EFFECT OF CREDIT RISK STRATEGIES IN IMPROVING QUALITY OF LOANS IN MICRO-FINANCE INSTITUTIONS IN KENYA

(A CASE OF REAL PEOPLE MICRO-FINANCE KENYA)

BY

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LIST OF ABBREVIATIONS

FI	Financial Institutions
MFI	Micro finance Institution
LPM	Loan Portfolio Management
FI	Financial Institution
HOD	Heads of Department
PAR	Portfolio at Risk
RP	Real People
CR	Credit Risk
CRM	Credit Risk Management
SMEs	Small Micro Enterprises

DECLARATION

This research project is my original work and has not been presented for award of any degree in this or any other university.

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

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DEDICATION

This research paper is dedicated to my family and friends. My parents, Pst Samson and Hellen Oseno,my brothers, Victor, David and Joshua Oseno, my son Aiden Visha, my spouse Felix Hongo and my friends Yvonne and Linah among others. Thank you all and may God bless you.

ABSTRACT

This study sought to establish the effect of Credit Risk Strategies on improving quality of loan portfolio at Real People Kenya thus enhancing the practice of strategic management and Risk Management with a focus on Credit Risk Management. Based on the Evolutionary theory of Strategic Management, the study established that effective Credit Risk Management strategy cannot be an afterthought. Indeed, it requires a comprehensive effort involving all levels of the organization, driven by top management. It was revealed that in order to succeed and thrive in today's rapid-paced and tumultuous market, the organization must realise the need for an effective credit risk strategy to ensure portfolio quality. As a FI, Real People is in a business environment in which technology, finance and regulation change too quickly and unpredictably thus multi-year planning processes to address the outcome (risk) effectively. In this regards Evolutionary strategic management attempts to accelerate strategy development by breaking it into multiple smaller changes, with ongoing review enabling more rapid adjustments to the original plan which is at the core of risk management. Evolutionary approaches, while not optimal for a particular environment, allows the organization greater flexibility to adapt to unexpected change. The study design was a case study of RP where the researcher interviewed top management team. The qualitative data was analyzed using content analysis allowing the researcher to draw inferences from the data collected. The results from this study indicated that effectiveness of credit risk strategy in FI is critical for survival. The researcher recommended that given importance of business continuity there is need for MFIs in this case RP to incorporate greater emphasis on Credit Risk Strategies as part of the overall organization strategy.

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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

MFIs face various risks that can be categorized into three groups; financial [with credit risk (CR) being a component], operational and strategic (Cornett and Saunders, 1999). These risks have different impact on the performance of MFIs. The magnitude and the level of loss caused by CR compared to others are severe to cause MFIs failures (Chijoriga, 1997). Over the years, there have been an increased number of significant MFIs problems in both matured and emerging economies. Various researchers have studied reasons behind these problems and identified several factors (Basel, 2004). Credit problems, especially weakness in credit risk management (CRM) strategies, have been identified to be a part of the major reasons behind these difficulties. Loans constitute a large proportion of CR as they normally account for 10-15 times the equity of a MFI.

Thus, MFI business is likely to face difficulties when there is a slight deterioration in the quality of loans. Poor loan quality has its roots in the information processing mechanism. BrownBridge (1998) observed that these problems are at their acute stage in developing countries. The problem often begins right at the loan application stage and increases further at the loan approval, monitoring and controlling stages, especially when CRM guidelines in terms of policy and strategies/procedures for credit processing do not exist or weak or incomplete.Effective loan portfolio management begins with oversight of the credit risk strategies in individual loans. Prudent risk selection is vital to maintaining favorable loan quality.

1.1.1 Credit Risk Management Strategy

An organization needs to ensure that its business partners, including customers, suppliers and lenders, are in good economic standing. A company establishes a credit risk strategy to review a business partner's financial information and creditworthiness before engaging in a transaction or providing a loan. A sound credit risk policy prevents operating losses. When a company grants credit to its customers it incurs the risk of non-payment as credit risk management refers to the systems, procedures and controls which a company has in place to ensure the different collection of consumer payments and minimize its risks.

Credit risk assessment and management will form a key part of the company's overall risk management strategy as weak credit risk management is a primary cause of many business failures and that such small business have neither the resources nor the expertise to operate a sound credit risk management system.Credit risk is directly related to the portfolio of the organization and is one of the most significant risks from an MFI perspective. Whenever an MFI lends to a client there is an inherent risk of money not coming back, i.e. the client turning into a defaulter, this risk is called the Credit risk.

Credit risk is simply the possibility of the adverse condition in which the clients does not pay back the loan amount. Credit risk is the most common risk for the MFI. The risk is of greater significance for MFIs as it has to deal with large number of clients with limited literacy. Further, MFI provides unsecured loans, i.e. loans without any collateral. In case a client default the MFI does not have any asset to meet its loss, which makes the credit even riskier. MFIs fund their portfolio through external borrowings, through their own capital and through client savings that the MFI has mobilized.

By giving a loan, an MFI also attracts risk to these sources of funds. It is therefore said that an MFI deals in public funds, acquired through banks, clients' savings or through donors who trust the MFI to carry out its activities effectively. If an MFI loses money it may not be in a position to meet its own financial obligations to its depositors or lenders thereby becoming a defaulter itself. This results in loss of confidence of the funders and the direct financial loss for the MFI as the organization loses not only interest but also its principal amount.

1.1.2 Loan Portfolio Management

Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled. Because review of the LPM process is so important, it is a primary supervisory activity. Assessing LPM involves evaluating the steps MFI's management takes to identify and control risk throughout the credit process. The assessment focuses on what management does to identify issues before they become problems.The lifeblood of each lending institution is its loan portfolio, and the success of the institution depends on quality of its loan portfolio. Loan portfolio quality is the key to loan portfolio management.Assessing the current

performance status of the most important asset of a financial institution – the loan portfolio – is a basic requirement for being able to actively manage the level of risk exposure and the profitability of an institution.

Like their commercial counterparts, the assets of the MFI's are in various form including cash balance, bank balance, outstanding loan balance, receivables and durable assets. In most MFIs, outstanding loan balance constitutes over 90% of their assets. Asset of the microfinance loan portfolio is the amount owned by clients to the institution. Loan portfolio is also refereed as the loans outstanding or current, active actual loans. The major income earning asset for MFI is the loan portfolio. This is the main product of the business and the reason for MFIs existence. Hence it is imperative for MFIs to maintain very high portfolio quality for the long term financial viability.

In general terms, portfolio quality indicators identify performing and non-performing parts of the loan portfolio and relate them to specific factors. The indicators provide a view (i.e. a snap shot picture) of the status of the portfolio's performance. By comparing indicators at different points in time, trend analysis can be carried out and positive or negative developments identified. In the search for the specific reasons for positive or negative developments, portfolio information should be structured to enable managers to answer questions on; what percentage of the loan portfolio is non-performing, ratio of delinquent to active borrowers, currently delinquent loans will turn out to be loan losses, loan portfolio concentration in specific regions, sectors, products and loan term and how loan portfolio concentration relate to current and past portfolio performance.

1.1.3 Micro Finance Industry in Kenya

In particular, micro-finance institutions have developed in response to the widespread poverty in Kenya and the need to provide financing and funds for investment to people who are unable to secure loans through the conventional banking system. The rapid growth of institutions providing micro-credit services is illustrated by the finding that less than 10% of Kenya's enterprises have access to financing from the conventional banking channels. This constraint arises primarily from the fact that most of these enterprises have neither sufficient assets nor

other property to enable them to post collateral. In spite of this constraint, there is immense demand for direct lending by small and medium sized enterprises. From this demand, various institutions have developed and tested specific methodologies towards their satisfaction.

The earliest cases of micro-finance and microcredit development were church-based lending programs that arose in the 1980s. Most were confined to specific church parishes that started with local financing for members before they developed into institutions that could cover a wider number of people in rural and suburban areas of Kenya. While these church-based lending programs served the primary function of providing the credit to the members of their congregations, they were often very small and operations limited to specific geographic locations hence with limited reach and financial resources. However, they still served the function of providing limited credit facilities for their members for use in specific purposes.

In many cases, these organizations were overwhelmed by the demand for credit by their membership. From the beginning, nongovernmental organizations (NGOs) began to fill the gap by extending the credit services more widely. Due to this, in the 1990s, the NGOs developed functioning systems to facilitate the administration of the credit delivery. The programs were funded and were not necessarily considered as outright business ventures in spite of the success that most of the schemes achieved. As the successes of the microcredit institutions grew, they received considerable funding and began to turn into full commercial entities. This development was also aided by the increased competence in administration, credit assessment and the organization of individuals into groups to facilitate the collective guarantee of loans by individual members.

As the MFI in Kenya grew, the institutions assumed various formal structures and were registered under different statutes. Towards the end of the 1990s, many MFIs have moved away from serving closed groups and into more formalized institutions. This institutionalization necessarily required that the micro-finance and micro-credit institutions also move away from subsidized institutions into more commercial entities. Evidence of the growth and increasingly significant role played by the micro-credit and micro-finance institutions is seen in the development of the K-Rep Bank. The K-Rep bank is the first of the micro-finance institutions in

Kenya to develop into a full commercial banking enterprise. In order to formally conduct its business as banking institution, the K-Rep Bank in Kenya is registered under the Banking Act (*Cap 488*). Because of this fast growth and the related demand for more micro-financial services, the micro-finance institutions are now focusing on building their capital base and financial stability hence need for effective risk management framework.

Microfinance here refers mainly to credit provision and saving mobilization, some microfinance also provides insurance service, pension management and money transfer service. The number of micro finance institutions that operate in the country has reached 58 in which 8 are Deposit taking MFIs at the end of 2012. More than 80% of these micro finance institutions in the country have been operating in the rural areas where access to formal financial institution was nearly impossible.

1.1.4 Real People Micro Finance Kenya

Real People MFI is one of the Micro Finance in Kenya and part of Real People Group in South Africa. Real People Kenya was a pure micro finance until recently when it's started targeting the SME clientele. The Real People group was established in 2001 and is a specialist provider of credit, education and debt collection services in the mass market. With over ten years of experience in the South African market, the group has developed a robust capability for the collection of non-performing and partially-performing unsecured debts.

The group identified the opportunity to leverage this collections expertise and now provide unsecured credit directly to the market through a proprietary branch network and through third party building merchants. Cellular and insurance products are now also offered to clients based on the same premise. In 2007 the Real People group diversified into providing affordable education solutions using the collections expertise to offer affordable payment terms to students, which is a significant differentiator in this market. The group has also developed market leading risk pricing capabilities based on many years of collection experience.

The group also provide micro-enterprise finance to small businesses in Kenya, Uganda and Tanzania. Real People Kenya provides a number of products and services ranging from Group

loans, Individual loans, Education loans and housing loans. In January 2013 the Company transformed its Lending department into two main departments, namely; Business Finance offering loans to both Micro Credit and SME loans. The other department is Housing Finance offering construction and home improvement loan. The loan portfolio is a major contributor to the income generated by Real People and if major steps are not taken to improve its quality, the survival of the Institution will be at a Risk.

1.2 Research Problem

The largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by for a largest asset of the microfinance institution (MFI). In addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For MFIs, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Credit risk results from a client's unwillingness or inability to repay its loans. MFI's most important asset is the loan portfolio, one of the MFI's key concerns is the amount of credit risk it has in the portfolio. Product pricing must reflect credit risk, and the MFI must build and maintain the institutional capacity to manage that risk.

Risk should not necessarily be seen as negative. Unlike customers of most conventional banks, MFI borrowers usually work largely in the informal sector and do not produce accounts or have any banking history. Lending to microfinance borrowers is frequently unsecured; if provided, collateral is limited in value and is often in the form of guarantees from friends and relatives. In many countries where MFIs operate, the situation is further complicated by the absence of credit bureau. Poor information on cash flow of borrower's has resulted to lending based on collateral than on credit-risk assessment.Sustainability of an MFI in this case Real People MFI depends on how good its portfolio quality is and is measured most commonly by the Portfolio at Risk (PAR) ratio which is one of the Credit Risk Strategy.

MFIs often operate in areas which lack basic infrastructure pertaining to payment systems and microfinance clients rarely have bank accounts. Also, microfinance operations are human intensive and MFIs are susceptible to the risk of quality loans. MFI Credit managers have concentrated most of their effort on prudently approving loans and carefully monitoring loan

performance. Although these activities continue to be mainstays of loan portfolio management, analysis of past credit risk problems, such as those associated with poor portfolio analysis,poor pricing,lack of concentration analysis,poor analysis of credit cycles,weak MIS and tracking system for overdue loans, and inadequate credit risk management framework has made it clear that portfolio managers should do now focus on establishing Credit Risk Management Framework to help improve the quality of the loans.

Annual MFI report for 2012 indicated that risk coverage ratio for the whole sector, although displaying improving trends from Dec 2011, stands at a low 46.2%. However it is reasonable to believe that DTMs would show a strong collateralization of the portfolio. The risk coverage ratio drops further when excluding DTMs from the calculations, to 45.4% in Dec 2012, suggesting that among unregulated credit-only institutions provisioning policies are weak and not adequate to cover for present and future exposure to credit risk. Additionally, the ratio (DTMS) shows a worryingly negative trend.A significant challenge facing these institutions is the battle for financial self-sufficiency which means having quality loan portfolio. This includes controlling all the risks in the loan portfolio.

Despite all efforts by MFIs to improve their asset quality, the quality of the loan portfolio has continued to deteriorate over time. It is thus upon such reports on setbacks suffered in the quality of loan portfolio that the study seeks to focus on how Credit Risk strategies can be employed to improve quality of loan portfolio in Real People Kenya.Several studies have been conducted on the issue of successful of Micro-Finance (Narayan, Schaft, Rademacher and Schulte, 2000) in their study "Susseful establishment of Micro Finance at K-REP" focused only on establishment and sustainability of MFIs but nothing on how quality affects sustanability of MFIs.

A study conducted by Faith Wangeci (2012) titled "Factors Influencing Sustainability Of Microfinance Institutions In Kenya: A Case Of Kenya Women Finance Trust" offered some insight into quality of loan portfolio in ensuring MFIs sustanability but however it failed to focus on the Credit risk strategies which plays a key role in portfolio quality.bThis study seeks to fill the knowledge gap by seeking to answer two key questions. What are the credit risk strategies

employed by Real People Micro-Finance Kenya?What is the effect of credit risk strategies in improving the quality of loan in Real People Microfinance?

1.2   Research Objective

This study addresses the following two research objectives:

i)   To determine the Credit Risk Strategies employed by MFIs in Kenya

ii) To establish the effect of Credit Risk Strategies in improving quality of loans in MFIs specifically to Real People.

1.3 Value of the study

The study intends to build on the existing literature and add more knowledge in the field of risk management and strategic management by providing a basis for future research in the field. The study will provide industry players with useful insight of how best to effectively manage employ Credit risk strategies in improving quality of loan Portfolio. It seeks to empower managers and leaders in the MFIs with knowledge on Credit Risk Management and its importance on Portfolio Quality.

The study shall provide practitioners and policy makers with adequate literature in the field of strategic management as well as provide a reference point for further research into the complex of Risk Management in Strategic Implementation in an organization.In order for business continuity, Real People must identify the Credit risk strategies that can be applied to enhance the quality of loan portfolio. The results of the research will go a long way to help the management of Real People and MFIs as a whole understand and appreciate the underlying factors that will improve quality of loans. The study is also important to the academicians in building their knowledge base and creating an insight in understanding overall Credit Risk strategies used by Financial Institution to improving quality of loan portfolio.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This literature review provides an overview of areas under study and differences between past research studies and the one being undertaken. This chapter reviews various sources of materials and information that relates to the area of study. This assessment is based on sufficient information about the prior research on Credit Risk Strategies used in MFIs in Kenya.

2.2 Theoretical foundation

This study was based on the Theory of Strategic Planning and also the evolutionary theory of strategic management. Evolutionary strategic management attempts to accelerate strategy development by breaking it into multiple smaller changes, with ongoing review enabling more rapid adjustments to the original plan which is at the core of risk management. A major facet of evolutionary strategic management is a population ecology model, in which firms in an industry are seen as akin to a population of animals. Some firms, the business environment including technology, finance and regulation change too quickly and unpredictably for multi-year planning processes to address effectively. Evolutionary approaches, while not optimal for a particular environment, allowed the organization greater flexibility to adapt to unexpected change.

The evolutionary school became prominent in the 1980s, coupled with the emergence of Information and Communications Technology into mainstream business operations and society at large, and global events such as the end of the Cold War. Due to the rise of a more complex business environment, firms could not afford to plan rationally, but "adapt or die" in an almost Darwinian sense. The school is termed 'evolutionary' with respect to its resemblance to classical Darwinian Theory, and the application of zoologically-derived population ecology models to business environments.

Strategic planning which is critical part of risk management helps determine the direction and scope of an organization over the long term, matching its resources to its changing environment and, in particular, its markets, customers and clients, so as to meet stakeholder expectations.

Strategic planning is a systematic process of envisioning a desired future, and translating this vision into broadly defined goals or objectives and a sequence of steps to achieve them. In contrast to long-term planning (which begins with the current status and lays down a path to meet estimated future needs), strategic planning begins with the desired-end and works backward to the current status.

At every stage of long-range planning the planner asks, "What must be done here to reach the next (higher) stage? At every stage of strategic-planning the planner asks, "What must be done at the previous (lower) stage to reach here? Also, in contrast to tactical planning (which focuses at achieving narrowly defined interim objectives with predetermined means), strategic planning looks at the wider picture and is flexible in choice of its means. Strategic Planning has resulted to identifying the business environment responding appropriately to changes that affect the business which is has resulted to Strategic Risk Management.

2.3 Assessment of Credit

The three processes in assessment of credit in MFIs include Loan Approval Process, Loan Monitoring Process, and Loan Termination Process. Understanding each of the mentioned processes in the assessment of credit is central to successful Credit Risk management. Because of the significance of a MFI's lending activities, the influence of the assessment of credit culture frequently extends to other Organization activities. Staff members throughout the Organization should understand the MFI's assessment credit culture. The knowledge should pass from the Head of Credit to all staff. Directors and senior management should not only publicly endorse the credit standards that are an assessment of credit culture's backbone but should also employ them when formulating strategic plans and overseeing portfolio management (Milton 2000).

2.4 Analysis of Loans

Analysis of loans varies from one MFI to another. Some MFIs' analysis of loans is done using a very conservative approach, as a result of lending only to financially strong, well-established borrowers. Growth-oriented MFIs may approach lending more aggressively, lending to borrowers who pose a higher repayment risk which calls for a rather more sensitive analysis of loans. These differences are grounded in a MFI's objectives for asset quality, growth, and earnings. Emphasizing one of these objectives over another does not, in and of itself, preclude achieving satisfactory performance in all three (Saunders 2003).

However, the emphasis on approach to analysis of loans will influence how lending activities are conducted and may prompt changes in credit policies and risk control systems. For example, a Micro Finance driven to achieve aggressive growth targets may require more detailed credit policies and more controlling administrative and monitoring systems to manage the analysis of loans. Consistently successful MFIs achieve a balance between asset quality, growth, and earnings. They have cultural values, credit policies, and processes that reinforce each other and that are clearly communicated, well understood, and carefully followed (Saunders 2003).

2.5 Portfolio Diversification

Portfolio diversification remains an important part of managing a MFI's credit risk, but portfolio diversification also involves looking at entire segments of the portfolio — groups of loans with similar risk characteristics. MFIs management may make a different decision about underwriting requirements for an individual transaction if it takes into account the risk profile of the MFI's entire portfolio rather than focusing only on the individual transaction (Zarruk 1989).

Effective portfolio diversification requires an understanding of all of the risk characteristics of the portfolio. A micro finance should segment its portfolio in a number of different ways — for example, by loan type, industry, geography, structure, collateral, tenor, and risk of default or loss. The same loan may be included in several portfolio segments based on different risk elements. Portfolio diversification is fundamental to Credit Risk management. The MFI should identify the risk characteristics of each segment. And, as part of concentration management, the

MFI also should try to identify possible covariance, similarities, or interrelationships among portfolio segments (Zarruk 1992).

2.6 Portfolio Risk

Lending is both a risk-taking and profit-making business, and MFI's loan portfolios should return profits commensurate with their risk. Although this concept is intellectually sound and almost universally accepted by Financial Institutions and examiners alike, MFIs have had difficulty implementing it. Over the years, volatility in industry's earnings usually has been linked to the loan portfolio. While there are many contributing factors including market forces, anxiety for income, poor risk measurement, and weak risk management, a common underlying factor has been MFI's tendency to underestimate or under-price credit risk (Sarkar 2002).

MFIs managements and boards are responsible for serving their communities, achieving acceptable shareholder returns, and protecting the interests of customers, they need to ensure that the loan portfolio provides consistent, reasonable returns. Individual credits and portfolio segments should be priced to provide reasonable shareholder returns while maintaining adequate capital and allowance levels. The price (index rate, spread, and fees) charged for an individual credit should cover funding costs, overhead/administrative expenses, the required profit margin (generally expressed as a return on assets or equity), and risk (Sarkar 2002).

Funding costs are relatively easy to measure and incorporate into loan pricing. Measuring overhead and administrative costs is more complicated because MFIs traditionally have not had strong cost accounting systems. Additionally, common services with differing or ambiguous values to each user (What, for example, is the dollar value of loan review?) can be difficult to measure. The required profit margin is a straightforward concept and is usually derived from the strategic plan. This leaves "risk," which is the crux of the pricing dilemma. The methods used to incorporate risk into loan pricing decisions range from simple "pro-rata" allocations of existing loan loss reserves and capital to complex estimations of default frequency and probability, loss levels, and loss volatility (Comptroller's Handbook 2002).

Recent developments in credit and portfolio risk measurement and modeling are improving MFIs' ability to measure and price risk more precisely and are facilitating the management of capital and the allowance for loan and lease losses. However, these methods require accurate risk measurement at the individual loan level and robust portfolio risk MIS. Even with these developments, the loan pricing decision is clouded. MFIs often incorporate other revenues attributed to the lending "relationship" into the loan pricing decision. The lending relationship has been, and continues to be, used to win other business with the customer.

MFIs however, must be alert to inappropriate application of relationship pricing and return methods. Loans may be booked at unprofitable rates based on the assumption, or promise, that other profitable business will follow. When the other business fails to materialize, the returns may be insufficient to compensate the MFI for the credit risk. MFIs should have systems to accurately measure relationship returns, and must exercise tight controls over loans granted on the basis that relationship profitability will be achieved in the future (Sarkar 2002).

Portfolio risk and return concepts encompass almost all of the credit risk measurement and management principles. Ultimately, the risks in individual credits, lending relationships, portfolio segments, and entire portfolios will be incorporated into pricing decisions through discrete risk-based allowance and capital charges. For now, pricing for risk continues to be a developing science. MFIs are encouraged to develop sufficient systems to measure and price risk within credits and portfolios accordingly (Comptroller's Handbook 2002).

2.7 Loan Portfolio Management

Effective management of the loan portfolio and the credit function is fundamental to a MFI's safety and soundness. Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled. Because review of the LPM process is so important, it is a primary supervisory activity. Assessing LPM involves evaluating the steps bank management takes to identify and control risk throughout the credit process. The assessment focuses on what management does to identify issues before they become problems (Milton 2000).

Effective loan portfolio management begins with oversight of the risk in individual loans. Prudent risk selection is vital to maintaining favorable loan quality. Therefore, the historical emphasis on controlling the quality of individual loan approvals and managing the performance of loans continues to be essential. But better technology and information systems have opened the door to better management methods. A portfolio manager can now obtain early indications of increasing risk by taking a more comprehensive view of the loan portfolio (Wiley 2002)

2.8 Performing and Non-Performing Loans

Non-performing loans are loans that are past due and unpaid for more than 90 days (usually equally to three dates of payments) and a performing loan is that which is serviced as agreed between the MFI and the client. (Rosenberg, R.1999) say that MFIs work best when they disclose and measure their performance. Accurate standardized performance is imperative and this takes into account both social (number of clients reached and their poverty levels) and financial information display in terms of interest rates, loan repayment and cost recovery.

Louis and Henry (2003), there have been persistently high non-performing assets that have pervaded the FIs for a prolonged period of time. This situation was partly a result of poor culture of loan repayment compounded by economic decline suffered in the 1970s and 1980s. The risk aversion tendency is based on the experience of poor loans repayment over many years. This has led to exceptionally high lending rates and interest rate spreads.

Berger and De Young (1997) analyzed the relationship between cost efficiency and NPLs in an ambivalent way that the higher the NPL-volume the lower the cost efficiency; nevertheless, mismanagement also lead to a rising amount of bad loans. Louis *et al* (2003), the financial institutions themselves have suffered from governance and management weakness that have resulted into weak internal controls, inability to accurately assess lending risks, monitor loans and recover loans. In some situations, there have been shortages of skills and strong social pressures on loan officers to favor certain borrowers especially those who are politically connected.

The failure to correctly assess the creditworthiness of borrowers arises because of information asymmetry and the resultant adverse selection problem. To circumvent this problem, banks have generally required firms to pledge more collateral than the value of the credit they receive and/or limited their services to prime borrowers whose reputation, collateral and other types of guarantees reduce the default risk to a minimum. It is noted that prime borrowers are mainly foreign firms that enjoy the trust of foreign owned banks, dominating the FIs sector.

2.9 Credit Policies

Credit Policies and Procedures in MFIs is catered for by the Credit Risk Management Framework for the entire management process and sets objective standards and parameters that guide the Loan officers in the granting of loans and the management of the loan portfolio. The policies within MFIs with regards to Real People involve interaction with customer; visits to premises of customers by loan Officers; credit analysis and appraisal of the customer on character, capacity, collateral, capital and condition (fill in a checklist summary for presentation to the Branch Approval Committee and National Approval committee); recommendation by branch loans committee to the head office; monitoring and recovery of the loan done by Loan officers.

In case of complete failure to recover the loans, the branch management refers the cases to the legal department, which in turn forwards them to the auctioneers for forceful recovery. From the above framework, it is conceptualized that at the onset of a loan approval process, there is a need for combined efforts by Branch Managers, Approval Officers and Loans Officers to critically analyze all specific underlying principles and assumptions regarding lending. This would then set a platform where clients can be assessed while considering their capacity to re-pay and character. This can be followed by comparing the information gathered in Loan Approval strategies, Loan re-payment strategies, Loan portfolio management and Loan monitoring issues.

It is this process that would thus act as a benchmark from which Managers can then decide on approving such loans. At the last stage therefore would be strategies for loan repayments.
It is also identified that to improve corporate loan portfolio, efforts should be made to use the last stage as means of learning and thus continuous improvement and modification of the process.

2.10 Measuring Credit Risk

In order to be able to manage something, you must first be able to measure it. MFIs use a number of variables to assign a risk rating to a particular borrower. MFIs then conduct regular reviews of each borrower, to assess the rating over time. One of the most commonly used methods for measuring credit risk is the credit rating assigned to customers by credit rating agencies. These agencies specialize in tracking customers' trends in debt and financial history. Another good way to measure credit risk is to measure debt. The balance sheet provides an overview of a customer's debt. Customers with a high debt-to-assets ratio are said to have a greater degree of financial risk than customers with a low debt-to-assets ratio.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides the methodology proposed for use in the study. It gives the research design, data collection methods and how the data collected will be analyzed to enable the realization of the research objectives.

3.2 Research design

The study was conducted using a case study research design; this method allows researchers to gain in-depth understanding and insight into the topic as well as allowing a detailed and intense study of the case. A case study allowed the researcher to observe the study subject under special conditions that make it possible to capture the particular characteristics that are being sought by the researcher. The aim of the case study was to establish the effect of Credit Risk Strategies on improving loan quality at Real People Kenya.

3.3 Data collection

The study used primary data and secondary data. This involved collecting data by means of direct interactions with the human subject. Examples of such methods used are interviews, observations, measurements, and abstractions from real people reports and MFI reports. The research included executives at Real People. Data was collected using in-depth interview technique. The interview guide contained open-ended questions to gather qualitative data. In this case the data was collected through an interview guide and secondary data. This is to enable the researcher to collect qualitative data.

The interview guide enabled the researcher to obtain up to date information as well as bring to the fore information that could otherwise not be obtained through other data collection techniques. It was also preferred over other methods of data collection because of its ability to extract information from the respondents as well as give the researcher a better understanding and more insightful interpretation of the results from the study. The interview guide was administered to Head of Departments .i.e. Head of Credit, Head of Finance, Head of Business Finance, and Head of Human Resources depending on their time and availability, other executives who have not been mentioned above were not interviewed. The above executives interviewed play a key role in strategic formation and implimentation in the organization.

3.4 Data Analysis

The completed interview responses were edited for completeness and consistency after which data processing commenced. This involved reading, editing and cleaning up of the interview notes and entry into the computer. Content analysis was used for data analysis. Cooper and Schindler, (2003) describes content analysis as a techniques for objective, systematic and qualitative description of the manifest content of a communication. Content analysis according to Mugenda and Mugenda (2003) as well as Dowson (2009) is any technique that allows for making inferences by systematically and objectively identifying specific characteristics of messages.

The breath of the content makes it flexible and wide ranging tool that may be used as a methodology or as a specific technique. It guards against selective perception and content, provides for rigorous application of reliability and validity criteria and is amenable for computerization. Content analysis will be used to make inferences by systematically and objectively identifying specific themes from the data, representing how credit risk management can improve loan portfolio quality. This technique has been successfully used by other researchers such as Muriuki, (2005),Khamisi, (2006), and Kinyanjui, (2011).

CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data findings, analysis and the interpretation of effect of Credit Risk Strategy on loan quality at Real People Kenya. The chapter also presents the discussions that relate to the findings of this study to previous studies that have been conducted on Credit Risk Strategies and portfolio quality. A case study research design was used. To achieve its objectives, this study was carried out using an interview guide. Four senior managers of the Real People were interviewed. Their responses were written down and this data was subjected to content analysis. Secondary data was also used during analysis. The use of secondary data was necessary to support the data received from the interviews with the managament team.

This chapter is divided into three sections. The first section deals with Credit Risk Strategies. It presents the findings of the study on credit risk strategies studied. The second section deals with effectiveness of credit risk strategies on quality of loans at Real People Kenya. It discusses how effective credit risk management strategies are,and whether the processes do improve loan quality.. The last section is a discussion of the findings in view of other research that have been conducted on simillar studies on Credit Risk Strategies and loan quality in other organisations.

4.2 Credit Risk Strategies

According to findings, the interviewees were in agreement that MFIs and FI's out there often face credit risks. Literally, risk is an integral part of any business as well as organization. However, it becomes an inevitable fact to take care when risk involves the financial status of the business. Companies and the business owners must have a system or person who can manage risk factors. Truly, in the financial world credit risk management plays an important role in managing all types of risks that comes the way of the business owners thus MFIs needs to have a good credit risk management team that works according to a framework. The risk management

team should perform different processes in order to have better understandings of the customers who form part of their loan portfolio.The management has been at the forefront in establishing and implementing credit risk strtageies in Real People Kenya.The interviewees further highlighted some of the the credit risk strategies adopted by the organization so far.

The as part of establishing Credit Risk Framework they are trying to ensure each credit proposal is subjected to careful analysis by a credit analyst with expertise which commensurate with the size and complexity of the transaction. Where necessary, the establishments of specialist credit groups to analyze and approve credits relating to significant product line, types of credit facilities, industry or geographic sectors. Further standard documented formats for appraisal and standard approach in analysis are being put in place. The evaluation includes a thorough understanding of the borrower, purpose and structure of credit and its source of repayment.

As part of credit risk strategy the RP has an effective evaluation process that has been established with minimum requirements for the information on which the analysis is to be based and minimum financial performance standards or benchmarks in appraising loans for each product or type of industry. There are written policies in place regarding the information and documentation needed to approve new credits renew existing credits and/or change the terms and conditions of previously approved credits. The information received is on basis for any internal evaluation or rating assigned to the credit and its accuracy and adequacy is critical to management making appropriate judgments about the acceptability of the credit. The Head of Credit also verifies the accuracy of such information.

Real People Kenya credit approval is made in accordance with the MFI's written guidelines and granted by the appropriate level of management. In addition a formal underwriting standard document which lays down the risk acceptance criteria has been established as a foundation for which the whole credit approval process is based. The Head of credit also highlighted that the credit approval process establishes accountability for decisions taken and designate who has the authority to approve credits or changes in credit terms and what the authorized limit is. The Head Finance mentioned Real People Kenya as having a clear audit trail documenting that all aspects of the approval process has been complied with and identifying the individual(s) and/or committee(s) providing input as well as making the credit decision for clients and performance incentives for staff play important roles, and information acts as a virtual substitute for real guarantees are being used to

reduce risk. A number of diversification strategies (geographic, sectorial, commodity) are being used to cope with risk. Portfolio exposure limits are being used to reduce risk. Excessive provisioning also being used to absorb and internalize risks. The interviewees also mentioned the use of credit scoring models for risk based pricing

4.3 Effectiveness of Credit Risk Strategy on loan quality

The study sought to also establish the effectiveness of Credit Risk Strategy on loan quality at Real People MFI Kenya. Effectiveness in this case means that Risk Management is embedded into the strategic goal by finding an optimal balance between performance goal, target and related risks. Thus, Credit Risk effective in an organization becomes effective when activities within that organization are established for the purpose of moving the organization toward accomplishing its goals and objectives.

RP taking credit risk is part and parcel of financial intermediation. Yet, the effective management of credit risk by financial intermediaries is critical to institutional viability and sustained growth. Failure to control risks, especially credit risk, can lead to insolvency. However, too often, the mere perception of high credit risk can dissuade MFIs from entering a particular market segment when a large contributing factor to that perception may be lack of adequate credit risk evaluation and management techniques. This seems to be the case with Real People Micro-finance Kenya, especially lending to the SME. Real People has decided to venture into the SME space which very competitive as the bank also target the same, they tend to limit exposure to SME finance and to favor clients with established credit histories and significant collateral as part reducing risk exposures due to the fact that group lending is not only expensive but also risky.

The Head of Business Finance indicated that as part of credit risk strategy it is critical that the loan size be appropriate for the size of the business. In this regard Real People MFI Kenya must ascertain the repayment capacity of clients' businesses by collecting data on sales and assets. It could be maintained that loans should be given solely on the basis of character, since microcredit

is often called "character-based lending," but loans create debt for the client. Real People MFI Kenya staff use financial ratios to determine appropriate loan size.

These ratios require that the credit officer collect sales, assets, and liabilities information from each client.

This information is important to collect because if Real People MFI Kenya is lowering sales or decreasing a client's net worth, then the loan may be harming rather than helping the client which will be against RP's vision of sustainably improving lives. The interview also indicated that based on credit scoring and profiling of customers, new area of business are selected in conformity with the portfolio risk guidelines and also resulting to risk based pricing. In each credit file, a loan checklist is included, summarizing the various steps that have been taken to properly establish a new loan. This loan checklist is completed by the lending officer responsible for the loan or by a designated credit committee member, where applicable. It should be reviewed and initialed by the loans supervisor/manager to ensure the credit and security files are in order before these files are stored.

According to the Head of Finance this has expanded from the acquisition of fixed assets to financing working capital, the focus of analysis has shifted from the static balance sheet to cash flow, a set of financial ratios, and a consideration of the competitiveness of the borrower. The Credit analyst's main concern is how the loan will be used, how competitive the borrower is within the sector or industry in question, how sensible is the business strategy being pursued, how good is the management team in delivering results, and ultimately if the borrower will generate sufficient revenue to service the acquired loan plus confront likely hiccups and shocks in the course of conducting business.

In this regard the credit officer usually employs a set of standard and specialized industry-specific ratios that are used to compare the potential borrower to industry benchmarks with some of the most common ratios. Expert-based credit risk analysis methodologies work, but they can also be problematic and fail from time to time due a number of reasons: poor selection of analysts, poor training, and failure to follow agreed upon procedures, overly large and bureaucratic structures wherein the sense of individual responsibility of each analyst is diluted,

and natural tendencies to over concentrate the portfolio. Over time, the institution have developed expertise in analyzing creditworthiness in sectors they lend to which has been based on standard matrix. and also relies on research department for further analysis on whether to expand rapidly in "boom times." When systematic shocks occur in the overexposed sectors, the portion of the portfolio that is nonperforming can worsen thus Real People has obtained credit insurance or securitize its portfolio and thereby transfer its risk of overconcentration to another party.

The interview indicated that a good credit analysis depends essentially on capable staff and on accurate and timely information. Other factors such as management information systems, the application of sophisticated mathematical techniques, and the availability of efficient and low-cost communication technology can facilitate credit analysis but cannot replace the need for capable staff and quality information. The first critical element is that all the institutions rely on well-prepared staff. Second, the institution use performance incentives to promote a sense of responsibility and to reward results. Third, copious amounts of information on character, managerial ability, reputation for repayment, and financial viability are gathered and processed by the credit analysts.

The analysts rely on credit bureaus, interviews, and personal references. Information is more important than guarantees. Guarantees are more formalities and there is no intent to foreclose on them in the event of a default. Since the legal costs can be prohibitive to execute land guarantees, liens on moveable property and co-signers are preferred. Fourth, cash flow and sensitivity analysis are used that view the household as the unit of analysis and not a single line of business or investment project. Fifth, there is a distinct preference to finance households with diversified streams of income to reduce risk of default. The key concern is that the household has sufficient debt service capacity.

Sixth, repayment incentives are widely used. The promise of access to a graduated loan and lower transaction costs for repeat loans serves to motivate clients to avoid strategic defaults. Seventh, direct monitoring of clients is essential. Credit officers visit clients randomly to reduce risk of default and to alert upper management if the client is likely to default due to observed

problems. As a further means to reduce risk, the institutions tended to limit exposure to SME lending making 80% of its book. As result reports on the amount of exposures undertaken in credit activities, broken down by categories, for example, by types of exposures, products and level of credit grades; concentration, NPLs and exception reports on credit performance are produced weekly.

The last line of defense is loan loss provisioning. Adequate provisioning due to a risk classification scheme helps protect the institution from liquidity and capital adequacy crises and represents absorption of the inherent credit risk. Marginal and substandard loans have a higher probability of deteriorating into a "loss situation" and adequate provisioning protects the institution. However, as group lending tend to be classified regularly as higher risks, it's a disincentive to lend to the sector and makes group lending more expensive hence more concentration on SMEs

The interview indicated that Credit risk management in Real People MFI Kenya is improving and evolving, but much still needs to be done. As per the interviews comments demonstrated success as measured by high overall rates of profitability, low delinquency rates in both group and SME portfolios, and sustained growth rates in SME portfolios over time. Also to note from the interview is that Real People has now introduced wide diffusion of risk transfer techniques (insurance, securitization, etc.) and the wider acceptance of different types of collateral (inventories, accounts receivables, warehouse receipts, etc.).

The interview with the Head of Human Resources revealed that the organization leadership contributed largely to the success of Credit Risk Strategy as they have the responsibility of endorsing major credit policy and business plan annually to ensure that they are consistent with each other and are within the institution's level of tolerance for credit risk. She also maintained that Board set the minimum credit standards and approve all significant policies relating to the management of credit risk throughout the institution. The Board ensure that the credit risk policy is consistent with the institution's capital strength, management expertise and risk appetite. She argued that the management facilitates and enables implementation of strategy by interpreting,

communicating and enabling employees rather than instructing and imposing strategy on them. Leaders influence followers and drive organizational objective by promoting process values.

According to findings, Credit Risk Strategy was one of the most significant factors contributing to the success of the the Institutions sustabnability. Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. The prudent management of credit risk can minimize operational risk while securing reasonable returns. Ensuring lending staff complies with the organizations policy is the first step of having an effect credit risk strategy.

The second step is to ensure board approved policies exist to limit or manage other areas of credit risk, such as syndicated and brokered loans, and the concentration of lending to individuals and their connected parties (companies, partnerships or relatives). Nevertheless, the overall credit quality profile of the Real People's loan portfolio remains good, largely due to efforts made during the previous years to strengthen the Credit risk management framework, upgrade credit risk infrastructure and tools, and better quality control at entry. Board and Senior Management oversight and active involvement in the credit risk appetite definition have also contributed significantly to improving the institution's credit processes.

4.4 Discussions of findings

This study established that an effective Credit Risk Management strategy cannot be an afterthought. Indeed, it requires a comprehensive effort involving all levels of the organization, driven by top management. It was revealed that in order to succeed and thrive in today's rapid-paced and tumultuous market, the organization realises the need for an effective credit risk strategy on portfolio quality. This is simillar to the findings of Ledgerwood, J. (2000) who was of the view that like their commercial counterparts, the assets of the MFI's are in various form including cash balance, bank balance, outstanding loan balance, receivables and durable assets.

In most MFIs, outstanding loan balance constitutes over 90% of their assets. Asset of the microfinance loan portfolio is the amount owned by clients to the institution. Loan portfolio is

also refereed as the loans outstanding or current, active actual loans. The major income earning asset for MFI is the loan portfolio. This is the main product of the business and the reason for MFIs existence. Hence it is imperative for MFIs to maintain very high portfolio quality for the long term financial viability and this why strategy implementation of MFI must have credit risk strategy as part of it.

This study found that Portfolio Management was the most commonly used as part of Credit Risk Framework. It revealed that as the MFI matures, it focus more consistently on the importance of portfolio quality: how well is Real People recovering the money they lend? Loan recovery is, after all, the most basic ingredient of long-term sustainability. In view of this it is important for Real People to prepare the portfolio Reports according to the age of the payments due regularly. This helps Real People to monitor the quality of the loan portfolio and manage the loan delinquency in time.

The amount of time a loan has had an amount past due is an important indicator of the likely repayment.This is in consistent with Ulrich W. and R. Shakya(2001),who said that the largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by for a largest asset of the microfinance institution (MFI). In addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For MFIs, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Fortunately, many MFIs have learned how to maintain loan portfolios of very high quality. In fact, leading MFIs typically outperform their commercial banks peers in many countries.

The study also found that Credit Assessment is critical part of Credit risk strategy .There are three processes in assessment of credit in MFIs include Loan Approval Process, Loan Monitoring Process, and Loan Termination Process. Understanding each of the mentioned processes in the assessment of credit is central to successful Credit Risk management. Because of the significance of a Real People Kenya's lending activities, the influence of the assessment of credit culture frequently extends to other Organization activities. Staff members throughout the Organization should understand the MFI's assessment credit culture. The knowledge should pass

from the Head of Credit to all staff. Directors and senior management should not only publicly endorse the credit standards that are an assessment of credit culture's backbone but should also employ them when formulating strategic plans and overseeing portfolio management (Milton 2000).

The study found that credit analysis was also effective in reducing credit risk and thus loan quality. Analysis of loans varies from one MFI to another. For Real People Kenya analysis of loans is done using risk based approach, as a result of lending only to financially strong, well-established borrowers. High risk clients the analysis is more aggressive and sensitive. Emphasizing one of these objectives over another does not, in and of itself, preclude achieving satisfactory performance in all the above (Saunders 2003).However, the emphasis on approach to analysis of loans will influence how lending activities are conducted and may prompt changes in credit policies and credit risk control systems. Real People is driven to achieve aggressive growth targets and requires more detailed credit policies and more controlling administrative and monitoring systems to manage the analysis of loans. Thus Real People Kenya has successful achieve a balance between asset quality, growth, and earnings according to (Saunders 2003).

The study established that Portfolio diversification is fundamental to Credit Risk management strategy in improving loan quality. Portfolio diversification remains an important part of managing a MFI's credit risk, but portfolio diversification also involves looking at entire segments of the portfolio — groups of loans with similar risk characteristics. Real people Kenya' management may make a different decision about underwriting requirements for an individual transaction if it takes into account the risk profile of the its entire portfolio rather than focusing only on the individual transaction which is also according to (Zarruk 1989).

Effective portfolio diversification requires an understanding of all of the risk characteristics of the portfolio. Real People has segmented its portfolio in a number of different ways — for example, by loan type, industry, geography, structure, collateral, tenor, and risk of default or loss. Thus same loan may be included in several portfolio segments based on different risk

elements. This was supported by (Zarruk 1992) who indicated the importance of identifying possible covariance, similarities, or interrelationships among portfolio segments.

Finally on the issue of Credit cultutre and processes at Real People Kenya, the study found that credit culture plays a critical role in effectiveness of the credit risk strategies.Credit culture is the unique combination of its credit values, beliefs, practices and management attitudes, which defines the lending environment and determines the lending behavior acceptable to the institution. Real people's management have ensured the policies involve interaction with customer; visits to premises of customers by Credit Officers; credit analysis and appraisal of the customer on character, capacity, collateral, capital and condition (fill in a checklist summary for presentation to the Branch Approval Committee and National Approval committee) recommendation by branch loans committee to the head office; monitoring and recovery of the loan done by Credit officers.

This is set by the tone at the top by board members and senior management play a critical role in implementation which forms part of the Organization strategic plan. This finding was found to be in line with the findings of studies conducted by Davis and Holland (2002), whose empirical studies have supported the efficacy of this strategy for successful implementation of strategy. However, employee involvement alone is not sufficient with managers still playing a critical role encouraging and rewarding innovation and expressing support for implementation. This study concurs with this view, advising organizations that the involvement of employees should be widespread and span all phases of the implementation process, but also emphasizing the importance of a supportive and engaged management team.

CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses the findings of the research and draws conclusions from the major findings while providing conclusions, recommendations and way forward with regard to the effect of Credit Risk Strategy in improving loan quality in Real People Kenya and further research in the area.

5.2 Summary of the Findings

This study revealed that Credit Risk Strategies are critical for ensuring loan portfoilio quality.Most of the interviewees acknowledged that the key to sustainability organizational is loan quality. According to the them various factors influencing non-repayment of loans which could arise from businesses characteristics. These factors included type of business, age of the business, number of employees and business profit. The only way to manage and monitor these factors at the same time is by establishing an effective Credit Risk strategy.A Credit culture must be cultivated that can support the planned credit risk strategies. Envisioning, energizing, and enabling are all important strategies for rallying support for Credit Risk Strategic initiatives. Management at the for front of ensuring the process are effective and serve the intented course.

According to the interview, loan portfilio management is the critical aspect of credit risk strategy. It focuses more consistently on the importance of portfolio quality: how well is Real People recovering the money they lend? Loan recovery is, after all, the most basic ingredient of long-term sustainability. In view of this it is important for Real People to prepare the portfolio Reports according to the age of the payments due regularly. This helps Real People to monitor the quality of the loan portfolio and manage the loan delinquency in time.Portfolio Management also encompsses portfolio analysis on loans using risk based approach, thus portfolio diversification

The study reveals that the strategic planning and implimentation process at Real People Kenya was a structured approach to ensure tradeoff between risk and reward. Strategic planning which is critical part of risk management helps determine the direction and scope of an organization over the long term, matching its resources to its changing environment and, in particular, its markets, customers and clients, so as to meet stakeholder expectations.

In this case Real People keeps monitoring is environment to encompass the evolutionary strategic management in which at every stage of long-range planning the planner asks, "What must be done here to reach the next (higher) stage? At every stage of strategic-planning the planner asks, "What must be done at the previous (lower) stage to reach here? Also, in contrast to tactical planning (which focuses at achieving narrowly defined interim objectives with predetermined means), This has resulted to identifying the business environment responding appropriately to changes that affect the business which is has resulted to Strategic Risk Management which credit risk strategy is a part of.

5.3 Conclusions of the Study

From the research findings some conclusions that can be drawn from the study are that effectiveness of credit risk strategy in Financial Institution is critical for the survival of that organization. It's important to testing its effectiveness because of the changes in the business environment and be sure that strategies adopted reduces risk of deteriorating loan portfolio to the minimum. It is also important that management set the tone at the top in regards to credit risk strategies ensure that the people internalize and own the processes which is a critical component of strategic implementation.

Based on the findings, successful credit risk strategies can only be effective if credit cultutre and processes at Real People Kenya, are effective.Because credit culture plays a critical role in effectiveness of the credit risk strategies, credit culture is the unique combination of its credit values, beliefs, practices and management attitudes, which defines the lending environment and determines the lending behavior acceptable to the institution this then assist in assessment, analysis, monitoring, reporting and taking timely action where necessary.

The study further concluded that there was need to spend extra time and energy reviewing and always improving the credit risk strategy due to volatility of financial business environment.

Communication to staff should be done to ensure that they understand, can communicate about, and support the process. This is because critical part of the credit risk strategy is implementation in which the staff should be skilled and knowledgeable on the strategies.

Finally, the study concluded that organizations needed to align the Credit Risk Strategy to the overall organizational strategy and establish systems to support the same. These include the Loan Portfolio Management, Credit Assessment, Portfolio Analysis, Portfolio Diversification, Credit Policies and Credit Measurements. This should be done in order to ensure consistence and avoid deviation in objective setting and outcome.

5.4 Recommendations of the Study

Recommendations were divided into two major sections namely, implications for theory and knowledge and implications for strategic management and practice.

5.4.1 Recommendations for Strategic Management and practice

The study recommends that there is need for Real People to incorporate greater emphasis on Credit Risk Strategies as part of the organization overall Organization strategy. As a Financial Institution, Real People is in a business environment in which technology, finance and regulation change too quickly and unpredictably thus multi-year planning processes to address the outcome (risk) effectively. In this regards Evolutionary strategic management attempts to accelerate strategy development by breaking it into multiple smaller changes, with ongoing review enabling more rapid adjustments to the original plan which is at the core of risk management. Evolutionary approaches, while not optimal for a particular environment, allowed the organization greater flexibility to adapt to unexpected change.

Credit Risk Strategies being the key component to the survival of Finance Institution in regards to loan quality. It's thus paramount for Real People to ensure effectiveness of its implementation which should form part of the strategic implementation. This means that the credit risk strategy should be approved at the board level in line with the Credit risk appetite. Board set the minimum credit standards and approves all significant policies relating to the management of credit risk throughout the institution. The Board ensures that the credit risk policy is consistent with the institution's capital strength, management expertise and risk appetite.Senior

management then facilitates and enables implementation of strategy by interpreting, communicating and enabling employees rather than instructing and imposing strategy on them.

There is also need for training and development of employees through on the job training as well as providing them with opportunities to seek higher education as credit risk management need expertise. This is because the importance of effectiveness and implementation of credit risk strategies especially in risk based pricing. The employees' knowledge and capability will be reflected on effectiveness and implementation of credit risk strategy.

5.4.2 Implications for theory and knowledge

The study found that the Strategic planning and implementation adopted at Real People is evolutionary. The researcher recommends that the organization should ensure that credit risk strategies forms part of the overall organization strategy and should not be handled in isolation. This is because it's from the overall strategy of the business that the organization will determine the risk appetite.

A point emerging from the review is that the literature is consistent in indicating that an organization needs to ensure that its business partners, including customers, suppliers and lenders, are in good economic standing. A company establishes a credit risk strategy to review its customer's financial information and creditworthiness before engaging in a transaction or providing a loan. A sound credit risk strategy prevents operating losses. When an organization grants credit to its customers it incurs the risk of non-payment. Hence it's upon this inherent risk to the organization that it must ensure it overall strategy is in line with its credit risk strategy for its sustainability.

Credit risk assessment and management will form a key part of the company's overall risk management strategy as weak credit risk management is a primary cause of many business failures and that such small business have neither the resources nor the expertise to operate a sound credit risk management system.Credit risk is directly related to the portfolio of the organization and is one of the most significant risks from an MFI perspective.

5.5 Limitation of the Study

The findings presented in this study must be viewed in the context of several limitations. The problem of inaccessibility of the managers as well as conflicting time schedules have been the major challenges encountered in this study. The study encountered difficulties in securing face to face interviews with some of the senior managers mainly due to their busy schedules. Similarly, the researcher had a difficult time convincing the organization's management to allow the study to be conducted in the organization.

The study was also limited by follower response bias due to leaders being allowed to identify the personnel who participated in the study. The Organization's leaders may have selected only those interviewees likely to offer positive ratings of interview. The organization's leaders selected top personnel in their departments to participate in the study when they were themselves not able to attend the interviews. The study was also limited by the confidential nature of some of the company's strategies especially concerning analytical content in credit risk like pricing methodologies.

5.6 Suggestions for Further Research

The study was limited to Real People Limited where the researcher sought to examine the effect of Credit Risk Strategy on loan quality. A similar research could be conducted in a different context in order to affirm the findings of this research as well as many other researchers who have done the same research. The research recommends the need for further research to establish the important components of credit risk strategies in financial institutions.

While the numerous positive outcomes of credit risk strategies are indeed impressive including positive effects on profitability, sustainability, loan quality, efficient process and overall performance of the organization. Hence making it very critical in strategic planning and implemintation especially for Financial Institutions. Credit Risk Strategy research is also needed to link the specific risks in organizations and how they interrelate. Finally, future research is needed to further clarify the specific importance of Risk Management and strategic management.

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APPENDICES

Appendix I: Introduction Letter

Dear Sir/Madam,

 RE: <u>INTRODUCTION LETTER</u>

I am a postgraduate student at the University of Nairobi pursuing a course in Master of Business Administration, specialising in strategic management. In partial fulfilment of the course requirement, I am conducting a case study on effect of Credit Risk Strategies in improving quality of loan portfolio at Real People Kenya.

For the purpose of completing my research, i wish to collect data through the attached Interview guide. Any information gathered during this study shall be treated as confidential and shall be used solely for my research project. A copy of the final research report shall be availed to you upon request.

YOURS SINCERELY,

Sarah June Oseno

Appendix II: Interview Guide

Section A: Questions for staff at Real People

1. What position do you hold in Real People?

2. Do you think assessment of individual loans is adequate?

3. In your view are the internal controls effective in regards to credit decision?

4. How can we are address default risk?

5. What are the areas of lapses in documentation?

6. In your view what are the credit risk management priorities?

7. How can we improve on the Loan Policy and Underwriting Guidelines?

8. Do you think we should introduce a risk grade system for our clients?

9. How can we improve on our loan approval process?

10. What Loan Report do you think are not value adding and which ones to replace them?

11. What are the critical reports in your opinion that should be reviewed daily

12. Do think the analysis of financial statements; primary and secondary source of repayment and appraisal are effective? What should we do differently?

13. In your opinion how should we evaluate repayment terms against the borrower's ability to repay?

14. Do you review the industry practices and environmental indemnification? How often?

15. Is the Management resistant to employee decision making?