

**A SURVEY OF IMPACT OF UNSECURED BANK LOANS ON
PERSONAL FINANCES**

BY

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DECLARATION

This management research project is my original work and has not been presented for a degree in any other university.

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DEDICATION

To my Father and Mother

and

To my loving husband and son with whom we have faced the challenges of life together.

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May God bless you all.

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ABBREVIATIONS

CBK - Central Bank of Kenya

Co-op - Cooperative Bank of Kenya

KCB - Kenya Commercial Bank

NBK - National Bank of Kenya

NIC - National Industrial Bank of Kenya

StanChart - Standard Chartered Bank of Kenya

ABSTRACT

Since the introduction of banking services and in particular lending, banks in Kenya have been offering loans against collateral to their customers. The requirement of an asset locked out a large number of potential clients who did not have collateral but rather had the ability to repay the loans using their salary. In line with financial innovation, the banking industry in Kenya has in the recent past introduced financial instruments and processes in order to respond to the changing environments and customer needs. One of the financial products introduced is the unsecured personal loan which the banks can lend clients on the basis of their employment salary. The objective of this study was to establish the features of unsecured personal loans and their implications on personal finances. A better understanding of these issues will allow for better planning and decision making by potential borrowers as well as provide for a safe and sound financial environment.

The study targeted unsecured personal loan borrowers in 3 large institutions, namely the University of Nairobi, Kenyatta National Hospital and Kenya Airways Ltd. A sample survey design was used for the study due to the limitation of time and the large number of existing unsecured loan borrowers.. A random sample of 150 employees from these institutions was used for the survey. Questionnaires were distributed through the companies' human resources department and payroll office where together with an introductory letter they were attached to 50 pay slips at random. Responding to the questionnaires was voluntary. Data was also collected through the use of financial publications to find out the features of unsecured personal loans. A response rate of 67% was achieved from the number of questionnaires issued to respondents. Data analysis employed the use of tables and percentages for collation and summarization of data gathered as well as graphs for data presentation.

The findings of the study showed that personal unsecured loans are developed to finance client's personal needs. They have a determined maximum repayment period, interest rates and amount depending on the bank offering the loan. The amount that can be offered to a client depends on one's salary capability and banks have different methods to

determine the maximum amount that a client can qualify for. The results of the study showed that most respondents purchased vehicles, shares in the stock market and took study loans. The findings of the study also showed that there was a general decline in personal net worth and net cash flow and thus a negative effect on personal finances for borrowers.

CHAPTER 1

1.0 INTRODUCTION

1.1 Background

This chapter will explain the background of the research study. This will guide in understanding of unsecured lending which is a new facility introduced in the banking industry. It also shows the problem area, the research objectives and the research questions.

In view of financial innovation, the period from the mid 1960s to mid-1980s was a unique one in American financial history (Miller, 1986). Looking backward, he rhetorically asked. "Can any twenty-year period in recorded history have witnessed even a tenth as much (financial innovation)?" Looking forward, he asked the question. "Financial innovation: Is the great wave subsiding?" Answering "No" to the first question and "Yes" to the second, he concluded that the period was an extraordinary one in the history of financial innovation. However, with developments in the world finance sectors, we can disagree with his assessment and answer the two questions somewhat differently.

History shows that financial innovation has been a critical and persistent part of the economic landscape over the past few centuries. In the years since Miller's (1986) piece, financial markets have continued to produce a multitude of new products, including many new forms of derivatives, alternative risk transfer products, exchange traded funds, and variants of tax-deductible equity. A longer view suggests that financial innovation like innovation elsewhere in business is an *ongoing* process whereby private parties experiment to try to differentiate their products and services, responding to both sudden and gradual changes in the economy. Surely, innovation ebbs and flows with some periods exhibiting bursts of activity and others witnessing a slackening or even backlash. Since the introduction of banking services and in particular lending, banks in Kenya have been offering loans against collateral to their customers. This meant that a client was required to have an asset for which a borrowing would be given against. This requirement locked out a large number of potential clients who did not have collateral but rather had the ability to repay back the loans using their regular income. In line with financial

innovation, the banking industry in Kenya has in the recent past introduced financial instruments and processes in order to respond to the changing environments and customer needs. Some of the financial products introduced are unsecured personal loans and credit cards which represent unsecured lending facilities.

The emergence of new successful financial instruments in the industry brings about development of financial systems as well as the economy. Kenya's financial services sector, despite some cyclically, displays continuing evolution and aggressive innovation. The country's leading financial institutions have enhanced and expanded services and products for their clientele. New financial products for consumers reflect an on going integration of external economic influences and improved understanding of local consumers' needs (Market Intelligence, 2006).

For the purposes of this study, financial innovation refers both to technological advances which facilitate access to information, trading and means of payment, and to the emergence of new financial instruments and services, new forms of organization and more developed and complete financial markets. This brings about financial reforms, which describe the actions of market participants and regulatory authorities to address issues raised by the failure to achieve a stable financial and monetary framework (The Economic Council of Canada. 1998).

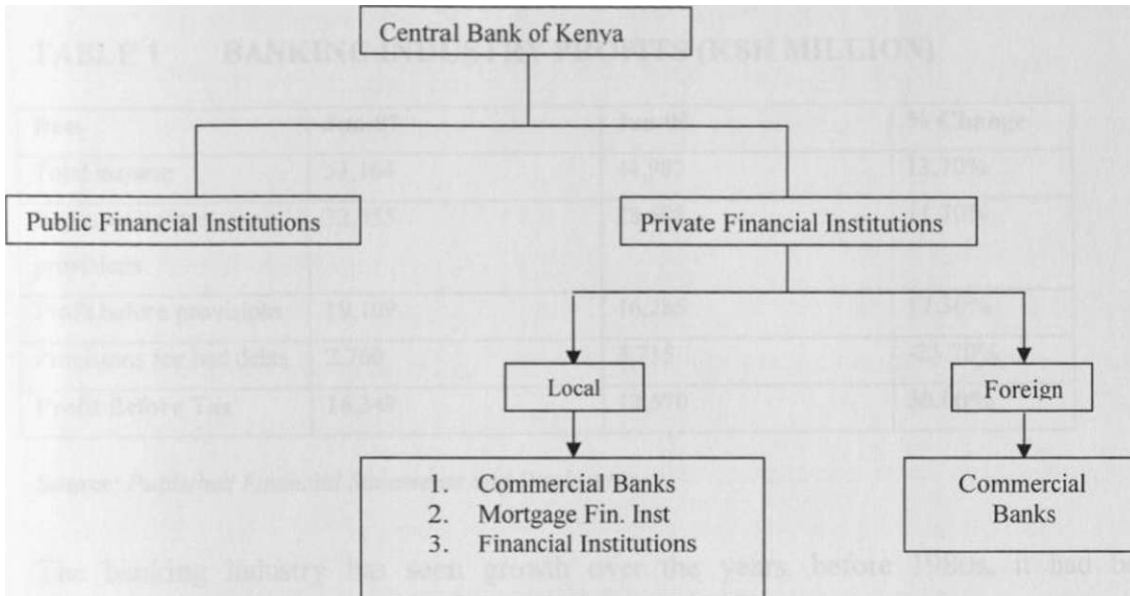
Many studies have shown a relationship between the development of the financial system and economic growth (Valadares. 2004). Development of the financial sector can allow for faster economic growth and "better protection of vulnerable groups to income shocks".

1.1.2 The Banking Industry in Kenya

Kenya's banking industry has expanded significantly since the country attained independence in 1963 (Economist Intelligence Unit. 1995). The country at independence had only seven commercial banks and by 1972 only one more bank had been established. However, during the 1980's a rapid expansion of the banking sector took place by 1982 there were 15 banks and by the end of 1993 there were 30 banks. The number of banks as of July 1995 was 41. Similarly, there has also been a phenomenal growth of non bank financial institutions. When the country attained independence, there were only six financial houses and by 1973 the number had risen to eight. The number of finance house have, however been reduced as a result of the Government decree in 1994 that finance houses should by the end of 1995 have converted themselves into banks and or merge with their parent banks.

According to (Annual Report of the CBK, 2006/07) the financial institutions in Kenya are 45. comprising of 42 commercial banks, two mortgage finance companies (Housing Finance of Kenya - HFCK and Savings and Loans Ltd - S&L) and one non-bank financial institution (Prime Capital and Credit Ltd). Family Finance Building Society, the only remaining Building Society converted its operations to a Commercial Bank with effect from April 30, 2007. The period 2006 -2007 was characterized by rapid expansion of branch network of banking institutions. During the year. 83 branches for banks were approved. The opening of new branches in rural areas is a manifestation that the banks are now moving downstream. This move coupled with the new products that the banks have been launching is expected to improve access to financial services.

Figure 1



Source: Monthly Economic Review, June 2007

The banking sector total assets expanded by 19.9 percent in response to the favorable macroeconomic environment during the period 2006/2007. The growth in assets was funded by an increase in deposits, fresh capital injection and retained profits. The major components of the asset portfolio were loans and government securities. Loans and advances constituted 50 percent of total assets in June 2007, while Government securities comprised 22 percent of total assets. Loans were mainly disbursed to private households, transport and communications, building and construction and manufacturing sectors.

Profitability

As shown in Table 1.0 below, the Kenyan banking sector's pre-tax profits grew by 30 percent from Ksh 12.6 billion in June 2006 to Ksh 16.3 billion in June 2007. The improvement in profitability was attributed to an increase in interest income from loans and advances; increased volume of transactions based and related fees and commission charges coupled with reduction in bad debt charges. The sector derived a greater proportion of its income from loans and advances which constituted 49 percent of total income. Interest income from loans and advances increased by 13 percent from Ksh 22.2

billion in 2006 to Ksh 25.2 billion in 2007. Non-funded income including fees and commission charges constituted 25 percent of total income.

TABLE 1 BANKING INDUSTRY PROFITS (KSH MILLION)

| Item | Jun-07 | Jun-06 | % Change |
|-----------------------------------|---------------|---------------|-----------------|
| Total income | 51,164 | 44,983 | 13.70% |
| Expenses before provisions | 32,055 | 28,698 | 11.70% |
| Profit before provisions | 19,109 | 16,285 | 17.30% |
| Provisions for bad debts | 2,760 | 3,715 | -25.70% |
| Profit Before Tax | 16,349 | 12,570 | 30.00% |

Source: Published Financial Statements and Disclosures

The banking industry has seen growth over the years, before 1980s, it had been dominated by oligopolistic foreign and government owned banks (Economist Intelligence Unit, 1995). Later on, locally owned private sector banks started to gain a significant share of the financial market. The local banks have provided benefits to the Kenyan economy and facilitating the objectives of financial liberalization by boosting competition in the banking industry, stimulating improvements in services to customers and expanding access to credit, especially to domestic small and medium scale businesses as well as personal loans.

The local banks have improved financial intermediation in two areas in particular. First, they have extended access to credit to a segment of the market, principally small businesses and individuals, which have traditionally experienced difficulty in securing credit from the established banks. Local banks and their managers have some advantages over the established banks in servicing this sector, not least because social and community links can provide them with informal channels of knowledge about borrowers (Economist Intelligence Unit, 1995).

Second, some of the local banks provide better services than the established ones in order to attract customers. Opening hours are longer and queues in banking halls shorter. Small scale depositors are provided with better terms than those available in the established

banks, such as higher deposit rates and/or lower minimum balances. It is possible for loan applicants to see the manager, often without making an appointment. Many local banks process loan applications quickly, often sending an officer to visit a new applicant's premises within a day or so and giving a decision within a week. In contrast, a loan application can take several weeks to be processed in the established banks.

1.1.3 Background on Unsecured Loans

A loan is an arrangement to receive cash now and pay for it in future. An unsecured loan refers to credit obtained without collateral (ICapoor, et al 1994). Unsecured loans are obtained for consumer credit which refers to the use of credit to purchase personal needs, such as durable goods, finance education, medical care and other expenses (except a home mortgage). The average loan to each borrower is relatively small. Most loans have maturities from one to five years, repaid in installments, and carry interest rates.

Consumer credit dates back to the colonial times. While it was originally a privilege of the affluent, it came to be used extensively by farmers. No direct finance charge was imposed; instead, the cost of credit was added to the price of goods. With the advent of the automobile in the early 1900s, installment credit - in which the debt is repaid in equal installments over a specific period of time - exploded on the American scene. The movement of the baby boom generation into the age group that tends to use credit most heavily has added to the growth of consumer credit. The 25-44 age group currently holds about 60% of the outstanding debt. The people in this age group have always been disproportionate users of credit, since consumption is highest as families are formed and homes are purchased and furnished. Thus, while the intense use of debt by this age group is nothing new, the fact that it has grown rapidly adds to the overall debt use.

Financial and Opportunity Costs

The use of an unsecured loan provides immediate access to funds, flexibility in money management, safety and convenience, a cushion in emergencies, a means of increasing resources, and a character recommendation if debt is paid in a timely manner (Kapoor, et al. 1994). The use of debt is a two sided coin. Failure to repay the loan may result in the loss of income, good reputation, court action and bankruptcy. Although loans permit more immediate satisfaction of needs and desires, it does not increase total purchasing

power. Loans must be paid for out of future income; therefore, credit ties up the use of future income. Furthermore if one's income does not increase to cover rising costs, one's ability to repay credit commitments will be diminished. Before getting credit, consider whether the goods or services to be purchased will have lasting value, whether they will increase one's personal satisfaction during present and future income periods, and whether one's current income will continue or increase. Credit costs money, it is a service for which there is a payment. The cost of getting an unsecured loan, includes, interest and other finance charges as may be charged from bank to bank.

Measuring Credit Capacity

Before one takes a loan, one needs to ask himself whether he can meet all of the essential expenses and still afford the monthly loan repayments (Kapoor, et al. 1994). An alternative is to find out if one could make some trade offs, for example, if one currently saves a portion of his income greater than the monthly repayment, then he can use these savings to pay off the loan. There are some general rules of the thumb that one can use to find out more on the credit capacity: these include Debt payments- to income Ratio - This is calculated by dividing one's monthly repayments by his net monthly income. Experts suggest that one should not spend more than 20 percent of the net income on credit payments. This is a recommended maximum limit based on the average family, with average expenses not taking into account major emergencies. Another general rule that may be used is. Debt-to-Equity Ratio. This is calculated by dividing one's total liabilities by his net worth. In this calculation, the home or an amount of mortgage is excluded. If the debt to equity ratio is about 1, then you have probably reached the upper limit of debt obligations. In comparison, for business firms the debt - equity ratio should be in the general ranges of 0.33 and 0.50. The larger the ratio, the riskier the situation is for borrowers and lenders. The debt to equity ratio can be lowered by paying off debts.

1.1.4 Background on Personal Finances

There are two documents that one can create to help determine one's financial status and progress (Sebastian. P.1989). These two documents are the personal balance sheet and the cash flow statement: they are also referred to as the personal financial statements. These reports provide information on one's current financial position and present a summary of one's current income and spending. The main purposes of personal financial

statements are to report the current financial position in relation to the value of the items one owns and the amounts one owes and maintain information on one's financial activities.

The Personal Balance Sheet

A balance sheet, also called a net worth statement, it reports what one owns and what they owe (Sebastian. P, 1989). A personal balance sheet is prepared to determine the financial position using the following formula, items of value (what you own) -amounts owed (what you owe) = net worth (your wealth)

Listing the items of value - Available cash and money in bank accounts combined with other items of value are the foundation of one's current financial position. Assets are cash and other property with a monetary value. They may be listed under three categories: Liquid assets: these refer to cash and items of value that can easily be converted into cash. Money in current and savings accounts is liquid and available to the individuals for current spending. The cash value of life insurance may also be borrowed if needed. Household assets and possessions: these are the major portions of assets for most people. Included in this category are homes, cars, and other personal belongings. These items may be difficult to convert to cash quickly. Items on the balance sheet are usually listed at their original cost. However, these values probably need to be revised over time since a five year old television, for example, is worth less now than when it was new. Thus, one may wish to list their possessions at their current value, also referred to as Market value. This method takes into account that such things a home or jewelry increase in value over time. Estimating current value may be done by looking at ads for the selling price of comparable homes, or other possessions. Investment assets: these consist of money set aside for long term financial needs. For example, financing children's education, purchasing a retirement home, and other retirement plans. Since investment assets fluctuate in value, the amounts listed should reflect their value at the time the balance sheet is prepared.

Determining amounts owed - these consist of debts. Liabilities are amounts owed to others but do not include items not yet due, such as next month's rent. A liability is a debt that one owes now. not something one may owe in the future. Liabilities can be divided

into two. that is. Current Liabilities: these are debts that must be paid within a short time, usually less than one year. These liabilities include such things as. medical bills, tax payments, insurance premiums and short term loans. Long term Liabilities: these are debts that are not required to be paid in full until more than a year from now. For example, loans taken to buy cars, pay for education and mortgage loans. The debts listed in the liability section of the balance sheet represent the amount owed at the moment; they do not represent future interest payments.

Computing net worth - This refers to the difference between one's total assets and total liabilities. The relationship is stated as $\text{Assets} - \text{Liabilities} = \text{Net worth}$. Net worth is the amount that a person would have if all assets were sold for the listed amounts and all debts were paid in full. Few people liquidate all of their assets; the amount of net worth has a more practical purpose; a measurement of one's current financial position. A person may have a high net worth yet face financial difficulties. Having many assets with a low liquidity means not having the cash available to pay current expenses. Net worth is an indication of one's financial position on a given date.

The Personal Cash Flow Statement

A cash flow is the actual inflow and outflow of cash during a given period of time (Sebastian. P. 1989). Income from employment represents an important cash inflow, other sources may be interest earned on savings account. Payments on the other hand, for such things as rent, food and loans are cash outflows. A cash flow statement is a summary of cash receipts and payments for a given period, such as a month or a year. The process for preparing a cash flow statement is: $\text{Total cash received during the time period} - \text{cash outflows during the period} = \text{Cash surplus or deficit}$

Sources of income: Income is the inflows of cash to an individual or household. For most people, the main source of income is money received from a job. Other sources are: wages, commissions, self employment income, interest and dividends earned, gifts, pension and child support payments received.

Cash out flows: Cash payments for living expenses and other items make up the cash outflows component of the cash flow statement. There are two major categories under this, they are: fixed expenses and variable expenses. Fixed expenses are payments that do

not vary from month to month. Rent or mortgage payments, installment loan payments, insurance premiums and transport ticket expenses to work are examples of constant or fixed cash outflows. Variable expenses: these are flexible payments that change from month to month. These may include food, clothing, utilities such as electricity and telephone, medical expenses, donations and gifts.

Net Cash Flow: The difference between one's income and cash outflows can either be positive (surplus) or negative (deficit) cash flow. A surplus exists where the cash inflow is more than the cash outflow during a specified period. While a cash deficit exists if more cash goes out than comes in during a specified period. A personal cash flow statement shows the cash / funds status of an individual during a specified period of time.

1.2 Statement of the Problem

Many authors acknowledge that innovation has both positive and negative impacts on society; their conclusion regarding the *net* impact of financial innovation reflects a diversity of opinions. To research on the question of the net social benefits of innovation one needs to study specific examples. For example, researchers have attempted to measure the size of the gains from financial innovation in the mortgage market in the form of securitization and unbundling through the creation of collateralized mortgage obligations. Hendershott and Shilling, (1989) conclude that innovation led to materially lower mortgage rates charged to borrowers. However, other researchers such as (Sirmans. 1992) are quick to identify contrary examples, the legal and policy literature has extended discussions of the "costs" of innovation that defer and evade taxation, giving rise to loss of tax revenues, loss of confidence in government, a sense of inequity, and extensive resources devoted to this activity which does not enhance social welfare. There are other arguments that innovation leads to complexity that in turn leads to bad business decisions and social costs.

In the Kenyan context, banks face tremendous competition for business than they were previously uniquely qualified for. This has led to development and innovation of services offered in the market as each bank strives to capture its market share. The competition within the industry has led to introduction of different credit facilities and one such facility is the unsecured personal loans. The product is offered to individuals who can

show proof of a regular income from employment. The trend has been seen as a way to grow the loan portfolios along with the recent consumer confidence and spending which in turn increases the operating income of the banks especially since the treasury bills' interest rates started on a low trend in the late 90s. The above trends have seen banks increase the customer base.

However, due to the accessibility of these personal loans, customers have increasingly got themselves into debt that they are expected to pay over a period spanning up to 5 years. These loans are unsecured therefore it means that they are riskier to the banks and thus offered at higher interest rates than secured loans. The borrowers determine the use of the funds as the banks are not restrictive since they do not necessarily enquire.

The contributions of this research were to establish the implications brought about by the introduction of the unsecured personal loans on individuals' finances. A better understanding of these issues will allow for better planning and decision making by potential borrowers as well as provide for a safe and sound financial environment.

Research Questions

What are the features of the unsecured personal loans offered by commercial banks in Kenya?

What are the implications of unsecured personal loans on personal finances?

1.3 Research objectives

- a) To determine the features of the unsecured personal loans offered by the commercial banks in Kenya
- b) To determine the implications of unsecured personal loans on personal finances by analyzing personal net worth and cash flows

1.4 Importance of the Study

The study sought to find out the implications of borrowing unsecured loans on individuals' finances. The study seeks to benefit potential borrowers as well as providers of unsecured loans in the banking industry. Potential borrowers will hence be in a position to make better decisions when they are borrowing and banks will make better policies to counter the challenges identified affecting their clients and thus a healthier

loan portfolio will be maintained. In addition, other credit issuing institutions will also benefit as their understanding of credit and its effects to clients will be enhanced.

1.5 Justification of the Study

There have been developments in the banking industry in Kenya today and new products and services are being adopted by banks as they strive to increase their loan portfolios and market share as competition grows due to the support of favoring economy and liberalization. (CBK. June 2007). Existing studies on lending are mostly foreign based. The studies on loans carried out have also been on collateralised or secured loans. This study seeks to earn out a research of unsecured loans in Kenya thus it will benefit the potential borrowers and the local banking industry players as well as increase their knowledge on the same. In addition, unsecured personal loans is a new product in the market therefore there is need to study the new challenges that have come up with its introduction in order for borrowers to make informed decisions.

CHAPTER 2

2.0 LITERATURE REVIEW

2.1 Financial Innovation

innovate' is defined in *Webster's Collegiate Dictionary* as 'to introduce as or *as if* new,' with the root of the word deriving from the Latin word "novus* or new. Economists use the word 'innovation*' in an expansive fashion to describe shocks to the economy (for example, "monetary policy innovations") as well as the responses to these shocks (for example, Euro deposits). Broadly speaking, financial innovation is the act of creating and then popularizing new financial instruments as well as new financial technologies, institutions and markets. The "innovations' are sometimes divided into *product* or *process* innovation, with product innovations exemplified by new derivative contracts, new corporate securities or new forms of pooled investment products, and process improvements typified by new means of distributing securities, processing transactions, or pricing transactions. In practice, this innocuous differentiation may not clear, as process and product innovation is often linked (Rogers. 1983).

2.2 The Causes of Financial Innovation

If the world were free of all 'imperfections' such as taxes, regulation, information asymmetries, transaction costs, and moral hazard and if markets were complete in the sense that existing securities spanned all states of nature, we could arrive at an M&M-like corollary regarding financial innovation. Financial innovations would benefit neither private parties nor society and would simply be neutral mutations. Miller is careful to note that the existence of seemingly neutral mutations can permit the adaptation to the new conditions to take place more quickly or surely in response to real changes in the economy (Miller, 1977).

The imperfections in the market prevent participants in the economy from efficiently obtaining the functions they need from the financial system. Financial innovations are optimal responses to various basic problem or opportunities, such as incomplete markets that prevent risk shifting or asymmetric information.

According to (Merton, 1992), the functions that innovations help us to perform and delivered by financial systems are. moving funds across time and space, the pooling of funds, managing risk, extracting information to support decision-making, addressing moral hazard and asymmetric information problems and facilitating the sale of purchase of goods and services through a payment system.

Finnerty (1992) identifies a set of functions, two of which correspond closely to Merton's functions (reallocating risk and reducing agency costs), and a third (increasing liquidity) which is an amalgam of Merton's movement of funds and pooling functions. (The Bank for International Settlements BIS, 1986) has a slightly different scheme to identify the functions performed by innovation, focusing on the transfer of risks (both price and credit), the enhancement of liquidity and the generation of funds to support enterprises through credit and equity.

2.2.1 Role of Innovation in Inherently Incomplete Markets

In an incomplete market, not all states of nature can be spanned, and as a result, parties are not able to move funds freely across time and space, nor manage risk (Duffie and Rahi. 1995). In their *Journal of Economic Theory* on financial market innovation and security design, the review on the literature on market incompleteness shows that, from a spanning point of view, it can be seen that there are incentives to set up markets for securities for which there are no close substitutes, and which may be used to hedge substantive risks. In another study, (Grinblatt and Longstaff, 2000) study a different innovation (treasury strips or zero-coupon bonds). They find that investors create new strips primarily to make markets more complete, a conclusion drawn from the observation that strips are created when it would be most difficult to synthesize the discount bond from existing coupon instruments.

2.2.2 Role of Innovation in Inherent Agency Concerns and Information Asymmetry

Throughout history, information asymmetries have prompted a number of innovations. Throughout much of the nineteenth and early twentieth century, firms and individuals disclosed very little credible financial information. Over time, market forces and governmental action materially increased the quantity and quality and thus lowered the cost of information about firms and individuals. Early innovations tended to substitute for

(or economize on) the use of costly information, while later innovations capitalized on its lower cost. One of the earliest innovations, the nineteenth century practice of issuing assessable stock, provided some mechanisms to squeeze information from firms while the introduction of individual loans provided some mechanisms to squeeze out information from individuals (Guillen and Tschoegl. 2002)^N.

The nineteenth century firms' almost complete reliance on secured debt for debt financing may also be interpreted as a costly contracting choice that substituted for more precise monitoring prevented by inadequate disclosure (Baskin. 1988). Later in the nineteenth century innovations took advantage of the presence of cheaper and more reliable information. Later preferred stocks conditioned their holders' voting rights on firms' failure to comply with covenant terms (Dewing, 1934). These covenants, especially after 1900. were more likely to be tied to financial ratios, as were bond covenants keyed to working capital tests or asset maintenance tests (Dewing. 1934)? Finally, income bonds, popularized in the late nineteenth century, were completely linked to the availability of accounting information. These unsecured obligations required issuers to pay interest only if the firm earned positive accounting profits in the current period. This early history shows how innovations were a response to information asymmetries. Certain innovations forced the revelation of information and others exploited the low cost information generated through other processes.

2.2.3 Role of Innovation in Transaction Minimization and Search Costs

Merton. (1989) discusses how the presence of transaction costs provides a critical role for financial intermediaries. Financial intermediaries permit households facing transaction costs to achieve their optimal consumption-investment program. Merton uses this argument to explain how equity swaps can be an efficient way to deliver returns to multinational investors. A similar explanation is invoked by (McConnell and Schwartz, 1992) that provide a clinical study of one particular innovation. Lyons (liquid yield option notes). Lee Cole, the Options Marketing Manager at Merrill Lynch noticed that retail investors tended to place most of their money in low-risk securities and then buy a series of call options. Merrill Lynch's Lyons allowed investors to replicate this payoff

without having to incur the commission costs of rolling over their call option positions at least four times a year.

Many of the process innovations in payment systems technologies are aimed at lowering transaction costs. ATMs, smart cards, ACH technologies and many other new businesses are legitimate financial innovations that seek to dramatically lower the sheer costs of processing transactions. By some estimates, these innovations have the potential to lower the cost of transacting by a factor of over 100. For example, by one estimate, a teller-assisted transaction costs over \$ 1 and the same transaction executed over the ATM would cost \$0.01. The product innovation of unsecured loans available to customers reduces costs related to collaterals, such as joint registration, transfer costs, legal fees and insurance fees among others (Ross. 1989).

2.2.4 Innovation as a Response to Taxes and Regulation

Miller. (1986) is often cited on this point: "The major impulses to successful innovations over the past twenty years have come; I am saddened to have to say, from regulation and taxes." The list of tax and regulatory induced products would include zero coupon bonds, Eurodollar Euro bonds, various equity-linked structures used to monetize asset holdings without triggering immediate capital gains taxes, and trust preferred structures.

The strong Islamic prohibition against interest has stimulated a number of alternative financing vehicles (Vogel and Hayes. 1998). Many of these innovations seem to respect the letter, but not the spirit, of the ban on interest, using sale-repurchase contracts to effectively deliver interest to lenders. A while ago, taxes were a visible force in the U.S economy and when one wanted to acquire financing for whatever purpose, there had to exist collateral in which case on acquisition various taxes and fees were paid, this has stimulated a number of alternative financing vehicles which do not require existence of collaterals and thus circumvent taxes and regulations involved.

2.2.5 Technological Shocks Stimulate Innovation

Shocks to technology are thought to provide a "supply-side" explanation for the timing of some innovations (White. 2000). Advances in information technology support sophisticated pooling schemes that is observed in financing. IT and improvements has

facilitated a number of innovations (not all successful), including new methods of assessing potential customers. New 'intellectual technologies,' for example, derivative pricing models, are also credited with stimulating the growth and popularization of a variety of new contracts. Many new forms of derivatives were made possible because business people could have some confidence in the methods of pricing and hedging the risks of these new contracts.

Without the ideas developed by Black, Scholes, Merton and many others, many developments in derivative products would probably never have occurred. Various forms of innovations such as new risk management systems and measures and on-line retirement planning services (like Financial Engines) clearly were facilitated by both intellectual and information technology innovations. For example, the existence of developments in numerical analyses and simulation, hardware that enables faster processing, and the Internet are all elements that support new businesses willing to lend and individuals seeking to take on loan facilities and thus make better financial decisions.

2.3 Strategic View on Environmental Challenges

Pearce and Robinson. (1991) describe external environment as all conditions that affect a firm's strategic options but which are beyond the firm's control. Ansoff and Mc Donnell, (1990) noted that changing environment brings about unpredictability. They referred to this as environmental turbulence. Aosa. (1992) noted that this environmental turbulence brings about challenges to management. Chandler. (1962) and Daft, (1986) separately argued that organizations are environmentally dependant and changes in the external environment shapes the opportunities facing the organization. Thus understanding the environment helps a firm to objectively and rationally develop strategies that can cope with challenges affecting these organizations. According to (Porter, 1996) the environment is important in providing initial insight that underpins competitive advantage. The required inputs, accumulated knowledge and skills over time as are forces needed to keep progressing.

The environment is changing rapidly and therefore it is imperative that organizations constantly adapt their activities to reflect the new requirements of the environment. Strategies therefore equip firms with the knowledge to counter the challenges of the

environment (Bruce and Longdone, 2000). Strategy can be viewed as building defenses against competitive forces (Pearce and Robinson, 1991). They emphasize that for a good strategy to be formulated; first and foremost, the environment must be understood since the environment influences the strategy of the firm.

Gerry, et al, (2005) considered the environment to exist in the context of a complex political, economic, social, technological, environmental and legal world. Lawrence and Lorsch. (1967) emphasized the importance of market and technological innovation, and the concept of a rapidly changing environment, thus moving away from a static view of the environment.

2.4 Implications of Financial Innovation

Many authors acknowledge that innovation has both positive and negative impacts on society; their conclusion regarding the *net* impact of financial innovation reflects a diversity of opinions. Merton. (1992) stakes out one side of the argument: "Financial innovation is viewed as the "engine" driving the financial system towards its goal of improving the performance of what economists call the "real economy." Merton cites the U.S. national mortgage market, the development of international markets for financial derivatives and the growth of the mutual fund and investment industries as examples where innovation has produced enormous social welfare gains. Others take the opposite viewpoint, sometimes employing literary license (and movie metaphors) to make the argument that innovation's benefits are less clear: Nothing is more dangerous than a good idea. That ominous generalization seems inescapable given the development of finance over the past 40 years. Time and again, business has seized upon new idea junk bonds, derivatives only to push it far past its sensible application to a seemingly inevitable disaster.

The phrase "financial engineer" suggests another profession, that of genetic engineer. Indeed, one legal scholar invoked the vision of derivatives inhabiting a financial Jurassic Park with the implication that financial engineers have the potential to create financial products that could end up destroying civilization (Peter Huang. 2000).

To research on the question of the net social benefits of innovation, one "methodology" in the literature extrapolates from specific examples, like the mortgage market. For any one innovation, one can attempt to measure the impact of innovation. For example, researchers have attempted to measure the size of the gains from financial innovation in the mortgage market in the form of securitization and unbundling through the creation of collateralized mortgage obligations. Hendershott and Shilling, (1989) conclude that innovation led to materially lower mortgage rates charged to borrowers. However, other researchers such as (Sirmans. 1992) are quick to identify contrary examples—the legal and policy literature has extended discussions of the "costs" of innovation that defer and evade taxation, giving rise to loss of tax revenues, loss of confidence in government, a sense of inequity, and extensive resources devoted to this activity which does not enhance social welfare. There are other arguments that innovation leads to complexity that in turn leads to bad business decisions and social costs.

2.5 Factors that Bring About the Implications of Unsecured Loans

According to (Porter, 1980) competitive rivalry comes into play as a major factor contributing to an organizational response. The greater the number of competitors, the more equal their relative power, their products are also highly standardized, their fixed costs are higher hence slower the growth of the industry. Responses in such a competitive industry is in the form of lowering prices, accessibility of products, using cheaper raw materials, improving quality and employing mass production to gain economies of scale. Both offensive and defensive responses are very risky in a situation of intensive rivalry as they may have implications.

Peter Huang. (2000) concentrated on uncertainties as the major issue affecting the effectiveness of repayments of debt by individuals. He considered the change in effectiveness to involve changing the environments within which the individual operates so as to guarantee success. Response to this type of changes is achieved through transforming the presiding environment which is always unpredictable to favor the outcome. Organizations as well as individuals survive to the extent that they are effective and they are only effective when the environmental information and resource dependencies are managed successfully (Pfeffer and Salancik. 1978).

Susan (2003), acknowledges that some of the factors that might bring about implications in lending is multiple borrowings as some argue that loan sizes are not enough and different banks are willing to lend therefore many may have over-extended themselves, have been running from bank to another to get money during the last few years and have end up having repayment problems.

According to Bardhan (2000). market imperfections such as incomplete and asymmetric information problems are particularly acute in the context of development. The market imperfections result in smaller scale and risk taking by lenders. Similarly. Aghion and Murdoch (2005), argue that entrepreneurs cannot obtain all the capital needed to run their businesses when there are market failures. Among the most important problems are: adverse selection, moral hazard and credit rationing.

Adverse selection arises from lack of good information of the riskiness of the borrowers which make banks unable to distinguish the riskier borrowers (Aghion and Murdoch. 2005). Stiglitz and Weiss, (2001) explain that since different borrowers have different probabilities of repayment and banks cannot properly access them due to lack of complete information, borrowers may end up having a higher amount of loan than they can comfortably repay.

The interest rates individuals are willing to pay could be used for accessing individuals, as argued by (Stiglitz and Weiss, 2001). Individuals willing to pay higher interest rates would be perceived, on average, as riskier. Aghion and Murdoch, (2005) argue that since banks do not have good information, the outcome is exceedingly high interest rates that results in the exclusion of the worthy potential borrowers (more prudent or better informed). The borrowers at the end anticipate the difficulties in generating returns enough to repay very expensive loans and leave the market.

Brownbridge (1998), alleges that Insider lending is a contributor to the bad loans of many of the failed local banks. He says that most of the larger local bank failures in Kenya, such as the Continental Bank. Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians just because of their public stature. Lending to high-

risk borrowers by the banks is another factor contributing to negative implications on personal finances because once the high risk individuals get the loans they may not be in a position to repay due to the overburdening debt.

In conclusion, the literature above describes financial innovation and unsecured loans in the banking industry and the implications of such innovations to customers' personal finances. The banks can make a potentially valuable contribution to the development of financial markets, especially by improving access to loans. They can also inject the much needed financial products into financial markets and offer customers better services and thus the need to utilize their facilities in the right means. However the unsecured loans have their implications on individual's finances, therefore this study proves relevant to the Kenyan context and once taken will help the potential borrowers make better financial decisions and the industry players to be more aware of the problems that the clients may be facing so as to adopt better policies on lending and thus maintain healthier loan portfolios.

CHAPTER 3

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter set out the methodology that was used in this study. The section set out the appropriate research design for the study and further looked at the population as well as the sample design used.

3.2 Research Design

A sample survey design was chosen for the study. The study sought to determine the implications of the unsecured personal loans on individuals' finances in the Kenyan market and a survey was the most appropriate design due to the large number of unsecured loan borrowers and time limitation. The choice of a survey as a design was to provide an avenue of relating descriptions, explanations and predictions in a systematic manner. It is also the best design that defines the domain of generalizability (Frankfort and Nachmias. 1996). Similar studies have been carried out using this design and the results were satisfactory (Ndegwa, 2003 and Odemo. 2903).

3.3 Population

The population studied was the borrowers of unsecured personal loans in 3 institutions in Kenya, which are. The University of Nairobi. Kenyatta National Hospital and Kenya Airways Limited. The institutions are large and have employees who come from different parts of the country due to the stature in the country. This was intended to gather information on experiences of the unsecured personal loans on their personal finances

3.4 Sample and Sampling Design

Three large institutions were selected for the study, namely The Nairobi University, Kenyatta National Hospital and Kenya Airways Limited. A sample survey design was most appropriate due to the large number of unsecured loan borrowers and time limitation. A random sample of 150 employees from these institutions was used for the survey. Questionnaires were distributed through the companies' human resources department and payroll office where together with an introductory letter they were attached to 50 pay slips at random. Responding to the questionnaires was voluntary'. This was a representative sample which was able to provide appropriate data for the research. Although a census would have been done, it was not possible due to the timeframe

available for this study and the number of existing borrowers of unsecured loans. Previous studies have been done using samples with outstanding results obtained thereafter: (Nkari, 1985) used a sample of 20 when carrying out research on the tourism sector, (Ouso, 2004) also used a sample of 50 to carry out a survey on the use of incentive marketing in promotion of domestic tourism.

3.5 Data Collection

Data collection relied on both primary data and secondary data. The primary data was collected using a semi-structured questionnaire (Appendix 1). The questionnaire was divided into three sections. Section one sought to establish the profile of the borrowers, the second section sought to establish the nature of unsecured loans provided by the commercial banks to the borrowers and the third section sought to find the implications of borrowing unsecured loans. These questionnaires were distributed through drop and pick method from the Human resources and payroll offices of the companies being studied. The secondary data sources mainly entailed the use of financial articles in magazines relating to unsecured loans and Central Bank of Kenya monthly, quarterly and annual reports. A data collection form was used for the purposes of tracking the secondary data sources. Use of secondary data has been done before in other researches and was proven useful (Lancaster, 1990)

3.6 Data Analysis

this study conducted first level data quality checks which were done at the data collection level while secondary level quality checks were done at the data entry level. The development of ranges, skip and fill rules accompanied by validation checks with all possible means of data cleaning were used to meet the assumptions of the analytical techniques employed. The use of frequencies and percentages came in handy. The analysis of these facts was presented in graphs and in a tabular manner on tables. These techniques were used to analyse variables such as earnings and debt levels. Further, there was need to simplify and prune the data in order to obtain a rather easy to understand data. Finally, there was comparison of the analysis with the theory to draw the conclusions.

CHAPTER 4

4.0 DATA ANALYSIS AND PRESENTATION

4.1 Demographic Profiles

The population for the study was employees from 3 selected large institutions that are the University of Nairobi, Kenyatta Hospital and Kenya Airways. A random sample of one hundred and fifty borrowers of unsecured loans was considered for the study.

4.2 Features of Unsecured Loans

This study sought to determine the features of unsecured personal loans. The study used primary data sources such as news paper publications. A summary of the features of unsecured loans offered by various commercial banks in Kenya is presented in the below Table 2.

Table 2: Personal Unsecured Loan Features

| Personal Unsecured Loan | | | | | |
|--------------------------------|--------------|------------------------------------|-------------------------------|---------------------------|----------------------------|
| | Rates | Max Period (Months) | Max Loan '000' | Processing Fee | Insurance Cover |
| KCB | 16.00% | 36 | 1,500 | 2% | 0.54% |
| Coop Bank | 16.00% | 60 | 2,000 | 2.5% | From CIC |
| Equity | 15.00% | 60 | | 3% | N/A |
| EABS | 18.00% | 60 | 1,000 | 2% | N/A |
| NBK | 18.00% | 60 | 1,000 | 1% | 0.25% |
| Bank of Africa | 18.00% | 48 | 1,000 | 1% | N/A |
| CBA | 19.00% | 48 | 1,000 | 1% | |
| StanChart | 19.00% | 48 | 1,300 | nil | N/A |
| NIC Bank | 19.00% | 48 | 1,000 | nil | 0.25% |
| CFC Bank | 19.50% | 36 | 1,000 | 1.5% | |

Source: Money magazine. Daily Nation. Thursday July 17, 2008

Table 2 above shows the maximum period that each bank offers for their personal unsecured loan product. As shown above, the longest period offered for repayment is 60 months provided by Co-operative Bank, Equity Bank, EABS Bank and National Bank of Kenya. The limited period offered for these loans is due to their unsecured nature and the

amounts involved. The loan repayment is done monthly by the borrowers since the clients are granted the loans on the basis of their salary.

As table 2 above shows, the interest rates per annum of unsecured personal loan ranges between 19.50% as the highest rate offered at CFC Bank and 15.00% being offered by Equity Bank. The quoted interest rate is on a reducing balance and is composed of a banks' base rate and the margin with which an individual bank wishes to apply.

The personal unsecured loans have specified maximum amounts that a bank offers as shown on Table 2 above. The maximum loan amount that is offered is Kenya shillings 2 million offered by Cooperative Bank followed by Kenya Shillings 1.3 million offered by Standard Chartered Bank. The limited amount of loan is due to its nature that it is unsecured thus posing more risk to the bank than secured loans where larger amounts are offered. The maximum amount that a client can get depends on one's salary capacity. Banks have different methods that are applied to determine the maximum amount that a client can borrow.

The other feature of personal unsecured loan is that some banks charge an arrangement fee for every lending. The highest amount of arrangement fee charged in the market is 3% of the loan amount borrowed while on the other hand some banks do not charge an arrangement fee which is used as a marketing tool to attract potential borrowers. The arrangement fee is charged to cover for the service offered while processing the loan documents.

Insurance cover is another feature that personal unsecured loans have attached to them in some commercial banks that offer the product. As per Table 2 attached above, where applied insurance cover is stated as a percentage per annum of the loan amount borrowed. The highest insurance cover is 0.54% charged by Kenya Commercial Bank followed by 0.25% charged by NIC Bank and National Bank of Kenya. The other banks do not charge for insurance cover. The insurance cover taken against a personal unsecured loan is meant to cover and pay the lending bank the loan amount balance incase a borrower dies.

Lastly, the individual banks do not have these rates and terms as per the above table as fixed but rather the rates and terms are subject to change without notice by the banks and borrowers are always urged to check before finalizing any arrangement.

4.3 Analysis of Purpose for unsecured loans

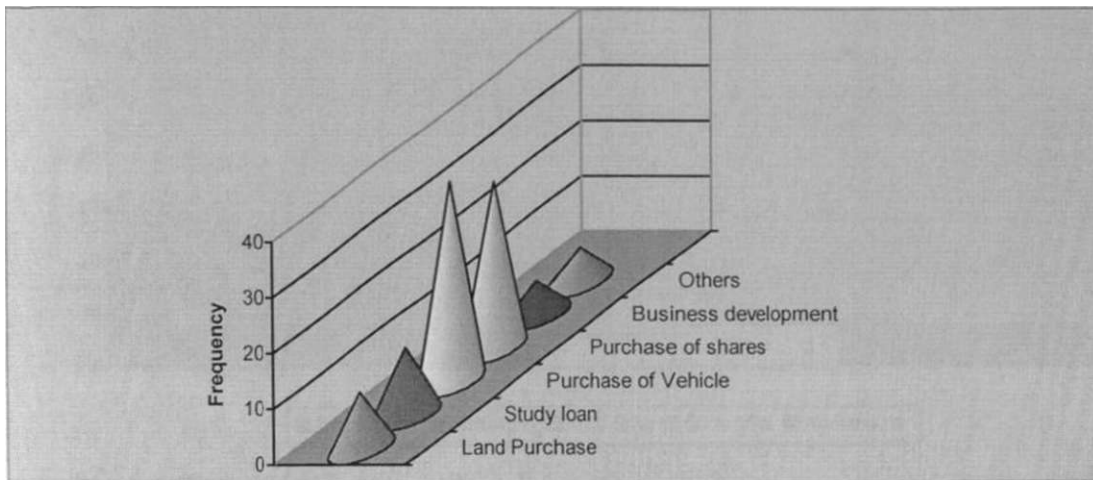
The study sought to establish the reason for which the respondents took the loan, the respondents gave various responses which were classified as below. The results show that majority of the respondents acquired the loan for purchase of vehicles; this was represented by 36%, followed by purchase of shares at 30%. This is because majority of the borrowers were employed people who are buying assets that will aid them in the day to day living. Purchase of shares was next in terms of frequency due to the investment sensitization that has been happening through the media and word of mouth in the recent past.

Table 3: Analysis of Purpose for Unsecured Loans

| Purpose for loan | Frequency | Percentage |
|-------------------------|------------------|-------------------|
| Land Purchase | 10 | 10% |
| Study loan | 12 | 12% |
| Purchase of Vehicle | 36 | 36% |
| Purchase of shares | 30 | 30% |
| Business development | 6 | 6% |
| Others | 6 | 6% |
| Total | 100 | 100% |

Source: Research Findings

Chart 1: Purpose of Loan Taken



Source: Research Findings

4.4 Percentage of Income used for repayment

The table below shows the results of the responses regarding the percentage of the monthly income used for repayment of the monthly loan installments. The results show that for a majority of the respondent, 54%, the percentage of income used to repay was between 20%-40%. A sizeable number of the respondents 32% indicated that they used below 20% of their income for the repayment installment. There was a nil result in the category of above 60% because this is the maximum debt income ratio considered for lending. This is so, because apart from repayment of loans, people have to continue meeting other commitments in life and thus an allowance is set for this.

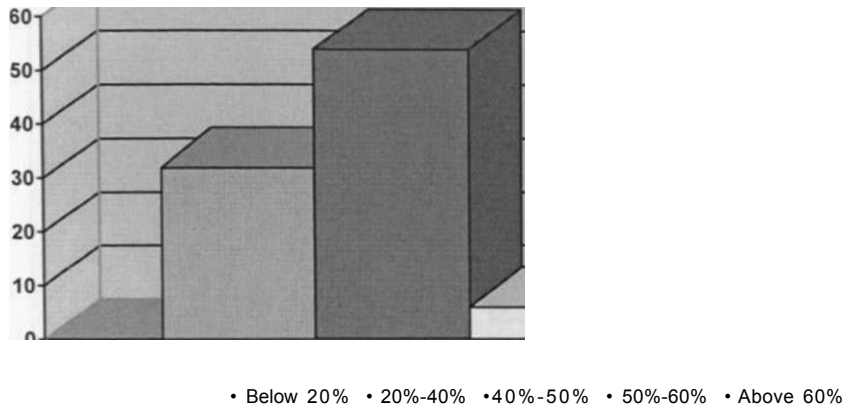
The results of these findings are presented in the table and graph below:

Table 4: Percentage of Income Used for Repayment

| Percentage of Income | Frequency | Percentage |
|----------------------|-----------|------------|
| Below 20% | 32 | 32% |
| 20%-40% | 54 | 54% |
| 40%-50% | 6 | 6% |
| 50%-60% | 8 | 8% |
| Above 60% | 0 | 0% |
| Totals | 100 | 100% |

Source: Research Findings

Chart 2: Percentage of Income used for Repayment



Source: Research Findings

4.5 Reasons for Default of Unsecured Personal Loans

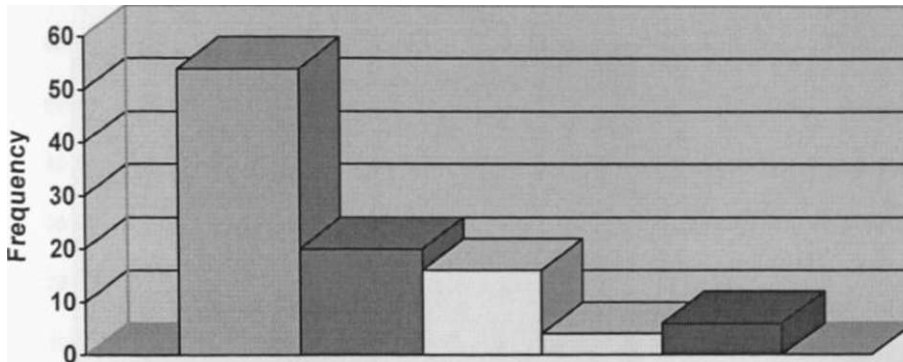
The respondents were asked to show the reasons for default of unsecured loans, the results indicate that most respondents felt that defaults were due to loss of employment which was 54% and was followed by 20% who indicated that the multiple loans acquired led to the defaults. The highest frequency in loan default was established to be due to loss of employment because the monthly salary is what is used to repay the loans and once the jobs are terminated then, there the loan will fall into arrears. Multiple loans acquired from different banks is next in frequency because of lack of sharing information within banks and lack of full disclosure by the clients. The results are shown below on the table and graph.

Table 5: Reasons for Default of Unsecured Personal Loans

| Reasons for default | Frequency | Percentage |
|---------------------------------|------------|-------------|
| Loss of employment | 54 | 54% |
| Multiple loans acquired | 20 | 20% |
| Increased financial commitments | 16 | 16% |
| Inconvenient period | 4 | 4% |
| Other | 6 | 6% |
| Total | 100 | 100% |

Source: Research Findings

Chart 3: Reasons for Loan Default



- Loss of employment
- Multiple loans acquired
- Increased financial commitments
- Inconvenient period
- Other

Source: Research Findings

4.6 Action taken on Defaulters of Unsecured Personal Loans

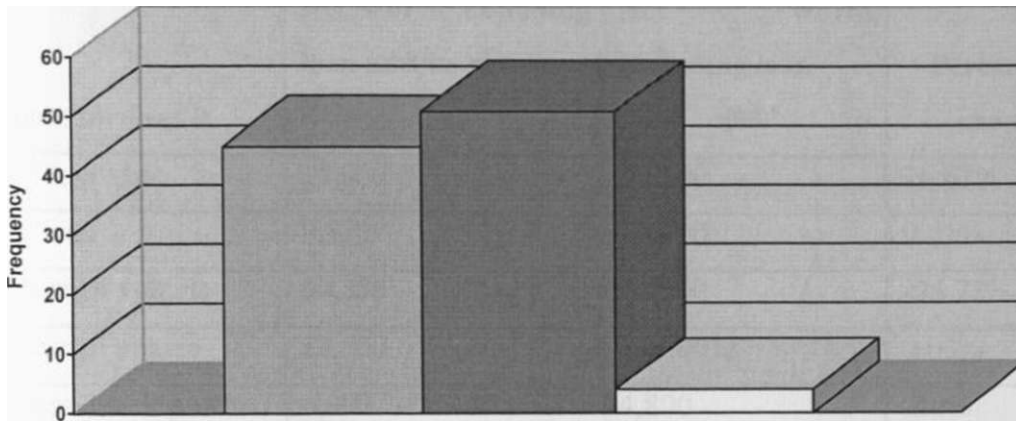
The respondents were asked to indicate the actions taken on defaulters of the loan, the responses were grouped into listing at the credit reference bureau, filing of legal suits, and others. The banks in this case do not have assets to liquidate. The results show that majority of the respondents felt that the action taken on defaulters was mostly filing legal suits and then followed by listing at the credit reference bureau companies that present all the information about the defaulter to other subscribers and this results in making worse a client's credit status.

Table 6: Action taken on Defaulters of Unsecured Personal Loans

| Actions for default | Frequency | Percentage |
|------------------------------------|------------------|-------------------|
| Listing on Credit Reference Bureau | 45 | 45% |
| Legal suit | 51 | 51% |
| Other | 4 | 4% |
| Totals | 100 | 100% |

Source: Research Findings

Chart 4: Actions on Loan Default



• Listing on Credit Reference Buereau • Legal suit G Other

Source: Research Findings

The graph above shows the results of the research in relation to actions taken against unsecured loan defaulters.

4.7 Total Impact on Personal Net worth of respondents

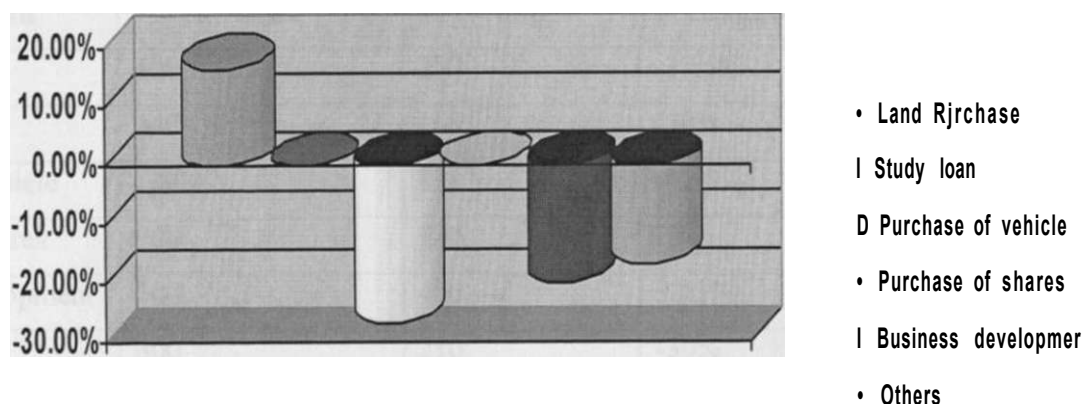
The respondents were asked to indicate the value of funds in their accounts, an estimate of the current market value of household assets and possessions and investments to find out their total personal assets. They were also asked to indicate the total liabilities that they owe including the amounts due on loans. The difference between the assets and liabilities for all the respondents was used to calculate their net worth. The respondents were grouped under the purposes of loan borrowed. The results as indicated on the table below show that the highest positive percentage change in net worth is for borrowers who borrowed funds for land purchase which is 16.67% and the worst affected clients on their net worth is those who purchased cars with a percentage change of -26.77%. The clients, who borrowed the unsecured loan to purchase land, buy shares and pay for studies had their net worth increasing because land appreciates in value and shares had their value increasing over time. The clients who borrowed loans for other purposes such as purchase of vehicles had their net worth decreasing because of depreciation of the vehicles over time. Net worth for most clients who had borrowed loans for financing their small businesses also had their net worth decreasing due to factors such as the inflation that has been experienced in the recent past.

Table 7: Total Impact on Personal Net worth of respondents

| Purpose for loan | Net worth excluding loan and its use '000' | Net worth including loan '000' | Percentage change |
|-------------------------|---|---------------------------------------|--------------------------|
| Land Purchase | 15.000 | 17.500 | 16.67% |
| Study loan | 9.870 | 10,000 | 0.01% |
| Purchase of vehicle | 60.500 | 44,300 | -26.77% |
| Purchase of shares | 14.500 | 15.000 | 0.03% |
| Business development | 6.000 | 4,800 | -20% |
| Others | 3,000 | 2,500 | -16.67% |
| Total | 108,870 | 93,600 | -14% |

Source: Research Findings

Chart 5: Total Impact on Personal Net worth of respondents



Source: Research Findings

4.8 Total Impact on Personal Net Cash Flow of Respondents

The respondents were asked to indicate the sources of income that they have including their monthly salary and their monthly fixed and variable expenses. The difference between the monthly income and expenses was used to get the net personal cash flow.

The respondents were grouped under the purposes of loan borrowed. The results show

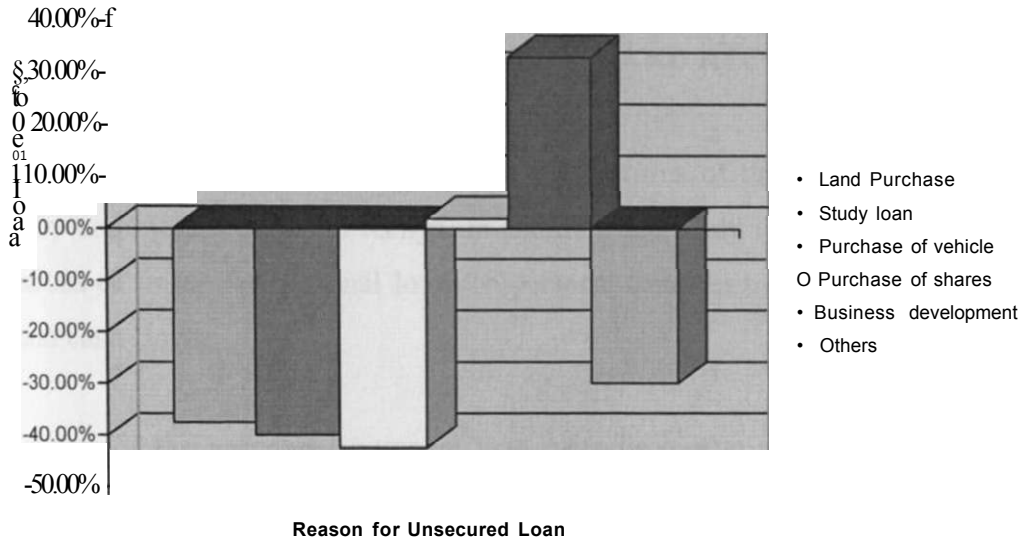
that the highest positive percentage change in personal net cash flow is for borrowers who borrowed funds for business development which is 33.3% and the worst affected clients on their personal cash flow is those who purchased cars with a percentage change of -42.5%. Clients who had borrowed unsecured loans for land purchase and study generally had their net cash flow decreasing. This is because investments on land and studies generally took a long time to yield cash inflow. The clients who took unsecured loans to purchase personal vehicles also had an overall negative net cash flow because the vehicle was not yielding cash in flow. The study established that the clients who took unsecured loans to purchase shares and develop their small businesses had an increase in net cash flow. This is because shares yielded dividends while small businesses yielded cash inflow due to their daily operations.

Table 8: Total Impact on Personal Net Cash Flow of Respondents

| Purpose for loan | Net cash flow excluding loan '000' | Net cash flow including loan '000' | Percentage change |
|-------------------------|---|---|------------------------------|
| Land Purchase | 400 | 250 | -37.5% |
| Study loan | 240 | 168 | -30% |
| Purchase of vehicle | 1,800 | 828 | -42.5% |
| Purchase of shares | 900 | 920 | 2% |
| Business development | 300 | 400 | 33.3% |
| Others | 300 | 210 | -30% |
| Total | 3,580 | 2,776 | -22.45% |

Source: Research Findings

Chart 6: Change in Net Cash Flow



Source: Research Findings

CHAPTER 5

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings and Conclusions

The objective of the study was to establish the features of unsecured personal loans offered by commercial banks in Kenya. In addition, the study was set to determine the implications of unsecured personal loans on personal finances by analyzing personal net worth and cash flows.

The features of the unsecured personal loan were unique to the product with a few similarities to the secured loan. One of the features was that the personal unsecured loans have specified maximum amounts that individual banks offer. The limited amount of loan offered was due to its nature, that it is unsecured thus posing more risk to the bank than secured loans where larger amounts were offered. The maximum amount that a client could get depended on one's salary capacity and banks had different methods that were applied to determine the maximum amount that one could borrow. The unsecured loans had a maximum period within which repayment could be made. The limited period offered for these loans was also due to their unsecured nature and the amounts involved, which did not justify a longer repayment period. The loan repayment was done monthly by the borrowers since the clients were granted the loans on the basis that they were salaried employees.

The personal unsecured loan product had interest rates per annum attached to it. The interest rate ranged between 19.50% as the highest rate and 15.00%. The interest rates were higher than the interest rates for secured loans due to the fact that the loans were unsecured. The quoted interest rates were on a reducing balance. The interest rate was composed of a bank's base rate and the margin with which an individual bank wished to apply. The other feature of personal unsecured loan was that some banks charged an arrangement fee for every lending. The highest amount of arrangement fee charged in the market was 3% of the loan amount borrowed while on the other hand some banks did not charge an arrangement fee which was used as a marketing tool to attract potential

borrowers. The arrangement fee was charged to cover for the service offered while processing the loan documents.

Insurance cover was another feature that personal unsecured loans had attached to them in some commercial banks that offered the product, where applied, insurance cover was stated as a percentage per annum of the loan amount borrowed. Other banks did not charge for life insurance cover. The insurance cover taken against a personal unsecured loan was meant to cover and pay the lending bank the loan amount balance in case a borrower died.

In relation to the demographic characteristics, the findings of the study were that most of the respondents were within the age bracket of 31 -40 years, others were also significantly above 40 years. Majority of the respondents had worked in the firms for a period of 2-5 years. The income bracket for most of the respondents was established to be Kshs 20,000- 50,000. This was because this age group had not yet accumulated funds and acquired a significant amount of assets to use as collateral for a bank loan and thus the largest source of credit being the personal unsecured loan.

The findings of the study were that most of the employees had acquired the personal unsecured loan for the purchase of motor vehicles and a significant number also had acquired the loan to buy shares at the stock market. The amount of unsecured loan that had the highest frequency from the respondents was established to be between the Kshs 100,000-300,000. The study also established that the repayment period for most of the respondents was established to be four years. The highest frequency in the loan amount bracket corresponded to the highest frequency in the income bracket. This was because banks offered loans to clients depending on their repayment capability which was assessed from the monthly salary. Most respondents took the unsecured loan with a repayment of four years: this was because with four years one would be able to pay a lower monthly installment compared to a shorter period for the same amount of loan taken.

The study established that the main action taken by lenders when unsecured loan borrowers defaulted was filing of legal suits followed by lenders listing defaulters at the credit reference bureau companies where a defaulter's information was posted and other subscribers of the bureau could access the information. This makes a defaulter's credit status very bad. The main reasons for default were established to be loss of employment by the borrowers; a significant portion of other respondents had multiple loans from other banks and credit institutions.

In relation to the objective of implications of unsecured personal loans on personal finances, the study used instruments such as personal net worth and personal net cash flow. The study established that the net worth of clients changed depending on the purpose of borrowing. The clients, who borrowed the unsecured loan to purchase land, buy shares and pay for studies had their net worth increasing because land appreciates in value and shares had their value increasing over time. The clients who borrowed loans for other purposes such as purchase of vehicles had their net worth decreasing because of depreciation of the vehicles over time. Net worth for most clients who had borrowed loans for financing their small businesses also had their net worth decreasing due to factors such as the inflation that has been experienced in the recent past.

Using the personal net cash flow factor in the study, it was established that the net cash flow changed depending on the purpose of the loan borrowed. Clients who had borrowed unsecured loans for land purchase and study generally had their net cash flow decreasing. This was because investments on land and studies generally took a long time to yield cash inflow. The clients who took unsecured loans to purchase personal vehicles also had an overall negative net cash flow because the vehicle was not yielding cash in flow. The study established that the clients who took unsecured loans to purchase shares and develop their small businesses had an increase in net cash flow. This is because shares yielded dividends while small businesses yielded cash inflow due to their daily operations. In general, the study established that the overall personal net worth and net cash flow declined. The Personal net cash flow declined by a higher margin than personal net worth.

Lastly, although loans permitted more immediate satisfaction of needs and desires, it did not increase total purchasing power. Loans must be paid for out of future income; therefore, credit ties up the use of future income. Furthermore if one's income did not increase to cover rising costs, one's ability to repay credit commitments was diminished. Before getting credit, one should consider whether the goods or services to be purchased will have lasting value, whether they will increase one's personal satisfaction during present and future income periods, and whether one's current income will continue or increase.

5.2 Limitations of the Study

The research was limited by the sensitivity of information required from the respondents. This led to limitations in getting accurate data from clients regarding their financial status; the study was therefore undertaken using the financial estimates provided by the respondents for fulfillment of the research objective of implications of personal unsecured loans on personal finances. Personal finance is a branch of personal wealth which covers the area of personal finance and the social aspects of personal development. Due to the wide scope of the social aspects of personal development and time limitation, the study only considered the implications of personal unsecured loans on personal finances.

5.3 Recommendations for further research

The study covered implications of unsecured personal loan on personal finances, however personal finances is a branch of personal wealth. Personal wealth covers social and financial aspects of personal development, therefore while one may borrow an unsecured loan for a specific purpose and have a decline in his personal finances, it might have a large positive impact on his social aspect of life and thus a justification of the borrowing. Therefore a research carried out on a larger sample on. *Implications of personal unsecured loans on personal wealth in Kenya*, would be a welcome idea and of benefit to the society. This will enhance the findings of this study.

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APPENDICES

Appendix I: Questionnaire



UNIVERSITY OF NAIROBI

School of Business

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Telegrams: "Varsity". Nairobi

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Hilda Ndolo

P.O. Box 78858 -00507

Nairobi. Kenya

Dear Sir/Madam,

RE: REQUEST OF PARTICIPATION IN MBA RESEARCH PROJECT

The bearer of this letter, Hilda N. Ndolo is a Postgraduate student undertaking a Master of Business Administration (MBA) degree at the School of Business, University of Nairobi Finance Major. As part of her course work assessment, she's required to submit a research project report on the introduction of personal unsecured loans by commercial banks in Kenya and the implications on personal finances.

Kindly assist her by completing the attached questionnaire. We assure you that the information provided is purely for academic purpose only and will be treated with utmost confidentiality.

Should you be interested in the findings of the research, a copy will be availed to you on request by the student. In addition a copy will also be availed at the University of Nairobi Library.

Thanks you for your cooperation.

Mr. Ondigo

MBA Department

Tel 020 318262

Hilda Ndolo

MBA Student

0722-241931

QUESTIONNAIRE

Where applicable, please mark the relevant box with a tick 0.

SECTION 1

Respondent's profile

1. Please indicate your age bracket

a.) Below 20 Years b.) 21-30 Years c.) 31-40 Years d.) Above 41 Years

2. Name your occupation

3. For how long have you worked in your current job?

a.) Below 2 Years b.) 3-5 Years c.) 6-10 Years d.) Above 10 Years

4. Please indicate the level of your income bracket

a.) Below Ksh.20.000 b.) Ksh.20,001-50.000 c.) Ksh.50. 001-100.000
d.) Ksh. 100.001-200.000 e.)Above Ksh. 200,001

SECTION 2

Nature of Unsecured Loans Offered by Commercial Banks

1. Please name of the bank / banks that offered you an unsecured personal loan

2. For what purpose did you get an unsecured personal loan?

3. What amount of unsecured loan did you get from the bank?

a.) Below Ksh. 100.000 b.) Ksh. 100.001 -300,000 c.) Ksh.300,001 -500.000
d.) Ksh.500,001 -700.000 e.) Ksh.700,001 -900.000 e.)Above Ksh. 900.001

4. How long is the repayment period of the unsecured personal loan acquired?

- a.) Below 12 Months b.) 12- 24 Months c.) 25-36months d.) 37-48 months e.) 49-60 months f.) Above 60 months

5. Please indicate the monthly repayment for your loan in Kenya Shillings

6. On application of the unsecured loan, were there other fees that you were required to pay?

- a.) Yes b) No

7. If yes, please name and give an estimate of the percentage of the fees to the loan amount

8. Does your bank require that an insurance policy should be taken for unsecured loans? If yes, please name the type of insurance cover you paid for and the percentage of the insurance cover to the loan amount

9. On getting the unsecured personal loan, does the bank give you a grace period for when the first repayment is supposed to begin? If yes. how long?

10. Does penalty fees and interest surcharges exist in your loan contract? Is this information relayed to you as a customer on a clear and transparent manner on application of the loan?

- a.) Yes b) No

11. If no. please indicate on how you learnt of the penalty fees and interest surcharges that are in the loan contract?

- a.) Through word of mouth

- b.) Through awareness programmes in the media
- c.) Through the fine print of the contract after reading
- d.) Others methods (please indicate)

12. Does your bank charge a penalty for paying off a loan before its due period?

- a.) Yes [] b.) No []

13. If your bank charges penalty fees for paying off a loan before the due period, what is the rate of this charge?

SECTION 3

Implications of Unsecured Personal Loans

1. Please indicate the sources of income that you are using to repay the unsecured personal loan

2. Please indicate the percentage of your monthly installment of loan to your net income

- a.) Below 20% [] b.) 21%-30% [] c.) 31%-40% [] d.) 41% - 50% [] e.) Above 50% []

3. Please indicate the terms of your job

- a.) Permanent basis [] b.) Contract basis []

4. If your job is on contract, kindly indicate if the length of your contract is longer or shorter than the repayment period of the unsecured loan?

- a.) Longer b.) Shorter c.) Same length of time

5. If your contract is shorter than the repayment period of the unsecured loan, please explain on how you intend to make the monthly repayments of the loan

6. Please indicate the sources of income that you have besides your employment and their estimate monthly values

7. Please indicate your fixed monthly expenses and their estimate values

8. Please indicate your variable monthly expenses and their estimate values

9. Please indicate an average value of the funds that you hold in current accounts, savings accounts as well as the cash value of life assurance incase you hold one

10. Please indicate the estimated total sum of the current market value of household assets and possessions that you hold

]

11. Please indicate the estimated total sum of the current market value of investment assets that you hold

]

12. Please list and indicate the total amounts owed to others (liabilities), this includes medical bills, current debt, credit card balances and amounts due on loans and mortgages

13. Please indicate the kind of assistance that your bank would offer incase you encounter a problem w ith repayment of unsecured personal loan/s

- a.) None
- b.) Restructure of the loan []
- c.) Provide a grace period within which one may reorganize them selves []
- d.) Relationship advise during the period of financial constraint []
- e.) Other methods, please indicate

14. In your view, what are the main reasons for loan default?

- a.) Loss of employment []
- b.) Multiple loans acquired []
- c.) Increase in commitments to cater for []
- d.) Inconvenience in the repayment method []
- e.) Others, please indicate

15. Please indicate the action taken by your bank on a customer incase of loan default

16. In conclusion, please indicate any other general implications of your unsecured personal loan

~Thank You-