CAUSES OF DEFAULT IN MICROFINANCE PROGRAMS

(A Case Study of DECSI, Mekelle Town)

By

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A Project work Submitted in Partial Fulfillment of

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Under the Guidance of

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CAUSES OF DEFAULT IN MICROFINANCE PROGRAMS

(A Case Study of DECSI, Mekelle Town)

By

Teshale Birhanu

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Declaration

I**,** Teshale Birhanu, here by declare that the project work entitled "**Causes Of Default In Microfinance Programs: a case study of DECSI, Mekelle Town**" Submitted by me in partial fulfillment of the requirements for the award of the degree of MBA in Finance to the College of Business and Economics, Mekelle University, through the Department of Management, is original work carried out by my self. The matter embodied in this project work has not been submitted earlier for award of any degree or diploma to the best of my knowledge and belief.

Name of the student: Teshale Birhanu

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Signature & date _____

CERTIFICATION

This is to certify that Teshale Birhanu has carried out his project work on the topic entitled "**Causes of Default in microfinance programs: a case study of DECSI, Mekelle Tow**n". This work is original in nature and is suitable for submission for the award of the Degree of MBA in finance.

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Co-Advisor: Mr. Abadi Afera (Lecturer)

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Abstract

This study endeavors to investigate causes of default in microfinance programs. The problem identified was that microfinance programs perform poorly because of slow repayment and high default rates. Hence, it was important to establish if these limitations prevailed in the DECSI schemed by determining the average repayment delay and default rate and the causes of the observed trends. In order to address those issues, the researcher used questionnaires and conducted interview with the relevant company managers and referred secondary data sources. The collected data and information were compiled and analyzed for possible indications of problem areas. The results reveal that the board has an average repayment delay of 31.4 percent. The default rate increased over the review period and averaged 57.41 percent as well. The main cause of default was found to be poor business performance, in terms of low profitability or business losses. Loan diversion to unprofitable uses, domestic problems, numerous dependents, and tenancy problems were other factors that caused loan default. The inability to deal with slow repayment and default also was a matter of concern. The study found that operations and maintenance resources are too small to facilitate follow-up on loan usage, and that management information systems are manual. Such systems do not facilitate early detection of potential defaulters and slow-repaying borrowers. Further, nonprosecution of defaulters and the perception that government credits are grants rather than loans encourage default. The board is also understaffed, and key personnel have limited computer skills—factors that cause delays in processing and disbursing loans. Study recommendations are geared largely toward improving the board's capacity to manage the loan program. The board should computerize its management information system and build staff capacity in computer applications. Staff strength should be increased and sufficient operations and maintenance budgets should be provided. Processes should be worked out to identify borrower capacity and any obligations that may interfere with repayment. Finally, the board should intensify recovery of outstanding balances from defaulters through increased borrower follow-up.

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Acronyms

AEMFI	Association of Ethiopian Microfinance Institutions.
ASA	Association for Social Advancement
CBE	Commercial Bank of Ethiopia
DBE	Development Bank of Ethiopia
DECSI	Dedebit Credit and Saving Institution
ERS	Economic Recovery Strategy for Wealth and Employment Creation
FINCA	The Foundation for International Community Assistance
MDGs	Millennium Development Goals
MEDaC	Ministry of Economic Development and Cooperation
MFDR	Micro Finance Development Report
MFI	Micro finance Institution
MTDP	Market Towns Development project
NGO	Non-Governmental Organization
POCSSBO	Project Office for the Creation of Small–Scale Business Opportunities
RCST	REST Credit Scheme in Tigray
REST	Relief Society of Tigray
SMEs	Small and Medium Enterprises
TK	Total Capital
UN	United Nations
UNDP	United Nations Development Program

CHAPTER I

Introduction

1.1 Background

1.1.1 General

According to Dejene Aredo (1993), (as cited in Jemal Abafita, 2002), Ethiopia is one of the lowest income countries in the world. Its economy, which is mainly dependent on agriculture, has been hit by several internal and external shocks. Devastating wars, frequent draughts, high population growth, distorted investment environment, volatile primary product prices, etc have been some of the shocks the economy has been experiencing. These and a lot other factors resulted in the decline of the economy as a whole, while the living conditions of the population have been continuously deteriorating. Specifically during the Derge period (1974 -1991) the Ethiopian economy was performing very poorly under a socialist oriented command economy.

After the fall of the Derge, however, the government of Ethiopia has taken several measures to reverse the economic decline and worsening poverty situation in the country. According to the report by MEDaC (1999) the Ethiopian economy has registered a recovery in economic performance since the introduction of economic reform program after a period of stagnation and decline for nearly two decades.

Although the reform programs and policy changes resulted in economic recovery and growth in GDP, the achievement towards eradication of poverty was not satisfactory. This is because of the fact that without ensuring adequate private sector activities, thereby creating higher employment opportunities, it is difficult to reduce the existing unemployment problem in the country (Berhanu, 1999).

The unemployment problem in the country has forced a lot of people to join the informal sector of the economy. This sector of an economy is said to have a significant role in the creation of jobs and income generation for quite a large proportion of the population in a developing country like Ethiopia. According to a paper compiled by the Ministry of Trade and Industry (cited in Berhanu, 1999) the number of people earning their livelihood from the informal sector activities and small scale manufacturing industries is eight times larger than those engaged in the medium and large scale industrial establishments (Mauri A,1997).

Micro credit to farmers and artisans needs to be routed through some voluntary agencies preferably of farmers and/or artisans. This has been the findings of almost all research studies undertaken in this regard particularly in Asia. The reason is very obvious. Most of the farmers and artisans in rural areas do not possess necessary skills and drive to transform themselves as viable entrepreneurs. They lack in technical knowledge and market intelligence. It is, therefore, necessary that they should get support from within by grouping themselves and also by joining with others who have necessary expertise and leadership to become better entrepreneurs (Souren Ghosal ,2009).

A large literature in development economics examines the optimal design of credit contracts when clients are unable to provide collateral and there is limited liability. However, this literature has paid scant attention to a central feature of the typical credit contract offered by microfinance institutions in a group setting (Armendariz and Morduch 2005).

According to Daley-Harris (2006), MFIs are increasingly a central source of credit for the poor in many countries. The typical repayment schedule offered by a MFI consists of weekly repayment starting 1-2 weeks after loan disbursement. The weekly repayment amount is usually calculated as the principal and interest due divided by the number of weeks until the end of term and payments are generally collected in a group meeting led by the MFI loan officer. Weekly collection of repayment installments by bank personnel is one of the key features of microfinance that is believed to reduce default risk in the absence of collateral and make lending to the poor viable. On the other hand, it also

dramatically increases MFI transactions costs, thereby limiting the set of loan sizes and client types that are profitable under this model.

Despite the sharp disjunction in the predictions offered by the rational economics model and the behavioral model, evidence on whether repayment frequency influences default rates in microfinance remains limited. Armendariz and Morduch (2005) report anecdotal evidence from Bangladeshi microfinance providers suggesting that microfinance contracts with less frequent repayment saw higher client default. Mcintosh (2007) exploits spatial variation in the repayment schedule associated with microfinance contracts offered by FINCA in Uganda to provide a more formal analysis. In 2000, FINCA offered clients in the east and north of the country the option to elect (by a unanimous vote) to change from the standard weekly repayment practice to repaying the loan every other week. Relative to weekly repayment schedule, groups which opted for the fortnightly weekly schedule saw lower drop-out and increased repayment. While supportive of the predictions from economic theory, the fact that clients chose their repayment schedule makes it possible that "better" clients self-selected into the fortnightly repayment schedule.

1.1.2 Credit Policy in Ethiopia

The formal and informal financial sectors are the principal sources of finance for any investment or business that can be undertaken at micro, small-scale and large-scale levels in an economy. The major financial institutions in the formal financial sector in Ethiopia are the Commercial Bank of Ethiopia (CBE), the Development Bank of Ethiopia (DBE), and other Private Banks. As Dejene (1993) noted, because of the elaborate paper work, bureaucratic lending procedures and stringent collateral requirements, the institutions do not deliver credit as and when needed. Moreover, they operate at high transaction costs.

During the imperial regime, the banking sector was partly owned by foreigners and the lending policy was mainly oriented to financing foreign enterprises and wealthy clients

while domestic small borrowers were rationed out and forced to seek credit from informal finance (Mauri, 1997).

During the Derg regime (1974-1991), all financial institutions were nationalized and credit was mainly channeled to public enterprises, state farms and cooperatives. The provision of credit was not based on economic rationality but entirely on government preference. The private sector was marginalized. The discrimination against the private sector was not only in credit access but also in interest rate, which was for instance 9% for private sectors as opposed to 6% for public industrial enterprises since July 1986 (Itana, 1994).

Abreham (2002), as cited in Jemal Abafita, noted that with the downfall of the Derge, the private sector got equal access to credit with other sectors; banks were also given autonomy to decide by themselves based on purely commercial criteria and establishment of private banks and insurance companies was permitted. As a result, loan disbursed to the private sector, which was 49% in 1992/93, rose considerably and reached 87.7% in 2000/01. In fact there is still unsatisfied demand for credit from this sector of the economy due to inability to meet banks' lending requirements.

As Solomon (1996) noted, the banks serve big businessmen and disregard poor households as bankable. Many small, creditworthy businessmen, with their viable investment ventures, are denied access to institutional credit because they couldn't afford the required collateral. He also indicated that, "Overall; the prevailing operation of the formal financial institution in many low-income countries such as Ethiopia is inefficient in providing sustainable credit facilities to the poor." Regarding delivery of financial services access to institutional credit was very limited in Ethiopia. Because of this limited access, the majority of the poor get financial services through informal sources like moneylenders, Iqub, Iddr, merchants, friends and relatives, etc. The formal financial sources have not been interested in delivering credit to the poor. Even if the banks in the country, which are part of the formal financial sources decide to give credit to the poor (as in the case some banks have been forced to do so during the Derge regime) their outreach was also very limited for long. Thus, delivering financial services to the poor

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requires an innovative targeting deign and a mechanism of credit delivery that helps identify and target only the poor who can take the initiative and sustain productive use of loans.

In recent years, the informal and semi-formal lending institutions (such as Iqub, Iddir, moneylenders etc.) are becoming the dominant and important sources of finance for poor households in Ethiopia. According to Dejene (1993) these two institutions account for 81% of the agricultural credit.

Currently, the establishments of sustainable and profitable microfinance institutions that serve large number of poor households have been a prime component of the new development strategy of Ethiopia (Wolday, 2000). NGOs have also been directly funding microcredit activities as part and parcel of poverty alleviation.

Although provision of credit to rural agricultural household for purchase of agricultural inputs and tools has since long been practiced in Ethiopia, credit schemes targeted at the urban or rural poor were non-existent until recently. Since the 1970s; however; some NGOs have been providing credit to poor households in some parts of the country, side by side with activities like delivering relief and development services (MFDR, 2001; Mengistu, 1997).

Wide scale micro financing begun in 1990, following the credit agreement signed between the Ethiopian government and the IDA. The credit program was an urban micro financing scheme that aimed at financing the Market Towns Development Project (MTDP), whose actual operation begun in 1994 (Mengistu, 1997).

Since microcredit delivery and saving mobilization in Ethiopia are being carried out by NGOs, government departments, cooperatives and others in a fragmented and inconsistent way, the government took the initiative to establish a regulatory framework in order to facilitate sound development of the microfinance industry. Accordingly, proclamation No. 40/1996 was enacted to provide for the licensing and supervision of the business of micro financing by empowering the NBE to license and supervise them (MFDR, 2000).

1.1.3. An Overview of DECSI /the Study Area/

Twenty-seven MFIs have been licensed by the NBE and started delivering microfinance services since the issuance of this proclamation. These MFIs aim at poverty alleviation through targeting specific groups (reaching the poor) and group based lending. In a short period of time the MFIs have managed to reach a sizable portion of the rural and urban poor, and in so doing have gained significant experience (MFDR, 2000). One of the MFI so established is Dedebit Credit and Savings Institution (DECSI for short) which is operating in the Tigray Regional State of Ethiopia.

As to the findings in the early 1990s, financial services at the county level at large and in Tigray region were very insignificant even in urban areas let alone to cover the rural areas. Considering such phenomenon and looking into the series poverty problems prevailing among the major portion of the population, Relief Society of Tigray (REST) started crediting the poor rural people targeting to arrest poverty prior to the 1990s. The good result of the credit services of REST and the seriousness of the poverty of the

people gave result for the birth of Dedebit Credit and Saving Institution (DECSI) and served for few years.

DECSI was registered as a Share Company in 1997 based on the proclamation of the National Bank of Ethiopia. Since then, DECSI has been mainly working widely in rural and urban Tigray for the last 15 years. As indicated on the project proposal document of the rural credit scheme in Tigray, the main objectives of the scheme were:

- To reverse the age-old circle of "low income, low saving, low investment, low income" into an expanding system of "high income, high saving, high investment, high income" through the provision of credit, technical advice and skill training;

- To eliminate exploitation by money lenders;

- To create opportunities for self employment for the unutilized and under utilized human resource; and

- To empower the disadvantage groups.

The organization is owned and controlled by its stakeholders, comprising REST, Tigray Women's Association, Tigray Farmers' Association, Tigray Youth Association, and the regional government. As the end of 2002, the organization had more than 100 sub branches, which were grouped under nine branch offices and one head office. The sub-branch is the basic organizational and operational unit. That is, all loans are processed, approved, disbursed, and follow-up at this level along with the mobilization of savings and deposit withdrawal services (AEMFI.2000)

Table 1.1. Maximum Loan Size and Loan Term

Type of Loan Products	Maximum loan size (Birr)	Maximum loan term Per product(Months)
General Loan	5,000	12
Agricultural Loan	5,000	12
Input Loan	350	8
Civil Servant Loan	Five times his/her monthly salary but should not exceed 8000 birr.	24

Source: DECSI Website statistics

Currently, DECSI provides different financial services in the rural and urban areas of Tigray. Loan, savings, and pension services are the main products offered by the institution. The loan product has three forms, which are: regular loan to regular clients; in-group collateral system with a loan size ranges between Birr 500 and Birr 5000. The second loan product is input loan; which is mainly to rural clients in the form of fertilizers and improved seeds. And the third loan product is civil servant loan which is mainly aimed at provision of financial services to the civil servants in the region, especially to those who are in the remote rural area of the region to meet their demand for financial services. The second product type is savings which has two forms, namely: voluntary savings (also called individual saving) and compulsory saving which is also sub-divided in to two categories: group saving and center saving. Pension service is the third product line on which DECSI is engaged i.e. it serves as agent for the social security authority to effect pension payment to the pensioners in the region.

Impacts of DECSI's Programs

- Up to now Birr 4 Billion loan is disbursed out of which Birr 2.8 Billion is given particularly for agricultural production.

- At least 464,622 persons are interacting possessing money.

- To over 281,000 household saving clients, DECSI has played significant role in introducing saving tradition.

- The institution has 2000 employees which created wide employment opportunity in the region.

- Currently DECSI is providing financial services through 115 sub-branches, 8 main branches and 15 microfinance-collateral based branches.

- DECSI is providing fast and efficient financial services to different sectors of agriculture, service, handcrafts, trade and industry.

- It has also built its own standard offices in major towns of Tigray so that it can facilitate any banking services. (see from www. Decsi.com.et/brochure)

The performance of the institution in terms of outreach and by product type as of December 2008 is quantitatively shown below

Table 1.2. Outstanding portfolios as of December 2008

NO	Type	Outstanding amount in million	No of Clients
1	Regular loan	160,715,862	60,619
2	Rural household package	693,708,445	313,598
3	Urban package loan	52,786,606	21,535
4	Agricultural input loan	5,025,301	38,455
5	Business loan	354,707,268	4,578
6	Housing loan	118,427,777	4604
7	TVET loan	2,196,141	625
8	Cooperative loan	1,498,622	100 groups
9	Micro leasing loan	27,172,771	297
10	Total	459,217,367	464,622
11	Net Saving	397,684,513	281,000

Source: Available at www. Decsi.com.et/brochure

1.2. Statement of the Problem

An overwhelming majority of the world's poor live in the Third World countries. Various approaches have been employed in alleviating poverty of which provision of credit that targets the poor is one. Many are now of the opinion that allowing the poor to have command over resources through credit can contribute towards poverty alleviation.

Gibbons (1992) argues that the best way to do something about poverty is to let the people do their own thing. Nobody will have more motivation to change his situation than the sufferer himself.

It is generally accepted that credit, which is put to productive use, results in good returns. But credit provision is such a risky business that, in addition to other reasons of varied nature, it may involve fraudulent and opportunistic behavior. The lender in the formal financial system is at a disadvantage of information on the borrower's behavior. Fortunately, group based micro financing system that involves peer pressure and joint liability has evolved to counter the problems of a conventional bank that provides a collateral backed credit alienating the poor (Mengistu, 1997).

The performance of most microfinance programs, however, has not been encouraging. Many have been plagued with such problems as high default rates, inability to reach sufficient numbers of borrowers, and a seemingly unending dependence on subsidies. Few of them have lived up to their original objective of "including the excluded" (Bhatt, 1997).

For such MFIs to be successful, they should be sustainable both financially as well as institutionally. On top of sustainability, one has to include developmental effects like income on the target group as core measure of success. For agencies that are involved in the development or in assisting the development of a microcredit institution, it is recommended that profitability and sustainability should be the final goals, and therefore, the only indicators of success (Rudkins, 1994).Although the performance of the MFIs in Ethiopia has been impressive since their establishment, they are experiencing default problems'.

Hunte (1996) argues that default problems destroy lending capacity as the flow of repayment declines, transforming lenders into welfare agencies, instead of a viable financial institution. It incorrectly penalizes creditworthy borrowers whenever the screening mechanism is not efficient. Loan default may also deny new applicants access

to credit as the bank's cash flow management problems augment in direct proportion to the increasing default problem.

Despite its remarkable achievements, there remained several weaknesses in microfinance that need to be improved to ensure its continuous development and successful implementation. A critical aspect of microfinance that needs to be focused on is the risks management aspect. Microfinance is entrapped by various types of risks, such as default risk (Goetz and Gupta, 1995), disaster risks (Kumar and Newport, 2005), currency risk (Lewis, 2005), interest rate risk (Hughes and Awimbo, 2000; Rahman, 2005) and commercialization risk (Micro Banking Bulletin, 2003). This paper focuses on the issue of managing default risk in the specific context of microfinance. Default risk is chosen instead of other type of risks because default risk has severe negative repercussions on the success of microfinance. A series of defaults could lead to liquidity problem in the MFIs and would consequently limit the ability of the MFIs to extend loan to other recipients. As would be revealed later, due to the serious consequences of defaulted loans, the MFIs might resort to various ways to reduce the possibility of default among the borrowers.

It is obvious that many rural credit schemes have sustained heavy losses because of poor loan collection. And yet a lot more have been dependent on government subsidy to financially cover the losses they faced through loan default. But, such dependence will not prove helpful for sustainability. MFIs should rather depend on loan recovery to have a sustainable financial position in this regard; so that they can meet their objective of alleviating poverty. This study endeavors to investigate causes of default in microfinance programs. The problem Identified is that microfinance programs perform poorly because of slow repayment and high default rates. Hence, it is important to establish if these limitations prevail in the DECSI scheme by determining the average repayment delay and default rate and the causes of the observed trends.

1.3. Research Questions

The study tried to answer the following research questions:

1. What are the factors which influence loan default problem in DECSI scheme?

2. How efficient the institution is in the process of screening their clients in a way that will not jeopardize their financial position due to the default problem?

3. What is the Effect of Repayment on Enterprises, Families, and the Community?

4. What is the effect of Non-payment on Enterprises, Families, and the Community?

1.4. Objective of the Study

The major aim of this study is to identify the causes of loan default in the DECSI scheme, and to draw policy implications for the proper utilization of the financial resource of DECSI with particular reference to borrowers in Mekelle Town.

Specifically, the researcher plans:

1. To identify the factors which are influencing the loan default problem of borrowers financed by DECSI;

2. To evaluate the impact of DECSI screening mechanism on default;

3. To assess the effect of repayment on enterprises, families, and the community;

4. To assess the effect of non-payment on enterprises, families, and the community

5. To draw policy implications for the proper utilization of the financial resource of the country to meet the envisaged development objectives and future microfinance practice in the country.

1.5. Significance of the Study

Targeting credit to the poor is one of the several instruments of alleviating poverty. MFIs are engaged in providing credit to the poor so that they can generate income and employment for themselves. Although some studies have been conducted on the credit schemes that targeted the poor in Ethiopia, no empirical study has been done on causes of loan default of DECSI so far. So this study tries to provide a detailed analysis on the loan repayment performance of DECSI. It also tries to investigate the screening mechanisms used by the institution and assess the impact of loan repayment on enterprises, families, and the community in terms of reducing poverty. The study results will also be used for policy formulation and decision making with respect to government microfinance programs. Further more, the findings will be useful to the government's district trade offices, development offices, and other departments that implement government microfinance initiatives. Finally, the study will contribute to the existing body of literature and form a basis for additional research.

1.6. Scope of the Study

The study focuses on cause of loan default, screening mechanism and impact (which are all part of the borrower viability aspect of sustainability) based on data obtained from the two sub-branches of DECSI located in Mekelle Town. More over, other schemes are not considered in this study. Nonetheless, there is no reason to rule out the possibility that the findings of the study might workout for other related schemes. This study is limited to the household of Mekelle town, who are participating in the microfinance scheme of DECSI. The study focuses on the DECSI covering its performance in terms of disbursement and loan recovery from micro entrepreneurs who received financial support between the years 2005 and 2009.

1.7. Limitation of the study

Some of the major reflected limitations of the study are:

➢ The time allotted to undertake the research was too short/unexpected;

➢ The financial constraint and the problem associated with the external environments forced the researcher to limit the sample size and the scope of the paper;

➢ Limited data sources of the microfinance industry of Ethiopia and lack of adequate reports and statements from the institutions engaging in the microfinance activity; and

➢ Limited coverage of the study, i.e. the study covers only one area of the region in which DECSI operates.

1.8. Organization of the Paper

The paper is organized in five sections. Chapter one: Introduction; which includes Background of the industry, Background of the study area, Statement of the problem, Objective of the study, Research questions, Significance of the study, Scope of the study and Limitation of the study. Chapter two presents literature review, including Theoretical and Empirical Review. The methodology used to collect and analyze data is explained in the third chapter, and chapter four deals with the research findings. Chapter five offers conclusions and policy recommendations for enhancing the performance of the DECSI scheme.

CHAPTER II

Review of Literature

2.1. Theoretical Review

2.1.1. Role of Micro credit/finance

Micro financing, (as quoted by Rose Ajiambo Bwonya-Wakuloba, 2007), is a strategy for alleviating poverty. It is broadly accepted that robust, labor-intensive, and equitable economic growth combined with larger outlays for social programs (especially directed toward the poor populace, now estimated at 1.3 billion people worldwide) is a winning formula in the fight against poverty (UN 1997).

"Microcredit" refers to small loans extended to poor people so that they can undertake self-employment projects that generate income and enable them to provide for themselves and their families. This form of credit is targeted toward people in the lower economic brackets of society. Rural-based microcredit programs in particular have the potential to help poor people perform some business activities through which they may acquire employment as well as income. As such; microcredit provision has been an effective development intervention because such services can be directed specifically to the poorest members of the population. (Ibid)

In Kenya, the 2003–07 Economic Recovery Strategy for Wealth and Employment Creation (ERS); policy document has set a target to create 500,000 jobs annually during the recovery period. Accordingly, it intends that 88 percent of those jobs be created in small and medium enterprises (SMEs). These enterprises also are expected to contribute to a decline in poverty rates—from 56.7 percent to 51.8 percent. Therefore, provision of microcredit is regarded not only as a tool for empowering the poor, but also as an instrument for alleviating poverty in Kenya. The strategy paper identified restoring economic growth, generating employment opportunities, and reducing poverty levels as

key challenges facing Kenya (Ministry of Planning and National Development 2003). The paper estimated that SMEs contribute 18 percent and 72 percent to the national gross domestic product and employment, respectively, of the targeted jobs were to be created in SMEs. Elsewhere, a survey of SMEs identified a lack of access to affordable credit as one of the key constraints facing the SME sub sector. Micro credit generally is important to the growth and development of micro enterprises. However, many credit programs previously viewed the poor as potential defaulters and placed credit programs beyond their reach. Even though wide experience today shows that poor people are not bad credit risks and that their repayment rates can be exemplary, the poor still are considered to be a high-risk credit population, expensive to serve, and unable to pay the full cost of credit; they are believed to require government subsidization of credit.

According to the UN Secretary-General (UN 1997), there is increased interest in microcredit to promote growth with greater equity. His report noted that growth occurs through empowering all people by increasing their access to all factors of production, including credit. The report also observed that poor people's latent capacity for entrepreneurship would be encouraged by the availability of small-scale loans that would introduce them to the small-enterprise sector. Microcredit could enable them to be more self-reliant, could create employment opportunities, and could release women to engage in economically productive activities.

Very poor individuals are often described as high risk due to their lack of collateral and unstable sources of income and hence timely repayment of loans is often not anticipated. Holt (1994) and Christen (1997) cite loan repayment as one of the major challenges to microfinance, particularly in the Caribbean context, for example, given that a poor repayment culture has plagued numerous microfinance initiatives within the region (von Stauffenberg, 2000; Lashley, 2004). Dignard and Havet (1995) and ASA (1997) propose several causes of default in microcredit, which can be divided into four main categories. These are organizational, household/financial, group dynamics and other factors such as geographical location and environmental degradation. Christen (1997) observes that initially between 1970s and 1980s, the latter three categories were held responsible for

high delinquency rates in credit programs for the poor. However, he suggests that contemporary microfinance programs have countered this view by demonstrating that the responsibility essentially relies upon factors within the control of the lending institution, that is, organizational factors such as staff inefficiency and skill as well as clear communication of repayment expectations. Despite the various factors influencing default in microcredit programs, the current literature generally concedes that high repayment rates are a common feature of most microcredit programs (Dignard and Havet, 1995; Brau and Woller, 2004).

As quoted by Desta Asayehgn; In an era of unprecedented world-wide economic growth, it is interesting to note that the richest fifth of the world's people consume 86 percent of all goods and services while about a fifth of the world's poor population (1.2 billion people) still live on less than US $1 a day and almost half of the world's population live on less than US $2 a day (UNDP 2002, Gibson, 2009).Poverty is not simply having a very low income. It is a multifaceted phenomenon. In addition to low income, poor people also suffer from illiteracy, unsafe drinking water, and lack of access to basic health services. They live in remote and resource-poor areas. Frequently encountered with their vulnerability, the "chronically poor are unable to develop their personal capabilities or provide a good start in life for their children, and often die prematurely of preventable causes." (Alston and Shepherd, 2008-09.)

With the hastening of the global poverty crisis and the absence of an adequate social safety net for those marginalized and vulnerable sections of society in the less developed countries, a number of researchers have moved beyond the relentless pursuit of short-term toward long-term anti-poverty, environmentally sustainable paradigms to assist chronically poor sectors of society. Though remarkably polarizing issues, in the last three decades micro credit programs have been made available to the chronically poor as a viable option to involve them in the formal economic sector. It is assumed that the disadvantaged groups will become productive members of society if they involve themselves in small businesses that may contribute to powerful changes within their lives. (1997, Fisher and Sriram, 2002).

In formal financial markets, the poor are excluded from establishing their own small businesses because they are not recognized as being creditworthy, i.e. unable to save, lacking verifiable credit history or goods to offer as collateral to secure loans, forcing them to turn to traditional money lenders. (Zamperetti and Franca Dalla Costa, 2008.)

Recognizing the needs, capacity, and the talents of the poor to repay the loans, micro lending programs are loans extended to group members rather than to individuals. In view of the contingent group loan approach, it is generally assumed that group members would have an incentive to monitor their progress and that this would lead to a greater rate of repayment of their loans since each borrower's creditworthiness would be a factor in the overall creditworthiness of the group (Fisher and Sriram, 2002; Stiglitz, 1990; Varian, 1990; and Becker, 1991). In short, the success of group lending creates positive incentives for members to repay because in case of default, no member of the group will receive future loans. For prompt repayment, there is repeat lending to the group. In group lending, the probability of moral hazard is largely reduced because all borrowers are members of the group and subject to peer pressure, group dynamics, cohesiveness, and the ultimate success of each member of the group (Ajit et al 2006).

In simple terms, microcredit refers to the process of lending small amounts of seed money to groups rather than to one person, without collateral, to help poor people to establish their own business. Microcredit, especially designed for eco-entrepreneurship, encourages innovation in rural and urban areas to produce environmentally friendly products for the marketplace. Thus, the philosophy of demand-led microcredit finance visualizes the poor not as objects of charity but as socially productive persons. The rationale and objective of advancing microloans to the ultra poor is to improve their liquidity constraints, create employment opportunities, and induce sustainable incomes by engaging the poor in the reinvention of everything from the bottom-up, with limited top-down directives. Therefore, the loans accorded to the poor are not only bankable but it is assumed that micro-enterprise activities will eradicate poverty and foster sustainable development. As argued by Doocy et al, "Microfinance is a logical approach to development because it functions at the grassroots level, can be sustainable, is capable of

involving large segments of the population, and builds both human and productive capacity (summer, 2005)." Stated differently, microcredit is an investment in people, the poor and their abilities, which sharpens entrepreneurial initiatives, and strengthens developing countries' economies. Microcredit is a vital tool for economic development because it enables the poor to build assets, increase income, and reach self-sufficiency. Thus, microcredit not only delivers macro benefits but creates a silent revolution in poverty-stricken rural areas (Sharma, 2005).

The Millennium Development Goals (MDGs) are seen by many as being overly modest. However, it needs to be mentioned in passing that this assessment omits or glosses over some of the greatest challenges to lowering the poverty rate. For example, one of the most serious issues omitted in the report is the fact that it failed to establish that it is the lack of access to land ownership (micro-landowning program) that has caused many people to remain in poverty, and that microcredit loans have accomplished very little in solving the land ownership systems in developing countries (Prosterman, R. April 2005). Instead, the promotion of microcredit ventures in developing countries has the potential to create private groups (cutthroat money-lenders), which have vested interests in perpetuating the prevailing poverty situation (Elahi, K.Q. and Danopoulos, C. P. (2004).

Microcredit participants end up borrowing more from other non-institutional sources (double-dipping) to reduce their indebtedness, which is a paradox. As it stands now, instead of reaching the core poor, microcredit improves incomes of the better-off poor. It is more beneficial to borrowers living above the poverty line than to borrowers living below the poverty (Hume and Mosley, 1996). As succinctly argued by Kamani, "Although microcredit yields some non-economic benefits, it does not significantly alleviate poverty; Indeed, in some instances microcredit makes life at the bottom of the pyramid worse (2007)."

Contrary to the hype about microcredit being the best way to create jobs, increase workers' productivity, and eradicate poverty, Banerjee and Duflo argue that, "Although some microcredit clients have created visionary businesses, the vast majority are caught in subsistence activities. Participants have no specialized skills and so must compete

with all the other self-employed poor in entry-level activities (2006)." In his critique of the newest financial technology of the Washington Consensus, Flynn argues that while the technologies are new, the rhetoric is familiar and suggests that we may be seeing a new form of green washing or "charity washing" in the making. The risk is that new microfinance technologies targeting people with low incomes will be mistaken as benevolence. Bankers are not in the business of charity. They galvanize their activities to the bottom line generating sufficient priorities to stay in business (2007). In addition, Neff argues that micro credit models have been judged disproportionately from a lender's perspective (repayment rates, financial liability) and not from the borrower's. Therefore, according to Neff, micro credits have privatized public safety-net programs and stimulated governments to cut their budgets on education, public health, and the early livelihood needs of the poor (1996).

Despite the provocative criticisms enumerated above, the idea of microcredit as a key to socio-economic transformation has taken a prominent place in the international sphere. A number of voluntary associations, non-government organizations, friendly societies, savings and-credit cooperatives, national and regional government organizations, and commercial banking institutions have joined hands in providing financial services to the marginalized sectors of the world's developing countries. Nonetheless for microcredit programs to alleviate poverty in the long run, the participants need to demonstrate sensitivity to the environment and be involved in environmentally sustainable projects. (Gehlich-Shillabeer, 2008).

Currently, it has been reported by Forbes Magazine that two microfinance institutions operating in Ethiopia are among the top 50 Microfinance Institutions in the World. The Amhara Credit and Savings Institution ranks sixth in the world and Dedebit Credit and Savings Institution (based in Tigray) ranks 31st in the world (Nazret, 2009). The Forbes Magazine study was focused on the size of gross loan portfolio, efficiency (operating expense and the cost per borrower as a percent of the gross national income per capita of their country of operation), risk (looks at the quality of their loan portfolios, measured as

the percent of the portfolio at risk greater than 30 days), and returns (measured as a combination of return on equality weighted for an institution's over all ranking).

2.1.2. Strategies to Minimize Defaults

Because of the vulnerability of the microcredit sub-sector, lending institutions continue to adopt different techniques to improve repayment frequency and grant more credit access to borrowers who pay their loans on time.

The Grameen Bank model is cited widely as the most successful microfinance institution. The Grameen Bank, founded by Muhammad Yunus in Bangladesh, emerged from pro-poor grassroots institutions. According to this model, the prospective clientele is identified after the purpose, functions, and mode of operation are explained to the population of the area covered— usually 15 to 22 villages. Identifying clients in this manner resolves the problem of direct targeting by specifying the members' eligibility requirements on the basis of asset ownership. Indirectly, the model may make the loan amounts small and may lay down conditions (such as attendance at weekly member meetings) so that the non-poor are discouraged from borrowing (Hulme and Mosley 1996). The meetings reinforce a culture of discipline, routine repayments, and staff accountability. With such innovative practices, Grameen Bank has risen to fame for its performance in targeting and for its low default rates, which average 3 percent.

The Kenya, Women Finance Trust believes that small loans are expensive to administer and that the institution can survive only by charging competitive interest rates, lending to women, and keeping defaults to a bare minimum. Women are targeted as clients by this trust because they have been found to have a high propensity to repay.

According to Mann (1993), some lenders prefer known clients to avoid default. People on a loan committee will give preference to an applicant with whom they have dealt previously. Hence; lending institutions will give money based on previous banking

experience with the client. The same study also showed that institutions lend to profitable businesses that have cash flow available to pay back the loan.

Another strategy for dealing with default is lending to groups. The collective coming together of individuals is useful in a number of ways, including peer pressure that obliges the members to work within agreed norms. Although studies indicate that such schemes work well if groups are homogeneous and jointly liable for defaults, the practice of denying credit to all group members in case of default is the most effective and least costly way to enforce joint liability (Huppi and Feder, 1990).

2.1.3. Three Cs of Microcredit

Most literatures also describe three "Cs" that should be observed to reduce default when providing microcredit: **character, capacity, and capital.**

- ➢ **Character** refers to the way a person has handled past debt obligations. Paying heed to character includes determining the borrower's credit history and personal background, honesty, and reliability to pay credit debts.

- ➢ Considering a borrower's **capacity** involves determining how much debt he or she can handle comfortably by analyzing income streams and identifying any legal obligations that could interfere with repayment.

- ➢ **Capital** refers to a borrower's current available assets, such as real estate, savings, or investments that could be used to repay debt if income is unavailable.

2.2. Empirical Review

2.2.1. Repayment Default and Its Effect on Microfinance Programs

The most dangerous problem a microcredit program faces is repayment default. The Association for Social Advancement (ASA, a Bangladesh-based nongovernmental organization focusing on microfinance) has pointed out that if the money invested by the lending organizations cannot be recovered, the whole program may collapse.

Any formal lending program directed toward the poor faces a number of challenges. The first problem is exact targeting to ensure no Type I or Type II errors, as defined by Cornia and Stewart (1992). These are errors of omission of poor people and of inclusion of non-poor people. The second problem is screening to distinguish the good (creditworthy) borrowers from the bad (not-so-creditworthy) borrowers. This is a problem because poor borrowers generally do not maintain any accounts of their past business activity or furnish any documented business plan for use of the loan they are seeking. Third, the funding agencies may not be able to monitor and ensure productive usage of the loans. Viewed differently, the challenge here is determining whether the loan application is for the purpose of expanding a profitable ongoing business or whether it will be channeled into unprofitable operations. Achieving and maintaining repayment discipline is crucial to the sustainability of any microcredit program. Lending institutions must make good loans because default without sanctions will damage the people's commitment and the whole program may collapse.

Generally, the conventional theory of rural development finance shows that rural finance in low-income countries has many inherent failures, including low levels of loan recovery, insufficient savings mobilization, high transaction costs, and distribution bias to relatively wealthier customers. According to Izumida and Duong (2001), exceptional success was found in Vietnam. For example, Central Java's Badan Kredit Kecamatan has shown considerable promise in providing the access to microcredit and the convenience and flexibility desired by poor borrowers while ensuring the credit institution's financial viability by minimizing administrative costs and imposing interest

rates sufficient to cover costs and prevent capital erosion. The bank, however, did have problems when it experienced delayed borrower repayments among other failures (Riedinger 1994).

Several factors predispose borrowers to default. Beneficiaries of microcredit tend to use their credit for the same limited range of small-scale activities. In any given situation, it is likely that only a limited range of economically viable small-scale activities is available to the poor and causes of default in government microcredit programs that there is a limited demand for the product of any particular activity (Bundell 1997). These factors increase poor people's vulnerability to defaulting.

Diagne and Zeller (2001) analyzed the determinants of access to credit and its impact on farm and non-farm income and on household food security in Malawi. Their report showed that the contribution of rural microfinance institutions to small income holder can be limited or negative if the design of the institutions and their services do not take into account the constraints and demands of their clients.

A vast body of literature supports the view that borrower characteristics are highly influential determinants of repayment. There is also strong evidence that institutional characteristics are equally important and that both factors need to be taken into account if loan default is to be minimized (Derban, Binner, and Mullineux 2005).

Regarding the poor borrower, ASA noted that difficulty in meeting family expenditures may leave a borrower no option but to spend the loan to cover such expenditures. The same study found that the poor did not invest all loan money in income-generating activities, but spent part of it making payments on previous loans and meeting family expenses.

Basu (1997) examined why institutions remain unable to extend credit to rural poor people. His analysis indicated that, at best, poor peasants can offer as a mortgage an entitlement set comprising only future shares of their harvest—a commodity itself subject to risk. Loan repayment by borrower farmers is influenced by timeliness of input supply, participation in off-farm activities, and yield loss due to natural calamities,

among other things (Hundie, Belay, and Demeke 2004). Consequently, lenders cannot advance loans without risking extensive loss of loanable funds. It is also true that public perception of credit programs is an important factor influencing default.

Studies in Africa have revealed a tendency for people to think that funds from the government are free and do not require repayment. Tunisia has had a strong tradition of non-repayment of government-provided loans (ENDA, 2005). Similarly, Makina and Malobola (2004) studied the causes of low repayment for South Africa's Khula Enterprise Finance credits. They found that a major contributing factor for default was beneficiaries' perception that the microloans were free government grants.

In Nepal, for instance, the more efficient microfinance institutions managed by the private sector were found to be better-off than government-owned institutions. Efficiency may come from improvement in processes, computerization of management information systems, and improved financial management. Particularly with microcredit, small loans can be profitable only if administrative costs are reduced to a bare minimum. The Kenya Women Finance Trust's strategy is to keep administrative costs down and link the growth in lending to the availability of funds.

Regarding default in joint loan board programs, an impact study carried out by Kenya Consulting Associates attributed default to poor program management, which resulted in minimal follow-up on borrowers. The report noted that there are no systematic follow-up procedures.

Furthermore, commercial law in Kenya provides a debtor's limitation period. The law states," If a creditor does not demand repayment of the loan from his debtor within six years of the loan, he cannot enforce his claim in the court in case the debtor refuses to pay" (Hussain 1978).

Elsewhere, lenders of micro credit have been found to have limited, if any, means of mitigating damages in the event of default because poor people lack assets to back up their loans and poor countries lack civil infrastructure (such as adequate court systems) to collect bad debt. Without a safety net for loans in default, micro credit portfolios can

fail if borrowers perceive that there are no consequences for defaulting on their loans (Own contribution).

It is also true that there are costs to a lending institution for being in arrears. Arrears deplete portfolio turnover and erode the image of the institution. It has been found that clients of such an institution will inform themselves of the chance that the institution will fail and that debts will begin to grow rapidly. Within the institution, personnel blame each other and the institution's prestige plummets—which again compromises the institution's sustainability (Own contribution).

As quoted by Jemal Abafita; looking at the situation of Ethiopia empirical studies on the analysis of determinants of loan repayment and impact analysis are very few. Regarding loan repayment, an econometric estimation was conducted by Mengistu (1997) taking the case of micro enterprises in Awasa and Bahir Dar Towns. The analysis consisted of estimating two equations, one for loan repayment and the other for loan rationing. According to the estimation results (employing binomial probit model for loans repayment) he reported that the number of workers employed has positive relation with full loan repayment for both Towns, while loan size and loan diversion were negatively related. Age and weekly repayment period had positive relation with repaying loan in full for Awasa. In the case of Bahir Dar, loan expectation and number of workers employed have a positive relation with full repayment, while loan diversion and availability of other sources of credit have a negative impact. The predicted probabilities of full loan repayment were 53% and 78% for Awasa and Bahir Dar respectively.

Accordingly, loan size, expectation for another loan and availability of other credit sources are positively related with loan granting without rationing. On the other hand, number of workers employed, supervision visits and loan diversion have negative impact. For the case of Awasa, five variables are significant; namely, loan size, age, education, and weekly repayment period and loan diversion. Literate borrowers and borrowers with relatively higher level of age were incorrectly rationed despite being good payers./Ibid/

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In another relevant study by Abreham (2002) an investigation of determinants of repayment status of borrowers and criteria of credit rationing were conducted with reference to private borrowers around Zeway area who are financed by the DBE. The estimation result employing tobit model revealed that having other source of income, education, work experience in related economic activity before the loan and engaging on economic activities other than agriculture are enhancing while loan diversion, being male borrower and giving extended loan repayment period are undermining factors of loan recovery performance. With regards to loan rationing mechanism, it was found that borrowers who secured high value of collateral and those with relatively longer period were favored while those with higher equity share and extensive experience in related activity were disfavored. This leads to the conclusion that the bank's rationing mechanism didn't much with the repayment behavior of the borrowers.

Berhanu (1999) also used Wilcoxon test and found that health, education and consumption expenditures have increased after loan compared to that before loan. Employment and household income have also increased after the loan. But he found unsatisfactory results for saving mobilization, as POCSSBO did not attach the saving facility with its credit program or facility. Retta (2000) also reported a positive impact of microfinance on the living conditions of fuel wood carriers (WFCs), there by enhancing their economic empowerment. This was reflected in the rise of their income, expenditure and in their shift to other alternative income generating activities after the loan rather than engaging in fuel wood collecting, carrying and selling activity.

Teferi (2002) in his study on Dedebit Credit and Saving Institution (DECSI) found out that credit scheme has made its own positive contribution to the beneficiaries in relation to income, access to educational facilities, medical facilities, household diet and savings.

Bekele et.al. (2003), as cited in Jemal Abafita., employed a logistic regression model to analyze the factors influencing loan repayment performance of small holders in Ethiopia. The authors used data on 309 borrowers of input loans in the Oromia and Amhara National Regional states and found out that individuals who took larger loans had better repayment performances than those who took smaller loans. Further the results of the

study revealed that late disbursement of inputs purchased by the loan funds was an important bottleneck in loan repayment while livestock were found to be important in improving the farmers' repayment performance.

Given the contemporary salience and the future promise of microfinance as a poverty alleviating tool, researchers have studied various aspects of microfinance from a theoretical and from an empirical perspective. Focusing on La Paz, Bolivia, Navajas et al. (2003) have analyzed the ways in which changes in competition between lenders have affected the terms of loan contracts and the diligence with which borrowers repay their loans. Daru et al. (2005) describe the outcome of an International Labor Organization (ILO) sponsored study designed to alleviate the plight of poor borrowers in South Asia who often have great difficulty in repaying their loans because they are "bonded to their employers." McIntosh and Wydick (2005) have argued that competition between MFIs can give rise to situations in which the most impatient borrowers begin to obtain multiple loans and thereby create a negative externality that leads to less favorable equilibrium loan contracts for all borrowers. Andersen and Malchow-Moller (2006) have used a game theoretic model to show that the existence of a collateral requirement in connection with formal loans gives rise to a Nash equilibrium in which both informal and formal lenders earn higher profits.

Karlan et al. (2006) have used experimental methods in Lima, Peru; to explain why MFIs have increasingly been moving away from group based lending practices. Katchova et al. (2006) point out that relative to static models, a dynamic model better explains the present experience with individual and group lending in developing nations. Karlan and Zinman (2007) have studied information asymmetries in lending by using a field experiment in South Africa. They find stronger evidence for the presence of moral hazard but weaker evidence in support of the existence of adverse selection. Simtowe et al. (2007) have used data from Malawi to conduct an empirical investigation of the salience of moral hazard in microfinance. This analysis shows that MFIs cannot rely on peer selection and pressure to reduce the incidence of moral hazard. Instead, in repeated borrowing and lending contexts, MFIs need to continuously evaluate the changing, and

typically growing, financial needs of the borrowers. Finally, using a cross-country perspective, Hartarska and Nadolnyak (2008) have studied the extent to which rating agencies have helped MFIs in raising funds.

The significance of peer monitoring in improving repayments in group credit is highlighted by a number of authors. Stiglitz (1990), for example, observes that the major problem facing MFIs is ensuring that borrowers exercise prudence in the use of the funds so that the likelihood of repayments is enhanced. Stiglitz notes that a partial solution to this problem is peer monitoring: giving neighbors or group members the responsibility to monitor each other. The incentive for peer monitoring comes from the fact that peers are supposed to pay loans for any defaulting group members. Studying the incentive rationale for the use of group lending as a method of financing liquidity-constrained entrepreneurs, Che (2002) observes that the joint liability lowers the liquidity risk of default but creates a free-riding problem. Che points out that in the static setting, the free-riding problem dominates the liquidity risk effect, thus making group lending unattractive. However, when the projects are repeated over time, the joint liability feature provides the group members with a credible means of exercising peer monitoring and sanctioning, which can make the group lending attractive, relative to individual lending.

2.2.2. Is Default Risk an Issue in Microfinance?

Default risk refers to a situation where the lenders are unable to recover the loans that have been extended or the borrowers fail to fulfill their financial obligations at the stipulated time due to various reasons. In general, default risk is claimed to be a non-issue in microfinance. Taking Grameen Bank as an example, since its inception, the bank has distributed around Tk347.75 billion (or an equivalent of US$6.55 billion) in loans. Of this amount, Tk313.11 billion (or US$5.87 billion) has been repaid. The bank claims a loan recovery rate of 98.4 percent in 2003, an improvement compared to the 95 percent recovery rate claimed in 1998. In short, micro lending is known to have very low default rate, such as in the case of Grameen Bank which has a default rate of as low as 2 percent.

However, many critics doubt this recovery rate, particularly on the definition that Grameen Bank uses to categorize loan as default as well as the method of recovering the loans being extended. Micro lenders have been reluctant to highlight the weaknesses of Grameen Bank mainly due to its well-known reputation as a symbol of microfinance. However, in the recent years, the repayment difficulties faced by Grameen Bank are even acknowledged by the founder himself, Mr. Yunus. Several factors have been attributed to the repayment difficulties such as political upheavals, the 1998 flood and management errors. Information lag due to inefficiency is also quoted as another reason, where the recovery rate of 95 percent was only true until 1996.

More importantly, field investigations revealed that the high degree of loan recovery in microfinance is partly contributed by some element of "forced-recovery" imposed on the borrowers, either directly or indirectly. Informal interviews with the villagers and direct observations in the villages seem to indicate that there are actually frequent incidences of default in microfinance. In some cases where the borrowers are not able to pay back their loans, they are pressured to repay with whatever means that they have. In several circumstances, the borrowers faced losses where their business or agriculture projects do not bear fruit but they still have to repay according to the agreement that they have had with the MFIs. As a result, these borrowers were forced to sell off their lands or whatever property that they have, making them poorer than they were before and sometimes even making them homeless. Obviously, in this case, the MFIs are successful in recovering the loan that they have extended but the true objective of microfinance of alleviating poverty and improving the living standard of the poor are clearly being ignored.(Own contribution)

The role of sanctions in enhancing the willingness of individuals to repay their loans is also discussed in Besley and Coate (1995). They show how moderately successful group members may willfully decide not to repay their loans because of the burden of having to repay the unsuccessful members´ loan. They note however, that in the presence of strong social ties among group members, willful default is minimized because potential defaulters are afraid of facing sanctions from both the bank and the community.

2.2.3. Real Incidences of Defaults in Microfinance

According to Kassim, Salina and Rahman (2008), it can be concluded that the MFIs are only concerned about extending financing without much effort being done to provide any form of post disbursement supervision. Post-disbursement supervision is highly relevant in ensuring the success of microfinance project due to the fact that around 80 percent of the recipients of microfinance are illiterate women. Furthermore, around 82 percent of these women had no business experience before joining the microfinance program, while the rest 18 percent had some basic business experiences. The illiteracy of the recipients is rather serious to the extent that some do not even know how to count the amount of money that they received from the MFIs.

Commonly, the MFIs provide loan without any technical assistance except for some briefing of around five to ten minutes to the recipients. It should be emphasized that the technical assistance is just as important and should complement the financial assistance in ensuring the success of the business project. (Own contribution)

Case 1: Lack of Post-Disbursement Supervision Leading to Moral Hazard

In many instances, once the fund is being released to the recipient, there is no close supervision of how the fund is being utilize. This results in the tendency of moral hazard on the part of the recipients. For example, in a particular case, the recipient is supposed to expand her chicken rearing farm, has instead given the money to her husband on the pre-text of undertaking a more profitable business venture. However, the business venture did not turn in to be profitable, and as a result, the recipient failed to pay the installment of the microfinance loan. After a year, the original amount of loan became almost doubled and the recipient had to pay the debt by selling her house which made the family homeless.

Case 2: Lack of Training on Basic Business Skills and Knowledge

Several incidences of default happened due to lack of basic skills such as book-keeping or recording of sale transactions. As mentioned, based on a survey on the recipients of

microfinance loan from an MFI in Bangladesh, around 82 percent of respondents had no business experience before joining the microfinance program and only 18 percent had some business experiences. The lack of experience resulted in the recipients unable to manage their business projects effectively, leading to a business failure. In a specific case, a recipient had to close down a tea stall that had been set up using a microfinance facility due to lack of basic business skills and knowledge. Due to illiteracy, the recipient had difficulties to do calculations and keep track of the everyday sales. In the absence of systematic recording of profit or loss in the business, it was difficult for the recipient to estimate expenses that are made allowable by the available profits. As a result, a few months later the recipient had to close the stall and sold it off because of the failure to pay the weekly installments. This is a clear case of default case resulting from the lack of basic business skills and knowledge.

Case 3: Lack of Health Awareness Resulting in the Need to Spend on Medical Expenses

As a result of poverty and illiteracy, there is a general lack of awareness on the importance of sanitation and cleanness as well as the importance of healthy food intakes and disease prevention. Family member's illness is one of the reasons leading to recipients to channel the funds provided by the MFIs to pay for medical treatment, resulting in default in payments. In a specific case, a goat-rearing project funded by an MFI turned out to be successful at the initial stage that it provides the recipient with some profit and the ability to repay. However, a family member's illness led the recipient to sell-off the goats in efforts to pay for the medical bills. The recipient later defaulted on the payment.

Case 4: Burdensome Immediate Repayment Schedule

Most microfinance contracts require repayments to start immediately after the loan is disbursed. Since it is common to have weekly payment schedule, most payments normally start the following week after the loan has been disbursed. This payment arrangement proved to be a challenging situation for new and non-experienced recipients

since most projects undertaken by microfinance recipients need some incubation period. In a specific case, a woman failed to pay the weekly installments which started directly after the loan was being disbursed simply because her chicken-rearing activity had yet to turn in some profit.

Case 5: Lack of Motivation to Improve Standard of Living

It is often overlooked that the mindset of the poor and illiterate are very much different from those who are educated. The poor people have no incentive to give the best to ensure the success of a business project since their major concern is on meeting the daily consumption requirements or just to fulfill the basic needs. In a particular case, a recipient with five children were more concerned to make end meets by setting up a road-side stall and were not concerned about further improving their standard of living. Due to lack of motivation, the recipient had no effort to really give out the best that she could even though she was provided with the financial assistance. This would increase the likelihood of default of the loan being extended.

2.2.4. Causes of Defaults in Microfinance

Based on the real incidences of default mentioned above, in general, the causes of default can be divided into two categories: (i) weaknesses from the lender side, particularly in the funds administration by the MFIs; and (ii) moral hazard problem on the borrower side.

a. **Lender perspective** -Weaknesses in funds administration: these are weaknesses relating to funds administration by the MFIs that provide the opportunities for the recipients to utilize the loans for other reasons than the original intentions. This increases the possibility of default by the recipients.

➢ Absence of post-disbursement monitoring system: in the absence of a close supervision on how funds are being disbursed, recipients tend to utilize the funds for other reasons than the original purpose that the funds were released for.

➢ Lack of technical assistance given to the microfinance recipients: as mentioned, 82 percent of the recipients had no business experience before joining the microfinance program, while the rest had some basic business experience. As a result, the recipients cannot handle their business effectively without basic technical assistance being provided by the MFIs.

➢ Inexperienced field workers: the field workers who are working for the MFIs are lowly educated and lack of experience. As a result, they fail to deliver effectively the objectives of the MFIs to the recipients, what more to give motivations to the recipients.

➢ Burdensome immediate weekly payment system: the fixed repayment system is difficult to be met by many recipients, depending on the nature of their business projects. Also, very frequent collection schedule increases the transaction costs to collect the installments for the MFIs.

➢ Lack of common accessible database of the microfinance recipients: since there is no systematic database that keeps the record of the microfinance recipients, this provides the opportunity for the recipients to apply for more than one loan from various MFIs. When the recipients are over-stretched in their financial commitments, they are more likely to default on the installment payment.

b. **Borrower perspective** - moral hazard problem: resulting from the lack of technical assistance and post-disbursement supervision, the followings are the consequences which result in greater possibility of default by the loan recipients:

➢ Hiding business: majority of the recipients are women and in a male-dominant society such as Bangladesh, women are normally obedient to whatever the requests of the husbands. In many cases, once the wife has secured a loan to run a particular business, the husband persuades the wife to

undertake more risky business that more likely to provide higher return. Thus, lack of proper monitoring system by the MFI could lead to recipients to undertake more risky business, thereby increasing the possibility of default by the borrower.

➢ Family member's illness: rather than utilizing the loans through the channel that has been agreed upon, the recipients spent it for more urgent and pressing reason such as for medication of the family member. There are also cases where the focus of attention has shifted to taking care of the sick ones, resulting in the business project to be abandoned. Other than illness, funds are also sometimes being spent for other expenses such as marriage and festivities.

➢ Lack of motivations: the mindset of the poor which is more concern about meeting the basic needs does not provide them with the motivations to give out the best in conducting the business project.

➢ Over-stretched financial commitments due to multiple borrowings from MFIs: amid the increased competition among the MFIs and the absence of a common database to keep track of the microfinance recipients, many recipients borrow from more than one MFIs, resulting in the difficulty to meet the multiple payment installments.

CONCLUSION

A number of lessons can be drawn from the literature reviewed.

🦐 Micro credit is important to the growth and development of micro enterprises.

🦐 Face unique problems of targeting, distinguishing between creditworthy and not-so-creditworthy borrowers, and monitoring the productive use of loans

- Default on repayment poses a major challenge to the survival of micro credit programs

- Character, capacity, and capital play a role in loan repayment.

- The public perception that government credit is a grant influences default ;i.e. Default rates increase

- The lending institution should maintain efficiency in terms of :

  - improved processes,

  - computerized information systems, and

  - Improved financial management to handle its credit programs effectively.

- Poor management and a lack of effective legal infrastructure to prosecute defaulters encourage default.

  - Adopted strategies for minimizing default in micro credit:

  - imposing conditions to which members must adhere,

  - targeting women as borrowers,

  - doing repeat business with borrowers who have good repayment records, and

  - lending to groups to promote joint liability

CHAPTER III

DATA AND METHODOLOGY

This section describes the methods used in carrying out this study. It explains the data types, sources, and procedures used for the comparative analysis, and it describes the data collection instruments and techniques and the sampling procedures followed.

3.1. Data Types and Sources

Both primary and secondary data sources were used in this study. Primary data were collected through questionnaires. Secondary data sources include information taken from official reports, file records, and statistics issued by the relevant institutions. In addition, secondary documented data were obtained from both published and unpublished literature related to the topic.

3.2. Sample Size and Sampling Techniques

The DECSI has made a total of twelve disbursements since its inception in 1997. This study, however, focuses on the period 2005-2009 during which a total of five disbursements were made (2005, 2006, 2007, 2008, and 2009). Of the total clients benefited from the two sub-branches of DECSI's work over that period, a sample of 100 clients was selected for data collection concerning the reasons for default among those who did not repay and those who repaid slowly, and concerning the factors influencing

timely repayment by the regular borrowers. Using the 2009 repayment status, groups were classified into 3 categories: fully-paid groups, partially-paid groups and nothing-paid groups. A stratified random sampling procedure was used to randomly select the sample groups from the three selected strata. A group was classified as fully paid if the 2009 group loan was fully paid. It was classified as a partially-paid group if only part of the 2009 group loan had been paid at the time of the survey. And a group was classified as nothing-paid if no member had paid anything for the 2009 loan.

Stratified sampling guarantees representation from each disbursement strata at one level, and representation of fully-paid groups, partially-paid groups and nothing-paid groups. Systematic sampling also was applied to capture clients as they come to repay loans.

3.3. Data Collection Instruments

Several data collection instruments were used during the study. Primary data were generated from two types of questionnaires. The first type comprised two questionnaires to be administered to defaulters, slow repayers, and regular borrowers. The questionnaires had four sections: section A inquired about the borrower's personal and business details; section B sought information on causes of default or timely repayment; section C dealt with business performance; and section D addressed the effect of loan repayment on the enterprise, family, and community.

The other type of questionnaire was used in interviews with board officials. It had three sections: section A inquired about the official's personal details, including professional qualifications, work experience, and main responsibilities; section B sought the interviewee's considered opinion on causes of default and factors influencing loan repayment; and section C dealt with the impact of loan repayment on the DECSI scheme.

Secondary data were obtained from a number of data instruments used by the trade office. These instruments included the loan application form, the appraisal of the applicant, and the loan agreement form. The other tool was the account ledger for each group to which funds were disbursed.

3.4. Data Collection Procedures

The data were collected at two levels. Primary data were obtained by administering the questionnaires to selected loan beneficiaries who defaulted and to borrowers who completed their loan repayments.

Prior to its use in the field, the questionnaire was tested using board clients in each of the three categories who are based in the Town of Mekelle. Following this testing, research assistants went to the field under the guidance of an officer to help identify borrowers. The board clients' questionnaire captured data on their demographic and socioeconomic characteristics, business characteristics, and causes for default or timely repayment.

Additionally, a questionnaire was administered to the board staff to find out the board's considered opinion on the causes of default and the factors influencing repayment. The questionnaire's three sections asked about board officials' professional qualifications, their duties, and the loan program's performance.

3.6. Data Analysis

The study used a comparative analysis approach to investigate the causes of default in microfinance programs: a case study in DEBSI, Mekelle Town. To facilitate data analysis, questionnaires collected were serialized and coded before enter into Microsoft Excel software. After data screening, only 92 questionnaires were found suitable for data analysis. Data then were exported to SPSS statistical analysis software. Descriptive analyses tools, such as frequencies and percentages, were used to study the repayment performance and other relationships of interest. In addition, various qualitative analyses were applied to establish causes of default in repaying the board's credit. Secondary data concerning board clients' repayment performances were entered in Excel spreadsheets to compute relevant statistics.

CHAPTER IV

DATA ANALYSIS AND PRESENTATION

This section presents the study's findings on the causes of default in a government micro credit program—specifically, the DECSI scheme. The average repayment delay period and default rates are estimated and factors that contributed to loan default and slow repayment are presented.

4.1. DECSI Clients' Profile

Ninety-two clients who received loans from the two sub-branches of DECSI during the study period were analyzed. Two-thirds of the clients were repeat borrowers (having received other loans before or during the study period). About 70 percent of the clients were male. All clients were aged 28 to 79 years, with a mean of 47. Sixty-five percent of them were aged 40–59 years. Figure 1.1 shows the age distribution of the study sample.

Figure 1.1. Age Distribution of Study Area
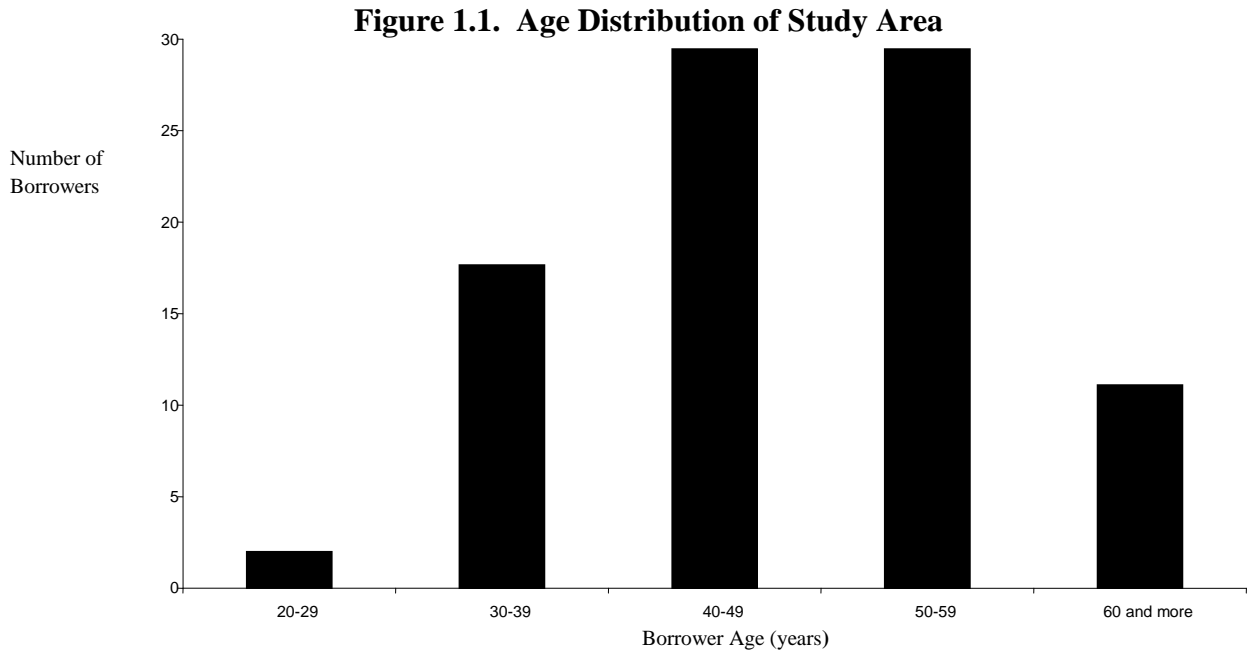
Source: Researcher's compilation based on questionnaire responses.

As proved from the questionnaire responses, the education level of borrowers ranged from no education to postsecondary training. Ninety-one percent of the clients had either primary or secondary education, with 51 percent having secondary education. The great majority of the clients were married (86 percent); approximately 10 percent were single; and 4 percent were separated, divorced, or widowed.

The amount of money disbursed to each client ranged between 1000 birr and 5000 birr. These loans were to be repaid over a period ranging from 12 to 18 months. At the time of the study, outstanding balances per slow-repaying or defaulting client went very high. Some clients had made no payments at all on their loan accounts.

Board clients had varied amounts of business experience. The common type of businesses run by 73 percent of board clients fell mainly in regulated trade (retail). Manufacturing, motor vehicle repair, hotel and catering services and miscellaneous businesses together amounted to only 27 percent.

With respect to income levels, 65 percent of those interviewed said that their income level had improved to either an average or high extent since receiving the credit loan. About 85 percent had personal income above 1000 birr per month, with approximately 45 percent reporting personal monthly income of more than 1800 birr. The major source of income among the borrowers was their business enterprise, although 34 percent had diversified, with farming or employment as their major source of income.

4.2. Loan Default Analysis

Because both slow repayment and default rates negatively affect the DECSI's performance, identifying the average repayment delay and the default rate is important.

Average Repayment Delay: Of the 92 DECSI beneficiaries studied, 45 exceeded the repayment periods stated in their loan agreements. The repayment delays described in figure 1.2 are the months between the agreed repayment periods and actual completion of the loans by the slow repayers. The analysis revealed that slow repayers delayed repaying their loans for 1 to 23 months. Most of them cleared their loans within five months after the expiration of the loan agreement period.

Figure 1.2. Repayment Delays among Study Area   Slow Repayers

□ 21-23 months (2.2%)

▨ 11-15 months (6.7%)

▩ 6-10 months (28.9%)

■ 1-5 months (62.2%)
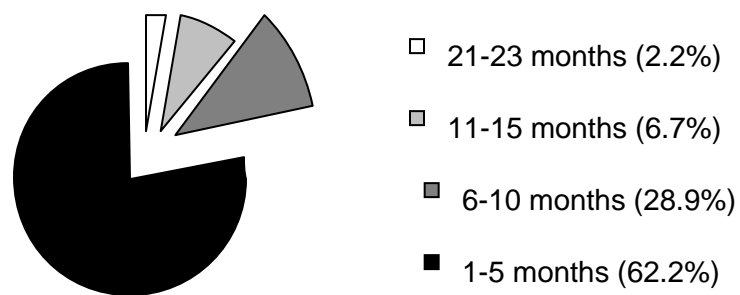
Source: Researcher's calculations based on office records

Note: Of the 92 borrowers studied, 45 failed to adhere to their repayment schedules. This chart shows   their   periods of arrears.

Table 1.3. Descriptive Statistics on Repayment Delays among Slow Repayers

Statistic	Number of cases	Minimum	Maximum	Mean	SD
Actual repayment period	45	13	35	20.51	4.794
Repayment delay (% Beyond agreed period)	45	5.56	191.67	31.4392	32.746
Delay in months	45	1	23	4.78	4.512

Source: Researcher's calculations, based on office records, DECSI, Sub-branches at Mekelle Town.

Note: SD = standard deviation.

Table 1.3 provides the descriptive statistics of the slow repayers over the study period. The repayment delay was calculated as the number of months delayed in completing a loan, divided by the agreed repayment period in months, and then multiplied by 100. The results indicate that the minimum repayment delay occurred among those who were to repay in 18 months (they delayed an average of one month); the maximum delay occurred among those who were to repay in 12 months (they delayed an average of 23 months). Therefore, the average repayment delay among the DECSI's slow-repayment borrowers was approximately 31 percent longer than the agreed period. In other words, a slow-repayment board client who received a loan to repay in 12 months was more likely to repay it in 16 months, a client given a loan to repay in 18 months was more likely to repay in about 24 months, and so on.

Repayment and Default Rates: In this study, it was important also to compute the study area's default rate for the DECSI scheme.

Table 1.4. DECSI's Repayment and Default Rates; study years

DEBSI Performance	2005	2006	2007	2008	2009
Disbursement (Birr)	16,149,885.00	29,007,850.00	57,872,400.04	44,749,341.09	26,420,379.04
Recovered funds at the expiration of loan agreement(Birr)	4,555,817.26	15,244,445.78	40,533,035.03	24,859,701.08	1,746,160.38
Outstanding Balance (Birr)	11,594,067.74	13,763,404.22	17,339,365.01	19,889,640.01	24,674,218.66
Default rate (%)	71.79	47.44	29.96	44.45	93.39

Source: Researcher's calculation, from the Archives of two-sub branch of DEBSI

Table 1.4 shows the board's performance in 2005, 2006, 2007, 2008 and 2009 by comparing total disbursements with total repayments and outstanding balances at the ends of the loan agreement periods. The default rate, therefore, is based on outstanding balances at the ends of the agreed repayment periods. It is clear from the outstanding balances and amounts disbursed that the board experienced default rates of 71.79 percent, 47.44 percent, 29.96 percent, 44.45 percent and 93.39 percent for 2005, 2006, 2007, 2008 and 2009 respectively. The results give rise to an overall average default rate of approximately 57.41 percent.

4.3. Slow-Repayment Borrowers

Borrowers who exceed their agreed repayment schedules are viewed as a type of defaulter because they did not repay their loans on time. Therefore, it was important in this study to establish the causes of slow repayment.

Figure 1.3. Causes of Default among Slow Repayers

- Other (5%)
- Many dependents (5%)
- Business closed (5%)
- Diversion of funds (50%)
- Poor business performance (35%)
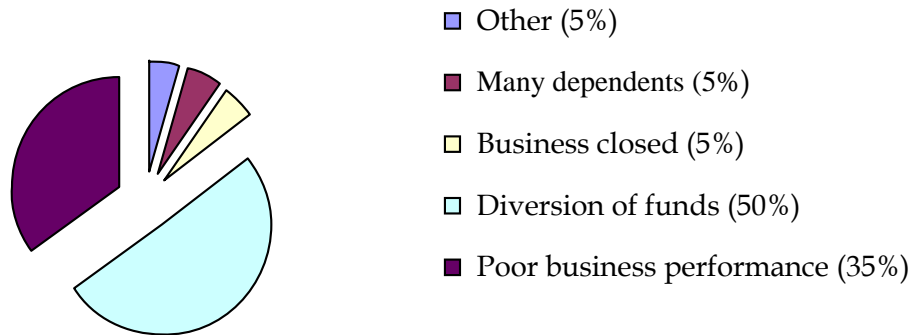
Source: Researcher's calculations, based on responses to study questionnaires

Figure 1.3 shows the causes for default stated by the slow repayers. It emerges that diversion of funds and poor business performance were the key causes of untimely loan repayments. Other borrowers were affected by business closure or by having many dependents.

4.4. Defaulters

Using the responses gathered from the questionnaires, the study established a number of causes for default among DECSI clients.

Figure 1.4. Specific Causes of Default among Defaulters

Legend:
- Other (10%)
- Theft/Robbery (6%)
- Many dependents (4%)
- Business closed (2%)
- Tenancy problems (6%)
- Poor timing (6%)
- Domestic problems (20%)
- Poor business performance (36%)
- Diversion of funds to unprofitable use (10%)
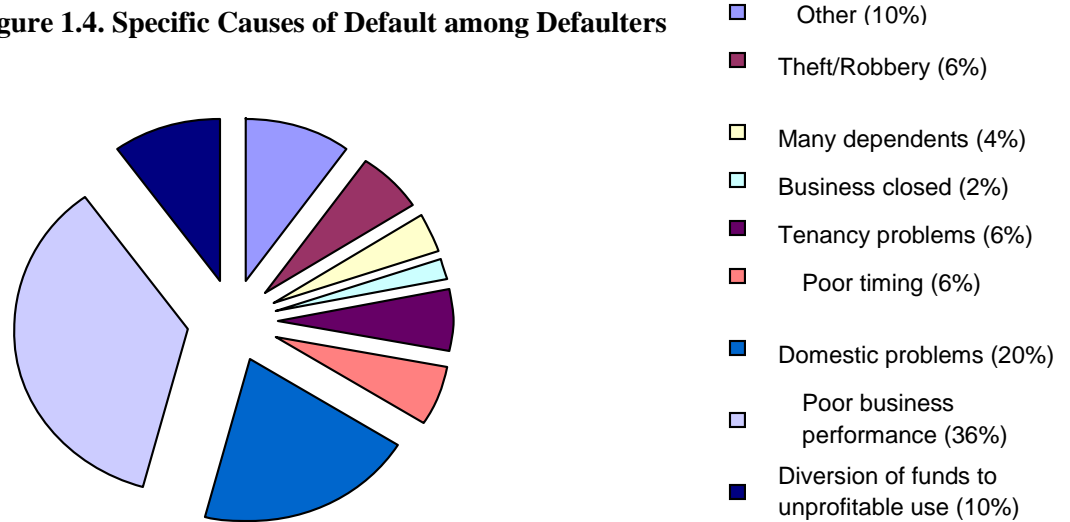
Source: Researcher's calculations, based on responses to study questionnaires

Figure 1.4 provides a frequency distribution of the causes of default among the board's clients. Thirty-six percent of the defaulters attributed their non-repayment to poor business performance. Twenty percent cited domestic problems, and another 10 percent admitted having diverted the funds to other unprofitable uses. Poor timing, tenancy problems, theft, and business closure also were named as causes for default, although on a small scale.

The "other" causes (10 percent) of nonpayment identified among the defaulting borrowers included harsh economic conditions, stiff competition, government policy banning certain activities, servicing of other loans, and bad debts on services offered to their customers.

Owing to the sensitive nature of the issue of default, the study endeavored to find out whether household characteristics contributed to non-repayment. The study was

interested in establishing any relationship between a borrower's number of dependents and the cause of default, or between the major source of income and the cause of default.

Table 1.5. Household Characteristics of DECSI Defaulters

Characteristic	Frequency	Percent	Characteristic	Frequency	Percent
Number of dependents			**Major source of income**		
1	0	0	Farming	15	30
2	2	4	Business enterprise	29	58
3	7	14	Employment	5	10
4	5	10	other (causal worker)	1	2
5 or more	36	72			

Source: Responses to study questionnaires

Table 1.5 shows that about three-quarters of the defaulters had five or more dependents, and that approximately 60 percent of the borrowers relied on the micro enterprise for most of their income.

Table 1.6. Relationships between Household Characteristics and Causes of Default

Number of dependents	Causes of default						
	Poor business performance	Diversion of funds	Domestic Problems	Tenancy problems	Many depen.	Other	Total
2	0	0	1	0	0	1	2
3	3	0	2	0	0	2	7
4	3	0	0	1	0	1	5
5 or more	12	5	7	2	2	8	36
Total	18	5	10	3	2	12	50

Major source of income	Causes of default				
	Poor business performance	Diversion of funds	Domestic problems	Other	Total
Farming	5	3	3	4	15
Micro enterprise	12	2	7	8	29
Employment	1	0	0	5	6
Total	18	5	10	17	50

Source: Responses to study questionnaires.

Table 1.6 provides cross-tabulations between the number of dependents and the cited cause of default and between the major source of income and the cited cause of default.

The cross-tabulations show that many defaulters who had a large number of dependents also experienced poor business performance, diverted funds, or had domestic problems. It is surprising, however, that only two defaulters cited "many dependents" as the cause of default (both of whom had five or more dependents). The associated p-value of the cross-tabulation between many dependents and cause of default was 0.534 (53.4 percent), meaning that many dependents and cause of default are statistically independent.

Table 1.6 also shows that many defaulters who relied for income on the micro business alone experienced poor business performance. Because approximately 60 percent relied on the business as the main income source, the vulnerability of the micro enterprise to poor business performance was revealed. The cross-tabulation for major source of income and cause of default had a p-ratio of 0 percent, which indicated that the major source of income and the cause of default are statistically dependent.

4.5. Comparative Analysis of the Causes of Default among Slow Repayers and Defaulters

The analysis of causes of default revealed that there are variations on causes of default among the two categories—slow repayers and defaulters.

Table 1.7. Comparison of Causes of Default between Slow Repayers and Defaulters

Percent

Cause of default	Slow Repayers	Defaulters
Poor business performance	35	36
Diversion of funds to unprofitable use	50	10
Business closure	5	2
Many dependents	5	4
Domestic problems	0	20
Other	5	28

Source: Responses to study questionnaires

Table 1.7 compares the percentage of respondents in each category who cited each reason as the main cause for default. The results indicate that poor business performance is a key cause of default identified by both slow repayers and defaulters. Although half of the slow repayers attributed their default to diversion of funds to unprofitable uses,

only 10 percent of the defaulters did so. Hence, although diversion may increase the possibility for defaulting, it may not be the major cause. Domestic problems and other causes (including harsh economic conditions, stiff competition, servicing of other loans, and bad debts) also were important, especially among defaulters.

4.6. DECSI's Perspective on the Causes of Default

Christen (1997) suggests that contemporary microfinance programs have countered this view by demonstrating that the responsibility essentially relies upon factors within the control of the lending institution, that is, organizational factors such as staff inefficiency and skill as well as clear communication of repayment expectations.

The DECSI believes that some defaults occur because of limitations of the board, whereas other defaults are borrower driven. Accordingly, therefore, a number of factors were identified as causes of loan default from the board's perspective.

Board employees were unanimous in their belief that failure to prosecute defaulters was an important cause of loan default. Default cases are referred to the state counsel, which is based in Mekelle. Furthermore, proper follow-up of clients is constrained by inadequate funding for operations and maintenance resources. For instance, transport operating budgets have been declining, a situation that does not facilitate consistent monitoring or follow-up on defaulters. Chances of default also increase when loan amounts given are lower than the amounts requested. And the board's institutional structure was described as too rigid and thus not responsive to changing client needs.

Board members also believe the length of time it takes for a potential borrower to apply and get the loan has an effect on the use and repayment of the loan. In the DECSI program, it takes at least two months for an applicant to apply and receive a loan.

The board also acknowledges that its records on clients are inadequate for efficient program management. Although the board has computer facilities, those facilities do not contain appropriate software to process borrower information promptly or to track potential defaulters. Data relating to borrowers are manually kept in files and account

ledgers, but those files and books were found to be too bulky and tedious for the board's sole clerical officer to handle. Because basic data on loan repayment are not in a readily and conveniently available format, cases of loan over- and under-repayment exist.

Regarding loan repayment, default was associated with diversion of funds to unprofitable uses, like paying school fees. Other factors included a lack of discipline in the use of working capital, poor management skills, and poor business performance. In some cases, defaults were believed to be a problem of attitude, with beneficiaries assuming that government funds are grants and need not be repaid.

The study also found that board members do have measures to deal with various categories of default. Cases of chronic default are forwarded to the state counsel for prosecution. Some occasional defaulters are threatened with sale of their security to recover the outstanding balances, and others simply are counseled on the importance of repaying the loan on time. These measures have improved loan recovery, albeit marginally. Despite the measures, the board believed that the default trend is increasing.

4.7. Factors Influencing Repayment of Loans among Regular Borrowers and Slow Re-payers

To establish factors that influenced repayment of loans disbursed by the DECSI, questions were posed to both regular and slow-repaying borrowers. The regular borrowers, who made timely payments in accordance with their agreed payment schedules, were asked to state what prompted them to repay on time; and the slow repayers were asked to state what caused them to repay the remaining balance after they failed to repay the loan as scheduled. The study sought to discover links between the motivations for repayment and default.

Figure 1.5. Reasons for On-Time Repayment among DECSI Borrowers

Percent of regular borrowers who responded

Reason categories: To build credibility with trade office, Because business performance has been good, To get another loan

Reason
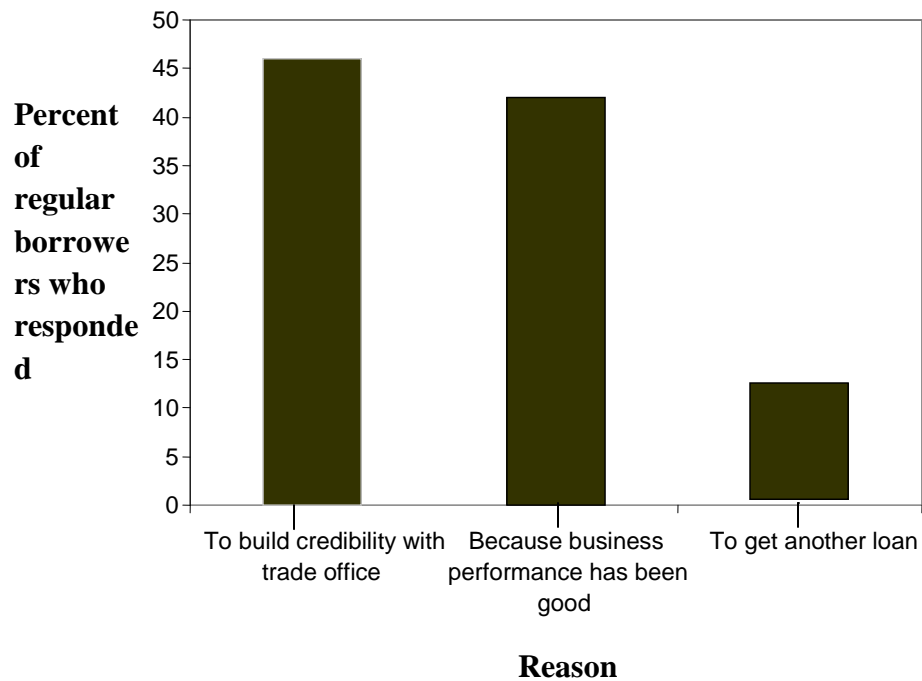
Source: Researcher's calculations, based on responses to study questionnaires.

Figure 1.5 shows key factors found to influence board clients to repay on time. As the figure illustrates, regular borrowers repaid their loans on time for three reasons: (1) because they wished to build credibility with the trade office (46 percent), (2) because they associated timely repayment with good business performance (42 percent), and (3) because they wished to get another loan (12 percent).

The study also was keen to discover what triggered slow-repaying borrowers finally to repay the outstanding balance.

Figure 1.6.Reasons for Eventual Repayment of the Loan by Slow Repayers

Legend:
- Receipt of demand notice (5%)
- Urgent need for collateral used to secure the loan (30%)
- Fear of loosing security deposits (5%)
- Improvement of business (5%)
- Desire to complete outstanding loan (55%)
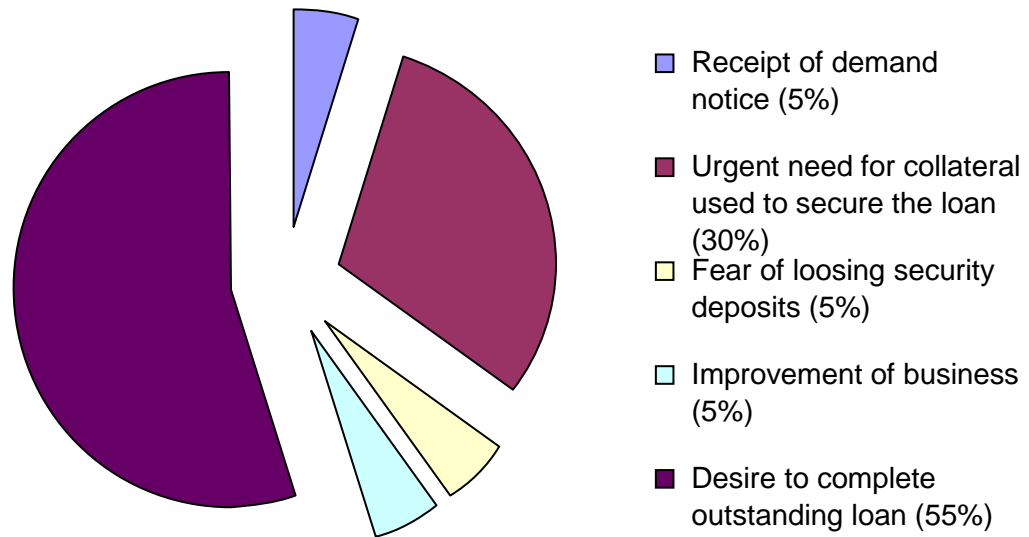
Source: Researcher's calculations, based on responses to study questionnaires.

Figure 1.6 shows the stated reasons for eventual repayment of a trade loan. It reveals that 55 percent of the slow repayers eventually repaid because of a desire to fulfill the outstanding obligation. However, 30 percent repaid because they urgently needed collateral deposited at the trade office, and 5 percent repaid because they feared losing that security deposit. Issuance of demand notices and improved business triggered full repayment of the loan for 10 percent of the slow re-payers.

4.8. Effect of Repayment on Enterprises, Families, and the Community

The study also sought to discover what repayment burdens placed on the enterprise might cause default. Responding to study questionnaires, one-third of the study area indicated repayment had no effect on the enterprise. The remaining two-thirds, however, said that repayment had led to a reduction in their stock levels. Some said that they were

not able to make any savings because they used profits to repay the loans. Other borrowers said that they were using means beyond business to repay their loans. Some loan recipients even admitted suffering from depression as a result of the repayment burden, and they said the depression was affecting relationships with customers and was leading to poor business performance. As a result of repayment, some businesses had closed their doors. Those who were repaying were doing so to maintain trust with the loan office or to avoid prosecution. Some borrowers explained that repayment was a burden only when sales were low.

With respect to the burden on borrowers' families, less than 20 percent said that repayment had no effect on the family. The remaining 80 percent said that repayment reduced family income and that children's school fee payments might be compromised. They noted that repayment was expensive because they had to spend a lot more on transportation. The impact of repayment was felt greatly during times of ill health or other emergencies. Some respondents also revealed that they sold property to repay their loans. Families who repaid poorly said that they lived in fear and suffered psychologically when they saw any government vehicle. For that reason, they tried to repay so as to maintain a good relationship with government.

Sixty-six percent of the borrowers also were aware of the effect of their repayment on the community. They said that community members benefited by loan repayments. Some respondents noted that good repayment encouraged other community members to take loans and start businesses that provided needed goods and services to the community. They also pointed out that loan defaults cause the community to lose those goods and services and that poor loan repayment makes community members hesitant to take any loans for development.

4.9. The Effect of DECSI's Screening Mechanism on Default

Hunte (1996) argues that default problems destroy lending capacity as the flow of repayment declines, transforming lenders into welfare agencies, instead of a viable

financial institution. It incorrectly penalizes creditworthy borrowers whenever the screening mechanism is not efficient.

Figure 1.7. The Screening Process Mechanisms Used By DECSI

Step-1: Awareness creation   about the program

Step-2: Receiving loan   application

Step-3: Screening with Kebelle committee

Step-4: Loan approval:

1st by group members
2nd kebelle committee
And 3rd sub-branch committee
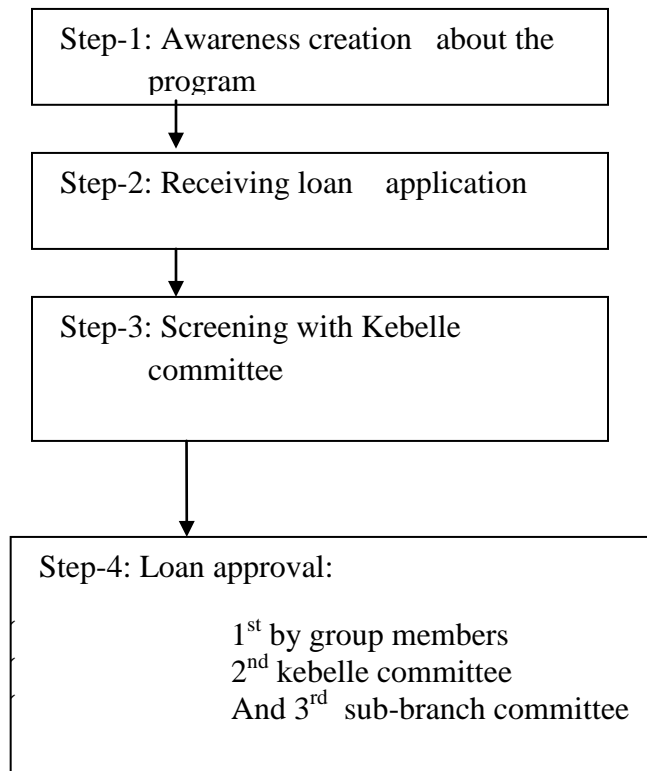
Source: Responses from interview made with the boards of DECSI

Figure 1.7 depicts the screening process mechanisms used by DECSI. Using these steps, the institution used to identify the borrower either as creditworthy or non-creditworthy which may penalize the creditworthy borrowers due to insufficiency of the technique. According to Grameen Bank model, the prospective clientele is identified after the purpose, functions, and mode of operation are explained to the population of the area covered. However, this issue is not incorporated in the screening mechanism which has been used by DECSI.

A vast body of literature supports the view that borrower characteristics are highly influential determinants of repayment. There is also strong evidence that institutional

characteristics are equally important and that both factors need to be taken into account if loan default is to be minimized (Derban, Binner, and Mullineux 2005). However, these two factors seem to be denied in the screening process mechanism of DECSI. Hence, identifying clients in this manner may not resolve the problem of direct targeting by specifying the members' eligibility requirements on the basis of asset ownership.

CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS

This final section of the report presents conclusions drawn from the findings and offers suggestions to strengthen the DECSI and better equip it to deal with the problem of slow repayment and default.

5.1 Conclusions

Study findings revealed that default on loans disbursed by the DECSI is strongly related to the major source of income. Borrowers' major source of income was found to be the business enterprise, and the predominant cause of default was poor business performance. Therefore, it can be concluded that borrowers who depend on their poorly performing businesses default.

Timely repayment of loans disbursed by the board, on the other hand, is influenced by good business performance and by the desire to build credibility with the trade office. Among slow re-payers who eventually repay their loans, however, repayment motivations include the desire to fulfill their outstanding obligations and the urgent need to reclaim or the fear of losing the security deposited as collateral for the loan. To a lesser extent, demand notices influenced repayment among slow-repaying borrowers.

Business performance in this study is viewed in terms of enterprise profitability. Therefore, board clients who had profitable businesses were able to repay their loans, whereas business losses led clients to default or repay slowly. The effect of poor business performance was confirmed further by the revelations of some borrowers that they used sources of income other than their micro enterprises to repay loans. This

finding indicates that borrowers who lack other sources of income easily could default if their businesses performed poorly.

Notwithstanding those factors, however, and drawing from the literature reviewed, this study observed that loan default averaging 57.41 percent is very high. Sustainable microfinance programs, such as the Grameen Bank, were found to have low default rates (roughly an average of 3 percent). Therefore, reducing the DECSI's default rate is a survival priority for the loan program. Sufficient repayment rates are necessary to facilitate re-disbursement of financing, and they contribute to achieving the board's objectives.

Findings of this study indicated, however, that there is a mismatch between the board's mandate and its capacity to handle core functions. It has a small staff whose operations are further constrained by limited operations and maintenance resources. As a result, although the DECSI has the potential to perform well in providing and recovering government micro credit disbursements, it lacks the necessary support.

This study also concluded the board's manual information systems are inadequate. For instance, manual recordkeeping is not suitable for effective program management. With the records as they presently are kept, the board cannot detect slow-repaying borrowers and potential defaulters—a fact further confirmed by the small number of borrowers who have received loan repayment demand notices. Although not many borrowers were served with demand notices, the notices did trigger repayment whenever they were used.

This study further observed that not prosecuting defaulters contributed to the rising trend in program loan defaults. Therefore, the options open to the board in dealing with either slow re-payers or defaulters are ineffective. Default rates are likely to rise and may negatively affect the board's operations.

The study also found that delays in disbursing funds to borrowers may be as great as two months from the time a loan application is filed. Timely disbursement enables a borrower to match acquired resources to business needs. With such delays, there is a possibility that business priorities and market conditions will have changed by the time

funds are received. That situation can lead to a diversion of funds for some unprofitable uses and so to an increased chance of loan default.

5.2 Recommendations

This study has found that improving the DECSI's performance is a prerequisite to make it more effective in carrying out its mandate and providing technical support to micro enterprises so as to improve their profitability. To that end,

I.   The DECSI should consider the following recommendations:

➢ Strengthen its management information systems to produce up-to-date loan repayment statements for borrowers and to enable early detection of potential default and slow-repayment problems. Doing so will help the board take quick follow-up actions, such as providing debt counseling or issuing demand notices.

➢ Strengthen its staff by enhancing the capacity of its computer applications. This will enable optimal use of the available computer facilities, speed up loan processing, and ensure timely disbursements.

➢ Intensify its follow-up on borrowers to improve recovery of outstanding loan balances accruing to slow re-payers and to prosecute defaulters.

➢ Revise its borrower appraisal instrument to help identify deserving but vulnerable micro entrepreneurs. Vetting should determine how much debt the borrower can handle comfortably, his or her income streams, and any other obligations that might interfere with repayment. Doing so can enable the board to provide the borrower with appropriate counseling and support to avoid repayment default.

➢ Carry out a workload analysis to establish the optimal trade office staffing levels for consideration by the Ministry of Trade and Industry.

➢ Establish common financial information sharing center so that the institution will have the chance of controlling any financial aspects

II. **The Ministry of Trade and Industry should consider the following recommendations**:

➢ Increase the staffing levels in the trade office to facilitate efficient service delivery in terms of quick processing of applications, disbursement of loans, and monitoring of loan usage.

➢ Provide to DECSI sufficient resources for operations and maintenance to permit efficient monitoring of borrowers and to cover the expense of prosecuting those who default.

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Appendix: A

Questionnaire

Dear Sir/madam:

My name is Teshale Birhanu and I am a master student in Business Administration/MBA in finance/ at Mekelle University under the supervision of Assistant   Professor   Mr. G. Sirinivasa Rao. I am writing this to invite you to participate in research in the form of a questionnaire. My project thesis is entitled as "CAUSES OF DEFAULT IN MICROFINANCE PROGRAMS, a case study in Dedebit, mekelle town". The aim of this study is to determine the causes that enhance the defaults of borrowers. For this matter, you are selected as a one who could provide me relevant information. The information supplied by you will be treated as confidential and access to the questionnaires is restricted to my supervisor and my-self. Completion of the questionnaire is voluntary. If you decide that you no longer want to be involved in this study you are free to withdraw at any time without adverse consequences. If you would like to obtain a summary of the results of this research, I am happy to send you copies of it.

Please put the response for each item:

- ✓ *Circle the correct letter for choose questions.*
- ✓ *Provide your explanation in the space provided for open ended questions.*

Please feel free to contact me on 0912210732 or teshalebir@yahoo.com in regards to any queries you may have, or my supervisor, Mr. G. Sirinivasa Rao on 0914216055 or gtsrinivas@gmail.com .

Thank you for your sincere cooperation and for sparing of your precious time.

ENNUMERATOR_____

DATE_____

1: PERSONAL DETAILS

1.1 Area of Borrower_____

1.2 Age_____

1.2 Sex_____ 0. Female   1. Male

1.3 Marital Status_____   1. Single   2. Married   3.divorced   4. widowed

1.4 Educational level _____ 1. Illiterate   2. Grade1-8   3. Grade 9-12

4. Above grade 12

2. Number of dependents: 1. 1   2.2   3.3   4. 4   5. 5 or more

3. LOAN UTILIZATION

3.1 What was the purpose for which the loan was taken? _____

1. Retail

2. Manufacturing

3. Motor vehicle repair

4. Hotel and catering services

5. Miscellaneous Business __

3.2. Was the amount of loan you took enough for the purpose intended?

1. Yes   0. No

3.3. If no, what was the amount you requested? Birr--------------------------------

3.4. Did you spend the entire loan on purposes specified in the loan agreement

1. Yes   0. No

3.5. If no. What was/were the reason(s) for spending part/entire loan on non intended purposes? _____

      1. The loan amount was not enough for the intended purpose

      2. The loan agreement did not coincide with my initial intention

      3. Market problem

      4. To repay another loan

      5. To make a more profitable business

      6. Other (specify) _____

4. INCOME AND WEALTH

4.1. Did you have a source of income (cash income) for your household before joining the program loan? ____1. Yes 0. No

4.2. If yes, what was/were the source(s) and level of your income?

Source	**Annual Income**

4.3. What was your annual income from activities financed by the loan during the last 12 months?]

1. Below Birr 1000   4. Between Birr 3001-4000

2. Between Birr 1001-2000   5. Between Birr 4001-5000

3. Between Birr 2001- 3000   6. Above Birr 5000

5. <u>Non defaulters</u>: what prompts you to repay the loan on time?

       1. To build credibility with the trade office
       2. Because of good business performance
       3. To get an other loan

6. <u>Slow re-payers:</u> what are the causes which force you to default?

       1. Diversion of funds
       2. Poor business performance
       3. Business closure
       4. Having many dependents

7. <u>Slow re-payers</u>: what forces you to repay the remaining balance after you fail to repay it as scheduled?

       1. Desire to complete outstanding loan
       2. Urgent need for collateral used to secure the loan
       3. Fear of loosing security deposits
       4. Receipt of demand notice
       5. Improvement of business

8. <u>For Defaulters</u>: what are the causes which lead you to default?

       1. Poor business performance
       2. Domestic problems
       3. Diversify the funds to unprofitable uses
       4. Poor timing
       5. Theft

6. Business closure

9. What is the Effect of repayment on enterprises?

    1. Has no effect on the enterprises

    2. Leads to a Reduction in your stock levels

    3. Not able to make any savings out of your profits

    4. Results in high depression and which in turn affects the relation ship with

     customers and Leading to poor business performance

10. What is the Effect of repayment on families?

    1. Repayment has no effect on families

    2. It reduces family income and children's school fees may be compromised

    3. Sells some properties to repay the loan

11. What is the Effect of repayment on the community?

    1. Repayment has no effect on community

    2. Good repayment encourages other community members to take loans and start businesses that provide needed goods and services to the community

    3. Loan default causes the community to lose those goods and services

Boards' Perspective on the Causes of Default:

12. Your qualification/position/----------------------------------

13.What is your believe regarding the causes of default?

    1. Failure to prosecute defaulters

    2. Lack of proper follow-up due to inadequate funding for operations and maintenance resources

    3. When loan amounts given are lower than the amounts requested

14. Have you ever observed that the length of time it takes for a potential borrower to apply and get the loan has an effect on the repayment of the loan?

1. Yes   0. No

15. How long does it take to complete the application process?

1. Two months
2. Four months
3. Six months
4. More than six months

16. What is your attitude towards the information system which has been used by DECSI?
    1. Its records on clients are inadequate
    2. Facilities do not contain appropriate software to process borrower information promptly
    3. Data relating to borrowers are manually kept in files
    4. Cases of loan-over and under-repayment exist
    5. Properly designed information system is there.

17. Which factors could be considered as cause of default?
    1. Diversion of funds to unprofitable uses
    2. Lack of discipline in the use of working capital
    3. Poor management skills
    4. Poor business performance

18. What measures do you have to deal with various categories of defaults?
    1. Sale of defaulters' security to recover the outstanding balances

2. Cases of long-lasting default are forwarded to the state counsel for prosecution

3. Counsel the defaulters on the importance of repaying the loan on time

19. If you believe that you have the above measures; what is the trend of default currently?

     1. Decreasing,   0. Increasing

20. What screening mechanism do you use to identify creditworthy borrowers from non-creditworthy borrowers before loan disbursement?

THANK YOU!!!

Appendix: B

Performance of DEBSI from the year 2005-2009 as of December 31

South-sub branch DECSI

Year	sex	Load Dispersed	Loan Recovered	Outstanding
2005	Male	2,498,800.00	688,402.29	1810397.71
	Fem.	3,803,850.00	998,725.22	2,805,124.78
	Total	**6,302,650.00**	**1,687,127.51**	**4,615,522.49**
	Regular:			

Year	Category			
2006	Male	15,000,000.00	13, 504,502.25	1,495,497.75
	Fem.	2,893,700.00	436,834.93	2456865.07
	Urban			
	Male	840,300.00	118,332.40	72,1967.60
	Fem.	1,728,800.00	233,547.35	1,495,252.65
	Total	**20,462,800.00**	**14,293,216.93**	**6,169,583.07**
2007	**Regular**:			
	Male	2,996,700.00	227,160.35	2,769,539.65
	Fem.	4,940,200.04	795,760.62	4,144,439.42
	Urban			
	Male	222,400.00	193,501.31	28,898.69
	Fem.	356,700.00	43,819.85	312,880.15
	Total	**8,516,000.04**	**1,260,242.13**	**7,255,757.91**
2008	**Regular**:			
	Male	4,984,797.92	4,635,997.92	348,800.00
	Fem.	5,208,413.98	4,629,413.98	579,000.00
	Urban			
	Male	17,828,800.00	16,221,175.49	1,607,624.51
	Fem.	4,219,228.19	596,728.19	3,622,500.00
	Total	**32,241,240.09**	**26,083,315.58**	**6,157,924.51**
2009	**Regular**:			
	Male	5,649,276.70	1,760,218.35	3,889,058.35
	Fem.	3,587,196.77	474,895.77	3,112,301.00
	Urban			

		Load Dispersed	Loan Recovered	Outstanding
	Male	2,141,014.42	601,514.42	1,539,500.00
	Fem.	5,509,291.15	2,099,291.15	3,410,000.00
	Total	**16,886,779.04**	**4,935,919.69**	**11,950,859.35**

Source: Compiled by Researcher from the Archives of South-sub branch of DECSI

Appendix: c

Performance of DEBSI from the year 2005-2009, *as of December 31*

North-sub branch of DECSI

Year	sex	Load Dispersed	Loan Recovered	Outstanding
	Regular:			
	Male	3,126,700.00	1,103,059.50	2,023,640.50
	Fem.	2,564,200.00	663,798.25	1,900,401.75
2005	**Urban**:			
	Male	1,200,000.00	90,282.00	1,109,718.00
	Fem.	2,373,115.00	899,100.00	1,474,015.00
	Rural:			
	Male	510,000.00	105,000.00	405,000.00
	Fem.	73,220.00	7,450.00	65,770.00
	Total	**9,847,235.00**	**2,868,689.75**	**6,978,545.25**
	Regular:			
	Male	1,869,300.00	20,893.85	1,848,406.15
	Fem.	2,316,350.00	362,313.40	1,954,036.60
	Urban			

2006	Male	1,648,000.00	265,831.50	1,382,168.50
	Fem.	2,521,100.00	470,205.10	2,050,894.90
	Rural:			
	Male	146,150.00	-149,495.00	295,645.00
	Fem.	44,150.00	-18,520.00	62,670.00
	Total	**8,545,050.00**	**951,228.85**	**7,593,821.15**
2007	**Regular**:			
	Male	37,322,500.00	33,598,859.50	3,723,640.50
	Fem.	3,828,800.00	844,398.25	2,984,401.75
	Urban			
	Male	3,245,000.00	2,135,282.00	1,109,718.00
	Fem.	4,715,000.00	3,240,985.00	1,474,015.00
	Rural:			
	Male	122,550.00	-595,611.85	407,310.00
	Fem.	122,550.00	48,880.00	73,670.00
	Total	**49,356,400.00**	**39,272,792.90**	**9,772,755.25**
2008	**Regular**:			
	Male	4,573,701.00	-595,611.85	5,169,312.85
	Fem.	3,640,650.00	173,415.85	3,467,234.15
	Urban			
	Male	1,473,500.00	-408,460.70	1,881,960.70
	Fem.	2,670,500.00	-12,542.80	2,683,042.80
	Rural:			
	Male	86,850.00	-317,475.00	404,325.00

	Fem.	62,900.00	-62,940.00	125,840.00
	Total	**12,508,101.00**	**-1,223,614.50**	**13,731,715.50**
2009	**Regular**:			
	Male	3,203,300.00	-1,959,107.02	5,162,407.02
	Fem.	2,861,800.00	-177,966.77	3,039,766.77
	Urban			
	Male	1,173,000.00	-177,966.77	2,286,536.05
	Fem.	2,295,500.00	-874,718.75	3,170,218.75
	Rural:			
	Male	-----------	-----------	279,545.30
	Fem.	----------------	-------------------	93,075.00
	Total	**9,533,600.00**	**-3,189,759.31**	**14,031,548.89**

Source: Compiled by Researcher from the Archives of South-sub branch of DECSI

Note: ------ not available