CREDIT MANAGEMENT TECHNIQUES APPLIED BY FINANCIAL INSTITUTIONS OFFERING MICROCREDIT IN KENYA

MUDIRI. JOSECK LUMINZU
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DECLARATION

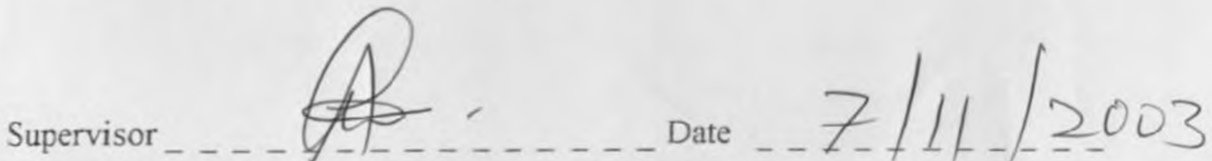
This Management Research Project is my original work and has not been presented for a degree in any university.

Author ________________________ Date 7/11/03.

Mudiri, Luminzu Joseck **Registration Number:** *D/61/P/8755/2000*

Candidate

This Management Research Project has been submitted for examination with my approval as the University Supervisor.



Supervisor ________________________ Date 7/11/2003

Mrs Kithinji Angela

Lecturer

Department of Accounting

Faculty of Commerce

University of Nairobi.

DEDICATION

To all those who make a difference in the provision of micro finance services

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ABBREVIATIONS

AMFI	-	Association of Microfinance Institutions
CBS	-	Central Bureau of Statistics
CGAP	-	Consultative Group to Assist the Poor
GOK	-	Government of Kenya.
MFIs	-	Microfinance Institutions
MSEs/SMEs	-	Small and Micro enterprises
NGOS	-	Non-Governmental Organizations
RFIs·	-	Rural Finance Institutions

ABSTRACT

Over the years, banks have been absent in the provision of micro credit to the small and micro enterprises. The sector has remained the preserve of Microfinance Institutions (MFIs). The liberalization of the financial sector has increased competition; hence banks are looking for avenues to expand their revenue base. The presence of a large underserved market in the small and micro credit sector provides an opportunity.

This paper highlights the issues that affect performance of the banks and MFIs in the provision of micro credit; their credit management models and the impact of the models and related issues on the default rate of the institutions.

The paper observes that banks lend to the sector using the individual lending model, while majority of the Microfinance Institutions (MFIs) use group-based model (Grameen).

The study finds that properly administered credit programs do well whether individual or group-based loans. In case of poor administration, individual loans are more likely to perform poorly.

The study finds that Bank products have a higher default rate than MFIs since MFIs treat micro credit as core and therefore expend effort and time on the services.

The study concludes by encouraging banks to participate more in the provision of micro credit services using methods adopted by successful MFIs.

CHAPTER ONE

1 INTRODUCTION

1.1 Background

1.1.1 Emergence of Micro credit Sector

Access to formal credit by small-scale businesspersons has been quite poor particularly among the low-income category. This is largely as a result of the credit policies associated with loans provided by the formal sector. To bridge this gap, the micro credit sector, with specific principles that target and feed loans to the small and micro enterprise (SME) sector, has emerged (Wright, 2000).

It is widely known that banks have been more active in providing savings on behalf of the SME sector, collecting deposits yet lending the same to the formal sector (Otero and Rhyne, 1994). Banks are still largely absent in the provision of micro credit. The area has literally evolved on it's own accord from an informal level to the current status whereby some banks actually provide micro credit facilities as a result of growing evidence of the viability of micro credit (Oketch, 2001).

1.1.2 Banks and Micro credit Sector

Many banks may be unwilling to provide credit to the small and micro enterprise sector because the clients of the sector are largely poor, lacking of normal securities that can be used as collateral in conventional lending. Banks have therefore for a long time perceived such businesses as highly risky and un-deserving of any credit even though the businesspersons save with the banks. Moreover, the costs associated with administering and monitoring credit services are quite high. The loan value required

by clients in this sector is low hence proportionately low revenues are generated from the loans. This is an issue that could explain why for a long time lending to the rural areas has been driven by governments or donors who subsidise lending. Banks have also been unable to develop the necessary capacity to be sustainable in the market. The banks avoided and were unable to learn and understand the operations of the market preferring to deal with the conventional lending activities that they know best. A better understanding of the market would lead to better credit risk management technologies that would enhance their revenue generating activities. It is also evident that government regulation has not encouraged commercial banks into the sector. Central banks demand cash ratios that limit the availability of funds to lend, while the nature and cost of setting up and operating banking premises discourage banks from locating in areas where the poor would access loans (Baydas et al, 1997).

Growth in the micro credit sector has been mainly driven by NGOs that are donor supported. A large number of these NGOs have collapsed or are unable to operate sustainably and continue to rely heavily on donors (Baydas et al, 1997).

The world over, there are cases of NGOs that started out by offering micro credit, transforming themselves into commercial banks with admirable/comparable levels of profitability to commercial banks (Christen et al, 1995).

Initial attempts into micro lending were made by governments through creation of development banks that were meant to allocate credit to certain sectors at subsidised rates. Studies have shown that directed credit has undermined development of sound financial systems in many third world countries mainly because the loans are limited

to budgetary allocation and are priced below market rates. The presence of moral hazard in many developing countries means that credit rarely reaches desired clients and, in many cases, there is no obligation to repay the loans. Credit management techniques are rarely in place, and even if they are, largely ignored (Coetzee, 1997). The default rate is therefore quite high. During latter years, some development banks have been restructured to provide loans commercially.

Over the past few years, banks have also made a significant push into the provision of micro credit in order to take advantage of the prevailing high levels of profitability. The challenge faced by banks is whether to replicate credit appraisal techniques already established in the industry or to apply their own tried and tested credit appraisal techniques to the new market (Otero et al, 1994).

1.1.3 Definition Of Terms

Loan Products: Types of loans with particular sets of terms and conditions, and often for a particular use.

Micro credit: Micro credit may be defined as the credit given mainly to low-income entrepreneurs or the informal sector to finance them in their businesses. The loans may be provided by both the formal sector and the informal sector.

Micro And Small Enterprise: The study adopts the definition given by the 1999 National MSEs Baseline survey whereby a micro enterprise refers to any business that employs not more than 10 people. A small enterprise is one that employs between 11 and 50 persons (CBS 1999). Employment here refers to people working in the enterprise whether paid or not. Business enterprise or firm are used interchangeably to

refer to an economic unit producing goods or providing services, for example salons, kiosks, among others.

Microfinance: The Association of Microfinance Institutions (AMFI) defines Microfinance as the provision of micro credit as well as other services such as savings, deposits, insurance services and other financial instruments/products aimed at the poor or low-income people. This study focuses on the micro credit aspect.

Microfinance Institution: This is an institution set up and primarily dealing in the provision of micro finance services.

Banking Institution or Bank: This is an institution that is allowed by law to accept deposits and give advances under various statutes.

Development banks. These are banks that are constituted only to deal with specific sectors such as agriculture etc. They give directed credit. This study is not concerned with development banks.

Default Rate: The rate at which loans become bad and cannot be collected unless legal process commences.

1.2 Problem Statement

A major issue that is encouraging entry into the micro credit sector is the growing level of competition within the banking industry (Baydas et al, 1997). The increase in the number of banks and other financial institutions fighting for the formal banking sector has led to a glut in the sector. A large number of international banks are taking over corporate banking business, forcing many local banks into retail business. The liberalisation within the banking sector in the mid 1990s has led building societies to

rethink their strategies and ended up in micro credit after realising that this is one market that remains largely untapped (Coetzee et al, 2002)

There are indications that borrowers from microfinance institutions have a lower default rate than micro credit borrowers within commercial banks. (Annual Reports KREP, 2001; Annual Reports KCB, 2001). Given this rate, commercial banks might benefit from understanding how best to employ the methods adopted by the MFIs so as to reduce their default rate. The high default rate could be as a result of the credit management techniques employed by the commercial banks.

1.3 Objectives Of The Study

The objectives of the study are

a) To determine credit management techniques employed by institutions offering microfinance services in Kenya.

b) To identify any differences in credit management techniques employed by commercial banks in micro credit versus those employed by other MFIs.

c) To determine whether there is a relationship between credit management techniques and the default rate of institutions offering Microfinance services.

1.4 Significance Of The Study

The study will be important in the following ways:

i) The study will assist banks in their endeavour to cultivate better methods of managing credit for the SME sector. Banks will understand the issues that are faced within the sector and the factors that determine success.

ii) Microfinance Institutions (MFIs) in Kenya will use the research findings and the knowledge gained to assist them as they commercialise. Microfinance institutions are faced with the need to adopt sustainable methods of delivering services, which only can be achieved by offering sustainable products, of which the default rate is a crucial part.

iii) Managers in Kenya will have knowledge on how to limit default among micro credit customers. Since the micro credit area is a growing sector, managers need to learn how to handle the challenges of growth by understanding all the facets that include loan default.

iv) The Government, in formulating policy that relates to the regulatory environment of the country as far as micro credit activities are concerned. As the sector grows, the government has to come up with policies that address the various challenges within the sector, to reduce any resultant chaos, and to facilitate faster growth with minimum drawbacks.

v) Donors who provide funding for credit, need better understanding of the best opportunity to invest money. Donors should understand if their funds are reaching the desired objectives and whether lenders to MFIs are putting in place safeguards to reduce default. They also need to compare their institutions.

vi) Facilitating an increase in the general knowledge of the subject. The area of micro credit is still suffering from a dearth of information. Research in the various components of the sector will help to unearth hitherto unknown information that will go along way in facilitating further understanding of the micro credit sector.

CHAPTER 2

2 LITERATURE REVIEW

2.1 Small and Micro Enterprises

The importance of small and micro enterprises, also referred to as the informal sector or "Jua Kali", sector in the alleviation of poverty in Kenya has been recognised in the Ministry of Finance budget speeches (1999/2000, 2000/2001, 2001/2002, 2002/2003). The businesses are largely undertaken by self-employed persons; own account workers or working employers of a small number of workers (Economic Survey, 2003). The Small and Micro Enterprises (MSEs) employ nearly 2.3 million persons or 29% of the country's total employment (CBS, 1999).

2.2 Microfinance Institutions

Microfinance Institutions have provided the largest volume of credit to the SMEs. The market for small loans in Kenya has remained under-served for a long time and therefore filled by the Microfinance Institutions (Coetzee et al, 2002). The Government of Kenya is also in the process of developing a framework within which Microfinance providers will fall (Budget speech, 2002/2003).

2.3 Financial Needs for SMEs

Small and micro enterprises have faced persistent pressure when seeking funds for investment. The SMEs cannot easily access funding because they have underdeveloped businesses that have a very short history hence banks are often not willing to lend using conventional methods. Furthermore, the promoters lack securities that can be given to lenders or guarantee other investors into their business and, the promoters have neither the education nor the ability to convince investors or

financial intermediaries. Owners may also not have a saving history with a financial intermediary that can form the basis for savings-led credit. This possibly explains why banks in the past few years have relocated from rural and suburban areas rendering potential customers in these areas to have no access to credit (Coetzee et al, 2002). SMEs need credit for new investment in business, operational activities, and for growth of the business.

Investment in business: SMEs require funds as start up capital for investing in new ventures that they may have come up with. Rukwaro (2000) observes that most SMEs obtain funds from own sources, including savings and from friends, citing the fact that very few creditors are willing to lend for start up businesses.

Operational purposes: SME s need funds so that they can purchase raw materials, supplies and carry out activities that they need to facilitate the production process. SMEs may make sales on credit and hence need bridging funds as they await repayment. Studies have found that most funds received from credit institutions are used for working capital (Gatune, 2002).

Growth of Business: As SMEs grow, they require funds to finance growth in fixed assets and increase working capital. SMEs therefore require longer-term credit in ever increasing amounts. SMEs obtain such funds from formal institutions as well as own funds since many micro credit institutions lack the appropriate programs to finance such growth. Studies indicate a high drop out rate from MFIs that remain rigid, insisting on group methodology and lower amounts of loans for customers, who have

progressively graduated to higher loan requirements (Graham, 2000; Gatune, 2002; Rukwaro, 2000)

Other purposes; Promoters of SMEs need lumpsum funding to finance personal issues so that they can repay the credit using income generated from business. "Often, loans are diverted to "providential" or "non-productive" purposes, to meet emergency medical or education expenses. It is increasingly clear that to tie loans to specific uses without addressing other needs and opportunities is naïve at best" (Graham, 2000).

2.4 Sources of Funds for SMEs

SMEs source funds through equity/own funds or, through debt. Internal/own funds include accumulated savings from likely strategic investors who become part owners (Rukwaro, 2001; Atieno, 1998). SMEs also access credit, which requires repayment with interest or when given as a grant, with no interest. In a few situations the SMEs may be awarded grants and they may not be required to repay. Access to credit has been limited mainly to microfinance institutions and informal institutions like moneylenders and rarely do the commercial banks lend to the sector to provide micro credit and other financial services to the sector. Studies show that commercial banks provide the lowest amount of financing to SMEs and where it is provided, the credit is rationed (Atieno, 1998).

2.5 Classification of MFIs

Financial institutions offering micro credit are classified on the basis of emphasis on micro credit at the time of establishment of the institutions, a majority of the institutions being NGOs that have always offered and continue offering micro credit;

other NGOs started out purely as micro finance institutions, but have since evolved and operate as commercial banks offering both formal and micro credit services (Glosser, 1994); as those institutions that started out as banks, and, have since diversified into offering either, micro credit alongside conventional banking products, or, strictly microcredit products such as Bank Raykat Indonesia (Boomgard et al, 1994); and, banks that were set up primarily as microfinance banks e.g Centenary Bank in Uganda (Baydas et al, 1997).

The SME sector is ripe for entry of more banks because banks have the network necessary to offer loans to the sector. The commercial banks are therefore stable and can lend, given appropriate lending methodologies, to a larger number of people hence realising a bigger impact. Moreover, banks have the resources to expand further and lend more money. They are unlike most NGOs that rely heavily on donor and government support, which is drying up. Governments are beginning to realise the impact of the small and micro enterprise sector on the economy and are therefore availing mechanisms that will facilitate its growth (Budget speech, 2003/2004).

Governments have realised the need to de-link themselves from competing with the private sector and that subsidising the sector has worked to its disadvantage. There is effort towards regulation, as well as encouraging private banks to get more involved in the sector (Coetzee, 2002). The Kenyan Government is in the process of finalising a sessional paper on the SME sector, which will encourage entry of more players (Budget speech, 2003/2004).

2.6 Requirements for Successful Micro Credit Providers

Successful micro credit activities for banks must be driven by among others the following; Oketch (2001) highlights commitment and bank culture whereby the banks must treat the micro credit sector as part of the areas within the institution where profits will be made; staff must be appropriately rewarded and motivated to work towards improving business and limit delinquencies; administrative structures should be put in place to ensure that the banks are able to monitor their loans from analysis to repayment; development of appropriate lending technologies that fit the particular clientele so that the borrowers can benefit from the loan programs as well as repay the loans with interest to limit default rates. The necessary capacity in terms of human resources must be in place to ensure that staff are able to appraise loanees, and follow up on loans made (Otero et al, 1994).

2.7 Credit Techniques for MicroFinance Institutions

As a result of the uniqueness of the SME sector, the micro credit sector has developed a number of credit models. Mohamed Yunus, a Bangladeshi professor advanced the most famous model, the Grameen model (Graham, 2000). The model revolves around the micro credit institution providing credit to groups of people who come together to access loans and guarantee each other. The Grameen model uses the group as a substitute for individual collateral. When a member of the group defaults, the group pays on behalf of the defaulter. Under the strict Grameen model, any savings collected by the group cannot be withdrawn, and the members of groups may be forced to access loans even when they do not need the loans. It has been observed that the

model works best in the early stages of lending to a group of borrowers as well as when the group members want relatively small loans. The system works well within the first few loan cycles before becoming largely irrelevant (Yakub, 1995;Sharif 1997). Many micro finance institutions have a high drop out rate as a result, as they have not sufficiently designed products that are flexible and allow graduation. The security aspect under group guarantees may also be defeated with the 'unzipping' effect, in which case, the entire group defaults. The second model revolves around individual based lending programs. This is led by the school of thought that believes borrowers can graduate and access loans at minimal risk individually. They use examples of the credit unions, which use individual guarantee. Individual loans may use savings accumulated, or better analysis of the income generating activities of the person to secure credit. A number of institutions have successfully managed to carry out these activities. A survey by Oketch (2001), observes that banks involved in micro finance link credit given to cash crops grown hence payments are made directly to the banks. A problem that might hinder further involvement of banks into the sector is prevailing rules where all unsecured loans are classified as bad and doubtful.

2.8 Principles of Micro Credit

The past few decades have led to the development of principles or best practices in the provision of micro credit. Graham (2000) highlights these principles as follows.

Full cost loans: micro credit providers, whether banks or NGO s, should price the loans at full cost so as to ensure the products are sustainable. Studies have shown that what matters to the borrower is not the cost but rather access to credit. Subsidised

credit attracts the wrong types of borrowers. Gatune (2001) observes in a survey of 39 firms that there is a positive relationship between interest rates charged and profits made. Therefore charging loans at full cost will not reduce profits of firms.

Individual basis; loans on an individual basis are more easily collectable especially when well appraised. The individual method of lending is popular among clients that have specific needs and who have graduated sufficiently to have other means of managing their associated risks.

Group guarantee; loans may be given to groups of people who lack collateral securities. This lending methodology is necessary for individuals who have a common heritage and yet they do not have other means of collateral.

Small regular payments; a standard successful feature of micro finance institutions that succeed is a loan repayment schedule emphasizing small regular payments. SMEs tend to get small revenues regularly and tend to rely on one source of income. Collections should ensure the amount does not increase to excessive amounts that cannot be collected.

Flexible purpose; successful programs allow the borrower to use or divert the loan to other activities. Many times, borrowers take credit for lump sum activities and repay using their business income rather than withdrawing funds from the business.

Short loan duration: micro finance practitioners across the globe have shown that longer-term loans have higher default rates than shorter-term loans. In cases where long term loans are required, then there's need to insist on physical security.

Increasing loan size and credit history: This is an area that has been borrowed from the banking sector. As borrowers become familiar with the credit programs, they become better trained and educated, while the institution is able to vouch for the viability of the borrowers projects. On this basis, they can be given larger loans.

2.9 Methodologies of Micro Enterprise Finance.

In Otero et al (1994) the authors identify four types of lending. Each of the lending methodologies is graduated; at the lowest level is the village bank where credit is accessed at the rural level and by the very poor. The Foundation For Community International Assistance (FINCA) pioneered the village banks concept. They are community managed credit and savings associations formed to improve the member's access to financial services (Holt, 1994). At the second level is the solidarity group lending which accesses credit to the more affluent. The solidarity group lending is the basis for group lending and is the most common form of lending to SMEs. The third level is transformation lending, whereby borrowers have graduated sufficiently enough to warrant longer-term finance but just not enough to access conventional loan products (Reed et al, 1994). Lastly, there is a fairly different approach to micro enterprise finance called the credit unions. These are cooperative financial institutions that began developing in the developing world in the 1950s. They are organised along basic cooperative principles and also finance micro enterprises (Magill, 1994)

2.10 Micro credit Programs

Micro credit programs have a number of dimensions which include those targeted toward poor people or women only; individual or group-based; savings or credit-led;

parallel or linked; credit-only or credit and other services; and government or non-governmental organization (NGO) sponsored.

In practice, one is more likely to find combinations of one or more of the above dimensions. Some institutions providing microfinance services target programs towards women only or the very poor in order to enhance their social standing. In Uganda, the Foundation for Credit and Community Assistance (FOCCAS) and Foundation for International Community Assistance (FINCA) serve only women, while Uganda Microfinance Union (UMU) serves all (MicroSave Africa, 2003). The Center for Women and Enterprise in Boston assists only women to initiate business through its micro enterprise training and technical assistance programs primarily to ensure that women, who have been excluded from commerce, are able to sustain themselves and offer themselves a greater chance of independence. Micro credit programs are modelled either as individual borrowers or with groups comprised of individual borrowers. Bank Raykat Indonesia (BRI) makes micro loans to individuals only. On the other hand, programs offered under the Grameen model are very likely to be group based with the associated group dynamics. The groups may contribute towards savings and withdraw from the pool. Most group based micro credit programs hold the group accountable for loan repayment should individuals default. Savings-led micro credit is normally used as a limited security against default on repayment. In addition to leveraging capital and serving as a source of emergency funds, groups often are required to meet regularly to monitor loan activity, collect repayment of interest and principle, and offer mutual support as in the case of programs under KREP. This substantially lowers transaction costs, making micro credit programs

viable. Government-led micro credit programs are programs that are mainly financed by the governments. They are mainly targeted towards a certain income category or community. For instance, they may be targeted towards financing agriculture in the rural areas. Non-Governmental Organisations micro credit programs are credit programs mainly handled by NGOs and financed by donor funds. Credit programs may be minimalist or integrated, minimalist credit programs are those that offer only credit services to clients while integrated credit programs are those that offer other services such as micro insurance, training and other services to supplement credit (Otero et al, 1994).

2.11 Permanent Institutions and Sustainable Systems.

"Successful micro finance programmes start with a clear objective to set up permanent institutions or systems designed to provide financial services on a long term sustainable basis" (Graham, 2000). The institution must therefore develop products or services that reflect the needs of the community rather than the financial institution, in which case the services are expected to meet the needs of the targeted that will therefore utilise these services to generate income and therefore minimise default. In addition, the Microfinance Institution must have the commitment to provide sustainable products to the clients and not provide subsidies to beneficiaries. This will have a positive impact on the attitude of staff (Oketch, 2001). The products must be pilot tested before roll out to ensure that they will assist the organisation to learn by doing (Graham, 2000). Institutional framework needs to be put in place to ensure that the programs are targeted and the appropriate corporate governance structures are in place to prevent abuse of the system by politicians. Politicians are the

major cause of moral hazard in lending, especially in publicly owned banks as they influence the borrowers to access credit and encourage them not to repay the loans (Mucheke, 2000).

2.12 Credit Appraisal Criteria in MFIs

The guiding principle in credit appraisal is to ensure that only those borrowers who require credit and are able to meet repayment obligations can access credit. 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 loans to less than the borrowers would like to borrow (Mishkin, 1997). Financial institutions engage in the second form of credit rationing to reduce their risks.

There are two arguments on how much credit the SMEs should be given. One school of thought argues that the SMEs know best what they want to invest in and thus they should be given what they apply for (Reinke, 2001). The author further argues that some credit schemes assume that the poor people themselves know best how to better themselves and thus credit should not be targeted to particular activities. In Cameroon and Togo, consumer and investment credit is provided and there is no constraint on how loans are used (Gurgand, 1994).

The other argument contends that credit should be made available according to repayment capability based on current performance. Some of the factors of determining the size and target for credit include:

Savings: Gurgand (1994) notes that mandatory and voluntary savings schemes have been used effectively by Rural Finance Institutions (RFIs) where savings play a

significant role in gaining access to credit. Cr'edit e'pargne-logement in Rwanda provides 5 to 15 years credit for home construction after one year of recorded saving effort. Reinke (2001) identifies saving as a means of determining who to give credit and how much, whereby a borrower is required to accumulate savings both prior to and after borrowing. The borrower may also be required to pledge such savings as collateral. This excludes the potential borrowers and contradicts logic of micro lending in that the borrowers may not have funds to save.

Ability to pay: In Burkina Faso and Malawi, failure of one member to repay was used to block access to new credit for all group members, increasing repayment performance due to social pressure (Gurgand 1994). Reinke (2001) notes that instead of blocking all the group members, access to future larger loans may be made dependent on punctual and full payment of small initial loans.

Evaluation of business ability: This approach is practiced in Burkina Faso whereby a careful analysis of the economic opportunities available in the villages where credit is provided is carried out. Use of credit is discussed with borrowers and includes a variety of firm or non- firm investments. The scheme is flexible allowing reallocation of funds to activities that had not been previously planned.

Target group: target groups are also used to allocate credit. Gurgand (1994) found that Smallholder Agricultural Credit Administration (SACA) in Malawi concentrates on small holder farmers, cr'edit soudure in Burkina Faso concentrates on poor people in rural Sahel that suffer lack of capital with emphasis on women. Other organizations have well-defined target population. Reinke identifies several ways of determining

target group. Among the ways identified include; target women who are seen as economically less independent, the youth due to high unemployment and insufficient jobs, and the rural people who are seen not to benefit from development and employment creation in the cities and towns. A lender has to decide how to reach his target group and ensure that targeting objectives are met. A number of micro finance loans are targeted towards the employed class in order to minimise default.

Character assessment: The Grameen bank model bases credit on the character assessment and trust of the groups. However, if an individual does not belong to a group and is able to pay, he may be denied credit if the MFI is purely using this model.

Others: other factors identified by Reinke (2001) include such factors like ethnicity, nationality or factors of social disadvantage such as physical disability, location and objective of the micro credit institution and mandatory training. Objective of the lender may be to fund activities away from the trading activities so as not to dilute the sector's profit thus undermining the viability of all trading activities. An MFI serving the poor may locate its offices where the poor live. Such criterion may sometimes lead to poor choices as cities and towns have the best infrastructure connections. Access to credit may be conditioned on undergoing credit training. This may be worthy as more borrowers will succeed in their business and be able and willing to repay their loans. However, training is costly and it will exclude some potential borrowers.

Oketch, (1995) when studying the demand and supply of MSE s finance in Kenya, established that the size of loans to various borrowers depended on the lending

technology. Where funds are lent to individuals, appraisal depended on business assessment, collateral, business needs and repayment capacity, type of business and availability of funds. For group-based loans, it depended on age of the group appraisal of the project, past repayment records, demand by clients and availability of funds. Oketch used the SMEs financiers and did not consider the influence of rationing on MSE s operations. Oketch's findings contribute to this study in defining the possible variables from the perspective of the SMEs such as credit size and security. Rukwaro (2000) took the perspective of both the SMEs and their financiers and went further to determine the influence of credit rationing on operations of SMEs and indeed concluded that credit rationing impacts negatively on operations of SMEs.

2.13 Credit Appraisal Techniques Among Banks

Credit appraisal techniques among banks are very costly. The techniques involve a lot of paperwork and procedures to ensure that a bank covers all it's costs and interest charges and the bank must be sure that the borrower has intent and ability to repay. The key determinants for bank credit include: -

- Character of the individual, which is vouched through reference checks
- Project appraisal to assure the viability of the projects of the borrower. However, many SMEs do not keep records of their businesses.
- Physical collateral, which is meant to ensure the financial institution does not lose funds in case the borrower does not repay the loan (Otero et al, 1994). The key determinants are represented by 6 Cs, namely Character of the person borrowing; Collateral or security which is mainly physical; Contribution in assets to the project

for which the borrower needs funds; Common sense in terms of the reasonableness of the borrowers projections, Conditions within the area, economy and lastly the Capacity of the business to achieve or borrower to attain his goals.

Borrowers may default if there is poor credit appraisal when the individual is given a loan in which case the financial institution fails to give the borrower the correct credit rating either as a result of the borrower providing wrong information or the bank using the wrong instruments to vet the borrower; poor institutional mechanism in following up the loans especially where the financial institution must ensure that the loan collections and follow-ups are rigorous so as to avoid loan amounts becoming un-collectable; unforeseen contingencies may mean that a borrower might be unable to pay back their loans because there has been a flood, or other unforeseen situations that paralyse their operations; political interference where politicians encourage organisations to give loans to undeserving clients or encourage clients not to pay up loans, leading to high levels of default; and collapse of security. In cases of group guarantee, this may entail all members of a group deciding to "unzip", that is, choosing not to repay the loans advanced to all of them at a go.

CHAPTER THREE

3 RESEARCH METHODOLOGY

This section covers the research design. population and sample size, data collection methods, and procedures; and data analysis.

3.1 Research Design

The survey design was used in this study.

3.2 Population

The target population of this study was the micro finance institutions (MFIs) and banks offering micro credit in Kenya.

There are hundreds of institutions that carry out micro-finance activities in Kenya, some organised within churches, some organised as cooperative societies, and others operating on part-time basis. The population of registered microfinance institutions in Kenya comprise of 64, according to the KREP register of MFIs, the Association of Microfinance Institutions of Kenya and the Central Bank of Kenya. There are also 6 other banks offering micro credit services, that is, 2 building societies, 1 specialised microfinance bank and 3 commercial banks.

The population targeted by this study constituted the banks and registered microfinance institutions.

3.3 Sampling

The sample frame constituted the commercial banks and microfinance institutions.

The quota sampling technique was used which involved the use of both stratified sampling and convenience sampling. The strata included the banks, and micro finance

institutions. Convenience sampling was used to select the registered microfinance institutions within Nairobi, which are 30 in number.

3.4 Data Collection Methods

The names and addresses of Microfinance Institutions (MFIs) in Kenya were obtained from the Association of Microfinance Institutions, Central Bank of Kenya and the KREP register.

Data was collected from primary sources through semi-structured questionnaires distributed to the managers of the commercial banks and microfinance institutions. Follow-up was done through a research assistant who assisted in administering the questionnaires. Secondary data was obtained to reinforce collected data from brochures and supplements in newspapers covering micro credit providers.

3.5 Data Analysis

Data was analysed using descriptive statistics such as means, percentages and tabulations with the help of the SPSS package. The analysis was carried out on the credit management approaches of different institutions when offering micro credit. The analyses helped determine if there are significant differences in credit management approaches used by bank based micro credit institutions versus those used by other Microfinance institutions.

Chi-square was used to establish the default rate among institutions offering microcredit against the type of institution i.e. whether bank or Microfinance Institution and whether the relationship was significant.

CHAPTER FOUR

4. DATA ANALYSIS AND INTERPRETATION

This chapter covers data analysis and interpretation on the credit management techniques employed by institutions offering micro credit and the relationship between the credit management techniques used and the performance of the institutions in terms of default rate.

Data on the various types of institutions was collected, separated into distinct components, and analysed.

The data was collected in order to respond to the 3 key objectives; i.e. to determine credit management techniques employed by institutions offering micro credit services in Kenya; to identify any differences in credit management techniques employed by banks versus those employed by other micro finance institutions, and; to determine whether there is a relationship between the credit management techniques and the default rate of institutions offering micro finance services.

4.1. Data Collection and Response Rate

Data was collected from 20 institutions located within Nairobi out of the total 30-targeted institutions through a questionnaire. The questionnaire was administered using drop and pick later method. The data was collected from the heads of the MFIs offering micro credit as well as heads of the various units handling micro credit in the selected banks.

Follow up questions were directed to the respondents as well as staff within the targeted institutions to validate information that did not come out very clearly.

Brochures were also obtained from the specific institutions to further clarify information on credit management and products offered by the institutions.

The overall response rate was 66.67%. Specifically, the response rate was 80% for the banks and 64% for the Microfinance Institutions offering micro credit, which was considered adequate to use as a basis for deriving conclusions from the study.

Table 1: Analysis of The Response Rate

Type of institution	Questionnaires	Number who responded	Percentage
Banks	5	4	80%
NGOs	25	16	64%
Total	**30**	**20**	**66.67%**

Source: Research Data

The institutions that did not respond positively to the research gave a number of reasons. Many financial institutions have a policy of not releasing information to third parties for fear of misuse of such information by the third parties; due to the sensitive nature of financial information, only specific individuals have the mandate to avail the required information to other persons. However, the empowered persons were not immediately available as they were either too busy finalising some other work or frequently out of the country.

The completed questionnaires were in certain instances incomplete as to certain required information. However, the researcher was able to access and verify this information through direct interviews with staff in the relevant departments of the surveyed institutions.

The findings and conclusions drawn are based on the 80% response by banks and 64% by Microfinance Institutions.

4.2. Background of the Studied Institutions Offering Micro Credit

The information on the background includes the location of institutions, type of institutions, source of funds for micro credit, whether the institutions operate separate units for micro credit, whether the institutions have a separate strategy for micro credit.

4.2.1 Type of Institutions

The credit institutions included banks and Microfinance Institutions. 3 out of 4 banks surveyed have special units for handling micro credit activities, which translates to 75% of the respondents. One bank surveyed managed micro credit activities alongside other types of activities.

The Microfinance Institutions surveyed showed that 13, that is, 81.25% had special units for the micro credit services while 3 institutions or 18.75% offered micro credit to supplement the other core operations of the NGO.

4.2.2 Location of the Institutions

- For micro credit providers surveyed, all the 4 banks, i.e. 100% that responded had their head offices located within the city centre while 11 Microfinance Institutions (68.75%) were located outside the city centre. They were located within areas that are easily accessed by their target markets. 5 Microfinance Institutions were located within the city centre.

4.2.3 Sources of Funds for Micro credit

The sources of funds for micro credit range from internal operations and savings, among others. The study showed that all the banks obtained 100% of funds for micro credit from internal operations while for the Microfinance Institutions the breakdown is as indicated in table 2 below: -

Table 2: Sources of Funds For MFIs

Source	Percentage of funds	Number	Percentage
Donors only	100%	8	50%
Donors	75% to 99.9%	4	25%
Internal Operations	100%	2	12.5%
Internal operations	Below 20%	2	12.5%
Savings	10% to 20%	6	37.5%

Source: Research Data

There was a mix as to the sources of funds for lending by MFIs. The study observed that MFIs relied heavily on donor funding for funds to lend. 50% of the institutions indicated that they received 100% of their funds from donors, while 25% showed that they received over 75% of their funds from donors. This in total adds up to 75% of Microfinance Institutions receiving over 75% of their funds from donors. Furthermore, only 12.5% fully obtained funds from internal operations while 37.5% of the institutions obtained 10% to 20% of funds from savings made by the borrowers. The heavy reliance on donor funding has an impact on the sustainability of the credit providers as they are heavily subsidised by donors.

4.3 Management of Micro Credit Activities

4.3.1 Long Term Strategy

Out of the total number of institutions surveyed, 19, that is 95% indicated that they had a long-term strategy to deal in micro credit activities. Only one, which is 5% of the respondents, indicated they did not have long-term strategy. The institutions that have a long-term strategy treat the business as a future business for them and therefore strive to make it sustainable.

4.3.2 Availability of Micro Credit Policies

All 16 Microfinance Institutions (100%) surveyed had developed specific micro credit policies to guide in their credit provision. 2 banks (50%) had developed micro credit policies while 2 others, (50%), did not have a specific policy. Overall, 90% of the providers of micro credit had prepared and documented policies in micro credit as shown in Table 3 below.

Table 3: Whether Providers Have Specific Micro Credit Policies.

Institution Type	Has Specific Policies	No specific Policies	Total
Bank	2	2	4
NGOs	16	0	16
Total	**18**	**2**	**20**
Percentage	**90%**	**10%**	**100%**

Source: Research Data

The study shows that a majority of institutions tend to have policies set for their products.

The response on micro credit targets among banks was that only 50% of the banks that responded had specific officers with micro credit targets for the services. In the remaining 50%, the same officers handling corporate business handled debt collection (see table 4 below). The targets set within banks, were not separated for the different sets of products i.e. micro credit products; and corporate products.

Table 4: Whether Institutions Have Specific Microcredit Targets

Institution Type	Have Specific Targets	No Specific Policies	Total
Banks	2	2	4
MFIs	12	4	16
Total	**14**	**6**	**20**
Percentage	**70%**	**30%**	**100%**

Source: Research Data

In the case of Microfinance Institutions, 12 institutions representing 75% of the respondents had specific credit officers with clear targets for the products. 25% handled their credit activities alongside other activities like provision of AID among others. For the 25%, micro credit was carried out as a subsidiary activity to other NGO related activities like training, empowerment of women, and HIV/AIDS activities.

Most Microfinance Institutions have a tendency to set separate targets for their products as they consider their micro credit business core to their survival.

4.3.3 Micro Credit Services

Out of the banks surveyed, only one bank had more than 4 products; the remaining 3 banks had less than 3 products each. The Microfinance Institutions surveyed showed

that 13 Microfinance Institutions had less than 3 products each, while 3 had more than 4 products each. Majority of the institutions provided funding to targeted markets. For instance, some targeted commercial sex workers, while others targeted certain localities etc.

Table 5: Number of Products Per Institution

Institution Type	0 to 3 products	Above 4 Products	Total
Bank	3	1	4
MFIs	13	3	16
Total	**16**	**4**	**20**
Percentage	**80%**	**20%**	**100%**

Source: Research Data

The findings show that most institutions preferred to keep fewer numbers of products for control and management of their services.

4.3.4 Credit Management Techniques

The banks provided all their products (100%) through individual basis. On average 87.5% of the products provided by Microfinance Institutions were offered through group guarantee while 12.5% were provided through individual basis. The loans provided through individual basis meant that clients were given loans on their individual strength and failure to repay did not revert liability to other persons. Banks avoided group guarantee, instead preferring to lend to individuals as per the practice in lending to their corporate customers.

4.4 Evaluation of Default Rate

4.4.1 Default Rate Versus Group Guarantee

Table 4 indicates that 75% of the banks had a default rate of less than 20%, while the remaining bank representing 25% recorded over 30% default rate. 67.8% of the MFIs recorded a default rate of less than 10%, while the rest (32.3%) had a default rate of above 20%.

Table 6: Default Rate Versus Type of Institution

Type of Institution	Average Default Rate					Total
	Below 5%	5.1% to 10%	10.1%to20%	20.1%to 30%	Above 30%	
Bank	25%	25%	25%	-	25%	100%
NGO	57.1%	10.7%	-	3.6%	28.6%	100%

Source: Research data.

The analysis thus shows that a larger proportion of products offered by Microfinance Institutions had a much lower default rate than those offered by banks. In the category of default rate below 5%, a higher percentage of products from MFIs featured as compared to banks (Table 6). The default rate among banks was more evenly spread across the selected bands, while the MFIs were more concentrated within the very low and very high default rates.

In the case of products offered under individual basis, the default rate among products featured in the extreme bands. The study shows that 61.5% of the products had a default rate below 5% (Table 5); with 38.5% lying above 30% default rate. This indicates that the products offered under individual basis have a good chance of performing well in the micro credit sector.

Table 7: Default Rate Among Products Under Individual Basis

Default Rate	Frequency	Percent
Below 5%	8	61.5
Above 30%	5	38.5
Total	13	100

Source: Research Data.

Under the group guarantee (Grameen model), 47.2% of the products had a default rate below 5%, which was lower than the individual basis. However, when expanding the default rate band to below 10%, a total of 68.5% of the products had a default rate below 10% (Table 8). This shows that products under this model have a chance to have a low default rate mainly driven by peer pressure. Table 8 also indicates that 31.7% of the products had a default rate of more than 10%, with 21.1% of the products having a default rate of over 30%.

Table 8: Default Rate Under Group Guarantee

Default Rate	Frequency	Percent
Below 5%	9	47.4
5.1% to 10%	4	21.1
10.1% to 20%	1	5.3
20.1% to 30%	1	5.3
Above 30%	4	21.1
Total	**19**	**100**

Source: Research Data

From this analysis, whether products are offered under individual basis, or group guarantee, they have an almost equal chance to perform well. However, products under individual basis have a higher chance of performing poorly if other factors are not well managed.

4.4.2 Average Loan Size Versus Default Rate

There was no evidence of loans amounting to less than Kshs 5,000. The study indicates that on average, loan sizes of 5000 to Kshs 10,000 had the lowest average default rate of 4.2%, while loans of above 50,000 had the highest average default rate of 47.3%. Loans between Kshs 10,001 to Kshs 50,000 had default rates ranging from 14% to 22%.

The survey found out that average lower loan sizes had a relatively lower default rate than loan sizes of relatively larger amounts (Table 7).

Table 9: Loan Size Versus Default Rate.

Relative loan size	Average default rate
5,000 – 10,000	3%
10,001 - 20,000	14%
20,001 - 30,000	15%
30,001 - 50,000	22%
Above 50,000	47%

Source: Own research.

Average default rate for loans below Kshs 50,000, averaged 4% while for larger loans of over Kshs 50,000 averaged 47.3%.

The study showed that banks had an average loan value of Kshs 75,500, which was well over the average loan value for MFIs of Kshs 24,600 (Table 8).

The study also found that banks tend to give loans of larger size than MFIs

Table 10: Type of Institution Versus Average Loan Size

Type of institution	Average loan size
Banks	75,500
NGOs	24,600

Source: Research.Data

Individual loan sizes for loans borrowed ranged between Kshs 5000 to Kshs 500,000 for all types of institutions.

4.4.3 Default Rate Versus Average Loan Duration.

The study further noted that a majority of the loan products had loan durations ranging between 3 months to 12 months.

None of the loan products surveyed had maximum loan duration of 3 months. 14 products (42.42%) offered by MFIs had a loan duration ranging between 3 months and 6 months, while 8 institutions (24.24%) of MFIs had loan duration between 6 months and 12 months. Only one product had loan duration above 12 months.

For the banks, 7 products, 21.2% of the products had a duration of between 6 months and 12 months, while 3 (9.1%) of the products had loan duration beyond 12 months.

This shows that on average banks tended to have fairly longer-term loans than MFIs.

Table 11: Type of Institution Versus Loan Duration.

Type of institution	Average Loan Duration		
	3 to 6 months	6 to 12 months	Above 12 months
Banks		7	3
MFIs	14	8	1
Total	14	15	4

Source: Research data

It was hence observed that many micro credit providers prefer to give loans of short-term duration since they are able to recover money within the shortest possible time.

In terms of default rates, 16 loan products (48.5%) had default rates below 5%, while 8 loan products (24.25%) of between 6 months and 12 months had default rates of above 30%. The only loan product above 12 months had a default rate above 30%. The rest of the products had default rates ranging between 5.1% and 30%.

Table 12: Default Rate Versus Average Loan Duration

Maximum Loan Duration	Average Default Rate					Total
	Below 5%	5.1% to 10%	10.1%to20%	20.1%to 30%	Above 30%	
3 – 6 months	16	0	0	0	0	16
6 – 12 months	2	1	2	2	8	12
Above 12 months		1	0	0	1	2
Total	18	2	2	2	9	33

Source: Research Data

Average default rate was 5% as compared to 27% for loans of 12 months.

4.4.4 Default Rate Versus Security Required

The MFIs respondents identified types of security that they use for their loan products. Under the group guarantee loans, two types of security were identified, namely the group guarantee and savings. It was observed that 40% of the products required only group guarantee, while 55% required both group guarantee and savings. One institution required a Kenyan guarantor.

The reason advanced for group guarantees was that the borrowers were unable to raise any savings to receive loans.

Table 13: Type of Security for Institutions

MFIs		**Banks**	
Type Security	**%**	**Type Security**	**%**
Group guarantee	40%	Physical/savings	100%
Group Guarantee/savings	55%	Physical/ savings/ Insurance Products	30%
Kenyan Guarantor	5%	Savings	10%

Source: Research Data.

In the case of loans advanced by banks, 3 main types of security were identified. The survey found that 100% of the loan products included physical security and savings products as requirements for the loans. Almost 30% indicated that insurance products could also be used to access loans (Table 13 above).

Table 14: Default Rate Versus Security

Security Type	Default rate
Group Guarantee/Savings Products	3%
Savings	21%
Kenya Guarantor	75%
Group Guarantee	32%
Physical security/savings	15%
Physical security only	14%
Physical security/savings/insurance products	14%

Source: Research Data

Overall, the default rate among institutions that had both group guarantee and savings was the lowest at 3%. Products that had only savings had a default rate of 21%; the default rate for both physical security and savings was 15%, while the default rate for physical security only stood at 14%. The worst performers were the institutions that accept only group guarantee, which had an average, default rate of 32%. One institution gave loans to persons on the basis of a guarantor and had a default rate of 75%, which was the highest evidenced in the survey.

4.4.5 **Default Rate Versus Frequency of Loan Collections.**

Banks surveyed indicated that a majority of them collect repayments of loans with the same frequency of loan collections as applied in collecting their other loan products. Out of the 4 banks, 75% indicated that they collect loan repayments on a monthly basis, while the remaining 1 i.e. 25% collects weekly.

Further enquiries revealed that the banks preferred to wait for customers to come to their banking halls and repay the loans.

Table 15: Loan Collections Versus Default Rate

Institution	Frequency of collection	% of respondents	Default Rate
Banks	Weekly	75%	3%
MFIs	Weekly	75%	
Banks	Monthly	25%	32%
MFIs	Monthly	18.75%	
MFI	Ad hoc	6.25%	75%

Source: Research Data

The survey showed that 75% of the MFIs collect loan repayments on a weekly basis, while 18.75 % collect the same on a monthly basis. One institution indicated that they collected the loan on an ad hoc basis.

Institutions that collected loans on a weekly basis had a better repayment rate than those that collected on a monthly basis. The institution that collected ad hoc had the worst default rate at 75%.

4.4.6 Default Rate Versus Proportion of Micro Credit Revenue to Total Revenue

Of the 4 banks surveyed, 2 indicated that revenue from micro credit products accounted for less than 5% of their total income; 2 institutions indicated that their revenue lay in the 50.1% to 100% ranges of total revenue.

In the case of Microfinance Institutions, 60% of the NGOs surveyed indicated that income from micro credit activities accounted for 50.1% to 100% of their total income.

The banks that had over 50.1% of revenue represented by micro credit income had the lowest average default rate of 3%.

Table 16: Institution Type Versus Micro Credit Revenue to Total Revenue.

Type of Institution	Proportion of revenue to total revenue			Total
	Below 5%	5% to 20%	50.1% to 100%	
Banks	2		2	4
MFIs	3	5	8	16
Total	6	5	9	20

Source: Research Data

The survey showed that 13 products of institutions that had micro credit revenue as a proportion of total revenue below 5% registered default rates above 30%. None of the products in institutions where revenue to total revenue was above 50.1% had a default rate higher than 10.1%.

The higher default rate among institutions with lower proportion of micro credit revenue to total revenue can be attributed to the focus given to the business as a result of its contribution.

Table 17: Default Rate Versus Micro Credit Revenue to Total Revenue

Revenue To Total Revenue	Average Default Rate					Total
	Below 5%	5.1% to 10%	10.1%to20%	20.1%to 30%	Above 30%	
Below 5%	1	1	0	0	11	13
5.1% to 20%	8	0	0	2	0	10
50.1% to 100%	8	2	0	0	0	10
Total	17	3	0	2	11	33

Source: Research Data

4.5 Reasons Advanced For High Default Rate

The institutions surveyed identified a number of reasons for the high default rate among microcredit providers.

Generally low business income also affected the repayment of loans since borrowers were forced to spend the money on their own upkeep.

Poor performance of the agriculture sector was also listed as this led to poor incomes.

NGOs felt that they suffered when their clients were faced with uncovered business risks including fire, theft among others. A number of micro credit providers indicated that they suffered when they did not manage their portfolio very well. This means that they did not adequately appraise borrowers or monitor and evaluate their clients.

Another category of lenders felt that loss of source of income or job affects the ability of borrowers to repay. This shows that some borrowers ask for loans to supplement their income. Diversion of funds was also listed as a key reason where funds are diverted to non-productive uses rather than being for the intended purposes.

A reason advanced particularly with lenders in AIDS prone categories is death due to the illness. Borrowers die before they can repay the loans.

- Lack of a loan tracking system, which would track loans from the time it is given, and age it also affects loan assessment.

Intentional default was listed as contributing to the default rate since some borrowers borrow with the aim of defaulting. There is also lack of qualified staff among the lenders who can monitor the loans advanced to borrowers.

4.6 Reasons For Limited Involvement By Banks In Microcredit

The banks surveyed listed the following reasons as guiding their limited involvement in lending to the Micro and Small Enterprise sector. They indicated that company policies regarding lending to certain markets discouraged entry into the sector. Most banks prefer to lend to the corporate sector. Lack of collateral by the target market affects the creditworthiness of the borrowers, as banks prefer physical collateral on which basis they lend. Banks consider lending to the micro sector as non-core to their operations and they believe that they would run a high risk of default if they lent to the sector.

Microfinance institutions listed the following as reasons for limited involvement of banks in the small and micro enterprise sector.

Stringent lending conditions by banks, which have long procedures for handling micro-credit and other credit related services. There is also the fear of the risk of default. MFIs feel that banks would like to make more money per account yet the sector has low incomes per account.

4.7 Extent of Potential in Micro Credit

The institutions were asked to rank the extent of potential they felt there is in micro credit on a scale of 1 to 5 with 1 as the highest potential and 5 as the least potential.

Table 18: Ranking of Institution Potential

Institution Type	Ranking of potential	Number of institutions	Percentage of Rate
Banks	1	1	25%
	2	3	75%
MFIs	1	15	93.75%
	2	1	6.25%

Source: Research Data

The result was that 16 institutions felt that there is very high potential while only 4 ranked potential as 2 i.e. high potential. When broken down to reflect the different types of institutions, 15 Microfinance Institutions ranked potential as 1 while only one institution ranked potential 2. The score for banks was 3 reflected potential as 2 while one bank indicated 1.

It can therefore be deduced that even though all players felt that the sector has good potential, banks were less optimistic of the potential available in micro credit compared to Microfinance Institutions.

Of the products of banks that indicated highest potential, 67.9% had a default rate of below 20%, while 32.1% of the products had a default rate of above 30%. In the case of products in institutions that felt there is low potential, 50% of the products had a default rate of below 20% while 50% of the products had a default rate of above 30%.

4.8 Testing of the Hypothesis and it's Interpretation

4.8.1 Hypothesis Testing Using Chi-square:

The hypothesis was tested using Chi-square as follows:

Null Hypothesis: Credit management techniques employed by banks have no effect on the default rate of borrowers relative to the techniques employed by the MFIs offering micro credit.

Alternative Hypothesis: The credit management techniques employed by banks affect the default rate of borrowers (where their clients are more likely to default on loans borrowed) relative to those techniques employed by MFIs offering micro credit (where the clients are less likely to default on credit advanced)

Test Statistic: Chi-square at 5% level of significance. Since the computed chi-square is greater than the tabulated chi-square (Table 19) below, we reject the hypothesis and conclude that the credit management techniques employed by banks affect the default rate of borrowers relative to those techniques employed by MFIs offering micro.

Table 19: Contingency Table for Observed and Expected Frequencies

Type of Institution	Average Default Rate					Total
	Below 5%	5.1% to 10%	10.1%to20%	20.1%to 30%	Above 30%	
Bank	1 (2.6)	2(.8)	1(.2)	0(0.2)	1(1.2)	5
NGO	16(14.4)	3(4.2)	0(.8)	1(.8)	8(6.8)	28
Total	17	5	1	1	9	33
Level of significance is 5%			Tabulated Chi Square value = 9.48			
Degrees of freedom = 4			Computed Chi Square value = 16.45			

Source: Research Data.

The strength of the influence as indicated by phi square = 16.45/33 = 49.8%. This means that the credit management techniques employed by the banks relative to those employed by MFIs can explain 49.8% of the variance of the default rate among borrowers from banks, thus 50.2% of the variance is explained by credit related techniques.

4.8.2 Interpretation of the Hypothesis

The hypothesis has very strong indications regarding the involvement and performance of institutions in the lending to the small and micro sector.

It shows that the banking institutions that operate within the sector face a greater likelihood to have clients default on their loans, while Microfinance Institutions have a lower likelihood.

The study has shown that when other factors have been properly considered, such as the loan value, loan collection periods, among others have been properly instituted; loans under group guarantee or individual lending have an equal chance of performing well. However, when the other factors are not properly instituted, individual basis loans are likely to perform poorly as compared to loans under group guarantee.

- The study shows that institutions are more likely to record a high default rate if they give loans of smaller quantities to customers. Many serious borrowers in this sector can manage only smaller loans, as there businesses are likely to be smaller.

The default rate further indicates that an institution is more likely to perform well if the loan is shorter term. However, micro credit providers face the challenge of devising ways of dealing with loans to ensure a low default rate.

Focus on the micro products is also very crucial to the success of micro credit activities. This can be shown through having a long-term strategy as well as separating micro credit activities from the rest of the products, setting separate targets and treating the market segment as separate and identifiable as such.

CHAPTER FIVE

5. SUMMARY OF RESEARCH FINDINGS AND CONCLUSIONS, LIMITATIONS OF THE STUDY, RECOMMENDATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

5.1. Summary of Research Findings and Conclusions

5.1.1. Summary of Research Findings

The study aimed at establishing the differences between credit management techniques employed by banks in micro credit versus those employed by Microfinance Institutions and whether a relationship exists between credit management and the default rate of the institutions offering micro credit services.

The study established that there are broadly 2 credit models that are employed in Kenya by institutions offering micro credit, namely the Grameen (group-based) model and the individual loan model.

It was realised that all products of banks that responded are based on the individual loan model, while a majority of the Microfinance Institutions (87.5%) products are based on the Grameen model. A few products offered by Microfinance Institutions (12.5%) are based on the individual model.

The study established that whichever credit model is adopted, a product has an almost equal chance of performing well. However, products under individual basis are more likely to do poorly than those under group guarantee if other factors are not well managed.

The study established that most Microfinance Institutions tend to be located in the suburbs where a majority of their clients can be found.

All the micro finance institutions had prepared and documented policies that guide them in operations, while only 50% of the banks had done the same. This is likely as a result of the fact that to most MFIs lending to this sector is the core business.

A majority of the Microfinance Institutions had fewer products per institution compared to the banks. The Microfinance Institutions are generally small with only one outlet and provide targeted business to an identified market such as slum population in Kibera, or commercial sex workers within Kawangware, among others.

The default rate of institutions offering micro credit was influenced by the contribution that micro credit business made to the overall business of the institution. It was realised that the institutions with a larger contribution of micro credit revenue to total revenue had a lower default rate than those with a much higher contribution. This defined the focus of management in the products since such institutions need to have a small default rate to remain in business. Banks generally had a lower contribution of micro credit revenue to total revenue than Microfinance Institutions. This is because, many banks considered Microfinance Institutions to be non-core to their business.

The default rate was also influenced by the principles of micro credit. The research found that loan products that were on average of lower value had a much lower default rate than those of higher value. Clients borrowed and were able to repay since this was within their means.

The loan duration further influenced the default rate. Institutions offering micro credit offered products for up to 1-year duration. Loans of much shorter periods were more

likely to be repaid than those of long term. Borrowers needed loans to finance working capital in times of need and when they had done so, quickly repaid the loans. The loan repayment period also had a relationship with the default rate. Institutions that collected repayments more frequently were more likely to have a better repayment rate than those that collected less frequently. This is because the clients received little amounts more often and hence could not accumulate large amounts of money that could eventually become bad and doubtful debts.

It was realised that security of the products was also crucial to the loan repayment. Institutions that relied on a combination of savings and group guarantee; and physical assets had a much better repayment rate than those that had a guarantor, and only group guarantee.

The institutions surveyed when asked to indicate the extent of potential they perceived existed in micro credit, indicated that micro credit business has high potential to their business. They were mainly optimistic because many considered such business can do well in a country that has a high rate of poverty.

The study indicated that there are a number of factors that influence the high default rate among micro credit customers. Low business and agricultural income affected the repayment of loans since borrowers were forced to spend the money on their own domestic upkeep. A high level of uncovered insurance risks including fire, theft of property, among others. Many providers have poor skills to manage micro credit portfolio leading to poor appraisal and monitoring of borrowers or monitor. Some borrowers divert funds to non-productive uses such as consumption when they do not have an alternative source for funds to repay loans. There is also prevalence of

HIV/AIDS among the communities that borrow from the institutions. When the borrowers fall ill, they are unable to produce and repay their loans, or they are forced to spend most of their incomes on medication. When they die, they leave large unpaid debts. Most institutions lack good management information systems to assist in tracking loans, and ageing debtors hence affecting loan assessment. The study also found out that there is outright incompetence among micro credit staff in monitoring loans advanced to borrowers.

The study shows that there are a number of reasons that are affecting the involvement of banks on the sector. Critical among them is the policy of the banks, which does not favour involvement in the sector. Such policies have affected the development of critical policies in managing the sector, the location of their main offices that deal in microfinance, and the development of specific targets that deal with the sector. There is fear among banks that the sector is too risky. Customers do not have the necessary collateral to support the lending programmes. The low margins in micro credit loans due to the low value of the loan size and the associated work involved in managing the clients.

5.1.2 Conclusions

The study found that there are very few banks involved in the provision of micro credit in Kenya, while there are very many Microfinance Institutions that operate in the sector. Majority of the Microfinance Institutions are small and target only a few clients. The MFIs are also heavily subsidised in their operations by donors and hence there total operations may not be sustainable.

The study concludes that banks have a higher default rate than other Microfinance Institutions mainly because micro credit is considered non-core to their operations and hence they have other areas where they have always received high incomes such as lending to the corporate sector.

The main factors that limit default include small average loan size, frequent collections, security of funds, and focus on the products. The study concludes that individual credit model or Grameen based group model have an equal chance of performing well all factors being constant. However, if other factors are not considered, then individual based model is more likely to have a poor default rate than the Grameen model.

Both categories of institutions are optimistic that there is high potential in lending to the small and micro credit sector therefore institutions should design structures that will accommodate the expansion of the sector.

5.2 Limitations of the Study

While conducting the above study, the researcher came across various limitations. These include the following:

- Many of the institutions targeted by the survey, though listed, were found to have changed locations too frequently. The researcher was thus unable to locate and include them in the research.

Majority of Microfinance Institutions unlike Banks whose information is public due to regulatory requirements, operate like individually owned sole proprietorships, therefore, they are very sensitive about financial information that comes to the public

domain. The researcher had to rely on information as given by the MFIs introducing some bias.

The study was limited to the credit management techniques and default rate. Issues of overall sustainability of the programmes were not addressed; hence default rates may have been low yet they compromised on the costs of operation.

The concentration of the study within Nairobi may have introduced an element of geographical bias. However, due to the nature of information required, it was difficult to get data from outside Nairobi.

5.3 Recommendations

The study recommends that banks increase their presence in the small and micro enterprise sector. While lending to the sector, banks should focus on the customer as a different category of customer with identifiable differences with the conventional customers.

The study further recommends that institutions offering micro credit may adopt individual or the Grameen model depending on their areas of strength, as they have a good chance of performing well. However, such institutions should implement the principles of microfinance to limit poor performance.

5.4 Suggestions For Further Research

There is need to carry out research to determine if credit for longer-term periods is sustainable. The research carried out had very limited evidence on credit for longer term (beyond 1 year) as a majority of the institutions provided credit for periods shorter than one year.

A study on matching of the credit repayment history and longer-term needs of the borrowers can be undertaken, otherwise, it could be suggested that borrowers with a good history of repayment graduate to formal loans with banks.

Further research may be carried out to determine the causes of the individual discrepancies among Microfinance Institutions. While some of the best performers in terms of default could be found among the MFIs, the worst default rates were also observed in the sector. It is very likely that the management styles within Microfinance Institutions are affecting the performance of the MFIs.

There is need for a study to determine the sustainability of the entire credit programmes. For instance, the institutions that have a low default rate may have such high costs, that they may need to be subsidised all the time, while those with relatively high default rates may have other features that are making their credit programmes sustainable.

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APPENDIX A: LIST OF INSTITUTIONS OFFERING MICROCREDIT

1. Kenya Rural Enterprise Programmes – (K-REP)
2. Kenya Women Finance Trust
3. Faulu Kenya
4. Pride Africa
5. Young Women Christian Association
6. Jitegemee Trust
7. Cooperative Bank
8. Kenya Commercial Bank
9. Hope Africa
10. Sunlink Microfinance Partners
11. Family Building Society
12. Equity Building Society
13. Barclays Bank of Kenya
14. Jaru Micro Credit Africa Ltd
15. WEDCO
16. Ecumenical Church Loan Fund
17. Ghetto Child Programme
18. Vintage Management Consultants
19. Daraja Trust
20. World Vision
21. Small and Micro Enterprise Programmes
22. Jamii Bora

23. Kenya Small Traders and Enterprise Society

24. Vintage Management Consultants

25. Undugu Society

26. Small Enterprise Credit Association

27. ADRA Kenya

28. Action AID

29. Widows and Orphans Welfare

30. AREP

APPENDIX B: INTRODUCTORY LETTER

JOSECK MUDIRI

FACULTY OF COMMERCE

UNIVERSITY OF NAIROBI

P.O. BOX 30197

NAIROBI

AUGUST 2003

Dear Sir/Madam,

Ref: Request For Research Data – Credit Management Techniques Applied By Financial Institutions Offering Micro Credit In Kenya.

I am a postgraduate student at the University of Nairobi undertaking research in the above area.

Your institution has been selected randomly for this study. I would therefore highly appreciate if you could provide me with information requested in the questionnaire at the earliest convenience.

I would wish to guarantee that the information provided would be treated confidentially, and used only for research purposes.

The report will be available to you if required.

I look forward to your favourable response.

Thank you.

Yours sincerely,

Mudiri Joseck.

APPENDIX C: QUESTIONAIRE FOR THE INSTITUTIONS

Institutional Information

Please indicate;

a) Name of institution. . . . .

b) Name of respondent (Optional). . . . .

c) Location of Main office. . . . .

d) When the institution was established. . . . .

e) How many outlets the institution has. . . . .

Ownership

a) Please indicate the proportion of ownership by each of the following

- Government ( )%
- Churches ( )%
- NGO ( )%
- Private ( )%
- Other, specify ( )% . . . .

b) Is your organisation involved in micro credit?

Yes ( ) No ( )

c) If yes, when was micro credit introduced?

- On inception. . . . .
- Any other (state the year). . . . .

d) **Please rank the following in ascending order (i.e. with 1 as the main reason) the reasons why micro credit services were introduced in your organisation.**

- To assist the poor. ( )
- To increase profitability of the institution. ( )
- To satisfy a government requirement. ( )
- To satisfy a powerful promoter within the organisation ( )
- Any other reason. (Specify) ( )

Management of Micro credit Activities

a) **Does your institution have a long-term strategy to maintain micro credit activities? (Please tick where appropriate).**

Yes ( ) No ( ).

b) **If the answer above is yes, please highlight the main objective of your strategy**

. . . .

. . . .

c) **How are your micro credit activities organised? (Tick as appropriate)**

Within a separate department ( )

A unit within a department ( )

Any other, specify ( )

d) **Please indicate the proportions of funds sourced for your micro credit activities. (Give relative percentages)**

- Internally generated funds ( )%
- Customer savings ( )%
- Donor funds ( )%

- Government funds ( )%
- Disbursement of funds for other organisations ( )%
- Any other. ( )%

e) **Please indicate the number of outlets where micro credit is offered in your institution. . . . .**

f) **Does the institution have specific micro credit policies?**

Yes ( ) No ( )

If, yes, please highlight the percentage of involvement of your institution in formulating micro credit policies for the micro credit products? (Use relative percentages)

- The institution ( )
- Third parties ( )
- Other, please specify ( )

b) **Does the institution set targets for micro credit services?**

Yes ( ) No ( )

If yes, how does monitoring of these targets compare with monitoring of targets of other types of services?

- Favourably comparable ( )
- There is lower emphasis on targets than the other products. ( )
- Any other, (specify) ( ).

c) **Does the micro credit department have specific credit officers?**

Yes ( ) No ( )

If yes, indicate the level of attachment to the micro credit products. (Tick where appropriate).

- Fully attached ( )
- Partially attached ( )
- Other, specify. ( )

If partially attached, how is the performance of the staff evaluated?

- Staff have separate targets for micro credit products ( )
- Staff targets are not separated for micro credit products. ( ).
- Any other, specify ( ).

d) **How are new products introduced? (Tick which ever is appropriate)**

- New products are designed ( )
- Tested before introduction. ( )
- Any other (Highlight how). ( )

Micro credit services

a) **How many micro credit products do you have? . . . .**

b) **What proportion of your products are offered through,**

- Group guarantee ( )%
- Individual basis ( )%
- Any other (please describe) ( )%

c) **For each of your products kindly complete the table**

Loan type	Average loan size (Kshs)	Maximum loan duration (in weeks or Months)	Security required if any	Frequency of collection (e.g. weekly, daily etc)	Average default rate in percentage	Average outstanding loan balance. (Kshs)
Group Loans						
Individual loans						
Any Other						

d) **The organisation applies the following in credit appraisal criteria (tick where appropriate)**

Micro enterprise Best Practices ( )

The 6 Cs of credit appraisal ( ).

Any other credit appraisal criteria ( )

e) **If your institution applies Microenterprise Best Practices, what level of importance is placed on the following attributes? Rank the attributes in the micro credit programme, where 1 stands for most important.**

Savings ( )

Ability to pay ( )

Evaluation of business ability ( )

Target ( )

Character Assessment ( ).

Other (state) ( )

f) **If your organisation applies the 6 Cs of credit appraisal in micro credit kindly rank the following attributes in the order of importance, where 1 stands for most important.**

Character ( )

Capacity/Completion ( )

Conditions ( )

Collateral/security ( )

Common sense ( )

Contribution ( )

g) **Kindly indicate the proportion of revenue to total revenue that micro credit services bring to your business. (Tick where appropriate).**

Below 5% ( ) 5.1 % to 20% ( )

20.1% to 50% ( ) 50.1% to 100% ( )

h) **What are the main reasons for the default rate in your institution?**

----

i) **What are the reasons for the limited involvement of commercial banks in micro credit?**

. . . .

. . . .

. . . .

. . . .

j) **Please highlight on a scale of 1 to 5, the extent to which in your opinion there is potential in micro credit for your institution. Where, 1 indicates the highest potential and 5 the lowest potential. (Tick where appropriate).**

Potential 1 2 3 4 5