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### RESEARCH ARTICLE

## EFFECTS OF COLLATERAL REQUIREMENT ON LOANS PROVISIONS: CASE STUDY OF SACCOs IN KENYA

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### Abstract

The study sort to establish the relationship between collateral requirement 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 collateral requirements had great influence on loans provisions in SACCOs. The study recommended that SACCOs should ensure collateral requirements policies are put in place in order to improve their loan portfolios and also consider using credit policy documents from other successful similar organizations as a benchmark for best practices. The findings contributed to new knowledge to literature and theory.

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### Introduction:-

Lending institutions play a major role in economic growth and development through provision of credit to execute economic activities. However, the major concern of any lender while advancing credit is how they will get their money back (Fleisig, 1995), and this implies that the engagement between lenders and borrower is accompanied by certain level of risk. The major types of risks faced by lending institutions globally include market risk, operational risk, and performance and credit risks (Pyle, 1997).

Credit risk is defined as the change in the value of the asset portfolio of a bank, due to the failure of an obligor to meet his payment commitments (Pyle, 1997; CBK, 2005). The risk attributable to loan default leads to high effective borrowing rates, through a risk premium that varies with the exposure to default. This is because a bank has to undergo costs to carefully evaluate and closely monitor the risk, especially in an environment where probability of default is high (Parlour and Winton, 2008). In Kenya, credit risk is a real threat to the banking industry due to the fact that loan portfolios form the largest part of the balance sheet items (CBK, 2005). Bank for International Settlement (2004) identifies four major techniques of credit risk mitigation namely: collateral, guarantees, on-balance sheet netting and credit derivatives.

Collateral can generally be described as a defined asset issued by the borrower to the lender, in a show of commitment towards repaying the loan advanced. If the counterparty fails to honor his repayment commitments, the collateral is liquidated and the value of the loan recovered from such proceeds. Collateral involves contractual arrangements revolving around the defined asset which are generally difficult to implement in developing and least

developed countries that have diverse and weak legal and regulatory systems. This is detrimental to such economy because it exposes the capital of financial institutions to the risk of default by debtors, making it hard for both borrowers and lenders to meet their economic goals. Globally, there exist several forms of collateral accepted by banks for purposes of guaranteeing the recovery of loans like personal guarantors, receivables, fixed deposit accounts among others. The persistence of credit risk accompanied by growing importance of credit in the global economic setting has seen a shift in credit risk mitigation strategies, and that is the subject of this study.

### **Statement of the problem**

Credit risk is perhaps the oldest and most challenging risk for financial institutions, leading to innovations geared at addressing this problem (Broll, Pausch and Welzel, 2002). This risk emanates from the probability that borrowers will default on terms of debt, subsequently putting the capital of a bank in jeopardy.

SACCOs in Kenya, like other financial institutions elsewhere face the same problem and rely heavily on collateral lending which is a traditional instrument of providing security against loan advances to the borrower. Although collateral lending gives the lender some confidence in business, FSD-Kenya (2009) notes that collateral has serious shortcomings in Kenyan SACCOs. Firstly, the choice of a borrower is inhibited by the fact that there are no concrete legislations on transfer of collaterals. This is because assets presented as collateral in Kenya take several forms, with different legal requirements governing them. | This leaves the borrower with no room to move to a more attractive option if collateral is already attached by one lender, even in an environment of changing interest rates. As a result, it is not possible for the borrower to switch to a financial services lender with more competitive rates making loans unresponsive to changing interest rates.

Secondly, land-related assets are the most utilized as collateral in Kenya. Land system in Kenya has its unique challenges, making clearing of the said asset quite slow and costly. For example to create and perfect a building in the capital city of Nairobi as collateral for a loan of Ksh.10,000,000, it will cost a total of Ksh.577,995 or 5.78% of the loan amount and sixty working days (FSD-Kenya, 2009). This in turn erodes the value of the loan advanced against such collateral because lenders transfer all the related financial and time costs to the borrower. Although there are measures being implemented by various stakeholders to remove these inefficiencies, they are likely to take a longer period to bear outcome and cannot promise an immediate solution to the policy concern of high cost of credit in the country.

Furthermore, the process of realizing the loan amount outstanding from security liquidation (enforcement) has proved to be very cumbersome and costly for lenders. The owners of property obtain court injunctions and restraining orders, which sometimes make it difficult to dispose the said property leaving the lender with unrealized securities and non-performing loans. According to FSD-Kenya, obtaining statutory power for sale of the property in the above scenario will cost the lender Ksh.379,700 and 150 working days if the borrower doesn't litigate. Otherwise the cost in terms of time and money may go up as it may take up to four years to realize the security. Furthermore, the risk associated with collateral increases the capital requirement for banks, through increased capital provision for such risky assets. According to CBK (2006) a 50 or 100 per cent risk weight is attached to residential and other properties that are mostly pledged as collateral by borrowers, for purposes of determining the capital adequacy of a bank. This requirement and over-reliance on collateral imply limited capacity for creating loans (supply) as well as profitability of banks. In addition, difficulties affecting enforceability of collateral make lenders more risk-averse thereby limiting provision of credit for economic activity. Generally, over-reliance on collateral lending is detrimental to borrowers; lenders and the general economy. This study seeks to identify ways through which banks can lend more without over-relying on the collateral system, thus supporting economic growth and development goals

Despite the creation of a Risk Management Department in SACCOs in Kenya, which is responsible for managing the SACCO's risks including credit risk, available records show a rise in the value of non-performing loans. In relation to lending activities, the ratio of non-performing loans to total loans rose to 19 percent in 2017 from just 2.0 percent in 2016 (SACCOs in Kenya financial report, 2017).

This is a very disturbing phenomenon because if the high level of non-performing assets in the SACCO's portfolio is not brought under control, it may erode the capital base of the SACCOs 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. Is there a lax in implementation of credit risk policies i.e. Collateral requirement policies? This study

attempts to answer these questions by evaluating the existing Collateral requirement policies of the SACCO in order to identify the strengths and weaknesses and most importantly exploring ways of improving upon them. They also attempt to close this gap by providing further insights and information on the effect of collateral requirement practices on lending portfolios of SACCOs', (Kipsigis Framers SACCO financial report, 2009).

### **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.

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 Sacco's found out that the Saccos adopted various approaches in screening and analysing risk before awarding credit to client to minimize loan loss. This includes establishing capacity, conditions, use of collateral, borrower screening and use of risk analysis in attempt to reduce and manage credit risks. He 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.

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.

### **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. Results also showed 68% of the respondents which is the biggest percentage were single while 24% and 8% of the respondents married and divorced respectively. Results also revealed that 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. Further, results showed SACCOs in Kenya clients are fairly educated able to have capacity to understand questionnaires and answer accordingly. 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.

**Table 1:-** Consideration of collateral.

	N	Minimum	Maximum	Mean	Std. Deviation
SACCOs in Kenya takes into consideration historical record before asking for collateral.	25	1	4	1.64	1.114
Customer trustworthiness is considered first before collateral requirement	25	2	5	3.12	1.092
Loan amount applied for determines whether there is need for collateral.	25	1	4	2.16	.898
Need for a guarantor substitutes the need for collateral.	25	1	5	2.28	1.400
Valid N(Listwise)	25				

Using a scale of 1 to 5 where 1 represented strongly disagree and 5 strongly agree, the findings reveal that only one of the factors is considered least when assessing collateral requirement. This factor is historical record of borrowing of the client, had a mean of 1.64. It was further established that two other factors: loan amount and need of a guarantor had means of 2.16 and 2.28 respectively, are considered moderately. Customer trustworthiness was considered crucial, had a mean of 3.12.

**Table 2:-** Assessment on effect of collateral Requirement on Loan Provision.

	N	Maximum	Minimum	Mean	Std.Deviation
Collaterals requirements negatively affect loan provisions in SACCOs in Kenya	25	1	5	2.44	1.828
Valid N (Listwise)	25				

Using a scale of 1 to 5 where 1 represented strongly disagree and 5 strongly agree, it was found out that collaterals were crucial in determination of loan provisions with means of 2.44.

The main objective of the study was to establish the effect of collateral requirements on loans provisions in SACCOs in Kenya. The study used multivariate regression analysis in establishing this relationship. The dependent variable of the study was the loan provision of the SACCO while the independent variables was Collaterals. The results from the regression analysis was as follows:

**Table 3:-** Model coefficient.

Model coefficients	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	St. Error	Beta		

(Constant)	154.24	3137.67	.523	2.653	.000
Collaterals.	-.896	.201	-.086	-.952	.544

The table of coefficients above reveals that collaterals has a positive coefficient of 24.387. The findings further indicate that if the independent variables assume a value of zero, then the loan provision constant will be 154.24.

### Conclusion:-

It was certain from the study findings that the Collateral requirements play a very significant role in rating the soundness of the Sacco's credit policy bearing a coefficient of (24.387). The study further established that the main significance of risk identification in SACCOs in Kenya is to ensure that risk management is practiced in the organization. The goal of credit risk management is to maximize the Sacco risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters.

Most SACCOs in Kenya have a loan risk management policy in place. These policies are very crucial in providing guidelines on how to manage the various risks these organizations encounter in their lending activities. Minimizing bad loans has benefits to all parties involved especially the lenders. First and foremost it will help in the identification of potential credit risks related to loan restructuring, underwriting and documentation. Secondly, it will assist in selecting appropriate solutions to solve emerging credit problems by using strategies that optimize the outcome for the institution.

### Recommendations:-

The study has revealed that collaterals is of high importance in loan provision. Therefore, SACCOs in Kenya should ensure that there are policies on collateral requirements put in place in order to improve their loan portfolios.

It will also be important if the SACCOs can also consider using collateral policy documents from other successful similar organizations as a benchmark for best practices.

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