



# Factors affecting loan repayment behaviour in Tanzania: Empirical evidence from Dar es Salaam and Morogoro regions

Robert Fanuel Makorere \*

*Mzumbe University, Morogoro region, Tanzania*

## Abstract

This paper examines factors affecting loan repayment behaviour in Tanzania because experiences show that many financial institutions still are facing poor loan recovery. Convenience sampling technique was used in the selection of 100 sample size. Data were collected using administered questionnaire. Moreover, descriptive statistic was used in data analysis. Results show that the uttermost factors like interest rate, grace period, profitability, moral hazard, electricity rationing, and economic stability have strong effects in stimulating loan repayment behaviour in Tanzania. It is, therefore, concluded that government intervention is important. And also, financial institutions should assess credit risk management adequately using collateral, condition, characters, capacity and capital measurement to control delinquency rate. Appropriate policy on the institution framework was recommended to improve loan repayment behavior in Tanzania.

**Keywords:** Financial institutions; Loan repayment behaviour; Lending policy and Regulations

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## **1. Introduction**

Financial institutions play a vital role in supporting the business sector as well as in national development. Through financial institutions, businesses deposit, transfer money and acquire business loans. The process of issuing loans by the financial institutions goes hand in hand with risks such as loan repayment risks, liquidity risks, interest rate risks, foreign exchange risks, operating risks, technological risks, fraud risks, regulatory risks, off-balance sheet risks and capital adequacy risks (Santomero, 1997). In order for the financial institutions to reduce risks, they should establish appropriate and effective loan repayment environments. This could include operating under sound loan provision processes, maintaining an appropriate loan repayment administration, having clear procedures and criteria for evaluating a loan application, organized documentations and release of credits, efficient internal control systems and demanding adequate and easily realizable collaterals (Bank of Tanzania Report, 2000).

Despite the efforts made to collect loans, available data indicates that many financial institutions still face a problem of an increase in an outstanding balance withheld by defaulters due to the fact that not all loans disbursed are repaid on the due date. For example, for the period of 2008, National Bank of Commerce loan provision was reduced by 27 percent (National Bank of Commerce Report, 2008), National Microfinance Bank Report by 26 percent (NMB, 2008) and Trust Fund by 29 percent (Trust Fund, 2008) due to the failure of borrowers to repay loans on time. With this borrowers' failure to repay the loans, the financial institutions are rendered unable to provide loans to new loan applicants (Chijoriga, 1997). It is also fundamentally known that poor loan repayment behaviour by the borrowers negatively affects the financial institutions' operations in a number of ways. These include the inability of the financial institutions to fully disburse the loans at the expected maximum levels.

The objective of this paper is to identify and analyze the factors influencing effective loan repayment behaviour in the financial institutions. The study whose findings are reported here was justified by its potential to generate empirical information on which interventions might be based to strengthen organizations' abilities to recover the loans so that at the end, they can contribute more to increasing loan sizes. The findings of the study may therefore help the financial institutions to reduce risks associated with loan repayment. This could, in turn, contribute to the steady attainment of the growth and reduction of poverty as clearly stipulated in the National Strategy for Growth and Reduction of Poverty of which improving entrepreneurship activities and credit access is one of the main themes (URT, 2005).

## **2. Financial institutions and loan supply services**

The philosophical orientation of this paper poses a theory that a well-created business environment is the one that facilitates business performance thereby improving loan repayment to the financial institutions. In Tanzania, financial institutions are the key providers of financial services to the low income households particularly in rural and urban areas. For example, such financial institutions involve of all registered commercial banks, savings and credit cooperative societies, and all unit banks whose micro-credit delivery

operations are done in Tanzanian. Despite the presence all these financial institutions operating in Tanzania, a large part of the population still has no access to financial assistance in terms of credit; whether formal or informal financial assistance, with over half of the population being completely excluded as cited by Olomi from Finsco (2007). Despite the expansion of semi-formal financial institutions such as SACCOs and NGO-MFIs in the recent past, only 2 percent of the rural population has managed to access financial assistance through credit from these organizations (Finsco, 2007).

### 2.1. Lending policy and regulatory framework

In the Tanzanian context, currently the regulations require the ratio of loan to deposit to be at most 80 percent and the ratio of movable assets to total capital to be at least 20 %. Collateral is required to be 125 % of the value of the loan, the loan to be 25 % of the core capital if the loan is fully secured, 10% of the core capital if the loan is partially secured and 5 % if the loan is not secured. Loan provisioning requirement is 5% of the core capital. In addition, the credit policy shall take into account the following guidelines; a credit facility shall be granted only in the amount and for the determined purpose or project and period essential to complete the operation or project to be financed. Overdraft facilities shall be granted for working capital purposes only for a maximum of one year (BFIA, 1991).

Before granting a loan, every registered commercial bank and financial institution shall exercise proper caution to ascertain that the borrower is capable of fulfilling his or her commitments. With this view, the financial institution will demand from the loan applicant the statements of his or her assets and liabilities as well as income and expenditures. The applicant reports to be engaged in business with a substantial volume of transactions; revenues or assets, the submission of the audited accounts and balance sheet, profit and loss accounts, and cash flow statements of the business for each of the last three years should also be required. In addition, a copy of the applicant's official returns submitted for the past two years of the income tax should also be sent to the financial institutions for effective financial scrutiny so as to be able to get a clear picture of the financial position of the loan applicant. Where the loan is intended to finance an already existing project or new one or to rehabilitate the business, the applicant is also required to submit a project feasibility study which shall be reviewed in evaluating the credit application (Lending Policy and Regulation Paper, 2010).

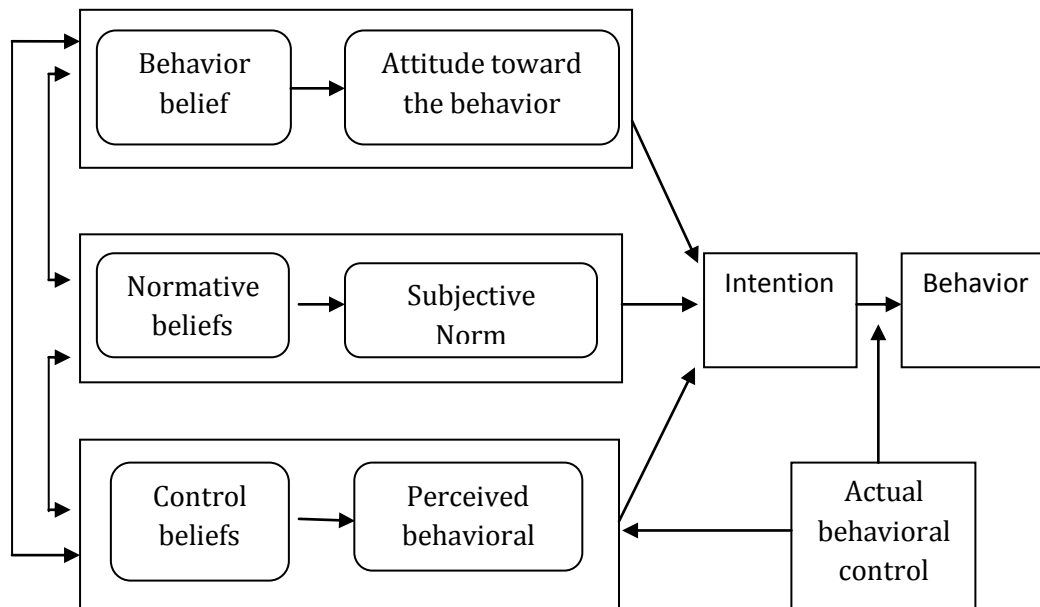
Every financial institution shall make a credit investigation and analysis of the character and financial position of each loan applicant. No loan shall be granted to an applicant who lacks the capacity to repay in full the loan expected to be disbursed even if the applicant is deemed to be financially responsible. The lending financial institution should also require the applicant to submit acceptable collateral with sound realistic value that the financial institution deems to be adequate to cover any risk of loan default. Unsecured credit shall not be granted unless unanimously approved by all its directors and notified in advance to the financial institution. Moreover, the purpose of any loan shall be stated in the application. Where the financial institution finds that the funds have been deployed without the financial institution's approval, for purposes other than those agreed upon; the financial institution shall terminate disbursement of the loan and demand immediate repayment of the obligation unless the borrower gives satisfactory reasons (Malimba, 2008).

### 3. Planned behaviour theory

According to the theory of planned behaviour (TPB), human action is guided by three main kinds of considerations; these are behavioural beliefs, normative beliefs and control beliefs. Behavioural beliefs are beliefs about the likely results of the behaviour and evaluations of them, while normative beliefs are the beliefs about the normative expectations of other people and motivation to comply with them, and control beliefs are beliefs about the existence of factors that may affect the performance of the behaviour (Ajzen, 2006).

The behavioural beliefs create a favourable or unfavourable attitude towards the behaviour (ATB), normative beliefs give rise to subjective norms (SN), while a rise on perceived behavioural control (PBC) is always a result of control beliefs (Ajzen, 2006).

The attitude towards the behaviour, subjective norms and perceived behavioural control leads to the formation of a certain behavioural intention. The uttermost important contribution of the planned behavioural model is that despite there is not absolute relationship between behavioural intention and actual behaviour, but still intention can be employed to measure the behaviour of a person in the theory of planned behaviour relatively (Francis et al., 2004).



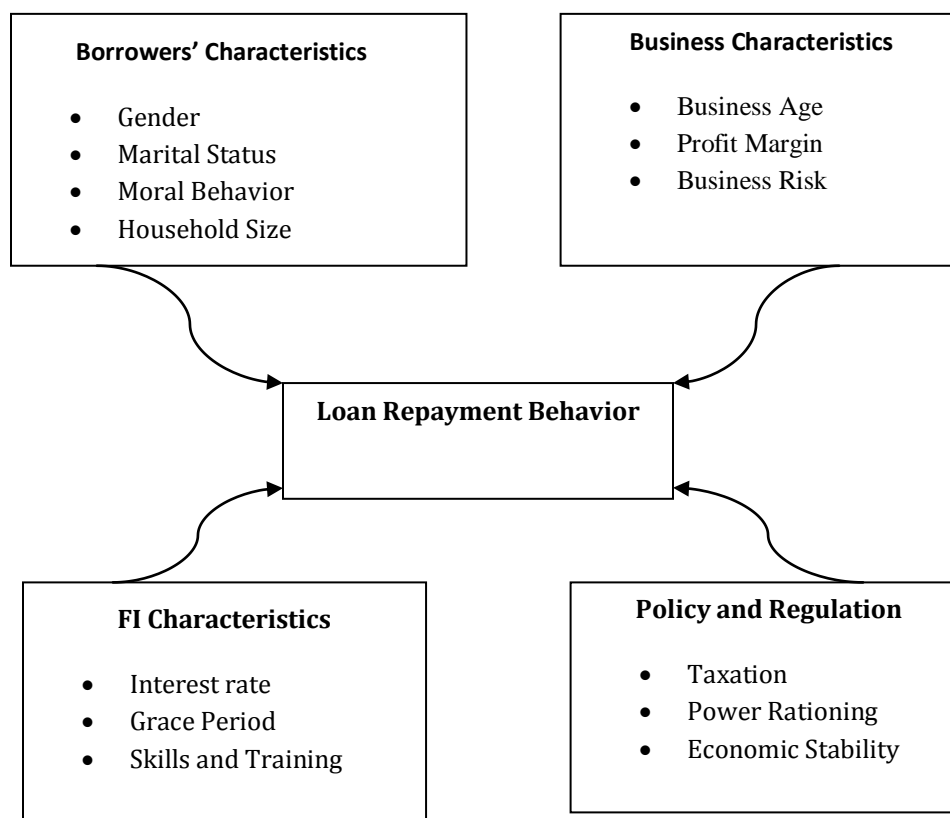
**Figure 1.** The Planned Behavioural Model (Source: Francis et al., 2004)

The study effectively used the model above to express the probable behaviours of a loan borrower in different scenarios. Through this model, the study investigated factors that influence effective loan repayment behaviours using the following specific variables: profit margin, moral hazard, electricity rationing, and economic stability (borrower’s behaviour on one side) and interest rates and grace period (financial institution’s characteristics on the other side).

### 3.1. The theory of planned behaviour and loan repayment behaviour

The theory of the planned behaviour is used to determine factors influencing effective loan repayment behaviour. According to the theory of planned behaviour, human action is guided by three factors. These include behavioural beliefs, normative beliefs and control beliefs which are considered as borrowers' behaviour (Ajzen, 2006). The study identified the relationship between the theory of planned behaviour on one hand and borrowers' behaviour on the other so as to show clearly the specific factors that influence the whole process of loan repayment by the loan borrowers to the financial institutions.

Basically, the loan repayment process is the function of borrowers' behaviour, business characteristics, financial institutions' characteristics and policy and regulatory issues. The study is intended to analyze the factors influencing effective loan repayment by loanees. The borrowers' behaviour, business characteristics, financial institutions' characteristics and policy and regulatory issues are believed to influence the whole loan repayment process. For the borrowers to effect the financial institutions' loans, there must be a conducive and predictable business environment in terms of profit generated, less business risks, business training given to the loan borrowers, competitive and reasonable interest rates charged by the financial institutions, well regulated taxes, and a fair grace period and constant power supply (Kuzirwa, 2002).



**Figure 2.** Determinants of Loan Repayment Behavior (Source: Author)

In practice, therefore, these factors have to be considered adequately so as to stimulate and ensure loan repayment behaviour. This is because; accessibility to loans by the borrowers can be determined by effective borrowers' behaviour, financial institutions' characteristics, business characteristics, policies and regulations. Borrower's behaviour can be determined in terms of age, marital status, gender, profit margin, business location, household size, moral hazard, nature of business, power rationing, and economic stability. In most cases, financial institutions use these factors to determine the amount of loan to be disbursed to the borrower.

#### **4. Materials and methods**

The study employed a cross sectional design because the study was done once in point of time. The study sample size was 100 respondents because the study was a pilot study. The study employed convenience sampling technique based on the accessibility and willingness of respondents to participate in the study. Questionnaire method was used in capturing primary data, while descriptive statistic was used in analyzing of data using frequencies and percentages.

#### **5. Description of factors affecting loan repayment behaviour in Tanzania**

Despite the fact that the model has various variables this paper focuses on interest rate, grace period, profit margin, moral hazard, electricity rationing, and economic stability. The following emerged as the factors that influence effective loan repayment in financial institutions, in the Tanzanian context:

##### **I. Interest rate**

Interest rate imposed on principal amount seems to be high according to majority of the respondents who were interviewed. Majority of the borrowers who comprised of 32% of the respondents interviewed failed to pay loan balances on time and the high interest rates imposed was the main reason mentioned. In this instance, financial institutions should impose reasonable and competitive interest rates to ensure effective repayment. In most cases, high interest rates discourage business to grow in the sense that a big part of the profit generated goes back to the financial institution to service the loan that was once given to the borrower. It is of essence that small business enterprises need to transform into becoming medium business enterprises and finally large business enterprises in order to enjoy both easy loan acquisition from the financial institutions and economies of scale. The government intervention through the Bank of Tanzania, as the regulator and policy maker should intervene to control the high interest rates charged by financial institutions to protect the business firms from collapsing in their infancy.

##### **II. Profit margin**

Fundamentally, profit margin is an indicator of business growth. For the business firm to be able to repay its loan effectively, it requires an assured profit earnings. However, here it has to be considered that, effective

loan repayment is not the only function of profit margin because the business firm can make high profits as reflected on income statements, but still a large part of it could be coming from sales on credit. During the survey, the study observed that 30% of the respondents failed to adhere to loan repayment schedules as demanded by the financial institutions where these respondents obtained their loans due to low profits or total losses in other cases that the business enterprises obtained. Empirical evidence drawn from Mr. H (Box 1) shows that he managed to pay his debts adequately because of the good profit he made. He sells items strictly in cash.

#### **Box 1: Case of Mr. H Restaurant -Dar es Salaam**

Mr. H started business in Dar es Salaam, Buguruni area in 1989 as a sole proprietor with a retail shop sold variety of items including sugar, beans, rice, and other food items. He moved into self-employment after completing his secondary school education. After making a reasonable amount of profits, in fact, which he was not willing to disclose, in 1998 he decided to divert into restaurant business. He opened the restaurant business in Buguruni, Dar es Salaam region; however, it had monopolized for a long time by Pemba and Asian traders, and was seen to be generating good profit.

#### **Business Performance**

The restaurant business started to expand as more and more profit was made and re-injected back into business. He also employed his wife as an assistant manager and had five restaurant attendants. The clients were mostly common people who often working in various offices within the Ilala district, and called restaurant for lunch.

The restaurant business performs so well with growing demand. Tremendously increase on demand for food in 2003, forced Mr. H to go NMB bank and loaned Tshs. 15 million to expand business. He opened two more restaurants, one at Bungoni and other one at Boma in Ilala District. The business performs very successfully.

Mr. H paid up the Loan within the time, at the same times, the businesses are performing very well despite of the numbers of constraint, amongst which are high taxation, high rents, stiff competition from other similar business and high price for food items. However, Mr. H was able to repay back the NMB loan with an interest, even though it took him three year instead of four years to do so. The loan was taken in 2003 and fully paid in 2005.

### **III. Grace period**

Grace period is the period given by the financial institution to the borrower before the first installment is due. In other words, it is considered to be the time between when the loan was disbursed to the loan applicant and when the first installment is paid. In Tanzania, most financial institutions grant only one month grace period before initial payment is expected. Commercial banks specifically provide a shorter time interval for

the borrower to make the first installment. However, the study revealed that at least 8% of the respondents interviewed complained about the inadequacy of the time given for them to make their first installment. Most of the financial institutions tend to provide a grace period of one month only, which was seen not to be sufficient for the small business enterprise owners to start realizing enough revenue for them to start paying their loans. The study found that businesses get enough grace period and have never experienced problem of default as shown in Box 1 above. In the case of Mr. H, he managed to pay his bank loan in three years instead of four years.

#### IV. Moral hazard

Moral hazard emerges when borrowers never fulfil their part of the agreement between the beneficiaries and the financial institutions. As it is known, business loans are given for the sake of business growth only, that is, to improve the business enterprise's working capital. Unfortunately, sometimes it happens that some of the loan borrowers are not trustworthy in honouring the agreement made with the financial institutions. This specifically happens when the borrowers tend to diversify or misuse the loans advanced to them. The study found that some borrowers misuse the loan to meet the household consumptions such as food items and other utilities including electricity and water bill items and to pay school fee for their children. For instance, Mr. A (Box 2) after receiving a bank loan, he married a second wife instead of using it for the business. The result is that Mr. A failed to pay back his outstanding balance in time.

##### **Box 2: Case of A Food Store-Morogoro**

Mr. A is a 38 years old man, and comes from the southern part of Tanzania. He went to school up to Standard VII and sub sequentially took some courses on business management.

In 1982 he started a business in Morogoro Municipality as a sole proprietor and sold variety of items such as beans and rice.

Despite a tremendous increase in demand for food, items Mr. A had experienced shortage of working capital in order to meet excess demand. This made him to borrow some amount from Barclays Bank to meet the demand in the year 2007.

After he received the loan, he married a second wife instead of using it for the intended purpose. As a result, he failed to pay back the fifth installment, at the end he becomes a defaulter.

This is a bad behavior shown by Mr. A for not utilizing funds to the purpose intended.

Moreover, moral hazards could as well be seen in the scenario where by the borrowers purposely deceived the financial institutions by giving wrong or incorrect profile information so as to be able to qualify



for the loan acquisition. During the survey, the study found that 14% of respondents who borrowed from the financial institutions, in one way or another, were associated with moral hazards, such as giving wrong information to the financial institutions and diversifying or misusing the loan given to serve household consumptions and other unintended uses as explained above.

## V. Electricity rationing

Most of the businesses surveyed depend heavily on power supply for their production. It is important to note that businesses need constant power supply in order to improve business production and income. This is not the case in Tanzania. There is no constant power supply in business areas. The problem of power rationing is a serious case in Tanzania. This led the Tanzanian government to lose more revenues due to the power rationing problem. The study observed that some few enterprises had already stopped production altogether. The problem therefore jeopardizes growth of business ultimately slowing down the Tanzanian economy. In some cases, the problem of power rationing can trigger default. For instance, let us look at Box 3; the case of Ms. N:

**Box 3: Case of Ms. N deals with Fresh Food Retail Shop, located at Magomeni Kagera-Dar-es-Salaam Region.**

She is selling fresh fish and chicken in retail bases. She has three million Tanzanian Shillings debts from National Microfinance Bank (NMB Bank).

Power rationing caused damage worth three hundred and thousand Tanzanian Shillings. This is the results of 66kgs of fresh fish and chicken perished. Fish were 60kgs and chicken were 6kgs perished because of power rationing. She sells fish and chicken Tshs. 4500 and 5000 per kilogram respectively.

Her working capital is worth five million Tanzanian Shillings before excised loss.

## VI. Economic instability

Inflation is one of the factors that affect repayment behaviour of a borrower. Rise in inflation figures can affect purchasing power of the customer. Inflation goes hand in hand with operational costs. Operational costs -cost of electricity, fare, and petrol and raw materials- are increasingly as a result of persistent increase in general price levels. High inflation figures discourage potential investors to invest in Tanzania. Economic instability is an outcome of the high inflation rates. The study revealed that the problem of inflation in one way or another is associated with loan default. This can be shown by the response of 40% of borrowers surveyed who attributed their loan default to the high operational costs. Although the Tanzanian government tries to solve the problem of high operational cost of a Tanzanian small business and large enterprise, a lot still needs to be done to harmonize the situation. For instance, in early 2009, there was a serious economic

instability in Tanzania, which caused by world financial crisis. This instability caused most of borrowers failed to repay bank loans accordingly. And causes some lender to be financial instable. To solve this problem, the Tanzanian government through Bank of Tanzania was set aside Tanzanian Shilling 1.7 trillion (equivalent to \$1.3 billion) as an economic stimulus package, out of that the government has already channeled Tanzanian shilling 21.9 billion to the banking sub-sector to cover losses suffered by bank defaulters like cooperatives and firms that bought agricultural products from farmers.

## **6. Conclusion and policy implications**

### **6.1. Conclusion**

The study took a simple model that shows how loan repayment behaviour is influenced by borrowers' behaviour, financial institution characteristics, business characteristics and policy and regulatory issues. The results show that the borrowers' and business characters have a strong effect on loan repayment behaviour as well as bank's character. The loan repayment performance in the financial institutions was good. Number of defaulters was found to be less compared to number of non-defaulters. It is therefore concluded that loan recovery is good to a large extent. It is further concluded that socio-economic characteristics of the borrowers need to be taken into account by the financial institutions before advancing loans to mitigate the proportion of wilful defaulters.

### **6.2. Policy implications**

In terms of policy that can make prompt loan repayment obligatory, the study recommends that the banks and other financial lenders should capitalize on educating borrowers the essence of early loan repayment. If the objective is to promote effective loan repayment behaviour, the conditions needed, including the business characters, bank characters and borrowers' character both should be given due attention. In other words, an integrative approach needs to be taken in managing loan repayment and loan recovery behaviour for financial institutions. Loans, however, enhance the business to grow.

## **Endnotes**

- NGOs : Non-governmental Organizations;
- SACCOS : Saving and Credit Cooperative Association;
- MFIs : Microfinance Institutions;
- URT : United Republic of Tanzania;
- PBC : Perceived Behaviour Control;
- SN : Subjective Norms;

- ATB : Attitude toward Behaviour;
- BOT : Bank of Tanzania;
- NMB : National Microfinance Bank;
- FI : Financial Institution
- NBC: National Bank of Commerce.

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