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**KENYATTA UNIVERSITY**  
**SCHOOL OF BUSINESS**

**FACTORS THAT INFLUENCE LOAN DEFAULT RATE: A CASE OF  
THE MICRO FINANCE FIRMS IN NAIROBI, KENYA.**

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**November, 2009**

*Factors that influence  
loan default rate: a*



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## DECLARATION

This research project is my own work and has not been presented for examination in any other university.

Signed-----

Date-----

Jacob Muthomi Kirera

**D53/13244/05**

I confirm that this research project was written and presented for examination by the candidate under my supervision.

Signed-----

Date-----

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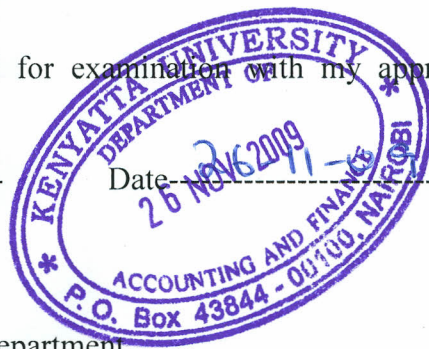
This research project has been submitted for examination with my approval as the Chairman of the department

Signed-----

Date-----

Mr. James Muturi

Chairman, Accounting & Finance Department



## DEDICATION

To my children, Shirlynn and Sheila, my parents, brothers and sisters.

## ACKNOWLEDGEMENTS

My sincere gratitude goes to Mr. Maganjo for accepting to supervise and guide me through this very involving process to the final end, to Mr. Murungi, you critiqued my work and offered useful guidelines, other KU lecturer that immensely changed and transformed my creativity through the whole course; you for ever remain my heroes, may God bless you all.

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My utmost gratitude is to almighty God who enabled me to accomplish this by his grace.

## ABSTRACT

This study investigated the influence loan design, client screening and credit committee control have on loan default rate in the microfinance firms. The need to carry out this study was influenced by the fact that non-performing loan has continued to increase over the years from 9.55% in 1997 to 38.4% in 2001 (MI, Banking Survey 2002, PP 122). Competition for microfinance clients has become fiercest with some borrowing more than they can handle leading to delinquencies or no performing loans. Existence of non-performing loan reduces the profitability of an institution and its sustainability or survival.

During literature review, the researcher established that related studies have been done on commercial banks but no study have been done to establish the influence loan design, client screening and credit committee control have on the loan default rate in the microfinance firms in Kenya.

The study adopted descriptive research design which involves breaking down vague problem statement into smaller and precise sub-problem statement. This research design was used to obtain information on the current status of phenomenon. It entailed survey and fact-finding and sought to establish the relationship between the variables the study also used explanatory design because the tools allowed the use of primary and secondary data and gave room for application of the study results. A face- to- face interview and

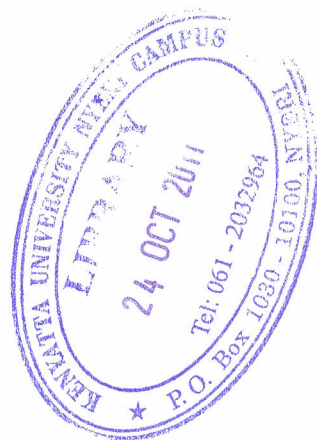
structured questionnaire were used in data collection to elicit the required information needed for the purpose of completing the study.

The population consisted of the 27 registered firms with AMFI from which a sample of 50% firms was selected by stratifying the population and selecting them randomly. The researcher piloted the study to test the research instruments to ensure their validity and reliability. The advice of the University Supervisor was sought to correct any ambiguity detected in the research instruments before field administration.

Data were analyzed through tabular presentations, pie charts and graphs. The analysis touched all the research questions clearly showing the relationship between loan product design, client screening, credit committee control and loan default rate. Later, the study results, study recommendation and conclusion were drawn which gave room for further study.

## LIST OF ACRONYMS AND ABBREVIATIONS

AMFI	Association of Microfinance Institutions
ASA	Adaptive Security Appliances
CBK	Central Bank of Kenya
DV	Dependent Variable
ERM	Enterprise Risk Management
ERSWEC	Economic Recovery Strategy
IV	Independent Variables
K-REP	Kenya Rural Enterprise Programme
MFIs	Microfinance Institutions
MI	Market Intelligence
NGO	Non Governmental Organizations
PRSP	Poverty reduction strategy paper
SHG	Self- Help Groups
SMSs	Small Scale enterprises
WWW	World Wide Web



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## DEFINITION OF KEY TERMS

### **World Wide Web**

This is a system of interlinked hypertext documents on the internet with a web browser where one can view web pages that may contain text, images, videos and other multimedia and navigate between them using hyperlinks.

### **Non Governmental Organizations**

This is a term that has become widely accepted as referring to a legally constituted non-governmental organization created by natural or legal persons with no participation or representation of any government.

### **Self Help Groups**

These are nonprofessional organization formed by people with a common problem or situation for the purpose of pooling resources, gathering information and offering mutual support or care.

### **Market Intelligence**

This is information gathered from sources external to the firm for use in decision making.

### **Micro-Finance Institution**

This is an institution that offers financial services to poor and low income clients. The term is often used more narrowly to refer to loans and other services from providers that identify themselves.

### **Enterprise Risk Management**

This is a process of planning, organizing, leading and controlling the activities of an organization in order to minimize the effects of risk on an organizations capital and earnings.

### **Central Bank of Kenya**

This is a government institution charged with the responsibility of issuing the currency and notes, implementing the foreign exchange policies, foreign exchange reserves, supervising the money market and acting as a banker and fiscal agent to the government.

### **Dependent Variable**

This is a variable dependent on another variable

### **Independent Variable**

This is a variable whose value determines the value of other variables.

### **Small Scale Business**

These are mainly small scale Industrial undertakings.

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background to the Study

Micro-finance businesses are considered to be small and mostly have one employee, the owner. Micro finance-development programmes make loans to poor people to help them to start or to strengthen their businesses. Scholars, donors and practitioners have increasingly recognized that the sustainable provision of formal or semi-formal financial services to the poor and other sectors of the population is a useful tool in poverty alleviation, enterprise development, and financial sector deepening. Although the majority of the clients served by the formal financial sector in developing countries comprise upper class, urban, educated males, some financial intermediaries have attempted to encompass a wider clientele by operating in more isolated rural areas.

As a result of the information, a symmetry and high transaction costs associated with financial intermediation in rural areas, member-based institutions such as credit unions and village banks have evolved as a mechanism to transfer the high costs of screening, monitoring and evaluation from an external financial intermediary to the village level (Manfred & Richard, 2006). Some other scholars believe that micro-enterprise is a promising way to help the working poor, the unemployed, and those who receive public assistance (Raheim & Alter, 1998; Clinton, 1997; Soloman, 1992; Balkin, 1989; Friedman, 1988). Micro-finances are often considered the most effective and flexible strategies in the fight against global poverty. They are sustainable and can be

implemented on the massive scale necessary to respond to the urgent needs of those living on the less than \$ 1 a day, the world's poorest. Micro-finance firms make small loans, usually less than \$200, to individuals to establish or expand a small, self-sustaining business.

In the decades since Muhammed Yunus gave his first \$27 loans to women in Chittagong, Bangladesh, the micro-finance industry has come a long way, what began as a collection of individual, non- governmental organizations funded by development donors has become a professional business offering not just credit, but a full range of banking services to poor people. (<http://www.forbes.com/2007/12>).

In the last 15 years in the United States, the number of micro enterprise programmes has grown to more than 340 (Langer, Orwick & Kays, 1999). Growth has also been rapid in the United Kingdom (Rogally, Fisher & Mayo, 1999; Rogaly & Roche, 1998). In India, micro-finance traces its roots to mid -1970 when some prominent Indian NGO like Myrada and Pradan started using the Self- Help Group (SHG) Model and in 1990s the Grameen model and ASA model both from Bangladesh, found rapid acceptance in India due to the models capability for rapid scaling in terms of client outreach. In Kenya micro-finance is a relatively new phenomenon, with a few agencies starting about 20 or so years ago but the sector gaining the status of an industry only in the last 10 years (Otto Hospes et al., 2002).

According to an evaluation of micro-finance programmes in Kenya as supported through the Dutch Co-financing Programme, 2002, the Government of Kenya, many international donor agencies and a large number of Kenyan NGO's consider micro finance as a key instrument for development and poverty alleviation. In March 1999, Association of Micro-Finance Institutions (AMFI) was registered under the society Act. with a vision to become a strong and sustainable association, which promotes the growth of a vibrant micro-finance sector that meets the financial needs of needy Kenyans. AMFI recognizes that micro-finance is one of the major tools for poverty alleviation not in Kenya alone, but worldwide.

On the other hand however, as observed by Joan, 2000 MFIs may be risky because their profitability is affected if interest revenue is not received on delinquent loans. The most significant effect on profitability occurs when the loan principal is not repaid and loan loss provisions must be made. This greatly affects the profitability of the MFI.

Credit risk management, therefore requires a comprehensive review of the lending methods, operational procedures and institutional image of the MFI. The process of financial intermediation and trading, banks and other financial institutions assume various kinds of financial and non-financial risks (Hennie, 2000). While MFIs and commercial banks have faced difficulties over the years, for a multitude of reasons, the major cause of serious financial problems continues to be directly related to credit standards for borrowers, poor portfolio risk management or lack of attention to changes in the economic circumstances and competitive climate (Central Bank of Kenya Annual Supervision Report, 2000).

In the framework of the financial system approach, adequate credit risk management techniques of the micro-finance institutions increasingly move into the centre of attention to ensure the safety of their client's deposits and the institutions revenue generation (Little Field, 2003). This is because, micro-enterprises development in the third world rests mostly on the innovative use of joint-liability groups to make loans to people without traditional collateral (Morduch, 1999), whereby each group member is liable for the debts of the others; if one does not pay, the others must pay, or else all will lose access to future loans (Mark Schreiner, 2001). Joint liability also means that honest borrowers must sometimes pay the debts of defaulters. This can spark a domino effect in which borrowers who would have paid their own debts choose instead to stop payment, both their own debts and those of defaulters (Besley & Coate, 1995). Ultimately, default leads to bad debts or non-performing loans. A high level of default leads to an erosion of capital or deposits and liquidity risk (Hennie, 2000). This will adversely affect its profitability and money available to loan to members. Ledgerwood, 2000 observes that delinquency is often a result of poor designed loan product and delivery mechanism. This leaves the researcher wondering the effect of loan product design, client screening and credit committee control on the loan default rate within the MFI's. Related studies done in the past have focused on Kenya commercial banks (Mbole, 2004. Kiyai, 2003). No study has been done in Kenya to establish whether loan product design, client screening and credit committee control have a relationship with the loan default rate in the micro-finance firms in Kenya.

## 1.2. Statement of the Problem

Joint liability practised by MFI's means that honest borrowers must sometimes pay the debts of defaulters. This can spark a domino effect in which borrowers who would have paid their own debts choose instead to stop payment, both their own debts and those of defaulters (Besley & Coate, 1995). Expanding the portfolio too rapidly may increase loan arrears and losses. These losses may precipitate in risk management as well as from more opportunities for mistakes in evaluating and managing credit risks.

Expected loan losses exist from the moment a loan is granted (Banco de Espana, 2001). In Kenya, the level of non-performing loan has continued to increase over the years from 9.55% in 1997 to 38.4% in 2001 (MI, Banking survey 2002, PP 122). Existence of non-performing loans reduces the profitability of an institution and its sustainability or survival (Svoronos, 2002, Siche, 2000 & Omuodo, 2002).

According to the Central Bank of Kenya annual report 2006, out of 25 AMFI members, 21 collectively had an outstanding loan portfolio of Ksh. 16,007 million. Default is a common problem facing all loan giving institutions. A default occurs when, in the judgment of a lender, a borrower cannot repay a loan that is already considered overdue. A World Bank survey of loan repayment in Kenya in 1975 for instance, found that one third of the agricultural loans disbursed by several credit institutions between 1973 and 1975 were in default (Von Pischke, 1975).

Otero, from one of the case studies done in Indonesia, Unit Desa System, observes that loan losses increased steadily since loan write-offs were instituted in 1987. Although the increase in loan losses is to be expected in a rapidly growing loan portfolio, the increase in the ratio of loan losses to average loans is a negative trade. The ratio, which increased from 1.4 percent in 1987 to 2.6 percent in 1988 and 2.9 percent in 1989, is still in the acceptable range, but continued growth could be of some concern (Otero, 1994 p.219)

In the words of Drake and Rhyne, 2002. “ In countries where competition for micro finance clients has become fiercest, notably Bolivia and Bangladesh and to some extent Uganda, evidence is emerging of a dangerous tendency: clients borrow more than they can handle and delinquency rises throughout the micro finance market. Over lending has led to a full – blown crisis in Bolivian micro-finance. In Bangladesh, MFIs are increasingly concerned about the effect of over lending may have on loan loss rates.”

Many credit problems reveal basic weaknesses in the credit granting and monitoring processes while shortcomings in underwriting and management of market- related credit exposures represent important sources of the losses to financial institution, many credit problems would be avoided or mitigated by strong credit risk analysis process ( Basel, 2000). To mitigate default risk, MFIs should start by designing loan products that meet client’s needs (Churchill and Frankiewicz (2006).

With the loan default rate in Kenya on an upward trade as noted above it leaves some questions begging for answers, for example what is the effect of factors used by MFI's to prevent lending to risk borrowers? This study therefore, was to investigate the influence loan design, client screening and credit committee control have on loan default rate within MFI's in Kenya. The study was to capture the degree of influence and default rate as at December 2008.

Loan default rate is a function of client screening, which tends to evaluate how risky the client is and his capacity to repay. Loan product design that looks at the needs of the borrowers by ensuring no fungitive money is lent out just like credit committee control that is charged with the responsibility of ensuring the borrower before them is a risk free to MFI even with loan default rate increasing in Kenya.

### **1.3. The Purpose of the Study**

The purpose of this study was therefore to investigate the influence loan design, client screening and credit committee control have on loan default rate in the micro finance firms in Kenya.

### **1.4. The Objectives of the Study:**

- i) To evaluate loan product design and its effect on loan default rate.
- ii) To review client screening practised and its impact on loan default rate.
- iii) To appraise credit committee control measures practised and its effect on loan default rate.



- iv) To establish the influence of loan product design, client screening and credit committee control on the loan default rate.

### **1.5. Research Questions**

- i) What is the effect of loan product design on loan default rate?
- ii) What is the impact of client screening on loan default rate?
- iii) What is the effect of credit committee control on loan default rate?
- v) How does loan product design, client screening and credit committee control influence loan default rate within the micro-finance firms in Kenya?

### **1.6 Justification and Significance of the Study:**

Management and governance of micro-finance firms- as the people charged with the design and implementation of procedures and policies related to credit granting operations; they will realize the need for refining credit risk analysis tools, policies, procedures and controls. Academicians- Enterprise risk management (ERM) has aroused a lot of interest in the current times. It is hoped that the findings of this study will expand enterprise risk portfolio and form a foundation for further research on the relationship between loan product design, client screening and credit committee control and the loan default rate in the micro finance firms in Kenya.

The Central Bank of Kenya (CBK)- Recently was a micro finance Act. 2006 enactment that intends to regulate micro-finance firms in Kenya by the Central Bank. The study will highlight issues, which will enhance the supervisory and regulatory framework. Also, the

study will help in formulating guidelines that will enhance credit risk analysis in the micro finance industry.

The public and other stakeholders- Poor credit risk management touches on the public as it mostly follows the principle of joint-liability where each group member is liable for the debts of the others. Thus, the study will broaden the understanding of the various stakeholders on the issue of loan default in the micro finance firms in Kenya.

### **1.7 Scope of the Study**

The study targets micro-finance firms operating in Nairobi. This area was chosen because of high population concentration within which many micro-finance firms operate. The study over looked other risks such as market, financial, riot that may need further study. Relevancy of the questions and therefore, the responses differed from one respondent to another. However, this was addressed by cross checking the questions.

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

- i) Low response rate- some of the respondents failed to answer all questions and others to return the questionnaires.
- ii) Misinterpretation of the responses from the respondents in regard to the strength of their opinions.
- iii) Some respondents being dishonest with their responses.

## 1.9 Expected Results

The expected findings are that weak credit risk analysis to loan product design, client screening and credit committee control adversely affect the loan default rate within micro-finance firms. There is direct relationship between the independent variables and the loan default rate.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.1 Introduction

A risk is the possibility of suffering harm or loss. Micro-finance institutions take risks all the time. They lend money to low-income persons, often without collateral, and take the risk that borrowers will not repay their loan. Credit risk in micro-finance perspective is the chance that an MFI may not receive its money back from borrowers together with the interest. This is the most common and often the most serious vulnerability in a micro-finance institution.

Churchill and Frankiewicz, (2006) observe that one micro loan does not pose a significant credit risk because it is such a small percentage of the total portfolio but since most micro loans are unsecured, delinquency can quickly spread from a handful of loans to a significant portion of the portfolio. This contagious effect is exacerbated by the fact that micro-finance portfolios often have a high concentration in certain business sectors; consequently, many clients may be exposed to the same external threat, like a crackdown on street vending or a livestock disease or “tribal” war resulting from a national political contest. These factors create volatility in micro loan portfolio quality, heightening the importance of managing credit risk. According to Claudio Gonzalez-Vega et al., (1996), growth of a micro-finance is not easy, and that expanding the portfolio too rapidly may increase loan arrears and losses. These losses may precipitate changes in risk

management as well as from more opportunities for mistakes in evaluating and managing risks.

Morduch, 1999 observes that the success of micro-enterprise development in the third world mostly rests on the innovative use of joint-liability groups to make loans to people without traditional collateral. Each group member is liable for the debts of the others whereby if one does not pay the others must pay or else all will lose access to future loans. Joint-liability also means that honest borrowers must sometimes pay the debts of defaulters. This can spark a domino effect in which borrowers who would have paid their own debts choose instead to stop payments, both their own debts and those of defaulters (Besley & Coate, 1995).

Ledgerwood, 2000 observes that delinquent loans play a critical role in an MFIs expenses, cash flow, revenue and profitability. Additional effort to collect delinquent loans usually mean additional expenses for closer monitoring, more frequent visits to borrowers, and so forth. The more time, effort and resources that are put into controlling delinquency, the less there are available for the MFI to reach new borrowers and expand services or outreach.

Mbole, 2004 in his research observes that a high level of non-performing loans leads to an erosion of capital or deposits and hence liquidity risk.

## 2.2 Why Micro Finance is Growing

According to Ledgerwood (1996) micro-finance activities can support income generation for enterprises operated by low-income households. They help to build financially self-sufficient, subsidy-free, often locally managed institutions. Sometimes these micro-finances mimics traditional systems (such as rotating savings and credit associations). They provide the same services in similar ways but with greater flexibility, at a more sustainable basis. This can make micro-finance services very attractive to a large number of low-income clients. They strengthen existing formal financial institutions, such as savings and loan co-operatives, credit union networks, commercial banks and even state-run financial institutions by expanding their markets for both savings and credit- and potentially, their profitability. There is an increasing number of well-documented, innovative success stories in setting as diverse as rural Bangladesh, Urban Bolivia and Equity Kenya. This is stark contrast to the records of state run specialized financial institutions, which received large amounts of funding over the past few decades but have failed in terms of both financial sustainability and outreach to the poor. The innovations that have shown the most promise are solving the problem of lack of collateral by using group-based and character-based approach; solving problems of repayment discipline through high frequency of repayment collection, the use of social and peer pressure, and the promise of high repeat loans; solving problems of transaction costs by moving some of these costs down to the group level and by increasing outreach; designing staff incentives to achieve greater outreach and high loan repayment and providing savings services that meet the needs of small savers.

Today, micro-finance plays a major role in the development of many African, Asian and Latin American nations. Its impact is substantial, it is a community-driven and managed micro-finance model where NGOs play the role of a facilitator, for instance providing capacity building services to the groups. The Government of Kenya recognizes MFI's as an economic recovery strategy. In the year 2002, the Kenyan government prepared a poverty reduction strategy paper (PRSP) that outlined key policies and strategies for poverty reduction with the then Minister of Finance David Mwiraria saying:

Microfinance institutions and the savings and credit co-operative societies play an important role in our economy. There is need to encourage and promote them by creating a conducive and enabling environment as well as setting up a regulatory framework.

According to the Central Bank of Kenya annual report 2006, the economic recovery strategy for wealth and employment creation (ERSWEC) sets out priorities for the financial services and efficient intermediation of financial resources. The ERSWEC recognizes that improved access to financial services and products can only be realized by building an inclusive financial system in which alternative financial services providers like microfinance (MFI's) together with mainstream financial institutions all play a role in financial deepening.

The enactment of the micro-finance Act in December, 2006 was a significant step in the development of this industry. It was introduced to enhance the performance of this sector by putting in place the necessary laws and regulatory framework for the establishment, licensing and supervision of deposit-taking focusing on providing services and products to low-income households and enterprises. It is

envisaged that the regulatory requirements and prudential norms that the Central Bank of Kenya has developed for microfinance institutions will be flexible and reflect the specific characteristics and stages of evolution of this industry in Kenya.(Central Bank of Kenya Annual report, 2007).

### **2.3. Measures practiced by MFIs to mitigate credit risks**

#### **2.3.1. Loan Product Design**

According to Churchill and Frankiewicz (2006), to mitigate default risk, MFIs should start by designing loan products that meet client's needs. It is designed to address specific purpose for which the loan is intended. For example, a loan to purchase inventory for a neighborhood grocery store might have a different repayment schedule and use different collateral than a loan for a sewing machine. They recognize the following as the loan products within MFI's:

#### **Income Generating Loans**

The most common is an income-generating or micro-enterprise loan. The intention behind offering these loans assumes that the credit was a missing ingredient for development. If the self- employed in the informal economy had access to investment capital, they could put it to productive use that would generate a return for themselves and for the financial service provider. Today, many MFIs offer a range of enterprise loans including both group and individual products for working capital and fixed assets.

## **Emergency or Consumption Loans**

Recognizing that their customers need credit for other purposes, many MFIs also offer small, immediately available loans to assist clients to cope with unexpected expenses generally secured through group guarantees, pawn items or simply the borrowers credit history. These loans can be used for other purposes as well, including business opportunities, school fees or general consumption purposes.

## **Housing Loans**

These assist low- income households to make incremental improvements to their dwelling and usually take one to three years period either to build a room or upgrade the roof and once that loan is repaid they may borrow again to build or improve another part of the house.

## **Leasing**

Financial lease allows clients to purchase or use assets without a major down payment and without additional collateral. Since the financial institution retains ownership of the asset until the end of the lease term, the assessment process can be simple. In addition, the value of the asset and the lease term can be larger and longer respectively than the size and term of most micro-enterprise loans without increasing risk to the lessor.

## **Savings**

Deposit- taking typically offers savings products that respond to saver's needs for liquidity. If people need access to their savings, then the MFI provides a demand deposit or pass book savings account.

## **Insurance**

Many MFI's offers basic credit life insurance to repay the outstanding loan balance if borrowers die, but recently there has been a growing interest in using insurance more effectively to help clients and their families to manage risks, including death, disability, illness and property loss. This is recognized as a fundamentally different business from savings and credit and the way is managed is in partnership with formal insurance companies.

## **Payment services**

Some microfinance institutions have started offering money transfer services so that their clients can send or receive money from persons in other countries or in other parts of their own country. The most familiar type of payment service is a migrant worker remittance. Remittance can be used to repay loans or to deposit funds in a contractual savings account for school fees. MFI's that offer payment services usually do so in partnership with international money transfer companies like Western Union or money gram.

On the other hand to manage the risks in the above loan products the following should be considered (Churchill and Frankiewicz, 2006).

## ***Eligibility***

The loan is only given to those considered to qualify under the scheme. For example, some MFIs only lend to women because they think women are lower risk. Other firms are careful to only lend to poor people because in part they consider the not-so-poor to be too knowledgeable and more likely to take advantage of the loan scheme.

### ***Interest rate and fees***

Higher interest rate and fees is charged to those that are considered riskier.

### ***Term***

Short-term loan is generally considered less risky than long-term loan. This is because it is easier to predict what will happen in the next three months than in the next three years.

### ***Repayment frequency***

More frequent repayments are generally considered to be less risky because it provides the MFI with a way to continuously monitor whether borrowers are upholding the loan contract than if the entire principal and interest are to be paid at the end of the period.

### ***Installment amounts***

Low-income households generally do not have equal monthly incomes, so it can be difficult for them to repay equal monthly loan installments. Ideally, repayment amounts are designed to accommodate the borrowers expected cash flow.

### ***Collateral and collateral substitutes:***

MFIs use a variety of different means for securing loans, including group guarantees, co-signers or guarantors, and non-traditional collateral such as business equipment, household appliances and livestock. Some loans are also backed by a household member's salary (i.e. the employer repays the loan to the lender by deducting a small amount from each pay cheque). For new clients, MFIs commonly adopt conservative product design features, such as small loan amount, short loan terms and frequent repayment periods and once the client establishes a track record with the lender, the MFI often increases the flexibility in loan terms to make the product more appropriate to the

borrower's needs. This change reflects a balance between risk and control. New clients are categorized as high risk and once they establish a credit history with the MFI, they are considered a lower risk and the lender can reduce some of its controls.

The process of loosening these controls also timely rewards repayment. MFIs also inform their clients from the beginning that their ability to access more accommodating services depends on their repayment history. If they repay on time, they can access preferred product features such as larger loan sizes, lower interest rates, less frequent repayment periods and even additional products.

### **2.3.2. Client Screening**

Client screening is carried out to ensure that they have the willingness and ability to repay a loan.

When analyzing client creditworthiness, micro finance institutions typically use the following five Cs:

#### **i) Character**

To an MFI, character is the single most important means of screening new applicants. By assessing a client's character, the lender gains important insights into the client's willingness to repay. Although it is not the intention of the MFI to put clients in a difficult situation, clients with good character will find a way of repaying their loans even if their businesses fail. Also character is a very important trait to a micro finance because many micro enterprises do not have sufficient records to demonstrate their capacity to repay. Screening the character varies by the lending methodology. In group-lending programmes, the group assumes responsibility for selecting members of strong

motivation and character because members guarantee each other's loans. With individual lending, besides interviewing neighbours and opinion leaders in the community, loan officers also ensure that information provided by the applicant is internally consistent by, requiring the applicant to provide information about themselves and their businesses in a loan application, loan officer to visit the household or business to among other things verify that the application information is correct.

The loan officer checks other sources to assess the reliability of the information, such as a landlord regarding the size of rent and the length of residence, or a supplier regarding the frequency and size of the inventory purchase. Loan officers also look for warning signs that suggest the applicant might be risky. For example, some loan officers are wary of applicants who are in a hurry to get a loan, because that might suggest that they need the money to pay off other loans or if the applicants are wearing too much jewelry or expensive clothes, perhaps it may suggest that they do not spend their money wisely. In this regard, MFIs help their loan officers develop a gut for who is and is not credit worth borrower.

## **ii) Capacity**

This establishes whether the cash flow of the business (or household) can service loan repayment. However, the challenge to determine the business capacity is when the client says she will use the loan for a certain project but uses it for a different undertaking. The appropriate loan amount is dependent on the purpose of the loan and the ability of the client to repay the loan. When determining the debt capacity of potential clients, it is

necessary to consider their cash flow as well as the degree of risks associated with the cash flow and their claims that may come before repayment of a loan to the MFI. Adjusting the debt capacity of a borrower for risk should reflect reasonable expectations about adverse conditions that may affect the enterprise. Adjustment for adversity has to reflect the lender's willingness to assume the risks of borrower's inability to repay. The greater the MFI's capacity to assume risks, the higher the credit limits the lender can offer (Von Pischke, 1991).

### **iii) Capital**

This establishes the strength in terms of more of the assets than liabilities in the business or household. MFIs collect information on the assets and liabilities of the business to construct a simple balance sheet. This allows the loan officer to determine if the business is solvent and how much capital the client has already invested in the business.

### **iv) Collateral**

This is access to an asset by the lender that the applicant is willing to cede in case of non-payment or guarantee by a respected person to repay a loan in default. However, MFIs mostly use collateral substitutes such as compulsory savings and co-signers but as loan size increases, this soft approach to collateral changes so that larger loans are indeed backed by appropriate security.

Generally, MFI's lend to low- income clients who often have very few assets. Consequently, traditional collateral such as property, land, machinery and other capital

assets is often not available. Various innovative means of reducing the risk of loan loss have been developed, including collateral substitutes and alternative collateral. (Ledgerwood, 2000).

Ledgerwood, 2000 observes that one of the most common collateral substitutes within MFIs is peer pressure either on its own or jointly with group guarantees. MFIs facilitate the formation of the groups whose members jointly guarantee each other's loans. Guarantees are either implicit with other group members unable to access a loan if all members are not current in their loan payments or actual guarantees with group members liable if other group members default on their loans.

**v) Condition**

This is a business plan that considers the level of competition and the market for the product or service and the legal and economic environment and since the loan officers mostly do not have the expertise to analyze the conditions of all types of business, the primary means of controlling the credit risk posed by business conditions is to require that applicants be in the business for a certain number of months before they are eligible for a loan. This requirement means that applicants should have sufficient experience to answer questions about market conditions.

**2.3.3 Credit Committee Control**

Churchill and Frankiewicz (2006) observes that a committee of persons to make decisions regarding loans is an essential control in reducing loan default (and fraud) risk.

If an individual has the power to decide who will receive loans, the conditions of the loans and which loans will be written off or rescheduled, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved.

For larger loans, a committee of three or more individuals is appropriate. A credit committee typically includes senior and middle managers, but it might also include community leaders, local bankers and even clients. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, getting involved in delinquency management. This way the credit committee lives with the implications of its decisions. With group lending methodologies, the group usually fulfils part of the credit committee's function. Since group members guarantee each other's loans, it is important that they be involved in the approval process.

#### **2.4 Monitoring Mechanism Practised by Micro-finance Firms**

For the loans that become delinquent, the following management systems are necessary according to Churchill and Frankiewicz (2006):

##### **Institutional Culture**

A critical delinquency management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow-up on all late payments.

MFIs can also remind clients who have had recent delinquency problems that their repayment day is approaching.

### **Client Orientation**

A logical first step towards developing a zero tolerance institutional culture is to communicate this concept to each new client before she receives a loan. An orientation curriculum should be prepared along with graphics and teaching aids to simply and clearly describe the terms of services being offered, the expectations of each client and procedures that will be followed in the case of arrears.

### **Staff Incentives**

Creating staff involvement in discouraging delinquency through staff incentive system. To be eligible for financial incentives, MFIs should establish a minimum portfolio quality criterion. In addition, the scheme should have a greater weight for portfolio quality than for portfolio quantity. Staff should carry bad debts in their portfolio for a significant period of time to ensure that they are held accountable for making credit decisions. Non-financial incentives include branch and loan officer competition and special recognition for top performers.

### **Delinquency Penalties**

Clients should be penalized for late repayment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance. The following is an example of these types of penalties from Alexandria Business Association in Egypt.

**Table 2:1 Delinquency Penalties**

Number of Days (Cumulative)	Sanction
3+ days late (First Loan)	A repeat loan is refused
< 5 days late (Repeat Loan)	No consequences
6 to 9 days late (repeat Loan)	A penalty of one Month's interest and the next loan amount may be kept constant
10+ days late (Repeat Loan)	A second penalty of one Month's interest and further loans will likely be refused.

**Source: Alexandria Business Association, Egypt.**

According to Alexandria Business Association, MFI will quickly lose control of portfolio quality if it fails to enforce its contracts. Clients are oriented to penalties and delinquency procedures before receiving their first loans so that they know exactly what to expect if their loans become delinquent. While certain accommodations can be made for borrowers who are willing but unable to repay, MFIs respond to any unco-operative behaviour from delinquent clients by escalating the pressure. Additional measures might include official letters, pressure on co-signers and persons who gave character references for the applicant, seizing collateral and perhaps even the involvement of local law enforcement.

### **Loan Rescheduling**

Given the vulnerability of the target market, it is common for borrowers to be willing but unable to repay. After careful determining that this is indeed the case, it may be

appropriate to reschedule a limited number of loans. This may involve extending the loan term or reducing the installments size. MFIs must be transparent about their rescheduling policies and they must report their portfolio accordingly. Portfolio quality indicators and provisioning requirements should clearly distinguish between regular and rescheduled loans. In developing their delinquency management policies, senior managers and the board have to determine their credit risk tolerance. As institutions and markets mature and as staff develop expertise, MFIs may want to consider adjusting their tolerance for credit risk.

### **Information Sharing**

Growing competition and the desire to avoid crises of over indebtedness such as that experienced in Bolivia in 1999 have led to a serious interest in client information sharing. MFIs are increasingly exchanging client blacklist (list of past clients who are no longer eligible to receive loans from an institution because of poor repayment histories), creating semi-formal credit Bureaus or participating in private credit bureaus.

Institutional survival is the most basic objective – sharing information on client histories will minimize risks and help maintain the healthy portfolio quality that has allowed MFIs to become sustainable. In competitive environments where other commercial players are offering small loans, a second objective is also becoming important: credit bureau consultation will help reduce transaction costs by weeding out client's with poor repayment histories, resulting in increased institutional efficiency. According to Churchill and Frankiewicz (2006), the following is the important information that is shared:

- Current and past delinquencies or defaulters. Knowing a client's credit history facilitates credit risk assessment.
- Current outstanding balances, including information on guarantees and collateral, with complete information about the client's current level of indebtedness; the MFI can more easily assess repayment capacity. Information on guarantees or collateral pledged against existing loans will help the MFI protect itself from accepting the same guarantee to secure a new loan.
- Credit histories of guarantors and co-signers. Some MFI authorized loans based on guarantors or co-signers. The MFI might refuse to accept a certain guarantor or co-signer who has a poor credit history with another financial institution.

By examining such client related information at the time of the loan application, the MFI can quickly eliminate potentially bad borrowers from the review process, thus reducing overall transaction cost and increase efficiency.

### **The Role of Central Bank of Kenya**

According to annual report, 2007 of the Central Bank of Kenya, MFIs are now recognized as legitimate providers of financial services and as the key to unlocking economic growth for entrepreneurs and poor families, especially in rural areas. A significant step in the development of the micro-finance industry in Kenya is the enactment of the micro-finance Act in December 2006. The Act envisages two tiers of micro-finance institutions, the national wide micro-finance institutions whose minimum core capital is prescribed at Ksh. 60 million and community institutions with a minimum core capital of Ksh. 20 million.

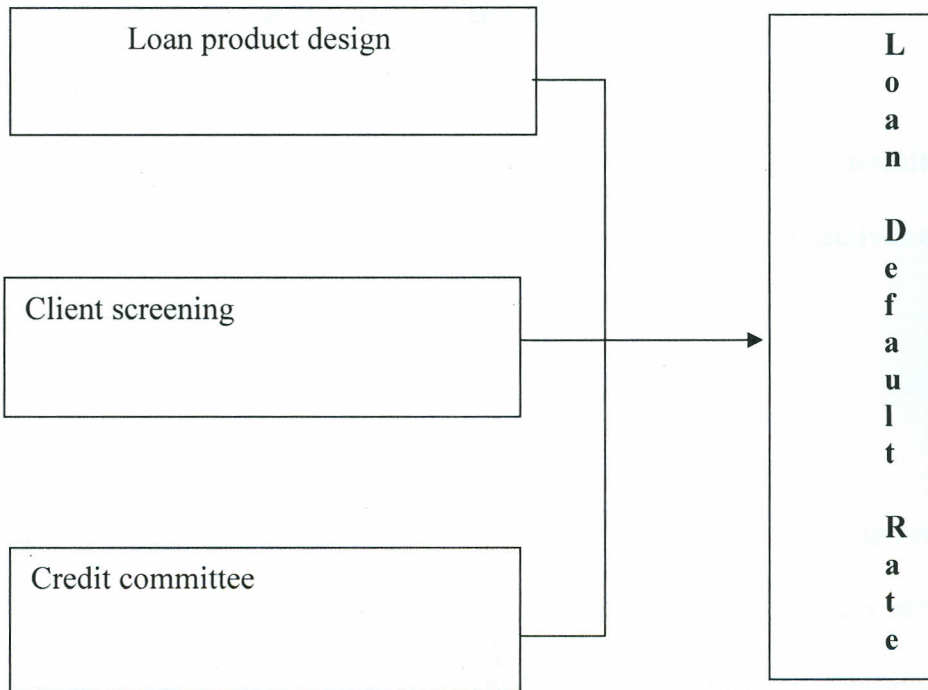
In this regard, the Central Bank of Kenya has developed the prudential micro-finance regulations that will enhance efficiency and promote a broader and deeper access to financial service and products, while ensuring safety and soundness of the financial system as a whole. For example, non-performing loan has been clearly defined as a loan or credit facility that is past due and is not generating any income and according to this Act, loans are considered non-performing if:

- i) Two installments for principal are due and unpaid and
- ii) Interest payments equivalent to two installments payable have been capitalized, refinanced, renegotiated or rolled over.

## **2.5 Conceptual Framework**

The rate of loan default in the MFIs is a function of the following independent variables (client eligibility constraints), which significantly influence the giving of loan to the client. These independent variables are: Loan product design, client screening and credit committee control. This is presented below.

**Figure 2.1: Relationship between independent variables and dependent variable**



Independent Variable (DV)

Dependent Variable (IV)

**Source: Researcher (2009)**

Loan product design is an independent variable that intends to address the specific purpose for which the loan is intended. Strong loan design leads to low loan default rate. On the other hand, client screening tries to find out the client willingness and ability to repay the loan. Weak client screening will lead to high loan default rate while credit committee control evaluates whether the requirements on the loan applications are met, it is also charged with the responsibility for monitoring loan repayment and default management.

## **CHAPTER THREE:**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This section presents the procedures that were used to collect data and thereafter perform an analysis and then present the data in a way to meet the research objectives and answer the research questions.

#### **3.2 Research Design**

This study was a cross-sectional research design. It also employed descriptive survey in carrying out the research. This is because the study aimed at providing a picture of the relationship between loan product design, client screening and credit committee control management and the loan default rate in the micro-finance firms. The expectation is that strong management practices resulted to low loan default rate.

#### **3.3 Target Population**

The target population of the study was all registered MFIs operating in Nairobi total to 27 firms as per the AMFI 2008 Microfinance Directory.

#### **3.4 Sample Size**

A sample size of 50% of the registered MFIs operating in Nairobi was used for the study. The population was stratified and randomly selected.

### **3.5 Sample Techniques**

The researcher used non-probability techniques. MFI offices in Nairobi were visited with the guidance from AMFI office with a view to seeking their assistance to identify the right officers to be interviewed. The researcher used questionnaires to elicit data.

### **3.6 Data Collection Instruments and Procedures**

Data were collected using questionnaires. More than 90% was predetermined scores of scale with three independent variables that were used to obtain responses. Issues covered were sequenced and worded. This was to make data collection systematic. It was anticipated that any clarification would be sought in the process. Secondary data were also collected from the MFIs. This were supplemented the questionnaires in report writing.

### **3.7 Data Collection**

Data was gathered by structured open and closed-ended questionnaire. The respondents were briefly introduced to the purpose of the study before administering the questionnaires. The researcher explained to the respondents the nature and importance of the study during pilot and actual study. Confidentiality was assured to the respondents through transmittal letters that accompanied the questionnaires. Secondary data were obtained from the MFIs and journals.

### **3.8 Data Analysis**

This involved interpreting information collected from respondents when the questionnaires were completed and collected from each respondent. The researcher then compiled them by use of data editing, data coding and data tabulation. Data were analyzed quantitatively describing summarizing data using descriptive statistics to enable the researcher to meaningfully describe distribution of score or measures using statistics. Qualitative data from in-depth interview were analyzed in a systematic way in order to come to some useful conclusions and recommendations. The researcher obtained detailed information about the study and tried to establish patterns, trends and relationships from the information gathered. The researcher used frequencies to enable arranging of data from the lowest to the highest. Percentage measures of central tendency were also used as the data analysis techniques. This was presented in frequency tables, pie and bar charts. Percentages were used to present the data in a clear and a more understandable way.

### **3.9 Pilot Study**

The research instruments were pretested to determine their validity and reliability. The advice of the University Supervisor enabled the researcher to correct any ambiguity detected in the research instruments before field administration.

#### **3.9.1 Validity**

Validity is the degree to which a test measures what it purports to measure (Mugenda & Mugenda, 1999 quoting Gay, 1982). They define validity as the accuracy and meaningfulness of the inferences which are based on the research results. It is the degree

to which results obtained from the analysis of the data actually represents the phenomena under study. The scholars contend that the validity of the questionnaire data depends on the ability and willingness of the respondents to provide the required information.

### **3.9.2 Reliability**

The reliability of the instruments measures the consistency of instruments (Orodho, 2004). He posits that the reliability of the instruments to be the degree of consistency that the instruments or procedure demonstrates. In our pilot study, reliability was tested using finance officers, credit managers, loan officers in the micro-finance firms and the University Supervisor.

## **CHAPTER FOUR**

### **DATA ANALYSIS AND PRESENTATION**

#### **4.1 Introduction**

This chapter presents the analysis of the data collected from the study to get a clear picture of the results and compare them with the expectations. The study results were used as a guideline for future studies. The purpose of the study was to analyze the influence of loan design, client screening and credit committee control have on loan default rate in the micro-finance firms in Kenya. The findings were qualitatively and quantitatively analyzed and presented in the tables and percentage form. It includes data analysis from questionnaires that were distributed to the respondents.

#### **4.2 Quantitative Analysis**

Quantitative data analysis refers to a scientific method of investigation that is based on the numeric data. The data are presented in form of numbers; numeric values numeric levels and categories meant to describe, predict and explain the research findings. This was achieved through collection of numerical data on the observable behaviour and subjecting such data to statistical analysis. The data collected from the research were analyzed to filter and interpret findings that have come up. This is due to the fact that data obtained were raw and required processing for them to be of value to the users of the research findings.

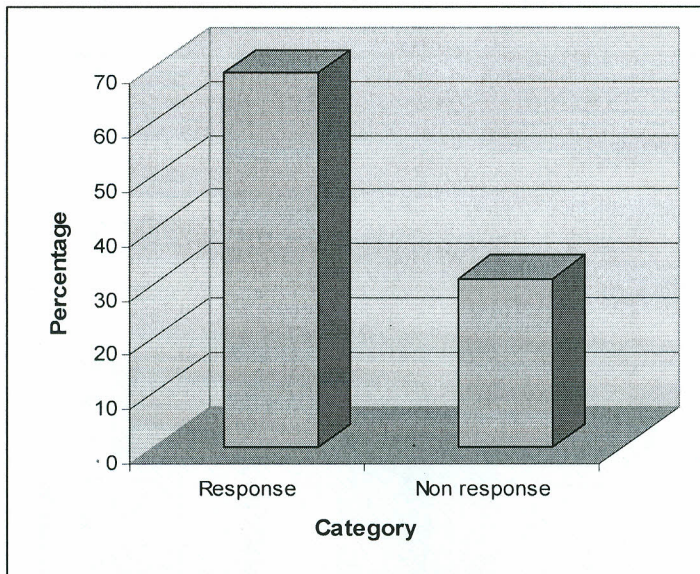
#### 4.2.1 Response Rate

Table 4.1 Rate of response

Response Category	Frequency	Percent	Valid Percent	Cumulative Percent
Response	9	69.0	69.0	69.0
Non response	4	31.0	31.0	31.0
<b>Total</b>	<b>13</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: Researcher, 2009

Figure 4.1 Rate of response



Source: Researcher, 2009

The data in table 4.1 indicate that, the response rate was anticipated to be higher than the above but due to the fact that other registered MFIs have resorted to other businesses other than micro- financing, it was hard to get the required information. This shows that 69% of the respondents responded positively to the study and only 31% did not.

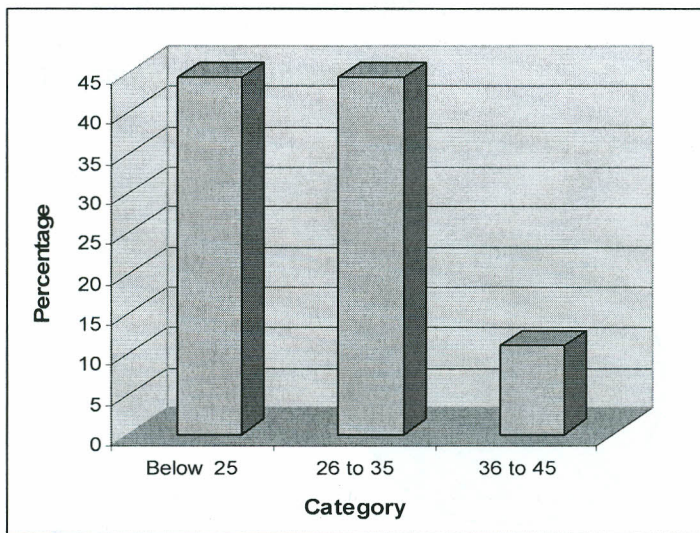
## 4.2.2 Age of the Respondent

Table 4.2 Respondents Age

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Below 25	4	44.4	44.4	44.4
	26 to 35	4	44.4	44.4	88.9
	36 to 45	1	11.1	11.1	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.2 Respondents Age



Source: Researcher, 2009

The information on table 4.2 above indicates that, majority of the respondents are within the age bracket of below 25 years and 26-35 years having 44% representation each, followed by those that are within the age bracket of 36-45 having 11%. Those who are above 45 years of age were not represented.

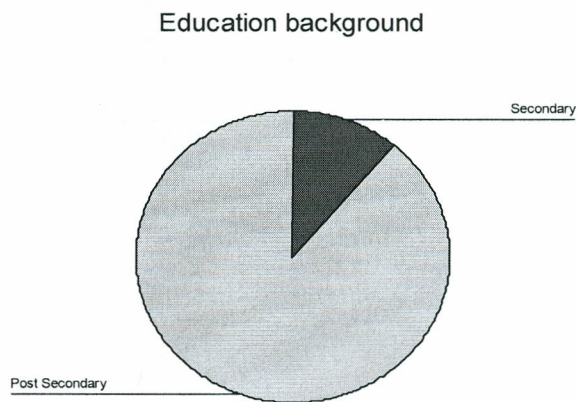
### 4.2.3 Education background

Table 4.3 Educational background

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Secondary	1	11.1	11.1	11.1
	Post Secondary	8	88.9	88.9	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.3 Educational background



Source: Researcher, 2009

The results indicate that majority of the respondents have attained post-secondary educational level having over 88%, followed by those who have attained secondary level at 11%. There was no respondent with non-formal education.

#### 4.2.4 Work duration

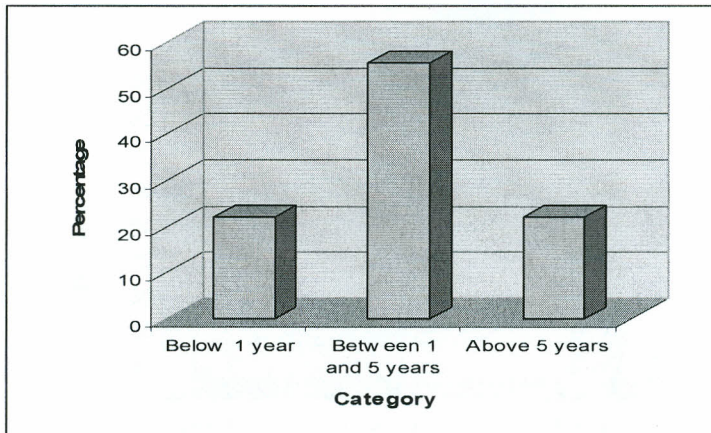
Table 4.4 Respondents work duration

			Freque ncy	Percent	Valid Percent	Cumulative Percent
Valid	Below year	1	2	22.2	22.2	22.2
	Between and 5 years	1	5	55.6	55.6	77.8
	Above years	5	2	22.2	22.2	100.0
	Total		9	100.0	100.0	

Source: Researcher, 2009



Figure 4.4 Respondents work duration



Source: Researcher, 2009

The table and figure 4.4 above shows that, 56% of the respondents have worked in their respective organizations for 1 – 5 years, 22% have worked for below 1 year and above 5 years each. This shows that most of the employees have good working experience on the business operational cycle.

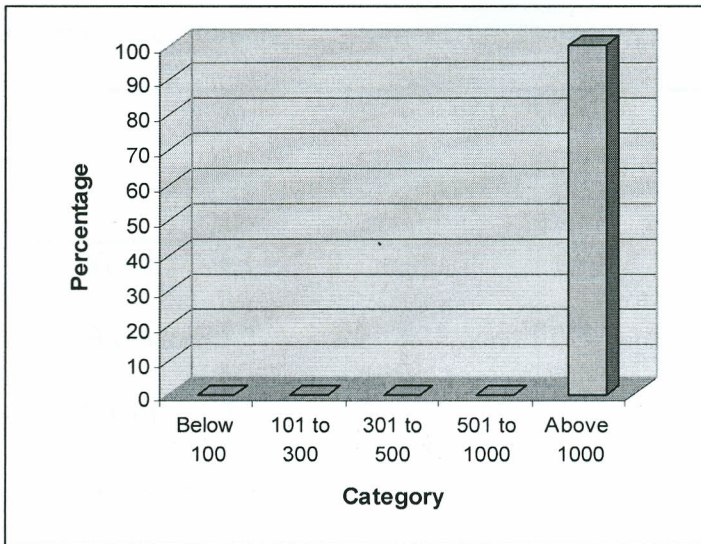
#### 4.2.5 Information on Clientele Base

Table 4.5 Information on clientele base

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid				
Below 100	0	0.0	0.0	
101 to 300	0	0.0	0.0	0.0
301 to 500	0	0.0	0.0	0.0
501 to 1000	0	0.0	0.0	100.0
Above 1000	9	100.0	100.0	
<b>Total</b>	<b>9</b>	<b>100.0</b>	<b>100.0</b>	

Source: Researcher, 2009

Table 4.5 Information on clientele Base



Source: Researcher, 2009

The data above show that all respondents argued that they have a clientele base of over 1000 having a 100% representation. This indicates that all the organizations under study are well established and have a good number of clients.

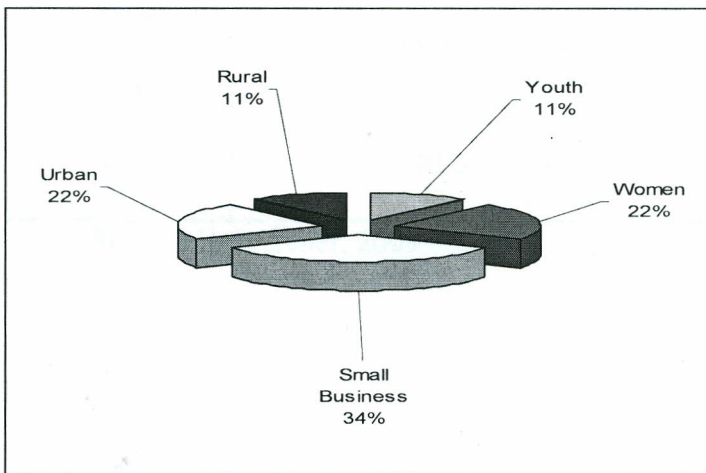
#### 4.2.6 Targeted Customers

Table 4.6 Targeted customers

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Youth	1	11.1	11.1	11.1
	Women	2	22.2	22.2	33.3
	Small Business	3	33.3	33.3	66.7
	Urban	2	22.2	22.2	88.9
	Rural	1	11.1	11.1	100.0
	<b>Total</b>	<b>9</b>	<b>100.0</b>	<b>100.0</b>	

Source: Researcher, 2009

Figure 4.6 Targeted customers



Source: Researcher, 2009

According to table 4.6, 34% of the respondents argued that they target small businesses, 22% of the respondents said that they target women and urban dwellers each while 11% of the respondents said that they target youth and rural dwellers each. This shows that most MFIs under study base more emphasis on small business enterprises than other client categories. The reason given for targeting small businesses is that they require less capital making it possible for the MFIs to reach out to many Kenyans living below the poverty line. The government policies also tend to target the same category as a means of economic recovery strategy. Others argued that this class is less risky.

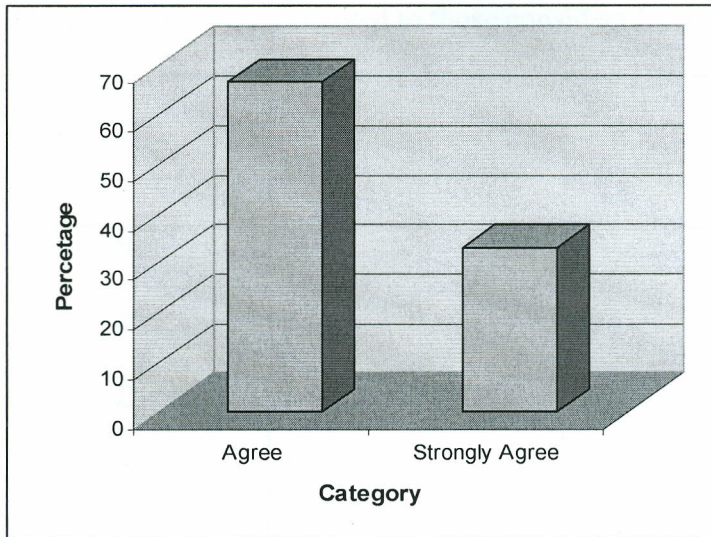
#### 4.2.7 Loan Applicants Qualified Under Scheme

Table 4.7 Applicants qualified under scheme

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	6	66.7	66.7	66.7
	Strongly Agree	3	33.3	33.3	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.7 Applicants Qualified Under Scheme



Source: Researcher, 2009

According to table and figure 4.7 above, 67% of the respondents agreed that loan is only given to those considered to qualify under the scheme. Thirty three percent of the respondents strongly agreed with the statement. There were no respondents that disagreed or strongly disagreed.

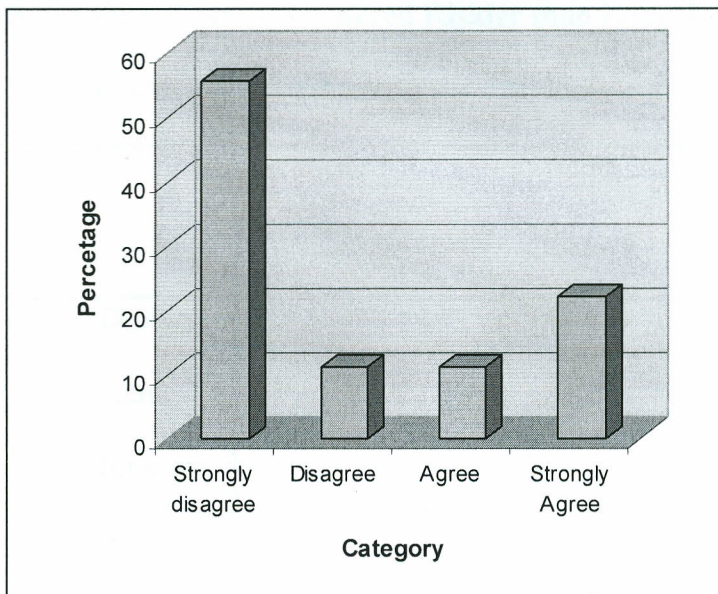
#### 4.2.8 Higher Interest Rate Charged to Those Considered Riskier

Table 4.8 Higher interest rate charged to those considered riskier

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	5	55.6	55.6	55.6
	Disagree	1	11.1	11.1	66.7
	Agree	1	11.1	11.1	77.8
	Strongly Agree	2	22.2	22.2	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.8 Higher interest rate charged to those considered riskier



Source: Researcher, 2009

The above table shows that 56% of the respondents strongly disagreed that there is higher interest rate charged on those loan applicants that are considered riskier, 22% strongly agreed, while a considerable number of 11% both disagreed and agreed with the statement.



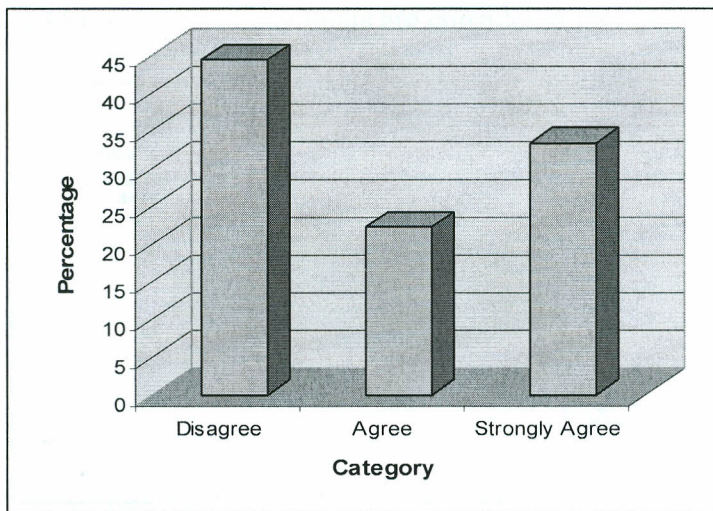
#### 4.2.9 Short term Loans Considered Riskier than Long Term Loans

Table 4.9 Short- term loans considered risky than long-term loans

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	4	44.4	44.4	44.4
	Agree	2	22.2	22.2	66.7
	Strongly Agree	3	33.3	33.3	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.9 Short term Loans considered riskier then long term loans



Source: Researcher, 2009

From the above figure, it is clear that 44% of the respondents disagreed that short-term loans are more risky than long-term loans. Thirty three percent strongly agreed while only 22% of the respondents agreed with the statement.

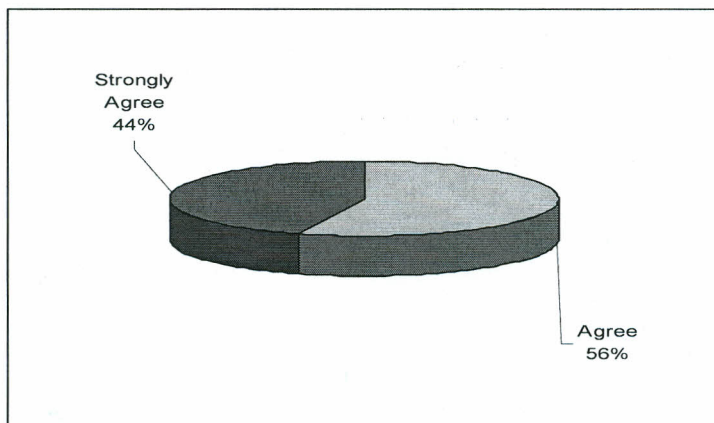
#### 4.2.10 Information Regarding Most Frequent Payments Considered Less Risky

Table 4.10 Most frequent payments are considered less risky

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	55.6	55.6	55.6
	Strongly Agree	4	44.4	44.4	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.10 Most frequent payments are considered less risky



Source: Researcher, 2009

The table 4.10 indicates that 56% of the respondents agreed that most frequent payments are considered less risky while 44% strongly agreed.

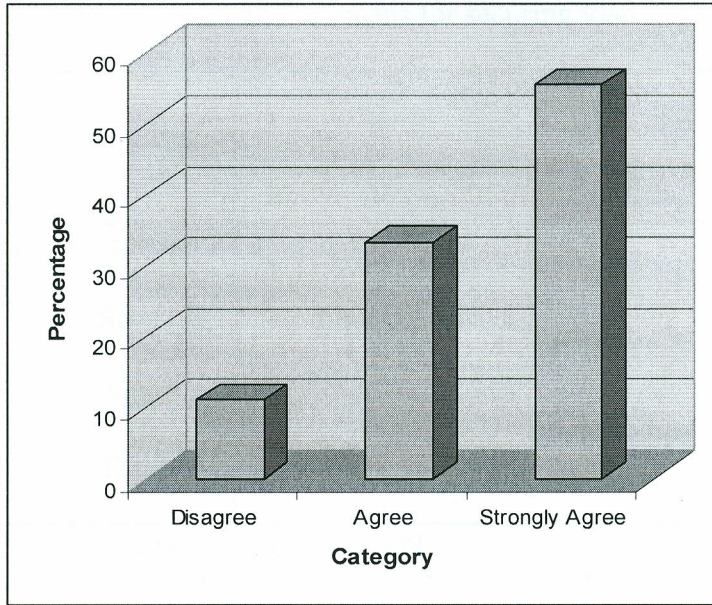
#### 4.2.11 Repayment Amounts Designed to Accommodate the Borrower's Cash Flow

Table 4.11 Repayment amounts designed to accommodate the borrower's cash flow

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	11.1	11.1	11.1
	Agree	3	33.3	33.3	44.4
	Strongly Agree	5	55.6	55.6	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.11 Repayment amounts designed to accommodate the borrower's cash flow



Source; Researcher, 2009

Responses from the questionnaire indicated that 56% of the respondents strongly agreed that the repayment amounts is designed to accommodate the borrowers expected cash flows, 33% agreed while 11% disagreed.

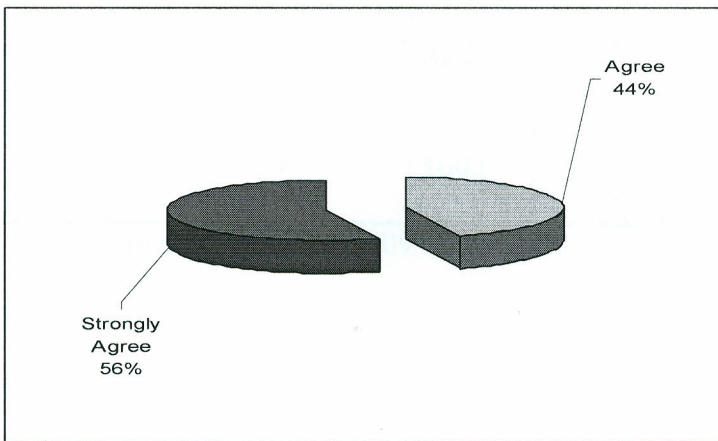
**4.2.12 MFIs Use a Variety of Means for Securing Loans**

Table 4.12 MFIs use a variety of means for securing loans

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	4	44.4	44.4	44.4
	Strongly Agree	5	55.6	55.6	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.12 MFIs use a variety of means for securing loans



Source: Researcher, 2009

It is evident from the above table and figure that 56% of the respondents strongly agreed that MFIs use a variety of means for securing loans, while 44% agreed. There were no respondents who declined.

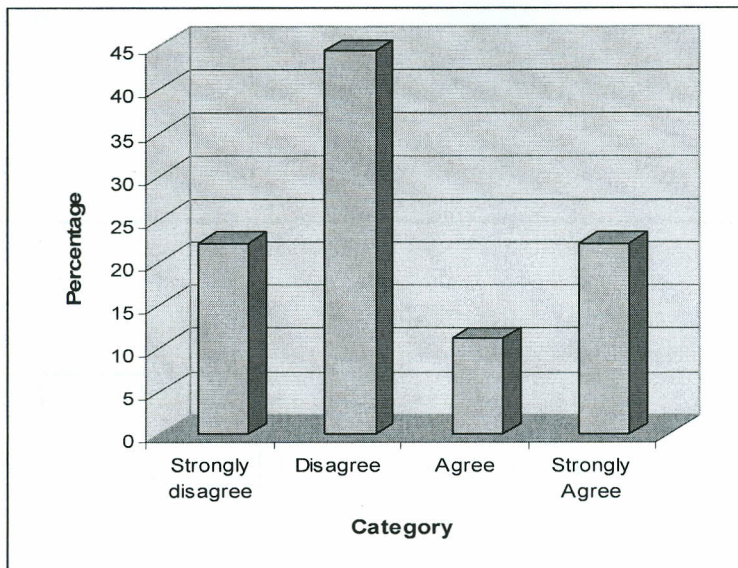
#### 4.2.13 MFIs Character is the Most Important Means of Screening New Applicants

Table 4.13 MFIs character is the most important means of screening new applicants

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	2	22.2	22.2	22.2
	Disagree	4	44.4	44.4	66.7
	Agree	1	11.1	11.1	77.8
	Strongly Agree	2	22.2	22.2	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.13 MFIs character is the most important means of screening new applicants



Source: Researcher, 2009

From the table and graph above, it is evident that majority of the respondents (44%) disagreed that to MFIs character is the most important means of screening new loan applicants, 22% strongly disagreed. Twenty two percent of the respondents also strongly agreed while only 11% agreed with the statement.

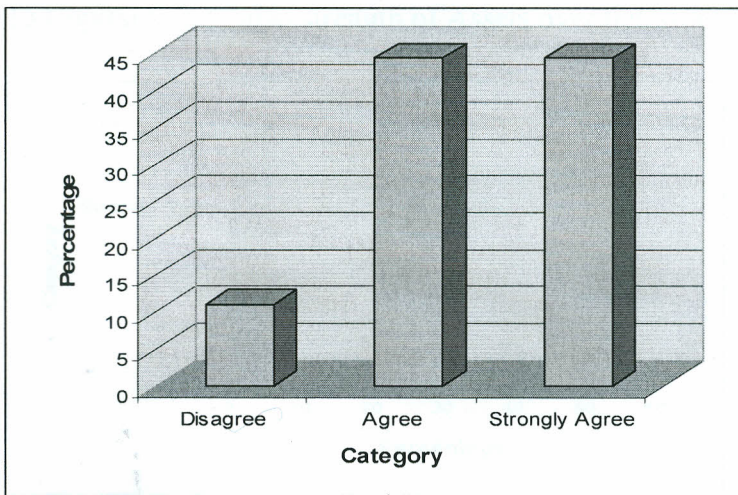
#### 4.2.14 Business Capacity Considered as to Whether Cash Flows Can Service Loan Repayment

Table 4.14 Business capacity considered as to whether cash flows can service loan repayment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	11.1	11.1	11.1
	Agree	4	44.4	44.4	55.6
	Strongly Agree	4	44.4	44.4	100.0
	Agree				
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.14 Business capacity considered whether cash flows can service loan repayment



Source: Researcher, 2009

The table 4.14 show that over 88% of the respondent agreed that business capacity is considered to establish whether the cash flow of the business can service loan repayment. Only 11% disagreed.

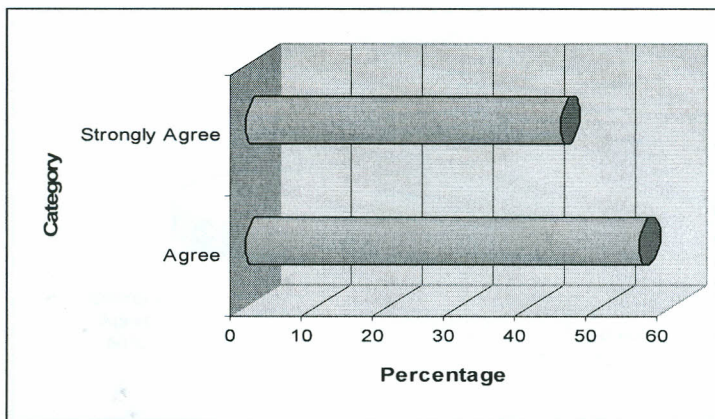
#### 4.2.15 Capital Considered to Establish Strength of the Business in Terms of Assets Over Liabilities

Table 4.15 Capital to establish strength of Assets over liabilities

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Agree	5	55.6	55.6	55.6
	Strongly Agree	4	44.4	44.4	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Table 4.15 Capital to establish strength of Assets over liabilities



Source: Researcher, 2009

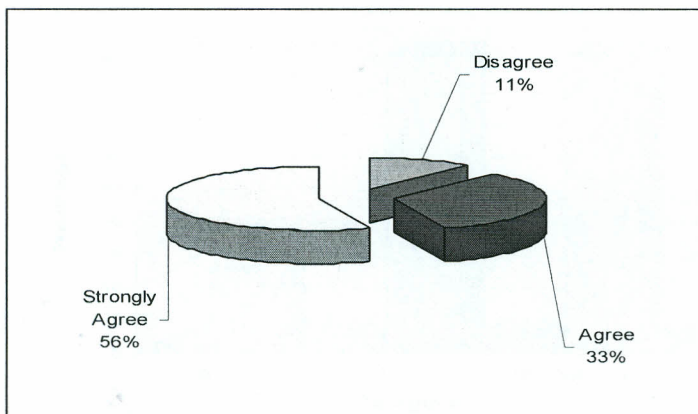
The data in the table above show that 56% of the respondents agreed and 44% strongly agreed that capital is considered to establish the strength in terms of more of the assets than liabilities in the business.

#### 4.2.16 Collateral is Required by the Lender to Cede for Loan Default

Table 4.16 Collateral is required by the lender to cede for loan default

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	11.1	11.1	11.1
	Agree	3	33.3	33.3	44.4
	Strongly Agree	5	55.6	55.6	100.0
	Total	9	100.0	100.0	

Figure 4.16 Collateral is required by the lender to cede for loan default



Source: Researcher, 2009

Form the research data shown above, it is evidenced that majority (56%) of the respondents strongly agreed that collaterals are required by the lender to cede in case of non- payment or loan default, 33% agreed while only 11% disagreed.

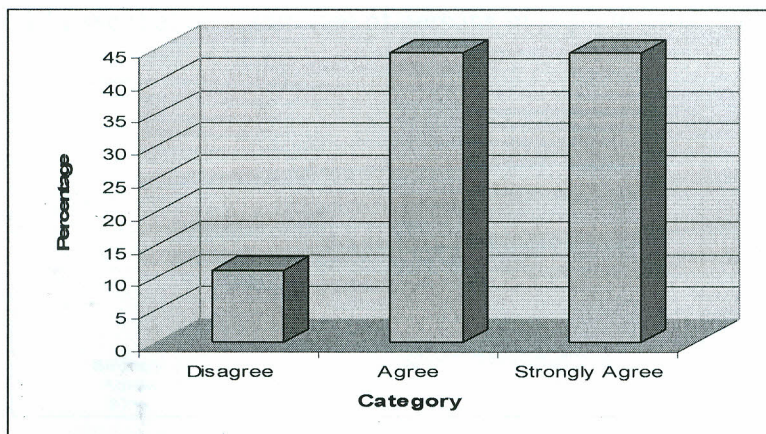
#### 4.2.17 Applicants to be in Business Before They are Eligible for Loans

Table 4.17 Applicants to be in business before they are eligible for loans

		Freque ncy	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	11.1	11.1	11.1
	Agree	4	44.4	44.4	55.6
	Strongly Agree	4	44.4	44.4	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.17 Applicants to be in business before they are eligible for loans



Source: Researcher, 2009

The table and figure 4.17 above indicates that over 80% of the respondents agreed that there is a condition required for the applicants to be in the business for a certain number of months before they are eligible for loans. Only 11% of the respondents disagreed.

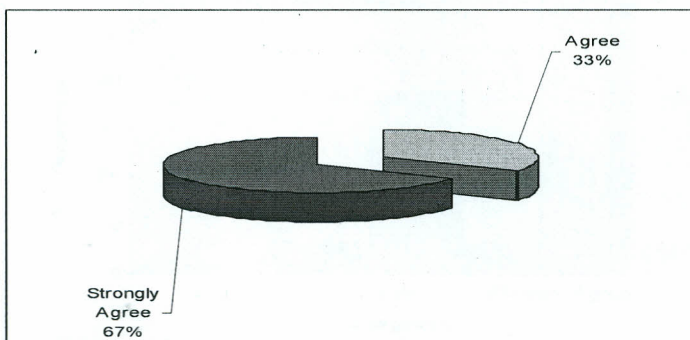
#### 4.2.18 Information on Committee of Persons is Essential in Reducing Loan Default Rate

Table 4.18 Essential of committee of persons is in reducing loan default rate

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Agree	3	33.3	33.3	33.3
	Strongly Agree	6	66.7	66.7	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.18 Essential of committee of persons in reducing loan default rate



Source: Researcher, 2009

The table and the figure above show that 67% of the respondents strongly agreed that a committee of persons are essential in reducing loan default rate, 33% agreed while no respondent that disagreed with the statement.

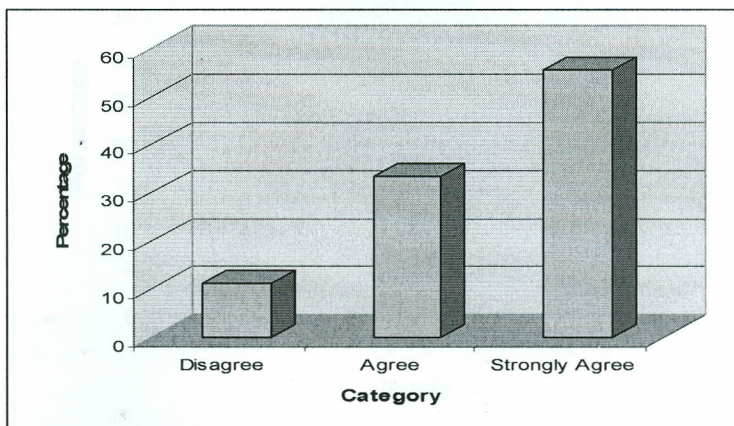
#### 4.2.19 Information on Appropriate Committee for Larger Loans

Table 4.19 Appropriate committee for larger loans

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	1	11.1	11.1	11.1
	Agree	3	33.3	33.3	44.4
	Strongly Agree	5	55.6	55.6	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.19 Appropriate committee for larger loans



Source: Researcher, 2009

From the study it has been established that 89% of the respondents agreed that a committee of three or more is appropriate for larger loans. Only 11% disagreed.

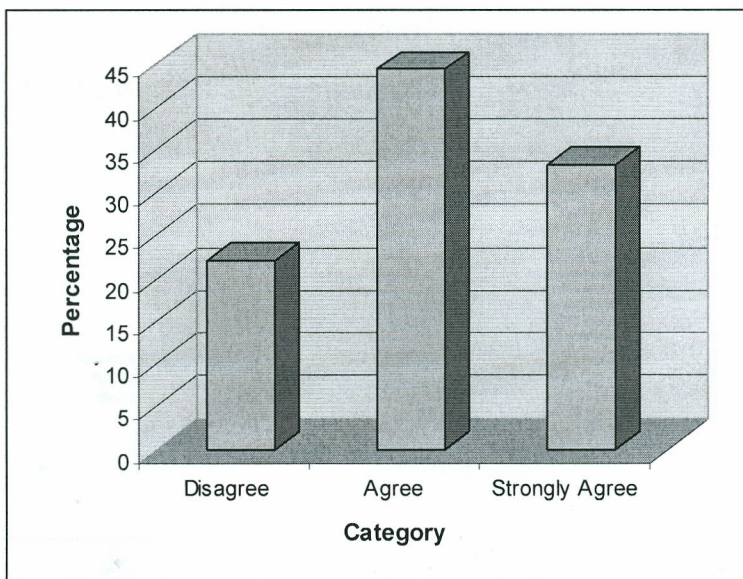
**4.2.20 Information on a Credit Committee Includes Senior and Middle Managers.**

Table 4.20 Information on a credit committee includes senior and middle managers.

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Disagree	2	22.2	22.2	22.2
	Agree	4	44.4	44.4	66.7
	Strongly Agree	3	33.3	33.3	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.20 Information on a credit committee includes senior and middle managers.



Source: Researcher, 2009

The data in the table 4.20 above show that 78% of the respondents agreed that credit committee includes senior and middle managers, only 22% disagreed that it does not include senior and middle managers.

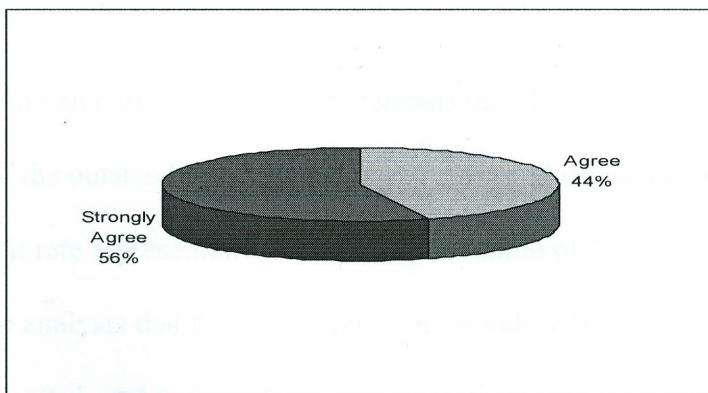
#### 4.2.21 Information on the Work of a Credit Committee

Table 4.21 The work of a credit committee

		Frequenc y	Percent	Valid Percent	Cumulative Percent
Valid	Agree	4	44.4	44.4	44.4
	Strongly Agree	5	55.6	55.6	100.0
	Total	9	100.0	100.0	

Source: Researcher, 2009

Figure 4.21 The work of a credit committee



Source: Researcher, 2009

It is evident from the above table and figure 4.21 that nearly all the respondents agreed that credit committee does not only approve loans but also monitor the loan repayment progress.

#### 4.2.22 Descriptive Statistics on Loan Default Rate

The table below gives a summary of the mean and standard deviation of loan defaulters, outstanding loan and rate of loan default. The mean and standard deviation have been determined by taking a simple average of the nine observations which is represented by (N).

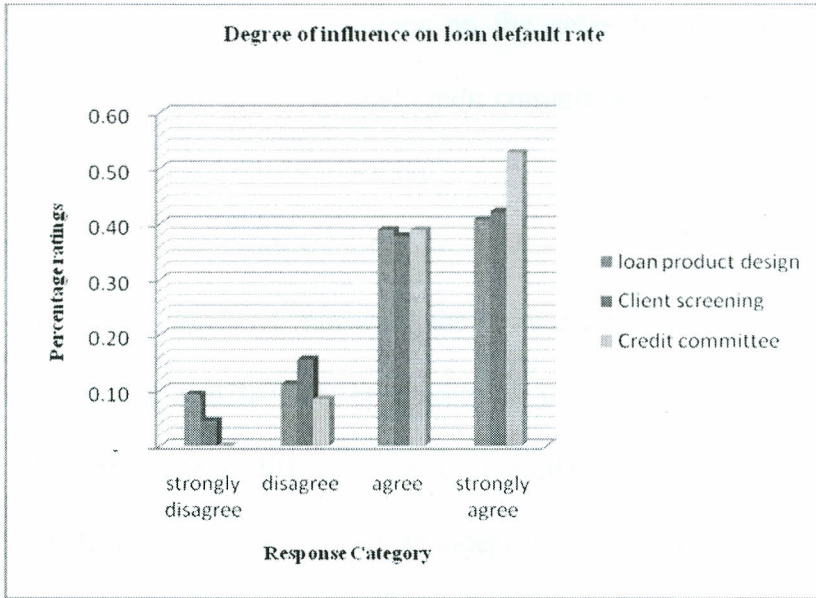
Table 4.22 Descriptive statistics

	Mean	Std. Deviation	N
Loan defaulters	22121.5556	59316.20241	9
Outstanding Loan	230811.7778	590901.33322	9
Rate of default (%)	6.0534	4.71949	9

Source: Researcher, 2009

The mean value of 6 for default rate means that the MFIs loan default rate has been rated at 6% of the outstanding loan, however still there has been a moderately high variability in default rate represented by a standard deviation of 4.7%, therefore it has been observed from the analysis that the loan default rate stands at 6%. This is regarded as very high and has been attributed to the following observations;

Figure 4.22: Degree of influence on loan default rate



Source: Researcher, 2009

It is observed from the graph that, from the three tested variables in the study, non of them seemed to be strongly administered by all firms in the industry, with credit committee ranking the best at only 54% as a measure of ensuring loan was lent out to non risky customers. Loan product design and client screening came below 50%. This clearly explains the reason why the default rate was very high.

### 4.3 Qualitative Analysis

Qualitative research refers to a method of investigation that is based on non-numeric data. The data take the form of narratives, explanations, documentation and records. Qualitative research is based on the doctrine that social reality is a construction and that people construct differently. The researcher analyzed the data qualitatively since to

provides an in-depth analysis of the data that were to be used to answer the research questions and give recommendations on the areas to establish the influence of loan product design, client screening and credit committee control on loan default rate within the micro-finance institutions in Kenya.

Qualitative data analysis allowed the researcher to rearrange and analyze data systematically. It also helped the researcher to comprehend and manage data, merge related data drawn from different sources, identify the key patterns and themes, draw and verify conclusions. This also involved categorization, identifying units for data collected and recognizing their relationship and categories.

#### **4.3.1 Loan Product Design**

MFIs should carry out proper loan design to meet and address client's needs and the purpose for which the loan is intended. The intention behind offering these loans assumes that the credit was a missing ingredient for development. If the self-employed in the informal economy had access to investment capital, they could put it to productive use that would generate a return for themselves and for the financial service provider. Today, many MFIs offer a range of enterprise loans including both group and individual products for working capital and fixed assets. With the recognition that clients need credit for different purposes, many MFIs also offer small, immediately available loans to assist clients to cope with unexpected expenses generally secured through group guarantees.

Collaterals is an asset the borrower is ready to cede in case of loan default. Loans support the growth of new businesses and jobs within the lender's trade territory. Despite the benefits of lending for both borrower and institutions, lending is among the riskiest of all MFI's functions, it's problems usually spring from loans that have become uncollectible due to mismanagement, illegal manipulation, misguided lending policies or an expected economic downturn. In order to assist low- income households to make incremental improvements to their dwelling, MFI,s allows clients to purchase or use assets without a major down payment and without additional collateral. This is possible mainly due to joint liability within the MFI's arrangements.

#### **4.3.2 Client Screening**

MFIs use a variety of different means for securing loans, including group guarantees, co-signers or guarantors, and non traditional collateral such as business equipment, household appliances and livestock. Some loans are also backed by a household member's salary. Client screening is carried out to ensure that they have the willingness and ability to repay a loan. MFIs mostly use collateral substitutes such as compulsory savings and co-signers but as loan size increases, this soft approach to collateral changes so that larger loans are indeed backed by appropriate security. Generally, MFI's lend to low- income clients who often have very few assets. Consequently, traditional collateral such as property, land, machinery and other capital assets is often not available. Various innovative means of reducing the risk of loan loss have been developed, including collateral substitutes and alternative collateral.

It has been observed that one of the most common collateral substitutes within MFI's is peer pressure either on its own or jointly with group guarantees since this forms the only way to screen the applicants. MFI's facilitate the formation of the groups whose members jointly guarantee each others loans.

#### **4.3.3 Credit Committee**

A committee of persons makes decisions regarding loans and is an essential control in reducing loan default risks. If an individual has the power to decide who will receive loans, the conditions of the loans and which loans will be written off or rescheduled, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved. A credit committee typically includes senior and middle managers, but it might also include community leaders, local bankers and even clients. The credit committee has the responsibility not only for approving loans, but also for monitoring and management of delinquent loans should borrowers have repayment problems. This way the credit committee lives with the implications of its decisions.

With the existence of group lending methodologies, the group usually fulfils part of the credit committee's function. Since group members guarantee each other's loans, it is important that they be involved in the approval process. A critical management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow-up on all late payments.

## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION**

#### **5.1 Introduction**

This chapter gives the major findings of the study, answers to research questions, recommendations, conclusions and suggestions for further studies. The investigator outlines a summing up of research findings in line with the study objectives. The section delineates the synopsis conclusion in line with the information gathered, evaluated and the study proposals.

#### **5.2 Summary of the Findings**

It emerged from the study that loan product design has a positive influence on the borrowing ability. This was evident as 56% of the respondents strongly agreed that MFIs used a variety of means for securing loans, while 44% agreed and no respondents declined. It showed that it was being used as a means to assist clients secure loans, including group guarantees, co-signers or guarantors, and non-traditional collateral such as business equipment, household appliances and livestock.

The study also established that the amount of interest charged on loans influences the ability of the borrower to pay the borrowed loan hence very high chances of defaulting on loan repayment schedule and time. This also confirmed that the business solvency is a factor of repayment ability which affects the performance of credit institutions. Majority

of the respondents (over 88%) agreed that business capacity is considered to establish whether the cash flow of the business can service loan repayment. Only 11% disagreed.

The study also confirmed that the size of individual screening on credit worthiness by credit committee affects the amount of loan and the value of collateral needed to provide security to the borrowed loan since 67% of the respondents strongly agreed that a committee of persons is essential in reducing loan default rate, while 33% agreed. The researcher established that MFIs have credit committee that not only approves loans borrowed but also monitors and manages delinquent loans. This is because nearly over 90% agreed that credit committee does not only approve loans but also monitors the loan repayment progress.

It was established from the study that the nature of credit risk varies with the size of the loan and the pledged collaterals. Thus, MFIs demand greater collaterals as the size of the loan increases. Sufficient collaterals will reduce the level of potential future default risks. The researcher established that some of the registered MFIs have pulled from the micro credit business to other unrelated businesses, while others that were purported to be in the same business now claim that they either not have not started lending to borrowers directly or lend only to MFIs.

## **5.3 Answers to Research Questions**

### **5.3.1 The Effect of Loan Product Design on Loan Default Rate**

The intention behind offering dynamic loan product design by the lending institutions is to meet the clients needs and purpose. Many MFIs offer a range of enterprise loans including both group and individual products for working capital and fixed assets. The application of loan product design recognizes the customer's need; Many MFIs also offer small, immediately available loans to assist clients to cope with unexpected expenses generally secured through group guarantees. These loans can be used for other purposes as well, including business opportunities, school fees or general consumption purposes.

From the analysis done, it has been established that the loan product design was rated at 40% which is very low since for example, different loan product design assists low-income households to make incremental improvements to their dwelling and it usually takes one to three year period either to build a room or upgrade the roof and once that loan is repaid, they may borrow again to build or improve another part of the house. Again, the existence of financial lease allows clients to purchase or use assets without a major down payment and without additional collateral. Since the financial institution retains ownership of the asset until the end of the lease term, the assessment process can be simple.

Deposit- taking typically offers savings products that respond to saver's needs for liquidity. If people need access to their savings, then the MFI provides a demand deposit or pass book savings account. This enhances the individual saving and investment habits.

The growing interest in using insurance helps clients and their families to manage risks, including death, disability, illness and property loss and has been recognized as a fundamentally different business from savings and credit.

The most familiar type of payment service due to loan product design by the lending institutions is a migrant worker remittance. Remittance can be used to repay loans or to deposit funds in a contractual savings account for school fees. MFI's that offer payment services usually do so in partnership with international money transfer companies like Western Union or money gram.

MFIs use a variety of different loan product designs as a means to assist clients secure loans, including group guarantees, co-signers or guarantors, and non-traditional collateral such as business equipment, household appliances and livestock. Some loans are also backed by a household member's salary. All these show how different MFIs use different loan product designs in the management of their credit facilities.

### **5.3.2 The Impact of Client Screening on Loan Default Rate**

Client screening is carried out to ensure that they have the willingness and ability to repay a loan. The impact of analyzing client creditworthiness, micro-finance institutions typically assess the client, the lender gains important insights into the client's willingness to repay since clients with good character will find a way of repaying their loans even if their businesses fail. Screening the character varies by the lending methodology. In group-lending programmes, the group assumes responsibility for selecting members of strong motivation and character because members guarantee each other's loans. This is

shown by the fact that client screening has been rated 38% since different institutions view other applicant evaluation criteria as equally important.

The loan officer checks other sources to assess the reliability of the information, such as a landlord regarding the size of rent and the length of residence, or a supplier regarding the frequency and size of the inventory purchase. Loan officers also look for warning signs that suggest the applicant might be risky. The screening of the business capacity establishes whether the cash flow of the business (or household) can service loan repayment. However, the challenge to determine the business capacity is when the client says she will use the loan for a certain project but uses it for a different undertaking since the loan amount is dependent on the purpose of the loan and the ability of the client to repay the loan. When determining the debt capacity of potential clients, it is necessary to consider their cash flow as well as the degree of risks associated with the cash flow and their claims that may come before repayment of a loan to the MFI.

Screening of the capital also establishes the strength in terms of the assets than liabilities in the business or household. MFIs collect information on the assets and liabilities of the business to construct a simple balance sheet. This allows the loan officer to determine if the business is solvent and how much capital the client has already invested in the business. MFIs mostly use collateral substitutes such as compulsory savings and co-signers but as loan size increases, this soft approach to collateral changes so that larger loans are indeed backed by appropriate security.

#### **5.3.4 The Effect of Credit Committee Control on Loan Default Rate?**

The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, they get involved in delinquency management. This way the credit committee lives with the implications of its decisions. The research established that credit committee ranked at 54% fairly above other variables with respondents indicating that all MFIs have credit committee to evaluate and monitor the loan repayment schedules within the organizations.

With the existence of group lending methodologies, the group usually fulfils part of the credit committee's function. Since group members guarantee each other's loans, it is important that they be involved in the approval process. A critical management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow-up on all late payments. A committee of persons make decisions regarding loans is an essential control in reducing loan default risk. If an individual has the power to decide who will receive loans, the conditions of the loans and which loans will be written off or rescheduled, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved.

### **5.3.5 The Influence of Loan Product Design, Client Screening and Credit Committee Control on Loan Default Rate Within the Microfinance Firms in Kenya.**

A system of organizational control is intended to provide motivation for employees and clients to take actions and make decisions consistent with the organizational objectives. MFIs have long recognized that the loan product design, screening and credit committee control are an integral part of an organizational control system that provides critical decisions influencing and facilitating the overall organizational performance. The opening of financial services and the structural reforms of domestic financial sector are two interwoven processes, both aimed at developing an efficient and competitive financial system to facilitate economic development.

Control helps the organizations to measure the level of performance while at the same time comparing these levels with the already set performance standard which the rules set to implement. Therefore, organizational rules and regulations are key in determining organizations efficiency and effectiveness in service delivery by MFI. This also controls and reduces the number of loan defaulters.

### **5.4 Conclusions**

The nature of credit risk confront MFIs varies with the size of the loan and the pledged collaterals. Thus, MFIs demand greater collaterals as the size of the loan increases. Sufficient collaterals will reduce the level of potential future default risks. The credit committee involvement in the credit evaluation and loan approval has been viewed as a

major milestone in the management of credit risks. A committee of persons making decisions regarding loans is an essential control in reducing loan default risk. If an individual has the power to decide who will receive loans, the conditions of the loans and which loans will be written off or rescheduled, this power can easily be abused and covered up.

Loan design strategies and screening of the capital also establishes the strength in terms of the assets than liabilities in the loan applicant. MFIs collect information on the assets and liabilities of the business to construct a simple balance sheet. This allows the loan officer to determine if the business is solvent and how much capital the client has already invested in the business. It has also enabled more clients with different credit needs to access funds through this MFIs operating within Nairobi area. The intention behind offering dynamic loan product design by the lending institutions is to meet the clients needs and purpose. Many MFIs offer a range of enterprise loans including both group and individual products for working capital and fixed assets. The borrower then enjoys the benefit of using the assets ahead of the effort required to obtain them, while the lender enjoys the benefit of the fee paid by the borrower for the privilege. Solvency can also be described as the ability of an institution to meet its long-term fixed expenses and to accomplish long-term expansion and growth. The better a company's solvency, the better it is financially.

## 5.5 Recommendations

The following are the study recommendations that will positively influence credit management performance in MFI sector.

- i) The organization should have a well-trained credit management staff to carry out credit management and collateral evaluation functions within the organization.
- ii) The government should regulate the establishment of credit institutions to control the establishment of sub standard lending institutions which is aimed at exploiting the public.
- iii) The lending institutions should avail the information regarding collateral sizes and the secrecy required in securing loans while considering reduction of interest charged on acquired loans. This will be the first step towards developing a zero tolerance to loan defaulting.
- iv) An orientation curriculum should be prepared along with graphics and teaching aids to simply and clearly describe the terms of services being offered, the expectations of each client and procedures that will be followed in the case of arrears.
- v) MFIs should establish a minimum portfolio quality criterion. In addition, the scheme should have a greater weight for portfolio quality than for portfolio quantity. Staff

should carry bad debts in their portfolio for a significant period of time to ensure that they are held accountable for making credit decisions.

- vi) Clients should be penalized for late repayment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance.
  
- vii) Institutional survival is the most basic objective – sharing information on client histories will minimize risks and help maintain the healthy portfolio quality that has allowed MFIs to become sustainable. In competitive environments where other commercial players are offering small loans, a second objective is also becoming important: credit bureau consultation will help reduce transaction costs by weeding out client's with poor repayment histories, resulting in increased institutional efficiency.

## 5.6 Suggestion for Further Study

The following points are suggested for further research:

- i. Analysis into the factors affecting credit management policies within the MFI sector.
  
- ii. An investigation into the role played by credit management committee in the collateral evaluation and loaning process.



- iii. The role of government involvement in the establishment of MFIs
- iv. Investigation into the factors that influence market risks of MFI's

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# APPENDIX I

## Introduction

The objective of this research is to establish the influence loan product design, client screening and credit committee control on loan default rate in the microfinance Institutions (MFI's) in Kenya.

Name of the Institution.....

### Part 1: Personal information

Please tick (v) the answer that corresponds to your opinion in each of the following:

1. What is your age?

(Below 25)  (26-35)  (36-45)  (Above 45)

2. What is your education background?

Non- Formal  primary  Secondary  Post secondary

3. How long have you been with Microfinance Institutions?

Below 1 year  between 1 and 5 years  above 5 years

4. How big is your firm in terms of clientele base?

(Below 100)  (101-300)  (301-500)

(501-1000)  (Above 1000)

5. Which customers do you target?

Youth  Women  Small businesses  Urban

Rural

6. Kindly give reason for your answer( Number 5 above)-----

**Part 2: Please circle (O) the number that best corresponds to your opinion in each of the following:**

---

	Strongly	Disagree	Agree	Strongly
	Disagree		Agree	

---

**(a) Loan product design information**

7. The loan is only given to those considered to qualify under the scheme.      1                      2                      3                      4
8. Higher interest rate and fess is charged to those that are considered riskier.      1                      2                      3                      4
9. Short-term loan is generally considered less risky than long-term loan.      1                      2                      3                      4
10. More frequent repayments are generally considered to be less risk      1                      2                      3                      4
11. Repayment amounts are designed to

accommodate the borrowers expected cash flow. 1 2 3 4

12. MFIs use a variety of different means for securing loans 1 2 3 4

**(b) Client information**

13. To an MFI, character is the single most important means of screening new applicants. 1 2 3 4

14. Capacity of the business is considered to establish whether the cash flow of the business (or household) can service loan repayment. 1 2 3 4

15. Capital is considered to establish the strength in terms of more of the assets than liabilities in the business or household. 1 2 3 4

16. Collateral is required by the lender that the applicant is willing to cede in case of non-payment or Loan default. 1 2 3 4

17. Condition is considered that require the applicants to be in the business for a certain number of months before they are eligible for a loan. 1 2 3 4

(c) **Credit committee**

18. A committee of persons to make decisions regarding loans is an essential control in reducing loan default rate. 1 2 3 4

19. For larger loans, a committee of three or more individuals is appropriate. 1 2 3 4

20. A credit committee typically includes senior and middle managers 1 2 3 4

21. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and should borrowers have repayment problems, they get involved in delinquency management. 1 2 3 4

**(d) Loan default rate.**

22. Kindly indicate the number of customers who have failed to repay more than two loan installments against the total number of loan outstanding as at 31 Dec. 2008 in the table provided below:

Date	Total number of loan outstanding (customers)	Number of customers with over two installment due but not paid
-----	.....	.....

## APPENDIX II

### List of registered Microfinance firms in Nairobi, Kenya.

1 AA Credit Services	18 K-Rep Bank
2 AIG Kenya Insurance	19 K-Rep evelopment Agency
3 Agha Khan Foundation	20 SUNLINK
4 Pride Limited	21 Micro Kenya Ltd
5 CIC Insurance	22 Post Bank
6 Co-Op Bank	23 Pride Ltd
7 Cross bridge redit Ltd	24 SISDO
8 ECLOF	25 SMEP
9 Oiko Credit	26 SNV
10 Equity Bank	27 WEDCO
11 Faulu Kenya	
12 Jamii Bora	
13 Jitegemee Crdit scheme	
14 Jitegemee Trust Ltd	
15 KADET	
16 kenya Gatsby Trust	
17 KWFT	

Source: 2008 Association of Microfinance Institutions Directory.

## APPENDIX III

### LETTER OF INTRODUCTION- QUESTIONNAIRE

I am currently a graduate at Kenyatta University, studying for the degree of Masters of Science (Finance).

I am conducting a survey for my study entitled 'Factors that Influence loan default rate: A case of micro finance firms in Nairobi, Kenya' as a partial fulfillment of completion of my degree program.

Your participation in the exercise will be highly appreciated as an essential part of the study and hence the request for your assistance in filling out this questionnaire. It is my assurance that any information provided will be highly regarded, treated with confidentiality and for academic purposes only. The information so attained will give insights as to how factors affecting loan default rate affect MFI's in Kenya. Further a copy of the results so attained will be forwarded to you.

Sincerely,

J.M Kirera

Graduate Student- KU

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