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FACTORS AFFECTING CLIENTS ON LOAN REPAYMENT FOR MICROFINANCE INSTITUTIONS: A CASE STUDY OF PRIDE ARUSHA, TANZANIA.

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This study analyzed the factors affecting loan repayment performances in Microfinance Institutions (MFIs) with a case study of (Promotion of Rural Initiatives and Development Enterprises) PRIDE Arusha, Tanzania. The study used both quantitative and qualitative techniques to investigate factors affecting loan repayment performances. The findings show that clients' characteristics (age, household size, gender and level of education), nature of business (business type, business stability and income level) and loan characteristics (repayment period, repayment mode, and repayment amount) were among the factors that influenced borrowers in repaying their loans. Lack of business knowledge was another factor mentioned by clients which leads to low productivity hence failure to have enough fund to repay their loans.

The study further revealed that there was a significant relationship between loan repayment performances with clients' businesses challenges, loan diversification to other non-income activities, and other outside factors such market imperfections, higher interest charges, drought, among others.

Keywords: *Loan repayment, clients' characteristics, loan characteristics, nature of business,*

I. Introduction

Microfinance is the provision of financial services to low-income clients. It is a form of financial tool that is allegedly focused on poverty alleviation by providing financial services to the poor clients. According to World Bank (2001), microfinance is a kind of financial services provided to low-income groups and individual operators by credit institutions. Clients create a big risk on repayment of both principal and interest amounts. Lending is a risky business, because repayment of loans can seldom be fully guaranteed. Indeed throughout Asia, Africa, and Latin America, the last decade has witnessed substantial efforts that aim at opening the poor towards access to loans and at the same time improve their incentives to meet repayment obligations (Microfinance report 1994).

The context of providing loans to borrowers has increasingly been rapidly calling for MFIs innovations that combine prudent microfinance principles with effective screening and monitoring strategies that are not based on physical collateral. Like other businesses, sustainability and continuity of the MFIs depends much on the repayment rates which provides assurance on returns and income, since high repayment rates promise MFIs a better sustainability.

Although Microfinances were used as the major tool in poverty eradication, there are several factors which affect loan repayment performance among microfinance institutions (MFIs). The factors can be categorized into two groups: individual or borrowers factors, firm factors, loan factors, and lender's factors. Under firm factors, the provision of non-financial services such as training, basic literacy, and health services has a positive impact on repayment performance. A few researchers have also found out that loans play an important role in determination of repayment performance. They are the key determinant issues that accelerate and decelerate loan repayment in MFIs. The financial services to the poor have serious limitations in terms of cost, risk, and convenience. Lacking or taking little collateral, poor households, and living far from MFIs turns out to be expensive to MFIs, and these may force the need of increasing interest rates which will affect repayment performance. Then repayment of money may then be worse off.

To overcome this problem MFIs employ varieties of strategies to reduce all risks in providing loans to poor clients, detail information, and legal enforcement to low income borrowers without collateral assets, loan

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ladders to allow successful borrowers to take larger loans so as to increase repayment rates. Repayment performance is a key variable to lenders and funding agencies on which MFIs still depend for accessibility of funds.

Data shows that microfinance programs in China have claimed average repayment rate of above 90%. The group lending mechanism is often considered to be the key to such success in China. In attaining better financial performances, MFIs need to solve problems and challenges that are faced in loan repayment which call for strong understanding and major steps should be done towards better loan repayment performance. This has attracted attention of many researchers, and as a result, several studies have attempted to explain the factors affecting financial performances of MFIs; however, no study has been done specifically on factors affecting clients in loan repayment to microfinance institutions, a gap that this study seeks to fill.

1.1. Microfinance in Tanzania

Microfinance involves activities directed at provision of access to financial services for the working poor or small and micro-enterprises. Micro financial services comprise of micro credit, savings, micro leasing, micro insurance, and other forms of financial services. The micro finance market consists of the poor who are essentially involved in some form of economic activities. The small and micro enterprises in Tanzania operate in the informal sector which is estimated to support about 60% of the economically active population.

Microfinance institutions operating in Tanzania provide financial services to the SMEs mainly in the form of micro credit with an exception of cooperative based microfinance institutions, which are predominantly savings based. The credit based institutions number between 80 and 100 out of which 42 are registered members of the Tanzania Association of Microfinance Institutions (TAMFI), the local microfinance network. The main microfinance institutions can be categorized as non-governmental organizations (NGOs), Cooperative based institutions namely saving and Credit Cooperatives (SACCOS) and SACCAs while the third category is banks.

It is estimated that all the MFIs in Tanzania put together serve a combined client population of about 400,000 SMEs, which is only around 5% of the total estimated demand. Commercial banks including community banks account for around 50,000, while the NGO category accounts for an estimated population of 220,000 clients. PRIDE Tanzania being the largest single player accounts for about 29% of the market share in this category or 16% of the existing total market share (BOT, 2008).

1.2. Regulatory Environment

The government of Tanzania is concerned about the state of poverty in Tanzania and is therefore actively involved in providing some poverty alleviation interventions. The government views microfinance not only as an effective tool for poverty alleviation, but also as an important ally in that direction. To this end, the government has been keen in improving and developing the microfinance industry. It has established a fully-fledged directorate of microfinance within the Central Bank of Tanzania (BOT, 2008) which spearheaded a number of key processes towards the development of the industry.

One of the unique aspects as a first step was the formulation of the National Microfinance Policy in 2002 to guide the microfinance activities in the country. The policy gave rise to the formulation of legal, regulatory, and supervisory framework for microfinance activities. It is important to point out that the entire process starting from policy formulation to the development of legal, regulatory, and supervisory framework was highly participatory involving all the stakeholders in the industry including MFIs. The legislation was concluded in the year 2003 by an amendment of the Banking and financial Institutions Act 1991, Bank of Tanzania Act 1995, Cooperative Societies Act 1991, and other related statues giving the Bank of Tanzania (BOT) the mandate to license, regulate, and supervise deposit taking equity-based microfinance companies to be established.

1.3. Research Gap.

Repayment problem is one of the critical issues in MFIs to attain better financial performance which threatens their continuity. PRIDE Tanzania faced the problems of low loan repayment as the trend of uncollected loans from the customer for the period of 2010 to 2013 indicate. Uncollected loans in 2010 were Tshs 2,037 million, followed by 2,053 million in 2011, 2,069 million in 2012, and lastly in 2013 it increased to 2,138 million which threatened continuity. This trend indicates that PRIDE Tanzania experiences poor loan repayment.

In view of the above, many studies, state of microfinance 2012/2013; International Food Policy Research Institute (IFPRI) for the Consultative Group to Assist the Poorest (CGAP) on assessing the relative Poverty level of Microfinance Institutions clients have been conducted in on MFIs loan repayment, but they were based on lenders only and not borrowers. In light of this, this study contributes to the existing body of literature on loan payments for MFIs by assessing the factors affecting clients in loan repayment in MFIs.

1.4. Objectives of the study

The general objective of this study was to assess the factors affecting clients in loan repayment performance to MFIs. Specifically, the study addressed the following objectives:

(i) To find out the criteria used to allocate loan beneficiary clients in PRIDE Arusha, Tanzania.

(ii) To analyze if cash returns methods used to follow up are good to support loan returns in PRIDE Arusha, Tanzania

(iii) To describe the aspects of microfinance institution clients centered on their repayment position category.

(iv) To analyze the external influences affecting PRIDE Arusha, loan clients in loan settlement.

1.5. Research Questions

To achieve the above objectives, this study was guided by the following questions:

a) What are the criteria used to allocate and classify loan client's beneficiaries.

b) Are the procedures for cash collection sufficient enough to ensure collection of loans disbursed to clients?

c) What are the aspects of microfinance institution clients based on their status repayment category?

d) What are the external influences affecting PRIDE Arusha Tanzania clients in loan settlement and how? (on borrowers/clients point of view)

1.6. Scope of the study

The study was restricted to the factors affecting clients in loan repayment to Microfinance with specific reference to PRIDE, Tanzania in the branches which are located in Arusha. The study was limited to clients, credit officers, marketing officers, and other staff only with the targeted population of 171 respondents and covered a period of five years, 2009 to 2013.

1.7. Significance of the Study

The significance of this study is:

(i) The result of this study will help business owners, managers in various firms and other stake holders.
(ii) It may also help other researchers to identify possible areas for further research, as it will offer additional references for those interested in undertaking the research on the loan repayment aspects in the loan services firms.
(iii) The study provided added knowledge to whoever interested to acquire and develop abilities on the formulation, monitoring, and implementation of loan repayment and cash collection procedure in the business.

1.8. Definition of terms

(i) **PRIDE-** is the short form for **Promotion of Rural Initiative and Development Enterprises** which deals with the provision of loans to small and medium entrepreneurs.
(ii) **Microfinance-** refers to the financial institution which deals with loan provisions to small and medium enterprises or others with a limited amount of capital depending on the business size of the client.
(iii) **Loan repayment-** refers to the return of the principal given and the interest to the loan provider as per the contract.
(iv) **Clients-** refer to the customers or the people who are supplied with certain products or service and they should be satisfied by the provider.

II. Literature Review

2.1 Theoretical Review

A study conducted in Nigeria by Abereijo and Fayomi (2005) found that "Although the business environments in developing countries and developed countries differ in many respects, the problems of servicing SME customers are similar." The problems reported by this study were the following: high- perceived risk, problems with information asymmetry, and high administrative costs.

On the other hand, Pandula (2011) points out that "there is a considerable gap in knowledge of the determinants of access to funding by the small and medium sized enterprises in developing countries and that's why many SMEs get little access to credits". Experience in business, level of education, age, and social background of the entrepreneur are considered when accessing credit from microfinance institutions and that for the SMEs, it becomes difficult not because all owners fulfil these requirements (Storey, 2004).

However, RAM (2005) found out that "Most of the bank officers have poor knowledge and skills on how to properly evaluate risk in SME businesses. He also found out that most banks still make their lending decisions based on the availability of collateral, and sometimes lean to subjective assessment. Credit scoring is seen as less important and has limited use if a potential loan is not fully collateralized, so it becomes cumbersome for entrepreneurs to get access to loans from the financial institution concerned".

Pinyasavatsut (2011) asserts that firm age relates to better financial access for older firms and younger firms tend to have low debt-equity ratios implying that young firms use their own fund to run the business, and older firms rely less on debt or have more options to finance their businesses.

2.2. History of PRIDE Tanzania

Promotion of Rural Initiative and Development Enterprises Limited (PRIDE) Tanzania is a micro finance institution involved in the provision of credit to small and micro entrepreneurs in Tanzania. It started its operations in January 1994 with its first branch and head office in Arusha. The mission of PRIDE Tanzania is to create a sustainable financial and information services network for small and micro-entrepreneurs in order to promote their businesses growth, enhance their income, and create employment in Tanzania.

PRIDE Tanzania offers the following products. First, **MEC Loan,** this product is based on modified Grameen model (Joshee, February 2008). To be eligible, a client must join a self-selected solidarity group guarantee of 5 members called Enterprise Group (EG). Solidarity groups combined into one large group of 50 called a Market Enterprise Group (MEC), for easy administration and enhancement of group mechanism. Peer pressure and a three tier loan guarantee system to ensure loan repayment, and access to a loan is subject to a minimum Loan Insurance Fund (LIF) amount to 25% of loan amount except for the first loan cycle.

Secondly**, Fahari Loan Product,** a product registers clients who successfully graduated from MEC loan. The group consists of three to five members who agree to guarantee each other. They are also required to provide additional collaterals to cover the loans because of the big loan amounts. Thirdly, **Ajira Loan Product,** a product targets employees in the government and other reputable organizations. Employers guarantee their employees, and repayment is done by employers on behalf of the clients. Fourthly, **Asasi Product,** is a product targets registered saving and Credit Cooperative Societies (SACCOS). Finally, **Individual Loan Products**, a product which is offered to individual clients from outside or within PRIDE Tanzania clients who may wish to take a loan. It is mainly offered in PRIDE Tanzania Dar Es Salaam branches.

2.2.1. Loan Screening Process

Is the process of observing the behavior of the client and proper study of the client portfolio on loan repayment and sort out whether the client qualifies for a new loan; It includes the repayment trends, client business, collateral of the clients, and performance of the business.

2.2.2. Credit history

This shows information about a client's credit. The finance or credit manager must know the history of clients so as to assess if they could be granted loans.

2.2.3. Cash Pattern and Loan Amounts

Loans should be based on cash patterns of borrowers and designed as much as possible to enable the client to repay the loan without undue hardship. This will help the MFI to avoid unnecessary losses and encourages customers to manage their funds effectively. The appropriate loan amount depends on the purpose of the loan and the ability of the client to repay the loan.

2.2.4. Assessment of Customers

The financial institution should know its customers, making them full aware of credit procedures. The procedures should not be overly restrictive or generous. A number of factors should be considered in lending decisions, which are popularly refer to as the **5Cs of credit**. They usually vary from lender to lender, but are used often. The 5Cs are **Character, Capacity, Collateral, Condition,** and **Credit history**.

2.2.5. Borrowing Methodology

Group borrowing methodology is an intergroup contract for insurance purpose that guarantees loan repayment to an institution. The mechanisms of group lending such as peer pressure and group solidarity are treated as instruments to attain favorable repayment rates. Social ties (Besley and Coates 1995) and group homogeneity (Besley and Coates 1995: Stiglitz 1990) are indirectly linked to the repayment performance as they can facilitate peer monitoring and peer pressure or result from an effective peer selection of group members. The success of Grameen Bank in Bangladesh has shown that it is possible to improve loan repayment performance by using a group lending methodology. Influences that can increase the probability of loan repayment include the effective use of group dynamics as well as appropriate training and leadership.

Regular repayment schedules or dynamic incentives are other appropriate incentives mechanisms used by MFIs to increase their repayment performance (Armendariz & Morduch 2000). A common characteristic of group lending is that groups obtains loans under joint liability, so each member is made responsible for the payment of their peers' loans. They include screening of loan applicants, monitoring the individual borrowers' efforts and enforcing repayment of their loans. Individuals are allowed to self-select each other with their preferred peers, and determine the capacity of the client and other claims that may arise before loan repayment of loan to the MFI (Ledgerwood 2000).

2.2.6 Frequency of Loan Payments

Loan repayments are often done on installment basis, that is, weekly or monthly. The frequency of repayment can be determined by the nature of the activities of the clients. They depend on the wants of the client and the ability of the MFI to ensure repayment of their loans.

2.2.7 Credit Management Policies

The credit policy is defined as the guideline for determining whether to extend credit to customers and how much to extend. The credit policy of the firm affects the working capital by influencing the level of debtors. The credit terms to be granted to customers may depend upon the norms of the industry to which the firm belongs. But a firm has the flexibility of shaping its credit policy within the constraint of the industry norms and practices. The firm should use discretion in granting credit terms to its customers. Depending upon the individual case, different terms may be given to different customers. A sound management of the MFI must establish an optimum credit policy to ensure good performance on loan repayments.

2.2.8 Loan Collection Process

Empirical data revealed that the rate of repayment performance has been a problem in MFI. This was due to poor management procedures, loan diversion, and unwillingness to repay loans by some clients. It has also been shown that borrowers who did not have any training in relation to their business had a higher probability of default (Roslan and MohdZaini 2009). The factors affecting loan repayment performance and their logistic model showed that loan interest rate ware the most important factor affecting repayment of loans (Kahansal and Mansoori 2009).

2.2.9 Credit terms

The credit term is one of the most important variables in microfinance. It refers to the period of time during which the entire loan must be repaid and affects the repayment schedule and ultimate suitability of the use of loan. Once credit terms are matched with client's needs, the repayment of loan will be done on time and in full (Pandey 2005).

III. Research Methodology

3.1 Sample size

This study involved a sample size of 136 people which were randomly selected from a total population of 6869 clients and staffs, out of which 6792 were clients and 77 were staff members; the location of the study was Arusha city, and the study was based on four years data from 2009 to 2013.

3.2 Data collection instruments

The primary data was collected through using the questionnaires and the secondary data was obtained from PRIDE Tanzania Head Office and Branches.

IV. Presentation and Discussion of the Research Findings

4.1 Analysis of Gender and Household size
It was found that the female proportion was 55% and male was 45%, indicating that a large portion of PRIDE Tanzania clients is made up of women. In some cases there was an inclination to believe that male clients had better managerial ability to run business than female ones. However, this study found that females had a better repayment performance than males.

4.2 Household size
About 76 (56%) of the surveyed households had family size of five members and above, while 15 (21%) had a family size ranging from one to two and 39 (29%) percent had a family size ranging from three to five. Household size was another important factor in this study. For a client who had large household size, a considerable amount of income from the business could be diverted away from loan repayment to household uses. For each additional dependent in the household, the probability of loan default increased. As potential claims against businesses increases, it encourages the diversion of resources to direct household purposes such as paying school fees and other social commitments. Therefore, the fund available for loan repayment may be misappropriated, leading to non- repayment of loan to the company.

4.3. Analysis of Education Level
The respondents were grouped into several categories with respect to educational background. Most of the clients had primary level of (46%) and secondary level of (38%). More education through trainings may lead to acquisition of more knowledge for efficient allocation of resources, leading to better and proper loan utilization, and has a positive relation with loan repayment performance.

Also clients who acquired extensive experience in similar economic activity before the loan knew how to run a profitable business than new ones, hence they had better repayment records. It is therefore thought that educated clients are more likely to choose more profitable business ventures than their counterparts. They are likely to have better book keeping records, better information about the existing investment opportunities, and may achieve more success. Thus, the clients with higher levels of education are more likely to have higher repayment rates.

4.4. Analysis of Loan diversification
It was assumed that the clients diversify their loans to the other non-productive activities rather than intended purposes. When clients divert loans to unviable activities rather than intended purposes, it impacts on loan repayment. The study revealed that loans granted to clients were not used for the intended primary objective because some clients used the loans for consumption instead of production; therefore a small portion of loan received was then used to run their ongoing businesses.

It was found that about 38% of clients have used their loans for paying school fees for their children, 12% for purchasing assets, 43% for meeting household expenditures, and 7% did not respond to the question. The loans given to clients are intended to help clients to promote their businesses so as to perform better than before. The study revealed that a portion of the loans were not injected in the business but instead were used for non-productive activities. This divergence of loan to other activities which did not generate income may account for low repayment rates.

4.5. Analysis of Loan screening processes for classifying clients to be given loans.

4.5.1 Preliminary Screening
In this early stage, loan applicants make contact with COs at PRIDE Tanzania Ltd, and are carefully screened and asked to answer specific questions regarding the status of their businesses in order to establish whether they qualify under PRIDE Tanzania's eligibility guidelines.

4.5.2 Loan Proposal and Approval
Loan applicants are assigned to specific CO's and applicants undergo a further review to verify the information taken at the initial stage, and a visit to the applicant's businesses and households is arranged. The information developed is organized into a formal loan and presented to PRIDE Tanzania Branch Manager for approval. The loan amount and tenure are confirmed conditional on the adequacy of the cash flows generated by the borrower's business, sufficient personal collateral, and group guarantors to co-sign the loan agreement.

When all applications forms are completed, reviewed, and approved, then loan disbursement commences. Applications are then signed by all guarantors i.e. five members of PEG and loans are disbursed according to loan levels, and client complete a certain loan level, and if they qualify, they may advance to the next level. This is also a proper control to assess a client's ability to manage company funds.

4.5.3 Monitoring and Repayment

After loan disbursement, COs frequently visits the borrower's business to ensure that the loan amounts are being used for the specific purpose for which the loan was granted, and to remind clients of their next repayment date, and that the business is efficiently being run, regular visits also serve to strengthen the relationship with the client, encouraging repayment while simultaneously gathering information concerning the state of the business and households finances. Clients who miss payments are pressured at this stage; if it is a group lending, other group members are required to pay for the missing client and the missing client will be punished by paying fine to group members. If arrears continue, legal action is initiated against the client to recover any amounts owed.

V. Summary of Findings, Conclusions, and Recommendations

5.1. Summary of the findings

The main objective of this study was to assess factors affecting loan repayment performances in MFIs, a case study of PRIDE Arusha, Tanzania. The results of the factors affecting loan repayment problems in PRIDE Tanzania show that clients' characteristics (age, gender, level of education), nature of business (business type) and loan characteristics (repayment period, repayment mode and repayment amount) were among the factors that influenced borrowers in repaying their loans. The study also found out that the age of borrowers contributed to loan repayment problems. The borrowers age of 40 years and above had loan repayment problems and higher financial commitments to family could be the reason.

The study also found out that the lending policies and procedures being used by the institution are generally reasonable and acceptable. The institution has good loan procedures and improvements of guidelines due to changes for the quality of loan portfolio. Also, the institution has good loan application procedures, loan approval system, loan disbursement, and collection techniques.

The researcher also observed that some procedures were rigid and outdated; they need review. The institution should use procedures which are updated and match with the prevailing circumstances. There should be continuous updating of credit policies to achieve best and sound practice at any time.

In terms of loan administration, the study highlighted the importance of paying special attention to loan repayment period, loan size, and Credit Officers' experience which constituted the factors affecting loan repayment performance in the study area at the period of research.

5.2. Recommendations

The study recommends that PRIDE Tanzania recognizes the weaknesses or challenges in their lending systems and modify them in order to reduce the burden of clients in loans repayment. It should closely monitor clients in certain age groups that had significant repayment problems and ensure that clients have necessary experience and skills in their businesses before granting them loans.

5.3. Policy Implications

Under policy implications, an assessment of the validity of the research findings, in particular the strength of causality was demonstrated; in general, the results and the descriptive analysis of information was used to describe the theoretical constructs. Also on the basis of the results, some issues and policies were examined that required strengthening, not only of PRIDE Tanzania, but also other Tanzania MFIs. The strategies to be adopted to ensure the viability of MFIs and lessons for the formal loan management should be well addressed.

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