A SURVEY OF THE LENDING PRACTICES OF FINANCIAL INSTITUTIONS TO THE AGRICULTURAL SECTOR IN KENYA

BY

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DECLARATION

This project is my own original work and has not been submitted for a degree in any other University.

Signed: ---------- Date: 25/1/2005

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The project has been submitted for examination with my approval as the University of Nairobi supervisor.

Signed: ---------- Date: 25th January, 2005

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DEDICATION

To my parents Elizabeth Anyangu Anangwe and Robert Ayako Anangwe.

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ABSTRACT

The main objective of the study was to carry out a survey to determine the lending practices of financial institutions to the agricultural sector in Kenya. Data was collected by the use of a structured questionnaire, which had both closed and open-ended questions. Data collection was done around factors affecting the lending practices by financial institutions to the agricultural sector which included the interest rate, collateral, exchange rates, the business environment, technological advancement, existing and new competition by financial institutions, customer type and government policy. Fifty (50) financial institutions were contacted with 100% response rate. The study was descriptive in nature and descriptive statistics were used to analyse the data, which was presented in tables, frequency distribution and percentages.

The study revealed that an increase in interest rates leads to increased interest burden on loan holders, which later leads to borrowers defaulting and probably to bank failures since this increases non-performing loans in a bank's portfolio. The study also revealed that of all the banks contacted a higher percentage (56%) were not lending to the agricultural sector while 46% were lending to the agricultural sector. This was as a result of the risks associated with lending to the agricultural sector especially those associated with lack of traditional forms of collateral, price falls, and yield risks. However, there is renewed interest in agricultural sector policy frameworks, financial systems building and demand for financial services by the rural population which may increase the level of lending to the agricultural sector.

It was also observed that government intervention coupled with the effects of interest rate liberalization, frequently result in too much credit being given to few, hence straining borrowers debt servicing capacities, and jeopardizing credit schemes.

CHAPTER 1

1.0 INTRODUCTION

1.1 Background

Kenya is a country whose economy largely depends on agriculture and it is to this end that any development in the agricultural sector cannot be understated. The agricultural sector contributes 30% of GDP (Economic survey 2002) and provides employment to the general populace, exports notwithstanding. It is therefore considered a vital sector if the Kenyan economy is to improve or register any substantial growth. The agricultural sector can therefore be considered an engine of growth to the Kenyan economy.

Financial institution are important because of the key roles they play in the economy; intermediation, maturity transformation, facilitating payment flows, credit allocation and maintaining financial discipline among borrowers. Financial institutions provide important positive externalities as gatherers of savings, allocaters of resources and providers of liquidity and payments services. The role that financial institutions play in the agricultural sector cannot be underestimated. The development of financial institutions to exclusively serve the interests of players in the agricultural sector is therefore of necessity.

Financial institutions are particularly subject to market failures arising from information asymmetries. On the asset side they take on the risk of valuing projects and funding borrowers whose ability to repay is uncertain on the liability side the confidence of creditors and depositors who have imperfect information on the financial institutions actual position is essential to an institutions ability to provide deposits and payment services. High average and liquidity of assets render financial institutions particularly vulnerable to loss of creditor confidence. Movements in interest rates, in stock returns and in changes in the deposit to currency ratio are key factors in understanding the occurrence of financial crises in financial institutions this is according to Friedman (1961), Kindleberger (1978) and Minskey (1994). A financial crisis is a situation where financial institutions are forced to sell assets at a loss to replenish reserves. This follows major withdrawals

by depositors leading banks to draw on reserves held at the central bank and sale of assets so as to raise funds to meet this intense depositors' demand. As at the end of September 2000 the Kenyan banking system comprised 50 commercial banks, 7 non-bank financial institutions (NBFI'S), 2 mortgage finance companies and 4 building societies.

Table 1 Commercial Banks, Non-Bank Financial Institutions.

Type of institution	Sept 1999	Sept 2000
Commercial banks of which	52	50
a) Operating	48	50
b) Not operating	-	-
c) Under central bank statutory management	4	-4
Building societies	4	2
Mortgage finance companies	2	7
Non Bank Financial Institutions	11	7
a) Operating	10	-
b) Under central bank statutory management	10	

Source: Central Bank of Kenya, monthly economic review, October 2000

According to the Central Bank of Kenya, monthly economic review of October 2000,
Kenya's farm credit system is ruralistic in structure, but most of the lenders are public sector institutions or under the administrative control of the government. Linkages between financial intermediaries serving agriculture are not well orchestrated and the government's overall agricultural credit policy-making mechanism is not rationalized or formalized. Agricultural lending rates are in most cases equal to those prevailing in other sectors and in practically all cases appear insufficient to cover lender's costs, including losses from default by borrowers. This situation constraints the supply of funds available to agricultural borrowers because it makes the market unattractive to lenders and limits the interest rate, which they can pay on savings accumulated by rural people. Lenders practice non-price credit rationing, which works against the small farm sector to a greater extent than against the large farm sector. Interest rate expression and non price credit rationing make rural market

unattractive to financial intermediaries operating in the larger economy, which contributes to the lack of financial services in rural areas. Without intermediation, rural savings capacity is not stimulated and is divorced from credit.

Government intervention coupled with the effects of interest rate expression, frequently results in too much credit being given to few who receive loans, severely straining borrower' debt servicing capacities and jeopardizing the financial performance of credit schemes and financial institutions. Insufficient contact with the domestic capital market and the image of the "poor" farmer in the minds of policy makers and administrators allows a situation of lax loan discipline to develop which further complicates the task of government in its efforts to stimulate agricultural development. The purpose for which credit is used in agriculture frequently vary with the term for which it is granted. Long term credit commonly provides access to the control over land as a factor of production. Medium term credit frequently is provided for the development of farm assets and for the purchase of assets other than land. Short-term credit often facilitates commercial transactions (Economic Review of 2000).

One of the problems in dealing with the concepts of small and large farms in Kenya is the inadequacy of these categories for practical purposes. Some large farms are informally subdivided and operated as an unrelated group of small farms by rural families. They are owned by companies and cooperatives composed of many people of means more modest than those associated with the image of the large landowner. Some large farms are on very poor land. Ranches and plantations further complicate the matter; the traditional classification consists largely of mixed farms. An enumeration of farm size, land use patterns, capital employed and organizational form could constitute a very useful contribution to policy-making in Kenya.

It should be noted that many quoted interest rates are relatively straightforward in Kenya. Discounting in advance is relatively rare and interest is usually charged on actual balances outstanding. Interest premiums or penalty rates are not normally levied on overdue balances. Fees and other charges levied directly on the borrower do not appreciably raise the costs of borrowing from most lenders. Mortgage and hire purchase nominal rates depart widely from the true interest rates, however.

According to the Agricultural Finance Corporation's 2000 annual report, the demand for credit for farming is derived from numerous factors and is tied to levels and changes in farm assets and output, changes in input prices, changes in farm-gate prices paid for agricultural produce, the timing of income and expenditure flows and the supply of profitable innovations available to farmers.

Rational borrowers and lenders behave in response to expectations rather than simply in consideration of current circumstances. The expected real rates of interest and return over the life of the credit transaction are thus key variables. Imperfect information systems serving the small farmer, the level of demand and supply, related to profitable innovations, plus the lack of rural financial services, all impact on effective demand for credit for agricultural development purposes.

Although Kenya appears to have an impressive financial infrastructure, the system of preferential interest rates used by the large financial institutions has contributed to the relative scarcity of financial intermediation in rural areas. The Agricultural Finance Corporation has 50 branches outside Nairobi and the commercial banking system has some type of presence in over 100 locations outside Nairobi and Mombasa. Post office branches offer savings bank facilities and a large number sell and cash postal orders and money orders.

According to the Agricultural Finance Corporation's 2000 annual report, the co-operatives banking system is much more "indigenous" than the Agricultural Finance Corporation or commercial banks in certain rural areas. Rural credit unions, moneylenders and pawnbrokers are not numerous. In certain areas there are revolving credit associations and other types of mutual assistance groups.

There is some evidence that the importance of these informal types of cooperation are decreasing in certain areas while increasing in others, but it appears that their role in agricultural development is limited. Merchants in rural centers give credit in certain circumstances, but it is not known whether such credit is available on a significant scale for the purchase of agricultural inputs. The lack of a rural money market means that credit and savings media are not widely available to rural people. That such a situation prevails is a direct result of the preferential lending rates prevailing in the large financial institutions. Deposit rates must be kept low so that lenders can obtain a return from the spread between lending and deposit rates. Intermediaries from the modern sector are thus kept out of

small farm areas. The reasons for the lack of spontaneous development of intermediaries in the rural areas are more difficult to describe or evaluate.

Some observers may be tempted to speculate that the funds and energies that might provide a basis for rural financial intermediation are drawn directly into the larger economy, leaving a vacuum in the countryside. The rural branches of commercial banks generally have relatively low loan to deposit ratios while urban branches are in the opposite condition, but this simplistic indicator overlooks the flow of bank credit in the economy and the secondary effect involved (Economic Review 2000).

Given the lack of rural financial institutions on one hand and the Government's stated desire to provide credit to as many farms as possible, on the other, the question becomes one of designing delivery mechanisms to meet the perceived need within as acceptable period of time. Can mechanism be designed within the present interest rate constraint, which will reconcile these opposing factors without massive uneconomic subsidies?

1.2 Statement of the Problem

Lending institutions have looked for a variety of ways to expand their portfolio into agriculture but there are risks associated with lending to farmers who lack traditional forms of collateral and face price falls and yield risks. Manfred Zeller (2004) in his article on models of rural financial institutions says that there is renewed interest in agricultural finance because of improved macroeconomic, financial and agricultural sector policy frameworks, financial systems building and demand for financial services by rural population. However, rural finance is more difficult because of: higher transaction costs for financial institutions and their clients; higher systemic risks, more volatile cash flows and complex, heterogeneous legal frameworks; lower risk bearing ability; higher vulnerability of rural households and Lower policy commitment to rural areas.

According to Janvry and Sadoulet (2003) making credit more attractive (and less risky) to farmers would require lowering the threshold level of collateral required to secure the loan. Without access to other forms of collateral, however, lowering the level of collateral provided to secure the loan increases the potential for problems of moral hazard and adverse selection for the lending institution. Therefore, the formal lending sector primarily relies on collateral to avoid these problems, or avoids

the agricultural sector altogether. To reach the millions of people who need loans, financial institutions must transition to commercially viable institutions that can mobilize savings, access commercial finance and achieve full cost recovery through appropriate interest rates.

In their article on expanding commercial agricultural finance in rural areas, Charitonenko and Campion (2004) say that in the past, governments and donors supported many subsidized lending programmes to spur economic growth and agricultural development. It is now widely acknowledged that subsidized credit leads to excessive demand and that the benefits of receiving cheap loans are generally reaped by relatively wealthy and politically connected farmers rather than by the targeted smallholders. Lack of agricultural finance therefore remains a major gap in the provision of financial services to the agricultural sector.

1.3 Objectives of the Study

To determine the lending practices of financial institutions towards the agricultural sector in Kenya

1.4 Importance of the Study

The study may impact on policy formulation in financial institutions in order to improve agricultural production and increase incomes to farmers. This study is expected to be of importance to: The Central Bank of Kenya as the country's banking supervisor and Ministry of Finance, in making financial policies that affect the agricultural sector and players in the agricultural sector who include farmers, the Ministry of Agriculture, the Agricultural Finance Corporation, and the Ministry of Livestock Development.

CHAPTER 2

2.0 LITERATURE REVIEW

Agricultural credit can make an important contribution to the solution of the problem of rural poverty. There is ample evidence that much modern agricultural technology is advisable and that small-scale operation could be the barrier to raising agricultural yields. If credit is regarded mainly as a tool for development, then its use will have to be enriched with the adoption of technologies suited to the task.

It has been a generally accepted view for several years now that agricultural credit programmes can only be successful if they are part of an "Integrated approach" to rural development problems. This means that price incentives, marketing, farm input supply, extension services and credit must be handled together. With respect to agricultural credit the practical step could include the formulation of a conceptual framework for the organization of this service to farmers. Such a framework would help in defining the problem areas, so that past errors can be avoided and more effective credit programmes designed. Moreover, there has been a common tendency to omit agricultural credit from early planning in national development. Thus agricultural credit is often not programmed into national development plans when these are drawn up. The need for developing small farmer sectors necessitate early and direct planning effort, including carefully programmed credit allocations (World Conference on credit for farmers in developing countries Rome 1975).

An "integrated approach" to credit problems by definitions, requires the coordination of different centers of decision-making. These centers are at least three: The individual borrower, the credit institution and the government. The motivation of these centers in credit operations can be very different and sometimes contradictory. But unless the related decisions of farmer, government and credit institution are made mutually consistent, difficulties and inefficiencies will arise. The first step to a realistic solution of credit problems is, therefore, to clearly identify possible inconsistencies and the true reason behind them. This is the necessary precondition to a possible harmonization of different and / or conflicting interests, Allen (1956).

The body responsible for buying farmers' crops can be a very suitable agent for both handling loan repayments and encouraging farmers to save. Thus, in the case of the Kenya coffee farmer cooperatives, proceeds from the sale of coffee have been paid to farmers in three installments.

But the farmer is not physically paid, rather his account with the cooperative is credited with the crop return, net of his loan repayment and cooperative charges, he is then able to withdraw, from his account, cash required for his immediate needs. The system ensures both high repayment rates and a high rate of saving. For the purposes of collecting loan repayments in this manner it is not necessary for both the credit and marketing operations to be carried out by the same institution, the bank can simply arrange for a "stop order" to be placed on any given borrower's account with the marketing agency. To ensure full cooperation in operating such a system there should be same financial incentive for the marketing agency, Allen (1956).

Allen continues to state that government investment is agriculture is likely to be of great importance in the provision of financial resources for agricultural credit operations. There are very good reasons why governments should find it necessary and desirable to provide the necessary funds. First, private investors are unlikely to do so because, on the one hand, urban investment is usually more profitable and on the other, rural people themselves generally have insufficient capital formation capacity to be able to provide all the necessary financial resources. Second, economic as opposed to financial consideration are of over-riding importance in planning something as important as a rural credit programme. In other words, it is frequently of more value to the total economy of the country to produce an increased agricultural output than would be indicated by the cost and return figures, judged rarely by financial criteria.

2.1 The Lending Decision

Van Horne (1989) asserts that with security, lenders have two sources of loan repayment: The cash flow ability of the customer to service the debt and, if that source fails for some reason, the collateral value of the security. Most lenders will not make a loan unless the firm has sufficient expected cash flows to make proper servicing of debts probable. To reduce their risks further, lenders require security. Secured lending arrangements are more costly to administer than unsecured loans and that

the incremental cost is passed on to the borrower in the form of fees and higher interest costs than would otherwise be the case.

The use of security is negotiated in keeping with conditions in the overall market for loans. If the borrower is unable to meet the obligation, the lender can sell the security to satisfy the claims. If the security is sold for an amount exceeding the amount of the loan and interest owed, the difference is remitted to the borrower. Because secured lenders do not wish to become general creditors, they usually seek security with a market value sufficiently above the amount of the loan to minimize the likelihood of their not being able to sell the in full satisfaction of the loan. The degree of security protection a lender seeks varies with the creditworthiness of the borrower, the security the borrower has available, and the financial institution making the loan.

Dewald (1970) in his article maintains that due to high administrative costs and insufficient earnings occasioned by agricultural credit institution, the question arises as to whether credit institutions are in a position to make careful investigation of each individual credit application and to work out, for each borrower, all the costs and benefits attributable to enterprises or projects financed by a credit programme. The position differs according to the size of the farm. Large farms are generally fewer in number and are managed by people competent enough to furnish all the basic information required for the construction of a farm budget. The lending bank should have no major difficulty in carrying out a detailed analysis of each credit application. However, the budget to be constructed will differ according to the nature of the credit concerned. For short term or working credits, the budget can be quite simple since the time of forecasts is relatively short. But for investment credits forecasts that cover a number of years, the budget will have to be more elaborate.

Small farms on the other hand are so numerous as to preclude separate investigation and the construction of a farm budget for each credit application. The lending bank could then follow the farm budget method. Here, the lending bank can try to group small farms in some way and thus establish model budgets applicable to separate categories of farms according to their specific circumstances and on the basis of a common denominator. This certainly is not an easy thing to do and pre supposes the existence of statistical methods and research services specially adapted to farm management surveys and economic analysis. This procedure certainly would have the advantage of credit distribution on a scientific basis. There is a strong case, therefore, for governments to promote

the construction of model farm budgets representative of an diversified a range of farm models as possible.

According to Modgman (1963) loan security has always been the stumbling block of agricultural credit schemes. There has been much debate not to say controversy about the nature and scope of security for farm loans, and different or indeed arguments have been put forward to uphold the divergent views of the parties concerned. Banks generally regard security as risk cover and hence a prior condition for any credit at all. If a bank or credit institution insists on security in the form of landed property this has the additional advantage of enabling it to verify the borrower's title to the land and his rights in the farm enterprise. Farmers often resent the requirement to pledge some of their property as an infringement of their freedom to deploy their productive capacity in full measure and hence to achieve social and human betterment, on the other hand they may accept, with resignation, the obligation to provide security as a condition to access credit.

Governments regard the problem of loan security as an altogether secondary matter. Credit is seen as a means of implementing an agricultural development policy intended to achieve certain targets such as higher output, reduction of rural employment and improvement of said conditions. Quite a part from these divergent views, there are real difficulties involved in the pledge of assets as security, especially, in the case of land, which, traditionally is the type of asset most often required. One major difficulty is the securities legal administration.

In many developing countries, farmers hold no registered title to the land and indeed the very concept of individual property may require that the actual rights of credit applicants are hard to ascertain – Credit institutions then have to proceed to lengthy and laborious verifications. Also, customary land law which is relevant in most cases is often far from clear and the absence of a land register makes it impossible to know the exact boundaries of a holding, movable property can hardly be regarded as effective security.

Modgman (1963) continues to assert that both the national requirements for economic development, and the ability of farmers to repay loans, necessitate special attention to encouraging the demand for credit to grow cash crops. The labour intensive nature of farm operations and the phenomena of unemployment and underemployment and low technical competence are important factors in

determining the specific purposes for which credit should be demanded. Credit is the vehicle for improved techniques which must be within the technical competence of the farmer and therefore simple, which normally should have a high ration of output to capital and which in the early stages would more fully utilize the labour force rather than dispense with the need for it.

Emphasis on labour saving investments will become more appropriate, however, as employment opportunities emerge outside of farming. The transition towards cash farming itself is likely to involve additional risks. These must be recognized as obstacles to be overcome in inducing changes in the character of the demand for credit; and allowed for in the conditions under which credit is given and by the integration of credit with extension and marketing and provision for effective supervision. The use of land as a basis for security is beset with difficulties and the farmer may be reluctant to pledge it. Other forms of security, especially in crops, must be sought. Moreover, insistence on tangible security prejudices the small farmer by compassion with the farmer with a large holding. The primary criteria in satisfying the demand should be repayment capacity rather than credit worthiness in the sense of adequate tangible farm assets. In addition to farm operations, credit is needed to provide fixed capital and working expenses for marketing and processing.

2.2 Conditions of Loans

Binns (1952) says that credit should be equally available on comparable terms in different areas for different classes of borrowers. While this may not be immediately practicable, especially in remote areas, it should be an objective of policy. Such a policy requires the promotion of institutional credit and special attention to the needs of small borrowers who are, or can be made, credit worthy. The cost of credit should be as cheap as in practicable. This also leads to the necessity to promote credit institutions, substitution for, or in competition with, private lenders, through which supply can be increased, the monopoly of private lenders reduced, cost of management lowered and risk reduced. While the aim should be to enable agriculture stand on its own feet without subsidies it may be necessary in the early stages to make public funds available on special terms and contribute to the establishment and operating costs of new institutions.

Varde (1952) suggests that risks should be reduced as far as is practicable to the borrower, credit institution, and lender. Reduction of interest risks as they affect farm operations requires attention to

improved farm technology, storage and processing and affirms the importance of agricultural extension and supervision. Commercial risks maturity arise from price fluctuation of produce. Diversification of crops may reduce risks to the farm, but there may be disadvantages in a smaller degree of technical specialization and smaller volume for processing and marketing.

Reduction of yearly price fluctuations leads into the debatable territory of stabilization schemes but short term or seasonal fluctuation may be reduced by better marketing information and by better storage and marketing organizations, both of which will require credit. Unavoidable risks to the farmer may be provided against by special funds to meet severe loss from drought, floods or other natural causes and by crop and cattle insurance. Flexibility in the repayment of loans may make it easier for the farmer to recover from losses due to such causes. Adequate geographical coverage by credit institutions, and diversification of transactions will help to spread risks.

The financial structure of these credit institutions is important, especially in the management of accounts, relating liabilities to the nature of assets and building gap of reserves. Loans must be suited to the convenience of the borrower. This requires simple procedures, convenience in the location of credit agencies, adjusting the period of loans to the revert of income, provision for deferment in exceptional circumstances, types of security which the borrower is willing and able to pledge without undue trouble, and arrangement of loans in sufficient time in advance for farm operations to be properly planned, Gritly (1949)

Binns (1952) suggests that there is therefore need to have agricultural credit institutions which are large enough and strong enough for the economy and efficiency, but at the same time to ensure close enough contacts with clients to be able to understand their needs and apply procedures consistent with them. Such decentralization is needed both to encourage more savings and to ensure loan operations which are both sound and flexible. It is required because of the sheer impracticability of dealing with a multitude of small cultivators from a remote center. Nevertheless, the cooperative society is a method of organization structure possessing important advantages, both social and economic, over most other forms, especially, because it provides a systematic way of promoting self help and mutual help Cooperative structure provide strong foundations in rural communities for sound credit, marketing and processing systems. This requires re-assessment of how cooperative principles may best be applied.

Allen (1956) suggests that there is importance in linking and integrating credit and marketing of produce. Such integration will usually be one of the main keys to success in both credit to farmers and marketing. On the other hand, credit may strengthen the position of the farmer in disposing of this crops to advantage instead of having the timing determined by urgency of his needs for cash, despite seasonably unfavourable prices; and the price determined by the greater bargaining power of the merchant. On the other hand, suitable marketing conditions provide better security in terms of repayment capacity, and systematic provision for repayment of loans.

Similarly, advantages may result from linking supply of farm requisites with credit and marketing by increasing the amount which can be bought, ensuring better prices and quality and making better provisions for repayment. An efficient system of marketing with which credit and supply may be linked need not necessarily be cooperative in form. Marketing may be organized by the government or by marketing boards, which are quasi cooperative in that members of the board are elected by producers.

2.3 Agriculture Finance Corporation

The Agricultural Finance Corporation (AFC) was established in 1963. In 1969, the Agricultural Finance Corporation was reconstituted under the Agricultural Finance Act (Cap 323 of the laws of Kenya) with wider powers and assumed the responsibilities of the Land Agricultural Bank.

As a statutory body, Agricultural Finance Corporation comes under the office of the president but for everyday operation the cooperation works in close consultation with the Ministry of Finance, Ministry of Agriculture and Ministry of Livestock Development. The running of Agricultural Finance Corporation is entrusted to a board of directors who in turn administer the corporation through a managing director.

Agriculture Finance Corporation as Kenya's largest single agricultural credit institution, assists in the development of agriculture and agricultural based industries by making loans to farmers, cooperative societies, incorporated group representatives, private companies, public companies, public bodies, local authorities and other persons engaging in agricultural industries.

The loans offered are classified into: short term loans (upto 3 years), medium term (4-7 years), and long term (8-30 yrs). The loans are further classified into sizes: small scale (less than Kshs 50 000) and large scale (more than Kshs 50 000).

(Millions 000')

Table 2: Loan Portfolio, Loan Disbursement and Loan Collection

	1984	**1985**	**1986**	**1987**
Loan Portfolio	—	—	—	3327
Loan Disbursement	578.1	383.7	904.3	745.0
Loan Collection	554.7	333.0	624.3	676.4
	1988	**1989**	**1990**	**1991**
Loan Portfolio	2845.3	2462.4	2486	2440
Loan Disbursement	629.9	338.7	342.7	
Loan Collection	703.9	567.3	552.0	499.4

	1992	**1997**	**1998**
Loan portfolio	2714	2253	2198
Loan disbursement	516.5	249	172.98
Loan collection	479	708.7	425.3

Source: Agriculture Finance Annual Reports.

2.3.1 Agriculture Finance Corporation Restructuring

Some of the innovations implemented during the restructuring and reorganization of the Agriculture Finance Corporation included: Enhancement of loan portfolio management; Improved credit delivery and collection systems; Revision of loan application forms (small scale); Administration of

repayment proposals to be limited to branch managers only; Close monitoring of branch assets; Lending to public institutions; Enhancement of loan accounting system and human resource development and management.

2.3.2 Loans to the Farmers

As previously reported, arrears of loans to farmers have continued to increase such that at 30 June 1990 such arrears stood at K£ 59,594,544 (1989 - K£56,751,126). Arrears of loans have mainly resulted from farmers' inability to pay their unsecured loans given on the loanee's character as well as from loans given to group farmers under the rehabilitation farm programme which were later sub divided into smaller units on Government directive.

The Corporation has not been servicing these loans apparently due to an anticipation that government would restructure in capital and convert some of the outstanding loan fund into grants. Although the corporation has indicated that negotiations are in progress with government with a view to capitalizing the principal loan amounts and writing of the accrued interest thereof.

AFC finances for development growth and export total loan disbursements 1980 – 1989 Kshs 5276,345,000 for Land purchase, Farm machinery, Farm infrastructure, Cash crop development, Livestock development, Food production

Kshs (million)

1980 –	245.6	1985 -	383.7
1981 –	394.1	1986 -	904.3
1982 -	596.3	1987 -	745.0
1983 -	460.7	1988 -	629.9
1984 -	578.1	1989 -	338.7

Total loan disbursement 1980 – 1989
Kshs 5,276,345,000

Source: Agricultural Finance Corporation Annual Reports

The balance of loans and interest as at 30th June 1997 stood at Kshs 2,208,879,100 compared to a balance of Kshs 2,068,557,520 outstanding as at 30th June 1996.

The trend of loan repayment arrears unless seriously addressed is likely to adversely affect the operation of the corporation. The corporation did not cover large and small scale loans together with accrued interest thereof totaling Kshs 2,644,127,663 including loans plus interest totaling Kshs 1,427,168,000 which has remained outstanding for over 10 years, an indication that the loans may eventually become non recoverable.

2.3.3 Land Development Loans

Table 3

Analysis of Loans Approved from 11th October 1963 to 31st March 1969 report of the board and accounts 31st March 1996

Area	No. of loans	Total amount approved
Nakuru	224	583,039
Transnzoia	228	484,676
Nandi	31	86,449
Laikipia	42	109,125
Kericho	84	251,272
Kiambu	295	515,548
Nyeri	107	163,169
Kirinyaga	50	39,531
Central Nyanza	12	20,700
South Nyanza	52	77,084
Uashin Gishu	202	369,674
Nyandarua	23	108,998
Naivasha	23	64,145
Machakos	61	179,995
Bungoma	127	142,139
Kakamega	56	59,688
Murang'a	121	134,934
Kisii	32	21,345

Embu	24	25,665
Baringo	4	4,380
Meru	65	60,457
Ngong	13	13,530
Thika	18	73,605
Mount Kenya	5	9,425
Kitui	4	15,000
Coast	41	80,047
Kajiado	87	125,552
Nairobi	49	116,072
Busia	23	26,924
Total	2,203	3,962,218

Source: Annual Reports – Agricultural Finance Corporation

By 3rd August 2000 the corporation was owed more than 1.9 billion making it difficult to discharge its responsibilities (Financial Review August 3 2000). One of the main handicaps confronting AFC is the challenge passed by the large number of defaulters among the country's lenders and other influential Kenyans and the continuing interference by such individuals in the corporation's operations. This category of borrowers has accumulated nearly Kshs 125million or 6% of total loan in arrears, (Financial Review 2000).

There are attempts to recover outstanding loans although this meets with resistance. The only avenue opened to Agriculture Finance Corporation when dealing with defaulters is to auction a defaulter's land or other tangible assets.

Table 4

Agriculture Finance Corporation Arrears by Area and Category (Financial Review 2000)

	AFC Schemes	Seasonal Crop Credit (S.C.C)
	Millions of Kshs'	
Head office	16.4	-
North Rift	78.3	545.7

South Rift	47.3	362.3	
Central Rift	52.6	159.1	
Nyanza	57	59.6	
Western	32.9	271.2	
			1,666,266,379.66
Western region	268.1	1397.9	
Eastern	100.7	4.6	
Mt. Kenya	45	37.1	
Coast	65	2	
Eastern	210.7	43.7	271,012,626.69
Region	495.2	1,441.6	1,937,279,006.35

Large-scale – 375m Small-scale - 112.3m

GMR – 397.7m NSCC – 1.04b

AFC loans are much sought after because of their soft conditions compared to those of commercial banks and other financial institutions. Minimum guaranteed returns (GMR) credit scheme was scrapped in 1980 nearly 400million was in arrears under the scheme most of it from large scale farmers and replaced it with seasonal crops credit (S.C.C) scheme which was largely administered through the district agricultural committees.

The new scheme required loans to be recovered directly from crops delivered by the borrowing farmers to various parastatal marketing boards such as the National Cereals and Produce Board and the Kenya Grain Growers Co-operative Union. This scheme unfortunately left Agriculture Finance Corporation at the mercy of these marketing bodies which were supposed to receive the loans on its behalf. Since its inception the scheme has accumulated defaults amounting to Shs 1.04 billion compared to Shs 495 million outstanding from other Agriculture Finance Corporation administered schemes (Financial Review 2000).

2.3.4 Dreams for the Future.

Once considered an institution for the plantation sector, the Agricultural Finance Corporation has gradually but deliberately shifted its lending to the small scale farmers as opposed to large scale farmers. This shift in objective aims at attaining a structure whereby 80% of corporation's total lending goes to small or medium scale farmers, 13 per cent to large scale farmers and 7 per cent to the ranching sector (Agriculture Finance Corporation Financial Review, 2000).

Three main strategies towards meeting this target and retaining the corporation are: to improve the liquidity position of the corporation; to revise credit extension policies, especially where they tend to impede the loan making process and institute measures to protect the interest of the corporation and; to enter into agreements with the marketing bodies on how best Agriculture Finance Corporation can be repaid loans made to farmers out of farmer's deliveries to the marketing bodies. On improved funding, improved Agriculture Finance Corporation capitalization is to be disbursed as budgetary allocations by the government.

This money would be for development loans as opposed to funds given annually to Agriculture Finance Corporation for the national season crop credit scheme. The treasury should continue to support its 1990 directive requiring financial institutions to purchase government guaranteed paper, such as Agriculture Finance Corporation promissory notes issued to finance the seasonal crop credit schemes and other government supported schemes. Agriculture Finance Corporation should be authorized as an approved specialized financial institution so as to enable it to take deposits and benefit from the rediscounting facilities of the Central Bank of Kenya, especially for funds tied in longer-term investments.

The rediscounting facility would enable Agriculture Finance Corporation to multiply in loan funds by 2 to 3 times on a short-term basis, within a period of only 12 months. According to the financial review 2000, on lending, the corporation should concentrate on short term loans and establish a ceiling for individual borrowers. The maximum amount for individual borrowers should be worked out to take into account various farm enterprises. Banks and non-banks financial institutions have not complied with a government directive requiring that 17% and 10 % of their total lending respectively be made to agriculture.

There should be a higher rate as bigger loan amounts (to discharge borrowers whose needs would be better served by commercial institutions), On loan collection the Financial Review 2001 urges the ability of the parastatal marketing bodies to pay farmers for their crops be improved so that farmers can improve their loan servicing. Should a marketing board fail to pay farmers on time, then the body as the marketing agent should automatically dissolve after. This would avoid the unnecessary accumulation of arrears and the interest chargeable to the farmers as these arrears. One method of taking care of some of the problems of late payment to farmers by marketing bodies would be for the marketing bodies to issue farmers with warehouse receipts that are negotiable as commercial paper. Farmers would pay AFC with such receipts and the corporation would in turn correct the instruments into cash by negotiating a loan with any financial institutions. Farmers who hold such a receipt could also negotiate a loan with any financial institution and use the proceeds of the loans to pay his commitments to AFC. A major advantage of this scheme is that it would not only enable the farmer to pay AFC, but also to acquire loans from commercial banks to finance his farming activities on time. The government should set up an agricultural generated loan fund scheme to cover AFC's losses, not just to the value of crop damaged but to cover the equipment of the whole of the Corporation's loan.

The Agricultural Finance Corporation was established in 1963 by an act of parliament as the single largest government agricultural credit institution in the country. At the end of March 1999, its total loan portfolio amounted to 3.1 billion (Financial Review2001). The corporation has a network of 47 branches and 3 sub branches and is administered through 8 area managers and two assistant general managers who man the two regional offices in western and eastern Kenya. Restructuring of the corporation to make is more effective and accountable especially at the branch level has taken place. Despite opposition, Agricultural Finance Corporation also included in its new loan policy, the provision of security.

Deposits, share certificates and company shares quoted on the Nairobi stock Exchange can also be pledged. Reputable individuals in a community are permitted to guarantee loanees as well. Because of the broad nature of the security requirements, the AFC can now cater for farmers of all categories. The branches would improve communication between the corporation and the farmer which in turn would make it easier to identify loan defaulters and assess the credit of the farmers before giving them any loans.

Like all other credit organizations, the AFC's principal source of funds is loan repayments. The World Bank and the Kenya Government are its other two major sources. The current farm credit system in the country has been criticized for its inadequacy in creating alternative lines of credit for the farmers. Corporations such as the AFC are isolated from the main money markets, which means that farmers in Kenya are not able to take advantage of funds generated from other sectors except through allocation from treasury. Economists argue that operators of these institutions would be better improved if they were to play a joint role in creating fund for farm credit together with commercial vendors.

The extent to which the AFC depends on the government as a source of fund limits its operations it also has the negative role of making the corporation non competitive on the money market since it is assured of funds . Probably the most unfair feature of farm credit in Kenya is where large scale farmers with ability to obtain and repay commercial loans are left to compete for the limited funds available at AFC with a much bigger capacity to borrow these groups of farmers often quality for this loans loading to a situation where small sale farmers are left out. This has grossly affected the productivity of the small holder sector. For Kenya to boost production, as much capital as possible should be channeled in the funding of the small scale farmers who are the majority and are always hard pressed for cash and other capital required for more productive farming.

The plan to introduce an Agricultural Development Bank that will mobilize rural saving and participate in the capital market could also offer an alternative to the present system which is heavily dependent on one corporation. The AFC also plans to accept deposits from the public in the future a step that would give it a premier capital base than at present. The Guaranteed minimum returns (GMR) scheme has been limited as the most realistic agricultural credit scheme in the country, given the risks involved in farming. Apart from the credit component of the scheme, it also provides for compensation in cases of losses due to crop failure.

Whatever option the government may decide upon in streamlining the agricultural credit system in the country, the greatest challenge is which of the systems can operate more effectively to boost agricultural production with minimal subsidy from public funds. As a first step, some analysts have proposed a grassroots education programme to teach Kenyan farmers the importance of farm credit

and the obligations that go with it, especially loan repayments (Agricultural Finance Corporation Financial Review, 2000).

Report and accounts of guaranteed minimum returns (GMR) and seasonal crop credit loans 30th June 1989 indicate that during this period the corporation continued with the reorganization exercise to further streamline the operations of the corporation in line with the thrust of the Government to provide effective services to all sectors of the economy. The following corporate units were re-organized during that year: management accounting division; credit control division; supplies and purchasing section and corporate planning division. The corporate planning department was strengthened and renamed corporation planning department, composed of planning and evaluation division and research and statistics division.

On corporate performance 30th June 1998 annual report and accounts states that during the year the corporations income decreased by Kshs 52.2 million or 9.2% from Kshs 568.2 in 1997 to Kshs 516 million in 1998 mainly due to reduction of the principal loan portfolio whereas the expenses rose by Kshs 62.2 million or 9.6% from Kshs 653.4 million in 1997 to Kshs 716 0 million in 1998 the assets decreased by Kshs 92 million from Kshs 4,811 million in 1997 to Kshs 4,719 million in 1998 due to the corporation's reduced investment activity. The decline is mainly attributed to the general poor economic performance that prevailed at the time.

2.4 Financial Institutions

According to Lorenzo Friediani (1975) the use deposit banks make of liquidity reserves made available to the system depends largely on loan and investment opportunities, an interest rates and on expected yield changes. Supposing credit expansion is possible only at risks so much higher as to make it uneconomic, much of the reserves will remain unused, since the deposit banks, in a situation of barely differentiated oligopoly, will put off price competition as long as possible, because of the uncertainties surrounding the reactions of rivals.

When therefore the banking system has liquidity reserves in excess of the desired level, it will be to the advantage of banks to raise the level of credits for imports thereby destroying monetary base which they do not want, which cannot be used profitably in other ways and which would otherwise

simply end up unproductive in the banks tills and depress their earning. If financial institutions find themselves with undesired reserves, they will probably adopt more generous credit policies and raise the transaction costs of deposits, thus pushing up the public's demand for currency.. Banks' financial liabilities and hence their liquidity management are influenced by the following factors: The expected rates of return on the deposit banks financial liabilities and their degree of liquidity ; Transaction costs; The time horizon of individuals; The expected rates of return and the degree of liquidity of similar financial assets obtained abroad. These are the factors that have a bearing on the liquidity reserves of deposit banks. Due to the fact that banks are business entities in the financial markets, high profits motivate them to lend.

Lorenzo Frediani (1975), in his article, the liquidity policy of deposit banks in Kenya says that the monetary authorities in Kenya require financial institutions to determine the amount of their liquidity reserves at short intervals. Nevertheless the inefficiency and small size of the credit market, the level and rigidity of the yield structure, the characteristics of the circuit of the banks" financial flows and the small size of most banks have done much to make the liquidity policy of deposit banks in Kenya more responsive to medium term than to short term fluctuations.

According to Robicheck and Coleman (1967) the failure of financial institutions to adopt seasonal liquidity policies would seem therefore to have been due to the following factors: Adjustment costs; The structure and rigidity of yields; Economies of scale; The rate of expansion of domestic money supply and the possibility of freely acquiring monetary base.

Diamond and Dybig (1983) in their article 'Bank runs, Deposit Insurance and Liquidity suggest that credit standards are conveniently summarized under 4 classifications concerning the status of the borrower:

Capacity to repay – Mainly cash flow considerations. How much cash will be generated by the investment financed by credit and what level of uncertainty is attached to these projections;

Character – willingness to repay according to the loan agreement;

Collateral to secure the loan – giving the lender some recourse is the event of default and subjecting the borrower to a certain discipline. In lending to individuals, collateral protects the lender in the event of the borrower's death or inability to operate his farm business;

Capital or net assets of the borrower, i.e. to what extent can the borrower provide his own funds to support the investment assisted by the loan and How large the lender's "cushion" is in the event that the investment does not generate the best cash flow.

These considerations are the basis for decision making models used as tools for assessing the degree of uncertainty, which the lender assumes in granting credit. These concepts are fundamental to the long run success of credit arrangements. One theoretical consideration is that rational borrowers and lenders behave in response to expectations rather than simply in consideration of current circumstances. The expected rates of interest and return over the life of the credit transactions are thus the key variables.

Individuals who are small farmers have fewer and more limited alternative services of credit open to them then do large farmers, as indicated by complete coverage of the large farm sector by institutional lenders and suppliers, and their relatively low degree of penetration of the small scale sector. Large farmers also have greater access to short term credit than do small holders. Large farmers may have commercial bank overdraft facilities. Short term credit is available only to small farmers having an established cash crop or non farm income. Small farmers as a class have lower debt to equity ratio than large farmer because of the lack of credit for small scale land purchases. Small farmers may face a higher degree of uncertainty than large farmers, reflecting the small number and less complete integration of enterprises on their farms, the higher properties of output consumed by the farm family and or labour force, the differences in access to suppliers, extension advice and marketing channels, for example.

Rational high risk farmers would carry relatively less debt then rational low risk farmers, ceteris paribus it is unlikely however, in the present Kenyan situation that the marginal return on credit is equal in both the large and small sectors. The relative lack of innovative approaches to the provision of rural credit in Kenya suggests that there is little information available, which could serve as a valid basis for the argument that the great majority of small holders are not "creditworthy".

Credit worthiness is a function of credit standards appropriate to the market the programme is designed to serve. That the smallholder is the victim of non price credit rationing is also suggested by the extent to which smallholders in certain circumstances might be willing to borrow at higher interest rates than large farmers.

Given the lack of rural financial institutions an one hand and the Government's stated desire to provide credit to as many farms as possible, the question becomes one of designing delivery mechanism to meet the perceived need within an acceptable period of time. Can mechanisms be designed within the present interest rate constraint which will reconcile these opposing factors without massive and uneconomic subsidies?

2.4 Separation of Savings and Credit.

According to Diamond and Dybig (1983) the low interest policy, exacerbated by the absence of local financial service in small farm areas results in the separation of savings and credit for farm development in Kenya. This separation is reflected in the structure of financial institutions serving agriculture and in the links between these institutions and the larger financial sector. The primary agricultural credit institutions, the Agricultural Finance corporation is almost exclusively a lending institution although it accepts deposits from the public to a limited extent, by requiring that large scale borrowers using loans to buy land deposit a down payment to AFC equal to the difference between the purchase price and the AFC loan. These deposits are liquidated when the title is transferred and farmer's savings are tapped by the cooperative banking system. The commercial banks operate on both sides of the market, of course, but small scale agricultural lending is not attractive. Short term trade credit and hire purchase financial for large farmers are supported by reasonably adequate financial linkages.

Hire purchase finance for buyers of new agricultural machinery is provided by local finance companies, which are closely linked with the commercial banks. Local merchant banks and finance houses lend directly to large scale agricultural firms in a limited number of cases. The commercial banks and their finance company and development corporation subsidiaries do participate in the capital markets, but agriculture is only one of their numerous concerns and there is no effective special market for securities generated by the agricultural sector. The Central Bank does have a preferential discount rate for agricultural paper, but commercial banks have used this facility infrequently.

The isolation of the specialized agricultural credit institutions from financial markets and from the mass of savers in the economy means that liquidity in other sectors cannot be channeled easily into

agricultural investments, except through the treasury and minor channels most of which are not highly specialized in agricultural finance. The separation of the AFC from financial markets also reflects, its operational isolation how great is the savings capacity of the rural population? How sensitive is rural savings to interest rates and institutional arrangements to encourage savings? The argument for increased financial specialization in rural areas assures that savings are and would be available at the right price. This assumption is related to the fact, demonstrated in certain areas with certain farm enterprises, that the rate of return to smallholder agriculture can be substantial, Davis (1973).

Frediani (1990) suggests that of great importance is the relationship between debt and equity and its relevance to agricultural finance and development. What is the optional gearing or leverage in the various segments of Kenyan smallholder agriculture? What depreciation of equity is operationally valid? It is commonly assumed that credit enables borrowers to do things more quickly or earlier than would be possible without such assistance, in which case they would be forced to rely on the accumulation of savings before investing. How can the saver or potential saver be identified in rural Kenya?

The World Conference on credit for farmers in developing countries, held in Rome in 1975 stipulated that no matter what the final objectives of Governments or the credit institutions are, i e (increased production, improved trade balance, returns to loan resources, etc) it is basically the generation of concrete benefits to the borrower which matters for the success or failure of credit programmes. It is therefore essential that a full recognition of the overwhelming importance of the borrowers' view points and interest be the very foundation of the decisions of the other participants in credit operations.

Farmers find procedures for loan application to institutional credit sources different and sometimes quite costly – credit institutions have a clear responsibility to develop streamlined procedures, which do not alienate this service from small farmers.

Much more is however involved in encouraging farmers to save and to invest. Thus government's must:-

Ensure that as incentive price structure exists, so that farming is seen as a viable, income-generating enterprise;

Strengthen the bargaining power of the agricultural sector;

Create a taxation policy, which leaves sufficient income within the agricultural sector to assist growth;

Direct sufficient public investment into agriculture;

Allocate sufficient resources to agricultural savings by urban banks;

Establish land tenure policies which will give farmers confidence in their future.

Peltzam (1969) asserts that monetary savings formed in rural areas may be drained by financial intermediaries. These intermediaries carry out their principal activities in urban areas and therefore are concerned especially with financing the industrial and tertiary sectors. The intermediaries involved include not only commercial banks, but also post office savings, co-operatives and non-institutional intermediaries such as money lenders. The broad answer to this problem is to foster farmers groupings that can assist in redressing balance of political and economic power in the rural areas, the government should ensure that suitable legislation exists and the government should assist in the establishment and growth of farmers' co-operatives an associations.

2.5 Investment in Agriculture.

Credit provision is a farmer service calling for government investment. This may be by central bank financing. Again the government investment may be, for example, by way of establishing credit programmes linked to the production of a given crop or livestock product, by providing lines of credit through private or co-operative banking institutions, or by setting up fully fledged, government credit institutions, Tobin (1970).

Agricultural investments are usually less attractive to private individuals than other types of investment, at least when judged by purely financial criteria. This is because prevailing price structures for agricultural products tend to lag behind, resulting in a relatively low return to money invested in this sector of the economy. But in developed countries, there are non-monetary incentives for agricultural investment, Morrison (1966).

The non monetary benefits and tax advantages do not usually apply in developing countries and when a government has decided to embark upon a development plan, then there is almost certainly ample scope for private investment in urban areas, in construction, trade, manufacturing and transport. Investments in agriculture is usually longer term and unless extremely favourable price conditions apply, then the return will be much less. There is plenty of evidence however to indicate that farmers when they have sufficient cash resources are prepared to plough these back in their farming operations and build up even further their capital formation capacity. This process would of course be assisted greatly by incentives such as favourable terms of trade Morrison (1966).

In contrast to agricultural products for domestic consumption, the marketing of crops such as tea, coffee and horticulture all in active demand on export markets has received continuing government attention. This is not surprising for these commodities not only bring in cash income to the producers, but also foreign exchange for the country. The main issue regarding credit management is again sharp variations in market prices, mainly in reflection of output changes due to disease, weather or other production conditions. International prices of these products are also very susceptible to political disturbances and breaks in trading relations, Robichek and Myers (1965).

Modgman (1963) asserts that not only are returns on agricultural credit low as to sometimes fail to cover costs, it may even cause downright losses when a loan cannot be recovered. Given the difficulties of high administrative costs and insufficient earnings, the question arises as to whether credit institutions are in a position to make careful investigation of each individual credit application and to work out for each borrower, all the costs and benefits attributable to enterprises or projects financed by a credit programme loan security.

Minskey (1994) says that loan security has always been the stumbling block of agricultural credit schemes. There has been much debate, not to say controversy about the nature and scope of security for farm loans, and different or indeed contradictory arguments have been put forward to uphold the divergent views of the parties concerned.

Banks generally regard security as risk cover and hence a prior condition for any credit at all if a bank insists on security in the form of land property this has the additional advantage of enabling it

to verify the borrower's title to the land and his rights in the farm enterprise. There are of course many farmers who simply have no assets they can offer as security.

Government corporations often regard the problem of loan security as an altogether secondary matter. Credit is seen as a means of implementing and agricultural development policy intended to achieve certain targets such as higher output, reduction of rural unemployment and improvement of social conditions. However, there are real difficulties involved in the pledge of assets as security, especially in the case of land, which traditionally is the type of asset most often required. The major difficulties include administrative and legal difficulties and difficulties connected with the adequacy of the security Minskey (1994).

Dewald (1990) in his article ' Bank behaviour with respect to deposit variability stipulates that the concept of repayment capacity clearly is a great step forward from the traditional view of credit worthiness in the sense of full coverage of loan by tangible assets. The problem of agricultural credit is shifted into a dynamic perspective and credit becomes more responsive to the creative potential of an agricultural investment programme, which in itself of course, must be well planned, well implemented and well supervised. Repayment capacity must be assessed in human and technical terms.

The first requires more intimate knowledge of the borrower and his skill and competence in terms of management with particular reference to the enterprise for which he requests the loan. But whilst repayment capacity is a useful concept, it raises problems of its own. A bank may not always be in a position to know all its clients well enough to assess their individual character and skill. This is especially true when the bank is handling a credit scheme for small farmers.

Nevertheless, decisions frequently have to be made by governments as to the appropriate type of credit institution to be promoted and supported in order to service the small farmer sector. For example, should credit be linked to a certain crop and handled by a marketing agency for that crop or should the already existing development bank be required to undertake lending in the small farmer sector or, again should government effort be directed towards the establishment of cooperatives and if so, which of the various types of primary society should be sponsored? Frediani (1990).

Banks have advantages with respect to rising outside funds, whereas cooperative systems are generally better able to handle both the mobilizing of local resources and the organization of links with input supply and marketing. Thus the effectiveness of a bank in servicing the small farm sector might well be increased by the formation of multi purpose cooperatives through which it could reach small borrowers. On the other hand, cooperative systems should forge links and make associations with banks in advantageous positions, This is for the purposes of raising finance and in withstanding undesirable influences from powerful individuals or pressure groups, Friedman (1961).

The problem of appropriate interest rates for agricultural credit has been debated at great length. Governments may want to reduce the interest rates on agricultural loans for political reasons. But then governments would do well to consider a policy of subsidized interest rates in the general context of their farm support policy, and to ask whether it is better to act on the price for the use of money on the price of the inputs farmers need, or on the improvement of institutional infrastructure. There are disadvantages in reducing the interest rates to low levels because very low interest rates may create a dangerous situation, where it is likely that cheap farm credit will be planned off into investments, which have little to do with developing the farmer. Any subsidy in this case will not help production in this sector since it does not reach those for whom it is intended. Also farmers' investment policies may be distorted by very low interest rates since the true cost of capital is not reflected in the farmers' transactions, Fleetwood (1964).

When interest rates are very low then it is likely that demand for credit will exceed supply and rationing will be necessary. Low interest rates encourage decapitalization where institutions concentrate on large loans to established farmers in order to economize and it may find difficulty in raising capital, partly because of its inability to offer attractive interest rates on deposits. Very low interest rates in one sector of the economy have a tendency to hinder the integration of capital markets, thus decreasing the efficiency of the economy by restraining the transfer of resources Fleetwood (1964).

Morrison (1966) says that Agricultural credit is not a glamour spot in banking, risks are high and turnover of funds is low. Banking operations for agricultural lending normally do not generate a succession of operations and transaction, which give a bank additional income from commissions and other charges.

But the most severe draw back in agricultural lending in the high administrative costs associated with this type of banking operation. Loans are relatively small and borrowers remote from urban areas. Moreover banking institutions are very often new to this type of clientele , so there is little in the way of accumulated knowledge of the potential borrowers. High administrative costs can be overcome by: Increasing the interest rate charged to the borrower; Simplifying lending procedures; Utilize other agencies for much of the supervision of loans; Lend to groups rather than individuals; Obtain a government subsidy to help with administrative costs.

CHAPTER 3

3.0 RESEARCH METHODOLOGY

3.1 Population

The population studied comprised 50 financial institutions. The total population was studied since virtually all of these institutions have their head offices in Nairobi. Only one branch (the head office or the principal office) was studied for each one of the financial institutions. The list of the financial institutions studied are found in appendix 2. The financial institutions studied are divided into 4 categories:

- Banks
- Non – Bank Financial Institutions
- Mortgage Finance Companies
- Building Societies

Each category was studied as per the objectives of the study, which included determining the lending practices of financial institutions and assessing the effect of such practices on the agricultural sector.

3.2 Data Collection

The study is a cross sectional survey so as to capture the true lending practices of financial institutions and their effect on the agricultural sector. The data was collected by the use of a structured questionnaire, which had both closed and open-ended questions.

The questionnaire is divided into 2 parts. Part A and part B. Part A mainly deals with the personal details of respondents, organizational structure of financial institutions and its relevance to the lending practices to the agricultural sector, financial decision – making, the products and services offered and their link to the agricultural sector, changes in the external environment and how these affect the lending practices, the business environment of the financial institutions, strategic planning,

customer base and determination of interest rates. Part B mainly deals with strategies, which are used in order to respond to challenges in dealing with operations linked to agricultural development.

Data collection was done around the factors affecting the lending practices to the agricultural sector. One of these factors is the interest rate. In collecting data concerning the interest rates the financial institutions are using to lend to the agricultural sector, the study will mainly be concerned with how they are determined and what interest rates are being used for credit by the financial institutions. In same measure, banks try to vary the interest rate charged according to the creditworthiness of the borrower; the lower the creditworthiness, the higher the interest rate. Interest rates charged also vary in keeping with money market conditions. One measure that charges the underlying market conditions is the prime rate. The prime rate is the rate charged on business loans to financially sound companies. The rate itself is usually set by large money market banks and is relatively uniform throughout the country. Interest rate differentials among the various customers of a bank supposedly should reflect only differences in creditworthiness. Interest rate charged on a short – term loan would depend on the prevailing cost of funds to banks, the existing prime rate, the creditworthiness of the borrower and present and prospective relationships of the borrower with the bank. Certain collateral loans are costly to administer, and this cost must be passed on to the borrower either in the interest rate charged or in a special fee. Because of the fixed costs involved in credit investigation and in processing of a loan, we would expect the interest rate on small loans to be higher than the rate on large loans. Interest income to the financial institutions is also of interest

Collateral issues are another factor that was considered when collecting data around the factors affecting the lending practices of financial institutions to the agricultural sector. First we determined whether collateral is required or not i.e. whether loans are secured or unsecured. The degree of security protection a lender seeks varies with the creditworthiness of the borrower the security the borrower, has chain label and the financial institution making the loan. Only the lender with a valid security interest in the collateral has a prior claim on the assets and can sell the collateral in settlement of the loan.

The value of the collateral to the lender varies according to several factors. Marketability is perhaps the most important. If the collateral can be sold quickly is an active market without depressing the price, the lender is likely to be willing to lend an amount that represents a fairly high percentage of

the collateral's stated value. The life of the collateral also matters. If the collateral has a cash – flow life that closely parallels the life of the loan, it will be more valuable to the lender then collateral that is much longer – term in nature. As the collateral is liquidated into cash, the proceeds many be used to pay down the loan. Another factor on the collateral is the basic riskiness associated with the collateral.

The greater the fluctuations in its market value or the more uncertain the lender is concerning market value, the less desirable the collateral from the standpoint of the lender. Thus marketability, life and riskiness determine the attractiveness of various types of collateral to a lender and hence the amount of financing available to a company.

Exchange rates is another factor determining the lending practices of financial institutions to the agricultural sector. Exchange rate tends to be relevant more in export and import financing by the financial institutions. When a devaluation or sharp drop in currency value occurs, if may offset future sales of a company, costs and remittances. If a company believes that the currency of a country is going to drop sharply in value, if makes sense to reduce monetary assets in that currency to as low a figure as possible and to borrow extensively in that currency. To protect itself against adverse exchange rate fluctuations, a company or financial institutions can hedge its monetary position. By hedging we mean offsetting monetary assets such as cash marketable securities and receivables with monetary liabilities, such as payable and loans of the same amount.

The business environment is yet another factor, around which data concerning lending practices of financial institutions, was collected. Constant interactions of the business environment with the financial institutions lending to the agricultural sector is of interest. Also of interest were the changes taking place in the external business environment.

Technological advancement of the financial institutions and its effect on the lending practices to the agricultural sector is yet another factor around which data was collected. The computer age has brought with it a continual broadening of applications to their financial services industry and a lowering of costs per transaction. Technology has had a profound influence. Electronic funds transfer, automatic teller machines, point of sale terminals, personal companies and telecommunications all have changed dramatically the way they are priced. Structurally, costs have

been lowered through automation. Often the accuracy and speed of transaction are improved which increases customer satisfaction. Existing competition and new competition of financial institutions is yet another factor around which data relating to lending practices of financial institutions was collected.

Product quality, product diversity, distribution network around the country, marketing strategy, profitability and market share are some of the contentious issues that were explored concerning existing competition and new competition.

Customer type is yet another factor around which data relating to lending practices was collected. The customer type is also supposed to be linked to the agricultural sector. When considering customer type we are looking at whether the customer is large-scale livestock farmer, small scale livestock farmer, large scale or small scale crop farmer, co-operatives societies, marketing boards exporters government agencies or companies. Also in consideration under customer type was a consideration of whether customer type has changed as a result of changes in the business environment. Customer sophistication was also linked to customer type.

Government policy and political connections of borrowers are other factors around which data concerning lending practices of financial investigations to agricultural sector were collected

The questionnaire was given to credit controllers or the person in charge of lending in the financial institutions who was expected to give information and see to its completion. Credit controllers are preferred because they are the ones concerned with the lending operations of the financial institutions. The questionnaire was self administered and the respondents were based in Nairobi. This is because the head offices of the financial institutions or their principal offices are based in Nairobi and also all the financial institutions being based in Nairobi becomes an advantage as this eases the collection of more accurate and reliable information. Completed questionnaires were examined before collection to ensure that they had been properly completed.

3.3 Data Analysis

The study was descriptive in nature and descriptive statistics was used to analyze the data. These included frequency distribution, percentages and tables to assist in analysis. Specifically statistical

packages for social sciences (SPSS) were used in analysis of content from the various respondents. There was no particular hypothesis to be tested, rather, the survey is considering the lending practices of financial institutions holistically and their effect on the agricultural sector with a view to considering agricultural development.

CHAPTER 4

4.0 DATA ANALYSIS AND FINDINGS

4.1 Introduction

This study is descriptive in nature and relies on the statistical package for social sciences for analysis. The findings have been presented in tables with percentages and frequency distribution. Data has been collected around variables set out in the questionnaire as shown in appendix 3.The study is a cross sectional survey

Table 5: Nature of Ownership of Financial Institutions.

Ownership	Frequency distribution	%Percentage
Predominantly local (50% or above)	27	54
Predominately foreign (50%) or above	9	18
Balance between local and foreign (50%)	14	28
TOTAL	**50**	**100**

Source: Research data

Majority (54%) of the banks are locally owned with 28% banks being 50% local and 50% foreign. Only 18% of the banks are predominantly foreign.

Table 6: Publicly Quoted Banks.

Response	Frequency Distribution	% Percentage
Yes	9	18
No	41	82
Total	**50**	**100**

Source: Research data

82% of the banks are not publicly quoted on the Nairobi Stock Exchange. 18% of the banks are quoted on the Nairobi Stock Exchange

Table 7: Number of Employees in the Financial Institutions Banks.

Response	Frequency Distribution	% Percentage	Average No. of employees
$X \leq 100$ employees	22	44	85
$100<X\leq 200$ employees	14	28	137
$200 \geq X$ employees	14	28	630
Total	50	100	

Source: Research Data

The number of employees in the bank is indicative of the size of the bank in terms of whether the bank has branches upcountry or within the major towns. Banks with branches upcountry are lending to the agricultural sector. The banks with an average of 630 employees are the larger banks with branches upcountry, as compared to those with an average of 85 employees. The larger banks have structured lending practices as compared to the smaller banks with an average of 85 employees. The lending practices include the setting of legal lending limits and loan reviews.

4.2 Data Analysis

During data analysis, factor analysis was used. This is a descriptive statistic, which is used for extracting those factors that have a significant effect on whatever variable, which is being examined.

This technique reveals subtle relations which ordinary procedures like cross tabulations and frequency analysis cannot capture. The initial step in factor analysis is the computation of the total variance that is attributable to each of the relevant factors. The factors are listed according to the variable under consideration.

Table 8: Financial Decision Making in Banks

	Component	
	1-Least extent	2-Great extent
Shareholders	0.732	0.348
Executive Board	0.327	0.841
Chief Executive	0.251	0.827
Temporary Teams	0.745	0.183
Consultants	0.378	0.632
Managers (Financial)	0.256	0.754

Factor analysis: Principal Component Analysis

The executive board, chief executive and financial managers are the principal financial decision makers in the Banks, while the temporary teams are least involved in financial decision-making.

Table 9: Banks Lending to the Agricultural Sector.

Response	Frequency Distribution	%Percentage
Yes	23	46
No	27	54
Total	**50**	**100**

Source: Research Data

Majority (54%) of the banks offer other products and services to other customers other than lending to the agricultural sector. Only 46% of the 50 banks interviewed are lending to the agricultural sector. This is as a result of the high risks associated with lending to the agricultural sector, high

transaction costs and low ability of players in the agricultural sector to repay loans given to them, i.e low creditworthiness.

Table 10: Products Service Offering by Banks to the Agricultural Sector

	Frequency Distribution	Percentage
Current Account	50	100
Savings Account	50	100
Fixed deposits	45	90
Bureau de Change	50	100
Export Financing	40	80
Letters of Credit	29	58
Import financing	35	70
Foreign currency dealing	40	80
Small scale credit (1-500,00)	50	100
Medium/Large scale credit (Over Ksh. 500,000)	48	96
Guarantees	45	90
International funds transfers	40	80
Local funds transfers	45	90

Source: Research data

All banks (100%) offer current accounts, savings accounts, bureau de change and small scale credit services. The small-scale credit is not necessarily to the agricultural sector. 90% of the banks offer fixed deposit accounts, guarantees and local funds transfer services. 96% of the banks offer medium/large scale credit and this is also not necessarily to the agricultural sector. 80% of the banks offer international funds transfer services, foreign currency dealings and export financing. Export financing may or may not be for agricultural products which includes tea, coffee and horticultural products. Only 58% of the 50 banks interviewed offer letters of credit for agricultural purposes.

Table 11: Changes that have Impacted on the Banks' Business.

	Components	
	1 – Little impact	2 – Great impact
Technology advancement	0.175	0.975
Existing competition	0.243	0.863
New competitors	0.531	0.417
Increased Customer sophistication	0.163	0.982
Liberalized interest rates	0.187	0.865
Liberalized Exchange rates	0.243	0.673
Infrastructure	0.421	0.582
Government Policy	0.478	0.634
Substitute Products/Services	0.321	0.432

Factor Analysis: Principal Component Analysis.

Technology advancement, existing competition, increased customer sophistication and liberalized interest rates have had a great impact on the way banks do their business in relation to the agricultural sector. These changes have had the effect of increasing lending to the players in the agricultural sector. New competitors have had the least impact on the way banks have been lending to the agricultural sector in the recent past (5 – 20yrs).

Table 12: Important Factors for Formulating Strategies for Lending to the Agricultural Sector.

	Component	
	1 - Not important	2 - Very important
Existing competition	0.276	0.873
New competitors	0.351	0.652
Suppliers	0.785	0.285
Increased customer sophistication	0.174	0.954
Substitute products	0.752	0.348
Government policy	0.431	0.681
Infrastructure	0.462	0.623
Political connections	0.351	0.572

Factor Analysis: Principal Competent Analysis.

Existing competition, increased customer sophistication are the most important factors for formulating strategies for lending to players in the agricultural sector. Substitute products and suppliers are the least important factors in formulating strategies for lending to the agricultural sector.

Table 13: Changes in Promotional Strategies as a Result of Changes in the External Environment

Response	Frequency Distribution	Percentage
Yes	46	92
No	4	8
Total	50	100

Source -: Research Data

92% of the 50 financial institutions contacted have had to change their promotional strategies due to external environmental changes. Changes in the external environmental include changes in the existing competition, new competitors, suppliers, changes in government policy and technological advancement. Due to external environmental changes, promotional strategies like branding of branches and changes of logo have had to change. The promotional strategies like advertising and better public relations to depict a better corporate image have had to be more aggressive.

Table 14: Customers in the Agricultural Sector.

	Component	
	1- Least focus	2 – Major focus
Large Scale Livestock Farmers	0.246	0.843
Small Scale Livestock farmers	0.279	0.856
Large scale Crop farmers	0.237	0.871
Small Scale crop farmers	0.281	0.882
Cooperative Societies	0.273	0.875
Marketing Boards	0.153	0.797
Exporters	0.172	0.914
Government Agencies	0.213	0.832
Companies	0.248	0.841

Factor Analysis: Principal Component Analysis.

Both large and small-scale crop farmers, Co-operative societies and exporters are the core customers from the agricultural sector who access credit from the financial institutions for their operations. When taking credit especially for large amounts, issues like collateral and capacity to repay the loan are taken into account.

Table 15: Customer Changes as a Result of Changes in the Business Environment

Response	Frequency Distribution	Percentage
Yes	43	86
No	7	14
Total	50	100

Source: Research Data

86% of the 50 banks interviewed are in the affirmative that the customer has become more sophisticated as a result of changes the business environment. Sophisticated in the sense that they are demanding better quality services from the banking institutions. Some of the customers had been lost as a result of closure of some branches especially by the major banks. The customers from the agricultural sector are also increasingly becoming more and more sophisticated

Table 16. Rating of Bank Competitors in Providing Services/Products Related to the Agricultural Sector.

	Component	
	1 – Very weak	2 – Very Strong
Product Quality	0.432	0.532
Product diversity	0.451	0.562
Market share	0.439	0.543
Grown Potential	0.241	0.852
Location	0.751	0.339
Distribution network (branches)	0.316	0.831
Pricing	0.620	0.413
Strategy/Marketing	0.326	0.754
Profitability	0.281	0.832

Factor Analysis:- Principal Component Analysis.

Growth potential, distribution network and profitability rate highest with competitors in terms of providing products/services related to the Agricultural Sector. Location and pricing rate the lowest.

Table 17: Interest Rates

Response	Frequency Distribution	Percentage
≥ 15%	6	12
< 15%	44	88
Total	50	100

88% of the financial institutions offer credit at less than 15% whereas only 12% of the financial institutions interviewed offer credit at above or equal to 15% . The main causes of high interest rates are high domestic debt, effect of the cash ratio requirement, inefficiencies in the financial sector, high levels of non-performing loans and perceived risks by investors. The financial institutions with interest rates of 15% and above are mostly for the mortgage finance companies. The major banks like Barclays, Kenya Commercial Bank, National Bank of Kenya, Co-operative Bank and Standard Chartered Bank Structure their interest rates depending on the product or service being offered, and on the perceived risk by management. An increase in interest rates leads to increased interest burden on loans. which may lead to borrowers defaulting. High interest rates have had the effect of shutting of players from the agricultural sector.

4.3 Strategies used in Responding to Challenges Linked to Agricultural Development.

Strategists in financial organizations need to scan their environment in order to determine what impacts on them most as thy design strategies to meet the discerned forces like increased interest rates and liberalized exchange rates. Their survival and well-being depends on well formulated and appropriate strategies.

Only 23 of the 50 banks interviewed offer credit services related to the agricultural sector.

Table 18: Broadening the Product/Service Line

Response	Frequency Distribution	Percentage
Not utilized	4	17.4
Least Utilized	-	-
Moderately Utilized	12	52.2
Fairly utilized	3	13
Utilized to a great extent	4	17.4
Total	23	100

Source: Research Data

52.2% of the banking institutions lending to the agricultural sector utilized moderately the strategy of broadening the product/service line. This is a strategy for diversifying risk especially considering the fact that risks associated with lending to the agricultural sector are high. This is due to the fact that farming activities in Kenya largely depend on the weather. The banking institutions have been widening their product range to become what they are calling one – stop points, so that the customer does not have to look elsewhere.

Table 19: Offering High Quality Products/Services.

Response	Frequency Distribution	Percentage
Not Utilized	-	
Least Utilized	-	
Moderately Utilized	-	
Fairly Utilized	2	8.7
Utilized to a great extent	21	91.3
Total	23	100

Source: Research Data

Offering high quality products/services is a strategy, which has a leaning toward customer satisfaction. As a strategy, 91.3% of the banks utilized to a great extent the offering of high quality products/services in order to meet customers' demanding expectations.

Table 20: Using a Wider Distribution Network

Response	Frequency Distribution	Percentage
Not Utilized	10	43.5
Least Utilized	7	30.5
Moderately Utilized	3	13
Fairly Utilized	-	-
Utilized to a great extent	3	13
Total	23	100

Source: Research Data

Using a wider distribution network as a strategy is not greatly utilized. This is in order to cut down on transaction costs of the banks lending to the agricultural sector. However the large banks tend to have a wider distribution network and are able to reach the rural customer who is concerned with agricultural activities.

Table 21: Having More Convenient Locations Compared to other Competitors

Response	Frequency Distribution	Percentage
Not utilized	14	61
Least utilized	1	4.3
Modality utilized	3	13
Fairly utilized	1	4.3
Utilized to a great extent	4	17.4
Total	23	100

Source: Research Data

Majority of the banks (61%) lending to the agricultural sector have not utilized the strategy of having more convenient locations compared to other competitors. Convenient locations, i.e upcountry and/or in major towns determines the direction of business by the financial institutions especially for players in the agricultural sector.

Table 22: Lowering Lending Interest Rates

Response	Frequency Distribution	Percentage
Not utilized	5	21.7
Least utilized	5	21.7
Moderately utilized	8	34.9
Fairly utilized	1	4.3
Utilized to a great extent	4	17.4
Total	23	

Source: Research Data

Only 34.9% of the banks lending to the agricultural sector moderately utilized lowering of lending interest rates as a strategy. This is because of the uncertain nature of agricultural business

Table 23: Using Superior Technology

Response	Frequency Distribution	Percentage
Not utilized	-	-
Least utilized	-	-
Moderately utilized	4	17.4
Fairly utilized	-	-
Utilized to a great extent	19	82.6
Total	23	100

Source: Research Data

Majority of the banks 82.6% lending to the agricultural sector use superior technology as a strategy to enhancing efficiency in operations linked to agricultural development and to mitigate external turbulence.

Table 24: Differentiating Products/Services

Response	Frequency Distribution	Percentage
Not utilized	3	13
Least utilized	4	17.4
Moderately utilized	12	52.2
Fairly utilized	4	17.4
Utilized to a great extent	-	-
Total	**23**	**100**

Source: Research Data

52.5% of the financial institutions lending to the agricultural sector are differentiating their products/services.

Table 25: Concentrating on Core Business

Response	Frequency Distribution	Percentage
Not utilized	-	-
Least utilized	-	-
Moderately utilized	-	-
Fairly utilized	-	-
Utilized to a great extent	23	100
Total	**23**	**100**

Source: Research Data

100% of the financial institutions lending to the agricultural sector are concentrating on their core business. This is in order to boost profits.

Table 26: Boosting the Organization Name and Reputation Through Sales Promotion and Better Public Relations.

Response	Frequency Distribution	Percentage
Not utilized	-	-
Least utilized	1	4.3
Moderately utilized	-	-
Fairly utilized	2	8.7
Utilized to a great extent	20	87
Total	**23**	**100**

Source: Research Data

87% of the banks lending at the agricultural sector utilized to a great extent the boosting of the organization name and reputation through sales promotion, advertising and donations. This is done in order to boost corporate image and profile.

Table 27: Having Good Systems for Receiving Customer Feedback to Aid in Service Improvement

Response	Frequency Distribution	Percentage
Not utilized	-	-
Least utilized	-	-
Moderately utilized	-	-
Fairly utilized	2	8.7
Utilized to a great extent	21	91.3
Total	**23**	**100**

Source: Research Data

91.3% of banks lending to the agricultural sector have good systems for receiving customer feedback to aid in service improvement and delivery and this as a strategy is utilized to a great extent.

Table 28: Establishment of Repayment Capacity

Response	Frequency Distribution	Percentage
Not utilized	-	-
Least utilized	-	-
Moderately utilized	1	4.3
Fairly utilized	4	17.4
Utilized to a great extent	18	78.3
Total	**23**	**100**

Source: Research Data

78.3% of the banks lending to agricultural sector utilized to a great extent the establishment of repayment capacity as a strategy in order to minimize default by customers

CHAPTER 5

5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary and Conclusions

Government intervention coupled with the effects of interest rate expression, frequently result in too much credit being given to few who receive loans, severely straining borrower, debt servicing capacities and jeopardizing schemes and financial institutions. Insufficient contact with the domestic capital market allows a situation of lax loan discipline to develop which further complicates the task of government in its efforts to stimulate agricultural development. The purpose for which credit is used in agriculture frequently vary with the terms for which it is granted. Rational borrowers and lenders behave in response to expectations rather than simply in consideration of current circumstances. The expected real rates of interest and return over the life of the credit transaction are key variables in the information systems serving the small farmer. The level of demand and supply, related to profitable innovations, plus the lack of rural financial services, all impact on effective demand for credit for agricultural development purposes. Although Kenya appears to have an impressive financial infrastructure, the system of preferential interest rates used by the large financial institutions has contributed to the relative scarcity of financial intermediation in rural areas. It can thus be concluded that interest rates are key in lending practices carried out by financial institutions.

To remedy the lending rates and deter further increases to allow more players in the agricultural sector to borrow, a number of steps may be taken. These may include, reduction in government domestic borrowing through streamlining of government operations to reduce government expenditure and enhanced revenue collections, reduction of the cash ratio requirement by the Central Bank to release more funds for lending and increased efficiency in banks through computerization and restructuring to reduce operational costs. Financial Institutions should diversify their income sources away from interest on advances and should employ more rigorous credit analysis and follow up, to reduce the incidence of non-performing loans. The Central Bank should explore other tools for controlling money supply other than the high yielding treasury bills. In the same light the Central Bank in its pursuit of a tight monetary policy should explore a trade –off between inflation targets and reduced interest rates. Development of capital markets may serve as an alternative to borrowing from the banking sector through facilities such as commercial paper and corporate bonds.

The changes in the financial institutions external environment induce existing competition and new events. In order to formulate strategies to respond to challenges in an organization's external environment the financial institutions need to identify the major factors that are having an effect on an organization from both the industry and the wider environment perspective. They also need to identify the team(s) that will be involved in narrowing down the key factors and formulating the relevant strategies for responding to identified challenges and educate the whole organization about the need to adopt the necessary changes. They should evaluate strategies and devise ways of coping with strategic implementation challenges. Financial institutions lending practices tend to be unique to the lending bank. However, there are some lending practices, which are common in all banks. One such common practice is the lending limit. Financial institutions tend to put a limit on the amount of money to be given out to borrowers. The amounts lent tend to be low if the loan is unsecured whereas if credit is fully secured by readily marketable collateral, the amount tends to be higher. Legal lending limits are dependent on the internal bank policies and on state law. Financial institutions impose legal lending limits in order to diversify their credit risk across an array of borrowers. However, market conditions dictate to what extent legal lending limits can be observed and these have largely affected lending to the agricultural sector.

Another lending practice that is common to all financial institutions is that of setting geographical limits to the borrower and this is done for a variety of reasons. Among the most important is that the further a borrower is physically located from the lender, the harder it is to develop a complete picture of the borrower's character. It therefore becomes more difficult and costly to monitor the borrowers' use of funds and evolving financial status.

A practice common to most financial institutions is the board's involvement in the loan portfolio. Since loans and their accompanying credit risk are the largest exposure that most banks face, directors often want to see monthly status reports on various aspects of the loan portfolio such as large loans, charge- offs and delinquencies. Depending upon management's aggressiveness in keeping abreast with evolving problems in the loan portfolio, financial institutions may perform internal loan reviews as often as once a Month. At a minimum, financial institutions are encouraged to conduct a quarterly internal review. This helps to determine the adequacy of allowance for loan and lease balances, which are reported in the quarterly report. Approving the loan policy is another common practice, which is done as a general rule. Financial institutions review and approve their

policies including the loan policy at least once a year. This is often done following the annual election of directors. Charging off loans is another common practice. Policy guidance and generally accepted accounting practices apply here. A loan, or a portion of a loan, should be charged – off at the time the financial institution determines the loan to be uncollectible.

5.2 Limitations of the Study

It was not possible to study the effect of other macro-economic variables such as inflation rate, exchange rates and balance of payments on credit to players in the Agricultural sector as this would have made this particular study amorphous.

Another limitation is that it was not possible to get all the required information due to the bureaucratic nature of the financial institutions and the fact that not all credit controllers were cooperative.

5.3 Suggestions for Further Research

A study on the impact of other macro-economic variables such as inflation rate, exchange rates and balance of payments on credit to players in the agricultural sector could be done.

Investigating whether ownership of the financial institutions plays a role in timely and effective response to external environment changes and how this affects players in the agricultural sector may also be a good area of research.

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APPENDIX 1: INTRODUCTORY LETTER TO THE RESPONDENTS

University of Nairobi,
Faculty of Commerce,
Department of Accounting,
P.O Box 30197
NAIROBI

June 2004

Dear Sir/Madam,

I am a graduate student in faculty of Commerce, University of Nairobi. I am currently engaged in a research project on "A survey of the lending practices of financial institutions to the agricultural sector in Kenya ". This is in fulfillment of the degree of Master of Business Administration (MBA).

I kindly request you to fill the attached questionnaire soonest possible and to the best of your knowledge. This exercise is strictly for academic purposes and any information obtained will be treated with the strictest confidence. A copy of the final research report will be availed to you upon request.

Your co-operation will be greatly appreciated.

Thanking you in advance.

Yours faithfully,

ANANGWE E.D.
MBA (P) STUDENT

MRS. W. NYAMUTE
SUPERVISOR,
DEPT OF ACCOUNTING

APPENDIX 2 LIST OF FINANCIAL INSTITUTIONS

BANKS IN KENYA

1. African BK Corp
2. Akiba Bank
3. Bank of Baroda
4. Bank of India
5. Barclays Bank
6. CFC Bank Ltd
7. CharterHouse Bank
8. Chase Bank
9. Citi Bank N.A
10. City Finance Bank
11. Comm. Bank of Africa
12. Consolidated Bank
13. Co-operative Bank
14. Credit Agricole Indo
15. Credit Bank
16. Daima Bank Ltd
17. Delphis Bank Ltd
18. Development Bank
19. Diamond Trust Bank
20. Dubai Bank
21. Equatorial Bank Ltd
22. Fidelity Com. Bank
23. Fina Bank Ltd
24. First American Bank
25. Giro Com. Bank Ltd
26. Guardian Bank Ltd
27. Habib A.G. Zurich
28. Habib Bank Overseas
29. Imperial Bank Ltd
30. Industrial Dev. Bank
31. Investments & Mortgage Bank
32. Kenya Com. Bank
33. K-rep
34. Middle East Bank
35. National Bank of Kenya
36. National Ind. Credit Bk
37. Para – Universal Ltd
38. Prime Bank Ltd
39. Southern Cr. Bking Corp
40. Stanbic Bank Kenya Ltd
41. Standard Chartered Bank
42. Trans-National Bank Ltd
43. Victoria Bank Ltd

NON BANKS IN KENYA

1. Prime Capital & Credit
2. Devna Finance

MORTGAGE FINANCE COMPANIES

1. Housing Finance Company of Kenya
2. Savings and Loans

BUILDING SOCIETIES

1. East Africa Building Societies
2. Equity Building Society
3. Family Finance Building Society

Source: The Central Bank of Kenya 2003.

APPENDIX 3: QUESTIONNAIRE

Faculty of Commerce, University of Nairobi.

Note: The information in this questionnaire will be used strictly for academic purposes only and will be treated with utmost confidentiality.

Date ..... Questionnaire No. .....

Personal details of respondent

1. Designation. .....
2. Responsibility (optional).....

PART A.

3. Name of your organization .....
4. Year of incorporation .....
5. Ownership (please circle appropriately)

    a) Predominantly local (50% or above)
    b) Predominantly foreign (50% or above)
    c) Balance between foreign and local (50% each)
    d) Any other (please specify)

6. Is your organization publicly quoted?

    Yes ☐

    No. ☐

7. Please state the current number of employees.

    .....

8. Please state the current number of branches

.....

9. To what extent are the following involved in financial decision making in your organization.

	Least Extent				Great Extent
Shareholders	1	2	3	4	5
Executive board	1	2	3	4	5
Chief executive	1	2	3	4	5
Temporary teams	1	2	3	4	5
Consultants	1	2	3	4	5
Managers (Financial)	1	2	3	4	5
Any other (please specify)	1	2	3	4	5
	1	2	3	4	5

.....

.....

10. Does your organization deal with any issues related to agriculture?

Yes ☐

No ☐

11. Which products/ services do you offer?

a) Current accounts ☐
b) Saving accounts ☐
c) Fixed deposits ☐
d) Bureau de change ☐
e) Expert financing ☐

f) Letters of credit ☐

g) Import financing ☐

h) Foreign currency dealing ☐

i) Small scale credit (1-500,000) ☐

j) Medium/large scale credit (over Kshs 500,000) ☐

k) Guarantees ☐

l) International funds transfers ☐

m) Local funds transfers ☐

n) Any other (please specify)

---

12. Of these products/services, which ones do you focus on?

Please use the following scale.

Least focus Emphasis Major focus Emphasis

1 2 3 4 5

---

13. Which of the products/services offered are linked to the agricultural sectors? Explain.

---

14. How do you determine which products/services to offer?

---

15. How have changes in the external environment affected your product/services offering?

16. Do you have a branch network?

Yes ☐

No ☐

If yes, how is it distributed?

Major urban centers ☐

Upcountry ☐

17. Of the products/services offered, which ones are directly linked to agricultural development?

a) Current accounts ☐
b) Saving accounts ☐
c) Fixed deposits ☐
d) Bureau de change ☐
e) Export financing ☐
f) Letters of credit ☐
g) Import financing ☐
h) Foreign currency dealings ☐
i) Small scale credit (Kshs 1-5000,00) ☐
j) Medium / large scale credit (over 500,000) ☐
k) Guarantees ☐
l) International fund transfers ☐
m) Local funds transfer ☐
n) Any other (please specify) ☐

.....

.....

18. If you deal in small-scale credit for agricultural development, do you require collateral? Explain

.....

.....

19. If you deal in medium / large scale credit for agricultural development, do you require collateral?

Explain. .....

.....

20. Which major agricultural products do you deal with if you are involved in export financing?

Explain. .....

.....

.....

21. Which major agricultural products do you deal with if you are involved in import financing?

Explain.....

.....

.....

22. How would you describe your business environment?

very stable Very turbulent

1 2 3 4 5

23. What changes have taken place in the recent past (5-20 years) that have had an impact in the way you do business.

		Little impact				Great Impact
A	Technology advancement	1	2	3	4	5
B	Existing Competition	1	2	3	4	5
C	New Competitors	1	2	3	4	5
D	Increased customer Sophistication	1	2	3	4	5
E	Liberalized interest rates	1	2	3	4	5
F	Liberalized exchange rates	1	2	3	4	5
G	Infrastructure	1	2	3	4	5
H	Government Policy	1	2	3	4	5
I	Substitute products/services	1	2	3	4	5

J. Any other (please specify)

.....

.....

.....

24. What extent the agricultural sector important to your organization in terms of strategic planning? Explain.

.....

.....

25. How important are the following factors is formulating your strategies for operations in your organization.

		Not important				Very important
A	Existing Competition	1	2	3	4	5
B	New Competitors	1	2	3	4	5
C	Suppliers	1	2	3	4	5
D	Increased customer Sophistication	1	2	3	4	5
E	Substitute products	1	2	3	4	5
F	Government Policy	1	2	3	4	5
G	Infrastructure	1	2	3	4	5
H	Political Connections	1	2	3	4	5

I Any other (please specify).....

.....

.....

26. Have you had to change your promotional strategies due to external environmental changes?

Yes ☐

No ☐

If yes, in what ways .....

.....

.....

27. When dealing with the Agricultural sector who are your core customers?

Least focus **Major focus**

1 2 3 4 5

Large-scale livestock farmers ☐
Small Scale Livestock farmers ☐
Large-scale crop farmers ☐
Co-operative Societies ☐
Marketing boards ☐
Exporters ☐
Government Agencies ☐
Companies ☐

Any other (please specify).....

28. Has your type of customer changed as a result of changes in your business environment?

Yes ☐

No ☐

If yes, in what ways.....

.....

.....

29. How do you rate your competitors in providing services/products related to the agricultural sector.

		Very Weak				Very Strong
A	Product Quality	1	2	3	4	5
B	Product Diversity	1	2	3	4	5
C	Market Share	1	2	3	4	5
D	Growth Potential	1	2	3	4	5
E	Location	1	2	3	4	5
F	Distribution Network (branches)	1	2	3	4	5
G	Pricing	1	2	3	4	5
H	Strategy/Marketing	1	2	3	4	5
I	Profitability	1	2	3	4	5

30. What interest rate do you use for credit services

.....

.....

31. How is this interest rate determined?

.....

.....

PART B.

RESPONSE TO CHALLENGES

32. Please indicate (circle) the extent to which the following strategies are used in order to respond to challenges in dealing with operations linked to agricultural development.

1) Not utilized 2) Least utilized 3) Moderately utilized

4) Fairly utilized 5) utilized to a great extent

1) Broadening the product/service line	1	2	3	4	5
2) Offering high quality products/services	1	2	3	4	5
3) Using a wider distribution network	1	2	3	4	5
4) Identifying unique ways of distributing Products/services	1	2	3	4	5
1. Having more convenient locations compared to other competitors	1	2	3	4	5
2. Lowering lending interest rates	1	2	3	4	5
3. Using superior technology	1	2	3	4	5
4. Differentiating product/Services	1	2	3	4	5
5. Concentrating on core business	1	2	3	4	5
6. Boosting the organization's name and reputation through sales promotion, advertising and better public relations	1	2	3	4	5
7. Having good systems for receiving customer feedback to aid in service improvement	1	2	3	4	5
8. Establishment of loan repayment capacity.	1	2	3	4	5

9. Any other (please specify)

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ANNUAL REPORTS AND ACCOUNTS 1989 – 1998 AGRICULTURE FINANCE CORPORATION

	1989	1990	1991	1992	1993	1994
TOTAL INCOME	188403131	16605907	17289684	18115897	225512631	25625880
TOTAL EXPENSES	24391146	14696883	16655884	16364569	19974450	23001954
L SCALE LOANS TO FARMERS	68507816	65138297	68074532	72892573	7583696	8191436
S. SCALE LOANS TO FARMERS	24379179	26976811	25118649	27179573	2317946	2768008
SEASONAL INTEREST INCOME	30233287	32182889	36775928	44459493	15539121	6069178
	17030283	15329561	15512855	16426869	20579495	6069178
LARGE SCALE	7606184	5979395	6347771	6590274	2222606	1719155
SMALL SCALE	2830107	2460774	2360302	2403787	2208312	1216973
SEASONAL CROP	4004706	3179350	3182904	3692943	4259188	7869101
OTHERS	2589286	3710048	3621878	3739865	5138732	6604347

	1997	1998		1995	1996	
TOTAL INCOME	568211	515955			558626	
TOTAL EXPENSES	653426	715929			769244	
L. SCALE LOANS TO FARMERS	2045127	2138181			1906721	
S. SCALE LOANS SEASONAL	550487	505947			648271	
INTEREST INCOME	532007	492160			517866	
LARGE SCALE	237696	242657			211764	
SMALL SCALE	72296	59046			94355	
SEASONAL CROP	112123	100307			129010	
OTHERS	**109892**	**90150**			**82737**	

Sources: Annual reports for Agriculture Finance Corporation