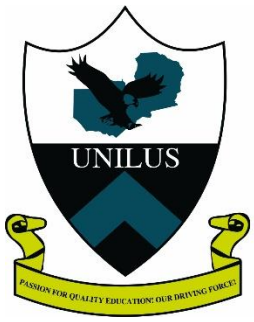

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DISSERTATION

HIGH DEFAULT RATES IN MICROFINANCE INSTITUTIONS OF ZAMBIA

MASTER OF BUSINESS ADMINISTRATION

By

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AN INVESTIGATION OF THE FACTORS INFLUENCING HIGH DEFAULT RATES IN THE SELECTED MICROFINANCE INSTITUTIONS OF LUSAKA DISTRICT, ZAMBIA

DECLARATION

I, Emmanuel Chintabamba Mwenya, do hereby declare that this dissertation is my own and all the work of other persons have been dully acknowledged, and that this work has not been previously presented at this university or any other for similar purposes.

Signature 

Date: 11th January 2024

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ABSTRACT

This research aimed to investigate the factors influencing loan defaults in microfinance institutions (MFIs) in Lusaka, Zambia, with a focus on Agora Microfinance, Unifi, and Foundation for International Community Assistance (FINCA). The study addressed the following objectives; analyzing the influence of interest rates on high default rates, assessing the association between loan appraisal and high default rates and investigating the link between loan payment training and high default rates in microfinance institutions.

The research employed a descriptive cross-sectional design with a quantitative approach. This design was adopted as it measures the qualities of a specific population. The quantitative approach was ideal for the study due to its objectivity and ability to replicate the results on a sample of 89 respondents. The sample size was determined using Purposive sampling. Purposive sampling allows researchers to select participants who possess specific characteristics or experiences relevant to the research objectives. This method ensures that the sample adequately represents the target population of interest, enabling researchers to gain insights into a group within that population. Data was collected through questionnaires, focusing on both closed and open-ended questions. Statistical analysis was conducted using Microsoft Excel. Data was coded and interpretation was done using descriptive statistics and regression analysis to determine correlations between variables. Validity and reliability checks were done to ensure the accuracy and consistency of the data. Ethical considerations were upheld, ensuring participant confidentiality and informed consent.

The results showed that an increase in the interest rate would lead to a noteworthy rise in non-performing loans. Furthermore, the findings showed that a negatively strong relationship existed between loan appraisal and defaults. An increase in enhanced loan appraisal techniques would reduce the likelihood of loan defaults. The findings also showed that client repayment training had no significant impact on loan defaults.

In conclusion, the results showed that high interest rates have a huge bearing on loan defaults in Microfinance. The firms' internal high operating costs and desire for high profitability were leading factors. Customers who are considered as high risk are the mostly likely to take up these loans as the low risk clients opt for less expensive credit. Furthermore, the study found that improved loan appraisal reduced loan defaults but not significantly. On the hand, loan payment training was not statistically significant and had no influence on loan defaults.

Policy recommendations from the results of the study would include joint participation from regulators and microfinance sector on reducing the cost of operations of MFIs and inevitably high interest rates. In addition, MFIs should include as part of their credit policies constant reviews of their portfolios to ensure clients are not contracting unaffordable loans within and with other financial institutions.

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LIST OF ACRONYMS

BOZ -Bank of Zambia

GDP- Gross Domestic Product

NPLs- Non-Performing Loans

MPC Rate- Monetary Policy Committee Rate

MFIs- Microfinance Institutions

NBFIs- Non-Bank Finance institutions

CRB- Credit Reference Bureau

FINCA- Foundation for International Community Assistance

NSCB - National Savings and Credit Bank

CETZAM - The Christian Enterprise Trust of Zambia

SACCOs- Savings and Credit Cooperatives

CHAPTER ONE

1.0 Introduction

Microfinance institutions (MFIs) play a critical role in developing nations as a tool for eradicating poverty, promoting development and uplifting the living conditions of people who have been financial excluded (AL-Maamari et al, 2022). Maksudova (2010) observed that unlike conventional and traditional banking systems where all clients are subject to the same banking policies, MFIs are flexible financial institutions that provide banking services to match different client needs and income levels. Maksudova further emphasized that for MFIs to be truly impactful, low-income family earners, young people, women, and those with disabilities should be given priority as they were most at risk of being financially excluded.

The origins of MFIs date back to Bangladesh in the late 1970s on account of the successes of the Grameen Bank. The institution was founded by the Nobel Peace prize recipient Muhamed Yunus (Hulme & Moore, 2006). However, the introduction and establishment of MFIs in Zambia has a relatively short history. Most of the growth and development occurred around the early 1990s with the Government of Zambia establishing key institutions in the promotion and development of the microfinance sector in Zambia (Maimbo & Mavrotas, 2003). Growth of the MFI sector was achieved through providing training and technical assistance to local organizations and facilitating the establishment of MFIs.

Microfinance institutions (MFIs) have four distinct categories as identified by Mia (2016). The first category primarily offers short-term credit services to its clients. The second category encompasses a broader spectrum of financial-related services, including credit, savings, micro-insurance, and remittances. The third category places its emphasis on enhancing societal capacity, while the fourth category is dedicated to delivering various social and developmental services to a wider clientele.

This research was primarily concentrated on investigating factors influencing loan defaults of two specific types of MFIs; those that exclusively provide short-term credit services and those that offer both credit and savings options. This Chapter contains an introduction and background of the research topic, the statement of the problem, purpose of the study, significance of the study, limitations and the research objectives.

1.1 Background of the Study

The microfinance landscape in Zambia lags behind its East African counterparts in terms of the number of participating microfinance institutions (MFIs), client base, and geographical coverage, as highlighted by Wakunuma et al (2019). Unlike other regions, the Zambian microfinance sector has not experienced the positive impact of substantial investments from major institutional players, hindering its growth and scalability, as noted by Siwale and Kimmitt (2019). According to the Bank of Zambia (2020), there were 32 licensed MFIs in October 2020, a decline from 2018 figures. The existing regulatory framework prioritizes the commercial and financial aspects over social missions, leading to a diminished emphasis on inclusive practices, as observed by Siwale and Okoye (2017). This profit-centric approach has resulted in a shift from group to individual-based lending, primarily focusing on high-value and salary-based loans. Despite these changes, the microfinance sector in Zambia continues to have limited rural presence and plays a relatively modest role in national financial inclusion efforts.

The Zambian economy and financial services sector, like those of many other developing countries, had undergone substantial reforms since the International Monetary Fund (IMF) and the World Bank recommended economic liberalization in the early 1990s (Mumba, 2019). Angelini (2018) pointed out that the liberalization of the financial services sector in most developing countries led to an influx of new banks and microfinance institutions. Subsequently resulting in increased competition and technological advancements that had significantly altered the structure and performance of the sector. Since the 1990s, financial sector reforms and shifting market dynamics in developing countries saw a rise in Non-Performing Loans (NPLs), signaling shortcomings in credit policy and management on the part of financial institutions. This

surge in NPLs has been associated with poor balance sheets and has eroded the intermediation role of financial institutions.

Loan default in Zambia has a distinct history that can be traced back to the emergence of the private sector and decisions by banks to extend credit services to the private sector having previously focused on relatively lower risk lending to the public sector (Mwiya, 2006). The financial environment since its liberalization had undergone considerable developments both in banks and non-bank financial institutions with the partial liberalization of interest rates and the removal of sectoral credit ceilings in the late 1980s (Maimbo and Mavrotas, 2004). Nonetheless, even after the liberalization of the financial environment, micro and macroeconomic factors have affected borrowers and MFIs regarding loan management. Loan defaults have persistently afflicted the Zambian financial services sector for an extended period. Various factors, such as a weak legal framework for penalizing defaulters and challenging economic conditions, were cited as reasons for banks' reluctance, particularly in lending to small borrowers within the private sector (Mumba, 2019).

The earliest signs of the consequences of NPLs in Zambia dates back to 1993, when the National Savings and Credit Bank (NSCB) was insolvent and only saved from collapse by government reorganization (Maimbo & Mavrotas, 2004). As part of a K400 million (US$ 100,000) investment program, the government separated it from the national post office and restructured it to manage external financing intended for micro and small enterprises. However, Lima Bank and Cooperative bank were not so fortunate and plunged into liquidation by 1997 due to a large non-performing loan portfolio, mismanagement, severe drought and low loan recovery rates.

Siwale et al (2021) linked the downfall of Lima Bank and Cooperative Bank to have shown similar characteristics to that of The Christian Enterprise Trust of Zambia (CETZAM). CETZAM was a Microfinance institution founded in 1995 to change the lives of the poor through microenterprise development. The sole purpose of CETZAM was to create employment opportunities and generate income through credit. Serious problems became apparent in 2003 for CETZAM. A high portfolio at Risk, internal fraud, an

unreliable management information system and high-cost structure were contributing factors. These problems eventually led to the closure of the company in 2016 (Banda, 2019).

Studies by Mubanga (2019) demonstrated the need for MFIs in Zambia to come up with credit policies and devise strategies that would be effective in loan recovery. In addition, most literature on determinants of non-performing loans in Zambia was primarily focused on the Banking sector.

1.2 Statement of the problem

Recently there have been increased number of default rates in Microfinance in Zambia rising from 9% in 2016 to 14.5 % in 2022. This signifies a 4.5% gap above the BoZ prudential limit of 10% while Commercial banks in comparison recoded an average of 6.1% for the same year 2022 (Zambanker, 2022). This increment in the percentage of the default rates has led to a number of scholars speculating on the causes of the default rates by MFIs' customers. Masheta (2019) revealed that, with the aim of increasing revenue and capturing a substantial market share, numerous MFIs in Zambia have disbursed loans and advances that ultimately could not be reclaimed.

Some scholars have suggested that the rise in defaults is due to high interest rates on the loans offered by these financial service providers (Siwale, 2021; Banda 2019). Mumba (2019) attributed it to poor loan appraisal, while others have indicated low incomes and high cost of living make it difficult for borrowers to service these loans hence the high default rates .This intellectual debate has generated a lot mysteries concerning this issue. It is in this regard that this research topic was conceived to investigate the factors influencing high default rates in the selected microfinance institutions in Lusaka district of Zambia.

1.3 General Objective

The general objective is to investigate the factors influencing high default rates in the selected microfinance institutions in Lusaka district of Zambia.

1.3.1 Specific Objectives

1)To analyze the effect of interest rate on high default rates of the selected microfinance institutions in Lusaka.

2) To assess the association between loan appraisal and high default rate in the selected microfinance institutions in Lusaka.

3) Investigate the link between loan payment training and high default rate in selected microfinance institutions in Lusaka.

1.3.2 Research Questions

1) What is the influence of interest rates on the high loan default rates in the microfinance sector?

2) What is the association between loan appraisal processes and the prevalence of high default rates?

3) What is the link between loan payment training and high default rates among microfinance clients?

1.4 Significance of the study

By conducting a thorough investigation into the intricate relationship between interest rates and loan defaults, the research has the potential to provide valuable insights to policy makers, MFIs and borrowers alike. The findings propose credit policy adjustments that encourage responsible lending practices while ensuring the mutual interest of lenders and borrowers are safeguarded.

Furthermore, the study brings substantial value by delving into the pivotal connection between loan appraisal and the prevailing high default rates. The outcomes of the research offer actionable guidance to MFIs, regulatory bodies, and industry stakeholders, thereby facilitating improvements in loan appraisal processes. Ultimately the research aligns with the broader objective of reinforcing resilience of microfinance and fostering economic growth.

Additionally, the significance of the study extends to the exploration of the potential impact of loan repayment training programs in mitigating high default rates. By uncovering the effectiveness of these training initiatives, the research provides valuable insight to MFIs and policy makers, whether these initiatives are cost effective and contribute positively towards the general performance of the institution.

1.5 Scope of the study

The scope of the study covered selected institutions in Lusaka District which included Agora Microfinance, Unifi and FINCA. The researcher targeted a sample size of 89 respondents, 15 Microfinance loan officers and 74 borrowing customers, all within the Lusaka district.

1.6 Limitations of the Study

The researcher encountered several limitations in achieving the specific objectives outlined for the study. First, the size and representativeness of the sample in the study was limited due to time and practical constraints. A small or non-representative sample limits the generalizability of research findings to a broader population. Second, validity concerns are present due to the unequal representation of elements within the population in the sample. However, the study's reliance on the responses from the MFIs as experts in the field underscores its valuable contribution to enhancing the understanding of the factors influencing loan defaults.

1.7 Definitions of key terms

Agora Microfinance, a microfinance institution with a mission to cater to low-income, rural households in Zambia by providing them with suitable financial services. The firm was established in 2010 as a non-depositing taking microfinance institution and received its license from Bank of Zambia in April 2011 (Kalasa, 2014). Agora microfinance offers loans and training to Small and Medium Enterprises and small holder farmers who undergo training on financial management before loans are disbursed (Mudege, 2021).

Credit Reference Bureau, this is a company that receives, stores, analyses and classifies all credit information of customers and issues credit reports to stakeholders (Chiumya, 2014). The creation of a credit reference Bureau to mitigate credit default in the banking sector has led to a considerable decrease in loan defaults in the banking sector (Chamangwa, 2021).

Credit Risk- credit risk is the risk of loss that might occur if one party to an exchange fails to honor the terms under which the exchange was to take place. Credit risk comes up from uncertainty in a given counterparty to meet up with the obligation of honoring the terms and conditions of the credit arrangement (Fatemi and Fooladi, 2006; Masheta, 2019).

Foundation for International Community Assistance Zambia- FINCA Zambia is a microfinance deposit-taking institution dedicated to delivering socially responsible financial services to individuals and communities with limited income. It operates as a member of the FINCA Impact Finance Group, which specializes in financial services, including financial literacy management and guidance for enhancing business performance (Kalasa, 2014; Kabuku, 2019).

Microfinance Institution, Maksudova (2010) describes Microfinance institutions as organizations that cater to different needs of low-income earners by offering services such as micro credit, insurance, remittances, healthcare, education and skills training. These institutions are also commonly known as entities created to support impoverished

households in increasing their involvement in productive endeavors and elevating their economic and material welfare (Addae-Korankye, 2014; Rahman, 2015).

Financial Inclusion- this refers to the presence of equal and accessible opportunities for individuals to access financial services and products (Nanda & Kaur, 2016). Financial inclusion can also be defined as a scenario in which a significant proportion of the population has access to a wide range of financial services (Olaniyi & Adeoye, 2016).

Financial Exclusion- Wenzel et al (2021) define financial exclusion as a process that hinders poor and marginalized social groups from accessing their country's formal financial system. Financial exclusion can occur due to issues related to pricing, marketing or voluntary withdraw in response to negative experiences or perceptions (Sinclair, 2001).

Traditional Banking System- Edwards & Mishkin (1995) describe traditional banking as business involved in making long-term loans and financing them by generating long-term deposits often referred to as borrowing short and lending long. Traditional banking services encompass activities such as maintaining bank accounts for legal entities, facilitating transfers, collecting funds and handling foreign currency transactions (Melnyk et al, 2022).

Small Medium Enterprise- The definition of a small business enterprise (SME) varies from one country to another. In Zambia an SME is based on number of employees, not exceeding 250 (Aurick et al, 2017). In service firms, Agriculture and ICT enterprises the definition limits the number of employees to not more than 50 (Omar et al, 2009).

Loan Officer- Loan officers serve as intermediaries between microfinance institutions and clients. They are the front-line personnel responsible for directly interacting with clients, and their subjective assessments play a significant role in forecasting the potential default of microenterprises (Cheruiyot, 2015; Cornee, 2009).

International Monetary Fund (IMF)- this is an international organization that fosters economic development by securing financial stability, facilitating international trade, and

supports global monetary cooperation amongst nations (Schlefer, 2013). Some key roles of the IMF are to collect, publish and disseminate information on member countries (Williamson 2000).

Non-Performing Loans- Non-performing loans are accounts whose principal or interest remains unpaid 90 days or more after due date and are also referred to as defaulted loans (Gorter & Bloem, 2001; Gezu, 2014).

Loan Appraisal- this is a process by which a credit officer verifies that loans are extended with suitable terms, considering the client's economic sustainability, financial viability, and the creditworthiness. Loan appraisal processes are viewed as critical drivers of institutional factors leading to loan defaults (Barongo, 2013; Gatimu 2014).

Moral Hazard- instances of moral hazard can be observed when borrowers intentionally deceive financial institutions by providing inaccurate or false profile information in order to qualify for obtaining the loan (Makorere, 2014).

Adverse Selection - The adverse selection problem occurs if lenders try to protect themselves against default risk by setting their contractual terms in a manner appropriate for the expected average quality of their loan applicants (Auronen, 2003).

CHAPTER TWO: LITERATURE REVIEW

The purpose of the Literature review is to provide a framework for relating new findings to previous findings within the research field. The literature review section delimits the research problem and helps in gaining methodological insights (Randolph, 2019). This Chapter is divided into 3 sections, namely, empirical review, theoretical framework and Conceptual framework.

Empirical review underlays the previous studies that have been undertaken by different researchers that are related to the study and their various findings (Sekaran and Bougie, 2016). Theoretical framework provides a comprehensive overview of literature related to a theory and synthesizes prior studies to strengthen the foundation of knowledge (Paul and Criado, 2020). Finally, the conceptual framework explains either graphically or in narrative form, the main elements to be studied and the key factors, concepts, or variables and the presumed relationships among them (Tamene, 2016).

2.1 Empirical Review

The empirical review presented herein aims to critically examine and synthesize existing research pertaining to factors influencing loan defaults. In the pursuit of a comprehensive understanding of NPLs, this review delves into the empirical literature to identify key findings, methodological approaches, and theoretical frameworks that have shaped the current understanding. Furthermore, previous researchers have provided their conclusions from the analysis of the data gathered which was replicated and used to address gaps in the research and answer the research questions.

Loan Interest Rates

Several studies have been conducted in Sub-Saharan Africa and other regions of the world investigating the various factors influencing loan defaults. Fofack (2005) studied causal analyses and macroeconomic implications on loan default in Sub-Saharan countries. Fofack finds evidence that the real interest rate, net interest margins, and

inter-bank loans are significant determinants of non-performing loans in these countries. The author attributes the strong association between the macroeconomic factors and non-performing loans to the undiversified nature of some African economies.

Makorere (2014) took a much wider approach and focused on other macroeconomic factors. Makorere added that significant influences on loan repayment behavior in Tanzania stem from pivotal factors such as interest rate (Fofack, 2005; Addae-Korankye, 2014), grace period, profitability, moral hazard, electricity rationing, and economic stability. In other regions of Africa such as Egypt, Rashem and Abdullah (2018) revealed that high interest were a major challenge affecting the growth and penetration of microfinance institutions. Mwakoba (2011) also investigated the factors influencing non-performing loans at SACCOs (Savings and Credit Cooperatives), revealing a robust correlation between non-performing loans and factors such as elevated interest rates, inadequate collateral, and business challenges.

Furthermore, Rosenberg et al. (2009) stated that high interest were merely a sub-product of other variables. Rosenberg found four main components reflected in the microfinance interest rates which were operating expenses, cost of funds, loan loss expenses, and profit. Operating costs represented about 60% of the total MFI costs. Inflation was another factor that had been investigated that can directly affect the lending rates. When general price levels increase across the board, the ability of borrowers to pay back loans would decrease (Rizwi and Khan, 2015). The instability of inflation rate made banks and other lenders apprehensive about their future values of the loans when they matured. Therefore, most of the lending institutions and banks proceeded to increase their interest rates to maintain the loan value.

Contrary to the findings of Mwakoba and Rosenberg, Kwayu (2011) argued that interest rates did not significantly impact loan repayment, emphasizing instead the high costs associated with loan applications were the main determinants of defaults. Additionally, Kwayu identified borrower attitudes and information asymmetry as a key contributing factor to the non-repayment of loans.

Loan Appraisal for existing and new Clients

Borrower characteristics and the amount of information that is availed during loan application process make up a huge component of client appraisal. Aliija and Muhangi (2015) revealed that MFIs use client appraisal in Credit management to a great extent. The authors recognized that client appraisal is a viable strategy for mitigating credit risk. Microfinance Institutions use the 5C"s model (i.e. Character, Capacity, Collateral, Condition and Capital) of credit to evaluate a customer as a potential borrower. If any of the five Cs are poorly analyzed, the likelihood of which a client defaults rate may be high. To limit this risk, institutions develop policies and procedures to analyze each component. The weight assigned to each component will vary depending on the lending methodology, the loan size and whether it is a new or repeat client. The loan officers and their immediate supervisors should consider the 5C"s when making credit decisions, and they should be held accountable for those decisions.

In addition to establishing viable strategies, condition and capacity are cardinal in managing credit risk. Mumba (2019) found that inadequate customer supervision (Condition) regarding loan utilization and subpar loan appraisal practices (capacity) both before and after loan disbursement contributed to high loan defaults (Addae-korankye, 2014; Asongo & Adamu, 2014). Mumba's study aimed to understand how employees in the Zambian banking sector perceived the factors influencing non-performing loans. Lymo (2019) equally found a noteworthy and positive correlation between utilization practice and loan delinquency among 485 active SMEs with loans at Equity Bank Tanzania in Dar es Salaam.

Furthermore, Arko (2012) investigated the factors influencing the occurrence and impact of non-performing loans on the operations of microfinance institutions. The focus of the study was on Sinapi Aba Trust, utilizing a five-year dataset encompassing variables such as interest incomes, operating profit, and loanable funds. Notably, inadequate loan monitoring by staff, business failures among borrowers, were identified as primary contributors to the occurrence of non-performing loans in the bank.

Loan Payment training in Microfinance

In terms of training, Awunyo (2012) streamlined the influences of loan defaults to farmers. The results showed that larger amounts, longer repayment terms and access to training were associated with a decreased likelihood of default. The discussion used data gathered through a survey of 374 farmers. In a similar study carried out in Ghana by Agbeko et al (2017), the researchers explored the impact of training and monitoring interventions by MFIs. Follow-up data was collected from the same clients one and a half years later. In contrast to Awunyo, the results indicated that training interventions failed to improve repayment rates. Strikingly, client monitoring on the other hand improved repayment rates significantly. Elhadidi (2018) also found that lack of business training and short maturity period of loan are factors that hinder the growth of MFIs and hence worsen the plight of microfinance clients. Elhadidi further asserted that unwillingness of clients to invest their loans in their microenterprises but rather use them on consumption is an obstacle to the growth of MFIs leading to loan default.

Bichanga and Aseyo (2013) investigated the factors contributing to loan default within microfinance institutions in Kenya. The research employed a sample of 150 respondents selected through simple random sampling. Bichanga and Aseyo further revealed that inadequate supervision by microfinance institution staff and a lack of sufficient training for borrowers regarding the utilization of loan funds were key factors leading to repayment default. Additionally, the study indicated that most borrowers did not allocate the loan amount received to the planned and approved projects, further contributing to the challenges of loan repayment.

2.1.1 Empirical Review Summary

Previous Research	Model Applied	Findings	Gap Analysis
Fofack (2005)	Cross- Country Panel Analysis	The results showed a high causality between non-performing loans and economic growth, real exchange rate appreciation, real interest rate, net interest margins and interbank loans	1. It ignores dynamics in the estimation methods 2. The study lacked in-depth analysis regarding the key factors influencing high interest such as Interest rates spread, Internal cost of operation and Profitability
Makorere (2014)	Cross sectional design	The uttermost factors like interest rate, grace period, profitability, moral hazard, electricity rationing, and economic stability had strong effects in stimulating loan repayment behaviour in Tanzania	The article did not address the efforts to improve financial literacy and business training for borrowers and how it could enhance their capacity to manage loans effectively, thereby improving loan repayment behavior
Addae-Korankye (2014)	A Critical Review	Some of the challenges faced by the clients include high interest rates and lack of training, whilst loan default, and sustainability issues are some of the challenges confronting microfinance institutions	While the article discusses challenges faced by microfinance institutions (MFIs), such as high operational costs and lack of skilled personnel, it does not delve into the effectiveness of training and capacity-building programs in addressing these challenges.
Rosenborg et al (2009)	Critical Review of Empirical Data	Their study found four main components reflected in the microfinance interest rates: operating expenses cost of funds, loan loss expenses, and profit	One strand of literature believes that a higher rate of profitability leads to an increased interest from investors and facilitates the development of the MFI simultaneously lowering interest rates. while another strand of literature claims that a higher rate of profitability applies an upward pressure on interest rates
Aliija and Muhangi (2015)	Descriptive survey research design	The study revealed that MFIs use client appraisal in Credit management to a great extent. Further, it established that client appraisal is a viable strategy for mitigating credit risk. The study also established that there was a strong relationship between credit performance of MFIs and client appraisal	Nguyen (2017), found that loan covenants are used to supervise and monitor borrowers, however, they have not been fully utilized. Therefore, the effectiveness of these appraisal techniques (5Cs) is inconclusive.

Awunyo (2012)	Probit Model	The results showed that larger amounts, longer repayment terms and access to training were associated with a decreased likelihood of default	Agbeko et al (2017), In contrast to Awunyo, indicated that training interventions failed to improve repayment rates. Strikingly, client monitoring on the other hand improved repayment rates significantly

2.2 Theoretical Framework

In the theoretical framework, the researcher presents and explained the theories that support the research from models developed by other researchers. The section critically evaluated and analyzed the concept of Non-performing loans, Moral Hazards, the Patronizing Effect, Die another Day effect, and the Asymmetric information theories. The theories were identified as the most relevant in addressing the research problem identified in Chapter 1.

2.2.1 The Concept of Non-Performing loans

Bloem and Freeman (2005) established a set of criteria to classify a loan as a Non-performing loan (NPL), defining it as a loan for which interest and principal payments are overdue by 90 days or more. Alternatively, if interest payments equivalent to or exceeding 90 days have been rolled over, refinanced, or postponed through an agreement, the loan is considered an NPL (Gorter & Bloem, 2001; Gezu, 2014). The concept of non-performing loans helps financial institutions to; recognize the NPLs early and employ remedial action at an early stage, they are an indicator of the firms profitability and control of NPLs and can help allocate funds towards ventures with higher risk profiles (Warue, 2013; Stuti & Bansal, 2013). In addition, NPLs can be used as a measure to forecast bank failures (Khairi et al, 2021).

However, the concept of non-performing loans presents various limitations. Athukorala (2001) claims the measure is backward looking and subjective in classification. In a context of rapid credit growth any such historical summary measure is likely to be an inadequate indicator of future performance and creditors always have the option of

arranging credit rollovers. Secondly, NPLs are subject to measurement errors primarily because of ambiguities surrounding the choice among many definitions.

Angelini (2018) argues that high NPLs can create an incentive for banks to increase the overall supply and getting rid of NPLs consumes capital, reducing the bank's ability to lend. Furthermore, the author concludes that the evidence does not support the view that high NPL levels directly impair banks' capacity to issue credit to the economy.

Most research will show the concept of NPLs and specifically the aspect of moral hazard and adverse selection in banking having a positive correlation between varying interest rates and high defaults (Stiglitz & Weiss, 1981). One of the aims of the research, therefore, is to assess whether the adoption of the relationship between interest rates and defaults produces similar results in MFIs in Zambia.

2.2.2 The Theory of Asymmetric Information

The theory was first presented in 1970 in the field of (Auronen, 2003). The Theory explains that people have different information and this information that they possess affects their purchasing behavior in many situations. The premise of the model is that borrowers may not consistently furnish all the necessary information. In such situations the party with more information on the specific transaction, typically the borrower, can negotiate more favorable terms (Mumba, 2019). In circumstances where borrowers provide the required information, not all of it may be accurate (Nyoni, 2018). In some instances, customers often want to find out if these microfinance institutions are serious in terms of collecting the loan payment since most of the MFIs employed staff who do not have much knowledge in the financial industry (Aidoo & Mensah, 2018).

Samoei et al (2017) emphasized the relevance of this theory, as it explains the uncertainty of mutual comprehension between both parties in a loan agreement. The hypothesis test results confirmed a statistically significant correlation between the

personal characteristics of members and the occurrence of non-performing loans within savings and credit cooperative societies in Kenya.

Stiglitz and Weiss (1981) explained another application of the theory on the effects of rationing credit to the financial markets. The authors prescribe that banks making loans are concerned about the interest rates they receive on the loan, and the riskiness of the loan. It is very difficult to distinguish good borrowers, and to do so requires use of various screening devices. The interest rate which an individual is willing to pay may act as such a device. Those willing to borrow at high interest rates because they perceive their probability of repaying the loan to be low, are the most at risk and likely to default.

Borrowers typically hold privileged knowledge regarding their projects, which tends to be more precise compared to the information available to lenders. Consequently, lenders might encounter uncertainty regarding the potential default risk of a loan agreement, leading to challenges in evaluating and managing the borrower's characteristics and actions (Viswanadham & Nahid, 2015).

A potential problem in the applications of the theory is that it only considers asymmetries in one direction and information differences may also favor the other party (Bond,1982). The theory itself might be faulty in its simplistic assumptions (Auronen, 2003) and may give rise problems of Moral Hazard, Adverse selection and Monitoring costs.

Moral Hazard

In economics, a moral hazard is a situation where an economic actor has an incentive to increase its exposure to risk because it does not bear the full costs of that risk. Essentially, the question of the moral hazard lies in the fact that the decision whether to disclose material facts or not is dependent on one economic agent. If this agent is of the view that they could gain some advantage over their counterparties, it will be unlikely that there will be a disclosure of such information (Moloi & Marwala, 2020).

Simtowe et al (2006) identified the moral hazard principle as another problem in credit markets mainly arising from information asymmetry. The theory states that influences on loan defaults may also stem from other factors such as a failing economy, government

bailouts which may encourage more irresponsible lending and bad borrower behaviour, unemployment and a rise in interest rates. Bebczuk (2003) emphasizes that moral hazard will be present once the debtor invests in a different project than that which was agreed upon with the lender.

Furthermore, moral hazard arises when borrowers fail to uphold their end of the agreement with financial institutions. Makorere (2014) reveals that in some business cases, loans are typically extended to foster business growth, specifically to enhance the working capital of the enterprise. Regrettably, there are instances where certain borrowers prove untrustworthy in adhering to the terms of their agreement with financial institutions. This often occurs when borrowers divert or misuse the funds provided to them. Makorere further revealed that some borrowers misappropriate the loan for personal uses, such as covering household expenses like food, utilities (including electricity and water bills), and paying school fees for their children.

In addition, instances of moral hazard can be observed when borrowers intentionally deceive financial institutions by providing inaccurate or false profile information in order to qualify for obtaining the loan.

Adverse Selection

A second problem arising from information asymmetry is that of adverse selection. Adverse selection is a market situation where buyers and sellers have different information. The result is the unequal distribution of benefits to both parties, with the party having the key information benefiting more than the other party with less information.

The adverse selection problem occurs if lenders try to protect themselves against default risk by setting their contractual terms in a manner appropriate for the expected average quality of their loan applicants (Auronen, 2003).

The theory was adopted for this research as it speaks directly into the potential inability by lenders, especially MFI to accumulate as well as disseminate all the relevant information to the borrower.

Monitoring Costs

Bebczuk (2003) states that if the borrower takes advantage of this better information to deceive the lender, by deliberately underreporting profits, the lender who cannot directly observe the investment outcome, will be forced to monitor the borrower every time they are unable to pay. The contractual agreement addresses this concern by specifying that upon the borrower declaring default, the lender is entitled to conduct audits, enabling the verification of the entire cash flow. However, audits come with associated costs, occasionally involving the engagement of accountants and lawyers to perform the necessary procedures. This precautionary measure aims to deter deceptive practices and ensures the lender's ability to assess the accuracy of financial information when defaults are declared, ultimately safeguarding the integrity of the lending relationship.

2.2.3 Patronizing Effect and Die another day Effect Theories

Islam et al (2005) introduced two models to explain the factors influencing loan defaults. The first model, known as the Patronizing Effects, suggests that lenders may be unwilling to collect loan repayments. The reluctance can stem from various internal issues, including flawed policies, procedures, organizational structure incentive system and physical environment. Such internal shortcomings weaken management and can foster borrower confidence that no severe action will be taken if they fail to repay their loans, ultimately leading to defaults.

The second model, Die another Day effects, suggests that in our society there is a significant emphasis on immediate consumption, if borrowers are not strictly followed up (Islam et al, 2005). The authors further observed that a weak follow up undermines the system leading to loan defaults and rising non-performing loans in the loan books of commercial banks.

However, the models require more empirical evidence to support the authors' claims. The relevance of the concept to the research is that it helps to describe and explain the correlation between inadequate loan appraisals and the influence on high defaults.

2.3 Conceptual Framework

The conceptual framework provides the guide for the study. Diagrammatic description of the variables that have been used to explain the relationship between the independent and dependent variable. Cresswell & Creswell (2018) state that the outcome of the dependent variable is highly influenced by the independent variables in the study. It has been established that the independent variables will constitute inadequate loan appraisal, lack of training of clients and high interest rates. Consequently, the high loan default rates will represent the dependent variable. Variations in the independent variables, either individually or in combination, can lead to changes in the dependent variable, such as an increase or decrease in high loan defaults

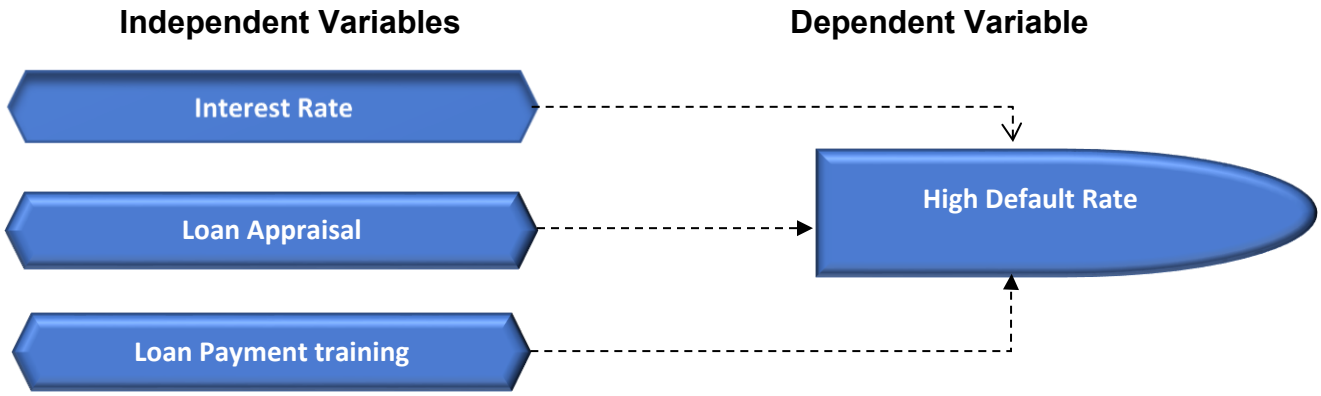


Figure 2.1: Conceptual framework

Source: Author (2023)

2.4 Research Gap

Most existing research on loan defaults in MFIs in Africa has primarily focused on countries in West and East Africa, with limited investigation on influences of loan defaults Zambian MFIs (Siwale, 2022). This knowledge gap can be attributed to

predominant emphasis in the current literature on the formal banking sector, particularly commercial banks. The researcher addressed this gap from the outcome of the collection and interpretation of primary and secondary data sources of the sample.
Furthermore, the proliferation of Financial Technology Companies and their widespread adoption across various platforms to facilitate microcredit access has brought new challenges. There are concerns that digitization, especially the use of digital credit through mobile phones, may in some places lead to overborrowing (Siwale, 2022).

The growth in access to credit necessitates a robust system to ensure loans are disbursed on merit and includes effective monitoring interventions to prevent high default rates.

CHAPTER THREE: METHODOLOGY

This Chapter contains the explanation of the methodological approach used for the research problem and what type of data was collected to answer the research questions. To achieve this, the researcher collected primary quantitative data. The Chapter contains the research design, the study location and population. In addition, the Chapter comprised the sampling criteria used for the selection of participants, tools, procedure and materials used to gather data. Lastly, the Chapter covers how the variables were measured to give enough details for it to be replicated by other researchers.

3.1 Research design

The study adopted a descriptive research design. A descriptive research design determines the frequency with which something occurs, or the relationship between variables (Sekaran and Bougie, 2016). This method includes data collection, analysis, and presentation. It allows the researcher to clearly present the problem statement in order to explain better the need for this kind of research. A descriptive research design was suitable for study as the researcher aimed to establish a cause-and-effect relationship.

3.2 Research approach

The study adopted a quantitative approach. This design was adopted as it measures the qualities of a specific population. The quantitative approach was ideal for the study due to its objectivity and ability to replicate the results from the selected sample.

The size of the target population is 840, and the elements of the sampling frame comprised loan officers, credit managers and borrowing clients. The extent of the target population covers three MFIs; Agora, FINCA and Unifi and their clients within the boundaries of Lusaka town. The choice of the three institutions was based on the length period of operations and diversity of the products they offerings. The researcher had access to this sample through administering and completion of questionnaires taking

into consideration the geographical dispersion and data collection resources that can affect accessibility.

3.3 Sampling technique and sample Size

Data was collected using purposive sampling technique, a type of sampling where the researcher chooses the desired sample to be included in the study (Chambua & Kester, 1993). This technique was ideal because it renders minimum bias and for purposes of achieving precision. Purposive sampling allows researchers to select participants who possess specific characteristics or experiences relevant to the research objectives. This method ensures that the sample adequately represents the target population of interest, enabling researchers to gain insights into a group within that population

The sample elements consisted of 15 loan officers from the three Microfinance institutions, that is, 5 coming from each institution and 74 representing clients of the microfinance institutions. Therefore, a suitable sample size of 89 respondents were required to complete the task effectively and efficiently, and were considered wholly representative of the study.

The three MFIs were selected for three specific reasons. First, the varying sizes provided insights into how different scales of operations impact their performance. Second, the three institutions have been operating for more than 8 years providing richness and depth of the data collected, as well as expertise to the study. Third, the three institutions have a diverse customer base providing a good representation of the entire population of the study.

3.4 Data Collection Method

The data collection method for the study involved the use of questionnaires as the primary tools. Berg (2001) emphasizes the accuracy of the data presented by the participants needs to be checked across different data sources through validation. This is to ensure the researcher provides an accurate account of the information.

Secondary data was gathered through reports, previous research findings and organizational records. The questionnaires administered included both closed and open-ended questions.

3.5 Data Analysis

Prior to conducting data analysis, the data set underwent a thorough examination for missing data and outliers. Subsequently, the Data collected was processed, coded and analyzed using Microsoft Excel. This tool was used based upon the embedded descriptive statistics and data analysis tools. It is an all-in-one data management software that allows the researcher to easily import, explore, clean, analyze, and visualize data. The application was appropriate for this study due to the small sample size and it was cost effective.

3.6 Validity

Content validity assesses whether the items or measures used in a study adequately represent the entire content domain of the concept being measured (Sekaran & Bougie, 2016). Methods for assessing content validity include expert judgment which was applied for this study.

3.7 Reliability

The Cronbach's alpha was employed to measure the reliability of the research instrument. Cronbach's alpha is a reliability coefficient that indicates how well the items in a set are positively correlated to one another. Cronbach's alpha is computed in terms

of the average intercorrelations among the items measuring the concept. The closer Cronbach's alpha is 1, the higher the internal consistency reliability (Sekaran & Bougie, 2016). Cronbach (1951) indicated that a Cronbach Alpha value of 0.7 and above is reliable. The study used this threshold of 0.7 and above.

3.8 Ethical consideration

All respondents and participants in the study were accorded the utmost respect, dignity, and anonymity, and all the information gathered was held confidential. Full consent was obtained from the participants prior to the study. Respondents of the study were not physically or psychologically coerced during the conduct of the study. Confidentiality was assured as data collected was used solely for the academic research purposes.

CHAPTER 4: DATA COLLECTION AND ANALYSIS

The general objective of the study was to investigate the factors influencing loan defaults in the selected microfinance institutions of Lusaka district. Primary data was collected through self-administered questionnaires from 15 loan and credit officers and 74 loan clients from the selected microfinance institutions. A total of 89 questionnaires were distributed and 71 were completed and returned, representing a 79.8% response rate. Data collected was processed, coded, and analyzed using Microsoft excel. All respondents were based in Lusaka district.

The results displayed with the narratives are arranged in the following order; respondent demographics, high interest rates and their correlation to loan defaults, loan appraisal methods and their influence on loan defaults, loan payment training and its impact on loan defaults. The researcher then tested the significance of the regression model linking loan interest rates, loan appraisal and loan payment training to loan delinquency.

4.1.1 Reliability Test

A pilot test was conducted on 20 respondents to test the validity and reliability of the questionnaire before it was used for the final survey. Cronbach (1951) indicated that a Cronbach Alpha value of 0.7 and above is reliable. The study used this threshold of 0.7 and above. All the questionnaire constructs recorded Cronbach's Alpha value of above 0.7 implying that the data could be treated as reliable (Nunnally & Bernstein, 1994).

TABLE 1 Reliability Test

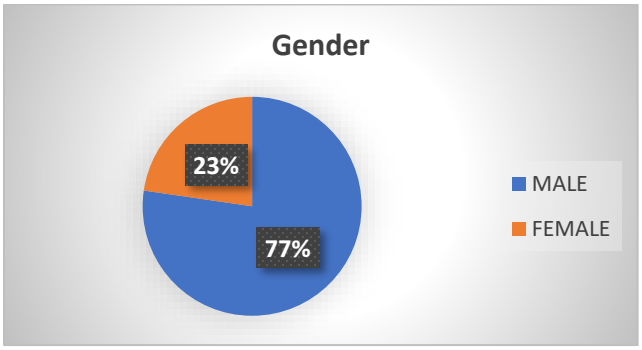
Variable	Cronbach Alpha α	Number of Items (Questions)	Recommendation
High Interest Rate	0.75	5	Reliable
Loan Appraisal	0.93	7	Reliable
Loan Payment Training	0.73	5	Reliable

Source: Author 2023

The Cronbach alpha was calculated from the data gathered by the questionnaires administered. Accordingly, the study scales were considered reliable enough to measure the constructs.

4.2 Respondent Demographics

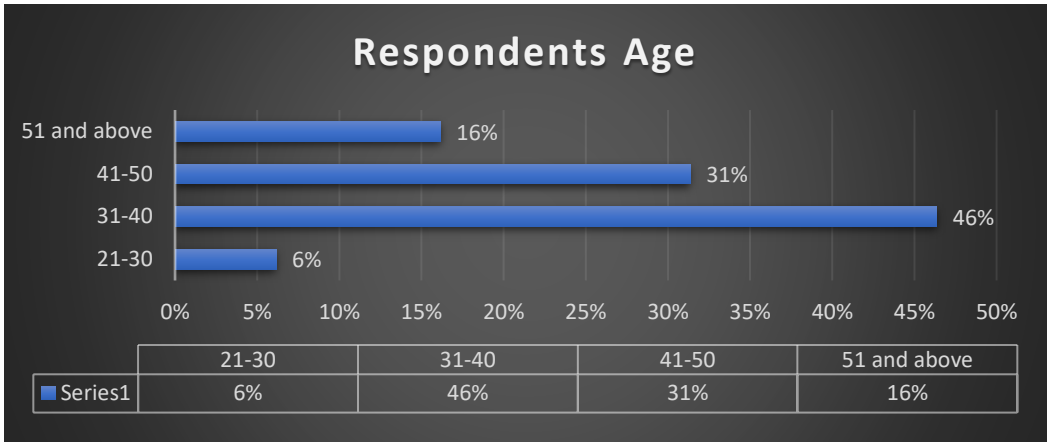
Figure 1: Gender



Source: Researcher 2023

The sample comprised 77% males and 23% females.

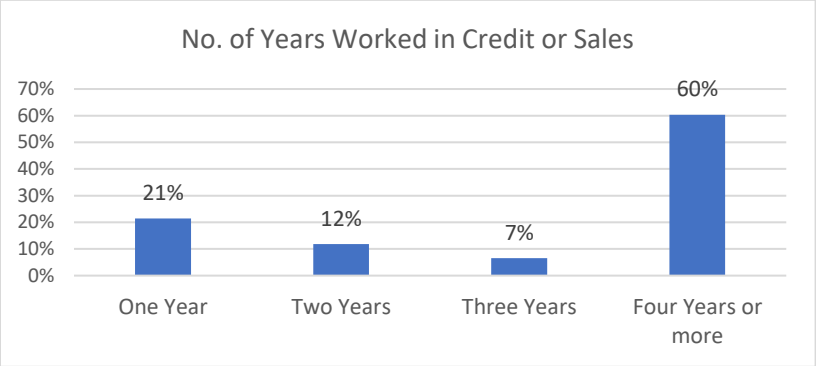
Figure 2: Age of Respondents



Source: Researcher 2023

The study revealed that 46% of the respondents were aged between 31-40 years, followed by 41-50 at 31%, 51 and above at 16% and 21-30 years at 6%.

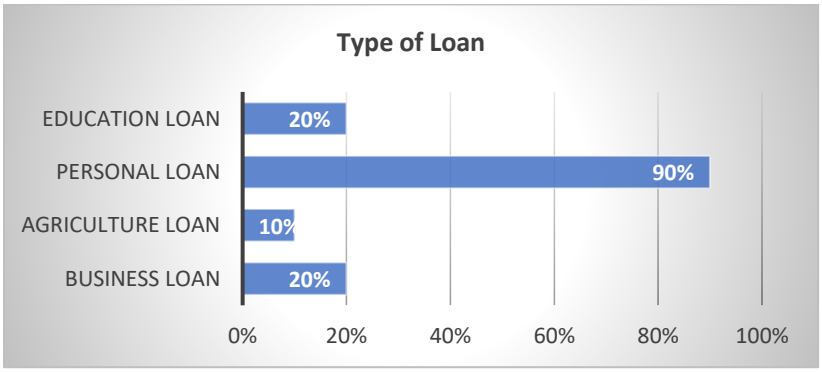
Figure 3: Work experience of Credit and Loan officers



Source: Researcher 2023

Further the Study revealed that for the credit officers representing the selected microfins, 60% had worked for four years or more, 21% for one year,12% for two years and less than 7% for three years.

Figure 4: Type of Loans obtained by the clients.



Source: Researcher 2023

The chart represented the types of loans that were taken out by the clients. Results show that 90% of clients had accessed personal loans, and 20% of the same sample size had accessed education and business loans. However, only 10% had attested to have applied for Agriculture loans.

The first objective of the study was to analyze the influence of interest rate on high default rates in the selected microfinance institutions in Lusaka.

To adequately measure and explain the relation between loan defaults and high interest rates, the study illustrated the cost of borrowing offered by the selected microfinance institutions in Table 2 and the NPL ratio trend analysis in Table 3.

4.3.1. Background on interest rates and loan defaults in operated microfins in Zambia.

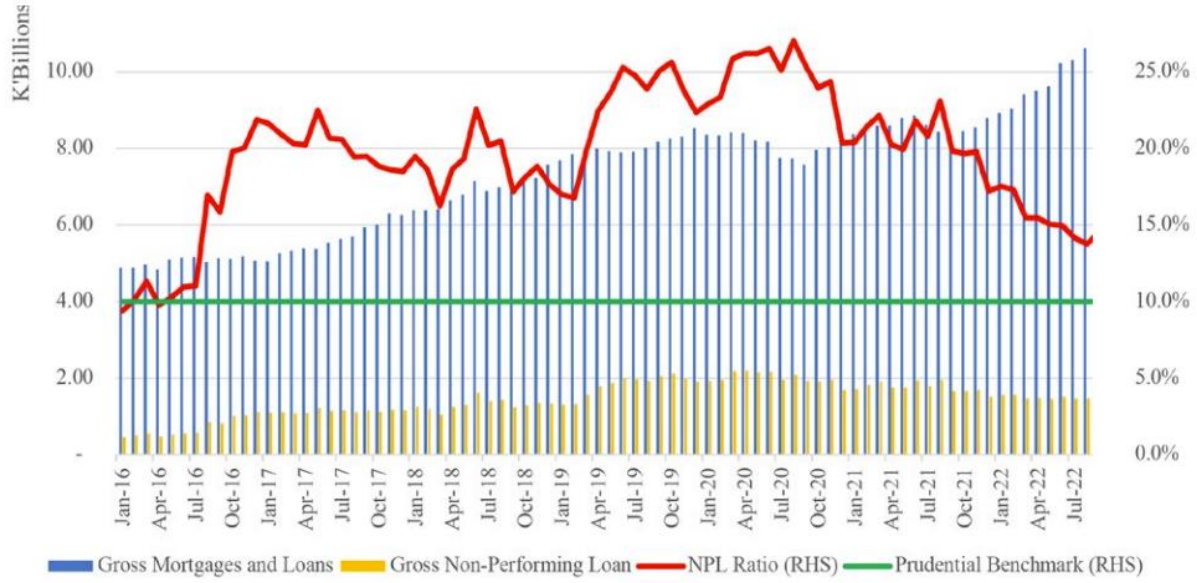
Table 2: Cost of Borrowing for the Three MFIs

Effective Annual Interest Rate (%)	Agora Microfinance Zambia Ltd	Finca Zambia Limited	Unifi
2022	76.04%	74%	101%
2021	77.92%	74%	97%
2020	77.92%	74%	97%

Source: Bank of Zambia: Demonstration of the cost of borrowing 2020-2022

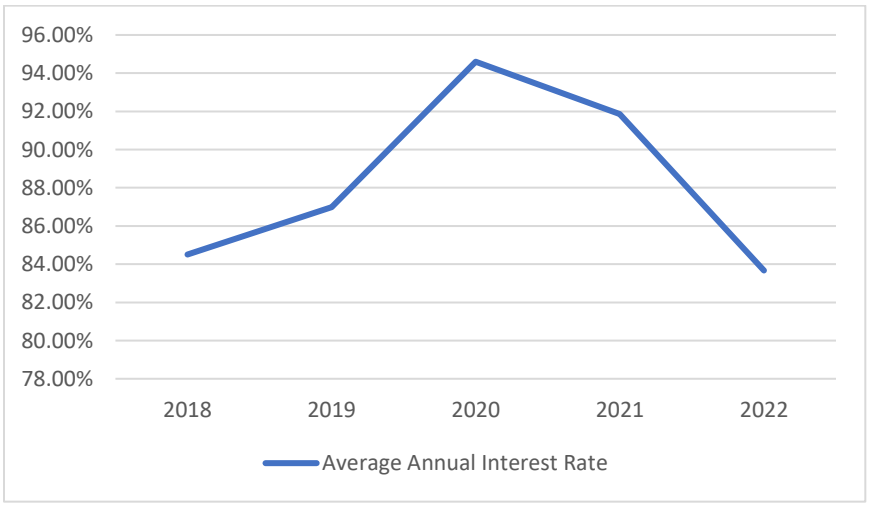
The cost of borrowing for the three microfinance institutions per annum ranged from 74% for FINCA to 77.9% for Agora, and 97% for Unifi in 2020. This was reflective of the annual interest rates for each borrower. For the year 2021, the rates ranged from 74% for FINCA to 77.9% for Agora, and 97% for Unifi. In 2022 the rates ranged from Agora to 74% for FINCA to 76.04% for Agora and 101% for Unifi.

Table 3: NPL trends in Microfinance Institutions



Source: Zambanker, 2022.

Table 4: Interest Rate trends in MFIs



Source: Bank of Zambia, Demonstration of the cost of borrowing 2018-2023

Table 3 and 4 highlight the trends analysis for the relation between NPLs and interest rates. In the periods 2018- 2021 a spike in the upward adjustment of interest rates shows a significant change in the NPL ratio, way above the benchmark prudential limit allowable by Bank of Zambia of 10%.

4.3.2 Respondents views, Perceptions and Analysis

Table 5: Respondents perception of the current level of loan default rates

Outcome Response	Proxy
Low	17.80%
Acceptable	11.10%
High	71.10%

Source: Author 2023

The respondents were asked to give an overview of their perception of the level of interest charged by the respective microfins. 71.10% attested to the rates being high to very high, with 11.10% referred to them as acceptable. 17.8% of the respondents deemed the interest rates to be low.

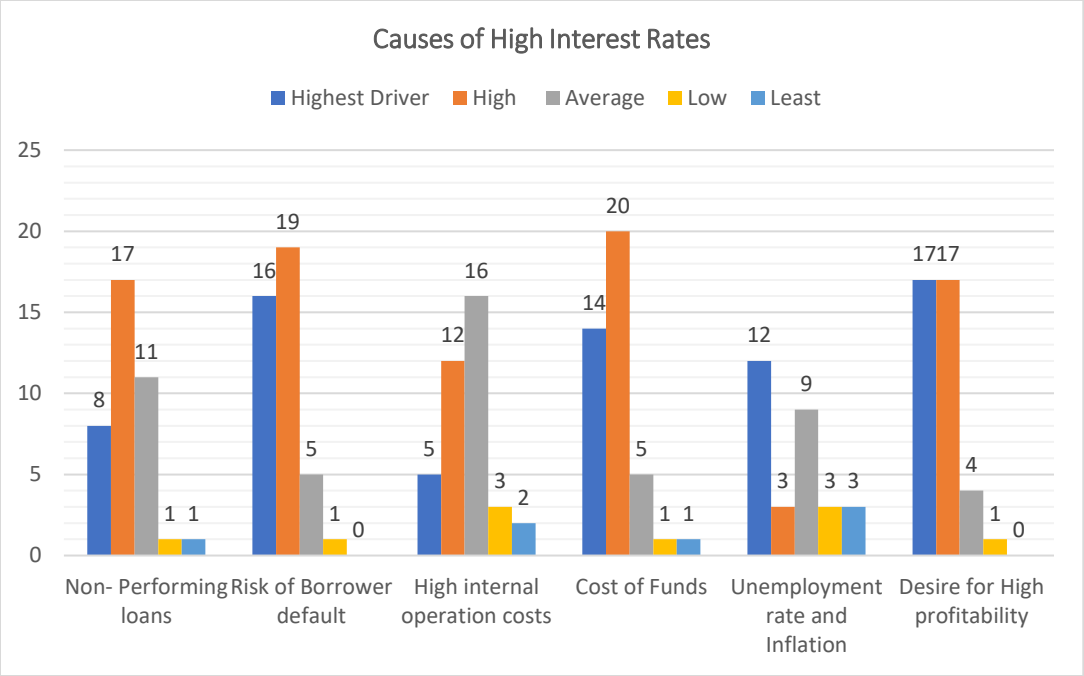
Table 6: Do high interest rates lead to loan defaults

S/N	Outcome Response	No. of Respondents	Proxy
	Strongly Agreed	59	83%
	Disagreed	12	17%
			100%

Source: Author 2023

The respondents were asked whether high interest rates led to loan defaults, 59 of them strongly agreed and 12 disagreed.

Figure 5: Factors influence high interest rates in MFIs

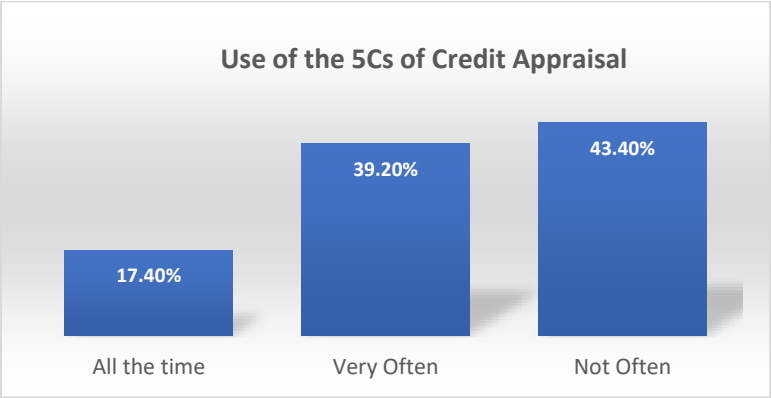


Source: Author 2023

The respondents were provided with an overview of some of the reasons for high interest rates in MFIs. The responses ranked desire for high profitability to have the highest tally, seconded by cost of funds and risk of borrower default. Other drivers such as high internal operational costs, non-performing loans, unemployment and inflation ranked lower.

The second objective of the study was to assess the association between loan appraisal and high default rates in selected microfinance institutions in Lusaka. The following tables and figures were used to adequately measure and present the relation between the two variables.

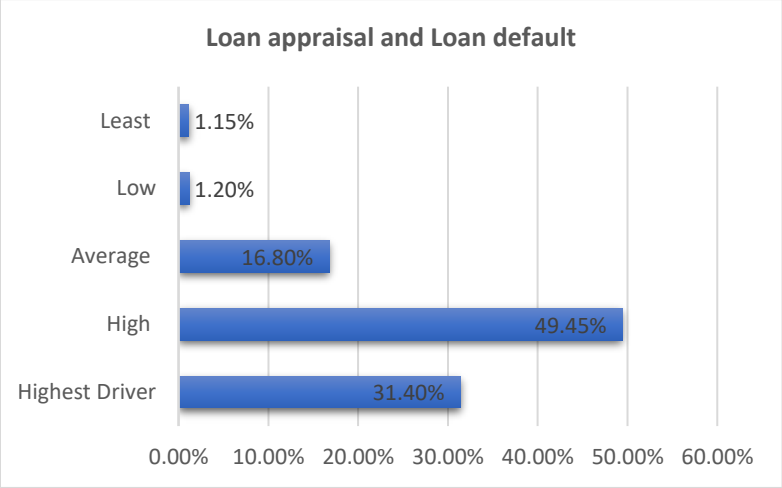
Figure 6: Use of the 5 Cs of credit appraisal (Capacity, Character, Collateral, Capital, Condition) to scrutinize loan applications



Source: Author 2023

Respondents were asked on how often the MFIs loan officers used the 5C's of credit appraisal to scrutinize loan applications, the Study revealed that 43.4% indicated that this was not done often, while 39.2% said very often and 17.4% stated it was done all the time.

Figure 7: Does poor loan appraisal lead to high default rates

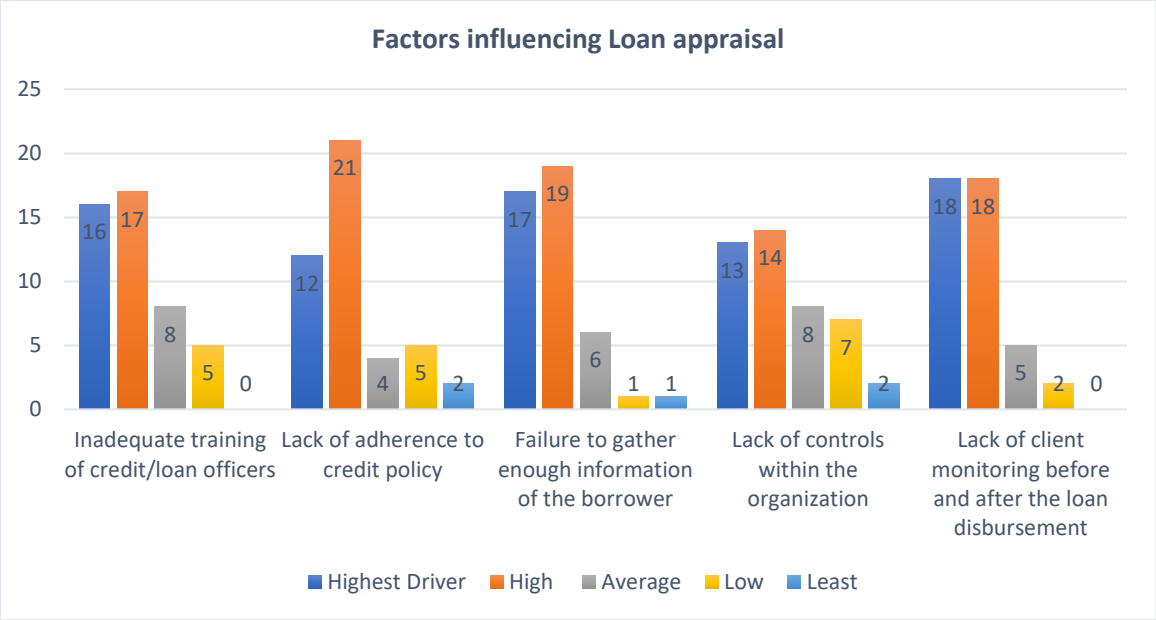


Source: Author 2023

The respondents were asked how much of an influence poor loan appraisal has on loan defaults. The findings indicated that 49.45% and 31.4% expressed the influence to be

high to highest driver respectively, while 16.8% considered the influence to be average. 1.2% and 1.15% considered the influence low to least contributor of loan defaults respectively.

Figure 8: Factors influencing Poor Loan Appraisal

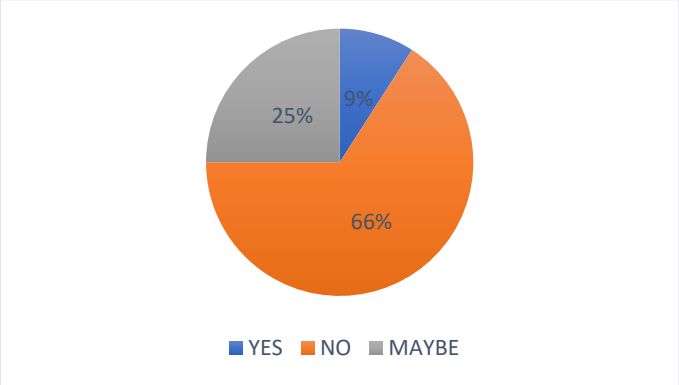


Source: Author 2023

The respondents were presented with some variables influencing poor loan appraisal and the results were summarized as follows. The highest driver of poor loan appraisal was recorded as lack of client monitoring before and after loan disbursement. Lack of adherence to credit policy and failure to gather enough information about the borrower both ranked second. Lack of controls within the organization was ranked as an average driver while inadequate training of loan and credit officers was recorded as the least contributor to poor appraisal.

The third objective was to investigate the link between loan payment training and high default rates. The following results illustrated an investigation between loan payment training and loan defaults.

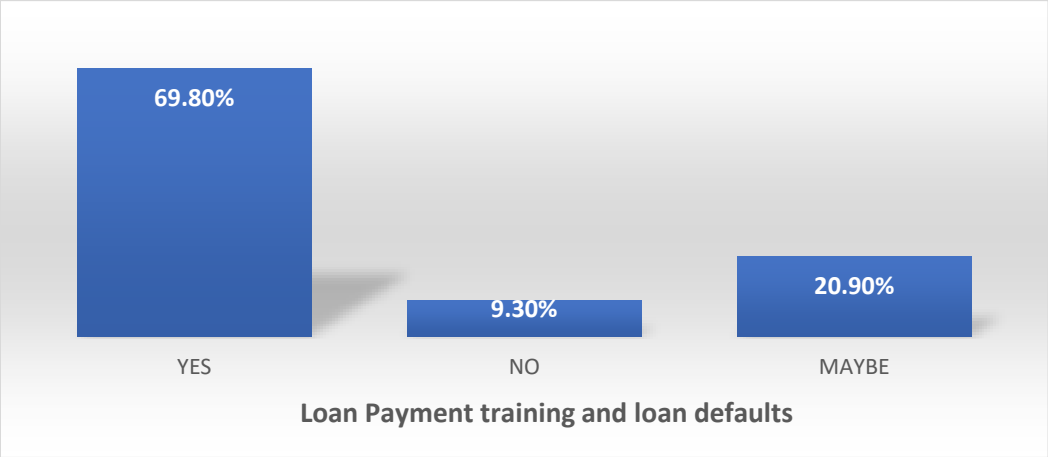
Figure 9: Do MFIs conduct any training for borrowers regarding managing their debt and loan repayments?



Source: Author 2023

From figure 9 above, it can be observed that 66% of the MFIs are not conducting any training around borrowers on their loan repayments. 9% do conduct training and 25% of the respondents stated they were uncertain.

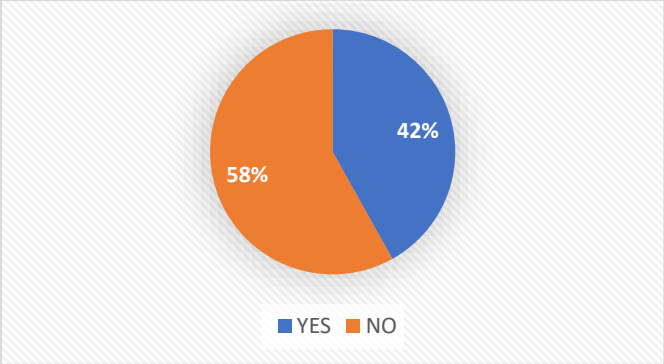
Figure 10: Does loan payment training for individual clients and SMEs reduce the incidents of loan default?



Source: Author 2023

The Study revealed that 69.8% of the respondents stated that the inclusion of loan payment training from MFIs can or has a chance of reducing the likelihood of loan defaults. 20.9% were uncertain, and 9.3% disagreed.

Figure 11: Are MFIs loan terms and conditions easy to understand and explain to borrowers?



Source: Author 2023

Further the Study indicated that 42% of the loan clients affirmed that the loan terms and conditions were easy to understand while 58% were in contradiction and did not understand the loan terms and conditions.

4.6 Correlation Analysis and Regression Model Summary

Multiple regression was used as it is the most appropriate tool to compare conditions on the dependent variable while controlling for other variables. The regression coefficients were used to determine the degree of association between the independent research variables and the dependent variable of loan defaults. The predictive element of the model was enhanced by the coefficient of determination. The multiple linear regression model was used to analyze and establish the significance of the independent variables on Loan defaults.

$$Y= \beta_0+ \beta_1X_1+\beta_2X_2+ \beta_3X_3 + \varepsilon$$

Where: Y is Loan defaults, X_1 is interest rates, X_2 is loan appraisal, X_3 is loan payment training, β_0 is the regression constant or intercept, β_1, β_2, and β_3 are the unknown parameters (regression coefficients), ε is the error term. Primary data from the respondents was coded and used for the Regression model analysis. The model was computed and summarized with the help of Microsoft excel as indicated in table 8 below.

Table 7: Regression Model Summary

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.400572893
R Square	0.160458643
Adjusted R Square	0.122297672
Standard Error	1.064518254
Observations	70

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	3	14.29457282	4.764858	4.204784095	0.008768389
Residual	66	74.79114146	1.133199		
Total	69	89.08571429			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*
Intercept	1.925838081	1.040216522	1.851382	0.068589135	-0.151021214
Interest Rates	0.626170023	0.19832389	3.15731	0.002400822	0.230203601
Loan Appraisal	-0.300477355	0.178351396	-1.68475	0.096760533	-0.656567406
Loan Payment training	0.099668805	0.100849631	0.988291	0.32661944	-0.101683979

Source: Author 2023

Multiple R

The multiple correlation coefficient (R) measures the strength and direction of the linear relationship between the dependent variable and all the independent variables together. In this case, it's approximately 0.401, indicating a positive correlation as presented in the Table above.

R Square

The R Square ($R^{2)}$ represents the proportion of the variance in the dependent variable that is predictable from the independent variables. In this case, approximately 16% of the variance in the dependent variable is explained by the independent variables. The R^2 is low implying that there maybe additional factors influencing the dependent variable that were not accounted for in the analysis.

Adjusted R Square

Adjusted R^2 adjusts the R^2 for the number of predictors in the model. It penalizes for adding irrelevant predictors. The adjusted R^2 of 12 % as given by the Table above is lower than the R^2, which might indicate that not all predictors are contributing significantly.

Standard Error: 1.065

The standard error of the regression (or standard error of the estimate) represents the average distance that the observed values fall from the regression line. It's a measure of the variability of the actual values from the predicted values. The Table above shows that standard error was 1.065. This explains a reasonably accurate prediction of the dependent variable with relatively small deviations between the observed values and the predicted values.

ANOVA (Analysis of Variance):

The ANOVA Table breaks down the variance in the dependent variable into components due to regression, and components due to residual (unexplained) variation.

The F-statistic is 4.205 with a p-value of 0.009, suggesting that at least one of the independent variables is statistically significant related to the dependent variable.

Coefficients

The coefficients Table provides information about each predictor variable.

Intercept: The intercept term is 1.926 with a p-value of 0.069. The confidence interval suggests that the true intercept lies between -0.151 and 4.003.

Interest Rates: For every unit increase in interest rate while holding other predictor variables (loan appraisal and loan payment training) at constant, loan default will increase by the factor value of (0.626). Additionally, the interest rate has a corresponding p-value of 0.002 which is less than the reference p-value of 0.05, it can be argued that interest rate was statistically significant at 95% confidence interval.

Loan Appraisal: For every unit change in loan appraisal while holding other predictor variables (interest rate and loan payment training) at constant, loan default will change by the factor value of (-0.300). Additionally, the loan appraisal has a corresponding p-value of 0.0967 which is bigger than the reference p-value of 0.05, it can be argued that loan appraisal was not statistically significant at 95% confidence interval.

Loan Payment Training: For every unit change in loan payment training while holding other predictor variables (interest rate and loan appraisal) at constant, loan default will change by the factor value of (0.0996). Additionally, the loan payment has a corresponding p-value of 0.326 which is bigger than the reference p-value of 0.05, it can be argued that that loan appraisal was not statistically significant at 95% confidence interval.

CHAPTER FIVE: DISCUSION OF FINDINGS

This Chapter discusses the findings that were evaluated and presented in the preceding chapter to address the specific objectives investigating the factors influencing high default rates in the selected microfinance institutions of Lusaka district. The discussion is organized to interpret key patterns, trends, and relationships discerned from the data, shedding light on the significance and implications of the results. Each sub-section scrutinizes specific aspects of the findings, drawing connections to existing literature, and the broader context of the study.

Through this exploration of the findings, the researcher endeavors to contribute to the existing body of knowledge within the field, offering a deeper understanding of the phenomenon under investigation. Additionally, the discussion addresses any unexpected outcomes or deviations from anticipated patterns, fostering a comprehensive and insightful interpretation of the research outcomes.

5.2 Respondent demographics

5.2.1 Age

The study sought to appreciate the dynamics of the respondents hence, the consideration to undertake the demographics on the respondents. Consequently, the least common starting age for the respondents was 21 years of age. This explains the scale starting from 21-30 years. The findings revealed that 51 years and above was the last parameter measure to ensure inclusivity as well as removing bias from the sample. Different age groups often exhibit distinct consumer behaviors and preferences. This also helps understand the composition of a population. From the data analysis it was clear that there were more borrowers between 31- 40 years and 41 – 50 years. This could explain increasing household demand and the need to supplement obligations with microcredit loans.

5.2.2 Gender

Further, on the dynamics of gender for the respondents, the results showed that 77% were male and 23% were females. The study had more males taking up the micro loans as they exhibited a higher appetite for risk than the females. In addition, the female respondents did not feel comfortable divulging personal finances even though the survey had assured confidentiality and anonymity.

5.2.3 Credit and Loan officers Work Experience

The study results from the data collected showed that 60% of the Credit and loan officers had four or more years of work experience. This distribution is representative of the research results to have objectivity. The experience of the credit and loan officers clearly contributed to the richness and depth of the data collected, as well as expertise to the study.

5.2.4 Type of Loans

The Study showed that 90% of the respondents had taken out personal loans. From the analysis and information gathered, these loans are easier to access as they rely on the clients' salary and are disbursed much quicker. In addition, the personal loan only required collateral to be provided for the borrowing above a certain amount.

5.3 Influence of high interest rates on Loan Defaults

Table 3 and 4 demonstrate the trends in NPL and loan interest rates in MFIs which is consistent with empirical investigations showing a positive correlation between elevated interest rates and loan defaults within the Microfinance sector (Fofack, 2005; Addae-Korankye, 2014; Makorere, 2014). A study by Rosenberg et al. (2009) identified four principal components reflected in microfinance interest rates, namely operating expenses, cost of funds, loan loss expenses, and profit. Notably, operating costs constituted approximately 60% of the overall Microfinance Institution (MFI) expenditures.

To delve deeper into the factors contributing to high interest rates in MFIs, the researcher conducted a thorough analysis of primary data. The findings highlighted the primary drivers, with a notable emphasis on the desire for high profitability, ranking highest with a tally of 17. This was closely followed by two significant drivers, namely the cost of funds and the risk of borrower default, both garnering a tally of 20 each. High operating costs were rated at an average level (16), while factors such as unemployment rate, inflation, and the impact of non-performing loans emerged as the least influential drivers, each registering a tally of 3.

Moreover, the study unveiled that 83% of the respondents strongly concurred that elevated interest rates exert a substantial influence on loan defaults, with a minority of 17% expressing disagreement. This underscores the critical need for collaborative efforts between MFIs, regulators, and policymakers to formulate effective solutions, rendering borrowing at the micro level more affordable for low-income earners. Such initiatives are imperative for fostering the growth and sustainability of the microfinance sector. Consequently, it becomes incumbent upon stakeholders to devise strategies that promote financial inclusion and address the challenges posed by high interest rates in the pursuit of a robust microfinance landscape.

5.4 Association between Loan appraisal Processes and Loan Defaults

Microfinance Institutions' (MFIs) utilization of the 5C's model of credit is paramount in evaluating potential borrowers, as explained by Aliija and Muhangi (2015). This model encompasses Capacity, Character, Collateral, Capital, and Condition, each representing a crucial aspect in assessing the creditworthiness of an individual. The meticulous analysis of these components is essential, as any lapse in scrutinizing the 5Cs might elevate the risk of loan default. To mitigate this risk, MFIs establish comprehensive policies and procedures, tailoring the weight assigned to each component based on factors such as lending methodology, loan size, and client history.

In gauging the effectiveness of MFIs in employing the 5Cs of Credit for application scrutiny, survey responses unveiled that only 17% affirmed its frequent utilization, while a significant 43% believed that MFIs did not employ this model regularly. Recognizing

that appraising clients is a pivotal step in the loan cycle, involving a thorough screening process to ascertain a borrower's willingness and ability to repay, underscores the critical importance of an effective credit evaluation framework (Aliija and Muhangi, 2015).

Delving deeper, the study explored whether poor loan appraisal contributed to high default rates. A striking 80.5% of respondents strongly believed that inadequate loan appraisal significantly influenced loan defaults. Within this context, the investigation identified key variables contributing to suboptimal loan appraisal. Foremost among them was the lack of client monitoring before and after loan disbursement, emerging as the primary factor leading to poor loan appraisal. This finding suggests that during the appraisal process, loan officers might overlook crucial borrower characteristics, such as character and capacity, emphasizing the need for enhanced diligence in client evaluation.

Furthermore, the study acknowledged the role of information asymmetry, where borrowers may be reluctant to disclose vital information to lenders, contributing to a potential gap in the appraisal process (Samoei et al., 2017). While other variables, such as non-adherence to policy and insufficient data gathering by lenders, exhibited a lower significance, they were recognized as institutional issues that could be mitigated through the implementation of more stringent measures by MFIs.

Interestingly, inadequate training of credit officers was not identified as a significant contributor to poor loan appraisal, as MFIs appeared to have implemented sufficient measures to ensure that frontline staff possessed the requisite competencies for effective loan scrutiny and disbursement. This underscores the importance of continuous training and development initiatives within MFIs to uphold the standards of credit evaluation practices. In summary, the study highlights the multifaceted nature of factors influencing loan appraisal and default rates, emphasizing the need for ongoing efforts to refine and optimize credit evaluation processes within the microfinance sector.

5.5 The link between Loan Payment Training and High Loan Defaults in the Microfinance Sector

The third objective of the study examined the connection between loan payment training and high default rates within microfinance institutions (MFIs). The results were presented in Chapter 4 to provide a clear perspective on whether MFIs provided training for borrowers on effectively managing their debts and loan repayments.

The Study presents that 25% of respondents expressed uncertainty about the occurrence of such training in MFIs. Conversely, a significant 66% firmly disagreed, unequivocally asserting that no such training was offered to assist loan clients in optimizing the utilization of borrowed funds. In contrast, a modest 9% of respondents concurred with the assertion that MFIs indeed conducted training sessions to aid loan clients in proficiently managing their loans and maintaining a positive payment record.

To further scrutinize the relationship between loan payment training and high default rates, the study sought to analyze whether such training, both for individual clients and Small and Medium Enterprises (SMEs), effectively reduced instances of loan defaults. The results, as depicted in Figure 10, revealed that 69.8% affirmed the positive impact of training in reducing defaults, while 9.3% expressed a contrary opinion, and 20.95% remained uncertain. This aligns with arguments presented in the preceding paragraph, as discussed by Awunyo (2012) and Elhadidi (2018), suggesting that training serves as a mitigating factor in lowering the likelihood of defaults.

In the final phase of investigation, the study aimed to ascertain whether the terms and conditions of loans offered by MFIs were comprehensible and easily explainable to borrowers. The outcomes, as illustrated in Figure 11, indicated that 42% of loan clients affirmed the clarity and ease of understanding of the loan terms and conditions. In contrast, a majority of 58% contradicted this view, asserting a lack of comprehension regarding the intricacies of the loan terms and conditions.

In summary, the study shed light on the perceived absence of loan payment training in a significant portion of MFIs, with divergent opinions on its effectiveness in reducing default rates. Additionally, the comprehension of loan terms and conditions emerged as a noteworthy concern, with a substantial percentage of borrowers expressing difficulties in understanding these crucial aspects of their financial agreements with MFIs. These

findings underscore the importance of enhancing communication and educational initiatives within the microfinance sector to empower borrowers and mitigate the risk of loan defaults.

5.6 Discussion of the Findings from the Analysis of Variance output:

The degree and direction of the linear relationship between the dependent variable (loan default) and all the independent variables (Interest rate, loan appraisal and loan payment training) taken together are measured by the multiple correlation coefficient (R). The correlation coefficient of 0.401 as given in the results above, suggests a favorable correlation.

The overall model has some explanatory power, as indicated by the significant F-statistic in the ANOVA Table. The model explains around 16% of the variance in the dependent variable (loan default). A low R-squared value indicates that there may be additional factors influencing the dependent variable that were not accounted for in the analysis. Interest Rates have a statistically significant positive relationship with the dependent variable. Loan Appraisal has a significant negative relationship and Loan Payment Training does not appear to be a statistically significant predictor in this model.

The R^2 is modified for the number of predictors in the model using adjusted R^2. Incorporating unrelated predictors which are penalized. Since the adjusted R^2 is less than the R^2, it's possible that some predictors aren't making a big difference. Therefore, from the model output, it is evident that loan appraisal and loan payment training had no significant impact on loan default.

The dependent variable's variance is divided into components resulting from regression and components resulting from residual, or unexplained, variation in the ANOVA Table. Admittedly, from the model at least one of the independent variables (interest rate) is statistically significant in relation to the dependent variable, as indicated by the F-statistic of 4.205 and p-value of 0.009.

5.7 Discussion of the Coefficients

Loan default increases by factor value (0.626) for each unit increase in interest rate, while holding other predictor variables (loan appraisal and loan payment training) at constant. The interest rate was also statistically significant at the 95% confidence interval, according to the associated p-value of 0.002, which is less than the reference p-value of 0.05. These results are consistent with findings illustrated by Makorere (2014).

Loan default changes by the factor value of (-0.3004) for each unit change in loan appraisal, while maintaining the same values for the other predictor variables (interest rate and loan payment training). It can also be claimed that the loan appraisal was not statistically significant at the 95% confidence interval because the loan payment has a matching p-value of 0.0967, which is more than the reference p-value of 0.05. This contradicts the findings of (Addae-korankye, 2014; Asongo & Adamu, 2014; Aliija and Muhangi, 2015).

When the interest rate and loan appraisal remain constant, there will be a corresponding unit change in loan default that corresponds to a factor value of (0.0996). Furthermore, the loan payment training associated p-value of 0.326 is greater than the 0.05 reference p-value, suggesting that, at a 95% confidence range, the loan payment training was not statistically significant. Confirming the findings outlined by Agbeko et al (2017).

1.926 is the intercept term, and the p-value is 0.069. According to the confidence interval, the true intercept is thought to be between -0.151 and 4.003. The meaning is that if all independent variables (interest rate, loan appraisal and loan payment training) are held at constant, the loan default will increase by the value of (1.926).

CHAPTER SIX: CONCLUSION AND RECOMENDATIONS

The concluding chapter contextualizes these findings by examining past research and theoretical frameworks to underscore the primary contributions of the study to the existing literature on the subject. Organized according to the sequence of the research objectives outlined in Chapter 1, the conclusions also incorporate recommendations, encompassing both policy suggestions and guidance for future research, derived from the insights gained during the study.

6.1 Conclusions of the Study

The Study investigated factors influencing high loan default rates in selected microfinance institutions in Lusaka District. The institutions representative of the sample were Agora Microfinance, Foundation for International Community Assistance (FINCA) Zambia and Unifi. The study applied theories such as the Concept of Non-performing Loans, Theory of Asymmetric Information, Moral Hazard, Adverse Selection, and Patronizing and Die Another Day Effects Theories. These theories were ideal in identifying various macro and institutional specific factors that may explain and contribute to the problem of loan defaults. The purpose of the study was to explore the relationship of the various factors to defaults by categorizing them through three objectives.

The analysis was structured around three main objectives. Firstly, the study examined the influence of interest rates on high default rates, identifying factors such as the impact of Non-performing loans on pricing new loans, risk of borrower default, high internal operating costs, cost of funds, unemployment rate, inflation, and desire for profit. The results highlighted that high interest rates, driven primarily by the desire for profit, cost of funds, and risk of borrower default, had a significant positive correlation with loan defaults.

Secondly, the association between loan appraisal and high default rates was assessed, with the 5Cs of credit (collateral, capacity, character, condition, and capital) serving as a framework. The findings indicated that the lack of client monitoring before and after loan

disbursement was the primary driver of poor loan appraisal, and a strong negative relationship was observed between loan appraisal and defaults. Enhancing loan appraisal techniques could potentially mitigate the risk of defaults.

Lastly, the study investigated the link between loan payment training and high default rates, finding that client repayment training had no significant impact on loan defaults. Despite efforts to improve repayment rates through training interventions, consistent failures were observed

To overcome and curb this prevalent increasing trend of nonperforming loans, some recommendations have been provided.

6.2.0 Recommendations

Client Monitoring and Supervision

Robust monitoring mechanisms and effective processes to control client's utilization of disbursed funds is key in ensuring the surge of NPLs is kept under control.

Extended Loan Tenures

Extending loan periods to accommodate high interest rates in times where rates are on the rise is vital in managing the client's debt. This will allow loan repayments to significantly reduce and to be within reach of the clients' affordability to service the debt.

Loan recovery methods

From a management perspective, vigilance in loan recovery is paramount, with no room for relaxation. Allowing a loan to become time-barred exacerbates the challenge, as the likelihood of fund recovery diminishes with the prolonged age of the loan. Therefore, any form of laxity should be strictly prohibited. In addressing this issue, the engagement of a recovery agency becomes a crucial and paramount concept.

Policy changes to help reduce cost of operations for MFIs

There is need for the Central Bank of Zambia and other stakeholders to consider incentives and policy adjustments to reduce lending interest rates and cost of operations for microfinance institutions.

6.2.1 Recommendations for future research

Write an introductory paragraph

(1) An area for future research would be to carry out an investigation into whether some clients are using microcredit to finance their lifestyles or habits such as gambling. Ease of access to funds via mobile platforms and other online applications may create elements of misappropriation of funds to ventures such as consumption and gambling.

(2) Another avenue of interest for other research would be to assess how inflation affects the performance of MFIs concerning non-performing loans.

(3) Assessing the effectiveness of Integrating mobile platforms in managing disbursements and collections of micro credit can be another area of interest for growth of the industry and financial inclusion.

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APPENDIX

ETHICS COMMITTEE APPROVAL

UNIVERSITY OF LUSAKA

SCHOOL OF POSTGRADUATE STUDIES

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UNILUS-RESEARCH ETHICS COMMITTEE

Ref no: FWA00033228-1512/23

Date: 10th December 2023

STUDENT NAME: EMMANUEL C. MWENYA

An Analysis of factors influencing high default rates in Microfinance institutions in Zambia: A case study of Lusaka Province

The above research was submitted to the research ethics committee for review. The study has no major ethical problems and is approved subject to the following:

1. The study cannot be changed without express permission of the UNILUS research ethics committee.

2. Approval from the necessary authority should be sought.

Congratulations and the committee wishes you success in your work.

Professor Kasonde Bowa
MSc(Glasgow),M.Med(UNZA),FRCS(Glasgow),FACS,FCS,DPH(LSTMH),MPH(UCL)
Chairman- UNILUS REC
Professor of Urology and Consultant Urologist
Deputy Vice-Chancellor – Research and Innovation
Executive Dean - School of Medicine and Health Sciences

LETTER OF INTRODUCTION

UNIVERSITY
of
LUSAKA

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All correspondence should be addressed to the Vice Chancellor

08th September, 2023

TO WHOM IT MAY CONCERN

Dear Sir/Madam,

RE: DATA COLLECTION REQUEST: AN ANALYSIS INTO THE FACTORS CONTRIBUTING TO HIGH DEFAULT RATES IN THE MICROFINANCE INSTITUTIONS: A CASE OF LUSAKA PROVINCE

This letter serves to introduce **EMMANUEL CHINTABAMBA MWENYA** Identity Number **MBAFIN18213345** as a bona fide student of the University of Lusaka pursuing Master of Business Administration in Finance.

EMMANUEL CHINTABAMBA MWENYA is required to submit a Dissertation as part of the requirements for the award of a Master of Business Administration in Finance and therefore seeks to collect data from your institution. His Dissertation title is stated above. The data will be used solely for Academic purposes and a copy of the final document can be availed to you upon request.

Any assistance given to him will be greatly appreciated.

Yours faithfully,

Mwamba Chanda (Mr.)
DEPUTY REGISTRAR

UNIVERSITY OF LUSAKA
REGISTRAR POSTGRADUATE
08 SEP 2023
P.O. BOX 36711,
LUSAKA.

Passion for Quality Education! Our Driving Force

QUESTIONNAIRE

Dear Respondent,

This survey aims to infer data on the research title: **An investigation of factors influencing loan defaults in selected Microfinance institutions in Lusaka District.** The responses to this survey will be kept completely anonymous and confidentiality will be assured as data will be collected and used solely for the academic research purposes intended. For purposes of this survey, Microfinance institutions will be referred to as MFIs.

SECTION A

The objective of this section is to receive information from the respondents for purposes of analyzing the influence of interest rate on high default rates in microfinance sector in Lusaka.

1. In your professional opinion, what are the average default rates for the microfinance sector? Select from options below.
    - 5-10%
    - 10-15%
    - 15-20%
    - Above 20%
2. What is your perception of the current interest rates in MFI. Select one option only
    - Very High
    - High
    - Within acceptable
    - Low
3. What is your perception of the current loan periods (loan tenure) for MFIs
    - Too Short
    - Adequate
4. In your opinion do high interest rates lead to loan defaults? Select one option only
    - Highest driver of loan defaults
    - high driver of loan defaults
    - Average driver of loan defaults
    - Lower drivers of loan defaults
    - least driver of loan defaults

5. What are the main causes of high interest rates in microfinance institutions. Please use this key: 5 = Highest driver, 4 = high driver, 3 = Average driver, 2 = Lower drivers, 1 = least driver
    - Non-performing loans
    - Risk of borrowers likely to default
    - High Internal operational costs
    - Cost of funds
    - Desire for high profitability
    - Unemployment rate and inflation

SECTION B

The objective of this section is to gather information on the association between loan appraisal and high loan default rates in microfinance institutions in Lusaka.

6. How often do MFIs use the 5 Cs of credit appraisal (Capacity, Character, Collateral, Capital, Condition) to scrutinize loan applications?
    - All the time
    - Very often
    - Not often
7. In your professional opinion, does poor loan appraisal lead to high default rates. Select one option only.
    - Highest driver of loan defaults
    - high driver of loan defaults
    - Average driver of loan defaults
    - Lower drivers of loan defaults
    - least driver of loan defaults
8. Are MFIs incorporating mobile and online platforms to administer loan disbursements
    - YES
    - NO
9. How effective are the platforms mentioned in Q8 in loan appraisal?
    - Very effective
    - Effective
    - Slightly effective
    - Inadequate
10. What are the main causes of poor loan appraisal in microfinance institutions. Please use this key: 5 = Highest driver, 4 = high driver, 3 = Average driver, 2 = Lower drivers, 1 = least driver
    - Inadequate training of credit/loan officers
    - Lack of adherence to credit policy
    - Failure to gather enough information of the borrower
    - Lack of controls within the organization

- Lack of client monitoring before and after the loan disbursement

SECTION C

The objective of this section is to gather information to investigate the link between loan payment training and high defaults in the microfinance sector.

11. Do MFIs conduct any training for borrowers regarding managing their debt and loan repayments.
    - YES
    - NO
12. If Answer to Q11 is yes, how often are the trainings done?
    - Monthly
    - Quarterly
    - Semi- Annually
    - Yearly
13. In your professional opinion, does loan payment training reduce the incidents of loan default?
    - YES
    - NO
14. Are the microfinance institution's loan terms and conditions easy to understand and explain to borrowers?
    - YES
    - NO
15. Are loan payment training programs on helping borrowers manage their debts cost effective
    - YES
    - NO

AN INVESTIGATION OF THE FACTORS INFLUENCING HIGH DEFAULT RATES IN THE SELECTED MICROFINANCE INSTITUTIONS OF LUSAKA DISTRICT, ZAMBIA

by Mwenya - Emmanuel Chintabamba MBAFIN18213345

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