FACTORS CONTRIBUTING TO LOAN DELINQUENCY IN AGRIBASED SMALL AND MEDIUM ENTERPRISES IN KENYA : A CASE OF THE AGRICULTURAL FINANCE CORPORATION

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ABSTRACT

A default on a loan occurs when the borrower does not make required payments on in some other way does not comply with the terms of a loan . SMEs all over the world play important roles in the process of industrialization and economic growth. There are indications that the SMEs account for about 70 percent of industrial employment and well over 50 percent of the gross domestic product . The purpose of this study was to examine the determinants of loan default among agribased SMEs in Kenya. The study fits into the quest to find a more objective and efficient way of accessing the default risk associated with abased SME lending in order to reduce the rate of non-performing loans in the Agricultural Finance Corporation. Research design refers to the way the study is designed, that is, the method used to carry out a research. Researcher examined a sample of 84 respondents drawn from the population of 168 staff and the micro-enterprises in Nairobi. The study used both secondary data from other sources and primary data collected using questionnaires to carry out the study. The descriptive statistical tools helped the researcher to describe the data and determine the extent used. Analysis was done quantitatively and qualitatively by use of descriptive statistics. This included frequency distribution, tables, percentages, mean mode, median etc.The study also found that type of business contributes to loan default among Agribased SMEs financed by Agricultural Finance Corporation to great extent. The study further revealed that type of business contribute to loan default among

Agribased SMEs financed by Agricultural Finance to great extent . The study established that project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation. It was revealed that managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation to a great extent.

Key Words: *industrialization, SMEs, non performing loans, Loan defaults, Commercial banks.*

Introduction

A default on a loan occurs when the borrower does not make required payments on in some other way does not comply with the terms of a loan (Al-Tamimi and Al-Mazrooei, 2007). It arises as a result to honor the agreement to meet the repayment terms which detail when money should be paid back to the lender. Loan/credit appraisal is a holistic exercise which starts from the time a prospective borrower walks into the bank and ends in credit delivery and monitoring with the objective of ensuring and maintaining the quality of lending and managing credit risk within acceptable limits. The quality of credit appraisal processes depends on two factors namely, a transparent and comprehensive presentation of the risks when granting the loan on the one hand, and an adequate assessment of these risks on the other hand (Strutt, 2005).

Greuning and Iqbal (2007) described non performing loans as those assets that are no longer generating income. Loan defaults in general terms refer to bad debts, whose recovery is highly doubtful, because they are not being serviced as required (Ghosh et al, 2005). The problem of loan defaults is not unique to Kenya alone. Immergluck (2009) observed that banking problems precipitated by loan defaults are not confined to the developing world alone. Sweden, Japan and USA have at one time faced severe banking crisis. Empirical studies on bank loan losses report distributions and basic statistics, such as means and quartiles, and examine the determinants of recoveries, the relationship between recoveries and the probability of default and the behavior of recoveries across business cycles.

Micro-enterprises as already defined by Thyra and William (2007) are those businesses that have 1-49 employees. The formal sector has been unwilling to provide credit to the micro-enterprises because the clients from this sector are largely poor lacking in securities that can be used as collateral in conventional lending. Commercial banks have therefore for a long time perceived such business as highly risky. Moreover the costs associated with administering and monitoring credit services are quite high. The loan value required by client in this sector is low hence proportionately low revenues generated from the loans. This has made commercial banks shy away from lending to these groups of people. This has made the government come up with projects that aim at supporting these groups and women enterprise fund is one of its projects (Ghosh et al, 2005).

In recent years a growing number of developing countries including Kenya have embarked on reforming and deregulating financial systems, transforming their institutions into effective intermediaries and extending viable financial services on a sustainable basis to all segments of the population (Strutt, 2005). By gradually increasing the outreach of their institutions some developing countries have substantially alleviated poverty through lending, institutional strategies and financial systems approaches. In the process a new world of funding to the marginalized less privileged groups for including women and the youth has emerged (Parrenas, 2005). The purpose of this study is thus to examine the determinants of loan default among agribased SMEs in Kenya. The study fits into the quest to find a more objective and efficient way of accessing the default risk associated with abased SME lending in order to reduce the rate of non-performing loans in the Agricultural Finance Corporation.

While many agribased SME had benefited from the various loan schemes obtained from Agricultural Finance Corporation, some SME face difficulties in managing their debt. The high default rate associated with Agribased SME lending has resulted in substantial increase in non-performing loans of Agricultural Finance Corporation, necessitating a reduction in credit extension to agribased SMEs and adoption of more stringent measures to control the situation. This confirms the argument by Baku and Smith (2008) that, the cost of loan delinquencies would be felt by both the lender and the borrower. 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 low probability in accessing an additional credit facility. Thus, there is the need to investigate the determinants of loan default in order to unearth the factors that distinguish creditworthy borrowers from those with high probability of default. The general objective of this study was to investigate the factors leading to loan delinquency among agribased Small and medium enterprise financed by Agricultural Finance Corpoartion. Specifically the study sought to;

i. investigate the contribution of type of business to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion
ii. establish the effects of credit risk evaluation on loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion
iii. assess the contribution of level of supervision of projects to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion
iv. investigate the effects of manangerial skills to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion

Theoretical Review

Financial Intermediation Theory

According to Scholtens and van Wensveen (2008), the role of the financial intermediary is essentially seen as that of creating specialised financial commodities. These are created whenever an intermediary finds that it can sell them for prices which are expected to cover all costs of their production, both direct costs and opportunity costs. Financial intermediaries exist due to market imperfections. As such, in a 'perfect' market situation, with no transaction or information costs, financial intermediaries would not exist. Numerous markets are characterized by informational differences between buyers and sellers. In financial markets, information asymmetries are particularly pronounced. Borrowers typically know their collateral, industriousness, and moral integrity better than do lenders. On the other hand, entrepreneurs possess inside information about their own projects for which they seek financing (Leland & Pyle, 1977). Moral hazard hampers the transfer of information between market participants, which is an important factor for projects of good quality to be financed.

Information Asymmetry Theory

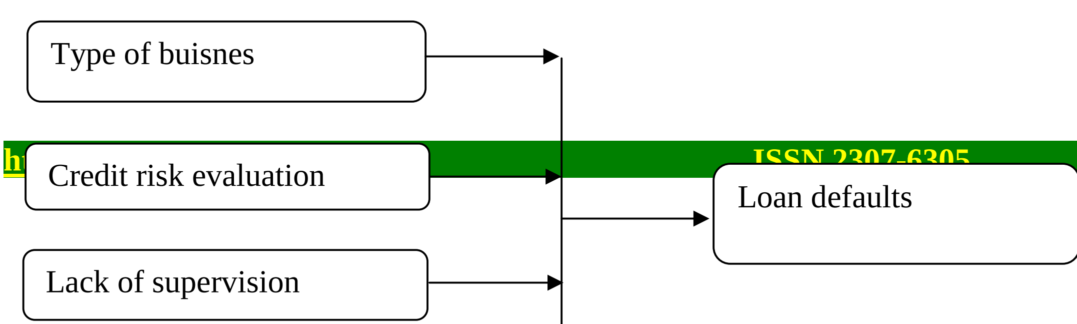
This strand of theory is based on the notion that the borrower is likely to have more information than the lender about the risks of the project for which they receive funds. This leads to the problems of moral hazard and adverse selection (Scholtens & van Wensveen, 2008). These problems reduce the efficiency of the transfer of funds from surplus to deficit units.

Theory of Delegated Monitoring of Borrowers

This is one of the most influential in the literature on the existence of banks. Defined broadly, 'monitoring' of a borrower by a bank refers to information collection before and after a loan is granted, including screening of loan applications, examining the borrower's ongoing creditworthiness and ensuring that the borrower adheres to the terms of the contract. A bank often has privileged information in this process if it operates the client's current account and can observe the flows of income and expenditure. This is most relevant in the case of small and medium enterprises and is linked to banks' role in the payments system (Drzik, 2005).

Conceptual Framework

Loan defaults are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck. From the foregoing, the factors that lead to loan defaults considered in this study are source of income, credit risk evaluation, lack of supervision of projects and managerial skills .



Independent Variables **Dependent Variable**

Figure 1: Conceptual Framework

Research Gap

Balogun and Alimi (2008) found that the default rates in loans to small farmers in Lagos region in 2005 and 2006 were in the range of 55 and 90 per cent respectively. However, the study by Balogun and Alimi (2008) relate only to small farmers, unlike this study that was based on enterprises from many sectors of the economy. Anderson (2002) spoke of default rates as varying from 10 per cent to 60 per cent or more in most developing countries. In recent years a growing number of developing countries including Kenya have embarked on reforming and deregulating financial systems, transforming their institutions into effective intermediaries and extending viable financial services on a sustainable basis to all segments of the population (Strutt, 2005). By gradually increasing the outreach of their institutions some developing countries have substantially alleviated poverty through lending, institutional strategies and financial systems approaches. In the process a new world of funding to the marginalized less privileged groups for including women and the youth has emerged (Parrenas, 2005). The purpose of this study is thus to examine the determinants of loan default among agribased SMEs in Kenya. The study fits into the quest to find a more objective and efficient way of accessing the default risk associated with abased SME lending in order to reduce the rate of non-performing loans in the Agricultural Finance Corporation.

Research Methodology

This study adopted a descriptive survey, Kothari, (2004) describes descriptive research as including survey and facts finding enquiries adding that the major purpose of descriptive research is description of affairs as it exists at present. The study hence considers a case study design suitable since data was gathered from a single source; Agricultural Finance Corporation and used to represent, factors leading to loan delinquency among agribased Small and medium enterprise financed by Agricultural Finance Corporation.

The population of interest consisted of the management staff that deal with marketing/loan processing in the Agricultural Finance Corpoartion. Additional respondents were drawn from the Agribased micro-enterprises that obtain loans from Agricutuarl Finance Corporation. This population consists of management staff and customers/micro-enterprises located within Nairobi

Region who obtain loans from Agricultural Finance Corporation. Mugenda and Mugenda, (2003), explain that the target population should have some observable characteristics, to which the researcher intends to generalize the results of the study. So the researcher examined a sample of 84 respondents drawn from the population of 168 staff and the micro-enterprises in Nairobi.

The study used both secondary data from other sources and primary data collected using questionnaires to carry out the study. The questionnaire included structured and unstructured questions and was administered through drop and pick method to respondents who were the staffs and customers of the Agricultural Finnace Corporation. A pilot study is a small scale preliminary study before the main research in order to measure the validity and reliability of data collection instruments, (Kothari, 2006).

Data collected was quantitative and qualitative in nature. The descriptive statistical tools helped the researcher to describe the data and determine the extent used. Analysis was done quantitatively and qualitatively by use of descriptive statistics. This included frequency distribution, tables, percentages, mean mode, median etc. In addition, advance statistical techniques (inferential statistics) were also considered. This was mainly the regression model to test relationship among variables (independent). Data analysis used SPSS and Microsoft excel, percentages, tabulations, means and other central tendencies. Tables was used to summarize responses for further analysis and facilitate comparison.

Results

The data collection instrument, which was the questionnaires, were sent to 84 respondents. However, out of the 84 questionnaires sent, only 77 questionnaires were received back fully completed making a response rate of 91.7% .

Reliability Analysis

Reliability of the questionnaire was evaluated through Cronbach's Alpha which measures the internal consistency. Cronbach's alpha was calculated by application of SPSS for reliability analysis. The value of the alpha coefficient ranges from 0-1 and may be used to describe the reliability of factors extracted from dichotomous and or multi-point formatted questionnaires or scales. A higher value shows a more reliable generated scale. Cooper & Schindler (2008) has indicated 0.7 to be an acceptable reliability coefficient. Table 4.1 shows that credit risk evaluation had the highest reliability (α=0.871) followed by level of supervison (α=0.814), then type of business (α = 0.791) and managerial skills (α=0.783). This illustrates that all the four scales were reliable as their reliability values exceeded the prescribed threshold of 0.6.

Reliability Coefficients

Scale	Cronbach's Alpha	Number of Items
Type Of Business	0.791	6
Credit Risk Evaluation	0.871	6

Level Of Supervision	0.814	6
Managerial Skills	0.783	6

Type of the Business

The study sought to investigate the contribution of type of business to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion

Contribution of type of business to loan default

Opinion	Frequency	Percent
Yes	65	84.4
No	12	15.6
Total	77	100.0

On whether the type of business contribute to loan default, the study requested the respondents to indicate whether type of business contribute to loan default, the study found that majority of the respondents as shown by 84.4% believed that type of business contribute to loan default whereas 15.6% of the respondents were of the opinion that the type of business doesn't contribute to loan default, this is an indication that the type of business contributes to loan default.

Extent to which type of business contribute to loan default

Extent	Frequency	Percent
very great extent	13	16.9
great extent	59	76.6
moderate extent	5	6.5
Total	77	100.0

From the finding on the extent to which the type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study found that majority of the respondent as shown by 76.6% indicated that the type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, 16.9% of the respondents indicated that the type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to very great extent whereas 6.5% of the respondent indicated that the type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to moderate extent , the above information show that type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to great extent.

Credit Worthiness Evaluation

The stduy sought to establish the effects of credit risk evaluation on loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion

Credit worthiness evaluation of Agribased SMEs Contribute to loan default

	Frequency	Percent (%)
Yes	54	70.1
No	23	29.9
Total	77	100.0

From the findings on whether credit worthiness evaluation of Agribased SMEs Contribute to loan default, the study found that majority of the respondents as shown by 70.1% believed that credit worthiness evaluation of Agribased SMEs Contribute to loan default whereas 29.9% of the respondent were of the opinion that credit worthiness evaluation of Agribased SMEs does not contribute to loan default , this is an indication that credit worthiness evaluation of Agribased SMEs Contribute to loan default.

Extent to which credit worthiness contribute to loan default

	Frequency	Percent
very great extent	10	13.0
great extent	53	68.8
moderate extent	11	14.3
Little extent	3	3.9
Total	77	100.0

From the finding on the extent to which credit worthiness contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study found that majority of the respondents as shown by 68.8% indicated that credit worthiness contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, 14.3% of the respondents indicated that credit worthiness contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to moderate extent ,13.0% of the respondents indicated that credit worthiness contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to very great extent whereas 3.9% of the respondent indicated that credit worthiness contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to little extent , the above information show that type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance

Level of Project Supervision

In this section the stduy sought to assess the contribution of level of supervision of projects to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion

Project supervision contributing to loan default among Agribased SMEs

	Frequency	Percent (%)
Yes	57	74.0
No	20	26.0
Total	77	100.0

On whether the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study requested the respondents to indicate whether the level of project supervision contributed to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study found that majority of the respondents as shown by 74% believed that the level of project supervision contributed to loan default among Agribased SMEs financed by Agricultural Finance Corporation whereas 26% of the respondents were of the opinion that the level of project supervision did not contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation .This is an indication that level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation.

Extent to which level of project supervision contributed to loan default

	Frequency	Percent
very great extent	16	20.8
great extent	49	63.6
moderate extent	12	15.6
Total	77	100.0

From the findings on the extent to which the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study found that majority of the respondents as shown by 63.6% indicated that the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to a great extent, 20.8% of the respondents indicated that the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to very great extent , whereas 15.6% of the respondents indicated that the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to a moderate extent , the above information show that the level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation to a great extent .

Managerial Skills

The sdtuy sought to investigate the effects of manangerial skills to loan delinquency among agribased Small and medium enterprises financed by Agricultural Finance Corpoartion

Managerial skills contributing to loan default among agribased SMEs

	Frequency	Percent (%)
Yes	69	89.6
No	8	10.4
Total	77	100.0

From the findings on whether managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation, the study found that majority of the respondents as shown by 89.6% believed that managerial skills contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation whereas 10.4% of the respondents indicated that managerial skills did not contribute to loan default among agri-based SMEs financed by Agricultural Finance Corporation. This is an indication that managerial skills contribute to loan default among Agri-based SMEs financed by Agricultural Finance Corporation**.**

Extent to which managerial skills contribute to loan default among agribased SMEs

	Frequency	Percent
very great extent	12	15.6
great extent	61	79.2
moderate extent	4	5.2
Total	77	100.0

The study sought to determine the extent to which managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation, from the findings the study found that majority of the respondents as shown by 79.2% indicated to great extent, 15.6% of the respondent indicated to very great extent whereas 5.2% of the respondent indicated to moderate extent, this is an indication that managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation to a great extent.

Regression analysis

In this study, a multiple regression analysis was conducted to test the influence among predictor variables. The research used statistical package for social sciences (SPSS V 20) to code, enter and compute the measurements of the multiple regressions.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.898[a]	.806	.801	.19758

Adjusted R^2 which is termed as the coefficient of determination tells us how changes in loan delinquency among agribased Small and medium enterprises financed by AFC varied with type of business, credit risk evaluation, level of supervision and managerial skills. According to the findings in table above, the value of adjusted R^2 is 0.801. This implies that, there was a variation of 80.1% of loan delinquency among agribased Small and medium enterprises financed by AFC varied with type of business, credit risk evaluation, level of supervision and managerial skills at a confidence level of 95%. R is the correlation coefficient which shows that there was a strong correlation between the study variable as shown by the correlation coefficient of 0.898.

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.744	2	0.372	3.131	.048[b]
	Residual	24.675	75	0.329		
	Total	25.419	77			

From the ANOVA statics in table above, the processed data, which is the population parameters, had a significance level of 0% which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. The F critical at 5% level of significance was 3.131since F calculated is greater than the F critical (value = 1.684), this shows that the overall model was significant.

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.833	.172		4.847	.000
	credit risk evaluation	-.643	.082	-.586	-7.835	.000
	level of supervision	-.232	.083	-.246	-2.806	.006
	managerial skills	-.162	.063	-.223	-2.583	.011
	Type of business	-.142	.082	-.132	-1.739	.034

From the finding in table the established regression equation was

$Y = 0.833 - 0.142\ X_1 - 0.643\ X_2 - 0.232X_3 - 0.162\ X_4$

From the above regression model, holding type of business, credit risk evaluation, level of supervision and managerial skillto constant zero loan delinquency among agribased Small and medium enterprises financed by AFC would be at 0.833. It was established that a unit increase in type of business would cause an decrease in loan delinquency among agribased Small and medium enterprises financed by AFC by a factor of 0.142, unit increase in credit risk evaluation would lead to decrease in loan delinquency among agribased Small and medium enterprises financed by AFC by a factor of 0.643, also a unit increase in level of project supervision would cause a decrease in loan delinquency among agribased Small and medium enterprises financed by AFC by factors of 0.232, further unit increase in managerial skills would cause an decrease in loan delinquency among agribased Small and medium enterprises financed by AFC by factors of 0.162. At 5% level of significance and 95% level of confidence, credit risk evaluation had a 0. 000 level of significance; level of supervision showed a 0.006 level of significance, managerial skills had a 0.011 level of significance while type of business showed 0.034 level of significance hence the most significant factor is credit risk evaluation. Overall credit risk evaluation had the greatest effect on loan delinquency, followed by level of supervsion, then managerial skills while type of businesss had the least effect on loan delinquency. All the variables were significant ($p<0.05$).

Conclusion

The study found that the type of business contributes to loan default. The study also found that type of business contributes to loan default among Agribased SMEs financed by Agricultural Finance Corporation to great extent. The study also found that credit worthiness evaluation of Agribased SMEs Contribute to loan default , the study further revealed that type of business contribute to loan default among Agribased SMEs financed by Agricultural Finance to great extent .The study established that project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance Corporation, the study found that level of project supervision contribute to loan default among Agribased SMEs financed by Agricultural Finance

Corporation to great extent. The study revealed that managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation. It was revealed that managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation to a great extent. The study concludes that managerial skills contribute to loan default among agribased SMEs financed by Agricultural Finance Corporation to a great extent.

Recommendations

The study recommends that there is need for Agricultural Finance Corporation to gather information on the company's payment history, ensure quality of SMEs loan approvals and manage the performance of the loans, verify the existence of the company, obtain a credit score from a commercial credit bureau, and perform a financial ratio analysis.The study also recommends that Agricultural Finance Corporation should establish the project's raw material prices, risk and control assessment of the projects, check the project's total budget, check the systems and ensure that they are in order to avoid losses hence default, check academic qualifications of the undertaking the debt collection process to contribute to micro-enterprises empowerment, to facilitate MSE's entrepreneurship, to assist micro-enterprises in their reproductive tasks and to ease their repayment burden. The study recommends that Agricultural Finance Corporation can reduce loan defaults through reduction of interest rate on loans, training on problem-solving and decision-making skills, adequate and effective procedures on risk management, ensuring proper communication of the requirements on the loans, developing a debt management program.

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