

Effects of Interest Rates Fluctuations on Loan Repayment in Moi University SACCO, Eldoret, Kenya

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Abstract: *The objective of this study was to analyze the impact of interest rates fluctuations on loan repayment in Moi University SACCO. The independent variable interest rates and the dependent variable is loan repayment. The study was guided by Default Risk Models and Credit Scoring Models. Data collected was analyzed using descriptive statistics such as frequency, percentages, Pearson correlation and chi square. Findings showed that interest rates have a strong significant positive relationship with loan performance. SACCO should protect itself from unforeseen contingencies of loan default due to the fact that the future is uncertain.*

Key words: *interest rates, loan repayment, loan performance*

Date of Submission: 13-09-2017

Date of acceptance: 14-10-2017

I. INTRODUCTION

The ideal situation of a lending business is assumed to be the most profitable business although is at the same time highly risk (Mwaisekwa, 2004). Loans are accompanied by the credit risk arising out of the borrowers' default in repaying the loan. In performing lending business SACCOs are always keen on the rules, regulations, principles and procedures that should be followed before the loan is granted. Most important on lending principles is the fact that the lender will part his money to any one possessing the marketable assets whose value exceeds that of the loan. The basic reason for this is that, market value of the pledged tangible or shares or financial asset fall that of the loan and in the case of the failure to repay the borrowed money the lending SACCO can still get back all its cash from the sale of the asset or offset it with the pledged shares. Alternatively the value of the project to be financed must exceed the amount of the loan.

For any SACCO, to operate in a manner consistent with the objective of maximizing shareholders wealth, it should neither engage in business in a manner that unnecessarily imposes risks upon it; nor absorbs risk that can otherwise be transferred to the other participants. The SACCO should engage in managing risks that are uniquely a part of that saving and credit array of services. Oldfield and Santamero (1997) argued that risk facing all financial institutions can be segmented into three separable perspectives. These are: risk that can be eliminated or avoided by simple business practice which enables to reduce the chances of idiosyncratic losses from standardized saving and credit activity by eliminating risks that are superfluous to the institutions business purpose. Risk that can be transferred to other participants, in this case markets do prevail for many of the risks borne by saving and credit firms. Interest rate products like swaps or other derivatives can transfer interest rate risk (Amonoo, *et al* 2003). Borrowing terms can be altered to effect a change in their duration. Risks that must be actively managed at the firm level in savings and credit financial services are two classes or activities where the risks need to be absorbed at the saving and credit level. This necessitates the use of firm's resources to manage savings and credit risks level. The first of this includes financial assets or activities where nature of the embedded risk may be complex and difficult to communicate to the third parties.

Regulatory impact on credit portfolio management concluded that efficiency credit portfolio management is a key success factor of a financial management. Adverse market environment and intensifying competition, financial institutions are exposed to increasing risks and decreasing return margin of their credit portfolio, while financial institutions shareholders are demanding higher risk premiums of invested capital, management ability to identified risk return optimal portfolio is a fundamental element of credit portfolio management. They have some relationship to the SACCOs current savings and credit environment where competition in savings and credit is stiff and margin significantly falling at the same time shareholders demanding higher returns (Ursula *et al* 2003).

Sinkey (1989) argues that the determination of creditworthiness of financial institutions is dependent on five conditions known as, the 'five Cs' of credit management. These are character (good citizen), capacity (a cash flow), capital (measured by the borrower's net worth), and position, collateral (i.e. quality of the asset pledged) and conditions about the economic measures of a borrower's vulnerability to environmental changes

such as economic downturns (credit crunch). Mudibo (2005) argues that with the Credit administration desired, loan analysis based on repayment capacity, loan size limited by capital amount requirements available and loan write-downs on quarterly eliminations is necessary.

Ndazi (2001) suggests that supplying liquidity to constrained firms is very risky as it reduces the probability of payments and increases moral hazards problems due to repayment period on loan performance. This implies that the supplying firm would also experience liquidity problems and high costs resulting from late payments that would further affect profitability of the firm. Good loans are loans that are repaid according to the terms and condition agreed when they were issued. In most cases loans are known to be a good source of financial institution profitability if not defaulted (Shango, 2000).

SACCOs should also establish a system of independent, ongoing credit review and the results of such review should be communicated directly to the Board of directors and senior management, and they must ensure that credit granting function is being properly managed and that credit exposures are within levels consistent with prudential standards (KUSCCO, 2010).

The SACCO Societies Regulatory Authority (SASRA) is entrusted with the responsibilities to confidently test and see to it that the model is used actively in the management of credit risk and at the same time confirm that the model is conceptually sound, empirically validate and produces capital adequacy requirements that are comparable across SACCO institutions (Vorgelegt *et al*, 2002).

1.1 Methodology

The descriptive research design was adopted in this study to describe the data and characteristics of quantitative data that was collected. Further, Chi-square, regression analysis and other statistical tools were applied. The data for this study was mainly Primary data collected from credit department and SACCO members. Secondary data was collected to complement primary data and was obtained through credit manuals like KUSCCO SACCO stars, SACCO magazine and brochures, journals, SACCO and portfolio reports, credit policy, financial statements and loan repayment schedules.

1.2 Model specification

Economists, bankers, SACCOs and analyst have developed many different models to assess the default risk on loans. These models are not mutually exclusive, in that financial institution managers may use more than one model to reach a credit pricing / loan quantity rationing decision (Vorgelegt *et al*, 2002). Consequently, different models have been developed to help economists and others to assess the default risk in SACCOs.

1.3 Results and discussion

1.3.1 High Interest Rates

In reference to high interest rates, results show that 30% of the respondents agree that high interest rates lead to non-performing loans, 18.7% disagree while 5.3% strongly disagreed as depicted in Table 3.1. These findings concur with that of Amonoo, *et al* 2003.

Table 3.1 Views of Respondent on High Interest Rates on Loan Performance in the SACCO

	Frequency	Percent
No response	11	7.3
Strongly agree	52	34.7
Agree	45	30.0
Undecided	6	4.0
Disagree	28	18.7
Strongly disagree	8	5.3
Total	150	100.0

1.3.2 Increased Returns

Results in table 3.2 show that the interest rate enhances increased good returns. From the results, 50.7% agree while 22.7% disagree, this means that there is a relationship between interest rates charged on loans and increased returns. 16.0% of the respondents were undecided while 10.7% gave no response. These findings concur with that of Ursula *et al* 2003).

Table 3.2: Response on Increased Returns on Loan Performance

	Frequency	Percent
No response	16	10.7
Strongly agree	42	28.0
Agree	34	22.7
Undecided	24	16.0
Disagree	16	10.7
Strongly disagree	18	12.0
Total	150	100.0

1.3.3 Poor Regulation of interest rates

Results on poor regulation tabulated in Table 3.3 shows that 36% of the respondents agree that poor regulation can lead to non-performing loans, 10.7% did not agree, 7.3% were undecided while 9.3% gave no response. These findings concur with that of Mudibo (2005).

Table 3.3: Responses on Poor Regulation on Loan Performance in the SACCO

	Frequency	Percent
No response	14	9.3
Strongly agree	47	31.3
Agree	54	36.0
Undecided	11	7.3
Disagree	16	10.7
Strongly disagree	8	5.3
Total	150	100.0

1.3.4 Exchange Rate fluctuation

Results on the impact of exchange rate fluctuation on Table 3.4 show that 28% of the respondents agreed that it can lead to non-performing loans, 17.3% did not agree while 12.0% gave no response while 13.3% were undecided. These findings concur with that of Ndazi (2001).

Table 3.4: Responses on Exchange Rate fluctuation on Loan Performance in SACCO

	Frequency	Percent
No response	18	12.0
Strongly agree	38	25.3
Agree	42	28.0
Undecided	20	13.3
Disagree	26	17.3
Strongly disagree	6	4.0
Total	150	100.0

1.3.5 Weak Credit Management on interest rates

Results on weak credit management on Table 3.5 show that 65.3% of the respondents agreed that it can lead to non-performing loans while 14.0% did not agree. The high number of respondents who agreed means it is prudent to look at the weak credit risk management in SACCOs. These findings concur with that of Basel Committee Publication (2000).

Table 3.5: Responses on Weak Credit Management on Loan Performance in the SACCO

	Frequency	Percent
No response	18	12.0
Strongly agree	54	36.0
Agree	44	29.3
Undecided	13	8.7
Disagree	17	11.3
Strongly disagree	4	2.7
Total	150	100.0

1.3.6 Poor Lending Policies on interest rates

Results on poor lending policies on Table 3.6 show that 68% of the respondents agreed that poor lending policies lead to non-performing loans, 17.3% did not agree, 9.3 % gave no response while 5.3% were undecided. These findings concur with that of KUSCCO, 2010.

Table 3.6: Responses on Poor Lending Policies on Loan Performance in Moi University SACCO

	Frequency	Percent
No response	14	9.3
Strongly agree	59	39.3
Agree	43	28.7
Undecided	8	5.3
Disagree	21	14.0
Strongly disagree	5	3.3
Total	150	100.0

1.3.7 Poor Loan Appraisal

Results on Poor loan appraisal on Table 3.7 shows that 68% of the respondents agreed that it contributes to non-performing loans with only 14% of the respondents not agreeing. Therefore, loan appraisal is a factor to be looked into to avoid the rise of non-performing loans. These findings concur with that of Mwisekwa (2004).

Table 3.7: Responses on Poor Loan Appraisal in Moi University SACCO

	Frequency	Percent
No response	13	8.7
Strongly agree	51	34.0
Agree	51	34.0
Undecided	14	9.3
Disagree	14	9.3
Strongly disagree	7	4.7
Total	150	100.0

1.4 Summary

A short loan repayment period is a cause of non-performing loans and a short loan repayment period can easily lead to a non-performing loan. Poor regulation can lead to non-performing loan thus implying that poor regulation is a clear indicator that a loan can be in the category of non-performing. Exchange rate fluctuation can have a bearing on loan performance and a weak credit management can lead to non-performing loans. The high number of respondents means it is prudent to look at the weak credit risk management in SACCOs.

Lack of credit reference bureau leads to non-performing loans and an indicator that it is a critical factor of loan performances. Another factor leading to non-performing loan could be poor lending policies. Poor loan appraisal is another factor that contributes to non-performing loans. Another factor for non-performing loan is the undervalued collateral securitization. Cause of loan default included overcommitted pay slips, employer suspending or sacking employee, interference with SACCO recovering loans and poor tracking hence taking long time to recover loans.

1.5 Conclusions and recommendations

It is important for the SACCO to ensure that people with credit management thinking skills and experience are involved in credit risk portfolio review from time to time at minimum annually and report their findings to the Board of Directors and the Senior Management of the SACCOs. The SACCO should protect itself from unforeseen contingencies of loan default due to the fact that the future is uncertain. This can be realized by adopting protective measures such as risk insurance being among others. Using such instruments, the risk of losing enormous amount of fund through credit default can be avoided or minimized.

People outside the credit process such as shareholders, senior managers, directors and politicians should not influence the credit decision in the SACCO. This is crucial due to the fact that if the loan is given through influence even the follow up is difficult by staff.

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Kirui D. Kipngetch. "Effects of Interest Rates Fluctuations on Loan Repayment in Moi University SACCO, Eldoret, Kenya." *International Journal of Business and Management Invention (IJBMI)*, vol. 6, no. 10, 2017, pp. 21–25.