RISK MANAGEMENT STRATEGIES USED BY FINA BANK LIMITED IN LENDING TO SME'S

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A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION,
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DECLARATION

This management research project is my original work, and has not been presented to any other institution for examination.

SIGNED DATE

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ALBERT ONGECHI
D61/P/8334/2004

This research Project has been presented for examination with my approval as the university supervisor.

SIGNED DATE

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DR. JOHN YABS

DEDICATION

To my precious mother Mellen Kwamboka Ongechi for bravely putting up with embarrassment to enable me get an education.

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First and foremost, I would like to express my deepest gratitude and appreciation to my supervisor, Dr. John Yabs. He has assisted me throughout the project by way of guidance and encouragement. He gave me a push to go on at a time when I almost despaired. His patience is truly inspiring.

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Most importantly, I thank God the Almighty for giving me life and seeing me through to the end of my study and to where I am today.

ABSTRACT

Bank financing of small and medium-sized enterprises (SMEs) recently received renewed interest as a result of the ongoing internationalization of financial markets for corporate finance. Effective risk management, from the point of view of financial institutions, is the key to the future success in banking and therefore these institutions should focus on professional management of risk. The successful financial institutions are and will increasingly be those that develop focused strategies, lower their overhead ratios, ingeniously exploit their advantages and know how to calculate their risks. The most important areas of concern to banks in credit risk management is to be integrative in terms of risk a bank is taking in doing business by client, by channel, by product, by business, by industry, by currency and by country.

The objective of this study was to investigate the risk management strategies used by Fina Bank limited in lending to SMEs.A survey method with reference to Fina Bank of Kenya was adopted. Primary data was collected for the purpose of this study using a self administered interview guide. The variables focused on included Credit scoring models, Credit Policy, Credit risk assessment and approval level, Credit risk management methodologies, 6 C's Credit Appraisal and Default Rate measurement and evaluation issues around risk management strategies at Fina Bank of Kenya.

The results of the study indicate that risk control is the most central aspect of risk handling and can involve a variety of different strategies. One of these seeks to reduce the magnitude of risk by controlling the terms on which the loan has been granted for instance interest rate variability, another consists of demanding security and using the 12Cs in credit risk assessment.

Risk management strategies are not a substitute for poor management. This will only succeed where best management practices are practiced. The study was however, limited to Fina Bank due to time and cost constraints. Replication of this study through comparative study using samples from other institutions is thus recommended.

TABLE OF CONTENTS

Title....................(i)
Declaration....................(ii)
Dedication....................(iii)
Acknowledgment....................(iv)
Abstract.................... ...(v)

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study.................... 1
1.1.1 Risk Strategies....................3
1.1.2 Fina Bank Ltd....................4
1.2 Statement of the Problem....................5
1.3 Objectives of the Study.................... 7
1.4 Importance of the Study....................7

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction....................9
2.2 The Concept of Risk Management as a strategic tool....................9
2.3 Risk Management 11
2.3.1 Prerequisite of Risk Management 11
2.3.2 The Institutional Environment 13
2.4 Strategy development and Competitive Advantage....................14
2.4.1 Strategic Responses 14
2.4.2 Competitiveness....................16
2.4.3 Competitive Advantage....................17
2.5 Credit Risk Assessment 21
2.6 Risk Reduction Techniques in the SME Sector....................22
2.6.1 Risk Avoidance....................24
2.6.2 Risk Pooling....................24
2.6.3 Risk Control....................25
2.6.4 Scanning and Interpreting for information....................26
2.6.5 Taking Security....................28
2.6.6 Imperfect Information and Adverse Selection....................28

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research Design....................32
3.2 Data collection....................32
3.3 Data analysis....................34

CHAPTER FOUR: DATA ANALYIS AND FINDINGS

4.1 Introduction....................34
4.2 Qualitative Data Analysis....................34
4.3 Credit Risk Management Strategies....................35
4.3.1 Taking Security....................35

4.3.2 Interest Rate Variability....35
4.3.3 Risk sharing among banks by use of syndicates....36
4.4 6 C's Credit Appraisal....36
4.5 Credit Risk Assessment....40
4.6 Nature of commercial bank lending....41
4.7 Default rate of the credit....42

CHAPTER FIVE: FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction....43
5.2 Summary of Findings....43
5.3 Recommendations....44
5.4 Limitations of the Study....44
5.5 Suggestions for further research....44
5.6 Conclusions....45

RERENCES
APPENDICES

CHAPTER ONE

INTRODUCTION

1.1. Background to the Study

Bank financing of small and medium-sized enterprises (SMEs) recently received renewed interest as a result of the ongoing internationalization of financial markets for corporate finance (Vitolis, 2000; Deeg and Lutz, 2000). Additionally the enforcement of the proposed Micro Finance Act is set to have a profound impact on the Kenyan banking system.

Small and medium-sized enterprises (SMEs) are non-subsidiary, independent firms which employ less than a given number of employees. This number, however, varies across countries. In the words of the OECD Glossary of Statistical Terms "the most frequent upper limit designating an SME is 250 employees, as in the European Union". Some countries set the limit at 200 employees, while the United States considers SMEs to include firms with less than 500 employees. In most OECD countries including Kenya small enterprises are those with less than 50 employees, while micro-enterprises have at most 10, or in some cases 5, workers. In addition to this, financial assets are also used to define SMEs. These institutions are the driving force in economic growth in Kenya as they comprise the larger part of our institutions.

Porter, (1985) defines strategy as the process of positioning a business to maximize the value of capabilities that distinguishes it from competitors. Since strategy influences the way organisations respond to their environment, strategy is a fundamental planning process. Strategy determines the businesses the organisation will engage in and reveals the organizational purpose in terms of long-term objectives, action programs and resource allocation priorities, and attempts to achieve long-term sustainable advantage in each of its businesses by responding properly to the opportunities and threats in the firm's environment, strengths and weaknesses of the organisation.

1.1.1 Risk Strategies

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

Innovation, deregulation and globalization in banking have contributed to making banking business more complex and potentially riskier. This has presented new challenges to bank supervisors with respect to the structuring of their ongoing supervision. In response, supervisors have developed new methods and processes for monitoring and assessing banks on an ongoing basis. Particular attention is being paid in this regard to improving the quality of bank examinations and to the development of systems that can assist supervisors and examiners in identifying changes, particularly deterioration, in banks' financial condition as early as possible (Sahajwala and Paul, 2000). Amongst the various new initiatives that have been taken or are being taken in this respect are the development of more formal, structured and quantified assessments not only of the financial performance of banks but also of the underlying risk profile and risk management capabilities of individual institutions. Collectively these various new approaches can be termed "supervisory risk assessment and early warning systems".

The need for institutionalizing risk management as a strategic tool can hardly be ignored. In the journey of organizational transformation, the critical challenge lies in evolving a performing organization so that the business deliverables can contribute to the operative efficiency of the organization (Meyer, 2002). Measuring organizational success and implementing effective strategies for future success represent continuous challenges for managers, researchers and consultants (Chan, 2004). Risk management

strategies primarily streamline, consolidate and improve processes but also reduce credit risk.

Clarke (1999) tells us that awarding credit is a journey, the success of which depends on the methodology applied to evaluate and award the credit. This journey starts from the application for credit and ends at the time the loan from the credit is fully paid. Like any human journey, the credit management process has got smooth paths, impediments and detours before the destination is reached. Therefore the credit needs to be effectively controlled for it to succeed eventually. Credit control can rightly be said to start when the client walks into the office. If during the discussion, with the client, the credit manager finally agrees to grant credit, the lender has embarked on a journey called credit control and the nature of that journey will directly be influenced by the quality of that decision (Clarke, et al., 1999).

1.2. The Banking Industry

Commercial banks in Kenya are governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance's docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The Central Bank Kenya publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks' interests and also addresses issues affecting its members.

The banking industry in Kenya is characterized by intense competition with more that 48 banks licensed to operate as at the start of the year 2008. The commercial banks offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services including investment banking. They are faced with a

lot of challenges that requires only those with the best mix of personnel and objectives to survive. Such challenge is competition. The increasing competition amongst commercial banks in Kenya has forced the management to use various tools they deem best to manage their employee performance.

1.2.1 Fina Bank

Fina Bank Kenya is one of the commercial banks operating in Kenya as part of the Fina Bank Group which operates in East African region. The origins of the group lie in Fina Bank Kenya, which opened in Kenya, which opened in Kenya in 1987 and subsequently expanded to Uganda and Rwanda. Currently, Fina Bank is growing in the region with emphasis on medium sized corporate organizations, SME's, development organizations and Non governmental organizations.

Fina prides itself in its ability to offer its clients and potential clients banking solutions to meet their individual needs- to this end, the bank has come up with various products and services to meet the specialized needs of SME's.

1.3. Statement of the Problem

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

The credit crisis has forced banks in Kenya to take a critical look at how they manage risk and has exposed some significant weaknesses in risk management across the financial services industry in Kenya. On first examination, the current predicament

appears to stem from the pursuit of revenue growth in a world of easy credit. The reality of course is more complex, and a number of themes emerge like, weaknesses in risk culture and governance, gaps in risk expertise at the non-executive board level, lack of influence of the risk function, lack of responsibility and accountability on the part of those on the front line, a compensation culture too oriented toward year-on-year profit increases, and business models that were overly reliant on ample market liquidity.

Organisations are constantly confronted with complications of multiple business units, products and markets that have duplicative supporting processes and staff. These structural complexities in the background of global competitiveness of firms have created a powerful case for uniform strategies in risk handling' due to enormous pressure to cut bad debts further to maintaining their margins and strategic readiness. Growing business complexities arising from the application of diversification strategies have led to Structure-Strategy complications which if not well aligned can lead to strategy misfit and ultimately a firm's failure.

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

Since scant research attention has been given to investigating risk management strategies and in particular their relationships to organisational strategies, there are no obvious paths to follow in the management of risk when lending to SMEs at Fina Bank Limited. This research aims to document these process. Subjective decision making by senior management of the Commercial Banks may lead problems

associated with credit. This includes extending credit to companies they own or which they are affiliated, to personal friends, to persons with a reputation for non financial acumen or to meet a personal agenda, such as cultivating a special relationship with celebrities or well connected individuals. A solution to this may be the use of tested lending techniques and especially quantitative ones, which filter out subjectivity (Gruening, et.al., 1999).

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

1.3. Objectives of the Study

The objective of this study was to investigate the risk management strategies used by Fina Bank limited in lending to SMEs.

1.4 Importance of the Study

The study is significant to the banking industry, especially to Credit Units. It highlights the challenges faced by the banking industry when identifying, appraising,

awarding and managing their loan clients and portfolios. To other sectors of the economy, it provides a start to finish account for what informed CEO's should consider when setting up their credit departments or applying for loans from banks.

Diversified organizations, both public and private, will benefit from the source of information regarding structural alignment to strategy specifically the risk management strategies. The study has documented FINA Bank's experience thus others will not need to 're-invent the wheel'.

To SMEs the study is informative on the points to take into account when deciding which sources of finance to go for. Finance managers are more sensitive to the influence that the risk management techniques have to the lending decisions to SMEs and thus the overall profitability.

The government policy makers will pursue reforms that will influence the SMEs access to credit; in this regard economic growth is likely to be stimulated. Scholars on the other hand studying the risk management techniques are made aware of the association between the credit policies and risk and their influence.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Risk refers to the potential variability of outcomes from a decision alternative. It can also be defined as the exposure to change or the probability that some future events will occur making the expected and actual outcome to differ from the expected. The wider and regular the variability, the greater the risk

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

2.2 The Concept of Risk Management as a Strategic Tool

The word strategy originates from the Greek word strategos, which initially referred to the general in command of an army. Quinn, Mintzberg and James (1988) noted that there is no single universally accepted definition of strategy. Different authors and managers use the term differently, some including goals and objectives as part of strategy, while others make firm distinctions between them.

Strategy has been defined by various scholars differently. The several definitions of strategy include: strategy as a game plan, commercial logic, competitive battle, and direction and scope. The definition of strategy by Johnson & Scholes (2002) as "The direction and scope of an organization over the long term, which achieves advantage for the organization through its configuration of resources within a changing environment to meet the needs of markets and fulfill stakeholder expectation", offers

a more complete version which includes the key aspects of strategy, i.e. direction, long term nature and business objectives. Mintzberg (1987) on the hand has defined strategy as a plan, ploy, pattern, position and perspective.

Porter (1985) defines strategy as the process of positioning a business to maximize the value of capabilities that distinguishes it from competitors. Since strategy influences the way organisations respond to their environment, strategy is a fundamental planning process. Strategy determines the businesses the organisation will engage in and reveals the organizational purpose in terms of long-term objectives, action programs and resource allocation priorities, and attempts to achieve long-term sustainable advantage in each of its businesses by responding properly to the opportunities and threats in the firm's environment, strengths and weaknesses of the organisation.

Thus, strategy is a unifying theme that gives coherence and direction to the actions and decisions of an organization, guiding the organization to superior performance by establishing competitive advantage. Strategy must match the external environment and internal capability of the organization thus the need for performance measurement (Porter, 1985; Mintzberg, 1987).

The need for institutionalizing risk management as a strategic tool can hardly be ignored. In the journey of organizational transformation, the critical challenge lies in evolving a performing organization so that the business deliverables can contribute to the operative efficiency of the organization (Meyer, 2002). Measuring organizational success and implementing effective strategies for future success represent continuous challenges for managers, researchers and consultants (Chan, 2004).

Risk management techniques primarily streamline, consolidate and improve processes but also reduce credit risk. The centralization of a core administrative function leads to a more customer focused approach to the service provided, bringing about changes in management and delivery. Research elsewhere (www.coda.com) has

shown that the most obvious opportunities for companies come from eliminating non-value-added activities such as multiple authorization processes and reconciliations. The organization can gain economies of scale and improved productivity by consolidating and centralizing repetitive or transaction-based activities.

2.3 Risk Management

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

2.3.1 Prerequisite of Risk Management

One of the most important prerequisite of risk management is that of planning for, the unknown. This requires asking questions such as how do we know when adversity will hit and how hard. Have we examined ahead of time where our financial staying power lies? Do we know what is to be our line of defense against any risk associated with nay line of business we are entering into? Secondly, can we anticipate, respond and cope with changes in the business environment? Operating a financial business has always been a matter of foreseeing and rapidly coping with change. Banks and their customers keep constantly changing, therefore all financial institutions should focus on providing quality services. To a large measure adapting to the new environment means changing culture, altering not only the way we have been operating in the past, but also adapting new ways of thinking and doing business (Thygerson,1995).

In more than one reason, risk is a corollary to competitiveness. To be properly managed money needs brains, open perspectives and adequate tools. Risk management has the same requirements but not every financial institution seems to be convinced that risk control policies can both limit undue exposure and give the bank a competitive edge. Risks are significantly increased when a bank losses its grip in the market as well as when it falls back in skills and technology.

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

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

'adverse selection' (Stiglitz and Weiss, 1981). The individualist theoretical framework favored by most economists, however, has difficulties in explaining the variation in approaches towards risk assessment which exists in different national environments, and within them between different types of organizations.

2.3.2 The Institutional environment

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

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

The study argues that in order to understand cross-national and cross-organizational divergence in bank managerial practice of risk assessment it is necessary to consider the institutional environment in which these relations are embedded (Lane and Quack, 2002). In order to apply such a perspective to the analysis of risk behaviour in banks the study suggests integrating recent sociological writing on risk with institutional and neo-institutional sociological theory emphasizing the social embeddedness of perception and handling of risks. Sociological authors such as Luhmann (1993) and Baecker (1991) have argued convincingly that perceptions and attitudes towards risk

are socially constructed. According to this view, risk is not an 'objective' fact out in the business environment which can be assessed through probability calculus but is continually created by bankers themselves when they make decisions in relation to observed risk structures and risk behaviour of potential business partners in their environment. Since the future is unpredictable any decision involves risk: it might lead to losses, or it might entail missing valuable opportunities. In order to deal with this uncertainty, banks have developed into 'specialized second order observers' which attempt to monitor how their potential business partners deal with risky decisions (Baecker, 1999).

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

2.4 Strategy Development and Competitive Advantage

This is traced to Chandler (1962), who was among the fist scholars to study strategic management. His book, Strategy and Structure (1962) describes the development of organizations. Noting that 'structure follows strategy' (Chandler 1962, p. 14), Chandler alluded to the impact that strategies have on the internal organization environment.

2.4.1 Strategic Reponses

According to the classic organizational literature, strategic responses are organizational responses in predictable ways to the conditions that surround them, adjusting their purpose and shape to meet market and other environmental characteristics. Risk management techniques can be taken as a strategic response by organizations to improve on the working environment. Risk management is a corporate strategy that resembles the credit policy; both approaches force a company to examine the causes and effects of removing non-strategic functions from the business units.

Bergeron (2003) argues that a Risk management strategy is a collaborative strategy in which a subset of existing business functions are concentrated in a new, semi-autonomous business unit that has a management structure designed to promote efficiency, value generation, cost savings, and improved service for internal customers of the parent corporation, like a business competing in the open market.

Some authors (Child, 1972; Weick, 1977) argue that this process is not unidirectional, that is organizations can also create their own environments through choices regarding markets, products, technologies, scale of operations, etc. According to these authors, firms constantly adjust to their environments in a dynamic process or adaptive cycle, and can be accordingly classified into several strategic types: reactors, defenders, analyzers and prospectors (Miles and Snow, 1978), form the most reactive to the most proactive. This typology alludes to broad aspects inherent to the firm's nature: organizational structures, processes, management style and others.

Other authors have related speed of the decision-making processes with organizational performance. According to Eisenhardt (1989), firms that are able to make fast decisions based on the perceptions of their managers, corporate culture and their use of information can outperform the slower ones, particularly in high velocity environments. Zaheer and Zaheer (1997) analyzed alertness and responsiveness in competitive environments and concluded that these attributes are linked to a highest organizational performance. These authors define alertness as proactive attentiveness to information about the environment, figuratively "having one's antennae out"; while responsiveness refers to the quickness with which firms respond to environmental signals. The information communication technology arena has become one of this aforementioned "high velocity environments", a medium in which firms are forced to be alert and responsive to the rapid changes in the present environments that require speedy adaptation processes (Bowman and Gatignon, 1995).

According to Wrigley (1970), the more diversified the growth and operational strategy, the more likely a firm has a multidivisional structure. This form of structure

is characterised by expansion into different industries and products, defined by both business unit and corporate levels of strategy. Since successful strategy implementation depends in part on the organisation's structure fit, corporate strategy must grow out of and reinforce competitive strategy, preferably in a way that focuses resources to convert distinctive competence into competitive advantage (Andrews, 1987). A corporate strategy based on shared activities clearly meets the better-off test because business units gain ongoing tangible advantages from others within the corporation. The ability to share activities is a potent basis for corporate strategy because sharing often enhances competitive advantage by offering the best avenues for value creation through economies of scope of related diversification (Porter, 1987).

2.4.2 Competitiveness

This is the ability to provide products and serves as or more effectively and efficiently than the relevant competitors. In the global trading sector, this means sustained success in international and national markets without protection or subsidies. Although transportation costs might allow national firms to compete successfully in their home market or in adjacent markets, competitiveness usually refers to advantage obtained through superior productivity. Measures of competitiveness in the global trade include firm profitability, the firm's export quotient (exports or foreign sales divided by output), and national, regional or global market share (Enright et al. 1994, 1996).

At the industry level, competitiveness is the ability for the national firms to achieve sustained success against (or compared to) foreign competitors, without protection or subsidies. Measures of competitiveness at the industry level include overall profitability of the national firms in the industry, the nation's trade balance in the industry, the balance of outbound and inbound foreign direct investment, and direct measures of cost and quality at the industry level. Competitiveness at the industry level is often a better indicator of the economic health of the nation than competitiveness at the firm level (Enright et al, 1994, 1996).

At the national level, competitiveness means that ability to the nation's citizens to achieve a high and rising standard of living. In most nations, the standard of living is determined by the productivity with which the nation's resources are deployed, the output of the economy per unit of labor and/or capital employed. A high and rising standard of living for all living for all the nation's citizens can be sustained only by continual improvements in productivity, either through achieving higher productivity in exiting businesses or through successful entry into higher productivity business. According to Enright et al, (1994, 1996), competitiveness at the national level is measured by the level and growth of the nation's standard of living, the level and growth of aggregate productivity, and the ability of the national firms to increase their penetration of world markets through exports or foreign direct investment.

2.4.3 Competitive Advantage

According to Hill and Jones (2001), competitive advantage is the ability of a company to outperform competitors within the same industry. They go on to say that innovations, efficiency, quality and customer responsiveness are the main building blocks of competitive advantage. Together, these four factors help a company create more value by lowering costs or differentiating its products from those of competitors. Fina Bank Ltd through its risk management strategies is motivated by the need to achieve competitive advantage.

Writing on the future of competition, Prahaland and Hamel (1990) posed the question, "is management fully alert of the dangers posed by new unconventional rivals and are potential threats to the current business model widely understood?" Aosa (1992) found that for the competitive strategy model to be applicable in Kenya, it required the inclusion of additional strategic forces when compared to similar models put forward in a developed country's context. He identified these additional forces as customers, suppliers, competitors, logistics, power play and government. This is very much in line with Risk management fundamental pillars of customer focus, people involvement, and factual approach to decision-making, leadership, and

mutually beneficial relationship with suppliers, process approach, systems management and continual improvement.

Models of competitive advantage revolve around position or environmental concepts and the resource based view. Proponents of the position or environment model argue that to achieve a competitive advantage, the firm is required to make a choice about the type of competitive advantage it seeks to attain, the scope within which it will attain it. Choosing the competitive scope or the range of the firm's activities plays a powerful role in determining competitive advantage for the firm because it aims to establish a profitable and sustainable position against the forces that determine the industry competition (Porter, 1985).

The approach to the analysis of competitive advantage has focused on the influence of the external environment on a firm's strategy. According to this perspective, firms operating in the same industry receive identical inputs and are forced to adopt identical strategies. All the firms operating in the same industry receive identical opportunities and should adopt identical strategies, obtaining the same results. Eventual diversity is possible only in the short period. Therefore, the firm's success is the result of the firm's ability to respond to threats and opportunities existing in the specific industrial environment in which it operates. The relationship between the firm and the industrial environment in which it operates is responsible for realizing a successful market position and develops along three dimensions (Learned, Christensen, Andrews & Guth, 1965).

First of all, the firm develops a consistent system of strategic objectives, adopting a complex of coherent functions policies. Second, the system of objectives and policies must be kept consistent with the external conditions of the market; that is, the strengths and weaknesses of the industry, which the firm must consider in deciding strategies and policies. Finally, the strategy must pursue the creation of 'distinctive competencies', which are 'patterns of resources and skill deployments that will help it achieve its goals and objectives' (Hofer & Schendel, 1979).

According to Hofer and Schendel, the firm is therefore able to develop and organize a set of resources through which it can obtain a position of competitive advantage. The industrial environment continues to be important but, at the same time, the firm's ability to develop its own strategy as the result of its distinctive competencies begins to be considered.

Porter (1985) shows that the five competitive forces, namely, the entry of new competitors, the threat of substitutes, the bargaining power of suppliers, the bargaining power of buyers, and the rivalry among the existing competitors play a major role in the company's success or failure. The collective strength of these five competitive forces determines the ability of firms in an industry to earn on average, a rate of return on investment in excess of the cost of the capital. He further notes that a business can develop a sustainable competitive advantage by following the two strategies cost leadership strategy or differentiation strategy.

The primary focus of a cost leadership strategy is to achieve low costs relative to competitors, which might often require additional investment in automated facilities, equipment and employees' skill and sharing of services. On the other hand, differentiation strategy focuses on creating uniqueness such that the organization's goods and services are clearly distinguished from those of its competitors. To this end, Carr and Johansson (1995) have found that, in today's business environment, an essential element to an organization's success is adaptability. You must be able to manage at the speed of change, and that takes creativity and innovation. Ostrenga, Ozan, Mcllhattan, and Harwood (1992) note that those companies that are effective at rapidly bringing innovative new products and services to the market have gained a huge competitive edge in today's business world.

The resource-based view of the firm is touted as an alternative theory of strategy to that developed by Porter (1985). Instead of focusing on positioning in the product market, it argues that firms achieve sustainable competitive advantage by developing

resources, which add unique or rare value, which cannot be easily be copied by others. Thus the firm with superior access to physical resources, which others cannot buy, holds a superior advantage. For example, a manufacturing firm, which invents a superior process or technology, holds an advantage over its rivals. Barney (1991) suggests that in order to understand sources of sustained competitive advantage, it is necessary to build a theoretical model that begins with the assumption that firm resources may by heterogeneous and mobile. To have this potential, a firm resource must have four attributes i.e. it must be valuable, in the sense that it exploits opportunities and/or minimizes threats in a firm's environment, it must be rare among a firm's current and potential competition, it must be imperfectly imitable ad lastly, there can not be strategically equivalent substitutes for this resource.

While writing on competitive strategy in hyper competitive conditions, Johnson et al. (2005) argue that organizations in such environments need to acknowledge that advantage will be temporary. They propose that competitive advantage will relate to organizations ability to change, speed, flexibility, innovation and disruption of markets. Hypothetically, an organization that has implemented Risk management concept successfully can be expected to possess most, it not all of the above attributes and therefore be able to enjoy and sustain competitive advantages through such moves as blocking first mover advantages and imitating competitors.

Organisations across the world are exposed to a dynamic and competitive environment characterised by globalisation, mergers, acquisitions and consolidations. Challenges of globalisation and environmental turbulence have inevitably required companies to change their growth strategies to suit the business environment. According to Chandler (1962), changes in an organisation's strategy lead to new administrative problems and economic inefficiencies which require new or refashioned structures for the successful implementation of the new strategy. He argues that organisational structure follows and reflects the growth strategy of the firm in order to most effectively administer the allocation of resources necessary to achieve its long-term goals. Not surprisingly, the chances that an organisation's

strategy will succeed are far greater when its structure matches its strategy. By the same token, as its basic strategy changes over time, so must its structure (Galbraith et al, 1986).

The real sources of competitive advantage are found in the management's ability to consolidate corporate wide technologies and skills into competencies that empower individual businesses to adapt quickly to changing opportunities (Prahalad et al, 1990). As companies extend their presence across borders, it becomes increasingly uneconomical to maintain duplicate processes and infrastructure within each country of operation. Challenges characterised by growing business complexities have been met by banks coming up with risk management strategies in their lending policies (Fahy et al, 2002).

2.5 Credit Risk Assessment

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

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

ensure the source of repayment is clear), Insurance (Security is necessary incase the repayment proposals fail to materialize).

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

According to Abedi (2000) banks use the 6 C's to evaluate a customer as a potential borrower. The 6 C's help banks to decrease the risk of default, as they get to know their customers. According to Abedi (2000) the 6 C's are; Character, Capacity, Completion, Condition, Contribution and Common sense.

2.6 Risk Reduction Techniques in the SME Sector

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

Large national and multinational companies in many industrialized countries are reported to be making increasing use of alternative sources of finance, such as stock market listing, international bond issues, and international markets for corporate lending which often involve transactions with financial actors other than just banks. However, small and medium-sized enterprises, which account for very significant parts of economic activity in Kenya, have only limited access to such alternative sources of finance and therefore still are dependent on expensive bank financing.

Risks, in the theoretical approach of Luhmann (1993) and Baecker (1991), are defined by bankers in the course of their decision making during the lending process. However, the perceptions, attitudes and motivations which enter into the risk-handling process, it is held by Douglas and Wildavsky (1982), are shaped by the business goals, as well as by the time horizons for the achievement of these goals. Institutional factors also influence whether primary importance is placed on possible opportunities for gain or threats of loss and hence creates a differing interplay between risk avoidance and risk acceptance (Lane and Quack, 1999).

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

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

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

relationship between banks and SMEs in Kenya appears to have improved, due to stabilization of the economic environment, as well as to various initiatives from economic and political actors in favour of bank finance for SMEs.

2.6.1 Risk Avoidance

Bank lending is by definition risky business, and general avoidance of risk is not an option (Baecker 1991); even partial risk avoidance carries its own risks (Luhmann 1993; Douglas 1986). Banks have instituted procedures which have normalized the taking of ordinary risks, and their risk politics is mainly concerned to limit risk. The degree of risk aversion and the kind of risks which are shunned depend on attitudes towards risk which are socially constructed and often legally supported.

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

2.6.2 Risk Pooling

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

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

(LGS) are operated in the two countries and in the dispensation of giants and subsidized loans to SMEs.

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

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

2.6.3 Risk Control

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

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

2.6.4 Scanning and Interpreting the Environment for Information

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

Existing research suggests that what is considered by banks as a reliable signal for the credit worthiness of a borrower (Spence 1974; Feldmann and March 1990) reflects what is perceived as appropriate performance standards in each country: British bank managers tend to rely more on a narrow range of financial information whereas German bank managers give more emphasis to managerial information, the

qualification of the entrepreneur and a well-prepared business plan. The most important kinds of information in Britain are of a historical nature whereas in German they include more future-oriented information (e.g. an evaluation of the market prospects of the project) (Deakins and Philpott 1993; Wood et al.1992). With regard to methods of risk assessment, British banks give more emphasis to class-based judgments and lending on a portfolio basis whereas German banks follow a more qualitative case-based approach (Hughes and Runde, without date; Suchting 1993).

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

2.6.5 Taking Security

Taking security is meant to lessen the risk taken in a direct manner, if the loss from default can be reduced. Security can take the form of collateral provided by the

borrowing firm, or it may be provided in the form of a credit guarantee by a third party (Lane and Quack, 1999).

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

2.6.6 Imperfect Information and Adverse Selection

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

The work by Stiglitz and Weiss (1981) marks the beginning of attempts at explanations of credit rationing in credit markets. In this explanation, interest rates charged by a credit institution are seen as having a dual role of sorting potential borrowers (leading to adverse selection), and affecting the actions of borrowers (leading to the incentive effect). Interest rates thus affect the nature of the transaction and do not necessarily clear the market. Both effects are seen as a result of the imperfect information inherent in credit markets. Adverse selection occurs because lenders would like to identify the borrowers most likely to repay their loans since the banks' expected returns depend on the probability of repayment. In an attempt to identify borrowers with a high probability of repayment, banks are likely to use the

interest rates that an individual is willing as a screening device (Atieno, 2001). However, borrowers willing to pay high interest rates may on average be worse risks; thus as the interest rates increases, the riskness of those who borrow also increases, reducing the bank's profitability. The incentive effect occurs because as the interest rate and other terms of the contract change, the behaviour of borrowers is likely to change since it affects the returns on their projects. Stiglitz and Weiss (1981) further show that higher interest rates induce firms to undertake projects with lower probability of success but higher payoffs when they succeed (leading to the problem of moral hazard).

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

Besley (1994), following this line of argument, analyses the rationale for interventions in rural credit markets in the presence of market failure. Since credit markets are characterized by imperfect information, and high costs of contract enforcement, an efficiency measure as exists in a perfectly competitive market will not be an accurate measure against which to define market failure. These problems lead to credit rationing in credit markets, adverse selection and moral hazard. Adverse selection arises because in the absence of perfect information about the borrower, an increase in interest rates encourages borrowers with the most risky projects, and hence least likely to repay, to borrow, while those with the least risky projects cease to borrow (Atieno, 2001). Interest rates will thus play the allocative role of equating demand and supply for loanable funds, and will also affect the average quality of

lenders' loan portfolios. Lenders will fix the interest rates at a lower level and ration access to credit. Imperfect information is therefore important in explaining the existence of credit rationing in rural credit markets. Moral hazard occurs basically because projects have identical mean returns but different degrees of risk, and lenders are unable to discern the borrowers' actions (Stiglitz and Weiss, 1981; Besley, 1994). An increase in interest rates negatively affects the borrowers by reducing their incentive to take actions conducive to loan repayment. This will lead to the possibility of credit rationing.

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

Empirically, research on the use of credit by rural households tends to imply that although it is not obvious that demand for credit far outweighs the supply, there are significant obstacles to the transformation of potential demand into revealed demand (Aryeetey, 1996). The absence of supply creates a lack of demand expressed in low revealed demand. Again, due to market failure in the credit market, the transaction cost involved in obtaining credit is considered greater than the utility, prompting

households to switch profits between activities as a way of financing working capital. This also explains the existence of informal credit markets alongside formal credit institutions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Research Design

Research design can be classified as experimental, survey, case study, archival analysis and historical design. According to Emory and Cooper (1995), research design can be classified by the communication used to gather primary source data. It is also a framework for specifying the relationship among the study variables, starting with a selection plan, and type of information used to answer the questionnaire.

A case study approach with reference to Fina Bank of Kenya was adopted. According to Kathuri & Pals (1993), the purpose of such a research is to describe and explore a phenomenon. The study adopted a cross-sectional design with the respondents being senior officers in charge of the credit and risk management function. This design was considered appropriate for this study because the data was cross-sectional and comparative nature of the data analysis.

3.2 Data Collection

Primary data was collected for the purpose of this study. It was collected using a self administered interview guide. The interview guide was semi-structured, having both open-ended and closed-ended questions. It was administered to the Manager-Credit and Manager- Risk Management at the head office. Questions were designed to identify the risk management strategies used by Fina bank when lending to SMEs.

The data specification was mainly on the risk management variables. The study used the credit scoring models in order to determine which credit models Fina Bank Ltd bank used, and thus determine if emphasis was placed only on the quantitative risk analysis models. The credit policy indicated the factors which the respondents used in their credit policy for appraising, assessing, evaluating and awarding credit to their clients. The credit policy was either stringent or lenient was considered as a foundation of constructing or managing risk sociologically.

The credit risk assessment and approval levels enabled the researcher to determine who did the credit assessment and who approved the credit risk at various levels. This also determined the bureaucratization of the decision making process in order to absorb the insecurities. Credit risk management methodologies enabled the researcher to determine how the banks managed risk to ensure that adverse selection was reduced. The variables the study sought to determine the extent of use included; use of security and use of higher security requirements for riskier clients, use of bank guarantees, interest rate variability depending on the perceived risk of the client, imposition of extra monitoring requirements on more risky clients and risk sharing among banks by use of syndicates.

The 6 C's credit appraisal was required to specify the factors they considered when appraising, assessing and evaluating credit risk of their customers. The default rate variable enabled the respondent to provide their default rate and how they decided and recognized the client that had defaulted.

3.3 Data Analysis

The data collected was edited for accuracy, uniformity, consistency and completeness and arranged before final analysis (Cooper and Emory, 1998). The complete interview guides were edited after completion of each interview. They were then checked and the one which was not fully completed or with errors corrected where possible. Content analysis was used to analyze and summarize the findings of the study.

CHAPTER FOUR

DATA ANALYIS AND FINDINGS

4.1 Introduction

This chapter presents data analysis and interpretation of the research findings. Content analysis was used to analyse the data collected in this study. The purpose of this analysis was to simplify, organize, summarize describe and interpret data and communicate the results in a meaningful way.

The presentation of the analysis and interpretations was captured in two parts: the first part capturing the general information in regard to those sampled, while the second part was further subdivided into parts capturing Credit scoring models, Credit Policy, Credit risk assessment and approval level, Credit risk management methodologies, 6 C's Credit Appraisal and Default Rate measurement and evaluation issues around risk management strategies at Fina Bank of Kenya.

4.2 Qualitative Data Analysis

The response frequencies was deemed adequate to be used to make conclusion about the research problem as the response given and received would still constitute sufficient data to the proportion of the target population to give adequate representation of the research problem.

The respondents all were of the view that competitive advantage is the ability of a company to outperform competitors within the same industry. They went on to say that innovations, efficiency, quality, risk management and customer responsiveness are the main building blocks of competitive advantage. Together, these four factors help a company create more value by lowering costs or differentiating its products from those of competitors.

The respondents both agreed that Fina Bank has a credit policy that is used during the entire lending process. The credit department as well as the risk management

department is involved in risk management. The former as the direct contact with customers while the latter to check that it was well mitigated. There are three approval levels for the loan applications as well as the loan processing.

4.3 Credit Risk Management Strategies

The study sought to establish the risk management strategies used and how long the respondents had been using the particular strategies. This was necessary because it would give an indication of the widely used strategies and if they are in use in the entire organization. These corresponded with the duration the employees had been in the organization apart from a few respondents who have been in the organization for more than 10 years. The strategies identified include;

4.3.1 Taking Security

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

Big Commercial banks and other formal institutions fail to cater for the credit needs of smallholders, mainly due to their prohibitive lending terms and conditions. The rules and regulations of the formal financial institutions that created the myth that the poor are not bankable because they cannot afford the required collateral is the main hindrance to lending to SMEs, Fina Bank has tried to solve this by accepting collateral that ordinarily is not accepted by the big banks. Despite efforts to overcome the widespread lack of financial services, especially among smallholders in developing countries, and the expansion of credit in the rural areas of these countries, the majority still have only limited access to bank services to support their private initiatives.

4.3.2 Interest Rate Variability

Fina Bank adopts interest rate variability as one of the strategies to mitigate risk. The Manager Credit explained that, interest rates charged by a credit institution are seen as having a dual role of sorting potential borrowers (leading to adverse selection), and affecting the actions of borrowers (leading to the incentive effect). Interest rates thus affect the nature of the transaction and do not necessarily clear the market. Both effects are seen as a result of the imperfect information inherent in credit markets. Adverse selection occurs because lenders would like to identify the borrowers most likely to repay their loans since the banks' expected returns depend on the probability of repayment. In an attempt to identify borrowers with a high probability of repayment, the bank adopts the interest rates that an individual is willing as a screening device. However, borrowers willing to pay high interest rates may on average be worse risks; thus as the interest rates increases, the riskness of those who borrow also increases, reducing the bank's profitability. The incentive effect occurs because as the interest rate and other terms of the contract change, the behaviour of borrowers is likely to change since it affects the returns on their projects.

4.3.3 Risk sharing among banks by use of syndicates

The credit policy of Fina Bank allows the credit manager to enter into syndicates with other banks for the purpose of risk sharing when the loan amounts are big enough to warrant this.

Risk sharing within these banking groups occurs in a number of ways: facilitating access to capital at lower interest rates and shielding individual banks from the fluctuations of the capital market; balancing liquidity surplus and shortage within the system, thus reducing the liquidity risk; forming credit consortia for large local loans; and last but not least, providing access to a large and valuable body of information. However, this approach is rarely adopted when lending to SMEs.

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4.4 6 C's Credit Appraisal

The responds were required to specify the factors they considered when appraising, assessing and evaluating credit risk of their customers.

According to the respondents Fina bank use the 6 C's to evaluate a customer as a potential borrower. The 6 C's help the banks to decrease the risk of default, as they get to know their customers. According to Fina Bank the 6 C's are; Character, Capacity, Completion, Condition, Contribution and Common sense. Other additional Cs that can be used by banks to decrease the default risk include; Collateral, Capital, Credit, Control, Communication and Cycle. These have been explained in depth below. Banks can use the 12Cs to evaluate potential customers.

Character is among the most difficult to evaluate and can vary tremendously between individual lending officers. A person's character can give the loan officer some insight to their willingness and commitment to pay their debt. Character traits of honesty, integrity and work ethic typically exhibit commitment; however, the bank also look for responsibility and consistency. The Loan officer is expected to draw from first impressions and subsequent meetings. The Loan officer will also look for the business's current and past successful experiences, an existing or past relationship with the bank, community or charitable efforts, and referrals and references from respected individuals to aid in their character assessment.

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

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

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

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

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

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

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

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

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

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

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

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

4.5 Credit Risk Assessment

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

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

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

The bank focuses on qualitative analysis of risk assessment. The loans applications are handled by individuals in the banks front office while the assessment and approval of loans is centralized. This is handled by the credit department at the head office and most of the tasks are separated to ensure that each loan is handled by atleast three people before final approval.

Erogenous factors are the ones that greatly affect risk assessment; however unrealistic targets have also led to higher risk in lending as managers try to attain the targets set for them. The banks performance has greatly improved in the last few years mainly due to better risk management strategies.

4.6 Nature of commercial bank lending

The credit department is responsible for the initial setting up of policies for lending to SME's however this must be approved by the board of directors who are charged with the ultimate responsibility for risk management. The risk management department is to ensure that these policies are being followed in the lending decisions thus ensuring that risk is mitigated. They also play an advisory role during the setting up process of policies.

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

4.7 Default rate of the credit

The banks default rate on credit currently stands at 3%. This has improved from a high of 10% in the late 1990's. However the risk is still high and the bank's handling of these risks in banks can take three basic forms: risk avoidance or, less extreme, risk aversion; risk management or control; and an attempt to share or pool risk (Lane and Quack, 1999). Whether the emphasis is only on controlling risk or also on sharing it depends on politically created and/or sanctioned opportunities for the latter strategy.

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

CHAPTER FIVE:

FINDINGS, RECOMMENDATIONS AND CONCLUSIONS

5.1 Introduction

This chapter summarizes the findings of the study in relation to the objectives of the study. The purpose of this study was to investigate the risk management strategies used by Fina Bank limited in lending to SMEs.

5.2 Summary of Findings

The concept of risk management is aimed at improving performance as well reducing the agency conflicts. Risk strategies therefore aid organizations in improving performance when they are managing performance. The rationale for risk strategies are largely based on principal/agent theory. The principal can only observe outcomes and cannot measure accurately the effort expended by the agent or distinguish the effects of effort from other factors affecting performance.

The study found out that awarding credit is a journey, the success of which depends on the methodology applied to evaluate and award the credit. This journey starts from the application for credit and ends at the time the loan from the credit is fully paid. Like any human journey, the credit management process has got smooth paths, impediments and detours before the destination is reached. Therefore the credit needs to be effectively controlled for it to succeed eventually. Credit control can rightly be said to start when the client walks into the office. If during the discussion, with the client, the credit manager finally agrees to grant credit, the lender has embarked on a journey called credit control and the nature of that journey will directly be influenced by the quality of that decision.

The results of the study indicate that risk control is the most central aspect of risk handling and can involve a variety of different strategies. One of these seeks to reduce the magnitude of risk by controlling the terms on which the loan has been granted for instance interest rate variability, another consists of demanding security and using the 12Cs in credit risk assessment. Above all, risk control occurs by using

information designed to reduce the unpredictability and variability of outcomes. Banks usually avail themselves of all these risk handling strategies. Nevertheless, as will be shown in the following, the emphases are set very differently in the two societies, due to their differing economic and institutional environment and customer profiles.

This point to the fact that risk strategies are viewed as a device to reveal information and motivate managers to exert effort. In the case of private enterprises, risk management strategies are also touted as a way to clarify the objectives of the multiple principals who govern private corporations, and hence make it easier to set goals and evaluate achievements.

It is a means of getting better results by understanding and managing performance within the agreed framework of planned goals, standards and competency requirements that may be set in risk management strategies. Risk management strategies are thus expected to influence performance to a great extent.

5.3 Recommendations

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

and opportunities. The credit demand schedule identification problem therefore implies the existence of credit rationing.

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

A solid legal framework, which sets out the basic premises and the status of the loan contract, may avoid ad hoc and fragmented solutions. The currents arrangements lack enforcement legal capacities. Stability of resources enhances the motivating effect of the loan contract. When resources are not available or availed late, the staff involved gets frustrated. The majority of respondents in the study expressed this view. Monitoring capacities and competence among the staff is central to the success of risk management and the management support and their technical knowledge is crucial.

5.4 Limitations of the Study

The study was limited to Fina Bank due to time and cost constraints. Replication of this study through comparative study using samples from other institutions is thus recommended. This will provide a complete picture of the effect on performance by better risk management strategies in lending to SMEs by Commercial banks.

5.5 Suggestions for Further research

Further research effort is needed to establish if Kenyan citizens perceive service delivery as having been improved since the implementation of risk management strategies in Commercial Banks. Results of such a study would confirm if the objectives of risk management strategies are being achieved in Kenya

5.6 Conclusions

There is need for a good definition of outputs and solid performance measures. This requires a well-defined training program for the employees to support implementation. Other instruments of control such as quality service charters and regulations concerning transparency and accountability must complement the risk management strategies. Credit provision tends to emphasize competition among staff to meet their targets. Competition if not well-controlled may bring conflicts with values hence interfere with organization culture.

Risk management strategies are not a substitute for poor management. This will only succeed where best management practices are practiced. Top management key competencies and participatory approach to decision making is crucial. There should be regular overall evaluations and audits of benefits and drawbacks of the implemented policies in order to learn from experiences.

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APPENDICES

APPENDIX I: INTRODUCTION LETTER

Dear Sir / Madam,

The purpose of this questionnaire is to examine whether commercial banks have sufficient information to assess the risks associated with their exposures to risks emerging from lending funds to Small and Micro-finance Enterprises (SMEs) within the country, and how these banks incorporate these assessments into their risk management framework and lending decisions: a case of Fina Bank Limited.

My sincere request is to urge you respond to the questions sincerely. The research is carried out purely for academic purposes and all the information obtained from you will be treated with the confidentiality it deserves. It is only the researcher and the project supervisor who will have access to the information given. Upon request, the summary of the results will be made to you after the information collected is duly analyzed.

Thank you very much for your valuable time and co-operation. .

Yours sincerely,

Appendix II

INTERVIEW GUIDE

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

Part A: General information

1. What is your job title ....
2. What primary functions does your job involve...
3. Is your department involved in Risk management...............................
4. Describe the credit scoring model in rating your customers applying for a loan...
5. Do you have a credit policy for your customers applying for a loan?.................
6. Describe your different levels of approval of loan application forms for your customers applying for a loan..........................
7. Describe the different levels of approval you have for the loan processing...........
8. If you have more than three levels of loan approval, please specify and elaborate...

Part B

Section I: Credit risk management

1. Describe the grouping of your credit applicants in order of likelihood of defaulting to repay and who develops the targets...........

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

   Use of security / collateral as a requirement................

   Use of a bank guarantee.....................

   Interest rate variability to customers........................

Risk sharing by use of syndicates..........................

Imposing extra risk requirements (Please specify)....................

3. If your bank imposes extra risk requirements to the customer before the approval of the application of the loan, please specify.

a) ....

b) ....

c) ....

d) ....

e) ....

Section II: The 12C's Credit Appraisal method

1. In your opinion, are the 12C's Credit appraisal methods a good measure for credit risk? Please elaborate.................

2. Do you think that setting targets to the credit appraisers is effective in the management of credit risk? Please expound.

3. Where else has risk management helped in the bank?

....

....

....

....

4. What problems have lending to SME's solved in commercial banks?

....

....

....

....

....

5. In your opinion are there any other issues you wish to comment on about perception of lending credit to SME's?

1. ………………………………………………………………………………………..
2. ………………………………………………………………………………………..
3. ………………………………………………………………………………………..
4. ………………………………………………………………………………………..
5. ………………………………………………………………………………………..

Section III: Nature of commercial bank lending

1. Describe the involvement of your department in setting up policies for lending to SME's…….

2. Who is responsible for the implementation of the set rules and regulations?
   Management (executive)
   Head of department
   Others (please
   (Specify)……………………………………………………………………...

3. Describe some of the problems you experience in implementing some of the rules……..

Section IV: Credit Risk Assessment

1. What are the techniques used in measuring risk in your bank?
   a) ……………………………………………………………………………….
   b) ………………………………………………………………………………..
   c) ………………………………………………………………………………..
   d) …………………………………………………………………………………..

2. Which of these factors do you think greatly affects risk assessment?

   Erogenous factors

   Unrealistic targets

   Exceptional items

   Others (please specify)

   ....

3. What can you say as the general trend of the performance of the bank after the introduction of risk management strategies.........

Section V: Default rate of the credit

4. From your opinion what is the default rate for the customers who get the credit from the bank? ....

5. Who is responsible for follow-ups, reporting, evaluation and monitoring of the defaulters..................................Please specify.

6. In your opinion, how has risk management of the bank helped in achieving the overall strategy of the organization............................

7. How do you determine that a customer has defaulted to pay the loan?

   ....

   ....

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

   a. ....

   b. ....

   c. ....

   d. ....

   e. ....