

**DETERMINATION OF FACTORS  
INFLUENCING COMPANIES TO OBTAIN  
CREDIT RATING IN KENYA**

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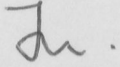
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D61/7085/2002**

**A Management research Project submitted in partial  
Fulfillment of the requirement of the Degree of Masters  
in Business Administration, School of Business,  
University of Nairobi.**

**NOVEMBER, 2006**

## DECLARATION

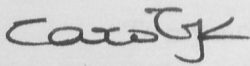
This management research project is my original work and has not been presented for a degree in any other university.



**JANE NYAMBURA MBUKI**

To my brother and best friend, Maina  
May this inspire you.

This management research project has been submitted for examination with my approval as the University Supervisor.



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## ACKNOWLEDGEMENT DEDICATION

I wish to thank all those who contributed to the completion of this study.

I would like to express my sincere gratitude to Mrs. Caroline Kigen, my supervisor who patiently advised and guided me to the successful completion of this project.

To my brother and best friend, Maina  
May this inspire you.

It is a 'big thank you' to all my lecturers, classmates, special thanks goes to Helen, Keith and the late Beaky and friends for their support both academic and moral throughout the entire programme.

And most of all I am grateful to my dear mother and brother, for their encouragement  
To my mother, Rahab Mbuki for teaching me the value of education and importance of hardwork and for encouraging me to undertake an MBA.

Last but not least I would like to thank the almighty God for giving me the knowledge and ability to carry out this study to completion.

## ACKNOWLEDGEMENT

### LIST OF TABLES

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I am grateful to the officers of the various companies who supplied the relevant data for this study. My sincere appreciation goes to Mr. Luke Ombara of the Capital Market Authority for his assistance and useful suggestion.

It is a 'big thank you' to all my lecturers, classmates, special thanks goes to Helen, Keith and the late Becky and friends for their support both academic and moral, throughout the entire programme.

And most of all I am grateful to my dear mother and brother, for their encouragement and support throughout my academic journey, who sacrificed and pushed me to go further when it seemed impossible.

Last but not least I would like to thank the almighty God for giving me the knowledge and ability to carry out this study to completion.

## LIST OF ABBREVIATION

### LIST OF TABLES

- Table 1: Response rate by the type of respondent
- Table 2: Response of companies by sector
- Table 3: Ownership of respondents
- Table 4: Duration of operation in Kenya of respondents
- Table 5: Summary of loans
- Table 6: Nature of loans
- Table 7: Average interest rates of loans
- Table 8: Factors encouraging companies to obtain credit ratings
- Table 9: Challenges facing companies when seeking credit rating
- Table 10: Factors hindering companies from obtaining credit rating

## LIST OF ABBREVIATION

|  | Page |
|--|------|
| BAT - British American Tobacco               | i    |
| CMA - Capital Market Authority               | ii   |
| FISMS - Fixed Income Security Market Segment | iii  |
| GCR - Global Credit Rating                   | iv   |
| MIMS - Main Investment Market Segment        | v    |
| NIC Bank - National Industrial Credit Bank   | vi   |
| NSE - Nairobi Stock Exchange                 | vii  |
| USA - United States of America               | viii |

|   |   |
|---|---|
| 1.1 Credit and Credit Rating  | 1 |
| 1.2 Credit Rating Agency  | 2 |
| 1.3 Advantages of credit rating over alternative credit information systems | 3 |
| 1.4 Statement of the problem  | 6 |
| 1.5 Objectives of the study   | 6 |
| 1.6 Importance of the study   | 6 |
| 1.7 Definitions   | 7 |

## CHAPTER TWO: LITERATURE REVIEW

|  |    |
|--|----|
| 2.1 Literature review  | 9  |
| 2.2 Historical development   | 11 |
| 2.3 Credit rating in Africa  | 12 |
| 2.4 Credit rating in Kenya   | 13 |
| 2.5 An overview of the credit rating process of body corporates in Kenya | 15 |
| 2.6 Factors encouraging companies to obtain credit rating                | 16 |
| 2.6.1 Rating based regulations   | 17 |

## TABLE OF CONTENT

|   | Page |
|---|------|
| Declaration   | i    |
| Dedication  | ii   |
| Acknowledgement   | iii  |
| List of table   | iv   |
| List of abbreviation  | v    |
| Abstract  | vi   |
| <b>CHAPTER ONE: INTRODUCTION AND BACKGROUND OF THE STUDY</b>                |      |
| 1.1 Credit and Credit Rating  | 1    |
| 1.2 Credit Rating Agency  | 2    |
| 1.3 Advantages of credit rating over alternative credit information systems | 3    |
| 1.4 Statement of the problem  | 6    |
| 1.5 Objectives of the study   | 6    |
| 1.6 Importance of the study   | 6    |
| 1.7 Definitions   | 7    |
| <b>CHAPTER TWO: LITERATURE REVIEW</b>                                       |      |
| 2.1 Literature review   | 9    |
| 2.2 Historical development  | 11   |
| 2.3 Credit rating in Africa   | 12   |
| 2.4 Credit rating in Kenya  | 13   |
| 2.5 An overview of the credit rating process of body corporates in Kenya    | 15   |
| 2.6 Factors encouraging companies to obtain credit rating                   | 16   |
| 2.6.1 Rating – based regulations  | 17   |

|       |  |    |
|-------|--|----|
| 2.6.2 | Requirement by market participants and trading partners  | 18 |
| 2.6.3 | Taking advantage of bond rating                          | 17 |
| 2.7   | Challenges facing Credit Rating                          | 19 |
| 2.8   | Factors hindering companies from obtaining credit rating | 21 |
| 2.8.1 | Rating downgrades  | 22 |
| 2.8.2 | Cost   | 22 |
| 2.8.3 | Fear of public scrutiny                                  | 23 |
| 2.9   | Main requirements to be licensed as credit rating agency | 23 |
| 2.10  | The importance of credit rating                          | 24 |

4.5.2 Competitors can use rating reports to the advantage of those rated 40

### CHAPTER THREE 40

|     |                           |    |
|-----|---------------------------|----|
| 3.1 | Research methodology      | 26 |
| 3.2 | Population                | 26 |
| 3.3 | Data collection procedure | 26 |
| 3.4 | Data analysis             | 27 |

### CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND SUGGESTIONS FOR FUTURE RESEARCH.

#### CHAPTER FOUR: RESEARCH FINDINGS

|       |   |    |
|-------|---|----|
| 4.1   | Response rate   | 29 |
| 4.2   | Company characteristics   | 30 |
| 4.3   | Factors encouraging companies to obtain credit rating in Kenya  | 33 |
| 4.3.1 | Very Important factors  | 33 |
| 4.3.2 | Important factors   | 35 |
| 4.3.3 | Fairly Important factors  | 35 |
| 4.3.4 | Unimportant factors   | 35 |
| 4.4   | Challenges facing companies when seeking credit rating in Kenya | 36 |



|       |  |    |
|-------|--|----|
| 4.4.1 | The most challenging factor  | 37 |
| 4.4.2 | Challenging factor   | 38 |
| 4.4.3 | Least challenging factors  | 38 |
| 4.4.4 | Others   | 38 |
| 4.4.5 | Suggestion listed by companies that would help<br>Improve credit rating in Kenya | 39 |
| 4.5   | Factors hindering companies from obtaining credit rating in Kenya                | 39 |
| 4.5.1 | Fear of downgrade  | 39 |
| 4.5.2 | Rating reports are publicly available therefore fear of public scrutiny          | 40 |
| 4.5.3 | Competitors can use rating reports to the advantage of those rated               | 40 |
| 4.5.4 | Others   | 40 |
| 4.6   | Finding from Capital Markets Authority   | 41 |
| 4.6.1 | Reason for allowing companies to issue debts without being rated                 | 41 |
| 4.6.2 | Factors hindering Kenya from obtaining credit rating                             | 41 |

## **CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND SUGGESTIONS FOR FURTHERE RESEARCH.**

|     |                                 |    |
|-----|---------------------------------|----|
| 5.1 | Summary of findings             | 43 |
| 5.2 | Conclusion and recommendation   | 45 |
| 5.3 | Limitation of study             | 46 |
| 5.4 | Suggestion for further research | 47 |

|                   |    |
|-------------------|----|
| <b>References</b> | 48 |
|-------------------|----|

## **APPENDIX**

|  |    |
|--|----|
| Appendix 1 : Letter of introduction        | 50 |
| Appendix 2a) : Questionnaire for companies | 51 |

|   |    |
|---|----|
| Appendix 2b) : Questionnaire for Capital Markets Authority                          | 56 |
| Appendix 3 : Applicants requirements to be approved and Registered as rating agency | 57 |
| Appendix 4 : List of rated Companies  | 59 |
| Appendix 5 : Meaning of ratings   | 60 |
| Appendix 6 : List of Companies listed in Nairobi Stock Exchange                     | 62 |

## ABSTRACT

Credit rating systems help to build an effective financial system by promoting transparency in lending. They are effective tools towards mitigation of adverse selection and moral hazard in credit market, and have been ground to lower overall default and interest rate and improve the pool of borrowers in formal credit markets. For companies who are unwilling to tap the capital market for funds, ratings could differentiate them among their joint venture partners, suppliers and competitors which will help them obtain a better market standings and credit facilities.

This study was therefore designed to identify factors encouraging companies to obtain credit ratings and factors hindering listed companies from obtaining credit ratings. Listed companies were selected for this study because only 4 out of the 52 companies listed in NSE have obtained credit rating and the CMA is considering the option of mandatory rating for all issuers of security in the capital market.

The study established that, the most important factors encouraging companies to obtain credit rating in Kenya are: - as a requirement by major trading partners and for the purpose of marketing the company to the customers. The common factor hindering companies from obtaining credit rating is fear of downgrades.

The study establishes that the most challenging factors companies face when seeking credit rating is lack of two or more local credit rating agencies.

The study recommends that in order to promote development of credit rating systems in Kenya regulators should play a supportive and facilitative role, an appropriate regulatory framework to be put in place, review of the guideline issued for requirement for approval of credit rating agency and creation of awareness to the government, investors and borrowers.

## CHAPTER ONE

### INTRODUCTION AND BACKGROUND TO THE STUDY

#### 1.1 CREDIT AND CREDIT RATING

Credit means the process of borrowing and lending. Credit can also be defined as the ability of a person to borrow money or to buy goods without making cash payment on the basis of confidence of other people in his honesty, integrity and financial soundness.

According to Capital Market Authority (CMA) (2004), Credit rating is an objective and independent opinion on the general credit worthiness of an issuer of a debt instrument and ability to meet its obligation in a timely manner over the life of the financial instrument based on the relevant risk factors including the ability of the issuer to generate cash in future.

According to Brealey and Myers (1988), Credit rating is a judgement about a firm's financial and business prospects.

According to Brealey and Myers (1997), Credit rating is an opinion on the ability of the issuing company (issuer) of a debt to meet its obligation in a timely manner. For the purposes of this study credit rating will be defined as a measure of the long-term fundamental credit strength of the companies that is their long-term ability and willingness to meet debt-servicing obligations.

Credit ratings are opinions, which stem from fundamental credit analysis, that are used to classify credit risk. In keeping with their status as opinions, ratings are determined by a rating committee. Ratings are not intended as a recommendation to buy or sell or hold a particular security (Sharpe, Alexander and Bolley, 1987), as such they do not address the suitability of an investment for a particular investor. Therefore it's recognized that investors may decide against a bond despite a high quality designation. Consequently ratings are not guarantee against loss and not predictors of default they are simply opinions about relative measure of risk.

Ratings may apply either to the general credit worthiness of an obligator or to its obligations with respect to a particular debt security or their specific financial obligations. General credit worthiness of an obligator depends upon the likelihood that the firm will default and the protection afforded by the loan contract in the event of default. Specific ratings are assigned to a particular debt security or other financial obligations. The original ratings of these debt securities have an impact on their marketability and effective interest rate. These original ratings are regularly reviewed to ensure that the assigned original rating is still valid, if not the revisions are made either upwards or downwards based on both the company and the issue.

Credit ratings can also be classified as international or local ratings. International ratings incorporate all sovereign risk including currency conversion. These ratings are easily comparable among countries. Local ratings are tiered against the best-assumed top rating of investment grade and differentiate risks only by the country.

Credit ratings can be assigned to government (sovereign) ratings. For these sovereign ratings the ordering of risk implied is broadly consistent with that country's economic fundamentals, which are a key building block in developing a market for government securities. These sovereign credit ratings often serve as a ceiling for private sector ratings of any given country.

## 1.2 CREDIT RATING AGENCY

A credit rating agent is a professional whose role is to give an objective and independent opinion on the general credit worthiness of an issuer of a debt instrument and ability to meet its obligation in a timely manner. (CMA, 2004).

Credit rating agencies base their analyses on a company's financial statements, franchise value, management quality and competitive position in its industry, and seek to predict credit performance (the servicing of debt obligations in full and on time) under a range of macroeconomic and credit conditions, including stress situations. This analysis is based not only on public information, but also on private/confidential information, which companies agree to share with credit rating agencies. Consequently credit rating agencies consider expectation over the life of this issue, along with the historical and current

financial position of the company. The credit ratings agencies continue to revise and monitor on an ongoing basis their assessment, hence ratings can be downgraded, upgraded or confirmed in subsequent ratings.

In essence rating agencies use an ordinal scale to gauge a borrower ability to pay full their debt obligations in a timely manner. Accordingly, all credit rating express the outcome of their assessment in the form of symbols such as Aaa, AAA, BBB etc which more or less correspond to each other across agencies.

The scale runs from AAA, the highest, then all the way to D, which reflects, for default. These ratings can be refined by adding plusses or minuses or additional numbers for example among the leading rating agencies; Duff and Phelps, Fitch, Standard and Poor and Global Credit Rating Company use plusses and minuses while Moody's use numbers (1, 2, 3).

The top ratings AAA (or Aaa), AA or (AC) and BBB (or Baa) are generally considered to be investment grade securities. BB – and B rated obligation are the next level of securities known as speculative securities. These are generally perceived to be more risky than those in the investment grade. The C categories are generally either income obligations or revenue bonds, many of which are trading flat (bond that are in arrears on their interest payments). In the case of D-rated obligations the issues are in outright default and the rating's indicate bonds relative salvage value.

### **1.3 Advantages of credit rating over alternative credit information systems.**

Credit rating play an important role in the process by which corporate by pass the banking system and borrow directly from investors through capital market. This is referred to as disintermediation. It also helps in promotion of the overall development of the capital market through enabling the investors to become aware of the underlying risks of the issuer or issued financial instrument. In developing markets such as Kenya, the bulk of private sector business is still financed by the traditional banking system. Future economic growth of the country and the increasing role of the private sector will result in large financing needs.

The capacity of the banks to meet rapidly growing business finance including long term project financing may also be limited by their short term funding position (CMA, 2004) and also bank finances are expensive and interest rate in Kenya are very volatile. This can be overcome by the development of an active corporate securities debt market that will allow prime users of fund direct access to fund providers.

For prime users of funds to have a direct access to funds there is need for lenders to have information which help them to better analyze, understand and quantify the risk emanating from the ability and willingness of the borrower to repay or default, so that the interest rate of a loan would always reflect the risk profile of the borrower. Consequently good borrowers would have no problem obtaining loans at low interest rates, while bad ones will be charged higher rates or denied loans altogether. This would in turn lead to higher confidence among lender's which would result in greater credit availability, a situation that enhances economic growth. This has created the need for credit information systems that provide potential lenders with both positive and negative data about the borrower. Therefore increasing transparency in the credit market, which will assist in credit risk evaluation.

Various credit information systems has evolved to meet the need for reliable information in determining the credit worthiness of a borrower for example, their recent financial statement, payment records, clear business history and interview with management. In a survey conducted by Rowena (2000) on experiences by eleven developing countries on whether it was difficult or easy to gather information about the credit worthiness of a borrower using their financial statements, payment record, owners personal wealth, and interviews with managements showed that it was difficult to gather the financial information and sometimes not possible at all. For example he found out that in Kenya it was very difficult to get information because the only information available is only bad debt information for example payment performance and no company in Kenya will give their monthly accounts receivable, plus most companies keep more than one set of books, one for the tax man, one for the owners and one for creditors, the question therefore arose on which one to rely on.

A credit rating system is one of the mechanisms that help to address the problem of lack of reliable information on borrowers credit worthiness in the credit market.

Empirical studies by Kallberg & Udell (2001) have proven that credit data produced by credit reporting agencies have substantially greater predictive power than the information contained in borrower financial statements.

By collecting information on borrowers, credit rating agencies facilitate information sharing, which adds value in solving problems associated with borrower information opacity (Kerandi 2004). Information sharing facilitated by credit rating agencies reduces loan interest and default rates and can have disciplinary effect because it encourages borrowers to try harder to meet obligations.

In the absence of credit ratings, most investor will have to make their investment decision on the basis of historical information, or alternatively some may just go by the name. Infact without a rating most investors in fixed income instrument have no means of evaluating the default risk or risk of full or partial loss of their investment. In addition, they have no means of comparing the default risks of many potential investment return opportunities available to them.

A study By Rowena Olegario (2002) shows that credit reporting agencies lead to higher confidence among lenders, greater credit availability for everyone, a situation that enhances economic growth. The study shows that countries with more intense and established formal information sharing, either via credit registries or voluntary information exchanges, exhibit greater bank lending as a proportion of Gross National Product. Conversely, the risk of default was higher in countries with lower levels of formal information sharing. Without a robust credit reporting system, economic growth is hindered because some contracts between savers and investors will not be possible or will stipulate wrong prices.

A recent survey by Margaret Miller of the World Bank noted Kenya as one of the countries that lack a credit reporting system. Unless the Government makes concerted efforts to create an enabling environment, this vital sector will remain undeveloped and at



a significant cost of the Kenyan economy. It is therefore important that the country institutes reforms that can enable this sector to grow.

#### **1.4 STATEMENT OF THE PROBLEM**

In Kenya credit rating is still a new concept and still very underdeveloped. There is only one credit rating agency operational in Kenya known as Global Credit Rating Company and only four of fifty two listed companies have been participating in rating (BAT, NIC Bank, Athi River Mining and Mabati Rolling Mills) since 2001 when the capital market issued the guidelines on approval and registration of credit rating agencies.

Understanding the factors that encourage credit rating as well as the factors hindering development of credit rating in Kenya aims at making recommendations, which will be useful to companies already participating in credit rating, potential borrowers and investors, potential credit rating agencies and capital market authority.

The need for the study arose from the fact that companies that have issued debt securities example Safaricom, East Africa Development Bank, Shelter Afrique have not been rated except Mabati Rolling Millings. In future the capital market authority is considering the possibility of requiring all existing and potential issuers of securities to capital market to be rated. The aim of the study therefore is to investigate what are factors hindering the participating in credit rating by companies and what factors encouraging credit rating in Kenya.

#### **1.5 OBJECTIVES OF THE STUDY**

1. To identify factors encouraging credit rating among body corporates in Kenya.
2. To identify factors hindering public listed companies from obtaining credit rating in Kenya.

#### **1.6 IMPORTANCE OF THE STUDY**

##### **Government of Kenya /capital market authority**

This study would assist the government of Kenya in its decision to take the initiative to embrace credit rating like other African countries example Botswana and South Africa. Credit rating would ease access to the international capital market as a major source of

funding. The sovereign credit rating would also be used as a benchmark for private sector rating in Kenya. The study will also identify factors that are hindering the embracing of the credit rating by body corporates in Kenya and suggest recommendation and solution to the problem, this will assist capital market in its endeavor to build an active securities debt market and to deepen the domestic capital market in Kenya.

#### Investment grade securities

#### **Academic Fraternity, Researchers, Scholars and Academicians.**

The study will suggest further academic investigations. The findings of the study will be useful for enhancing the understanding on the subject of the study and to enrich its stock of knowledge.

#### **Prospective Borrowers.**

The study will identify the importance of credit rating to borrowers, this information would encourage borrowers to participate in credit rating which would widen their access to investor capital, lower cost of funding and added financial flexibility.

#### characterize bonds in this class (Sharpe, Alexander and Bolley, 1987)

#### **Investors**

The study will suggest that investors should require that the potential borrowers to provide them with rating from independent raters this will assist in assessing how much return or risk premium to demand when purchasing a security.

## **1.7 DEFINITIONS**

### **Income bonds**

These typically arise from corporate reorganizations. These bonds pay interest only if income is actually earned by the company. Because the company, having gone through reorganization, has been in difficult financial circumstances, interests are not a fixed charge, the principal however must be paid when due.

Income bonds usually contain sinking funds provisions to provide for their retirements. (Weston and Brigham, 1972).

**Financial instrument**

International Accounting Standard number 39 defines financial instrument as any contract that give rise to both a financial asset and a financial liability or equity instrument or another enterprise.

**Investment grade securities**

There are securities judged to be of best quality. They carry the smallest degree of investment risk and are generally referred to as gilt edged. Interest payments are protected by a large or by an exceptionally stable margin and principle is secure. (Sharpe, Alexander and Bolley, 1987).

**Speculative grade securities**

These are securities which their future cannot be considered as well assured. Often the protection of interests and principal payments may be very moderate and thereby not well safeguarded during good and bad times over the future. Uncertainty of position characterizes bonds in this class. (Sharpe, Alexander and Bolley, 1987).

## CHAPTER TWO

### 2.1 LITERATURE REVIEW

Numerous studies have been done focusing on credit ratings and credit rating agencies in the world, for example Rowena (2000) and Luota and McIntosh (2002). Unfortunately no study has been done focusing on the factors hindering the development of credit rating as most studies are done in developed countries where most body corporate and government have embraced this concept. However there exist some case studies that have been carried out that relate to the importance of credit rating which are relevant to this study.

Jappelli and Pagano (2002) offer the first empirical investigation of the existence and impacts of Credit rating agency in various economies around the world. They find that the presence of private credit agencies or public credit agencies is associated with broader credit markets and lower credit risk. They find no differential effect between public and private institutions on credit market performance, and argue that public credit rating agencies are more likely to rise where there is not preexisting private rating agencies and creditor rights are poorly protected.

Margaret Miller's credit reporting systems and the Internal economy (2003) offers the first comprehensive source for the institutional aspects of credit reporting. Miller's own chapter uses results from a World Bank Internet survey to offer empirical data on the status of credit reporting activities around the world. She shows how credit bureaus can provide borrowers with 'reputation collateral'. Frequently viewed as more valuable than physical collateral by surveyed lenders. Furthermore, she argues that the types of data collected by a credit bureau often provide the best predictors of repayment.

Jappelli and Pagano (2000) conclude that the usefulness of credit rating is reduced in developing countries where large informal sectors exist in which enforcement of repayment compliance is difficult. They suggest that granting credit bureau access to informal lenders would increase the credit bureau's usefulness for both formal and informal lenders, due to the economies of scale that defines the industry. Jappelli and Pagano also argue that better information may lead banks to shift from collateral – based

lending policies to more information – based ones, supporting Miller’s empirical findings on lenders preference for credit rating data.

McIntosh and Wydick (2004) show that the total effect of a credit bureau can be decomposed into two distinct and separable effects on default rates. The first of these effects is a “screening effect”, the ability of a credit information system to reduce default rates through removing risky borrowers from the lender’s portfolio. As the credit history and current borrowing data of each new applicant is checked before loan approval, borrowers with high pre-existing debt are culled from the portfolio, leaving a portfolio of less indebted, lower risk borrowers, which after the completion of a single loan cycle will begin to reduce default rates. The second effect is an “incentive effect”, some borrowers, those on the margins of undertaking a safe or risky investment behaviour, are induced into the safe behaviour as the improved circulation of information within the credit bureau increases the negative ramifications of circulation of information within the credit bureau increase the negative ramifications of defaults.

Vercammen (1995) and Padilla and Pagano (2000) argue that limits to the information exchanged between lenders can lead to more optimal results. Vercammen uses a multi-period model with adverse selection and moral hazard to show that a certain level of adverse selection is required in a credit market in order to give rise to borrower reputation incentives and thus aggregate welfare. He concludes a system of full information sharing may be less efficient than one designed to preserve some level of asymmetric information, such as limiting the length of borrower data that is maintained.

Padilla and Pagano (2000) focus on the effect of information sharing as a “borrower discipline device” under perfect competition. They conclude that borrowers have greater incentive to perform if only negative information is exchanged, arguing that sharing positive borrower characteristics can ease the negative impacts of default and mitigate the disciplinary effect of a credit bureau.

## 2.2 HISTORICAL DEVELOPMENT

The precursors of bond rating agencies were the mercantile agencies, which rated merchants ability to pay their financial obligations. In 1841, in the wake of the financial crisis of 1837, Louis Tappan established the first mercantile credit agency in New York. Robert Dun subsequently acquired the agency and published its first ratings guide in 1859. A similar mercantile rating agency was formed in 1849 by John Bradstreet, who published a ratings book in 1857. In 1883, the two agencies were consolidated into Dun and Bradstreet, which became the owner of Moody's Investors services 1962.

Credit reporting agencies were private sector initiated organizations that first developed in the USA in the 1930. They greatly enhanced the transmission of business information during a time when other mechanisms example financial statements for conveying information on creditworthiness were unavailable. These agencies in the United States pioneered the network (branch) structure wherein local information on business owners was collected and broadcast to a wider audience (sometimes in distant localities) of potential creditors, hence facilitating the country's transition from a small scale and personalized form of commerce to a larger, more impersonal one. They helped standardize the criteria for creditworthiness across the country and legitimized business credit and its practices (Rowena Olegarios 2002). In other countries credit reporting agencies developed either as private sector initiated entities or as public agencies usually managed by the Central Bank as a banking supervision tool.

As trade globalizes credit rating agencies are forming international alliances in order to provide better coverage. Development of international and local public credit rating agencies promises to provide creditors with better information on a growing number of potential trading partners.

### 2.3 CREDIT RATING IN AFRICA

Africa remains the region of the world with the least developed credit information systems. However, both private and public credit reporting institutions operate in the formal sectors of many African countries (Luoto and McIntosh 2004). African countries with a public credit registry include Angola, Burundi, Madagascar, Mozambique, Nigeria and Rwanda. As for the year 2002, private credit bureaus existed or were in the process of development in Mali, Niger, Nigeria, Burkina Faso, Kenya, Benin, Senegal, The Gambia, Cote D'Ivoire, Ghana, Uganda, Tanzania, Botswana, South Africa, Swaziland, Namibia, Rwanda, and Togo (Miller M, 2003).

The demand for sovereign credit ratings by developing countries has been initiated in the recent time as a result of the growing importance of the international capital market as major source of funding for emerging market economies, which has created the need for standardized, and independent assessment of credit risks of these economies.

An initiative launched the United Nation Development Programme (UNDP) with Standard & Poor to help sub-Sahara Africa and other developing obtain sovereign credit rating has benefited several countries including Botswana, Burkina Faso and Ghana. (For details in Appendix 4). Through this project, the UNDP intends to support countries in their efforts to mobilize resources from private capital markets, which are required to secure accelerated rates of economic growth and reduce poverty.

Under the UNDP project more sovereign ratings on the African continent are likely to increase in the years to come, this new trend whereby African countries open up for scrutiny by independent rating agencies of international repute is going to increase prospectus of access to international finance market ensuring inflow of capital to finance Africa economic development.

## 2.4 CREDIT RATING IN KENYA

The capital market authority in its endeavor to build an active corporate debt market and to deepen the domestic capital market in Kenya, developed guidelines on the approval and registration of credit ratings agencies. The guideline comes into effect from November 2001.

In the year 2002 the capital market authority approved the registration of Global credit rating agency in Kenya. Since then it's the only credit rating agency that is operational in Kenya. Global credit rating Company (GCR) can trace its origin back to 1996 when the company was formed as DCR Africa, resulting from a joint venture agreement between a South African based rating agency and the USA-based Duff & Phelps Credit Rating Company. The company's Southern African regional headquarters are based in Johannesburg, while its main West and East African regional offices are based in Lagos and Nairobi respectively.

GCR's rating methodology embraces those methodologies used by international rating agencies, incorporating key principles specific to emerging market entities.

GCR's rating approach employs analytical techniques that incorporate quantitative and qualitative factors. Their ratings reflect an evaluation of the organization's current financial position, as well as how the financial position may change in the future. In addition, their analysis focuses on a range of administrative, economic and operational factors. GCR examines the ability of the organization to meet its obligations under reasonable and stressful scenarios. Although this methodology focuses on rating general obligations, it is also relevant to specific debt issues. GCR's objective is to assign ratings that are applicable throughout the various stages of a business cycle.

GCR's corporate credit ratings utilize the same rating scale and definitions that are applied to GCR's ratings of other debt issuers and organizations. The first 10 long-term rating categories (AAA to BBB-) are considered to be investment grade, while ratings below BBB-are considered non-investment grade. Short-term ratings, which generally correspond to periods of less than 12 months, are divided into seven key categories. These are listed in (*Appendix 5 in Table 1 and 2*).



This company has rated several companies in the country example among others; BAT (Kenya). The company was first rated in the year 2002. The company was accorded long and short term domestic Kenya shilling currency rating of AA (double A) and A/+ respectively. These ratings were supported by the company's dominant position in the local tobacco industry together with experience management team and implicit supported offered by the parents. They were reaffirmed in the year 2004.

PTA Bank was honored with high credit ratings in the year 2004. GCR accorded PTA Bank a strong long term domestic Kenya shilling currency rating of AA (double A) and the highest possible short-term rating of A -1 (A one plus). This was underpinned by well capitalized balance sheet as reflected by the common equity to asset ration of 54% in the year 2003 financial year. Coupled with its experienced management which under the bank strong position all of which served to support the rating.

Heritage AII Insurance company rating of A+ (single A plus) was reaffirmed in the year two thousand and four this is due bank favourable strategic position in the region coupled with its experienced management team.

#### Mabati Rolling Mills.

The Athi river based iron sheet maker was first given a single A and A one long and short-term domestic Kenya shilling currency rating respectively in the year 2003. The rating were reaffirmed in the year 2004. The ratings indicate high credit quality with good protection factors in the long term and excellent liquidity factors and very high certainty of timely payment in the short term. (East African Standard, 2004).

#### Athi River Mining Limited

Athi River Mining Limited was first rated in the year 2003 and was accorded A 1 – and A long term and short term domestic Kenya shillings currency credit ratings. The ratings were reaffirmed in the year 2004. The company market leader position within the industrial mineral and chemical markets were viewed positively. This, coupled with its

experienced and innovative management team, which have demonstrated an ability to deliver strong earnings growth in a difficult operating environment, supported the rating.

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It's noted that only four of the listed companies have been participating in rating this means that most companies have not embraced they concept in Kenya has compared to other countries example South Africa where listed companies are required to be rated.

It's also important to note that the Government of Kenya has not taken the initiative to seek independent sovereign rating that will act as a benchmark for corporate rating. This is one of the basis that could be hindering corporate rating in Kenya. Countries that don't have credit ratings are generally considered as mysterious and their access to the international capital markets is greatly constrained. Thus the government should seek credit ratings to reduce risk and ease their access to the international markets. These sovereign credit ratings also act as a ceiling for private sector ratings.

## **2.5 AN OVERVIEW OF THE CREDIT RATING PROCESS OF BODY CORPORATES IN KENYA**

Credit rating of body corporates in Kenya is initiated by either the finance department or marketing department or public relation department. After approval by the board of directors to obtain credit rating, the company applies to GCR for ratings. Upon agreement this company sends its rating staff to the concerned company. The rating process then follows which involves the following stages: -

- The gathering of relevant information, including historical operational and financial records, industry specific and economic data, as well as competitor statistics for comparative purposes.
- Meetings with management and key staff are undertaken, whereby more in depth and sensitive information is discussed.
- Following a thorough analysis of the relevant risks, forecasts and future prospects, a draft rating report is compiled and forwarded to management for comments.

- One feed back from management is obtained, a rating panel is convened and the relevant issuers discussed, at which time a short and long term, rating accorded by the panel.
- Ratings are then communicated directly to management.
- Ongoing monitoring of the company and contact with management is considered crucial in maintaining the integrity of the ratings accorded.

## **2.6 FACTORS ENCOURAGING COMPANIES TO OBTAIN CREDIT RATINGS.**

### **2.6.1 Rating – Based Regulations**

According to an empirical study carried out by Gonzalez and Ronald (2002), shows that regulators in regulation including public authorities that over see banks, insurance companies , capital markets , mutual funds and private pension have made increasing use of rating based constraining on their rules. The importance of rating based regulation has been particularly visible in the United States where it can be traced back in 1930s. This regulation include restricting or prohibiting the purchase of bonds with “low” ratings (usually below BBB), imposing variable capital charges depending on the rating of the holding or easing the issuance conditions or disclosure requirements to securities carrying a “satisfactory rating”.

This regulation has encouraged most companies to obtain and maintain a satisfactory rating category in order to obtain a wider access to investors capital. For example banks have been restricted from owning junk bonds since 1936 (Partnoy (1999) and West (1973) ) and in 1989, savings and loans were prohibited from investing in junk bonds such that they could not hold any junk bonds by 1994.

Regulatory agencies determine capital requirements for insurance companies and broker – dealers using credit rating as a scoring system that is insurance companies’ investment in securities of firms that are value of A or above get a value of 1, firms that are BBB a value of 2, BB get a 3, B a 4, any a level get a 5, and any D rating get a 6, therefore only companies with high grade rating would have access to investors fund. In Kenya due to

the limited capacity of the re- insurance companies to re-insurance all the risks of insurance companies, most insurance companies have re- insured their risk off- shore, according to the Commissioner of Insurance , they can only re- insure their risk with companies with a satisfactory rating grade.

These regulation reduces the cost of obtaining access to the capital markets, especially for those companies that have high grade ratings, consequently reducing the cost of obtaining funding and increases financial flexibility especially, where regulators of capital market impose variable charges depending on the rating of the holder, and easing the issuance conditions or disclosure requirement. Therefore companies strive to attain and preserve good rating grades as this market access translates in to real economic value for debt issuers.

The CMA in Kenya considering easing the issuance conditions and disclosure requirement for all debt issuers that would have obtained high-grade rating for their debt this would act as an incentive for all debt issuers to obtain rating thus encourages credit rating. The authority is also considering the possibility of requesting all existing and potential issuers of securities to capital market to be rated by an accredited rating agency, this will go along way in building investors confidence if rating based regulation enacted in Kenya this will encourage also companies to obtain rating so as to comply with the regulations.

### **2.6.2 Requirements by Market Participant And Trading Partners**

Market participant be they investors, market makers or broker dealers rely extensively on external ratings for the assessment of their trading counterparties (Gonales and Ronald, 2004). The credit worthiness of market participants as assessed by credit rating agency will affect materially a firm relationship with other market participants and trade partners, as it is through this ratings that determines either the conditions (costs) under which they access the market for example the magnitude of collaterisation that they will be required to provide and even the very access to the market. Thus ratings are extremely important for companies that would like to penetrate the international market. They would provide a simple way to communicate to the market the quality of the firm.

It's also through this rating that firms determine the selection of credit counterparties and definition of credit limits. This is also especially true with regards to the short term management of liquidity and over counter derivative transaction (Swaps and options) for example firms entering into long term supply contract require certain credit ratings from their counterparty and entering into swap arrangement may require a certain rating (e.g. AA – or above).

Therefore for a firm to access both local and international market easily and at lower costs they are required to obtain credit ratings from accredited rating agencies. This goes along way to encourage firms to be rated as it's a simple way to communicate to their trading counterparties and the market participants the quality of firm.

### **2.6.3 Taking Advantage of Bond Rating**

Receiving a bond rating has been a prerequisite for any debt issuer desiring any access to both domestic and international market. Without such a rating debt issuers are forced to seek financing from more expensive sources such as bank or the market for privately placed debt.

Debt issuers can use rating as a 'credit passport' to communicate their credit quality to local and international investors. For highly credit worthy borrowers obtaining a credit rating would enable them to raise low cost funds by way of bonds, debenture and commercial paper by attracting the risk adverse investors who may settle for lower yield for highly rated corporate debt issues (Sharpe, Alexander and Bolley, 1987). They could come to the market with larger and more frequent debt issues and with less regard to market conditions this could result in substantial savings in cost of capital.

Credit rating help to increase the marketability of corporate bonds and debentures especially for highly rated bonds, as it makes it much easier to market them using a rating in place of a 'story' about the credit quality of the borrower. Credit rating also help issuers to obtain a wider access to investors capital by providing a comparable means by

which investors can evaluate the credit worthiness of a borrower, this also increases the ability of the debt issuer to determine the quality of their investor bases. Hence, preserving and achieving a desired rating is frequently incorporated in corporate goals and represents an integral part of the financing strategy of companies.

## 2.7 CHALLENGES FACING CREDIT RATING IN KENYA

### a) **Lack of legal regulatory framework**

In a study carried out by Rowena (2002), to establish whether developing countries regulate credit rating agencies and credit bureaus and whether there are any laws (such as privacy laws) that limit what credit rating agencies and credit bureaus can do. Found out that in Kenya there is no regulatory framework and that credit bureaus in Kenya have voluntarily adopted the United Kingdom consumer credit act and data protection act. This basically means that they are self-regulated.

Due to lack of a regulatory framework means that credit rating agencies and bureau are not regulated and may grant information to anyone without a signature from the investigated company on individuals. The capital market authority in Kenya has only issued guidelines on requirement for approval of credit agency, and therefore due to lack of regulatory framework credit ratings can be enforceable, this poses a major challenge to a growing industry.

### b) **Cost**

Since the guidelines come into effect from November 2001, there is only one credit rating agency that is operational in Kenya, and which is not a local company as a result of this and lack of competition credit rating is very expensive in Kenya. Due to lack of competitive edge and alternatives in the form of cost. Therefore unless it's very necessary most companies would not want to incur this cost in the company.

### c) **Capacity of the rating agency**

Due to the fact that only one credit rating company is operational in Kenya most companies are concerned that this company could not be competent enough and it's

rating may be biased if two or more rating agencies were accredited so as to provide an alternative in the form of opinion, debt issuers would be able to seek third opinions from another firm and in this situation investors and issuers are comforted by confirmation of two firms ratings or believe that the other rating agencies may uncover aspects of the debt issuers financial conditions overlooked by another. Therefore this become a major challenge of those companies seeking to obtain credit rating who are left with no alternative but to take the ratings from only one company as seeking of alternative ratings becomes very expensive for that company.

**d) Few issuers of debt instruments**

In Kenya there are very few debt issuers in capital market currently five only. This is because of the stringent eligibility for example requirement for debt issuers and competition with the equities market which has less stringent requirements and no requirement for bank guarantee therefore most companies would prefer to raise capital from another source example bank loan because this stringent requirements results in increased this stringent requirements results in increased costs as companies try to comply and therefore increased cost of obtaining funds with few issuers of debt instrument credit rating industry is unlikely to grow because rating has been traditionally been required for issuers of debt instrument.

**e) Lack of awareness by potential issuers.**

Due to the fact that the rating industry is at it infancy stage in Kenya, most potential issuers are not aware of the advantages that they could benefit from by obtaining rating for their debt, this explains why most debt issuers in the financial why most debt issuers in the financial market have been rated, this poses a major threat to the growth of the industry because unless issuers are aware of advantages of credit rating this will not seek rating and therefore lack of development in the industry.

**f) High entry barriers in the industry**

The industry is characterized by a high relative fixed cost base and high entry barriers which result from the need for an agency to first establish it's credibility amongst

investors before it can generate a profitable client base due to the reason that credit rating local entrepreneurs who would like to venture into this business would not be able to gain entry into the industry and therefore the possibility of a local rating agency become impossible to most local investors because this is only possible in countries where rating industry has developed.

g) Financial requirement to setting up of a credit rating agency of paid up capital of Kshs. 12 million. According to the guideline issued by the CMA, the applicant for credit rating agency should have a stable financial base with a minimum paid up capital of Kshs. 12 million. This requirement although met to protect investor is very restrictive compared to the fact that credit rating industry is very new and underdeveloped in Kenya, therefore most local investor would be able to meet the requirement unless they form alliances with foreign owned credit raters.

**h) Fear of raters to venture into small corporate debt market.**

The corporate bond market in Kenya is very thin. Kenya has only five corporate bonds with a coupon based on the prevailing 91 day Treasury bill moving average rate plus a premium of 0.75% raters who would like to venture into the rating industries fear it would be uneconomic because of lack of clients. The market is dominated by the Government stock.

## **2.8 FACTORS HINDERING COMPANIES FROM OBTAINING CREDIT RATING**

### **2.8.1 Rating downgrades**

A credit rating downgrade can damage a company's access to the capital market and its ability to borrow particularly if the company's debt is demoted from investment grade to sub investment (or "junk") status. And if the downgrade brings an existing rating trigger clause into operations, the consequences can be fatal to the company. Rating triggers are clauses that aim to protect creditors from potential deterioration in the credit worthiness of a borrower firms are be concerned about credit ratings since triggers may exist for



changes in ratings (for example, bond covenants may be directly tied to the rating of the firm, forcing certain costly actions to be taken by the firm given a down grade)

Standard and Poors (2002) recently surveyed approximately 1,000 United States and European Investment grade issues and found that 23 companies show serious vulnerability to rating triggers or other contingent calls on liquidity, whereby a downgrade would be compounded by provisions such as ratings triggers or covenants that could create a liquidity crisis for example, Enron faced & 3.9 billion in accelerated debt payments as a result of a credit rating down grade. Further, the survey showed that at least 20% of the companies surveyed have exposure to some sort of contingent liability.

### 2.8.2 Cost

A debt issuer chooses which market to use to raise capital based on costs. Cost of the ratings depends on the type of issue, whether the issue is a general obligation or revenue bond and the size of issue, it is generally noted that revenue bond rating cost more than general obligation rating therefore, in most cases rating will make issuance of debt instrument more expensive, especially where ratings will not guarantee lower yield on the rated debts therefore the issuer may consider alternative finding like borrowing from banks.

The issue of cost of rating has been a major concern in credit rating especially in developing countries where there are no locally established credit rating agencies and have to rely on rating agencies from well developed countries. For example in Kenya, where there is no local credit rating agency and only one international credit rating has been approved by capital market, this increases the cost of rating because of lack of competition.

Credit rating may also affect the liquidity of bonds especially where bonds are rated as junk bonds. Patel, Evans and Burnett (1998) find that firms incur higher interest rates in less liquid markets distinguished by credit rating of bonds as 'junk' it may be necessary to avoid these ratings levels. Also, at certain credit rating levels (e.g. junk bond levels)

during difficult economic times, a firm may not be able to raise debt. Firms would therefore incur additional cost from having that credit rating (they may have to forgo positive net present value project due to inability to finance projects at those times). Therefore firms may not obtain credit rating especially for the fear possibility of low rating grade for their bonds, which will make them less liquids and increase the cost of obtaining funds.

Sharpe, Alexander and Bolley, (1987) notes that, although the credit rating agencies have done an admirable jobs mistakes happen. A study indicated that the rating agencies have tended to overestimate the risk of default, which has resulted in unnecessarily high risk premiums given the default probabilities. Therefore this increases the cost of capital to the firm, due to credit rating thus many firms concerns about ratings.

### **2.8.3 Fear of public scrutiny**

Credit ratings may provide information on the quality of a firm beyond publicly available information. Rating agencies may receive significant sensitive information from firms that is not public, as firm may be reluctant to provide information publicly that would compromise their strategic programs, in particular with regard to competitor who may also use the rating reports to the disadvantage of those who have been rated.

## **2.9 MAIN REQUIREMENTS TO BE LICENSED AS A CREDIT RATING**

### **AGENCY INCLUDE:**

- a) Evidence of capacity to perform the role of a rating agency
- b) Have a background and experience as well as professional expertise to provide the service of a rating agency
- c) Demonstrate its independence, objectivity, and demonstrate a proven rating methodology.
- d) Must be a body corporate with preponderance of an institutional shareholding of reputed and its shareholders, board of directors, management and professional analytical staff should be persons of impeccable character.

- e) Should partly be owned by an internationally recognized rating agency or have a contractual arrangement with an internationally recognized rating agency that provides technical and strategic support drawn from international experience.
- f) The applicant shall have a stable financial base with a minimum paid up capital of Kshs. 12 million (*for details see appendix 3*).

## **2.10 THE IMPORTANCE OF CREDIT RATING**

- a) Credit ratings provide through a simple symbol system, an objective and independent opinion of relative default risk that investors can use as supplement to but not as a substitute for their own internal credit research when making investment decisions.
- b) Ratings reduce uncertainty by improving the ability of creditors to predict outcomes. Less uncertainty means greater investors confidence, which encourages capital market growth, greater market affecting and liquidity.
- c) Ratings enables information sharing thus reducing information costs of the potential investors, increase the ability of investors to determine the quality of borrowers in the market, provide a common language for credit risk evaluation and contribute to the market common body of analytical information about various borrowers.
- d) Credit ratings help investors reduce the uncertainty about the credit risk of unfamiliar securities and issuers, this may help channel more capital into new segments of the capital markets.
- e) Credit ratings widen investment horizon by enabling investors to have a pool of both local and international borrower this is because they provide a comparable means by which both local and international borrowers can be evaluated on their credit worthiness.
- f) Borrowers can use rating as a 'credit passport' to communicate their credit quality to international and local investors. For highly credit worthy borrowers obtaining credit rating would enable them to raise low cost funds by way of bonds, debentures and commercial papers by attracting the risk adverse investors who may settle for lower yields of highly rated corporate debts.

- g) For companies who are unwilling or are too small to tap the capital markets for funds, ratings could differentiate them among their joint venture partners, suppliers and competitors which will help them obtain a better market standing and credit facilities.
- h) The process of undertaking a credit rating will give corporates a comprehensive third party review of the company's product, market offering, adequacy of control system and risk the company is exposed to. This objective review will offer considerable value addition by way of ideas, strategies and systems improvement advice to the management. Therefore they can take appropriate measures to overcome their weakness and improve on their strength.
- i) Government credit rating increase access to the international market and also serve as a ceiling for private sector rating of a country.
- j) By rating bonds when issued and continuing to monitor the issuing company after the issue help to solve the principal agent problem between investors and company managers, without this continued monitoring and the threat of down grades managers might engage in opportunistic behaviour to better themselves and or stock holders positions at the expense of bond holder.
- k) For intermediaries like merchant banks and underwriters ratings are found valuable in the planning, pricing and placement of their clients debt securities. The existence of a pool of rated debt securities may help to create a risk based price structure in the market which would enhance the intermediary's ability to price a debt issue of a given credit quality. This would also allow intermediaries to monitor the risk and pricing of debt securities that are held in their own portfolios.
- l) Ratings are also extremely important to regulators. An independent and well run rating system may serve a number of quasi – regulatory market functions at less cost to the government for example a system of rating that is continuously updated can aid in counteracting the effects of rumours, speculation and increase public confidence and stability in the financial system.

## CHAPTER THREE

### 3.1 RESEARCH METHODOLOGY

The study was an exploratory study. It was intended to provide detailed information regarding factors determining credit rating in Kenya as no study has been done on this subject earlier. Consequently the research was conducted through a survey of all the listed companies in the Nairobi Stock Exchange and rated companies, also due to the exploratory nature of study both open ended questions and close ended questions were used in the questionnaire.

### 3.2 POPULATION

The target population was

1. All the companies listed in the Nairobi Stock Exchange
2. Capital Market Authority
3. All rated companies but not listed in Nairobi Stock Exchange.

### 3.3 DATA COLLECTION PROCEDURE

The data was collected using two questionnaires consisting of both open ended and close-ended questions. (See appendix 2 (a) and (b)).

One of the questionnaires was administered to all companies listed in the Nairobi Stock Exchange and all rated companies not listed in the Stock Exchange. This questionnaire was structured into three sections (see appendix 2a). The questionnaire was administered to the Chief Accountant or Head of Finance Department.

The first section sought to obtain data pertaining to the general characteristics of the firm. These questions were to enable the researcher to know the ownership of the firms, the period of existence and the nature of the business as well as establish whether the firm have any loans, earlier the study has established that credit rating allows firms easy access to unsecured loans at cheaper rate. However, if firms were able to access unsecured loans at a cheaper rate than secured loan without credit rating. This would be a pointer for lack of credit rating.

The second section focused on rated companies and seeks to obtain information on reasons that encouraged such companies to obtain credit rating and the challenges they faced as they sought credit ratings.

The third section focused on firms that are not rated and sought to determine whether such firms are aware of credit ratings and the benefit accruing from the same and why they had not sought rating.

The second questionnaire was administered to the CMA (*see appendix 2b*). It consisted of open-ended questions; it was administered to a Research Officer in the CMA.

The questionnaires for all companies were administered by drop and pick method. The questionnaire for CMA was personally administered.

### **3.4 DATA ANALYSIS**

The data collected from the questionnaires administered to all companies was analyzed using factor analysis, content analysis and descriptive statistics. For data collected from section 2 of the questionnaire for companies that are rated, in order to identify the most important factor encouraging companies to obtain credit rating, the mean was calculated for each factor in order to obtain the mean rank for each factor. The factor with the least mean was the most important factor and with the highest mean was the unimportant factor.

For challenges facing companies when seeking credit rating the mean was calculated for each factor, in order to determine the most challenging factor according to the ranking by the company officers. The factor with the highest mean was the most challenging factor and the factor with the least mean was the least challenging factor.

Therefore, factor analysis and descriptive statistic were used to identify the most important factors encouraging companies to obtain credit rating and the most challenging factors they faced when seeking credit rating.

Content analysis was used to analyze the suggestions listed by companies to help improve credit rating in Kenya.

For data collected from section 3 of the questionnaire for companies not rated, content analysis was done to analyze other reasons companies stated for not being rated.

In order to identify the most common factor hindering companies from obtaining credit rating, for each factor the number of ticks were counted and a percentage was calculated by dividing the number of ticks with the total number of the companies that responded. The factor with the highest percentage was the most common factor hindering companies from obtaining credit rating and the factor with the lowest percentage was the least common factor.

Data collected from CMA was analyzed using content analysis

Out of 44 questionnaires distributed among the listed companies in the NSE only 27 were returned giving a response rate of 61%. The response rate represent 54% of the companies listed in the NSE.

Out of the 5 questionnaire distributed to the rated companies but not listed in NSE four questionnaire were returned giving a response rate of 80%.

The questionnaire to CMA was filled and returned.

Table 1: Response rate by the type of respondent.

| Type of organization       | Total number | Total number targeted | Questionnaire issued | Number of respondent | Response rate | Percentage of total target |
|----------------------------|--------------|-----------------------|----------------------|----------------------|---------------|----------------------------|
| Listed companies           | 52           | 52                    | 44                   | 27                   | 61%           | 48.1%                      |
| Capital Market Authority   | 1            | 1                     | 1                    | 1                    | 100%          | 1.7%                       |
| Rated companies but listed | 5            | 5                     | 5                    | 4                    | 80%           | 1.8%                       |
|                            | 58           | 58                    | 50                   | 33                   | -             | 56.8%                      |

## CHAPTER FOUR

### RESEARCH FINDINGS

This chapter deals with data analysis and discussion on the research findings.

#### 4.1 RESPONSE RATE

Out of the total target 52 companies listed in NSE only 44 questionnaires were issued, this is because in some companies the gate keepers and secretaries were under strict instructions not to allow any student with a questionnaire to interview the Company Officers. Some Chief Accountants also claimed to be too busy with the audit and no one else could fill the questionnaire therefore it was not possible to administer the questionnaires to all the targeted companies.

Out of 44 questionnaires distributed among the listed companies in the NSE only 27 were returned giving a response rate of 61%. The response rate represent 54% of the companies listed in the NSE.

Out of the 5 questionnaire distributed to the rated companies but not listed in NSE four questionnaire were returned giving a response rate of 80%. The questionnaire to CMA was filled and returned.

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|----------------------------|--------------|-----------------------|----------------------|----------------------|---------------|----------------------------|
| Listed companies           | 52           | 52                    | 44                   | 28                   | 61%           | 48.3%                      |
| Capital Market Authority   | 1            | 1                     | 1                    | 1                    | 100%          | 1.7%                       |
| Rated companies but listed | 5            | 5                     | 5                    | 4                    | 80%           | 8.8%                       |
|                            | <b>58</b>    | <b>58</b>             | <b>50</b>            | <b>33</b>            | -             | <b>56.8%</b>               |



The overall response was 56.8%. This was considered adequate for analysis. However the low response rate is common in social science research, which involved the use of a questionnaire to corporate officer who are reluctant to fill the questionnaire, and most of them returned the questionnaires unfilled.

## SECTION 1

### 4.2. COMPANY CHARACTERISTICS

Out of the 32 companies that responded 6% was from agricultural sector, 22% from the commercial sector, 31% from the financial sector and 41% from the industrial sector.

*Table 2: Response of companies by sector*

| Sector       | No. of respondent |
|--------------|-------------------|
| Agriculture  | 2                 |
| Commercial   | 7                 |
| Financial    | 10                |
| Industrial   | 13                |
| <b>Total</b> | <b>32</b>         |

*Table 3: Ownership of respondents*

| Ownership                         | No. of companies |
|-----------------------------------|------------------|
| Foreign owned                     | 0                |
| Locally owned                     | 3                |
| Partly local and foreign owned    | 29               |
| Partly government and local owned | 0                |
| Government owned                  | 0                |
| <b>Total</b>                      | <b>32</b>        |

**Table 4: Duration of operation in Kenya of respondent**

| Duration in years | Number of companies |
|-------------------|---------------------|
| 1 – 30            | 5                   |
| 31 – 60           | 24                  |
| Over 60           | 3                   |
| <b>Total</b>      | <b>32</b>           |

Out of the 32 companies that responded none was fully owned by foreigners this is because of the restrictions of foreign holding for a quoted company to an aggregate of 40% of the authorized share capital.

The companies that were classified as partly local and foreign owned had over 60% local ownership while those classified as locally owned had less than 5% foreign ownership.

**Table 5: Summary of loans**

| Organization         | Number of respondents | With loans | Without loans |
|----------------------|-----------------------|------------|---------------|
| Listed companies     | 28                    | 24         | 4             |
| Not listed companies | 4                     | 2          | -             |
| <b>Totals</b>        | <b>32</b>             | <b>26</b>  | <b>4</b>      |

Out of the 28 companies listed in NSE that had responded 4 didn't have any loan that is 14% of the total that responded. 24 had loans, which is 86% out of the total that responded.

Data on the amount of loans and whether secured or not secured was not readily available for companies not listed in the NSE. Corporate officers in these companies were not willing to disclose the information. Two of the respondent from this companies agreed that they had secured loans but didn't disclose the amount or the rates of interest. The other two didn't disclose the information and said that was beyond their authority.

**Table 6: Nature of loans**

| <b>Organisations</b> | <b>With Secured Loans</b> | <b>With Unsecured Loans</b> | <b>Total</b> |
|----------------------|---------------------------|-----------------------------|--------------|
| Listed companies     | 20                        | 4                           | 24           |
| Not listed companies | 2                         | -                           | 2            |
| <b>Totals</b>        | <b>22</b>                 | <b>4</b>                    | <b>26</b>    |

For the listed companies only 4 had unsecured loans which were obtained on the basis of letter of negative pledge or short term borrowings such as bank overdraft which were payable on demand within 3 months.

**Table 7: Average interest rates of loans**

| <b>Types of loans</b> | <b>Average interest rates</b> |
|-----------------------|-------------------------------|
| Secured loans         | 10.68%                        |
| Unsecured loans       | 7.0025%                       |

The comparison between the interest rate of loans that were secured and those not secured, indicated that two of the companies with unsecured loans were charged interest rate of 4.12% and 3.39%, the other two companies were charged 11.75% and 8.75%. The average was 7.0025%. The companies with secured loans were charged on average interest rate 10.68%. This indicated that companies could obtain unsecured loans at a cheaper interest rate than secured loans therefore no need to obtain credit rating. This conclusion may have been different if more respondent were involved.

## SECTION 2: FINDINGS FROM COMPANIES THAT ARE RATED

### 4.3 FACTORS ENCOURAGING COMPANIES TO OBTAIN CREDIT RATINGS

This section sought to investigate factors encouraging companies to obtain credit rating in Kenya and the relative importance of each factor to the company. The respondents were asked to indicate the relative importance of each factor listed on a 6 point likert scale as shown below. This means that the factor with lowest mean is the most important factor and with the highest mean is unimportant factor. The results are based on mean rank for each factor as shown in the table below.

#### Key

1. Very important
2. Important
3. Fairly important
4. Unimportant
5. Totally unimportant
6. Irrelevant

*Table 8: Factors encouraging companies to obtain credit ratings*

| Factor   | Mean |
|--|------|
| In order to issue debt instrument                    | 4.6  |
| A requirement by major trading partner               | 1.2  |
| For the purpose of marketing the company to customer | 1.6  |
| To create good corporate image to the public         | 2.2  |
| As a measure of the company position in the market   | 3.4  |
| A requirement by major shareholders                  | 3.9  |

#### 4.3.1 Very Important Factors

These constitute of factors with mean rank of 1.2 and 1.6. The factors requirement by major trading partners and for the purpose of marketing the company to the customers respectively were considered to be the very important factors encouraging companies to

obtain credit rating in Kenya. These factors were ranked highly by local companies investing offshore.

It was noted that Kenyan companies that want to access international markets are required to obtain credit rating which forms a simple way of communicating the firms quality to market participant and trading counterparts in international markets.

Sharpe, Alexander and Balley (1999) recognized that International credit rating agency's opinions are respected in the market. These opinions materially affect the cost of accessing the market and the very access to the market; therefore local companies that wanted to invest offshore were encouraged not only to obtain credit rating but also to preserve a satisfactory rating.

According to one of the respondent, international credit rating enables bank to facilitate long and short-term funds in the international markets. Such ratings also enable banks to negotiate better rates offshore from counter parties, including correspondent bank across all facets of banking products.

It was also noted local companies participating in developed market were required to be rated, this is because ratings are firmly entrenched in developed markets for example some insurance companies revealed that they were required to be rated because many of the major brokers and corporate clients will only place business with highly rated insurance in those markets. Therefore local insurers were required to be highly rated in order to access such markets. Local companies also used credit rating as a tool of marketing their companies and it's products in both local and international markets.

Ratings are able to differentiate the quality of a firm and it's products across all industry sector, therefore by obtaining and preserving satisfactory rating companies are able to achieve a higher profile and better standing in the market than their competitors.

It was noted that rating was used by local companies that provide service such as banking and insurance. Incase of insurance businesses ratings were used to communicate an insurers ability to meet it's current and future policy holders obligations with the terms of

such obligation. The company's rating therefore transmitted an insurer financial strength, credit worthiness and long term viability to its customers. These also applied to other companies that were rated including banks where high grade ratings of banks mean excellent liquidity factors and credit quality with good protection factors which most customers requires from a bank before entrusting them with their money.

#### **4.3.2 Important Factor**

This constitute of a factor with a mean rank of 2.2. The factor to create good corporate image to the public was an important factor encouraging companies to obtain credit rating in Kenya. Rating reports are available to the public, who include financiers, suppliers, government, customers and the society as a whole, by obtaining and maintaining good rating grade the companies are able to establish and maintain good will with their public. This factor was rated highly by companies in industries with many firms.

In Kenya only few companies are rated, therefore through this ratings a company is able to distinguish itself from other companies which help to establish good reputation, which increases prestige of that company and the public become more interested to deal with the company.

#### **4.3.3 Fairly Important Factors**

These constitute of factors with a mean rank of 3.4 and 3.9. The factors are a measure of the company's position in the market and a requirement by major shareholders respectively were factors considered fairly important factors encouraging companies to obtain in credit rating in Kenya.

Companies are pooled in classes according to the rating grades, companies that wanted to know where they rank both locally and internationally would do so by obtaining rating as these grades were universal scale. For example N.I.C Bank was ranked the 5<sup>th</sup> overall best bank in Kenya and the best local bank in Kenya. These rating categories will act as an incentive for a firm to maintain the higher rating if highly ranked or to obtain an upgrade if it has lower rating.

Multi – national companies in Kenya were required by their major shareholders to be rated, this was used to compare the performance of various subsidiaries across the world. It was also noted that because the parent companies were rated then subsidiaries were required also to be rated in order to contribute to the overall rating of the parent companies. The companies had to try to maintain and preserve their local ratings so as not to cause a downgrade to the parents company's international rating.

It was also established that the shareholders of this companies also used the rating as a way of monitoring and constraining the actions of their managers as a way of solving the agency problem. This acted as an incentive for building managers reputation for example negative credit rating developments may have negative consequences for a financial manager with regard to his job security or compensation likewise positive news (example an upgrade to AAA) may be considered positively in compensation decisions.

#### **4.3.4 Unimportant Factor**

This constitute of a factor with a mean rank of 4.6. The factor in order to issue debt instrument was considered as an unimportant factor encouraging companies to obtain credit rating in Kenya. Companies that have issued debt instrument in Kenya have not been rated except Mabati Roll milling, this was due to the fact that CMA has not made it mandatory for debt issuers to be rated.

It is also noted that companies that have bank – guarantee need not to be rated especially of they fail to meet only few of the requirement of the FIMS. Therefore most companies did not find it important to obtain ratings in order to issue debts if they had met other requirements required by CMA.

### **4.4 CHALLENGES FACING COMPANIES WHEN SEEKING CREDIT RATING IN KENYA**

This section sought to find out the challenges faced by companies when seeking credit rating. The respondents were therefore asked to indicate how challenging each factor listed was, on 4-point likert scale as shown below. This means that the factor with the

highest mean is the most challenging factor and the factor with the least mean was the least challenging. The result based on the mean rank of each factor is as shown in the table below.

**Key**

- 4 Most challenging
- 3 Challenging
- 2 Least challenging
- 1 Not challenging

**Table 9: Challenges facing companies as they seek credit rating**

| Factor                               | Mean Rank |
|--------------------------------------|-----------|
| Cost                                 | 3.7       |
| Lengthy procedures & formulaties     | 2.1       |
| Lack of local credit rating agencies | 4         |

**4.4.1 The Most Challenging Factor**

This constitute of the factor, with a mean rank of 4, the factor lack of local credit rating agencies was considered to be the most challenging factor companies encounter when seeking credit rating in Kenya.

Companies noted that due to the fact that there were no local credit rating agencies they had to obtain credit rating from outside the country this not only contributed to the length of time that it takes between the time when they applied for rating and the time they obtained the ratings from those agencies but also the cost of rating. Companies also major concern was that only one company had been approved by the CMA therefore this provided for no room to compare their rating among other firms and this could lead to their rating being biased.



#### 4.4.2 Challenging Factor

This constitutes of the factor with a mean rank of 3.7. The factor of cost of ratings was considered to be a challenging factor companies face when seeking credit rating. It was noted that it very expensive for companies to obtain rating in Kenya because of lack of local rating agencies. This meant that companies that wanted to be rated has to pay for the air tickets and accommodation costs for the staff that came to rate the company this increased the rating cost as they had to pay extra on top of the normal rating cost. It's was also noted that due to the fact that only one company had been approved in Kenya there was no competition therefore this resulted to high cost of ratings.

#### 4.4.3 Least Challenging

This constitute a factor with mean rank of 2.1  
The factor lengthy procedures and formalities was considered the least challenging factors that companies faced that when seeking credit rating in Kenya. The companies that sought credit rating were not required to follow long procedure neither were any many formalities required, there only needed to apply to the rating companies who would then send their staff to rate the company therefore this factor was least challenging.

#### 4.4.4 Others

Companies didn't specify any other challenges they encountered.

#### 4.4.5 The following were suggestion listed by companies that would help improve credit rating in Kenya.

- i) Companies suggested that the CMA should come up with incentives tailor made to encourage companies to be rated for example lower tax rate for rated companies and easing the issuance conditions and requirement for rated companies.
- ii) The CMA should approve at least two or more rating agencies as this will reduce rating cost.
- iii) Creation of awareness about the importance in credit rating to investor and borrowers.

### SECTION 3: FINDINGS FROM COMPANIES NOT RATED

Out of 24 companies that responded but were not rated all of them were aware of credit rating. 4 out of 24 companies that is 16.6% were aware the CMA is considering making it mandatory for all issuers of the securities in the market to be rated.

None of the companies had ever sought credit rating. 5 companies out of 24 were considering obtaining credit rating while 19 were not considering.

#### 4.5 FACTORS HINDERING COMPANIES FROM OBTAINING CREDIT RATING IN KENYA

This section sought to find out the common factors that hinder companies from obtaining credit rating in Kenya. Respondent were required to tick any of the factors that is hindering their company from obtaining credit rating. The factor with the highest percentage was the most common factor hindering companies from obtaining credit rating among the respondents and the factor with the least percentage was the least common factor hindering companies from obtaining credit rating among the respondents.

The results are as shown in the table below: -

*Table 10: Factors hindering companies from obtaining credit rating*

| Factor   | Count | % of the companies |
|--|-------|--------------------|
| 1. Rating reports are publicly available therefore fear of public scrutiny | 18    | 75%                |
| 2. Competitor can use rating report to the disadvantage of those rated     | 19    | 79.2%              |
| 3. Fear of down grade  | 23    | 95.8%              |

##### 4.5.1 Fear of Downgrade

The factor that was hindering most companies from obtaining credit rating in Kenya was fear of downgrade. 23 out of 24 companies that is 95.8% of the companies did not want to obtain credit rating due to fear of downgrades. It has been noted that most companies

fear downgrades because when a company is down graded there is likelihood of loss of confidence in the company, which could subject the company into liquidity problems.

#### **4.5.2 Rating Reports Are Publicly Available Therefore Fear Of Public Scrutiny**

It was also noted that 79.2% of the companies didn't want to obtain rating because of fear of public scrutiny. There was fear that rating reports would disclose so much about their companies to the public which was not desirable to most companies, they preferred the public to only rely on this financial statements which are required to be published by regulatory bodies, so that they could only disclose what is required instead of obtaining rating which would disclose a lot of information about the company to the public.

#### **4.5.3 Competitors Can Use Rating Report to the Disadvantage of those Rated**

75% of the companies considered the factor that competitors can use rating reports to their disadvantage as a factor hindering them from being rated. They noted that credit rating agency's in their analysis focus on the administrative, economic and operational factors of an organization which forms a basis for their opinion, information about these factors are reported in the rating reports, therefore the strength and weakness of the company are exposed to their competitors and therefore they can be used to their disadvantage.

#### **4.5.4 Others**

- Some companies noted that their parent companies were rated in the home countries so they didn't see the need for local rating
- Some companies also feared that they could not be able to obtain satisfactory rating. They therefore feared that low grade rating would translate to poor corporate image for their company and loss of investor's confidence. So they would prefer not to obtain the ratings at all.

The following additional factors were suggested by the CMA as factors hindering companies from obtaining credit rating in Kenya.

- Most of the listed companies in Kenya are equity issuers, credit rating has traditionally been required for issuers of debt instrument Equity issuers who conform to the minimum eligibility requirement do not need to be rated.
- Debt issuers who have their equity already listed at the NSE are not required to be rated as they already qualify to MIMS and FISMS and are deemed to be financial stable.

## **4.6 FINDINGS FROM CAPITAL MARKET AUTHORITY**

### **4.6.1 Reasons for Allowing Companies to Issue Debt without Being Rated**

The following were found to be the reasons for allowing companies to issue debts without being rated even there was a credit rating agency already licensed.

- i) Under developed rating industry in Kenya was the main reason. Only one company is licensed, this puts into focus the capacity, cost and speed of obtaining rating which may delay on application.
- ii) Companies that have a bank guarantee need not be rated especially if they fail to meet only a few of the requirement of FISMS.
- iii) Investors in these companies are high - net – worth, sophisticated and well informed and can make a decision on investment without needing to look at ratings. Mostly these investors are institutions but not individuals.
- iv) As per the current legal framework, there is no provision for rating in the FISMS, hence no need to be rated.

### **4.6.2 Factors Hindering Kenya from Obtaining Credit Rating**

1. The government has not appreciated the importance of sovereign rating as a concept so there is need for more awareness of the benefit that can accrue if the country obtained this rating. According to CMA this has been seen as one of the major impediment that have to be sorted out before making it mandatory for all existing and potential issuers of securities to the capital market to be rated.
2. Kenya as a country has not explored the idea of issuing an international debt instrument such as the Eurobond, since the bond market is still very young. The

listing of government of Kenya treasury bonds started in 1986. Hence no need to be rated.

3. Lack of political will. Kenyan in political leadership fear that due to actual and perceived corruption and other forms of political instability the country is at present more likely to get a poor rating so they rather not.
4. Rating is very tricky for Kenya according to East African (2004), countries that pursue balanced budget policies and protect individual property rights stand a better rating than those that don't. The two factors none of the three East African countries would confidently aim for a high level rating. Kenya has two cases pending in international courts over the abuse of individual rights, one at the COMESA court of justice and other at the international centre for settlement of investment dispute, a World Bank affiliate. Therefore at the moment Kenya is not likely to obtain high-grade rating and if poorly rated, investors will translate it as a poor choice for investment. Therefore there is still some reluctance.
5. Sovereign ratings act as a benchmark for corporation rating. If Kenya is poorly rated, this can be a substandard level for companies to measure themselves, therefore there is still some reluctance as Kenya is not sure of obtain high grade rating.

The study also found out that important factor that influences company to obtain credit rating was to create good corporate image. This factor had a mean rank of 2.2. It was found that rated companies were able to differentiate themselves from other companies in the industry, therefore by obtaining and maintaining good rating grade companies were able to create and maintain goodwill with the public.

Fairly important factors encouraging companies to obtain credit rating include the factor as a measure of the company's position in the market and as a requirement by major shareholders. These factors had a mean rank of 3.4 and 3.9 respectively although it is not the primary objective of obtaining rating of the most companies as there are other ways of obtaining the company's rank in the market, this factor was found to be fairly important as the ratings grade were universal scale so companies would be able to rank

## CHAPTER FIVE

### SUMMARY OF FINDINGS, CONCLUSIONS AND SUGGESTIONS FOR FURTHER RESEARCH.

#### 5.1 Summary of Findings

This study was set out to achieve the following objectives

- i) Factors encouraging companies to obtain credit rating in Kenya
- ii) Factor hindering companies from obtaining credit rating among public listed companies in Kenya.

Regarding the objective of determining factors encouraging companies to obtain credit rating in Kenya, the study found out that; the most important factors that encourage companies to obtain credit rating in Kenya are, as a requirement by major trading partners and for the purpose of marketing the company to their customers. These factors had a mean rank of 1.2 and 1.6 respectively. These factors were highly rated by companies that are operating in international markets as rating were found as important tool of communicating the quality of the firm in the market, which assisted in marketing the company as well as determining the very access to this markets and the cost (conditions) of the accessing the market.

The study also found out that important factor that an influences company to obtain credit rating was to create good corporate image. This factor had a mean rank of 2.2. It was found hat rated companies were able to differentiate themselves from other companies in the industry, therefore by obtaining and maintaining good rating grade companies were able to create and maintain goodwill with the public.

Fairly important factors encouraging companies to obtain credit rating include the factor as a measure of the company's position in the market and as a requirement by major shareholders. These factors had a mean rank of 3.4 and 3.9 respectively although it is not the primary objective of obtaining rating of the most companies as there are other ways of obtaining the company's rank in the market, this factor was found to be fairly important as the ratings grade were universal scale so companies would be able to rank

themselves locally and internationally. As for the factor the requirement by major shareholder this especially fairly important for multi-national companies rated as this acted as a way of comparison of performance of various subsidiary and for manager's utility.

The unimportant factor that influences companies to obtain credit rating is in order to issue debt instrument. It had a mean rank of 4.6. Debt issuers in Kenya are not required to be rated, therefore companies don't obtain rating in order to issue debt this is because credit rating has not been made mandatory in Kenya for issuers of debt security in the market.

The study also found out that the most challenging factor that companies faced when seeking credit rating was lack of local rating agency. This factor contributed to other challenges like cost and delay on application. Due to lack of local rating company and due to the fact that only one company has been approved as a rating agency in Kenya the study found out the cost of rating is expensive due to lack of alternative in form of costs. Also there was delay for rating on a application, as the rating agencies has to sent rating staff in Kenya, this took some considerable time between the time of application and the time they get rated.

The other factors which was found out to be challenging was cost, this was again due to lack of local credit rating agency and the fact that there is only one approved rater this contributed to increased cost due to lack of alternative in terms of cost and lack of competitive edge.

The least challenging factor that companies face when seeking credit rating was length procedures and formalities. They were no many procedures and formalities apart from just application procedure which most companies didn't find challenging at all.

Other factor suggested by most rated company was delay for obtaining credit rating after application. This was due to fact that global rating company has no physical office in Nairobi and rating staff had come all the way from South Africa.

## **5.2 Conclusions and Recommendation**

The finding of the study indicate that the most important factors that encouraged companies to seek credit rating were as a major requirement by major trading counterparties and for the purpose of marketing the company to customers this is especially true to companies seeking to access international markets, ratings were used as a means of communicating the quality of the firm to the clients and counterparties as these ratings are respected in the markets. It's also noted that ratings also determined the very access to the markets and the cost of accessing the market and therefore a company strived to obtain and preserve satisfactory ratings.

The findings of the study also revealed that the most challenging factors that companies face when seeking credit rating was lack of one or more local rating agencies, this resulted to increased cost of rating and delay of application. Other challenges facing rating include lack of regulatory framework, fear of raters to venture in a small corporate debt market, high cost or rating, lack of awareness of potential issuers, few issues of debt instruments and the competency of current rating company.

### **Recommendations**

In the light of the finding of the study, the study recommends the following: -

1. Educational campaigns to sensitize debt issuers, investors and the government on the role of credit ratings. A programme should be put in place to create more awareness on the importance of credit rating to the debt issuers, this will be able to encourage debt issuers to obtain ratings for their debts, consequently creating demand for ratings and therefore entrepreneurs will not fear venturing into the industry.

The government should be sensitized on the need to obtain credit rating because it will act as benchmark for corporate ratings. Investors should be sensitized on the importance of credit ratings and if they could require debt issuers to be rated, this would go long way to encouraging debt issuer to be rated.



2. Regulators should play a supportive and facilitative role in the development of credit rating and rating of more companies for example by encouraging all debt issuers to be rated.
3. Establish a regulatory framework to govern credit rating, this is seen as a major challenge facing credit rating. With a legal framework in place credit ratings become enforceable.
4. Review of the guidelines for approval of credit rating. These guidelines are too restrictive despite the fact that they are supposed to protect investors. If appropriate guidelines are in place, this could go along way in seeing more credit rating agencies being established which could encourage more companies to obtain ratings.

### **5.3 Limitation of the Study**

1. There was a time constraints in carrying out the study. Most corporate officers who were the targets for the questionnaire and personal interviews were very busy and most of the time when questionnaires were to be picked they had not been completed or interviews when interviews were to held they kept on postponing appointment.
2. Most of the companies were reluctant to participate in the research and secretaries and guards of some companies were under strict instruction not to take any questionnaire.
3. The study might have yielded more information had the response rate been higher.
4. The study only focused mostly on the companies listed in the NSE to identify factor encouraging and hindering companies to obtain credit rating. However in Kenya there are less than 60 companies listed and there are many other private companies. Therefore the findings of the study cannot be generalized to all companies in Kenya.

## 5.4 Suggestion for Further Research

1. A study can be carried out to investigate factors influencing companies to obtain credit rating among other body corporate other than those quoted in the NSE.
2. A study can be carried out to determine the role of credit rating in the Kenyan economy.
3. A further study can be undertaken to establish the challenges facing credit rating in Kenya. This study just outlines a few as it was not one of it's objective, therefore a detailed investigation can be carried out.

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## Appendix 1

### LETTER OF INTRODUCTION

Mbuki J. Nyambura  
University of Nairobi  
Faculty of Commerce  
P.O Box 30197  
Nairobi.

Dear Sir/Madam,

I am a master's degree student in the faculty of Commerce University of Nairobi. I am required to undertake a research on a management problem as part of my degree. Towards this end, I am conducting a study on credit rating in Kenya. The aim of the study being to establish reasons why companies participate in credit rating in Kenya and the factors hindering companies from participating in credit rating in Kenya so as to make recommendations.

You have been selected to form part of this study to this end, I kindly request for your assistance in completing the questionnaire.

The information data required is needed for academic purposes only and will be strictly confidential.

A copy of the research project will be available to your firm on request.

Yours faithfully

**Jane Nyambura**

MBA Student

**Appendix 2 (a)**

**Questionnaire**

**SECTION 1: General Information**

1. (a) Name of your organization \_\_\_\_\_
- (b) Ownership of the firm (tick the appropriate answer)
- i) Foreign owned
  - ii) Locally owned
  - iii) Partly local and foreign owned
  - iv) Partly government and local owned
  - v) Government owned
- (c) For how long has your company been operating in Kenya (duration in years) \_\_\_\_\_
- (d) What is the nature of your business \_\_\_\_\_
2. Does your company currently have any loans? Yes  No
- If yes go to 3. If No go to section 2 or 3
3. Please provide a summary of the loans and indicate whether these are secured or not in the table

| Amount of loan<br>Kshs. Million | (Average) interest<br>charged on loan per<br>annum | State whether<br>secured or<br>unsecured | For secured<br>loan state<br>nature of<br>security | For unsecured loan,<br>indicate the basis of<br>obtaining loans i.e.<br>guarantors, image of the<br>company etc |
|---------------------------------|--|--|--|---|
|                                 |  |  |  |   |
|                                 |  |  |  |   |
|                                 |  |  |  |   |
|                                 |  |  |  |   |
|                                 |  |  |  |   |

**Section 2: To be completed by those companies which have been rated**

1. When was your company first rated? \_\_\_\_\_
2. Have you ratings been revised (down graded or upgraded) or reaffirmed after the first rating? Yes  No

If yes were you last revision or reaffirmation (state the year) \_\_\_\_\_

3. Briefly describe the process that the company went through so as to be rated. Include details such as the department that initiated the process, the stages, which followed, and the time taken at each stage.

1. \_\_\_\_\_

2. \_\_\_\_\_

3. \_\_\_\_\_

4. \_\_\_\_\_

5. \_\_\_\_\_

6. \_\_\_\_\_

Others: Please specify and rank \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Please tick the challenges your company encountered when obtaining credit rating and rank them

Key

1. Most challenging

3. Challenging

2. Least challenging

1. Not challenging

4. The following are the common reasons of why companies participate in credit rating. Please indicate how important each of the factors is important to your company based on your rating.

- a) In order to issue debt instrument
- b) A requirement by major trading partners
- c) For the purpose of marketing the company to customers
- d) To create good corporate image to the public
- e) As a measure of the company position in the market
- f) A requirement by major shareholders

**Key**

- 1. Very important
- 2. Important
- 3. Fairly important
- 4. Unimportant
- 5. Totally unimportant
- 6. Irrelevant

**Others:** Please specify and rank \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

5. The following are the some challenges companies encounter as they obtain credit rating.

Please tick the challenges your company encountered when obtaining credit rating and rank them

**Key**

- 4 Most challenging
- 3 Challenging
- 2 Least challenging
- 1 Not challenging



- a) Cost
- b) Lengthy procedures and formalities
- c) Lack of a local credit rating agent in Kenya

**Others:** Please specify and rank \_\_\_\_\_

6. What can be done to improve credit rating in Kenya?

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_
4. \_\_\_\_\_
5. \_\_\_\_\_

**Section 3: To be completed by those companies which are not rated?**

1. Are you aware of credit rating? Yes  No
2. Are you aware that the CMA is considering making it mandatory for all companies to be rated if they want to issue securities in the market?  
Yes  No

3. Have you ever sought Credit Rating? Yes  No

Indicate the reasons why you are not rated if you ever sought Credit rating

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

4. Are you considering seeking Credit Rating? Yes  No

5. In your opinion, are there any advantages that may accrue to your company from credit rating?

If Yes state them

---

---

---

6. The following are some of the common factors that hinder companies from participating in credit rating in Kenya. Please tick any of the factors that is hindering your company from being rated and suggest a remedy/solution.

1. The rating reports are publicly available and there is fear of public scrutiny

---

2. The competitor can use rating reports to the disadvantage of those being rated

---

3. Incase of downgrade, there is a likelihood of confidence loss and this may subject the company to liquidity problems

---

4. Any other specify and suggest a remedy

---

Appendix 2 (b)

**CAPITAL MARKET AUTHORITY**

1. What factors do you think are hindering listed companies from participating in credit ratings? Please list them and suggest any remedies.
  - a) \_\_\_\_\_
  - b) \_\_\_\_\_
  - c) \_\_\_\_\_
  - d) \_\_\_\_\_
  
2. What are the reasons for allowing companies to issue debts without being rated and you have already licensed a credit rating agency?
  - a) \_\_\_\_\_
  - b) \_\_\_\_\_
  - c) \_\_\_\_\_
  - d) \_\_\_\_\_
  
3. What is hindering Kenya from obtain sovereign credit ratings
  - a) \_\_\_\_\_
  - b) \_\_\_\_\_
  - c) \_\_\_\_\_
  - d) \_\_\_\_\_
  
4. What are the challenges facing credit rating in Kenya
  - a) \_\_\_\_\_
  - b) \_\_\_\_\_
  - c) \_\_\_\_\_
  - d) \_\_\_\_\_

## **Applicant's requirements to be approved and registered as a rating agency**

### **1. Core professional capacity**

The applicant must have the capacity to perform the role of rating and must have a background and experience as well as professional expertise to provide the service.

### **2. Objectivity and independence**

The applicant must demonstrate its independence and objectivity. It must not be associated directly or indirectly with group (s) who have conflicting interests in the area of rating business and must also demonstrate that it has proven rating methodology.

The rating process must be based on quantitative and qualitative review of facts and must not rely on hearsay or rumours to downgrade or upgrade a particular issuer or issued financial instrument.

### **3. Ownership**

The applicant must be a body corporate with an institutional shareholding of repute. This is aimed at ensuring independence and objectivity of the rating firm.

The applicant should partly be owned by an internationally recognized rating agency or have a contractual arrangement with an internationally recognized rating agency that provide technical and strategic support drawn from international experience.

Agency that provide technical and strategic support drawn from international experience.

### **4. Capital requirements**

The applicant shall have a stable financial base with a minimum paid up capital of Kshs. 12 million.

### **5. Disclosure of information by rating agency**

The rating agency must disclose to the Authority, issuers, and the general public the following: (i) General fee structure or any change thereof (ii) Downgrading of ratings (iii)

Disclosure of rating of commercial paper or corporate bonds as applicable.

(iii) Disclosure of rating of commercial paper or corporate bonds as applicable.

## 6. Confidentiality

The rating agency must have a system of maintaining on a confidential basis, information supplied strictly for the purpose of rating by issuers in order to safeguard and promote confidence in rating process.

7. Documents to accompany the application for approval and registration of a credit rating agency are:

- Certificate of incorporation, Memorandum and Articles of Association;
- Business plan (to include resumes of top management staff, management structure, a brief on the rating methodology, rating grades, fee structure)
- A sample of a standard agreement between the rating agency and its clients; and
- Draft sample “ letter of requests” for rating accompanied by a draft of the “information requirements for rating securities”

|            |         |       |      |  |           |
|------------|---------|-------|------|--|-----------|
| Egypt      | Aug -02 | Fitch | BB+  | Principal                              |           |
| Morocco    | Feb -03 | S & P | BB   | "                                      |           |
| Cape Verde | Aug -03 | Fitch | B+   | Predominantly Speculative              |           |
| Lesotho    | Sep -02 | Fitch | B+   | "                                      |           |
| Senegal    | Dec -00 | S & P | B+   | "                                      |           |
| Ghana      | Aug -03 | S & P | B+   | "                                      |           |
|            | Dec -03 | Fitch | B    | "                                      |           |
| Cameroon   | Sep-05  | Fitch | B    | More speculative than B+               |           |
| Mozambique | July-03 | Fitch | B    | "                                      |           |
| Gambia     | Nov-02  | Fitch | B-   | Has a very high degree of speculation. |           |
| Malawi     | May -03 | Fitch | CCC+ | Has the highest degree of speculation. | Very poor |

## Appendix 4

| Country      | Last rating | Agency  | Rating | Meaning   | Quality      |
|--------------|-------------|---------|--------|---|--------------|
| Botswana     | Feb - 03    | S & P   | A      | Has a strong capacity to pay interest and repay principal.                                    | High quality |
| Mauritius    | May-00      | Moody's | Baa    | Has an adequate capacity to pay interest and repay principal.                                 | "            |
| South Africa | May -03     | Fitch   | BBB    | "   | "            |
| Tunisia      | May - 01    | Fitch   | BBB    | "   | "            |
|              |             |         |        | Has lowest degree of speculation with respect to capacity to pay interest and repay principal | Speculative  |
| Egypt        | Aug - 02    | Fitch   | BB+    | "   | "            |
| Morocco      | Feb - 03    | S & P   | BB     | "   | "            |
| Cape Verde   | Aug - 03    | Fitch   | B+     | Predominantly Speculative   | "            |
| Lesotho      | Sep - 02    | Fitch   | B+     | "   | "            |
| Senegal      | Dec - 00    | S & P   | B+     | "   | "            |
| Ghana        | Aug - 03    | S & P   | B+     | "   | "            |
|              | Dec - 03    | Fitch   | B      | "   | "            |
| Cameroon     | Sep-03      | Fitch   | B      | More speculative than B+  | "            |
| Mozambique   | July-03     | Fitch   | B      | "   | "            |
| Gambia       | Nov-02      | Fitch   | B-     | Has a very high degree of speculation   | "            |
| Malawi       | May - 03    | Fitch   | CCC+   | Has the highest degree speculation  | Very poor    |

Appendix 5

Table 1

| LONG TERM DEBT          |                             |   |   |
|-------------------------|-----------------------------|---|---|
|                         | Rating                      | Meaning   | Quality   |
| <i>Investment Grade</i> | AAA                         | The risk factor are negligible, being only slightly more than for risk free government bonds  | Highest   |
|                         | AAA+<br>AA<br>AA_           | Protection factors are very strong. Adverse changes in business, economic or financial conditions would increase investment risk, although not significantly  | Highest   |
|                         | A+<br>A<br>A_               | Protection factors are good. However, risk factors are more variable and greater in periods of economic stress.   | Highest   |
|                         | BBB+<br>BBB<br>BBB-         | Adequate protection factors are considered sufficient for prudent investment. However, there is considerable variability in risk during economic cycles   | Speculative   |
|                         | <i>Non investment grade</i> | BB+<br>BB<br>BB-  | Present prospective financial protection factors fluctuate according conditions of company fortunes. Overall quality may move up or down frequently within this category. |
| B+<br>B<br>B-           |                             | Financial protection factors will fluctuate widely according to economic cycle, industry conditions and/or company fortunes.  | Speculative   |
| CCC                     |                             | Considerable uncertainty exists as to timely payment of principal or interest. Protection factors are narrow and risk can be substantial with unfavourable economic/industry conditions, and / or with unfavourable company developments. | Very poor   |
| DD                      |                             | Issuer failed to meet scheduled principal and / or interest payments.   | Default   |

Table 2

Appendix 6

| <b>SHORT TERM DEBT</b>        |               |   |                |
|-------------------------------|---------------|---|----------------|
|                               | <b>Rating</b> | <b>Meaning</b>  | <b>Quality</b> |
| <b>High grade</b>             | A1+           | Short-term liquidity, including internal operating factors and/or access to alternative sources of funds, is outstanding, and safety is just below that of risk free treasury bills.      | Highest        |
|                               | A1            | Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.   | Highest        |
|                               | A1-           | Liquidity factors are excellent and supported by good fundamentals protection factors. Risk factors are very small  | Highest        |
| <b>Good Grade</b>             | A2            | Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small. | Good           |
| <b>Satisfactory Grade</b>     | A3            | Satisfactory liquidity and other protection factor qualify issues as to investment grade however risk factors are larger and subject to greater variation.                                |                |
| <b>Non – investment grade</b> | B             | Liquidity is not sufficient to insure against disruption in debt service. Operating factors and market access may be subject to a high degree of variation.                               | Speculative    |
|                               | C             | Issuer failed to meet scheduled principal or interest payments.   | Very poor.     |
|                               |               |   |                |



## Appendix 6

### List of companies listed in Nairobi Stock exchange

#### Main investment market segment

##### Agricultural

Unilever Tea Kenya Ltd

Kakuzi Investments Ltd

Rea Vipingo Plantations Ltd

Sasini Tea & Coffee Ltd

##### Commercial and services

Car & General (K) Ltd

CMC Holdings Ltd

Hutchings biemer Ltd

Kenya airways Ltd

Marshalls (E.A) Ltd

Nation Media Group

TPS Ltd

Uchumi supermarket ltd

#### Alternative investment market segment

##### Finance and investment

Barclays Bank Ltd

C.F.C Bank Ltd

Diamond Trust Bank Kenya Ltd

Housing Finance Co. Ltd

I.C.D.C. Investments Co. Ltd

Jubilee Insurance Co. Ltd

Kenya Commercial Bank Ltd

National Bank of Kenya Ltd

NIC Bank Ltd

Pan Africa Insurance Holdings Ltd

Standard Chartered Bank Ltd

**Industrial and Allied**

Athi River Mining

B.O.C Kenya Ltd

Bamburi Cement Ltd

British American Tobacco Kenya Ltd

Carbacid Investments Ltd

Crown Berger Ltd

Olympia Capital Holdings Ltd

E.A cables Ltd

E.A Portland Cement Ltd

East African Breweries Ltd

Firestone east Africa Ltd

Kenya Oil Co. Ltd

Mumias Sugar Co. Ltd

Kenya Power & lighting Ltd

Total Kenya Ltd

Unga Group Ltd

**Alternative investment market segment**

A. Baumam & Co. Ltd

City Trust Ltd

Eaagads Ltd

Express Ltd

Willimson Tea Kenya Ltd

Kapchorua Tea Co.Ltd

Limuru Tea Co. Ltd

Standard Group Ltd

## **Bonds**

Safaricom Medium Term notes

Shelter Afrique medium

Mabati Rolling Mills Ltd

East Africa Development Bank