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### RESEARCH ARTICLE

#### EFFECT OF INTEREST RATES REGULATIONS ON LOAN PROVISIONS: CASE STUDY OF SACCOs IN KENYA

**Mutai Nelly Chelangat, Philip Kiprotich Bii and Justine Ratemo Mabati**

Bomet University College, Bomet Business School, P. O. Box 701 - 20400, Bomet, Kenya.

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#### Abstract

The study sort to establish the relationship between interest rates and loan provision in SACCOs in Kenya. Descriptive survey research design and stratified random sampling method was used. The sample size used was 84 respondents comprising of three operation managers, four credit officers, three customer service officers and seventy-four registered sacco members. The study was guided by Classical interest, Keynesian Liquidity and Time preference theories. Results indicated that interest rates charged on loans had the least influence on loan provisions. The study recommends that the government through Central Bank and Kenya Bankers Association to advocate for more market-based regulations which would ensure affordable and accessible financing for the small businesses and startups that promotes enabling environments for entrepreneurial activities. The findings contributed to new knowledge to literature and theory.

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#### Introduction: -

Interest rate is the cost a debtor pays for taking a facility from financial bodies or fees paid for on-loan assets (Crowley, 2007). Interest rate capping on the other hand is the process of putting a tag on the maximum chargeable rate to a borrower. Interest rates helps in determining the current market and provides information about future inflation (Ndung'u, & Ngugi, 2000).

Loan provision policies, being internal guidelines on loan transactions are very vital for any microfinance success regardless of the sector and environment in which they operate. In some instances, trust may override the internal controls instituted by the management due to familiarity. Market failures usually result from market information asymmetries, moral hazards, adverse selection or the inability of financial institutions of differentiate between high and low risk clients.

Therefore, according to Miller (2013), interest rate caps are useful tool to support a sector until it is able to sustain itself. Since the capping of interest rates has a tendency to distort the market and cause adverse biases financial institutions tend to favour their lending to low risk clients which in turn leads to inefficiencies in the financial intermediation process. According to Ramsey (2013), this discrimination leads to a situation where those in dire need of financial assistance being locked out of the available finances because they are considered high risk. Financial institution ca however, still remains profitable in the midst of interest rate capping by the Government by venturing into other sources of income such as non-funded income as well as cutting their costs.

**Corresponding Author:- Mutai Nelly Chelangat**

Address:- Bomet University College, Bomet Business School, P. O. Box 701 - 20400, Bomet, Kenya.

**Statement of the Problem:**

According to a study on Impact of the New Financial Services Law in Bolivia on Financial Stability and Inclusion which examined credit quotas and interest rate ceilings, the targeted segments were found growing as intended per the law but increasing amount of loans from microfinances institutions and declining amount of borrowers pointed to the unfavorable effects of interest rate capping on the financial inclusion. (IMF Working Paper, 2015)

A study by Happy, Gerhard & William (2002) in South Africa on the Effects of the Interest Rate Capping on the Micro Lending Market established that the proposed linking of Interest ceiling to prime rate was illogical in that the biggest cost item of micro lenders is the running costs and not cost of capital.

Local studies done by Douglas, Lilian & Muniar (2015) indicated that Loan pricing has significant impact on the level of Non-Performing Assets (NPA) and they recommended financial institutions to charge friendly interest rates that will allure additional creditors therefore increasing revenues from interest income. Ngacha (2013) also established that positive connection existed concerning increase in rate of interest and the level of Non-Performing Loans. Fredrick & Husborn (2012) in their study on the investigation on the factors hindering Mortgage Finance in Kenya made findings that main factors affecting access to mortgage lending is credit risk.

Despite the creation of a Risk Management Department in Saccos, which is responsible for managing the bank's risks including credit risk, available records show a rise in the value of non-performing loans of the Sacco. In relation to lending activities, the Sacco's ratio of non-performing loans to total loans rose to 19 percent in 2015 from just 2.0 percent in 2013 (Kipsigis Framers Sacco financial report, 2015).

The continuous increase in the number of non-performing assets in the Sacco's portfolio has eroded the capital base of the bank and reduce its profitability. The worst case can happen where liquidation or bankruptcy may occur due to the Sacco's inability to manage its credit risk efficiently. The question is, is there a lax in implementation of interest rates policies? This study attempts to answer these questions by evaluating the existing interest rates management policies of the Sacco in order to identify the strengths and weaknesses and most importantly exploring ways of improving upon them. The study aimed at providing further insights and information on the effect of credit risk management practices on lending portfolios of Sacco's' (Kipsigis Framers Sacco financial report, 2015).

**Literature Review:**

According to WOCCU(2008) the financial discipline of provisioning for loan losses has not been part of the SACCO development since SACCOs have relied on the check-off system for decades. SACCOs therefore end up having extremely low net institutional capital and fail to meet the WOCCU prudential standard of excellence of a minimum of 10% net institutional capital. Institutional capital is a critical second line of defence after loan loss provisions from losses incurred by the credit union related to increasing delinquency and defaults.

Silikhe (2008) on credit risk management in microfinance institutions in Kenya found out that despite the fact that MFI's have put in place strict measures to credit risk management, normal loan recovery is still a challenge to majority of the institutions. This explains the reasons why most financial institutions are either not growing or about to close down.

Owusu (2008) on credit practices in rural banks in Ghana found out that the appraisal of credit applications did not adequately assess the inherent credit risk to guide the taking of appropriate credit decision he also found out that the drafted credit policy documents of the two banks lacked basic credit management essentials like credit delivery process, credit portfolio mix, basis of pricing, management of problem loans among others to adequately make them robust. In his recommendations he stated that credit amount should be carefully assessed for identified projects in order to ensure adequate funding. This situation provides the required financial resources to nurture projects to fruition, thus forestalling diversion of funds to other purposes, which may not be economically viable.

Githingi (2010) surveyed on operating efficiency and loan portfolio indicators usage by microfinance institutions found out that most microfinance institutions to a great extent used operating efficiency indicator as a credit risk management practice. Efficiency and productivity ratios are used to determine how well microfinance institutions streamline their credit operations. He also noted that microfinance institutions need to employ a combination of

performance indicators such as profitability, operating efficiency and portfolio quality indicators to measure their overall performance.

Asiedu-Mante (2002), has asserted that very low deposits and high default rates have plunged some rural banks into serious liquidity problems, culminating in the erosion of public confidence in these banks. He indicated further that a combination of poor lending practices and ineffective monitoring of credit facilities extended to customers has contributed to high loan delinquency in some banks.

Gisemba (2010) researched on the relationship between risk management practices and financial performance of Saccos and the results indicated that the Saccos adopted various approaches in screening and analysing risk before awarding credit to client to minimize loan loss. Some of the approaches include establishing capacity, conditions, use of collateral, borrower screening and use of risk analysis in attempt to reduce and manage credit risks. Gisemba (2010) concluded that for Saccos to manage credit risks effectively they must minimize loan defaulters, cash loss and ensure the organization performs better increasing the return on assets.

Wambugu (2009) on credit management practices in Saccos offering front office services found out that risk identification is an important stage in credit risk management and should be applied effectively to identify the current credit risks confronting the organization, provide the likelihood of these risks occurring and reveal the type and amount of loss these risks are meant to cause if they occur. He concluded that the establishment of a review system that provided accurate timely and relevant risk information in a clear, easily understood manner is key to risk monitoring. Griffin et al (2009) investigated the risk management techniques of twenty-eight Islamic banks by examining the perception of senior Islamic banker toward risk. The result revealed that, Islamic banks are typically exposed to the same types of risk in conventional banks with different levels of the risks.

### Methodology: -

The research used descriptive research design. Kothari (2006), descriptive study seeks to describe the way things are done in the organization. This research entailed the effects of microcredit loans on farmers investments. The Population for this study were registered members of Saccos, Operation managers, credit officers and customer service officers. The sample period was four months, this sample fairly represents the whole population and was considered large enough to provide general view of the entire population and serve as a good basis for valid and reliable conclusions.

Stratified random sampling was applied in carrying out the study as per the category of the respondent, a sample of 30% of the total population was used therefore 25 respondents constituted the sample population of the study. The researcher used structured questionnaires. Structures questionnaires refer to questions which were accompanied by a list of all possible alternatives from which the respondent select the answer that describes their situation. The study carried out pilot study to protest and validate the questionnaire. The study used Cronbach's alpha methodology, which enhanced testing of internal consistency. Quantitative data collected was analyzed using SPSS and were presented through percentages, means, standard deviations and frequencies.

### Results:-

Majority of respondents (76%) were females while minorities (24%) were males. This implies that the study involved more females than males. 68% of the respondents which is the biggest percentage were single while 24% and 8% of the respondents married and divorced respectively. 48% of the respondents were in the 26-35 age groups which were the majority. 24% were under 25 years, 16% between 36 and 45 years while 12% which is the minority is above 46 years. This indicates that most of the clients are already married, established and mature to organize and borrow money for income generating projects. Below 25 years, they are not economically and physically active. 72% of the respondents were found to be at the degree level, 20% were at diploma level while the minorities (8%) were found to be at the primary level. However, poor credit management was dominant among the degree and diploma holders despite their ability to understand all necessities regarding loan management.

**Table 4.1:-** Interest rates respondents' views.

Parameter	N	Minimum	Maximum	Mean	Std.Deviation
Interest rates of other lending institutions are higher.	25	1	5	1.80	1.472

There is consistency in interest rates charged by Saccos.	25	1	5	2.12	1.364
The Saccos are earning a lot of profit from credit services.	25	1	5	2.28	1.400
Prevailing economic conditions affects interest rates.	25	1	5	1.80	1.472
Customers are satisfied with the current interest rates.	25	1	5	1.96	1.428
Valid N (List wise)	25				

Using the scale of 1 to 5 where 1 represented strongly disagree and 5 strongly agree, the findings as illustrated in Table 4.6 above reveal that three components of interest rates determination that is: Interest rates charged by other institutions, customer satisfaction and economic conditions have a mean of 1.8, 1.8 and 1.96 respectively. This is an indication that these factors are least used in assessing interest rates effects on loan provision. It was also clear that consistency and profits earned by the Sacco on loans have a mean of 2.12 and 2.28 respectively. This implies that this factor is of great importance assessing whether Saccos take interest rates into consideration before extending credit services.

**Table 4.2:-** Model coefficients.

Model coefficients	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std.error	Beta		
(Constant)	154.24	3137.67	.523	2.653	.000
Interest rate.	-.896	.201	-.086	-.952	.544

The interest rate was found to have negative coefficient of -.896. The findings further indicate that if the independent variables assume a value of zero, then the interest rate constant will be 154.24.

The equation derived from the above regression results will take the form of:  $Y = 154.24 - .896X_2 + \text{error}$ . This equation successfully explains the effect of interest rate on loans allocation in Saccos.

### Conclusion:-

The main objective of this study was to establish the effect of interest rate on loan provision in Saccos in Kenya. The Interest rates charged on loans had the least influence on loan provision with a coefficient of -0.896 due to the fact that interest rates are always affected by external factors like prevailing economic conditions and stability of the currency.

### Recommendation:-

The study found that interest rates has least influence on loan provisions in the Sacco; a replication of this study in other sectors like banks is recommended.

There was influence of manager employee relationship and therefore the response from employees may have been either overrated or underrated therefore future research could consider ways of reducing such bias by controlling the influence of the managers

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