

**EFFECT OF CREDIT MANAGEMENT PRACTICES ON FINANCIAL  
PERFORMANCE OF SAVINGS AND CREDIT COOPERATIVE  
SOCIETIES IN THE HOSPITALITY INDUSTRY IN NAIROBI**

**BY**

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**D61/60986/2011**

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF  
THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS  
ADMINSTRATION OF THE UNIVERSITY OF NAIROBI**

**2015**

## DECLARATION

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

Signed.....

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This research project has been submitted for examinations with my approval as university supervisor.

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## **ACKNOWLEDGEMENTS**

My foremost acknowledgement goes to my supervisor, Mr. Barasa J. Lumumba, Department of Business Administration, University of Nairobi. He tirelessly guided me in the formulation and execution of the whole process of completing this project. THANK YOU.

I also acknowledge my wife Kagendo Ikua, whose guidance, moral and emotional support was integral in the completion of this project. I also wish to acknowledge all my research assistants who assisted in collecting and collating the data. God bless you.

My colleagues at NIC Bank, I could not have come this far without your support.

It is not possible to acknowledge everybody on this page; I therefore take this opportunity to thank everyone else who may have played a role in one way or the other in facilitating the execution of this project.

## **DEDICATION**

I wish to dedicate this work, first and foremost, to the Almighty God, for the gift of life, his grace and endless love.

And

To my lovely wife Kagendo Ikua and my daughter Sheba Mugure for your love and support and my entire family for your understanding, support and encouragement, it means a lot to me. I love you all and God bless you abundantly.

## **LIST OF ABBREVIATIONS**

SACCO	Savings and Credit Cooperative Society
GoK	Government of Kenya
WOCCU	World Council of Credit Unions
CAR	Capital Adequacy Ratio
IRB	Internal Rating-based
LGD	Loss Given Default
NI	Net Income
NPL	Non-performing Loan
NPLIR	Non-performing Loan Ratio
ROA	Return on Assets
ROE	Return on Equity
TL	Total Loan
TSE	Total Shareholders' Equity
SASRA	Sacco Societies Regulatory Authority

## **ABSTRACT**

SACCOs are in the business of safeguarding money and other valuables for their Members besides providing loans and offering investment financial services. Credit creation is the main income generating activity for the SACCOs. But this activity involves huge risks to both the lender and the borrower. The risk of a member not fulfilling his or her obligation as per the contract on due date or anytime thereafter can greatly jeopardize the smooth functioning of a SACCO's business. The general objective of the study was to analyze the effect of credit management practices on the performance of SACCOs in the hospitality industry in Nairobi.

Descriptive research design was used with a target population of 67 active SACCOs in the hospitality industry based in Nairobi. A sample size of 10 SACCOs was selected using systematic random sampling technique. The questionnaire was formulated with both open ended and close ended questions based on the objectives of the study. Both the questionnaire and the data collection sheet were administered to the SACCO members through drop and pick method. The entry and analysis of data was done using SPSS (Statistical Package for Social Science version) program. The data has been presented in form of tabulations, charts, graphs and percentages. The findings of the study show that SACCOs have heavily relied on particular credit risk techniques which are not adequate to mitigate against loan losses in a dynamic and competitive lending environment. Secondly adequate credit risk monitoring and control mechanisms are lacking in majority of SACCOs which results in late detection and determination of non-performing and defaulted loans. Thirdly, governance structures that would ensure that the laid down credit risk policies are strictly adhered to, is lacking in majority of SACCOs.

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# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

Credit management has established itself globally as a vital management function with a major contribution to the economic well-being of organizations in different sectors. The survival of any organization will depend on how quickly the revenue is collected and the retention of the customers for continuity. Credit risk is defined as the potential that a borrower or counterparty will fail to meet his obligations in accordance with agreed terms. According to Chijoriga (1997) credit risk is the most expensive risk in financial institutions and its effect is more significant as compared to other risks since it directly threatens the solvency of financial institutions. While financial institutions have faced difficulties over the years for a multitude of reasons, the major challenges faced by financial institutions continue to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management and lack of attention to changes in economic or other circumstances that lead to deterioration in the credit standing of financial institution's counterparties (Basel, 1999).

The goal of credit risk management is to maximize a SACCO's risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. The success of credit management is mainly determined by the level of risk management in place, policies and procedures, professionalism and governance.

Minimizing bad loans has benefits to all parties involved especially the lenders. First and foremost, it will help in the identification of potential credit risks related to loan restructuring, underwriting and documentation. Secondly, it will help in gathering information required to monitor borrower relationships for changes in risks including determining the appropriate level of monitoring and identifying information required for both the lender and borrower. Thirdly, it will help in evaluation of changes in credit management that require action including assessing internal and external factors and recognizing and evaluating warning signals. Fourthly, it will assist in selecting appropriate solutions to solve emerging credit problems by using strategies

that optimizes the outcome for the institution while also assist in recognition of lending institutions that entail exposure to lender liability. Lastly, it will help in identification of the potential impact of bad loans to the institution.

The provision of credit facilities is the core function of every savings and credit co-operative society. The credit management function facilitates efficient management and administration of the SACCO loans in order to ensure equitable distribution of funds and to encourage liquidity planning. In order to achieve prudence and accepted best practice, credit management should always be guided by clearly spelt out policies and procedures, strategic plan, by- laws , the co-operative act, the SACCO regulatory act and rules and regulations.

In the commercial world, management of accounts receivable has significant implications on the financial health of organizations. It is imperative to strike a balance between increased sales and the risk for bad debts. Firms must therefore ensure that the management of receivables is efficient and effective .Such delays on collecting cash from debtors as they fell due had serious financial problems, increased bad debts and affecting customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good business to put credit management at the ‘front end’ by managing it strategically and management must also determine a balance between sales and finance when developing an appropriate credit policy.

### **1.1.1 Credit Management Practices in SACCOs**

A savings and credit cooperative society also known as a credit union is a cooperative financial institution that is owned and controlled by its members and operated for the purposes of promoting thrift, providing credit at low interest rates and providing other financial services to its members. Generally, the idea behind establishment of SACCOs is to promote savings and make credits available to the members. SACCOs are important micro financing institutions for mobilization of financial resources for various development activities. The provision of credit facilities is the core function of every savings and credit co-operative society.

The credit management function facilitates efficient management and administration of the SACCO loan portfolio in order to ensure equitable distribution of funds and to encourage liquidity planning. In order to achieve prudence and accepted best practice, credit management should always be guided by clearly spelt out policies and procedures, strategic plan, by-laws , the co-operative act, the SACCO regulatory act and rules and regulations. Basically, Savings and credit co-operative has three operational aspects namely; the savings, the credit and channeling external funds to members. The management committee of the SACCO is responsible for formulation, reviewing and amending the loan policy. The supervisory committee is responsible for ensuring that the loan policy is adequately carried out and that it achieves the goals it was created. The committee determines if the policy is being complied with by periodically reviewing a sample of loans granted and denied. The policy is expected to achieve the following major goals i.e. to establish a fair loaning system, establish efficient credit admiration procedures, assist in proper recovery of loan funds and finally to guide staff and board members on the loaning process, Zeller (2001).

### **1.1.2 Financial Performance of SACCOs in Kenya**

The financial sector comprises players from hospitality industry, banking industry, micro finance institutions, capital markets, insurance companies, mutual funds and development finance institutions (CBK, 2007). In Kenya, SACCOs remain the most important players in provision of financial services and have deeper and extensive outreach than any other type of financial institute (ICA, 2002). Savings and credit cooperatives in Kenya emerged in the 1970's, initially in the main urban centers, with a major objective of mobilizing savings of their members and enabling them to get loans. Today SACCOs act as small Savings Banks, except they don't accept general deposits, and are among the most successful cooperatives in the country. These institutions have played an important role in the mobilization of domestic financial resources for general economic development and poverty alleviation.

In the pursuit of better operational performance and profitability, organizations are looking for strategies to improve their operational performance and boost their profitability. As competition intensifies due to changes in the industry structure and the emergence of new technologies, organizations are determined to reduce their operational costs which enhances their profitability.

Similarly, financial performance of SACCOs can also be viewed in light of their overall profitability and return on investment. When analyzing a firm's profitability, we are concerned with evaluating a firm's earnings with respect to a given level of sales / assets / owners' investment or share value. In doing so, the common profitability measures include: Common-size income statements; Return on total assets (ROA); Return on equity (ROE); Earnings per share (EPS); Price/Earning (P/E) ratio.

Return of total assets (ROA) takes into consideration the return on investment (ROI) and indicates the effectiveness in generating profits with its available assets, thus the higher the better. Return on equity (ROE) indicates the return on owners' equity, hence the higher the better. Earnings per share (EPS) indicate the Kenya Shilling amount earned on behalf of each common share, thus the higher the better. Price/earnings (P/E) ratio is the amount investors are willing to pay for each dollar of earnings, that is indicates investors' confidence (Hermann, 2008). In this study, the financial performance of SACCOs will be measured using Return on equity (ROE).

### **1.1.3 SACCOS in the Hospitality Industry**

The operations of Savings and credit Co-operative societies and average deposit and loan sizes differ substantially depending on the type of SACCOS and its clients' base. For example, the average deposit and loan size of the employee-based and urban/regional town SACCOs tend to be larger than those of community-based SACCOS, as the urban members generally have a higher income than those on village level. Similarly, the average loan and deposit of SACCOs with the MFC differs tremendously depending on the level of maturity of the SACCOs, number and type of members. Various types of SACCOs exist, depending on the membership profile and the products extended to the members differ accordingly.

Hospitality industry SACCOs fall in the class of employee-based SACCOs; these represent SACCOs where all the members are drawn from one employer and these SACCOs are generally located in urban areas or regional level. Specific salary based loans are extended which are often guaranteed by the employer.

## **1.2 Statement of the problem**

Weaknesses in their internal credit management practices can lead to the failure of financial organizations. Good credit management practices of an organization can enhance its liquidity, performance and improve profitability. The management must maintain a balance between the amount of the various financial resources in order to achieve stability, performance and profitability.

As of 2009, SACCOs in Kenya were not performing very well and hence were not playing the expected vital and vibrant role in the economic growth and development of Kenya, (Kimeu, 2008). Among the major problems hindering good financial performance in SACCOs was the lack of proper investment decisions, lack of investment opportunities, delayed cash flow from members and dubious investments which had very little or no gain to the members capital due to under regulation. Since the introduction of SASRA, there have been tremendous growths of SACCOs in Kenya, (KUSCO, 2009).

In Kenya empirical and case studies that have been done on credit management in SACCOs include, Gisemba (2010) who undertook a study on the relationship between credit risk management practices and financial performance of SACCOs in Kenya. The study concluded that the management of the SACCOs was involved in the management of the credit risk through standardization of loan documentation and processing. Gaitho (2010) carried out a survey on credit risk management practices adopted by SACCOs. Njiru (2003) studied credit risk management by coffee cooperatives in Embu district. Kabiru studied on the relationship between credit risk assessment practice and the level of non-performing loans of Kenyan banks while Vikuru (2008) studied credit management practices at Kenya Power and Lighting Company. Kabee (2009) studied credit management practices in the Manufacturing industries.

So far, studies done have not focused on the credit management practices of SACCOs in Kenya's hospitality industry. This study sought to fill the gap to determine the effect of credit management practices on the performance of SACCOs in the hospitality industry in Nairobi. This study tries to address the problem by answering the question: What is the effect of credit management practices on the performance of SACCOs in the hospitality industry in Nairobi?



### **1.3 Objectives of the study**

The objective of the study was to determine the effect of credit management practices on the performance of SACCOs in the hospitality industry in Nairobi.

### **1.4 Importance of the study**

The results of this study were important since they enlightened the management on the efficiency and effectiveness of its credit management practices and recommend measures for improvement. Further they enabled them to decide whether to give discounts for prompt payment or not. The study also helped them in deciding what evidence are needed for indebtness, which customers are likely to pay their bills, how much credit they are prepared to extend to each customer and the system of collecting the money when it becomes due.

The study findings were of great importance to the management of SACCOs in Kenya as it gave insights on the effects of efficient and effective credit management practices on performance and the ultimate goal of ensuring growth and sustainable income and maximum benefit to the members. The study also helped them in deciding what evidence is needed for indebtness, which customers are likely to pay their bills, how much credit they are prepared to extend to each customer and the system of collecting the money when it becomes due.

Through the study, the government can use the study in designing the taxation policies for firms in the hospitality industries in relation to receivables and bad debts and also being the majority shareholders they would like to account for their returns in earning per share which is determined by the working capital management.

# **CHAPTER TWO**

## **LITERATURE REVIEW**

### **2.1 Introduction**

This chapter reviews literature relating to credit management practices amongst financial institutions. The literature review has been organized in the following sections. First section covers the theoretical framework on effects of credit management practices on performance of SACCOs in Kenya. The second section covers the determinants of portfolio performance, empirical studies and summary of the literature review.

### **2.2 Theoretical Review**

This study seeks to determine the effects of credit management practices performance of SACCOs' in the hospitality industry in Nairobi. It will be based on the economic theory, financial regulations and the public choice theory, liquidity theory and the neoclassical theory of optimal capital accumulation.

#### **2.2.1 Transaction cost theory**

Transaction cost theory tries to explain why companies exist, and why companies expand or source out activities to the external environment. The transaction cost theory supposes that companies try to minimize the costs of exchanging resources with the environment, and that companies try to minimize the bureaucratic costs of exchanges within the company. Companies are therefore weighing costs of exchanging resources with the environment, against bureaucratic costs of performing activities in-house. The theory sees institutions and market as different possible forms of organizing and coordinating economic transactions. When external transactions costs are higher than the company's internal bureaucratic costs, the company will grow, because the company is able to perform its activities more cheaply, than if the activities were performed in the market. However if the bureaucratic costs for coordinating the activity are higher than the external transaction costs, the company will be downsized. According to Coase (1937), every company will expand as long as the company's activities can be performed cheaper

within the company, than by example outsourcing the activities to external providers in the market.

According to Williamson (1981), a transaction costs occurs “when a good or a service is transferred across a technologically separable interface”. Therefore transaction costs arise every time a product or service is being transferred from one stage to another, where new sets of technological capabilities are needed to make the product or service. Therefore, it may very well be more economical to maintain the activity in-house, so that the company will not use resources on example contacts with suppliers, meetings and supervision. Managers must therefore weigh the internal transaction costs against the external transaction costs, before the company decides whether or not to keep some activity in-house.

### **2.2.2 In-Kind Finance: A Theory of trade credit**

According to Burkart and Ellingsen (2004), it is typically less profitable for an opportunistic borrower to divert inputs than to divert cash. Therefore, suppliers may lend more liberally than banks. The model implies that trade credit and bank credit can be complements or substitutes. Trade credit has short maturity, is prevalent in less developed markets and accounts payables of large unrated firms are more countercyclical than those of small firms.

A remarkable feature of short-term commercial lending is the central role played by input suppliers. Suppliers not only sell goods and services, but extend large amounts of credit as well. In the presence of specialized financial intermediaries, it is far from obvious why exchange of goods is bundled with credit transaction: When trade credit is cheaper than bank credit, as is often the case, the puzzle is that suppliers are willing to lend and when trade credit is more expensive, the puzzle is banks are willing to lend. Indeed, a sizable fraction of firms repeatedly fail to take advantage of early payments discounts and thus end up borrowing from their suppliers. Many firms offer trade credit despite having to take (bank and) trade credit to finance their operations. We argue that firms simultaneously give and take trade credit because receivables can be collateralized. Once an invoice is pledged as collateral, it becomes completely illiquid from firm’s perspective, and the firm can obtain additional bank credit against receivables. Thus, offering an additional dollar of trade credit does not force a firm to reduce its

real investment by one dollar .According to Peterson and Rajan (1997), firms in financial distress increase their supply of trade credit, a result that they consider surprising. Trade credit should have shorter maturity than bank credit as trade credit loses its advantages once illiquid input is transformed into liquid output that's why bank credit is routinely rolled over, whereas trade credit is not.

### **2.2.3 Asymmetric information theory**

When sellers face uncertainty about their customers' creditworthiness and financial health, they cannot reliably make the best selling decisions. Likewise, when buyers face uncertainty about their suppliers' products/services they cannot confidently make the best purchasing decisions. In such circumstances, trade credit is used to deal with this asymmetric information problem: buyers will have a sufficient period of time to investigate and assess the quality of the product and its value for money and to pay when they are satisfied. So those faced with choices would go for suppliers offering credit as this is a sign that sellers have confidence in the quality of their products/services. Trade credit is seen as an implicit warranty guaranteeing product quality. On the other hand, sellers will gather valuable information about customers' financial health through their payment patterns and their abilities to take advantage of discounts for early payment when offered, and they will use credit periods as a signal to the market of high and consistent product quality or of long-term presence.

A supplier's inconsistent production process can reduce the quality of the buyer's final goods, which can lead to higher costs and damaged reputations (Krueger & Mas, 2004).In addition, suppliers who poorly manage regulatory compliance may be more likely to be shut down by regulatory inspectors, which can impose costly business interruption on their customers (Medina, 2002).Beyond seeking to mitigate risks to their end-product quality, brand image, and corporate reputation, some companies seek suppliers with superior environmental practices to promote their environmental image or objectives. Despite their importance, suppliers' management practices remain quite difficult for buyers to observe, which presents an information asymmetry problem.

## 2.2.4 Portfolio theory approach in trade credit decisions

A portfolio is a set of assets (for example, accounts receivable). The portfolio approach to accounts receivable management can be used by utilizing the rate of profit (rate of advantage from assets) as one of the basic criteria that the firm giving the trade credit should encourage the purchaser to consider when making decisions. The profit rate resulting from the trade credit can be defined as:

$$R_{nAR} = \frac{\Delta CR - \Delta Costs}{\Delta Costs}$$

Where:

$R_{nAR}$  = Profit rate from giving the trade credit to purchasers  $n$ ,

$\Delta CR$  = Cash from sales growth generated from additional sale to  $n$  customers instead of the cash sale,

$\Delta Costs$  = Growth of costs resulting from offering the trade credit to purchaser  $n$ .

The present rate of profit is realized amid conditions of risk and uncertainty. The rate of profit changes varies according to the various probabilities. These probabilities result from customers' marketable situations which influence their ability to regulate their accounts payable to the seller in an appropriate manner. In order to choose terms of sale proposed to purchaser a firm management can use incremental analysis to estimate the effects of changes in trade credit policy. Trade credit management should contribute to realization of basic financial purpose of an enterprise which is the maximization of its value. Many of the current asset management models that are found in financial management literature assume book profit maximization as the basic financial purpose. These book profit-based models could be lacking in what relates to maximization of enterprise value. The enterprise value maximization strategy is executed with a focus on risk and uncertainty. An increase in the level of accounts receivables in a firm increases both the net working capital and the costs of holding and managing accounts receivables. If the firm completes the transactions with more than one group of purchasers, it is possible to distinguish two or more homogeneous groups in relation to the risk and profit from giving the trade credit. In this case, the portfolio approach can be used.

### **2.3 Empirical studies**

A study by Murugu (2005), on credit risk management in SACCOs held that SACCOs have heavily relied on particular credit risk techniques which are not adequate to militate against loan losses in a dynamic and competitive lending environment. Secondly, adequate credit risk monitoring and control mechanisms are lacking in majority of SACCOs which results in late detection and determination of non-performing and defaulted loans. Thirdly, governance structures that would ensure that the laid down credit risk policies are strictly adhered to is lacking in majority of SACCOs. Descriptive research design was used with a target population of 1,926 active SACCOs based in Nairobi. A sample size of 193 SACCOs was selected using the systematic random sampling technique. The questionnaire was formulated with both open ended and close ended questions based on the objectives of the study. Both the questionnaire and the Data collection sheet were administered to the Sacco Managers through drop and pick method. The entry and analysis of data was done using SPSS (Statistical Package for Social Sciences) program. The data was presented in form of tabulations, charts, graphs and percentages.

A study by Dhakal (2011) on risk management in SACCOs found out that risk management is not imbedded into the SACCOs institutional cultures and its value is not shared by all employees. He also noted that given the capacity, introduction of sophisticated systems and technical tools risk management does not work in SACCOs and therefore they lack the capacity required for risk management. The study adopted descriptive research design study in which data was gathered just once over the period 2008 to 2010 for 35 SACCOs in Nairobi County registered by SASRA. The study was facilitated by use of secondary data. Multiple regression analysis was applied to the data to examine the effects of credit risk management on performance of SACCO's in Kenya.

Ogendo (2009), researched on effect of Savings and Credit Co-operative Societies strategies on member's savings mobilization in Nairobi, Kenya. The study found out that savings mobilization is a key component in any development endeavor as it is believed to be the surest way of increasing income and boosting productivity in attempt to eradicate poverty. The main purpose of the study was to determine the effect of cooperative strategies on members' savings mobilization and analyze the effect of intervening factor(family size, attitude, and income level)

on savings mobilization. The study utilized a sample of 30 SACCOs out of 2,500 and 180 SACCO members out of 150,000 in Nairobi area. These were selected through simple random sampling method. A semi structure questionnaire was used to collect data from 210 respondents. Data was analyzed using a multiple linear regression model to test relationship and assess impact of the independent variables on members' savings mobilization. A response rate of 45.7% (96) respondents was achieved. Correlation coefficient revealed that training requirement had an average positive influence on saving mobilization, while investment opportunities and intervening variables had a strong positive influence on saving mobilization. The most significant factors were investment opportunities, and intervening variables at 99% confidence level. It was therefore concluded that cooperative strategies partially affected members' savings mobilization.

A study by Essendi (2012) on the effect of credit risk management on loans portfolio held that credit management function facilitates efficient management and administration of the SACCO loan portfolio in order to ensure equitable distribution of funds and to encourage liquidity planning. Results indicated that formulation of the credit policy is largely done by members of the organization and regulation with moderate involvement of employees and the directors. The existing credit policy of the Sacco is the primary document upon which formulation of new credit policy is based, trends of creditors and overhead costs are also taken into account in the process of formulation. Descriptive research design was used with a target population of 106 licensed SACCOs from which a sample of 35 SACCOs was identified from Nairobi County. The study used both primary and secondary data. Primary data was obtained through questionnaires and secondary data from Sasra reports. Data collected was analyzed using descriptive statistics and regression analysis.

Gisemba (2010) researched on the relationship between risk management practices and financial performance of SACCOs found out that the SACCOs adopted various approaches in screening and analyzing risk before awarding credit to client to minimize loan loss. This includes establishing capacity, conditions, use of collateral, borrower screening and use of risk analysis in attempt to reduce and manage credit risks. He concluded that for SACCOs to manage credit risks

effectively they must minimize loan defaulters, cash loss and ensure the organization performs better increasing the return on assets.

A study carried on late payment & credit management in the small firm sector Peel et al (1999), held that trade credit involves supplying goods and services on a deferred payment basis that gave the customer time to pay. Trade credit involved two types of transactions: use of trade credit as customers and provide it as suppliers. For small firms, supplying and financing trade credit and managing trade debt, caused cash flow /financing difficulties. Trade credit contracts were incomplete with asymmetric bargaining positions between supplier and buyer. A study titled trend and cycle in trade credit quality Payne (1961), it was found that during the downturn in general business conditions, the cutback in production, the reduction in inventories and outstanding receivables yielded excess receipts on operations. The sharper were the downturn and the higher the preceding level of indebtedness, the greater the accumulation of excess receipts. As a result, the need for new credit was reduced and a reversal of the credit flow was facilitated. Thus during the downturn the reduction in debt accumulation and the partial liquidation of outstanding debt brought about an improvement in the quality of current and potential credit. The stage was set for the next business expansion.

According to Soke Fun Ho and Yusoff (2009), in their study on credit risk management strategies of selected financial institutions in Malaysia the majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk. The aim of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable boundary. The efficient management of credit risk is a vital part of the overall risk management system and is crucial to each bank's bottom and eventually the survival of all banking establishments. It is therefore important that credit decisions are made by sound analyses of risks involved to avoid harms to bank's profitability. They held effective management of credit risk is an essential component of a comprehensive technique to risk management and critical to the long-term success of all banking institutions.



According to Swarens (1990), suggested that the most pervasive area of risk is an overly aggressive lending practice. It is a dangerous practice to extend term beyond the useful life of the corresponding collateral. Besides that, giving out loans to borrowers who are already overloaded with debt or possess unfavorable credit history can expose banks to unnecessary default and credit risk. In order to reduce these risks, banks need to take into consideration some common applicants' particulars such as debt to income ratio, business history and performance record, credit history, and individual loan applicants their time on the job or length of time at residence.

Pyle (1997), in his study on bank risk management held that banks and similar financial institutions need to meet forthcoming regulatory requirements for risk measurement and capital. However, it is a serious error to think that meeting regulatory requirements is the sole or even the most important reason for establishing a sound, scientific risk management system. It was held, managers need reliable risk measures to direct capital to activities with the best risk/reward ratios. They need estimate of the size of potential losses to stay within limits imposed by readily available liquidity, by creditors, customers and regulators. They need mechanisms to monitor positions and create incentives for prudent risk taking by divisions and individuals.

According to Summers and Wilson (2000), in their study on trade credit management and the decision to use factoring most firms involved in inter-firm trade offer to their customers. Factoring is a convenient financing method involving the transfer of title of the debtors, with or without recourse, to the factor where the seller receives a discounted amount based on the face value of the accounts factored. In the UK corporate sector more than 80% of daily business transactions are on credit terms. There are wide variations between industries and firms in the credit periods offered and the terms and conditions underlying them. Trade credit is an important source of short-term finance for business and represents a substantial component of both corporate liabilities and assets, especially in the case of intermediate companies. Trade debtors is one of the main assets on most corporate balance sheets, representing up to 35% of total assets for all companies, and, of course, it is one of the riskiest. The management of trade credit (debtors) is, thus an important facet of short-term financial management and supplier-customer relations. They held, if a firm has such financing difficulties, factoring can be beneficial in two

ways; firstly by making cash from invoices available more promptly and secondly by making finance available to firms which may not have the requisite level of fixed assets as collateral for loans.

## **2.4 Credit Risk Management Practices**

Effective credit management is vital to ensure that a SACCO's credit activities are conducted in a prudent manner and the risk of potential failures reduced. The success of SACCOs hinges on their ability to manage their credit effectively. Even though there are no strictly laid down credit Management practices, most financial institutions practice the following in order to maximize profit as well as to reduce credit risk.

### **2.4.1 Policy Framework and Management Strategy**

The policy framework forms a key part of a company's overall risk management strategy. The board and the management of the SACCO's formulate regulatory framework upon which all staff adhere to. The SACCO determines what policy to follow e.g. lend at a lower price and increase loan take up thus increasing the credit risk or lend at a higher rate, lower the volume of loan take ups and hence lower the credit risk. Therefore, a SACCO formulates systems, procedures and controls which are puts in place to ensure the efficient collection of customer payments and minimize the risk of non-payment (Naceour and Goaid, 2003).

The risk management feedback loop will involve the management and senior staff in the risk identification and must assess, process, as well as to create sound operational policies, procedures and systems. Implementation and designing of policies, procedures and systems will integrate line staff into the internal control processes, thus providing feedback on the Sacco's ability to manage risk without causing operational difficulties.

### **2.4.2 Appraisal of Loan Borrowers**

The assessment of the credit worthiness of a borrower is very important. This involves the gathering, processing and analyzing of information on the loan applicant. An important aspect of information is by way of credit references and credit rating. With credit reference agencies

already in place in Kenya, information about a potential borrowers' previous credit performance is readily available.

According to Rose (1999) the question that must be dealt with before any other is whether or not the customer can service the loan – that is, pay out the credit when due, with a comfortable margin of interest. The factors underlying the assessment of pre-lending safeguards, in the opinion of Rose (1999) are; character, capacity, cash, collateral, conditions and control (i.e. the 6Cs). In another context, Rouse (1989) referred to mnemonics used as common checklist to review loan application as: CCCPPARTS (Character, Capital, Capability, Purpose, Person, Amount, Repayment, Terms and Security); PARSER (Person, Amount, Repayment, Security, Expediency, Remuneration); CAMPARI (Character, Ability, Margin, Purpose, Amount, Repayment, Insurance/Security).

Rouse (1989) however, held the view that no advances should be made until security procedures have been completed or at least at a stage where completion can take place without the need to involve the borrower any further. This suggests that the provision of adequate perfected security should be paramount in taking a credit decision. The rigidity in total secured collateral before disbursement of credit facilities needs to be relaxed in order not to delay the financing, which invariably impedes the success of projects.

### **2.4.3 Risk Identification and Analysis**

Risk identification is vital for effective risk management, for SACCOs to manage risks facing them effectively they need to know how to identify the credit risks. The first step in risk identification identifying is prioritizing key risks which are reviewed and approved by the management committee. There is also need to determine the degree of risk the Sacco should tolerate and to conduct assessments for each risk of the potential negative impact if it is not controlled. Finally analyze the risk faced by the Sacco in the areas of interest rates risk, liquidity, credit, operations and strategic risks (CBK SACCO).

Risk analysis and assessment by Fatemi, (2000), indicated that a typical risk analysis process consists of two components; financial analysis (quantitative analysis) and qualitative analysis.

Financial analysis consists of analysis of financial; data available for the credit applicant, the analysis of annual financial statements has a central position in this context. Mostly financial analysis is carried out by credit analysts, there should be a general guideline stipulating that the analysis is confirmed by the person in charge of the organizational unit supplying the module for credit analysis when this module is handed over to the credit officer managing the exposure. (Eldelshain 2005).

#### **2.4.4 Adherence to credit approval limits**

On credit approval, it is important to ensure that laid out processes of approving new creditors and extending the existing credits have been observed in the spirit of managing credit risks in SACCOs. SACCO's must have in place written guidelines on credit approval processes and approval authorities.

The board of directors should always monitor loan performance while approval authorities should cover new credit approvals and the renewal of existing credit changes in terms and conditions of previously approved credits particularly credit restructuring which should be fully documented and recorded. Prudent credit practice requires that persons empowered with the credit approval authority should have customer relationship responsibility. Approval authorities of individuals should be commensurate to their positions within the management ranks as well as their expertise (Mwisho, 2001).

#### **2.4.5 Credit Risk Control and Monitoring**

The importance of monitoring risks is to make sure that they can be managed after identification. The SACCOs play an increasingly important role in local financial economies where competition for customers and resources with Micro Finance Institutions and other commercial banks is high therefore they require effective and efficient risk control and monitoring systems.

Credit Risk Management Measurement Operating and financial ratios have long been considered as tools for determining the condition and the performance of affirm. Modern warnings models for financial institutions gained popularity when Sinkey (1975) utilized

discriminate analysis for identifying and distinguishing problem banks and Altman (1977) examined the saving and loan industry. The procedures to identify financial institutions approaching financial distress vary from country to country, they are designed to generate financial soundness ratings and are commonly referred to as the CAMEL rating system (Gasbarro et al.2002).In Kenya the central bank applies the CAMEL rating system to assess the soundness of financial institutions which is an acronym for Capital Adequacy, Asset Quality, Management Quality, Earnings and Liquidity (CBK, 2010). According to SASRA, CAMEL as an offsite evaluation tool has been adopted to identify SACCOs that are financially vulnerable and therefore need increased supervisory attention. The rating scale is from 1 to 5 with 1 being the strongest and 5 being the weakest. SACCOs with rating of 1 are considered more stable, those with 2 and 3 are considered average and those with rating of 4 or 5 are considered below average and are monitored to ensure their viability.

### **2.5.1 Variables**

The credit management practices are the Independent Variables and are employed by SACCOs to explain variation or changes in the performance of SACCOs (Dependent variable). The listed variables are Credit analysis and Client appraisal, Loan defaulter reporting, Systematic defaulter follow-up. Credit policy formulation, credit risk monitoring and control, internal rating system and credit scoring models. The application or use of these practices will determine the level of performance of the SACCOs.

The dependent variable is the SACCO's financial performance which attempts to depict the likely outcome on the application or use of the above independent variables. It is expected that the standard of SACCO performance will be affected by the use and application of the above mentioned independent variables (credit management practices). SACCO performance as the dependent variable will be measured by Financial performance (parameter is ROA, ROE and NPLIL Ratios) ,Loan Recovery, good or bad governance, regulation and prudent Supervision.

### **2.6 Conclusion**

Credit functions must be able to react to the change pressures imposed by their environment and at the same time, take advantage of opportunities, which seem worthwhile. Credit function

should meet the needs and expectations of the company's debtor clients. In Kenya, empirical and case studies have been carried out; Mutwiri (2003) studied the use of 6c's credit risk appraisal mode and its relationship with the level of non- performing loans of commercial banks. So far studies done do not focus credit management practices in the cement manufacturing industry in Kenya. According to Mian and Smith (1992), recognized five functions must be performed in the credit administration process: credit-risk assessment, credit granting, accounts receivable financing, credit collection, and credit-risk bearing. All these items are clearly associated with activities that directly impact on a firm's liquidity.

Accounts receivable management decisions are very complex. On the one hand, too much money is tied up in accounts receivables, because of an extreme liberal policy of giving trade credit. This burdens the business with higher costs of accounts receivable service with additional high alternative costs. Additional costs are further generated by bad debts from risky customers. On the other hand, the liberal trade credit policy could help enlarge income from sales. However, if they are considered as one of several groups of enterprise customers, and if their payment habits are correlated with the payment habits of the remaining groups, what was formerly impossible could become possible, and may even turn profitable. The portfolio of assets, like the portfolio of accounts receivables, sometimes presents a lower risk to acceptable advantages than the independently considered groups of purchasers.

The credit function, with debtors as the largest current asset on balance sheet, is such a functional area that should be concerned with providing organization with competitive advantage. Slow payment and high proportion of bad debts will defeat primary business objectives. Everyone in the company works hard to market the product or service, maintain high levels of customer satisfaction and try to obtain payment. The credit manager should examine the market environment where the credit policy should flow from the following: corporate and departmental mission, goals and strategies, size and structure of credit department function, level of information technology competence, credit service characteristics and credit sales process.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter covers the research design and methodology that was used in the study which helped in determining the effects of credit management practices to the performance of SACCOs in the hospitality industry in Nairobi. It comprises the study design, target population, sample design and size, data collection and procedure.

#### **3.2 Research design**

The research design that was used in this study was descriptive design. This is the description of the state of affairs as it exists and an attempt was made to report the findings. Kerlinger (1969) points out that this type of research design results in the formulation of important principles of knowledge and solutions to significant problems. The study is not just a collection of data but also involved classification analysis, comparison and interpretation of data.

According to Cooper and Schindler (2003) a descriptive study describes the existing conditions and attitudes through observation and interpretation techniques. The study will therefore be able to generalize the findings to all SACCOs in the hospitality industry in Nairobi.

#### **3.3 Target Population**

The target population was 67 active hospitality industry SACCOs within Nairobi as per the attached information obtained from District annual Reports, Ministry of Co-operative Development and Marketing.

#### **3.4 Sample and sampling procedure**

Using systematic random Sampling technique, a sample of 10 SACCOs was selected. The minimum acceptable sample size for Descriptive research is 10% of the population (Gay, 1976). This technique was appropriate since the population is large and every SACCO in the target population has an equal chance of being selected.

### 3.5 Data Collection Procedure

The questionnaire was used to obtain and gather information to analyze and compare different practices of credit risk management in the selected SACCOs. The questionnaire method that was employed was primary data collection, although observation method was used for confirmation of secondary data like annual accounts.

The questionnaire was supplemented by a data collection sheet to collect information for a period of 5 years (2005-2009). The questionnaire was formulated with both open ended and close ended questions based on the objectives of the study. Both the questionnaires and the Data collection sheet were administered to the SACCO Managers through drop and pick method.

### 3.6 Data Analysis

This involves interpreting information collected from respondents when the questionnaires are completed by the respondents. Data analysis was carried out by use of simple mean, percentages, standard deviations, regression and correlation analysis by use of computer software application known as Statistical Package for Social Sciences (SPSS) Version 17.

Regression analysis was used to come up with the model expressing the relationship between the dependent variable (performance of SACCOs) and independent variables (credit analysis and client appraisal, loan defaulters' report, credit policy formulation, internal credit rating system.) The data analysis method to be used will be based on Pearson correlation analysis and a multiple regression model which will be developed to describe the relationship between the dependent variable and independent variables. The regression equation, as used by Mwaura (2005) assumed the following form:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

Where:

Y = Performance of SACCO in terms of dividends payable

X1, X2, X3, and X4 = Independent Variables

X1- Credit analysis and client appraisal

X2 – Loan defaulters' report



X3 – Credit policy formulation

X4 – Internal credit rating system

$\beta_0$  = Constant

$\beta_1, \beta_2, \beta_3, \beta_4$ , = Regression coefficients or Change included in Y by each X value

e = error term

The dependent variable was the financial performance in terms of dividends to be paid, whereas the independent variables were measuring the strength of the variables. Correlation was used to check the overall strength of the regression model and the individual significance of the independent variables.

### **3.7 Data Reliability and Validity**

Reliability is defined as the extent to which a questionnaire, test, observation or any measurement procedure produces the same results on repeated trials (Allen & Yen, 1979). The results were numbered as the questionnaires are sent out and then grouped into two groups to measure the score for each group. From the two groups, the results were evaluated for internal consistency. Due to time constraints while undertaking the study it was difficult to repeat the questionnaires to determine repeatability of the study, however, some of the questions in the questionnaires were repeated with slight changes in the wording to evaluate the repeatability of the study.

Validity is defined as the extent to which the instrument measures what it purports to measure (Allen & Yen, 1979). For example test that is used to screen for a job is valid if its scores are directly related to future job performance. Content validity pertains to the degree which the instrument fully assesses or measure the construct of interest.

## CHAPTER FOUR

### DATA ANALYSIS, FINDINGS AND DISCUSSION

#### 4.1: Introduction

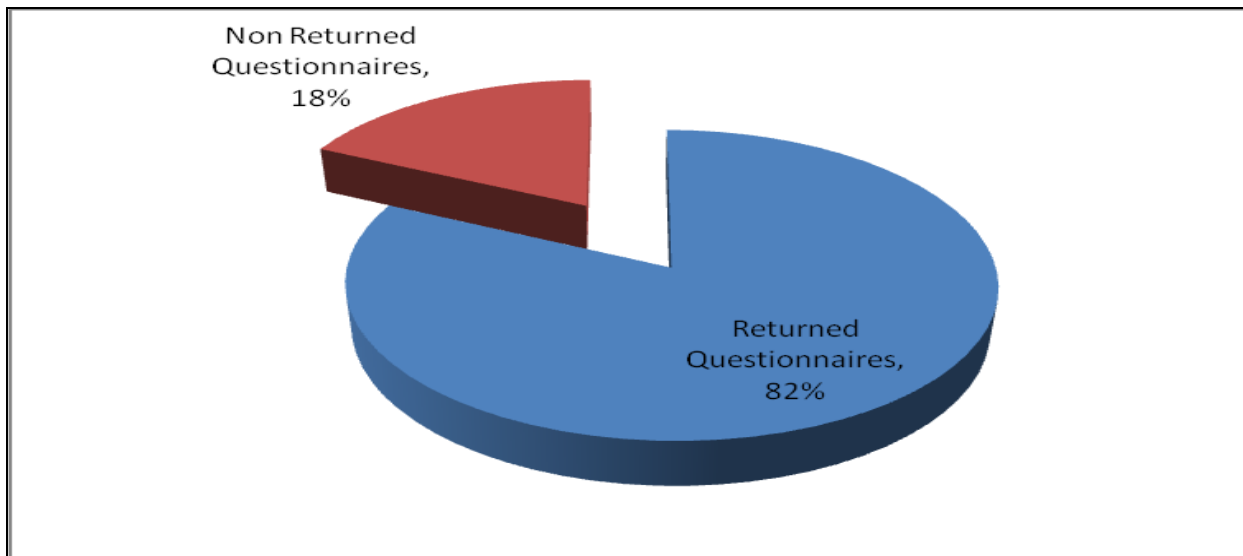
The research objective was to establish the effect of credit management practices on Savings and Credit Cooperative Society in the hospitality industry in Nairobi. This chapter presents the analysis and findings with regard to the objective and discussion of the same. The data was collected from the population of 50 respondents. The findings are presented in percentages and frequency distributions, mean, standard deviations, graphs and tables.

#### 4.2: Characteristics of Respondents

##### 4.2.1: Response Rate

A total of 50 questionnaires were issued out. The completed questionnaires were edited for completeness and consistency. Of the 50 Questionnaires used in the sample, 41 were returned. The remaining 9 were not returned. The returned questionnaires' represented a response rate of 82%, which the study considered adequate for analysis.

**Figure 4.2.1: Response Rate**



Source: Researcher, 2015

#### 4.2.2 Distribution by Gender

The respondents were asked to state the gender.

**Table 4.2.1: Distribution by gender**

	Frequency	Percent	Cumulative Percent
Female	20	48.8	48.8
Male	21	51.2	100.0
Total	41	100.0	

**Source: Researcher, 2015**

As shown in table 4.2.1, 48.8% of the respondents were female while the remaining 51.2% were male.

#### 4.2.2: Age Bracket

The respondents were asked to state their age brackets.

**Table 4.2.2: Distribution of respondents by age**

	Frequency	Percent	Cumulative Percent
Less than 25 Years	4	9.8	9.8
26-35 years	17	41.5	51.2
36-45 years	12	29.3	80.5
More than 45 years	8	19.5	100.0
Total	41	100.0	

**Source: Researcher, 2015**

The results are as shown in table 4.2.2. 9.8% of the respondents were of age less than 25 years, 41.5% were between 26-35 years of age, 29.3% were between 36-45 years old and the rest (19.5%) were over 50 years. On average the majority of the employees are between the age brackets of 26-45 years.

#### 4.2.3: Distribution by Marital Status

The respondents were asked to state their marital status. The results are as shown in table 4.2.3

As shown in table 4.2.3, most of the respondents (46.3%) were married, 36.6% were single, 9.8% were separated/ divorced and 7.3% were window(er). This shows that investment in real estate is open to all categories of people.

**Table 4.2.3: Marital status**

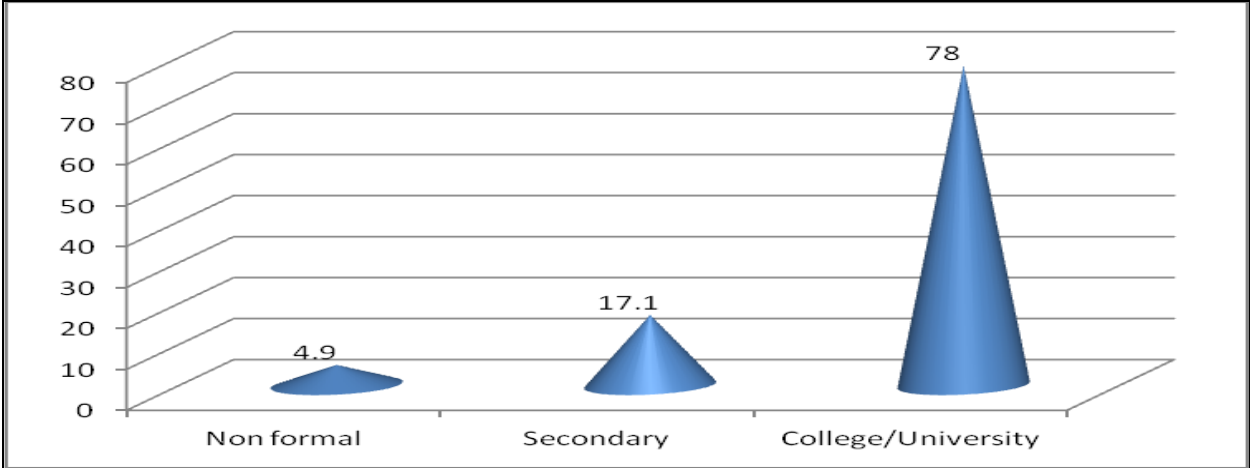
	Frequency	Percent	Cumulative Percent
Single	15	36.6	36.6
Married	19	46.3	82.9
Window(er)	3	7.3	90.2
Separated /divorced	4	9.8	100.0
Total	41	100.0	

Source: Researcher, 2015

**4.2.4: Distribution by Level of Education**

The respondents were asked to state their highest level of education. The results presented in figure 4.2.2.

**Figure 4.2.2: Level of Education**



Source: Researcher, 2015

As indicated in figure 4.2.2, majority (78%) of the respondents had college/university degree, 17.1% were secondary school graduates and 4.9% had non-formal education.

#### 4.2.5: Distribution of Respondents by the number of shares owned

As can be observed, in table 4.2.5, 31.6% of the respondent's owned between 100,000-300,000 shares, followed by between shares 500,000-1,000,000 at 29.3, less than 100,000 shares at 22%, between 300,000-500,000 at 9.8% and more than 1,000,000 shares at 7.3% respectively.

**Table 4.2.5: Number of Shares owned in the SACCO**

	Frequency	Percent	Cumulative Percent
More than 1,000,000	3	7.3	7.3
500,000- 1,000,000	12	29.3	36.6
300,000-500,000	4	9.8	46.4
100,000-300,000	13	31.6	78
Less than 100,000	9	22	100.0
Total	41	100.0	

**Source: Researcher, 2015**

#### 4.2.6: Distribution of Respondents by Time of joining the SACCO

As can be observed, in table 4.2.6, most (31.7%) of the respondents joined the SACCO within a period of 1 to 5 years ago, 26.8% joined more than 10 years ago, 24.4% joined 6 to 9 years ago and only 17.1% joined in less than one year ago.

**Table 4.2.6: When did you join the SACCO**

	Frequency	Percent	Cumulative Percent
More than 10 years ago	11	26.8	26.8
6-9 years ago	10	24.4	51.2
1-5 years ago	13	31.7	82.9
Less than 1 year ago	7	17.1	100.0

**Source: Researcher, 2015**

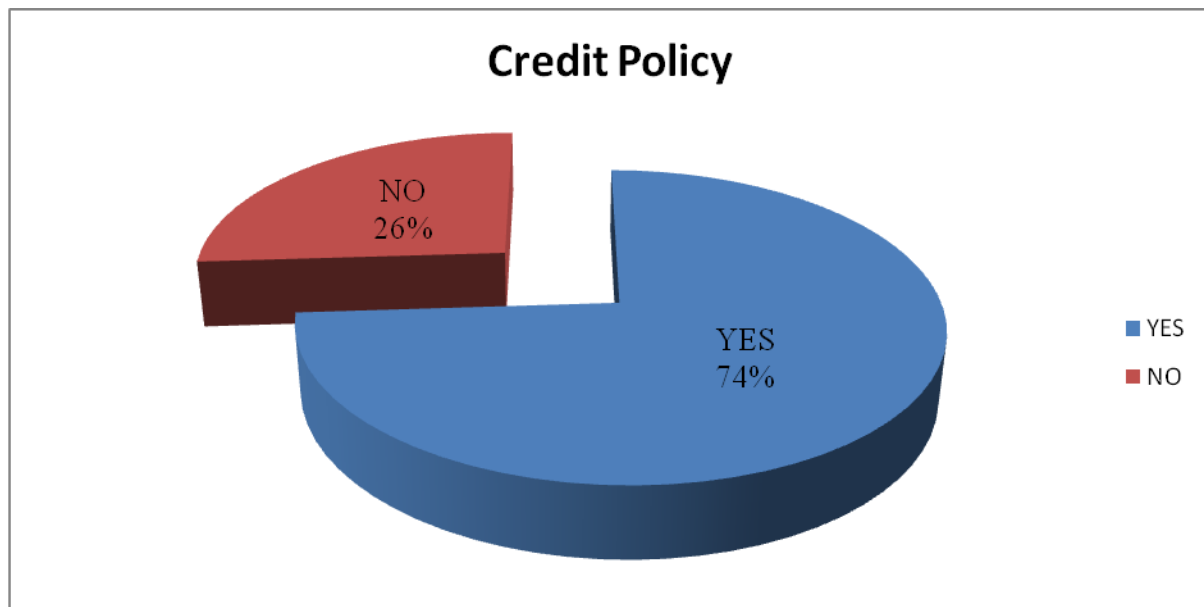
### 4.3: Results Presentation

This section covers the question posed to the respondents on the credit risk policy in terms of; risk mitigation strategies applied, credit rating worthiness parameters, credit reminder procedure, types of securities, and action taken by SACCOS to recuperate loans. Tables, frequencies and percentages were used to present the findings.

### 4.3.1: Credit Risk Policy

The respondents were asked to state whether their SACCOs have a credit policy or not. The results are as shown in chart 4.3.1

**Figure 4.2.6: Credit Risk Policy**



**Source: Researcher, 2015**

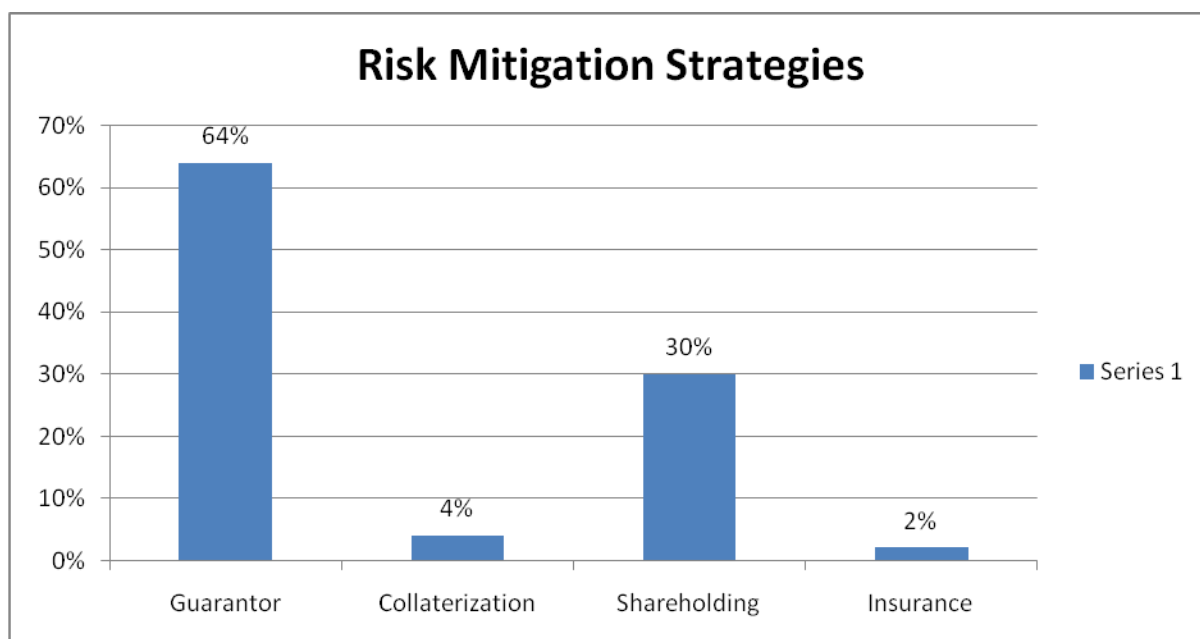
In 74% of the SACCOs, there is credit risk management strategy in place. This means that majority of the SACCO management recognize the importance of having a credit policy in the organization. These institutions will most likely have lower amounts of non-performing loans and lower loan default rate. Whether these credit risk policies in place are sufficient to mitigate the exposure to credit risk will be determined by a series of research findings below. 26% of the SACCOs have no credit policy in place. These institutions are likely to have high non-performing loans and high loan default rate because of the exposure of credit risk.

### 4.3.2: Risk Mitigation Strategies

The respondents were asked to state the type of risk mitigation strategy used by their SACCOs in credit risk management. The results are shown in figure 4.3.2. Guarantor is the most popular

risk mitigation strategy employed by the SACCOs. In case a member defaults in honoring his part of obligation, the SACCO is assured of recovering the principal amount and interest from the person(s) who guaranteed the loan. 30% of the shareholding is also used in an important proportion in mitigating credit risk. Insurance and Collateralization were not commonly used as a risk mitigation strategy.

**Figure 4.3.2: Risk mitigation strategies**



**Source: Researcher, 2015**

### **4.3.3 Credit rating worthiness parameters (New loans)**

Outstanding debts are most considered credit rating parameter for new loans. This implies that members with old loans or other debts are not given priority for new loans.

**Table 4.3.3: Credit rating worthiness parameters (New loans)**

<b>Credit rating parameter</b>	<b>Number</b>	<b>Percent</b>
Outstanding debts	12	28
Late payment	7	18
Length of credit history	7	18
New applications for credit	5	13
Types of credit in use	5	11
Delinquencies	4	10
Bankruptcies	1	2
Total	41	100.0

**Source: Researcher, 2015**

The second most popular rating is late payment and length of credit history which are given equal importance in rating a member's new loan. Bankruptcy is least considered as a parameter for giving new loan. This is because it is not easy to get this status at the point of giving out the loans.

Outstanding debts are most considered credit rating parameter for new loans. This implies that members with old loans or other debts are not given priority for new loans. The second most popular rating is late payment and length of credit history which are given equal importance in rating a member's new loan. Bankruptcy is least considered as a parameter for giving new loan. This is because it is not easy to get this status at the point of giving out the loans.

#### **4.3.4 Credit criteria used by the SACCOs to determine credit worthiness of a member**

**Table 4.3.4: Credit criteria used by the SACCOs**

<b>Credit Criteria</b>	<b>Number</b>	<b>Percent</b>
Income	18	46
Character, reputation and credit history	2	4
Existing personal debt	8	20
Employment history	8	20
Potential for long term credit	4	8
Ability to repay the loan	1	2
Total	41	100.0

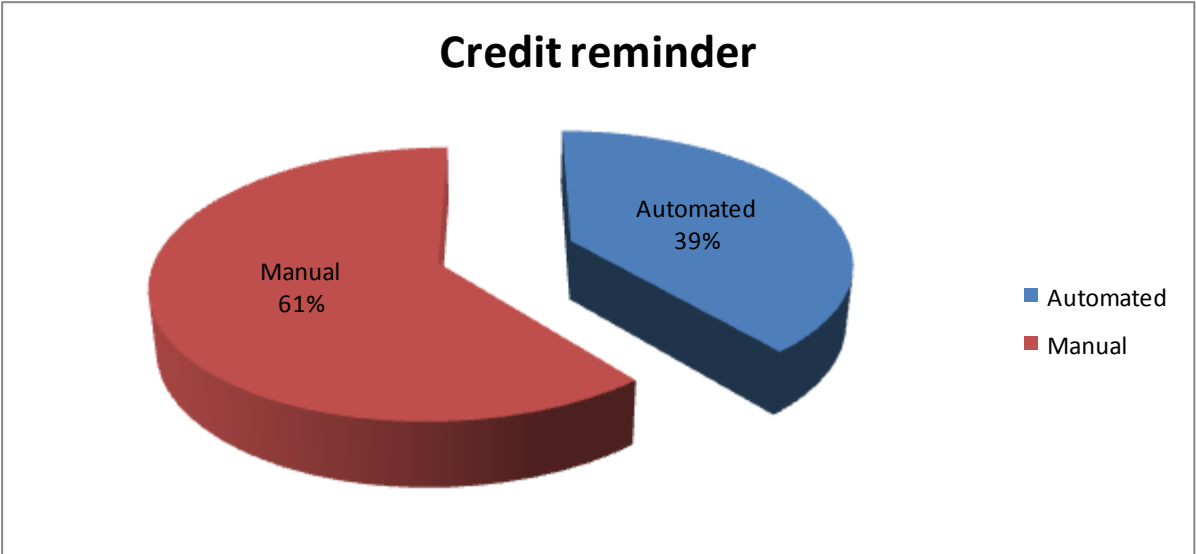
**Source: Researcher, 2015**



From the above table, income is highly considered as credit criteria in determining the credit worthiness of a member. Employment history of a member follows in the order of priority while existing personal debt is also given equal importance.

Potential for long term credit is among the least favored criteria, as was the character, reputation and credit history. The ability to repay the loan is least considered as a credit risk criteria scoring a paltry 2%.

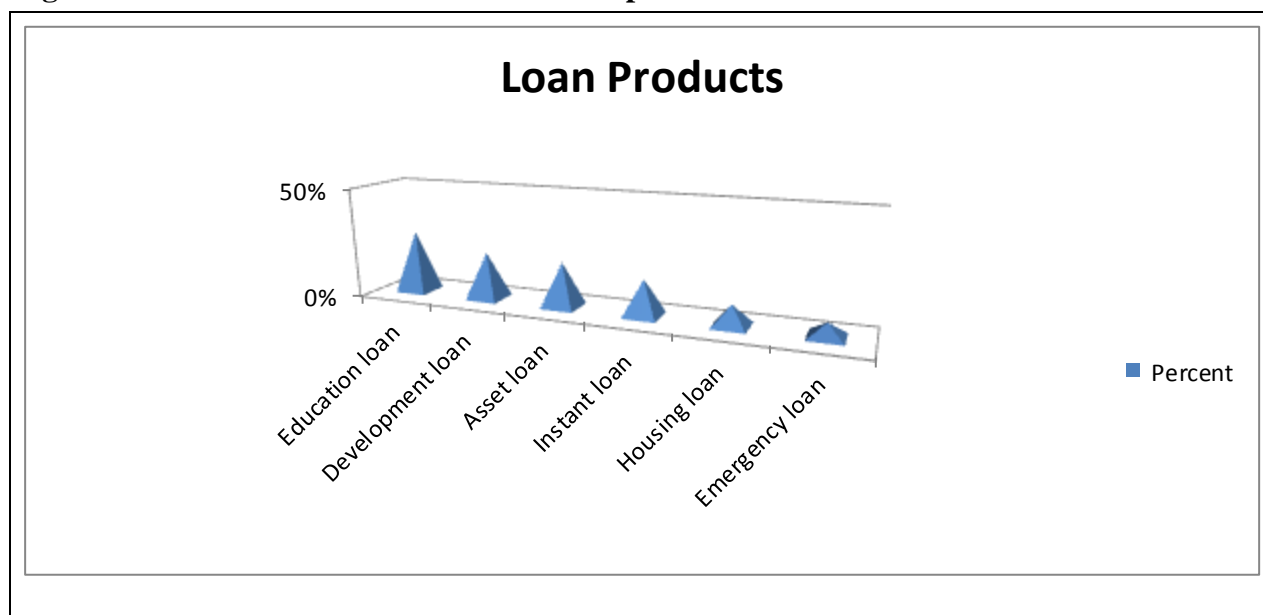
**Figure 4.3.4: Form of credit reminder in place.**



**Source: Researcher, 2015**

From the above observation, majority of SACCOs have not automated their systems to facilitate credit reminder to members. This implies that timely reporting of non-performing loans is not possible for majority of SACCOs.

**Figure 4.3.5: Diversification of SACCO loan products**



**Source: Researcher, 2015**

Manual credit reminder is common because a significant number of SACCOs have not fully computerized their operations. This is a major weakness in the monitoring and control of credit risk.

The diversification of loan products is one of the credit risk policies adopted by the SACCOs in order to spread the risks across many products. The more the loan products the more the SACCO is cushioned against credit risk because different loan products will carry different levels of risk. In this case education loans are the most popular form of loan followed by development loans while housing loans are the least popular.

**Table 4.3.5: Securities requested by the SACCOs**

Security	Frequency	%
Shares	24	59
Assets	7	16
Cash deposit	6	14
Insurance policy	3	7
Debentures	1	4
Total	41	100.0

**Source: Researcher, 2015**

Shares are the most common form of security requested by the SACCOs at 59%. This is because borrowing is mainly based in the number of shares a member has saved with the SACCO. Assets and cash deposit come second and third with 16% and 14% respectively.

Insurance policy and debentures are least considered as form of security at 7% and 3 % respectively. This is because at the time of borrowing, the membership is based on the member savings in form of shares and no other form of security is requested by SACCO.

#### **4.3.5: Credit reminder duration**

Majority of the SACCOs send credit reminders to members with non-performing loans between 1 and 3 months. This is a credit risk monitoring and control technique that is used to ensure the loans which are currently non-performing do not eventually become defaulted.

**Table 4.3.6: Credit reminder duration**

<b>Duration</b>	<b>Frequency</b>	<b>%</b>
After 1-3 months	28	69%
After 3-6 months	12	29%
After 6-9 months	1	2%
Total	41	100.0

**Source: Researcher, 2015**

Timely reminder ensures that the SACCO has timely information on the causes of the delay in remittance and an agreement on how the loan will eventually be settled can be reached. A short duration reminder therefore reduces the amounts of non-performing and defaulted loans.

**Table 4.3.7: Action taken by SACCO to recuperate loans.**

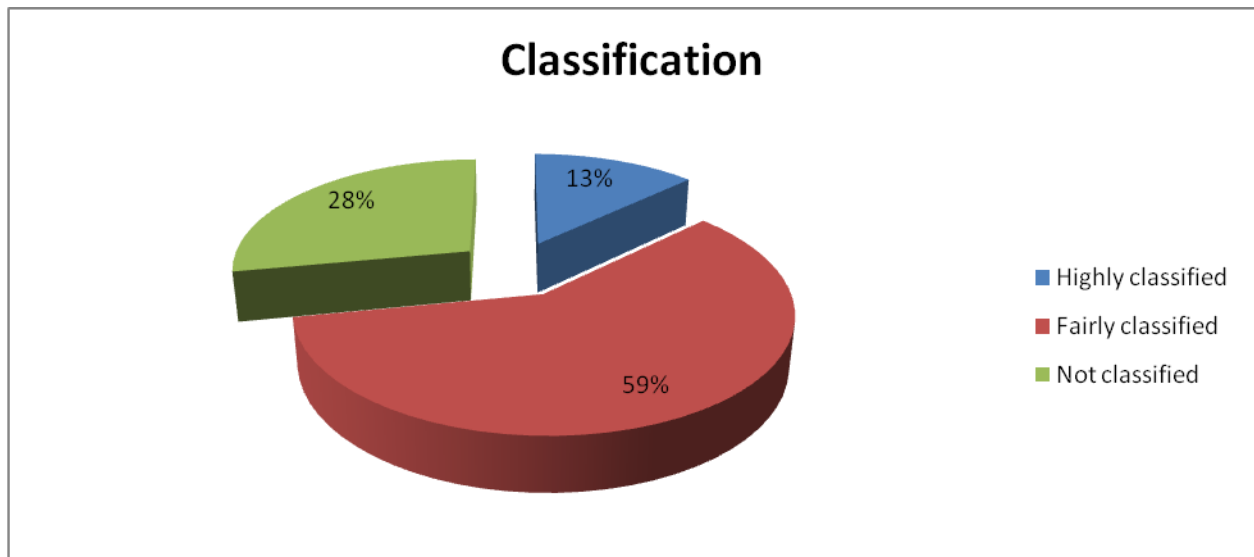
<b>Action</b>	<b>Frequency</b>	<b>%</b>
Follow-up guarantor to pay	25	62%
Claim with insurance	5	11%
Sue member by court	1	2%
Public auction of private property	4	10%
Ask member to pay loan without interest	6	15%
Total	41	100.0

**Source: Researcher, 2015**

In case a member defaults in payment of the loan, 62% of the SACCOs will immediately follow-up the guarantor to pay the loan. Defaulter reports will therefore involve balances that have been guaranteed and subsequent notices to the guarantor will have to be made. This means that this is the most popular method of defaulter follow-up employed by the SACCOs to ensure timely loan recovery and minimize loan losses.

Suing the member in court is the least defaulter follow-up method followed by public auction of private property. The reason is because the same methods are rarely used as securities when giving the loans to the members

**Figure 4.3.6: Level of loan classification**



**Source: Researcher, 2015**

SACCOs which have classified the loans, 59% of the loans are fairly classified while 13% are highly classified. This classification helps the SACCO to have a tailor made control and monitoring system for the high risk loans.

**4.3.10: Involvement of the board and senior management in credit policy evaluation.**

**Table 4.3.8: Board and senior management in credit policy**

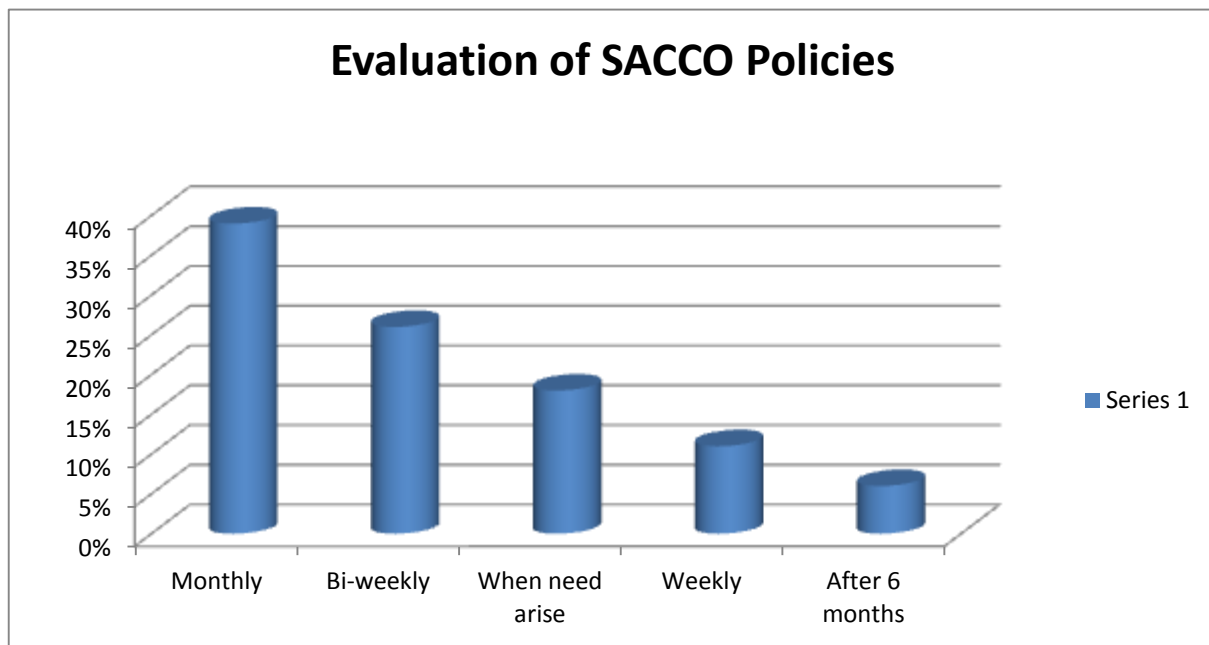
Involvement	Frequency	%
Very active	5	21%
Fairly active	24	36%
Active	12	43%
Total	41	100.0

**Source: Researcher, 2015**

Only about 36% of the sampled SACCOs have their board and senior management fairly active in credit risk assessment and internal processes, while 43% are just active and 21% very active. There is a major lapse on regulation, supervision and governance.

The extent to which the board and the senior management is involved in credit risk management and internal control is vital in ensuring reduction of credit losses. These are the leaders of these institutions and their active participation is very important. 4.3.11: Period of evaluation of the SACCO credit policies.

**Figure 4.3.7: Period of evaluation of the SACCO policies.**



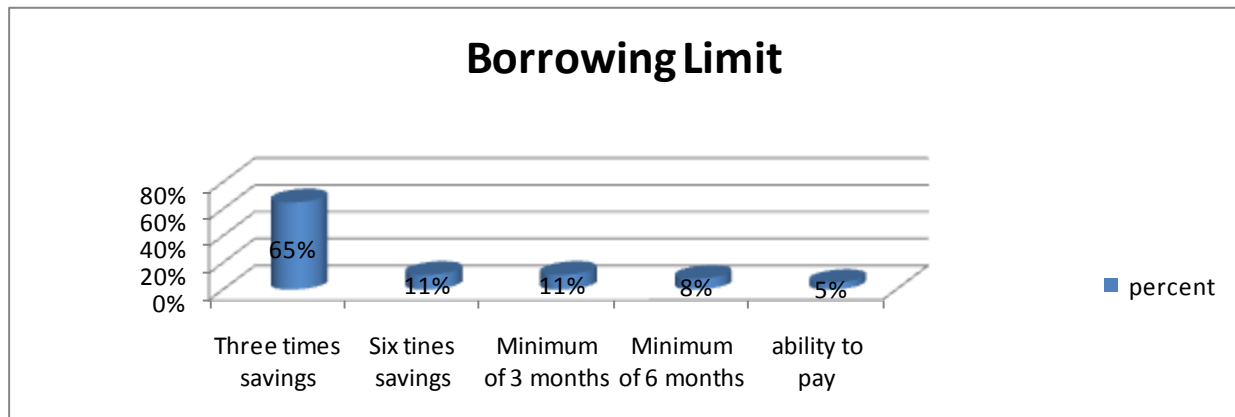
**Source: Researcher, 2015**

40% of respondents believed the SACCO did an evaluation of policies on a monthly basis, while 28% believed this was done once every fortnight. Only 7% of respondents believed this was done after every six months.

#### 4.3.12: Conditions on the borrowing limit

Majority of the SACCOs have conditions attached to the borrowing limit. From the observation on figure 4.3.12, 65% of them have a condition of 3 times a saving while 11% of them require six times and the same percentage requires a minimum of 3 months savings in order to qualify for a loan. Ability to pay the loan is least considered as a condition of borrowing. This is because the condition has little tangible financial basis, that is, the ability to pay cannot be established with a certain level of certainty.

**Figure 4.3.8: Conditions of borrowing limit**



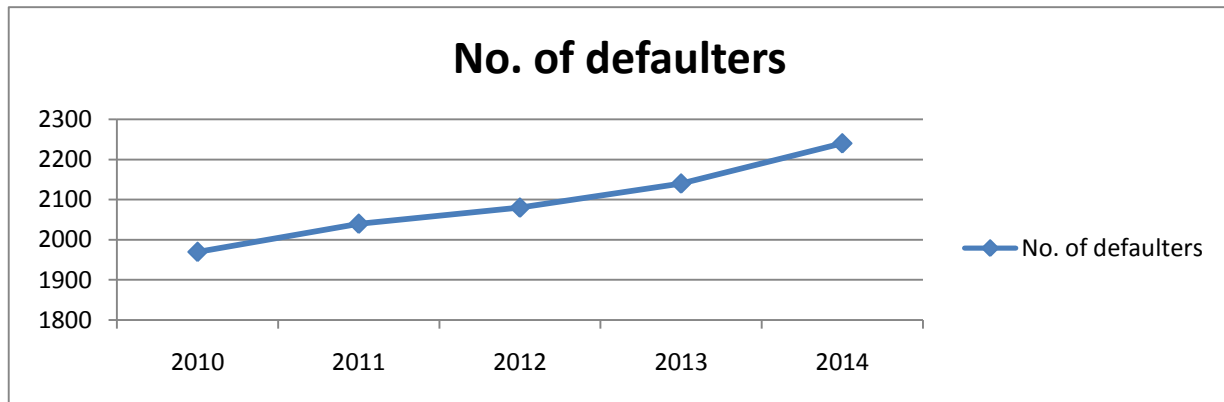
**Source: Researcher, 2015**

Based on the above observation, periodic evaluation and assessment of the credit risk policies is mostly done monthly with fewer SACCOs doing the evaluation after every two weeks. The shorter the evaluation period implies a better credit risk policy. 18% of the sampled population does the analysis when the need arises, which is not reliable to monitor the progress properly. Monthly evaluation is most popular because most of the SACCOs prepare monthly performance reports and therefore periodic credit reviews are done at the same time.

## 4.4: Data collection sheet

### 4.4.1 Default membership trend

Figure 4.4.1: Number of Defaulters



Source: Researcher 2015

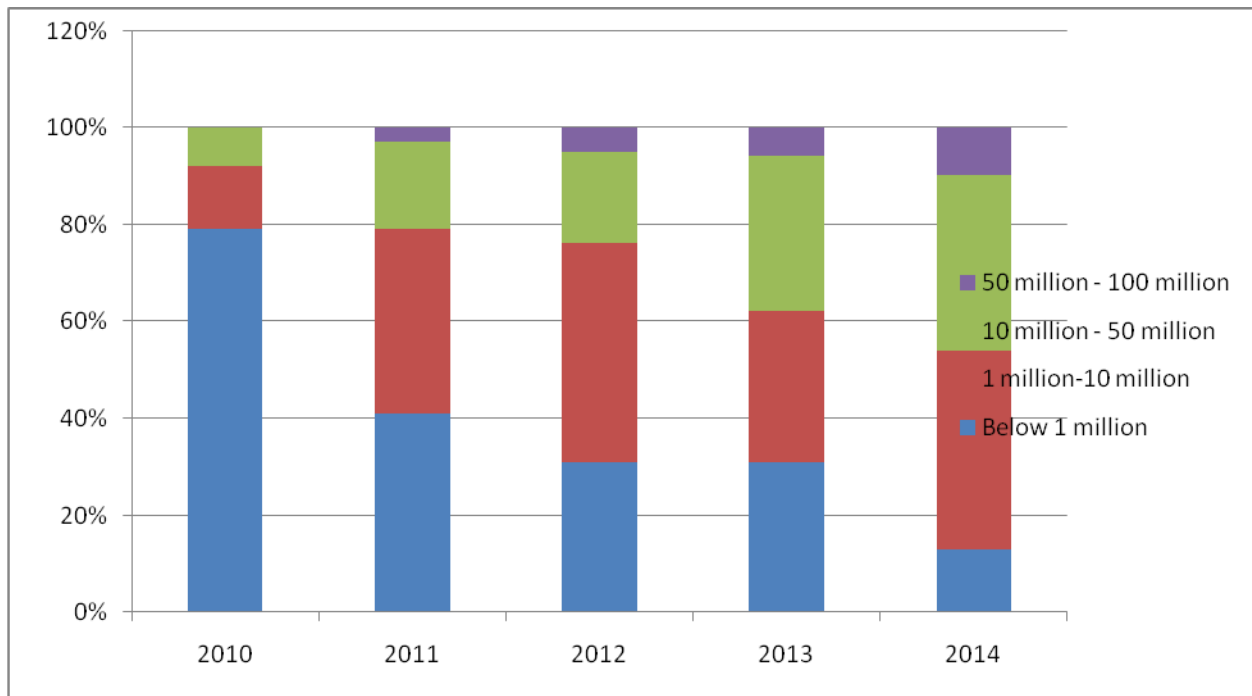
The number of defaulters in the sampled SACCOs have been on the increase every year as indicated above. This means that the credit risk practices currently employed are inadequate to reduce the loan losses. The number of defaulters has been increasing by an average of 15% per year since the year 2010.

This observation means that the performance of these SACCOs has been affected adversely by this trend. Increasing rate of non-performing loans eventually leads to higher amounts of defaulted loans. This reduces the interest income and the operating capital for the affected SACCOs.

### 4.4.2 Loan default trend categorized by amount

Based on the analysis on figure 4.42, it can be observed that the amount of defaulted loans has been on a steady increase for all the category of loans except below one million which reduced significantly in 2014.

**Figure 4.4.2 Loan default categorized by amount**



**Source; Researcher 2015**

The demands for loan amounts higher increased significantly from the year 2011 to 2014 and the defaulted between 1 million and 10 million had the highest notable increase in default for this period followed by amounts between 10 million and 50 million.

From the above analysis, default rate for higher amounts of loans advanced increased significantly per year from the year 2010 to 2014. The effect of this trend is loss of interest income for these SACCOs which in turn contribute to reduced profitability and lower returns to members. In the long run this trend may lead to bankruptcy of the SACCO due to reduced operating capital.

## **4.5: Regression Analysis**

### **4.5.1: Correlation Analysis**

Two predictor variable are said to be correlated if their coefficient of correlations is greater than 0.5. In such a situation one of the variables must be dropped or removed from the model. It was noted that, none of the predictor variables had coefficient of correlation between themselves more than 0.5 hence all of them were included in the model. The matrix also indicated high



correlation between the response and predictor variables, that is, credit analysis and client appraisal contribution to performance of the SACCOs with the highest correlation.

**Table 4.5.1: Pearson correlation coefficients**

	Financial performance of SACCOs	Credit analysis and client appraisal	Loan defaulters' report	Credit policy formulation	Internal credit rating system
Financial performance of SACCOs	1.000				
Credit analysis and client appraisal	.551	1.000			
Loan defaulters' report	.710	.288	1.000		
Credit policy formulation	.614	.233	.317	1.000	
Internal credit rating system	.882	.197	.445	.360	1.000

**Source: Researcher, 2015**

#### 4.5.2: Strength of the Model

Analysis in table 4.4.2 shows that the coefficient of determination (the percentage variation in the dependent variable being explained by the changes in the independent variables)  $R^2$  equals 0.789, that is, credit analysis and client appraisal, loan defaulters' report, credit policy formulation and internal credit rating system influence on the financial performance explain 78.9 percent of SACCOs leaving only 21.1 percent unexplained. The P- value of 0.000 (Less than 0.05) implies that the model of financial performance is significant at the 5 percent significance.

**Table 4.5.2: Model summary**

R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
				R Square Change	F Change	df1	df2	Sig. F Change
.888(a)	.789	.776	.51038	.789	1.242	4	37	.000

**Source: Researcher, 2015**

Predictors: (Constant), credit analysis and client appraisal, loan defaulters' report, credit policy formulation and internal credit rating system. Dependent Variable: Financial performance of SACCOs.

**Table 4.5.3: ANOVA**

	Sum of Squares	df	Mean Square	F	Sig.
Regression	21.772	4	4.354	4.201	.004 <sup>a</sup>
Residual	36.277	36	1.036		
Total	58.049	41			

**Source: Researcher, 2015**

The probability value (p-value) of a statistical hypothesis test is the probability of getting a value of the test statistic as extreme as or more extreme than that observed by chance alone, if the null hypothesis H<sub>0</sub> is true. The p-value is compared with the actual significance level of the test and, if it is smaller, the result is significant. The smaller it is, the more convincing is the rejection of the null hypothesis. ANOVA findings in table 4.4.3 shows that there is correlation between the predictors variables (credit analysis and client appraisal, loan defaulters' report, credit policy formulation and internal credit rating system) and response variable (financial performance of SACCOs) since P- value of 0.00 is less than 0.05.

### **4.5.3: Regression Equation**

The established multiple linear regression equation becomes:

$$Y = 1.808 + 1.353X_1 + 0.661X_2 + 0.035X_3 + 0.975X_4$$

#### **Elasticity**

Constant = 1.808, shows that if credit analysis and client appraisal, loan defaulters' report, credit policy formulation and internal credit rating system influence on the financial performance of the SACCOs were all rated as zero, financial performance of the SACCO rating would be 1.808

X<sub>1</sub>= 1.353, shows that one unit change in client appraisal strategy results in 1.353 units increase in financial performance of the SACCO

X<sub>2</sub>= 0.661, shows that one unit change in loans defaulted results in 0.661 units increase in financial performance of SACCO

$X_3 = 0.035$ , shows that one unit change in credit policies results in 0.035 units increase in financial performance of SACCO

$X_4 = 0.975$ , shows that one unit change in internal rating results in 0.975 units increase in financial performance of SACCO

**Table 4.5.4: Coefficients of regression equation**

		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
(Constant)		1.808	.527		3.428	.002
Credit analysis and client appraisal	$X_1$	1.353	.470	1.409	2.878	.007
Loan defaulters	$X_2$	.661	.312	.775	2.117	.041
Credit policy formulation	$X_3$	.035	.016	.037	2.160	.004
Internal credit rating system	$X_4$	.975	.265	.992	3.678	.001

**Source: Researcher, 2015**

The Dependent Variable is Financial performance of SACCO. The independent variables are credit analysis and client appraisal; loan defaulters; credit policy formulation and the internal credit rating system.

**Table 4.5.5: Individual Statistical Significance**

Hypothesis	
Hypothesis statement 1	Credit analysis and credit appraisal influence the financial performance of the SACCOs.
Hypothesis statement 2	Loan defaulters' report influences the financial performance of the SACCOs
Hypothesis statement 3	Credit policy formulations influence the financial performance of the SACCOs
Hypothesis statement 4	Internal credit rating systems influence the financial performance of the SACCOs.

**Source: Researcher, 2015**

The hypothesis testing was done with each of the variable tested on their influence on the financial performance of the SACCO. From the regression analysis on table 4.5.5 the independent variables have a significant relationship with the dependent variable which is the financial performance of the SACCO.

**Table 4.5.6: Hypothesis testing**

Hypothesis	P-Value	Significance level	Conclusion
H <sub>1</sub> : There is no significant relationship between credit analysis, client appraisal and financial performance Of SACCOs. H <sub>1a</sub> : There is a significant relationship between credit analysis, client appraisal and financial performance Of SACCOs.	.007	.05	Reject H <sub>1</sub> ,
H <sub>1</sub> : There is no significant relationship between loan defaulters' report and financial performance of SACCOs. H <sub>1a</sub> : There is a significant relationship between loan defaulters' report and financial performance of SACCOs.	.041	.05	Reject H <sub>1</sub> ,
H <sub>1</sub> : There is no significant relationship between credit policy formulation and financial performance of SACCOs. H <sub>1a</sub> : There is a significant relationship between credit policy formulation and financial performance of SACCOs.	.004	.05	Reject H <sub>1</sub> ,
H <sub>1</sub> : There is no significant relationship between internal credit rating system and financial performance of SACCOs. H <sub>1a</sub> : There is a significant relationship between internal credit rating system and financial performance of SACCOs.	.001	.05	Reject H <sub>1</sub> ,

**Source: Researcher, 2015**

The strongest independent variable being credit analysis and client appraisal which is 0.007 while the loan defaulters' report come second with the lowest independent variable is the internal rating system with 0.001.

This clearly shows that since all the P-Values for the individual predictor variables are less than 0.05, there is enough evidence to support H<sub>1a</sub> thus there is a significant relationship between the response and each predictor variable.

#### **4.6: Data analysis and findings**

With this observation therefore, it is evident that the current credit risk practices employed by the SACCOS are inadequate to mitigate against credit losses arising from the lending business. This trend also means that there is very high demand for the SACCO loans as a result of increased membership in these institutions. There has been no change in credit risk strategy that would respond to the challenges of lending in a highly competitive lending environment by balancing between high interest income and less of bad loans. All the independent variables were also individually linearly related with the

dependent variable thus a model of four predictor variables could be used to rate the financial performance of SACCOs in the hospitality industry in Nairobi..

The study found out that there exist a significant relationship between credit analysis and client appraisal, loan defaulters' report, credit policy formulation and internal credit rating system influence on the financial performance of SACCOs with the key determinants being; credit analysis and client appraisal on the financial performance.

From the observation, it is evident that the current credit risk practices employed by the SACCOs are inadequate to mitigate against credit losses arising from the lending business. This trend also means that there is very high demand for the SACCO loans as a result of increased membership in these institutions. There has been no change in credit risk strategy that would respond to the challenges of lending in a highly competitive lending environment by balancing between high interest income and bad loans.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1: Introduction**

In this section we discuss the main findings, draw conclusions and make recommendations.

#### **5.2: Summary of findings and interpretation**

The objective of the study was to establish the effect of credit management practices on the financial performance of SACCOs in the hospitality industry in Nairobi. From the analysis, the SACCOs have employed limited credit risk management tools and techniques. They have relied heavily on the shares of the members as a credit criteria parameter and the guarantor as the main risk mitigation tool. About 26% of the sampled SACCOs have no credit policy in place, while about 37% of the SACCO administrators believe that credit risk management has no effect on the performance of the SACCOs.

From the findings, it can be observed between 30% and 40% of the SACCOs have not embraced the modern credit risk management tools and techniques that can enable for timely and complete information about the loan portfolios already held. For example, a risk mitigation strategy like insurance which is widely employed by commercial banks is used by only 40% of the SACCOs. Even in the SACCOs where the credit policies and strategies are in place, the necessary monitoring and control mechanisms are clearly lacking.

About 25% of the SACCOs have no credit risk committee while 29% have no computerized system to monitor non-performing loans. 64% of the SACCOs still use experienced credit judgement while 61% use manual credit reminder for non-performing and defaulted loans. Only 43% of the SACCOs have their board members and senior management involved in evaluation of credit policy while 34% of loans in the SACCOs are not classified of the risk they carry.

### **5.3: Conclusion**

It is evident that if the credit Management practices are sound, the financial performance of SACCOs will also improve. On the other hand, if the credit management practices are poor, the performance will be unsatisfactory. Based on the data analysis in this study, the SACCOs have relied heavily on the guarantor as the main factor of mitigating credit risk. However, with the diversification and high demand for financial products aided with the rapid growth of the Co-operative sector operating in a highly competitive lending environment, SACCOs must employ diverse credit risk techniques. For example, insurance as a risk mitigating factor which is largely employed by the commercial banks is rarely used by the SACCOs as observed in the study.

The study revealed that 70% of the SACCOs have endeavoured to have the necessary credit risk policies in place, efficient and control mechanisms are lacking in meeting the overall objective of minimizing loan losses and maximizing returns for the shareholders. Compliance on the policies already in place highly depends on the supervision and good governance from the board and senior management. Their active role in this perspective has only been observed in 40% of the SACCOs. If the SACCOs have to maximize returns for members funds, guarantee the safety of their saving and remain in competitive lending environment, they must not only have credit risk policies in place but they also need to combine the traditional credit risk management practices with modern methods which will help them cope with the dynamics of the modern day lending and the at the same time have strong credit risk monitoring and control mechanisms.

### **5.4: Recommendations for Policy**

Credit management practices employed have a direct impact on the performance of the SACCOs in terms of non-performing and defaulted loans. This in turn leads to loss of interest income, operating capital loss, reduced SACCO profitability and diminishing returns to members.

Therefore, this study can be used by the Ministry of Industrialization (Co-operative development department) to draft a policy paper that will guide the SACCO authorities in the country on adopting credit risk practices. This will help to minimize loan losses and ensure that the profitability of these SACCOs and their members is safeguarded.

### **5.5: Limitation of the study**

In attaining its objective, the study was limited to SACCOs in the hospitality industry in Nairobi. The study was also limited to the degree of precision of the data obtained from the respondents hence it could be prone to shortcomings since it is not verifiable.

Another limitation was the confidentiality of respondents. Some of the respondents considered their savings and loans details to be confidential information hence they could not disclose such information. Others were unwilling to disclose the correct value of their investments.

The third limitation was time. Some respondents were unable to return questionnaire within the given time frame. The researcher had a limited time available for data collection and analysis hence some questionnaires were not returned on time to be considered in the data collection.

### **5.6: Recommendations for further research**

Researchers and scholars should carry out a research to establish the relationship between the credit management practices employed and the profitability indicators like ROA, NPL/ Total loans. They can also do more research to establish the effect of other types of risks like market risk and liquidity risk which are not considered in this study.

The researchers can also carry out the study to include larger sample since the results of this study were based on hospitality industry in Nairobi, the researcher can carry a research on other sectors for example in manufacturing, agriculture or banking SACCOs and also include rural based SACCOs.

More research on the extent to which external regulation, internal supervision and governance contributes to the employment of credit risk management practices and to the eventual performance of the SACCOs need to be explored.



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# APPENDIX 1

## QUESTIONNAIRE

### INTRODUCTION

The objective of the study is to determine the effect of credit management practices in SACCOs in the hospitality industry in Nairobi. Please answer the questions in this questionnaire by inserting "X" in the boxes provided or by filling out the spaces provided as briefly as possible.

### SECTION A:

Please tick (√) the option that corresponds to your answer in each of the following:

1. Gender

(a) Female ( ) (b) Male ( )

2. What is your age?

(a) Below 25 ( ) (b) 26 – 35 ( )

(c) 36 -45 ( ) (d) Above 45 ( )

3. Marital status

(a) Single ( ) (b) Married ( )

(c) Widow/widower ( ) (d) Separated/Divorced ( )

4. What is your highest level of education?

(a) Non-formal ( ) (b) Primary ( )

(c) Secondary ( ) (d) college/University ( )

5. In which SACCO are you a member?

.....

6. How many shares do you own in the SACCO?

.....

7. When did you join the SACCO?

(a) More than 10 years ago ( ) (b) (6-9) years ago ( )

(c) (1-5) years ago ( ) (d) Less than one year ago ( )

**SECTION B**

Where necessary tick ( ) appropriately in the space provided or state where possible.

1) Is credit risk policy part of the Sacco Management strategy?

Yes/NO.....

2) What combination of the following Risk mitigation strategies do your SACCO use in credit risk management?

a) Collateralization

b) Guarantor

c) Insurance

d) Shareholding

e) Others (Please specify) .....

3) Tick the credit rating worthiness parameters in use by the SACCO to give new Loans.

a) Late payments

b) Delinquencies

c) Bankruptcies

d) Outstanding debts

e) Length of credit history

f) New applications for credit

g) Types of credits in use.

4) Which of the following (or a combination) is the credit criteria used by the SACCO to determine credit worthiness of a member?

a) Income

b) The character, reputation and credit History.

c) Existing personal debt

d) Employment History

e) Potential for long term credit

f) Ability to repay the loan

5) What form of credit reminder procedure is in place in case of default?

- a) Standardized or automated credit reminder
- b) Manual credit reminders
- c) Other please specify.....

6) What are the types of Loan diversification products offered by the SACCO?

- a) Instant loan
- b) Education Loan
- c) Development loan
- d) Housing Loan
- e) Asset loan
- f) Emergency Loan
- g) Other please specify .....

7) Which of the following types of Securities ( or combinations) requested by SACCO?

- a) Shares
- b) Assets
- c) Cash Deposit
- d) Life Insurance policy
- e) Debentures
- f) Other( please specify).....

8) What is the Credit Reminder Duration?

- a) After 1-3 months Default Payment
- b) After 3-6 months Default Payment
- c) After 6-9 months Default Payment

9) What is the Action(s) taken by SACCO to recuperate Loan?

- a) Follow-up guarantor to pay
- b) Claim with Insurance
- c) Sue member by court

- d) Public Auction of private property
- e) Ask Customer to pay loan without interest.

10) Are Sacco loans classified on basis of credit risk?

YES/NO .....

If Yes which of the following categories do the current Loans fall?

- a) Highly classified
- b) Fairly classified
- c) Not classified

11) How is of Board of Directors and senior management involved in credit risk assessment and internal control processes?

- a) Very active
- b) Active
- c) Fairly active
- d) Not active at all.

12) How often do SACCO supervisors periodically evaluate the effectiveness of a SACCO's credit Risk policies and practices for assessing loan quality?

- a) Weekly
- b) Bi-weekly
- c) Monthly
- d) After 6 months
- e) When need arises.

13) To what extent is experienced credit judgment and reasonable estimates used in recognition and measurement of loan losses?

- a) Very often
- b) Often
- c) Sometimes
- d) Not in use at all

14) How does the SACCO have a system to identify early warning indicators to monitor and control credit risk?

YES/NO .....

15) Do you think credit risk management helps to improve on performance of your Sacco?

YES/NO .....

If yes explain briefly how.....

.....

16) What are the conditions on the borrowing limits?

a) Three times savings

b) Six times savings

c) Minimum saving of 3 months

d) Minimum savings of 6 months

e) Ability to pay

f) Others specify.....

17) Is there a Credit Risk Management committee or such other oversight body in place involved in the implementation and compliance of credit risk policy and strategy?

YES/NO. ....

18) Does the SACCO have a customized computer based reporting system which allow for detection of overdue loans in the shortest possible time?

Yes/NO.....

**THANK YOU FOR YOUR CO-OPERATION.**



## **APPENDIX 2**

### **SAMPLE LIST OF SACCOS IN THE HOSPITALITY INDUSTRY IN NAIROBI**

1. Safari Park Hotel SACCO
2. Windsor Golf Hotel SACCO
3. Tribe Hotel SACCO
4. Nairobi Safari Club Hotel SACCO
5. Sarova Stanley Hotel SACCO
6. Intercontinental Hotel SACCO
7. Utalii Hotel SACCO
8. Panari Hotel SACCO
9. Ole Sereni Hotel SACCO
10. Jacaranda Hotel SACCO

**APPENDIX 3**  
**DATA COLLECTION SHEET**

	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
<b>Loans given</b>					
<b>Loan repayment</b>					
<b>Amount outstanding</b>					
<b>Amount defaulted</b>					
<b>No. of defaulters</b>					
<b>Defaulted loan w/o</b>					
<b>Number of loanees</b>					