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INFLUENCE OF CREDIT RISK MANAGEMENT PRACTICES ON LOAN DELINQUENCY IN SAVINGS AND CREDIT COOPERATIVE SOCIETIES IN MERU COUNTY, KENYA

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Abstract

The study aimed at assessing the influence of credit risk management practices on loan delinquency in SACCOS in Meru County, Kenya. The study was guided by the research objectives which were to determine the influence of credit risk control and collection policy on loan delinquency. The study adopted a descriptive research design and the population consisted of all the44 credit officers of SACCOs in Meru County. Questionnaire was used to collect data. Multiple linear regressions were used in data analysis. Analyzed data was presented in percentages and frequency tables. The study revealed that there exist a strong relationship between credit risk controls, collection policy and loan delinquency in SACCOs. Thus the study concludes that credit risk management practices significantly influenced loan delinquency in SACCOs in Meru County. The study recommends adoption of a more stringent policy on credit risk management practices in SACCOs for effective debt recovery.

Keywords: Collection Policy, Credit Risk Control, Credit Risk Management Practices, Loan Delinquency, SACCOS

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INTRODUCTION

Saving and credit cooperative societies are an autonomous association of persons united voluntarily to meet their common economic and social needs through jointly owned and democratically controlled enterprises, which are organized and operated under the principles of cooperatives (ICA, 2005). They are embodied in the values of self-help, honesty, openness, self-responsibility, democracy, quality, equity, solidarity, mutual caring, efficiency, transparency and accountability (ICA, 2005). The fundamental objective of a SACCO is to promote the economic and social welfare of its members by granting loans to cover their economic needs, supporting the spirit of initiative in agricultural or industrial work and careful use of the saving produced locally (WOCCU, 2005).

The first cooperative society in Kenya was organized by Europeans settlers in Rift Valley in 1908.The society was supposed to market cereal crops, fruits and dairy products. That time there was no Co-operative Law to govern it until 1931. In 1966, the cooperative societies Act was enacted which introduced control measures to counteract mismanagement and misappropriation of funds. The savings and credit cooperative societies were formed in late 1970's. SACCOs have grown significantly and they play a major role in providing financial services to majority of Kenyans particularly in the rural areas for example between 1985 and 2006 the number of registered SACCOs rose from 1285 to 4876 (Ministry of Co-operative Development and Marketing, 2007). SACCOs have a high exposure to credit risk; the risk that borrowers are unable to pay or risk of delayed payments as well as operational risks (Alfred, 2011). There has been massive fraud of funds by SACCOs' leaders (Mugisa, 2010) and loan delinquency in SACCOs have increased.

Credit risk is the change in net asset value due to changes and the perceived ability that counter parties to meet their contractual obligations. It is the most obvious risk of a credit union by the nature of its activity and in terms of potential losses; it is typically the largest type of risk. It occurs when a borrower defaults and does not honor his or her obligation to service debt on time. Reasons for default may include cases where the obligor is in a financially stressed situation, may be facing a bankruptcy procedure or willingly refusing to pay. The default of a small number of members may result in a very large loss for the union (Bessis, 2003). Credit risk is the oldest and important risk which credit unions are exposed to. Importance of credit risk management is increasing with time because of some reasons like economic crises and stagnation, company bankruptcies, infraction of rules in company accounting and audits, growth of off-balance sheet derivatives, declining and volatile values of collateral, borrowing more easily for the small firms, financial globalization and business risk-based capital requirements (Boston Consulting Group, 2001). The basis of a sound credit risk management system include

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guidelines that clearly outline the scope and allocation of credit facilities and the manner in which the credit portfolio is managed, that is, how loans are originated, appraised, supervised and collected (Greuning & Bratanovic, 2003).

Problem Statement

Despite SACCOs offering small sized loans to their members compared to other financial institutions in Kenya, they experience a high level of loan default rate (Triodos Facet, 2011; Karumuna & Akyoo 2011). This trend threatens financial viability and sustainability of SACCOs and hinders the achievement of their aim which is maximizing benefits to members which include the social role of providing loans to help members achieve their standard of living (Lagat, Mugo, & Otuya, 2013). Failure to control credit risk, could lead to insolvency as success of every savings and credit co-operative society largely depends on the effectiveness of their credit risk management practices (Alfred, 2011). Hence knowing the SACCOs credit risk management variables that influence the loan default rate might help the SACCOs to mitigate the credits' risks effectively. Locally few studies have been done on credit risk management, among them includes Silikhe (2008) on credit risk management in microfinance institutions, Njiru (2003) on credit risk management practices adopted by farmers in cooperatives in Embu, Wambugu (2009) on credit management practices in SACCOs offering front office services and Kimeu (2008) on credit risk management techniques of unsecured bank loans. While the above research outcomes provide insight on credit risk management techniques, there is no known study to the researcher which has been done on the influence of credit risk management practices on loan delinquency in SACCOs hence the need for the study.

General Objective

The general objective of this study was to analyze the influence of credit risk management practices on loan delinquency in SACCOs in Meru County.

Specific Objectives

1. To determine the influence of credit risk control on loan delinquency.
2. To establish the influence of collection policy on loan delinquency.

LITERATURE REVIEW

Asymmetric Information Theory

Information asymmetry refers to a situation where business owners or manager know more about the prospects for, and risks facing their business, than do lenders (PWHC, 2002) cited in

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Eppy (2005). The theory describes a condition in which all parties involved in an undertaking do not know relevant information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with investment projects for which the funds are earmarked. The lender on the other hand does not have sufficient information concerning the borrower (Edwards and Turnbull, 1994). Binks and Ennew (1992) point out that perceived information asymmetry poses two problems for the SACCOs, moral hazard (monitoring entrepreneurial behavior) and adverse selection (making errors in lending decisions). SACCOs will find it difficult to overcome these problems because it is not economical to devote resources to monitoring where lending is for relatively small amounts. This is because data needed to screen credit applications and to monitor borrowers are not freely available to SACCOs.

Empirical Review

Soke Fun Ho and Yusoff (2009), in their study on credit risk management strategies of selected financial institutions in Malaysia established that the majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk and hence affect a firm performance.

Moti, Masinde, Mugenda, and Sindani, (2012) in their study on Effectiveness of Credit Management System on Loan Performance: Empirical Evidence from Micro Finance Sector in Kenya found out that credit risk controls adopted by microfinance institutions have an effect on loan performance. Credit insurance, signing of covenants with customers, diversification of loans, credit rating of customers and reports on financial conditions refrain from further borrowing had an effect on loan performance. Collection policies adopted by microfinance institution had an effect on loan performance, stringent policy had a great impact on loan performance, and the lenient policy had an effect but was not as great as that of stringent policy.

According to Pandy, (2005) in his study on Exploring public sector communication performance asserted that, prompt collection is needed for fast turnover of working capital; keeping collection costs and bad debts within limits and maintaining collection efficiency. A collection policy should lay down a clear cut collection procedure. The procedures should be followed with tact to avoid losing some customer to other competitors by covering overdue accounts. Firms should start early enough to collect his accounts from customers and it should be known that it is the duty of the firm to remind debtors to pay their due accounts. Kariuki (2010) in his study on Effective Collection Policy stated that there are various policies that an

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organization should put in place to ensure that credit management is done effectively, one of these policies is a collection policy which is needed because all customers do not pay the firms bills in time. Some customers are slow payers while some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses.

According to Ahmed and Malik (2015) in their empirical investigation on credit risk management and loan performance of micro finance banks of Pakistan indicated that credit collection procedure is a systematic way required to recover the past owing from clients within the legal framework. Different financial institutions have different collection policies and processes which have to be lawful (Latifee, 2006). For better performance of credits or loan a well structure collection policy is needed and if the financial institutions do not implement it would lead to loan delinquency (Boldizzoni, 2008).

Magali (2013) in his study on the impacts of credits risk management on profitability of rural Savings and Credits Cooperative Societies a case study of Tanzania recommended that rural Savings and Credits Cooperative Societies should be keen in credits' processing, monitoring and follow-up. Moreover, they should screen borrowers before issuing loans by using the credit policy and carrying out a feasibility study on the client and they should also issue loans only to qualified borrowers. Considering risks variables and diversity of income of borrowers also is vital for dealing with default risks (Mustafa, Al-Sayed, Awaideh, & Miller, 2011). Kurui and Kalio (2014) found that credit risk control assist in decreasing loan default levels and may aid in improving organization financial performance.

Vogiazas and Nikolaidou (2014) in their study on Credit risk determinants in the Bulgarian banking system and the Greek twin crises stated that recently credit risk has achieved more significance because of the financial contagion effects from the debt-burdened neighbors or nations. In the wake of this financial crisis, financial institutions such as SACCOs have initiated unique ways to alleviate any decline in financial value caused by mismanagement in credit allotment and collection. Credit risk management presents a possible way out to such disputes. Credit management does not end till the full and final payment has been received (Moti et al., 2012). Thus, as financial environment transform, the credit approach of the financial institutions may equally adjust.

Credit risk management is the mixture of coordinated tasks and actions for controlling and directing risks confronted by an organization through the incorporation of key risk management tactics and processes in relation to the organization's objectives (Vogiazas & Nikolaidou, 2014). Credit risk is basically the risk faced by the lender to lose money from borrower who fails to make payments. It is vital to note that risk management practices are not

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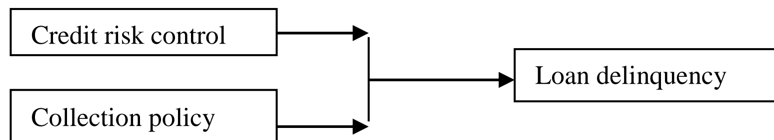
developed and designed to get rid of risks in wholesome but they aspire at controlling chances and hazards that may result in risk (Frank, Simon & Josephine, 2014). Additionally, Ross, Westerfield and Jordan (2008) in their discussion on essentials of corporate finance argued that that risk management practices also ensure that financial institutions must have strong and rational framework for decision making by which firm's objectives can be attained. However, effective credit risk management practices have never been victorious in reducing the human element in decision making about controlling risk (García, Giménez, & Guijarro, 2013).

Conceptual Framework

The study proposed that the credit risk management practices are determined by credit risk control and collection policy as captured in figure 1.

Figure 1: Conceptual Framework



METHODOLOGY

The study used a descriptive research design. Descriptive research design was used since it provides insights into the research problem by describing the variables of interest. This helped in providing useful and accurate information to answer the questions based on who, what, when, and how. The study was conducted in SACCOs in Meru County, Kenya. The study was conducted in Meru County owing to its being cosmopolitan in various SACCOs. It has diverse SACCOs accommodating the three types of SACCOs i.e. rural, urban and transport SACCOs. The target population was all the SACCOs in Meru County which consisted of all the 44 SACCOs in Meru County which had existed for at least five years since inception. The respondents were the credit officers of these SACCOs. The study used census study methodology which enabled the researcher to gather more information to assist in analysis and arriving at accurate results. The 44 credit officers or respondents who were more than the threshold of 30 participated in the study. Data was collected from primary sources. Self-administered questionnaires were issued to the respondents.

Descriptive statistics was used to analyse the data. Data was edited, coded, classified and summarized into categories. Multiple linear regression was also used to link the relationship

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between loan delinquency and the independent variables (credit risk control and collection policy) and was guided by the following model:

$LD= \beta_0 + \beta_1 CRP + \beta_2 CP + \varepsilon$

Where, LD is the dependent variable (Loan Delinquency),

β_0 is the intercept

CRP =Independent variable Credit Risk control.

CP =Independent variable Collection Policy.

Ei is the error term.

ANALYSIS AND FINDINGS

Credit Risk Control

The objective of this study was to determine the influence of credit risk control on loan delinquency in SACCOs. 100% of the respondents were of the view that their organisation considered existing credit policy and the state of economy when establishing a credit control policy and that loans approvals were done by a credit committee. SACCOs in Meru County were found to lend fund direct to individuals with 100% of the respondents stating so. On dealing with clients who default in repaying their loans the SACCOs in Meru County were found to sell clients property to recover their money with 37% of the respondents stating so while 63% said they recover from guarantors. The SACCOs were found to mitigate credit risk through credit covenants.

Collection Policy

The second objective of this study was to establish the influence of collection policy on loan delinquency in SACCOs. SACCOs in Meru County were found to have continuous education of customers on loan usage, on importance of on time payments and incentives for those who repaid their loan on time to ensure that customers comply with the loan terms. On tracking the loan payment and arrears on a daily basis the SACCOs were found to ring clients' mobile phones before the due date, send text messages and physically visit defaulting customers with 100% of the respondents stating so. 100% of the respondents were of the view that the collection policies were stringent and they had great impact on loan delinquency.

Regression Analysis

Table 1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.909[a]	.827	.817	.338

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Referring to the table above, the two independent variables that were studied, explain 81.7% of the influence of credit risk management practices on loan delinquency in SACCOs in Meru County as represented by the adjusted R^2. This therefore means that other factors not studied in this research contribute 18.3 % of the influence of credit risk management practices on loan delinquency in SACCOs in Meru County Therefore, further research should be conducted to investigate the other influencers (18.3%) of credit risk management practices on loan delinquency.

Table 2: ANOVA of the Regression Model

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	19.591	2	9.795	85.980	.000[b]
Residual	4.101	36	.114		
Total	23.692	38			

Table 2 above shows the significance value is 0.000 which is less that 0.05 thus the model is statistically significance in predicting how loan collection period and credit risk control influence loan delinquency in SACCOs in Meru County. The F critical at 5% level of significance was 2.32. Since F calculated is greater than the F critical (value = 85.980), this shows that the overall model was significant.

Table 3: Coefficients of Regression Model

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.643	.153		4.209	.000
credit risk control	.266	.122	.341	2.183	.036
loan collection policy	.473	.125	.591	3.777	.001

The researcher conducted a multiple linear regression analysis so as to explain the influence of credit risk management practices on loan delinquency. The three variables as per the SPSS generated, the equation: LD= 0.266CRP + 0.473CP + 0.643.To assess the significance of each independent variable on the dependent variable, the researcher established that credit risk control and loan collection policy were significant and influenced loan delinquency as their P values were less than 5%. The model revealed that there exists a significant relationship between credit risk control and loan delinquency. This concurs with Moti, Masinde, Mugenda, and Sindani, (2012) in their study on Effectiveness of Credit Management System on Loan Performance who found out that credit risk controls adopted by microfinance institutions have an effect on loan performance. It also revealed that there exists a significant relationship

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between collection policy and loan delinquency which agrees with the study of Moti, Masinde, Mugenda, and Sindani, (2012) on Effectiveness of Credit Management System on Loan Performance who concluded that collection policies adopted by microfinance institution had an effect on loan performance, stringent policy had a great impact on loan performance, and the lenient policy had an effect but was not as great as that of stringent policy.

CONCLUSIONS

On loan collection period the study concludes that there exists a significant relationship between loan collection period and loan delinquency in SACCOs in Meru County. Loan collection period should be stringently followed to ensure that credit defaulters are detected early and hence necessary measures taken to recover the loans. Credit risk control was also found to play a significant role on loan delinquency in SACCOs in Meru County, this brings out the need for SACCOs to enact strict measure to enable them identify potential defaulters before disbursing loans. Credit committee plays a key role in loan appraisal to members hence ensuring that there is a high possibility of loan repayments from the borrowers.

RECOMMENDATIONS

Based on the findings of this study, the following recommendations have been suggested:

i. Saving and credit cooperative societies should adopt stringent policy as a method of collecting loans as compared to lenient policy. This is because stringent policy yields high loan performance compared to lenient policy.

ii. There is also need for SACCOs to enhance their credit risk control this will help in decreasing default levels. This will help in improving their client's loan repayment rate.

iii. Persistent awareness should be created on the importance of prompt loan repayment to SACCO members hence ensuring that they pay their loans when due. This will assist in decreasing loan default levels.

iv. SACCOs need to seek members' information from credit referencing bureaus before issuing loans to them so as to verify their credit worthiness.

v. SACCOs need to recruit or employ credit officers who have a professional background in credit management who will form a credit committee which is professional in creating good policies, issuing loans and monitoring their payments for the firm.

vi. There is need for SACCOs to increase the grace period for clients from four months to one year so as to reduce loan delinquency. This would assist the client to invest the fund taken from a loan and use the proceeds from the investment to pay the loan. It would also improve the members or client welfare.

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