</b>	<b>Percentage</b>
<b>1 to 7 days</b>	<b>48</b>	<b>40</b>
<b>7 to 30 days</b>	<b>22</b>	<b>18</b>
<b>30 to 60 days</b>	<b>27</b>	<b>23</b>
<b>60-90 days</b>	<b>12</b>	<b>10</b>
<b>Over 90 days</b>	<b>11</b>	<b>9</b>
<b>Total Respondents</b>	<b>120</b>	<b>100</b>

Source; Author (2010)

Use of days in default as the procedure for sampling was used to ensure all possible reasons of default are identified, both major and minor.

### 3.3 Sampling method

According to Mugenda & Mugenda (2003), a representative sample is one that is at least 10% of the population of interest. In addition this, this sampling technique should be used when the population of interest is not homogeneous, in this particular case the population of interest is composed of the number of days in arrears . These groups are mutually exclusive and are expected to give answers that are unique to the topic of the study

The stated target population will be stratified according to the number of days in default that is 1 to 7 days ,7days to 30 days, 30 to 60 days; 60 to 90 days and above 90 days. The research population will be 120 people. Systematic random sampling was used on the respondents in each of these stratum: at least 30% in each stratum will be selected and this therefore made the research sample. From a sample of 120 customers who had defaulted a sample of 30% will be drawn by use of stratified Random Sampling where the 3 rd customer in arrears will be selected for interview.

The sample will be obtained as indicated in the following table

*Table 3.2 Sample Design Method*

<b>Number of days in Days in arrears</b>	<b>Population</b>	<b>Sample ratio</b>	<b>Sample size</b>
1 to 7 days	<b>48</b>	<b>0.3</b>	<b>14</b>
7 to 30 days	<b>22</b>	<b>0.3</b>	<b>7</b>
30 to 60 days	<b>27</b>	<b>0.3</b>	<b>8</b>
60-90 days	<b>12</b>	<b>0.3</b>	<b>4</b>
Over 90 days	<b>11</b>	<b>0.3</b>	<b>3</b>
<b>Total</b>	<b>120</b>	<b>0.3</b>	<b>36</b>

Source; Author (2010)

Use of days in default as the procedure for sampling will be used to ensure all possible reasons of default are identified, both major and minor.

### **3.4 Data collection tools**

Data will be collected mainly by use of questionnaire method. Oppenheim (2001) suggests that this method of data collection ensures a high response rate and accurate sampling. He also urged that greatest care is needed in briefing the respondents, or they may, with the best intentions, introduce fatal bias.

The questionnaire used will use the Likert scale format of the '*strongly agree...strongly disagree*' style. The Likert scales tend to perform well when it comes to a reliable, ordering of people with regard to a particular subject (Oppenheim, 2001).there will be also few structured questions to get more information from the interviewees.

The questionnaire will aim at a representative sample of respondents, who will be stratified into clusters according to the table above. Questions will be directed towards the variables as brought out in the conceptual framework.

### **3.5 Data Analysis**

The data will be analyzed quantitatively using descriptive statistics. Nachmias and Nachmias (2006) says that descriptive statistics has an advantage to the researcher because it allows a researcher to organize information in an effective way and also allows information to be reduced to an understandable form .The presentation methods statistics to be used included Frequency distributions, Pie charts, Bar graphs.

It will also consider measures of central tendency especially mean, median and mode and measures of dispersion especially standard deviation. Correlation analysis will be used to compare relationship between Independent variable and dependent Variable.

The researcher will use will the Excel, SPSS software to aid in the analysis.

## CHAPTER FOUR

### DATA ANALYSIS

#### 4.0 Introduction

This chapter gives an analysis of the data collected by the researcher. The researcher collected data from 30% of the general research population. The data collected was to shed some light on why the client has defaulted in his loan repayments.

The research Total target population was 120 respondents out of which 30% were interviewed. Systematic random sampling was done in each stratum and 30% in each stratum was picked in that every third person on the loan default data base was picked. This formed the research sample of 36 respondents as shown above.

#### 4.10 Description of respondents

This section describes the respondents on their personal physical characteristic, age, Education and Years they have been in Business.

Out of the sample interviewed, 61% respondents were Male and 39 % were Female as Shown in Table 4.1.1 below

As shown on table 4.1.1 Below a large percentage of respondents who had defaulted were male with 61% and Female at 39%.

**Table 4.1.1 Gender of the respondents**

Gender	Frequency	Percentages
Male	22	61
Female	14	39
<b>Totals</b>	<b>36</b>	<b>100</b>

**GENDER OF THE RESPONDENTS**

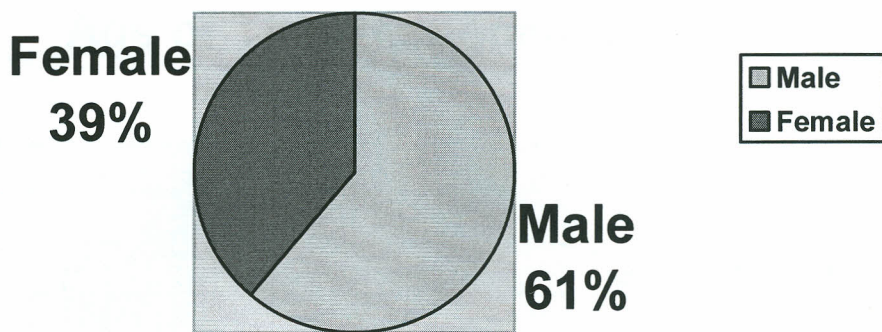


Figure 4.1.1 Frequency of Male and Female

**Table 4.1.2 Age of respondents**

The age of the respondents ranged from 18 to 75 years of age. The highest respondents were in the age group of 30 to 40 years and they comprised 44%. Others were in the age group Below 30 years comprising of 25%. 19% of the respondents were of the age 40 to 50 years. 50 to 60 years took 5% and the and 5% aged over 60 years. This is as below tabulated. (table 4.1.2)

Table 4.1.2 Age of the respondents

Age	Frequency	Percentages
Below 30	9	25
30-40	16	44
40-50	7	19
50-60	2	6
Over 60	2	6
<b>Totals</b>	<b>36</b>	<b>100</b>

The Information is also shown in the following Bar Graph below

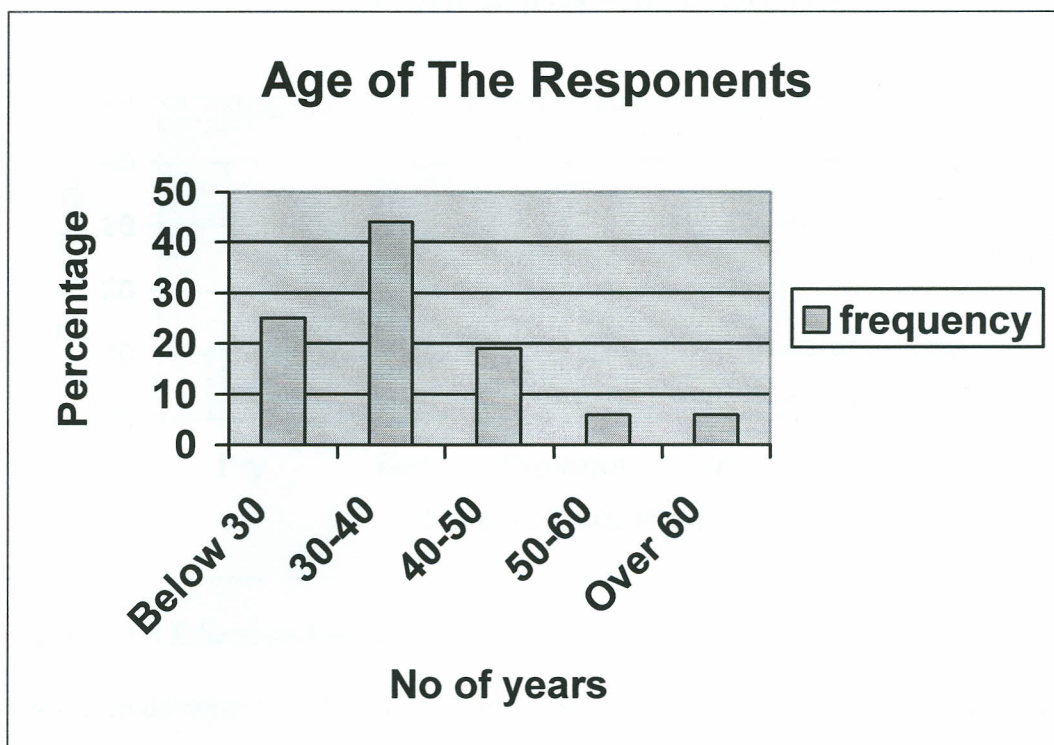


Figure 4.1.2 Age of the respondents

People with Secondary level constituted with the Highest level of SME interviewed .This was 39% and the lowest was Others these Includes Post Graduate at 5 %

Table 4.1.3 Education background

Level of education	Frequency	Percentage
Primary	4	11
Secondary	14	39
Diploma College	10	28
University	6	17
Others	2	5
<b>Totals</b>	<b>36</b>	<b>100</b>

The Information is also shown in the following Bar Graph below

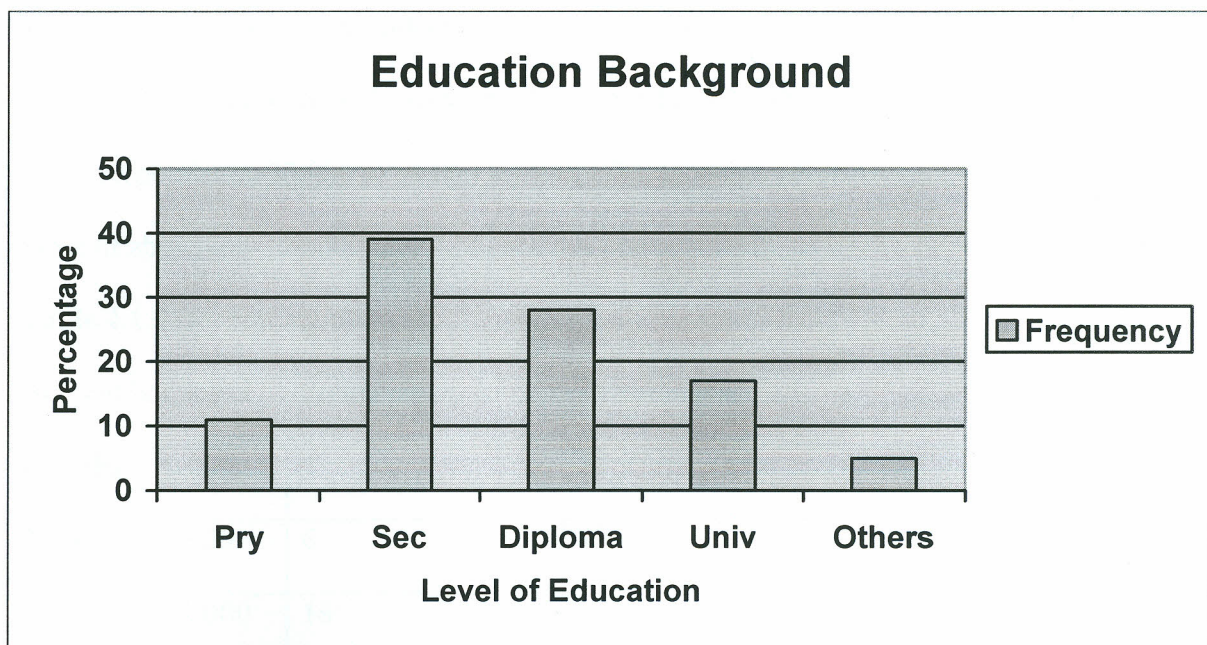


Figure 4.1.3 Education Background

As shown on table 4.1.4 below research revealed that the highest number of respondents came from people who had been in business for less than a year. The respondents argued that During The time of loan appraisal they had not known how to utilize their loans and how to invest the Borrowed money, they did not have any existing business. Business people who had been in business for a long time, over 7 years seem to form the smallest numbers of Business People who had defaulted.

Table 4.1.4 Number of years in business

Years in business	Frequency	Percentages
Less than 1 year	16	44
1 to 3 years	10	28
3 to 5 years	5	14
5-7 years	3	8
Over 7 Years	2	6
<b>Totals</b>	<b>36</b>	<b>100</b>

The highest number of respondents had borrowed between kes 50,000 and 100,000 and they formed 44% of the sample. Borrowers of between kes 100,000 to kes 300,000 comprised of 22% of the respondents. 30,000 to 50,000 formed 17%. However, borrowers of less than kes 30,000 and those of above kes 300,000 took 11% and 6% consecutively, as shown on table 4.1.5 Below

**Table 4.1.5 Borrowing history**

Amount borrowed	Frequency	Percentages
Less than 30,000	4	11
30,000 to 50,000	6	17
50,000 to 100,000	16	44
100,000 to 300,000	8	22
Above 300,000	2	6
<b>Totals</b>	<b>36</b>	<b>100</b>

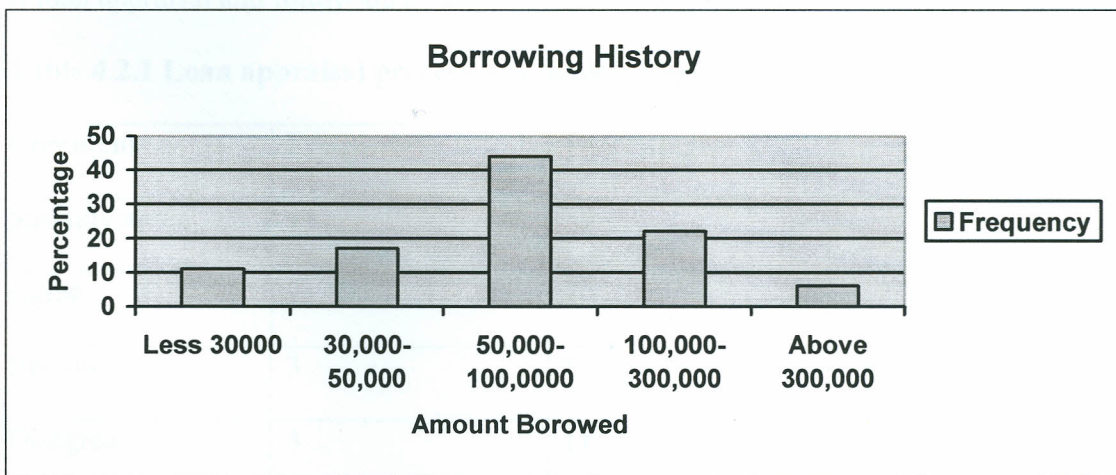


Figure 4.1.5 Borrowing History

The highest number of respondents had borrowed between Kes 50,000 and 100,000 and they formed 44% of the sample. Borrowers of between Kes 100,000 to Kes 300,000 comprised of 22% of the respondents. 30,000 to 50,000 formed 17%. However, borrowers of less than Kes 30,000 and those of above Kes 300,000 took 11% and 6% consecutively, as shown on table 4.1.5 above.

#### 4.11: summary of the findings (description of the respondents)

Most of the respondents according to the research and had defaulted were male, aged between 30 and 40 years, who have attained just but the Secondary education and had run their businesses for less than a year. Majority of the respondents had borrowed between kes 50,000 and 100,000.

#### 4.20 To find out if Loan Appraisal and Follow up contribute to loan defaults

It was clear from the respondents that there were some flawed appraisals, which seemed to have contributed to defaults. About compromise on loan appraisals, 39% of the respondents felt strongly that one goes through the whole loan appraisal process to get a loan. 20% argued that yes that one goes through the whole loan appraisal process. 8% were not sure, 11% disagreed with this and 22 strongly disagreed. As shown on table 4.2.1 Below.

If loan appraisal and follow-up procedures affect rate of Loan Default in SME

**Table 4.2.1 Loan appraisal process in a bank is vigorous**

Comment	Frequency	Percentages
Strongly agree	14	39
Agree	7	20
Not sure	3	8
Disagree	4	11
Strongly disagree	8	22
<b>Totals</b>	<b>36</b>	<b>100</b>

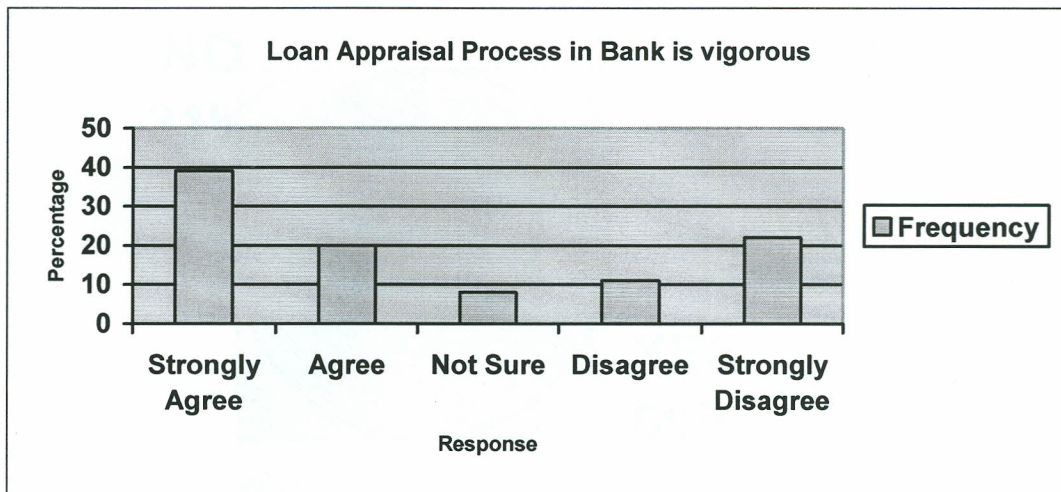


Figure 4.2.1 Loan Appraisal process in bank is vigorous

Table 4.3.1 If loan Appraisal affect Loan Default

Response	Frequency	percentage
yes	25	70
No	11	30
Total	36	100

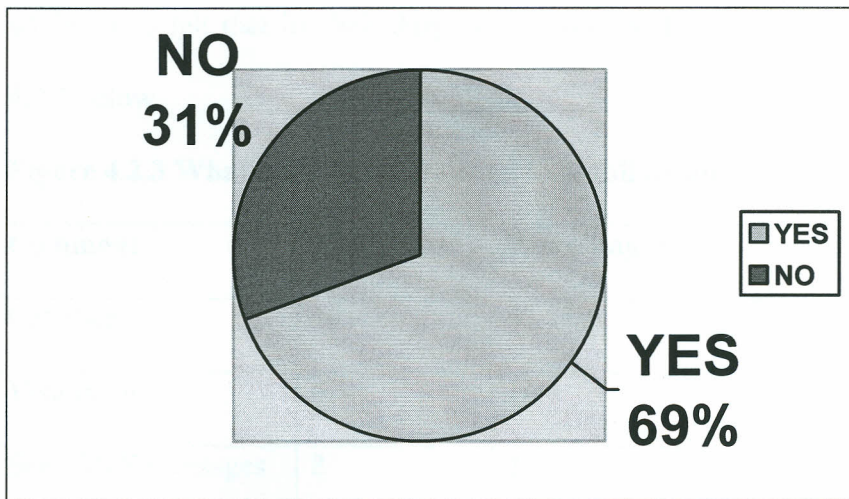


Figure 4.3.1 If loan appraisal affect loan Default

Of the respondents interviewed 45 % felt that loan appraisal and follow up is a key thing in loan default. There are some who felt that they have to be reminded on their loan dates due to their work schedule. However 11 % felt that appraisal and follow up doesn't affect the way they paid their loans. It is summarized in the table below

Table 4.2.2 if Loan Appraisal and follow up affect rate of loan default

Comment	Frequency	Percentages
Very Great	16	45
Great	8	22
Moderate	5	14
Low	3	8
Very low	4	11
<b>Totals</b>	<b>36</b>	<b>100</b>

About 53 % of the respondents felt that they need to be called or reminded to pay. 11 % felt that the credit officer should pay them a visit, 22 % felt that by sending them an SMS will remind them while 14 % felt that its their duty to pay so they don't need reminder. This is tabulated in table 4.2.3 below

**Figure 4.2.3 What needs to be done on loan follow up**

Comment	Frequency	Percentages
Call them	19	53
Visit them	4	11
Send SMS messages	8	22
No reminder	5	14
<b>Totals</b>	<b>36</b>	<b>100</b>

#### **4.21 Summary of the findings: Loan appraisal and follow up contributing to loan defaults**

The research showed that the Loan appraisal and follow up plays a big role in determining business performance and loan repayments thereof. The loan follow up was considered of great importance and many respondents seem to forget about their loan dates. Its importance for bank officers to call their customers regularly and even visit them so that to reduce the loan defaults.

#### **4.30 To find out if Economic factors contribute to loan defaults**

Of the respondents interviewed 83% felt that Economic factors affect Their business hence contributing to reduction business growth hence are unable to service their loans. Only 17 % felt that economic factors doesn't affect their Business.

**Table 4.3.1 If Economic factors affect Loan Default**

Response	Frequency	percentage
yes	30	83
No	6	17

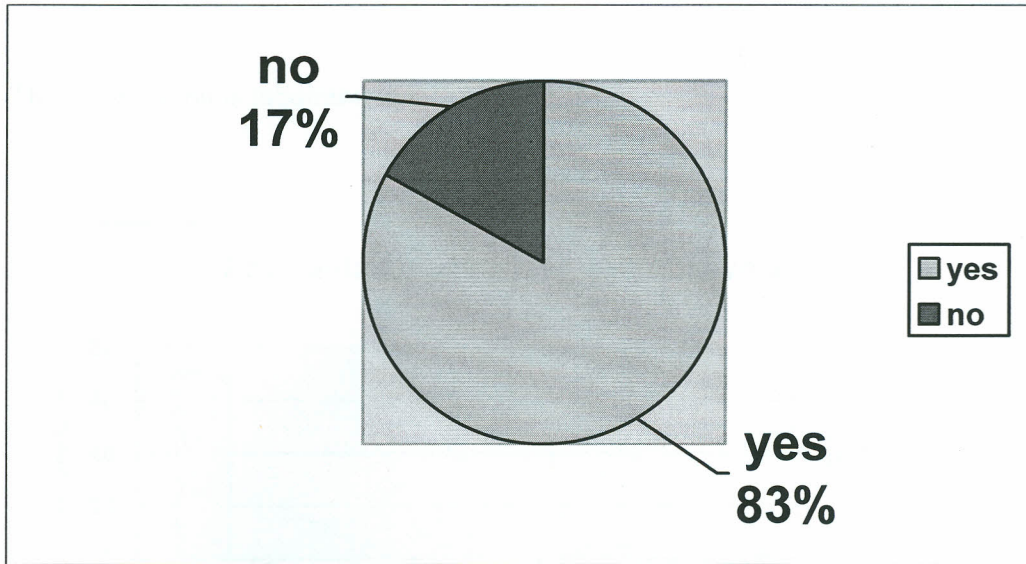


Figure 4.3.1 If Economic factors affect loan default

Most of the respondents also felt that the state of the economy contributed a lot on performance of the businesses. 70% said that when the economy was doing well then their businesses prosper hence are able to pay off their debts and invest more. 5% said that this was of minimal effect whereas 3 % said that State of economy had no effect at all on their business. It summarized in Table 4.3.2 below.

Table 4.3.2 Economic situations influence on loan repayments

Level of contribution	Frequency	Percentage
Very Great	25	70
Great	5	14
Moderate	3	8
Minimal	2	5
None	1	3
<b>Totals</b>	<b>36</b>	<b>100</b>

The Information is tabulated in table below

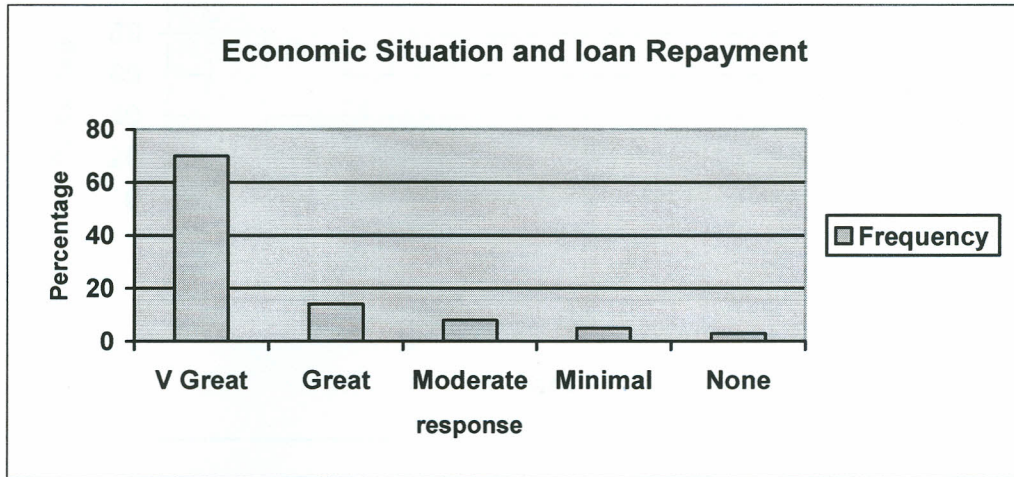


Figure 4.3.2 Economic situations influence on loan repayments

A large percentage therefore was positive that the local politics affected largely their business performance. 86 % said that this was a great contributor to their default due to poor Business performance and Economy, 2% said the effects were minimal and 2% said that they were not affected at all. This is shown on table 4.3.3 below

Table 4.3.3 Political influence to loan defaults

Level of contribution	Frequency	Percentages
Very Great	31	86
Great	3	8
Moderate	1	2
Minimal	1	2
None	1	2
<b>Totals</b>	<b>36</b>	<b>100</b>

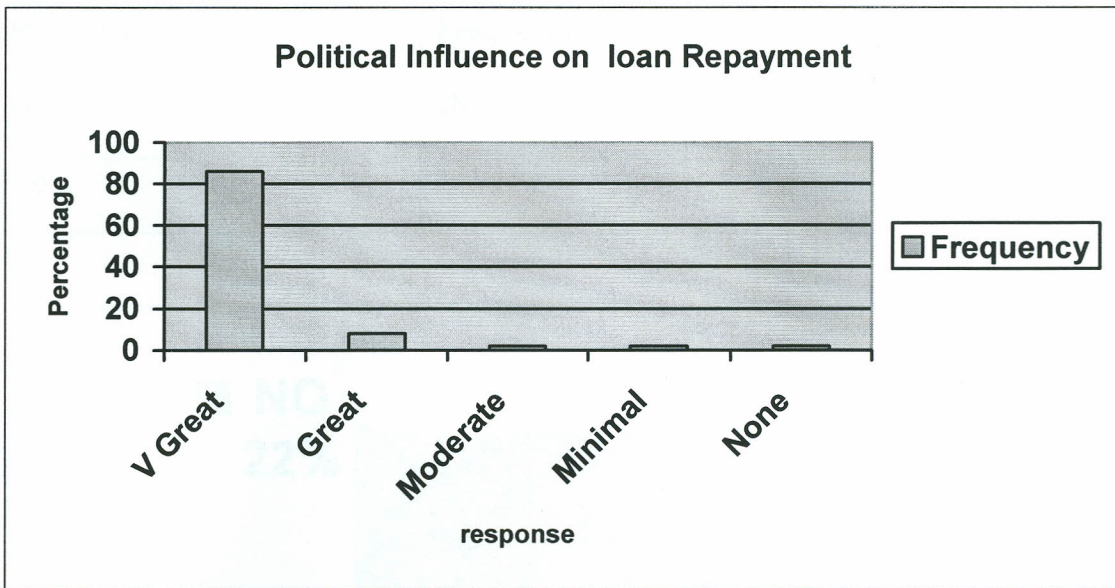


Figure 4.3.3 Political influence to loan defaults

#### 4.31 Summary of the findings: Economic factors contributing to loan defaults

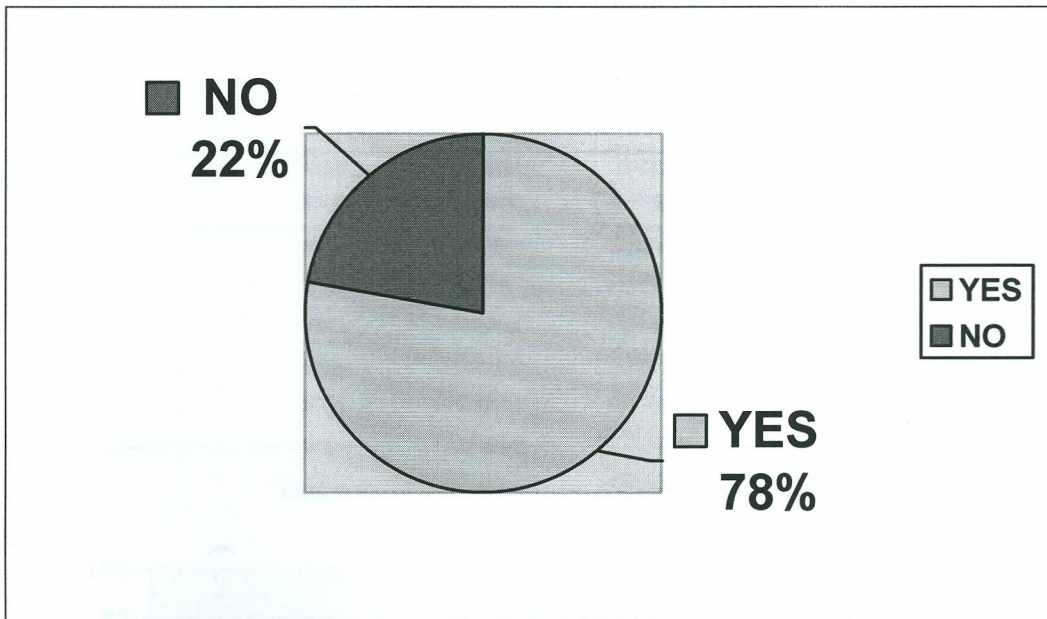
The Effects of Economy seems to have greater impact to SMES that loan appraisal. The state of Economy affects the daily running of the business therefore State of Economy is more detrimental than Loan appraisal and loan follow up when dealing with loan default. The research showed that the country politics play a big role in determining business performance and loan repayments thereof. The economic situation also was considered a great impact on business performance and by default, meeting debt obligations to the bank. Little can be done by Respondent on Political instability hence the Government should take action on how to improve Economy and how to maintain peaceful atmosphere to do Business

#### 4.40 If Business Failure affect loan Default

78% of the respondents felt that business failures affects their Business growth hence are un able to pay their debts.22% felt that Business failure doesn't affect their Business

**Table 4.4.1 If Business failure Influence to Loan Default**

Response	Frequency	percentage
yes	28	78
No	8	22



**Figure 4.4.1 Business Failure and loan Default**

Most of the respondents also felt that Business Failures such as poor Marketing ,poor planning and poor management contributed a lot on performance of the businesses. 89% said that when the if they plan, Market and manage well their businesses, they prosper and make good income hence are able to pay off their debts and invest more. 3% said that this was of minimal effect whereas none said that Business failures had no effect at all on their business. It summarized in Table 4.3.3 below.

**Table 4.4.3 Business Failure influence to loan defaults**

Level of contribution	Frequency	Percentages
Very Great	32	89
Great	1	3
Moderate	1	3
Minimal	2	5
None	0	0
<b>Totals</b>	<b>36</b>	<b>100</b>

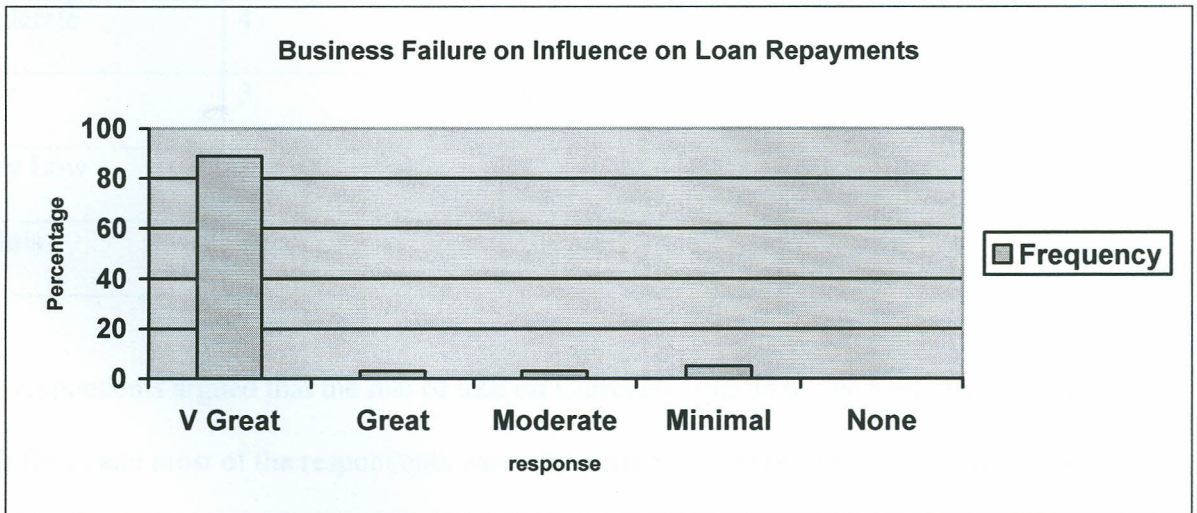


Figure 4.4.3 Business Failure influence to loan defaults

**4.41 Summary of the findings: Business Failures contributing to loan defaults**

If A Business fails then the Entrepreneur will close and wind up the Business. According to research Business Failures plays a very crucial part in loan Defaults .When all the factors affecting Business such as Marketing ,Planning and management are not checked this can bring down the

Business hence resulting to loan defaults. Business Failure as per interview contributed to 89% and if a business fails then there is no profits and leads to businesses not honoring their obligations. This leads to loan defaults

**4.50 If Interest and Repayment Schedule affect loan Default**

85% Respondents were for the opinion that Banks charge high interest as compared to MFIs. Only 3 % respondents were for the view that Banks charge lower interest than MFIs

**Table 4.5.1 comparison of Interest between Banks and MFIs**

Level of contribution	Frequency	Percentages
Very High	16	45
High	12	33
Moderate	4	11
Low	3	8
Very Low	1	3
<b>Totals</b>	<b>36</b>	<b>100</b>

The respondents argued that the rate of interest Currently offered by the bank contributed to their cash flows and most of the respondents were comparing the interest rates with what is offered by competition and felt that it fair comparing where Banks are coming from However, a large percentage of 42% argued that interest rates had no effect at all with their repayments but argued that customer service mattered a lot. 11% said that interest rates contributed to their defaults where as 17% said that the effect was minimal. It summarized in table 4.4.2

**Table 4.5.2 Effects of interest rates to loan repayments**

Level of contribution	Frequency	Percentages
Very Great	4	11
Great	4	11
Moderate	6	17
Low	15	42
Very Low	7	19
<b>Totals</b>	<b>36</b>	<b>100</b>

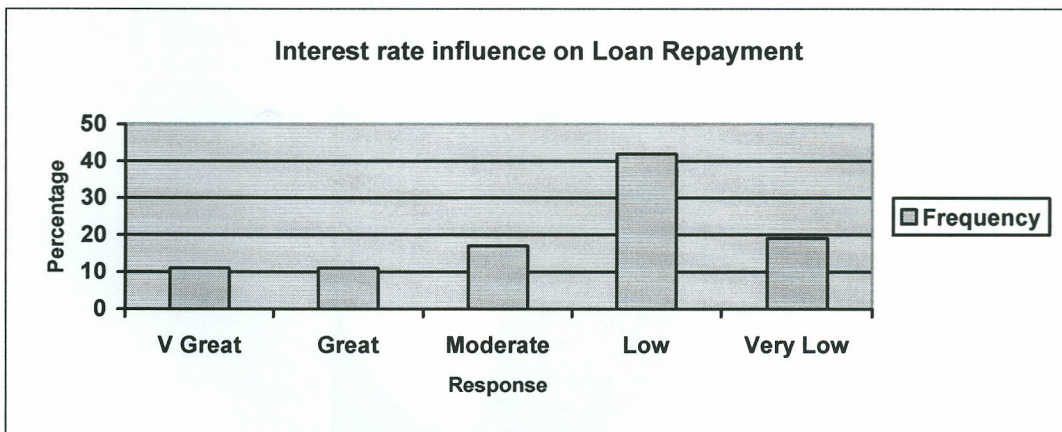


Figure 4.5.2 Effects of interest rates to loan repayments

The respondents who had been interviewed majority had taken loans payable in 12 months and contributed to 42 % of the total Respondents. There were few who had taken loan payable in 18 Months. They felt that loans payable in 12 Months are more flexible and one can plan his payments well unlike those payable in 6 Months and over 18 Months. They are tabulated in the table below.

**Table 4.4.3 Loan tenure**

Loan tenure	Frequency	Percentages
6 months	8	22
9 months	11	31
12 months	15	42
18 months	2	5
Over 18 Months	0	0
<b>Totals</b>	<b>36</b>	<b>100</b>

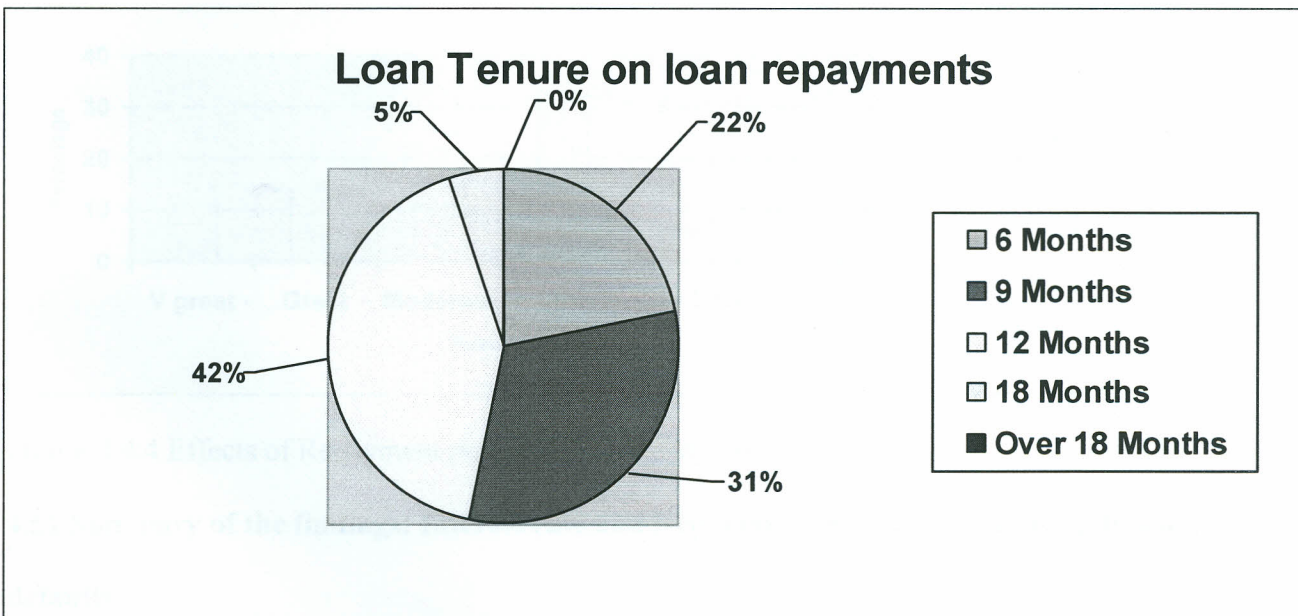


Figure 4.4.3 Loan tenure

Majority of the respondent felt that the period doesn't affect them much in terms of loan repayment. they however noted that they need to have longer grace period to enable them utilize the funds well.33 % noted that the period doesn't matter much if the Economy is performing. However 11% felt that the period can Greatly affect their loan repayment since they will not have turned the loan enough to cover their costs.

**Table 4.4.4 Effects of Repayment period to loan Repayment**

Level of contribution	Frequency	Percentages
Very Great	4	11
Great	5	14
Moderate	8	22
Low	12	33
Very Low	7	20
<b>Totals</b>	<b>36</b>	<b>100</b>

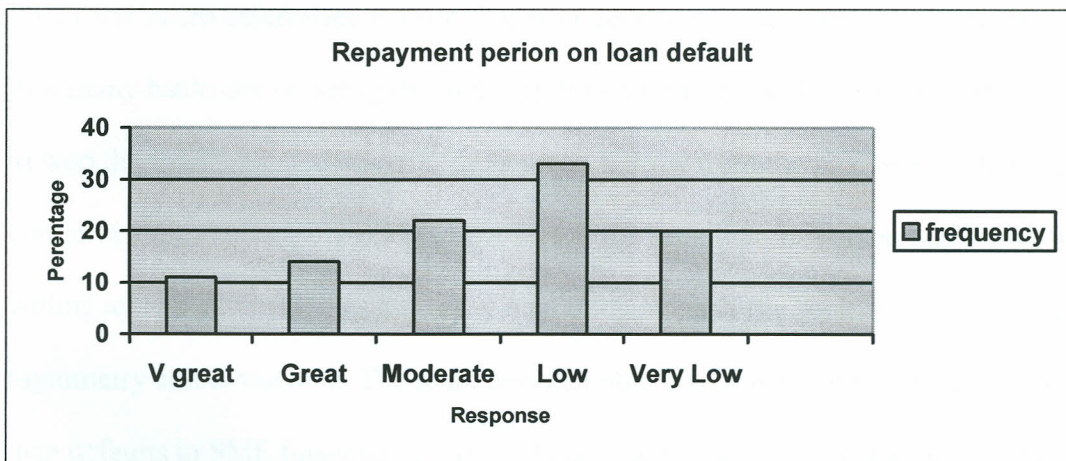


Figure 4.4.4 Effects of Repayment period to loan Repayment

#### 4.51 Summary of the findings: Interest rate and Repayment period contributing to loan defaults

According to research the respondents suggested that the rate of interest need to be fair and the repayment period for Micro loans needs to be extended as it gives the borrower time to plan and recover however the Banks prefer shorter period since they make more income and the risk is minimal. There need to have balance on loan repayment and the rate of interest so that a situation of win win is achieved by both the bank and the Borrower.

## CHAPTER FIVE

### SUMMARY, RECOMMENDATIONS AND CONCLUSION

#### 5.1 Introduction

In this chapter, a summary of the study is presented, together with summary of the key study findings. The chapter also presents a conclusion of the study, recommendation and suggestions of studies that could be carried out in future.

#### 5.2 Summary

Small and micro enterprises industry has been seen to be a key driver to the Kenyan economy and thus many banks are targeting this industry for their products: deposits and loans. Even as banks try to woo the small and medium entrepreneurs to borrow from them, a serious challenge of default comes up. The challenge hereby is how sure is the bank that the person borrowing from them is willing and able to meet his / her repayment obligations to the bank. The issue of information asymmetry comes out here. The main research objective was to determine the Factors Influencing loan defaults in SME financed by Co-op Bank. The research is aimed at helping the Banking industry in formulating ways of mitigating this risk. The research was also to help; Donor bodies targeting SMEs, Government in implementing policies to Banks and Building the Economy the credit firms in vetting their loan applicants as well the general public in understanding good credit management and future researchers.

The research was designed such that the population was composed of the current loan defaulters who totaled to 120 respondents. Stratified random sampling was done and the stratification was based on the number of days a customer has been in arrears. Systematic random sampling was then

done on the stratum and 30% of the respondents were picked from each stratum to form the research sample.

Questionnaires were then used to collect the data which was analyzed by use of spread sheets and information tabulated by use of frequency tables.

Data analysis was presented in forms of frequency tables in which the number of occurrences were noted for each response. 36 respondents were interviewed and out of the sample, all the 36 employees sampled responded to the interview and questionnaire designed by the researcher.

Of the respondents interviewed 61 % were men and 39 % were women .it showed that Women were better payers than men since all interviewed had defaulted

The age of the respondents ranged between 22 to 75 years with the majority being 30 to 40 years. It also turned out that majority of respondents had Secondary education background and had been in business for less than a year. The research showed that those in business less than 1 year tend to default more.

Business Failures was featured as the commonest and highest cause of loan defaults, a factor which can be controlled by the borrower. The lender can also assist the borrower on trainings and giving financial advice on how best to run the business.

Economic factors were also a noted as a high factor causing loan defaults. The Government needs to come up with measures to maintain a stable economy hence conducive environment for business.

Political influence was rated highest among the factors influencing loan repayments. This affected the economic factors hence unconducive environment to do business resulting to heavy losses and business close down. This leads to loan defaults

The other factors such as Loan Appraisal and follow up, Interest rate and repayment period are also importance but didn't feature much in this research.

### 5.3 Conclusion

In conclusion, Factors influencing loan defaults are diverse and unique to different market segments. However, some are said to be universal and thus can apply to all possible markets. The weight age of all Factors influencing defaults also vary from market to market. The physical characteristic of the borrower might also be said to play a significant role in loan defaults. Some of the very obvious characteristics observed from the research were the age, education background, number of years in business, loan tenure and the type of customers one deals in.

This research concentrated on SME loan customers in Stima Plaza Branch of Co-operative bank. In causes of loan defaults, some factors came out strong than others. Business failures emerged as the highest factor influencing Loan Default in SMEs

Other factors beyond the scope of the borrower were politics which ranked highest and economic situation ranking second.

Moreover, there were also other Factors especially relating to loan appraisals and it was strongly felt that the bank staff need to evaluate the financial need of the customer so as to give adequate funds to meet the need, and this would avoid diversions of funds. Other major issue raised was rate of interest and repayment period .The rate needs to be fair and many respondents felt that the Banks needs to avoid charging Penalty on loans in arrears instead reschedule the loans at a reasonable fee is the case of the borrower is genuine.

From the research there were other factors which came out strongly as a factor that might influence default. These includes Overborrowing, Natural calamities such as death, Floods Diversion of funds by the borrower, overspending by the borrower and the overall character of the borrower.

## **5.4 Recommendations**

Most Factors influencing loan defaults were discussed, the industry need to put precautionary measures to militate against the vice. Lenders should be careful when lending to ensure that the funds are directed to the specific project the funds were sought for. The borrowers should also be taken through some training on credit management. This would assist them in managing their business well and reduce chances of Business failure which found to be a major factor Influencing loan Default.

The factors beyond the scope of the industry, like political influences, then the industry should look for a hedge position to minimize the spill over effects of this vice. During lending therefore, the bank needs to look at all possible environmental conditions which could otherwise have an effect on the business operations. The Government needs to come up with measures to make the Economy stable. Also Political stability is of great importance in matters relating to the Economy.

It is also recommended that the loan appraisal and lending should be manned by personnel of integrity and well trained analysts as lending has been seen as an easy way of losing money by the bank. It is an avenue of fraud and staff given the responsibility should exercise utmost integrity and precaution lest they lose funds to potential bad debtors. Proper loan appraisal and thorough vetting before a loan is given is of great importance by the bank.

## **5.5 further study**

This study was carried out in Ngara Area, Parkroad N.C.B.D covering riveroad, Kirinyaga Road and Tom Mboya Street .This area is characterized by many small and upcoming businesses and thus considered good for research. Nairobi City experiences different and unique situations and therefore the research findings cannot be generalized. The researcher therefore recommends further study in other areas within city and other towns to determine the Factors influencing loan

defaults in such markets. The researcher also recommends that a similar study to be carried out in other Banks to find out whether similar factors would influence loan repayment.

The research was also done when the Kenyan Economy was growing and the researcher would also recommend further study on the same market segment during another period of time.

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**APPENDIX 1**  
**QUESTIONNAIRE**

**A Survey on Factors Influencing Loan default in Small and Medium Enterprises financed by Co-op Bank.**

**Appendix 1: Letter To Respond**

Jim Mugambi,  
Kenyatta University,  
P.O. Box 1190  
Ruaraka

Dear Sir/ Madam

This questionnaire has been designed to gather information regarding the Factors Influencing Loan Default in Small and Micro Enterprises Financed by Co-op Bank. This information is to be used to complete a research project, a requirement for a degree in Master of Business Administration at Kenyatta University .

You have been selected to take part in this survey. Kindly spare some time and fill the attached questionnaire to the best of your knowledge. This information is purely for academic purposes and all responses will be treated with utmost confidentiality.

A copy of the research report will be availed to you upon request. Your co-operation will be highly appreciated

Yours sincerely;

Jim Mugambi-MBA Student

**APPENDIX II**  
**QUESTIONNAIRES**

**SECTION 1: GENERAL INFORMATION**

1. Gender (A) Male                      (B) Female

2. Age

(A) Below 30

(B) 30-40 Years

(C) 40-50 Years

(D) 50-60 Years

(E) Over 60 Years

3. Education Level

(A) Primary

(B) Secondary

(C) Diploma College

(D) University

(E) Others (Specify).....

4. How long have you been in this Business?

(A) Less Than 1 year

(B) 1-3 Years

(C) 3-5 Years

(D) 5-7 Years

(E) Over 7 Years

5. How much did you borrow from the bank?

(A) Less than 30,000

(B) 30,000-50,000

(C) 50,000-100,000

(D) 100,000-300,000

(E) Above 300,000

**SECTION 2: FACTORS CONTRIBUTING TO LOAN DEFAULTS**

**A) Loan Appraisal and Follow up**

5. To get a loan from the Bank one has to go through a vigorous process of loan approval ?

- (A) Strongly Agree
- (B) Agree
- (C) Not Sure
- (D) Disagree
- (E) Strongly disagree

6. In your opinion does the loan appraisal procedures affect the rate of loan default in the SMEs that are financed by the Co-operative Bank?

- YES
- NO

7. To what extent does the loan appraisal and follow up procedures affect the rate of loan default in the SMEs that are financed by the Co-operative Bank ?

- V.Great
- Great
- Moderate
- Low
- V.low

8. Suggest what can be done on the loan follow up procedures to reduce the rate of loan default in the SMEs that are financed by the Co-operative Bank?

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.....

.....

**B) Economic Factors**

9. In your opinion do Economic Factors such as Inflation, Political influence ,currency Fluctuations affect the rate of default in the SMEs financed by the Co-operative Bank?

- Yes
- No

10. To what extent does do Economic Factors affect the rate of default in the SMEs financed by the Co-operative Bank ?

- V.Great
- Great
- Moderate
- Minimal
- None

11. Comparing with the economic situation before 2007 general elections, has your business Profitability been affected?

- V Great
- Great
- Moderate
- Minimal
- None

12.Suggest what needs to be done on economic Factors to reduce the rate of default in the SMEs financed by the Co-operative Bank?

.....

.....

.....

**C) Business Failure**

12.Does business failure Such as Poor Marketing, Poor business and financial Planning and poor Management contribute to loan default ?

- Yes
- No

13.To what extent does business failure contribute to default by customers of the Small and Medium Enterprises funded by Co-operative Bank?

- V.Great
- Great
- Moderate
- Low
- V.low

14.Suggest what needs to be done with regard to business failure to reduce default by customers of the Small and Medium Enterprises funded by Co-operative Bank?

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.....

**D) Interest and Repayment Schedule**

15.How is the interest rates charged by the Banks when compared to the ones offered by MFIs?

- V.High
- High
- Moderate
- Low
- V.Low

16.To what extent did the loan interest affect your repayment ability

- V.Great
- Great
- Moderate
- Low
- V.Low

17.What was the Tenure of the loan?

- 6 Months
- 9 Months
- 12 Months
- 18 Months
- Over 18 Months

18.To what extent did the loan Repayment Period affect your repayment ability

- V.Great
- Great
- Moderate
- Low
- V.Low

19.Suggest what can be done with to the interest rate and the loan repayment schedule to reduce the rate of default in the SMEs financed by the Co-operative Bank?

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**SECTION 3**

20. In your opinion what are Other factors that cause loan default in the Small and medium Enterprises ?

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21. What can be done to reduce the default rate in the Small and Medium enterprise funded by Co-operative Bank?

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### APPENDIX III

#### Research Budget

ACTIVITY	COST
Researching Books, photocopying materials and Computer usage	30,000
Proposal typing	8,000
Binding	2,000
Transport	10,000
<b>TOTAL</b>	<b>50,000</b>