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EFFECT OF CREDIT APPRAISAL ON LOAN DEFAULT IN AGRICULTURAL FINANCE CORPORATION

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Abstract: **The Agricultural Finance Corporation (AFC) has experienced loan defaults totaling Kes.10 billion in the last five years, from 2015 to 2020, against a portfolio of loans amounting to Kes.17 billion. This is in line with the crime rate of 58.8 percent compared to the 12 percent industrial indicator. This type of situation, if not addressed immediately, could lead to the decline of the Agro-financing financial institution over time. The cause of this loan failure has not been determined. The purpose of this study was to determine whether the principles of credit management, especially when debt management and repayment procedures are implemented, would reduce the borrowing burden on Kenya's Agricultural Finance Corporation. The study sought to investigate the effect of credit appraisal on loan default in agricultural finance corporation. A descriptive research design was used for the study. Data was gathered through the use of questionnaires administered by the researcher. The target population was 485 AFC employees, with a sample of 141 employees, particularly department heads from AFC's 47 branches, chosen to complete the questionnaires. Operations, Finance, and Loan Recovery are among these departments. Purposive sampling was used to select the 141 heads. The Statistical Package for Social Sciences (SPSS) version 21 was used to analyze the data. The effect of the study's independent variables on the quantitative dependent variable was determined using a multiple regression model analysis (loan defaulting). Tables and other statistical presentation techniques were used to present descriptive analysis. According to the study, credit appraisal was statistically significant in predicting loan default. According to the findings of the study, credit terms, credit appraisal, credit monitoring and evaluation, and credit review all play a role in predicting loan default. The study recommended that management include significant credit terms that are well communicated in order to protect AFC clients from inflation and rising costs of living. However, management should do so with the understanding that, when used alone, credit terms lack the defaulting contributing potential. As a result, organizations should supplement credit terms with other credit management practices such as pandemics, severe drought, and poor markets for their produce, which the study identifies as long-term factors.**

Keywords: **Credit Appraisal, Loan Default.**

1. INTRODUCTION

Effective credit management and loan procedures ought to be finished in a precise and steady way as per laid out strategies and systems. To have the option to judiciously get advances and decide proper loaning offices, banks need to have a viable credit risk the board framework set up to facilitate consumer lending (Kagwa, 2016). According to Glen (2016), a well-structured loan management system is an important tool in distinguishing the level of credit risk from the various exposure to bank debt. This allows for a more accurate assessment of all aspects of the loan portfolio, loan repayment opportunities, and, ultimately, the adequacy of the loan loss conditions. As a result, debt management processes play a vital role in maintaining a healthy financial balance between borrowing and investing, thus reducing the risk of losing money on borrowing.

Consumer credit is considered one of Kenya's most important economic sectors. Consumer credit includes borrowing money or goods from the bank and repaying them on time or date, plus interest. In addition, over the past decade, mobile phone loan applications have taken over the Kenyan economy (DFID, 2018). According to Kenya's credit market analysis, strong policies that promote market stability and prosperity will lead to increased government revenue and create more jobs for Kenyans (Rozas, 2015). The consumer credit industry has grown significantly over the past two decades. Risk management is essential to facilitate sustainable and sustainable industry growth.

Credit risk management safeguards Pakistani banks against potential losses or crises that could jeopardize their financial stability. However, the bank's total financing is not bad. Before financing, banks must conduct a customer assessment process, which is required for the banks' survival (Naqvi, Channar & Ahmed, 2018). According to Masood (2019), banks and other financial institutions in Pakistan and around the world are suffering from the dilemma of loan default, which not only reduces the bank's profitability but also has an impact on the country's economic conditions. Loan default is extremely damaging in developing economies such as Pakistan, affecting not only the banking sector but also the country's economic conditions.

According to Rukundo (2018), having objective and appropriate credit standards for commercial banks in Bujumbura, Burundi, allowing banks to inspect credit records properly, as well as clear rules on the handling and payment of credits, as well as checking their reimbursement plans, straightforwardly affects default rates and reimbursements. Subsequently, business banks in Burundi ought to comply rigorously to laid out loaning rules that obviously defined out the boundaries for the development of a senior administration business, as well as the circumstances to be met to fit the bill for a credit endorsement, and that there ought to be a pre-consumer pre-credit check.

According to Njenga (2019), despite the fact that most deposit-taking microfinance institutions in Kenya implemented credit management practices, the gross loan portfolio has steadily increased over the years. The number of non-performing loans grew gradually. This default rate could be the result of borrowers making poor investment decisions due to a lack of professional advice from deposit-taking microfinance institutions on how to choose and select viable investments that can yield profitability. As a result, small financial institutions that take deposits in Kenya should think about using credit policy documents from other similar successful organizations to gauge best credit management practices.

The table below depicts the trend of non-performing loans over the last five (5) years.;

Table 1: AFC Total Assets against Loan portfolio and Non-performing loans

Year	2015	2016	2017	2018	2019
ssets (Kes. Billions)	12.1	13.3	14.1	14.7	16.1
Total loan portfolio (Kes. Billion)	8.1	9.2	10.2	11.5	12.6
Non-performing loans (NPL) (Kes. Billion)	6.2	7.8	8.7	8.5	10.8
NPL/Total Assets (%)	51.2%	58.6%	61.7%	57.8%	67.1%

Source: AFC Credit linkage report, November 2019

Between 2015 and 2019, AFC Total Assets increased steadily, as shown in Table 1.1 above. In addition, loan amount has increased, and In 2016, the rate of increase in non-performing loans increased by Kes. 1.9 billion compared to 2015. Non-performing loans increased by Kes. 0.9 billion in 2017. The slowdown in 2018 was due to the president's directive to cancel bad loans, the AFC received compensation from the government. In 2019, the growth trend of NPLs compared to total assets continued.

Debt management procedures are considered an important part of a bank's success (Lalon, 2015). This is because the commitment to debt management ensures the longevity of banking institutions by protecting itself from loans. According to Kitsinji (2019), debt mismanagement has a negative impact on banks, leading to lower interest rates and credit problems due to the rising interest rate on loans from Non-Performing Loans (NPLs), which creates a particularly challenging situation for banks. Credit appraisal, credit terms, credit monitoring and evaluation, and credit review will be the credit management practices used in this study.

Credit appraisal is a comprehensive exercise that begins where the prospective borrower enters the bank and manages credit delivery and monitoring, fully intent on guaranteeing and keeping up with the degree of getting and controlling credit risk inside satisfactory cutoff points (Seyfried, 2017). According to Kabiru (2019), the quality of credit appraisal processes is determined by two factors: from one perspective, an unmistakable and complete show of the dangers when

you are given a credit, and then again, a satisfactory evaluation of these dangers. Furthermore, because of the huge contrasts in the idea of the different borrowers (confidential people, recorded organizations) and the resources for be financed (private, assembling, apparatus), and the enormous number of items and their intricacy, there. it can't be a similar gamble evaluation process.

The Agricultural Finance Corporation (AFC) is a state-owned financial institution founded in 1963 with the goal of providing credit facilities for the development and expansion of agricultural activities in Kenya, which is regarded as the country's backbone (www.afc.org.ke). The Corporation currently has Kes.17.1 billion in net assets and a loan portfolio of Kes.15.7 billion. The center employs 485 full-time workers (DFID, 2019).

Statement of the Problem

Since 2009, the development finance sector has grown significantly. In that note, issuing credit to customers is the primary function of DFI institutions; therefore, institutions have put in place programs to reduce loan failure while ensuring that trained farmers and other institutions receive credit. Agricultural-based financial institutions do not have detailed borrowing procedures to be followed when issuing loan loans to management staff, members and farmers. As a result, many of them face hardships as a result of bias and loan fraud and corruption by leaders and managers. In addition, credit systems do not have the necessary flexibility due to continuous economic changes. Better risk management will ensure the survival of the firm. CMP has been the subject of a number of studies, including the CMP of coffee associations in the Embu region (Njiru, 2013), the CMP survey of pharmaceutical companies in Kenya (Nduku, 2016), and the CMP and profits of commercial banks in Kenya in. (Kithinji, 2017) and a review of the CMP strategies used by Kenyan firms (Mwirigi, 2006). In addition, Opande's (2018) study on financial institutions and lending rates has shown that organizations are lagging behind when faced with risk factors.

As of (2014) you have investigated the effects of debt management procedures on loan performance in Kenyan microfinance institutions. The findings also revealed that, in addition to the fact that most of the small credit institutions that adopted debt management systems, the loan portfolio grew steadily over time. Mutura and Omagwa (2018) investigated the effects of debt management practices on the financial performance of small financial institutions in Kenya's Central Nairobi region and the study also found that credit risk management, customer evaluation, collection policy, and credit terms all have positive relationships. in financial performance. A study by Mburu, Mwangi, and Muathe (2020) investigated the relationship between credit management and credit performance: strong evidence from Kenyan Commercial Banks, and the study discovered that debt collection and credit policy had a positive impact on the loan performance of Kenya Commercial Banks. The Agricultural Finance Corporation investigated the impact of credit appraisal on loan default.

2. LITERATURE REVIEW

Theoretical Literature Review

Merton (1974) proposed credit default theory, the implication of the risk in repaying the loan stems from the fact that the repayment capacity varies over time. Over time, the human condition and the general environment may change. The borrower's ability to repay the loan may be impaired due to unpredictable environmental and economic conditions. According to Moody's (2017), debt default is defined as both a crime and an expected loss to the donor. If the borrower is unable to repay the loan, debt restructuring is always an option. According to Keenan (2018), a non-performing loan repayment program is a process of two separate transactions: delinquency followed by indebtedness. The deficit is negligible if the borrower is always paying in full on time. On the other hand, the crime scene is thought to lead to a review of the balance of the budget, which may lead to debt default and debt default.

According to Bohn (2018), the underlying framework for failure includes rebellion and lack of funding. Loan fraud is the condition of not having enough money to repay a loan. Rebellion creates a test of solvency, which may result in the assumption of a negative equity position, leading to termination of the loan and the expectation of losing the lender. Fraud occurs when a borrower is unable to repay a loan on a due date due to lack of funds. One of the main causes of liquidity failure is poor cash flow. Debt payments are usually made by a company through a cash outflow. Liquidity failure occurs when insufficient income from running a business, resulting in losses. The negative cash flow condition is used to model financial failure as a simplification.

Jarrow and Protter (2019) proposed a causal framework in which debt repayment theories could be systematically developed to investigate the causes of debt default. The default for credit is due to both delinquency and indebtedness, according to the argument. Only if the risk factor has a significant impact on rebellion or drowning can it be considered

appropriate. Debt management processes seek to understand the fraudulent process in order to determine the root of the debt crisis. Debt repayment theory was used as the basis for research to develop credit management procedures for non-performing loans from Kenya's Agricultural Finance Corporation.

Empirical Literature Review

Mureithi (2018) conducted a study on the relationship between the credit assessment process and the level of non-performing women's loan loans made available by Kenyan financial intermediaries. This study was a survey of all financial advisors who provide loans to women entrepreneurs. The study was based on preliminary data collected from a questionnaire. Data were analyzed using both descriptive and non-descriptive statistics. According to research, most organizations receive funding from external donors, and the most important factor in establishing a debt management policy is the existing credit policy.

The study by Githama and Gachanja (2020) looked at the results of non-performing loan audits in public financial institutions, using Kenya Commercial Bank Limited as an example. The researcher used a descriptive research design in which questionnaires were distributed to respondents. The respondents were drawn at random from a sample of twenty financial institutions. In this case, credit officers of all ranks were the intended audience. According to the study, credit appraisal models are used by appraising personnel to determine whether or not to lend.

Arene (2019) used retrospective analysis to determine whether the debt ratio had a significant impact on loan payments by farmers' organizations in the Nigerian province of Anambra. The credit test model is made up of approximately 5 C's Credits: Character, Bull, Power, Collateral, and Conditions. The study found that loan assessments and loan approval procedures do not require a minimum. Minor requirements, on the other hand, shape borrowing decisions. Although this study contradicts these factors, it is worth re-examining them as there may be a link between Kenya's non-payment of loans and the lack of a proper credit rating system.

3. RESEARCH METHODOLOGY

A descriptive research design was used for the study. Data was gathered through the use of questionnaires administered by the researcher. The target population was 485 AFC employees, with a sample of 141 employees, particularly department heads from AFC's 47 branches, chosen to complete the questionnaires. Operations, Finance, and Loan Recovery are among these departments. Purposive sampling was used to select the 141 heads. The Statistical Package for Social Sciences (SPSS) version 21 was used to analyze the data. The effect of the study's independent variables on the quantitative dependent variable was determined using a multiple regression model analysis (loan defaulting). Tables and other statistical presentation techniques were used to present descriptive analysis.

4. FINDINGS

Table 1 shows the descriptive results for credit appraisal. 2.

Table 2: Stakeholder Involvement

Item	1	2	3	4	5	Median
Does a person's personality influence loan repayment?	52.5%	25.8%	10.8%	10.8%	0%	1
Is it true that a borrower's credit score obtained from Credit Reference Bureaus influences loan repayment/loan default?	43.3%	45.8%	10.8%	0%	0%	2
Does the borrower's debt affect his or her willingness to repay the loan in the future?	48.3%	30%	9.2%	6.7%	5.8%	2
Is a borrower's contribution to a funded project considered when calculating loan repayment?	32.5%	45.8%	13.3%	8.3%		2
Is there an impact on loan repayment when a borrower's income is compared to his / her recurring debt and the DTI income is calculated?	50.8%	22.5%	10%	7.5%	9.2%	1

Source: Researcher (2022)

Table 4.7's descriptive results show that the median value for the findings is 2, indicating that the respondents agreed with the statements on credit appraisal. These findings point to a link between credit appraisal and loan defaulting in the Agricultural Corporation of Kenya..

Results of Regression Analysis

Table 3: Model Summary of Regression Analysis

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.666[a]	.456	.428	8.21523

Source: Research Data (2022)

The model has an R-square of 0.456, according to the results in Table 3. This means that credit appraisal explains 45.6 percent of loan default variations. As a result, the study established that credit management practices in Agricultural Finance Corporation can predict loan default. The researcher then used an analysis of variance test to confirm the importance of credit management practices in predicting loan default.

Coefficient of Determination of the Variable

Table 4: Coefficient of Determination of the Variable

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.548	.266		2.060	.012
Credit appraisal	.342	.025	.357	13.68	.011

Source: Research Data (2022)

Table 4 demonstrates that the model's credit appraisal was statistically significant in predicting loan default. Furthermore, one unit change in credit appraisal reduces loan default by 0.342 units.

5. CONCLUSIONS

The research looked into the impact of credit management practices on loan default in the Agricultural Finance Corporation. This was in relation to the increased number of loan defaults of key clients that the corporation is said to be dealing with at the moment. The study sought to investigate how credit review, credit terms, credit appraisal, and credit monitoring and evaluation affect loan defaulting. According to the study, credit appraisal, credit review, and credit monitoring and evaluation were statistically significant in predicting loan defaulting, and they also reduced the likelihood of loan defaulting. Terms of credit were statistically significant in predicting loan default, but they also increased a client's likelihood of default. The study also concluded that credit appraisal is critical in lowering loan default rates. Credit appraisal with reasonable terms and regular review is essential for better loan repayment and client loyalty. For financial institutions to increase loan repayment by their customers, credit management practices should be accompanied by good terms of credit, an unbiased appraisal system, and credit monitoring and evaluation practices, all of which are long-term loan repayment factors.

6. RECOMMENDATIONS

The study recommended that management include significant credit terms that are well communicated in order to protect AFC clients from inflation and rising costs of living. However, management should do so with the understanding that, when used alone, credit terms lack the defaulting contributing potential. As a result, organizations should pair credit terms with other credit management practices such as pandemics, severe drought, and poor markets for their produce, which the study considers long-term factors. Create an enabling monitoring and evaluation system that will aid in reporting the project's status to the financial institution. This will aid in evaluating the project's implementation and the results reflected in the post-disbursement report. This will assist in identifying risk areas in a client's project, which will also be used for future reference when lending to the same individual. The management will gain a better understanding of credit appraisal, which will evaluate the clients' credit scores and income statements. Loans should be underwritten with the five Cs criteria in mind to promote credit management. This will contribute to the development of a fair appraisal system by ensuring increased loan payment as well as better satisfaction comprehension by agricultural institutions.

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