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Relationship between Lending Requirements and Loan Performance of Deposit Taking Savings and Credit Cooperative Societies in Kenya

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Abstract

Savings and Credit Cooperative Societies play an important role in providing financial services to many Kenyans. SACCOs have been identified as crucial growth engines in many countries across the world. According to the Sacco Society Regulatory Authority (SASRA) Annual report for 2021, the amount of NPLs increased from Kes 25.79 billion in 2019 to Kes 39.86 billion in 2020. The goal of this study was to determine the relationship between lending requirements and loan performance of deposit-taking SACCOs in Kenya. The anchoring theory was credit default theory. The study used a causal approach research design with a target population of the study 11 SACCOs in Meru County selected using purposive sampling. Results showed that revealed a strong and positive relationship between the lending requirement and loan performance. The study concluded that lending requirements and loan performance are positively and significantly correlated. The study recommends that DT-SACCOs should have a credit risk management policy that guarantees loan repayment, accurate estimation of loan defaults, and suitable mitigation measures.

Keywords: *Lending Requirements, Loan Performance, Deposit Taking Savings and Credit Cooperative Societies*

1.0 Introduction

Loan performance refers to how loans are meant to work and how they compare to actual payments in terms of payment schedules. This is linked to on-time and consistent interest payments and loan repayments. Non-performance of funds received can be caused by unfavorable circumstances that can affect the borrower's ability to repay (Hull, 2007). Technology advancements and improved management control systems enhance risk management. According to Ogilo (2011), the portfolio manager can now get an early indicator of increasing risk, which assists him in determining the initial overall management and control of the loan portfolio.

Lending requirements are necessary conditions that are set for members to fulfill before disbursement. This includes credit history, personal information, business experience, business plan, financial statements, collateral, and many more. According to Tarimo (2020), the most significant criterion is the organization's procedure for implementing its lending policy. Institutions should have adequate procedures and processes that are documented and defined in enough detail to provide operational direction to employees.

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Licensed DT SACCOs in Kenya continue to grow impressively in all major performance metrics of total assets, total deposits, and gross loans, according to a new SASRA report. In 2019, the overall assets portfolio surpassed the half-trillion-dollar mark, reaching Kes 556.71 billion. The gross loan portfolio has grown to Kes 419.55 billion while the net loans and credit advances were Kes 400.16 billion while the total deposits grew to Kes 380.44 billion. In 2020, the DT-SACCOs reported an increase in gross loans to Kes 474.77 billion, reflecting a growth rate of 13.16 percent, compared to Kes 419.55 billion, showing a growth rate of 12.09 percent in 2019. The net loans and advances, on the other hand, climbed by 12.60% to Kes 450.58 billion in 2020, up from Kes 400.16 billion in the year before, an increase of 11.46%.

Meru is unique because it has all SACCOs which have grown vastly in all sectors of the economy being rich in agriculture. There are some formed by tea farmers like Nyambene Arimi, coffee-based like Dhabiti, milk-based like Capital, teachers-based like Solution, transport-based like Menya, Business based like Meru Traders, church-based like MMH, and Miraa-based like Mwenge Miraa. When compared to other financial institutions in Meru County, SACCOs have a higher percentage of loan defaults (Karumuna & Akyoo 2011). Failure to manage credit risk could spell doom for every SACCO (Alfred, 2011). Despite the fact that significant study has been done in Kenya on SACCOs, Meru County has been mostly ignored. As a result, SACCO's leadership in the area tries to foster a vibrant economy in the area, which is active with small and medium-sized enterprises and agricultural activities.

1.1 Problem Statement

The SACCO sector is significant because it helps the nation's economy thrive and realize Vision 2030. In Kenya, it contributes to more than 30% of the country's GDP development while also providing work possibilities for young people. According to Maiti (2015), SACCO has seen a significant increase in default rates and non-performing loans, indicating poor credit risk management and poor performance.

The Sacco Society Regulatory Authority (SASRA) Annual report for 2021, the amount of NPL increased from Kes 25.79B in 2019 to Kes 39.86B in 2020. This was evidenced by the increase in the substandard, doubtful, and loss categories of the loan portfolio, which together constitute the Non-Performing Loans (NPLs) portfolio thus an indication that loans were not being serviced in accordance with their contractual obligations. The report further indicates a drop in the statutory liquidity ratio dropped from 50.92% in 2019 to 48.5% in 2020 while there was the NPLs ratio dropped from 6.15% in 2019 to 8.39% in 2020. The foregoing implies the likelihood of a high default rate. According to the Annual Report of the Meru County Cooperative Directorate, 2020, SACCOs in Meru County had Kes 8,121,311,849 in savings and had provided loans amounting to Kes 6,603,192,779.

If the financial institution is not properly managed, it is possible for dangerous failure, therefore effective credit risk management (Musyimi, 2015) for survival and expansion is important. Given that their main activity is a loan, the risk of failure is high risk of failure, financial complaints, including bankruptcy due to the customer's specificity and the situation of their operations. Since their main activity is a loan, they are in contact with the environmental suffering environment, which includes bankruptcy because the initial risk has increased.

An empirical study on credit risk management and credit effectiveness that concentrated on Pakistani microfinance banks was done by Ahmed and Malik in 2015. The study, however, was carried out in Pakistan, not Kenya. After investigating the effect of credit risk management on the financial success of licensed SACCOs in Nairobi, Charit (2019) concluded that the assessment, monitoring, and management of credit risks had a substantial impact on financial

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performance. A conceptual gap exists because the research did not use loan performance as the dependent variable. Kipsang (2020) examined how debt collection methods affected the outcome of Fintech loans and found a substantial correlation between loan performance and negative credit listings, fines, and a reduction in loan limits. It is in light of the aforementioned research gaps that this research sought to examine the impact of lending requirements on deposit-taking SACCO loan performance in Kenya.

1.2 Research Hypothesis

H_{01}: Lending requirements have no substantial effect on deposit-taking SACCOs loan performance in Kenya.

2.0 Literature Review

2.1 Theoretical Review

Melton (1974) advanced the Credit Default Theory, which is said to be a default event arising from the evolution of firm assets, modeled by a constant parameter diffusion process. These models are often constructed structural models based on characteristics that are relevant to a particular publisher. Credit default theory, according to Wilson (2007), is a systematic study of the reasons that directly contribute to the consequences of credit defaults.

Credit default theory establishes a direct causal link between the macroeconomic factors of changes in the credit environment and their microeconomic impact on changes in personal or corporate credit conditions. Most existing credit default theories fail to meet this causal requirement. As Kenan (1999) found, credit default is a loan default by a business, person, or entity. An asset model with exogenously determined default losses represents the evolution of this category.

This theory was crucial in explaining the causal effects of the varying loan performance of a company. NPLs are a clear indication of poor loan performance of the credit cooperatives (Wilson Sy, 2007). The theory was essential as it highlighted the possible source of credit default which is presented as the loan failure of an entity and also suggests a systematic cause of credit default all of which are set to be examined in the current study. Hence, the theory underpins the lending requirements variable.

2.2 Empirical Review

Ahmed and Malik (2015) investigated credit efficacy and credit risk management. This article's main objective is to review how credit risk management strategies, encompassing aspects like credit terms and policies, client assessment, credit risk-taking, and control policies, affect loan performance. Data were collected from 157 credit managers at microfinance banks in Islamabad and Rawalpindi. The main data collection tool used for data collection is a questionnaire. Loan length had a significant and beneficial impact on loan performance. The loan's performance is unaffected. There is a contextual gap because the prior investigation was carried out in Pakistan rather than Kenya.

Yusoff (2016) examined the credit risk management strategies of several Malaysian financial institutions. This study's primary objective is to examine the credit management procedures used by a few Malaysian financial institutions. The data show that the majority of losses incurred by lenders and banks are due to catastrophic failures caused by customers' failure to meet their commitments relating to loans, trading, settlements, and other loan operations. According to the findings, a poor portfolio might attract liquidity and credit risk, harming the company's performance. The study advised careful investigation of the loan granted and careful assessment of the customer's capacity to fulfill the loan obligation.

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Njenga (2014) looked at how credit risk management affects loan performance. The study focuses on nine MFIs that are within Kenya's Central Bank's regulatory umbrella. Some loan officers put too much faith in their clients, failing to properly control credit risk when disbursing loans. However, this has resulted in a rise in non-performing loans, which have resulted in low loan repayments and, as a result, poor loan performance. The investigation recommends developing credit risk management principles and putting credit protocols in place in the microfinance industry to reduce nonperforming loans to microfinance organizations for deposits and to actively participate in the legislation regarding credit risk management practices for microfinance organizations in Kenya. Since the current study concentrated on lending criteria and their impact on loan performance, the study did not especially focus on lending requirements as a practice of credit risk management.

3.0 Methodology

To examine the connection between lending requirements and loan performance, this study used a causal approach research design with a target population of the study 11 SACCOs in Meru County selected using purposive sampling. The sample size was 44 managers from the 11 DT-SACCOs who were involved directly in credit management and were the primary respondents. The study employed primary data acquired from the questionnaires and responses were analyzed using both descriptive and inferential statistics.

4.0 Results and Discussion

4.1 Descriptive Statistics on Lending Requirements

This was to find out whether due diligence was carried out before issuing credit to the members. This was in terms of credit analysis, assessment, and client's capability to pay.

The approach used in Credit Risk Analysis

The respondents were asked to describe the method that their institution uses to assess credit risk before granting credit to a customer.

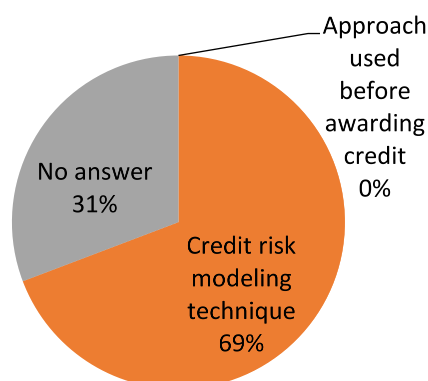

Figure 1: Approach Used Before Awarding Credit

Source: Researcher (2022)

Most respondents 27(69%) said their organization employed a credit risk modeling technique while 12(31%) did not answer the question. The respondents further explained they mainly use this method since it helps to create strategies that maximize return and minimize risk.

Credit Analysis and Assessment

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The respondents were questioned about the extent their institution took credit analysis and assessment into account before granting credit. The outcome of the analysis is shown in Figure 2.

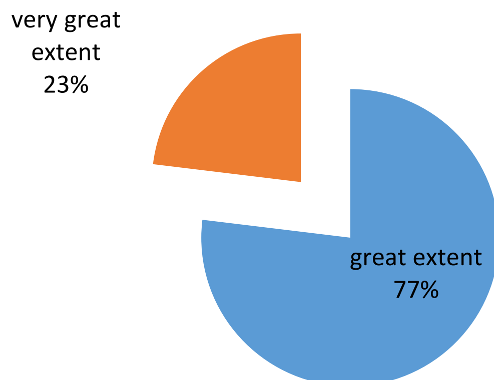

Figure 2: Extent of Credit Analysis and Assessment

Source: Researcher (2022)

Majority 30 (77%) of participants indicated a very great extent while 9 (23%) indicated a great extent. This response indicated that due diligence was done before issuing members with credit to the members hence a minimal default rate.

Evaluating Clients on Loan to be Awarded

Respondents were asked about the extent they considered evaluating their clients on the loan to be awarded and Table 1 indicates the outcome of the analysis.

Table 1: Lending Requirements

Statement	No Extent All	Small Extent	Moderate Extent	Great Extent	Very Great Extent	M	Std.Dev
Clients' ability to generate sufficient cash flows to honor his or her obligations	2 (5.10%)	6 (15.30%)	3 (7.60%)	11 (28.20%)	17 (43.50%)	3.97	1.20
Collateral provided by clients to ensure that loans are properly secured	3 (7.60%)	5 (12.80%)	4 (10.2%)	8 (20.50%)	19 (48.7%)	3.92	1.36
Clients' financial net worth and cash flows	2 (5.10%)	3 (7.70%)	2 (5.10%)	15 (38.40%)	17 (43.60%)	4.16	1.03
Integrity of the borrower and belief in his ability to repay	3 (7.60%)	3 (7.60%)	3 (7.60%)	10 (25.60%)	20 (51.30%)	4.11	1.25
Obtaining the borrower's credit history from other banking organizations	5 (12.8%)	4 (10.20%)	2 (5.10%)	14 (35.90%)	14 (35.90%)	3.74	1.41

Source: Researcher (2022)

Analysis of findings showed most of the participants who were 17(43.50%) indicated that their institution considered clients' ability to generate sufficient cash flows to honor his or her obligations to a great extent before giving out the loan (mean=3.97, std.dev=1.20). This shows that the cash flow capability of the customer is an important factor in an individual's ability to repay the loan. Additional results show that the majority of respondents 19 (48.7%) reported that their institution considers the customer's collateral base to ensure that loans are properly secured before granting loans (mean = 3.92, std. dev = 1.36). This means that having customers with good collateral is a key factor in getting the loan repaid. In addition, the results showed that the majority of respondents, namely 17 (43.6%), indicated that their institutions gave high consideration to the net financial wealth and cash flows of customers before providing loans (mean = 4.16, std . dev = 1.06). This suggested that the financial net worth of a client enhanced loan repayment.

The findings also reveal that the majority of respondents (20/51.3%) said their SACCO gives serious consideration to the borrower's moral character and faith in their ability to repay before extending the loan (mean = 4.11, standard deviation = 1.25).

This concludes that borrowers with good integrity can be held responsible for repaying their loans. In addition, the results showed that the majority of respondents 14(35.9%) reported that their institutions mostly obtained borrowers' credit checks from other financial institutions before providing loans (mean = 3.74, std. dev = 1.41). This infers that the credit history of a borrower of other institutions helped the SACCOs determine if the client would be able to repay the loan.

Credit Manual

The participants were further asked to determine if the firm has a credit manual that guides on requirements needed before issuing credit to the client. Results are shown in Figure 3.

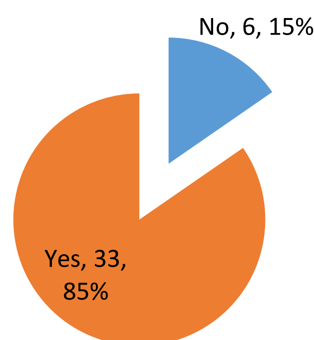

Figure 3: Credit Manual

Source: Researcher (2022)

The findings revealed that 33 (85%) said their SACCO has a credit manual that guides the requirements needed before credit is given to customers, while only 6 (15%) respondents do not have credit. This implied that most SACCOs had a credit manual that guides on requirements needed before issuing credit to the client.

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Additionally, respondents were asked to describe how they adhered to the manual. The participants stated that they make sure the customer meets the requirements set out in the manual before granting a loan. The respondents further explained that giving a credit manual to clients enabled the clients to understand the terms of the SACCO as well and it helped clients to develop trust with the firm.

4.2 Descriptive Statistics on Loan Performance

The respondents were also required to indicate their loan performance trend, credit risk management practices in place, and loan performance indicators. The results were analyzed as shown.

Loan Performance Trend

The respondents were further asked to indicate their loan performance trend in the organization from year 2016-2020 and the findings were shown in Figure 4.

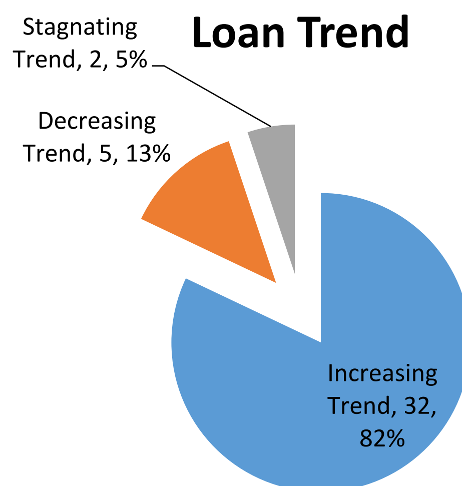

Figure 4: Loan Trend

Source: Researcher (2022)

The results showed that the majority of the respondents who were 32(82%) indicated that their loan performance trend was increasing in their organization from year 2016-2020, 5(13%) indicated that their loan performance trend was decreasing in their organization from year 2016-2020 while 2(5%) indicated that their loan performance trend was stagnating in their organization from year 2016-2020. This suggested that the majority of DT SACCOs had a significant growth over the previous five years.

Credit Risk Management Practices

The participants were further asked to explain the credit risk management practices that contributed to the increasing, decreasing, or stagnating trend of loan performance. The respondents indicated that the major loan recovery process led to an increasing trend of loan performance in the deposit-taking SACCOs. However, loan monitoring did not contribute much towards loan performance.

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Loan Performance Indicators

Table 2 shows results on loan performance indicators.

Table 2: Loan Performance Indicators

Statement	No Extent All	Small Extent	Moderate Extent	Great Extent	Very Great Extent	Mean	Std.Dev
Increase in the amount of loan disbursed	3 (7.70%)	5 (12.80%)	2 (5.10%)	6 (15.40%)	23 (59.50%)	4.11	1.35
Decrease in level of non-performing loans	2 (5.10%)	4 (10.30%)	1 (2.60%)	7 (17.90%)	25 (64.10%	4.24	1.24
Repayment of loans within the scheduled time	3 (7.70%)	2 (5.10%)	2 (5.10%)	18 (46.20%)	14 (35.90%)	3.97	1.17
Increase in loan products	3 (7.70%)	6 (15.40%)	2 (5.10%)	14 (35.90%)	14 (35.90%)	3.82	1.29
Increase in profitability of the institution	4 (10.30%)	5 (12.80%)	1 (2.60%)	11 (28.20%)	19 (48.70%)	3.95	1.39

Source: Researcher (2022)

The findings revealed 23(59.5%) of participants indicated an increase in the number of loans disbursed (mean = 4.11, std. dev = 1.35). This means that most of the SACCOs had increased loan disbursement. Further, 25 (64.2%) indicated that the proportion of non-performing loans fell sharply (mean = 4.24, std. dev = 1.24). This indicates that SACCOs access their loan performance through a reduction in the rate of non-performing loans. In addition, 18 (46.2%) indicated loan repayment within the scheduled time (mean = 3.97, std. dev = 1.17). This implied that most SACCOs were able to offer loans to the right people who were able to repay the loans in the scheduled time. Additional results showed that the majority of respondents 14 (35.9%) showed a significant increase in credit products (mean = 3.82, std. dev = 1.29). This suggests that most SACCOs were innovative and developed new products. In addition, most of the respondents 19(48.7%) indicated that the profitability of the institution has increased rapidly (mean = 3.95, std. dev = 1.39). This implies that most SACCOs' increase in profitability was a measure of loan performance reduced collection costs.

4.3 Correlation Analysis

Table 3: shows the correlation results.

Table 3: Correlation Results

	Loan performance	Lending requirement
Loan performance	1	
Lending requirement	.781** 0.000	1

** Correlation is significant at the 0.01 level (2-tailed).

Source; Researcher (2022)

Results in Table 3 demonstrated a positive and substantial correlation between lending requirement and loan performance (r=0.781, p=0.000). This suggests that lending requirements and loan performance are positively correlated. The results supported Njenga's (2014) assertion that there was a strong and positive association between credit risk management and loan performance.

4.4 Hypothesis Testing

H_0: Lending requirements have no significant effect on the loan performance of deposit-taking SACCOs in Kenya.

The findings of the regression coefficients showed that the p-value was 0.001 less than 0.05. Lending requirements are substantially connected with loan performance as a result of this; the null hypothesis was not accepted. The findings agree with Njenga (2014) which found that lack of credit sharing information, leniency, and too much trust in the customers by credit officers affected loan performance. The study further agrees with the study by Yusoff (2016) on investigating the credit risk management practices of several Malaysian financial institutions. The study advised careful investigation of the loan granted and careful assessment of the customer's capacity to fulfill the loan obligation.

5.0 Conclusion

The study concluded lending requirements and loan performance were positively and significantly related. The study also concluded that clients with the ability to generate sufficient cash flow enhance loan performance. In addition, most SACCOs use clients' collateral base to ensure that the loans are well secured. The study also concluded clients' financial net worth and cash flows were a great determinant of loan performance. The investigation came to the additional conclusion that before giving the loan, the majority of SACCOs requested the borrower's credit history record from other financial institutions.

6.0 Recommendations

The research recommended that DT-SACCOs should have credit risk management policies, which guarantee loan repayment, accurate estimation of loan defaults, and suitable mitigation measures. Moreover, SACCOs should access customers' ability to generate sufficient cash flow, collateral base, financial net worth and cash flows, and credit history records from other financial institutions. Further, it is recommended that customers should be informed of late payment penalties, and the management to ensure strict implementation of credit policies.

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