THE DETERMINANTS OF NON-PERFORMING ASSETS IN FINCA INTERNATIONAL INCORPORATION

THE CASE STUDY OF MOROGORO BRANCH

THE DETERMINANTS OF NON-PERFORMING ASSETS IN FINCA INTERNATIONAL INCORPORATION

THE CASE STUDY OF MOROGORO BRANCH

By

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A Thesis submitted in partial fulfilment of the requirements for Award of the Masters of Science in Accounting and Finance (MSc. A&F) of Mzumbe University

2015

CERTIFICATION

We, the undersigned, certify that we have read and hereby recommend for acceptance by the Mzumbe University, a thesis entitled **The Determinants of Non-Performing Assets in FINCA: The case study of Morogoro Branch.** In partial fulfillment of the requirements for the award of the degree of Masters of Science in Accounting and Finance of Mzumbe University.

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Major Supervisor

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Internal Examiner

Accepted for the Board of school of business

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CHAIR SCHOOL BOARD

DECLARATION

I, Beatrice John Bernard, declare that this research report is my own original work and that it has not been presented and will not be presented to any other University for a similar or any other degree award.

Signature……………………………

Date…………………………………

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ACKNOWLEGMENT

I would like to express my profound gratitude to Almighty God for the strength and life given to me to undertake this research work. I am also thankful to all those who in one way or the other contributed in the successful completion of this workespecially Mr. John Kanyoro and Eric John.

The preparation and production of this thesis would have not been possible without assistance from a number of committed individuals. Thus my great pleasure is to convey my sincere gratitude to the FINCA Morogoro Branch Management, employees and customers. All kinds of support, material and moral, that the management and staff of FINCA provided in accomplishment of this thesis report and their cooperation is highly appreciated.

My heartfelt thanks are also expressed to my supervisor, Prof. Srinirvas Madishetti for his unconditional assistance, helpful comments and his guidance while writing this report that enabled me to come up with this thesis. Sir, may the Almighty God Bless you indeed.

Finally, I am eternally grateful to my Husband; **Mr. Furaha E. Mazinge** for his support, sacrifices, encouragement and understanding in the course of undertaking this project work.

DEDICATION

I dedicate this work to my late father Mr. John B. Rugakila, my beloved Husband, Daughters and my mother Oliver J Bernard, who all together in one way or another have supported me throughout my studies to the completion of this report.

ABBREVIATIONS

BOT	Bank of Tanzania
FINCA	Foundation of International Community Assistance
GDP	Gross Domestic Product
IT	Information Technology
MFIs	Microfinance Institutions
NBC	National Bank of Commerce
NPAs	Non-Performing Assets
NPLs	Non-Performing Loans
PAR	Portfolio at Risk
TZS	Tanzania Shillings- a unit of currency in Tanzania

ABSTRACT

Microfinance Institutions (MFIs) in the World currently provide significant financial services including microcredit facilities particularly to the rural and semi-urban areas across the country. Granting of microcredit facility (Loan) is a major activity of the MFIs and the loan portfolio constitute a significant proportion of the assets of the MFIs. Undoubtedly, the MFIs derive most of their interest incomes from loans, however, not all loans granted to beneficiaries perform well and earn the expected returns and this tend to have adverse effect on the quality of the loan portfolio. The purpose of the study was to find out the Determinants of non-performing assets in Microfinance Institutions. The study focused on trend of Non-Performing Assets at FINCA as a whole and the causes or factors for Non-Performing Assets at FINCA Morogoro Branch. The study reviews both theoretical and empirical aspects of Non-Performing Assets.

Chi-square analysis is employed, both primary and secondary data were used for the study. The study found FINCA recorded significant amounts as non-performing assets in the five-year period reviewed and has adversely affected the financial performance of the organization by reducing its operating profits, loanable funds and undermining the liquidity position. The findings revealed that external factors are more prevalent in causing non-performing assets in FINCA. Findings suggest that integrity of borrower such that use of funds forpurposes different from agreed ones as a major factor that cause NPAs.Close monitoring of borrowers is critical to lending business, good relationship with borrowers was found to be the most favorable strategy of reducing non-performing assets.

The researcher suggests future studies should be broad to assess the performance of Credit Risk Management in line with the level of NPA in MFIs.

This thesis is organized into five chapters. Chapter one covers introduction of the study. Chapter two presents review of related literature. In this chapter, the key issues concerning Non-performing Assets are discussed. Chapter three is the research methodology. Chapter four discusses various findings and analysis, while several recommendations and conclusion are found in chapter five.

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CHAPTER ONE

1.0 Introduction

This chapter expect to explain the background of the problem to be studied, Statement of the research problem, objectives of the study, research questions, scope of the study and significant of the study.

1.1 Background of the study.

The seed for Microfinance in its current form were planted during the period 1950-80s when small loans were extended to poor borrowers who would not post meaningful collaterals. Major organisations who pioneered this initiative were ACCION International, Latin America, SEWA Bank in India and Grameen Bank founded by Muhamad Yunus in Bangladesh. (Suresh S. 2008)

Microfinance is a finance service of small quantity provided by financial institutions to the poor. “These financial services may include savings, credit, insurance, leasing, money transfer, equity transactions and so forth. Micro-entrepreneurs value the opportunity to borrow and save with Microfinance Institutions (MFIs) since they provide service that are cheaper than those that would normally be available to poor clients or that would be entirely unavailable to them. Microfinance is a better mechanism to reduce poverty gradually. (Soumitra S.&Samirendra N. D 2011)

NPA is defined as a loan or an advance in respect of which the interest &/or installment of principal remains “overdue” for a period of more than 90 days in respect of a term loan or remains “out of order” for a period of more than 90 days in respect of an Overdraft /Cash Credit. NPAs are a typical by products of financial crises. Raising interest rates (raising the burden of debt service), economic slowdowns (eroding the viability of borrowers) and exchange rate depreciation (increasing the liability of borrowers with unhedged position in their foreign currency borrowing) can all severely undermine the capacity and sometimes the willingness of borrowers to continue servicing and to repay their debt. If left unresolved NPA can deepen the severity and duration of financial crises and complicate macroeconomic management.

The collapse of Tanzania Housing Bank and Meridian Bio bank, closure of Greenland Bank and Trust Bank as well as privatisation of Tanzania's giant's commercial bank NBC Ltd., had brought a challenge to other banks and financial institutions to fasten control over non-repayment of loans so as to minimize credit risk. National economic downturn, insider lending, political connection of bank owners, customer failure to disclose vital information during the loan application process, lack of proper skills amongst loan officials were among major factors identified in other countries to cause non-performing loans (Santomero, 1997; Brownbridge and Harvey, 1998; Basel, 1999; Waweru and Kalani, 2009).

Due to these findings therefore it is imperative that effective assets management policies designed both to contain any further deterioration of asset quality and to resolve NPA be an integral part of financial crisis stabilization. (David W. 2000).

Controlling non-performing loans is very important for both the performance of an individual bank and the economy's financial environment (McNulty et.al, 2001). It is thus the essence of this study to establish factors behind non-performing loans thereby identifying weaknesses, if any, in the system and possibly suggests reasonable measures for improvement.

Despite ongoing efforts to control bank lending activities, non-performing loans are still a major concern for both international and local regulators. The issue of loan default(NPLs) is becoming an increasing problem that threatens the sustainability of MFIs (Boudriga et al, 2009).This is why the researcher thought there is still a need to look into the trend and Determinants of Non-Performing Assets, which Micro finances could look at and get solutions to this Problem.

1.2 Statement of the Research Problem.

The banks, in their books, have different kind of assets, such as cash in hand, balances with other banks, investment, loans and advances, fixed assets and other assets. The Non-Performing Asset (NPA) concept is restricted to loans, advances and investments. As long as an asset generates the income expected from it and does not disclose any unusual risk other than normal commercial risk, it is treated as performing asset, and when it fails to generate the expected income it becomes a

"Non-Performing Asset". In other words, a loan asset becomes a Non Performing Asset (NPA) when it ceases to generate income, i.e. interest, fees, commission or any other dues for the bank for more than 90 days, (Selvarajan B. and Vadivalagan G, 2013)

FINCA's loan portfolio is made up entirely of loans made to individuals and groups of individuals for a specific purpose. Credit risk arises from FINCA's microfinance activities. Looking into FINCA`s Consolidated Financial Statements for the past 5 years from 2009 to 2013. The value of all loans outstanding that have one or more installments of principal past due more than a certain number of days; known as Portfolio at Risk includes the entire unpaid principal balance, including both past-due and future installments, but not accrued interest. Portfolio at risk (PAR) is usually divided into categories according to the amount of time passed since the first missing principal installment. This has appeared to be an indicator of Risk/threat to all the 24 Subsidiaries inclusively in Latin America, Africa, Eurasia and Middle East making an alert of a Non Performing Asset.

Loan Loss Provisioning is the vehicle for adjusting the value of loans, so as to reflect the loan review and classification. Once the review shows that a value of loan becomes "doubtful" a provision needs to be established to reflect the loss of loan value. The cost of provisions constitutes a normal business expenses and reduces bank/microfinance profit, (Luis C. et al, 2000). FINCA depends on donations to do their operations sometimes there is shortage of the donations leading to high Loan loss provisions.

Loan portfolio constitutes the largest operating assets and source of revenue of most financial institutions‟. However, some of the loans given out become non-performing and adversely affect the profitability and overall financial performance of the lending institutions. Along with all the above literatures, much was not discussed on the determinant of non-performing assets which is the target of the researcher.

In view of NPAs for FINCA over the past five years has been increasing in some countries and decreasing in other countries, short of donations to meet the demand

and high loan provisions have necessitated to study the factors responsible for such changes at FINCA. After the review of several literature on NPA I have found that there are very few studies done at FINCA especially on NPAs, This also necessitated me to conduct this study the factors leading to NPA at FINCA.

1.3 Research Objectives

The objectives of this study have been categorised into general objective of the study and specific objectives as follows below:-

1.3.1 General Objective.

The main objective of this study was to find out the determinants of Non-Performing Assets in FINCA International Incorporation.

1.3.2 Specific Objectives

The specific objectives of this study were:

(i) To examine the trend in Non-Performing Assets

(ii) To assess both Internal and External determinants of Non-Performing Assets

1.4 Research questions

This research was conducted under the following research questions:

(i) What is the trend in Non-performing Assets in FINCA for five years?

(ii) What are the determinants of Non-performing assets in FINCA?

1.5 Research Hypothesis

The purpose of this study was to find the determinants of nonperforming loans (NPLs) in FINCA International Incorporation. The empirical studies made around the world demonstrate various outcomes on determinants of nonperforming loans of the financial sectors. From the research findings the researcher observed as there is no relationship between the level of education in customers, years of experience in a lending institution and the awareness of the causes of NPLs.

1.6 Significance of the study

Around the World, the lessons of experience in providing financial services to low income people have converged in a consensus about how to provide such services effectively, efficiently and sustainably. The government of Tanzania expects institutions involved in microfinance to apply these practices or to develop capability to do so. Donors and others who provide support to Micro finances should insist on the application of best practices. Microfinance programs use techniques and products adapted to the circumstances of low income clients. Particular techniques may vary widely. A variety of collateral substitutes and repayment incentives can be used so that loans are not secured in a predictable sense but are adequately protected against risk (Ministry of Finance, May, 2000).

The researcher believes that the result of this research will contribute to the following significances.

First, the paper could be used as an initiation for those who are interested to conduct a detailed and comprehensive study regarding the performance of micro finance institutions in credit risk management practice.

Second, it will enable the governing body, specifically the managements, and the higher responsible body, risk management department of the institution to be aware of credit risk management and its effect on growth of institutions income.

Third this study shall contribute to existing knowledge on how to institute and implement Credit Risk Management process for better and strengthened performance of the Loan portfolio.

Fourth This study has an attempt to find out on the Determinants of Non-Performing Assets in Microfinance, The study will provide evidence on the trend of NPAs and its Causes also it will highlight on the loan review System, Credit Granting System and collection/recovery Procedures FINCA International.

Lastly the researcher will expand her knowledge on Credit Issues also it is a partial fulfillment of the requirements for the award of the degree of Masters of Science in Accounting and Finance of Mzumbe University.

1.7 Scope of the study

The researcher believes that the findings of this study would have been more productive to MFIs if it has been conducted on all MFIs. However, due to time and financial constraints, it is out of the reach of the researcher to incorporate all MFIs in this study. Due to this, the paper is limited to only one selected Microfinance Institution which is FINCA International. The period of assessment will also be limited to 2009-2013 to obtain the trend of NPA at FINCA as a whole and will obtain the cause of NPA through the Questionnaire and interview from FINCA Morogoro Branch as a representer. This is to ensure that the result reflects the current trend in the operations of FINCA.

1.8 Limitation of the study

Time is a major constraint in this study, also financial constraint was the other challenge to the researcher. This is why the research was limited to only One Microfinance. Among the major constraints in this study was time. Looking at the short period required for the completion of the work, the case study approach was adopted. Even though the MFIs in the country share common characteristics and face similar challenges, some aspects regarding the topic will not be discussed. This is main reason why FINCA Morogoro Branch which has operated in Morogoro for over 10 years with all the typical characteristics of MFI was chosen for the study. A sample of the credit staff, Customers and Managers and Supervisors of FINCA were administered with questionnaire to obtain the primary data. This obviously imposed some limitations on the study. Again, another limitation was to get access to essential information that was to come from the defaulters themselves. FINCA Morogoro researches have never been conducted on causes of NPA and Confidentiality of Information was another factor that lead to not get much information. Most financial institutions will not readily disclose information to researchers for fear of breach of Oath of Secrecy (Duty of confidentiality). This constraints was dealt with by relying on published annual reports and financial statements and also assuring the respondents that the information was mainly for academic purposes and that their identities will not be disclosed anywhere.

1.9 Chapter Scheme/Plan

This study will be divided into Five Chapters.

Chapter one deals with the Introduction or Problem setting covering Background to the problem, statement of the problem, Research Questions, Objectives, Significance of the study, scope of the study and limitation of the study.

Chapter Two deals with the Literature Review, Covering the Theoretical and Empirical part of the Review, Conceptual framework and Research Model and the Hypotheses.

Chapter Three deals with Research Methodology showing type of the study, study area, types and source of Data, Sample size, Methodology and model specification and data analysis.

Chapter Four will present the findings obtained after the collection and analysis of data Collected from different sources through different Analysis Methods. And

Chapter Five discusses the findings and summarises Conclusions, Discussion, and will provide suggestions for Future Research if any

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

In this chapter the researcher will present the Critical Review both theoretical and empirical reviews from different recent related literature on the topic of Non-performing loans/assets conducted in different financial institutions. All these literatures will give the researcher the chance to determine the knowledge gap and draw hypothesis for the study. Furthermore in this topic the conceptual framework about the determinants of NPAs will be presented.

2.1 Theoretical literature review

2.1.1 Microfinance

Microfinance encompasses the provision of financial services and the management of small amounts of money through a range of products and a system of intermediary functions that are targeted at low income clients. It includes loans, savings, insurance, transfer services and other financial products and services. Microfinance is thus one of the critical dimensions of the broad range of financial tools for the poor, and its increasing role in development has emanated from a number of key factors that include the fact that the poor need access to productive resources, with financial services being a key resource, if they are to be able to improve their conditions of life. (Maria O.and Beth R. C, 1998).

‘Sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs." (Kofi Annan, December 2003).

2.1.2 Background Information of FINCA International

Since 1984, FINCA International (Foundation for International Community Assistance) has provided village banking and other associated loan services to the poor in 24 countries on five continents. Since its establishment there has been number of non-performing assets that reduce the performance of FINCA as per financial statements of different financial years.

FINCA is a leading international Microfinance Institution. It was established in 1984 by Dr. John Hatch who also is the creator of Village Banking-a unique and influential method for delivering small loans, savings, and other financial services to the poor worldwide. FINCA offers financial services and products to small scale businesses that have been turned down by traditional banks, so that these businesses can start, grow, and diversify with resulting increases in family income, nutrition, employment and well-being. FINCA launched its first program in Africa. FINCA Uganda opens in 1992, proving that Village Banking can work in diverse geographic and cultural environments. FINCA Tanzania started its operations in April 1998 in Mwanza, then extended throughout the lake Zone in the north western part of Tanzania, including Shinyanga, Mara, Kagera and Tabora. FINCA then expanded to Morogoro (Kilosa, Ifakara, Iringa and Kilombero), Dar es Salaam, the Coast region, Mbeya and most recently Dodoma and Njombe. The United Nations declares 2005 the Year of Microcredit. The 2006 Nobel Peace Prize was awarded to Muhammad Yunus and Grameen Bank, validating the positive global impact of microfinance. 2010 Milestone: FINCA celebrates 25 years of providing financial services to low-income entrepreneurs. By 2013 FINCA reaches 1 million clients, and they operate subsidiaries in 23 countries of Africa, Eurasia, the Middle East and South Asia and Latin America, serving over one and a half million people. Inspite all these achievements FINCA is still faced with the Non Performing Advances(FINCA, 2015)

FINCA Morogoro was established in 2000, FINCA then expanded to Morogoro (Kilosa, Ifakara, Iringa and Kilombero) with only 10 employees and 300 clients with a loan portfolio of Tsh. 300,000,000.00. To date FINCA Morogoro has 30 Employees and 3910 clients; in 2010, 2012 and 2014 had a Loan Portfolio of 1.7 billion, 1.8 billion and 2.0 billion respectively. It has currently issued 2.1 billion to its 3910 clients

FINCA Tanzania mission is to provide financial services to the world's lowest-income entrepreneurs so they can create jobs, build assets and improve their standard of living. FINCA`s aim is to shatter the vicious cycle of poverty by assisting its clients to improve their businesses and the quality of their lives. FINCA`s vision is to be part of a global network collectively serving more poor entrepreneurs than any other MFI while operating on commercial principles of performance and sustainability.

(i) Activities and Products

FINCA serves its clientele through the provision of two financial products, described below:

The Village Bank: Micro and small scale entrepreneurs form groups of between 25 to40 members for the purpose of accessing loans from FINCA Tanzania. These groups are called Village Banks. Village Bank loans do not require members to provide collateral or securities, but are based on group guarantee scheme and individual integrity. Members undergo four weeks training in which they learn about FINCA Tanzania`s Village Banking methodology, basic principles of business management and record keeping. For a person to have access to the loan, he or she must be a Tanzanian running any legal business for at least 2 months; needs to be guaranteed by the group and willing to guarantee other members; needs to be willing and able to attend trainings and stipulated meetings. All clients and their loan balances are covered by Credit & Life Protection Cover that provides valuable life cover for client, spouse and dependents in event of death by accident, plus all loan balances. The Village Banking loan ranges from TZS 30,000/- to TZS 2.5million, whereas the average loan term is 16 weeks and clients are required to save on a weekly basis, and opening group accounts at licensed commercial banks.

The Business Loan: open for any Tanzanian entrepreneur who is seeking to expand their businesses. The loans range from Tshs 500,000 to 10 million. The loans are repaid on a monthly basis (interest and principal). Eligible participants are Tanzanian nationals running any legal business, with a minimum age of 18 with experience of at least 2 years in the same business

(ii) Mission

FINCA's mission is to alleviate poverty through lasting solutions that help people build assets, create jobs and raise their standard of living.

(iii) Vision

FINCA's vision is to build a global network of sustainable and scalable social enterprises that improve lives worldwide.

(iv) Approach

When clients visit FINCA for a loan, most of them are already micro-entrepreneurs. They have enough experience to know that, without additional working capital, their odds of becoming or staying profitable and productive, or of making improvements in their lives, remain low. They look for a business loan, much like any other entrepreneur, but at a micro level. For these small-scale businesses, even small amounts of capital can make a dramatic difference. A business loan of a few hundred dollars can enable micro-entrepreneurs to pay wholesale rather than retail prices for the goods they resell, or to buy with cash rather than on consignment, or acquire a more modern piece of essential equipment, turning their businesses into profitable, sustainable enterprises. This small increase in purchasing power can have an immediate impact on a client's productivity and earnings. For other clients, having a safe and trusted place to store and save their daily revenue is most critical. FINCA meets all these needs.

FINCA provides clients with a wide range of the financial products and services that micro-entrepreneurs need including savings accounts; group and individual loans; credit life, short-term disability, and hospitalization insurance; and money transfers. These products vary by local demand, and they are adapted to comply with local regulations and culture. Each FINCA Subsidiary is run by a local team of professionals with intimate knowledge of their market, and it is this localized, client-driven approach that has made FINCA's global expansion possible and so effective. FINCA is firmly committed to Client Protection and fair practices and maintains strict policies to ensure compliance. Our local loan officers are trained in FINCA's mission, and dedicated to helping clients build successful businesses while ensuring that they are protected from unnecessary risks.

(v) Leadership

FINCA's Board of Directors brings diversity of experience and dedication to the mission. And its senior management leads a worldwide organization of more than 12,000 employees.

(vi) Who funds FINCA?

FINCA is funded through donations, social investment and loans.

Donated funding comes from a variety of sources, including U.S. and international governmental development agencies, private foundations, corporations, service and religious organizations, and individual donors.

Investment funding from FINCA Microfinance Holding Company LLC (FMH) is funded by investors including International Finance Corporation, a member of the World Bank Group; KfW, the German development bank; FMO, the Dutch development bank; responsibility Global Microfinance Fund, an investment fund advised by the Zurich-based asset manager responsibility Social Investments AG; Triple Jump, a Netherlands-based microfinance investment firm, and Triodos Investment Management, owned by Triodos Bank. FINCA International, Inc. is the majority shareholder.

Business model: FINCA operates with a unique, integrated business model that accepts donations and investment dollars. Their approach leverages available capital and promotes greater transparency, sustainability and higher standards of business practices. Their business model allows them to achieve balanced financial and social performance that is unmatched in the industry.

FINCA charges interest in order to cover its costs and achieve operational sustainability. The interest charged on our loans supports our credit staff in the field, allowing us to bring services to customers, even in remote areas; enables us to borrow, re-lend and repay commercial capital, which means we can reach many more low-income customers; and ensures that we remain a reliable resource for our customers.

(vii) FINCA entities

Through its headquarters, foreign representative offices and branches, controlled Subsidiaries and affiliates, FINCA operates in 26 countries. All Subsidiaries and affiliates are controlled by FINCA directly or through FMH (see Note 1). The significant are listed below:

Table 2.1: Operating Subsidiaries and controlled affiliates of FINCA

	AMERICAS	
1	Ecuador	Banco para la Asistencia Comunitaria, FINCA S.A. Joint Stock Company
2	El Salvador	Asociación de Fomento Integral Comunitaria de El Salvador Not for profitAssociation FINCA S.A. de C.V.
3	Guatemala	Fundación Internacional para la Asistencia Comunitaria de Guatemala *Foundation* FINCA S.A.
4	Haiti	FINCA HAITI *Non-Governmental Organization*
5	Honduras	SociedadFinanciera FINCA Honduras, S.A. *Joint Stock Company* FundaciónInternacional para la AsistenciaComunitaria de Honduras *Not-for-profit Organization*
6	Mexico	SOFOM Mexico SAPI Fundación Integral Comunitaria, A.C. *Civil Association*
7	Nicaragua	Financiera FINCA Nicaragua, S.A. *Joint Stock Company* FundaciónInternacional para la Asistencia Comunitaria de Nicaragua *Not-for-profit Foundation*
	AFRICA	
8	Congo	FINCA DR CONGO SARL *Limited Liability Joint Stock Company*
9	Malawi	FINCA Limited *Company Limited by Shares*

Table 2.1: Operating Subsidiaries and controlled affiliates of FINCA

10	Tanzania	FINCA Tanzania Limited *Company Limited by Shares*
11	Uganda	Foundation for International Community Assistance Uganda Limited *Company Limited by Shares*
12	Zambia	Foundation for International Community Assistance-Zambia Limited Company Limited by Shares
	EURASIA	
13	Armenia	FINCA Universal Credit Organization *Closed Joint Stock Company*
14	Azerbaijan	FINCA Azerbaijan *Limited Liability Company*
15	Georgia	JSC MFO FINCA *Closed Joint Stock Company*
16	Kosovo	FINCA International, Inc. (Branch)
17	Kyrgyzstan	FINCA Micro-Credit Company *Closed Joint Stock Company*
18	Russia	FINCA CJSC *Closed Joint Stock Company*
19	Tajikistan	FINCA Micro-Credit Deposit Organization *Limited Liability Company*
	MIDDLE EAST	
20	Jordan	FINCA Jordan Specialized Micro Loans Company
21	Afghanistan	FINCA Afghanistan *Joint Stock Company Limited by Shares*
22	Pakistan	FINCA Microfinance Bank Limited
	CHARITABLE AFFILIATES	
23	Canada	FINCA Canada
24	United Kingdom	FINCA UK

2.1.3 Loan and Risk

Neil J and Raymond S. in their book of 1942 have identified the basic elements that define a term loan are: (1) credit extended to a business concern; (2) a direct relationship between borrower and lender; (3) provision at time of making the loan that some part of the principal is repayable after the passage of one year. The terms of credit are defined over five critical financial parameters: amount of credit, interest rate, maturity of loans, frequency of loan servicing and collateral.

In Financial Institutions loans and Advances are the largest and most obvious source of credit risk. Many credit problems are associated with weaknesses in the credit granting and monitoring processes. Commercial banks find carrying out a thorough credit assessment (or basic due diligence) a substantial challenge. For traditional bank lending; lack of capabilities, competitive pressures and the growth of loan syndication techniques create time constrains that interfere with basic due diligence principle.

FINCA International defines Loans and advances as non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. (FINCA, 2008)

A delinquent loan is one on which payment of interest or scheduled payment of principal has not been received as of due date.

Risk is the probability that a decision will lead to a different outcome as thought due to the fact that decisions are made under uncertainty with imperfect information (Harry C. and William C. M, 2010). Risk taking is an inherent element and integral part of financial services in general and of microfinance in particular and, indeed, profits are in part the reward for successful risk taking in business. On the other hand, excessive and poorly managed risk can lead to losses and thus endanger the safety and soundness of microfinance institutions and safety of microfinance institution’s depositors. Consequently, microfinance institutions may fail to meet its social and financial objectives. This implies that proactive risk management is essential to the long term sustainability of microfinance institutions (MFIs), (Wright and Haynes, 2005).

National Bank of Ethiopia 2010, explains Credit risk that it arises from all activities in which success depends on counterparty, issuer or borrower Performance. It is the risk to earnings or capital due to borrower’s late and non-repayment of loan obligation. Credit risk encompasses both the loss of income resulting from the MFI’s inability to collect an anticipated interest earnings as well as the loss of principal resulting from loan defaults.

Directorate of banking supervision, BOT. Aug, 2010 explains “Credit risk” to arise from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the institution.

Ken and Peter (2008), there are three characteristics that define Credit Risk:

a) Exposure (to a party that may possibly default or suffer an adverse change in its ability to perform)
b) The likelihood that this party will default (or the default probability) on its obligations.
c) The recovery rate (that is how much can be retrieved if a default takes place)

It should be noted that the higher the first and second elements the greater the exposure. On the other hand the higher the amount that can be recovered the lover the risk.

Credit Risk= Exposure X Probability of Default X (1 less Recovery rate)

Components of Credit Risk are:

(i) Credit Growth in the organization and composition of the credit folio in terms of sectors, centers and size of borrowing activities so as to assess the extent of credit concentration.
(ii) Credit quality in terms of standard, sub-standard, doubtful and loss-making assets.
(iii) Extent of the provisions made towards poor quality credits.
(iv) Volume of off-balance sheet exposure having a bearing on the credit portfolio.

2.1.4 The Concept of Non-Performing Loan

A performing Asset is an account which does not disclose any problems and carries not more than normal risk attached to the business this is to say all loan facilities which are regular. It can therefore be deduced that loans that are up to date in terms of principal and interest payment are described as performing loans and they constitute the healthy asset portfolio. (BoG, 2008)

Non- performing loans are also commonly described as loans in arrears for at least ninety days (Guy, 2011). Non-performing assets (NPAs) are problematic for financial institutions since they depend on interest payments for income. As such interest is no longer anticipated (Hennie van G. & Sonja B. B, 2003).The current banking environment shows that one of the major constraints of the competitive efficiency of banks is the tendency to accumulate poor quality of assets because NPAs act as a drag on profitability and inhibits the lending decisions of the banks. An asset becomes Non-performing when it ceases to generate income for a Bank. Once the borrower has failed to make interest or principal payments for 90 days the loan is considered to be a non-performing asset.

Loan portfolio constitutes the largest operating assets and source of revenue of most financial institutions‟. However, some of the loans given out become non-performing and adversely affect the profitability and overall financial performance of the lending institutions. Along with all the above literatures, much was not discussed on the determinant of non-performing assets which is the target of the researcher.

It is argued that the non-performing assets are one of the major causes of the economic stagnation problems. Each non-performing loan in the financial sector is viewed as an obverse mirror image of an ailing unprofitable enterprise. From this point of view, the eradication of non-performing loans is a necessary condition to improve the economic status. If the non-performing loans are kept existing and continuously rolled over, the resources are locked up in unprofitable sectors; thus, hindering the economic growth and impairing the economic efficiency.

The essential component of a sound NPA management system is quick identification of non-performing advances, their control at minimum levels and ensuring that their impingement on the financials is minimum. The approach to NPA management has to be multi-pronged, calling for different strategies at different stages a credit facility passes through. (Ambuj G. 2010)

2.1.5 Loan Classification and Provisioning

RBI Report (2008),All licensed financial institutions are required to monitor and review their portfolio of credit and risk assets at least once every quarter on a regular basis. Assets are classified into four grades of risk: (i) standard; (ii) sub-standard ;(iii) doubtful; and (iv) loss.

NPLs comprises of three categories where no income may be accrued on them:-

a) Substandard
b) Doubtful
c) Loss

(i) Sub-standard Assets:

A substandard asset was one, which was classified as NPA for a period not exceeding two years. With effect from 31st March 2001, a sub-standard asset is one, which has remained NPA for a period less than or equal to 18 months. Such assets will have well defined credit weaknesses that jeopardize the liquidation of the debt and are characterized by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected. Banks are required to make 10% on total outstanding balance & 10 % on unsecured exposures as provisions.

(ii) Doubtful Assets:

A doubtful asset was one, which remained NPA for a period exceeding two years. With effect from 31st March 2001, an asset is to be classified as doubtful, if it has remained NPA for a period exceeding 18 months. With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months.100% to the extent advance not covered by realizable value of security. In case of secured portion, provision may be made in the range of 20% to 100% depending on the period of asset remaining sub-standard

(iii) Loss Assets:

A loss asset is one where the Bank or external Auditors or the RBI inspection has identified loss but the amount has not been written off wholly. In other words such an asset is considered uncollectable and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value. Generally 100% of the outstanding balance is kept as a provision.

Across the world, the major factor considered by the lending institutions before granting loans is the ability and the willingness of the borrower to repay the loan on the due date. When the probability of collecting a loan becomes very low, the normal practice is to charge the loan off by deducting its value from the loan portfolio balance by reducing loan loss reserve or, if there is no reserve, by charging an equivalent expense to the income statement. Thus, as a results of uncertainties in future cash flows and willful defaulting and to be able to minimize the risk of default, microfinance institutions normally require security in the form of guarantee and/or deposit, (usually up to 25% of the loan amount). Borrowers who miss payments are pressured at the due date and if the arrears continue, legal action is initiated against the borrower and guarantor(s) to recover any amounts owed, but usually after the designated collateral has been seized and liquidated to reduce the borrowing(outstanding loan balance). Provisioning for delinquent microfinance and small business loans is made on a “basket” basis, rather than on an individual loan basis. Basket-based provisioning involves making a blanket provision for the aggregate outstanding balances of loans grouped in each age basket, without regard to any security available for individual loans.

Table 2.2:- Loan classification and provisioning system for the international standard

Period Overdue	Status of classification	Rate of provision	Frequency of classification
Less than 3 months	Unclassified	1% - 5%	At least quarterly, Usually monthly.
Loans overdue for 3 to 6 months	Substandard	10% - 25%	At least quarterly, Usually monthly.
Loans overdue for 6 to 9 months	Doubtful	50%-75%	At least quarterly, Usually monthly.
Loans overdue for 9 months or more	Bad/loss	100%	At least quarterly, Usually monthly.

2.1.6 Causes of NPAs

To ensure sustainability of microfinance institutions, a risk management framework was developed. As the microfinance industry matures, standardized risk management techniques consistent with International Financial Reporting Standards (IFRS) are being adopted by microfinance institutions. (Karla Brom 2009)

The problem of NPAs is related to several internal and external factors confronting the borrowers (Muniappan, 2002). The internal factors are diversion of funds for expansion/diversification/modernization, taking up new projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing) failure, inefficient management, strained labour relations, inappropriate technology/technical problems, product obsolescence, while external factors are recession, inflation, inputs/power shortage, price escalation, accidents and natural calamities.

According to Macaver and O.Ehimare (undated) the source of credit risk can be eitherfrom borrower level or financial (lender) level.

a) Causes of Credit Risk at Borrower Level

The causes of loan default at the borrowers' level include the following:

(i) Failure of investment to generate sufficient income due to improper technical advice, inadequate support services, marketing risks or natural disasters.

(ii) Diversion of loan from desired objective operations to non-essential consumption which makes it difficult to meet repayment commitment on time.

(iii) Existence of liabilities towards informal lenders, which may get precedence over institutional lenders, leading to delinquency and default.

(iv) Contingencies at the borrower household, such as sickness, accident or death (pure risk).

(v) Operation at very low level of subsistence, forcing additional income generated through loan-supported activities to be appropriated for basic needs.

(vi) Prevalence of low real rate of interest or pegging of interest rate far below the market rate.

(vii) Absence of incentives for prompt repayment, or penalties for delayed repayment.

(viii) Delays in loan application to meet the soon coming purpose to be fulfilled by the loan applied.

b) Causes of Credit Risk at Financial Institution (Lender) Level

At the financial institution level, loan default may be due to any or a combination of the following:

(i) Defective procedures for loan appraisal, which could lead to financing of bad projects, thereby giving rise to delinquencies and defaults.

(ii) Quality of loan officers, their mobility in the field, and their capacity to judge borrowers as well as the incentive package available to them affect repayment. When loan officers are assessed more on the basis of compliance with lending targets than with recovery performance, it could lead to bad loans. When responsibility for lending and recovery are vested with separate officials in a credit agency, recovery tends to decline.

(iii) Untimely loan disbursement and inappropriate repayment schedules. In addition, when the procedure for repayment is bulky, borrowers tend to default.

(iv) Inability or reluctance of lenders to enforce sanctions against conspicuous defaulters.

(v) When institutions have limited contact with borrowers, default tends to increase. But when borrowers are in frequent contact and use several services of lenders, default reduces.

(vi) Absence of sound accounting and management information system.

2.1.7 Implication of NPAs for Microfinance Institutions

The interest income generated from loans contribute significantly to the profitability performance of the microfinance institutions. However, when loans become delinquent, it has a serious negative effect on the health and operations of the MF institution.

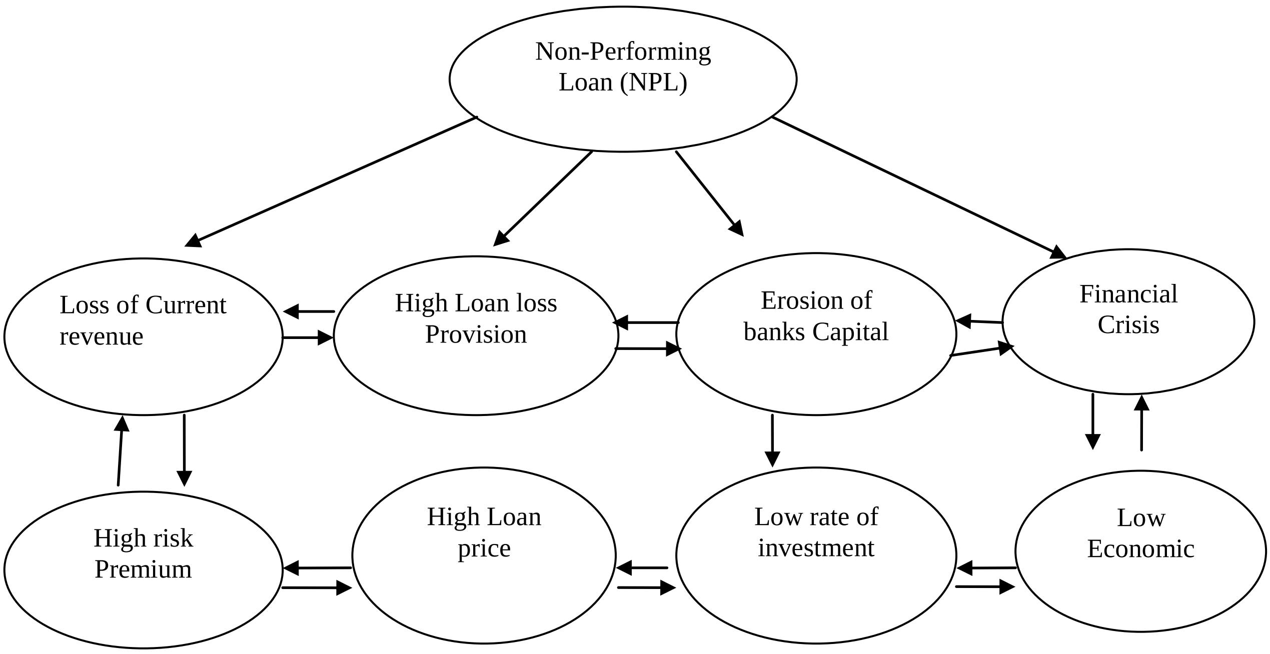
Again, large non-performing loan portfolio tend to undermine the Microfinance Company's ability to grant more credit. This is because the loanable funds tend to deplete when repayment of loans delays or fail to come.

Another important implication of non-performing loans; which is sometimes described as toxic "asset" is the loss of confidence on the part of depositors and investors leading to liquidity challenges. Yet again, another implication of non-performing for the microfinance institutions is the that huge amounts written off as bad debt adversely affect the growth of the shareholders wealth since the profit which is re-invested(ploughed back) into the business to grow the capital base is reduced as a result of provision for credit losses. In a similar token, dividend payment is equally negatively affected because the provision for credit losses are deducted before dividends are declared.

Some foreign literatures indicate that failing banks have huge amount of non-performing loans prior to failure and that asset quality is a significant predictor of insolvency. (Berger and De Young (1997).

The economic and financial implications of NPAs in a bank-centered financial economy can be best shown by the following diagram:

Figure 2.1:- Economic and Financial implications of NPLs



Source: Bangladesh Institute of Bank Management: NPLs in the banking sector of Bangladesh

The above figure illustrates the catastrophic effect of NPLs in a bank-centered financial system. Having such a system, Banks needs to study the condition of NPAs on a routine basis in order to augment investible capital in the productive sectors as well as to ensure sustainable economic growth.

2.1.8 Factors Accounting for NPAs

There are both Internal and external factors that could contribute to NPA. Some research findings and publications indicate that non-performing loans are caused by poor management. Berger and De Young (1997) .They argue that managers in most banks or MFIs with the problem of non-performing loans do not practice adequate loan underwriting, monitoring and control.

Credit culture is another factor which has been identified by some research findings as a cause of NPLs. Sometimes borrowers decide to apply for loan without thinking enough about the future and what else they need to buy with their income. When this occurs, a credit culture can develop where borrowers take out large loans not because it is financially wise to do so but because they see others do it. This can result in defaulted loans.

A world Bank policy research working paper on NPLs in Sub-Saharan Africa revealed that NPLs are caused by adverse economic shocks coupled with high cost of capital and low interest margins (Fofack, 2005) Goldstein and Turner (1996) stated " the accumulation of NPLs is generally attributable to a number of factors, including economic downturn, macroeconomic volatility, terms of trade deterioration, high interest rate, excessive reliance on overly high-priced inter-bank borrowings, insider borrowing and moral hazard.

Another literature identified sudden market changes as yet another factor which account for NPLs. Any sudden market change can change the loan market by affecting how much money people can take as loans and make payments. If the market suddenly changes and prices of items increase due to shortage or increased demand, borrowers will have less money to pay off their loans which can lead to loan default.

Nicholas Rouse (1989) indicated in his work that lack of good skills and judgement on the part of lenders as a possible cause of NPLs.

Again, another publication (kalyan-city.blogspot.com) identifies speculation: i.e investing in high risk assets to earn high income and also fraudulent practices such advancing loans to ineligible persons or advances without security or reference as some of the causes of NPLs. It also cites internal reasons such as labour agitation/shortage and market failure as some of the causes of the incidence of NPLs. External factors such as recession in the economy and natural calamities/disasters were also cited by the same publication as some of the factors accounting for loan default.

2.1.9 Different Theories

(i) Asymmetry Theory

The theory of asymmetric information tells us that it may be difficult to distinguish well from good and bad borrowers (Auronen, 2003 and Richard, 2011), which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted is in a position to negotiate optimal term for the transaction than the other party (Auronen, 2003). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of Non-performing loan in banks (Bester, 1994).

(ii) Agency Theory

According to the Agency theory, the principal agency problem can be reduced by better monitoring such as establishing more appropriate incentives for managers. In the field of corporate risk management agency issue have been shown to influence managerial attitudes towards risk taking and hedging Smith and Stutz (1985). Theory also explains a possible mismatch of interest between shareholder management and debt holders due to asymmetries in earning distribution, which can result in the firm taking too much risk or not engaging in positive net value project (Smith and Stulz, 1987). Consequently, agency theory implies that defined hedging policies can have important influence on firm value (Fite and Pfleiderer, 1995).

(iii) Transaction Cost Theory

In transaction cost theory, does not contradict the assumption of complete markets. It is based on convexities in transaction technologies. In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed,

(1937) by Ronald Coase. Here, the financial intermediaries act as coalitions of individual lenders or scale or scope in the transaction technology. Transaction cost theory has proven an essential framework for decision on the vertical boundaries of the firm. Transaction costs are the cost associated to the division of work. Williamson (2000), indicated that transaction occurs when a good or service is transferred across a technology separable interfaces. Variables that describe a transaction are among others, the specificity, the uncertainty, and the frequency of the transaction, whether an asset or a service is only or much more valuable in the context of a specific transaction. In the following human capital specificity the asset specificity and the site specificity are taken into account (Reddy, 2002).

(iv) Stakeholder theory

Stakeholders' theory, developed originally by Freeman (1984) as a managerial instrument, has since evolved into a theory of the firm with high explanatory potential. Stakeholder theory focuses explicitly on equilibrium of stakeholder's interests as the main determinant of corporate policy. The most promising contribution to risk management is the extension of implicit contracts theory form employment to other contracts, Including sales and financing Cornell and Shapiro, (1987). To certain industries, particularly high-tech and services, consumer trust in the company being able to continue offering its services in the future can substantially contribute to company value. However, the value of these implicit claims is highly sensitive to expected costs of financial distress and bankruptcy. Since corporate risk management practices lead to a decrease in these expected costs, company value rises (Klimczak, 2005). Therefore stakeholder theory provides a new insight into possible rationale for risk management. However, it has not yet been tested directly. Investigations of financial distress hypothesis provide only indirect evidence (Judge, 2006)

(v) Loan Management Theory

The plausible and coherent body or set of tested principles, practices or propositions that act as an abstract but scientific baseline for teaching, learning, implementing and practicing the Discipline known as Loan Management in what is considered to be a generally acceptable, predictable and repeatable manner.

(vi) Credit Default Theory

Wilson Sy in this work paper of 18 October 2007 wrote that delinquency and insolvency underlie most definitions of credit default. Delinquency is defined as a failure to meet a loan payment by a due date, whereas insolvency is defined as a situation where assets are less than liabilities. On the other hand, the structural approach to credit default theory uses implicitly the insolvency definition of credit default.

The underlying logic is: if a corporation or an individual is unable to meet a debt payment obligation by the due date, then the assumption is either a debt-restructure or bridging finance will be sought by the borrower. If the implied cash flow problem is not solved within a fixed period such as 90 calendar days for Basel II, then it is assumed that the entity may be insolvent, the loan is considered formally in default and the creditor would then initiate proceedings to recover what remains of the secured assets. In his paper he assumed that it is assumed that a credit default theory is mainly intended for use to estimate expected losses through an understanding of the causes of credit default.

(vii) Joint Liability Lending

Maitreesh G & Timothy W. G (1999); Economists have applied notions taken from the economics of information and contracts to show how joint liability performs ''. . . the apparent miracle of giving solvency to a community composed almost entirely of insolvent individuals''. These economic models of JLLIs are efforts to formalize the idea that a well-structured JLLI can deal effectively with the four major problems facing lenders by utilizing the local information and social capital that exist among borrowers. These problems are:

a) To ascertain what kind of a risk the potential borrower is (adverse selection), adverse selection arises when borrowers have characteristics that are unobservable to the lender but affect the probability of being able to repay the loan.

b) To make sure she will utilize the loan properly, once made, so that she will be able to repay it (moral hazard), once a borrower has taken a loan, the project's payoff depends in part on the borrower's actions, including levels of labor and other inputs.

c) To learn how her project really did in case she declares her inability to repay (auditing costs) and

d) To find methods to force the borrower to repay the loan if she is reluctant to do so (enforcement)

Julia Anne P (1996) the mechanisms of group lending, such as peer pressure and group solidarity are marketed as instruments to attain favorable repayment rates.

In analyzing JLLIs, economists have focused on either the effects of joint liability on the pool and behavior of borrowers, or on the fact that lending to groups as opposed to individuals is a way to reduce transactions costs. According to the transactions-costs argument, under many circumstances, it is only slightly more expensive to administer a group of loans than to administer a single loan, so group lending enables a reduction in transactions costs per loan. By putting these together in a group can save on processing, screening and loan collection costs.

There are many theories addressing this problem of Non-Performing assets in financial institutions, with this study we shall use the asymmetry theory that it is difficult to tell or know who is a good or bad borrower.

2.1.10 Loan Processing in MFIs

There is an element of risk in any loan granted because the expected repayment may not occur. Lending involves a lender providing a loan in return for a promise of interest and principal repayment in future (Kay Associate Ltd), 2005). Because of this risk of default in loan repayment, lenders needs to project into the future and make sound judgment that will ensure that repayment is effected at the agreed date. Available literature places so much importance on the lender's role in ensuring good decisions relating to the granting of loans in order to minimize credit risk. The lender must always aim at assessing the extent of the risk associated with the lending and try to reduce factors that can undermine repayment. The lender should therefore assemble all the relevant information that will assist him/her in arriving at a sound credit decision. In view of the possibility of non-payment which leads to NPLs, MFIs have adopted a standard loan request procedures and requirements usually contained in credit policy manual to guide loan officers and customers. Some of the factors that the MFIs consider before granting loans include the following which are often referred to as the canons of good lending:

(i) The character of the prospective borrower
(ii) Amount being requested by the customer
(iii) Margin (Interest margin, commissions and relevant fees.
(iv) The purpose of the loan
(v) Ability of the borrower to manage business successfully.
(vi) Repayment (source of repayment must be credible)
(vii) Insurance (security provided by the customer)
(viii) Technical and financial viability of the business

Individuals that apply for loans from FINCA Morogoro proceed through three stages prior to obtaining approval.

a) Preliminary Screening

In this stage, loan applicants make contact with the institution and are carefully screened and asked to answer specific questions regarding the status of their business and household accounts, in order to establish whether they qualify under FINCA`s eligibility guidelines. This is one of the most critical stages in the loan processing procedures since it is the stage where the information about the business and creditworthiness of the customer is analysed.

b) Loan Proposal and Credit Committee

Loan applicants are assigned to specific loan officers. Applicants undergo a further review to verify the information taken at the initial stage, and a visit to the applicant's businesses and household is arranged. The information thus developed is organized into a formal loan proposal and presented to the credit committee for approval. The loan amount and tenure are determined based on the adequacy of the cash flows generated by the borrower's business, sufficient personal collateral and or guarantors agreeing to co-sign the loan agreement.

c) Monitoring and Repayment

After disbursement, the credit officer frequently visits the borrower's business to ensure that the credit facility (loan) are being used for the specific purpose(s) for which the loan was granted, and to remind borrowers of their next repayment date. According toRouse (1989) this is one area many lenders pay little attention but if it is properly followed, the incidence of NPAs can be reduced considerably. He identifies internal records, visits and interviews, audited and management accounts as some of the things that help in the monitoring and control process.

Monitoring can help minimize the incidence of NPLs in the following ways:

(i) Ensuring the utilization of the loan for the intended purpose

(ii) Identifying early warning signals of any problem relating to the operations of the business that are likely to affect the performance of the loan

(iii) Ensuring compliance with the covenants of the loan facility.

(iv) Affording the lender the opportunity to discuss the problems and prospects of the borrower's business.

Borrowers who miss repayments are pressured at this stage; if the arrears continue to pile up, legal action is initiated against the borrower and guarantor(s) to recover any amounts owed, but usually after the designated collateral has been seized and offset against the indebtedness.

d) Credit Terms

This refers to the conditions under which an MFI advances credit to its customers. The credit terms will specify the credit period and interest rates. Credit period refers to the period of time in which the credit is granted. The length of the credit period is influenced by Collateral value, Credit risk, the size of the account and market competition (Ross, Westerfield& Jordan, 2008). Debt in a particular class will have its own interest rate in accordance with the theory of term structure. The interest rates charged is a cost on borrowed funds and may affect the loan performance.

2.1.11 Credit Assessment Methods

Ken and Peter (2008), It is necessary to analyse the credit in order to know its quality. In Credit Risk Management, we would want to determine the counterparty`s creditworthiness. This is on obligator`s ability and willingness to honour its agreement with the party extending the credit. That is the party "at risk" from non-performing of the legal entity.

To establish the status of the counterparty, credit analysts will have to use a combination of financial or accounting data and non-financial variables as well as number of different models or analytical tools.

These methods would be:-

(i) Subjective approach like judgmental methods

(ii) Systematic approaches like quantitative techniques

Table 2.3:- Different approaches to the credit evaluation process

Approach	**Methodology**
Judgmental Methods	Applies the assessor`s experience and understanding of the case to the decision to extend or refuse credit
Expert System(Example lending Committees)	Uses a Panel approach to judge the case or formalities judgmental decisions via lending system and procedures
Analytic Models	Uses a set of analytical methods, usually on qualitative data to derive decision.
Statistical model(Example Credit scoring)	Uses statistical inference to derive appropriate relationship for decision making.
Behavioral Models	Observes behavior overtime to derive appropriate relationship for reaching a decision
Market Models	Relies on the information content of financial market prices as indicators of financial solvency.

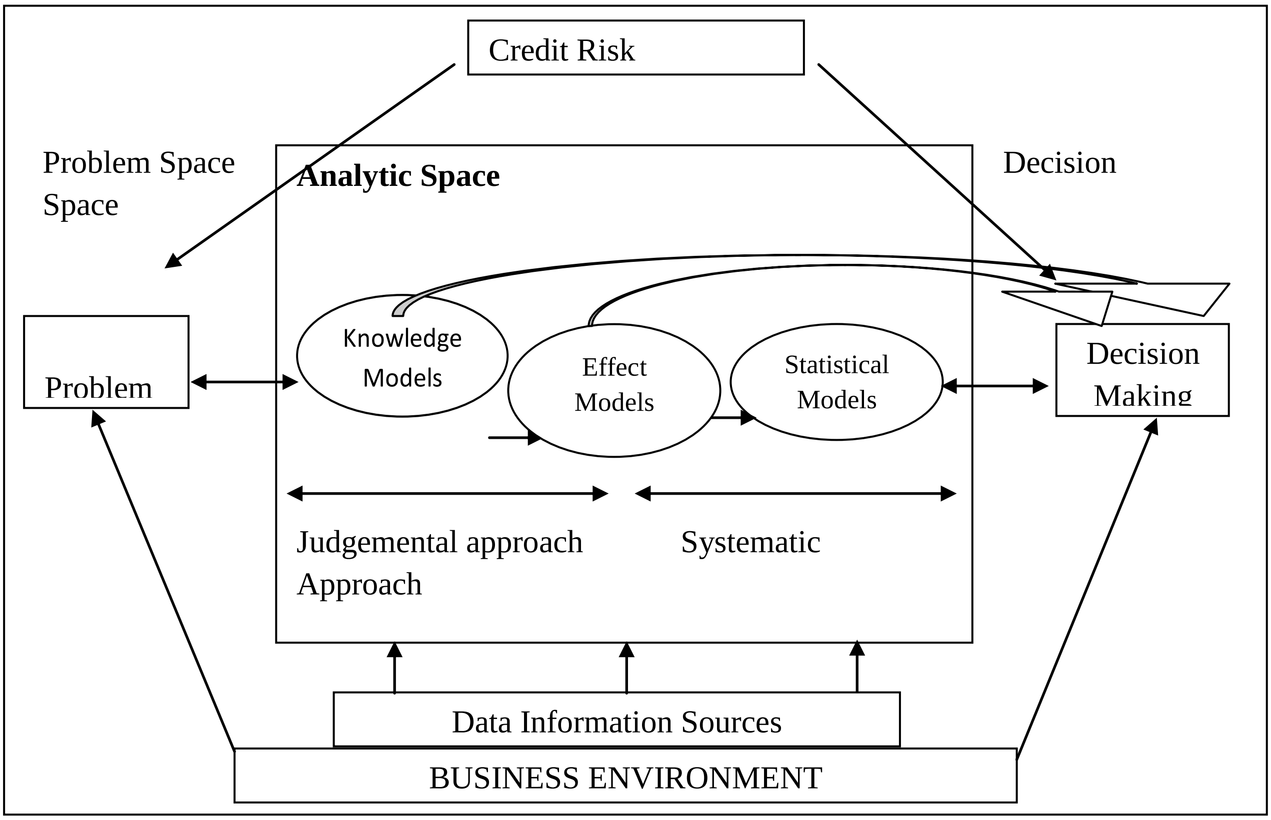
2.1.12 Credit Evaluation Process

In evaluating the desirability to taking on credit risk, different situations will have different levels of risk based on (a) the probability of default and (b) the amount of loss that is expected or actually incurred. If a firm goes into liquidation, the loan might be an almost total write-off. Part of the evaluation process therefore needs to calculate the exposure that will arise if default takes place and this exposure needs to be controlled by setting overall credit limits per individual counterparty

First step is to define the problem. In most cases is a no-default/default variable, then analyse the problem. We require data and/or information from the business environment, example Company reports, news reports, financial statements, market prices of the firm's securities, payment history and so on). Then we apply the analytic approaches Example the statistical models that considered more systemic in approach (credit scoring models are of this kind). The results of the analysis are then used in the decision space whether to grant or not grant credit; Ken and Peter (2008).

Two different types of error can arise when evaluating a credit decision. The type I error is advancing credit to a lesser quality credit, that is a 'bad credit', that has mistakenly been classified as a 'good credit' and thereby incurring an unanticipated loss. The type II error arises from misclassifying a 'good credit' as a 'bad credit' and thereby forgoing an opportunity to earn profit. The different risks can be portrayed in terms of the actual credit quality (here simply called 'good' or 'bad' credit) versus the analysed credit quality

Figure 2.2:- Credit Evaluation Process



(i) Controlling Credit Risk

The key issue in Credit Risk Management is controlling Risk. The Traditional Approach is to evaluate the risk by assessing the borrower`s ability to repay. The core issue is whether the Credit/Loan officer in the firm believes whether the counterparty can reasonably expect to meet their repayment in full and on time. Ken and Peter (2008)

Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Another term for credit risk is default risk. Investor losses include lost principal and interest, decreased cash flow, and increased collection costs. Credit risk can be mitigated using risk based pricing, covenants, credit insurance, tightening and diversification (Ross et al, 2008).

(ii) Managing the Loss Given Default

There are various policies that an organization should put in place to ensure that credit risk is being managed effectively if a default should take place. This is called Loss Given Default (LGD). There are number of ways a firm can do to manage the risk; one of this includes the use of Collateral and Collateralisation. With this Approach the party taking Credit provides a security against default. The benefit (for the lender for using collateral is that in the event of default, the lender is spared the expense of the default process and dealing with the borrowers other creditors assuming that the collateral pledged sufficiently covers the loan amount. Ken and Peter (2008)

2.1.13 Loan Review System

Donna N. (May, 2010) explains in the technical assistance Memo that; all lending involves risks. Lenders control risk on the front end by developing and using strong underwriting policies and procedures. Once a loan is originated, lenders use loan portfolio management to manage risk. One Critical element of a strong portfolio management system is a loan review.

A loan review provides an assessment of the overall quality of a loan portfolio. Specifically a loan review:

a) Assesses individual loans, including repayment risks.
b) Determines compliance with lending procedures and policies. Assesses the adequacy of and adherence to internal credit policies and loan administration procedures and monitor compliance with relevant laws and regulations.
c) Identifies lapses in documentation.
d) Provides credit risk management priority findings.
e) Recommends practices and procedures to address findings and
f) Evaluates risk grades and their accuracy

The Loan Review Checklist contains the sections listed below:

(i) Credit Initiation: Review of initial underwriting including analysis of the following: financial statements; primary and secondary source of repayment, management and appraisal.

(ii) Loan Structuring: Evaluation of repayment terms against the borrower`s ability to repay and industry best practices, guarantees, environmental indemnification and other loan terms.

(iii) Loan Appraisal Procedures: Review of written approval procedures and policies.

(iv) Credit/Collateral File Documentation: Verification of all relevant initial and ongoing documentation. Review of post-closing procedures for outstanding items.

(v) Normal loan Monitoring: Verification of ongoing monitoring as appropriate.

(vi) Problem Loan Management: Evaluation of Problem loan Management including reporting to senior management and downgrading of delinquent loans.

(vii) Loan Workout Management: Review of action plans and workout agreements or seriously delinquent loans.

2.1.14 Reducing Non-Performing Loans in Microfinance Institutions

The incidence of NPLs can be reduced by ensuring that loans are granted to only applicants who demonstrate the ability to repay the loan at the agreed date. Credit analysis of the prospective borrower should be carried out to determine their risk profile and to reach a sound credit decision.

Again, loan repayment should be constantly monitored and whenever there is a default in repayment a quick action should be taken. The MFIs should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments, and renegotiate loans whenever borrowers get into difficulties.(Kay Associates Ltd, 2005)

Golden and Walker (1993) also identify the 5Cs of bad credit, which represent things to guard against to help prevent the incidence of NPLs.

a) **Complacency** refers to the tendency to assume that because things were good in the past they will be good in the future. Common examples are over reliance on guarantors, reported net worth or past loan repayments success because things have always worked out well in the past.

b) **Carelessness** involves poor underwriting typically evidenced by inadequate loan documentation, lack of current financial information or other pertinent information in the credit files and a lack of protective covenants in the loan agreement. Each of these makes it difficult to monitor a borrower's progress and identify problems before they become unmanageable.

c) **Communication** ineffectiveness refers to when a Lender's credit objectives and policies are not clearly communicated. This is when loan problems can arise. Management must effectively communicate and enforce loan policies and loan officers should make management aware of specific problems with existing loans as soon as they appear.

d) **Contingencies** refer to lenders" tendency to play down or ignore circumstances in which a loan might result in default. The focus is on trying to make a deal work rather than identifying downside risk.

e) **Competition** involves following competitor`s behavior rather than maintaining the lender's own credit standards. Doing something because another lender is doing it does not mean it is a prudent business practice.

(i) CRB as the tool to minimize Non Performing Loan's

The theory of asymmetric information tells us that it may be difficult to distinguish well from bad borrowers (Auronen, 2003), which may result into adverse selection and moral hazards problems.

The theory explains that in the market, the party that possesses more information on specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender) (Auronen, 2003). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction (ibid). Adverse selection and moral hazards have led to substantial accumulation of nonperforming assets (NPLs) in banks (Bester, 1994; Bofondi and Gobbi, 2003).

A credit reference bureau is a company that collects information from various sources and provides consumer credit information on individual consumers for a variety of uses. It is an organization providing information on individuals' borrowing and bill-paying habits.

A privately owned, profit-making establishment that as a regular business collects and compiles data regarding the solvency, character, responsibility, and reputation of a particular individual or business in order to furnish such information to subscribers (Banks, Micro Finance Institutions and Credit Institutions), in the form of a report allowing them to evaluate the financial stability of the subject of the report.

This way, the institution that is opening a new account for you will have enough information about the way you pay the accounts you already have, so that they can make responsible decisions about granting you credit, through this the financial institutions will minimize the possibilities of nonpayment of loans.

The main business of a Credit Reference Bureau is to maintain credit information reported to it by lenders and other providers of credit, and to provide credit information in response to enquiries from members.

(ii) Credit Reference bureau in Tanzania.

The Bank of Tanzania Act, 2006 mandates the BOT to create a Credit Reference System designed to collect and provide information on the payment record of all clients of banks and financial institutions, savings and credit schemes and other entities engaged regularly in extension of credit in Tanzania.

The establishment of the credit reference system is a continuation of government’s efforts to reform the financial sector which dates back to the enactment of the Banking and Financial Institution Act, 1991 which paved the way for creating an effective and efficient financial system in the country. Lack of credit reference system in Tanzania has been one of the major factors limiting access to credit. Small firms and individuals borrow at high rates because of the high risks involved as lenders do not have information on their credit behaviors. As a result of lack of credit information, banks and financial institutions have been setting high lending rates as a means of mitigating any risks which could result from the scant information they have about borrowers.

Credit information such as a person's previous loan performance is a powerful tool to predict his future behavior. If you apply for a new loan or credit facility, a credit provider will look at your credit report and quickly see whether you are a person who repays your debt responsibly and punctually. This way, a credit provider can minimize their risk and have confidence when offering you credit because they have the assurance and the evidence that you have the means and ability to repay them by looking at how you repay your other accounts.

Also Credit Reference Bureaus are vital to the economy as they:

a) Allow for faster access to credit
b) Allow consumers and commercial entities to buy now and pay later
c) Help lenders to assess the risk so that they are able to extend credit
d) Help lenders keep the rates lower by not having to raise the price to counter for poor payment behaviour of a few
e) Help lenders exclude poor payers from the process
f) Give borrowers access to credit without them having to save the full amount before they can buy
g) Increase the level of economic activity in the country
h) Stimulate lending by promoting collateral free lending to those without collaterals

2.2 Empirical literature review

Vighneswara S. (2012) Most of the empirical evidence suggests that banks' NPAs as closely linked to the economic activity. In other words, macroeconomic factors matter: downturns/slowdowns in the economy, recessions, low rate of savings, weak markets, depressions in industrial production, and reduction in per capita income levels and most importantly the inflation levels in the economy. A fair amount of the academic literature has dealt with determinants of banking crisis, which is the most severe of the consequences of bad loans in a banking system which is of valuable understanding as a backdrop for the study of NPAs.

Lis*et.al.,*(2000) used a simultaneous equation model in which they explained bank loan losses in Spain using a host of indicators, which included GDP growth rate, debt-equity ratios of firms, regulation regime, loan growth, bank branch growth rates, bank size (assets over total size), collateral loans, net interest margin, capital-asset ratio (CAR) and market power of default companies. They found that GDP growth (contemporaneous, as well as one period lag term), bank size, and CAR, had negative effect while loan growth, collateral, net-interest margin, debt-equity, market power, regulation regime and lagged dependent variable had positive effect on problem loans. Lis, et.al, (2000) have found that Gross Domestic Product growth, bank size and Capital had negative effect on NPAs while Loan growth, collateral, net interest margin, debt-equity, market power and regulation regime had a positive impact on NPAs. There is a very close relationship between problem loans and the economic cycle. During recessions problem loans increase as a result of firms' and households' financial distress. When the economy grows strongly, the income of non-financial firms and households expands and they can repay loans easily, contributing to the decline in banks' problem loans ratios.

Sergio (1996) in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank's lending policy offering to relatively unselective and inadequate assessment of sectoral prospects. Interestingly, this study refuted that business cycle could be a primary reason for banks' NPAs. The study emphasised that increase in bad debts as a consequence of recession alone is not empirically demonstrated. However, according to Bloem and Gorter (2001) NPAs may be caused by wrong economic decision or by plain bad luck.

Misra and Sarat (2008) in their study analyzed the non-performing loans of public sector banks in India in terms of the response of NPLs to terms of credit, bank size and macroeconomic condition variables. Using the pooled regression analysis, the study found that the terms of credit variables had significant effect on the banks" non-performing loans in the presence of bank size and macroeconomic shocks. Moreover, alternative measures of business cycle could give rise to differential impact on bank's non-performing loans. The results of the study provide important insights for banks‟ lending behavior. From policy perspective, these findings are in line with the policy approach to banking sector in India, which emphasizes on the appropriate credit culture and lending policy designed with relevant economic and financial factors. The business cycle impact on non-performing loans could be managed with appropriate terms of lending in terms of maturity, loan interest rate and capital requirement

Accordingly, banks face a number of challenges such as; worrying level of NPAs,strict prudential norms, increasing competition, growing customer expectations, increasing pressure on profitability, liquidity and credit risk management, assets-liability management, shrinking size of spread, rising operating expenditure and so on. However, Singh (2005) argues that globalization of operations and new technologies development are taking place swiftly and these has given rise to the increase in resource productivity, increasing level of profitability, deposits and credits and thereby decrease in NPAs.

Using a dynamic model and a panel dataset covering the period 1985-1997 to investigate the determinants of problem loans of Spanish commercial and saving banks, Salas and Saurina (2002) reveal that real growth in GDP, rapid credit expansion, bank size, capital ratio and market power explain variation in NPLs.

Collins N. and Kenneth W. (2011), Interest rate spread affect the non-performing assets in banks as it increases the cost of loans charged on the borrowers. Mode or type of interest rate charged (whether fixed or float) for they all have different dynamics that might affect the borrower`s ability to repay credit loaned. Goldstein and Turner (1996) also concluded that accumulation of non-performing assets is attributable to high cost of loans.

Findings from most of the literatures suggest that the Assets performance is highly related with the economic condition. This has been proved by Borgdam (2012) on his study on the determinants of Non-performing loans in central and eastern

European countries where he found that the larger the difference between peak and depth of economic growth is, the higher the NPL ratio jumps during recession period.

Kwan and Eisenbeis (1997) use a simultaneous equation framework to test hypotheses about the interrelationships among bank interest rate and credit risk-taking, capitalization, and operating efficiency. Both papers provide evidence that both efficiency and capital are relevant determinants of bank risk-taking and moral hazard incentives.

Regarding Louzis et al. (2010) in the Greek banking sector, they use the method of dynamic panel data to examine the determinants of NPL for each category of loan. A set of basic macroeconomic indicators, namely, the real rate of GDP growth, the unemployment rate and the real interest rate for each loan type are studied. They used a data set of new large Greek banks for the period 2003 to 2009. The results show that impaired loans is related to the macroeconomic variables (GDP, unemployment rate, the interest rate) and to the quality of management.

Ranjan and Dhal (2003) attempted an empirical analysis of the NPAs of Public Sector banks in India and probed the response ofNPAs to terms of credit, bank size, and macroeconomic condition and found that terms of credit have significant effect on the banks' Non-Performing Assets in the presence of bank size and macroeconomic shocks. They also found that alternative measures of bank size could give rise to differential impact on NPAs.

Keeton (1999) uses data from 1982 to 1996 and a vector auto regression model to analysetheimpact of credit growth and loan delinquencies in the US. It reports evidence of a strong relationship between credit growth and impaired assets. Specifically, Keeton (1999) shows that rapid credit growth, which was associated with lower credit standards, contributed to higher loan losses in certain states in the US. In this study loan delinquency was defined as loans which are overdue for more than 90 days or does not accrue interest.

Ngugi (2001) analyzed the interest rates spread in Kenya from 1970 to 1999 empirically the paper investigates the determinants of interest rate spread in Kenya's banking sector based on panel data analysis. The findings show that bank-specific factors play a significant role in the determination of interest rate spreads. These include bank size, credit risk as measured by non-performing loans to total loans ratio, return on average assets and operating costs, all of which positively influence interest rate spreads. On the other hand, higher bank liquidity ratio has a negative effect on the spreads. On average, big banks have higher spreads compared to small banks. The impact of macroeconomic factors such as real economic growth is insignificant. The effect of the monetary policy rate is positive but not highly significant. The results largely reflect the structure of the banking industry, in which a few big banks control a significant share of the market.

According to a World Bank report (1994) in Uganda, owing to lack of proper regulations the country' s banking industry was described as extremely weak, with huge non-performing assets and some banks teetering on the verge of collapse. Mukalazi (1999) notes that reeling from years of economic mismanagement and political interference, Uganda's banking industry posted huge losses in the early 1990s. To help address credit risk management in Ugandan banks, the government has introduced a statute that deals with several issues

In Tanzania, according to findings cited by Richard, E (2006) suggest that use of funds for purposes different from agreed ones as a major factor that cause NPLs. Creating an environment to make banks seen as problem solvers and trusted advisor to borrowers was cited as the main strategy towards solving NPLs problems. Findings imply that close monitoring of borrowers is critical to lending business.

The high NPAs suffered by governments banks and other financial institutions had led to the restructuring of almost all banks, In Tanzania, empirical evidence suggest that NPAs are due to external(macro) and internal(micro) factors, (William,1995;Chijoriga,1997;Kimei,1998) included in the internal factors are reckless lending, corruption, fraud and dishonest, management deficiencies, poor credit documentation and non-use of credit classification, lending to insider and poor supervision capacity. External factors such as bank deregulation/regulation policies and procedures, lack of information among bank customers, political and government interventions as being causes of NPL.

Table 2.4:- Summary of the Empirical Review

S/No.	Author and year	Topic/Them and Place	Methodology	Causes/Determinants of NPAs
1.	Lis et all (2000)	Credit Growth, Problem loans and credit Risk provisioning in Spain	Simultaneous Equation model	Loan growth Collateral Net interest margin Market power Regulation regime and Economic cycle
2.	Sergio M. (1996)	Non-performing loans Cyclical patterns and sectoral risk		Banks' lending Policy Wrong economic decisions
3.	B.M Misra and Sarat Dhal(2008)	Pro-cyclical Management of Banks Non-performing loans by the Indian Public Sector Banks	Pooled Regression analysis	Terms of credit in the presence of Bank size and Macroeconomic shock like commodity prices, income(wages and self-employment income), changes in employment
4.	Salas and Saurina (2002)	Credit Risk in Two Institutional Regimes Spanish Commercial and savings Banks	Panel Data	GDP growth rate Branch expansion Inefficiency Portfolio composition Size of a portfolio Net interest margin Market power
5.	Collins N. and Kenneth W. (2011)	The effect of interest rate spread on the level of non-performing assets in Kenya		Interest rate spread Cost of loan

Table 2.4:- Summary of the Empirical Review

7.	Kwan S. and Eisenbeis R. (2010)	Bank Risk, Capitalization and operating efficiency in US banks	Simultaneous equation	Operating efficiency Capitalization
8.	Louzis D. Petal(2010)	Macroeconomic and bank specific determinants of non-performing loans in Greece	Dynamic Panel data	GDP Unemployment rate and Interest rate quality of management
9.	Rajan R. and Dhal S.C (2003)	Non-perfominglons and terms of credit of public sector banks in India	Panel regression Model	Terms of credit in the presence of bank size induced risk preferences and macroeconomic shocks
10.	Keeton W. R (1999)	Does faster loan growth lead to higher loan losses in Kansas City?	Vector auto regression model	Credit growth and Impaired assets
11.	Ngugi R. W (2001)	An Empirical analysis of interest rate spread in Kenya	Panel Data analysis	Interest rate spread
12	Evelyn R. (2011)	Factors that cause Non-Performing Loans in Commercial Banks in Tanzania and Strategies to Resolve Them		Poor monitoring Divergence of purpose loan

2.3 Conceptual framework and Research model

The determinants of Non-performing assets in financial institutions have been discussed by different literature and brought in different factors. Various reasons can be cited for an account becoming NPA.

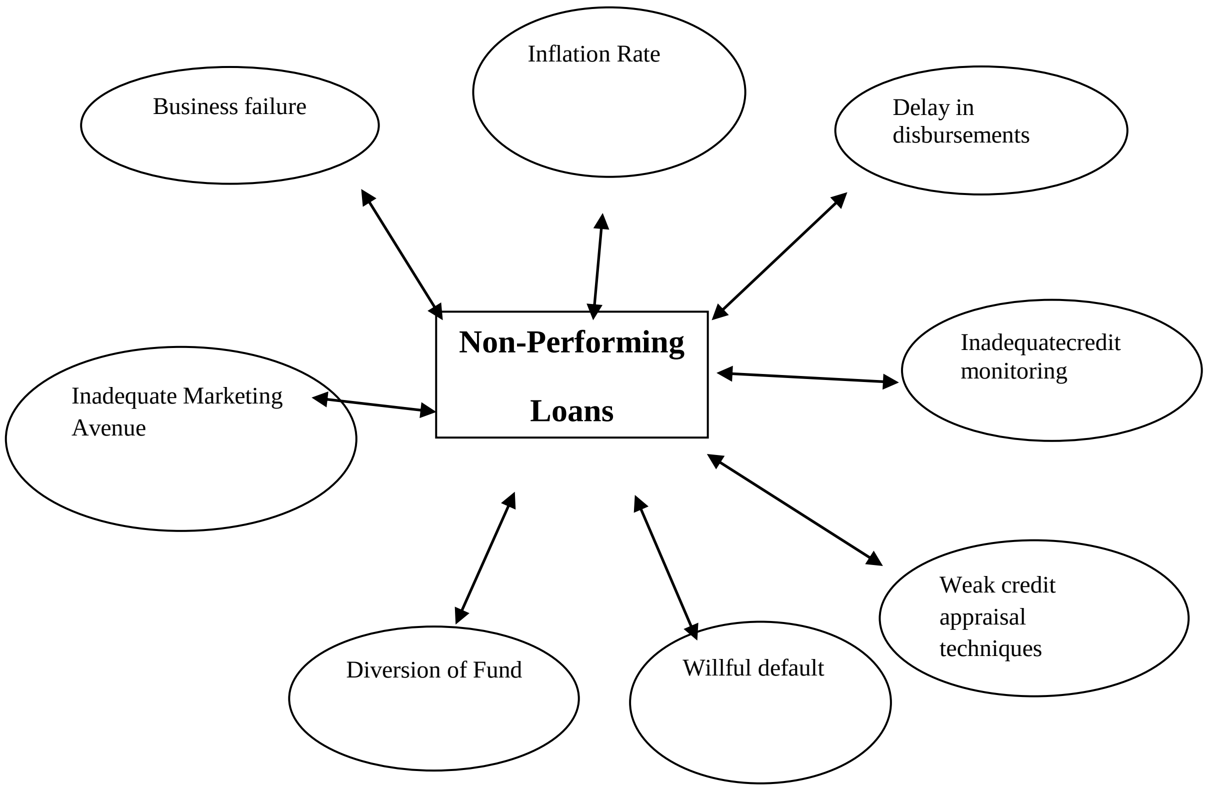
An asset leads to NPA when borrowers fail to repay the interest and/or principal on agreed terms (Siraj& Pillai, 2012). With regard to the reasons for NPA, it has argued that it is not mainly because of lack of strict prudential norms, but due to legal impediments, postponements of the problems by the financial institutions to show higher returns and manipulation by the debtors using political influence (Reddy, 2002), which can also be the case for FINCA international.

All credit exposures over a country specific threshold are individually assessed for impairment. For such credit exposures, it is assessed whether objective evidence of impairment exists. Any factors which might influence the customer's ability to fulfill his contractual payment obligations towards the Microfinance like:-

(i) Delinquencies in contractual payments of interest or principal;
(ii) Breach of covenants or conditions;
(iii) Initiation of bankruptcy proceedings;
(iv) Any specific information on the customer's business example reflected by cash flow
(v) Difficulties experienced by the client
(vi) Changes in the customer's market environment;
(vii) The general economic situation.

The Figure below shows some of the main Determinants/causes of Non-Performing Loans. These variable were used toanalyse the data obtained

Figure 2.3:- Conceptual framework for NPAs



Source:- Researcher, 2015

Explanations of Variables in relation with NPLs

There is a strong association between NPAs and several factors, the relation between these factors and NPAs are shown here under,

The rise in the NPAs in bank can be due to diversion of funds away from the original purpose for which they were granted,

Default in repayment obligations by the borrower to the lender even when it has the capacity to honour the said obligations we say "wilful default" is deemed to have occurred. The borrowing unit may default ‘willfully’ for several reasons such as deliberate non-payment of dues despite adequate cash flow, underreporting of cash flow, diversion of funds, drain off funds from the business.

Credit Appraisal is a process to ascertain the risks associated with the extension of the credit facility. It is generally carried by the financial institutions to measure the financial condition and the ability of the customer to repay back the loan in future. Once there is a weakness in this appraisal it is among the most causatives of NPAs in Lending Institutions.

Credit Programs have no special claim to infallibility. A borrower may be determined to repay on time but because of some unexpected events fail to do. If the lender does not follow up promptly with a query, the borrower will take note. She/he may simply be grateful not to have been embarrassed

Also there a positive relationship between the inflation rate and non-performing loans, studies, shows that inflationary pressures contribute to the high level of impaired loans, inflation is responsible for the rapid erosion of commercial banks' equity and consequently higher credit risk in the banking sectors.

Table 2.5:- Summary of the variables related to NPAs

Factors	**Details**	**Expected Coefficient**	**Rationale**
Inflation rate	High inflation rate	+ve	Increase level of NPLs
Weak credit appraisal system	Weak credit analysis from the beginning	+ve	Increase level of NPLs
Willful default	Those customers that are capable and are liquid enough to pay the loan decide not to pay when due	+ve	Increase level of NPLs
Inadequate credit monitoring	Lack of loan follow up by bank	+ve	Increase level of NPLs

Table 2.5:- Summary of the variables related to NPAs

Factors	Details	Expected Coefficient	Rationale
Diversion of Fund	Borrower's tend to divert the funds to other investments with intention of more profits, failure of those unmentioned project means non-repayment of loans	+ve	Increase level of NPLs
Lack of Reliable market information	People engaged in business without knowing where to sell or buy. Failure to get market means Operating business in loss.	+ve	Increase level of NPLs
Business failure	Engage in unstudied business lead to failure of business, this means loss of everything which was injected in the business.	+ve	Increase level of NPLs
Delay in disbursements	Application process takes a long time, there are possibilities of change in economic conditions, and so secured loan can be insufficient.	+ve	Increase level of NPLs

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter presents the procedures that will be employed in the study. The chapter therefore, presents the methodology that will be deployed in the study by specifying the type of the study, study area, Types and source of data, methodology and model specifications, and data analysis.

3.1 Types of the Study

This study is partly quantitative and partly qualitative kind used data from the published financial reports of FINCA international from 2009 to 2013 to make the analysis on the trend of non-performing loans in FINCA. It used the secondary data or documentaries together with primary data that were obtained as a result of questionnaires to the FINCA officials to obtain the causes of NPA.

3.2 Study area

The study was carried in FINCA international through the published financial reports from 2009 to 2013. These reports consist of the report from all countries where FINCA is operating. Also the questionnaire administering to various groups of respondents was conducted in FINCA branches found in Morogoro Tanzania due to the accessibility by the researcher.

3.3 Study Population

Thirty respondents as workers of FINCA Morogoro Branch this includes loan (credit) officers, Back office employees, supervisors and a Branch manager were selected from the entire population of all the workers who had varied experience in microcredit administration. Also One Hundred Borrowers where selected and questionnaires were administered to them. Biases were avoided in the selection of participants by drawing respondents from different branch locations

3.4 Data collection method and approach

The data collected for the study consisted of primary and secondary data. The type of data, their sources and the instruments used in gathering them are discussed as follows:

3.4.1 Primary Data

Structured questionnaires were used in the data collection. The structured questionnaires were used to get the unbiased opinion of respondents, this data collection instrument made it very convenient for respondents to give the information needed for the analysis.

3.4.2 Secondary Data

The secondary date were obtained from the published annual reports and financial statements of the institution. The information covered a period of five years from years 2009 to 2013. This category of data was mainly found in the print and electronic mediameant for public consumption. The use of this type of information was so beneficial in several ways to the study and some of the benefits include:

(i) Firstly, this was less expensive to collect, in terms of time and money.

(ii) It afforded the researcher the opportunity to collect high quality data which would not have been of the same quality if the researcher were to collect it in its primary form. Saunders et al (2007) quote Stewart and Kamins (1993) as stating that secondary data are likely to be of higher-quality than could be obtained by collecting empirical data.

(iii) The data collected had in it very useful information needed to answer the research questions like loan portfolio of the institution, provision and charge for credit loss (that is provision for bad and doubtful debt).

3.5. Type of data

Primary and secondary data constituted the sources of information for the research. The administration of questionnaires forms the basis of primary data. Data collected from this source focused on the background characteristics of respondents and their knowledge on the operational activities of Microfinance; particularly microcredit, challenges affecting the operations of microfinance and the impact of NPLs on the operations of MFIs. In the case of secondary sources, information from published and unpublished sources including official annual financial reports from 2009 to 2013 of FINCA were used to support the primary data.

3.6 Limitation of data collection

Largely, the data collection was a very successful undertaking. However, it must be said that some of the respondents had extremely tight work schedules coupled with individual personal commitments and this occasionally gave rise to delayed or rushed responses.

3.7 Ethical Issues

FINCA has strict policy on confidentiality and one can pay the ultimate price for the breach of this duty of confidentiality. Exposing of information by employees to a third party on defaulter`s details can expose the institution to potential legal tussle and therefore being mindful of this ethical issue, the respondents were worried in the disclosure of information. This genuine apprehension was addressed by first explaining the essence of the study to the respondents and also with the assurance that the data will be handled professionally and that their identities are not going to be revealed.

3.8 Reliability and Validity of the data

Researcher has minimized error in collecting data by applying techniques like administered questionnaire and carrying out interview on days that personnel are not occupied with their job as to get information that are correct also downloading Published Financial Statements from FINCA International Website. Also the researcher measured what was intended to be measure.

3.9 Management and analysis of data

3.9.1 Data management

This involves systematically organizing mass of raw data to be collected in a manner that will be facilitating analysis of data. Researcher will design numbers directly for close ended questions in the questionnaire and for open ended questions; the researcher will categorize all responses give and assign numbers to them.

3.9.2 Data analysis

The secondary data obtained were scrutinized to determine their suitability, reliability, adequacy and accuracy. The data was obtained for the period 2009-2013 Spread sheet and simple excel were used to process the data for the analysis. Tables and statistical diagrams also aided in the data presentation. The primary data were presented by some of these statistical tools and by way of narration. Presentation of the data on these statistical tools made the analysis very easy to understand. The statistical tools were used to convey the meaning of the data gathered and as such made the analysis straight forward.

CHAPTER FOUR

ANALYSIS AND FINDINGS

4.1 Introduction

The chapter captures the presentation, analysis and discussions of the data used in this research work.The objective of the study was to find the determinants of Non-Performing Assets in Microfinance Institutions. The study was carried at FINCA Morogoroto obtain the causes of NPAs.Considering the research objectives, attempts are made to identify the problem of non-repayment of loans as they fall due at FINCA. And other data obtained from the financial reports published by FINCA international for the period of five years from 2009 to 2013 to find the trends of NPAs in FINCA International. This chapter thus depicts the findings which seek to answer the research questions against the background of the objectives of the study. Generally, the chapter plays a very key role in the entire research work since it relates empirical data to secondary data reviewed in the previous chapters.

4.2 The trend of Non-performing assets in FINCA

The following table and figure showthe Gross advances, Gross NPAs and Percentage of NPAs over Gross Advances of FINCA for five years from 2009 to 2013.

Table 4.1:- Gross NPAs and Percentage of NPAs over the Gross Advances

YEAR	GROSS ADVANCES (In US $)		NPAs (In US $)		NPAs AS A PERCENTAGE OF GROSS ADVANCES
		Percentage Growth		Percentage Growth	
2009	317,208,208.00	100.00	10,721,273.00	100.00	3.38
2010	380,264,304.00	119.88	6,731,790.00	62.79	1.77
2011	512,787,594.00	161.66	6,484,057.00	60.48	1.26
2012	636,610,459.00	200.69	11,704,911.00	109.17	1.84
2013	840,630,667.00	265.01	12,659,884.00	118.08	1.51

Source:- FINCA Consolidated Financial Statements for 2009 to 2013

From the analysis of the table 4.1 above and the figure 3 below the following observations can be made:-

(i) Gross Advances have increased significantly from 100% to 265% over the period of five years. It was $ 317,208,208.00 in 2009 and went up to $ 840,630,667.00 in 2013 this is to say it signifies a double increase.

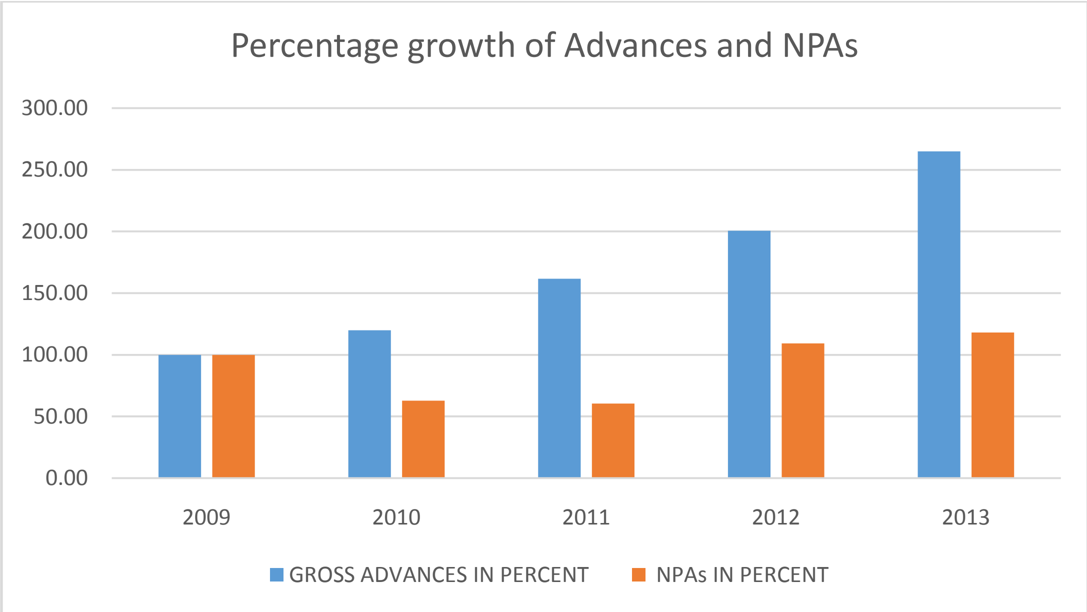
(ii) The NPAs have come down from 2009 to 2011 for 100% to 60.48% being $10,721,273.00 2009 and $ 6,484,057.00 in 2011. From 2012 to 2013 it went up to 118.08% in 2013. This is to say it grew from $10,721,273.00 in 2009 to $ 12,659,884.00 in 2013. Though in Percentage it is seen to decrease but in its Gross value shows a significant rise.

(iii) The Percentage of NPAs over the Gross advances has come down from 3.38% in 2009 to 1.26% in 2011. Instantly went up to 1.84% in 2012 and came down to 1.51% in 2013. This is to say there has been a fluctuation of in the percentage NPAs over the gross advances.

(iv) The trend of NPAs shows that there is no constant increase or decrease over time. The results imply that the NPAs in FINCA can be mitigated since there is no actual trend that means that they just happen as a dependent issue.

The findings obtained in the above table 4.1 are justified by the graph below which shows fluctuation of the NPAs over the period of 2009 to 2013.

Figure 4.1:- Trend of Gross Advances and NPAs from year 2009 to 2013



Source:- Researcher, 2015

From Fig 4.1 above it shows the trend of Gross Advances to the NPAs in Percentage. The Gross Advances growth percentage and NPAs growth in percentage are rounded to 2 decimal places to ensure consistency.

4.2.1 Trend in Gross Advances and Write-offs

FINCA conducts biannual historical loan-loss migration analysis across its subsidiary network in order to determine the probability of default. As well as an examination of other current observable factors like Macroeconomic, operational, policy and Systems changes, and political risk in order to establish subsidiary credit reserves.

FINCA has a practice to writes off a loanwhen FINCA's Credit Committees and affiliated Audit Committees determine that the loans are uncollectible. This determination is reached after considering information, such as the occurrence of significant changes in the borrower's financial position, such that the borrower can no longer pay the obligation, or that proceeds from collateral, if any, will not be sufficient to pay back the entire exposure.

The following table 4.2 and figure 4 showthe Gross advances, Gross Write-offs and Percentage of Gross Write-offs over Gross Advances of FINCA for five years from 2009 to 2013.

Table 4.2:- Gross Advances and Gross Write-off

YEAR	**GROSS ADVANCES (in US $)**	**GROSS WRITE-OFF (in US $)**		**GROSS WRITE-OFF IN PERCENTAGE**
			Percentage Growth	
2009	317,208,208.00	8,843,864.00	100.00	2.7
2010	380,264,304.00	9,750,697.00	110.25	2.5
2011	512,787,594.00	5,313,522.00	60.08	1.0
2012	636,610,459.00	9,201,179.00	104.04	1.4
2013	840,630,667.00	13,700,413.00	154.91	1.6

Source: - FINCA Consolidated Financial Statements for 2009 to 2013

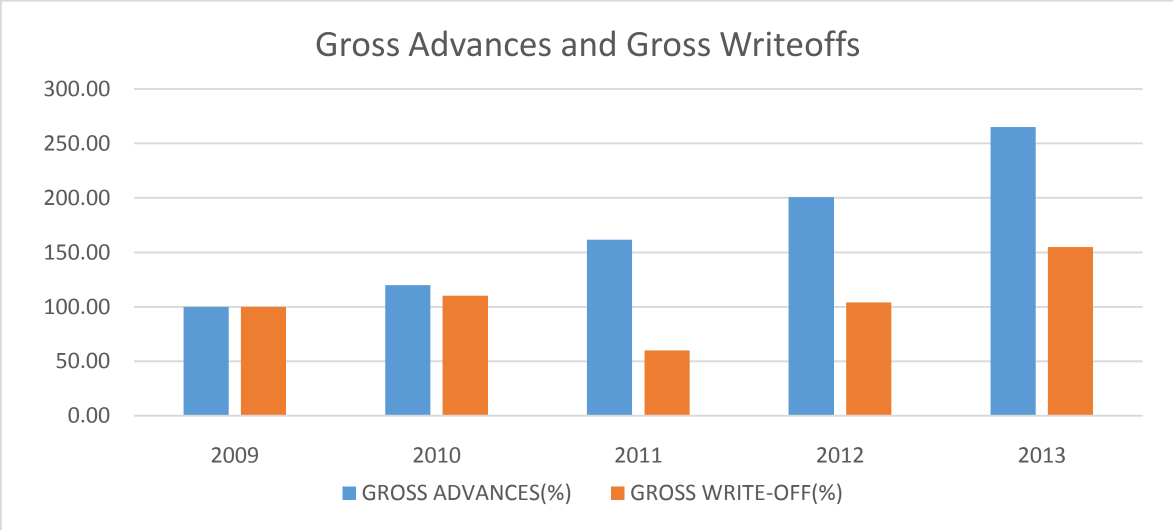
From the analysis of the table 4.2 above and the diagram below the following observations can be made:-

(i) Gross Write-offs (net of recoveries) have increased significantly from 100% to154.91% over the period of five years. It was $ 8,843,864.00 in 2009 and went up to $13,700,413.00 in 2013.

(ii) The Write offs (net of recoveries) went up from 2009 to 2010 being from 100% to 110.25% being $ 8,843,864.00 in 2009 and $ 9,750,697.00 in 2010. It then dropped in 2011 to 60.08% then gently rose from 2012 to 2013 being from 104.04% to 154.91% and its Gross Write-off (net of recoveries) being $ 9,201,179.00 in 2012 and $ 13,700,413.00 in 2013.

(iii) The Percentage of Gross write-off on recoveries over the Gross advances has come down from 2.7% in 2009 to 1.0% in 2011. Instantly went up to 1.4% in 2012 and kept on rising to 1.6% in 2013. This is to say there has been a slight fluctuation of in the percentage Gross write-off on recoveries over the gross advances.

Figure 4.2:- Gross Advances and Gross Write-off of net recoveries in percentage



Source: - Researcher, 2015

From Fig 4.2 above it shows the trend of Gross Advances to the NPAs in Percentage. The Gross Advances growth percentage and NPAs growth in percentage are rounded to 2 decimal places to ensure consistency.

FINCA's Global Risk Management Director declares to be no substantive changes in FINCA's exposure to the financial risks (which include interest rate risk, foreign exchange risk, political risk, market risk, liquidity risk, operational risk and credit risk its objectives, policies and processes for managing these risks or the methods used to measure them have not changed.

4.2.2 Load Advances and NPAs in FINCA Morogoro

The following table 4.3 and figure 4.3 show the Loan advances, NPAs and Percentage of NPAs over Loan Advances of FINCA Morogoro branch for three years from 2011 to 2013.

Table 4.3:- Loan advanced and NPAs – FINCA Morogoro

YEAR	AMOUNT OF LOAN ADVANCED (In Tsh.)		NPAs (In Tsh.)		NPAs IN PERCENTAGE
		Percentage Growth		Percentage Growth	
2011	1,860,000,000	100.00	10,100,000.00	100.00	0.54
2012	1,810,000,000	97.31	19,650,000.00	194.55	1.09
2013	2,000,000,000	107.53	10,210,000.00	101.09	0.51

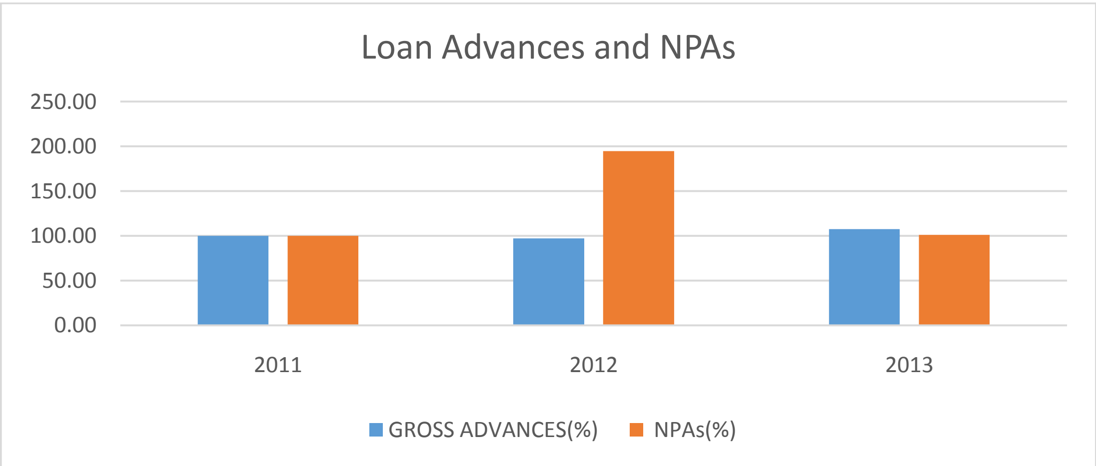
Source:- FINCA Morogoro

From the analysis of the table above and the diagram below the following observations can be made:-

(i) Loan Advances have slightly increased from 100% to 107.53% over the period of three years at FINCA Morogoro Branch. It was Tsh. 1,860,000,000.00 in 2011 and went up to Tsh. 2,000,000,000.00 in 2013.

(ii) The NPAs have come up from 2011 to 2012 for 100% to 194.55% being Tsh.10, 100,000.00 in 2011 and Tsh.19, 650,000.00 in 2012. From 2012 to 2013 it went down to 101.09% in 2013. This is to say it went down from Tsh.19, 650,000.00 in 2012 to Tsh.10, 210,000.00 in 2013.

Figure 4.3:- Trend of Loan Advances and NPAs at FINCA Morogoro



From Fig 4.3 above shows the trend of loan advances and NPAs at FINCA Morogoro. Though the NPAs as percentage of gross advances appears small in a fluctuation tendency, the write-off are increasing. This was why necessitated the study to find the cause of NPAs and write-offs.

The loan advances figures quoted in old currency were converted to the new currency by dividing by 100,000 and rounded to 2 decimal places to ensure consistency.

4.3 Factor accounting for the incidence of NPAs in FINCA

4.3.1 Profile of the respondents

The profile of both employees and defaulters who have been involved in this study is ascertained and discussed hereunder;

4.3.2 Profile of employees

The profile of employees helps to understand their ability and appropriateness in responding to the specific questions relating to the study.

Table 4.4 Profile of the employee respondents

Current Role	Experience in Lending				Level of Education				Frequency
	(1-5 years)		Above 5 years		Graduates		Graduate & above		
Loan officer	13	72.22%	5	27.78%	15	83.33%	3	16.67%	18
Tellers and Customers care	4	80.00%	1	20.00%	3	60.00%	2	40.00%	5
Supervisors	3	50.00%	3	50.00%	4	67%	2	33%	6
Branch manager	-	-	1	100%	-	-	1	100%	1
Total	20	66.67%	10	33.33%	22	73.33%	8	26.67%	30

Source: Field Findings FINCA Morogoro

The following observations can be made from the table 4.4

(i) Based on the experience back ground of the employee respondents 33.33% have more than 5 years of experience while 66.67% of respondents have worked with the bank in lending units have serviced between 1 and 5 years.

(ii) Based on education back ground 26.67% of respondents have masters and above while 73.33% already have degree or advanced diploma.

(iii) The fact that majority of the respondents had few years of experience in FINCA and also possess required education this shows that many respondents possess required knowledge of the lending activities hence helped capture a good quality of data since they experience challenges on the loan repayments by customers.

4.3.3 Profile of Defaulters:

The profile of the customer respondents is given in the table 4.5 in terms their Education of below Graduate level and those above the graduate level

Table 4.5 Profile of the Customers (includes defaulters) respondents;

EDUCATION			Total
Below graduate Level	73	73.00%	73
Above Graduate Level	27	27.00%	27
Total	100	100.00%	100

(i) 73% of customer`s education below the Graduate level while 27% had education level of above graduate. Thus it shows that the sample covered both those with small level of education and those with High level of education

4.3.4 Causes of Non-Performing Assets in FINCA –Morogoro

In order to find out what factors are dominant in being causes of NPAs in FINCA, The researcher had administered questionnaires to respondents both employees and customers. These respondents were asked to rank the causes of Non-performing loans in FINCA using the scale of 1-10, with 10 being the leastimportant cause, followed by 9 as the next least common factor and so on with 1 as the mostcausing.

Among 30 employees only 22 respondents had returned the Questionnaires. The following are the responses of the employees:-

Table 4.6: Factors that cause Non-Performing Loans (employees' point of view)

Factor	Experience in Lending				Rank	Total response	%
	1 to 5 years		Above 5 Years				
Diversion of funds	12	66.67%	6	33.33%	7th	18	12%
Inflation Rate	14	70.00%	6	30.00%	6th	20	13%
Inadequate marketing avenues	13	68.42%	6	31.58%	2nd	19	12%
Business failure	12	70.59%	5	29.41%	5th	17	11%
Inadequate Credit monitoring	15	68.18%	7	31.82%	3rd	22	14%
Willful default	14	70.00%	6	30.00%	8th	20	13%
Weak credit appraisal techniques	12	66.67%	6	33.33%	1st	18	12%
Delay in disbursements	14	66.67%	7	33.33%	4th	21	14%
Total						155	100%

Source: Field at FINCA Morogoro

After the administration of the questionnaires, the responses given by the respondents are discussed below. Many reasons were assigned to the causes of non-performing loans in FINCA. The major factors identified by the respondents were Poor credit appraisal techniques, Inadequate monitoring, Diversion of funds, Business Failure, Inadequate marketing avenues, Delay in Disbursement, willful default and High Inflation Rate. These factors are discussed below as per the responses:-

a) Ineffective Credit Monitoring

Out of 22 respondents who returned the questionnaires, all of them mentioned inadequate monitoring as the most dominant cause of NPAs. Understaffing and lack of logistics (vehicles/motor bikes) were the most common reasons cited as the causes of ineffective monitoring.

b) Inadequate Marketing Avenues.

Inadequate marketing opportunities was cited by as many as 19 of the respondents as the second most cause of NPAs in FINCA. Their reason was that as a result of inadequate market, the goods get perished or goods suffer post-harvest losses leading to inability to repay loans.

c) Business failure

According to 17 of those who answered the questionnaires, business failure is the 6^{th} most causing factor of non-performing assets in FINCA Morogoro. Those from whom the researcher sought further explanation said sometimes borrowers with previous satisfactory credit record suddenly default and most of such cases are traced to business failure.

d) Weak credit Appraisal techniques.

In the view of 18 respondents, poor credit appraisal techniques on the part of credit/loan officers also account for some loans becoming delinquent. Such respondents rank weak credit appraisal techniques as the 7th causative factor of NPAs in FINCA Morogoro. They explain this to mean that some loan officers lack the skills to adequately assess a credit proposition to reasonably determine their commercial viability or otherwise. In this sense, they accept some unbankable projects which eventually fail and repayment of the loan becomes sticky.

e) Diversion of Funds

The next factor that was cited by the respondents was diversion of funds. 18 of the respondents believe diversion of funds is indeed one of the causes of the incidence of NPAs and they rank it the 1st on the scale of 1 to 10. Most respondents explained that diversion of loans granted to undertake a particular project once is used for unintended purpose this leads to a drop in the projected cash flows and ultimately result in loan default.

f) Delay in Disbursement

Sometimes, because of the delays in approving loans being requested by the customers, some business opportunities are lost before the loan amount is disbursed to the customers. When this happens and the disbursement is done in cash, because money has alternative uses, the borrowers tend to misuse these funds or at best use them for wrong or unplanned business ventures which in most cases fail to perform well. In the end they are unable to repay the loan. This reason was shared by 21 respondents and they place it at number 4th on the scale.

g) High Inflation rate:

High inflation was cited by 20 respondents as a cause and it was ranked number 8 among the other reasons causing the incidence of NPAs in FINCA. Those who gave reason on why High inflation could be a cause, they said Instead of saving, consumers may start borrowing and inflation re-distributes wealth and income. This was not considered too strong a reason

h) Willful Default

These category of loan defaulters do so for no apparent reason. According to 20 respondents, many of the defaulters are considered to be in a position to repay the loan but somehow they fail to repay the loan. It is considered to be a 3rdcause of loan default in FINCA

Chi square test was applied to know if there is a significant relationship (at the 5% level) between the responses of those employees who worked for less than five years and those with experience with the firm for more than five years among 8 factors which were reveal by both respondents as the major factors that causes NPAs, To find significance of responses, I have used 8 factors causing NPAs at FINCA.

The Two variable under the analysis are:-

(i) Experience from 1-5 Years

(ii) Experience for above 5 years

A	Diversion of funds
B	Inflation Rate
C	Inadequate marketing avenues
D	Business failure
E	Inadequate Credit monitoring
F	Willful default
G	Weak credit appraisal techniques
H	Delay in disbursements

Table 4.7:- Employees observed Frequencies

Years of Experience/Factor	A	B	C	D	E	F	G	H	TOTAL
1 -5 years	12	14	13	12	15	14	12	14	106
Above 5 years	6	6	6	5	7	6	6	7	49
TOTAL	18	20	19	17	22	20	18	21	155

Therefore I assumed **Ho**: - Being Experienced for less than Five years and having experience on lending for more than five years are statistically Independent. Meaning there is no relationship between the two variables.

And my alternative hypothesis will be **Hi**: - Being Experienced for less than Five years and having experience on lending for more than five years are associated.

The value of the test-statistic is:- $\chi^2 = \sum \frac{Oi^2}{Ei} - n$

Where O_i is the observed frequency and Ei is the expected frequency.

To Calculate the Expected frequencies Ei = (Column Total X Row Total) / Grand Total

Expected Frequencies working

Years of Experience/Factor	A	B	C	D	E	F	G	H
1 -5 years	12.31	13.68	12.99	11.63	15.05	13.68	12.31	14.36
Above 5 years	5.69	6.32	6.01	5.37	6.95	6.32	5.69	6.64

Then;

Table 4.8:- Calculated Expected frequencies

Years of Experience/Factor	A	B	C	D	E	F	G	H	TOTAL
1 -5 years	11.70	14.33	13.01	12.39	14.95	14.33	11.70	13.65	106.05
Above 5 years	6.33	5.69	5.99	4.65	7.05	5.69	6.33	7.38	49.11
TOTAL	18.02	20.02	19.00	17.04	22.00	20.02	18.02	21.03	**155.16**

The difference between the observed frequencies and expected frequencies is equal to 0.16. The larger the difference between the observed frequencies in the Table 4.7 above and the expected frequencies in Table 4.9 the less likely it is that the two variables are independent.

From the above test where X^2 is 0.16, the study confidently observed that the two variables are Independent.

Since Contingency table was used, the appropriate chi-squared distribution has degrees of freedom equal to (r-1) (c-1) = (2-1) (8-1) = 7

The 5% significant level obtained from the chi-square distribution tables, with 7 degrees of freedom is 14.067. The study found a chi-square statistic of 0.16. This statistic is less than the 5% significance level of 14.067. At this significance level, the study cannot reject the null hypothesis. There is therefore no association between the responses on causes given between employees with experience between 1-5 Years and those of 5 Years and above. This is to say having high or low experience in a lending Institution does not hinder a FINCA employee from knowing challenges facing them and their firm in loan repayments.

4.3.5 Response of Customers on factors that cause NPAs in FINCA

The responses of defaulters are ascertained on 8 factors which were identified in the review of literature and shown in the conceptual frame work. The factors identified are not mutually exclusive and hence customers have been asked to give more than one response depending upon their Level of education.

Where;

A	Diversion of funds
B	Inflation Rate
C	Weak credit appraisal techniques
D	Inadequate marketing avenues
E	Business failure
F	Inadequate Credit monitoring
G	Willful Default
H	Delay in disbursements

Table 4.9:- Customers Observed responses and its frequencies

Factor	Level of Education				Frequency	%
	Below Graduate		Graduates and Above			
Diversion of funds	23	52.30%	21	47.70%	44	19.56%
Inflation Rate	16	43.24%	21	56.76%	37	16.44%
Weak credit appraisal techniques	15	37.50%	25	62.50%	40	17.78%
Inadequate marketing avenues	2	40%	3	60.00%	5	2.22%
Business failure	11	39.30%	17	60.70%	28	12.44%
Inadequate Credit monitoring	16	47.10%	18	52.90%	34	15.11%
Willful default	11	47.80%	12	52.20%	23	10.22%
Delay in disbursements	6	42.90%	8	57.10%	14	6.22%
Total					225	100.00%

Source:- Field FINCA Morogoro

The analysis of the table 4.10 reveals the following:

(iii) In all 225 responses were received on 8 factors from 87 respondents. The responses for every factor were varying between 2.22% and 19.56%.

(iv) Among all, 19.56% of the responses are in favor of Diversion of funds indicating that the loans availed are diverted for other purposes. Taking the Education background as the base this view was endorsed by 52.3% of respondents who have education level below Graduate and remaining 47.7% Above Graduate level. Thus it can be inferred that this is the prime reason as per the customers which is resulting into NPAs.

(v) 12.44% of the responses reveal Business failure. Taking education of the respondents as the base this opinion was endorsed by 39.30% with below graduate level and 60.70% graduates and above. Thus it can be inferred that this is another fifth factor which cause of NPAs as per customers.

(vi) 10.22% of the responses reveal willful default. Taking education of the respondents as the base this opinion was endorsed by 47.80% with below graduate level and 52.20% graduates and above. Thus it can be inferred that this is the fifth major factor which cause of NPAs as per customers.

(vii) 17.78% of the responses reveal inadequate credit Appraisal technique by FINCA staff especially weak credit analysis from the beginning. Taking education of the respondents as the base this opinion was endorsed by 37.50% with below graduate level and 62.50% graduates and above. Thus it can be inferred that this is the second major factor which cause of NPAs as per customers.

Thus as per defaulters point of view, lack of integrity of borrowers indicating that the loans availed are diverted for other purposes, High inflation rate,Weak credit appraisal technique Business failure, and Inadequate Credit monitoring were the top five factors which resulted into NPAs in FINCA Morogoro.

Chi-square is applied to know the association between the two variable

Table 4.10:- Customers observed frequencies

Level of education/ Factor	**A**	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**TOTAL**
Below Graduate	23	16	15	2	11	16	11	6	100
Graduates and Above	21	21	25	3	17	18	12	8	125
TOTAL	44	37	40	5	28	34	23	14	225

Therefore the study assumed **Ho**: - Having level of education below graduate and being above graduate level are statistically Independent. Meaning there is no relationship between the two variables.

And my alternative hypothesis will be **H*i***: - Having level of education below graduate and being above graduate level are associated.

The value of the test-statistic is:- $\chi^2 = \sum \frac{Oi^2}{Ei} - n$

Where O_i is the observed frequency and Ei is the expected frequency.

To Calculate the Expected frequencies Ei = (Column Total X Row Total) / Grand Total

Expected Frequencies working

Level of education/ Factor	**A**	**B**	**C**	**D**	**E**	**F**	**G**	**H**
Below Graduate	19.56	16.44	17.78	2.22	12.44	15.11	10.22	6.22
Graduates and Above	24.44	20.56	22.22	2.78	15.56	18.89	12.78	7.78

Table 4.11:- Calculated Expected frequencies

Level of Education/Factors	**A**	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**TOTAL**
Below Graduate	27.05	15.57	12.66	1.80	9.72	16.94	11.84	5.79	101.36
Graduates and Above	18.04	21.45	28.13	3.24	18.58	17.15	11.27	8.23	126.09
TOTAL	45.09	37.02	40.78	5.04	28.30	34.09	23.11	14.01	227.45

The difference between the observed frequencies and expected frequencies is equal to 2.45. The larger the difference between the observed frequencies in the Table 4.11 above and the expected frequencies in Table 4.12 the less likely it is that the two variables are independent.

From the above test where X^2 is 2.45, the study confidently observed that the two variables are Independent.

Since Contingency table was used, the appropriate chi-squared distribution has degrees of freedom equal to (r-1) (c-1) = (2-1) (8-1) = 7

The 5% significant level obtained from the chi-square distribution tables, with 7 degrees of freedom is 14.067. The study found returned a chi-square statistic of 2.45. This statistic is less than the 5% significance level of 14.067. At this significance level, the study cannot reject the null hypothesis, there is therefore no association between the responses on causes given between customer with level of education below graduate and being above graduate level. This is to say the level of education does not matter to make a customer know what could cause him or other customers from not paying their loans when due.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This study was aimed at investigating the determinants of NPAs in MFIs with particular focus on FINCA. This chapter summarizes the research findings that emerged after the conduction of the study. It further gives the conclusion of the study and offers some recommendations in line with the objective of the study to be implemented. The chapter is thus a conclusion of findings of the research, that is, a summary of the research outcomes and appropriate recommendations to help reduce the incidence of NPAs in FINCA.

5.1 Summary of findings

The write-offs seen in FINCA`s consolidated financial statements of the year 2009 to 2013 necessitated to conduct this study so as to see the trend and later find out the causes of these non-performing loans. Both Primary and secondary data collection methods were used to obtain the findings of the study.

The findings of the study based on objective one saw that the trend of NPAs at FINCA is not moving in a consistency way rather it goes up and down. Furtherbased on objective two in finding the causes of NPAs in FINCA. Both customers and employees mentioned the 8 factors to be the most causing of NPAsthese factors that accounted for loan delinquency in organization are Diversion of funds, ineffective/inadequate monitoring of loans, willful default, delay in disbursement, inadequate marketing avenues, business failure, weak credit appraisal techniques, and high inflation rate.

The Chi-square test show that Education levels and working Experiences in Lending Institutions are Independent variable, thus every customer and employee is aware of the factors causing NPAs in FINCA.

5.2 Conclusion

NPAs reflect the overall performance of the Microfinance. A high level of NPAs suggests high probability of a large number of credit defaults that affect the profitability and liquidity of microfinance. The NPA growth involves the necessity of provisions, which reduces the overall profits and shareholders' value. The broad objective of this research was to see the trend of Non-performing assets and find the causes of Non-performing assets in FINCA

Conclusions made for each objective are as under:

(i) **Accessing the trend of Non-Performing Loans**

The findings above bring the study to conclusion that FINCA need to strength its loan management process especially in monitoring its borrowers loan payment when they fall due and regular follow up to make sure the loan provided was not diverged into unintended purpose.

Due to the fluctuating movement of the trend of NPAs at FINCA this shows there are weaknesses that arise in both employees and customers when the Level of NPAs goes high.

(ii) **Identifying the causes of Non-Performing Loans**

Research findings indicated that non-performing assets in FINCA Morogoro, were caused by internal and external factors. The respondents had consensus over 8 major factors that caused NPAs. The internal factors are the ones that influenced nonperforming assets These internal factors can be easily controlled such as improving credit appraisal system, speed up loan process and reducing cumbersome process and make timely disbursement, regular follow up to see use of funds are absolutely necessary measures for preventing or reducing NPAs which will enhance the creditability of the microfinance.

External factors can be a threat to the operations of FINCA because these factors cannot be easily controlled, finding show that the major external factor that caused nonperforming assets in FINCA was the high inflation rate. The rising prices, impact the cost of living, the cost of doing business, borrowing money and every other aspect of the economy. Banks and other lending institutions, however, may be reluctant to lend money to consumers when rates of return on loans are low, which decreases profit margins. When inflation is volatile from year to year, it becomes difficult for individuals and businesses to correctly predict the rate of price inflation that will happen in the near future. Therefore the management of FINCA has to be attentive in its lending decisions so as to avoid loan losses and the accumulation of non-performing loans.

Since these are the factors that play a significant role in causing NPAs in FINCA hence the management has to look carefully on these factors and act correctly.

5.3 Recommendations

It needs to be mentioned that management of NPAs must be multi-divided, with different strategies pursued at the different stages through which a credit facility passes. Measures should be in place for both prevention and resolution. With regard to preventive measures, emphasis needs to be placed on credit screening, loan surveillance and loan review functionaries both at credit officer`s side and in the management level. Resolution measures must be accompanied by legal measures, which is improving the efficiency of the legal and the judicial system and developing other out of the court settlement measures like compromise settlement schemes, incentive packaging, formation of asset management companies, factoring, and asset securitisation. To institute sufficient measures to address the flow problem of bad loans effectively.

(i) To institute immediately a concrete NPA management strategy equipped with both preventive and resolution measures.
(ii) To develop specific tools and techniques to distinguish the wilful defaulters from the genuine ones.
(iii) To strengthen the supervisory and monitoring functions of FINCA so as to discipline credit officers that engage in unprofessional conduct.
(iv) Finally, to place emphasis on ethical standards in the banking profession from all corners to make the credit environment trustworthy and exciting.

Ever since the introduction of financial sector developments in MFIs the Non-Performing Assets of the banking system have been catching attention. NPA cause serious strain on the profitability as, on the one hand banks cannot book income on such accounts and on the other hand they are required to charge the funding cost and provision requirements to their profits. A mounting level of NPA in the Lending institution can severely affect the economy in many ways.

In the light of the major role that MFIs play in extending financial support to micro-enterprises and low income earning bracket in the economy, it is important that sound and prudent measures are put in place to forestall the total collapse of the MFIs under the weight of the huge NPA portfolios in their books.Therefore, this study has highlighted recommendations that once applied will play a great role in improving the debt recovery environment and solving the NPA problems of FINCA.

a) Effective and regular monitoring.

One of the most potent means of cutting the incidence of NPAs is by effective and regular monitoring of the loan from the time of disbursement till the final repayment. This will help to prevent diversion and misapplication of funds which are identified as two important causes of NPAs in FINCA. This activity also afford the loan officers the opportunity to inspect the books of accounting of the customers and help the customers to keep proper records of their business transactions. It is also recommended that management should make a conscious effort to resource the loan officers sufficiently at all times in terms of vehicle and other logistics to support the monitoring activities. It is also worthwhile to mention that management should ensure the periodic visit of the institution’s internal auditing team to the branch to make sure that the branches comply with the stipulations of the credit policy. Effective monitoring of the loan facility and periodic review of the customer’s accounts help the lending institution to pick early signals and take remedial measures to prevent further deterioration of the credit facility.

b) Refresher Training Courses for Credit Officers and Managers

It is recommended that periodically relevant training programs are organized for loan officers particularly in the area of risk management, management of NPL and financial analysis. This helps improve the knowledge and analytical skills of the credit officers so as to improve their credit appraisal techniques. The training program will assist the loan/credit officers to appreciate the importance of prompt credit delivery in loan default prevention. Through the training, credit officers will be able to better assess and analyse the loan portfolios (using tools such as Portfolio at Risk {PAR} and ageing Analysis) and pick early warning signals much more quickly and take potent remedial measures to stop any further deterioration of the loan portfolio. It is also strongly recommended that management will always give a serious attention to the health of loan portfolio and resource the credit officers to prevent loans or credit facilities slipping into adverse classification. For effective training programmes, it is recommended that seasoned and knowledgeable employees and micro finance experts with practical experience in microcredit be engaged to provide this training services. In all this, it is worth noting that commitment on the part of management to ensure successful implementation of training program is crucially important. In order to decrease the chance of NPAs, MFIs should be selective as to which borrowers or projects they accept for funding and available literature suggests that lending institutions which do poorly in this area risk creating more NPAs in their books.

c) Provision of security for Credit Facility

In the light of the uncertainties that surround repayment of loans, lenders cannot tell from the looks of people's faces whether they are good or bad borrowers as indicated by Kwarteng(2007), it is therefore strongly recommended that MFIs will begin to demand some form of security even if not adequate to ensure that at least, it can recover part of the indebtedness in the event of default. Security such as blocked savings account, fixed deposit or guarantee could all be considered as acceptable security arrangements. This will reduce the losses arising from NPAs and help minimize the adverse impact of such loans on the financial performance of the MFIs.

It is imperative to state that if a credit facility is secured in one way or the other, it reduces the chances of willful defaulting since the borrower is aware that the security will be realized to offset the indebtedness. Management is therefore strongly advised to review the security requirement policy with the view to tighten the screws to ensure that in the event of default, the institution will able to salvage something to compensate for the provision for credit losses or to reduce the impact of NPAs on its profitability.

d) Use of Credit Reference Bureau

Most of the MFIs lack the efficient risk management mechanism that will help eradicate or screen out serial defaulters. To effectively lock out these serial defaulters, MFIs requires referencing solution that will enable them submit and share data whilst processing their customers‟ credit application. The credit reference bureau is a body working in collaboration with the central bank to provide credit reference of prospective borrowers to lending institutions. The idea is to prevent borrowers with unsatisfactory credit record from accessing further credit from other unsuspecting lending institutions. The Credit Referencing Bureau collate the information of all borrowing customers into a common database where the credit history of any loan applicant can be cross-checked for a sound credit decision. It is therefore recommended to the management of FINCA to avail itself of the services of this body to enable them to check the credit history of loan applicants. This will reduce the incidence of loans going bad since the organization will avoid lending to borrowers with unsatisfactory credit record.

Credit Reference databank at the Bank of Tanzania (BoT)started to operate in September, 2012 in an effort to facilitate easy access to borrowers' information by banks, financial institutions and other institutions authorized by the Bank(BoT)

e) Recovery Strategies

The following recovery strategies are also highly recommended for adoption:

(i) **Personal persuasion**; in this strategy, the lender tries to appeal to the conscience of the defaulting customer to live up to their repayment obligation.

(ii) **Civil procedure**; here the lender institutes civil suit against the defaulting customer for the recovery of any outstanding debt after the persuasion avenue has failed.

(iii) **Compromise**(Negotiated settlement); in this strategy, when the defaulter demonstrates enough commitment towards retiring the obligation, the lender by way of encouraging the defaulter may ignore part of the accumulated interest or give away interest payment.

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APPENDICES

QUESTIONNAIRE FOR CREDIT STAFF, CLIENTS AND BRANCH MANAGER

Dear respondents,

The purpose of this questionnaire is to collect data concerning a study on **The Determinants of Non-performing Assets in FINCA International Incorporation -a case study of Morogoro Branch.** The study is conducted for a partial fulfillment for the award of the masters' degree of Accounting and Finance of Mzumbe University. Note that all the data will be treated only for academic purposes and not otherwise.

Instructions: Please tick the bracket provided

1. Sex
1. FEMALE [ ]
2. MALE [ ]

2. Your Level of Education
1. Graduate [ ]
2. Masters and above [ ]
3. Other [ ]

3. Years of experience working in the Microfinance Institutions?.
1. 0-5 years [ ]
2. 5 years and above [ ]

4. Which best describes your position?
1. Credit Officer [ ]
2. Head of Department/Branch manager [ ]
3. Risk Officer [ ]
4. Other [ ]

5. How often are the trainings or meetings on Credit issues including RISK of Credit loss given to employees? (***To management and employees)***
1. Weekly [ ]
2. Monthly [ ]
3. Yearly [ ]

4. Other [ ]

6. Is there any relationship between credit risk control and loan performance in FINCA(***To management and employees)***

1. Strong relationship [ ]
2. Moderate relationship [ ]
3. No relationship [ ]

If yes (in QN. 6) what kind of Credit risk monitoring and management information system____
____
____

If No (in Qn. 6) how does the Institute monitor the Credit risk?

____
____
____

7. Briefly comment on the nature and quality of the Credit initiation analysis, collection perfection, loan proceeds disbursement and Credit administration processes. (Please include in your comments: -Guidelines in place; setting out procedures/criteria for granting new loans, extending credits and so on. – Quality control over collateral documentation)(***To management)***

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8. In your opinion, which of the following factors account for the incidence of non-performing loans in your organization?

(i) Poor weather [ ] (ii) Business Failure [ ]

(iii) Weak credit appraisal techniques [ ](iv) Inadequate credit monitoring [ ]

(v) High interest rate [ ] (vi) Inadequate marketing avenues [ ]

(vii) Willful default [ ] (viii) Diversion of funds [ ]

(ix)Delay in Disbursement [ ] (x) High Inflation rate [ ]

(xi)Cost of borrowing [ ] (xii) All of the above [ ]

(xiii) Others [ ]

9. Do you think non-compliance with credit policy account for NPAs?(***To management and employees)***

1. Yes [ ]
2. No [ ]

10. If yes to above, which of the following account for that?(***To management and employees)***

1. Customer pressure [ ]
2. Management pressure [ ]
3. Ignorance of the requirements [ ]
4. Others [ ]

11. How will you rank the following factors as causes of NPLs using a scale of 1 to 10, with 10 being the lowest and 1, the highest? (***To management and employees)***

(i) Poor weather [ ] (ii) Business Failure [ ]

(iii) Weak credit appraisal techniques [ ](iv) Inadequate credit monitoring [ ]

(v) High interest rate [ ] (vi) Inadequate marketing avenues [ ]

(vii) Willful default [ ] (viii) Diversion of funds [ ]

(ix)Delay in Disbursement [ ] (x) High Inflation rate [ ]

(xi)Cost of borrowing [ ] (xii) All of the above [ ]

(xiii) Others [ ]

12. Which of the following factors hinder effective monitoring of loans?

1. Staffing problem [ ]
2. Lack of logistics [ ]
3. Poor road network [ ]
4. All the above [ ]

13. What are the causes of delayed loan approval?

1. Rigid approval procedures [ ]
2. Customers inability to meet approval requirement [ ]
3. Insufficient loanable funds [ ]
4. Poor credit appraisal [ ]

14. Do you have any formal training in credit appraisal?

1. Yes [ ]
2. No [ ]

15. What type of security / collateral are often offered by borrowers to secure loans or overdraft?

1. Landed property [ ]
2. Cash (Fixed Deposit, S/A) [ ]
3. Guarantee [ ]
4. Other [ ]

16. Which of the following factors account for diversion of funds?

1. Lack of proper monitoring [ ]
2. Ignorance of lending terms and conditions [ ]
3. Over financing [ ]
4. Under financing [ ]
5. Anticipation of windfall profits in other business areas [ ]

17. Are there any particular reasons for your answer in above? Please specify

____

____

____

18. Does a firm have comprehensive documented policies and procedures to ensure safe protection of its Money?

____

____

____

19. Has the Senior Management define the firm`s Credit Risk Appetite (method to help guide an organization`s approach to risk and risk management)? Please Explain if YES

____

____

____

____

20. What technique do you employ to monitor the health of loan portfolio?

1. Ageing Analysis [ ]
2. Portfolio at Risk (PAR) [ ]

21. How do you deal with problem loans?

1. Legal Action [ ]
2. Outsourcing (External solicitor/ Debt collectors) [ ]
3. Write off [ ]
4. others [ ]

22. Is there a Credit Risk Committee at FINCA-Morogoro Branch?

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____

23. What are the measures put in place by management to help reduce the incidence of NPAs?

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