LENDER – BORROWER RELATIONSHIPS ON CREDIT QUALITY IN UGANDA

THE CASE OF MICROFINANCE INSTITUTIONS IN KAMPALA

BY

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Declaration

I, **NATUKUNDA ANNET** hereby declare that this work is a result of my own effort and has not been presented, and will not be presented to any other institution of higher learning for the same award.

Signed………………………….

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Date…………………………

Approval

I, the undersigned hereby certify that I have read and therefore recommend for acceptance by Makerere University Business School, a dissertation entitled 'effect of lender – borrower relationships on credit quality in Uganda' in partial fulfillment of the requirements for the award of Master of Science in Accounting and Finance of Makerere University.

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SUPERVISOR

Dedication

This work is dedicated to my children, husband and parents for the love and support through this project life.

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First of all, I would like to thank my supervisors, Dr. Ngoma Mohammed and Dr.Isaac Newton Kayonga for their guidance and suggestions in all stages of writing this dissertation.

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Abstract

This study is about the effect of Lender- Borrower relationship on credit quality in Microfinance Institutions in Uganda. The study focused on customer participation, relationship lending, lending terms and conditions and credit quality and the relationships between these variables. The study was cross sectional and data was collected from 126 respondents in six microfinance institutions. Both qualitative and quantitative methods of analysis were used in the study.

It has been established that there is a strong positive relationship between customer participation and relationship lending. Evidence from the study suggests that higher levels of customer participation improve relationship lending. If an MFI involves customers in generating solutions to the problems arising during interaction of both parties, and allows customers to generate ideas, relationship lending can improve. Furthermore a significant positive relationship between relationship lending and lending terms and conditions has been established. A better lending relationship can influence better terms and conditions of borrowing. A customer with a favorable relationship with the MFI would secure a loan quickly, at a lower interest rate and with minimal collateral. A statistically significant positive relationship between relationship lending and credit quality has also been established. Better relationship lending improves the quality of the credit in MFIs since a borrower may obtain individualized service, and gain empathy as well as reliable services. Lending terms and conditions, customer participation and relationship lending are all significant predictors of credit quality, accounting for up to 73% of the variation in credit quality. Such a strong predictive power is confirmed by a small standard error of estimate, which means that these results are generalizable to the population from which the study sample was drawn. However, lending terms and conditions as well as relationship lending are individually better predictors of credit quality than customer participation.

In situations of resource scarcity, any MFI that is interested in improving credit quality should start by offering favorable lending terms and conditions, build relationship with customers and then introduce customer participation in problem solving and idea generation. MFIs should charge a fairly reasonable interest rate, introduce favorable collateral requirements, and should engage customers in solving problems. They should also provide advisory services, undertake through customer assessment and constant loan monitoring and need to demonstrate to their clients that both parties are complementary and are in business to help each other.

CHAPTER ONE

INTRODUCTION

1.1 Background to the study

The importance of micro and small enterprise (MSE) sector to economic and social development in developing countries is well recognized. In Uganda MSE's are frequently hailed as the back bone of the economy mainly due to their flexibility, their innovative capacities and their role in strengthening competition and social cohesion. They provide employment to 90% of the school dropouts, army veterans, the retired, the skilled unemployed, and the retrenched civil servants (Masembe, 2001). It is also estimated that approximately 22% of the households are engaged in MSE's activities (Santos, 2003).

Despite their importance to the economic and social development to the economy, MSEs are still constrained from accessing credit from financial institutions. Concerns about small business financing have stemmed largely from perceptions that small firms have more difficulty gaining access to credit sources than do large businesses or other types of borrowers. The source of this difficulty may be that lending to small business is generally considered riskier and more costly than lending to larger firms. Small businesses are much more susceptible to swings in the economy and have a much higher rate of failure than larger operations. In addition, lenders historically have had difficulty determining the creditworthiness of applicants for some small business loans. The wide variation in the characteristics of small firms has impeded the development of general standards for assessing applications for small business loans and has made evaluating such loans less straightforward

and relatively expensive. According to the United Nations Conference on trade and industry on "**the proceedings of the symposium on modalities for Financing SMEs in Uganda**" (2002) it was generally established that lenders think that SMEs are difficult to lend to because they borrow small amounts which require large amounts of time/effort to manage; have low levels of technical and managerial skills; lack of professionalism and networking; lack understanding of SME needs and have difficulty in assessing creditworthiness. They also appear to have unreliable accounting procedures, pose unrealistic business plans and generally lack financial information which increases the transaction costs of financial institutions and makes it impossible to evaluate the chances of getting their money back. It is commonly stated by some financial institutions that most SMEs do only tax accounting and usually under declare sales/profits. So in the end, financial institutions do not have reliable financial information which would indicate a track record.

It is true that the Uganda government initiated economic reforms over the last 20 years which have led the country to undergo several remarkable changes coupled with an increase in public investment of which has been the steady growth of the banking sector. However, because conventional banks look for requirements like formal books of accounts, stringent collateral and prefer clients who borrow big loan amounts which requirements are rarely or hardly fulfilled by MSEs, micro finance institutions (MFIs) have taken advantage of this credit gap left by formal financial institutions and have been growing since 1995 to date.

Many MFIs in Uganda replicate or adopt products without considering the specific needs of their targets clients. Most MSEs access MFIs products for various reasons but all expect value

for what they buy and this determines the perception and hence the attitude towards payment. It appears that the lender-borrower relationship is not good as there is often limited borrower participation in the form of information sharing, personal interaction and responsible behavior in service delivery. This poor borrower participation results into unfavorable terms and conditions to the borrowers. These conditions are reflected in high interest rates, expensive collateral security, and shorter repayment periods. Such conditions impede credit availability, reliability, accessibility and consequently reduce performance of MSEs (Berry, 1993; Christopher et al, 1998; Zeimatel et al, 1998).

The foregoing represents an unresolved challenge regarding how to provide complex and adverse MSEs with sustainable access to appropriate credit facilities.

1.2 Problem Statement

The liberalization of financial sector in Uganda has led to the set up and expansion of micro finance institutions targeting small-scale enterprises operating in both urban and peri-urban areas. Consequently, many micro and small-scale enterprises have positively responded and acquired credit with hopes of achieving business growth and competitive priorities. However, despite obtaining credit from MFIs, some firms have remained stagnant and others collapse. This failure raises questions about the quality of credit received by owners of Micro & small enterprises

1.3 Purpose of the study

The study was intended to establish the effect of Lender- Borrower relationship on credit quality.

1.4 Objectives of the study

The primary objective of the study was to investigate the effect of lender borrower relationships on the quality of credit MSEs receive from MFIs in Uganda.

1.4.1 Specific objectives of the study

The researcher aimed at achieving the following specific objectives:

i. To examine the relationship between customer participation and lender borrower relationships in Uganda.
ii. To examine the relationship between lender borrower relationships and lending terms and conditions
iii. To examine the effect of lender borrower relationships, customer participation, lending terms and conditions on the quality of credit.

1.5 Research questions

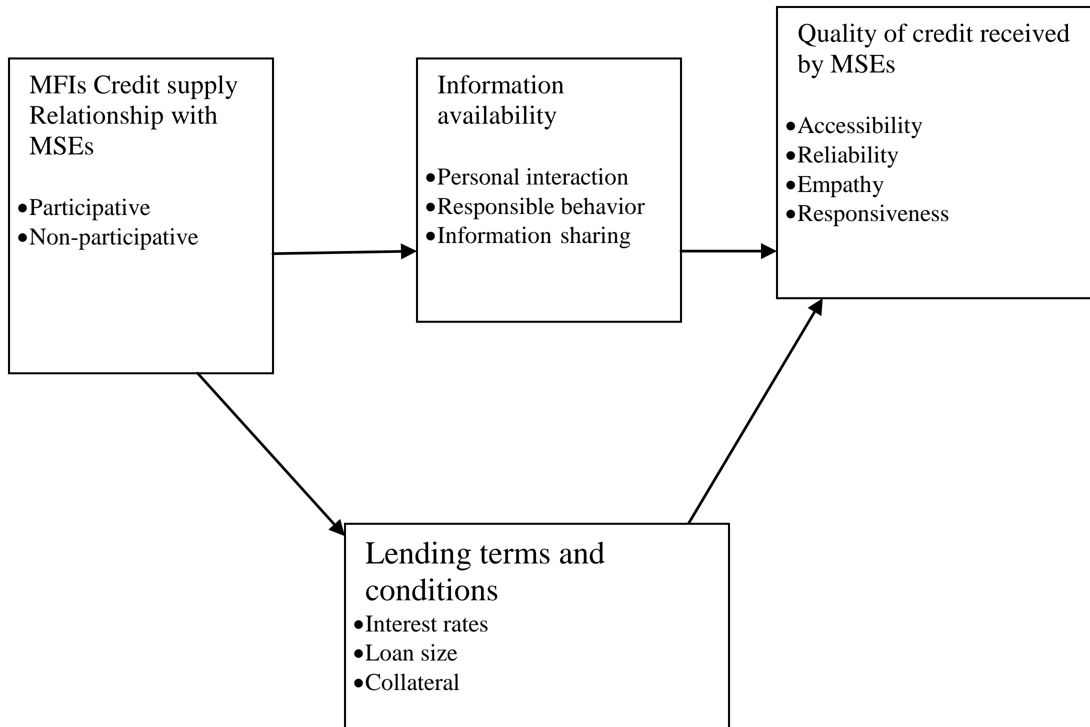
i. What is the effect of participation on lender borrower relationships in Uganda?
ii. What is the effect of lender borrower relationships on lending terms and conditions?
iii. What is the effect of lender borrower relationships, customer participation, lending terms and conditions on the quality of credit MSEs receive from MFIs?

1.6 Significance of the Study

The findings of the study will assist MFIs in designing of better lending terms and conditions that will enhance the flow of credit from MFIs to MSEs in the country. The results will also help MSEs in knowing the importance of customer participation in the credit supply relationship and its effect on the quality of credit they receive from financial institutions. More importantly, the findings of the study will add to the body of knowledge and existing literature for future researchers with interest in Micro finance institutions and small-scale enterprises.

1.7 Conceptual framework

Figure 1. Evolution and benefits of lending relationships



Source: Developed from Literature by Binks & Ennew (1996)

The concept of customer participation in service delivery has a long history having been identified as one of the important characteristics of service provision (Ennew, Reed & Binks, 1996). Participation in service relationship is held to be of particular importance for services in which credence qualities play an important role in evaluating customers where perceived risk is high. In particular, we hypothesize that there should be a relationship between lender-borrower participation, lending terms and conditions and the quality of credit customers receive from financial institutions, and according to Binks (1996), it was suggested that there can be benefit to be gained from lender-borrower participation in the credit supply relationship in the form of better lending terms and conditions such as interest rates, loan period, loan size and collateral,

improved information sharing, personal interaction and responsible behavior which will lead to the better quality of credit in terms of credit availability, reliability, accessibility and better project performance. Similar observations were emphasized by Berry (1993), Christopher et al (1998) & Zeimatel et al (1998).

1.8 Scope of the study

The study was limited to MSEs that obtain credit from MFIs and focused on the effect of customer participation on the lending procedures and the quality of credit MSEs receive from MFIs. Data was collected from FINCA, BRAC, Pride Microfinance, Opportunity Uganda and RUCREF and the study was conducted in Kampala and Mukono districts.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

The special nature of lending relationships has been a subject of extensive theoretical and empirical literature. This section presents discussion of a review of what has been written by other researchers about lender borrower relationship and also identifies the gaps in the literature that the study has attempted to fill with findings. Relationship lending' is one of the most powerful technologies available to reduce information problems in small firm finance and a main subject of this paper.

Under relationship lending, financial institutions acquire information over time through Contact with SMEs owners and its local community on a variety of dimensions and use this information in their decisions about the availability and terms of credit to the firm such as loan interest rates and collateral requirements (e.g., PetersenPetersen & Raghuram G. Rajan, 1994).

2.1. Meaning of Relationship Banking

Relationship banking may be defined as the provision of financial services by a financial intermediary on the basis of long-term investment in obtaining firm-specific information through multiple interactions with diverse financial services (Boot, 2000) Financial institutions have advantages in gathering/producing information about their clients, mainly to the nature of information production. For example, there are economies of scale that accrue as a result of repeated transactions which reduce on the cost of information gathering or production.

Secondly, financial institutions may also be obtained as a result of cross selling. This is a situation where financial institutions utilize the information obtained on a type of service for other services. (Petersen and Rajan, 1994).

The term relationship banking is not still sharply defined in the literature. Boot defines relationship banking "as the provision of financial services by a financial intermediary that invests in obtaining customer- specific information often proprietary in nature and evaluate the profitability of these investments through multiple interactions with the same customer over time and/or across products" (Boot 2000, p.10). This broad definition allows examining the principle elements characterizing relationship banking, which can be summarized as "a personalized process as it is based on ongoing interaction between two parties and on a deep knowledge of firm's financial needs".

In particular Ongena and Smith have explored banking relationship- Banking in over twenty European countries and their findings were that, relationship banking "is a long-term process elations lending implies multiple interaction with the same customer over time and or across products, aiming at increasing the customer loyalty and stabilizing the profitability of the lender. It must be profitable for both parties: a relationship can develop only if both the MFI and the SME realize the added value and seek to foster their commitment. It involves a number of client-specific information, often proprietary in nature; it tends to be asymmetric; according to the literature, in relationship banking, the overall quality and effectiveness of the relationship deeply rest on the lender. Nevertheless, the asymmetry of the relationship does not represent an intrinsically characteristic of relationship banking, but it seems rather specifically characterizing MFI-SMEs customer relationships. Despite the absence of a unique definition of what

relationship banking is, there is a general consensus among Authors that it is a great deal more than a way of lending;

Relationship banking represents a strategic choice with serious managerial implication. This means that its establishment requires the implementation of several elements (mission, policies, programs and strategies and Organizational changes) that foster a customer-oriented culture, encourage mutual and continuous investment in the relationship and create a climate of trust and loyalty (Moriarty et al., 1983; Perrien et al., 1993; Ricard and Perrien, 1999). According to Moriarty“relationship banking involves more than an emphasis on the overall credit received, but includes an acknowledged perception of mutual interdependence between the MFI and the customer. The perceived interdependence on both parties is often based on mutual trust and openness, shared objectives, and a commitment to doing business with each other on long-term basis” (Moriarty, 1983).

However, relationship banking does not involve only funding but includes also various other financial services –e.g. savings deposits, money transfers, check accounts fixed deposit Accounts, cash management services, risk and insurance management services, Advisory and financial consulting services – in most cases, lender-borrower relationship tends to assume the nature of lending relationship”.

2.2 Participation in lending relationship.

Perhaps the main function of financial intermediaries is to alleviate, if not overcome, information frictions or asymmetry that exist between borrowers and lenders (Hendry & Moran, 2004). This is because, in the free market, borrowing and lending usually do not work perfectly well since

lenders know less about the risk-return features of the project than borrowers do as a result of information asymmetry (Troske & Lu, 2004). But prior to reviewing the benefits of lending relationships, it is imperative to examine the need and role of participation in a lending relationship.

The fact that services typically are produced and consumed simultaneously means that it is common for customers to have direct input to service provision. Thus customer involvement becomes one of the many problems to be addressed by service marketers (Zeithaml et al, 1985). In order to evaluate the benefits that might accrue to customers and banks from participation it is useful to consider their rationale for involvement in a service relationship.

According to Binks et al (1997), provision of much service occurs with customers' involvement. And the way in which customers participate in a service delivery have important implications for both parties, and that participative customers may expect to receive a service which is more appropriate to their needs and better quality because the provider has a better understanding of their circumstances. They may also be more aware of the constraints of the service provider in terms of what can and cannot be delivered, and according to Binks et al (1997), they have more realistic expectations and this reduces the gap between expectations and performance. This is because the ability of a financial service provider to meet the needs of its customers is heavily dependent on the information provided by those customers (Ennew & Binks, 1996).

Existing theories predict that establishment of strong lender-borrower relationships can mitigate problems of asymmetric information and generate significant benefits for the parties involved

(Bharath et al, 2004). Similar observations were made by Ennew & binks (1997) and according to them, benefits can be got inform of enhanced service quality. More importantly, the interaction between the borrower and the MFIs and the degree of customer participation in the relationship has been identified as a possible antecedent of customer satisfaction (Solomon, suprenant, czepiel and guttman, 1985).

The ability of a financial institution to develop and maintain a relationship with its customers is dependant on the willingness to participate and for this relationship to materialize; customers (borrowers) should understand that it is beneficial to participate rather than be non-participate (Ennew & Binks, 1996). According to Bitner (1995), participation has three dimensions; information sharing, responsible behavior and personal interaction. For instance, customers need to share information with their service providers to ensure that the service received meets their needs also service providers should provide information to their customers as one of their most basic functions (Bitner, 1995). The author is supported by Boot (1999) who argues that typically, the strength of the relationship is dependent on its duration because the length of the relationship lubricates and enhances information exchange. Bitner (1995) argued that personal interaction between the parties forms the basis of relationships while Bowen and Scheider (1988) stipulated that responsible behavior makes parties involved in a relationship to put themselves in each other's shoes and as such it plays a great role in service delivery.

Financial institutions therefore rely on participation to develop relationships with their customers and rely on the later to overcome problems that arise from asymmetric information on credit worthiness (Cocco *et al*, 2004).

2.3 Effect of relationships on lending terms and conditions

The value of developing good relations has been highlighted in a number of studies to benefit both the borrower and the lender (Turnbull & Gibbs, 1987; Watson, 1986; Bannock and Doran, 1991).

In recent years, there has been increasing interest in the economics literature on unfavorable loan terms and conditions for small-scale borrowers. For instance, Rwe-Beyanga *et al* (2000) argue that, collateral requirement is one of the conditions to be negotiated before commercial institutions grant a loan. Furthermore, Rwe-Beyanga *et al* (2000) and Bresson (2003) give a sweeping statement that; lenders in Uganda are obsessed with collateral for business loans. And a matter of critical concern is not the inability of most MSEs to meet collateral requirements but this problem does not attract sympathy from lenders considering the high risks of lending in Uganda (Essoke, 1996 & Mugisha, 1996).

Most of the existing literature on lending relationships rests the blame of stringent collateral requirements for business loans on the absence of information about the prospects of the firm seeking credit from the financial institution and advances that lender-borrower relationships are likely to wave off collateral requirements (Binks *et al*, 1992). In the same respect, Berger and Udell (1995) analyze the empirical association between lending relations and collateral decision. The authors find that lending relationships reduce the need for collateral and that the probability that the lender requires collateral to secure the loan decreases with the length of the relationship. Related studies by Shaker (1990), Brick and Palia (2003) provide similar evidence that collateral requirements fall with the life of a relationship.

One of the outstanding challenges to micro-borrowers in Uganda, the majority of who are the poor, is accessing favorably priced loans, which can spur their economic progress. With the expansion of micro finance in developing countries, many legislators and the general public have found it difficult to accept that small loans to poor people generally cost more than normal commercial bank rates (Donor brief, 2004). In Uganda, interest rates for Micro finance loans are five times higher than in Bangladesh some reaching an astounding 80% a year (Rwebeyanga, 2001& Murray, 2001). It therefore illogical to expect smooth progress under such borrowing conditions because, gains accrued from the credit investment are normally dwindled in servicing sharp interest rates. This renders most of the poor entrepreneurs helpless and retards efforts for poverty eradication one of themes of development in the third word. Next is a review of the literature on whether lending relationships have a role to play in shaping interest rates charged on micro loans to the benefit of small-scale borrowers?

Some studies have specifically modeled the association between the length of the Bank borrower relationship and loan pricing. In an extension of Diamond (1989). Petersen and Rajan (1993) developed a theoretical model with both adverse selection and moral hazard in which banks offer higher rates in the first period and lower rates in later periods after borrower types have been revealed. Boot and Thakor (1995) demonstrated that the length of the bank-borrower relationship may be important in determining loan prices even in a model without learning. They also found that collateral requirements are related to the length of the relationship.

Some studies have specifically modeled the association between the length of the bank-borrower relationship and loan pricing. *The theoretical literature generates conflicting*

predictions about the evolution of interest rates over the duration of a relationship. In an extension of Diamond (1989), Petersen and Rajan (1993) developed a theoretical model in which banks offer higher rates in the first period and lower rates in later periods after borrower types have been revealed. Diamond (1989) inferred that as the borrower develops positive relationship with the lender the interest rate charged on the borrower will decline.

Thakor (1994) further advances that loan interest rates reduce with the duration of relationships as a result of reduced information asymmetries. Jaffee and Russell (1976), Stiglitz, Weiss (1981), Boot and Thakor (1995) provide similar evidence that interest rates decreases as problems of asymmetric information are overcome in the life of a lending relationship particularly after borrowers have demonstrated some project success. Typically, relationship lending involves repeated interaction between a lender and a borrower over time. Such interactions generate "inside information" for the lender and could reduce its cost of providing further loans and other services.

However, there is an existing body of literature that provides evidence on the contrary. For instance, Petersen and Rajan (1994), Elsas and Krahnen (1998) infer that borrowers do not receive any preferential interest rates as a result of a relationship. Furthermore, Green Baum et al (1989), Sharpe (1990) and Wilson (1993) predict that interest rates increases with the duration of a lender - borrower relationship, arguing that the lenders improved knowledge locks the borrower into relationships, and the lenders charges above cost interests. As such, the effect of lending relationships on loan pricing remains an issue of empirical and theoretical inquiry.

Existing theories seem to suggest that the effect of lending relationship on loan pricing is not exceptionally known. In some banks, interest rates increase (e.g. Diamond, 1989; Thakor, 1994; Boot and Thakor; 1995) with the life of the relationship while in others; they decrease (e.g. Sharpe, 1990; Wilson, 1993). This theoretical contradiction justifies the need for further inquiry this time in MFIs since the existing findings are based on data from commercial banking institutions.

2.4 Effect of lender borrower relationships on the quality of credit

There is evidence that interaction between customers and service providers is an important determinant of the perception of service quality (Zeithaml *et al*, 1988). The author also asserts that service providers reap massively for relationships with their customers. Reichheld & Sasser (1993), Rust & Zahorik (1993) give a sweeping agreement that, building effective and successive relationships can contribute significantly to customer satisfaction, loyalty and retention and thus improve performance. This has been proved to work between small businesses and Banks in the UK (Binks & Ennew, 1996).

The measurement of service quality is a subject of extensive and on going debate (Lewis, 1993). Ennew, Reed & Binks (2001) stress that, quality can be thought of as the ability of a service or product to perform its specified tasks. In addition, most approaches to the measurement of service quality focus on the relationship between what customers expect from a particular service and what they actually get (Caruana &Pitt, 1997). According to a study conducted in the UK by Ennew & Binks (1997) and using a factor analysis model, credit quality is often perceived in terms of credit availability, performance and the overall satisfaction derived by the borrower.

Caruana & Pitt (1997) further advance that; reliability, responsiveness and empathy are special dimensions of service quality.

Parasuman *et al* (1993) asserts that reliability is the most important dimension of service quality because of its emphasis on “keeping promises” and also the aspect of managing customer’s expectations. The meaning of service reliability has been extensively advanced (e.g. Berry & Parasuman, 1991) as performing a service dependably and accurately. However, little is known in the literature on how lender-borrower relationships affect the reliability and loan size.

One strand of literature has concerned itself with credit availability, which is the other dimension of credit quality. Indeed, the issue of credit availability to small firms has guaranteed worldwide concern recently. Models of equilibrium credit rationing that point to moral hazard and adverse selection problems (e.g. Stiglitz and Weiss, 1981) suggest that small firms may be particularly vulnerable because they are often so informational opaque. That is, the informational wedge between insiders (lenders) and outsiders (borrowers) tends to be more acute for small companies, which makes the provision of external finance particularly challenging. Small firms with opportunities to invest in positive net present value projects may be blocked from doing so because potential providers of external finance cannot readily verify that the firm has access to a quality project (adverse selection problem) or ensure that the funds will not be diverted to fund an alternative project (moral hazard problem). Small firms are also vulnerable because of their dependency on financial institutions for external funding. These firms simply do not have access to public capital markets. As a result, shocks to the banking system can have a significant impact on the supply of credit to small businesses. Thus, small firms are subject to funding problems in

equilibrium and these problems may be exacerbated during periods of disequilibrium in financial markets (Berger and Udell, 2002).

Relationship lending may have an impact on credit rationing (Krahnen and Schmidt, 2004). The extant bank relationship research argues that establishing a lending relationship with a bank can reduce asymmetries of information and create value to the borrower (Jiangli et al, 2004). According to Berger and Udell (2002), one of the most powerful technologies available to reduce information problems in small firm finance, and a main subject of this paper, is “relationship lending.” Under relationship lending, banks acquire information over time through contact with the firm, its owner, and its local community on a variety of dimensions and use this information in their decisions about the availability and terms of credit to the firm.

Though lending relationships offset information asymmetry and are therefore likely to increase credit availability to small firms, existing literature is quite ambiguous. There exists a body of empirical work supporting the propositions of Diamond (1989) that an ongoing relationship with a lender leads to increased credit availability (e.g. Petersen and Rajan, 1994; Cole, 1998; Elsas and Krahnen, 1998; Machauer and Weber, 2000). Prior literature shows that knowledge of the borrowers reduces the adverse selection problem banks face during periods of financial distress (Bodenhorn, 2003; Boot and Thakor, 1994; Cole, 1998; Diamond, 1991; Harhoff and Korting, 1998; and Peterson and Rajan, 1995).

Though the lending relationships have extensively been favored to increase credit availability by most scholars in this area, flaws are emerging in this part of literature in recent times. Jiangli et al

(2004) after analyzing World Bank data from various countries finds that lending relationships exhibit country-varying impacts on credit availability. For instance both Korean and the Thai firms benefit from strong lending relationship, while the opposite is true for the Philippine firms (ibid). The findings suggest that empirical evidence on the effect of lending relationship on credit availability is still a subject of inquiry.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Research Design

The study adopted a cross sectional research design. The reason for using this design was because data was collected on many respondents in a relatively short period of time and this in turn reduced on the costs of data collection. Also the study was correlational in nature and did not focus on establishing cause-effect relationships, thus a cross sectional design was sufficient.

3.1 Area of the Study

The study was conducted in Kampala district covering five MFIs, RUCREF, BRAC, FINCA, PRIDE UGANDA and Opportunity Uganda.

3.2 Study population

Data were collected from a population of MSEs' owners who had borrowed from MFIs and MFI employees. The entire population was estimated at 7000 people.

3.4 Sampling

Curry and John (1984) propose that for a population of 5001 – 10000, a 3% sample size is sufficient to generate representative responses. In this study therefore, a sample size of 210 was targeted but due to non-response, only 126 useful questionnaires were returned. This represents a response rate of 60%, which is more than the recommended 50% response rate.

The study used simple random sampling method to select respondents who had borrowed money from each of the respective MFIs. The staff of MFIs who participated in the study were also purposively selected whereby focus was only of loans officers.

3.5 Data Collection

The study used mainly primary data. Primary data was collected from respondents using both qualitative and quantitative approaches. Qualitative data was obtained by observation and interviewing individual respondents. Quantitative data was obtained by administering questionnaires to individual respondents.

3.6 Measuring the Variables

The study focused on four variables; relationship lending, customer participation and lending terms and conditions as independent variables. The dependent variable was credit quality. Measurements for all the independent variables were developed by the researcher using theory and literature that was reviewed. The items were anchored on a Likert scale with values ranging from strongly disagree to strongly agree. The dependent variable was measured using an adjusted scale of SERVPERF with items originally developed from SERVQUAL. The items were anchored on a Likert scale with values ranging from strongly disagree to strongly agree.

3.7 Validity and Reliability Test

To ensure reliability, the questionnaire was pre-tested on 10 respondents before the actual surveys. The findings were entered into computer to allow for a Chronbach alpha test to be done. The constructs were very reliable where relationship lending scored 0.877, customer participation scored 0.765, terms and conditions 0.0707 and credit quality scored 0.915. an exploratory factor analysis was performed and only items with correlations above 0.6 were retained and used in the study.

3.8 Data Analysis

Quantitative data was coded and captured using EPIDATA and analyzed using the Statistical Program for Social Scientists (SPSS). The data was summarized using frequency tables and cross tabulations from which descriptive statistics were obtained. Statistical inferences were made using results of both Pearson correlations and Multiple Regression Analysis. Data was normalized using natural Log to remove multicollinearity and enable statistical manipulations to be done.

CHAPTER FOUR

PRESENTATION AND INTERPRETATION OF FINDINGS

4.0 Introduction

This chapter presents field findings and their interpretation. The findings include the demographic characteristics of the respondents, characteristics of the surveyed firms, descriptive statistics and inferential statistics.

4.1 Demographic Characteristics of the Respondents

Data were collected from a total of 126 respondents, of whom 46 were staff of the microfinance institutions where data were collected. A total of 81 borrowers from the respective microfinance institutions participated in the study. The following are the frequency distributions of the demographic characteristics of the borrowers who participated in the study: the demographic characteristics of the MFI staff who participated in the study are not presented because they were of no interest to the study.

4.2 Age of respondents

Age was one of the demographic characteristics that were captured in the study. This categorical variable was important to establish as it would give an indication of the average age of people that borrowed from the selected MFIs. Age is also an important aspect of research because it is used to eliminate respondents that are not eligible for research purposes.

Table 1: Age of borrowers

Age group (years)	Frequency	Valid Percent	Cumulative Percent
18-25	11	13.6	13.6
26-30	26	32.1	45.7
31-35	21	25.9	71.6
36-40	11	13.6	85.2
41-45	6	7.4	92.6
Above 46	6	7.4	100.0
Total	81	100.0	

Source: Primary data

Results in table 1 above indicate that up to 85.2% of the borrowers that participated in the study were below the age of 40 years. Within this group, majority (45.7%) were below 30 years and only about 40% were aged 31 – 40 years. Very few borrower respondents (7.4%) were above 46 years of age. These results have a number of implications. First, predominance of borrowers below 30 years could be indicative of the marketing efforts and segmentation strategies of the MFIs. These groups could be targeted mainly because such borrowers may not have accumulated enough own savings to run their businesses. Other research in Uganda (e.g. Stevenson and St-Otenge, 2005) indicates that entrepreneurs in Uganda are largely aged 25-40 years of age. This therefore means that most business people are middle aged, and this research further confirms that finding. The other implication of the study is that the fairly young borrowers could have been in search of capital to start and expand their enterprises. However, it was not sufficient to make conclusions about the sample based on only age of the respondents.

Table 2: Education Level of respondents

		Frequency	Valid Percent	Cumulative Percent
Valid	Degree	19	23.5	23.5
	Diploma	16	19.8	43.2
	A Level	18	22.2	66.7
	O Level	19	23.5	90.1

Other	9	11.1	100.0
Total	**81**	**100.0**	

Source: Primary data

Results in table 2 above generally show that only 23.5% of the respondents had up to a degree as the highest education qualification. Respondents with diploma qualifications were 19.8%. These two together accounted for 43.2% of the respondents. These results imply that about 4 in every 10 MFI borrowers had either a degree or diploma. The implication is that considerably, the borrowers from MFIs were educated. However, up to over 57% of the respondents had no formal training qualification, except A level, O level and primary education. In fact some respondents did not have any education at all. On a positive note however, majority of the respondents (90%) could read and write and were literate enough to interpret and understand the terms of services of the MFIs.

Table 3: Position Held in Company

	Frequency	Valid Percent	Cumulative Percent
Managing Director	20	24.7	24.7
Director	27	33.3	58.0
General Manager	5	6.2	65.4
Manager	9	11.1	76.5
Employees	19	23.5	100.0
Total	**81**	**100.0**	

Source: Primary data

Table 3 above shows that above majority of the respondents (33.3%) who participated in the study on behalf of the borrowers were directors. It is also seen that about 25% were managing directors and others were mainly general managers and managers. Only about 23% were employees. These findings imply that most of the borrowers who participated in the study were

the direct owners and managers of the respective companies. This is understandable considering the fact that most companies were small in size, and majority were sole proprietorship businesses. Details on the characteristics of businesses are summarized below.

4.3 Characteristics of the enterprises that borrowed from MFIs

Legal status of the companies

It was important to establish the legal status of the companies whose owners borrowed from MFIs. Table four below summarizes the findings.

Table 4: legal status of the companies surveyed

	Frequency	Valid Percent	Cumulative Percent
Sole proprietorship	59	72.8	72.8
Partnership	9	11.1	84.0
Limited Liability Company	6	7.4	91.4
Others	7	8.6	100.0
Total	81	100.0	

Source: Primary Data

Results in table 4 above show that majority of the enterprises that borrowed from MFIs were sole proprietorship businesses (72.8%). About 11% of the enterprises were partnerships and limited liability companies were 7.4%. From these findings, it can be said that generally MFIs dealt with small businesses that were cash deficient. Findings in table 4 could also explain why most respondents were directors and general managers.

Table 5: Common Financial Institutions Used by Respondents

	Frequency	Valid Percent	Cumulative Percent
Community MFIs	26	32.1	32.
Microfinance institution	46	56.8	88.9
Savings and loans association	9	11.1	100.0

	Frequency	Valid Percent	Cumulative Percent
Community MFIs	26	32.1	32.
Microfinance institution	46	56.8	88.9
Savings and loans association	9	11.1	100.0
Total	81	100.0	

Source: Primary Data

Table 5 indicates that most respondents (56.8%) preferred to borrow from microfinance institutions when they needed a loan. However, a considerable 32.1% also used community MFIs to solve their financial problems. The difference between community MFIs and microfinance institutions is that the former were generally concerned with formed by community members while the latter were centralized institutions with branches in different parts of the country. Very few respondents (11%) resorted to savings and loans schemes when they needed financial assistance.

Table 6: Duration of the loans obtained

	Frequency	Valid Percent	Cumulative Percent
very short term	22	27.2	27.2
Short-term	36	44.4	71.6
Long term	23	28.4	100.0
Total	**81**	**100.0**	

Source: Primary Data

In this study a loan was classified as short-term if its life spanned 2 months to one year. A loan was classified as long-term if it extended beyond 12 months. And a very short-term loan ranged from 1 day to 60 days. Findings in table 6 reveal that most of the loans advanced to borrowers were short-term loans (44.4%). Generally longer and very short-term loans were fairly represented. However, it is also observed about 72% of the loans were both short term and very short term loans. The nature of these loans raises questions as to whether the borrowers were

able to utilize the obtained loans effectively. This question is especially valid if one considers the fact that most borrowers were small sole proprietorship businesses. Further investigations revealed that the interest charged ranged between 10% to 15% per month and the grace period was in some instances as short as a week. It thus appears that the loans were short term, with a small grace period, high interest rate and to small scale businesses.

Table 7: Age of the business

	Frequency	Valid Percent	Cumulative Percent
Young business	38	46.9	46.9
Mature Business	23	28.4	75.3
Old Business	20	24.7	100.0
Total	81	100.0	

Source: Primary Data

A business enterprise was classified young if it had lasted for less than five years. A business which had lasted 5-10 years was classified as mature while all business enterprises that had been in existence for more than 10 years were classified as old businesses. Based on this classification, results in table 7 reveal that most business enterprises studied were young (46.9%), mature businesses constituted 28.4% while as expected, old businesses were the fewest (24.7%). The implication if these results is that the study covered enterprises of different ages and this would have implications on perceptions of credit quality and lending relationships between MFIs and borrowers.

Table 8: Number of people employed

	Frequency	Valid Percent	Cumulative Percent
0-3 employees	46	56.8	56.8
4-7 employees	20	24.7	81.5

Above 8employees	15	18.5	100.0
Total	81	100.0	

Source: Primary data

From table 8, it is seen that about 57% of the business enterprises of the people that borrowed from MFIs employed fewer than three people. Moreover, most of these were casual and in many instances family members. 24.7% employed 4-7 employees while only about 19% employed more than 8 staff. Generally, the study gathered data from small scale enterprises.

While the loans were short term, and attracted high interest rates, a number of conditions were set. The table below summarizes the requirements for obtaining a loan from the surveyed MFIs.

Table 9: Requirements for obtaining a loan from the visited MFIs

		Frequency	Valid Percent	Cumulative Percent
Valid	Collateral	37	45.7	45.7
	Deposit	3	3.7	49.3
	Neither collateral nor deposit	14	17.3	66.7
	Other	27	33.3	100.0
	Total	81	100.0	

Source: Primary Data

Table 9 above indicates that most of the MFIs required borrowers to stake collateral for the loans. This is reflected by about 46% of the respondents who participated in the study. Furthermore, there were many other requirements such as letter of introduction, having an account with the MFI, having a business and having referees which the borrowers had to fulfill.

In fact table 10 below shows that in instances where collateral was required, it had to be certain specific valuables.

Table 10: Type of collateral required by MFIs

	Frequency	Valid Percent	Cumulative Percent
Land	9	11.1	11.1
House	29	35.8	46.9
Machinery	11	13.6	60.5
Home assets	26	32.1	92.6
Other	6	7.4	100.0
Total	81	100.0	

Source: Primary Data

From table 10, it is observed that the most common type of collateral asked by MFIs was a house (35.8%). This was followed by home assets such as chairs, fridges, beds and anything that was valuable (32.1%). Other types of collateral were machinery (13.6%) and land. (11.1%). These results indicate that while land is a valuable asset, it was not normally considered a key requirement for loans from MFIs. Maybe this is because the clients were urban poor residents. It could be due to the fact that MFIs were trying to mitigate risk by not venturing into land which is generally vulnerable to fraud.

In addition to lending to customers, MFIs also provided other services to their customers. These services are summarized in table 11 below:

Table 11: Other services offered by MFIs to the borrowers

	Frequency	Valid Percent	Cumulative Percent
Keeping my savings	**10**	**12.3**	**12.3**

Handling money transfers	**7**	**8.6**	**21.0**
Giving me financial advice	**10**	**12.3**	**33.3**
Advising me on how to do my business	**45**	**55.6**	**88.9**
Other	**9**	**11.1**	**100**
Total	**81**	**100**	

Source: Primary Data

Table 11 reveals that about 56% of the respondents indicated that in addition to providing loans, MFIs provided advice to the borrowers on how to do business better. The MFIs provided financial advice (12.3%) as well as keeping savings for the clients. Sometimes, MFIs handled money transfers for their customers (8.6%).

4.4 Descriptive statistics for the key variables of the study

The research computed the descriptive statistics of the normalized variables to determine the extent to which the variables existed or were absent. The statistics include the mean, standard deviation and measures of dispersion. Of particular interest is the standard error which helps to determine extent to which the results of the sample are generalizable in other similar settings. The findings of the descriptive statistics are summarized in table 12 below:

Table 12: Descriptive statistics

	Mean	Std. Deviation
Relationship lending	3.1651	.66234

Customer participation	2.7850	.62969
Credit terms and conditions	2.9410	.58770
Credit quality	3.2317	.71030

Source: Primary Data

The response items were anchored on a five point scale ranging from 1 (strongly disagree) to 5 (strongly agree. The descriptive statistics in table 12 indicate that generally all the study variables were perceived to be weak. However, credit quality (mean=3.2) as well as relationship lending (mean=3.2) were ranked slightly better than other variables. This does not make them existent in the MFIs but the magnitude of customer perception of their existence in relation to credit terms and conditions (mean=2.9) and customer participation (mean=2.8) was lower. In fact table 12 shows that the worst rated variable was customer participation, giving an impression that customers were not often engaged in generating ideas or decisions concerning their transactions with the MFIs.

4.5 Correlation Analysis

In order to determine the relationships between independent variables and the dependent variable, correlations had to be performed. Pearson correlation analysis was used to measure relationships between lending relationship, customer participation, lending terms and conditions as well as credit quality. The results are summarized in table 13 below:

Table 13: Pearson Correlations

	Relationship lending	Customer participation	Lending terms and conditions	Credit quality
Relationship lending	1			
Customer participation	.716**	1		

Terms and conditions of lending	.632**	.511**	1	
Credit quality	.766**	.680**	.750**	1

**. Correlation is significant at the 0.01 level (2-tailed).

Source: Primary Data

4.5.1 Relationship between customer participation and relationship lending

Results from table 13 above show that there was a strong positive relationship between customer participation and relationship lending (r=.716, p-value<0.01). The implication is that the higher the participation of borrowers in sharing information, solving problems and contributing ideas to the MFI, the better the lending relationship will be between the two parties (borrower and lender). The reverse is also true.

4.5.2 Relationship between relationship lending and lending terms and conditions

It is observed from table 13 that a strong positive relationship existed between relationship lending and lending terms and conditions (r=.632, p-value<0.01). The interpretation of the finding is that the better the terms and conditions of borrowing, the better will the relationship between borrower and lender be. However, it could also mean that a better lending relationship could influence better terms and conditions of borrowing. If for example a given customer has kept a good relationship with the MFI such a customer can secure a loan at favorable terms and conditions.

4.5.3 Relationship between relationship lending and credit quality

Findings in table 13 show that a strong positive relationship existed between relationship lending and credit quality (r=.766, p-value<0.01). This statistic means that there is 99% confidence that the observed relationship between the two variables is positive and strong within the study

sample. Going by this correlation coefficient, better relationship lending improves the quality of the credit. When the relationship between the borrower and lender is favorable, a borrower may obtain individualized service, and gain empathy as well as reliable services. However, the reverse of this relationship may also be true.

4.6 Multiple Regression Analysis

Having established that there were relationships between the dependent variable and the independent variables, the researcher had to test the extent to which such variables influenced the dependent variable. A multiple regression analysis was performed to serve this purpose and the findings are summarized in table 14 below.

Table 14: Multiple Regression Model Summary

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1.a	(Constant)	-.028	.083		-.331	.742
	Relationship lending	.368	.102	.342	3.588	.001
	Customer participation	.236	.093	.219	2.555	.013
	Terms and conditions of lending	.494	.091	.421	5.446	.000

Coefficients[a]

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1.a	(Constant)	-.028	.083		-.331	.742
	Relationship lending	.368	.102	.342	3.588	.001
	Customer participation	.236	.093	.219	2.555	.013
	Terms and conditions of lending	.494	.091	.421	5.446	.000

Model	R	R square	Adjusted R Square	std. Error of the Estimate
1.b	.852	.727	.716	.13093

a. Predictors: (constant), Terms and conditions of lending, customer participation, Relationship lending

b. Dependent Variable: Credit quality

Source: Primary Data

It is observed from the table above (table 14 model 1.a) that all the three independent variables were good predictors of the dependent variable. For example, it is seen that a 0.342 unit change in credit quality was accounted for by relationship lending (β=.342). However, terms and conditions of lending were the strongest predictor of credit quality since a (β=.421, t=5.45, p-value<.000). Customer participation is third (behind terms and conditions of lending and relationship lending) in terms of influencing credit quality (β=.219, t=2.56, p-value<0.013).

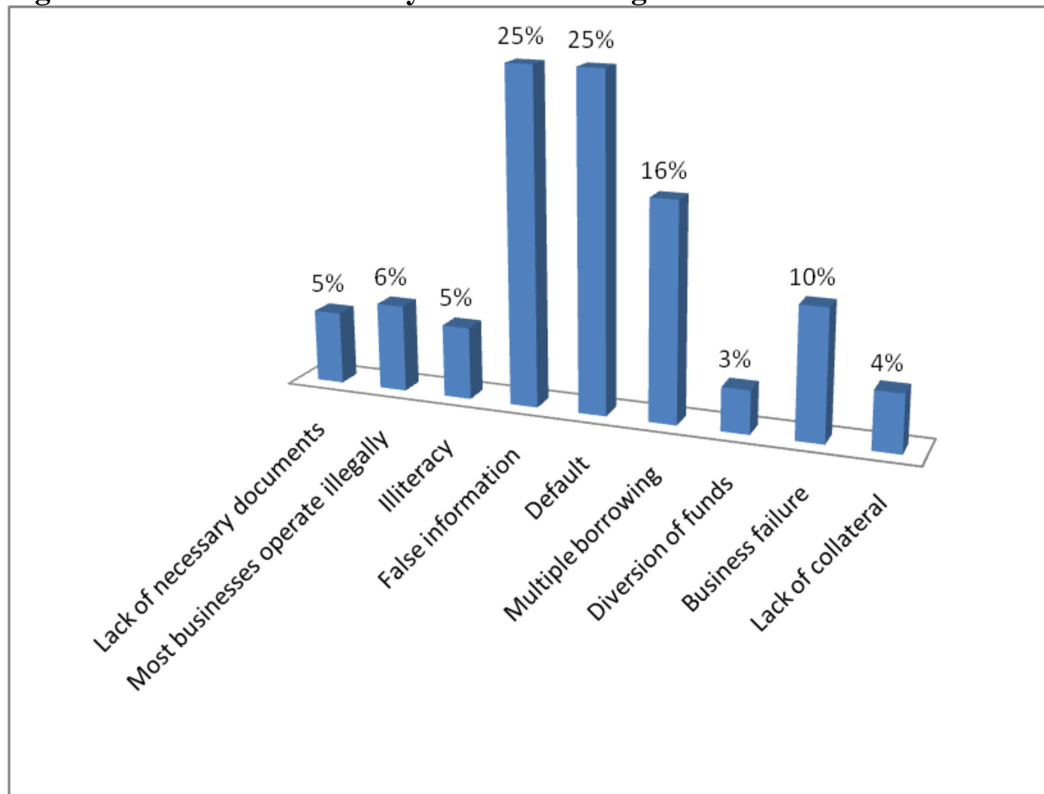
It is further observed in table 14 model 1.b that Customer participation and relationship lending accounted for about 73% of the variation in credit quality (R Square= .727). It can thus be said that these three independent variables do indeed account for a bigger proportion of the dependent variable. Such predictive power is confirmed by a small standard error of estimate (.13), which means that these results are applicable to the population from which the study sample was drawn.

The implication of the above is that improving credit quality in the MFIs from which the sample was drawn will require specific attention to lending terms and conditions, relationship lending and customer participation.

4.7 Constraints faced by MFIs in dealing with borrowers

The researcher also interviewed MFI staff to determine the constraints faced while dealing with borrowers. Figure 1 below summarizes the findings:

Figure 1: Constraints faced by MFIs in dealing with borrowers



Source: Primary data

Figure 1 above shows that the twin biggest constraints faced by MFIs when dealing with borrowers were provision of false information (25%) and default (25%). The researcher found that on many occasions borrowers provided information that was not correct. Such information was often the kind of information that was difficult to verify yet was key in determining whether a customer was to be given a loan. Many clients for example would deceive on the purpose of the loan; one could secure a loan for business expansion and later on use the money to pay school fees for the children. Other customers would lie about the ownership of collateral or even

the worth of the business. This fact reduced trust and made the MFI staff to develop stringent conditions and terms of borrowing.

The problem of loan defaults was also common in the surveyed MFIs. This problem became a concern when many customers would change address, switch off their telephones and others would genuinely fail to meet their end of the loan bargain. These problems were compounded by multiple borrowing, where a single borrower would have loans in more than three MFIs with the same collateral attached to all loans. Such problems would result into disputes and loss of business to the MFIs. Also issues of business failure and lack of legal documents were key constraints in the relationships between borrowers and lenders.

CHAPTER FIVE

DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.0 Introduction

This chapter discusses the research findings in chapter four in relation to the objectives of the study and review of related literature. The chapter also contains study conclusions, recommendations and areas for further research.

5.1 Relationship between customer participation and relationship lending

The first objective of the study was to examine the relationship between customer participation and relationship lending. Findings revealed that there was a strong positive relationship between customer participation and relationship lending. The strength of this relationship implies that higher levels of customer participation improve relationship lending. Using descriptive statistics, it was revealed that both customer participation and relationship lending existed in the studied MFIs.

From the theoretical point of view, the relationship identified in this study is supported. When Boot (2000) argues that relationship banking is dependent upon multiple interactions between the financial institution and the customer, indirectly the notion of information sharing is talked about.

In this study the MFIs kept close contact and interactions with the borrowers to the extent that in some MFIs weekly meetings were organized. In such meetings, borrowers would provide information about their businesses and if they had any problem, the MFI always tried to provide

advice. In some instances MFI staff visited borrower premises to help them fix their business problems. These interactions built some of trust and interdependence to the degree that some customers had started obtaining loans without trust. The MFIs would regularly encourage their members to save, work hard and pay their installments in time. In agreement with Ennew & Binks (1996), these interactions made MFI borrowers realize the benefits of closely working with MFIs. .

However, further analysis of the qualitative findings indicated that customer participation was slightly higher among customers who had stayed longer with the MFIs. This finding is in congruence with the argument of Boot (1999) that the strength of the relationship is dependent on its duration because the length of the relationship lubricates and enhances information exchange. Bitner (1995) argued that personal interaction between the parties forms the basis of relationships. While customer participation was cited as existent, and a strong relationship existed with relationship lending, the staff of MFIs revealed a deep concern that many times the borrowers provided wrong information. Most of such dishonest borrowers provided information that favored them without minding about the interests of the MFIs. For instance, borrowers would deceive that they did not have loans with other MFIs; lied on the purpose of the loan and others would lie on the worth of the business. In fact they would end up running away and turning off their contact telephones, thus resulting in high default rates.

Like Bowen and Scheider (1988) stipulated, such irresponsible behavior would create mistrust and thus derail efforts for relationship lending. In effect, this argument means that both parties must be honest to each other and should be willing to share information openly. The mistrust and

high incidences of misinformation increased the loan risks, and as a remedy MFIs became more stringent on the collateral requirements. Even with high value collateral, the MFI staff would still closely monitor the borrowers and made formal contact at least once a week. This contact was in form of meetings. Also client visits, client dinners, client workshops, and customer care were among the forums used to communicate with clients. Before giving a loan to any new borrower, the MFIs had to critically assess the type and nature of business to determine, to the extent possible, the credit worthiness of the borrower. Furthermore, the interest rate was high until such a time when the customer was trusted by the MFIs. Such trustworthy customers would obtain cheap loans, sometimes without collateral. MFIs thus should rely on participation to develop relationships with their customers and rely on the later to overcome problems that arise from asymmetric information on credit worthiness (Cocco *et al*, 2004).

5.2 Relationship between relationship lending and lending terms and conditions

The second objective of the study was to examine the relationship between relationship lending and lending terms and conditions. Using Pearson correlation analysis the researcher found a significant positive relationship between relationship lending and lending terms and conditions. The interpretation is that there was 99% confidence that the observed relationship between the two variables was positive and strong within the study sample. Ideally, the better the terms and conditions of borrowing, the better will the relationship between borrower and lender be. Indeed in the current study, a better lending relationship could influence better terms and conditions of borrowing. If for example a given customer kept a good relationship with the MFI such a customer could secure a loan at favorable terms and conditions. This argument is supported by studies such as that of Binks *et al* (1992) and Berger and Udell (1995) who found that lending

relationships reduce the need for collateral and that the probability that the lender requires collateral to secure the loan decreases with the length of the relationship. Related studies by Shaker (1990), Brick and Palia (2003) provide similar evidence that collateral requirements fall with the life of a relationship. In the current study however, customers that did not keep in good terms with the MFI would be harassed by the MFI staff through regular reminders, threats and court cases. In extreme cases such customers would run away from the MFI.

The study found that essentially two dimensions of lending terms and conditions were predominant; security and interest. Nearly every borrower indicated that the MFIs required collateral from everyone that wanted a loan. This similar finding was obtained by Rwe-Beyanga *et al* (2000). In exceptional circumstances, borrowers who had been customers for longer periods of time had access to loans without collateral. However, on many occasions everyone was required to stake a property or any asset that was valuable. And not every asset qualified to be collateral; most homes, household property, land, machinery and a few other assets were the assets required by MFIs. Moreover the value of such assets had to be so high that the MFI would easily recover their loans in the event of failure to pay by the borrower. The MFIs had to do a lot of analysis and investigations to prove whether the staked collateral actually belonged to the borrowers. This was the case especially when the collateral staked was land. Certificates of ownership were required and if one had to stake a car, h/she had to park at the courtyard of the MFI. This finding is congruent with the work of Essoke (1996) and Mugisha (1996) who concluded that the problem of collateral does not attract sympathy from lenders considering the high risks of lending in Uganda (Essoke, 1996 & Mugisha, 1996).

Besides asking for high value collateral, the MFIs charged considerably higher interest rates. Since most of the loans were short term, lasting less than a year, most borrowers had to pay up to 15% per week. And given that most of the borrowers were small scale business owners and had little capital, the high interest rate was detrimental to the success and expansion of the borrower enterprises. Providing security as well as willingness to pay high interest was still not sufficient to enable anyone obtain a loan. The MFI staff had to assess the personality characteristics of the borrower in terms of age, reputation, social status, marital status, religion, income level and education level. If anyone was found in the extreme, such a person would not qualify for a loan. Type of business as well as its capital base was also always examined and of particular importance were the cash flow trends of the business (only as reflected on the bank statement or original documents such as receipt books, invoices and sales records). And if the borrower was located vey far from the MFI offices, such a person would not be given a loan. Furthermore, the new borrowers needed to have guarantors who, upon failure to repay the loan by the borrower, the guarantor would have to pay and such a person had to have an account and must have had resources on it.

5.3Relationship between relationship lending and credit quality

The final objective of the study was to examine the relationship between relationship and credit quality. This objective was the major objective of the study and results indicated that there was a statistically significant positive relationship between relationship lending and credit quality. This statistic means that there is 99% confidence that the observed relationship between the two variables was positive and strong within the study sample. Going by this correlation coefficient, better relationship lending improves the quality of the credit in MFIs. When the relationship

between the borrower and lender is favorable, a borrower may obtain individualized service, and gain empathy as well as reliable services. Relationship lending indeed improved credit quality as regular communication, information sharing and the interdependent nature of the interactions increased trust as well as loyalty of both parties. This finding is further supported by Reichheld & Sasser (1993), Rust & Zahorik (1993) who observe that building effective and successive relationships can contribute significantly to customer satisfaction, loyalty and retention. The same finding has been proved to work between small businesses and Banks in the UK (Binks & Ennew, 1996).

This study suggests that relationship lending was strongly linked to organizational citizenship behaviors among MFI staff as the MFI staff usually sympathized with customers when they had repayment problems and also provided timely assistance whenever needed. This finding means that keeping a truly rewarding lending relationship will require MFIs to go an extra mile and help borrowers with solutions beyond the contractual frameworks. It was cited by many respondents that borrowers also exhibited some discretionary efforts. For example, borrowers exuded an extra sense of willingness to defend their MFIs whenever ill was spoken of them. Thus while communication and information sharing are important, the two may not be effective without some elements of citizenship behaviors among both borrowers and lenders. This way, it is possible to use relationship lending to increase credit quality.

This study also found that MFIs had to build a sense of interdependence in their relationships and dealings with the clients. It had to be a deliberate strategy by MFIs to demonstrate to the borrowers that the intent of their interactions was mutually beneficial to both parties. It is for

instance indicated that management of the MFIs built trust in the borrowers, was interested in building long-term relationships and always provided and shared information with the borrowers. These three aspects of support, intent to remain partners and sharing of information are indicative of interdependence. The reason is that if neither of the two parties was interested there would be no need to share information and desire for a long term relationship. And since quality is a perception, then where such values exist, perceptions of credit quality will be high.

In this study, borrowers regarded credit as of quality if there existed high levels of responsiveness, reliability, empathy and assurance. Responsiveness was a particular concern for the borrowers given that most of them were sole business operators with limited time to spend in queues in the MFI offices. And responsiveness was also necessary to help these entrepreneurs secure funds to exploit opportunities as quickly as possible. Thus an MFI that was able to respond to borrower needs quickly was regarded as a highly quality MFI. However, while speed was key, borrowers also regarded individualized attention as an important aspect of service delivery. Also of importance was the feeling of safety and comfort borrowers had when they were transacting with their MFIs. Generally, the tenet of assurance and empathy were regarded as key by borrowers just as has been found in other studies on the subject of service quality (e.g. Parasuraman, et al, 1991). In this study however, it is noted that all the components of service quality, except tangibles were regarded as important by the borrowers and every component was complementary to the others. Ideally, this means that all the components had to be observed by the MFI for the customers to perceive the credit to be of quality.

Overall, it was conceptualized at the beginning of the study that, terms and conditions, customer participation and relationship lending were significant predictors of credit quality. As expected, these three independent variables accounted for up to 73% of the variation credit quality. It can thus be said that these three independent variables do indeed account for a bigger proportion of the dependent variable. Such predictive power is confirmed by a small standard error of estimate, which means that these results are applicable to the population from which the study sample was drawn. Individually, each of the three independent variables was a good predictor of the dependent variable. For example, it was seen that a 0.342 unit change in credit quality was accounted for relationship lending (β=.342), and such a predictive power was significant at 99% confidence level (t=3.588, p-value<.001). However, terms and conditions of lending were the strongest predictor of credit quality (β=.421, t=5.45, p-value<.000). Customer participation was third (behind terms and conditions of lending and relationship lending) in terms of influencing credit quality (β=.219, t=2.56, p-value<0.013). The implication of the above is that improving credit quality in MFIs requires specific attention to lending terms and conditions, relationship lending and customer participation and the same conclusion has been made by other scholars (e.g. Turnbull & Gibbs, 1987; Watson, 1986; Bannock and Doran, 1991).

5.4 Conclusions

The purpose of the study was to establish the effect of Lender- Borrower relationship on credit quality. As a first objective towards achieving this purpose, the study sought to examine the relationship between customer participation and relationship lending. It has been established that there was a strong positive relationship between customer participation and relationship lending. Evidence from the study suggests that higher levels of customer participation improve

relationship lending. Using factor analysis, this study found that the key aspects of customer participation included sharing of information, solving problems and contributing ideas to the MFI. Ideally, if an MFI involves customers in generating solutions to the problems arising during interaction of both parties, and allows customers to generate ideas, relationship lending can improve.

The study further found that a significant positive relationship between relationship lending and lending terms and conditions existed. Evidence showed that there was a 99% confidence that relationship lending and lending terms and conditions were strongly related. It has been established in the study sample that the better the terms and conditions of borrowing, the better will the relationship between borrower and lender be. A better lending relationship could influence better terms and conditions of borrowing. If for example a given customer kept a good relationship with the MFI such a customer could secure a loan at favorable terms and conditions. A customer with a favorable relationship with the MFI would secure a loan quickly, at a lower interest rate and with minimal collateral. This was because the MFI perceived risk of know customer was less and thus such a customer attracted more opportunities to deal with.

Finally the study found that there was a statistically significant positive relationship between relationship lending and credit quality. As hypothesized at the start of the study, results indicate that better relationship lending improves the quality of the credit in MFIs. When the relationship between the borrower and lender is favorable, a borrower may obtain individualized service, and gain empathy as well as reliable services. Relationship lending indeed improved credit quality as regular communication, information sharing and the interdependent nature of the interactions

increased trust as well as loyalty of both parties. In fact results of multiple regression analysis showed that lending terms and conditions, customer participation and relationship lending were significant predictors of credit quality. These three independent variables accounted for up to 73% of the variation in credit quality. Such a strong predictive power is confirmed by a small standard error of estimate, which means that these results are generalizable to the population from which the study sample was drawn. However, while individually each of the three independent variables was a good predictor of the dependent variable, lending terms and conditions as well as relationship lending were better predictors of credit quality. For practical interventions in situations of resource scarcity, any MFI that is interested in improving credit quality should start by offering favorable lending terms and conditions, build relationship with customers and then introduce customer participation in problem solving and idea generation.

5.5 Recommendations

This study recommends the following as key for improving credit quality in MFIs:

Charge a fairly reasonable interest rate

While the risk of lending is high in situations of information asymmetry, it is important for any MFI to give a benefit of doubt to its borrowers. MFIs should endeavor to offer favorable interest rates, perhaps tailored to the specific needs and capacity of the borrower. This effort would create some level of trust of mutual interests against which a favorable borrower-lender relationship can be built.

Introduce favorable collateral requirements

It is understandable that an MFI should ensure as much as possible to safeguard its assets, and particularly the cash it gives out to customers but undervaluing collateral should not be done. The MFI staff should become reasonable enough to apply appropriate market rates and standard depreciation values to the assets staked by customers. If the customers believe that the MFI is reasonable, then elements of doubt and feelings of exploitation will be neutralized, hence creating a recipe for building a good relationship.

Engage customers in solving problems

Problems that directly affect customers and are to a large degree connected to the business should be resolved through active participation and involvement of both the MFI and customers. Effort should be made to encourage customers to share ideas, provide innovative solutions and opinions on how constraints for their relationships with MFIs can be addressed.

Provide advisory services

This study has shown that most of the customers for MFIs are micro sole proprietary businesses without much capital and business experience. It is therefore imperative for MFIs to continue providing free and practical advisory services to their borrowers to instill some level of professional business management practices. Such services would help borrowers grow their businesses and thus become viable customers for the MFIs.

Undertake through customer assessment and constant loan monitoring

The problem of loan default emerged as one of the critical challenges of MFIs. It also emerged that many customers provide false information which consequently misleads the MFIs in their

decision making processes. To counter these two problems, MFIs need to assess the capital, capacity and commitment of the prospective borrowers. Even if a loan is offered, MFIs need to keep in regular contact with the client to help identify potential sources of default and generate solutions before a client fails to repay the loan. The MFIs should make it clear to the borrowers that the intention of monitoring is not to catch the borrower in the wrong but to help them manage the loan better. The monitoring should also be accompanied by advisory services, especially where problems appear to emerge.

Other recommendations

MFIs need to demonstrate to their clients that both parties are complementary and are in business to help each other. Therefore, all customers need equal treatment in terms of respect, responsiveness, empathy and other services. Besides, MFIs should endeavor to be dependable and must instill confidence in their borrowers that they are professionals mandated to serve the interests of the customers. Essentially, MFIs need to offer good customer care and need to offer customer friendly products. The staff must be polite, friendly and professional in all their dealings. They need to have organizational citizenship behaviors, commitment and motivation appropriate to serve. Borrowers need to be rewarded and constantly encouraged to repay their loans through avenues such as client dinners, customer open days, workshops and trainings.

5.6 Limitations of the study

The researcher encountered a problem of non-response due to fear, and unavailability of respondents. However, she tried to fully explain the purpose of the study as a solution to the limitation.

5.7 Arrears for further research

The researcher recommended further research to be conducted on the role business environment plays in influencing the lender borrower relationship.

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Appendix 1: Response to Comments from the Viva Voce Held on 4th September 2012

S/N	Comment	Response
1.	The problem in the background is not quite clear. Be precise	Problem is precisely incorporated in background. Page 2.
2.	The knowledge gap is not concise. Address this.	Addressed on page 3 and in discussion section.
3.	The population is not clear whether they are MSEs or people, correct this anomaly	The study used a population of MSE owners and employees of MFIs. Page 18.
4.	The results were not adequately discussed. Discuss them	Discussion section has been improved and the discussion section is detailed.
5.	Revisit the multiple regression analysis	Results of multiple regression analysis have been revisited. Page 32.
6.	Use borrowers instead of MSEs	Borrowers are used in the study. This is what the study originally focused on.
7.	The researcher does not provide areas for further research. Correct this.	Areas for further research have been added. Page 47.
8.	All cited works, particularly in the background, source of the conceptual framework, literature review and the discussion of the study findings should be referenced with correct dates/years	All cited works have been referenced in the list of references.
9.	Use APA format of referencing, particularly listing last names first	APA format is used in referencing.

Appendix 2: Research Questionnaire……………………………………………………………67