STRATEGIES ADOPTED BY CO-OPERATIVE BANK OF KENYA IN RESPONSE TO LOAN DEFAULTERS AMONG THE SMALL AND MEDIUM ENTERPRISES IN KENYA

BY

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DECLARATION

This research project is my original work and has not been submitted for examination to any other University.

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

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To God Almighty, Thank You Very Much.
DEDICATION

This project is dedicated to my children Keagan Fred Ojiimbo, Jason Omwera, Mary Mmboga and Joram Aladwa. My husband Mr. George Aladwa Omwera for their support and prayers throughout my studies. May God bless you all.
ABSTRACT

Credit risk has been a concern to all financial institutions involved in lending money because the risk of default by clients can jeopardize the business of the lending institution. It’s therefore prudent that lending procedures are consolidated into an integrated strategy aimed at reducing late repayment and default in repayment. The main objective of this study was to identify strategies adopted by Co-operative Bank to reduce loan defaults among SME customers. The study adopted case study design to carry out this research where an interview guide targeting 5 business relationship officers of the bank was employed to collect data using open-ended questions. The data collected was analysed qualitatively using content analysis method.

The study found that loan default among clients is influenced by external factors such as the prevailing economic conditions in the country and globally, political environment at a particular time, and even socio-cultural factors and internal factors to the organization such as lax procedures for credit management, untrained staff and unaggressive debt collection methods. The study also established that various strategies can be adopted by a lending institution to reduce loan defaults including diversification of credit portfolios, establishing sound credit granting process, effective credit administration and monitoring and even training staff and educating clients on prudent investment of loans.

The study finally recommended that every lending institution should develop sound credit control policy, establish mandatory credit risk departments, and develop an integrated credit risk strategy aimed at dealing with loan defaults.
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ABBREVIATIONS AND ACRONYMS

CBK: - Central Bank of Kenya
CRBs: - Credit Reference Bureaus
FASB: - Financial Accounting Standards Board
PAR: - Portfolio at Risk
SMEs: - Small and Medium Enterprises
CHAPTER ONE
INTRODUCTION

1.1 Background of the Study
In every country including Kenya, Small and Medium Enterprises (SMEs) play a major role in economic development. Ayyagari, Demirguc-Kunt and Maksimovic, (2011) state that on average 60 percent of formal employment in manufacturing sector is contributed by SMEs in advanced and developing economies alike. A crucial element in the development of the SME sector is access to finance, particularly to bank financing, given the relative importance of the banking sector in serving this segment. However, banks are more concerned with ability of every borrowing customer to repay their loans in time to avoid credit risk exposure.

The portfolio at risk (PAR) which is a standard international measure of portfolio quality that measures the portion of a portfolio which is deemed at risk because payments are overdue is a crucial measure for commercial banks. PAR 30 means the portion of the portfolio whose payments are more than 30 days past due and spells trouble for banks as such loans may not be recovered. This chapter therefore explores the objectives of this study and explains the concept of loan defaulting, loan recoveries and what is considered small and medium enterprises (SMEs). The chapter also includes the problem statement, the scope of the study and explains the significance of this study.
1.1.1 Concept of Strategy

Strategy is an important element of this management process (Aosa, 1992). Johnson and Scholes, (2000) define strategy as a direction and scope of organization over the long-term, which achieves advantage for the organization, through its configuration of resources within a changing environment to meet and fulfill expectations. The strategic decisions in an organization are a blend of deliberate and purposeful actions aimed at marching the activities of the organization in which it operates.

Strategy making therefore bring into play the critical managerial issues of how to achieve the intended results in light of the organization’s prospect. The complexity of strategic decisions requires strategic management. Strategic management has been defined as a set of decisions that results in formulation and implementations designed to achieve organizations objectives. Believes that strategic management represents an organization’s ability to analyse strengths, weaknesses, opportunities and threats facing the organisation; develop the scope, resources, competitive advantage, and synergy; and create organizational flexibility in order to respond to changes in the environment.

1.1.2 Strategic Response

Strategic responses can be categorized according to the dimension of magnitude, domain, and speed, and they conceptualize resources as tangible and intangible. The theoretical framework is meant to understand the relationships among; strategic response to new technologies; organizational resources; and firm performance (Lee and Grewal, 2004).
Strategy is the sustained pattern of resource allocation by which firms align themselves effectively to their external environment. Hence, a useful place to start is to consider the macro-environmental context in which industry finds itself. This is a period of unparalleled change driven by factors such as genomics, health economics and globalization. Each of these factors individually would call for a considered response from the industry, but taken together they represent a fundamental change in the market environment (Smith and Tushman, 2002).

When a firm’s environment moves to a new turbulence level, the responsiveness of the firm’s capability to the environment stimuli must also move to a different level. If the capability fails to keep pace with the environment, the firm is in danger of losing its competitive position and becoming unprofitable (Ansoff and McDonnell, 1990). Thwaites and Glaister (1992) point out that different response despite perception of the same challenges, may be due to differences in a firm’s resources or capacities.

1.1.3 The Concept of Credit
According to Mishkin (2007), the term credit is used specifically to refer to the faith placed by a creditor (lender) in a debtor (borrower) by extending a loan usually in the form of money, goods or securities to debtor. Essentially, when a loan is made, the lender is said to have extended credit to the borrower and he automatically accepts the credit of the borrower.

Credit can therefore be defined as a transaction between two parties in which the creditor or lender supplies money, goods and services or securities in return for promised future
payments by the debtor or borrower. There are three major types of credit. These are commercial credit, consumer credit and investment credit. Commercial credit can be bank credit such as overdraft, loans and advances; trade credit from suppliers; commercial papers (or note); invoice discounting; bill finance; hire purchase; factoring, etc (Basel, 2004).

1.1.4 Loan Defaults
A default on a loan occurs when the borrower does not make required payments or in some other way the borrower does not comply with the terms of a loan (Al-Tamimi and Al-Mazrooei, 2007). It arises when the borrower does not honor the agreement to meet the loan repayment terms which details when money ought to be paid back to the lender. The quality of credit appraisal processes depends on two factors namely, a transparent and comprehensive presentation of the risks when granting the loan on the one hand, and an adequate assessment of these risks on the other hand (Strutt, 2000).

Khan and Ahmed (2001) argued that some banks factors that related to risk management structures put in place by banks were to blame for loan defaults. These banks factors include lax procedures used in credit risk assessment. Negligence in monitoring loan defaults, insider loans, lack of trained personnel and unaggressive credit collection methods. Ndung’u (2007) concluded that when loans are not performing the quality of assets declines and can affect the asset base of a bank and affects the bank’s ability to lend further.

1.1.5 Small and Medium Enterprises (SME)
Though SMEs are commonly defined as registered businesses with less than 250 employees (IFC, 2009), the definition still varies from country to country and even from bank to bank. There is therefore no universally accepted definition of what constitutes an SME. This is because SMEs are heterogeneous in nature and the differing economic environments they operate in hinder a global definition. However, there are various definitions that are acceptable for SME.

According to Financial Access (2010), the most common definitions used by regulators are based on the number of employees (headcount), sales and loan size (assets). The most common among the three is the number-of-employees criterion. The SME sector is the backbone of the economy in developed economies, though it is less developed in low-income countries.

1.1.6 Banking Industry in Kenya

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (2011). The CBK, which falls under the Ministry of Finance, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system.

The banking sector was liberalized in 1995 and exchange controls lifted and as at December 2011 there were forty six commercial banks, one lone mortgage finance institution, fifteen micro finance institutions and one hundred and twenty nine foreign exchange bureaus. The banks have come together under the Kenya Bankers Association
(KBA), which serves as a lobby for the banking sector’s interests. The KBA serves as a forum to address issues affecting members.

The banking industry has been characterized by stiff competition in the last five years. There have been a lot of strategic moves such as rebranding, mergers, takeovers, opening of new branches, increasing of banking hours and focusing attention to the lower end of the market. There has been close attention to loan products for the salaried persons as well as small and medium size enterprises (SMEs) and many of the banks are now hiring direct sales agents to sell their products. Use of ICT has created efficiency and increased delivery channels with such products as e-banking, mobile banking and SMS banking that has enabled payment of bills and cash transfers.

1.1.7 The Co-operative Bank of Kenya Limited
The Cooperative Bank of Kenya was established by a group of farmers in 1965 with the mandate of providing financial services to Co-operative societies. Co-operative Bank runs three wholly-owned subsidiary companies, namely: Co-op Trust Investment Services Limited, Kingdom Securities Limited and Co-operative Consultancy Services (K) Limited, the corporate finance, merchant and investment banking subsidiary. As a former cooperative society, the bank has strategically positioned itself in different areas in the country with a sole aim of reaching its customers. Among the main customers of this bank are the small and medium enterprises (SMEs).

The Bank has gone ahead to establish an SME Department under the Retail Banking Division as a key plank to cater specifically for the SME banking needs in terms of liability (deposits) and assets (loans provision) (Co-op Bank, 2011). The SME
Department is situated on the 5th Floor of Co-operative Bank House which houses the bank’s headquarters. The department has 25 SME Relationship Managers.

1.2 Research Problem
Pearce and Robinson (2007) define a strategy as the pattern or plan that integrates organizations major goals, policies and action sequence into a cohesive whole. Porter (1980), states that strategy is creating a fit among a company’s activities. The success of a strategy depends on doing many things well not just a few and integrating them. If there is no fit among activities, there is no distinctive strategy and little sustainability.

Although much research has been done on bank performance, very few studies relate to challenges facing commercial banks on Non-Performance of Loans in developing countries and in Africa (Carlin and Mayer, 2003; Mishkin 2007). According to Central Bank of Kenya (2012) the Kenyan banking sector was in the 80’s and 90’s saddled with a momentous non-performing loans portfolio. This invariably led to the collapse of some banks. One of the catalysts in this scenario was serial defaulters who borrowed from various banks with no intention of repaying the loans. Undoubtedly these defaulters thrived in the information asymmetry environment that prevailed due to lack of a credit information sharing mechanism. The Government of Kenya had to write-off debts for coffee farmers in 2006 which was disbursed to farmers through Co-operative Bank.

Various studies have been carried out on commercial banks in Kenya. Njiru (2003) did a study on credit risk management by coffee cooperatives in Embu District. Nyaoke (2007) did a study on the responses of commercial banks in Kenya to the challenge of loan

To the best knowledge of this researcher, no study has specifically been done on strategies to reduce loan defaults of small and medium enterprises financed by Cooperative Bank of Kenya. A knowledge gap therefore exists. This study sought to find what strategies Co-operative Bank should put in place to ensure efficient repayment of loans by SMEs?

1.3 Research Objectives
i. To determine the main factors that lead to defaults in repayment by SME customers.
ii. To identify strategies that Co-operative Bank can use to reduce loan defaults among SMEs customers.

1.4 Value of the Study
Small and medium enterprises may be enlightened on the factors that lead to loan defaults and the strategies they can discuss with the bank to avoid legal proceedings against them.
sale of collateral and how to restructure a loan facility. The institutions will also obtain information on problem of credit management in Kenya and the strategies that need to be put in place to solve these problems and the experience of similar organizations in other parts of the world in solving these problems.

The study may help the Government of Kenya and CBK with useful information for the formulation of policies that may act as deterrent measures to errant loan defaulters and also those that may better help regulate credit management in the sector. This is because it’s the government’s responsibility to come up with policies that address various challenges in any sector of the economy.

Co-operative Bank and other financial intuitions who provide credit in terms of loans to the general public may benefit from the findings of this study on the factors that influence loan defaults of SMEs and strategies that they may employ to safeguard them from escalation of non-performing loan portfolios. Commercial banks may also find this study useful in gauging their performance in this high-worth market. Finally, the researcher is most likely to gain useful skills that will aid her personal future research work. Other academic researchers may also find this study necessary to induce further research in areas of loan defaulting by commercial bank customers. It may thus form a good background for further research. It may also contribute to the existing body of knowledge and fill in the gap on the strategies that a bank may adopt to reduce non-performing loan portfolios.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter presents a summary of literature from other sources concerning loan defaults and strategies that can be adopted to reduce the occurrence of defaults. It provides theoretical and empirical literature on which this study is grounded. It will also provide the conceptual framework of the study.

2.2 Factors Influencing Loan Defaults
The payment of a loan usually receives less attention than it deserves. The loan is said to be defaulted if any of the terms of repayment is not met. The various factors that lead to loan defaults include source of income, credit risk evaluation, lack of supervision of projects and length of litigation process.

2.2.1 Source of Income
Carlin and Mayer (2003) argue that is expected that level of one’s income will affect their capability to purchase of finance property. A consideration made by the financing firms to the employees at different levels of employment focus on employees’ income and job security in determining the possible number of installments to be given to the employees seeking for financial grants.

Employment rate is used to reflect the relative health of an economy and it is expected that higher employment rate will increase the likelihood of purchasing of property.
However, the studies show mixed findings. Cunningham and Capone (1990) find the regional employment rate significant but, contrary to expectations, negatively related to default. Deng et al. (2002) find unemployment rate to be highly significant and positively related to default/foreclosure.

2.2.2 Credit Risk Evaluation
Poorly unprofessional credit risk evaluation; lending decision are made in the past by lending institutions put a lot of emphasis on security than other similar important considerations (Santomero, 1997). There are instances in the past when it was easier to get a loan from a financial institution as long as the borrower had security to be charged rather than the ability to service the loan. Cash flow projections, viability of the project, character of the borrower, previous loans completion and ability to repay were not considered as important. This way a number of lending institutions ended up with many loan defaults due to incomplete, poor and unprofessional credit risk assessment.

For credit quality report to be meaningful, all credits must be monitored, and reviewed periodically. It is, in fact, standard for all credits above some dollar volume to be reviewed on a quarterly or annual basis to ensure the accuracy of the rating associated with the lending facility. In addition, a material change in the conditions associated either with the borrower or the facility itself, such as a change in the value of collateral, will trigger a re-evaluation. This process, therefore, results in a periodic but timely report card on the quality of the credit portfolio and its change from month to month (Parrenas, 2005). Generally accepted accounting principles require this monitoring. The credit portfolio is subject to fair value accounting standards, which have recently been tightened
by The Financial Accounting Standards Board (FASB). Commercial banks are required to have a loan loss reserve account which accurately represents the diminution in market value from known or estimated credit losses (Araten; Jacobs; and Varshney, 2004).

2.2.3 Lack of Supervision of Projects
Lack of supervision of projects arises when update of customer information and borrowers circumstances is not done frequently as a result the lending institution employees’ inability to be close to their customers (Sundarajan, 2007). Moral hazard on the part of senior management, credit officers and borrowers arises when loans are not subjected to normal objective credit assessment before disbursement.

SME loans are generally structured as long-term loans, the periodic payments for which are similar to an annuity and calculated according to the time value of money formulae (Erste, 2009). While only a limited number of impact assessments exist that focus on this issue, the available evidence highlights that a significant part of medium-enterprise, who may have access to finance, may not have control over the loans contracted.

2.2.4 Length of Litigation Process
Lending institutions have in many occasions been frustrated when pursuing loan defaulters due to lengthy litigation process. The required statutory notices to the defaulters which are usually three in number take seven months. Although lending institutions give sufficient notices to sell securities, costly and inefficient delays are occasioned by court injunctions given usually on the day of sale, stopping the realization (Hospes; Musinga and Ong’ayo, 2002).
The banking industry has long viewed the problem of risk management as the need to control four of the above risks which make up most, if not all, of their risk exposure, viz., credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most bankers would view legal risks as arising from their credit decisions or, more likely, proper process not employed in financial contracting.

2.3 Strategies to Reduce Loan Defaults
The devastating effect of credit loss which is the aftermath of non-performing loans and advances makes sound evaluation of credit request paramount in all our banks. The Credit Officers of banks need to properly evaluate and articulate the projects, the customers and the prevailing economic situations. Aremu et al (2010) described three basic principles for evaluating credit as safety, suitability and profitability. In the first instance, safety of any advance or loan is of utmost importance. Banks must emphasize among other things, the character (honesty, integrity and reliability) of borrowers.

2.3.1 Credit Scoring and Reference Bureaus
The inadequacies of the traditional approaches to loan processing with its attendant problems arising from repayment and recovery have been the concerns of banking professionals over time. This then calls for an approach that can take care of the inadequacies in the credit processing and administration procedures. The CBK (2011)
maintained that the credit framework of banks should be designed to serve as a tool for monitoring and controlling risk inherent in individual credits. The concept has been referred to as ‘credit scoring’ in some quarters.

“Credit Reference Bureaus (CRBs) complement the central role played by banks and other financial institutions in extending financial services within an economy. CRBs help lenders make faster and more accurate credit decisions. In Kenya, CRBs collect, manage and disseminate customer information to lenders within a provided regulatory framework – the Banking (Credit Reference Bureau) Regulations, 2008”, (CBK, 2012).

2.3.2 Efficient Information Support Systems and Financial Education

To properly analyze collections activities, it is necessary for the institution to have in place an efficient information system to facilitate the monitoring of past-due clients and the production of clear and precise reports (Carlin and Mayer, 2003). Generally there are three kinds of reports. Management reports such as lists of past-due clients to visit by loan/collections officer, list of past-due clients by amount and days late, or daily collections report, used by field staff to follow up with clients. These reports should be generated daily.

Borrower education can go a long way towards reducing default rates. Prior to disbursement, institutions should educate and train the client and guarantor about the implications of obtaining a loan, how the product works, the benefits of paying on time and the payment schedule, while also providing information about the closest and easiest way for this particular client to make loan payments (Acharya, 2007).
2.3.3 Appropriate Collections Procedures

Collections activities command an immense amount of time and resources in order to be implemented well. Banks have a choice to make—whether to hire a specialized collections agency or to create an internal collections unit. Before deciding, however, the bank must analyze its options carefully, noting available resources, costs, and benefits associated with each path and the existence of collections agencies in the market (Misino, 2004). While many institutions currently consider data mining vital to portfolio evaluation, it is still not used as an important tool to maximize the effectiveness of collections activities. Data mining allows lenders/creditors to forecast the probability of recovery and provides them with a score useful in prioritizing past-due loans based on recuperation probability (Nimal, 2008).

2.3.4 Select and Train Staff Members

Once the decision is made to either create an internal collections unit or work with an outside collections agency, the bank must identify the position and roles in the collections process, if any, that should be filled by internal staff and selected accordingly based on the appropriate profile for each position. It is important to define the roles and responsibilities of each participant in the collections process (e.g. field agents, call center, collections agencies, lawyers). This includes exact levels of participation. For example, call-center staff may contact the client, but should not negotiate payment, as they are not trained to take on this task (Gersbach and Lipponer, 2003). Training is vital to achieving successful loan collections and good customer service.
2.3.5 Customer Segmentation

Another methodology used to implement successful collections strategies is client segmentation. Not all clients are the same, nor are their reasons for delinquency. Effective client segmentation results primarily from identifying the cause of delinquency and classifying the client based on attitude, capacity to pay, solvency and location (Acharya et al, 2007). Effective client segmentation is not achieved early on; classification is a difficult task, which is why it is important to follow up with clients and monitor the number of days any client falls past-due. As the number of past-due days increases, strategies should change as the bank and collections agents come to know the client better.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter outlines how the study will be carried out. The following components of the study shall be discussed: research design, population, data collection methods and procedure, and data analysis methods. Research methodology is said to be important because it presents a procedural way of solving a research problem (Kothari, 2004).

3.2 Research Design
This research study will adopt case study of Cooperative Bank of Kenya. Mugenda (2008) further explains that a case study attempts to thorough investigate the concept at hand which leads to understanding loan default among small and medium enterprises. This research design has been successfully used by Mumbi (2005), Machuki (2005) and Abshirow (2004) among others.

The case study design will give an in-depth explanation of topical issue. The case study method will be selected because it will enable the researcher to have an in-depth understanding of phenomena at hand.

3.3 Data Collection
To meet the objectives of this study, the researcher will collect primary and secondary data. Secondary data included but will not limited to previous studies by other researchers and other literature on the bank that helped achieve the objectives of the study. The
interview guide will consist of questions covering issues on loan recovery, the challenges loan default management and ways of overcoming these challenges. These will facilitate a more in-depth interaction with the respondents of the study. Interview guide will be administered in person to the six direct sales and five relationship managers under the SME department. Interview guide was used because it was easier to analyze and since it is in immediate usable format it allowed the researcher to corroborate the information with data collected from secondary sources.

3.4 Data Analysis

Content analysis will be used to analyze the collected data. According to Mugenda (1999), content analysis is the systemic qualitative description of the composition of the objects or materials of the study. It involves observation and detailed description of objects, items or things that comprise the study. Content analysis technique will be selected on the basis that subjecting the collected data to this kind of analysis would enable the researcher to achieve the objectives of the study.

This analysis technique will allow the researcher to learn and understand the underlying issues to do with reducing loan defaults by Co-operative Bank. Content analysis will enables the researcher to include large amounts of textual information and systematically identify its properties, e.g. the frequencies of most loan defaults (KYC) meaning "Know your customer") by locating the more important structures of its content.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction
This chapter presents the data findings on strategies adopted by Co-operative Bank in response to loan defaulters among SMEs in Kenya. Using an interview guide, 5 Business Relationship Officers from 5 different Co-operative Bank branches in Nairobi City were interviewed for this study. A response rate of 100% was recorded for this study since all the 5 officers agreed to take part in the study. Interview method allowed the researcher to ask probing questions and get an in-depth explanation of scenarios that would have not been possible using questionnaires. The findings of this study were presented in prose and explanations provided.

4.2 Position Held in the Bank
The respondents were required to provide information on their job title. All the five respondents indicated their designation was Business Relationship Officer. This term was given to all staff who handled SMEs customers who were borrowing irrespective of their ranks which included clerks, section heads and supervisors. Those in the level of section heads and supervisors were in the managerial level though not at the level of senior managers. The respondents were however quick to point out it was rare to find clerical staff in that position. This showed that the bank considers SME clientele key to the bank that the officers entrusted with the job are in the rank of section heads and above.
4.3 Contents of Credit Manual in Use

The respondents were asked if they had a credit manual in place and to mention the key contents of that manual. All the respondents indicated they had a credit manual in place and is available in all branches and all head office departments dealing with lending. The key contents of the credit manual included procedures on measurement and reporting of non-performing loans, loan classification and provisioning, documentation and securities, authorization procedures and ethics to be followed in lending, pricing procedures of credit facilities, assessment of risks, and prudential oversight of asset quality.

4.4 Factors Considered in Setting Credit Policy

The credit policy is considered the general guideline governing the process of giving credit to bank clients. The bank considers various factors when setting up its credit policy. These include regulations by the regulatory authorities (Central Bank of Kenya). The CBK through Prudential Guidelines insist on certain aspects that banks must include in their credit policy including credit approval limits, collateral and underwriting standards, exposure limits, non-performing loan limits and enforcement of strict provisioning for bad loans.

Setting up of credit policy is also affected by the overall objectives and policies of the bank. The lending policy must be in line with the overall bank strategy. Another factor to be considered is the industry norm. The credit policy of the bank should conform to the industry practices to help position the bank effectively to gain competitive advantage and comply with industry practices. Another key factor is the general economic conditions
prevailing in the country. The policy should take into consideration the general economic outlook considering factors such as general inflation in the country, the GDP of the country, the wage rates, and the general growth of the various sectors of the economy such as the SME sector. The prevailing global economic climate also affects the credit policy of the bank. This means the credit policy should be flexible and allow for review to take into consideration such factors like the recent global credit crunch affecting USA and the European Union. These factors have spill-over effects on the local credit market. The bank also considered industry norms in setting up its credit policy to ensure that they remain competitive enough in the market.

4.5 Factors Leading to Loan Defaults
The respondents mentioned that several factors contribute to loan defaults among SME clients. These were categorized as external factors and those internal factors to the organization. External factors included prevailing political conditions in the country. For example, they mentioned there was an increase in loan defaults after the post election violence in 2008. They generally observed that political activities negatively affected loan repayment by SME clients. Unfavourable economic environment in the country also triggered loan defaults since it meant great changes in income. Economic factors affected the cash flows of a business thereby negatively affecting loan repayment. Socio-cultural factors and religious factors were also mentioned to affect loan repayment among clients.

There are also other internal factors to the bank that lead to defaults. Khan and Ahmed (2001) observe that some risk management structures put in place by banks encourage loan defaults. This study also found similar results. For example, the respondents also
mentioned internal factors that lead to loan defaults included lax procedures used for credit risk management, negligence on the part of credit officer in monitoring loan repayments by clients, insider loan dealings – where credit officer colludes to manipulate the credit scoring system by providing false information to grant credit to unqualified customers without ability to repay the loan. Another leading cause for loan default is the use of untrained bank staff to perform credit appraisal and disburse loans to clients. Use of unaggressive credit collection methods by the bank or individual credit officers also contributed to loan defaults.

4.6 Approval of Loans
The respondents indicated that loan approvals are done by the Branch Managers of each bank branch backed by the branch credit committee. Each branch has a credit committee chaired by the branch manager, which sits every morning to review all loan applications for the previous day and approve. Once an SME loan is approved at the branch level and signed by the business relationship officer and the branch manager, the application form is sent to Credit Risk Manager at the Head Office to also review and approve or ask for additional documents and considerations if not in agreement with the branch committee. The approval limit for all SME loans is between 5-20 million shillings. This seemed as a good control mechanism for the bank as far as approval of loans are concerned. The multi-approval levels provided checks and balances that might help reduce portfolio of bad loans. However, the process of sending the application forms to head office for further approval should be fast-tracked to ensure efficient service delivery.
4.7 Lending Period
As a credit policy of the bank, all SME loans are advanced for a period between 3-12 months. However, the respondents mentioned there are those SME clients who are allowed a period longer than 12 months, usually maximum of 24 months, based on the loan repayment records. On average, the majority of SME loans were advanced for a period of 6 months, graduated depending on the history of repayments.

4.8 Methods Used for Credit Appraisal
Respondents were further asked to indicate the methods used by the bank for credit appraisal. The findings showed that the bank combined the use of different methods in appraisal for credit. Individual loan appraisal was subjected through all the different methods to make a decision to grant a loan or not. The main appraisal methods used by the bank included use of portfolio approach, use of credit scoring system, and the use of financial ratios.

The bank used credit scoring method which is a statistical analysis of a borrower's credit report used to represent creditworthiness of that client. Credit scoring is based on credit report information of that particular client as per records existing in the bank and that obtained from credit reference bureaus. It is used to evaluate potential risks posed by giving loans to clients and to mitigate losses due to bad debts. The bank also used financial ratios method during credit appraisal. The most common ratios used by the bank included liquidity ratios to determine whether the SME firm could meet its short term obligations – that is pay creditors and repay short-term debts – by calculating current ratios and quick Ratios. The bank also calculated leverage ratios to determine if the firm
can generate new funds from the loan/capital being sought (debt-to-asset ratios and debt-to-equity ratios) and rates of return ratios to determine profitability through return on assets (ROA) and return on equity (ROE) ratios. The bank also used Portfolio Approach which provided a complete view of portfolio credit risk – that is the expected losses and actual losses. The portfolio approach involves quantitative portfolio review using credit scoring method by measuring concentration risk of each portfolio as explained Seppala et al (2001).

4.9 Ways to Make Employees Aware of Credit Risk
The respondents mentioned that the bank used different methods to disseminate information to all bank staff on credit risks. The main methods include the use of credit manual which available on the E-learning portal accessible to all staff through the bank’s intranet. The bank expects staff to take a test after each episode of E-learning to ensure that staff had grasped the contents. The bank also employed the use of mandatory training on basic credit for all new bank staff through the training school (Co-operative Bank Management Centre) based in Karen Nairobi. Further, all staff handling credit are taken through rigorous training on credit skills development on commercial lending and credit risk management at the same training school. The training for credit staff is performed by external and international trainers to ensure best trained credit officers to handle the key SME clients.

4.10 Mitigating Factors to Reduce Default
Different mitigating factors were put forward by the respondents. The main factors identified as effective in reducing loan defaults included portfolio diversification, limiting
loan sizes, education of staff and SME clients, trade-off between loan outreach and efficiency, monitoring and evaluation of loans, and flexible repayment schedules.

The bank diversified loan portfolio geographically and sectorally to ensure that there is less concentration of loans in a particular sub-sector of the SME that might collectively be affected by a single major factor like political or prevailing economic conditions. The bank also traded-off product outreach for efficient loan administration. The bank focused more on quality of loans as opposed to the breadth (number of loans disbursed). The focus on outreach may give the bank more returns on loans but is quite heavy on loan administration given the numbers and small sizes of such loans. This view of trading outreach for efficiency in loan administration and quality is also supported by Cull et al (2007).

Training of staff and educating clients was also mentioned as an effective strategy in reducing loan defaults. Training reduces recurring costs, improves operational efficiency in terms of quality of appraisal of loans, and loan recoveries. Financial and business education helps SME clients to seek funds and invest in appropriate projects where they are sure to get good returns. The respondents also indicated that developing adequate monitoring and evaluation tools to monitor and evaluate investment and repayment of each loan helps to reduce loan defaults. Such monitoring tools help to improve overall institutional efficiency and effectiveness of each follow up process.
Developing flexible loan repayment schedules also helped to reduce default rates. The bank therefore provides means through which clients can reschedule the repayments to suit the realistic changes in their cash flows. This should be coupled with delinquency control methods such as signing contracts with clients to allow their debtors channel payments through the bank directly to enable for recovery as and when payment is made. Insider dealings may be addressed by proper training of staff on the consequences of their actions and adequate compensation of staff through commensurate salaries and other staff benefits to ensure they do not engage in such dubious activities with the bank’s funds.

4.11 Considerations before Extension of Credit

The respondents listed and explained main factors considered before availing credit to clients. These included cash flow projections for the borrower, character of borrower, term of the loan sought, credit policy of the bank, statement of financial position, income statement, capacity of the borrower to repay, availability of collateral, and the prevailing economic conditions in the country.

The credit policy of the bank is a key consideration. All credit must be advanced as per the credit policy of the bank. This is due to the fact that the credit policy sets the bank’s lending philosophy – for example, the bank has it as a policy that they lend to clients who need credit and are able to meet repayment obligations, but not lending to collateral. The credit policy is also important because it sets specific procedures to be followed when lending. It also provides the means for monitoring the lending activity.
Cash flows for the business is an important appraisal consideration because businesses borrow mainly when cash outflow is larger than cash inflows such that their own cash resources are not large enough for the business to operate. The difference in the timing of cash outflow and cash inflow is very important while lending to a business since it will dictate when you will expect your loan to be repaid. It will also determine the possible number of instalments required to repay the loan.

The bank also considers the term of the loan before disbursement is made. The term of the loan is dependent on the cash flow of the business and the policy of the bank. It's therefore important to determine and agree with the customer the term of the loan before credit is advanced. The maximum repayment period extended to the client must be in conformity with the bank's policy after considerations of all exceptions available to the customer. Statement of financial position (commonly referred to as the balance sheet) is also an important consideration. Lenders rely on the financial reports prepared by the managers of a business in order to present a fair and consistent picture of how successful the business has operated in the past. The financial statement help lenders to gain an insight about some of the important issues on strengths and weaknesses of the business. The loan officer must therefore understand how the items and amounts in the statement represent actual assets, liabilities, revenues and expenses for that business.

The other important consideration is the income statement (statement of profit and loss). The income statement shows what happened between the dates on which the statement of financial position was prepared – that is what the business sold and what it cost to sell. It
shows a summary of all the activity directed toward increasing investment during a given period (usually 12 months). Availability of collateral is another important factor since collateral/securities provides the bank with a fall back situation should the client become totally incapable of repaying the loan. That collateral will be sold to settle the remaining loan balance in total or in part if the collateral is not sufficient to cover the whole debt. In such a case a loan write-off is considered. The loan officer must therefore ensure that security held is adequate to cover for the whole amount at present value.

4.12 How to Decide a Loan is Defaulted
The respondents were unanimous that the bank decides a loan is defaulted when a client fails to honour agreement to meet loan repayment as scheduled.

4.13 Dealing with a Defaulting Client
The respondents indicated that the first step in dealing with a defaulting client is to re-structure the loan. Re-structuring involved review of the term of the loan (extending the period of repayment within the stipulated credit policy of the bank), and adopting flexible loan repayment strategy where a client is allowed to repay what they can sufficiently afford given the circumstances at hand. This client must also be monitored closely by the relationship officer to ensure a customer friendly but aggressive collection method is used.

The other way to deal with a defaulting client is to higher debt collectors to act on behalf of the bank. The debt collectors could be external experts hired by the bank or internal staff specially trained on debt collection procedures. In some cases where the client
refuses to comply with the restructuring of the loan, a demand letter is issued to the customer notifying them of their obligation to repay. Should this fail, the bank moves in after one month notice to repossess assets used as collateral. Where the repossessed assets are inadequate to recover the loan amount and interest, the loan is written-off and insurance involved to repay the bank.

4.14 Regulations by CBK to Protect Banks against Loan Default
Respondents indicated that they felt Central Bank of Kenya has adequately addressed information asymmetry that prevailed previously due to lack of a credit information sharing mechanism. Since 2008, CBK created the Banking Credit Reference Bureau Regulations to enable the credit reference bureaus to collect, manage and disseminate customer information regarding credit repayment to lenders within the provided regulatory framework. However, some of the respondents felt that some regulatory controls may directly limit banks' risk taking as they limit banks portfolio composition. Stringent regulations may also force banks to expand into areas they previously would have not entered thereby creating bad loans. This same view is shared by Coyle (2000) who is of the view regulations may lower credit standards applied by banks.

4.15 Strategies to Reduce Loan Defaults
Each respondent gave several strategies that in their opinion have worked to ensure loan recoveries. These included:

Establishing appropriate credit risk environment
The Board of Directors should have the responsibility for approving and periodically reviewing credit risk strategy and significant loan recovery policies for the bank. The
senior management should have the responsibility for implementing the credit risk and recovery strategy as approved by the board. They should also develop policies and procedures for identifying, measuring, monitoring and controlling credit risk to help ensure all loan are recovered in full plus interest.

**Operate under sound credit granting process**

The criteria for availing credit should include clear indication of the bank's target market and a thorough understanding of the borrower as well as the purpose and structure of the loan and the source of repayment of the credit extended.

**Establish credit limits**

The bank should establish overall credit limits at the level of individual borrowers and counterparties. These limits should never be violated unless reviewed by the top management of the bank and communicated in writing to the credit/lending officers.

**Effective credit administration and monitoring**

The bank should also maintain appropriate credit administration, measurement and monitoring process. A system for administration of all credit facilities (including setting up a department to focus solely on credit administration), especially all credit risk-bearing should be put in place. Monitoring the condition of individual loans including the determination of the adequacy of provision should also be carried out on regular basis using a specific system.
Develop use of information systems
The development of information system and analytical techniques that can enable management and lending staff to measure the credit risk inherent in a loan and monitor the progress of credit repayment at the touch of a button should be in place. The information system should be integrated with the core banking system in order to provide for adequate information on the composition of the credit portfolio, including identification of any concentration risk.

Develop internal risk rating system
Bank should also develop and utilize internal risk rating system in managing credit risk thereby reducing default rates. The system should take into consideration the nature, size and complexity of the bank’s activities. Similarly, the bank can establish clear processes for credit approval, credit amendment, renewal of loan facilities and re-financing of existing credits (what is commonly known as top-up loans in Kenyan lending parlance).

Training staff and educating clients
Financial education of clients and training staff on effective use of capital and credit risk management respectively should be carried out on regular basis through simulation trainings and seminars. Door to door visit of clients through the use of customer relationship managers to walk the customer through the loan repayment process should also be encouraged to ensure satisfied customer and building of loyal customers who regularly service their loans.
4.17 Discussions

The literature review postulated that there are different reasons why clients default on loans. These factors that influenced loan default include the source of income for client, poor and unprofessional credit risk evaluation, and lack of periodical review and monitoring of loans (Santomero, 1997; Parrenas, 2005; Carlin and Mayer, 2003). This study also found similar results that the major factors that led to loan defaults among SMEs included unfavorable economic conditions, socio-cultural factors, lax procedures used for credit risk management, negligence in monitoring and review of loans, use of untrained staff and unaggressive credit collection methods. The factors that encourage loan defaults therefore seem similar and proper mechanisms to deter their occurrence should be well formulated.

This study pointed out that default on loans by SME clients can be reduced through various strategies such as diversification of loan portfolios (geographically and sectorally), through monitoring and evaluation of credit advanced to clients on a regular basis, use of flexible loan repayment schedules, educating staff and borrowers on credit risk management and prudence investment of funds respectively, and proper credit scoring of individual clients before credit is advanced. Literature review had advocated for the use of credit scoring and reference bureaus, use of information systems (Carlin and Mayer, 2003), financial education, customer segmentation, and use of appropriate debt collections procedures as some of the effective ways in reducing loan defaults as put forward by (Acharya, 2007; Misimo, 2004; Nimal, 2008).
This study also established that lenders consider various factors before extending credit to clients despite the fact that the client may possess adequate collateral for the credit sought. The main factors considered were the ability and willingness of the client to repay the loan, the cash flow for the client (for all business loans), the character of the borrower and the history of repayment, and prevailing economic conditions. Similar argument is advanced by Santomero (1997) who observed that lenders no longer peg borrowing on security offered by the client but the ability of the borrower to service the loan. This is also supported by Mishkin (2007) who argues that lenders may refuse to make loans even though borrowers are willing to pay a higher interest rate, or make loans but restrict the size of the loan if the repayment capability is not adequately demonstrated.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary
Client audit services have evolved to strategic and value-add services that focus on the firm’s future rather being viewed as a routine-have-to-provide services. Firms can therefore transform their client audit services through strategic positioning, marketing strategies and technology establishment to provide higher margin, value-added services to the client. The study established that the major audit firms in the country put more emphasis on product positioning, price positioning and application positioning strategies to capture and retain their market share. The study also found out that the main challenges facing audit firms in implementing positioning strategies include staffing challenges, leverage and technology challenges and too stringent regulations that affect the manner in which firms deliver their audit services to the clients.

5.2 Recommendations
As a first step this study recommends that every lender should develop a credit control policy as a key strategy to reducing cases of loan defaults. A credit control policy is considered as the general guideline governing the process of giving credit to bank customers. It sets the rules on who should access credit, when and why they should obtain the credit. It also indicates the methods of assessment and evaluation of credit risk of each client applying for credit facility.
This study also recommends that each lender should put in place credit risk management team or department that will be responsible for establishing credit policies and standards that conform to regulatory requirements, developing and maintaining credit approval structure, granting approval authority to all clients after thorough review, assessing and continuously monitoring portfolio credit exposures through special management information system, reviewing the adequacy of credit training across the bank, and ensures that all portfolios are adequately collateralized by cash equivalents and fixed and current assets.

Finally, this study recommends that each bank should develop an integrated and comprehensive strategy aimed at reducing cases of loan defaults among clients. The integrated strategy should include specific strategies touching portfolio diversification, limiting loan size to address concentration risks, financial education of clients, thorough training of staff on credit risk management, effective evaluation and credit monitoring strategies, and efficient collection/recoveries strategies for all credit advanced.

5.3 Limitations of the Study
The researcher faced limitations especially in getting the respondents to find time to sit for an interview. Given the fact that bankers work from 8am to sometimes after 8pm, most interviews were conducted after working hours since this is the only available time the respondents could afford. Further given the nature and sensitivity of banking practice, most respondents were cautious about giving away too much information on their strategies and protecting the privacy of their businesses thereby giving scanty responses. Another limitation was the scope of the study where only 5 business relationship officers
were interviewed despite the fact that the bank had more than 120 branches and possibly a similar number of officers taking care of SME business for the bank. The findings therefore may not be generalized to all Co-operative Bank branches nor the industry in general.

5.4 Areas for Further Research
Since this study was concerned with the strategies adopted by Co-operative Bank to deal with loan defaults among SME customers, there is need for further research to be carried out on strategies that a lending institution may adopt to ensure efficient debt collections. Further still, there is need for investigation on the relationship between credit risk management strategies adopted by commercial banks and the profitability of the banks.

5.5 Conclusion
The study established that a borrower is considered to have defaulted on a loan as long as they are unable to meet the loan repayment terms as detailed by the lender. A host of many factors will lead to loan defaults ranging from lax credit appraisal procedures by the bank and untrained staff to prevailing economic conditions in the country and globally. This study therefore concludes that there are equally various strategies that a bank may adopt to reduce cases of loan defaults among clients. Key strategies adopted by Co-operative Bank among SME clients included the use of credit control policy, adopting effective credit risk management structure, use of effective credit appraisal method and finally effective monitoring of credit portfolios to ensure credit repayment falls as per schedule.
REFERENCES


Appendix 1: Letter to Respondent

Dear Respondent,

RE: STRATEGIES TO REDUCE LOAN DEFAULTS BY SMEs

I am a student at the University of Nairobi pursuing a Masters Degree in strategic management. I am conducting a research on the strategies that Co-operative Bank can employ to ensure reduction in loan defaults by their SMEs customers. I kindly request you to spend a few minutes of your time in answering the following questions. Your opinions are highly valuable to assist me gather data from you for the completion of this project. The interview guide covers a number of important areas on Cooperative Bank of Kenya credit administration and I assure you that any information will be treated with utmost confidentiality for the sole purpose of this research.

Thank you,

Julia Ojiambo (Researcher)
Appendix 2: Interview Guide

1) Name of the interviewee

2) Designation

3) How do you consider the following factors in establishing a credit control policy? To what extent do you apply the factors?
   i. Existing credit policy
   ii. Overhead costs
   iii. General trend of credit extended to your organization
   iv. The state of the economy

4) Do you have credit manual? If yes please list the 5 most key contents of the manual in regards to controlling loan defaults

5) Please list 5 main factors you consider when setting up your credit policy?

6) Explain how the following factors contribute to loan default in your bank: do you have policies formulated with focus to any of the factors in mind?
   i. Political factors
   ii. Economic factors
   iii. Socio-Cultural factors
   iv. Religious factors
   v. Environmental factors

7) Who approves loans in your organization and what are their approval limits ceilings?

8) What is the average lending period for your SME loans?
9) How would you classify the method used by your organization in the process of credit appraisal? How regularly do you review your credit policy?

10) Through what way do you make your employees aware of credit risk? Please list 5.

11) What are some of the mitigating factors that you consider to reduce loan default?

12) Which aspects do you consider before availing credit? To what extent is the attribute important in the appraisal process for creditworthiness?

13) How do the following aspects affect your extension of credit facilities to your customers?
   i. Character of borrower
   ii. Capacity to repay
   iii. Prevailing economic conditions
   iv. Availability of collateral/security

14) When does your organization decide that the client has defaulted in loan repayment?

15) How does your organization deal with clients who default in repaying their loans? Are there exemptions to the rules?

16) Do you think Central Bank has put in place adequate regulations to protect commercial banks against loan defaults? Explain your answer.

17) What do you think should be done to strategize on loan recovery for commercial banks?