RISK MANAGEMENT STRATEGIES ADOPTED BY KENYAN COMMERCIAL BANKS IN LENDING TO SMES

BY

LILIAN BUSHURU MUCHITI

D61/P/8427/2005

A MANAGEMENT RESEARCH STUDY SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF MASTERS OF BUSINESS ADMINISTRATION (MBA) DEGREE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

2009

DECLARATION

This Management Research Project is my Original Work, and has not been presented for the award of a degree in any other university

SIGNED DATE

………………………. …………………

LILIAN BUSHURU MUCHITI

This management research project has been submitted for examination with my approval as the university supervisor

SIGNED DATE

……………………….. ………………….

WINNIE NYAMUTE
LECTURER, DEPARTMENT OF FINANCE & ACCOUNTING,
SCHOOL OF BUSINESS,
UNIVERSITY OF NAIROBI

2009

DEDICATION

To my loving parents Philip Muchiti Shitanda and Elizabeth Masitsa Shitanda for your unconditional love, and support always; you have made me who I am today. To my siblings Eric, Hillary and Sylvia, for your constant prayers and encouragement that saw me complete my MBA Study. I share this success with you all. God bless you!

ACKNOWLEGMENT

I would like to acknowledge the support and contribution of individuals and institutions that have made the publication of this project possible. First, I would like to thank my Supervisor, Winnie Nyamute whose contribution, comments and guidance were extremely useful in writing and improving the various chapters of this project.

I wish also to give thanks to my Parents, Family, and Colleagues in MBA Class/Workmates for their unwavering support and prayers that ensured my success in this programme.

Special thanks to my workmates Elizabeth Kisebu and Andrew Nyakundi for their valuable input in the project.

My profound gratitude goes to my dear Friend and Fiancé June James Okall, for critically reviewing the project, and whose views shaped the final presentation of this project.

Above all, I thank you Almighty God for all your Grace and Mercies!

TABLE OF CONTENTS

ABSTRACT

In the recent past, there has been an increased effort in the country to fund credit small-scale enterprises. Awarding this credit to the small scale enterprises is a journey, whose success depends on the methods applied to evaluate and award the credit so as to minimise the risk the banks expose themselves in and how the banks mitigate the same risks. It is with this regard that the study seeks to identify the institutional risk management strategies applied by commercial banks in lending to SMEs.

The research was a survey that was conducted within all the banks represented in Nairobi, An exploratory survey was used in carrying out this study. The study focused on all commercial banks in Kenya who have well established SME products. According to the Central Bank of Kenya Act Chapter 491, there are forty six commercial banks operating in Kenya, with one bank under statutory management. The research drew its data from primary sources using a structured questionnaire. Both E-mail system and the use of the “drop & pick later” method were used to collect the data. The questionnaire was administered to the Credit-Manager or their equivalent in each banks office. Data from the questionnaire was coded to facilitate statistical analysis.

The data was organized through frequency tables, to enable develop a summary of the data collected and to organize it into meaningful form. Percentages were used to compare groups of the different sizes.

The results of the research revealed that there were three distinctive institutional risk management strategies that are applied by Kenyan banks in lending to SME borrowers. These are risk pooling strategies, the risk control strategies and risk avoidance strategies. The research indicated that the institutional context in Kenya has determined how the banks handle the three risk strategies.

CHAPTER ONE

1.0 INTRODUCTION

1.1. Background to the Study

New innovations in banking have resulted in making banking business more complex and potentially riskier. This has presented new challenges to banks as they have to developed new methods and processes for monitoring and assessing the banking operations on a continuous basis. Particular attention is being paid in this regard to improving the quality of bank examinations and to the development of systems that can identify changes that would result in the operations of the banks, due to the new innovation. More emphasis is on identifying changes in the deterioration of a bank's financial condition as early as possible (Sahajwala and Paul, 2000). Amongst the various new initiatives that have been taken or are being taken in this respect are the development of more formal, structured and quantified assessments not only of the financial performance of banks but also of the underlying risk profile and risk management capabilities of individual institutions. Collectively these various new approaches can be termed "risk assessment and early warning systems".

Butterworth (1990) asserts that effective risk management, from the point of view of financial institutions, is the key to the future success in banking and therefore these institutions should focus on professional management of risk. The successful financial institutions are and will increasingly be those that develop focused strategies, lower their overhead ratios, ingeniously exploit their advantages and know how to calculate their risks. One of the most important areas of concern to banks in credit risk management as a result of their lending business is to be integrative in terms of the risk a bank is taking in doing business; by client, by channel, by product, by business, by industry, by currency and by country. Banks will put out lines of business as well as of areas, where the risk they are taking is disproportionate compared to the profit they make or hope to make (Hempel, et. al., 1999).

Businesses get capital from various sources. Large national and multinational companies make use of alternative sources of finance, such as stock market listing, international bond issues, and international markets for corporate lending which often involve transactions with financial actors other than just banks. However, small and medium-sized enterprises, who account for a very significant part of economic activity in Kenya, have very limited access to such alternative sources of finance and therefore still dependent on expensive bank financing.

Commercial banks and other formal institutions fail to cater for the credit needs of smallholders, mainly due to their prohibitive lending terms and conditions. The rules and regulations of the formal financial institutions created the myth that the poor are not bankable because they cannot afford the required collateral. (Adera,1995). Despite efforts to overcome the widespread lack of financial services, especially among smallholders, and the expansion of credit in the rural areas, the majority still have only limited access to bank services to support their private initiatives (Braverman and Guasch, 1986).

In the recent past, there has been an increased effort to fund credit programmes in the developing countries aimed at small-scale enterprises. In Kenya, despite emphasis on increasing the availability of credit to SMEs, access to credit by such enterprises remains one of the major constraints they face. A 1995 survey of SMEs found that up to 32.7% of the entrepreneurs surveyed mentioned lack of capital as their principal problem, while only about 10% had ever received credit (Daniels et al., 1995). Although causality cannot be inferred a priority from the relationship between credit and enterprise growth, it is an indicator of the importance of credit in enterprise development. The failure of specialized financial institutions to meet the credit needs of such enterprises has underlined the importance of a needs-oriented financial system for rural development. (Mc Cormick, 2001) observed that targeting support for small and medium sized enterprises in Kenya is difficult mainly due to the sub-optional capitalization and capital structure of the enterprises, poor management and technical skills, weak market linkages and alliances and finally, scares business opportunities and associated networks. The result is a high mortality rate of the local enterprises and reluctance of the banks to offer the finance.

The institutional environment has furthered a more arms-length relationship between SMEs and banks (CBK, 2001). A greater instability in the economic and institutional environment, a higher concentration in the banking sector, combined with a stronger orientation towards trade and international finance, as opposed to industrial and domestic finance, have historically hampered the development of a closer relationship between SMEs and banks (Lane and Quack, 2002). More recently however, the relationship between banks and SMEs in Kenya appears to have improved, due to stabilization of the economic environment, as well as to various initiatives from economic and political actors in favour of bank finance for SMEs.

The study thus seeks to analyze in more detail the role of banks in financing SMEs in Kenya. It presents an institutional approach, developed in an earlier paper (Lane and Quack, 1999), to how banks in different institutional contexts construct and manage risk relating to SME business. Clarke (1999) tells us that awarding credit is a journey, the success of which depends on the methodology applied to evaluate and award the credit. This journey starts from the application for credit and ends at the time the loan from the credit is fully paid. Like any human journey, the credit management process has got smooth paths, impediments and detours before the destination is reached. Therefore the credit needs to be effectively controlled for it to succeed eventually. Credit control can rightly be said to start when the client walks into the office. If during the discussion, with the client, the credit manager finally agrees to grant credit, the lender has embarked on a journey called credit control and the nature of that journey will directly be influenced by the quality of that decision (Clarke, et al., 1999).

Lane and Quack (2000) in their study on sociological institutional lending argued that in order to understand cross-national and cross-organizational divergence in bank managerial practice of risk assessment it is necessary to consider the institutional environment in which these relations are embedded (Lane and Quack, 2002). In order to apply such a perspective to the analysis of risk behaviour in banks the study suggests integrating recent sociological writing on risk with institutional and neo-institutional sociological theory emphasizing the social embeddedness of perception and handling of risks. Sociological authors such as Luhmann (1993) and Baecker (1991) have argued convincingly that perceptions and attitudes towards risk are socially constructed. According to this view, risk is not an ‘objective’ fact out in the business environment which can be assessed through probability calculus but is continually created by bankers themselves when they make decisions in relation to observed risk structures and risk behaviour of potential business partners in their environment. The future is unpredictable thus, any decision involves risk might lead to losses, or it might entail missing valuable opportunities. In order to deal with this uncertainty, banks have developed into 'specialized second order observers' which attempt to monitor how their potential business partners deal with risky decisions (Baecker, 1999).

Small-scale enterprises have become an important contributor to the Kenyan economy. The sector contributes to the national objective of creating employment opportunities, training entrepreneurs, generating income and providing a source of livelihood for the majority of low-income households in the country (Republic of Kenya, 1989, 1992, 1994), accounting for 12-14% of GDP. With about 70% of such enterprises located in rural areas, the sector has a high potential for contributing to rural development. Yet the majority of entrepreneurs in this sector are considered uncreditworthy by most banks (Atieno, 2001). Whereas a small number of NGOs finance an increasing number of SME activities, most formal institutions still deny these enterprises access to their services due to the nature of these businesses. It is with this in mind that the researcher focuses the study on small firm lending.

From the theoretical perspective suggested above, risk is not something objective existing 'out there' in the business environment but is instead socially constructed by banks themselves. In the case of small firm lending, this means that risk will be defined by bankers in the course of their decision making during the lending process. The motivations, perceptions and implicit rationalities which enter into this decision making process reflect the institutional rule systems of the banks in which they work. These organizational rule systems are shaped by the institutional context of their society (Lane and Quack, 2002).

Lane and Quack (2002) in a survey on British and German banks analyzed the impact of the institutional environment on risk handling strategies of banks. They assumed that the institutional context affects the risk handling strategies in both countries, with respect to the degree and forms in which they attempt to externalize part of the risk involved in lending to

SMEs. Externalization can occur through pooling it with other institutions or by displacing it onto individual customers. Furthermore, they expect the institutional environment to impact on the ways in which banks internalize the handling of the remaining risk involved in lending to SMEs in their decision making processes on such lending, as reflected in their organizational structures, informal routines and rule systems. They focus on how banks as organizations construct and manage risk involved in lending to SMEs in different institutional contexts.

Lane and Quack (1999) suggest that banks in Britain and Germany focus on distinctive risk handling strategies which have motivated this study to determine if the Kenyan Banks do have their own distinctive strategy. British Banks, operating in what, following Douglas and Wildavsky (1982), can be characterized as a 'market-type' institutional setting, which tends to externalize risks as far as possible by transferring it to customers.

In contrast, German Banks, situated in a more hierarchical bureaucratic and coordinated institutional setting which ensures them a greater amount of ex ante risk reduction, should focus more on the management and control of internalized risk. If externalization of risk takes place in German banks, it should take collectivist forms of risk sharing with intermediary organizations such as public loan guarantee schemes which have been in existence for a longer time and have a more encompassing character in Germany than in Britain.

Externalization of risk by transferring it to customers can occur in different forms: British banks are said to make little effort to appraise individual loan applications, and use instead, interest rate to price for risk differentials (Cosh and Hughes, 1994). The literature also suggests that British banks tend to lend more often short-term and at variable interest rates than their German counterparts, thereby displacing risks which they incur on the refinancing side to their customers (Deakins and Philpott, 1993). Another form of transferring risk to customers is to ask for higher collateral for loans which are considered to involve above average risks. Whereas some studies report that British banks tend to take more collateral (Kaufmann and Kokali, 1989; Binks, 1991), other studies did not find any differences in volume (Bank of England 1995a) but reported that different kind of securities were being asked for. British banks are said to take private property more often, whereas German banks take mainly business assets (Kershaw, 1996).

Financial institutions identified credit risk management as a far bigger issue than a simple matter of regulatory compliance, according to the findings of a recent survey from Risk Waters Group and SAS, the leader in business intelligence www.sas.com/crsurvey. The global survey of more than 250 financial institutions and regulators sought to identify the business drivers behind credit risk programs and how they relate to regulatory requirements. Companies have identified longer-term benefits and economic rewards as top benefits for improving their credit risk management function, such as improved business and performance management and improved risk-based pricing. Overwhelmingly the findings show that organizations anticipate significant rewards, including a 10 percent reduction in economic capital and a 14 percent reduction in the cost of credit losses.

1.2. Statement of the Problem

Bank financing of small and medium-sized enterprises (SMEs) recently received renewed interest as a result of the internationalization of financial markets for corporate finance (Vitolis, 2000; Deeg and Lutz, 2000). Additionally the enforcement of the Micro Finance Act is set to have a profound impact on the Kenyan banking system. The level of nonperforming loans has continued to increase, posing a great danger to the entire financial system in Kenya. Bank lending to the SME sector poses the greatest default risk and thus the need to investigate what risk management strategies banks use in their case.

The credit crisis has forced banks in Kenya to take a critical look at how they manage risk. This has exposed some significant weaknesses in risk management across the financial services industry in Kenya. On first examination, the current predicament appears to stem from the pursuit of revenue growth in a world of easy credit. The reality of course is more complex, and a number of themes emerge. Examples include, weaknesses in the risk culture and governance, gaps in risk expertise at the non-executive board level, lack of influence of the risk function, lack of responsibility and accountability on the part of those on the front line, a compensation culture too oriented toward year-on-year profit increases, and business models that were overly reliant on ample market liquidity.

Many surveys on formal and informal credit sources in Kenya have been mainly qualitative in nature (Raikes, 1989; Alila, 1991; Dondo, 1994; Daniels et al., 1995). Zeller (1993, 1994) used a univariate probit model to estimate the factors that determine an individual's borrowing decisions, in terms of their participation in formal or informal credit markets. The market segments are treated separately in order to identify similarities and differences between the sectors in credit applications and rationing. The results show that among the informal lenders, age, schooling, wage, income, sick days and household headship are significant determinants of applications for credit.

Oduor (2007) observed using quantitative techniques that commercial banks have credit risk assessment polices as a basis for objective credit risk appraisal. The study also showed that banks involve their employees in developing the credit risk assessment policies. In addition, the commercial banks use the credit risk manual to sensitize their employees on the credit risk assessment. These banks also have a separate department that handles all credit related processes. Kimeu (2008) used quantitative models to indicate the techniques used by commercial banks in evaluating their risk of their unsecured loan book. Subjective decision making by senior management of the commercial banks may lead to problems associated with credit. This includes extending credit to companies they own or are affiliated, to personal friends, to persons with a reputation for non financial acumen, to meet a personal agenda, such as cultivating a special relationship with celebrities or well connected individuals, and finally lend for the sake of obtaining a set target, paying no regard to the qualities of the lender. A solution to this may be the use of tested lending techniques and especially quantitative ones, which filter out subjectivity (Gruening, et.al., 1999).

Despite all the models and controls put in place by banks in measuring credit risk, the level of nonperforming loans has continued to increasing, thus posing a great danger to the entire financial system in Kenya .There is need to determine whether the sociological institutional approach to lending will provide a remedy. The basis of this research is thus to determine the factors that banks focus on in constructing and managing risk using the sociological approach, with emphasis to small firm lending in Kenya. Externalization of risk by transferring it to customers for instance through high interest rates to price for risk would suggest that banks would make little effort to appraise loan applications further increasing the non performing loans portfolio. There is need to determine whether the institutional approach to lending will provide a remedy to commercial banks in managing risk related to SMEs.

1.3. Objective of the Study

To identify the institutional risk management strategies applied by banks in lending to SMEs.

1.4. Importance of the Study

Banking Industry

The study will be significant to the banking industry, especially to Credit Units. It will highlight the challenges faced by the banking industry when identifying, appraising, awarding and managing their loan clients and portfolios, in addition to the already existing mathematical models that they use to appraise the loans. To other sectors of the economy, it will provide a start to finish account for what informed CEO's should consider when setting up their credit departments or applying for loans from banks.

SMEs

To SMEs the study will be informative on the points to take into account when deciding which sources of finance to go for, other that the more statistical models that have been in place

Finance Managers

Finance managers will be more sensitive to the influence that the risk management techniques may have to the lending decisions to SMEs and thus the overall profitability.

Government

The government policy makers will pursue reforms that will influence the SMEs access to credit; in this regard economic growth is likely to be stimulated.

Scholars

Scholars will study the risk management techniques will be made aware of the association between the credit policies and risk and their influence.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter gives a review of the literature related to the study. It is specifically concerned with how banks construct and manage risk relating to SME business. The review seeks to analyse the types of credit risk management by banks, the techniques structured by banks in their approach to managing the uncertainties through risk assessment and finally the strategies developed to manage and mitigate the risks.

2.1 Types of Risks faced by commercial banks

Risk refers to the potential variability of outcomes from a decision alternative. It can also be defined as the exposure to change or the probability that some future events will occur making the expected and actual outcome to differ from the expected. The wider and regular the variability, the greater the risk. According to Butterworth's (1990), there are numerous risks, facing today's financial institutions. These risks are interrelated hence their effective management is of utmost importance to the performance of the bank. Risk is an integral part of the banking business and hence, every Financial Institution must aim at the delivery of superior shareholder value by achieving an appropriate trade-off between the risks and returns. The banking industry is exposed to various risks, the major ones being credit risk, market risk, liquidity risk, operational risk, compliance risk, taxation risk, reputation risk and business risk.

The focus of this study is on credit risk which is the risk that a customer or counterparty of the bank will be unable or unwilling to meet a commitment that it has entered into with the bank. It is the risk of loss due to the failure of a borrower to meet its credit obligations in accordance with the agreed contract terms. It arises through non-performance by counter-party for facilities used. These facilities include typically loans and advances, including the advancement of securities and contracts to support customer obligations, such as letters of credit and guarantee. The risk apply not only to loans but also to other on-and off-balance sheet exposure such as guarantees, acceptances and security investments (Hempel, et. al., 1994). The largest source of credit risk is loans, although the credit risk exists in other activities of the institution, including acceptances, inter-bank transactions, trade financing, foreign exchange transactions, futures, swaps, options and guarantees. On average the size of the loans portfolio constitutes 63% of the bank's assets in Kenya. This renders credit risk currently the most significant risk to the local banking sector. An effective and sound credit risk management is therefore critical to the success of any banking sector (CBK Risk management survey, 2004).

2.2.1 Risk Management

Risk management is the art and the science of thinking about what could go wrong and what should be done to mitigate those risks in a cost effective manner. Butterworth (1990) asserts that effective risk management, from the point of view of financial institutions, is the key to the future success in banking and therefore these institutions should focus on professional management of risk. The successful financial institutions are and will increasingly be those that develop focused strategies, lower their overhead ratios, ingeniously exploit their advantages and know how to calculate their risks. The most important areas of concern to banks in credit risk management is to be integrative in terms of risk a bank is taking in doing business by client, by channel, by product, by business, by industry, by currency and by country.

Banks will put out of lines of business as well as of areas, where the risk they are taking is disproportionate compared to the profit they make or hope to make (Hempel, et. al., 1999). Credit risk makes up the largest part of the banks risk exposure. Banks measure, monitor and manage credit risk for each borrower and also at the portfolio level. Comprehensive resources, expertise and control must be in place to ensure efficient and effective management of all risks. Most banks have a risk management strategy which is based on a clear understanding of the various risks, disciplined risk assessment and measurement procedures and continuous monitoring. The risk management functions of the banks use comprehensive quantitative tools for the assessment, management and mitigation of risks in the bank.

2.2.2. Prerequisite of Risk Management

One of the most important prerequisite of risk management is that of planning for, the unknown. This requires asking questions such as how to know when adversity will hit and how hard it will be are some of the salient questions that need to be answered. Other important issues to be addressed include examining ahead of time the financial staying power lines of the bank, knowing the defense and mitigations of the risk associated with any line of business, engaged, anticipating and finally responding and cope with changes in the business environment. Operating a financial business has always been a matter of foreseeing and rapidly coping with change. Banks and their customers keep constantly changing, therefore all financial institutions should focus on providing quality services with the changing times. To a large measure adapting to the new environment means changing culture, altering not only the way we have been operating in the past, but also adapting new ways of thinking and doing business (Thygerson,1995).

Risk has to be properly management but not every financial institution seems to be convinced that risk control policies can both limit undue exposure and give the bank a competitive edge. Risk significantly increased when a bank losses its grip in the market as well as when it falls back in skills and technology.

Bank financing of small and medium-sized enterprises (SMEs) and the risks involved in the lending decisions so far, has not received much sociological attention (Lane and Quack, 1999). The subject has mainly occupied economists who, following Stiglitz and Weiss (1981) have viewed bank managers in individualistic terms as rational decision makers. According to Lane and Quack (1999) the latter are perceived to adhere to universally valid assumptions about risk assessment, irrespective of their specific organizational, industry and national environment. This paper aims to develop a sociological perspective on the comparative study of risk in the bank financing of SMEs.

Luce and Raiffa (1957), assert that lenders make decisions on the basis of risk. Risk is a decision making situation in which there is variability in the possible outcomes and the decision maker can specify the probabilities of this outcomes. Risk handling of banks, that is how they deal with and manage risk involved in their decision making, has been largely ignored by sociologists and left for a long time to be analysed by economists (Lane and Quack, 2002). Most economic theories, however, conceptualize decision making of and within banks based on ‘rational actor’ models and mathematically inspired decision theory. Coleman (1990) assert that economic theories assume not only that actors behave rationally if not fully, then at least within the limits of ‘bounded’ rationality. They additionally assume that a clear distinction can be drawn, with the help of statistical probability models, between secure and risky decisions about payments which will be realized in future. Problems of risk handling in banks thus have been perceived predominantly in terms of ‘markets with imperfect information’, ‘bounded rationality of decision makers’, ‘moral hazard’ and ‘adverse selection’ (Stiglitz and Weiss, 1981). The individualist theoretical framework favoured by most economists, however, has difficulties in explaining the variation in approaches towards risk assessment which exists in different national environments, and within them between different types of organizations.

2.3 The Institutional environment

Banks are faced with very different customer demands and hence risk decisions. Although the SME sector is heterogeneous, a stabilizing institutional framework in general (Quack and Hildebrandt, 1995) and the universally high level of skill among business owners/managers, in particular, make the SME population more internally homogenous and stable, and hence easier to classify and less risky.

According to Lane and Quack (1999) there are many institutional factors which impact on risk handling within banks by shaping business goals, time horizons and attitudes towards the future, as well as more general meaning systems and incentive structures which build up interaction with relevant economic and political actors. These factors will influence the level of uncertainty and the kinds of risk with which banks are confronted. At the macro level, these are the role of the state in the economy, the financial system and certain aspects of the legal system. In the more immediate institutional environment of banks, banking regulation, the structure and role of the banking system and the nature of the SME population are vital influences on managerial risk decisions.

In sum, the examination of the institutional environment has revealed how this context is likely to affect the level of uncertainty and the kinds of risks with which banks in Kenya are confronted when lending to SMEs.

2.4. Credit Risk Assessment

According to Saunders (1996), banks need to gather adequate information about potential customers to be able to calibrate the credit risk exposure. The information gathered will guide the bank in assessing the probability of borrower default and price the loan accordingly. Much of this information is gathered during loan documentation. The bank should however go beyond information provided by the borrower and seek additional information from third parties like credit rating agencies and credit reference bureaus.

Rouse (1989) state that applying 'CAMPRI' technique during the initial assessment of the borrower will help in determining whether a loan is good or bad, recoverable or not recoverable. CAMPRI is a technique by which the viability of a proposal is assessed and evaluated. It is an acronym that stands for; Character (says a lot about the probability of a loan arrangement going sour), Ability (borrower's ability in managing financial affairs), Margin (the bank should obtain a reasonable return in view of risk taken), Purpose (should be acceptable to the bank), Amount (the potential customer should justify the amount requested), Repayment (lender should ensure the source of repayment is clear), Insurance (Security is necessary incase the repayment proposals fail to materialize).

If any of these areas are ignored, problems will be encountered sooner or later. A full assessment must be made in order to reach a balanced judgment. Although bad debts can occur for many reasons, the cause of loss to the bank should not be through failure to establish facts or through inadequate analysis of information available.

According to Abedi (2000) banks use the 6 C's to evaluate a customer as a potential borrower. The 6 C's help banks to decrease the risk of default, as they get to know their customers.

According to Abedi (2000) the 6 C’s are; Character, Capacity, Completion, Condition, Contribution and Common sense. Other additional Cs that can be used by banks to decrease the default risk include; Collateral, Capital, Credit, Control, Communication and Cycle. These have been explained in depth below. Banks can use the 12Cs to evaluate potential customers.

Character

Character is among the most difficult to evaluate and can vary tremendously between individual lending officers. A person's character can give the loan officer some insight to their willingness and commitment to pay their debt.

Character traits of honesty, integrity and work ethic typically exhibit commitment; however, the bank also look for responsibility and consistency. The Loan officer is expected to draw from first impressions and subsequent meetings. The Loan officer will also look for the business's current and past successful experiences, an existing or past relationship with the bank, community or charitable efforts, and referrals and references from respected individuals to aid in their character assessment.

An additional factor that the loan officer may consider as evidence of character is the amount of investment the owners are committing to the business. An insignificant investment or lack of sweat equity may suggest a lack of dedication and warrant a denial.

Capacity

Capacity refers to the ability to repay the loan based on management's ability to successfully run the business and generate the income or cash flow required to service the debt. Capacity also refers to an alternative source of repayment such as collateral.

The bank prefers all payments to be made from cash flow and will analyze the financial statements to make this determination. To further secure the debt and mitigate risk, the bank looks to the value of collateral for a secondary source of repayment in case cash flow fails to support the debt payments.

Collateral

Collateral is the most traditional of all the seven Cs, where the bank takes security for funds advanced. The principal collateral types for loans are Mortgages over residential properties, charge over business assets such as premises, inventory and accounts receivable and charge over financial instruments such as debt securities and equities.

Conditions

Conditions refer to external factors beyond the control of the firm that may affect their ability to repay such as the economy and industry specific environments. Repayment sources often vary with the business cycles and the lender will analyze the borrower's vulnerability to changes in conditions such as recessions, interest rate changes, and asset price deflation.

Common sense

Common sense is the intuition that is not always backed up by tangible evidence. An opinion is formed whether a default will occur and this is largely dependent on the credit provider's experience and observation of the particular consumer.

Capital

Capital refers to the wealth position or financial soundness of a business. It represents the equity capital a business has that can be liquidated for payment if all other means fail. Equity in a business can be built through retained earnings, the injection of cash from the owners, and an appreciation of assets greater than liabilities.

The bank expects borrowers to take a certain amount of personal financial risk prior to requesting a loan, and that capital amount represents the owner's personal stake in the business. If the equity is a loan from business owners, the bank will require the business to subordinate that debt.

Credit

The "credit" refers to a credit report or credit reputation and the bank has added credit to its framework of categories to assess borrower risk. Personal and business credit reports should be obtained and reviewed prior to applying for a loan. If there are any errors or discrepancies, they can be corrected before they jeopardize the loan request. An occasional late payment may not adversely affect the credit report or score; however excessive late payments in the 60 to 90 day range, unpaid credits, or judgments will make it difficult to obtain a loan.

Controls

Controls refer to the ability of a firm to safeguard the assets of the organization. It represents the measures taken by the bank to ensure that there is proper accountability in the use of the firms' assets. The borrower is expected to safeguard and make use of the loan amount appropriately and for its intended use. The borrower is them expected to repay the principal and the interest accordingly.

Communication

Communication refers to the involvement and exchange of information between the borrower and the lender, for this case, between the bank and the client. Communication would be in the form of appraisals of loan, bank statement of the client, financial reports from the client that are used to appraise the loan, any other information requested by the borrower in determining the credit worthiness of the client. The bank is also expected to communicate to the client on the progress of the loan and its approval.

Cycle

Cycle refers to the business cycle phase is which the assessment of the loan is being carried out. For example, during recessions, people cut on luxuries and less on food commodities. Thus corporate borrowers in the consumer durable goods sector of the economy are more prone to default risk during such economic phases.

2.5 Nature of Commercial Bank Lending

The various forms of commercial bank cross-border lending are best categorized by the type of risk assumed, the type of borrower, the term of the loan and the nature of the underlying activity being financed. Four fundamental risk categories are briefly characterized below, with an indication of recent trends in the region: unsecured lending, export-secured lending, asset-based finance and secured lending (Sirleaf & Nyirjesy, 1990). While individual transactions often combine different forms of risks, all of the categories are typically counted as cross-border loans in the World Bank Debt.

2.5.1 Unsecured Lending

Unsecured lending encompasses loans that are extended on the basis of the borrower's ability to service the loan from resources generated within the borrowing country and transferred to the lending bank through the country's normal foreign exchange allocation system. The lender assumes both the "commercial" risk, i.e. the borrower's solvency and the 'political" risk i.e. principally that of foreign exchange availability (Sirleaf & Nyirjesy, 1990).

Under this category, the three most prevalent forms of lending to Africa have been the following: Short-term revolving facilities extended to central and commercial banks for the advance settlement of obligations to offshore suppliers of goods and services, typically through confirmation and negotiation of letters of credit or through short-term advances. As these advances are repaid by foreign exchange transfers from the borrowing country, new availability for further advances is created within the limits of the facility; Loans to non-bank borrowers (sometimes underwritten by local banks) in the form of guarantees to their offshore suppliers or through discounted purchases of suppliers' credits; Medium-term loans, typically for specific private or parastatal investment projects, based on the borrower's creditworthiness the viability of a project as established by cash flow projections, and confidence in the availability of foreign exchange for debt servicing.

The degree of risk in unsecured lending tends to increase in those cases where foreign exchange availability is regulated and/or constrained. Thus banks have continued to provide short and medium-term unsecured loans to profitable bank and non-bank borrowers in other regions. Banks have also tended to be more active on an unsecured basis in countries with adequately funded auction systems- such as Guinea, Madagascar and Nigeria, though generally restricted to short-term financing, and in countries that have not experienced payment problems, such as Zimbabwe, Kenya, Ethiopia, Mauritius, Burundi and Rwanda (Sirleaf & Nyirjesy, 1990).

Increasingly banks have been moving away from unsecured lending and for many countries now require some form of offshore security. This may take the form of cash deposits formally committed as collateral, or of revolving flows of export proceeds that are ultimately repatriated to the borrowing country. Thus, partly as a means of preserving commercial bank lending and services, since 1983 Zaire has required that all cross-border loans be fully secured by foreign exchange deposits with the lending bank (Sirleaf & Nyirjesy, 1990).

2.5.2. Export Secured Lending

A variety of mechanisms are used to mitigate transfer risk by establishing liens on exports and/or export proceeds. Banks may require, inter alia; assignment of title to exports, the issuance of irrevocable instructions to a buyer to make payment directly to a lending bank, or the establishment of foreign exchange escrow accounts which are held in the bank's or the exporter's name either with the lending bank, another offshore bank, or within the borrowing country's foreign exchange system (Sirleaf & Nyirjesy, 1990).

A classic form of export-secured lending, and an area where there continues to be considerable activity and competition, is pre-export finance. Individual banks and syndicates have been providing substantial facilities essentially for purposes of balance-of-payments support, to a wide range of countries, such as Angola, Cameroon, Tanzania, Uganda and Zimbabwe (Sirleaf & Nyirjesy, 1990). The structure of the facilities ranges from single disbursements repayable in one 'bullet' (typically within less than one year) to multi draws/multi installment repayments, r evolving on a more or less permanent basis, but typically with terms of not more than three years. In addition, formal control over exports or export proceeds is used extensively by the oil and mining sectors to secure medium-term loans.

2.5.3 Asset-Based Finance

Banks have demonstrated a willingness to finance high-value, moveable assets such as aircraft, vessels and mobile equipment, based on a lien on the asset typically for a reasonable percentage (50 to 70 percent) of the asset's market value. The private insurance industry generally supports such transactions by providing loss and/or repossession coverage. Except in the case of Liberia's vessel registry, asset-based loans tend to be recorded in the World Bank statistics as cross-border credits, unless structured as leasing arrangements, which often applies in the aviation sector.

2.5.4 Secured Lending

Secured lending encompasses loans that are collateralized by offshore cash deposit or protected by an identified external irrevocable source of repayment. Unless guaranteed by an official agency (such as an export credit agency), these loans tend to appear in the World Bank statistics, but typically are not included in the BIS reports. Typical security includes cash deposits, cross guarantees among suppliers, buyers and direct investors, commitments or undertakings from official agencies, most times conditional on borrower performance, and private political risk insurance.

Another form of secured lending involves the provision of guarantees to the banks by offshore private entities, such as oil exploration and production companies. These guarantees can vary from "comfort letters" to legally-binding full or partial guarantees, depending on the nature of the relationship between the corporation and its bank, and the degree of risk associated with a given transaction (Sirleaf & Nyirjesy, 1990).

2.6. Risk Reduction Strategies in the SME Sector

Banks are faced with very different customer demands and hence risk decisions. Although the SME sector is heterogeneous, a stabilizing institutional framework in general (Quack and Hildebrandt, 1995) and the universally high level of skill among business owners/managers, in particular, make the SME population more internally homogenous and stable, and hence easier to classify and less risky. In sum, the examination of the institutional environment has revealed how this context is likely to affect the level of uncertainty and the kinds of risks with which banks in Kenya are confronted when lending to SMEs.

Risks, in the theoretical approach of Luhmann (1993) and Baecker (1991), are defined by bankers in the course of their decision making during the lending process. However, the perceptions, attitudes and motivations which enter into the risk-handling process, it is held by

Douglas and Wildavsky (1982), are shaped by the business goals, as well as by the time horizons for the achievement of these goals. Institutional factors also influence whether primary importance is placed on possible opportunities for gain or threats of loss and hence creates a differing interplay between risk avoidance and risk acceptance (Lane and Quack, 1999).

Banks have to deal with three main types of risks throughout the lending process. As both the ability and willingness of the creditor to pay back may change over the period of the loan, the bank is exposed to a default risk. In order to grant credit, the bank raises funds from savers for which it guarantees them a certain interest rate over a certain time period (Lane and Quack, 1999). This exposes banks to further uncertainties arising from differing maturity structures of assets and liabilities. Although the resulting liquidity risk is now less acute as banks can raise additional funds on money markets (Baecker, 1991) the interest rate risk, i.e. the risk of divergent interest rates between what is lent and what is borrowed remains.

The handling of these risks in banks can take three basic forms: risk avoidance or, less extreme, risk aversion; risk management or control; and an attempt to share or pool risk (Lane and Quack, 1999). Whether the emphasis is only on controlling risk or also on sharing it depends on politically created and/or sanctioned opportunities for the latter strategy.

2.6.1 Risk Avoidance

Bank lending is by definition risky business, and general avoidance of risk is not an option (Baecker 1991); even partial risk avoidance carries its own risks (Luhmann 1993; Douglas 1986). Banks have instituted procedures which have normalized the taking of ordinary risks, and their risk politics is mainly concerned to limit risk. The degree of risk aversion and the kind of risks which are shunned depend on attitudes towards risk which are socially constructed and often legally supported. Risk avoidance strategies usually are in the form of transferring the risk to the borrower. This is known as Externalization. Externalization of risk by transferring it to customers can occur in different forms. One is by use of interest rate to price risk. Secondly is by offering short-term loans at variable interest rates thereby displacing risks which would be incurred on the refinancing the customer. Finally by over collateralization for loans considered above average risks

2.6.2 Risk Pooling

Banks may share risks with the state and state-sponsored agencies, with each other, or they may seek to pool them with borrowers, i.e. displace risks to a greater or lesser degree onto customer firms (Lane and Quack, 1999). The organizational mode in which sharing is accomplished is important: whether it occurs in a centralized bilateral relationship between the state and SMEs, or whether it takes place in decentralized pluri-lateral networks which directly involve banks. Risk sharing is, according to Douglas (1986), typical of the 'collectivistic' organizational type, whereas risk displacement onto weaker market participants tends to typify the 'market' type.

Risk sharing by the state and intermediary organizations is, indeed, an accepted part of the German ideology of the social market economy, whereas it is not easily assimilated into the British 'liberal market' approach (Zysman 1983; Albert 1993; Hutton 1995). This is reflected both in the way in which loan guarantee schemes (LGS) are operated in the two countries and in the dispensation of giants and subsidized loans to SMEs.

Lane and Quack (1999) found out that in both countries, LGSs provide guarantees to smaller businesses with longer-term prospects but unable to provide security (Bannock and Partners 1995: 40). Whereas German LGS have been in existence since the 1950s and the overall sums guaranteed are very high, the British scheme was only introduced in 1981, and the scale of sums guaranteed has only recently gained momentum (Storey 1994; Bannock and Partners 1995; Bank of England 1995b: 30; Hughes and Leube 1997). German guaranteed loans are not only substantially larger, but also have longer maturity terms (Bannock and Panners 1995).

In Germany, risk sharing is not only undertaken by external, state-sponsored institutions, but non-private ownership also enables savings and cooperative banks to share risks with each other (Lane and Quack, 1999). Risk sharing within these banking groups occurs in a number of ways: facilitating access to capital at lower interest rates and shielding individual banks from the fluctuations of the capital market; balancing liquidity surplus and shortage within the system, thus reducing the liquidity risk; forming credit consortia for large local loans; and last but not least, providing access to a large and valuable body of information.

2.6.3 Risk Control

Risk control is the most central aspect of risk handling and can involve a variety of different strategies. One of these seeks to reduce the magnitude of risk by controlling the terms on which the loan has been granted, another consists of demanding security (Lane and Quack, 1999). Above all, risk control occurs by using information designed to reduce the unpredictability and variability of outcomes. Banks usually avail themselves of all these risk handling strategies. Nevertheless, as will be shown in the following, the emphases are set very differently in the two societies, due to their differing economic and institutional environment and customer profiles.

Given the greater default risk in Britain due to both more marked instability in the SME sector and the more developed bank practice of lending to vulnerable start-ups, one would expect greater alertness on the part of British banks in the area of risk control. However, as the following discussion will show, this is not consistently the case. It has even been suggested that the degree of sophistication of British banks' risk analysis is too low to cope with the 'adverse selection' problem (Deakins and Hussain 1993: 182). Both the kind of generalist training received and the constant career moves between specialisms militate against sophistication in this area. In contrast, risk management has been regarded as a consistent strength of German banks' (Lane and Quack, 1999). According to the theoretical perspective of Douglas and Wildavsky (1982), this contrast in the degree of control exerted is not only an expression of the different national degrees of risk tolerance; it also points to national differences in the availability and quality of information and security which can be used by banks in order to control lending risks.

2.6.4 Scanning and Interpreting the Environment for Information

Guarantors are also important in granting credibility to information which banks use for their decision making on lending (Coleman 1990). As a consequence, bank managers at the lower level will often have prior knowledge of the state of affairs in certain firms. In Britain, in contrast, the institutional environment lends itself much less to the use of external evaluations by intermediary organizations, and growing regional mobility, higher turnover of business, and concentration of banking activities in London have undermined personal trust and the value of 'gossip information'. Lenders increasingly have had to rely on whatever the customer tells them (Bannock and Partners 1994).

Existing research — although scarce — suggests that what is considered by banks as a reliable signal for the credit worthiness of a borrower (Spence 1974; Feldmann and March 1990) reflects what is perceived as appropriate performance standards in each country: British bank managers tend to rely more on a narrow range of financial information whereas German bank managers give more emphasis to managerial information, the qualification of the entrepreneur and a well-prepared business plan. The most important kinds of information in Britain are of a historical nature whereas in German they include more future-oriented information (e.g. an evaluation of the market prospects of the project) (Deakins and Philpott 1993; Wood et al.1992). With regard to methods of risk assessment, British banks give more emphasis to class-based judgments and lending on a portfolio basis whereas German banks follow a more qualitative case-based approach (Hughes and Runde, without date; Suchting 1993).

Douglas and Wildavsky's (1982) market-based institutional type can also be applied to the structures and procedures along which the decision making is organized in banks. The British lending manager is considered to act as a 'quasi-entrepreneur' whose decision making should not be hampered by too many bureaucratic procedures and standards. In order to achieve greater flexibility and speed of response, the individual bank manager can decide about loans up to a certain limit without consulting others. According to Deakins and Hussain (1991) this leads to a great variation in the attitude and standards applied in assessing loan applications, both within and between British banks (see also Hutchinson and McKillop 1992). Attempts to overcome these problems by automating and standardizing decision making on lending have only been partially successful (see Cowling and Sugden 1993; Bannock and Partners 1994). In contrast, the internal organization of German banks more resembles the bureaucratic institutional type since many resources are used to standardize procedures and create uniformity in decision making (Quack and Hildebrsindt 1997). This reflects not only the more bureaucratic culture of German enterprises but also the legal framework of the banking sector. The latter emphasizes security over profit seeking and obliges banks to document the lending decision in a way which is comprehensible for control institutions (Lane and Quack, 1999).

2.6.5 Taking Security

Taking security is meant to lessen the risk taken in a direct manner, if the loss from default can be reduced. Security can take the form of collateral provided by the borrowing firm, or it may be provided in the form of a credit guarantee by a third party (Lane and Quack, 1999).

2.6.6 Other Related Studies

An increasing body of analytical work has attempted to explain the functioning of credit markets using new theoretical developments. Challenging the paradigm of competitive equilibrium, they have explored the implications of incomplete markets and imperfect information for the functioning of credit markets in developing countries. These provide a new theoretical foundation for policy intervention. Most of this body of literature has followed from the pioneering work of Stiglitz and Weiss (1981).

The work by Stiglitz and Weiss (1981) marks the beginning of attempts at explanations of credit rationing in credit markets. In this explanation, interest rates charged by a credit institution are seen as having a dual role of sorting potential borrowers (leading to adverse selection), and affecting the actions of borrowers (leading to the incentive effect). Interest rates thus affect the nature of the transaction and do not necessarily clear the market. Both effects are seen as a result of the imperfect information inherent in credit markets. Adverse selection occurs because lenders would like to identify the borrowers most likely to repay their loans since the banks' expected returns depend on the probability of repayment. In an attempt to identify borrowers with a high probability of repayment, banks are likely to use the interest rates that an individual is willing as a screening device (Atieno, 2001). However, borrowers willing to pay high interest rates may on average be worse risks; thus as the interest rates increases, the riskness of those who borrow also increases, reducing the bank's profitability. The incentive effect occurs because as the interest rate and other terms of the contract change, the behaviour of borrowers is likely to change since it affects the returns on their projects. Stiglitz and Weiss (1981) further show that higher interest rates induce firms to undertake projects with lower probability of success but higher payoffs when they succeed (leading to the problem of moral hazard).

Atieno (2001) asserts that since the banks are not able to control all actions of borrowers due to imperfect and costly information, it will formulate the terms of the loan contract to induce borrowers to take actions in the interest of the bank and to attract low risk borrowers. The result is an equilibrium rate of interest at which the demand for credit exceeds the supply. Other terms of the contract, like the amount of the loan and the amount of collateral, will also affect the behaviour of borrowers and their distribution, as well as the return to banks. Raising interest rates or collateral in the face of excess demand is not always profitable, and the banks will deny loans to certain borrowers.

Besley (1994), following this line of argument, analyses the rationale for interventions in rural credit markets in the presence of market failure. Since credit markets are characterized by imperfect information, and high costs of contract enforcement, an efficiency measure as exists in a perfectly competitive market will not be an accurate measure against which to define market failure. These problems lead to credit rationing in credit markets, adverse selection and moral hazard. Adverse selection arises because in the absence of perfect information about the borrower, an increase in interest rates encourages borrowers with the most risky projects, and hence least likely to repay, to borrow, while those with the least risky projects cease to borrow (Atieno, 2001). Interest rates will thus play the allocative role of equating demand and supply for loanable funds, and will also affect the average quality of lenders' loan portfolios. Lenders will fix the interest rates at a lower level and ration access to credit. Imperfect information is therefore important in explaining the existence of credit rationing in rural credit markets. Moral hazard occurs basically because projects have identical mean returns but different degrees of risk, and lenders are unable to discern the borrowers' actions (Stiglitz and Weiss, 1981; Besley, 1994). An increase in interest rates negatively affects the borrowers by reducing their incentive to take actions conducive to loan repayment. This will lead to the possibility of credit rationing.

Bell (1990) demonstrates that incomplete information or imperfect contract enforcement generates the possibility of loan default and eventually problems of credit rationing. The result is loan supply and implicit credit demand functions, both of which are simultaneously determined. The role of risk in allocation of credit through its effect on transaction costs, therefore, becomes important in incomplete credit markets. Accordingly, where default risk exists, with an upward sloping supply curve, lenders offer borrowers only a choice of points on the supply curve, and borrowers are restricted to these points. It is impossible to identify the loan demand schedule using the observed loan amounts since these only reflect the existing supply (Atieno, 2001). The credit demand function can only be interpreted from the borrower’s participation decision, i.e., the decision to borrow or not, and from which sector to borrow. Such a decision will depend on, among other things, the borrower’s economic endowment and opportunities. The credit demand schedule identification problem therefore implies the existence of credit rationing (see also Elhiraika and Ahmed, 1998).

Empirically, research on the use of credit by rural households tends to imply that although it is not obvious that demand for credit far outweighs the supply, there are significant obstacles to the transformation of potential demand into revealed demand (Aryeetey, 1996). The absence of supply creates a lack of demand expressed in low revealed demand. Again, due to market failure in the credit market, the transaction cost involved in obtaining credit is considered greater than the utility, prompting households to switch profits between activities as a way of financing working capital. This also explains the existence of informal credit markets alongside formal credit institutions.

2.7 Conclusion

This chapter contains a summary of some pertinent literature in the area of risk management techniques employed by banks. There are empirical studies on the models and controls put in place by banks in measuring credit risk. However, the level of nonperforming loans has continued to increasing, thus posing a great danger to the entire financial system in Kenya .There is need to determine whether the sociological institutional approach to lending will provide a remedy. The basis of this research is thus to determine the factors that banks focus on in constructing and managing risk using the sociological approach, with emphasis to small firm lending in Kenya. Externalization of risk by transferring it to customers for instance through high interest rates to price for risk would suggest that banks would make little effort to appraise loan applications further increasing the non performing loans portfolio. There is need to determine whether the sociological institutional approach to lending will provide a remedy to commercial banks in managing risk related to SMEs.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0. Introduction

This chapter sets out the research methodology that was adopted so as to meet the objectives stated in chapter one of this study. The research setting, the population of interest, the sample, the data collection instruments and the data analysis techniques discussed.

3.1. Research Design

The research was a survey that was conducted within all the banks represented in Nairobi, An exploratory survey was used in carrying out this study. According to Cooper and Schindler (2003), exploratory design aims at determining the ‘why’ phenomena. The survey method was preferred for this type of study as it enabled the sampling of different characteristics exhibited by the members of the defined population.

3.2. Population and Sample

The study focused on all commercial banks in Kenya who have well established SME products. According to the Central Bank of Kenya Act Chapter 491, there are forty six commercial banks operating in Kenya, with one bank under statutory management. The population consisted of 40 credit managers or their equivalent, each representing the 40 banks. The study aimed at doing a representative survey of the entire banking sector. The questionnaire was administered to 40 credit managers or their equivalent.

3.3. Data Collection

The research drew its data from primary sources using a structured questionnaire. Both E-mail system and the use of the “drop & pick later” method were used to collect the data. This enabled the respondents to dedicate enough time, conveniently to themselves to fill the questionnaire. The questionnaire was administered to the Credit-Manager or their equivalent in each banks office. The questionnaire was semi-structured, having both open-ended and closed-ended questions.

3.4. Data Analysis

After all the questionnaires were completed, they were checked and verified to ensure consistency, exhaustiveness and completeness of the information expected. The study was descriptive in nature and thus descriptive statistics was used on the data such as mean, percentages and variances. The data was organized through frequency tables, to enable develop a summary of the data collected and to organize it into meaningful form. Percentages were used to compare groups of the different sizes. Data from the questionnaire was coded to facilitate statistical analysis.

In determining the factors, the study used factor analysis method. The factors were tested in the questionnaire using like scale through SPSS. This is the most frequently used variation of the summated rating scale. Summated scale consists of statements that express either a favorable or unfavorable attitude towards the object of interest. The respondent is asked to agree or disagree with each statement. Each response is given a numerical score to reflect its degree of attitudinal favorableness and the scores may be totaled to measure respondents' attitude (Cooper and Schindler (2003).

The questionnaires were administered to 40 banks, in which 27 responded by completing and returning the questionnaire. 7 banks did not respond. This translates to a 67.5% response rate and a non response rate of 32.5%. The research considers this response to be fairly representative in providing valid conclusions to the sociological institutional approach strategies that Kenyan banks in their institutional environment construct, and how they manage risk relating to SME business. The data was collected from the credit managers or their equivalent at the banks. The questionnaire were edited and coded.

CHAPTER 4

4.0 DATA PRESENTATION, ANALYSIS & INTERPRETATION

4.1 Introduction

This chapter presents the findings of the data collected through the use of questionnaire and scheduled interviews by the researcher. It covers data analysis and findings. The information is presented and discussed in relation to the objectives and research questions investigated in this study.

4.2 Data Analysis

The data was analyzed using frequencies and percentage. Frequency and percentages were used to analyse the general information in part one. The 5 point rating scale was used, varying from very large (5) to no extent (1). Mean scores were used to determine the extent to which the commercial bank applied the various risk strategies identified. The score "Small Extent" (SE) and "No Extent "represented a variable practiced to a small extent. This was equivalent to 1 to 2.4 on the continuous likert scale ($1 \leq SE \leq 2.5$). The Score "Moderate Extent" (ME) represented a variable practiced to a moderate extent. This was equivalent to 2.6 to 3.5 on a likert scale ($2.6 \leq$

ME $\leq$ 3.5).The Score “Large Extent” (LE) represented a variable equivalent to 3.6 to 5.0 on a likert scale (3.6$\leq$ LE $\leq$ 5.0).

4.3 Background Information of the Institutions Studied

This Section presents the general information about the banks that participated in the study. This included the name of the commercial bank, the position of the respondent, whether there was an SME department in the bank, when the department was established and the products and services offered by the bank to the SME clients.

4.3.1 Names of Commercial Banks

The names of all the commercial banks sampled are detailed in Appendix IV.

4.3.2 Position of the Respondent.

The researcher asked respondents to indicate the title that best describes their positions and found that the Credit/SME managers or their equivalent represented 51.8%, Credit/SME officers represented 29.5% while the rest where other bank employees who worked as customer service advisers, represented 18.5%. The job titles were all related and relevant to the study and where key in managing the SME services in their respective banks

Table 4.1 Position of the Respondent

	Frequency	Percentages
Credit/SME Managers/Assistant Manager	14	51.9%
Credit/SME Officers	11	40.7%

Others	2	7.4%

Source: Research Data

4.3.3 Classification of Credit Department.

All the 27 banks a Credit department. However 48.1% of respondents indicated that they have a separate department that specifically deals in SME only, that is different from other credit facilities offered by the bank. 7.4% of the respondent indicated that they do not have a clear department called SME per say. All their clients are classified as one. 37.1% have one department that houses where all types of credit facilities are offered. This shows a positive growth towards banks offering specialized services to SMEs.

Table 4.2 Classification of the Credit Department

	Frequency	Percentages
SME Only	13	51.9%
Credit Only	2	7.4%
SME and Credit Combined	12	44.4%

4.3.4 Introduction of the SME product in the bank

44.4% of the respondents indicated that SME product had been introduced in their bank operations within in the last 5 years while 37.0% indicated that the SME product had been introduced between the last 6 to years. This shows a positive trend towards more interest in the SME sector than ever before.

Table 4.3 Introduction of the SME product in the bank

Years	Frequency	Percentages
1-5	12	44.4%
6-10	10	37.0%
>11	5	18.5%

Source: Research Data

4.3.5 Products offered to SME clients

All the 27 banks offer the same services which range from account opening, cash deposits fixed deposits. They also offer credit facilities in term of loans, overdrafts, letters of credit, guarantees, safe custody, and consultancy among others .100% of the respondents offer the same facilities to their clients.

4.3.6. Percentage of the SME clients to the total population of the banks clients

The researcher sought to investigate whether the SME population to the total population of all credit clients in the banks. The responded to indicate the percentage of SME clients who made up the total clientele of the bank and 22.3% indicated that the SME client percentage was below 30% and 48.1% indicatives that the SME clients made up between 30 to 60% of their total credit population, while 29.6% indicated that the SME clientele made up over 60% of their total population of clients

Table 4.4 Percentage of the SME clients' population to the total population of all the banks Credit clients

	Frequency	Percentages
0-30%	6	22.3%
31-60%	13	48.1%
>60%	8	29.6%

Source: Research Data

4.3.7. Reasons as to why banks engage in Credit Risk Management.

The research revealed that there were varied reasons as to why the respondents engaged in Credit risk management. All the banks cited economic reward and improved financial performance as the major reasons. Other secondary reasons are summarized in Table 4.5

Table 4.5 Importance of Credit Risk Management

	Frequency	Percentages
Reduce losses through provisioning	13	48.1%
Regulatory requirement	8	29.6%
Reputation	5	18.5%
To beat competition	1	3.7%

Source: Research Data

4.3.8. Duration of the SME loans

The research revealed 66.6% of the respondent had most of their loans having a period up to 36 month, or 3 years. 22.2% had the loan period being between 3 years to 5 years whereas 11.1% had the loans period over 5 years. This has been summarized in table 4.6

Table 4.6. Duration of the SME loans.

	Frequency	Percentages
Up to 3 year	18	66.6%
3 years to 5 years	6	22.2%
> 5 years	3	11.1%

4.4: Institutional Risk Assessment and Management Strategies in lending to SMEs

4.4.1 Prerequisites for Risk assessment

Table 4.7 Prerequisites for Risk assessment

Prerequisites for Risk assessment	Mean	Standard Deviation
Planning for the SME portfolio management	3.93	0.97
Developing SME Credit Policies and standards	3.33	1.15
Conforming to the Regulatory requirements	3.81	1.19
Identifying the risk tolerance of the bank	2.48	1.1
Employing qualified with unquestionable integrity	2.15	1.04
Developing and maintaining Credit Approval Authority structure.	2.59	1.28
Setting systems to identify significant portfolio indicators	3.29	1.18

and any credit failures		

Source: Research Data

Most commercial banks consider planning as key in being a major prerequisite of risk management. There has to be a plan put down that clearly list all possibilities that could go wrong and a plan of what should be done to mitigate those items listed in a cost effective manner, without jeopardizing the operations of the bank. The research also revealed that conforming to the Central Bank regulatory requirements is also a major prerequisite in assessing any risk that the bank would get involved in. A bank could lose its license to operate or even be fined by the Central Bank for lack of compliance and conforming to its risk regulations. Others respondents cited setting systems to identify significant portfolio indicators as important in risk management. Another reason cited to be of moderate extent as a prerequisite was developing credit policies and standards and employing qualified personnel with unquestionable integrity. All the other reasons were cited as having a small extend as prerequisite for risk assessments.

4.4.2 Type of information required to processing a loan

The results in table 4.8 below shows that the respondents identified financial information as being very vital in the formation of the decision to grant a loan, as opposed to the managerial information which is futuristic. The research shows that most banks require the SME clients to furnish them with their Financial Information which acts as the basis of making the decision as to whether the client will be granted a loan or not.

Table 4.8 Type of Information

	Frequency	Percentages
Financial Information/Historical Information	23	85.1%
Managerial Information/Futuristic Information	4	14.8%

Source: Research Data

Table 4.9 reveals that the most banks 85.1% demanded the client to produce their balance sheet, income statement, bank statements, past cash flows and details of their company to a very large extent. Future cash flows and business plans were required by 14.8% of the respondents surveyed

Table 4.9 Information Requirements

		Mean	Standard Deviation
a.	Balance Sheet and Income Statement	4.15	0.85
b	Historical Cash flow statements	3.9	0.99
c	Future Cash flow statements	2.19	1.5
d	Business plan	2.11	1.22
e	Bank Statements	4.19	0.72
f	Academic qualifications of the entrepreneur	1.48	0.79
g	Business details like date of incorporation, Memorandum of Association among others	3.18	1.33

4.4.3 Methods used in rating SME clients applying for a loan

As indicated in table 4.10 the mean of 3.96 shows that most of the respondent use financial ratios in rating a client. Other methods that are in use to a large extent include use of the Credit Scoring models with a mean of 3.67 and use of the credit officers/managers judgment. Use of Value at risk method and the portfolio approach methods where the least in use. Use of the central bank prudential guidelines is in use at a moderate level.

Table 4.10 Methods used when rating SME Clients

	Mean	StdDev
Use of Credit Scoring systems	3.67	1.18
Use of Internal Rating systems	3.19	1.24
Use of the Credit Officers /Managers Judgment	3.88	1.37
Use of Basle Accords requirements	2.96	1.32
Use of Value at Risk methods	1.63	0.98
Use of the Portfolio Approach methods	1.48	0.56

Use of Financial Ratios	3.96	0.88
Use of Central Bank of Kenya Prudential Guidelines	3.50	0.80

Source: Research Data

4.4.4. How banks rate the default risk of SME clients.

From the analysis in table 4.11 majority of the respondent consider SME clients risky 70.4% of the respondents indicated that SME clients were risky, whereas 25.9% consider the risk to be medium.

Table 4.11 Default risk rating of SME clients

Years	Frequency	Percentages
High	15	70.4%
Medium	5	25.9%
Low	0	0%

Source: Research Data

4.4.5 Macro Level Institutional factors that impact the risk handling in credit lending to SME's.

The researcher needed to investigate what role the macro institutional factors played in the risk management of the SME clients.

Table 4.12 Macro Level Institutional Factors

	Mean	Standard Deviation
The role of the state in the economy	3.30	1.35
The Financial System	3.41	1.49
The Legal System	2.81	1.38

Source: Research Data

All the three macro level Institutional Factors were to a moderate extent considered by the respondents in handling the risk in the respective banks.

4.4.6 Micro Level Institutional factors that impact the risk handling in credit lending

The researcher sort to establish the Micro level institutional factors that where in play while handling risk in lending to SME. Both the Banking Regulation and the Nature of the SME population play a level ground on the impact in the risk handling in SMEs as shown in table 4.13

Table 4.13 Micro Level Institutional factors

	Mean	Standard Deviation
The Banking Regulation	3.29	1.50
The Structure and Role of the Banking system	3.11	1.17
The Nature of the SME population	3.22	1.28

Source: Research Data

4.4.7 Risk handling strategies employed by banks

Table 4.14 Risk handling strategies

	Mean	Standard Deviation
Risk Avoidance	3.58	1.02
Risk Pooling	3.53	1.08
Risk Control	3.58	1.01

Source: Research Data

Table 4.14 summarizes the key risk handling strategies in play among the surveyed banks. The respondents indicated that all the three risk strategies to a large extent are used by the commercial banks in managing risk.

4.4.8 Risk Controls in managing the risk while lending to SME clients.

Table 4.15 Controls

	Mean	Standard Deviation
Geographical diversification of the clients	3.18	1.33
Product diversification of the clients businesses	3.22	1.39
Loan size limit (Rationing)	3.18	1.1
Collateralization	3.8	1.01

Credit Insurance	2.2	0.67
Credit Rating Agencies	2.3	1.08
Portfolio Securitization	1.92	1.92
Use of different approval levels	3.14	1.97
Use of the Enterprise Risk management Department	3.5	1.40

Source: Research Data

The research revealed that Enterprise risk management programmes and collateralization where in use to a large extent. The use of different approval levels, rationing of the loans, product and geographical diversification were in use to a moderate extent. The other methods were used to a least extent.

4.4.9 Risk pooling strategies in managing the risk while lending to SME clients.

Table 4.16 Risk pooling

	Mean	Standard Deviation
Use of the State	2.59	1.36
Use of loan Guarantee Schemes	3.7	1.39
Use of the borrowers/Group guarantees mechanisms	2.70	1.52

Source: Research Data

The respondents indicated that the use of loan guarantee schemes was to a large extent in use. The respondents cited International Finance Corporation and the African Development Bank as the main Loan Guarantee schemes that guarantee some specific SME loan for example IFC guarantees private owned primary schools entrepreneurs in most of the respondent banks.

4.4.9 Risk Aversion strategies in managing the risk while lending to SME clients.

Table 4.17 Risk aversion

	Mean	Standard Deviation
Short term loans with variable interest rate	3.60	1.19
Externalization through high interest rate	3.67	1.14
Over collateralization	3.70	1.55

Source: Research Data

The respondents indicated that their banks employed all the three strategies at a large extent in managing their risk. Most of the loans where short-term loans as indicated in table 4.17, and had variable interest rates. The loans also had high interest rates due to their nature and finally the banks push the client to give more collateral from the clients to cater for the high risk of the loans.

4.4.10 Loan approval limit for a Bank Manager.

The research revealed that most bank managers or their seniors could approve loan limits of up to 500,000/- without necessarily consulting others. There were several reasons provided by the respondents as to why managers were allowed to approve loans to the specific limits. The major reason was to increase flexibility and speed of response, with most banks promising customers a turnaround time of 48 hours from the time the loan application is received to the time the loan is processed into their accounts. Another reason cited for allowing managers the discretion to approve loans to a certain limit was due to competition in the market. Other players in the industry have less bureaucratic procedures and as such faster loan processing which in effect, attract more customers to them than the more bureaucratic banks whose loans take time to process due to the long procedures approval levels.

4.4.11 Factors to consider in default risk determination

Table 4.18 - 12 C

	Mean	Standard Deviation
Character	4.19	0.81
Capacity	3.07	1.38
Collateral	3.74	0.98
Conditions	3.50	1.35
Common sense	3.40	1.16
Capital	3.81	1.01
Credit	3.48	1.26
Controls	3.81	1.01
Communication	2.4	1.39

Cycle	2.92	1.31
Completion	2.63	1.3
Contribution	2.81	1.8

Table 4.18 indicates the major factors the respondents consider when rating SME clients. It is evident from the table that character of the client is to a large extent the most crucial factor when rating the client. Other factors that bank consider when rating a client to large extent include the capital of the client, the collateral being provided and the controls in place.

4.4.12 Challenges in credit risk management

The researcher sort to find out the challenges the responded considered as major impediments in credit risk management. The research revealed that majority of the respondents consider lack of standardization of procedures, new innovations and competition to a large extend as being the major challenges in credit risk management. Lack of established and easily available credit rating agencies was considered to a moderate extent as a challenge to credit risk management.

Table 4.19 Challenges

	Mean	Standard Deviation
Lack of skill	2.03	1.17
Lack of resources	2.48	1.41
Lack of standardization of the procedures	3.85	1.00
Lack of credit rating agencies in the country	2.78	1.54
Interferences from senior management	2.52	1.13
Competition	3.81	1.18
New innovations	3.74	1.00

Source: Research Data

CHAPTER 5

5.0 SUMMARY FINDINGS CONCLUSIONS & RECOMMENDATIONS

5.1 Introduction

This chapter discusses the findings of the research and draws conclusions from the major findings. The main objective of the study was to identify the institutional risk management strategies applied by commercial banks in lending to SMEs. The primary data was collected using a questionnaire that was distributed using the "drop and pick later" method to the respective respondents. A total of 27 questionnaires were obtained from the survey.

5.2 Summary of findings and Conclusions

The results indicate that there are three distinctive institutional risk management strategies that are applied by Kenyan banks in lending to SME clients. These are risk pooling strategies, the risk control strategies and risk avoidance strategies. The research shows that the institutional context in Kenya has determined how the banks handle the three risk strategies.

The results show that the Kenyan banks apply the risk avoidance strategy by externalizing the risk as much as possible to the client by offering high interest rates on the SME loan to price. The banks also use the risk avoidance strategy by offering short term loans which have a loan period of up to 36 month. These loans have variable interest rates. Loans with a period of over 3 years are mostly asset financing loans and are secured by property including motor vehicles, land and building. Finally, the banks seek to avoid the risk by over collateralization of the loans as a strategy of transferring the risk to the clients. The Kenyan banks can be said to externalize part of the risk involved in lending to SMEs to their borrowers.

The research revealed that Kenyan banks use pre-set interest rates to price the loans as opposed to appraisal of each individual SME loan application to determine the risk inherent and therefore the price the loan according to the appraisal carried out. The pricing of the loan is usually determined by the senior management and the market prices prevailing. The price is already set in the system so that, any SME loan that would be considered successful, would have its price set.

In risk pooling the research revealed that two organizations were very key in providing the guarantee schemes. These were International Finance Corporation and the African Development Bank. The research revealed that these two organization identified businesses that had potential but did not have enough security. The banks to a moderate extent also used the group guarantee mechanism in sharing the risk between the banks and the borrowers.

The research shows that risk control is a commonly used strategy in management of the risk. The research revealed a new dimension called the Enterprise Risk Management Program (ERM), whose main purpose is to analyse the risk inherent in the business, with credit risk being one of the major risk analyzed. All the banks have the department and depend on it to analyse the credit risk more objectively. Other risk controls in place include geographical diversification of the SME clients, product diversification of the borrowers, limiting the loan size, collateralization and the use of different approval limits to act as a second eye.

The research however revealed a major weakness in the controls. All the banks surveyed are less bureaucratic. This was evident by the fact that bank managers could offer loans up to certain limits without necessarily referring to anyone. There are no strict bureaucratic procedures. The main reason for this type of system is to achieve greater flexibility and response rate for the customer. The banks promise their customers a 48 hour turnaround time, from the time the loan application is received to the time the clients account is credited with the money. Another reason for the lack of strict bureaucratic procedures has been as a result of competition in the market. Several banks have been attracting customers with their short turnaround processing time. The competitors in the industry have less bureaucratic procedures and hence, faster loan processing time, which in effect, attract more customers to them than the bureaucratic systems whose loans take time to process due to the long procedures of the approval levels. There is need to closely monitor the loans granted under such systems and study their repayment cycle. The procedure could be open to a lot of abuse if no monitoring measures are undertaken and maybe could explain the high level of nonperforming loans that are being experienced by banks.

The research also revealed that 85.1% of the Kenyan banks heavily rely on the information the customer provides to make judgment as to whether the client qualifies for a loan. Financial information which is historical is in use unlike the managerial information, which is futuristic. The banks should embrace both the historical and the futuristic information in making informed judgment as future oriented information is better in the evaluation of the market prospects of a particular business.

From the research in the last 5 years 44.4% of the banks have introduced SME as a new product. 59.1% of the respondents also have departments that specifically deal with SME clients only, hence clearly showing the renewed interest banks have taken in SME. Due to the rapid growth of the sectors, competition has also become a major issue the banks have to deal in. This has resulted in other banks bowing down to pressure as they fight to retain their existing customers and attract new customers. This has forced some banks to compromise on their controls in order to retain customers. This has been a major contributor and challenge to the increase in the risk associated in lending to SMEs

The research revealed the major challenges in managing credit risk to a large extent as being lack of information from Credit risk bureaus, use of historical information to make informed decisions, conflict of interest by the managers and the senior management, weaknesses in the controls, inheritance of bad portfolios from officers/managers who have left the institution for greener pastures, lack of responsibility of the credit managers and the senior management and finally unrealistic targets in the loan disbursements that results in the credit mangers compromising on the controls and procedures

Better management of Credit risk would involve the introduction of credit reference bureaus which would offer information to banks on the rating of the credit clients who wish to access credit facilities from the bank. This would also encourage clients to adhere to the covenants so as to have good ratings for any future loans.

Introduce more bureaucratic systems for the banks to help curb the errors that may occur as a result of bank managers solely approving loans upto certain limits. This would also help curb any abuse by the said managers in terms of extending credit to companies they own or are affiliated, to personal friends, to persons with a reputation for non financial acumen, to meet a personal agenda, such as cultivating a special relationship with celebrities or well connected individuals, and finally lend for the sake of obtaining a set target, paying no regard to the qualities of the lender.

Introduce systems that make the officer in charge of granting a loan responsible for the repayment of the same loan. This would help make the officer more diligent in appraising the loan to ensure that all the necessary details are thoroughly checked and that the client is properly vet before disbursing any loan.

Incorporate risk management responsibilities into the performance goals and compensation of senior management. The banks could also evaluate the enterprise risk management programs to ensure that they are as integrated and comprehensive in their assessment of all the risk an institution is exposed to, credit risk included.

5.3 Limitations to the Study

The main limitation was that some of the respondents refused to fill in the questionnaire despite the numerous visits and pleas. This may have reduced the possibility of reaching a more conclusive study.

Another limitation was the lack of information on SME in some of the banks. These banks do not have a clear distinction of the SME market from the rest of their borrowers. All their borrowers are grouped one. This affected the study as the information provided pertained to the all the borrowers and not necessarily SME borrowers

Finally, it is evident that banks are not the only source of borrowing for SME. In the recent past, there have been several other intermediary institutions that offer credit to SME businesses. This also hindered the research as this study was specific to commercial bank lending to the SME Sector and not all the lending available to the SME sector.

5.4. Recommendations for Further Study

The researcher suggested that a future research be done on the Enterprise Risk Management programme assessment and the value it has on the credit risk of the SME sector.

A study could also be carried out to cover all the risk management strategies applied by other intermediary lending institutions that are not commercial banks, in lending credit to the SME sectors.

REFERENCES

Abedi S. (2002). ‘Highway to Success.’ Credit Management Journal (Electronic Version). http://leathersointers.com/do you talk to you banker. Html.

Adera, A. (1995). ‘Instituting effective linkages between formal and informal financial sector in Africa: A proposal.’ Savings and Development, 1/1995: 5-22.

Albert, Michel (1993): Capitalism against capitalism. London: Whurr.

Aleke, Dondo. (1994). ‘Credit to the informal sector approaches and models experienced in Kenya’. KREP Occasional paper No. 27. Nairobi: Kenya Rural Enterprise Programme.

Anthony Saunders (2008) Financial Institutions Management, Marcia Million Cornett, Mcgraw Hill International, 6th edition, 2008.

Aryeetey, E. (1996). ‘Rural finance in Africa: Institutional developments and access for the poor’. The World Bank Annual Conference on Development Economics, 25- 26 April, Washington, D.C.

Atieno Rosemary. (2001). ‘Formal and informal institutions’ lending policies and access to credit by small-scale enterprises in Kenya: An empirical assessment.’ AERC, Nairobi Research Paper 111

Bank of England (1995a): The provision of bank finance for small businesses in Germany. Mimeo. London: Bank of England.

Bank of England (1997): Finance for small firms: A fourth report. London: Bank of England

Binks, Martin (1991): Small businesses and their banks in the year 2000. In: Curran, J./Blackburn, R. A. (eds.): Paths of enterprise. London: Routledge, pp. 149-162.

Butterworth’s B. (1990). ‘Risk management.’ A modern perspective: Published by McGraw.

Central Bank of Kenya Annual Report. (2004).

Central Bank of Kenya Risk Management Survey. (2004).

Central Bank of Kenya. (2000), (2001), (2003), (2004). Annual Bank Supervision Reports

Clarke C.J and Survirvarma. (1999). ‘Strategic risk management: The new competitive: Long range planning’ Vol 32 Published by Elsevier Ltd.

Coleman, James. S. (1990). ‘Foundations of social theory.’ Cambridge, MA: Harvard University Press.

Cosh, Andy/Hughes, Alan. (1994). ‘Size, financial structure and profitability: UK companies in the 1980s.’ London, Routledge, 18-63.

Deakins, David/Hussain, Ghulum (1991): Risk assessment by bank managers. Discussion paper. Birmingham: Polytechnic Business School.

Deakins, David/Philpott, Toby (1993): Comparative European practices in the finance of small firms: UK, Germany and Holland. Discussion paper. Birmingham: Polytechnic Business School.

Deeg, Richard/Lütz, Susanne (2000): Internationalization and financial federalism: The United States and Germany at the crossroads, Comparative Political Studies, 33, 3, pp. 374-405.

Douglas, Mary/Wildavsky, Aaron (1982): Risk and culture. Berkeley. LA and London: University of California Press.

Greuning H.V & Bratonovic S.B. (1999). ‘Analyzing Banking Risk,’ A framework for assessing corporate governance and financial risk management, Published by the World Bank.

Hempel G.H; Simson and Coleman. (1994). ‘Bank Management: Text and Cases,’ Fourth Edition Publishers, John Wiley & Sons, Inc.

Hutton, Will (1995): The state we're in. London: Jonathan Cape.
Kershaw, Stephen (1996): Loan trusts for small and medium sized enterprises in the UK. London: The Bow Group.

Lane C. & Quack S. (2002). ‘How banks construct and manage risk. A sociological study of small firm lending in Britain and Germany. ESRC Centre for Business Research, University of Cambridge, Working Paper 217

Luce & Raiffa. (1957). Risk Management: A conceptual framework. Long range planning. Published by Elsevier Ltd.

Luhmann, Niklas (1993): Risk: a sociological theory. Berlin: De Gruyter.

Mullineux, Andy (1994): Small and medium-sized enterprise financing in the UK: Lessons from Germany. London: Anglo-German Foundation

Saunders A. (2002). Financial Institutions Management. A modern Perspective, Third Edition. Published by McGraw Hill.

Stiglitz J. & A. Weiss. (1981). ‘Credit rationing in markets with imperfect information.’ American Economic Review, Vol. 71, no. 3: 393-410.
Thygerson K.J. (1995). Management of Financial Institutions. Harper Collins College publishers.

Vitols, Sigurt (2000): Globalization: A fundamental challenge to the German Model? In: Stubbs, R./Underhill, G. D. (eds): Political Economy and the Changing Global Order. Oxford: Oxford University Press, pp. 373-381.

Zysman, John (1983): Governments, markets and growth. Oxford: Martin Robertson

APPENDIX I

LETTER OF INTRODUCTION

Lilian Muchiti
C/O MBA Office
Faculty of Commerce, UoN
P.O. Box 30197
NAIROBI

Dear Respondent

Re: MBA Research Project

I am a post graduate student at the University of Nairobi, pursuing a Masters degree in Business Administration, majoring in Finance. I am undertaking a research project in partial fulfillment of the academic requirements of the MBA degree.

The purpose of this questionnaire is to examine whether commercial banks have sufficient information to assess the risks associated with their exposures to risks emerging from lending funds to Small and Micro-finance Enterprises (SMEs), and how these banks incorporate these assessments into their risk management framework and lending decisions as a result of the institutional environment in which they operate in. The results of the questionnaire should provide insights into the lessons from Kenya Financial markets. Your responses will be kept confidential. Your assistance and co-operation will be highly appreciated.

Yours sincerely,

Lilian Muchiti

MBA Student

APPENDIX II

QUESTIONNAIRE

Please freely answer the question below. The information provided will be treated with the highest degree of confidence.

Section 1.General information

1. Which Commercial bank are you representing? ....

2. Position of the respondent……………………….

3. Do you have an SME Department in your bank? Yes ( ) No. ( )
Others-Specify……………………………………………………………

4. When was the department established……………….

5. Which products are offered to your SME clients?
…………………………………………………………………………...........

6. What is the percentage population of your SME Client to the total Credit clients?
………………………………………………………………………………..

7. Why does your bank engage in credit risk management?
……………………………………………………………………………….

8. What duration are your SME loans?
……………………………………………………………………………….

Section II: Institutional Risk Assessment and Management Strategies in lending to SMEs

1. What do you consider as the main prerequisite of risk management in lending to SMEs clients in your bank? Please use a five (5) point rating scale where: -

1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Planning for the SME portfolio management					
b	Developing SME Credit Policies and standards					
c	Conform to Regulatory requirements					
d	Identifying the risk tolerance of the bank					
e	Employing qualified personnel with unquestionable integrity.					
f	Developing and maintaining Credit Approval Authority structure.					
g.	Setting systems to identify significant portfolio indicators					

Please provide a reason for choosing any of the above……………………………………………………………………………..

2. What information do you require an SME client to produce before processing a loan at your bank.

Financial Information/Historical Information	
Managerial Information/Futuristic Information	

3. Please select the most commonly used information provided by a client when applying for a loan?

   Please use a five (5) point rating scale where: -

   1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Balance Sheet and Income Statement					
b	Historical Cash flow statements					
c	Future Cash flow statements					
d	Business plan					

e	Bank Statements					
f	Letters of recommendation					
g	Details of the business, date of incorporation, memorandum of Association, Articles of Association, Directors					

Others…………………………………………………………………………..

4. What methods do you use in rating your SME clients when applying for a loan?
   Please use a five (5) point rating scale where: -

   1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Use of SME Credit Scoring systems					
a.	Use of Internal Rating systems					
b.	Use of the Credit Officers Judgment					
c.	Use of Basle Accords requirements					
d.	Use of value at risk methods					
e.	Use of the portfolio approach methods					
f.	Use of financial ratios					
g.	Use of Central Bank of Kenya Prudential Guidelines					

Others………………………………………………………………………………………
…………………………………………………………………………..

5. How does your bank rate the default risk of an SME client who applies for lending from your bank?

   High ( )

   Medium ( )

   Low ( )

6. The following are the Macro Level Institutional factors that impact the risk handling of SMEs by bank. In your opinion, which factor affects the credit lending to SME's in your bank? Please use a five (5) point rating scale where: -

    i. 1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	The role of the state in the economy					
b	The Financial System					
c	The Legal System					

7. The following are the Micro Level Institutional factors that impact on risk handling of SMEs by bank. In your opinion, which factors affect the credit lending to SME's in your bank? Please use a five (5) point rating scale where: -

    1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	The Banking Regulation					
b	The Structure and Role of the Banking system					
c	The Nature of the SME population					

8. The following are the risk handling strategies employed by banks in managing credit risk to SMEs. In your opinion, which method best represents the strategy employed by your bank. Please use a five (5) point rating scale where: -

    = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Risk Avoidance					
b	Risk Pooling					
c	Risk Control					

9. Please indicate the extent to which your bank uses the following Risk controls strategies in managing the risk while lending to SME clients.

Please use a five (5) point rating scale where: -

1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Geographical diversification of the clients					
b	Product diversification of the clients business					
c	Loan size limit (Rationing)					
d.	Collateralization					
e.	Use of Independent risk related models					
f	Credit rating agencies					
g	Portfolio Securitization					
h.	Use of different approval levels					
i.	Use of the Enterprise Risk management department to assess the activities of the Credit department					

Others…………………………………………………………………………………………
……………………………………………………………………………

10. Please indicate the extent to which your bank uses the following Risk pooling strategies in managing the risk while lending to SME clients.

Please use a five (5) point rating scale where: -

1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Use of the State					
b.	Use of Loan Guarantee Schemes					
c.	Use of the borrowers/Group guarantee					

(Specify)……………………………………………………...

11. List any Loan Guarantee Schemes that your bank has been a beneficiary of, in providing guarantee to the SME businesses.

…………………………………………………………………………………………………

…………………………………………………………………………..

12. Please indicate the extent to which your bank uses the following Risk aversion strategies in managing the risk while lending to SME clients.

Please use a five (5) point rating scale where: -

1 = No extent at all and 5 = Very great extent

		1	2	3	4	5
a.	Short term loans with variable interest rate					
b.	Externalization through high interest rate					
c.	Over collateralization					

13. How do you rate the level of controls in place to curb any defaulters from getting the bank credit/loan?

Highly rated ( )

Above average rated ( )

Above average rated ( )

Lowly rated ( )

Poorly rated ( )

Please give a reason for your rating above………………………….................

14. To avoid adverse selection in the vetting of the customers, which of the following does your bank use and how frequent?

Please use a five (5) point rating scale where: -

1 = Not applicable and 5 = Must be availed

		1	2	3	4	5
a.	Use of security / collateral as a requirement					
b.	Use of a bank guarantee					
c.	Interest rate variability to customers					
d.	Risk sharing by use of syndicates					
d.	Use of different approval levels					

15. Up to what limit can your bank manage approve a loan without necessarily consulting others.

a.	< 500,000/-	
b.	500,001 – 1,000,000/-	
c.	1,000,000 – 5,000,000/-	
d.	> 5,000,000/-	

16. The following statements relate to risk management by commercial banks lending to SMEs. Mark appropriately with X in spaces provided in the table, which signify to what extent you rate possibility of default based on the factors given.

		Highly rated	Above average	moderately	lowly rated	poorly rated
1.	Character					
2.	Capacity					
3.	Collateral					
4	Conditions					
5	Common sense					
6	Capital					
7	Credit					
8	Controls					

9	Communication					
10	Cycle					
11	Completion					
12	Contribution					

17. What are the key challenges that you experienced in evaluating the credit risk in the bank?

		1	2	3	4	5
a.	Lack of skill					
b.	Lack of recourses					
c.	Competition					
d.	New innovations					
e	Setting unrealistic targets for loan disbursements					
f.	Interference from senior management					

Others…………………………………………………………………………..

18. What other strategies does your bank use in managing risk to SMEs?

……………………………………………………………………………

……………………………………………………………………………..

……………………………………………………………………………..

………………………………………………………………………………

THANK YOU!

APPENDIX III

LIST OF COMMERCIAL BANKS IN KENYA

	BANK NAME	P.O. Box	postal code	City
1	African Banking Corporation Ltd.	46452	100	**Nairobi**
2	Bank of Africa Kenya Ltd.	69562	400	**Nairobi**
3	Bank of Baroda (K) Ltd.	30033	100	**Nairobi**
4	Bank of India	30246	100	**Nairobi**
5	Barclays Bank of Kenya Ltd.	30120	100	**Nairobi**
6	CFC Stanbic Ltd.	72833	200	**Nairobi**
7	**Charterhouse Bank Ltd**			
	(UNDER STATUTORY MANAGEMENT)	43252	100	**Nairobi**
8	Chase Bank (K) Ltd.	28987	200	**Nairobi**
9	Citibank N.A Kenya	30711	100	**Nairobi**
10	City Finance Bank Ltd.	22741	400	**Nairobi**
11	Co-operative Bank of Kenya Ltd.	48231	100	**Nairobi**
12	Commercial Bank of Africa Ltd.	30437	100	**Nairobi**
13	Consolidated Bank of Kenya Ltd.	51133	200	**Nairobi**
14	Credit Bank Ltd.	61064	200	**Nairobi**
15	Development Bank of Kenya Ltd.	30483	100	**Nairobi**
16	Diamond Trust Bank (K) Ltd.	61711	200	**Nairobi**
17	Dubai Bank Kenya Ltd.	11129	400	**Nairobi**
18	Ecobank Kenya Ltd	47499	100	**Nairobi**
19	Equatorial Commercial Bank Ltd.	52467	200	**Nairobi**
20	Equity Bank Ltd.	75104	200	**Nairobi**
21	Family Bank	11666	400	**Nairobi**
22	Fidelity Commercial Bank Ltd	34886	100	**Nairobi**
23	Fina Bank Ltd	20613	200	**Nairobi**
24	First Community Bank	26219	100	**Nairobi**
25	Gulf African Bank	43683	100	**Nairobi**
26	Guardian Bank Ltd	67681	200	**Nairobi**
27	Giro Commercial Bank Ltd.	46739	200	**Nairobi**
28	Habib Bank A.G Zurich	30584	100	**Nairobi**
29	Habib Bank Ltd.	43157	100	**Nairobi**
30	Imperial Bank Ltd	44905	100	**Nairobi**
31	Investment & Mortgages Bank Ltd	30238	100	**Nairobi**

32	K-Rep Bank Ltd	25363	603	**Nairobi**
33	Kenya Commercial Bank Ltd	48400	100	**Nairobi**
34	Middle East Bank (K) Ltd	47387	100	**Nairobi**
35	National Bank of Kenya Ltd	72866	200	**Nairobi**
36	National Industrial Credit Bank Ltd	44599	100	**Nairobi**
37	Oriental Commercial Bank Ltd	44080	100	**Nairobi**
38	Paramount Universal Bank Ltd	14001	800	**Nairobi**
39	Prime Bank Ltd	43825	100	**Nairobi**
40	Southern Credit Banking Corporation Ltd.	11666	400	**Nairobi**
41	Standard Chartered Bank (K) Ltd	30003	100	**Nairobi**
42	Trans-National Bank Ltd	34353	100	**Nairobi**
43	Victoria Commercial Bank Ltd	41114	100	**Nairobi**
44	Housing Finance Ltd	30088	100	**Nairobi**
45	Savings and Loan (K) Ltd	45129	100	**Nairobi**

APPENDIX IV

LIST OF COMMERCIAL BANKS THAT RESPONDEND TO THE QUESTIONNAIRE

	BANK NAME
1	African Banking Corporation Ltd.
2	Bank of Africa Kenya Ltd.
3	Bank of Baroda (K) Ltd.
4	Barclays Bank of Kenya Ltd.
5	CFC Stanbic Ltd.
6	Chase Bank (K) Ltd.
7	Citibank N.A Kenya
8	Co-operative Bank of Kenya Ltd.
9	Commercial Bank of Africa Ltd.
10	Consolidated Bank of Kenya Ltd.
11	Development Bank of Kenya Ltd.
12	Diamond Trust Bank (K) Ltd.
13	Ecobank Kenya Ltd
14	Equity Bank Ltd.
15	Family Bank
16	Fina Bank Ltd
17	First Community Bank
18	Gulf African Bank
19	Imperial Bank Ltd
20	Investment & Mortgages Bank Ltd
21	K-Rep Bank Ltd
22	Kenya Commercial Bank Ltd
23	National Bank of Kenya Ltd
24	National Industrial Credit Bank Ltd
25	Southern Credit Banking Corporation Ltd.
26	Standard Chartered Bank (K) Ltd
27	Housing Finance Ltd