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Analysis of Member Quality and Portfolio Quality in Deposit-Taking SACCOs in Kenya: Positivism Paradigm Approach

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Abstract:
Deposit-Taking SACCOs have been actively recruiting and expanding financial services to promote financial inclusion, reaching out to all segments of society, especially the underserved populations, particularly those marginalized in rural areas. However, during membership recruitment, traits such as loyalty, profitability, engagement, and advocacy set high-quality members apart. These traits play pivotal roles in driving business growth, building brand reputation, and ensuring long-term sustainability. During the loan appraisal and approval process, customer characteristics and their perceived value carry significant weight. Therefore, evaluating member quality in terms of creditworthiness, financial literacy, and the ability to make timely payments stands as the central activity in the loan appraisal and approval process. Nevertheless, the empirical studies that were reviewed have presented diverse findings on this subject. The present study, therefore, investigated the effect of member quality on portfolio quality in deposit-taking SACCOs in Kenya. The study used primary data, and structured and unstructured questionnaires were administered to purposely selected credit managers in deposit-taking SACCOs in Kenya. Results of the study revealed that member quality positively and significantly influences the portfolio quality of DT SACCOs in Kenya ($p = 0.000 < 0.05$) and R2= 31.9%. These results are essential to SACCO managers, SACCO regulators like SASRA, scholars, and policymakers like the government.

Keywords: *Member quality, repeat borrower, portfolio quality, business income, member experience, microcredit loans*

1. Introduction

Member quality is a relative value to the business attached to a member. Several studies, such as those of Ozdemir and Boran (2004), confirmed that a loan may not be paid due to the unwillingness or inability of the borrower to pay the loan. Stiglitz and Weiss (1981) recommend that a thorough screening should be done by bank managers to separate creditworthy borrowers from uncreditworthy borrowers and that the borrowers should be monitored to ensure that they do not divert the loan funds for the purposes that they were not intended for because if the loan funds are diverted, the loan may not be paid back as per the loan schedule. The borrower's loan payment history and current and expected income should be evaluated to determine whether the borrower is likely to repay or not Greenbaum and Thakor (1995). When a member's loan account is delinquent, such a member is of poor quality to the Sacco, while when a member's loan account is performing, the member is of good quality to the Sacco. In the Sacco movement, members are the customers and, at the same time, the owners of the SACCO. The sole purpose of a business is to create a customer (Drucker, 1973).

Customers are assets that need to be acquired before they can be managed for profit (Levitt, Theodore, 1986). Buttle and Francis (1998) suggested that managers charged with customer acquisition should target customers who will be valuable to their business. Once targeted customers have been identified, a Know Your Customer (KYC) needs to be done; KYC refers to a regulatory requirement by banks and other financial institutions to gather information about a prospective and existing customer that will enable them to monitor, audit, collect, and analyze their customers or potential customers before engaging with them (Bilali, G; 2011). The evidence from KYC will prove that due diligence was conducted at the point of onboarding the customer. The manager will then evaluate how valuable this potential customer is to their business. Doing a proper KYC for potential customers from the recruitment stage to loan application and appraisal stage are parameters of assessing member quality at the onboarding stage. Member quality can also be accessed through the loan review stage. Specifically, this can be done regarding loan policy and underwriting guidelines, including the risk grade system and loan reserve policy (Nails, 2010). In assessing the determinants of Know Your Customer compliance in Commercial Banks in Kenya, Arasa and Ottichilo (2015) revealed that customer characteristics determine KYC compliance in Commercial Banks; furthermore, the researchers observed that in the modern world, technology is a useful tool in performing KYC compliance hence should be adopted.

Muhangi and Aliija (2017) studied loan appraisal process management and credit performance in microfinance institutions in Uganda. Their study used both qualitative and quantitative approaches. Respondents were 44 loan officers and credit managers; data was collected by questionnaires from the respondents. Results revealed that loan officers use client appraisal in credit management to a great extent. Results revealed that client appraisal is a good strategy for mitigating credit risk. Finally, the study confirmed that there is a strong correlation between the credit performance of MFIs and client appraisal; therefore, determination of the effect of member quality on portfolio quality in deposit-taking SACCOs remains imperative.

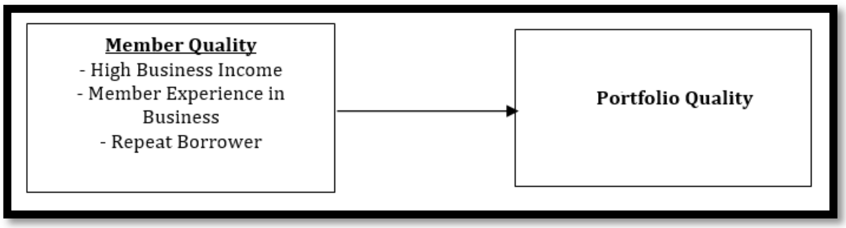

Figure 1: Conceptual Framework
Source: Adopted and Modified from Essendi (2013)

2. Literature Review

The quality of a member is an important factor in determining the quality of the portfolio. The aspect of the quality of loan customers has not been exhaustively studied. In most studies, it is a sub-construct of the main variables or a control variable. For instance, Olando (2022) investigated loan portfolio quality and performance of commercial banks in Kenya; the study used market and infrastructural dynamics as a control variable. Market dynamics is a general term; hence, member quality can be categorized under market dynamics since the customers determine the demand and supply of products. In yet another unique study, Khalipour and Khalili (2016) modeled customer classification in the banking system of Iran. The final model revealed a 95% probability that if the next customer data is entered into the model, then the model can identify accurately the degree of customer risk. This result reveals that customer quality or membership quality is related to credit risk and subsequently related to portfolio quality.

The caliber of members significantly impacts the performance of the loan portfolio. Several studies have explored the significance of members' social connections and reputations in the context of loan defaults, yielding varying conclusions. For instance, Agasha, Monametsi, and Feela, 2020) investigated the influence of capital structure, cost of capital, credit risk management, and the quality of clientele based on the portfolio quality of MFIs in Uganda. They employed an exploratory research design and concluded that the quality of customers indeed affects the quality of the loan portfolio. They recommended that MFI managers assess prospective customers' reputations, social networks, dependability, trustworthiness, social circle standing, business profitability, and accountability within those circles. In contrast, Wydick et al. (2011) studied social networks, neighborhood effects, and credit access in rural Guatemala. They did not find a correlation between strong social ties and borrowers' loan repayment. Hermes, Lensink and Mehrteab (2005) examined the economic value of social capital in Eritrea and found that group leaders utilized social ties to enhance their loan appraisal and monitoring efforts, resulting in a lower default rate among group members.

Ahlin and Townsend (2007) used survey data from borrowers of BAAC, an MFI in Thailand, to assess social capital, including clients' social networks and reputation. They found a negative association between measures of social networks, client reputation, and loan repayment. Benabu and Tirole (2006) measured reputation using the concept of social image, highlighting the importance of how individuals perceive themselves or are perceived by others. This perspective emphasizes the norm of keeping promises, thus raising the moral costs of breaking promises.

While these studies have demonstrated a relationship between member quality and portfolio quality, it is worth noting that most of them are based on MFIs and group lending, and they do not specifically pertain to the Kenyan context. Deposit-taking SACCOs, which lend to both groups and individuals, present a different dynamic. Moreover, the measurements were not on the quality of the portfolio.

3. Methodology

The methodology section is one of the most important parts of research work. Algouti and Tulud (2021) underscored the importance of the methods section. The study pointed out that the common parts in the method section are an introduction, research design, data collection method, data analysis, and ethical considerations. The study, however, asserted that these stages were common in the theses they reviewed. However, the stages were sometimes interchanged, even in cases involving the same discipline. The present study included an introduction research design, sample size and population, study area and data analysis.

3.1. Research Design

Research design is a plan that is geared toward the accomplishment of an entire goal (Vibha & Walsh, 2019). Research design is a blueprint that holds research elements together and ensures that research objectives are achieved and research questions are answered (Copper and Schindler, 2014; Kothari, 2004). In general, research can follow quantitative, qualitative, or pragmatic paradigms (Philips, 1987; Creswell, 1994). Given the conceptualization in this study, the type of data, and the study objective, the study followed the positivism paradigm and employed a correlation research design.

3.2. Sample Size and Study Population

The study population consisted of 84 deposit-taking SACCOs that offer microcredit loan products. As of the end of 2022, there were 176 licensed deposit-taking SACCOs. The study purposely sampled 84 deposit-taking SACCOs. Respondents were the credit managers of each deposit-taking SACCO.

3.3. Data Analysis

The study used questionnaires to collect data from the respondents. The validity of data was arrived at by subjecting the questions to experts for analysis before getting the expert's opinion. On the other hand, the reliability was assured by doing a pilot test followed by Cronbach's test with a test threshold of 70%. The data from the correspondents were then coded and analyzed using SPSS statistical software. Both inferential and descriptive analyses were adopted in the study. Results were presented in tables and graphs.

3.4. Model Specification

A model developed to establish a relation between member quality (X's) and portfolio quality (Y) of deposit-taking SACCOs in Kenya

$Y=\beta_0 + \beta_1 X_1 \, e_t$……………………………………………………………………3.2

Where:

Y= Portfolio Quality,

β_0= Constant coefficients,

β_1= coefficient of member Quality

X_1= Member quality

e_t= error term

4. Results

The objective of this study was to determine the Effect of member quality on portfolio quality in deposit-taking SACCOs.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.565[a]	.319	.308	.20900
a. Predictors: (Constant), Member Quality				

Table 1: Model Summary of Member Quality on Portfolio Quality Model Summary

Table 1 presents a summary of the results of the Ordinary Least Squares (OLS) regression model. A modified R-value of .565 indicates that the results were trending in the right direction (positively) based on the provided range of -1 to +1. There exists a 0.565 (56.5%) chance that the Member Quality will affect the Portfolio Quality of deposit taking-SACCO. Member Quality accounts for 31.9%, leaving 68.1% to other factors not considered in this study. The value of R indicates how closely actual values of the dependent variable match those forecasted values of Portfolio Quality of deposit-taking SACCOs.

ANOVA[a]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.230	1	1.230	28.169	.000[b]
	Residual	2.621	60	.044		
	Total	**3.851**	**61**			
a. Dependent Variable: Portfolio Quality						
b. Predictors: (Constant), Member Quality						

Table 2: ANOVA of Member Quality on Portfolio Quality

Table 2 presents the analysis of variance (ANOVA), the F-statistic, and the significance level. From the table, F statistics of 28.169 is above 2 and significant at a 95% confidence level where ($P=0.000<0.05$). This implies that Member Quality has a significant effect on Portfolio Quality at a 95% confidence level.

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.718	.452		3.799	.000
	Member Quality	.568	.107	.565	5.307	.000
a. Dependent Variable: Portfolio Quality						

Table 3: Coefficients of Member Quality on Portfolio Quality

$PQ = 1.718 + 0.568\, MQ$ ……………………………………………………………….1

Member Quality (p=0.000) significantly affects Portfolio Quality. A unit increase in Member Quality causes an increase in Portfolio Quality by 0.568 units. The coefficient for member quality suggests that for every one-unit increase in one quality member, portfolio quality is estimated to increase by approximately 0.568 units. The high standardized coefficient (Beta) of 0.565 indicates that member quality has a moderate influence on portfolio quality compared to other variables in the model. The significant p-value (p=0.000) suggests that the relationship between member quality terms and portfolio quality is unlikely to be due to random chance and is statistically meaningful. In table 1, the Coefficient of determination ($R^2 = 0.319$) implies that 31.9 % of loan portfolio quality can be explained by member quality.

These results indicate that member quality has a significant and positive impact on portfolio quality, with higher member quality associated with higher portfolio quality. These outcomes align with the results of a study conducted by Postelnicu et al. (2015), which centered on Microfinance institutions in Eritrea and employed similar indicators of social connections. Their research unveiled that strong social networks and positive client reputations led to reduced instances of payment issues, ultimately lowering non-performing loans and the risk of default.

In a similar vein, Agasha *et al*. (2020) conducted a study investigating the impact of factors like capital structure, cost of capital, credit risk management, and the quality of clientele on the portfolio quality of Microfinance Institutions (MFIs) in Uganda. Their research, following an exploratory research design, concluded that customer quality significantly influences the quality of the loan portfolio. They recommended that MFI managers consistently evaluate the reputation of prospective customers and their social networks to determine their reliability, trustworthiness, standing within their social circles, the profitability of their businesses, and their level of accountability within those circles. However, it is important to note that the results of this study do not align with the findings of Ahlin and Townsend (2007), who utilized survey data from borrowers of BAAC, an MFI in Thailand. The study centered on assessing clients' social networks and reputations, specifically focusing on the extent to which group members were willing to share resources, provide labor, and coordinate activities related to crop transportation, input procurement, and crop sales. Interestingly, they discovered a negative association between measures of social networks and client reputation and the repayment of loans.

5. Conclusions and Recommendations

The study revealed that there is a positive relationship between member quality and microcredit portfolio quality; the study concludes that constructs of member quality, which are high Business Income, member Experience in Business, repeat borrower, and good credit scores in CRB positively and significantly influence microcredit portfolio quality. Therefore, members with good credit ratings, stable income, good experience in business, and second-time borrowers pay their loans well. The study recommends that deposit-taking SACCO managers should strive to attract, recruit, and be able to retain long-time members who will add value to the Sacco by making timely contributions to the Sacco, are creditworthy, and have skills in running businesses. This may involve implementing measures that enhance customer service, improve members' satisfaction, and increase loyalty. DT-SACCOs should invest in member development by providing financial literacy programs, personalized financial advice, and access to resources for improving credit scores that help enhance member quality and portfolio quality. DT-SACCOs should invest in data analytics to monitor the relationship between member quality and portfolio quality over time to enable them to gain insights into the effectiveness of their current strategies and identify areas for improvement. DT-SACCOs should consider member quality in the process of loan appraisal and lending since the study revealed that member quality affects microcredit portfolio quality.

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