

## IMPACT OF LOAN REPAYMENT DETERMINANTS ON LOAN REPAYMENT PERFORMANCE OF MICRO & SMALL ENTERPRISES IN DILA TOWN OF ETHIOPIA

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### ABSTRACT

In developing countries, micro finance institutions (MFI'S) emerged with unique opportunity to serve poor people. The objective of micro finance institutions is to serve the financial needs of unserved as meeting development objectives. The study aims to investigate the impact of factors affecting loan repayment performance of the Micro Small Enterprises taking borrower characteristics and loan related issues into consideration. The research was conducted between Jan -March 2016. The primary data was collected by distributing structured questionnaire for 164 different groups of MSEs located in Dila town by using stratified random sampling technique, and financed by Omo Micro Finance (OMFI). The representatives from each sector were: construction (42), manufacturing (36), urban agriculture (27), trade (34) and services (25). From the representative samples 149 (90.85%) group owned MSEs returned the filled in questionnaires and analysis were made accordingly. The descriptive statistical methods and regression model were used to analyze the effect of the literature driven variables (independent variables) on loan repayment (dependent variable). The multiple regression result shows among the variables hypothesized to affect loan repayment performance; business practice/experience, loan supervision, suitability of repayment situation, loan size, beneficiary size of the enterprise and initiation have statistically significant effect on loan repayment. The identified factors totally account about 82.7% and separately; business related experience (15.47%), loan supervision (14.29%), suitability of repayment situation (12.39%), loan size (15.18%), beneficiary size of the enterprise (14.75%) and initiation for the loan (10.6%) had contributed significant influence on loan repayment of MSEs in Dila town.

**KEYWORDS:** Loan repayment, Micro and Small Enterprises

### INTRODUCTION

Loan is defined as a type of debt, and like all debt instruments, a loan entails the redistribution of financial assets over time between the lender and borrower. In a loan, the borrower initially receives or borrows an amount of money called the principal from the lender, and is obligated to pay back an equal amount of money to the lender at a later time. Typically the money is paid back in regular instalments or partial repayments in an annuity; each instalment being of the same amount (Signoriello, 1991). However loans from other financial institutions like the informal financial institutions may have a different repayment structure which is custom made for the borrower. The loan is generally provided at a cost, referred to as interest on the debt, which provides an incentive for the lender to engage in the loan. In a legal loan, each of these obligations and restrictions are enforced by contract, which can also place the borrower under additional restrictions known as loan covenants (Signoriello, 1991).

**MICRO AND SMALL SCALE ENTERPRISES**

Micro and small business is an entity that is privately owned and operated, with a small number of employees and relatively low volume of sales. Small businesses are normally privately owned corporations, partnerships or sole proprietorships. There is no clear definition of small scale enterprises as small varies by country to country and industry to industry. However, three criteria's are mainly used in literature to define Micro and Small Scale Enterprises (MSEs). The first one, based on number of employees, defines MSEs as those enterprises below a certain number of workers (In Ethiopia it can range from 5 to 30 employees including enterprise owners and his/her family members). The second criterion concerns with the degree of legal formality and is mainly used to distinguish between the formal and informal sectors. According to this criterion, MSEs are those enterprises that are not registered and do not comply with the legal obligations concerning safety, taxes and labour laws. The third criterion defines MSEs by their limited amount of capital and skills per worker. The degree of informality and size of employment have perhaps been the two most readily accepted criteria on which classification of MSEs are based. The term MSE incorporates firms in both the formal and informal sectors.

However, the terms MSEs and informal sector are normally used interchangeably as most MSEs are informal enterprises (Mead and Morrison, 1996). Moreover, small scale enterprises are characterized by: ease of entry; small scale of activity; self-employment with a high proportion of family labour; little capital and equipment; labour intensive technologies; low skills; low level of organization with little access to organized markets; informal credit; education and training or services and amenities; cheap provision of goods and services or provision of goods and services otherwise unavailable; low productivity and low incomes (Charmes,1997).

**DEFINITION OF MSEs IN ETHIOPIAN CONTEXT**

According to the new Small & Micro Enterprises Development Strategy of Ethiopia (published 2011) the working definition of MSEs is based on capital and Labor.

- **Micro enterprise:** means commercial enterprise whose capital is not exceeding birr 100,000 in industry sector and birr 50,000 in service sector and manpower also not exceeding 5 in both sectors
- **Small enterprise:** means a business engaged in commercial activities whose capital is not exceeding birr 1.5 million in industry sector and birr 500,000 in service sector and both sector employs 6-30 manpower

**Table: 1 Summary of criteria of defining micro & small enterprises**

Sr.no	Enterprise level	Sector	Hired labor	Capital
1.	Micro	Industry	≤ 5	\$6000.00 or £4500.00 ≤Birr 100,000.00
		Service	≤ 5	\$3000.00 or £2200.00 or ≤Birr 50,000.00
2.	Small	Industry	6-30	\$90,000.00 or £70,000.00 ≤Birr 1,500,000.00
		Service	6-30	≤Birr 500,000.00

**MICRO & SMALL SCALE ENTERPRISES' FINANCE SOURCE**

A financial institution is an establishment that provides financial support services to its clients or members. Most financial institutions are highly regulated by government bodies due to the high amount of money that they handle on behalf of their clients. Broadly there are three major types of financial institutions which include: Deposit taking institutions that accept and manage deposits and make loans. This category includes banks, credit unions, trust companies, and mortgage loan companies, insurance companies and pension funds, and the brokers underwrite and investment funds (Siklos, 2001).

These institutions provide service as intermediaries of the capital and debt markets. They are responsible for transferring funds from investors to companies in need of those funds. The presence of financial institutions facilitates the flow of money through the economy. To do so, savings are pooled to mitigate the risk brought about by providing funds for loans. Acting as a provider of loans is one of the principal tasks of financial institutions (Fry and Maxwell, 1995). Potential sources for finance for small scale enterprises include commercial banks, non-banking financial institutions, non-governmental organizations (NGOs), multilateral organizations, business associations, and rotating savings and credit associations. In addition to this, financial transactions also take place between traders, friends, relatives and landlords, as well as commercial money lenders (Atieno, 2001)

In developing countries, including Ethiopia, micro financing institutions (MFIs) emerged with unique opportunity to serve poor people who do not have access to commercial banks. Microfinance involves the provision of micro- credit, savings and other services to the poor that are excluded by the commercial banks for collateral and other reasons. Microfinance is relatively new to Ethiopia and came into existence during 1994-95 with the government's licensing and supervision of microfinance institution proclamation (Zerai and Rani, 2012). The main objective of these institutions are that they deliver micro- loans, micro-savings, micro- insurance, money transfer, leasing etc, to a large number of productive resource-poor people in the country in a cost effective and sustainable way. The objective of microfinance institutions as development organizations are to serve the financial needs of un-served or underserved markets as a means of meeting development objectives such as to create employment, reduce poverty, help to develop existing business or diversify their activities, empower women or other disadvantaged population groups, and encourage the development of new business ( Bayeh, 2012).

A large number of MFIs in Ethiopia has progressed significantly in terms of sustainability. Although the development of MFIs started very recently, however, the industry showed a remarkable growth. As of 2007, there are 27 MFIs registered under National Bank of Ethiopia (NBE) which had an active loan portfolio of about birr 2.7 billion delivered to 1.7 million active clients. At the same year they also mobilized about 951 million birr of savings. Moreover about 38% of the clients of the MFIs are females (Amaha, 2008). While at the end of 2011, the total number of MFIs has risen to 31 with 433 branches and 598 sub branches. At the same year the study shows 10 to 25% of the total microfinance demand in the country. The institutions have extended total credit of 6.9 billion ETB to 2,470,611 active borrowers (Mohana and Ludego, 2013).

### **RESEARCH OBJECTIVE**

The objective of this research is to analyze the impact of loan repayment determinants on loan repayment performance of micro & small enterprises in Dila Town of Ethiopia

### **REVIEW OF LITERATURE OF THE RELATED STUDIES**

Microfinance refers to the provision of financial services to low income clients, including the self-employed. Financial services of MFIs include savings and credit. However, some offer payment and insurance services, (Kitchen R., 1989). Theoretically, microfinance encompasses any financial service used by the needy, including those they access in the informal economy such as loan from a village money lender. In practice however, the term is usually only used to refer to institutions and enterprises whose goals include both profitability and reducing the poverty of their clients. Microfinance services are needed everywhere, including the developed world. The World Bank defines microfinance as "Small-Scale financial services- primarily credit and savings – provided to people who farm or fish and who operate small enterprises or microenterprises where goods are produced, recycled, repaired, or sold; who provide services, who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban" (Robinson 2001)

Reta (2011) analyzed and identified the factors that influence the loan repayment performance of the beneficiaries of Addis Credit and Savings Institutions (ADCSI) a micro finance institution in Ethiopia. He found out that age and five business types (baltina and petty market, kiosk and shop, services providing, weaving and tailoring and urban agriculture) were important in influencing loan repayment

performance of the borrower. In addition, sex and business experience of the respondents were found to be significant determinants of loan repayment rate. Berhanu (1999) employed the Tobit model to analyze the factors that affect loan repayment. A total of 17 explanatory variables were considered in the econometric model. Out of these seven variables were found to significantly influence the repayment performance. These were land holding size of the family, agro-ecology of the area, livestock holding, number of years of experience, number of contacts, sources of credit and income from off farm activities. Though borrowers were different in their socio-economic bases across different countries, loan repayment factors had some similar characteristics been observed. The determinants of loan repayment under the indigenous financial system in Southeast, Nigeria was made by Eze and Ibekwe, 2007. They employed descriptive statistics and multiple regressions to analyze the data. The analyzed data reveals that the amount of loan received, age of beneficiaries, household size, educational attainment, and occupation can influence loan repayment. After surveying different banks in India, Berger and De Young (1995) identified the main causes of defaults of loans from industrial sector as improper selection of an entrepreneur, deficient analysis of project viability, inadequacy of collateral security/ equitable mortgage against loans, unrealistic terms and schedule of repayment, lack of follow up measures and default due to natural calamities.

Determinants of loan repayment performance of fishermen, Ghana employed multiple regression analysis in their study. Their result revealed that low level of education, lack of alternative income generating activity, cumbersome loan processing procedures, are likely to have high loan default. The study identified fishing income, amount borrowed and size of loan invested into fishing as significant predictors of loan repayment (Acquah and Addo, 2011)

Bindra (1998) argues that the true underlying cause of non- performing loans is entirely of our own making- poor risk management. This is a situation where the bank credit officials do not properly assess the suitability of advancing credit to their customers; they do not adhere to good lending principles. He concludes that loan losses can be minimized through professional management of the lending function. Muasya (2009) studied the impact of non-performing loans on the performance of the banking sector in Kenya and confirmed that non-performing loans affect commercial banks in Kenya. Further analysis of individual commercial banks with more than KES 25 Billion worth of asset indicated that the impact of non- performing loans to interest income and profitability are not adverse to these banks.

Bhatt and Tang (2002) showed that women had low repayment rate because some women entrepreneur in the study might have been engaged in high risk and low return activities.

A study by Ade (1999) on the determinants of small holder loan repayment performance evidence from Nigerian micro finance system found out that the proportion of borrowers with secondary education, number of times borrowers were visited by loan officials and the loan size were the major factors that caused the loan default by the borrower.

Vigano (1993) in his study about the case of development bank of Burkina Faso employed a credit scoring model. He found out that being women, married, aged, more business experience, value of assets, timeliness of loan release, small periodical repayments, project diversification and being pre-existing depositor are positively related to loan repayment performance. On the other hand, loan in kind, smaller loan than required, long waiting period from application to loan release and availability of other source of credit were found to have negative relation with loan repayment performance.

The study conducted by Okorie (1986) in Ondo state in Nigeria revealed that the nature, time of disbursement, supervision and profitability of enterprises contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of loan; term of loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans.

CONCEPTUAL & MATHEMATICAL FRAMEWORK

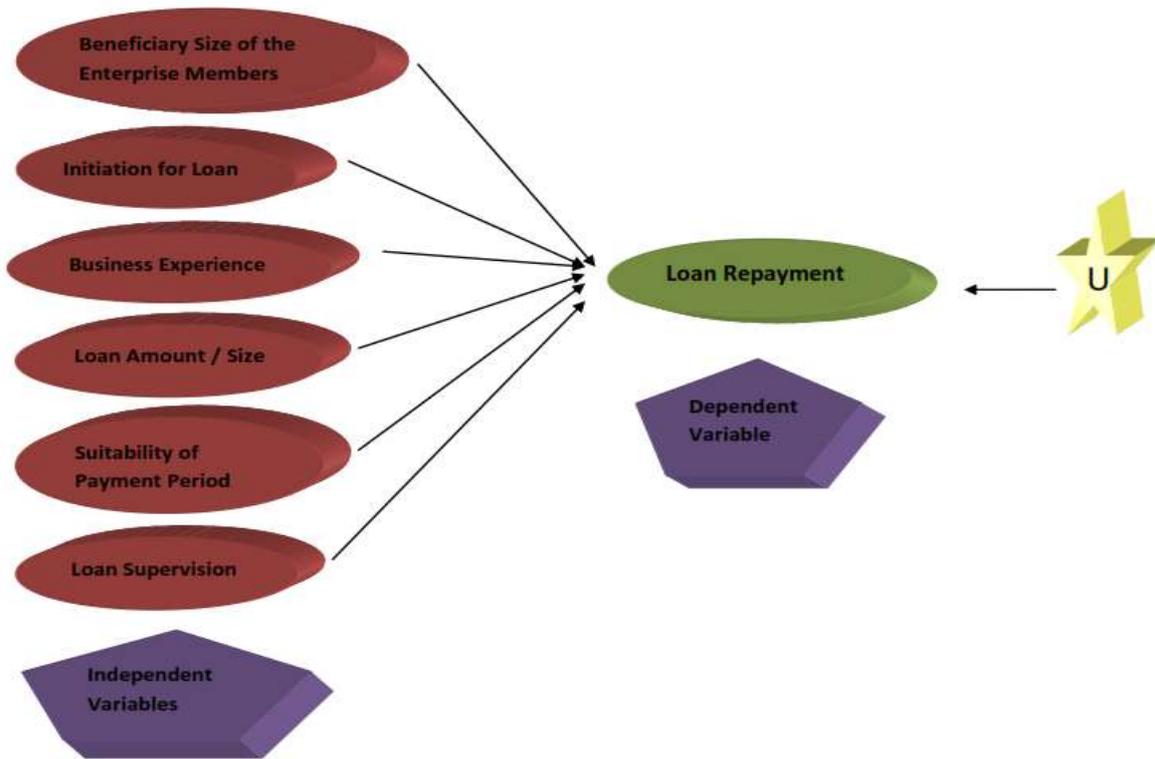


Fig 1: Conceptual Framework of study

$$LR = \beta_0 + \beta_1 BSEM + \beta_2 IL + \beta_3 BE + \beta_4 LA + \beta_5 SPP + \beta_6 LS + U$$

Where,

LR = Loan repayment

$\beta$  = Intercept & constant

$\beta_1 - \beta_5$  = Coefficients

BSEM = Beneficiary Size of the Enterprise Members

IL = Initiation for loan

BE = Business experience

LA = Loan amount / size

SPP = Suitability of payment period

LS = Loan supervision

U = Random error

HYPOTHESIS OF THE STUDY

After review of related literatures the study was intended to evaluate whether the identified factors namely; Beneficiary size of enterprises' member, initiation for loan, Business experience, Loan amount, Suitability of loan repayment period and loan supervision were really affecting the performance of loan repayment or not. Therefore the researcher had set the following alternative hypothesis that led to the actual findings of the study.

**Ha<sub>1</sub>:** Beneficiary size of the Enterprises Member has significant impact on loan repayment performance of MSEs in Dila town.

**Ha<sub>2</sub>:** Initiation for loan taking has significant impact on loan repayment performance of MSEs in Dila town.

**Ha<sub>3</sub>:** Business experience has significant impact on loan repayment performance of MSEs in Dila town

**Ha<sub>4</sub>:** Loan amount/ Size has significant impact on loan repayment performance of MSEs in Dila town.

**Ha<sub>5</sub>:** Suitability of loan repayment period has significant impact on loan repayment performance of MSEs in Dila town.

**Ha<sub>6</sub>:** Loan supervision has significant impact on loan repayment performance of MSEs in Dila town.

**RESEARCH METHODOLOGY**

The study has been conducted based on primary data collected through structured questionnaires. Since the approach aims at analyzing the impact of loan repayment determinants on loan repayment performance of micro & small enterprises in Dila Town in Ethiopia, the research design has been taken to be Causal. The research was conducted between Jan -March 2016. The measurement scale for the instrument is considered five point Likert Scale representing the intervals. The primary data was collected by distributing structured questionnaire for 164 different groups of MSEs located in Dila town by using stratified random sampling technique, and financed by Omo Micro Finance (OMFI). The representatives from each sector were: construction (42), manufacturing (36), urban agriculture (27), trade (34) and services (25). From the representative samples 149 (90.85%) group owned MSEs returned the filled in questionnaires and analysis were made accordingly. In the pilot study, reliability Cronbach alpha was 0.751.

**ANALYSIS & DISCUSSION**

**Table 2: Summary of mean and standard deviation of Loan repayment determinants**

S.No.	Determinants of loan repayment performance of MSE's	Mean	Standard deviation	Factor rank
1.	Beneficiary size of the enterprises member	3.94	0.506	5
2.	Initiation for loan taking	3.91	0.397	6
3.	Business experience	3.97	0.375	2
4.	Loan amount/ size	3.95	0.418	4
5.	Suitability of loan repayment period	3.95	0.387	3
6.	Loan supervision	3.99	0.313	1

Table 2 states that Loan supervision is the most important determinants for loan repayment.

**Table 3: Correlation Result of Relationship among Loan Repayment Performance & Its Determinants**

Item		loan repayment performance	Beneficiary size of the enterprises member	Initiation for loan taking	Business experience	Loan amount/ size	loan repayment period	Loan supervision
Loan repayment performance	Pearson Correlation	1	.782 <sup>**</sup>	.664 <sup>**</sup>	.801 <sup>**</sup>	.794 <sup>**</sup>	.717 <sup>**</sup>	.770 <sup>**</sup>
	Sig. (2-tailed)		.000	.000	.000	.000	.000	.000
Beneficiary size of the enterprises member	Pearson Correlation	.782 <sup>**</sup>	1	.590 <sup>**</sup>	.646 <sup>**</sup>	.761 <sup>**</sup>	.607 <sup>**</sup>	.657 <sup>**</sup>
	Sig. (2-tailed)	.000		.000	.000	.000	.000	.000
Initiation for loan taking	Pearson Correlation	.664 <sup>**</sup>	.590 <sup>**</sup>	1	.626 <sup>**</sup>	.552 <sup>**</sup>	.579 <sup>**</sup>	.509 <sup>**</sup>
	Sig. (2-tailed)	.000	.000		.000	.000	.000	.000
Business experience	Pearson Correlation	.801 <sup>**</sup>	.646 <sup>**</sup>	.626 <sup>**</sup>	1	.696 <sup>**</sup>	.610 <sup>**</sup>	.696 <sup>**</sup>
	Sig. (2-tailed)	.000	.000	.000		.000	.000	.000
Loan amount/ size	Pearson Correlation	.794 <sup>**</sup>	.761 <sup>**</sup>	.552 <sup>**</sup>	.696 <sup>**</sup>	1	.635 <sup>**</sup>	.683 <sup>**</sup>
	Sig. (2-tailed)	.000	.000	.000	.000		.000	.000
loan repayment period	Pearson Correlation	.717 <sup>**</sup>	.607 <sup>**</sup>	.579 <sup>**</sup>	.610 <sup>**</sup>	.635 <sup>**</sup>	1	.645 <sup>**</sup>
	Sig. (2-tailed)	.000	.000	.000	.000	.000		.000
Loan supervision	Pearson Correlation	.770 <sup>**</sup>	.657 <sup>**</sup>	.509 <sup>**</sup>	.696 <sup>**</sup>	.683 <sup>**</sup>	.645 <sup>**</sup>	1
	Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	

\*. Correlation is significant at the 0.05 level (2-tailed).

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

Table 3 states a matrix of the correlation coefficients of six independent variables and loan repayment performance as dependent variable. The result indicates that at level of 95% confidence, all determinants are significantly related with loan repayment performance.  $R > .05$  &  $p > .05$

**Table 4: Regression Model Summary- Coefficient Of Determination**

R	R Square	Adjusted R Square	Std. Error of the Estimate
.909	.827	.819	.098124

Table 4 states that the variables included in the model explain 82.7% of the variability in loan repayment and only 17.3% other factors not included in model explain it.

**Table 5: Individual Correlation Coefficients**

S.no.	Determinants of loan repayment performance of MSE's	Correlation	Correlation coefficient (R <sup>2</sup> )	Share of each Factor	
				Each factor separately	From total
1.	Beneficiary size of the enterprises member	0.782	0.612	61.2%	14.75%
2.	Initiation for loan taking	0.664	0.44	44 %	10.6%
3.	Business experience	0.801	0.642	64.2%	15.47%
4.	Loan amount/ size	0.794	0.630	63.0 %	15.18%
5.	Suitability of loan repayment period	0.717	0.514	51.4%	12.39%
6.	Loan supervision	0.770	0.593	59.3%	14.29%

Table 5 shows the variance in dependent variable by independent variable. Beneficiary size of the enterprises member explains 64.2%, Initiation for loan taking 44%, Business experience 64.2%, Loan amount/ size 63%, Suitability of loan repayment period 51.4%, Loan supervision 59.3% of variance individually and 14.75%, 10.6%, 15.47%, 15.18%, 12.39% & 14.29% from total variance respectively.

**Table 6: Regression result of loan repayment performance regressed on its determinants**

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Correlations		
	B	Std. Error	Beta			Zero order	Partial	Part
(Constant)	-.595	.210		-2.834	.005			
Beneficiary size of the enterprises member	.214	.060	.208	3.542	.001	.782	.285	.124
Initiation for loan taking	.092	.043	.103	2.117	.036	.664	.175	.074
Business experience	.362	.079	.263	4.572	.000	.801	.358	.160
Loan amount/ size	.140	.047	.183	2.969	.004	.794	.242	.104
Suitability of loan repayment period	.142	.055	.134	2.602	.010	.717	.213	.091
Loan supervision	.209	.062	.187	3.347	.001	.770	.270	.117

Table 6 shows that all the six independent variables have significant impact on loan repayment performance as  $p < .05$ . After seeing the t value we can say that Business experience has the high impact

having t value 4.572 and Beneficiary size of the enterprises member and Loan supervision have 2<sup>nd</sup> & 3<sup>rd</sup> having 3.542 & 3.347 as t value. This table also test all the all alternative hypothesis accepts which states Beneficiary size of the enterprises member, Initiation for loan taking, Business experience, Loan amount/size, Suitability of loan repayment period & Loan supervision have significant on Loan repayment performance (  $p < .05$ ). Hence  $H_{a1}$ ,  $H_{a2}$ ,  $H_{a3}$ ,  $H_{a4}$ ,  $H_{a5}$ , &  $H_{a6}$  are accepted.

Regression model can be summarized as:

$$LR = \beta_0 + \beta_1 \text{BSEM} + \beta_2 \text{IL} + \beta_3 \text{BE} + \beta_4 \text{LA} + \beta_5 \text{SPP} + \beta_6 \text{LS} + U$$

$$LR = -0.595 + 0.214 \text{BSEM} + 0.092 \text{IL} + 0.362 \text{BE} + 0.140 \text{LA} + 0.142 \text{SPP} + 0.209 \text{LS}$$

The equation shows that the slope of Beneficiary size of the enterprises member is 0.214 which explains that for every one unit increase in Beneficiary size of the enterprises member, loan repayment performance increases by 0.214 keeping other independent variables constant.

## CONCLUSION

Based on findings, it is concluded that not all identified variables have similar influence of bad loans from the viewpoint of SMEs borrowers in Dila town. However, all of the variables have significant influence in this respect.

In the study Initiation to loan and Suitability of the repayment period are treated as moderate determiners of bad loans among other variables by the Regression Analysis.

Moreover, Business related experiences (15.47%), loan supervision (14.29%), suitability of repayment period (12.39%), loan size (15.18%) and initiation to loan (10.6%) are found to be significantly and positively while beneficiary size of the enterprises (14.75%) is adversely associated with the loan repayment rate. Borrowers who have extensive experience in related activity show better repayment record while borrowers with low loan size show poor repayment record.

Borrowers engaged in urban agriculture, manufacturing and some sort of construction activities are relatively found to be defaulters as compared with other sectors. This emanates from the sectors vulnerability to risk and uncertainty. The default problems associated with these sectors are inter-management problems, insufficient loan supervisory and shortage of capital and market failure.

The adverse and significant association between business related experience and loan recovery rate seems to suggest the need for training to small scale entrepreneurs so as to develop their entrepreneurship and managerial capacity.

Further the loan size also should be matched with the business plan in such a way as to fit with the managerial capacity of borrowers

Suitability of loan repayment period for borrowers was also found to significantly increase the probability of repaying loan. Therefore, the institution has to give enough time to clients so that they will be able to work with loans they have borrowed and arrange the time to collect loan that will be suitable for them to sell their business output.

Micro finance institutions would need to consider some attributes of SMEs more closely before lending to them through intensive supervision. Some of these factors are the experience of SME entrepreneurs in business, their initiation to loan, the size of beneficiary members and the type of products they sell. Though enlightening findings have been reached in this research, more empirical studies are needed on the subject. Empirical studies need to be conducted from the perspective of lending to individuals and large firms as well. Future studies can also be geared towards revealing the effect of bad loans on the financial performance of Microfinance institutions in Dila town.

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