STRATEGIC RESPONSES ADOPTED BY KENYA COMMERCIAL BANK TO COPE WITH THE CHALLENGES OF NON PERFORMING LOANS

By

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DECLARATION

Declaration by the student

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

Signed.. Date 15th NOV. 2011..........

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Declaration by the Academic Supervisor

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

Signed .... Date 15/11/2011...................

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DEDICATION

To my dear husband, Chris,

daughter Mona,

sons Melvin and Brian

and

my mum Zadie.

ABSTRACT

Organizations operate as open systems that are dependent on the environment for their inputs and for the release of their outputs. The current business environment is very dynamic and rapidly expanding mainly because of globalization. An organization's inability to recognize the dependence existing between itself and its environment is a key attribute in explaining a loss of competitive performance in that organization. Organizations therefore, ought to monitor and scan their external environments, anticipate and adapt timely to continual change in order for their survival and prosperity.

The banking environment is dynamic and always presenting totally new challenges to an individual organization. The principal business activity of most banks is lending. This is because the loan portfolio typically is dominant as the largest asset and also as a source of revenue to a bank. Banks lend in order to grant loans on a sound and collectible basis, to invest their funds profitably for the benefit of shareholders and also to serve the legitimate credit needs of their communities. The business of lending presents a risk of default, which worsens as the business environment factors such as economic and political environment, also worsens. The increase in NPLs in a bank tends to be followed by decrease in measured cost efficiency, and therefore low profitability.

The purpose of this study was to identify the strategic responses undertaken by KCB in addressing the challenge of non-performing loans. KCB is one of the largest banks in the East African region, having branches in Kenya, Southern Sudan, Ruanda, Tanzania and Uganda. The bank has the largest asset base and carries out lending in all its subsidiaries. The loans therefore are segmented into several portfolios in order to meet the needs of different customers in the region.

The study made use of primary data, which was collected through face to face interviews with the researcher in order to obtain an in-depth investigation and capture the real-life context of KCB. An interview guide was used to collect data on the response strategies adopted by the bank in managing non-performing loans. A total of fifteen respondents were interviewed who comprised managers in Retail, Mortgages, Credit, Risk and Operations. The data obtained from the interview guide was analyzed qualitatively by making general statements on how categories or themes of data are related. Content analysis was done by observation and giving detailed description of the strategic responses given.

The strategic responses identified included the enhanced credit analysis, centralization of lending processes, regional portfolio management, frequent customer physical visits, training of staff, independent Risk and Credit Administration Units and applying temporary restrictions on lending to certain sectors.

As a result of the research findings, it was recommended that further research should be undertaken on the implementation and effect of such response strategies on different portfolios, which represent different customer segments. It will be interesting to carry out an impact analysis on such strategies on each individual portfolio and come up with the best loan management diagnosis for each of the portfolios. This will help the bank to apply the right strategies that would match a particular loan portfolio.

The limitations of this study included that the respondents were very busy individuals and therefore a time constraint was experienced during the research. The second limitation applies to all case studies, where the findings cannot be used for generalization purposes because the findings may be unique to the institution depending of the level of development, the current environmental and the internal capabilities. Lastly, the secrecy in a financial institution is a limitation because crucial information cannot be obtained because the respondents have committed to keeping in house affairs as confidential as possible.

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CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

All organizations are dependent on the environment for their survival. According to Ansoff & McDonnell (1990), organizations are environment dependent and environment serving. Most authors contend that it is the fact of the organization's dependence on the environment that makes the external constraint and control of organizational behaviour both possible and almost inevitable.

Pearce and Robinson (2003) categorize the business operating environment into internal and external environment. The external environment refers to those factors outside the organization's influence but which affect the organization's operations. The external environment presents opportunities which the firm can exploit and poses threats which can hinder the organization's activities. The internal factors refer to factors within the organization which the organization exercises a great deal of control over and which affect the organization's operations.

According to Bluedorn (1979), an organization has certain patterns and events which are determined by the extent of the environment turbulence and the amount of resources available to support the organization. Ansoff & McDonnell (1990) define environmental turbulence as a combined measure of the discontinuity or changeability, predictability, and frequency of the shifts of the firm's environment. Strategy creates link between an organization and the environment. To achieve its objective the organization chooses strategies that align them properly with environment. This is aimed at avoiding any mismatch between the organization and the environment. According to Pearce and Robinson (2003), in order for organizations to achieve their goals and objectives it is necessary for them to adjust to their environment.

1.1.1 Environment dependence

Environment dependence emerges from the external environment's control of resources, which an organization needs to effectively function in order to counter the turbulence in the environment. Successful operation, and indeed survival, will require organizations to focus on effective responses to environmental turbulence. Strategic responses according to Pearce and Robinson (2003) are a set of decisions and actions that result in the formulation and implementation of plans designed to achieve a firms objectives. Strategic responses are part of competitive strategies that organizations develop in defining their goals and policies. They are reactions to what is happening on the environment of the organization.

Ansoff & McDonnell (1990) asserts that the management system used by a firm is a determining component of the firm's responsiveness to environment changes because it determines the way that management perceives the environment, diagnosis their impact on the firm, decides what to do and implements the decisions. Ansoff & McDonnell (1990) noted that strategic responses involve changes in the firm's strategic behaviours to assure success in transforming future environment. Firms in dynamic industries respond to environmental changes and competitive forces in different ways. Some improve current products, diversify and divest, while others employ techniques that ensure firm's internal strengths and the opportunities faced in the external environment. In the banking sector, Kiyai (2003) noted that some banks respond to challenges in loan management by using restructuring techniques such as extended repayment periods, interest waivers, interest holidays, capital holidays concessions additional facilities and conversions.

Each organizations response to an environment is unique to the particular environment and the success on the particular strategy is also unique to the organization. David (2003) observes that strategists in most successful organizations take the time to formulate, implement and then evaluate strategies deliberately and systematically.

1.1.2 Non-Performing Loans

A major problem being observed all over the world in the banking sector is the problem of bad loans. Indeed Berger et al. (2002) observed that failing banks have often shown a level of bad loans and that such banks increase in non-performing loans tend to be followed by decrease in measured cost efficiency, suggesting that high levels of problem loans cause banks to increase spending on monitoring, working out, and / or selling off these loans, and possibly become more diligent in administering the portion of their existing loan portfolio that is currently performing. Therefore, the first step of building a stable and strong financial system is to minimize the non-performing loans (Crotty and Jobone, 2004).

Loans are a major output provided by a bank, but the loan is a risky output. There is always an ex ante risk of a loan to eventually become non-performing. Non-performing loans can be treated as undesirable outputs or costs to the bank that does the loaning, which decreases the bank's profitability (Chang, 2009). The risk of NPL becomes worse off as the external operating environment becomes worse off such as economic depression. Controlling the NPL level becomes therefore important for both an individual bank performance (McNulty et al, 2001) as well as the economy's financial environment.

In any banking system, the bad loans problem consists of a stock component, old debt that is not performing and a flow component, new lending that may become non-performing. The two components are linked by normal client relationship in banking and in some countries, by the government's encouragement or even directing state owned enterprises. The NPL is a source of credit risk that is the probability that some of the bank's assets, particularly its loans will decline in value and become worthless or generate returns below required level (Sanda et al., 2005). Prudent credit risk assessment and creation of adequate provisions for bad and doubtful debts can cushion the banks risk. However, when the level of non-performing loans (NPLs) is very high, the provisions are not adequate protection. According to the CBK report (March, 2011) the level of NPLs in 2011 was estimated at Shs. 33 billion or 8.2% of advances, down from 9.2% in 2009 or Shs 35.5 billion of advances as compared to 17.6 percent in December 2004. The decline in gross non-performing loans was supported by enhanced credit appraisal standards adopted by banks in 2010.

According to Haruna (2007), non-performing loans is considered as one of the major causes of the economic stagnation problem. Each non-performing loan in the financial sector is viewed as an obverse mirror image of an ailing unprofitable enterprise. From this point of view, the eradication of non-performing loans is a necessary condition to improve the economic status. If the non-performing loans are kept existing and continuously rolled over, the resources are locked up in unprofitable sectors; thus, hindering the economic growth and impairing the economic efficiency (Robinson, 2001).

Mullei (2003) observes that as the banking sector expands at an increasing rate and becomes intensely competitive, every organization needs to adopt some strategies which will enable it to have a competitive edge over the others. Thus many businesses will continue to seek profitable ways in which to differentiate themselves from competitors. Strategies are at ends and these ends concern the purpose and objectives of the organization. They are the things that organizations do, the paths they follow and the decisions they take in order to reach certain points or level of success. As the banks arm twist each other in wooing customers to take loans from them which some have even gone to the extent of offering non secured loans, the greatest challenge which all the banks faces is the default or nonpayment of the loans by the customers which leads to non performing loans. This therefore calls for a change of tact by employing new strategies (Mullei, 2003).

1.1.3 Banking industry in Kenya

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya (CBK) Act and the various prudential guidelines issued by the CBK. The banking sector was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system.

According to CBK (2010), as at 31st December 2010, the banking sector comprised of the Central Bank of Kenya, as the regulatory authority, 44 banking institutions (43 commercial banks and 1 mortgage finance company), 2 representative offices of foreign banks, 5 Deposit-Taking Microfinance Institutions (DTMs) and 126 Forex Bureaus. 31 of the banking institutions are locally owned while 13 are foreign owned The locally owned financial institutions comprise of 3 banks with public shareholding, 27 privately owned commercial banks, 1 mortgage finance company (MFC) while 5 DTMs and 126 forex bureaus are privately owned. The foreign owned financial institutions comprise of 9 locally incorporated foreign banks and 4 branches of foreign incorporated banks.

The CBK (2010) further affirm that the total assets increased by 24.4 percent from Ksh. 1.35 trillion in December 2009 to Ksh. 1.68 trillion in December 2010. The growth was supported by the increase in loans and advances. The number of loan accounts increased from 1.67 million in December 2009 to 1.74 million in December 2010. During the same period, the number of deposit accounts increased from 8.7 million in December 2009 to 12.8 million in December 2010. This growth demonstrates increased access to financial services by the populace. CBK (2010) shows that the ratio of non-performing loans to gross loans improved from 8.0 percent registered in December 2009 to 6.3 percent in December 2010. The reduction in credit risk is largely attributable to enhanced appraisal standards deployed by banks.

The CBK (2010) categorizes the financial institutions into three tiers; Large, Medium and Small. It further indicates that Kenya Commercial Bank (KCB) falls in the large tier category with the largest market share of 18.9%, net assets of Kshs. 223.025 million and a high customer deposit base.

Over the last few years, the banking sector in Kenya has continued to grow in assets, deposits, profitability and products offering. The growth has been mainly underpinned by an industry wide branch network expansion strategy both in Kenya and in East Africa community region as well as automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional 'off-the-shelf' products. The CBK (2009) emphasizes that the banking institutions will need to cope continuously with changing business environment and a continuous flood of new requirement via a robust ICT platform, while staying sufficiently agile. Consumers will continue to demand individualized services, and-to demand them faster than ever. Hence banks will continue aggressively to design new products that leverage on ICT to remain competitive CBK (2009).

1.1.4 Kenya Commercial Bank Limited (KCB)

According to KCB (2009), KCB commenced operations in 1896 when its predecessor, the National Bank of India opened a branch in the Coastal Town of Mombasa. In 1958 Grindlay Bank of Britain merged with National Bank of India to form The National and Grindlay Bank. In 1970, the government of Kenya acquired 60% shareholding in

National and Grindlay bank and renamed it the KCB. In 1976, the government acquired 100% shares, effectively taking full control of the largest commercial bank in Kenya. A wholly owned subsidiary, Savings & Loan (K) was acquired in 1972 to provide mortgage finance.

The government progressively started reducing its shareholding in KCB to 80% in 1988, 70% in 1990, 60% in 1996 and 35% in 1998. In June 2004 it offloaded a further 9% holding by renouncing its rights in a Rights Issue. The government however continues to remain a single major stakeholder controlling 26.2% stake in the Bank. In 2008, the Government again renounced its Rights in a 1 for 9 Rights Issue thus further reducing its shareholding to 23.6%. The completion of the last Rights issue has seen a drop in government holding to 17.7% as it did not take its allocation (KCB, 2009).

According to KCB (2009), KCB's business objective is to provide banking services to both individual and corporate entities. Among the products are retail banking, corporate banking, treasury and mortgage finance. The KCB strategy is to fully exploit the IT system's benefits, roll out new products depending on the market, protect stakeholder value and investment, attract and retain top employee talent, continue to be profitable and to provide leadership in terms of corporate governance practices and standards as well as support for needy communities through the KCB Foundation (KCB, 2009).

1.2 Statement of the Problem

The operating business environment is becoming increasingly dynamic, complex, diverse and perhaps, hostile. Ansoff and McDonnell (1990) observe that different organizations will be required to deal with continually changing challenges. There can be no single prescription for future success which will apply to all organizations. Each firm will be required to diagnose its unique pattern of future challenges, threats and opportunities, and then must design and implement a unique response. Ansoff (1987) contends that organizations depend on the environment for the resources and also to discharge their outputs.

Over the past years, the Kenya financial sector has witnessed phenomenal growth in its asset base, which is attributed to the increase in deposits and injection of capital as well as retention of profits by industry players. To maximize on market opportunities, most banks have been flexible and even going into an all out lending spree without undertaking prudent assessment measures. This has led to the increase of non-performing loans and followed by decrease in measured cost efficiency and profitability and therefore banks have been forced to respond to this menace.

Locally, various studies on strategic responses have been conducted. Mathara (2007) undertook a research on the response of National Bank of Kenya to the challenge of Non-performing loans and found out that the challenges the NPLs pose to the bank are liquidity problems, low profitability, bad public image and problems with debt collection. Kanyiri (2005) did strategic response of commercial banks in Kenya to the challenge of

Non-performing loans and the results were that banks introduced new policies and procedures to disburse loans, subjecting of credit proposals to rigorous risk assessment by the lending officers, vetting of credit proposals by senior management for objectivity and avoiding lending to seasonal or non performing sectors. On her part, Ndegwa (2010) undertook a research on the strategic responses by Commercial Bank of Africa to the challenges of non-performing loans. She observed that the banks response strategies include, leadership change, turnaround strategy comprising both retrenchment and restructuring of the bank, culture change, re-capitalization of the bank, technology enhancement and marketing initiatives. Angara (2010) on his research in Strategic responses adopted by KCB to change in the environment observed that the banks responses included improvement in human resource management, establishment of research and development department, adoption of a marketing system to reach its clients alongside the use of modern IT system and taking very calculated less risky ventures for financial investment.

The few studies on responses to the NPLs cannot exactly represent the case of KCB. This is because the strategies employed by one bank may not necessarily work in another bank. In today's business world organizations operate as open systems. The external environment presents opportunities and challenges to organizations. Organizations are in turn required to respond to the changing environment by developing aligning strategies. KCB exists in such an environment and is presented with the challenges of non-performing loans. What strategic responses have KCB adopted to cope with the challenge of non-performing loans?

1.3 Objective of the Study

This research seeks to determine the strategic responses used by KCB to cope with the challenge of non-performing loans.

1.4 Value of the Study

It will assist KCB management to evaluate how effective they have been in responding to the challenge of NPLs. This may enable them identify gaps in their responses which may enhance their strategic response as a result move to effectively manage the non-performing loans which will improve their financial performance.

This study will benefit the government and especially the Ministry of Finance for making policy decisions whose overall objectives are to reduce the amount of non-performing loans and at the same time accelerate the rate of growth in the banking industry sector and take advantage of the improved economy thus more lending to individuals and institutions.

It will be useful to the shareholders of the bank in evaluating the effectiveness of the banks management response to the challenge of non-performing loans as they try to reduce the loans to a manageable level. Other organizations can also use the response strategies employed by the bank to manage the challenge of non-performing loans. It will be useful to other researchers and scholars as it will contribute to the body of knowledge in the area of strategic responses to the problem of non-performing of loans.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This section explores theoretical and empirical literature touching on the strategic responses with regard to the challenge of nonperforming loans. The purpose of this section is to establish the foundation for the proposed study and identify a framework within which primary data will be contextualized and interpreted.

2.2 Business operating Environment

According to Pearce and Robinson (2003), the business operating environment can be categorized into internal and external environment. The external environment refers to those factors outside the organization's influence but which affect the organization's operations. The external environment presents opportunities which the firm can exploit and poses threats which can hinder the organization's activities. The internal factors refer to factors within the organization which the organization exercises a great deal of control over and which affect the organization's operations. This presents the organization's strengths and weaknesses. The internal environment therefore constitutes an organization's internal capability which is essential in addressing the external environment. Pearce and Robinson (2003) further argue that in order for organizations to achieve their goals and objectives it is necessary for them to adjust to their environment.

Johnson and Scholes (2005) contend that the environment encapsulates different influences. It is quite difficult to make sense of this diversity. They view future environment as likely to be different from the past. Having scenarios of possible futures would in turn help managers to consider the different ways in which strategies might need to change depending on how the environment behaves. The external environment influences an organization's strategic development by creating opportunities and threats, David, (2003). Successful strategies rely heavily on the organization having the strategic capability to perform at the level that is required for success. An understanding of the strategic capabilities is important because it aids an organization to determine whether its strategies continue to fit the environment in which it operates and the threats and opportunities that exist. Strategic development is concerned with changing environment; strategic capability is about providing products or services that customer's value or management value in future (Beer and Eisenstat, 2000).

2.3 Strategic alignment to environment

As the business operating environment changes, firms must change strategies to survive. With each new strategy, new capabilities are developed. The adoption of dynamic perspective on strategy alignment necessitates a shift in emphasis towards dynamic capabilities (Lynch, 2003). Dynamic capabilities is an approach to strategy that tries to identify the dimensions of firm specific capabilities that can be sources of advantage and to explain how combinations and competencies and resources, can be developed, deployed and protected.

The operating environment involves factors in immediate situations that may provide many of the challenges a particular firm faces in attempting to acquire needed resources or in striving to profitably market its goods and services. According to Burnes, (2004), among the most prominent of these factors are a firm's competitive position, customer profile, reputation among suppliers and creditors. The operating environment differs from remote environment in that the businesses can be much more proactive (as opposed to reactive) in strategic planning than is the case with remote factors.

Aosa (1998) observed that as the organization environment changes, it is necessary that the firm continuously adopts its activities and internal configurations to reflect the new external situations, failure to do this endangers the future success of the organization. Pierce and Robinson (2003) further argue that even if an organization has no outstanding competencies and capabilities, managers still must tailor strategy to fit the firm's particular resources and capabilities. They identify three levels of strategy namely corporate level, business level and functional level.

The corporate level involves the setting of objectives and forming strategies at the corporate level, usually by the board of directors and the Chief Executive Officer. Decisions at this level are characterized by greater risk, cost and profit potential, as well as longer time horizons and greater need for flexibility. It includes decisions such as choice of business, dividend policies and priorities for growth. The business level involves translating general statements of direction and intent developed at the corporate level into concrete, functional objectives and strategies for individual business divisions or strategic business units. This is carried out by the business and corporate managers.

The functional level is carried out by managers of products, geographic and functional areas. They are the implementers and executioners of a company's strategic plans. It involves the development of annual objectives and short term strategies in areas such as production, operation, research and development, marketing, finance and accounting (Pierce and Robinson, 2003).

The dynamic and turbulent environment therefore calls for organizations to continuously respond by developing internal capabilities to match the environment. Angara (2010) observes that organizations have found themselves in a position where they not only have to address environmental changes but actually anticipate them. Liberalization and globalization have further opened up the markets to environmental forces. With these ever changing opportunities and challenges, the organizations management must continuously create a fit in order to survive. Grant (1991) agrees that survival and success for an organization occurs when an organization creates and maintains a match between its strategy and environment and also between its internal capability and the strategy. Carvey and Kipley (2010) observed that only managements that can implement a system to respond to strategic surprises during these highly turbulent levels are those who have a high probability of survival and success.

2.4 Strategic responses to the changing business environment

According to Ansoff and McDonnel (1990) strategic responses involve changes in the organizations strategic behavior. Such responses may take many forms depending on the organizations capability and the environment in which it operates. Well developed and targeted strategic responses are formidable weapons for the firm in acquiring and sustaining a competitive edge. Senior (1997) further notes that there are various catalysts for organizational changes such as restructuring. These triggers may include the purchase of new IT equipment or systems, business process intensification/ extensions, the re-design of group jobs, staff right sizing and subsequent staff cutbacks as well as redundancies.

Firms largely are open systems where there is continuous interaction and interfaces with the external environment and therefore they should respond to the challenges posed by the environment and also match the strategy to internal capability. Aosa (1998) contend that strategy is creating a fit between the external characteristics and internal conditions of an organization to solve a strategic problem.

In the past years managers developed and operated according to managerial mindsets formed through years of experience (Bettis and Prahalad, 1995). Managers' experiences were often in traditional organizations employing formal strategic planning tools. However, the traditional managerial mindset can no longer produce effective strategies and strategic processes in the new competitive landscape. The watchword in the new competitive landscape is flexibility in strategy and organization. Because of the rapid changes in technology and speed with which new products are introduced to the market, firms must remain flexible in the strategies they employ to respond to competitors' strategic actions. To have strategic flexibility, firms must use a flexible process of strategic decision making to maintain flexibility in the deployment of critical resources.

Managers must also develop a mindset that allows cooperation with competitors as well as traditional economic competition. Because of the need to pool resources to develop more and better new technology in order to remain competitive, firms have been forced in numerous cases to form competitive alliances with current and potential competitors (Bettis and Prahalad, 1995). Strategic alliances are particularly prominent between domestic and foreign competitors, but are also numerous between domestic competitors to help fight off foreign competition or achieve, at least, competitive parity in global markets.

According to Banbury and Mitchell (1995), due to the dynamism of the new competitive landscape, firms cannot remain static even if they operate in mature industries. Incremental (and perhaps even radical) innovation may lengthen the product life cycle and change the competitive dynamics within the market. Thus, firms in the new competitive landscape must achieve dynamic efficiency regardless of their industry's life cycle (Costa, 2003). As such, managers must have an entrepreneurial mindset, emphasizing innovation in most industry settings.

The significant dynamism in the new competitive landscape requires that firms concurrently unlearn and learn. Managers must have a mindset that allows them to unlearn traditional practices, processes, and strategies and to be receptive to new ones. In fact, as argued, they must have a learning-oriented mindset; the ability to learn and unlearn is important. Levinthal and March (1993), further argue that learning can improve organizational performance, but also limit future improvements. Because of the simplified world and the reinforcing nature of success from learned behavior, firms become vulnerable to environmental change. Therefore, the managerial mindset in the new competitive landscape must entail continuous and simultaneous unlearning and learning.

Finally, the managerial mindset must change from a focus on a vertical to a horizontal organizational structure. A radical re-conception of organization structure is required. They refer to this change in the managerial mindset as a frame break. The traditional hierarchical structures slow decision making and implementation processes. Horizontal structures with decision making decentralized to cross- functional teams unleash creative forces in the organization. These forces are necessary for a firm to respond and operate in the new competitive landscape.

Competition positioning and competitive advantage are two central components of marketing strategy. Managers routinely assess their brand's market position relative to a well defined group of competitors and undertake actions such as evaluating competitive products' key features to gain insights. However, in spite of the emphasis on competitive positioning and vying for relative advantage, the scope and nature of condition are not well defined or operationalized. This may be due to the viewpoint, from which competition is defined by Day and Nedungadi (1994), because competition typically is characterized from a firm's perspective instead of from a customer's perspective. The optimal design of an organization depends on trade-offs associated with various characteristics such as information, incentives, and coordination which in turn are a function of the environment in which the firm operates (Roberts, 2004).

An external shock to the environment, such as an increase in the intensity of product market competition, can cause firms to reorganize along various dimensions. One traditional explanation is that firms are not optimizing and that competition forces firms to eliminate organizational slack (Liebenstein, 2006). However, explicit changes to organizational design need not be the result of earlier inefficient behavior, but could be an optimal response to the trade-offs inherent in distinct strategic and design choices.

Porter (1980) notes that companies compete with the firms that most resemble them, but leaves open the question of how to identify and assess inter category competitors (i.e., those from different product categories). On his part, Aaker (1992) describes three competition categories, which include very direct, less intensive direct and indirect types. Roberts (2003) further categorizes competition as brand, industry, form or generic, based on price cross-elasticity and substitutability, which again defines competition from a firm's perspective.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research Design

The research design used was a case study. A case study is an in-depth investigation of an individual, institution or phenomenon. The primary purpose of a case study is to determine factors and relationships among the factors that have resulted in the behavior under study. A case study, when used intricately and when overlaid with influences of themes from the practice area, enables further exploration and reflection on previous and future practice.

The case study research study was adopted in this particular study since not all the target population of the study will be knowledgeable on the strategic responses adopted by the bank on the problem of non-performing loans. In light of this therefore, a case study design was deemed the best design to fulfill the objective of the study as the results were expected to provide an insight in understanding what strategies the organization has adopted in overcoming the non-performing loans. A case study research design was used to capture the real-life context, which gave the researcher a sharpened understanding of why the loan recovery trends behave the way they do in the organization.

3.2 Data Collection

The study made use of primary data which was be collected through face to face interview with the researcher. An interview guide was used to collect data on the response strategies adopted by the bank in managing non-performing loans. An interview guide is a set of questions that the interviewer asks when interviewing.

The respondents were KCB managers responsible for loan processing, administration or support. The managers therefore worked in the following departments: Credit, Mortgages, Finance, Corporate, Retail banking and Risk. The researcher believes that this made it possible to obtain data required to meet specific objectives of the study. These respondents were considered to be key informants for this research. In addition the departments in which the intended respondents work in are the key host of strategies relating to the management of loans.

3.3 Data Analysis

The data obtained from the interview guide was analyzed qualitatively by making general statements on how categories or themes of data are related. The qualitative analysis is adopted in this study in order to be able to describe, interpret and at the same time criticize the subject matter of the research since it would have been difficult to do so numerically.

The qualitative analysis was done using content analysis. Content analysis is the systematic qualitative description of the composition of the objects or materials of the study. It involves observation and detailed description of objects, items or things that comprise the object of study. The respondents' views were captured and coded to enable responses to be grouped into various categories. Tables and other graphical presentations as appropriate were used to present the data collected for ease of understanding and analysis.

CHAPTER FOUR- DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction

This section presents the analysis and findings of the study as set out in the research methodology. It summarizes the major findings in the strategic responses adopted by KCB to cope with the challenges of non-performing loans. The method of data collection was done through the use of in-depth interviews. The interview guide contained both open ended and closed ended questions which were developed in line with the objective of the study The objective of the study was to determine the strategic responses used by KCB to cope with the challenge of non-performing loans.

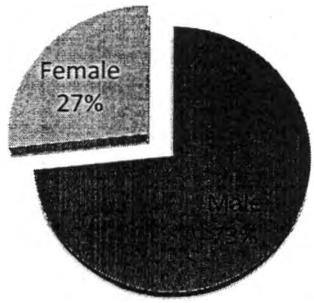
4.2 Demographic Information

In order to capture the general information of the respondents, the issues covered included gender, period worked in the current unit and the total length of service in the institution. This was important because it enhanced the reliability and gave the basic understanding of the respondents.

4.2.1 Gender

The respondents who participated in the research were mostly male as indicated in the below table.

Fig.4.1 Gender



Source: Interviews

4.2.2 Respondent Division/Unit

This section sought to establish the unit or division from which the respondent works in KCB. Table 4.1 indicates that a total of 15 people were interviewed, with most of them from Credit division (7 managers).

Table 4.1 Respondent Division/Unit

Division/Unit	Credit	Retail	Mortgages	Operations	Risk	Total
Number	7	3	2	2	1	15

Source: Interviews

4.2.3 Period of service in current division/unit

Table 4.2 Respondent period in current division/unit

Years worked in current division/Unit	Number of Respondents	Percentage (%)
1-3	4	26.7
4-6	8	53.3
7-15	2	13.3
Over 15	1	6.7

Source: Interviews

From the above table, the respondents indicated that they had worked in the current stations for 4 to 6 years, while one respondent had worked in the current station for over 15 years.

4.2.4 Period of service in the organization

Table 4.3 Respondent period in current division/unit

Length of Service in KCB (Years)	Number of Respondents	Percentage (%)
1-10	1	6.7
11-20	6	40
21-30	7	46.7
31 and above	1	6.7

Source: Interviews

Table 4.3 indicates that most of the respondents have work experience of over 11 years in KCB and one has worked for the institution for more than 31 years.

4.3 Strategic Responses by KCB to the challenges of NPLs

This section sought to obtain the strategic responses adopted by KCB to cope with the challenges of non-performing loans. First, the researcher sought to understand the loan portfolio considered by KCB to carry more weight in the risk of default. Then a number of questions were used to capture as many responses as possible to the problem at hand.

4.3.1 Loan portfolio that carries higher risk of default

All managers interviewed are well versed with the existing loan portfolio types that are considered for lending in KCB. These include personal loans, mortgages, SMEs, staff loans, asset finance products, corporate loans, micro loans, salary advances and card business. The consensus at KCB is that the personal loans portfolio carries the highest risk compared to other loan portfolios, mainly because the loans are not collateralized. However, there are some managers with different views on the high risk portfolio. Those with the view that corporate portfolio carries more risk state that such loans have colossal amounts granted to individual entities and such facilities are securitized by high valued complex securities which may not be easily recoverable. Any error in the analysis of such a facility can cause losses to the bank.

The Small and Medium Enterprises (SME) and micro loans portfolios are also considered by some managers to carry the highest risk compared to other portfolios. The reason is that the borrowers in this tier are considered to lack elaborate credit history and that most operate startup businesses. The problem on this is that thorough credit assessment with proper customer disclosure is required. This is normally costly and any short cuts could result in fraudulent cases or other losses.

The following sections provide the actions taken by KCB not only to reduce the chances of loans migrating in to non-performing loans but also increase the chances of recovery as stated by the respondents.

4.3.2 Enhanced credit analysis

KCB has enhanced credit risk analysis tools and techniques in order to reduce the chances of loan default presented by the current environment. In particular, intelligent software has been developed and used by the bank to assist in decision making and analysis. Credit managers have also embraced KYC (Know Your Customer) policy in addition to making use of credit reference bureaus credit reports while reviewing facilities for draw down. KYC is the due diligence and bank regulation that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business.

Credit analysts are required to carry out certain actions such as opportunity assessment to provide a framework for comprehensive risk analysis. They should understand the industry risks by identifying the changes in the environment in which the borrower operates by examining the economic, market, demographic, and other forces that are generally outside the borrower's or the lender's control. This assessment enables the analyst to identify the markets and customers that are good to lend money.

The credit analysts further probes into the real reasons behind a borrower's loan requests. The borrowers are expected to fully disclose their borrowing intention which avoid borrower's misappropriating the funds borrowed and therefore reduces the risk of default. Carrying out financial statement analysis and cash flow analysis also enables credit analysts to interpret financial statements as a reflection of the entire range of a company's operations, from sales and distribution to purchasing. Understanding these facets of a borrowing company enables the lender to know the important component of the repayment source and margins.

4.3.3 Centralization of lending processes

KCB acquired the services of consultants to reengineer the processes that affect its stakeholders. Lending decisions such as securities documentation, loan analysis and loan draw down, restructuring and waiving of arrears and many other processes are applied to most loan portfolios and carried out centrally by different units.

The main purpose of centralization of the lending processes is to increase effective controls and therefore reduce the risks involved in lending process. The clear separation of roles from one unit to another enhances quality of the tasks performed and reduces the workload in the branches as earlier experienced. Before the implementation of this strategy, KCB branches undertook not only their basic role of cash management and sales, but also all lending procedures.

4.3.4 Regional portfolio management

KCB has established a regional portfolio management charged with the responsibility of not only monitoring compliance and approval conditions but also daily tracking of any arrears positions. A region refers to a collection of KCB branches within a certain geographical area. A region is headed by a Regional Business Manager and oversees branch related tasks.

There are designate loan portfolio managers in each region and credit administrators in each branch to closely monitor and reverse migration. Regional managers work closely with branch officials and follow up matters arising in the normal working hours.

4.3.5 Frequent customer physical visits

The credit administrators in the branches and relationship managers carry out visitation to customer physical location in order to closely monitor business performance and also to show partnership with the individual borrowers. Visiting customers before and after loan draw down helps to uncover a customer's misappropriation of funds if any.

A plan on customer visits is scheduled early in each year while setting individual performance targets. On each visit, a detailed report is written covering the customer or the business evaluation. Monitoring the loans from inception helps to detect early warning signs of default and therefore institute recovery measures before it is too late. It also gives details on prospects for further lending, which the customer may not diagnose early. The credit administrators and relationship managers act as loans counselor by suggesting to the customer the most appropriate type of loan and explaining specific requirements and restrictions associated with a loan. With such an elaborate assessment in lending, the costs related to loan management are reduced because of early detection of NPL problem related situations.

Other efforts to ensure the bank is in contact with the customer after loan draw downs include intensive telephone use, emails and demand letters. Auto SMS alerts are also being developed to ensure frequent communication with the customer. Where no response is received and all the above methods have failed to yield the desired results, then other methods such as employing customer tracing and collection agencies, lawyers and auctioneers to ensure the loans are repaid.

4.3.6 Training of staff

Lending is a broad field consisting of so many detailed tasks such as securitization, draw down, monitoring and recovery. These tasks can be complex because of country, regulatory or institutional policies and therefore any errors of commission or omission presents different levels of risks to a lending institution. For this reason, the need to constantly enhance credit analysis skills has never been more evident than today, therefore KCB has introduced courses that are offered by internal and external facilitators and also an E-learning facility to permit more knowledgeable staff in an efficient and cost-effective manner.

The training function is administered from KCB's training centres by Human Resources division and is included as a key result area in an individual's score card. The courses offered include bank lending environment, credit analysis, understanding financial statements and risk management. Credit officers are required to enroll for credit courses internally or externally to enable them master and review the latest trends in financial innovation and to ensure standards are maintained in the organization.

4.3.7 Independent and reinforcement of Risk and Credit Administration Units

The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. Since exposure to the risk of default continues to be the leading source of problems in banks world-wide, KCB is keenly aware of the need to identify, measure, monitor and mitigate the risk of default as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

The independency and reinforcement of the Risk and Credit Administration units is believed to enable sound practices for managing this risk. The sound practices set out specifically includes establishing an appropriate credit risk environment, operating under a sound credit-granting process, maintaining an appropriate credit administration, measurement and monitoring process and ensuring adequate controls over credit risk.

4.3.8 Restrictions on lending

The respondents generally agreed that there exists some restriction to lending strategy adopted by KCB to reduce the risk of default. The issue of sector concentration policy sets a limit for only single borrower; this is to avoid the risk of over exposure in case of default. This also applies to owners of more than one company with totally different considerations.

Further restrictions included temporary restrictions to individuals or organizations where employees have frequently defaulted and even to some KCB branches where the level of risk is high. Finally the lending restrictions related to regulatory compliance, such as lending prohibition to persons involved in drug business, money laundering, buying of arms, weaponry, and people in activities that result in destruction of the environment.

4.3.9 Change management as a strategy

The ability to recognize the changes in the business operating environment and to react by using aligning strategies and developing internal capabilities to match the new changes is a desirable aspect of an organization. Change in the organization has an impact on all facets of organizational entities including loan performance in a bank. It is therefore important to be alert and embrace change in the organization when necessary.

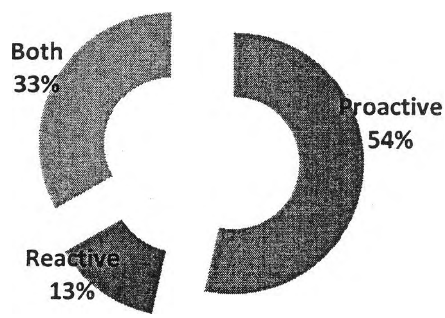
'Making the Difference' slogan has been adopted by KCB to portray a changing and a learning organization to its stakeholders. The ability of KCB to align, execute, and renew itself faster has a great impact in the performance of the organization in all aspects. It is therefore in this context that KCB is willing to adapt to the present environment and shape up for the future. This strategy is demonstrated in one of KCB values stated as 'a willingness to change' and it is an endevour by the bank to make positive impact on its culture, structure, processes, technology and people.

The slogan has assisted the people to embrace change in the organization and very often this is demonstrated on email communication where people sign off their emails with an inclusion of such a slogan. With this attitude, people are able to implement new loan management strategies easily and therefore a positive impact is realized. Without resisting change people are able to learn and use new ICT methods for example the new IT system that is used in the loan processes.

4.4 Approach taken on response strategies

KCB followed a proactive approach to respond to the challenges of NPLs. However there are a few managers who believe that either reactive or both approaches were used to cope with the challenge. These views are validated by the argument that the loan portfolios differ in many ways and that KCB has taken different approaches in its response strategies to different portfolios. The results of the study are shown below.

Fig.4.3 Activity



Source: Interviews

4.5 Discussion of the Results

It is evident from the study that KCB's current external operating environment is diverse and encapsulates different influences as Johnson and Scholes (2005) contend. The authors view future environment as likely to be different from the past which concur with the findings of this study that the large volume loan book in KCB presents diverse and changing challenges. This is true especially when there are major changes in the economic and political environments as is the case in the current situation.

The dangers of bad loans are fully cited by many authors such as Berger et al. (2002) who refer to bad loans as a characteristic that failing banks have often shown and that an increase in NPLs tend to be followed by a decrease in measured cost efficiency. KCB has proactively applied several strategies to minimize or avoid their loans being categorized as bad loans as captured in the findings.

Ansoff & McDonnell (1990) noted that strategic responses involve changes in the firm's strategic behaviours to assure success in transforming future environment. The interviewees pointed out that the bank has sought the services of some consultants including McKinsey & Company to carry out a study and advice on the best practice in transforming the bank from good to great. The general impact of this strategy has transformed the structure, technology, bank processes and people. The KCB structure at the senior management level has been narrowed down, there has been an acquisition of a robust IT system to process all requests, the loans processes have been shortened, centralized and staff have been migrated to new stations as evidenced by Table 4.2 which indicates that most respondents have worked in current division or unit for less than six years, yet their length of work experience in the bank is long (mostly over eleven years). All these actions are environment alignment strategies to collate with the observation made by Aosa (1998) that as the organization environment changes, it is necessary that the firm continuously adopts its activities and internal configurations to reflect the new external situations, failure to do this endangers the future success of the organization.

The study further reveals that strategies such as restructuring and waiving of arrears are used by the bank. This concur with the findings of Kiyai (2003) who noted that some banks respond to challenges in loan management by using restructuring techniques such as extended repayment periods, interest waivers, interest holidays, capital holidays concessions additional facilities and conversions.

Finally, as part of KYC policy, KCB managers have adopted a mindset that allows cooperation with competitors as well as traditional economic competition to assist in the management of NPLs in the industry. KCISI News (2010) reveals that all commercial banks in the country have demonstrated tremendous commitment by participating in the three successful test runs performed to ensure that their systems are ready for full roll out of data sharing initiative. The support and adoption of CRB as an analysis tool helps to cut off the serial defaulters from the industry. This strategy has been cited by Bettis and Prahalad, (1995) who reveals the need to pool resources to develop more and better new technology in order to remain competitive, firms have been forced in numerous cases to form competitive alliances with current and potential competitors.

CHAPTER FIVE – SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter provides a summary of the findings of the research, the conclusion and the recommendations of the study which sought to establish the strategic responses adopted by KCB to cope with the challenge of NPLs.

5.2 Summary of the findings

This study focused on the strategic responses adopted by KCB to cope with the challenges of non-performing loans. The study made use of primary data which was collected through face to face interview with the researcher. An interview guide was used to collect data on the response strategies adopted by the bank in managing non-performing loans. The respondents interviewed were KCB managers responsible for receiving and processing of loan applications from customers both corporate and retail, the loan administration unit, lending risk unit, the loan recovery unit and retail banking. In order to capture the general information of the respondents, the issues covered included gender, period worked in the current unit and the total length of service in the institution. This was important because it enhanced the reliability and gave the basic understanding of the respondents.

The KCB loan portfolios include personal loans, mortgages, SMEs, staff loans, asset finance products, corporate loans, micro loans salary advances and card business. Personal loan portfolio is considered high risk portfolio because it is not collateralized.

The results indicate that KCB has put in place various strategies to minimize credit risk and they include enhancement of credit risk analysis tools and techniques, setting up a regional portfolio management, reinforcement and establishment of independent Risk and Credit Administration units, training and change management strategies.

5.3 Conclusion

KCB proactively formulated strategies to respond to the challenges presented by its environment in the management of loans. The company's intention was to minimize the problems that arise due to non performance of loans which include the decrease in cost efficiency and also decrease in profitability.

KCB has undertaken the following measures in order to reduce the chances of customer loan default, a challenge presented by the current business operating environment. It has enhanced credit risk analysis tools and techniques. In particular, intelligent software has been developed and used by the bank to assist in decision making and analysis. Regional portfolio management offices have been set up to reinforce the lending processes that are undertaken in the bank. Centralization of the lending processes has been undertaken in order to increase effective controls and therefore reduce the risks. The reinforcement and independency of the Risk and Credit Administration units is also believed to enable sound practices for managing this risk.

The bank has supported training of staff by ensuring that the courses relevant to particular bank processes are available and has also provided the environment to administer the same, branch credit administrators and relationship managers carry out regular customer visits, temporary restriction to lending is also used in the case where credit risk is eminent and cannot be avoided by other means. Finally, change management has been considered critical in all aspects of the bank, including lending. The bank has therefore undertaken measures to promote a willingness to change in the organization.

The response strategies developed by KCB are detailed and results driven. For this reason if the strategies are implemented successfully, then the credit risk will be greatly minimized. This will bring sustained profits and the fulfillment to the KCB stakeholders. The same responses can also be replicated by any other institution facing such challenges in an environment similar to that of KCB. The obtained results could also benefit the government and especially the Ministry of Finance in making critical decisions regarding the minimization of credit risk in the banking industry.

5.4 Limitations for the Study

The most observed limitation is the fact that the respondents of this study were very busy individuals and therefore a time constraint was experienced during the research. The respondents are currently occupied in many aspects in relation to the company's state at the moment. KCB is going through many developments and implementation of strategies already formulated for different fields in the spirit of transforming the company from better to great.

The second limitation applies to all case studies, where the findings cannot be used for generalization purposes. This is because the findings may be unique to the institution depending of the level of development, the current environment and the internal capabilities.

Lastly, the secrecy in a financial institution is a limitation because crucial information cannot be obtained. The respondents have committed to keeping in house affairs as confidential as possible. It is therefore important to recognize that the study may have some scanty information in some areas where full details were not disclosed.

5.5 Suggestions for further research

The research focused on response strategies formulated and used by KCB to cope with the challenge of NPLs. The results obtained did not give suitability of the application of each strategy on each loan portfolio, which is a representation of customer segments.

It is therefore recommended that further research studies be undertaken on the implementation and effect of such response strategies on different loan portfolios. It will be interesting to carry out an impact analysis on such strategies on each individual portfolio and come up with the best loan management diagnosis for each of the portfolios. This will help the bank to apply the right strategies that would match a particular loan portfolio, therefore will reduce costs in the management of loans.

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APPENDIX I: Authorization Letter

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

Telephone: 020-2059162
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE 20/9/2011

TO WHOM IT MAY CONCERN

The bearer of this letter PRISCILLA KIPTOO

Registration No. D61/70593/07

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

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

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

Thank you.

JUSTINE MAGUTU
ASSISTANT REGISTRAR
MBA OFFICE, AMBANK HOUSE

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA OFFICE
P. O. Box 30197
NAIROBI

APPENDIX II: Letter of Introduction

Priscilla Kiptoo

School of Business Management

University of Nairobi

P.O. Box 13720-00100, Nairobi

Dear Respondent,

RE: REQUEST TO RESPOND TO AN INTERVIEW

I am a postgraduate student in the above university. I am currently undertaking a case study on the “Strategic Responses adopted by KCB to cope with the challenges of non-performing loans” as a partial requirement towards the award of an MBA degree.

The purpose of this letter is to humbly request you to cooperate by responding to the questions in the interview as precisely as possible.

Please note that the findings of the research are meant for academic purposes and shall be kept confidential. A copy of the findings will be forwarded to you for your records.

Thanks you,

Yours Faithfully,

Priscilla Kiptoo

APPENDIX III: Interview Guide

PART A: GENERAL INFORMATION

Name of department ....

What is your designation in the department? ....

What is your total work experience in the department? ....

What is your length of time in the Company? ....

What is your gender? (please tick)

Male [ ]

Female[ ]

PART B: STRATEGIC RESPONSES BY KCB LIMITED

Which loan portfolio do you consider to carry more credit risk when compared to other loan portfolios in KCB? ....

....

What actions have the bank managers undertaken to minimize this risk of default? Are they specific to loan portfolios? ....

....

....

Has there been any restriction on lending to a particular group of people, institution or any other group in the past? ....

....

....

Which are the various strategic responses adopted to increase the recovery of the already nonperforming loans in KCB ……………………………………………………………………

…………………………………………………………………………………..

Has KCB structure, processes, technology, people or any other been impacted by such actions taken in response to non performance of loans? ……………………………………..

……………………………………………………………………………………………

……………………………………………………………………………………………

Do you consider the various response strategies adopted by KCB to be proactive or reactive to the treatment of performance of loans?

…………………………………………………………………………………………...

…………………………………………………………………………………………...

What are the possible suggestions you would like to make regarding a working solution to the challenge of non-performing loans even with the increased competition in the banking sector? ……………………………………………………………………..

……………………………………………………………………………………………

…………………………………………………………………………………………...

THANK YOU

APPENDIX IV: KCB Corporate Structure - 2011