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IMPACT OF BORROWER CHARACTER ON LOAN REPAYMENT IN COMMERCIAL BANKS WITHIN KAKAMEGA TOWN

Sophia Kerubo Ogeisia[1], Dr. Douglas Musiega[2], Gerishom Wafula Manase[3]
[1]MBA- Jomo Kenyatta University of Agriculture and Technology
[1]PETER ANJEYO VUYA- Phd Student Maseno, University
[1]JANET OWOLA- PhD Student Maseno, University.
[2]Director - Jomo Kenyatta University of Agriculture and Technology - Kakamega Campus
[3]PHD Student - Jomo Kenyatta University of Agriculture and Technology

***Abstract*— Lending is a risky principal business activity for banks as repayment can seldom be fully guaranteed. The study seeks to examine impact of borrower character on loan repayment in commercials Banks – in Kakamega town, Kakamega County. It examined impact of borrower character on loan repayment in commercial banks within Kakamega town. A cross-sectional survey design with a sample of 105 respondents was selected using purposive sampling and simple random sampling. The study may add to the already existing literature on effects borrower character, and loan repayment; enable commercial banks identify the credit management policies that are critical in the lending business; lending policy formulation and assessment of its loan risk management abilities ; may provide guidance to the Central Bank and other regulators in the credit risk management, policy formulation and to stimulate further research into the area of lending policy formulation and performance of loans. A self-administered questionnaire was used to collect the data, processed and analyzed using the Statistical Package for Social Sciences (SPSS V22). It has been established that there is a strong positive relationship between borrower character on loan repayment. Evidence from the study suggests that borrower character greatly influences loan repayment.**

***Key words*— Borrower character, loan repayment.**

I.INTRODUCTION

Lending is a risky enterprise because repayment of loans can seldom be fully guaranteed. According to Brown et al., (2004), implicit contracts between lenders and borrowers, thus, banking relationships can motivate high effort and timely repayments. Fehr & Zehnder, (2005) also confirm that long-term relationships are a powerful disciplinary device. They posit that in credit markets dominated by short-term interactions, borrowers may only be motivated to repay if they know that, due to loan reporting, their current character is observable by other lenders. The work of Fehr & Zehnder, (2005) indicates that the impact of credit reporting on repayment character oncredit market performance is highly dependent on the potential for relationship banking. Therefore, when bilateral relationships are not feasible, the credit market essentially collapses in the absence of acceptable borrower character. As repayments are not third-party enforceable, many borrowers default and lenders cannot profitably offer credit contracts (Brown, Falk, & Fehr, 2004). The availability of information on past repayment character allows lenders to condition their offers on the borrowers' reputation. As borrowers with a good track record receive better credit offers, all borrowers have a strong incentive to sustain their reputation by repaying their debt (Orebiyi, 2002). Therefore, by repeatedly interacting with the same borrower, lenders establish long-term relationships that enable them to condition their credit terms on the past repayments of their borrower. As only a good reputation leads to attractive credit offers from the incumbent lender, borrowers have strong incentives to repay.

Out of the 28 operational branches of Commercial banks micro lending performance indicates that the total portfolio for the headquarter branch is approximately UGX. 14.1 billion of which UGX. 3.7 billion is in individual micro loans with a total arrears rate of 3.7% for the year 2007. For the years 2006 and 2005, the bank closed with arrear rates of 3.6% and 5.46% respectively. In addition, the bank's micro lending performance for the last three years reveals that it has continued to record average arrear rates of 4.24% and Non-Performing Assets (NPA) rates of individual micro loans of 1.4% where the acceptable rate by Bank of Uganda is 1%. The above weaknesses may be responsible for the high default rate. It is upon this background that the study seeks to establish impact of borrower characters and loan repayment in Commercial banks in Kakamega town.

II. STATEMENT OF THE PROBLEM

The performance of loan repayment in Banks has declined as evidenced by the annual report of which revealed that the recovery rate and arrears rate were low, profitability margins have gone down and there is poor capacity utilization.

In 2003, the Government of Kenya (GoK) published the Economic Recovery Strategy (ERS) paper on Wealth Creation and Employment that defined certain critical high-level objectives that underlined the reform efforts through 2007. In the ERS, the government acknowledged that the banking sector was experiencing difficulties that would undermine the achievement of the objectives set out in the ERS, including a comparatively high ratio of non- performing loans in some major banks, inadequate competition in the banking sector; persistence of wide interest rate spreads leading to a high cost of credit; insufficient quantities of credit (and poor quality credit assessments); absence of vibrant institutions for provision of long term finance; weak legal arrangements creating long delays in contract enforcement; and weak dispute resolution mechanisms, Thorsten, B. et al (2010)

Further evidence indicates continuous increase in the default rate. This could be due to poor borrower character. Karumba and Wafula(2012) in their article on alternatives for Kenyan banking industry identified that credit risk is one of the oldest and most challenging risk faced by banks, which results due to the probability that borrowers may default terms of their debt and hence putting an institutions capital into risky positions. Increase in defaults leads to piling of non-performing loans in an institutions balance sheet. Musyoki and Kadubo(2011) in their paper on credit risk management on financial performance of banks concluded that default rate is the most important factor as it influences 54% in total credit risk influence on bank performance. Irungu (2011) on property Kenya stated that the total outstanding loan portfolio for commercial banks in Kenya was 1.2 trillion and a statistic by index mundi show the total non-performing loans was 5.4% in 2011. Nonperforming loans impacts on a bank's performance by reducing its revenue as they become expenses. They are usually transferred to the income statement are expenses to the institution.

Objective

The study sought to examine impact of borrower character on loan repayment in Kakamega town.

Hypotheses

- There is no relationship between borrower character on loan repayment.

There is a relationship between borrower character on loan repayment

Limitations

Respondents may have withheld information due to fear of being victimized. Unwillingness of respondents to fill questionnaires. Respondents may have a view of not obtaining any direct benefit from the research results. However the researcher assured them that they were to benefit in the long run when the pertinent issues are raised to management and acted upon.

III.LITERATURE REVIEW

A. Conceptual Framework

According to the conceptual framework, borrower character affected the relationship during the lending process between the borrowers and bank loan officers which in turn affected the loan repayment performance of the bank (recovery rate, portfolio growth and portfolio quality). From the model borrower character was measured according to borrower values, attitudes, experiences and beliefs was measured according to trust and commitment and loan repayment was measured according to recovery rate, arrears rate and portfolio at risk (Figure 1.1; Conceptual framework)

B. Borrower character on loan Repayment

Consumer character is rarely the result of a single motive. Several factors combine to make one buy or consume a product or service; or a borrower to promptly repay or default repayment of a facility. Character primacy theory holds that, common character results mainly from an individual's interactions with the environment (Nguyen, 2007). As the environment changes, individuals tend to cope by changing their character. Thus bank borrowers' character is determined by economic, cultural, social, psychological, personal and political factors: Economics was the first discipline to construct a specific theory of buying character. The Marshallian Economic theory postulates that consumers strive to maximize their utilities and do this by consciously calculating the consequences of any (purchase) decision. The key economic factors that influence borrower character are income, expenditure patterns, cost of investment project, and marketing success of the project (Kon and Storey, 2003). Expenditure pattern refers to the relative extravagance of the borrower in spending. The higher the extravagance, the higher the chances of borrowing and defaulting. The need for borrowing and the amount of loan needed depend on the cost of the project for which the credit is sought.

A person's culture arguably, exerts the broadest influence on his or her character. Lazer and Cull defined culture as the learned patterns of symbolism and character that are passed from one generation to the next; it represents the totality of values that characterize a society. Kon and Storey (2003) asserted that people live in a cultural milieu that embraces their history, values, morals, customs, art, and language. Kotler' also identified four types of sub-cultural influences on consumers as nationality groups, religious groups, racial groups, and geographical areas (Orebiyi, 2002). Social psychologists view the social environment as the chief determinant of cognitive structure as well as of perceptual bias. Cognition is the process by which we make sense of the things we perceive. Man, as a social being, is often influenced by other persons and by a group he belongs or aspires to belong to (Nguyen, 2007). These may include family members, friends, neighbours, office colleagues, reference groups, social roles, statuses, etc. The fear of being ostracized by church or club members or reference groups could motivate a borrower to repay a facility. Conversely, bad friends and neighbours could influence one to default repayment of facility extended to him or her.

Such psychological factors in a certain way as motivation, perception, learning, beliefs and attitude have profound impact on consumer character (Kon and Storey, 2003). A motive is a need that is sufficiently pressing to drive the person to act. Thus, needs give rise to drives which energize motives which then stimulate character. Many psychologists have developed theories of human motivation. Abraham Maslow propounded the hierarchy of needs theory which sought to arrange human needs into physiological, safety, social, esteem and self actualization and which shows that people are motivated at different times by these different needs. Sigmond Freud in his psycho-analytic theory assumes that the real psychological forces shaping people's character are largely complex and unconscious even to the individual himself. Frederick Herzberg's two factor theory reduced Maslow's motivator into satisfiers and disatisfiers.

Kotler (2008) is of the opinion that a motivated person is ready to act. How he eventually acts is influenced by his or her perception of the situation. He contends that different people in same environment can perceive a phenomenon in different ways due to the perceptual process of selective attention, selective distortion and selective retention. Gestalt psychology argues that our perception depends on patterns formed by various stimuli and on the order of our expressions (Orebiyi, 2002). We thus see an object in relation to its background or environment. Furthermore, when people act they learn. Learning refers to changes in people's character arising from experience. Finally, beliefs and attitudes are acquired through acting and learning and influence consumer character. A belief is a descriptive thought that a person holds about something (Kon and Storey, 2003). Attitude is a disposition to act. It comprises cognitive, evaluative and action tendencies. From the above analysis, the propensity to repay a facility depends inter-alia on the borrower's belief and attitude which are learnt and which depend also on perception and motivation (Nguyen, 2007). Consumer character is also influenced by the consumer's personal characteristics, notably his age, life-cycle stage, occupation, economic circumstances, life style, personality and self-concept. There is no gain saying the fact that older people are less prone to taking risks than youngsters. This means they are more likely to repay debts than the later people. Same argument goes for people at the mid and later stages of their life-cycle. Additionally, professionals with sound occupation, personality, self-concept and life-style will be higher in debt repayment rate than the others (Nguyen, 2007). Human beings are politica1animals. Their involvement in politics projects them into limelight and thus makes them less prone to loan defaults. Additionally, political environment may make or mar a project financed by debt and consequently enhance or hinder the prompt repayment of such debt.

Relationship lending is regarded as a potentially vital instrument linking interests of borrowers with those of lenders through a screening mechanism that identifies reliable economic agents and selects the good from bad borrowers (Brown and Zehnder, 2006). Economic contracts involving relational issues have economic viability to the extent that all parties to a financial contract gain from the lending relationship (Berger et. al., 2001). Lenders have an incentive to utilize greater relationships in the lending process to take advantage of the information generated in the process and the resultant reduction in monitoring. On the other hand, loyal borrowers are given the opportunity to establish the necessary reputation required for loan availability and accessibility (Orebiyi, 2002). Further, because it is not necessary to undertake explicit contracting in linking lending, bureaucratic procedures associated with verification of documents and collateral requirements are reduced.

Current financial literature points out that organizations that emphasize stronger and long-lasting relationships with consumers often perceive this to be a core element of the services they offer (Ongena and Smith, 2000). Recent studies indicate that relational strategies seek to address closer and more cooperative relationships with customers (Nguyen, 2007). Lending relationships are viewed as a form of lender-borrower interactions including partnerships, collaborative linkages and alliances. Further, establishment of these relationships is viewed as an indicator that markets are evolving from emphasis on mere transaction oriented marketing where firms carried out transactions without prior consideration of consumer desires, to emphasis on relation-oriented marketing involving aggressive, integrated, goal-oriented, and systematic pursuit of customers (Hendriske and Veerman, 2001). The significant aspect of these relationships is that firms have a greater bargaining power, and so generate potential for greater competition by capturing a greater share of the market.

IV.RESEARCH METHODOLOGY

A cross-sectional survey design was used with a target population will include 2,020 comprising of about 20 credit officers and 2000 business borrowers in commercial Banks in Kakamega town. A total of 105 respondents with 12 purposively sampled credit officers in commercial banks in Kakamega town from Standard Chartered, Kenya Commercial, Equity, National, Family and Barclays Banks and 93 randomly sampled borrowers (table 3.1). Primary data was obtained through the use of self-administered questionnaire to respondents following systematic and established academic procedures, as suggested by Nunnally and Bernstein (1994). The questionnaires were used for the collection of data from borrowers and staff. Secondary data was obtained through the already existing bank's literature and any other literature from Bank annual reports, credit performance reports, Reports and journal articles. The reason for this was to make comparison of secondary data with primary data. A self administered questionnaire was used to collect data from respondents given that they were many in numbers that it would take much time to interview them face to face. More precise information was collected from the different categories of the respondents. Borrower character was measured basing on the item scale adapted from Nguyen, (2007). The items in the domain scored on the 5 point Likert scale ranging from strongly disagree (1) to strongly agree (5).

Loan repayment was measured based on the item scale adapted from Orebiyi, (2002). The items in the domain was scored on the 5 point Likert scale ranging from strongly disagree (1) to strongly agree (5).Closed questionnaire was developed in harmony with the guidelines specified by Sekaran (2000). The validity of the instrument was measured using the Content Validity Index (CVI). Reliability (internal consistency and stability) of the instruments was tested using Cronbach's Alpha Coefficient. Data collected from the primary source was compiled, sorted, edited for accuracy and clarity, classified, coded into a coding sheet and analyzed using a Statistical Package for Social Science (SPSS 22). During data analysis, cross tabulations, and frequency tabulations, Pearson's correlation analysis and regression analysis was used to present the results of the study.

V.RESULTS AND FINDINGS OF THE SURVEY

.Correlation results indicated a significant and positive relationship between borrower character on loan repayment ($r = .396^{**}$, $p<.01$). This implies that the way borrowers behaved during credit accessibility or after acquiring credit from the bank, had a lot of effect on determining the relationship that is formed during the lending process which would in turn affect effectiveness and efficiency of loan repayment. Therefore, having favorable borrower values, attitudes, experience and beliefs in an environment which promotes trust and commitment on either parties, this would greatly enhance loan repayment at the bank.

Regression analysis was used to determine the extent to which borrower character predict loan repayment in the banks in Kakamega town. The results obtained are shown by (table 4.1)

(Table 4.1)

Table 4.6 shows that the "adjusted R square" results indicate that the combination of borrower character predict 25.5% of the variance in loan repayment of Banks. The most significant predictor of loan repayment was borrower character (Beta= .294, t= 3.091, Sig. = 0.003) whereas (Beta= .108, t=.955, Sig 0.342) was not found to be a significant predictor of loan repayment. The low value of the adjusted R square is revelation that other than borrower character, there were other variables that influenced loan repayment at the banks.

VI.DISCUSSION, CONCLUSION AND RECOMMENDATIONS

A. Borrower Character on loan repayment

The findings revealed a significant positive relationship between borrower character on loan repayment which implied that if the borrower character was in favour of the banks' credit terms such that the borrowers complied with them then this would affect loan repayment. This is in agreement with Berger, Miller, Petersen, Rajan & Stein (2005) assertions that the character of the borrower will be sensitive to ethics, consequences of alternative actions including inaction, and the response of parties concerned to the borrower. Lending in low-income countries is notoriously difficult. Clients typically lack adequate collateral and lenders often have limited information about the profitability of their customers. Information asymmetries coupled with costly enforcement of repayment severely limits the profitability of lenders. The problem is particularly acute in agriculture because the nature of production precludes the use of many of the mechanisms used in microfinance (Berger & Udell, 2002). In addition, all farmers need cash at the same time, so allowing some farmers to borrow only after others have repaid their loans is problematic because some farmers would end up receiving credit when they do not need it (Berger & Udell, 2006). Even if all clients were allowed to borrow at the same time, joint liability may be ineffective if most production shocks are covariate.

The findings revealed a significant and positive relationship between borrower character on loan repayment which implied that the way borrowers behaved during credit accessibility or after acquiring credit from the banks had a lot of effect on determining the relationship that is formed during the lending process which would in turn affect effectiveness and efficiency of loan repayment. In credit markets, borrowers typically have more information about their investment opportunities, their own character ontheir prior indebtedness than lenders. Dell.Ariccia & Marquez, (2006) posits that this asymmetry of information gives rise to selection problems for lenders and potential moral hazard of borrowers, which may lead to a rationing of credit. In many countries problems of asymmetric information are aggravated by the fact that loan contracts are costly to enforce (Elsas &. Krahnen, 2000). One response to asymmetric information and costly enforcement in the credit market is information sharing between lenders about the characteristics and behavior of their borrowers. Theoretical models suggest that information sharing can reduce adverse selection in markets where borrowers approach different lenders sequentially (Han, 2008). Moreover, information sharing can also have a strong disciplining effect on borrowers. The model of Diamond (1989) suggests that a public credit registry can motivate borrowers to choose agreed projects. Further models show that information sharing can discipline borrowers into exerting high effort in projects (Vercammen 1995; Padilla and Pagano 2000) and repaying loans (Klein 1992).

Kano, Uchida, Udell & Watanabe, (2006) show that aggregate bank credit to the private sector is higher in countries where information sharing is more developed. Analyses of firm-level survey data (Kon & Storey, 2003) further show that access to bank credit is easier in countries where credit bureaus or registries exist. These studies cannot clearly identify the direction of causality between information sharing and credit volume. After all, theory suggests that information sharing will emerge where lenders benefit more from them (Ongena & Smith, 2001) and this is certainly the case where the credit volume is higher. Thus a positive correlation between credit reporting and credit market performance may arise simply because credit bureaus are more likely to emerge in countries where current lending is vibrant or an expansion of credit activity is expected. By applying experimental methods, our study allows us to circumvent this endogeneity issue and identify how the exogenous introduction of a credit registry affects credit market performance.

The impact of credit reporting on repayment behavior should depend on the presence of alternative disciplining mechanisms. One alternative disciplining mechanism is relationship banking. Theoretical models suggest that implicit contracts between lenders and borrowers, i.e., banking relationships, can motivate high effort and timely repayments (Boot and Thakor 1994). Empirical studies confirm that some credit market segments (in particular small business lending) are pervaded by relationship banking and that these relationships improve the access of potential borrowers to credit (Orebiyi, 2002). Experimental studies also confirm that long-term relationships are a powerful disciplinary device. In credit markets dominated by repeated interactions (e.g. working capital loans), information sharing may therefore not be required to discipline borrowers. In contrast, in credit markets dominated by short-term interactions (e.g. consumer credit markets when borrower mobility is high), borrowers may only be motivated to repay if they know that, due to credit reporting, their current behavior is observable by other lenders. In this paper we examine how the impact of credit reporting on repayment is related to the presence of relationship banking.

As repayments are not third-party enforceable, many borrowers default and lenders cannot profitably offer credit contracts. The introduction of a credit registry in this environment greatly enhances the performance of the credit market. The availability of information on past repayment behavior allows lenders to condition their offers on the borrowers' reputation. As borrowers with a good track record receive better credit offers, all borrowers have a strong incentive to sustain their reputation by repaying their debt. As a consequence a well functioning credit market is established in which a large percentage of the available gains from trade is realized. When relationship banking is feasible, credit reporting has no such effect on market performance. In this environment, the market participants solve the moral hazard problem related to repayment even in the absence of a credit registry. By repeatedly interacting with the same borrower, lenders establish long-term relationships which enable them to condition their credit terms on the past repayments of their borrower. As only a good reputation leads to attractive credit offers from the incumbent lender, borrowers have strong incentives to repay. The disciplining effect of these banking relationships is sufficiently strong so that the introduction of a credit registry only slightly improves credit market performance (Berger, Miller, Petersen, Rajan & Stein, 2005). Nevertheless, even when relationship banking is feasible, a credit registry does affect market outcome. First, the credit market is less dominated by specific borrower-lender relations, as these are no longer necessary to enforce repayment. Second, by improving the information available to "outside" lenders, a credit registry reduces the ability of lenders to extract rents from relationships.

VII. CONCLUSIONS

The study sought to investigate impact of borrower character, and loan repayment. In general, the study looked at the effect of borrower character on on loan repayment in banks in Kakamega town. In particular, the study examined relationships between the study variables borrower character on loan repayment. All the relationships were significantly positive. It also examined the effect of the study variables on the dependent variable and the study variable was found to be significant predictor of loan repayment.

The results revealed that there was a significant positive correlation between borrower character on loan repayment which implied that the way borrowers behaved during credit accessibility or after acquiring credit from the bank, had a lot of effect on determining the relationship that is formed during the lending process which would in turn affect effectiveness and efficiency of loan repayment. Therefore, the management of the Bank should put in place credit evaluation procedures that aim at ascertaining the character of the borrower and along with the loan repayment period, monitor closely the character of the borrower while ensuring that the required lending relationship is not compromised in the process. This will greatly enhance the loan repayment of the bank.

VIII. RECOMMENDATIONS

In light of the research findings, the following recommendations are made:

a) The model could only explain 25.5% in variance of loan repayment of banks in Kakamega town, it is recommended that a study be carried out consisting of other factors which were not part of the model so as to predict loan repayment.
b) According to the findings, borrower behavior was found to be a strong predictor of loan repayment. Therefore, the management of the bank should draw a lot of emphasis on borrower values, attitudes, experiences and beliefs as this will influence the bank's overall loan repayment at the banks.
c) The significant relationship between borrower character onfrom the findings calls for loan agreements that are incentive compatible. At the time a loan is made, the lender must be sure that after disbursement it will be in the borrower's interest to repay the loan. The lender must be satisfied that loans given will improve the position of the borrower and this should be brought to the knowledge of the borrower.

Areas for further study

a) Future research should attempt to collect data from other industries such as academic institutions, government ministries to see whether other services are the same and could therefore benefit from this study.
b) The study concentrated on borrower character on loan repayment in regard to finance institutions. Research may be done to determine the other variables that influence loan repayment at the banks.

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IX. APPENDIX : TABLE AND FIGURES

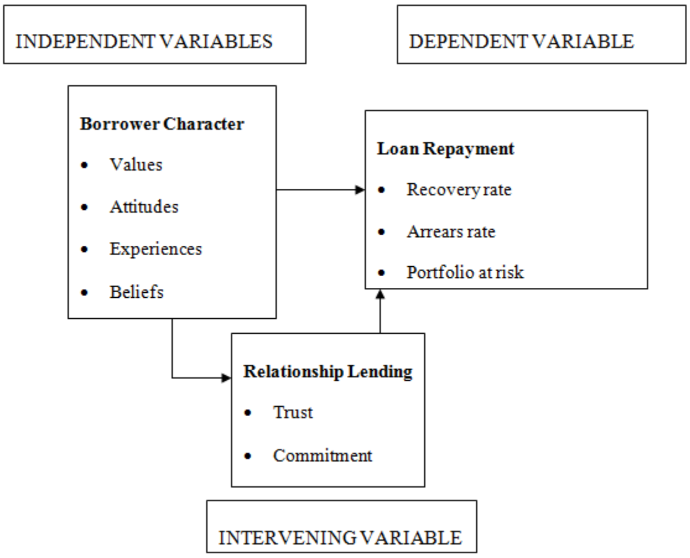

Figure 2. 1: Conceptual Framework

Sample size needed				
Population size	**(+_10%)**	**(+_5%)**	**(+_4%)**	**(+_3%)**
2600	93	335	488	757
2700	93	337	491	765
2800	93	338	494	773
2900	93	340	497	780
3000	93	341	500	787
4000	98	364	522	870
5000	100	384	600	1067

Table 3. 1: Sample Size Determination
SOURCE: RESEARCH ADVISORS (2006)

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.525	.307		4.963	.000
Borrower Character	.279	.090	.294	3.091	.003
Dependent Variable: loan repayment					
R Square = .276					
Adjusted R Square = .255					

Table 4.1: Regression Analysis
SOURCE: PRIMARY DATA