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Effect of Loan Collection Procedures and Loan Default in Microfinance Institutions in Kirinyaga County

By Munyua Cyrus Mwangi

Karatina University

Abstract- This study examined the performance of Microfinance Institutions (MFIs) in Kirinyaga County and particularly the women groups affiliated to the Institutions because they are registered as social welfare groups, (save for deposit taking MFI'S) and therefore they are not regarded as financial institutions and hence not registered at all and are also not under the control of Central Bank of Kenya, or the Micro finance regulatory body The Research targeted 300 employees of MFIs under study. The findings indicated that the operations of MFIs have grown remarkably due to expansion in the informal sector activities coupled with bank's reluctance to fund the evolving small and medium enterprises. On the other hand, financial services provided by MFIs have not been given any publicity or indicated among financial institutions in the official financial statistics.

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Abstract- This study examined the performance of Microfinance Institutions (MFIs) in Kirinyaga County and particularly the women groups affiliated to the Institutions because they are registered as social welfare groups, (save for deposit taking MFI'S) and therefore they are not regarded as financial institutions and hence not registered at all and are also not under the control of Central Bank of Kenya, or the Micro finance regulatory body The Research targeted 300 employees of MFIs under study. The findings indicated that the operations of MFIs have grown remarkably due to expansion in the informal sector activities coupled with bank's reluctance to fund the evolving small and medium enterprises. On the other hand, financial services provided by MFIs have not been given any publicity or indicated among financial institutions in the official financial statistics. From the findings, the researcher recommends that strong policies should be implemented in micro-finance institutions for them to do away with the problem of loan default by borrowers. The institutions should put up efficient loan collection procedures which are easy to follow for both the employees and the borrower, also there should be avoidance of loan diversions, efficiency in financial management and the amount of loan borrowed should be strictly monitored and evaluated by the micro finance institutions from time to time.

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I. INTRODUCTION

Efforts made by an Institution to collect loan from its loanees is an important element in reducing loan default and is defined as an effort made by an institution to collect past due accounts (Mc Naughton (1996). This may result to a loss on goodwill between a microfinance and the individual borrower (Brighan, 1997) as it includes ,attaching the property of the defaulter or group members who are guarantors and as this study found out involves hounding the property to force repayment including the children of the defaulter (Myers, 1998).

A Policy on collection procedures is therefore of essence because some clients do not pay the repayments are not in continuum with all borrowers, hence they are aimed at accelerating collections from slower payers to avoid bad debts in one hand and acceleration of Prompt payments on the other hand (Pandey, 1995) while care must be taken to avoid

severing the relationship between the microfinance and its permanent customers, rest they move to more friendly MFI's , who are their competitors in the market (Van Horn 1995).

a) Loan Collection Procedures

The loan recovery procedures employed by various micro finances will contribute to loans default to a greatest extent. Poor loan recovery procedures for example will create a huge portfolio of debt uncollected thus lending to loan defaults and vice versa. Most Women Groups affiliated to MFI's in question have adopted a joint loan liability model also referred to as Grameen loan model where members pay their loans on a weekly basis regardless of the profits made in their micro enterprises. This study attempts an investigation to find out how the weekly collection procedures affect loan default under the area of study.

A collection procedure is a detailed statement of steps to be taken regarding when and how the past-due amounts of a debt are to be collected. Each company has its own collection procedure, with information such as due dates, grace periods, penalties, date of repossession, date of turnover of delinquent account to collection agency, among others. The collection procedure for any loan arrangement should be spelled out as part of the loan terms. It is important for borrowers to be aware of the details of the collection procedure so as to avoid penalties, and in the case of collateral or secured loans, repossession of the collateral. While collection procedures may vary for each company they should all be complaint with existing laws. Third party collection agencies must also adhere to set Acts, not just in the collection procedure details but also the manner in which the collection takes place (Latifee, 2006). The Acts specifies not only collection procedures to be followed by government financial institutions, but also specifies that a person or organization indebted to the United States, against whom a judgment lien has been filed, is ineligible to receive a government grant. What this means is that it is of utmost importance to comply with the debt collection act, especially since non-compliance carries with penalties that can range from steep fines to imprisonment. If microfinance institutions do not come up with well administered

Author: Phd (student) Karatina University School of Business.
e-mail: cmmunyua@gmail.com

collection procedures then this could be a recipe for one defaulting to repay the loan (Boldizzoni, 2008).

II. STATEMENT OF THE PROBLEM

This study attempts to find out the factors affecting loan recovery and aims to provide a solution to the problem of loans default among women groups in Kirinyaga County. Just like other microfinance institutions around the world, there has been reported cases of peer pressure by desperate group members trying to enforce loan defaulters to meet their agreed obligations at times very disturbing to the extent of defaulters deserting their matrimonial homes and families, to flee from group members.

a) Agency Theory

Jensen and Meckling (1976) contributed to an influential application to the theory of the firm even though not the agency approach itself. Agency theory refers to the conflict that exists between owners of a business and the employees of the firm. The conflict is brought about by shareholders goal of wealth maximization as opposed to the welfare of the employees. This study sought to find out factors that affect loan default among MFI's in Kirinyaga County and further targeted 30% of the employees of the MFI,s because of the importance of the data they hold in relation to the women groups affiliated to the sampled MFI's in Kirinyaga County. Supervision of loan borrowers was a key issue of concern in relation to loan diversion without which, borrowers would diverts the loan borrowed at will to other uses leading to loan default.

What is important for the purpose of this study generally, is its concept that there exists a conflict of interest between shareholders and management or between creditors and shareholders and between government and shareholders. It has been noticed for example that whenever ownership is divorced from control, conflicts of interest emerges because management may pursue goals which are inconsistent with the shareholders goal of wealth maximization. Managers may transfer shareholders wealth to their advantage by increasing their compensation (Mitnick, 1975). On the other hand managers may refuse to undertake a risk and negotiate profitable investments. This in a way affects the growth of business or corporate entrepreneurship which may result to an inability to by the owners of the business not to meet their legal obligations such as loan repayments.

This theory is relevant in this study because MFIs are managed by other people other than the owners of these institutions and a possibility arises of an agency problem. Loan officers are endowed with so much resources for the sole purpose of monitoring loan borrowers on a regular basis and training women groups so as to avoid diversion of loan borrowed to non-core activities such as buying consumer goods

instead of productive goods and services for their business, teaching them basic financial management practices and group solidarity or cohesiveness. The researcher has witnessed women groups borrowing money from their groups to buy fashion clothes while some buy foodstuff with borrowed money. These activities lack business ethical orientation. This may have been caused by deliberate ignorance by employees of MFI's in the region under study and diversion of time and resources set apart for training and monitoring of women groups to other personal needs, thus proving to the letter and word the importance of agency theory to this study.

b) Grameen Model

The Grameen model was invented in 1976 by Professor Muhammad Yunus (1976), the founder of Grameen bank in Bangladesh. The model proved to be successful and is today practiced in more than 250 outlets of Grameen bank in more than 100 countries (Yunus, 1999). The Grameen model was copied and modified many times according to the respective needs of regional markets and clients. In Kenya this model has been adopted by many MFIs in rural areas including the area under this study. Unfortunately the efficacy of this model appear to be in doubt if judged from the gap identified by this study because success of Grameen bank is obviously noticeable as opposed to MFI's operating under the same model and especially among the selected MFIs and women groups who operate under the joint loan liability model of Grameen bank.

c) Solidarity Group Model

The solidarity group model is also referred to as peer lending group and normally consists of four to five individuals together to borrow a loan in solidarity. The members are self selected, based on their reputation and relationship to each other. The important thing here is the screening and peer pressure required to enforce repayment in case of default. This model was founded by Hazeltine and Bull (2003). The model fits this study of the women groups in Kirinyaga County in investigating the role played by the solidarity groups in alleviating the variables mentioned in the abstract. Peer pressure plays a great deal as MFI's are have less work to do since the borrowers of the groups have most of the responsibilities such as, forming the group and selecting the right members, administration and organization of repayment plan and scheduling group meetings with the loan officers from the MFI (Hazeltine& Bull, 2003). The above models are relevant to this study because finance management practices leave a lot to be desired as an independent variable affecting non recovery of loans borrowed from women groups for the purposes of this study.

III. RESEARCH METHODOLOGY

The study adopted a descriptive research design since the study intended to determine the effect of loan default in micro-finance institutions in Kirinyaga County. According to Kothari (2006) descriptive research is used to obtain information concerning the current status of the phenomena to describe "what exists" with respect to variables or conditions in a situation. The study considered this design appropriate since it facilitated gathering of reliable and accurate data that clearly helped to investigate the factors affecting loan default in microfinance institutions in Kirinyaga County.

a) Target Population

Target population as defined by Cooper (2010), is a universal set of the study of all members of real or hypothetical set of people, events or objects to which an investigator wishes to generalize the result. The target population consisted of the top management, middle level management and low level management of employees working in the following MFIs in Kirinyaga County which comprises of 300 employees as follows, Muhigia SACCO, Bingwa SACCO, Fortune SACCO, Almagamated Farmers Union, and Kenya Women Finance Trust. The employees were categorized as follows Table 3.1 below.

Table 3.1 : Target Population

Category	Target Population	Percentage
Top Management	15	5
Middle level Management	87	29
Low level management	198	66
Total	300	100

Source: Author (2015)

b) Sample Frame

The sampling frame describes the list of all population units from which the sample was selected (Cooper and Schindler, 2010). It is a physical

representation of the target population and comprises all the units that are potential members of a sample (Kothari, 2006).

Table 3.2 : Sample Size

Category	Target Population	Ratio	Sample size
Top Management	15	30%	5
Middle level Management	87	30%	29
Low level management	198	30%	66
Total	300	30%	100

Source: Author (2015)

c) Sampling Technique

According to Denning (2005) sampling is the process by which a relatively small number of individual, object or event is selected and analyzed in order to find out something about the entire population from which it was selected. Kothari (2006) define the target population as a complete set of individuals, case or objects with the same common observable characteristics. Therefore, the total number of respondents in this study was 85 out of the sample size of 90 and since the sample was drawn from all cadres of staff, the population is regarded homogeneous. The sampling technique employed was stratified random sampling. This was because the respondents were stratified into three categories i.e. top management, middle level management and low level management.

d) Instruments and Procedures of Data Collection

The study collected both primary and secondary data. Primary data was gathered using semi-structured questionnaires where the respondents were issued with the questionnaires. Questionnaires were preferred because according to Cox (2004), they are effective data collection instruments that allow respondents to give much of their opinions in regard to the research problem. According to Festing (2007) the information that will be obtained from questionnaires will be free from bias and researchers' influence and thus accurate and valid data will be gathered. Secondary data was gathered from past published scholarly articles explaining theoretical and empirical information on diversity management issues.

e) *Data Processing, Analysis and Presentation*

Before processing the responses, the completed questionnaires were edited for completeness and consistency. Descriptive analysis was used; this included the use of weighted means, standard deviation, relative frequencies and percentages. The Statistical Package for Social Sciences (SPSS) computer software was used for analysis to generate data array that was used for subsequent analysis of the data. SPSS has descriptive statistics features that assisted in variable response comparison and give clear indications of response frequencies. The data was coded to enable the responses to be grouped into various categories. Descriptive statistics was used to summarize the data. This included percentages and frequencies. Tables and other graphical presentations were appropriately used to present the data that was collected for ease of understanding and analysis. A multiple regression model was used to test the hypotheses of the combined effect of the four independent variables (loan recovery procedures, loan deviation, finance management practices and amount of loan borrowed) on the dependent variable (loan default). The study was guided by the following regression model to establish the relationship between the study variables.

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Y = Dependent variable (Default of Loan)

α = Constant (The intercept of the model)

β = Coefficient of the X variables (independent variables)

X1 = loan collection procedures

X2 = Diversion of Loan Funds

X3 = Finance Management Practice

X4 = Amount of Loan

ϵ = Error Term

The most significant factors identified from the analysis was considered as the determinants of loan default.

IV. RECOMMENDATIONS

The collection procedure for any loan arrangement should be spelled out as part of the loan terms. It is important for borrowers to be aware of the details of the collection procedure so as to avoid penalties, and in the case of collateral or secured loans, repossession of the collateral in the event of a loan default. The MFI can engage a consultant. The consultants will assist the MFIs on strategizing, thus becoming more competitive in loan collection procedure. The outsourcing enables the MFI management to think out of the box. This means that they change their way of thinking after they are made aware of other external factors they had not encountered including the adoption of the recent technology which emerges in the market. This will help in detecting the loan default in good time.

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