CREDIT RISK MANAGEMENT BY COFFEE COOPERATIVE SOCIEITIES IN EMBU DISTRICT

BY

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A MANAGEMENT RESEARCH PROJECT PRESENTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS OF THE DEGREE OF MASTERS IN BUSINESS ADMINISTRATION OF THE UNIVERSITY OF NAIROBI

September, 2003

DECLARTION

I declare that this management project is my original work and has not been presented for a degree in any other University.

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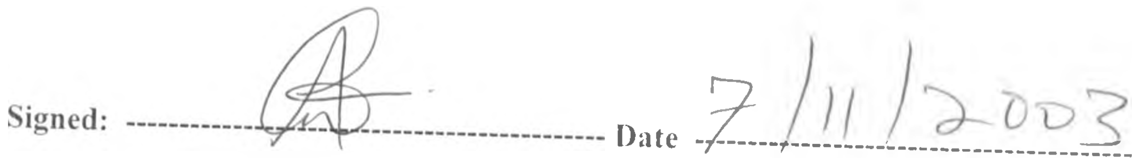
This management project has been submitted for examination with my approval as the University Supervisor.



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DEDICATION

My mum, for her love, care and sacrifice and without whose guidance and good upbringing, I would not have known the value of education.

My wife Maggie, Daughters Lavender and Lorna for the unstinted support and encouragement in the preparation of this work.

ACKNOWLEDGEMENT

I would like to record my gratitude to the many who have made the completion of this project successful. In particular, I feel greatly indebted to:

Mrs. A. Kithinji, my good supervisor without whose constructive criticisms and much valued contributions this project would have been impossible.

My lecturers and other University staff members.

All Embu District Cooperative societies secretaries/managers for having provided me with the data.

All my colleagues for all the encouragement and cooperation and especially Alex Njiru and Lekenke Pere.

Felistas Muchai and Ann Mukami for typing this project.

However, the responsibility for any errors, omissions or shortcomings of this project are entirely mine.

TABLE OF CONTENTS

PAGE

Declaration i
Dedication ii
Acknowledgement iii
Table of Contents iv
List of Tables vi
List of Abbreviations vii
Abstract viii

CHAPTER ONE

1.0.0 **INTRODUCTION** 1
1.1.0 Background Information 1
1.1.1 Definitions of Key Terms 2
1.2.0 Statement of the Problem 4
1.3.0 Objective of the Study 5
1.4.0 The Scope of the Study 5
1.5.0 Importance of the Study 6

CHAPTER TWO

2.0.0 **LITERATURE REVIEW** 7
2.1.0 History of Cooperative Movement 7
2.1.2 History and Future of Credit 8
2.1.3 Growth and Development of the Cooperative Movement in Kenya 10
2.2.0 Cooperative Organization Structure in Kenya 11
2.3.0 Liberalization in the Cooperative Sector 12
2.4.0 Cooperative Principles 13
2.5.0 Types of Cooperative Societies in Kenya 15
2.6.0 Uniqueness of Cooperatives 16
2.7.0 Credit Risk Management 16
2.7.1 Credit Policy 17
2.7.1.1 Credit Selection/Screening 17
2.7.1.2 Credit Standards 19
2.7.1.3 Credit Terms 19
2.7.1.4 Collection Policy 19
2.7.2 Elements of Credit Risk Assessment 21
2.7.2.1 Credit Portfolio Management 21
2.7.2.2 Credit Portfolio Quality Review 24
2.7.2.3 Lending Function and Operations 24
2.7.2.4 Non-Performing Loan Portfolio 25
2.7.2.5 Credit Risk Management Policies 25
2.7.2.6 Policies to Limit or Reduce the Credit Risk 26
2.7.2.7 Asset Classification 27

2.7.2.8 Loan Loss Provisioning Policy 27
2.7.3 Measurement of Credit Risk 27
2.7.3.1 Qualitative Models 28
2.7.3.2 Quantitative Models 28
2.7.3.2.1 Credit Scoring Model 28
2.7.3.2.2 Default Risk Model 28
2.7.3.2.3 Newer Models of Credit Risk Measurement and Pricing 29
2.80 Empirical Literature 30
2.90 Conclusion of Literature Review 32

CHAPTER THREE

3.0 **RESEARCH METHODOLOGY** 34
3.1 Population 34
3.2 Data Collection Method 34
3.3 Data Analysis 34

CHAPTER FOUR

4.0 **DATA ANALYSIS AND FINDINGS** 35
4.1 How Coffee Cooperatives Manage Credit Risk 35

CHAPTER FIVE

5.0 SUMMARY OF THE FINDINGS AND CONCLUSIONS, RECOMMENDATIONS, LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FURTHER RESEARCH 46
5.1 Summary of Findings and Conclusions.. 46
5.2 Limitations of the Study 48
5.3 Recommendation to Policy Makers 48
5.4 Suggestions for Further Research 49

References 50

APPENDICES

I Research Questionnaire 52
II List of Coffee Cooperatives in Embu as at 30/04/2003 58
III Letter to the Respondent 59
IV Letter of Identification 60

LIST OF TABLES

PAGE

Table 1 Types of Credit Advanced 35

Table 2 Type of Credit Policy 35

Table 3 Revision of Credit Manuals 36

Table 4 Reckless Lending 36

Table 5 Factors Leading to Reckless Lending 37

Table 6 Remedies to Safe Lending 37

Table 7 Time to Process An Application 38

Table 8 Minimum Conditions for Being a Committee Member 38

Table 9 Facilities which Default 39

Table 10 Models used in Credit Decisions 39

Table 11 Weighted Credit Management Elements 40

Table 12 Collection Procedure 41

Table 13 Collection Procedure Weighted 42

Table 14 Other Factors which May Improve Credit Risk Management ... 42

Table 15 Size of Societies in Terms of Membership 43

Table 16 Information Before Advancing Credit 43

Table 17 Qualitative Factors Weighted 44

Table 18 Conditions Before an Application is Considered 44

Table 19 Societies Future Plans 45

LIST OF ABBREVIATIONS

C.B.I	Confederation of British Industry
C.B.K.	Cooperative Bank of Kenya
G.D.P.	Gross Domestic Product
G.O.K.	Government of Kenya
K.F.A.	Kenya Farmers Association
K.N.F.C	Kenya National Federation of Cooperatives
KUSCCO	Kenya Union of Savings and Credit Cooperatives
MOCD	Ministry of Cooperatives Development
SACCOs	Savings and Credit Cooperative Societies
U. K.	United Kingdom
U.S.A.	United States of America

ABSTRACT

Credit risk management involves the systems, procedures and controls which an organization has in place to ensure the efficient collection of customer payments and minimization of the risk of non-payment. (McMenamin, 1999).

This study was aimed at determining how coffee cooperative societies in Embu district manage their credit risk.

The study was a census of all the twenty-four (24) coffee cooperative societies in Embu district.

Primary data was collected by the use of a questionnaire. Data was analyzed using tables and interpretations adduced thereto to find out credit risk management adopted.

The study found out that coffee cooperative societies in Embu district use only qualitative methods in evaluating the creditworthiness of their members and none of these societies use any of the quantitative methods. All the societies had credit policies but only eight societies representing 33% had written credit manuals while the rest (67%) had no written credit manuals. All the societies (100%) did not have a credit committee separate from the management committee and that the same committee which comprised of five members acted in both capacities. A large proportion of these committee members were semi-illiterate. The society secretary/manager was responsible for the credit risk management with some assistance of one and in large societies two clerical officers.

Before a member is advanced credit, the following was scrutinized thoroughly; the previous year's harvest, reputation of the borrowers and the amount of credit due.

The three major procedures used to follow credit defaulters include: personal visits, use of letters and telephone calls and use of other coffee cooperative societies within the neighbourhood where a member could have sold his coffee. These neighbours assist each

other to recover the credit from their defaulters. None of the societies used the legal action or the collective agencies to follow the defaulters.

Twenty (20) societies representing (83%) reported cases of reckless lending mainly due to related parties lending.

As a major conclusion of the study therefore, there seems to be lack of professionalism in some areas of credit risk management by coffee cooperative societies., namely insider dealings, favouring related parties when lending, influence from outside forces, too much reliance on reputation and lack of adequate knowledge on credit management. This calls for the qualified personnel to be employed in credit management aspects considering the importance of credit to the members. This would call for the government (probably through the ministry of cooperative development and marketing) to continually train all the societies managers in financial management other than training a few in procedures of financial accounting only. The government should set minimum qualification for those to be employed as society secretaries/managers and other permanent staff.

CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND INFORMATION

There have always been instances in the history of human society where individuals have come together to achieve certain aims in cooperation with others. In most tribal societies this has been a common feature. However, these common efforts were usually directed at fulfilling a certain temporary need. Organized cooperative business ventures of a more permanent character were comparatively rare, though some examples can be found throughout history in the middle ages as well as in classical times (Moshi, 1984).

Cooperatives cover the full range of business sizes from micro level credit association, community, fishing and worker cooperatives, to substantial players in the banking, insurance, agricultural marketing and supply sectors (Ongore, 2001). Examples of cooperatives in Kenya are Mwalimu, Elimu in the line of SACCOs and Coffee and Sisal among others in the line of producer/agricultural cooperative societies.

Most cooperatives especially those classified as savings and credit cooperative societies and producer cooperative societies have a major role of granting loans/credit to their members. These members are consequently expected to repay these loans with some interests. Every cooperative bears a degree of risk when it lends to members without exception. This is so because every cooperative experiences some loan losses when certain borrowers fail to repay their loan as agreed. Whatever the degree of risk taken, loan losses can be minimized by organizing and managing the lending function in a highly professional manner.

Recent banking history shows how critical it is for banks to control the risks of lending. Poor loan quality was the main factor in the growing number of U.S bank failures during the past decade, which culminated in an average of nearly 200 failures per year from 1987 to 1992 (Simonson and Colerman,1994).

In 1992, the confederation of British Industry (CBI) introduced a prompt payment code and despite having approximately seven hundred signatories, the problem of late payment persists. As a consequence of continuing pressure, especially from the small business community, the U.K. government in 1996 introduced a requirement for U.K. companies to publish their supplier payment policies and performance in their annual reports. Mc Menamin (1999) observed that the late payment problem still continues.

Of late there has been a lot of misunderstanding between cooperative management and members concerning the amount and the types of credit that members can qualify for. This has been so because at times members have felt that credit has been granted to undeserving cases and at times deserving cases have been denied the same, especially in the agricultural cooperatives. On the other hand, cooperatives have been experiencing an increasing number of credit defaulters.

The above leaves questions begging for answers as to whether the cooperatives have a credit culture or not. At the same time it is of paramount importance to investigate the credit risk management practices by cooperative societies concerning the amount and type of credit to grant to a member and how to ensure that the risk of default in payment is minimized.

1.1.1 Definitions of Key Terms

Asset Classification

A process whereby an asset is assigned a credit risk grade, which is determined by the likelihood that debt obligations will be serviced and debt liquidated according to contract terms (Gardner et.al, 2000).

Collateral

Asset forming the security of the loan.

Cooperative Society

An organization of persons, who voluntary join together as human beings on the basis of equality for the purpose of promoting their economic and social interests.

Credit Assessment

Is the process of determining the probability that a potential borrower can and will fulfil the obligations of a loan agreement or other debt claim (Kabiru, 2002). In this study, credit includes loans in form of money and other farm inputs farmers get on credit such as fertilizers, seedlings and other farm inputs.

Credit Risk

The possibility that the actual returns on a loan or debt investment may differ from what the lender expected, the difference of which constitutes a financial loss(Thygerson, 1995).

Credit Risk Management

The systems, procedures and controls which a company has in place to ensure the efficient collection of customer payments and minimize the risk of non-payment (Mc Menamin, 1999).

Credit Scoring

A statistical approach to assessing credit risk by assigning point values to various criteria thought to be associated with credit risk(Mc Menamin, 1999).

Non-Performing Loans

Are loans that do not generate income.

Producer Cooperative Society

A cooperative formed by people who are producing something (e.g. coffee) individually, so as to get the best price and also be getting temporary financial assistance through supply of seeds, seedlings and fertilizers etc, on credit among other things.

Risk

Exposure to change or the probability that some future events will occur making the expected and actual outcome to differ.

SACCOs (Savings and Credit Cooperative Society)

A cooperative society whose primary objective is to provide savings and credit facilities to members.

1.2 STATEMENT OF THE PROBLEM

Cooperative is a vital institutional framework for national development (G.O.K.1988). In all, cooperatives contribute about 50 percent of the nation's Gross Domestic Product (GDP). There is a lot of potential open to the cooperatives and given adequate financial resources and more efficient management practices within the movement, the contribution of the movement to the nation could be higher.

It is estimated that about 60 percent of the total investment in Kenya is currently undertaken by private investors and that about 30 percent of this is generated by cooperatives. G.O.K.(1987) observes that the individual members of cooperatives have used cooperative credit in investment activities such as purchase of land, starting small businesses, housing, education and individual or family welfare.

Granting credit to the members of Producer cooperative societies and SACCOs is an important activity, thus the importance of credit management in these institutions, coupled with taking necessary measures to reduce loan defaulters while at the same time advancing credit in a fair and undiscriminating manner, so as to continue offering services to their members.

Weak credit risk management is a primary cause of many business (particularly small business) failures (McMenamin, 1999). Hempel et.al (1994) carried out a study of national banks that failed in the mid - 1980s in the U.S.A, and found out that the consistent element in the failures was the inadequancy of the bank's management systems for controlling loan quality.

A common approach to customer credit selection and analysis is the use of the "six Cs" of credit as an initial screening and risk assessment device. These Cs, are: the capacity, capital, character, collateral, conditions and control.

Generally institutions are expected to manage their credit risk to avoid exposing their organizations to unnecessarily high levels of risk and subsequently a decline in returns.

A lot of research has been done in developed countries concerning credit risk management in banks but very little on cooperatives. No known study has been done to determine the credit risk management by producer coffee cooperative societies. This study, therefore, seeks to determine the credit risk management by coffee cooperative societies in Embu District.

1.3 OBJECTIVE OF THE STUDY

To determine how coffee cooperative societies in Embu District manage their credit risk.

1.4 THE SCOPE OF THE STUDY

There are various types of cooperatives in Kenya. This study focuses on coffee cooperative societies in Embu District. Cooperatives are managed by cooperative management committees. The functions, duties and responsibilities of a management committee are wide and diversified. However, this study concentrates on determining credit risk management practices by coffee cooperative societies in Embu District.
This study is a micro-economic analysis as it limits itself to Embu District only whereas there are very many districts in Kenya.

Coffee cooperative societies have been selected since they handle quite a large amount of the total turnover of coffee in the country. Even in terms of quality, the coffee cooperatives compare favourably with privately owned estates. It is believed that this achievement could perhaps be explained by the fact that coffee was the first agricultural cash crop to be organized and marketed through cooperatives. There are, of course a few coffee cooperatives which have not attained a high level of efficiency (Ouma, 1989).

1.5 IMPORTANCE OF THE STUDY

The evidence provided by the study will be important for the following purposes:-

To managers: They will be enlightened on the best credit risk management practices to be used as they advance credit to the members. This will make credit processing easier and fair.

Financial analysts: They will have added material to help them advise their clients appropriately.

Researchers and Scholars: The study will add to the body of knowledge in the finance discipline and form a basis for further research.

Members: The study will enlighten members on the credit risk management practices by their cooperatives. This will reduce conflicts between the management and the members concerning the amount of credit granted.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 HISTORY OF COOPERATIVE MOVEMENT

The cooperative movement was founded in the mid 1840s by a group of textile workers in Rochdale. Their aim was to buy goods and other necessities and sell them as cheaply as they could. At that time Mill owners could operate shops in or near their mills and charge high prices on the basis that the workers had no choice but to buy from them. The Rochdale pioneers had the idea of joining together, buying goods and then selling them to members of their movement without adding on any profit. At the end of the year any surplus was to be distributed among the members (i.e. those who had bought from them all year).

In England men like Robert Owen (1771-1858) and Dr. William King (1786-1865) inspired through their movement which laid its first success in the venture of Rochdale Pioneers, started in 1844 and which subsequently spread all over the world.

Charles Fourier (1772-1837), Louis Blanc (1811-1882), Philippe Buchez (1776-1865) and Charles Gide (1847-1932) promoted in Friance the idea of productive societies.

The agricultural cooperative movement had its starting point mainly in Germany where Friederich Wilhelm Raiffeisen (1818-1888) and Wilhelm Haas (1839-1913) built up within a few years a fairly compete system of rural cooperation, including credit, supply and later, marketing. Similar efforts were made about the same thing by Luigi Luzzatti (1941-1932) in Italy and Abbe de Lemmerais (1782-1854) in France in the field of Agricultural cooperative credit and at a later stage by Sir Horare Plunkett (1854-1932) in Ireland in the field of cooperative dairy industry.

The motives of these early cooperators were based either on the mere feeling of Christian or humanitarian responsibility of a man faced by the miserry of his fellowmen. This was the case of Raiffeisen, Hass, Plunkett and many others. Other moves were the political mainstream of

their time. For instance, Owen and Fourier were basically representatives of utopian socialism; King, Lemarais and Gide, were disciples of Henride Saint - Simon's Christian socialism. Some of these pioneers were for economic improvement of their society.(Moshi, 1984)

2.1.2 HISTORY AND FUTURE OF CREDIT

At least 3000 years ago, credit was used in the civilization of Babylon, Assyria and Egypt but it was in medieval Europe that trade developed rapidly on the back of credit facilities. (Edwards, 1997).

In the 12th century, great trading fairs were held in Europe and merchants travelled from fair to fair buying and selling continuously, so that a supplier at one place would be paid by the proceeds of his buyer's buyer in another place.

Credit was widely used in medieval England to sell basic commodities and rich merchants were able to get advantageous discounts by generating ample cash in advance.

Trade credit as a significant source of financing business increased in the 18th and 19th centuries, when trade expansion was helped by loans from local banks to local firms. (Edwards, 1997).

The U.K disease of late payment has always been allied to unwillingness to ask customers to pay up. As long ago as 1689 a Lancashire merchant recorded, "it being a year since I began to trade, I have been too forward in trusting and too backward in calling". A hundred years later, in 1980, a bookseller wrote, " I resolved to give no person whatsoever any credit, having observed that when credit was given, most bills were not paid within six months, some not for a twelve month and some not in two years. The losses sustained of interest in long credits and by those bill not paid at all; the inconvenience of not having ready money to lay out in trade to advantage; together with the great loss of time in keeping accounts and collecting debts. But I might as well attempt to rebuild the Tower of Babel as to run a large business without credit (Edward, 1997).

This and similar business records show how credit was becoming a tool of expansion but also another item requiring the owner's close attention.

The historical development of credit shows that business can and must learn from the past if it is to succeed in the future. It is easy to identify failures where past lessons were not learned. For example, the massive 1970s overlending by each country banks to Third World governments, when nobody counted the total indebtness of anyone country-resulted in the biggest bad debts in history. Another example is that, the unrestrained U.K credit boom of the 1980s, which led to the mass in ability of borrowers to withstand a downturn, which every credit manager has known for many years.

Ways have always been and will always be found to satisfy the demand from 'needers' without the means to pay right how, but good business management, whether of government, banks, companies, cooperatives or households requires decisions, about time scales and amounts that can be afforded from future earnings.

These decisions have always needed information on the customer or borrower, to be able to judge how much trust and for how long. In the olden days, information was largely by word of mouth. Nowadays, there is a vast industry of information providers, but the principle is the same - you only give credit where good information justifies it.

The modern demand for credit, according to Edwards, (1997) requires: the seller to organize a credit process to cope with continuing volumes; capital resources to fund the waiting time with a worthwhile return on the investment, and regulation, informally or by-law, of credit agreements and their enforcements.

Since big and rich banks exist to lend money to trading firms, people often wonder why sellers of goods and services have taken that task away from the banks by allowing credit, mainly, the reason is to have more connection with a customer and a more direct aid to selling. However, trade credit is mostly chaotic due to misplaced tolerance by sellers.

2.1.3 GROWTH AND DEVELOPMENT OF THE COOPERATIVE MOVEMENT IN KENYA

The cooperative sector has acquired a prominent role and a greatly increased weight in the Kenya's national economy at both the domestic and international levels. This is mainly due to the spectacular growth and development of the cooperative movement since Kenya's independence. The resultant effect has been extensive linkages being established between the cooperative sector and practically every sector of the economy of Kenya (G.O.K. 1988).

To a great majority of cooperators, the cooperatives are the source of ways and means to enhance their standard of living. Indeed, for a large number of cooperators, their whole livelihood has been totally transformed through participation in cooperatives. Moreover, cooperatives overall, afford cooperators a channel for their contribution, to national development whether directly or indirectly.

The growth of the cooperative movement in Kenya can be viewed in two different angles i.e. the pre-independence and post-independence periods.

During the early years of last century (about 1910), the European farmers in the Rift Valley formed the first collective group of farmers to market their produce such as dairy products, fruits, cereals and fruit products. Similar groups were formed in central and Nyanza provinces as well as Meru and Kisii districts. These initial farmers collective groups formed the nucleus of the cooperative movement although they were not registered as cooperative societies.

In 1931, the first cooperative ordinance (of cooperative act) was passed and marked the official start of the Kenya cooperative movement. Under this, the Kenya Farmers Association (Cooperative) Ltd was registered as the first cooperative society followed by the Kenya, Planters cooperative in 1937. The cooperative department was formed in 1945 and thereafter Africans were allowed to form cooperatives. By 1950, over 200 cooperatives were registered rising to 1030 by the independence period with a turnover of KShs. 100 million (G.O.K 1997).

After independence, the government realized the urgent need to amend the cooperative ordinance so as to streamline the running of cooperatives and to accommodate all activities they may diversify into and also to facilitate the financial control and management of the mushrooming cooperatives. The cooperative ordinance was ultimately amended and enacted in 1966 as the cooperative societies Act (1966) which provided for the appointment for a commissioner for cooperative development and a number of officers to assist him. Under this Act, government through the commissioner for cooperative development is empowered to give guidance, supervise and effect control measures in all cooperative matters, formulate and implement government policy relating to cooperatives.

During the post independence era, the cooperative movement has changed not only in size but also in structure. The number of registered cooperative societies now stands at about 5500 as compared to 1030 in 1963. The turnover has increased from KShs.100 million in 1963 to about KShs.5 billion in 1995. The membership has also increased dramatically rising from a mere 200,000 to about 2,000,000 in 1986.

2.2 COOPERATIVE ORGANIZATION STRUCTURE IN KENYA

The cooperative movement organization structure in Kenya is made up of four successive layers or a "four tier hierarchy". (G.O.K, 1988).

The first is the primary societies at the bottom layer. The primary cooperative societies are composed of individual members having a common interest such as coffee farming, who engage in joint undertakings and thereby realize economies of scale. The membership being drawn mostly from the same village, sub-location, location or employer facilitates the organization and interaction within a society.

In the second layer, are district cooperative unions whose membership is normally composed of primary cooperative societies. The district unions have in Kenya become the focal point of cooperative activity evidenced by the centralization under them of such functions as book

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keeping, bulk purchase of farm inputs and stationery, credit and savings facilities, education of staff and committee members among others.

The third layer is constituted by countrywide cooperative unions which act as umbrella organizations for all the district unions and societies handling certain commodities. Examples here are, Kenya Farmers Association(Cooperative) (K.F.A), The Cooperative Bank of Kenya (CBK) and the Kenya Union of Savings and Credit Cooperatives (KUSCCO).

The forth and final layer is the Kenya National Federation of Cooperatives (K.N.F.C): This is the Apex body to which the various cooperative organizations are affiliated. K.N.F.C is charged with a leadership role in the cooperative movement and responsibility for provision of services comprising education and training, printing press, auditing, coffee factory improvement services among other things. K.N.F.C is also meant to serve as the mouth piece of the movement and therefore in addition acts as a bridge between cooperatives in Kenya and the international cooperative organizations.

To coordinate the above, we have the Ministry of Cooperative Development (MOCD), which was set up in 1974. This was in itself significant in terms of recognition of an important role for cooperative's in Kenya's economy and expected contributions to national development.

2.3 LIBERALIZATION IN THE COOPERATIVE SECTOR

Before liberalization, the government was involved in form of offering free technical and financial assistance as well as development of management and financial systems. This implied that the movement came to almost wholly dependent on the government.

Liberalization was therefore, meant to reduce the government involvement in cooperatives substantially. This was thought would democratize and professionalize the management of cooperatives.

Liberalization in the cooperative sector involved the revision of the cooperative societies Act, Cap 490 of the laws of Kenya. With the revision of the Act, the ministry of cooperative

development was restructured to conform and be able to effectively address the emerging needs of the liberalized movement.(Oyoo, 2002).

In order to professionalize and democratize the management of the cooperatives and enable them to be member based and member controlled self-reliant organizations that can compete effectively with the rest of private sector, the government involvement in the day to day management of cooperatives was reduced substantially. The following functions and duties previously preformed were transferred to the cooperative movement; education and training, auditing, accounting and management systems, cooperative credit and finance, cooperative bank, approval of budgets, capital expenditure and allowances, hiring and dismissal of graded staff, removal and election of management committees after inquiry, inspection and investigations and settlement of disputes.

The main duties that have been left with the ministry of cooperative development are:- registration and liquidation of cooperative societies, enforcement of the cooperative societies act, formulation of cooperative policy, advisory and creation of conducive environment for cooperative growth and development, registration of cooperative audits and carrying out inquiries investigations and inspection.

2.4 COOPERATIVE PRINCIPLES

The modern cooperative movements all over the world, have their firm base on the principles of cooperative modelled on the Rochdale Pioneer cooperative society, in the 19th century. (Ouma, 1989). These principles were many and the main ones which were adopted by the international cooperative alliance are:-

Open and voluntary membership

The membership of a cooperative must be open to all who can fulfil the by-laws of the society and should not be limited by social, political, tribal, racial or religious differences. The only limitations may be imposed on persons who reside outside the stipulated geographical boundary or who are under 18 years of age. Agricultural cooperative societies also have a condition that

members must own land. This principle also provides that to become or not to become a member is at the sole discretion of the person concerned.

Democratic administration

The affairs of the cooperative must be administered in a democratic manner. Each member must have a vote. Each member must have only one vote, even if he holds a great number of shares or he sells to or buys from the society in large quantities. The principle states one man, one vote.

Limited rate of interest

Interest on loan is at a low rate compared to other institutions which advance loans such as banks.

Disposal of surplus

A cooperative society should pay dividends if it has surplus funds. This may be paid inform of bonuses or dividends. These are paid according to amount of purchase, sales a member has with the society or on the members contributions. SACCOs pay dividend on the basis of savings made by each member.

Cooperation with other cooperatives

One cooperative must cooperate with other cooperatives. They have a lot in common and can learn from each others' experiences. The cooperation should be extended at local, national and international levels.

Education

A cooperative must keep on educating its members on various issues. This includes advising them on how to grow high quality crops, how to spend their incomes wisely, and also on general information such as how to protect oneself from getting HIV/Aids. Also the cooperative should continuously engage in educational and training activities for their members of staff and management committees.

2.5 TYPES OF COOPERATIVE SOCIETIES IN KENYA

There are basically three types of cooperative societies, viz. producer cooperative societies, consumer cooperative societies and savings and credit cooperative societies. These are briefly discussed below:-

Producer cooperatives

These are formed by individuals engaged in a production occupation. Though it is possible for any group of businessmen engaged in production (e.g. factory owners, manufacturers, miners etc) to form a cooperative society, in Kenya producers' cooperative societies are mostly formed by farmers. By definition, a producers cooperative is formed by people who are producing something (e.g. coffee) individually so as to get the best price, and also be getting temporary financial assistance through supply of seeds, seedlings and fertilizers etc. on credit among other things.

Consumer cooperatives

These cooperatives are formed by people who aim to buy something jointly with a view to pay as low a price as possible. In Kenya there are very few purely consumer cooperative societies. However, the trend in this country is that bigger producer cooperative societies also act as consumer societies. For example, farmers not only sell their produce through their cooperative society to get the highest possible price but also buy their seeds and fertilizers through cooperative so as to pay as low a price as possible.

Savings and Credit Cooperative Societies(SACCOs)

These are the most recent in Kenya. They are usually formed by employed persons who save a part of their monthly salary with their cooperative societies. Their money earns good interest and when they have saved a good significant amount, they become entitled to borrowing money from the society for any personal project. These societies charges members much lower interest than ordinary banks and usually has much fewer formalities to complete. In Kenya, we see that large producer cooperative societies also provide savings facilities to their members. Cooperative bank of Kenya helps cooperative societies in the country.

The growth of SACCOs has changed the overall pattern of cooperative growth which was dominated by agricultural cooperatives. The primary objective of SACCOs is to provide savings and credit facilities. It is out of the savings mobilized credit is extended to the members on softer terms than what is offered by the existing financial institutions. The SACCOs by providing such savings and loans facilities make a very significant contribution towards indigenisation by providing local development capital.

2.6 UNIQUENESS OF COOPERATIVES

A cooperative society is a form of business organization that is owned by, and run for, the economic welfare of its members. This is where cooperatives differ from other forms of business ownerships. Whereas private enterprise aims at making a profit (as much as can be made legally), a cooperative society does not aim at making profit but to improve the economic lot of its members.

The registration of a cooperative society renders its status to a body - corporate. That is, the cooperative society becomes a 'person' in the eyes of the law, in its own right. This legal 'person' is the body-corporate. This means that the society can sue or be sued. For example, if a society failed to pay any debt it owes, it can be sued, at the same time the society can also sue its creditors in its right.

When a cooperative society assumes legal status, i.e. body-corporate, it also enjoys perpetual succession. This means that so long as the society is operative and successful as a business, it will continue to exist. The departure by some of its founder members or members who joined later; by death or for any other reason, will not affect its existence. It will continue regardless of such changes in membership.

2.7 CREDIT RISK MANAGEMENT

When a company grants credit to its customers, it incurs the risk of non-payment. Credit management, or more precisely credit risk management, refers to the systems, procedures and

controls which a company has in place to ensure the efficient collection of customer payments and minimize the risk of non-payment.

Credit risk management forms a key part of a company's overall risk management strategy. Weak credit risk management is a primary course of many business failures. Many small businesses, for example, have neither the resources nor the expertise to operate a sound credit management system (Mc Menamin, 1999).

2.7.1 **Credit Policy**

The management of accounts receivable essentially begins with the decision whether to grant credit to a customer, and if so how much and on what terms. It is consequently, the logical starting point for the examination of credit policy. The term credit policy is used to include all the company's systems and include credit selection, credit standards, credit terms and collection policy.

2.7.1.1 **Credit Selection/Screening**

This is the process of selecting the customers who will be granted credit and determining their individual credit limits. It is the initial stage in the operation of an effective credit management system. Usually, a set of criteria or checklists will be available to perform the intiail credit screening. The process of credit selection and analysis is essentially an exercise in risk assessment, that is, in assessing the probability of customer non-payment.

Sound credit selection procedures help to reduce customer default risk by eliminating unsuitable applicants at the outset, and thus avoiding the costly process of chasing slow payments and incurring bad debts later. The old adage "prevention is better than cure" is appropriate here. (Mc Menamin,1999).

A common approach to customer credit selection and analysis is the use of the "six Cs" of credit as an initial screening and risk assessment device. Applying the "six Cs" involves a review of a potential customer's capacity, capital, character, collateral, conditions and control as follows:

Capacity

This is an assessment of the potential customer's ability to repay the debt. The assessment would include a financial analysis of the customer's accounts with a particular emphasis on liquidity and borrowings. Information is also likely to be sought from sources such as bankers and other suppliers relating to the customer's payment record elsewhere.

Capital

How substantial are the potential customer's capital resource? What is the customer's capital structure?

Character

It relates to an assessment of the personal character, honesty and integrity of the customer and his willingness to comply with credit terms and conditions. Character references may be sought from bankers business contracts and associates. Are there any outstanding legal judgements against the customer.

Collateral

This relates to an evaluation of the assets which the customer has available as security for the debt if required.

Conditions

The decision to grant credit to a customer could be influenced by current economy and business conditions generally or by specific business conditions relating to the applicant or the firm's itself. For instance, if the applicant for the credit is a small business and there is an economic recession in the country, the risk of small business failure in such circumstances is considerably increased. Alternatively, if the firm itself is finding sales for some of its products slow it may take a more relaxed view to granting credit to a potential customer.

Control

This deals with the operating effectiveness of the information systems used by the borrower to manage the business. The lender and investor must be assured that the firm's accounting system

is effective, that the firm meets all regulatory and other legal requirements, and that its management information systems are adequate to mange it effectively.

2.7.1.2 **Credit Standards**

Normally a customer must meet certain minimum standards in terms of financial stability and strength before the granting of credit will be considered. If credit standards are set too high then sales and profit will be lost. Conversely, if they are set too low there is an increased risk of loss through bad debts as financially weak customers may be accepted.

According to Mc Menamin (1999), credit standards also have a direct effect on the level of investment in debtors overall. He notes that, relaxation of credit standards will allow debtors balances to increase as customers who would have been previously rejected are now granted credit.

2.7.1.3 **Credit Terms**

This is the period of credit allowed to a customer before payment becomes due. They also include any discount terms which may be offered as an incentive for prompt payment and to reduce the risk of non-payment.

2.7.1.4 **Collection Policy**

These are the systems and procedures which a company has in place to secure payment from its customers when payment becomes due.

This policy sets out the follow-up and late payment chasing procedures, such as the letters and telephone calls, which will come into operation when a customer's account becomes overdue. It is only when payment has been obtained from a customer that a sale is complete. There is a saying among accountants that "a sale is not a sale until it is paid for".

Collection policy is critical part of the overall credit management process. An effective collection policy is essential to control the investment in debtors and also to reduce the risk of financial loss and illiquidity through slow payment. Yet, if the collection policy is too stringent, it may antagonize customers and they may seek alternative suppliers.

It is a business reality that there will be late payers in every customer base. When a payment is regarded as late, a range of procedures and tactics can be adopted to obtain payment.

Mc Menamin, (1999), notes that, the actual payment collection stage can often be quite tricky and requires a certain range of interpersonal skills on the part of collection range of interpersonal skills on the part of collection staff. The company may not wish to offend a customer and destroy otherwise harmonious customer relations, particularly if the customer is large. However, the company needs to protect its cash flow and will have to investigate collection procedures when a payment is regarded as overdue. Typical payment collection procedures will include:

Letters and telephone calls.

Normally a written reminder will be issued when a customer's payment is late. This may be accompanied by a telephone call directly. If payment is still not forthcoming, then sterner reminders and telephone calls will be required.

Personal Visits

In some companies, sales staff may be responsible for regularly collecting payment when they call to fresh orders. In others cases, where a visit is not part of a sales routine, then a special personal visit to the customer by a member of the sales or accounts staff is usually productive.

Collective Agencies

If the company's internal attempts to obtain payment prove unsuccessful, then the account may be passed over to a collection agency, although this is a high cost method in terms of fees normally charged by such agencies. In some organizations, the entire credit collection process has been outsourced to collection agencies.

Legal Action

This is usually taken as a last resort to recover outstanding debts when all other efforts have failed. Sometimes, a solicitor's letter which threatens legal action and sets out the consequences of non-payment is sufficient to secure payment. This method is also expensive and so the costs of collection have to be borne in mind. The amount of the debt and the possibility of recovery have to be weighed against the costs of pursuing recovery through the courts. In some instances, it may be a case of "throwing good money after bad" (Mc Menamin, 1999).

2.7.2 Elements of Credit Risk Assessment

It is incumbent on banks to estimate default risk premiums on those securities commensurate with that risk exposure. The return distribution for credit risk suggests that banks need to both monitor and collect information about firms whose assets are in their portfolios. Thus managerial efficiency and credit risk management strategy affect the shape of the loan return distribution (Saunder, 2002).

Greuning and Bratanovic (1999), identifies the aspects of credit risk management function as constituting: credit portfolio management, credit portfolio quality, lending function and operations, non-performing loan portfolio, credit risk management policies, policies to limit or reduce credit risk, assets classification and loan loss provisioning policy.

2.7.2.1 Credit Portfolio Management

A good lending policy should allow for the presentation of loans to the board. It must be flexible to allow for fast reaction and early adaptation to changing conditions in an organization's earning assets mix and market environment.

Considerations that form the basis for sound lending policies include: limit on total outstanding loans; a limit on the total loan portfolio which is usually expressed relative to deposits, capital or total assets.

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A lending policy should stimulate portfolio diversification and strike a balance between maximum and minimum risk. It should also have a distribution by category i.e. limitations based on aggregate percentages of loans in commercial, real estate, consumer or other credit categories.

Greuning and Bratanovic (1999), notes that lending policy should cover.

Types of loans: a lending policy should specify the types of loans and other credit instruments that the banks intends to offer to clients and should provide guidelines for specific loans.

Maturities: a lending policy should establish the maximum maturity for each type of credit and loans should be granted with realistic repayment schedule. Maturity scheduling should be determined in relation to the anticipated source of repayment, the purpose of the loan and the useful of the collateral.

Loan pricing: rates on various loan types must be sufficient to cover the costs of funds, loan supervision, administration and probable losses. They should also provide a reasonable margin of profit, guidelines for other relevant procedure, such as the determination of fees on commitments on penalty internal rates.

Lending authority: it is often determined by the size of the bank. In small banks it is centralized and decentralized in large banks to avoid delays. Reporting procedures and frequency of committee meetings should be specified to ensure it works harmoniously and when required.

Appraisal process: a lending policy should outline where the responsibility for appraisal lies as well as acceptable types and limits on the amount of appraisal by qualified independent appraisers should be described. Ratio of amount of loan to appraised value of both project and collateral as well mention of valuation should be detailed.

Maximum ratio of loan amount to the market value of pledged securities; margin requirements should be related to the marketability of securities. Should assign responsibility and establish a timetable for periodic pricing of collateral.

Recognition; a bank should recognize a loan, whether original or purchased in its balance sheet, should initially carry the loan at cost.

Impairment, a bank should identify and recognize the impairment of a loan or a collecting assessed group of loans. This should be done whenever it is neither probable nor assured that a bank will be able to collect the amounts due according to the contractual terms.

Collections; loan policy should define delinquent obligations of all types and specify the appropriate report to be submitted to the board. The reports should include sufficient details to allow for the determination of the risk factor, loss potential and alternative courses of action.

Financial information; the safe extension of credit depends on complete and accurate information regarding every detail of the borrower's credit standing. A lending policy should define the financial statement requirements for businesses and individual at various borrowing levels and should include appropriate guidelines for audited, non-audited, interim, cash flow, and other statements. If the loan maturity is longer than one year, the policy should require that the bank's officers prepare financial projection with the horizon equivalent to the loan maturity, to ensure that the loan can be repaid from cash flow.

A credit policy cannot be complete without detailed requirements of human resource. Their number, lends exposure and specific responsibility should be identified. Quality and frequency of staff training is usually a good indicator of the level of lending competence.

2.7.2.2 **Credit Portfolio Quality Review**

A detailed credit portfolio review should include the following: all loans to borrowers with aggregate exposure larger than 5% of the banks capital, all loans to shareholders and connected parties, all loans for which the interest or repayment terms have been rescheduled or otherwise altered since the granting of the loan and all loans classified as substandard, doubtful or loss (Kabiru, 2002).

Beyond loans, inter-bank deposits are the most important category of assets for which a bank absorbs the credit risk. From a credit risk management perspective, interbank deposits should be treated just like any other credit risk exposure. A bank's policy should require that corresponding banks be carefully reviewed with regard to the routine establishment and evaluation of risk exposure limits as well as their ability to provide adequate collateral.

2.7.2.3 **Lending Function and Operations**

The board responsible for approving loans should ensure that a bank's lending function fulfills three fundamental objectives. These are; a loan should be granted on a sound and collectible basis, funds should be invested profitably for the benefit of shareholders, and the protection of depositors and the legitimate audit needs of economic agents and or households should be satisfied.

A review of the lending process should include analysis of credit manuals and other written guidelines applied by various departments of a bank. The review of the lending process should compile the following: a detailed credit analysis approval process, criteria for approval of loans, collateral policy for all types of loans, and communications and monitoring procedures.

The capacity and actual performance of all departments involved in the organization, appraisal, approval, disbursement, monitoring, collection, and handling procedure for the various credit functions provided by the bank ought to be reviewed.

A credit policy cannot be complete without detailed requirements of human resource. Their number, levels, age, experience and specific responsibilities should be identified. Quality and frequency of staff training is usually a good indicator of the level of lending competence. Therefore on-going training programs for a bank's credit staff should be reviewed and their adequacy assessed.

Efficient operations of a credit function largely depend on information flow. The policy should pay particular attention to information flows so as to establish whether or not the information actually supplied is complete and available in a timely and cost effective manner. According to Mc Menamin, 1999, sources of information are both quantitative and qualitative. He identifies the following sources of information; trade and bank references, financial accounts, business contacts and associates, company's internal records and credit agencies.

2.7.2.4 **Non-Performing Loan Portfolio**

A list of non-performing loans, including all relevant details, should be assessed on a case-by-case basis to determine if the situation is reversible, exactly what can be done to improve repayment capacity, and whether or not workout and or collection plans have been used. Provision levels should be considered to determine the banks capability to withstand loan defaults.

An indication of a distorted credit culture encompasses; self-dealing, compromise of credit principles, anxiety over income, existence of incomplete credit information, complacency, lack of supervision, technical incompetence and poor selection of risks (Saunders, 2002).

2.7.2.5 **Credit Risk Management Policies**

The basis, of sound credit risk management is the identification of the existing and potential risks inherent in lending activities. Measures to counteract these risks normally comprise clearly defined policies of the institutions credit risk philosophy and the parameters within which credit risk is to be controlled.

According to Basel Committee, (1999), the three major policies partaining to credit risk management includes: policies aimed to limit or reduce credit risk, policies of asset classification and policies of loss provisioning.

2.7.2.6 **Policies to Limit or Reduce the Credit Risk**

Large Exposures

Modern prudential regulations usually stipulate that a bank should not make investments, grant large loans, or extend other credit facilities to any individual entity or related group of entities in excess of an amount that represents a prescribed percentage of the bank's capital and reserves. Most countries impose a single customer exposure limit of between 10-25% of capital funds. (Greuning and Bratanovic, 1999).

Related Party Lending

Lending to connected parties is a dangerous form of credit risk exposure. Related parties create a relationship which results to the ability to exert control over or influence a bank's policies and decision-making especially concerning credit decisions, limits should be established for aggregate lending to related parties.

Over Exposure to Geographical Area or Economic Sectors

It is dangerous to concentrate on granting credit to a single sector of the economy or to a narrow geographical region. This makes a bank vulnerable to a weakness in a particular industry or region and poses a risk that it will suffer from simultaneous failures among several clients for similar reasons. It is often difficult to assess the exposure of banks to various sectors of the economy, as most banks reporting systems do not produce such information. (Hampel et. al. 1994).

Renegotiated Debt

These are loans that have been restructured to provide a reduction of either interest or principal payments because of the borrowers deteriorated financial position. Restructuring may involve a

transfer from the borrower to the bank of real estate, receivables, or other assets from third parties for satisfaction of the loan or the addition of a new debtor to the original borrower.

Sinkey, 1992 notes that bank policies should also ensure that such items are properly handed from an accounting and control stand point.

2.7.2.7 **Asset Classification**

All assets for which a bank is taking risk should be classified, including loans and advances, accounts receivables, investments, equity participation, and contingent liabilities. Banks determine asset classifications themselves but follow standards that are normally set by regulatory authorities (Gardner et. al, 2000).

2.7.2.8 **Loans Loss Provisioning Policy**

Asset classification provides a basis for determining an adequate level of provisions for possible loans losses. Policies on loan-loss provisioning range from mandated to discretionary, depending on the banking system. In many countries, in particular those with fragile economies, regulators have established mandatory levels of provisions that are related to asset classification (Basel Committee, 1999).

2.7.3 **Measurement of Credit Risk**

A cooperative manager needs to measure the probability of borrow default.

Economists, bankers and analysts have employed many different models to assess the default risk on loans and bonds. These vary from relatively qualitative to the highly quantitative. These models are not mutually exclusive in that a bank manager may use more than one to reach a credit pricing or loan quantity rationing decision, (Gardner, et.al 2000).

2.7.3.1 Qualitative Models

The financial institution manager can assemble information from private sources such as credit and deposit files and/or purchase such information from external sources such as credit rating agencies. The amount of information assembled varies with the size of the potential debt exposure and the cost of collection. Thygerson (1995) identifies two major classifications of factors that enter in to the credit decision. These are:

Borrower Specific Factors. These are those idiosyncratic to the individual borrower and includes; borrowers reputation, leverage or borrowers capital structure, volatility of earnings and collateral.

Market Specific Factors that have an impact on all borrowers at the time of the credit decision. These factors includes; the business cycle and the level of interest rates.

2.7.3.2 Quantitative Models

2.7.3.2.1 Credit Scoring Model

This is a credit analysis technique used extensively by banks, credit card companies, finance companies and other financial institutions involved in making consumer credit decisions. The company identifies a range of key financial and other variables and each is given a relative weighting or ranking. For instance, home ownership, salary/income range, bank reference and other credit references are normally identified as four of a range of key evaluation variables.

The customer completes a detailed application form which is assessed by a member of the credit selection staff. Based on the application points score (possibly out of 100) for each variable and this is in turn assigned a relative weighting as shown in the table below.

	Credit scoring	Points score	Weighting	Weighted score
1	Home ownership	90	0.20	18
2	Salary/Income range	75	0.20	15
3	Bank reference	80	0.15	12
4	Credit reference	60	0.15	9
5	-	-	-	-
6	-	-	-	-
			1.00	

Source: Financial management: an introduction by Jim McMenamin (1999).

The decision whether to extend credit will depend on a single figure - the total weighted score with at least a minimum total weighted score (e.g. 70), having to be attained before any credit will be extended. Usually, a pre-determined range of scores will have been set (e.g. 70-75, 76-80, 81-85) and this will dictate the credit terms and conditions offered. The higher the range the customers weighted score falls, the more favourable the credit arrangements.

2.7.3.2.2 Default Risk Model

This is a typical credit analysis performed by a bank which focuses on determining the underlying relationship between a borrower characteristic (both financial and non-financial) and the expected probability of default, d. We conceptualize this relationship as:

$$D = d \{ I(c), CF, NW, G)$$

Where:

I stands for information quality i.e. timeliness and accuracy.

c for character, (you cannot do business with bad people).

CF for the level and stability of cash flow.

NW for real net-worth, and

G for guarantees.

As each of these factors deteriorates, borrowers expected probability of default increases and vice versa. It is important to note that customer's risk cannot be considered in isolation, its contribution to portfolio risk is important as well. (Sinkey, 1999).

2.7.3.2.3 Newer Models of Credit Risk Measurement and Pricing

The newer group of credit risk models uses financial theory and more widely available financial market data to make inferences about default probabilities on debt and loan instrument. These models are most relevant in evaluating lending to larger borrowers in the corporate sector. These include: Risk Adjusted Return on Capital (RAROC), the term of structure of credit risk approach, mortality rate approach, option models, credit metrics and credit risk + model.

2.8 EMPIRICAL LITERATURE

Lending to agriculture in most developing countries is a high risk field having relatively slow turnover and involving great difficulty in obtaining an adequate return on capital as well as high default rates. **Onsuntogun and Oludimu (1980)** suggest that agricultural credit institutions should combine loan extension with savings mobilization. **Miller (1977)** also noted that, over time, savings and credit linkage should put rural credit programmes on an productive, self-sustaining basis. However, the above did not consider other factors other than savings. They also did not consider credit risk management determining practices adopted when determining the amount of credit to be granted by the credit institution.

In Ethiopia, the 1968-1973 Development plan estimated annual savings volume through rotating savings and credit associations to be 8-10 percent of the country's Gross Domestic Product. (Onsuntogun and Oludimu, 1980).

Williamson (1979), while writing on the reasons why Koreans save so little, he observed that Koreans voluntary savings had failed to increase by any appreciable proportion.

In a study of the Idanre cooperative produce marketing union in Nigeria, **Onsuntogun** and **Oludimu, (1980)** emphasized that, credit to small farmers should be given on reasonable conditions (appropriate interest rate and time limit for repayment) in order to improve the lot of farming. He argued that the payment of interest on cooperative members' savings and deposits

would encourage better mobilisation of rural savings. **Bhatt, (1974)** also notes that for rational and efficient mobilization of rural saving, it is necessary to:

Widen the geographical functional scope of financial institutions, develop financial instruments and to provide a yield pattern consistent with the preferences of savers and evolve such economic policies as would induce a higher rate of saving.

The limitation of the above is that they considered agricultural co-operatives in general and not coffee cooperatives specifically. Their study was, therefore, a bit general.

Coughlin (1990) also has written a lot on agricultural cooperatives. This writer also seems to be quite ignorant about credit management aspects of cooperatives. He did not also consider the credit policy aspects of co-operatives.

Hertz and Hilton International (1986), led Allegies corporation firm's management to seek ways to improve profit. It's financial statements suggested that operating expenses were too high relative to revenue and the several areas of the firms operations were not performing as well as management and shareholders would like. This made Allegies take some measures that made her profit to improve in 1987 compared to the previous year's profits. This study was not conducted in Kenya and also did not involve cooperatives.

Based on his analysis of the cooperative savings schemes in Kenya, **Von Pischke (1975)** listed the following conditions under which rural savings schemes would appear to have the greatest chance of success. That, they are linked with critical and growing cash income flows (as through cash crop marketing channels) which ensure a stream of deposits as well as involving an incremental clerical burden, as when produce buyers already maintain accounts for individual producers.

Mungai (1986) reviewed the role of SACCOs in Kenya's economic development. He went ahead to discuss the regional distribution of SACCOs in Kenya and their typological distribution in cooperative movement. This study did not consider credit risk management practices adopted

when granting credit to the members of co-operatives. It also did not consider producer cooperatives.

Mwarania and Mutugu (1986) studied the role of SACCOs in Kenya's economic development. They concluded that the one percent interest charged on loans gives a misleading signal on the relative scarcity of funds. This study was based in Nairobi and also considered only SACCOs.

In his study on the determinants of savings in SACCOs in Kenya, **Obuon (1988),** one of his objectives was to identify determinants of SACCOs savings deposits and loans and why they vary across societies. Though various determinants were identified the credit policy aspects were totally ignored and at the same time did not consider agricultural co-operatives.

In a more recent study, **Kabiru (2002)**, determined how banks assess credit risks in Kenya. His findings revealed that; there is a common understanding that shared information between banks regarding potential borrowers will assist in filtering out un-creditworthy customers; credit risk is the most critical and therefore, how well it is managed could greatly affect the performance of a bank; all banks surveyed have a credit policy manuals. Out of these, 80% revise them annually and 20% take as long as four years; 75% of the respondents have incidences of reckless lending, at a level between 0 to 30% of approved lending cases; segregation of duties is prevalent in all the banks, there are an average six departments or sections involved in the whole lending function; cases of default go hand in hand with reckless lending with only 50% of the banks with a low default rate of between 0 to 10% and, lending limits are according to levels of authority: they range from one in the small banks to four in the large banks.

This study, however, concentrated on banks and did not consider co-operatives in any way.

2.9 CONCLUSION OF LITERATURE REVIEW

From the foregoing, we note that although studies have been done on cooperatives in various countries, none seemed to have concentrated on credit risk management practices. This study, therefore, is intended to break the ground as far as these practices are concerned. Due to the

limitation of study time and other resources, only coffee cooperatives in Embu District will be considered.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

The study was a survey.

3.1 POPULATION

The population of interest consisted of all the registered coffee cooperative societies in Embu district as at 30th April 2003. The list of cooperative organizations was obtained from the Embu district cooperative office. Since the number of these cooperatives was twenty-four, the study was a census (Appendix II). It was necessary to study all these cooperatives to determine their credit risk management. Due to the similarity of coffee cooperative societies and also due to the limitation of time and financial resources, Embu district was selected as the focus of this study.

3.2 DATA COLLECTION METHOD

The study used primary data, which was collected from all the twenty-four coffee cooperative societies in Embu District. The respondents of the study were the managers of the cooperatives. A semi-structured questionnaire was administered to these officers through an interview.

3.3 DATA ANALYSIS

The data collected in the study was represented using pie charts and bar graphs. It was analyzed using descriptive statistics such as percentages, means and proportions. Comparative analysis was used to identify similarities or differences between cooperative societies. Tables were also extensively used to analyse the data.

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

4.1 HOW COFFEE COOPERATIVE SOCIETIES MANAGE CREDIT RISK

All the twenty-four(24) coffee cooperative societies responded to the interview. Explained below is an analysis and interpretations of the salient issues emanating from the questionnaire.

It was noted that the three major types of credit provided by the societies were farm inputs, crop advance, school fees and emergency loans. Farm inputs include fertilizers, seedlings and chemicals. This was advanced by 87.5% of the cooperatives. Crop advance payment was given by all the societies and were based on the amount of coffee delivered to the society and not paid for. School fees and emergency credit was advanced by 62.5% of the cooperatives. The amount depended on the need and the average amount of coffee delivered to the society for the last three years. Table 1 below clearly shows this.

Table 1: Types of Credit Advanced

Types of Credit Advanced	No. of Societies	%
Farm inputs	21	87.5
Crop advance	24	100
School fees and Emergency	15	62.5

Source: Research Data

All the twenty four(24) societies had credit policies but only eight representing 33% had written credit manuals. The rest (67%) had no written credit policy manuals. Table 2 below clearly shows this.

Table 2: Type of Credit Policy

Types of Credit Policy	No. of Societies	%
Written	8	33
Unwritten	16	67
Total	24	100

Source: Research Data

These manuals act as policy guidelines to effective lending. They confer authority to the lending officer.

Three societies representing 12.5% had revised their credit policy within the last four years, five (21%) within eight years and the rest had not revised theirs for more than thirteen years. This shows that the societies were not responsive to new changes in management field. This is shown in table 3 below:

Table 3: Revision of Credit Manual

No of years	1-4	5-8	9-12	13 and over
No of societies	3	5	0	16
%	12.5	21	0	66.5%

Source: Research Data

The results show that the societies hardly revised their credit manuals.

Twenty societies representing 83% had cases of reckless lending which ranges from 0 to 40%. These are attributed to a number of factors viz; influence from outside forces, insider dealings, lending to related parties and associates, too much reliance on reputation and lack of knowledge of credit risk management. The proportion of reckless lending is shown in table 4, below.

Table 4: Reckless Lending Table

Reckless Lending %	0%	1-10%	11-20%	21-30%	31-40%	Total
No of Societies	4	8	5	5	2	24
% of Societies	17%	33%	21%	21%	8%	100%

Source: Research Data

It is clear from the interview that where manuals exist and are written, case of reckless lending are minimal. Cases of reckless lending are minimal in large societies as compared to small societies. Reckless lending can be eliminated by upholding high standards of integrity, implementation of the lending policy to the letter and having highly trained staff and more

informed committee. Table 5 and 6 illustrates factors leading to reckless lending and remedies to ensure safe lending respectively.

Table 5: Factors Leading to Reckless Lending

Factor	Frequency	%
Influence from outside forces	8	33
Insider dealings	12	50
Related parties and associates	13	54
Too much reliance on reputations	10	42
Lack of credit management knowledge	11	46

Source: Research Data

From the results of table 5, the major factors leading to reckless leading are: lending to related parties and associates (54%), insider dealings (50%), lack of credit management knowledge (46%), too much reliance on reputations (42%) and the influence from outside forces (33%).

Table 6: Remedies to Safe Lending

Factor	Frequency	%
Upholding high standards of integrity	18	75
Implementation of lending policy	22	92
Having highly trained staff	20	83
Having more informed management committee	15	62.5

Source: Research Data

As regards remedies to safe lending, table 6 shows that the factors which may reduce reckless lending in descending order of importance are: implementation of lending policy (92%), having highly trained staff (83%), upholding high standards of integrity (75%) and having more informed management committee (62.5%).

Processing of successful applications takes between three days and two weeks with the average being one week. Large societies process credit faster as compared to small ones. Table 7 illustrates this.

Table 7: Time to Process an Application

Time(days)	3-5	6-8	9-11	12-14	15-17	18-20	21 & over	Total
No. of societies	6	8	7	2	1	0	0	24
%	25	33	29	9	4	0	0	100

Source: Research Data

Most (87%) societies process the applications in less than eleven days. This shows that the process is quite fast. None of the societies had a credit committee separate from the management committee or the other staff. Once an application for credit is made, it is scrutinized either by the manager or the management committee. If all the conditions are satisfied, the manager is left to process the credit with the assistance of the other clerks. All the societies had a management committee which also played the role of credit committee. The committee was composed of five members with the sixth member being the society managers. For a member to qualify for this committee he must meet the following conditions; know how to read and write(100%), not hold any political post(92%), be at least twenty years old(75%), be an active member(96%) and be loyal to his society(62.5%) among other things.

Table 8: Minimum Conditions for Being a Committee Member

Condition	Frequency	%
Be literate	24	100
Not holding any political post	22	92
At least twenty years old	18	75
Being an active member	23	96
Being loyal to his society	15	62.5

Source: Research Data

Default rate was quite small although all the twenty-four societies reported some degree of default. Eighteen societies representing 75% had default rate of between 0 and 10% while the rest (25%) had default rate of between 11 and 20%. This shows that a lot need to be done so as to reduce default rate and if possible eliminate it completely. Where it may not be possible to eliminate, for instance due to death, societies need to be encouraged to take up insurance policies to cover such. Table 9 shows the percentage of credit facilities which default.

Table 9: Credit Facilities which default

Default rate	0%	1-10%	11-20%	21-30%	31-40%	Over 40%	Total
No of societies	0	18	6	0	0	0	24
%	0	75	25	0	0	0	100

Source: Research Data

The study indicated that none of the society uses quantitative models to evaluate the creditworthiness of the members. All the twenty-four societies only used qualitative method. This was the case since they were easy to use considering their staff's levels of training. The three major qualitative factors commonly used are: the previous year's harvest, reputation of the borrower and the amount of credit due. Lending theory has it that lending has been built on trust. Trust is subjective and is the main premise of the qualitative factors. Quantitative methods were also not being used since the managers seemed not to be aware of them. In fact no manager mentioned models such as linear probability models, logit model or any other. This calls for highly trained managers in the field of financial management. Table 10 shows this.

Table 10: Models Used in Credit Decisions

	No of society	%
Quantitative	0	0
Qualitative	24	100
Total	24	100

Source: Research Data

Most of the respondents recommended the establishment of a shared database, which will maintain customer information on borrowing history. This will ensure that information flows freely between the societies. This is only possible by first computerizing their operations as suggested by most of the societies. This will ensure that the lending fraternity reduces unscrupulous borrowers greatly. Other recommendation to improve on credit risk management include government to ensure that there is a minimum pay out rate for coffee farmers. This can be done through the establishment of sinking funds and forcing management committee who misuse funds to repay.

As partains the credit management elements, all the twenty four societies seemed not to be aware of such risks. However, they indicated that they were aware of the general risk of default in payment. This calls for societies to engage staff who are more enlightened in financial management aspects. After explaining to them what these elements are, they gave their responses. Credit risk management policies emerged to be a major concern to the cooperatives. This was closely followed by credit portfolio management. Table 11 clearly shows this.

Table 11: Weighted Credit Management Elements

	Not Important	Important	Very Important	Very Very Important	Total
Types of credit management elements	Unit score	Unit score	Unit Score	Unit Score	Unit Score
Credit portfolio management	0	0	0.89	2.95	3.84
Credit portfolio quality review	0	0.64	1.21	1.05	2.90
Lending function and operations	0	0.64	1.21	1.05	2.90
Non-performing loan portfolio	0.15	1.58	0.95	0.21	2.89
Credit risk management policies	0	0	0.73	3.26	3.99
Policies to reduce credit risk	0.15	0.22	1.68	1.15	3.20
Asset classification policy	0.05	0.63	1.58	0.42	2.68
Loan loss provisioning policy	0	0.53	1.36	1.15	3.04

Source: Research Data

To come up with the above ratings, not important rating is given a score of 1, important is given 2, very important 3 and very very important is give a score of 4. These are weighted against the percentage of societies in the particular category of importance. The weights therefore, rank credit management elements in the descending order of importance. From the table 11, the order is: credit risk management policies, policies to reduce credit risk, loan loss provisioning policy, lending function and operations, credit portfolio quality review, non-performing loan portfolio and asset classification policy comes last.

Concerning the collection procedures, it was found that personal visits, letters and telephone calls and the use of shared information between cooperatives were the commonly used methods. Eleven societies representing 46% showed that use of letters and telephone calls was very important while the rest (54%) indicated that telephone calls and letters was very very important. In the case of personal visits, three societies representing 12.5% and the rest (87.5%) indicated that personal visits was very important and very very important respectively. Two (8%) societies used shared information as it was important to them, to twelve (50%) societies it was very important while to the rest (42%), it was very very important. There was no society which uses collection agencies or legal action to collect credit. Few societies used other societies to assist in credit collection since many did not cooperate especially the ones which had split into various societies due to leadership wrangles. Equally, none used legal action as they felt this would discourage the members from getting credit facilities from their societies for fear of being taken to court in case of default. Table 12 shows this clearly.

Table 12: Collection Procedure

	Not Important	Important	Very Important	Very Very Important	Total
Letters and telephone calls	0	0	11	13	24
Personal Visits	0	0	3	21	24
Collection Agencies	24	0	0	0	24
Legal Action	24	0	0	0	24
Through other coffee societies	0	2	12	10	24

Source: Research Data

Using the weighted collection procedure, not important rating is given a score of 1, important is given 2, very important 3 and very very important a score of 4. There are weighted against the percentage of societies in the particular category of importance. The weights therefore, rank credit collection procedures in the descending order of importance. From table 13, personal visits comes first with weighted score of 3.875, then the use of letters and telephone calls (3.54), while shared information between societies comes last with a score of 3.34. This is clearly shown in table 13 below.

Table 13: Collection Procedure Weighted

	Not Important	Important	Very Important	Very Very Important	Total
Letters and telephone calls	0	0	41.38	2.16	3.54
Personal Visits	0	0	0.375	3.5	3.875
Collection Agencies	1	0	0	0	1.00
Legal Action	1	0	0	0	1.00
Through other coffee societies	0	0.16	1.5	1.68	3.34

Source: Research Data

The study found out that if the following was done the problems of default in payment would be reduced tremendously. The cooperative societies should be allowed to prosecute the defaulters through the courts so that they can be forced to pay their debts, government should fix the minimum price per kilogram to be paid to farmers each year, election of management committee should emphasize on those who are more learned and informed, members to be educated on the importance of paying their credit at the appropriate time and farmers to be discouraged from selling their coffee to unscrupulous businessmen and instead take the whole of their produce to the societies. This is summarized in table 14 below:

Table 14: Other factors which may improve credit risk management

Factors	Frequency	%
Legal action	14	58
Minimum payout guaranteed	24	100
More education to the members	18	75
Elect high calibre board members	20	83
Prevent gate prices	22	92

Source: Research Data

From table 14, the various factors which may improve credit risk management include: fixing minimum payout per kilogram of coffee (100%), prevent selling to unscrupulous businessmen (92%), election of high calibre board members (83%), more education to be given to the members (75%) and the government to allow societies to be prosecuting credit defaulters (58%).

Large societies i.e. those with more than 2000 members, were 62.5% while the rest(37.5%) were considered as being small societies. Table 15 illustrates this.

Table 15: Size of societies in terms of membership

Membership	Number	%
0-2000	9	37.5
2001 and over	15	62.5
Total	24	100

Source: Research Data

Before advancing credit, the results indicates that the following information was required: capacity, character and the purpose of credit. There is no society which uses Trade and Bank references, financial accounts or cash flow. This again reveals that a lot of restructuring is needed to manage credit risk properly. Table 16 shows this.

Table 16: Information before advancing credit

Information	Frequency	%
Trade and bank references	0	0
Financial accounts	0	0
Cash flow	0	0
Capacity	9	37.5
Character	12	50
Purpose of credit	20	83

Source: Research Data

The purpose of credit was the most important information before credit was advanced since twenty (83%) societies use it. Nine (37.5%) societies use capacity while twelve (50%) use character to make decisions whether to advance credit or not.

The above information assists the management committee or the manager to know the type of credit as well as the amount to advance to an applicant.

As mentioned earlier, qualitative information was the only one used by societies, this can be ranked the way collection procedure has been ranked using the weighted information. Table 17 clearly shows this.

Table 17: Qualitative Factors Weighted

	Not Important	Important	Very important	Very very important	Total
Reputation of Borrower	0.05	0.7	1.15	0.8	2.70
Leverage	1.00	0	0	0	1.00
Volatility earnings	1.00	0	0	0	1.00
Collateral	1.00	0	0	0	1.00
The business cycle	1.00	0	0	0	1.00
Level of interest	1.00	0	0	0	1.00
Amount of credit due	0.05	0.6	0.35	1.80	2.80
Previous year's harvest	0.05	0.50	1.75	1.10	3.40

Source: Research Data

Table 17 ranks the qualitative factors from the highest to the lowest in order of importance as previous year's harvest (3.40%), amount of credit due(2.80%), reputation of the borrower(2.70%) and the others i.e. leverage, volatility in earnings, collateral, the business cycle and the level of interest being the least important with scores of 1 each.

The study found out that the following conditions must be met before an application for a credit facility is considered. The applicant must be an active member, have honoured the previous credits and the purpose of credit. Table 18 shows this.

Table 18: Conditions before an application is considered

Conditions	Frequency	%
Active member	23	96
Honoured previous credits	24	100
The purpose of credit	20	83

Source: Research Data

Twenty-three societies representing 96% only advance credit to active members while 24 (100%) and 20(83%) societies also consider credit due and the purpose of credit respectively.

All the twenty-four societies indicated that they do not consider any tangible security as they advance credit to farmers. Assets such as land, title deeds, log books and so on are not required.

All the societies indicated that they had some future plans. Most of them reported that they were thinking of computerizing their societies, start milling their coffee, diversify their activities by for instance buying peppers from farmers, expanding their societies or buying more land and replacing old machines with modern ones. However, none of these societies had a specific date on when to do what. Many were hoping that the project(s) would only be undertaken when the coffee prices improves. Table 19 illustrates this.

Table 19: Societies Future Plans

Plans	Frequency	%
Computerize the operations	13	54
Milling coffee	10	42
Diversify activities	9	37.5
Expand society	7	29
Buy modern processing machines	12	50

Source: Research Data

The above table shows that most of the societies had a plan to computerise (54%) and buy the modern processing machines (50%). Quite a number of the societies had plans for starting to mill their own coffee (42%), diversify their activities (37.5%) and expand their societies (29%).

CHAPTER FIVE

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

This chapter summarizes the findings of the study in relation to the objective of the study, gives conclusions drawn from the study and highlights the limitations of the study and recommendations for further research.

5.1 SUMMARY OF FINDINGS AND CONCLUSIONS

The study aimed at determining how coffee cooperative societies in Embu District manage their credit risk. This was in respect of the systems, procedures and controls which are put in place to ensure the efficient collection of credit so as to minimize the risk of non-payment. The following are the findings.

None of the coffee societies in Embu District use quantitative methods to evaluate the credit worthiness of their members and that all of the coffee societies use qualitative methods only. The three major qualitative factors considered include: the previous year's harvest, reputation of the borrower and the amount of credit due.

There is a common feeling that shared information between coffee cooperative societies in Embu District will assist to a large extent in filtering out un-creditworthy members. This is so because most members were found to belong to more than one society within the same locality.

The credit assessment method applied could influence the level of credit default and that education to members about the dangers of not paying in time could lead to a lower level of default.

Large societies manage their credit risks better than small ones since they have a lower levels of credit default. This could be due to the fact that large societies have better qualified and experienced staff since 75% had their secretaries/managers as graduates from Kenya Cooperative College. In small societies 25% had their secretaries/managers having been trained in any college. The management committee members of large societies are also more experienced and exposed as compared to the ones of small societies. Large societies were taken to be those with more than 2000 members.

All the societies in the District have credit policies. Eight societies (33%) have written credit policy manuals, while the rest (67%) have no written credit policy manuals. These policies are hardly revised in all the societies. If these policies were revised annually, this could improve the credit risk management greatly.

All the societies did not have a credit committee separate from the management committee and that the management committee acted in the two capacities. There was also no segregation of duties when it came to the lending process. This has encouraged reckless lending especially to the related parties. Twenty societies representing 83% of the societies have incidences of reckless lending. Cases of default go hand in hand with reckless lending.

The major procedures used to follow credit defaulters include: personal visits, letters and telephone calls and cooperation with the other cooperatives within the same locality.

50% of the societies were headed by a secretary/manager who had not attained any qualification related to cooperative management while the rest (50%) were headed by managers who had a certificate or a diploma in cooperative management. The ones with diploma also had an accounting qualification ranging from KATCE Intermediate to CPA Part one.

As a conclusion, the study revealed that most of the coffee cooperative societies do not manage their credit risk properly. This has led to high rate of default and consequently not being in a position to lend members promptly. A lot of education is needed by the members of staff as well as management committee members as regards credit management. This could be possible if

implemented through the ministry of cooperative development and marketing. The government need to ensure that the guidelines issued from time to time are adhered to by all the cooperative societies.

5.2 LIMITATIONS OF THE STUDY

There was a strong feeling of suspicion expressed by the societies managers interviewed. However, after explanations they later cooperated.

The study used a questionnaire and this implies that the findings could be opinions of the current societies managers and therefore the findings may not represent the real credit risk management.

The results of any case analysis are always to be considered as suggestive rather than conclusive because the case analysis statistically cannot be generalized to the whole population.

Credit risk management by cooperatives has not been researched in Kenya before; therefore, available reference material was limited.

5.3 RECOMMENDATIONS TO POLICY MAKERS

- The government through the Ministry of Cooperative Development and Marketing should fix the minimum payout per kilogram of coffee harvested by farmers. This would reduce the uncertainty when advancing credit to farmers. Farmers would also be motivated to take care of their coffee for they are assured of some returns.
- The Ministry should not leave farmers fully to control their affairs since the management committee have been sighted as being fraudulent and corrupt in many cases. The government should therefore, be prepared to assist members in such situations more than they are of late.

- Ministry to strengthen its role of educating members about the importance of paying their credit on time. This is encouraging them to take extra care of their coffee. This may be encouraged by having subsidised farm inputs.

5.4 SUGGESTIONS FOR FURTHER RESEARCH

- A similar study could be done in other coffee growing districts and provinces. This would be necessary to know whether the credit management are similar in all parts of the country.
- A study on why quantitative models are not used by coffee cooperative societies in Kenya would be important. This would be so as to encourage their use for they are considered better than the qualitative factors.
- A study on how to reduce credit default rate in coffee cooperative societies could be conducted. This would be to advice the societies on the best procedures to use so as to collect most of credit advanced to their members.

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APPENDIX 1

RESEARCH QUESTIONNAIRE

Credit risk management by coffee cooperative societies in Embu

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

(1) Please give the size of your cooperative in terms of the number of members.

----

(2) Name the types of credit provided by your society to the farmers.

----

(3) Does your cooperative have a written credit policy or manual?

Yes ------------------------ No -------------------------

(4) If your answer in question No. 3 is yes, explain how this credit policy manual is used.

----

(5) When was the manual last revised? ---

(6) Do you have a credit committee in your cooperative.

Yes ---------------------------------- No. --------------------------------

(7) If your answer in question no. 6 is yes, what is the number of people who constitute the committee? -------------------- and list four minimum conditions of entry into this committee in order of importance.

i. ---

ii. ---

iii. --

iv. ---

(8) In particular what information do you require from members before advancing credit?

(i) Trade and bank references --------------------------------

(ii) Financial accounts ---

(iii) Cash flow --

(iv) Others (list) ---

(9) How do you use this information?

----

(10) Indicate how important the following credit management elements are to a cooperative society. (Mark NI for not important, I for important VI for very important and VVI for very very important.)

(a) Credit portfolio management ( )

(b) Credit portfolio quality review ( )

(c) Lending function and operations ( )

(d) Non-performing loan portfolio ( )

(e) Credit risk management policies ( )

(f) Polices to reduce credit risk ( )

(g) Asset classification policy ( )

(h) Loan loss provisioning policy ( )

(11) (a) Do you use any of the quantitative models in arriving at credit decisions?

Yes ---------------------- No ------------------------

(b) If your answer in question no. 11(a) is yes, specify the model(s).

(a) Do you get any difficulties in their application? Explain

----

----

(12) Do you use qualitative information to make credit decisions?
Answer as in "10"

(a)	Reputation of the borrower	( )
(b)	Leverage	( )
(c)	Volatility earnings	( )
(d)	Collateral	( )
(e)	The business cycle	( )
(f)	The level of interest rates	( )
(g)	Amount of credit due	( )
(h)	Others, specify	( )

(13) Of the quantitative and qualitative models which do you rely mostly one? Explain

----

----

(14) Indicate how important the following collection procedures are to a coffee cooperative society. (Answer as in "10").

(a) Letters and telephone calls ( )

(b) Personal visits ( )

(c) Collective agencies ( )

(d) Legal action ( )

(15) As you review your credit facilities, do you find cases of reckless lending?

Yes ---------------------------

No ----------------------------

If yes, one in every how many cases?

----

(16) State four factors which you mostly blame on the reckless lending.

(a) ---

(b) --

(c) ---

(d) --

(17) What remedies would you suggest to ensure safe lending?

----

(18) Briefly outline the conditions to be met before an application for a credit facility is considered.

----

(19) How long does it take to process such an application if the conditions in "18" are all met.

-------------------(weeks).

(20) Do you have segregation of duties in the lending process? If so, who handles what from inception of a facility to the time of full recovery?

----

(21) Do you ever lend without tangible security? If so, in what types of lending?

----

(22) What percentage of your facilities default? (tick where appropriate)

(a) 0 - 10% ( )

(b) 11 - 20% ( )

(c) 21 - 30% ( )

(d) 31 - 40% ( )

(e) over 40% ( )

(23) What are some of the society's future plans"

----

(24) Provide any other information you consider important to improve on credit risk management

----

Designation: ---------------------------------------

Date: --

APPENDIX II

LIST OF COFFEE COOPERATIVES IN EMBU DISTRICT AS AT APRIL 2003

No.	Name
1.	Central Ngandori
2.	Gakundu
3.	Gatondo
4.	Ivinge
5.	Kagaari North
6.	Kagaari South
7.	Kamurai
8.	Kanjugu
9.	Kiangagwa
10.	Kibugu
11.	Kirindiri
12.	Kirurumwe
13.	Kithungururu
14.	Kiviuvi
15.	Mikiki
16.	Muramuki
17.	Murue
18.	Nembure
19.	New Kapingazi
20.	New Kirimiri
21.	New Kyeni
22.	New Runyenjes
23.	Rianjagi
24.	Thambana

Source: Embu District Cooperative Office (E.D.C.O).

APPENDIX III

Letter to the Respondent

Dear Sir/Madam,

I am a postgraduate student undertaking a degree of Master of Business Administration, Faculty of Commerce at the University of Nairobi. For my final research project, I am conducting a research on "Credit Risk Management by Coffee Cooperative Societies in Embu District" as a partial fulfilment of the requirements for the award of the degree.

Your organization has been selected to form part of the study. I kindly request you to fill the attached questionnaire. Any information that you provide will be treated in strict confidence and used only for the purpose for which it is intended i.e. academic. Neither your name nor the name of your organization is required.

A copy of the research project will be made available to you upon request.

Your cooperation will be greatly appreciated.

Thank you in advance.

Yours sincerely.

GEORGE MBOGO NJIRU
STUDENT

MRS. A. KITHINJI
SUPERVISOR

UNIVERSITY OF NAIROBI

FACULTY OF COMMERCE

MBA PROGRAM – LOWER KABETE CAMPUS

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P.O. Box 30197
Nairobi Kenya

DATE 6/05/2003

TO WHOM IT MAY CONCERN

The bearer of this letter NJIRU GEORGE MBOGO

Registration No: D61/7467/2001

is a Master of Business Administration (MBA) student of the University of Nairobi.

He/she is required to submit as part of his/her coursework assessment a research project report on some management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate if you assist him/her by allowing him/her to collect data in your organization for the research.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

DR. MARTIN OGUTU
CO-ORDINATOR, MBA PROGRAM