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LOAN APPRAISAL AND FINANCIAL PERFORMANCE OF DEPOSIT TAKING SAVINGS AND CREDIT COOPERATIVE SOCIETIES IN EMBU COUNTY, KENYA

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ABSTRACT

Over the past few years, SACCO'S have made a significant push into the provision of credit in order to take advantage of the prevailing high levels of profitability. They have embarked on serious marketing strategies for various loan products they sell. Despite the increased sale of loan products, there are reported cases in literature of massive loan defaults by the members and borrowers. Even though extensive studies have been conducted in Kenya, it is noted that the findings are inconclusive thus posing research gaps. It is on this premise the study sought to investigate loan repayment among SACCO'S in Embu County, Kenya. The objective of the study was to establish the influence pf loan appraisal, on financial performance of deposit taking SACCO'S in Embu County, Kenya. The study employed descriptive research design and targeted a total population of 250 respondents selected from of 10 SACCO'S operating in Embu County, Kenya. Out of the 250 respondents, Slovin's formula was adopted to select 158 respondents to be the sample size of the study. The study used primary and secondary data. Primary data was collected using questionnaires through drop and pick later method. Secondary data was gathered by a review of existing materials that included financial statements and related empirical studies. The content validity was determined by lecturers that were drawn from department of Accounting and Finance of Kenyatta University and industry experts who were draws from SACCO's. Reliability of the study was tested using Cronbach Alpha method. Data was analysed using Statistical Packages for Social Sciences (SPSS) version 21. Data was analysed using descriptive statistics like mean, percentages, standard deviation and frequencies. Inferential statistics such as multiple regression was conducted to establish the statistical relationship between variables at 95% confidence level and 5% significance level. The findings of the study were presented using tables and graphs. After conducting descriptive, correlation and regression analysis, it was revealed that there was a statistical relationship between independent variables loan appraisal, and financial performance of deposit-taking Savings and Credit Co-operative Societies in Embu County, Kenya). The study concludes that unless SACCO's embrace models of minimizing financial risks such as loan appraisal, achieving financial performance will be an uphill task. The study recommends that SACCO's not only need to focus on non-performing loans but also seek to understand and review loan appraisal policies to encourage repayment within the stipulated timeframe.

Keywords: Loan Appraisal and Financial Performance

Introduction

In today's society, cooperative financial institutions hold a considerable market share, with the IMF estimates that across all banking sector assets in developing countries, the market share of co-operative finance was equivalent to 14 percent in 2004 (Lagat, 2011).
Previous research on cooperative finance during crisis indicates that they tended to fare better than investor-owned savings and loans institutions, as they pursue more conservative investment policies (Mungai, Maingi, Muathe, 2014). For instance, analysis from the IMF indicates that co-operative banks in developed countries tend to be more stable than commercial banks, especially during financial crisis, as their investment patterns tend to be less speculative and returns are therefore less volatile According to Central Bank of Kenya (2015) SACCO'S in Kenya have mobilized over Kshs. 200 billion in savings, accounting for over 30% to National Domestic Saving (Co-operative Bank of Kenya, 2010). Liquidity risk is a failure of SACCO'S to honor approved loans due to inadequacy of loanable funds (Fiedler, Brown, & Moloney, 2002).

Over the last decade, SACCO societies have significantly increased to account for 50% of the registered Co-operatives. Kenya's national development blueprint, the Vision 2030 recognizes SACCO societies as important players in deepening financial access to mobilize savings for investments in enterprises and personal development. Kimenchu (2014) observed that Kenya has the largest SACCO movement in Africa with a total membership of 8 million followed by Senegal at 5 million. To date there are over 11,200 registered SACCO'S in the country, with a membership of 8 million Kenyans having mobilized domestic savings estimated at over $ 2.5 Billion. Of which 5,000 are SACCO'S and 230 have Front Office Service Activities (FOSAs). The SACCO sector has mobilized over Kshs 200 billion in savings which is about 30% of the national savings. Kenya accounts for 70%of Africa's continental portfolio hence being ranked 7th worldwide. Kenya sits in the group ten largest co-operative movements (G10) member countries (SACCO Congress, 2010). However even with these developments they still don't meet the demands for the loan applications.

Omondi (2008) observed that members are not satisfied with the shorter repayment period, and that pegging loan on deposits was denying member's money which they had ability to pay. The Kenya Union of Savings and Credit Cooperative reported that the consequences of the global financial crisis have led to reduced growth savings: 7.6 per cent growth in savings in 2008 compared to 31.2 per cent in 2007, (WOCCU, 2009). It was reported in interviews that SACCO'S in Kenya have reported increase in demand for loans, but have exercised caution in responding to requests (Nguta & Guyo, 2013). The World Council of Credit Unions (WOCCU) estimates that the Kenyan SACCO sector is the largest in Africa; in 2005, SACCO'S had an estimated membership of more than 2.5 million, share capital and deposits of US$1.66 billion, and a loan portfolio of US$1.24 billion (WOCCU, 2005). With over KES 230 Billion in assets and a savings portfolio estimated at

KES 190 Billion, the SACCO movement in Kenya constitutes a significant proportion of about 20% of the country's savings. The Kenyan SACCO sector has been observed to contribute greatly to the total financial industry and consequently the economy. It contributes to over forty five percent of the nation's Gross Domestic Product (MOCD&M, 2010). With the enactment of the SACCO Act, 2008 (SSA) and the subsequent establishment of the SACCO Societies Regulatory Authority (SASRA), SACCO'S have been brought under regulation and supervision.

Statement of the Problem

Mungai, Maingi, Muathe (2014) established that loan repayment and sustainability of Government funded micro-credit was determined by regular income streams among rural borrowers. Furthermore, their study revealed that system development to minimize uncertainties was one of the approaches that enhanced loan repayment among rural borrowers. However, it was noted that their study was confined to Government funded micro-credit but not deposit taking SACCO's in Embu County. SACCO'S are ultimately expected to drive efficiency and improve the level of savings among the Kenyan citizens as envisaged in the financial sector strategy in vision 2030 (Olando, Jagongo & Mbewa, 2013). Kenya has continued to record a significant improvement in social economic development as through initiatives stipulated in Kenya's vision 2030. SACCO'S have greatly contributed to the social economic developments in Kenya ranging from empowerment of entrepreneurs thus economic growth. Nguta and Guyo (2013) acknowledge that despite the concept that SACCO'S contribute to social economic developments in both developed and developing countries of the world, SACCO'S operating in developing countries and more especially in Kenya have continued experiencing deteriorating financial performance due to issues of loan repayment.

A survey conducted by SASRA (2015) further revealed that SACCO'S in Kenya were underperforming due to issues of technology, competition, change of regulations and management issues. However, it was noted that the findings of the study were confined to different variables which included regulations, credit risk and credit policies but failed to address the variables of this study. Majority (75%) of the SACCO'S in Kenya are facing stiff competition from commercial banks and microfinance institutions (Nkuru, 2015). On the other hand it was noted that non-performance of loans were some of the aspects that contributed to deteriorating financial performance of SACCO'S in Kenya. However, it was noted that the study was limited to SACCO'S within the agricultural sector in Meru County, Kenya. Another survey conducted by KUSCCO (2009) established that loan repayment has been a key challenge of SACCO'S operating in developing countries and more especially in Kenya. It was observed that issues of corporate governance and credit risk management are directly associated with non-performance of SACCO'S from the financial perspective. Further, it is noted that a number of stakeholders ranging from SASRA and shareholders have continued to raise concerns on the financial performance of the SACCO's.

Kimenchu (2014) noted that internal control practices like audit and corporate governance were associated with profitability of SACCO'S. However, it was observed that that study was confined to internal control practices like internal audit, communication and risk management. By extension, Sheila (2011) established that SACCO'S were more likely to perform well if they laid down risk management frameworks. However, it was observed that the study was limited to Sacco's in Uganda and sought to address different variables such as proactive internal audit and control. Furthermore, Nishimura, Kazuhito and Yukiko (2001) observed that loan appraisal procedures was a key factor of financial performance of SACCO's in Japan. However, from the findings of previous empirical studies, it was noted that conceptual, contextual gaps were evident and none of the studies conducted specifically addressed the variables of this study. For instance, some studies conducted by Nguta & Guyo (2013); Sheila (2011); (Nkuru, 2015) & Kimenchu (2014) were confined different variables like regulations, applicant knowledge, economic trends and credit policies. Further, other studies conducted by Arishaba (2011); Nishimura & Chen & Pan (2012) were confined to different countries such as Nigeria, Japan and Taiwan among others. Therefore, it is in this view that this study aimed to investigate effects of loan repayment and financial performance of deposit taking SACCO'S operating in Embu County, Kenya.

Objective of the Study

The study sought to determine the effects of loan appraisal and financial performance of deposit taking savings and credit societies in Embu County, Kenya and recommendations are made based on the findings of the study.

2.3.1 Loan Appraisal and Financial Performance

Kimenchu (2014) established that loan appraisal systems among financial institutions can enhanced financial performance. It emerged that the bulk of the profits generated by commercial banks was not influenced by the amount of credit and non-performing loans. It emerged that other variables other than credit and non-performing loans also influenced profits generated by commercial banks. The bulk of the profits of commercial banks were not influenced by the amount of credit and non-performing loans. It was concluded that other variables other than credit and non-performing loans impact on profits. .A study by Kiptoo (2015) on credit risk management strategies on performance of SACCO'S in Nairobi County established that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. The New Times of Rwanda (2010) established that to limit loan losses, SACCO'S should assess the customer's credit worthiness with the help of 5Cs namely: character, capacity, capital, collateral and conditions. The loan should generally be protected by collateral and the channel of approval should be documented and approved by the Board of Directors. This is because poor loan lending policies and short-sighted credit analysis can have a big negative impact on the SACCO'S profitability and hence performance. Loan lending policies indeed affect the performance of SACCO'S. Most of the SACCO'S have effective and efficient loan lending policies.

A study by Nkuru (2015) found that through loan appraisal; management can gauge its ability to generate earnings from the SACCO'S total pool of assets, that if not well done could lead to decline on asset returns thus financial performance of SACCO'S in U.S.A. The thorough loan appraisal of the loan applicant before loan advancing with an aim of assessing the study recommended that there was need for SACCO'S to enhance their client loan appraisal policy so as to influence positively on financial performance. Kimenchu (2014) also observed that credit assessment gives the SACCO'S an insight into the rate of interests to charge the customers that might not push them hard to the corner by considering the customer's financial strength, credit score history and payment patterns. The effectiveness of the credit appraisal system depends on the procedures and methods applied in the credit evaluation. Credit appraisal methods used in SACCO'S range from simple subjective or informal techniques to fairly complex approaches such as the use of simulation and computer generated models. Olokoyo (2011) studied determinants of SACCO'S lending behavior in Nigeria considered the effectiveness of loan appraisal in assessing the borrower's character and behavior before advancing the loan facility and how it influences financial performance of the SACCOs in Nigeria. Liabilities to be used in making quick return on investments in order to positively. Sheilah (2011) established that the ability of SACCO'S to promote growth and financial performance depends on the extent to which financial transactions are carried out with trust, confidence and least risk.

RESEARCH METHODOLOGY

The study employed descriptive research design to establish the influence of loan appraisal on financial performance of deposit taking SACCO's in Embu County Kenya. The study targeted all employees of the 09 deposit taking SACCO'S operating in Embu County in Kenya. Therefore, 250 respondents were the target population of the study. Slovin's formula was applied to determine the sample size of 158 respondents Purposive sampling was used to select the respondents for the study. The study will adopt Slovin's formula to determine the sample size as shown below. The study utilized questionnaires are appropriate because they provide opportunities of anonymity which encourages as instruments of data collection. Validity was determined using industry experts while reliability coefficient which stood at 0.731 was determined using Cronbach Alpha formula by taking a cutoff point of 0.7.Descriptive, correlation and regression analysis methods were conducted using Statistical Package for Social Sciences (SPSS version 21) and analyzed data was tabulated in form of mean scores, standard deviation, percentages and frequencies.

RESEARCH FINDINGS AND DISCUSSION

The study targeted a total of 158 respondents from the selected 09 SACCO's that operated in Embu County. However, after questionnaire administration, only 113 questionnaires were returned duly filled and 28% of them were incomplete and some were not returned. This contributed to 72% response rate.

Loan Appraisal and Financial Performance

The study sought to establish the influence of loan appraisal on financial performance of deposit taking SACCO's in Embu County and findings were depicted as illustrated in Table 4.1.

Table 4.1: Loan Appraisal and Financial Performance of Deposit Taking SACCO's in Embu County, Kenya

Statements	SA	A	N	D	SD	Mean	SD
My Sacco assesses the nature and capacity of businesses borrowers are operating before approving loans	24%	7%	0%	0%	0%	4.76	0.428
My Sacco approves loans based on adequacy of collateral /securities	61%	23%	16%	0%	0%	4.45	0.756
My Sacco scrutinizes loan applicants credit history through Credit Reference Bureaus before loan approval	50%	18%	18%	14%	0%	4.03	1.122
My Sacco considers the time taken to appraise loans	41%	41%	18%	0%	0%	4.22	0.741
My SACCO has a credit committee that scrutinizes all loans before approval	48%	35%	12%	5%	0%	4.25	0.871
Repayment amounts are designed to accommodate the borrowers expected cash flow.	63%	34%	3%	0%	0%	4.61	0.542
My SACCO has credit policies and controls in place	67%	25%	8%	0%	0%	4.59	0.636
The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and should borrowers have repayment problems, they get involved in delinquency management.	49%	45%	6%	0%	0%	4.42	0.610

As illustrated in Table 4.1, it was indicated by majority of respondents that to a larger extent, their SACCO's assessed the capacity of businesses before approving loans with a mean of 4.76, approved loans based on collateral security with a mean of 4.45, scrutinized loan applicant history before approving loans from the Credit Reference Bureaus with a mean of 4.03, considered time taken before approving loans with a mean of 4.22, credit committees scrutinized all loans before approval with a mean of 4.25, repayment amount was aligned with borrower cash flow with a mean of 4.61, existence of credit policy and control with a mean of 4.59 and credit committee not only approved loans but had the responsibility of monitoring loan repayment progress with a mean of 4.42.

These findings implies that majority of the SACCO's had were embracing loan appraisal practices such as assessing the capacity of the business before approving loans, demanded collateral security from loan applicants, had credit committees and policies but were experiencing cases of loan default after approving loans. The findings corresponds with that of Nkuru (2015); Nguta & Guyo (2013); KUSCCO (2009) & Kiptoo (2015) who revealed that despite existence of loan appraisal policies in financial institutions in Kenya, cases of loan default were common due to uncertain economic trends. Further, they pointed out that despite assessing the capacity of business enterprises before loan approval, it is difficulty or unclear to forecast to sustainability of the business.

Inferential Statistics

Pearson's product moment correlation analysis was conducted to determine whether there was a correlation between loan appraisal and financial performance of deposit taking SACCO'S operating in Embu County and the findings revealed that significance value was less than the critical value of 0.05 at a magnitude of 0.888, indicating a positive correlation between variables. These findings are in agreement with that of Chen & Pan (2012); Bhunia & Sarkar (2011) & Bratanovic (2009) who revealed that despite conflicting thoughts from scholars on the specific aspects that influence loan repayment, to a larger extent there is a statistical relationship between loan appraisal, interest rates and loan of follow-up procedures as compared to customer characteristics which is uncertain. Further, after conducting regression analysis at 95% confidence level and 5% significance level to establish the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable that is explained by loan appraisal and the findings revealed that holding all factors at a constant, significance value of loan appraisal was less than 0.05 at a magnitude of 0,887 indicating a positive effect on the dependent variable.

SUMMARY FINDINGS

The study revealed that loan appraisal practices such as assessing nature of businesses, demanding collateral security, involvement of credit committees, confirmation of customer credit history and development customer centred credit policies influenced financial performance of deposit taking SACCO's in Kenya. However, it emerged that to some extent SACCO's were finding it difficult to determine viability of business and their sustainability in the long term period. Further, it was noted that collateral security provided by members was not satisfactory but in some cases the applicant managed to access loan services and the ability of finding out the loan applicant history of loan repayment was also not a valid reason of approving loans.

Conclusions

The study concludes that for deposit taking SACCO's to maximize profits they should embrace practices that enhance loan repayment behaviour from beneficiaries such as establishing loan appraisal policies that are customer friendly such as assessing customer economic stability before approving loans. Further, the SACCO's should not only focus on maximizing profits but also to consider Central Bank of Kenya policies that determine interest rates charged.

Recommendations

The study revealed that to some extent, deposit taking SACCO's were finding it difficult to determine viability of business and their sustainability in the long term period. Therefore, this study recommends that management of deposit taking SACCO's in Kenya should seek to evaluate sustainability of business enterprises of loan beneficiaries by establishing the period the business has operated and also establish a criteria of determining ownership of properties presented as collateral security.

Areas of Further Research

The study recommends that future scholars and researchers should seek to investigate the moderating effect of inflation rates between loan appraisal and financial performance of deposit taking savings and credit societies in other Counties a part from Embu such as Nairobi to examine consistence of research results. Similarly, other studies should seek to examine the relationship between collateral securities and financial performance of deposit taking savings and credit societies as compared to commercial banks.

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