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RESEARCH ARTICLE

FINANCIAL INSTITUTION FACTORS INFLUENCING LOAN DEFAULT BY SMEs IN KITUI CENTRAL SUB-COUNTY

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ABSTRACT

The Small and Medium sized enterprises are considered as the power driving many countries' economies. It has been argued that SMEs are the lifeblood of most economies around the world and any government cannot afford to ignore the sector. Access to financial capital can be a critical factor for the success of SMEs, particularly in their early years. A recent Central bank of Kenya (CBK) survey shows these SMEs topped the list of biggest loan defaulters in the first quarter of 2015. The objective of this study is to assess financial factors influencing loan defaulting by the SMEs operating in Kitui central Sub-county. It is an extension of empirical work on the loan default. The target population in this study was all the registered SMEs operating in Kitui central Sub-county. This study adopted simple random sampling method to select reasonable number of firms to represent the target population. Data for this study constituted the primary data. Primary data was obtained by use of a structured questionnaire which was administered to the chief executive officers of each specific enterprise. The data was edited, coded and analyzed using statistical package for social sciences (SPSS). Descriptive analysis was also done and the respective statistics computed. The study employed multiple correlation and regression analysis. Correlation was used to investigate the association between the variables under study. Multiple regression analysis was used to measure the effect of financial factors on loan default by SMEs. The findings of this study revealed that there was a medium positive correlation and a significant relationship between the mode of loan payment and loan default. There was also a strong positive correlation and a significant relationship between the structure of interest rate and loan default. The research findings also revealed that there was also a weak positive correlation and a significant relationship between the size of loan and loan default. There was also a weak correlation between the loan repayment interval and loan default. There was a significant relationship between the type of financial institution and loan default. The study concluded that the mode of loan repayment, the structure of interest rate and the type of financial institution were highly associated with loan default. The study therefore recommends that the non bank commercial banks should revise their lending policies so that they can reduce loan repayment problems arising from lender, loan, and institutional characteristics.

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INTRODUCTION

The traditional role of a bank is lending and loans make up the bulk of banks' assets (Njanike, 2009). However, lending is not an easy task for financial institutions because it creates a big problem which is called non-performing loans (Chhimpa, 2002) as cited in Upal (2009). According to Alton and Hazen (2001), non-performing loans are those loans which are ninety days or more past due on their payment or no longer accruing interest. Due to the nature of their business, Banks expose themselves to the risks of default from borrowers (Waweru and Kalami, 2009). While issuing loans, banks ought to exercise caution in order to avoid cases of default by their potential customers. Several cases of default in a financial institution(s) can easily lead to a collapse in the entire banking system. Saba, Kouser and Azeem (2012) are of the view that Non-Performing Loans (NPLs) need to be studied closely as they have caused mayhem in the financial markets over the years.

This study is anchored on Moral hazard theory and the Information asymmetry theory. The moral hazard theory asserts that, a risk arises when one party to a contract changes his behavior to the detriment of the other party once the contract has been concluded. Moral hazard arises when individuals, in possession of private information, the asymmetric information theory asserts that the market participants often hold this information asymmetrically (Mas-Colell *et al*., 1995). Akerlof showed how we could obtain adverse selection in the markets in the presence of

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informational asymmetries. Spence (1973) demonstrated that informed economic agents in such markets may have incentives to take observable and costly actions to credibly signal their private information to uninformed agents, so as to improve their market outcome. Small and Medium sized enterprises (SMEs) are those enterprises whose annual turnover ranges between five hundred thousand and five million shillings; and which employs between ten and fifty people (Ruth, 2015). The Small and Medium sized enterprises (SMEs) are considered as the power driving many countries' economies. It has been argued that SMEs are the lifeblood of most economies around the world and any government cannot afford to ignore the sector (Ayyagari *et al*., 2007). SMEs access credit from financial institutions. According to Nene (2014) the main reason for failure of credit repayment by small and medium enterprises in Kenya is due to loans given out without any form of security to clients and lack of structure where funds are well projected over the period of repayment and portion money for such repayments. High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing (Ntiamoah *et al*., 2014). The evidence of the default pattern of loans to individual firms in emerging markets in general and the new EU member states in particular is still missing (Fidrimuc & Hainz, 2009). It is in this regard that this paper sought to highlight institutional factors that influence loan defaulting by SMEs, based on Kenyan perspective.

Financial institutions are organizations that process monetary transactions, including business and private loans, customer deposits, and investments. Institutional factors entail the totality of interacting factors within the financial institution which have real or potential effect on the loan performance. These factors are dependent on the type of the Institution and they include staff, policy and systems (Area, 2016). Some research findings and publications indicate that non performing loans are caused by poor management (Berger & De Young, 1997). They argue that managers in most banks or MFIs with the problem of nonperforming loans do not practice adequate loan underwriting, monitoring and control. According to Atsmegiorgis (2013) the factors affecting repayment performance can be grouped into four factors namely type of the financial institution, loan factors and lender factors. Lender characteristics are the factors within the financial institution that may influence loan repayment. Institutional factors include the time lag between loan application and disbursement, collection procedures, interest rate structure, access to business information and penalty for lateness to group meetings (Nawai and Shariff, 2010).A study by Kibosia (2012) established that poor credit analysis and interest rate structure and loan collection procedures also contributed to loan defaults by SMEs. Loan characteristics include the loan size, repayment period, collateral value, number of installments, and application costs among others. Past studies by (Nawai and Shariff, 2010), have established the influence of loan factors on default. Atsmegiorgis (2013) revealed that the loan default rate was significantly related with loan size, loan type, and loan repayment, purpose of loan, educational level and type of collateral offered. Types of financial institution include bank and non bank institutions. Banks are financial intermediaries that take funds from depositors, pool that money, and lend it to those seeking funds. They make money, in part, by paying depositors less interest than they charge borrowers and pocketing the difference. Banks often offer checking and savings accounts, certificates of deposits, personal and business loans, mortgages and credit facilities (Ochung, 2013), while a non-bank financial institution provides some banking services without meeting the legal definitions of a bank, or financial institutions operating without a license. This can cover many forms, as many types of institutions offer some form of financial services without qualifying as a bank (Area, 2016). Loan default can be defined as the inability of a borrower to fulfill his or her loan obligation as at when due (Balogun & Alimi, 1990). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (1980) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

Statement of the problem

According to Bank supervision report by CBK (2015), delayed payments and provisioning of loans, and high interest rates led to downgrading of loans accounts by banks thus impacting negatively on the quality of assets. As a result, non-performing loans (NPLs) increased by 36 per cent to Ksh.147.3 billion in December 2015 from Ksh. 108.3 billion in December 2014. Similarly, the ratio of gross NPLs to gross loans increased from 5.6 per cent in December 2014 to 6.8 per cent in December 2015 The report also shows that non-performing loans (NPLs) increased by 45.5 percent to KShs 214.3 billion in December 2016 from KShs 147.3 billion in December 2015. Matheka (2013) also investigated the causes of the high rates of default in the repayment of Constituency youth enterprise funded loans among youth groups in Kitui central constituency and established various factors, which influence loan repayment. Most of the previous studies reviewed established that there are different factors influencing loan default some of which are significant based on the context of study while other are insignificant on a different perspective. It is against this backdrop that this paper seeks to investigate financial factors that influence loan defaulting by SMEs, based on Kenyan perspective.

Objectives of the study

This study was guided by the three objectives: (1) to examine the effect of Lender characteristics on loan default by SMEs in Kitui central Sub-county (2) to investigate the effect of loan characteristics on loan default by SMEs in Kitui central Sub-county (3) to find out the effect of type of the institution on loan default by SMEs in Kitui central Sub-county

Literature review

Theoretical Literature

The Moral hazard theory was developed by Stiglitz and Weiss (1981). The theory states that that the lender does not use the

interest rate as a sorting device because changes in the interest rate may affect the riskiness of the pool of borrowers. The model assumes that riskier borrowers have access to riskier projects with lower probability of success but a higher return if they succeed, while safe borrowers have projects with higher probability of success but a lower return. The moral hazard theory asserts that, a risk arises when one party to a contract changes his behavior to the detriment of the other party once the contract has been concluded. Moral hazard theory is relevant in this study in that in most cases lenders are not certain that once a loan is advanced to the borrower (SMEs), it was used for its intended purpose, or that the borrower applies the expected amounts of complementary inputs, especially effort and entrepreneurial skill which is the basis for the agreement to provide the loan. If these inputs are less than expected then the borrower may be less able to repay it (Rahman and Sutradhar, 2006). Loan diversion leads to moral hazards, which may in turn, affect loan repayment by small and medium enterprises since the loan was diverted from its intended business purpose. The information asymmetry theory was developed by Akerlof (1970). This theory states that each party of an economic transaction should have the sufficient knowledge about the other party to be able to make accurate decisions. A key assumption for the theory to hold is that the characteristics of all products traded on the market should be equally observed by all agents. When such assumption fails to hold, i.e. when information is symmetric, a prices are distorted and do not achieve optimality in the allocation of resources. The asymmetric information theory asserts that the market participants often hold this information asymmetrically (Mas-Colell *et al*., 1995). Akerlof showed how we could obtain adverse selection in the markets in the presence of informational asymmetries. According to Rahman (2010), in the event adverse selection, the lender lacks information on the riskiness of its borrowers while the borrower has critical information on the financial institution. Riskier borrowers are more likely to default than safer borrowers, and thus should be charged higher interest rates to compensate for the increased risk of default. According to the information asymmetry theory, the borrower holds more information about the contract. However in the modern society sharing information using databases is has been made easy. This is because the database would acts as a medium from which people could retrieve the necessary information for decision making purposes.

Empirical Review

Makorere (2014) examined the factors affecting loan default behavior in Tanzania because experiences show that many financial institutions still are facing poor loan recovery. The study employed a cross sectional design because the study was done once in point of time. The study sample size was 100 respondents because the study was a pilot study. The study employed convenience sampling technique based on the accessibility and willingness of respondents to participate in the study. Questionnaire method was used in capturing primary data, while descriptive statistic was used in analyzing of data using frequencies and percentages. Results show that majority of the borrowers who comprised of 32% of the respondents interviewed failed to pay loan balances on time and the high interest rates imposed was the main reason mentioned. In this instance, financial institutions should impose reasonable and competitive interest rates to ensure effective repayment. In most cases, high interest rates discourage business to grow in the sense that a big part of the profit generated goes back to the financial institution to service the loan that was once given to the borrower. In a study done by Maina and Kalui (2014) where they assessed institutional factors contributing to loan defaulting in MFIs in Kenya. The study used primary data. The study target population compromise 59 MFIs. A descriptive survey design was used to carry out a census of 59 microfinance institution in Kenya. The data was collected through a structured questionnaire and administered to MFIs loan officers for response. The findings indicated that all the three factors tested had a significant impact on the loan default rate which are credit policies, loan recovery procedures, and loan appraisal process that are viewed as critical drivers of loan delinquency occurrence. Makorere (2014) examined the factors affecting loan default behavior in Tanzania because experiences show that many financial institutions still are facing poor loan recovery The study employed a cross sectional design because the study was done once in point of time. The study sample size was 100 respondents because the study was a pilot study. The study employed convenience sampling technique based on the accessibility and willingness of respondents to participate in the study. Questionnaire method was used in capturing primary data, while descriptive statistic was used in analyzing of data using frequencies and percentages. The study revealed that at least 8% of the respondents interviewed complained about the inadequacy of the time given for them to make their first installment. Most of the financial institutions tend to provide a grace period of one month only, which was seen not to be sufficient for the small business enterprise owners to start realizing enough revenue for them to start paying their loans. The study found that businesses get enough grace period and have never experienced problem of default.

Kibosia (2012) did a study that sought to determine the relationship between Non-performing Loans associated with SME sector and its determinants among commercial banks in Kenya. The research methodology used was a descriptive survey design and the population of was all commercial banks in Nairobi region. The population of the study consisted of all the commercial banks in Kenya. Information collected was by use of a questionnaire which made use of both open and closed ended questions. Data was edited for accuracy, uniformity, consistency and completeness and arranged to enable coding and tabulation for final analysis. This study also used multiple linear regressions to analyze the data. The study found out that Loan defaults by SMEs has significantly been increasing and a number of determinants affected the loan defaults key among them interest rates and how long the business has been in operation. The character of the applicant has been found to have a significant impact on loan defaults. Poor Credit Analysis and monitoring, type of loan, repayment period and economic conditions also contributed to loan defaults by SMEs. From the results, it is evident that for all the banks who lend to SME, the SME loan book contained a significant level of Non-performing loans. The study recommends that commercial banks should put more emphasis on Credit Risk Management, training of staff and adopt credit scoring in vetting of SME customers loan requests.

Methodology

Descriptive research design was adopted in this study. A descriptive research determines and reports the way things are

(Mugenda and Mugenda, 2003). Descriptive design was ideal as the study was carried out in a limited geographical scope and hence was logistically easier and simpler to conduct considering the limitations of this study (Mugenda and Mugenda, (2003). The target population in this study comprised of all the registered SMEs in the Sub-county and had access to credit. Kitui Central Sub-county has 512 registered SMEs in and only 407 SMEs have had access to credit facilities across the 5 wards (Ministry of trade, investments and cooperatives, 2016). The list of all SMEs registered within the county in 2017 constituted the sampling frame for this study and was obtained from the Ministry of trade, investments and cooperatives, Kitui County. This study adopted simple random sampling method to select reasonable number of SMEs to represent the target population. The study was confined to those SMEs who have once benefited from credit. This study used primary data only. Primary data for this study was collected directly from specific SMEs by use of structured questionnaires. The data collected for this study was accurately scored and systematically organized in a manner which facilitates analysis in order to enable the researcher make sense of the data. Data analysis was done after all data had been collected and cleaned. The data from the field was coded according to the themes studied in this study. A statistical package for social sciences (SPSS) package was used to aid in the analysis. Quantitative data was analyzed through the use of a combination of descriptive statistics particularly frequency distributions tables. Multiple regression analysis was used to determine whether the independent variables together predict the dependent variable.

Table 1. Correlation Analysis Table

		Loan default	Mode of loan repayment	Structure of IR	Size of loan	Loan repayment interval	Type of financial institution
Loan default	Pearson Correlation	1	.644**	.774**	.335**	.240*	.605**
	Sig. (2-tailed)		.000	.000	.003	.033	.000
Mode of loan repayment	Pearson Correlation	.644**	1	.495**	.271*	.183	.394**
	Sig. (2-tailed)	.000		.000	.016	.106	.000
Structure of IR	Pearson Correlation	.774**	.495**	1	.358**	.137	.468**
	Sig. (2-tailed)	.000	.000		.001	.229	.000
Size of loan	Pearson Correlation	.335**	.271*	.358**	1	.598**	.456**
	Sig. (2-tailed)	.003	.016	.001		.000	.000
Loan repayment interval	Pearson Correlation	.240*	.183	.137	.598**	1	.350**
	Sig. (2-tailed)	.033	.106	.229	.000		.002
Type of financial institution	Pearson Correlation	.605**	.394**	.468**	.456**	.350**	1
	Sig. (2-tailed)	.000	.000	.000	.000	.002	

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

RESULTS AND DISCUSSION

The researcher administered questionnaires to 81 study participants but two of them did not return their questionnaires hence N=79 questionnaires were completed and returned. The data collected from the 79 questionnaires was entered and analyzed to form the basis for the findings of this study. Majority (59.5%) of the study participants used direct cash deposit as the mode of loan repayment while the least (11.4%) used electronic money transfers. Raised standing orders and continued savings deposit were used by 12.7% and 16.5% respectively.

Correlation Analysis

There was a medium positive correlation at 99% confidence level between the mode of loan repayment and loan default (r=0.644, p=0.000). Since 0.000 is less than 0.01, it was concluded that there was a significant relationship between the mode of loan repayment and loan default. The findings also revealed that there was a strong positive correlation at 99% confidence level between structure of interest rate and loan default (r=0.774, p=0.000). Since 0.000 is less than 0.01 it was concluded that there was a significant relationship between the structure of IR and loan default. There was a positive relationship between the mode of loan repayment and loan default as well as between the structure of interest rate and loan default. The interpretation of these findings is that use of more advanced modes of loan repayment or shifting from simple to more advanced or technologically complex methods of loan repayment is likely to increases cases of loan default by borrowers in the study area. These findings were in agreement with those of Makorere (2014) who established that use of methods which were not readily available or accessible for use by borrowers would increase their probability of loan default. There was a weak positive correlation at 99% confidence level between size of loan and loan default (r = 0.335, p = 0.003). Since 0.003 is less than 0.01, it was concluded that there was a significant relationship between size of loan and loan default. The results also suggested that there was a weak positive correlation at 99% confidence level between size of loan and loan default (r = 0.240, p = 0.033). Since 0.033 is greater than 0.01, it was concluded that there was no significant relationship between the loan repayment interval and loan default. However, the relationship between the loan repayment interval and loan default was significant at 95% confidence level since 0.033 is less than 0.05. There was a positive relationship between loan repayment interval and loan default. This indicated that an increase in the loan repayment interval is likely to increase cases of loan default among the SME borrowers in the study area. It was not clear why this was so because the findings of other studied have suggested that an increase in the loan repayment interval is likely to significantly reduce cases of loan default among the borrowers (Roslan and Karim, 2009). However, there was a negative relationship between size of loan and loan default. The interpretation of this is that an increase in the size of loan borrowed is likely to decrease cases of loan default. These findings were in agreement with those of Makorere (2014) where he found out that borrowers of bigger loans were more likely to default than those of relatively smaller loans.

There was a medium positive correlation at 99% confidence level between type of financial institution and loan default (r = 0.605, p = 0.000). Since 0.000 is less than 0.01, it was

concluded that there was a significant relationship between the type of financial institution and loan default. There was a positive relationship between the type of financial institution and loan default. The interpretation of this is that the SME borrowers from commercial banks were less likely to default the payment of their loan compared to their counterparts from non commercial institutions. These findings were in line with those of Kibosia (2012) which established that there were more non performing loans in non commercial financial institutions than in the commercial banks. This was because the non commercial financial institutions had not put emphasis on credit risk management, training of staff and adoption of credit scoring in vetting SMEs customer loan requests. There was a significant relationship at 99% confidence level between mode of loan repayment structure of interest rate and type of financial institution (r = 0.495, p = 0.000) and (0.394, p = 0.000) respectively. However, the relationship between mode of loan repayment and size of loan as well as loan repayment interval was significant at 95% confidence level (r = 0.271, p = 0.016) and (r=0.183, p=0.106) respectively. There was a significant relationship between the structure of interest rate and size of loan as well as type of financial institution (r=0.358, p=0.001) and (0.468, p=0.000) respectively. There was no significant relationship between the structure of interest rate and loan repayment interval (r=0.137, p=0.229). There was a significant relationship at 99% confidence level between the size of loan and loan repayment interval as well as the type of financial institution (r=0.598, p=0.000) and (0.456, p=0.000) respectively. There was a significant relationship at 99% confidence level between loan repayment interval and type of financial institution (r=0.350, p=0.002).

Table 2. Model Summary Table

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.861[a]	.742	.724	.264

a. Predictors: (Constant), type of financial institution, loan repayment interval, mode of loan repayment, structure of IR, size of loan

The R-value of 0.861 indicates a strong positive correlation between the factors influencing loan default among SMEs in Kitui Central Sub-county. The coefficient of determination (R-square) of 0.742, the four predictots account for 74.2% of variability in loan default by SMEs in the study area.

Regression Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.141	.192		-.737	.463
	Mode of loan repayment	.140	.034	.290	4.133	.000
	Structure of IR	.547	.076	.535	7.165	.000
	Size of loan	-.036	.028	-.103	-1.278	.205
	Loan repayment interval	.097	.086	.085	1.127	.263
	Type of financial institution	.296	.085	.258	3.488	.001

a. Dependent Variable: Loan Default

Loan Default= -0.141 + 0.140(mode of loan repayment) + 0.547(structure of interest rate) – 0.036(size of loan) + 0.097(loan repayment interval) + 0.296(type of financial institution). The regression analysis in table 4.8 above shows how a unit change of the independent variable changes the dependent variable. The betas for mode of loan repayment, structure of interest rate, loan repayment interval and type of financial institution are positive indicating that every unit increase in any of the four independent variables would cause a positive change in the dependent variable with the following quantities: mode of loan payment (0.140), structure of interest rate (0.547) loan repayment interval (0.097), and type of financial institution (0.296). The beta for the size of loan is negative indicating that a unit increase in size of loan would cause a negative change in the dependent variable in the following quantity: size of loan (0.036).

Table 3. ANOVA[a] Table

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	14.635	5	2.927	42.013	.000[b]
	Residual	5.086	73	.070		
	Total	19.722	78			

a. Dependent Variable: Loan default

b. Predictors: (Constant), Type of financial institution, Loan repayment interval, Mode of loan repayment, Structure of IR, Size of loan

F-statistic was 42.013 and a p-value of 0.000 (which is less than the significance level of 0.01) indicating that the overall model was statistically significant. Therefore, mode of loan repayment, type of financial institution, loan repayment interval, size of loan, and structure of interest rate have a significant effect on loan default in the area of study.

Conclusions and Recommendations

There was a significant relationship between lender characteristics and loan default. Shift of the mode of loan repayment from simple to more technologically advanced modes increases the likelihood of loan default and vice versa. A change of the structure of the interest rate from flat rate to reduced rate increases the probability of loan default. There was no significant relationship between the loan characteristics (size of loan size and loan repayment interval) and loan default. An increase in loan repayment interval is likely to increase the probability of loan default while an increase in the size of loan is likely to decrease chances of loan default. There was a significant relationship between the type of financial institution and loan default. Loan default rate is likely to be higher in non bank financial institutions than in bank financial institutions. This study had the following recommendations:-

1. Firstly, this study recommends that the lending financial institutions in the study area should carry out more research on the most suitable and accessible modes of loan repayment to reduce loan default among the SME borrowers in the study area. Generally, the financial institutions should revise their lending policies so that they can reduce loan repayment problems associated with lender, loan and institutional characteristics.
2. Secondly, the non bank financial institutions in the study area should consider putting emphasis on credit risk management, training of staff and adoption of credit scoring in vetting SMEs customer loan requests.
3. Thirdly, the study recommends more investment in further research to provide a wider knowledge as well as deeper understanding of these and other factors which may influence loan repayment or may contribute to loan default in the study and similar areas in Kenya.

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