

## **EFFECT OF LOAN REPAYMENT TERMS ON REPAYMENT OF GROUP LOANS AMONGST MICROFINANCE INSTITUTIONS IN NAKURU TOWN**

**Henry Bundi Ndege**

University of Nairobi

Received: March 20, 2018

Accepted: April 4, 2018

### **Abstract**

*In Kenya, Micro Finance Institutions (MFIs) use the group lending models in lending to existing groups. According to the Micro Finance Act of 2006, a group loan means a loan given to an individual within a group and which is jointly guaranteed by all the members of that particular group. In the examination of the concept of loan repayment performance, Micro Finance Act of 2006 perceives loan performance in terms of defaults of individual group members in repayment of their loans and the ability of the group members to pay on their behalf. The act indicates that lenders need to classify as bad debts any loan defaults by group members which are not covered by the rest of the members. The group members therefore have a burden to pressurize their peers to make payments on their loans to avoid the whole group being denied future credit facilities. However different aspects of loan repayment terms including frequencies of payment, interest rates, loan sizes, fines and penalties, and loan repayment period the groups face challenges affect the loan performance or the groups. This study examined the effect of loan repayment terms on repayment of group loans amongst microfinance institutions in Nakuru town. A descriptive study design was utilized. The target population comprised of 2,280 members of groups that had borrowed from MFIs within Nakuru town. The study sampled 96 respondents. Structured questionnaires were used for data collection which was analysed using SPSS software. The p value for one way ANOVA for loan repayment terms and loan repayment performance was  $p=0.399 > 0.05$  thus leading to the acceptance of the null hypothesis that the loan repayment terms have no statistical significant influence on repayment performance of group loans amongst microfinance institutions in Nakuru. The study thus concluded that loan repayment terms didn't have statistically significant influence on the loan repayment performance of group loans amongst microfinance institutions in Nakuru. The study recommended that groups make payments on a weekly or bi weekly basis as most members have little capacity to save the funds for longer period of times.*

**Keywords:** Group Loans, Loan Repayment Performance, Loan Repayment Terms

---

### **I.Introduction**

The Microfinance Institutions (MFIs) play a critical role in financial inclusion leading to poverty eradication and economic empowerment of financially marginalized persons such as people of low economic status (Addae-korankye, 2014). In the provision of access to credit facilities to the financially marginalized persons, the MFIs often adopt the group lending policy with a view of mitigating credit risks in lending to their target customers (Mokhtar, 2011).

There are several advantages associated with group lending including the group members performing roles that would traditionally be performed by the MFIs in relations to loans of individual members such as screening of potential borrowers, and enforcement of repayment terms amongst members (Were, 2013). These functions reduce the credit risk associated with individual borrowers as the group members are able to utilize information on members that wouldn't be at the disposal of the MFIs (Sileshi, Nyikal, and Wangia, 2012). This information includes the levels of indebtedness, information relating to reputation of the members, and information on wealth of the borrower amongst other useful information. This enables the members to monitor loan disbursement and repayment in a more efficient ways than the MFIs. For example, members who are heavily indebted and multiple loan defaulters

may find themselves being denied opportunity for further credit access. The group members are also often in a better position from a logistical dimensions in enforcing loan recovery options such as seizing the members' properties due to ease of access amongst other aspects (Weber and Musshoff, 2012).

The loan repayment terms have an influence on the loan repayment performance. These terms include frequencies of payment, interest rates, loan sizes, fines and penalties, and loan repayment period. In the context of loan repayment frequencies, the high loan repayment frequency was correlated with higher loan repayment performance. This was attributed to the fact that the groups generate their cash flow on daily and weekly basis due to the fact that they generate their funds from petty trading activities.

Diverse metrics were used to examine loan performance amongst group loans in Upper West Region of Ghana by Bumbie (2013). These metrics included timely repayments, and number of late payments. The study using a sample size of 120 respondents from two microfinance institutions that is Wa Cooperative Credit Union and Sonzele Rural bank found that only 82.5% of the group members made timely payments. On the other hand, in the context of the number of late payments the study found that 2.5%, 4.2%, 1.7%, 4.2%, 2.5% and 2.5% of the respondents indicated that they had defaulted one, two, three, four, five and six times respectively. Still in Ghana, Addae-korankye (2014) examined the repayment challenges in microfinance institutions. The study using a sample size of 25 MFIs utilizing the group lending approach found that 40%, 32%, 16%, and 12% of the MFIs had default rates of <1-3%, >3-6%, >6-10%, and >10% default rates amongst their borrowers.

A study in Ethiopia by Abafita (2003) examined loan repayment levels within a credit and saving company. The study used the full repayment of the loan as a means of determining the loan repayment performance. In this context, using a sample size of 203 respondents, the study found out that 91.6% of the respondents had settled their loans in full while 8.4% of the respondents failed to pay their loans in full. All the loan defaulters were from the rural areas while those from the urban settings had fully completed their loans. In another study in Ethiopia, Addisu (2006) examined the Micro-finance problems in the Informal Sector in Addis Ababa. Amongst the issues that the study examined were aspects of loan repayment which was defined as ability to pay the due loan repayment in a timely manner. In this context, using a sample size of six MFIs operating in Addis Ababa City found that 51% of the group borrowers were considered good credit risk borrowers while 33% and 16% were found to be delinquent and default borrowers respectively.

In Nigeria, Coker and Audu (2015) examined the Agricultural Micro-Credit Repayment Performance with reference to Minna Microfinance Bank, Nigeria. The study using a sample size of 180 respondents found that in terms of loan repayment, 34% of the respondents had made payments after six months duration while a further 22.5% of the respondents were yet to repay a single installment of their loans. In Tanzania, Malamsha and Emanuel (2014) examined the challenges of loan repayment in MFIs. The study noted that an acceptable loan repayment performance to enable financial sustainability of MFIs is 95% repayment level of all loans that have been advanced. However, these rates are rarely achieved by MFIs in Tanzania.

In Kenya, MFIs use the group lending models in lending to existing groups. According to the Micro Finance Act of 2006, a group loan means a loan given to an individual within a group

and which is jointly guaranteed by all the members of that particular group (Central Bank of Kenya., 2017). In the examination of the concept of loan repayment performance, Micro Finance Act of 2006 perceives loan performance in terms of defaults of individual group members in repayment of their loans and the ability of the group members to pay on their behalf. In this context, the act indicates that lenders need to classify as bad debts any loan defaults by group members which are not covered by the rest of the members.

## **II. Research Objective**

To determine the effect of loan repayment terms on repayment of group loans amongst microfinance institutions in Nakuru town.

## **III. Research Question**

How do loan repayment terms determine repayment of group loans amongst microfinance institutions in Nakuru town?

## **IV. Research Hypothesis**

**H<sub>01</sub>:** The loan repayment terms have no statistical significant influence on repayment performance of group loans amongst microfinance institutions in Nakuru.

## **V. Literature Review**

### **Credit Rationing Theory**

The credit rationing theory was introduced by Freimer and Gordon in 1965. The theory looks at the effect of information asymmetry between the borrower and lender in relations to how such information affect loan repayment performance (Murathi, 2015). The information asymmetry refers to the differences in the information held between the lender and borrower on the purpose of the loan and capacity of the borrower to repay the loan (Godquin, 2004). This differences results in the need for the need for screening of the potential borrowers in order to establish their creditworthiness, purpose of the loan (ex ante moral hazard problems), past repayment behaviour (ex post moral hazard challenges), and capacity for repayment (Noor and Mohd, 2014). The ability to have effective screening process also determines the capacity of the borrower to repay their loans hence impacting loan performance.

### **Loan Repayment Terms and Repayment Performance**

The loan repayment terms have an influence on the loan repayment performance. These terms include frequencies of payment, interest rates, loan sizes, fines and penalties, and loan repayment period. Abafita (2003) examined the effect of loan size on loan repayment performance levels. The study noted the average loan size impacts on the loan performance levels. This is due to the fact the successive loan authorization are based on the payment of previous loans which are often of smaller sizes. Addae-korankye (2014) further notes that the loan size is critical especially in the subsequent loans. The study conducted noted that most groups have poor performance on the second and third subsequent loans owing to the loan sizes becoming too large. The study further noted that the loan sizes affect the borrowers' repayment capacity. The ability of the loan borrowed to fit the intended purposes of the loans is critical importance to repayment performance. Nawai and Shariff (2010) noted that the ability of the loan amount to be sufficient for the intended purpose is positively correlated with the borrower's capacity to repay the loan. However, if the loan amount exceeds the intended purpose of borrowing, there is a negative correlation with loan repayment performance. Bumbie (2013) in a study on determinants of repayment performance in Ghana noted that there might be apathy in getting into joint liability of too large loan amounts.

Despite a majority of the scholars indicating that higher loan amounts are likely to be defaulted on, there are a substantial number of scholars who hold contra opinions. Nganga (2010) in a study on the gender influence of group lending repayment behavior amongst MFIs in Kirinyaga examined the role of loan size of repayment levels. The study using a sample size of sixteen loan officers from MFIs found that it was only 19% of the respondent who thought that the loan size affected the repayment levels. The research concluded that it was not a significant number of respondents who thought that the loan size affected the loan repayment performance. Similarly, Owusu, Oppong, Agyeiwaa, and Abruquah (2015) notes that lower amounts of loans are likely to defaulted owing to the characteristics of the borrowers. Weber and Musshoff (2012) notes that smaller loans are often given to groups with lower business experiences and exposures leading to reduction of repayment capacity owing to failure of business venture they engage in.

Another factor affecting loan repayment levels is the repayment frequencies. Fischer and Ghatak (2010) demonstrated the importance of loan repayment frequencies on the loan repayment performance through giving practical examples of diverse MFIs across the world. The study noted that BRAC an MFI with over six million customers abandoned a monthly repayment frequency to a biweekly one leading to improved repayment rates. Similarly, Satin Credit Care had its loan default rates move from less than 1% to more than 50% when it moved from a daily to a weekly repayment plan. Similarly, Bumbie (2013) in a study of determinants of repayment performance of group loans in Ghana noted that groups with a bi weekly loan repayment plans had a better repayment performance compared to those with a monthly repayment method. Mokhtar (2011) notes that the high repayment rates of loans with higher frequency of payments (weekly and bi weekly) is attributed to the fact most groups generate revenues of a daily and weekly basis and have little capacity to save the funds for longer period of times. The groups generate their cash flow on daily and weekly basis due to the fact that they generate their funds from petty trading activities.

The aspects of interest rates influence on loan performance occur through the aspects of adverse selection challenges. The interest rates is the cost of borrowing funds from a lending institutions (Nganga, 2010). On the other hand, the adverse selection challenges imply that the MFIs are unable to determine the risky borrowers from the safe borrowers (Nthiwa, 2013). This leads to the MFIs charging high interest rates for both the borrowers often at the detriment of the same borrowers. This has an impact of driving the safe borrowers away from the credit market and the risky borrowers taking up the loan facilities (Murathi, 2015). The institutions therefore end up with a pool of risky borrowers which affects their loan repayment. On the other hand, Abafita (2003) in a study on microfinance and loan repayment performance in Ethiopia noted that the interest rates affects the kind of projects undertaken and hence the probability of the success of those projects. The borrowers who take loans under extremely high interest rates often undertake projects with lower probability of success but higher returns when successful.

The fines and penalties of defaulting have an effect on the loan repayment performance. The cases where the fines and penalties of loan default are high may lead to a willingness to pay for the loan (Godquin, 2004). The contra may also happen where the high interest rates actually discourage the customers who are making payments from further making the payments (Quidt, Fetzer, & Ghatak, 2013).

## **VI. Research Methodology**

This study employed a descriptive research design. This design was considered appropriate for the research as the researcher was interested in the influence of joint liability of group members on repayment of group loans amongst microfinance institutions. There was no manipulation of variables that was undertaken. The target population for this study comprised of all the 24 financially distressed commercial banks in Kenya that restructured their assets during the period 1992 -2016. The target population was 2,280 group members of the groups that had borrowed from MFIs within Nakuru town. The sample size was calculated using Naissuma's (2009) formula which resulted in 96 respondents. The 96 respondents were derived using the stratified random sampling method which ensured that the sample members were proportionally distributed across the MFIs. The study employed primary data extracted from structured questionnaires. The structured questionnaires were used since they allow easy analysis of data using software such as SPSS as they derive quantitative data. They can be distributed to a large number of respondents due to their ease of administration as well as responding to the set questions. A pilot study was undertaken amongst groups in MFIs in Gilgil using 10 respondents which constituted 10% of the sample size. It addressed issues including clarity of questions, presentation of the questions, validity and reliability of the questions. The pilot study was therefore undertaken. The content validity of the study was examined using the experts of MFIs which constituted the university based lecturers as well as industry practitioners. The reliability of the research instrument was examined using the internal consistency of the data and tested using Cronbach alpha coefficient of a threshold of 0.7 and above. The data analysis was undertaken using SPSS version 21. The descriptive statistics that were utilized include frequency distributions, means, standard deviations. The hypothesis testing was undertaken using the one way ANOVA.

## **VII. Research Findings and Discussions**

### **Descriptive Statistics**

In investigating whether loan repayment terms affect repayment performance of group loans, the metrics used were interest rates, frequency of payments, fines and penalties, loan repayment period, and loan amount. Most of the respondents felt that all the metrics related to loan repayment terms had an effect on loan repayment performance of group loans, that is, 61.3%, 54.3%, 63.8%, 68.8%, 57.5% on interest rates, frequency of payments, fines and penalties, loan repayment period, and loan amount respectively as shown in Table 1.

**Table 1: Frequency Distribution of Loan Repayment Terms**

|                       | <b>SA</b>   | <b>A</b>    | <b>U</b>    | <b>D</b>    | <b>SD</b> |
|-----------------------|-------------|-------------|-------------|-------------|-----------|
|                       | <b>%</b>    | <b>%</b>    | <b>%</b>    | <b>%</b>    | <b>%</b>  |
| Interest Rates        | 14<br>17.5% | 49<br>61.3% | 11<br>13.8% | 6<br>7.5%   | 0<br>0.0% |
| Frequency of Payments | 25<br>31.3% | 45<br>56.3% | 5<br>6.3%   | 5<br>6.3%   | 0<br>0.0% |
| Fines and Penalties   | 16<br>20.0% | 51<br>63.8% | 11<br>13.8% | 2<br>2.5%   | 0<br>0.0% |
| Loan repayment period | 14<br>17.5% | 55<br>68.8% | 2<br>2.5%   | 9<br>11.3%  | 0<br>0.0% |
| Loan amount           | 15<br>18.8% | 46<br>57.5% | 8<br>10.0%  | 11<br>13.8% | 0<br>0.0% |



*Effect of Loan Repayment Terms on Repayment of Group Loans Amongst Microfinance Institutions in Nakuru Town*

This was further supported by a few number of respondents who disagreed, that is, 7.5%, 6.3%, 2.5%, 11.3%, and 13.8% respectively, and there being no strongly disagreed response to all of the metrics on loan repayment terms.

On average the respondents tended to agree that loan repayment terms affect repayment performance of group loans, as the metrics used to examine it, that is, interest rates, frequency of payments, fines and penalties, loan repayment period, and loan amount all scored mean scores in the interval ( $3.5 < \mu \leq 4.5$ ). Individual metrics in order of influence on the loan repayment terms from the most influential to the least was frequency of payments (mean of 4.12), fines and penalties (4.01), loan repayment period (3.93), interest rates (3.89), and loan amount (3.81) as displayed in Table 2.

**Table 2: Means and Standard Deviations of Loan Repayment Terms**

|                       | Mean | Std. Dev. |
|-----------------------|------|-----------|
| Interest Rates        | 3.89 | 0.78      |
| Frequency of Payments | 4.12 | 0.79      |
| Fines and Penalties   | 4.01 | 0.67      |
| Loan repayment period | 3.93 | 0.81      |
| Loan amount           | 3.81 | 0.90      |

The frequency of payments impacting on the loan repayment performance had the highest average tendency of agreement as indicated by a mean of 4.12. This results was consistent with the findings of Fischer and Ghatak (2010), Bumbie (2013), and Mokhtar (2011). Fischer and Ghatak (2010) demonstrated the importance of loan repayment frequencies on the loan repayment performance through giving practical examples of diverse MFIs across the world. The study noted that BRAC an MFI with over six million customers abandoned a monthly repayment frequency to a biweekly one leading to improved repayment rates.

Similarly, Satin Credit Care had its loan default rates move from less than 1% to more than 50% when it moved from a daily to a weekly repayment plan. Similarly, Bumbie (2013) in a study of determinants of repayment performance of group loans in Ghana noted that groups with a bi weekly loan repayment plans had a better repayment performance compared to those with a monthly repayment method. Mokhtar (2011) notes that the high repayment rates of loans with higher frequency of payments (weekly and bi weekly) is attributed to the fact most groups generate revenues of a daily and weekly basis and have little capacity to save the funds for longer period of times. The groups generate their cash flow on daily and weekly basis due to the fact that they generate their funds from petty trading activities.

The loan size having an influence on loan repayment as illustrated through a mean of 3.81 is supported by findings of other scholars. In this context, Abafita (2003) noted the average loan size impacts on the loan performance levels. This is due to the fact the successive loan authorization are based on the payment of previous loans which are often of smaller sizes. Addae-korankye (2014) further notes that the loan size is critical especially in the subsequent loans. The study conducted noted that most groups have poor performance on the second and third subsequent loans owing to the loan sizes becoming too large. The study further noted that the loan sizes affect the borrowers' repayment capacity. However, in contrast to Abafita (2003) and Addae-Korankye (2014) findings, Weber and Musshoff (2012) disagree on higher loans being difficult to repay. The study noted that smaller loans are often given to groups with lower business experiences and exposures leading to reduction of repayment capacity owing to failure of business venture they engage in.

The finding that the interest rates with a mean of 3.89 had on average the respondents' tending to agree that interest rates had an influence on the loan repayment performance. These results are consistent with other scholars' findings. In this context, Abafita (2003) noted that the interest rates affects the kind of projects undertaken and hence the probability of the success of those projects. The high interest rates is correlated with high returns on investments but also higher risks. The fines and penalties of defaulting have an effect on the loan repayment performance. The cases where the fines and penalties of loan default are high may lead to a willingness to pay for the loan (Godquin, 2004). The contra may also happen where the high penalties rates actually discourage the customers who are making payments from further making the payments (Quidt et al., 2013). The standard deviations of the metrics were in the interval ( $0.5 < \sigma_X \leq 1$ ) implying that there was moderate consensus that all the metrics in the loan repayment terms matrix affect repayment performance of group loans, with fines and penalties having the lowest standard deviation implying that in the context of standard deviation, it attracted the highest consensus.

### **Hypothesis Testing**

The hypothesis testing was undertaken using the fisher one way analysis of variance. The first step was the stating of both the null and alternative hypothesis that was to be tested for each of the objective. The test statistic was then selected. In this study, the one way ANOVA was used in hypothesis testing at 0.05 level of significance. The p value of the ANOVA table was then compared to the significance level to inform on whether to reject the null hypothesis. The null hypothesis was rejected if the p value was less than the 0.05 level of significance.

The null hypothesis (**H<sub>01</sub>**) that the loan repayment terms have no statistical significant influence on repayment performance of group loans amongst microfinance institutions in Nakuru was accepted since  $p=0.399 > 0.05$ .

### **VIII. Conclusion of the Study**

The study concluded that loan repayment terms did not have statistically significant influence on the loan repayment performance of group loans amongst microfinance institutions in Nakuru.

### **IX. Recommendations of the Study**

The study recommended for groups adopt a weekly or bi weekly repayment schedule as most members have little capacity to save the funds for longer period of times. This will ensure that members are able to make their loan repayment regularly and improve repayment rates thus enhance the loan repayment performance of the groups.

### **References**

- 1) Abafita, J. (2013). Microfinance and Loan Repayment Performance: A Case Study of the Oromia Credit and Saving Share Company (OCSSCO) in Kuyu. *International Journal of Development and Economics*, 42(3), 983–995.
- 2) Addae-korankye, A. (2014). Causes and Control of Loan Default/Delinquency in Microfinance Institutions in Ghana. *American International Journal of Contemporary Research*, 4(12), 36–45.
- 3) Addisu, M. (2006). Micro-finance Problems in the Informal Sector in Addis Ababa. *Ethiopian Journal of Business & Development*, 1(2), 29–50.
- 4) Bumbie, M. Y. (2013). Determinants of Repayment Performance of Group and Individual Lending in Microfinance: A Case Study in the Upper West Region of Ghana. *Finance*, 8(3), 563–572.

*Effect of Loan Repayment Terms on Repayment of Group Loans Amongst Microfinance Institutions in Nakuru Town*

- 5) Central Bank of Kenya. (2017). *The Micro Finance Act No. 19 of 2006*. Retrieved from [https://www.centralbank.go.ke/wp-content/uploads/2016/08/Microfinance-\\_Deposit-Taking-Microfinance-Institutions\\_-Regulations.pdf](https://www.centralbank.go.ke/wp-content/uploads/2016/08/Microfinance-_Deposit-Taking-Microfinance-Institutions_-Regulations.pdf)
- 6) Coker, A. A., & Audu, M. K. (2015). Agricultural Micro-Credit Repayment Performance : Evidence from Minna Microfinance Bank , Nigeria. *International Journal of Business and Management*, 10(9), 877–885.
- 7) Fischer, G., & Ghatak, M. (2010). Repayment Frequency in Microfinance Contracts with Present-Biased Borrowers. *Research Journal of Finance and Accounting*, 6(3), 322–331.
- 8) Godquin, M. (2004). Microfinance Repayment Performance in Bangladesh - How to Improve the Allocation of Loans by MFIs. *Asian Economic and Financial Review*, 45(7), 106–112.
- 9) Malamsha, K. C. T., & Emanuel, K. M. (2014). Women Loan Repayment Rate: Evidence From Selected Microfinance Institutions , Moshi Municipality. *Co-operative and Business Studies ( JCBS )*, 2(1), 13-16.
- 10) Mokhtar, S. H. (2011). Microfinance Performance in Malaysia. *Eurasian Journal of Business and Economics*, 22(6), 134–145.
- 11) Murathi, A. (2015). Critical Factors in Repayment of Constituency Youth Enterprise Scheme in Kirinyaga Central District, Kenya. *Journal of Finance and Accounting*, 3(2), 19-20.
- 12) Naissuma, D. K. (2009). *Survey Sampling: Theory and Methods*. Nairobi: University of Nairobi.
- 13) Nawai, N., & Shariff, M. N. M. (2010). Determinants of Repayment Performance in Microcredit Programs : A Review of Literature. *International Journal of Business and Social Science*, 1(2), 152–161.
- 14) Nganga, K. J. (2010). Gender Influence on Group Lending Repayment Behaviour Among the Micro-Finance Service Providers in Kirinyaga. *Journal of Statistics and Economics*, 4(6), 901–915.
- 15) Noor, M., & Mohd, B. (n.d.). Repayment Performance in Microfinance Programs: An Individual Lending Approach. *International Journal of Business and Development* 3 (2), 489–498.
- 16) Nthiwa, M. A. (2013). Factors Influencing Repayment of Constituency Youth Enterprise Scheme Loans: A Case of Kitui Central Constituency in Kitui County, Kenya. *Journal of Finance and Economics*, 6(3), 786–795.
- 17) Owusu, A. D., Oppong, A., Agyeiwaa, D., & Abruquah, L. (2015). Reducing Loan Default Rate Among Microfinance Institutions (MFIs) in Ghana Through Innovative Product Design, Delivery and Efficient Loan Management. *International Journal of Economics, Commerce and Management*, 3(3), 1–15.
- 18) Quidt, J. De, Fetzer, T., & Ghatak, M. (2013). Group Lending Without Joint Liability. *Journal of Financial Econometrics*, 24(1), 897–914.
- 19) Sileshi, M., Nyikal, R., & Wangia, S. (2012). Factors Affecting Loan Repayment Performance of Smallholder Farmers in East Hararghe, Ethiopia. *Developing Country Studies*, 2(11), 205–213.
- 20) Weber, R., & Musshoff, O. (2012). *Price Volatility and Farm Income Stabilisation*. Retrieved from <https://ageconsearch.umn.edu/bitstream/122552/2/Weber.pdf>
- 21) Were, O. V. (2013). Determinants of Repayment of Loans Advanced to the Youth by the Government Through Youth Enterprise Fund. A Case of Mumias District. *Journal of Finance in State Funded SMEs*, 2(4), 34–40.

**How to Cite This Article;**

Ndege, H. B.(2018). Effect of Loan Repayment Terms on Repayment of Group Loans Amongst Microfinance Institutions in Nakuru Town. *International Journal of Business Management and Processes (IJBMP)*, 3(1), 18-25.