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Determinants of Loan Repayment in Small Scale Enterprises in Developing Countries

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ABSTRACT:
This study was conducted with the objective of identifying the major determinants of loan repayment in Small Scale Enterprises (SSEs) with particular reference to SSEs in one of Kenya's most dynamic informal business hub, Kariobangi Division in Nairobi. In order to achieve this objective, primarily data were collected from 50 randomly selected respondents by using questionnaires. Descriptive statistics were used to analyze data on the socio-economic characteristics of the borrowers. The study found that personal characteristics such as education level, family size, amount of loan applied and business experience of the respondents have a positive relationship to loan repayment. Age, interest rate and change in gender had an inverse relationship to loan repayment.

Keywords: *Small Scale Enterprises (SSEs), Loan repayment, Non-performing loans, Kariobangi division*

INTRODUCTION

Loan is defined as a type of debt, and like all debt instruments, a loan entails the redistribution of financial assets over time between the lender and the borrower. In a loan, the borrower initially receives or borrows an amount of money called the principal from the lender, and is obligated to pay back an equal amount of money to the lender at a later time. Typically, the money is paid back in regular installments or partial repayments in an annuity; each installment being of the same amount (Signoriello, 1991). However, loans from other financial institutions like the informal financial institutions may have a different repayment structure which is custom made for the borrower.

A small business is an entity that is privately owned and operated, with a small number of employees and relatively low volume of sales. Small businesses are normally privately owned corporations, partnerships or sole proprietorships. There is no clear definition of small scale enterprises as small varies by country and industry. However, three criteria are mainly used in literature to define Micro and Small Scale Enterprises (MSEs). The first one, based on number of employees, defines MSEs as those enterprises below a certain number of workers (it can range from less than 10 to less than50 employees). The second criterion concerns the degree of legal formality and is mainly used to distinguish between the formal and informal sectors. According to this criterion, MSEs are those enterprises that are not registered and do

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not comply with the legal obligations concerning safety, taxes and labor laws. The third criterion defines MSEs by their limited amounts of capital and skills per worker. The degree of informality and size of employment have perhaps been the two most readily accepted criteria on which classification of MSEs is based. The term MSE incorporates firms in both the formal and informal sectors. However, the terms MSEs and informal sector are normally used interchangeably as most MSEs are informal enterprises (Mead and Morrison, 1996). The third criterion definition of MSEs will be used for the purpose of this study.

Small scale enterprises are characterized by: ease of entry; small scale of activity; self-employment with a high proportion of family labor; little capital and equipment; labor intensive technologies; low skills; low level of organization with little access to organized markets, informal credit, education and training or services and amenities; cheap provision of goods and services or provision of goods and services otherwise unavailable; low productivity and low incomes (Charmes, 1997).

Potential sources of finance for the small scale enterprises include commercial banks, non-bank financial institutions, non-governmental organizations (NGOs), multilateral organizations, business associations, and rotating savings and credit associations. In addition, financial transactions also take place between traders, friends, relatives and landlords, as well as commercial moneylenders (Atieno, 2001).

Default on borrowed funds could arise from unfavorable circumstances that may affect the ability of the borrower to repay as pointed out by Stigliz and Weiss (1981). The most common reasons for the existence of defaults are the following: if the financial institution is not serious on loan repayment, the borrowers are not willing to repay their loan; the financial institution's staffs are not responsible to shareholders to make a profit; clients' lives are often full of unpredictable crises, such as illness or death in the family; if loans are too large for the cash needs of the business, extra funds may go toward personal use; and if loans are given without the proper evaluation of the business, Norell (2001). Wakuloba (2005) in her study on the causes of default in Government micro credit programs identified the main causes of default as poor business performance, diversion of funds and domestic problems.

Breth (1999) argued that there are many socio-economic and institutional factors influencing loan repayment rates. The main factors from the lender side are high-frequency of collections, tight controls, a good management of information system, loan officer incentives and good follow ups. In addition, the size and maturity of loan, interest rate charged by the lender and timing of loan disbursement have also an impact on the repayment rates (Oke et al., 2007). The main factors from the borrower side include socio-economic characteristics such as, gender, educational level, marital status and household income level and peer pressure in group based schemes.

Kariobangi is a local artisans' hub in Nairobi's County dominated by low and medium class habitat. It is an area for artisanal entrepreneurs who lost their employment in the formal sector as a consequence of the country's Structural Adjustment Program in the 1980s.The industrial area was demarcated bystreets and surrounded by low-income residential areas comprising mid-rise apartment buildings and slum dwellings. These collective entities, currently spread in the larger Kariobangi area has come to be known as Kariobangi Light Industries. To date, Kariobangi Light Industries is a concentration of micro and small metalwork enterprises, as well as hardware retail shops and machinery repair service workshops. There are approximately 300 enterprises and workshops, half of which are metalwork enterprises. The products manufactured include foundry products (such as car spacers); lathe works, welding, and metal fabrication (steel doors, windows, furniture, cooking stoves); and mechanical machines (flour millers, feed mixers, block makers, counterweight balances, band saws, candle makers, bakery machines, and chip cutters, among others).

Literature Review

Characteristics of Small-Scale Enterprises

Characteristics of small-scale enterprises make the cost of administering credit very high compared to the return on the loans. Small scale enterprises possess shallow management, often with little experience and training; they are usually undiversified, one product firms, they are sometimes new businesses, with little track record, and poor financial recording; they may have a new unproven product; they have little to offer by way of security to a lender; they may be reluctant to raise outside equity capital for reasons of expense, loss of control and increased disclosure requirements. These characteristics of small-scale enterprises provide little incentive for any aggressive loan recovery mechanisms (Baker and Dia, 1987; Kitchen, 1989).

Sources of Finances for Small Scale Enterprises

Access to financial services by smallholders is normally seen as one of the constraints limiting their benefits from credit facilities. However, in most cases the access problem, especially among formal financial institutions, is one created by the institutions mainly through their lending policies. This is displayed in the form of prescribed minimum loan amounts, complicated application procedures and restrictions on credit for specific purposes (Schmidt and Kropp, 1987). Stiglitz (1993) noted that most of the small scale enterprises are unable to access financial resources from formal financial intermediaries, such as banks, due to any of the following reasons: smaller size of their transaction, lack of collateral, inexperience, illiteracy or innumeracy of the borrower, physical remoteness of many of the informal sector enterprise, mobility of many informal sector enterprises, lack of bookkeeping or an appropriate compliance framework and lack of general information about the borrower and of predictability of the surrounding transaction. Potential sources of finance for the informal sector include commercial banks, non-bank financial institutions, non-governmental organizations (NGOs), multilateral organizations, business associations, and rotating savings and credit associations. In addition, financial transactions also take place between traders, friends, relatives and landlords, as well as commercial moneylenders (Atieno, 2001).

Rotating Savings and Credit Associations (ROSCAs); ROSCAs are also an important source of credit in the country. These are found in both rural and urban areas as either registered welfare groups or unregistered groups. They mainly provide credit to those who would likely be ineligible to borrow from other sources. ROSCAs have developed mostly in response to the lack of access to credit by small enterprises in the informal sector, forcing them to rely on their own savings and informal credit sources for their financing (Addisu, 2007)

In the recent past, a number of non-governmental organizations (NGOs) have been involved in financing of microenterprises. However, most NGOs have not had positive performance. Their inexperience in financial intermediation and limited financial resources has constrained their potential. There is little coordination among the NGOs, resulting in duplication of resources and activities. Most of them have high credit costs, are donor based and sponsored, lack adequate funding, and are limited in their geographical coverage. They also discriminate against small-scale enterprises who get rationed out by lenders since cheap credit creates excess demand for loanable funds, forcing lenders to loan to large enterprises that have collateral and are perceived to be less risky (Addisu, 2007).

A large part of financial transactions in Africa occur outside the formal financial system. Literature on the theory of credit markets with incomplete markets and imperfect information is largely relevant to the functioning of informal markets. Informal finance has been defined to refer to all transactions, loans and deposits occurring outside the regulation of a central monetary authority, while the semiformal sector has the characteristics of both formal and informal sectors. In Africa it has been defined as the operations of savings and credit associations, rotating savings and credit associations (ROSCAs), professional moneylenders, and part-time money lenders like traders, grain millers, smallholder farmers, employers, relative and friends, as well as cooperative societies (Aryeetey and Udry, 1997).

Empirical Review

A study assessing the relationship between interest rates and Non Performing Loans (NPLs) in commercial banks in Kenya found that there was a weak relationship between the two. A greater proportion of NPLs was attributed to factors other than the interest rate (Ongweso, 2006). Ocholla (2009), found that the credit risk management coupled with close supervision by the Central Bank greatly enhanced the decline of non-performing loans ratio in the banking sector.

Bindra (1998), argues that the true underlying cause of non-performing loans is entirely of our own making - poor risk management. This is a situation where the bank credit officials do not properly assess the suitability of advancing credit to their customers; they do not adhere to good lending principles. He concludes that loan losses can be minimized through professional management of the lending function. Muasya (2009) studied the impact of non-performing loans on the performance of the banking sector in Kenya and confirmed that non-performing loans affect commercial banks in Kenya. Further analysis of individual commercial banks with more than KES 25 Billion worth of asset indicated that the impact on non-performing loans to interest income and profitability are not adverse to these banks.

Reta (2011) analyzed and identified the factors that influence the loan repayment performance of the beneficiaries of Addis Credit and Saving Institution (AdCSI)- a microfinance institution in Ethiopia. He found out that age and five business types (baltina and petty market, kiosk and shop, services providing, weaving and tailoring and urban agriculture) were important in influencing loan repayment performance of the borrower. In addition, sex and business experience of the respondents were found to be significant determinants of loan repayment rate.

Brehanu (2008) employed the Tobit model to analyze the factors that affect loan repayment. A total of 17 explanatory variables were considered in the econometric model. Out of these seven variables were found to significantly influence the repayment performance. These were land holding size of the family, agro-ecology of the area, total livestock holding, number of years of experience, number of contacts, sources of credit and income from off-farm activities. The remaining variables (family size, distance between main road and household residence, purpose of borrowing, loan amount and expenditure for social festivals) were found to have insignificant effect on loan repayment performance of smallholder farmers. Bhatt and Tang (2002) showed that women has low repayment rate because some women entrepreneur in the study might have been engaged in high risk and low return activities.

Purpose of Study

As mentioned above, various studies were conducted on the determinants of loan repayment performance in different countries. Most of these studies were focused on the credit associated with agricultural activities and they identified the socio-economic factors that affect the loan repayment rate of rural household. Studies done in Kenya focused more on non-performing loans in relation to various aspects such as credit risk, causes of non-performing loans and performance of the banking institutions. However in the literature review there is no indication of coverage of loan repayment and its determinants in the small scale enterprises in Kenya. Therefore, this study aims at addressing this research gap.

Research Problem

Loan recovery is one of the key objectives of financial institutions as it enables them to refinance and to reach more people. To have a positive impact on the economy of a country, the institutions must be able to loan out funds and recover the same so as to remain relevant in the finance industry. Loan recovery is a strategic activity for financial institutions. For any economy to thrive there must be funds to foster investment which leads to well-being of the population. Proper investments eventually bring about poverty reduction through creation of employment. High recovery rates reflect the adequacy of financial institution’s services to clients’ needs (Godquin, 2004). However, where there is low recovery rate, financial institutions raise provisions for loan loss that decrease their revenue and reduce the funds for new lending. The cutback of loans impairs the small scale enterprises as they have difficulties in expanding their working capital blocking their chances of resuming normal operations and meeting their obligations which include loan repayment. This motivates the carrying out of this study to examine loan repayment and its determinants in the small scale enterprises.

Small scale enterprises comprise of petty traders involved in such activities as selling of second-hand clothes, shoe shinning, food selling and repair and construction; operating mainly from the streets of the main urban centers. It can also be described as any activity generating income and profits, though on a small scale, uses simple skills, is dynamic and not tied to regulation of the activities. Such activities include: vegetable selling, street vendors, masonry, carpentry, among others, Amenya (2007). The informal sector is expanding from time to time as an employer, especially for the urban population. However it is encircled by so many deep-rooted challenges that worsen the livelihood of its members. Lack or shortage of capital for start-up and running expenses, is found in the centre of these diversified challenges (ILO, 1991).

Kashuliza (1993) did a study on loan repayment and its determinants in small holder agriculture. He attempted to identify some of the main factors which influence loan repayment and default at the farm level. Results of the study indicated that better repayment rates were associated with use of machinery and hired labor in farming, optimal credit packages and higher farm incomes. Credit default was accounted for by high consumption expenditures, farmer attitudes, late input delivery, adverse production environment, and declining crop marketing margins.

Abafita (2003) did a study on Microfinance and Loan Repayment Performance in Ethiopia by analyzing the factors that influence microfinance loan repayment, evaluating the loan rationing mechanism and also assessing the impact of the program on the livelihood of borrowers. The results showed that education, income, loan supervision, suitability of repayment period, availability of other credit sources and livestock were important and significant factors that enhanced the loan repayment performance, while loan diversion and loan size were found to significantly increase loan default.

Mathara (2007) studied the response of National Bank of Kenya Ltd (NBK) to the challenges of NPLs and found that economic downturn, government interference in lending, inadequate government monetary policies and a slow inadequate judicial system, political appointments to top management, poor debt follow up, lack of management accountability for NPLs, inadequate credit policy guidelines, imprudent and reckless lending were some of the causes of NPLs. Muasya (2009) studied the impact of non-performing loans on the performance of the banking sector in Kenya and confirmed that non-performing loans affect commercial banks in Kenya.

It is clear from the above studies that loan repayment and their determinants in the small scale enterprises in Kenya has not been done. This study therefore is intended to narrow the research gap paying attention to this sector of the economy. It focuses on identifying factors behind the loan default problem that SSEs are associated with.

RESEARCH METHOD

This study used the descriptive research design to examine the determinants of loan repayment in small scale enterprises in Kenya’s Kariobangi Division, Nairobi County. A descriptive study was the most appropriate because it presents facts concerning the nature and status of a situation as it exists at the time of study. In addition, this approach tries to describe present conditions, events or systems based on the impressions or reactions of the respondents of the research (Robson, 1993).

The population of the study comprised 126 small scale enterprises based in Nairobi’s Kariobangi Light Industries. The owners of these businesses were the population elements in this study.

This research used a simple random sampling technique. This is sampling in which every member of the population has an equal chance of being selected. The study used primary data which was obtained from small scale enterprises with the aid of questionnaires. This was used to generate information on personal characteristics of the target group and to determine the factors affecting their repayment performance. Both closed and open ended questions were used to obtain responses. The questionnaire was physically administered to each respondent, who was allowed enough time to respond.

RESULTS AND DISCUSSION

The data was summarized and presented in the form of proportions, means, and tables. Consequently, the collected data was analyzed and interpreted in line with the aim of the study. Of the 50 questionnaires distributed for this research, 41 useable questionnaires were returned giving a response rate of 82 percent, which was considered satisfactory for subsequent analysis.

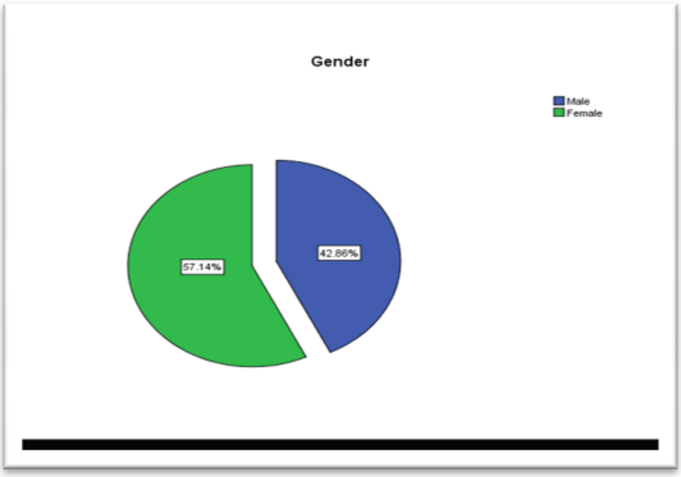
Personal Characteristics of the Respondents

✓ **Gender**

The respondents were asked to indicate their gender. From the research findings, it was established that 57.14 percent were female while 42.86 percent were male as shown in figure 1. This suggests that most SSEs in Kariobangi division are run by female.

✓ **Age**

The respondent's lowest age is 24 while the highest is 69. The age distribution of the respondents indicated that 38.10 percent of the respondents are between 30-40 years, 28.57 percent between 40-50 years, 23.81 percent below 30 years and 9.52 percent of them are above 50 years as shown in figure 2. This suggests that most businesses in Kariobangi division are run by individuals at the age of 30s and 40s.



Source: Research data

Figure 1: Gender

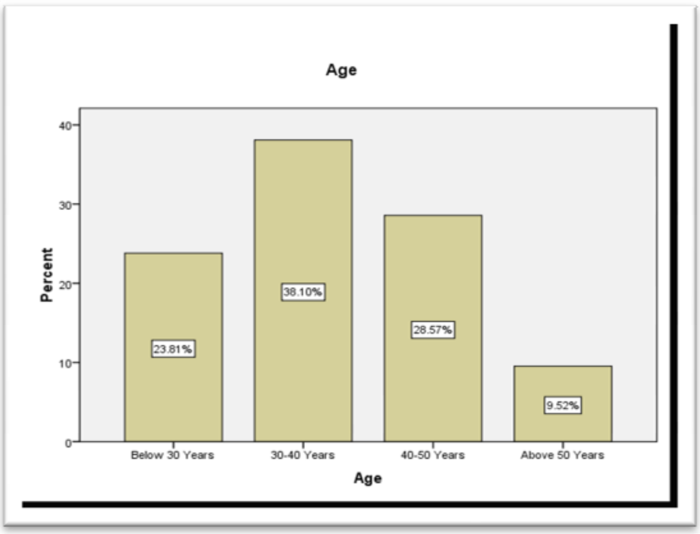


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Figure 2: Age

✓ **Education Level**

The majority of the sample respondents (95.24%) have attended primary, secondary or tertiary education. It was established that 47.62 percent of them had tertiary education level, 38.10 percent of them had secondary education level, 9.52 percent had primary education level and 4.76 percent had no formal education as shown in figure 3. This shows that most people who run SSEs in Kariobangi division have attained tertiary education. Therefore these SSEs possess limited management and modest technical skills.

✓ **Size of Family**

The study established that the family size for a considerable portion of the respondents, 47.62 percent had more than 5 members, 38.10 percent with between 2-5 family members. Only 14.29 percent of the families have only one member as shown in figure 4. This implies that most families who borrow loans have more than five family members.

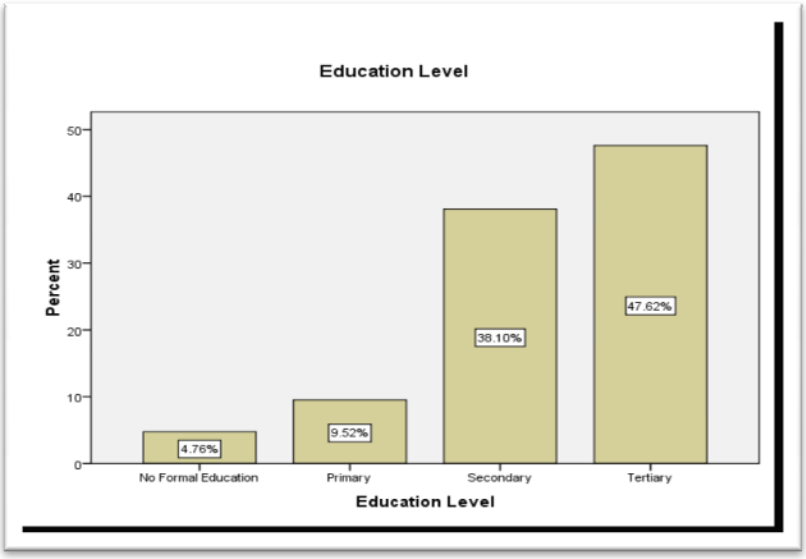

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Figure 3: Education level

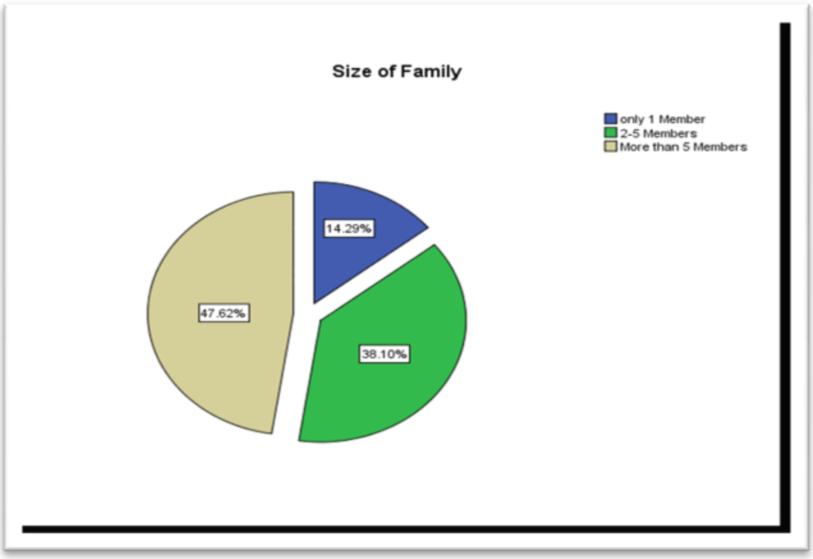

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Figure 4: Size of family

✓ **Business Experience**

The respondents were asked to indicate the duration they have run their business. From the study, it was established that 52.38 percent of them had run their business between 1-5 years followed by 19.05 percent of them which had run for between 5-10 years. It was noted that only 4.76 percent had run their business for less than one year as shown in figure 5. This suggests that most SSEs in Kariobangi division are not very experienced in business since they have been in operation for one to five years.

Loan Characteristics

✓ **Amount of Loan Applied**

The respondents were asked to state the amount of loan they usually apply. From the research findings, it was established that 57.14 percent usually applied between sh.51,000 - sh.200,000 while 23.81 percent usually applied below sh.50,000. Only 4.76 percent applied for above sh. 400,000 as shown in figure 6. This implies that most SSEs in Kariobangi division apply low amounts of loans. Due to a lack of working capital, they cannot purchase raw materials in bulk at lower prices and take their goods to market, where they can attract better prices.

✓ **Amount of Loan Awarded**

The respondents were asked to state whether they were awarded the entire loan they had applied. From the research findings, it was established that 100 percent were awarded the entire loan they had applied as shown in figure 7. This implies that most SSEs usually got the whole amount they had applied. This may be attributed to the small amounts of loans they usually applied. For small-scale enterprises, reliable access to short-term and small amounts of credit is more valuable, and emphasizing it may be more appropriate in credit programs aimed at such enterprises.

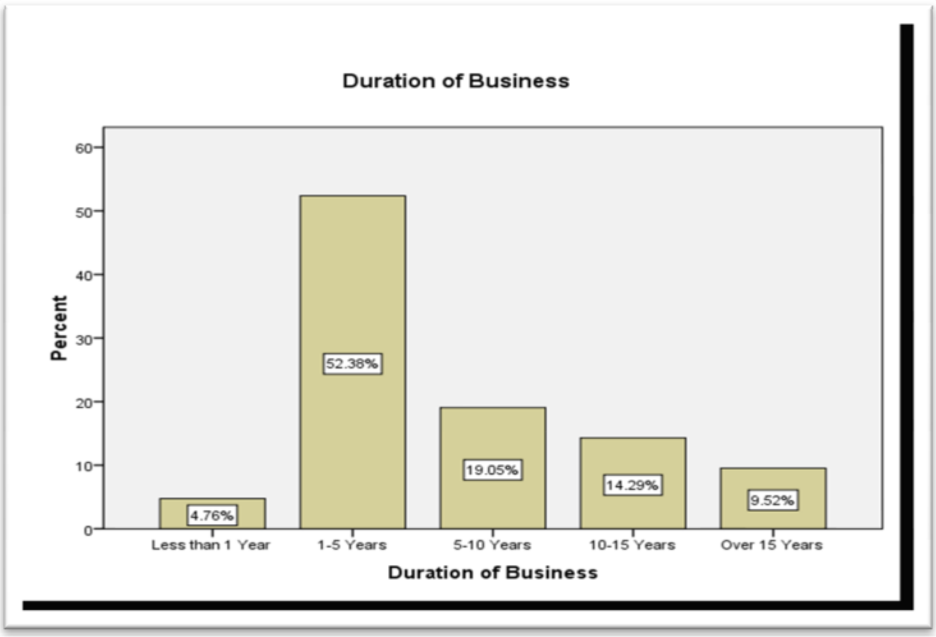

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Figure 5: Duration of business

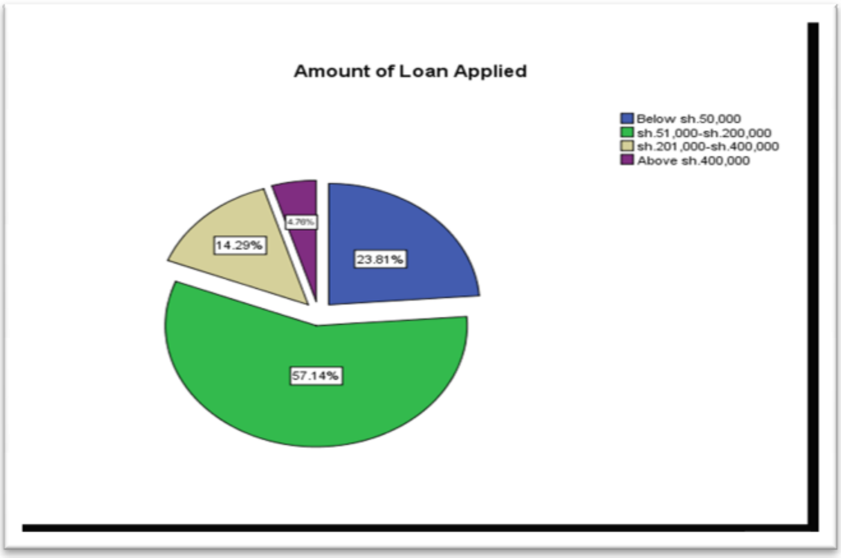

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Figure 6: Amount of loan applied

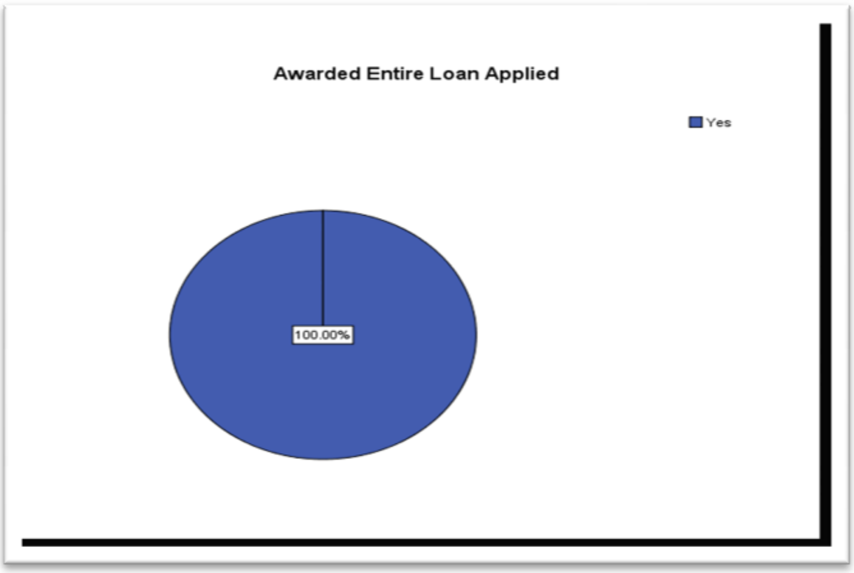

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Figure 7: Amount of loan awarded

✓ **Time the Loan was Received**

The respondents were asked to state whether they received their loans at the right time. From the research findings, it was established that 61.90 percent got their loans at the right time while 38.10 percent did not get their loans at the right time as shown in figure 8. This implies that the loan processing for SSEs is faster due to too much competition in low income markets.

✓ **Amount Repaid per Month**

The researcher wanted to establish the monthly loan repayment amount. From the research findings, it was established that 38.10 percent of them repay less than ksh.5, 000 per month followed by 33.33 percent of them who repaid between ksh.5,000-ksh.10,000. It was noted that only 4.76 percent repaid between ksh.16, 000-ksh.20,000 per month as shown in figure 9. This suggests that most SSEs in Kariobangi division are run by individuals with low incomes due to the small size of their businesses.

✓ **Interest Rate Charged on the Loan**

The respondents were asked to state the interest rate charged on their loan. From the research findings, it was established that 28.57 percent of them are either charged between 16%-25% or do not know the interest rate they are charged. 23.81 percent are charged an interest rate of between 6%-15%. It was noted that only 4.76 percent are charged an interest rate of below 5% as shown in figure 10. This suggests that most SSEs are run by individuals who do not know the interest rate they are charged on their loans. This may be attributed to limited management and modest technical skills of the borrowers.

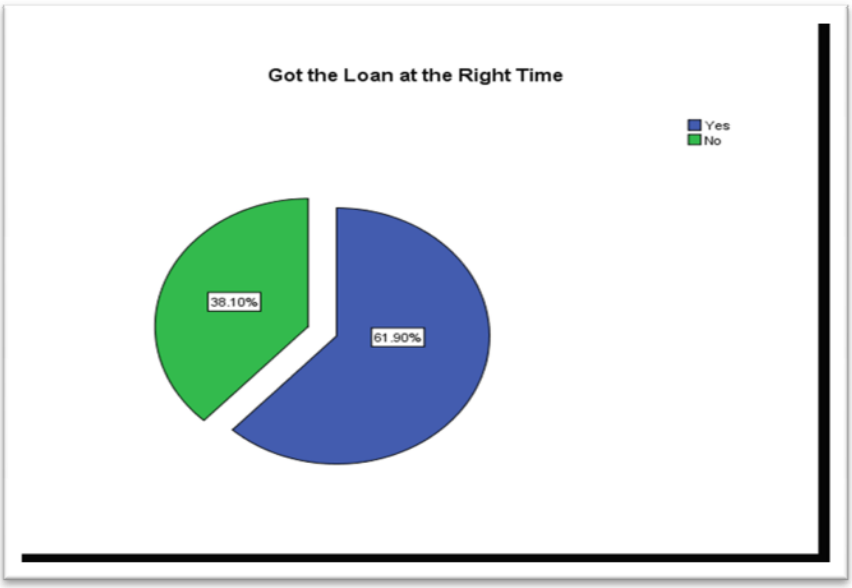

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Figure 8: Time the loan was received

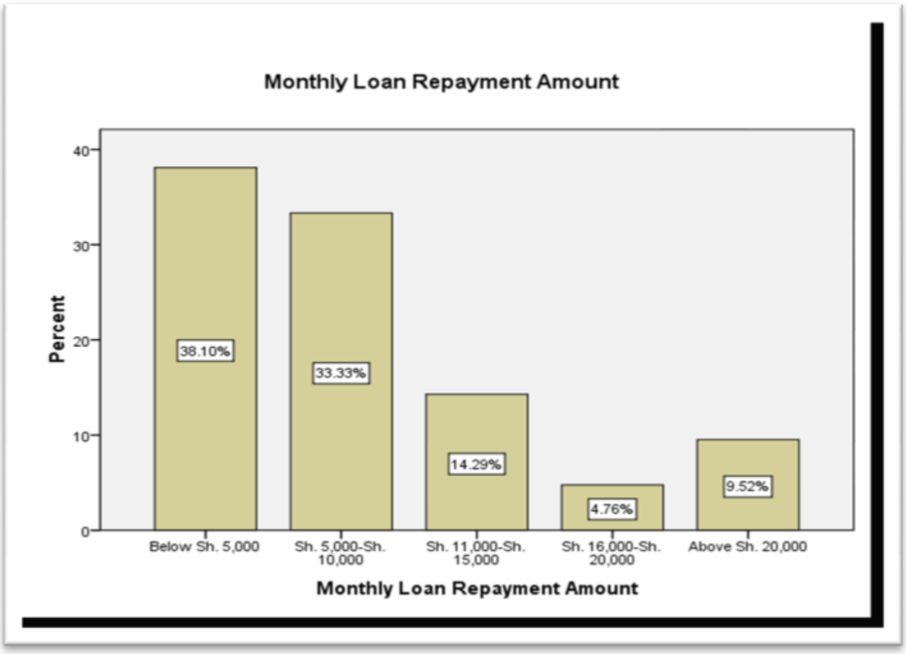

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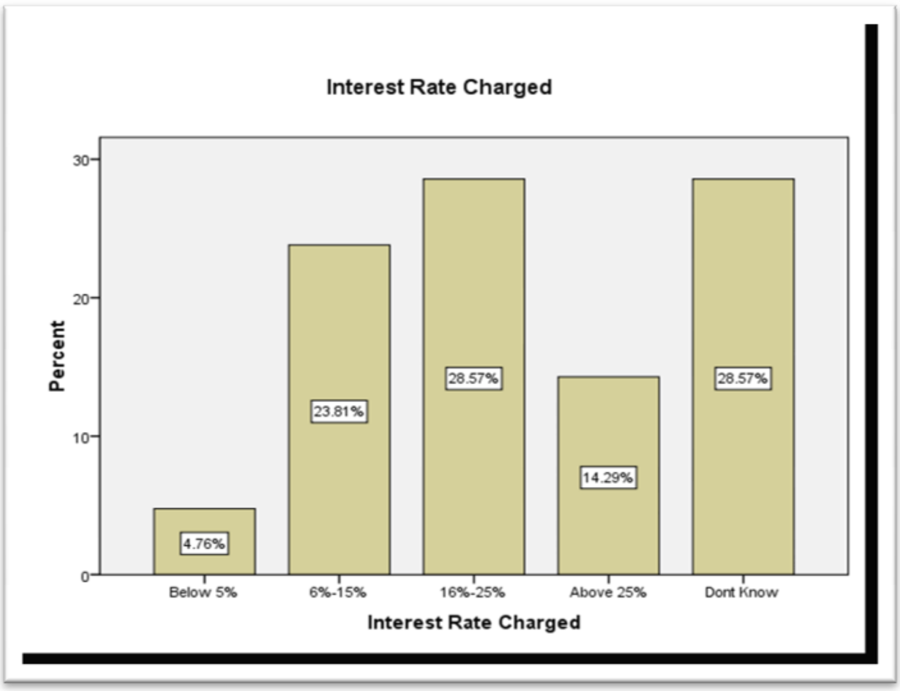
Figure 9: Amount repaid per month



Source: Research data

Figure 10: Interest rate charged on the loan

CONCLUSION

The study concluded that though many factors can lead to loan defaults, some of the factors were regarded to be of higher impact. This is evident from the way respondents replied to questions and the analysis arising thereof. The study found out that higher education level and large family size – personal characteristics - and large amount of loan applied and longer duration of business - loan characteristics - result in increased loan repayment and vice versa. However an increase in age, interest rate and change in gender leads to more loan default and vice versa.

Limitations and Future Research

This study was successfully undertaken but not without a few limitations. One such limitation was that some of the respondents declined to respond to the questionnaires. The study was limited to the Kariobangi area of Nairobi County in Kenya. Therefore, generalizations cannot adequately extend to other SSEs in other areas. Perhaps, the results would be more informative if the study is conducted in other regions in Kenya and other countries in Africa for comparison.

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