THE EFFECT OF CREDIT RISK MANAGEMENT PRACTISE ON LOAN LOSSES IN MICROFINANCE INSTITUTIONS IN KENYA

BY

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OCTOBER, 2012
DECLARATION

I declare that this is my original work and has never been presented in any other college or examination body.

Signature: ………………………….. Date: ……………………………..

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D61/75236/2009

This research project has been submitted for examination with my approval as the University of Nairobi supervisor.

Signature: ………………………….. Date: ……………………………..

MIRIE MWANGI
ACKNOWLEDGEMENT

I thank the Almighty God for seeing me through the entire period. I live for you God.

Thanks to my family for their encouragement and support during this entire period.

Many thanks too to my supervisor for his patience during this entire research period. You gave me the chance to see my best side.

In addition, thanks to my fellow staff members and friends for helping me with typesetting and proofreading of the document. This final document is as a result of your participation and input.
DEDICATION

This research project is dedicated to my family, friends and relatives.
ABSTRACT
Credit risk is simply defined as the potential that a borrower or counterparty fail to meet its obligations in accordance with agreed terms. Borrowers should be subjected to stringent CRMP, this enable analyze the borrowers character, ability to repay their loans, margin of the venture that the loan is to finance, purpose for the loan emphasizing on viability, amount of the loan relative to the venture, repayments and insurance to caution risk defaulting on the loan. This study sorted to determine the CRMP on loan losses in micro finance institutions in Kenya.

The sample frame constituted the commercial banks offering micro credit and micro finance institutions. The researcher adopted both the stratified random sampling technique as well as convenience sampling. Stratified random technique was used to select banks and registered MFIs within Nairobi, which are 31 in number. There were 52 respondents from various MFIs and banks offering micro credit services, this represented 83.8% response rate.

It was found that MFIs use different strategies to reduce the risk of loan defaulting. The most common as cited by the respondents includes having collateral against the loaned amount and having strict and through policies on leading. Others included stringent loan evaluation procedures and having provisions to accommodate the default, use of credit, insuring loans and use of guarantors. Credit risk management practice was found to have direct negative correlation, the higher the credit risk management practice weighted score the lower the rate of defaulted loans.
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## ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>CRM</td>
<td>Credit Risk management</td>
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<td>CRMP</td>
<td>Credit Risk Management Practice</td>
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<td>FSV</td>
<td>Force Sale Value</td>
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<td>MFIs</td>
<td>Microfinance Institutions</td>
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<td>NPLs</td>
<td>Non Performing Loans</td>
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<td>RM</td>
<td>Relationship Manager</td>
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<td>Recovery Unit</td>
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<td>SMEs</td>
<td>Small and Medium Enterprises</td>
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<td>U. S. A</td>
<td>United States of America</td>
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CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

Consumer credit is one of the major markets in the Kenya’s economy. Consumer credit is broadly understood to mean any of the many forms of commerce under which an individual obtains money or goods or services to repay the money or to pay for the goods or services, along with a fee or interest at some specific future date or dates. Kenya consumer credit market has shown that economic stability based on sound fundamentals can bring economic prosperity, high employment rate, low interest rates, and increased demand for MFIs credit by consumers (Rozas, 2009).

Over the past decade, the Kenya consumer credit market has grown significantly. By the end of 2009, the Kenya consumer credit market has doubled that of 2000. Managing risks in the consumer credit market is one of the critical dimensions to ensure the industry grows within a healthy environment. Effective regulations and laws will provide a safeguard for the industry from systemic risk, whereas sophisticated credit risk policy, strategies, and tools will provide institutions and consumers with risk protections (McGuire, 1998).

The process of risk management is a two step process. The first is to identify the source of the risk, which is to identify the leading variables causing the risk. The second is to devise methods to quantify the risk using mathematical models, in order to understand the risk profile of the instrument (Kealhofer, 2003). Once a general framework of risk identification and management is developed, the techniques can be applied to different situations, products, instruments and institutions. According to Marshall and Siegel (1996), there are some risks that can be eliminated, or at least
substantially reduced through the technique of risk transfer. Markets exist for many of the risks borne by the micro finance institutions. Interest rate risk can be transferred by interest rate products such as swaps or other derivatives. Borrowing terms can be altered to effect a change in their duration. The firm can also buy or sell financial claims to diversify or concentrate the risks that result in from servicing its client base. To the extent that the financial risks of the assets created by the firm are understood by the market, these assets can be sold at their fair value. Unless the institution has a comparative advantage in managing the attendant risk and/or a desire for the embedded risk they contain, there is no reason for the firm to absorb such risks, rather than transfer them (Morsman, 1993).

However, there are two classes of assets or activities where the risk inherent in the activity must and should be absorbed at the firm level. In these cases, good reasons exist for using firm resources to manage micro finance institutions level risk. The first of these includes financial assets or activities where the nature of the embedded risk may be complex and difficult to communicate to third parties. This is the case when the firm holds complex and proprietary assets that have thin, if not non-existent, secondary markets. Communication in such cases may be more difficult or expensive than hedging the underlying risk (Saunders, 1996). Moreover, revealing information about the customer may give competitors an undue advantage.

The second case included proprietary positions that are accepted because of their risks, and their expected return. Here, risk positions that are central to the firm’s business purpose are absorbed because they are the raison d'etre of the firm. Credit risk inherent in the lending activity is a clear case in point, as is market risk for the
trading desk of micro finance institutions active in certain markets. In all such circumstances, risk is absorbed and needs to be monitored and managed efficiently by the institution. Only then will the firm systematically achieve its financial performance goal (Tchankova, 2002).

1.1.1 Credit Risk Management Practices

Credit risk is the risk that micro finance institutions incur because the financial position of a borrower has deteriorated to the point that the value of an asset (including off-balance-sheet assets) is reduced or extinguished. Credit risk is most simply defined as the potential that a borrower or counterparty fail to meet its obligations in accordance with agreed terms. The goal of CRM is to maximize an organization’s risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters (Kealhofer, 2003). Micro finance institutions need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. These institutions should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any micro finance institution (Bofondi and Gobbi, 2003).

The importance of CRM is increasing with time because of some reasons like economic crises and stagnation, company insolvencies, infraction of rules in company accounting and audits, growth of off-balance sheet derivatives, declining and volatile values of collateral, borrowing more easily of small firms, and financial globalization. According to Fuser and Meier (1997) experiment in December 1997 indicated that institutions use various CRM methods such as credit limits, taking collateral, diversification, loan selling, syndicated loans, credit insurance, and securitization and
credit derivatives to avoid loan losses. It is important for staff of various micro finance institutions to understand the aspect of risk in their operations and the risks that are inherent and exposed in their business operations. Better understanding of risk management is also necessary especially in the financial intermediation activities where managing risk is one of its important activities.

The management of credit risk in finance industry follows the process of risk identification, measurement, assessment, monitoring and control. It involves identification of potential risk factors, estimate their consequences, monitor activities exposed to the identified risk factors and put in place control measures to prevent or reduce the undesirable effects. This process should be applied within the strategic and operational framework of the micro finance institution.

**1.1.2 Credit Risk Management in Micro Finance Institutions**

A comprehensive framework of risk management is applicable equally to micro finance institutions (Baldoni, 1998). It is crucial for micro finance institutions to have comprehensive risk management framework as there is growing realization that sustainable growth critically depends on the development of a comprehensive risk management framework (Greuning and Iqbal, 2007).

A robust credit management practice can help micro finance institutions to reduce their exposure to loan losses, and enhance their ability to compete in the financial market (Iqbal and Mirakhor, 2007). A reduction in each institution’s exposure will reduce the systemic risk as well. Hence, it is necessary that micro finance institutions have in place a comprehensive risk management and reporting process to identify, measure, monitor, manage, report and control different categories of risks. Common risk avoidance practices include at least three types of actions. The standardization of
process, contracts and procedures to prevent inefficient or incorrect financial decisions is the first of these. The construction of portfolios that benefit from diversification across borrowers and that reduce the effects of any one loss experience is another. The implementation of incentive-compatible contracts with the institution's management to require that employees be held accountable is the third. In each case, the goal is to rid the firm of risks that are not essential to the financial service provided, or to absorb only an optimal quantity of a particular kind of risk (Jorion, 1997).

1.1.3 Loan Losses in Micro Finance Institutions

While a number of definitions list potential reasons for loan losses (such as multiple lending), focus on measurement of loan losses, or do not distinguish between loan losses and repayment crises, this study follows a more stringent definition. Loan losses can be defined as inability of individuals or households “to repay all debts fully and on time” (Haas, 2006). First of all, a household or an individual is over-indebted if they cannot cover all payment obligations arising from all debt contracts in a given period by the excess cash, i.e. periodic cash income not used to cover all periodic expenses of the debtor, during that period (Wisniwski, 2010). It should be noted that this definition still misses a dynamic perspective. Loan losses only occur if this situation occurs chronically, i.e. in several periods in a row (Wisniwski, 2010) and against the borrowers’ will (Schicks, 2010). Haas (2006) also states a dynamic relationship between loan losses and characteristics of borrowers and credit markets, similarly Gonzalez (2008) and Vogelsang (2003). Both the static one-period and the more dynamic multi-period definition immediately lead to the most direct way of measuring risks of loan losses.
A regular household survey or frequent census data on microfinance clients’ household and enterprise finances, in particular its obligations from outstanding debt and its periodic cash flows related to income and expenses, would allow the calculation of growing loan losses. This would uncover loan losses survey subjects and estimates of its prevalence in the underlying population. However, those surveys are missing in most microfinance contexts, in particular for previous (pre-crisis) years. Recent attempts to record the finances of typical microfinance clients in “financial diaries” (Collins et al, 2009) have shown the complexity of information gathering on household finances and thus, the limitations of large-scale quantitative surveys in these contexts. In the absence of household data the study needs to take a more indirect route towards measuring loan losses and, in particular, early signs that such a situation could occur in the near future on a large scale.

1.1.4 Relationship Between Credit Risk Management and Loan Losses in Micro Finance Institutions

Loan losses is a popular type of risk that both non-financial and financial institutions must deal with, this occurs when borrower fails to fulfill his obligation to pay back the loans to the lender, payment is either delayed or not made, this causes cash flow problems and affect the financial institutions liquidity (Greuning and Bratanovic, 2009). Hence CRMP in financial institutions involves its practices to manage or in other words to minimize risk exposure and occurrence of loan losses. More than 70% of a bank balance sheet generally relates to his aspect of risk management. Therefore CRM is crucial to any financial institution’s success.
CRM refers to identification, analysis and assessment, monitoring and control of credit which has direct implications on the amount of loans and advances extended to customers as well as on the level of nonperforming loans (Loan losses). Amount of credit as measured by loan and advances extended to customers and loans losses are used as proxies for credit risk. Amount of credit is expressed as a proportion of total assets to control for the size of the banks. A loan loss is expressed as a proportion of the total loans extended by the MFIs (Bikker and Metzmakers, 2005).

For effective credit risk management, both the board and management are required to set up policies and procedures, which at a minimum should address parameters for composition and spread of credit portfolio. Globalization and deregulation call for sound management systems capable of early identification, measurement, monitoring and controlling the various risks, particularly credit risk. MFIs require risk management processes that cover four critical aspects of management oversight, policies, measurement and internal controls (Central MFIs Annual Report, 2006). Parameters to identify risk composition to avoid overconcentration of risk, credit approval limits, collateral and underwriting standards, exposure limits, nonperforming loan limits, qualified staff and availability were identified by (Laker, 2008). Profitability of MFIs improved and non-performing loans decreased in the year 2006 due to enhanced corporate governance and provisioning of bad debts. Establishment of credit bureaus received emphasis from the central bank to enable sharing of information on non-performing loans and one credit rating bureau was established in 2008 (Central Bank Annual Report, 2008).
According to Checkley and Dickinson (2010), borrowers should be subjected to stringent CRMP, this will enable analyze the borrowers character, ability to repay their loans, margin of the venture that the loan is to finance, purpose for the loan emphasizing on viability, amount of the loan relative to the venture, repayments and insurance to caution risk defaulting on the loan.

1.1.5 Micro Finance Institutions in Kenya

The concept of microfinance is not new. Savings and credit groups that have operated for centuries include the "susus" of Ghana, "chit funds" in India, "tandas" in Mexico, "arisan" in Indonesia, "cheetu" in Sri Lanka, "tontines" in West Africa, and "pasanaku" in Bolivia, as well as numerous savings clubs and burial societies found all over the world. Formal credit and savings institutions for the poor have also been around for decades, providing customers who were traditionally neglected by commercial banks a way to obtain financial services through cooperatives and development finance institutions. One of the earlier and longer-lived micro credit organizations providing small loans to rural poor with no collateral was the Irish Loan Fund system, initiated by the author and nationalist Jonathan Swift. Swift's idea began slowly but by the 1840s had become a widespread institution of about 300 funds all over Ireland. Their principal purpose was making small loans with interest for short periods. At their peak they were making loans to 20% of all Irish households annually.

In the 1800s, various types of larger and more formal savings and credit institutions began to emerge in Europe, organized primarily among the rural and urban poor. These institutions were known as People's Banks, Credit Unions, and Savings and
Credit Co-operatives. The concept of the credit union was developed by Friedrich Wilhelm Raiffeisen and his supporters. Their altruistic action was motivated by concern to assist the rural population to break out of their dependence on moneylenders and to improve their welfare.

A number of self-described microfinance institutions have sprung up across Kenya over the recent years. These institutions seem more intent on exploiting their clients than helping them work their way out of poverty. The pursuit for profits have led to mushrooming of bogus microfinance institutions taking out adverts in the press telling people what to look out for when seeking microcredit,( Kimanthi, chairman of the Association of Microfinance Institutions (AMFI) 2010). AMFI serves as an umbrella body for 23 of the approximately 50 microfinance groups that operate in Kenya. However, few measures govern the sector overall: an office, start-up capital and a license from the city council permitting someone to run a money-lending business are all that is needed. With these things in hand, various organizations have set up shop under the microfinance banner, but operated as banks instead, taking deposits other than those for microloan repayments (Kimathi, 2010). A Microfinance Bill was put forward in 2002, but has yet to receive the green light from cabinet and parliament. The gap left by Microfinance Bill has created a loophole for quacks to operate (Mutua, 2009). For instance Kenya Akiba Micro Finance was one of the culprits having taken deposits of almost 7,000 dollars from some of its clients was declared insolvent due to high loan losses.
1.2 Statement of the Problem

Granting credit to the members is an important activity thus the importance of CRM in institutions, coupled with taking necessary measures to reduce loan defaulters while at the same time advancing credit in a fair and undiscriminating manner so as to continue offering service to their members. Weak CRM are the primary cause of many business (particularly small business) failures. Parrenas (2005) carried out a study of micro finance institutions that failed in the mid 1980s in the U.S.A and found out that the consistent element in the failures was the inadequacy of the micro finances institutions management system for controlling loan quality. A common approach to customer’s credit selection and analysis is the use of the “six Cs” of credit as an initial screening and risk assessment device. The six Cs are: the capacity, capital, character, collateral, conditions and control. Generally institutions are expected to manage their credit risk to avoid exposing their organizations to unnecessarily high level of risk and subsequently a decline in returns.

Since 1990, a few micro finance institutions in Kenya have closed down with court bails and deposit money paid to utility firms such as Kenya Power and Lighting Company. Cent Sacco collapsed and closed its door without refunding over 1,500 members’ their savings. The Kisumu-based micro-finance institution, which started three years ago, closed its doors after battling liquidity problems for more than a year. Cent Sacco board chairman George Rubik told The Standard newspaper (November 2011) that the institution closed its doors after differing with the landlord over a rent arrears amounting to over Sh1.5 million. He said the sacco was banking on funds from a group of new investors who had pledged to inject Sh100 million in capital and board of expertise to enable operations to continue but the delay in the new capital
could not enable them sustain further operation. Members of sixty two branches micro finance across Western accused the management of embezzlement of their funds and poor management. However, the board chairman said the problem was largely caused by poor loan recovery. He however did not disclose how much money has been lost as a result of loan defaulters and the amount saved by members before the closure.

A lot of research has been done in developed countries on CRMP. Haas (2006) studied relationship between micro finance customers over indebtedness and their characteristics and credit markets, Wisniwski (2010) researched on pilot methodologies for an early warning system to signal loan losses in a microfinance market in Swiss land.

Locally, a few studies have been done on CRM and among them are CRMP by coffee cooperatives societies in Embu district (Njiru, 2003), survey of CRMP by pharmaceutical manufacturing firms in Kenya (Nduku, 2007), CRM and profitability of commercial banks in Kenya by (Kithinji, 2010) and assessment of CRM techniques adopted by firms in Kenya (Mwirigi, 2006). Calvin et al (2010) did a study on regulations of MFI’s but was only able to come up with assumptions on actual cost benefit of regulations due to lack of sufficient data for trend analysis. To the researcher’s understanding no study has been done on the CRMP in relation to loan losses in micro finance institutions in Kenya. Based on this evaluation, there is a gap in literature that warrants a research to be conducted in this industry. This study therefore sought to determine the CRMP on loan losses in micro finance institutions in Kenya.
This study therefore sought to answer the question what are the effects of credit risk management practice on loan losses in microfinance institutions in Kenya.

1.3 Objective of the Study

To determine the effects of Credit risk management practices on loan losses in microfinance institutions in Kenya.

1.4 Value of the Study

The study was beneficial to microfinance institutions managers as its focus is on CRMP which are the core source of business for many microfinance institutions. The study will recommend various CRMP which can be shared by many microfinance institutions in the industry to reduce loan losses.

Finally, this study will contribute knowledge to the broader realm of business and academic research. In business, through its recommendations, the study will add value to better credit management practices in businesses and service quality. In academia, the study will add value to academic research in the broader area of credit management. Future researchers will use this study as a form of reference for future studies. It will also suggest future research activities that can be explored.
CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction
This chapter presents a review of literature related to the subject of the study as described by various scholars, researchers, analyst and authors.

Literature review provides the study with an explanation of the theoretical rationale of the problem being studied as well as what research that has already been done and how the findings relate to the problems at hand. The literature is reviewed from journals, published books, periodicals, reports and working papers. This chapter explains the theoretical orientation and the empirical framework.

2.2 Theoretical Literature

2.2.1 Interest Rate Theory
Interest rates play a crucial role in the pricing of both default-free and defaultable securities. One can not avoid considering interest rates when talking about credit risk. The theory of credit risk has many similar characteristics with the theory of interest rates, for example, the adjusted interest rate in credit risk and the default-free interest rate. In order to keep the context complete, talking about the interest rate theory becomes a necessity. Both practitioners in industry and the theorists in academia are enthusiastic about modeling the dynamics of the interest rate. This enthusiasm has never been cooled down ever since the first study on short rates by (Glasserman, 2009).
The level of interest rate risk attributed to the MFIs lending activities depends on the composition of its loan portfolio and the degree to which the terms of its loans (e.g., maturity, rate structure, and embedded options), this expose the MFIs revenue stream to changes in rates. Pricing and portfolio maturity decisions should be made with an eye to funding costs and maturities. Significant individual credits or portfolio segments are especially sensitive to interest rate risk this should be periodically stress-tested. If the asset/liability management committee responsible for managing the MFIs interest rate risk is to manage all of the MFIs positions, it must have sufficient reports on loan portfolio and pipeline composition and trends. These reports might include a maturing loans report, pipeline report, and rate and reprising report (Glasserman, 2009).

MFIs frequently shift interest rate risk to their borrowers by structuring loans with variable interest rates. Borrowers with marginal repayment capacity may experience financial difficulty if the interest rates on these loans increase. As part of the risk management process, MFIs should identify borrowers whose loans have heightened sensitivity to interest rate changes and develop strategies to mitigate the risk. One method is to require vulnerable borrowers to purchase interest rate protection or otherwise hedge the risk (Glasserman, 2009).
2.2.2 Credit Risk Theory

Although people have been facing credit risk ever since early ages, credit risk has not been widely studied until recent 30 years. Early literature (before 1974) on credit risk used traditional actuarial methods of credit risk, whose major difficulty lies in their complete dependence on historical data. There are three main quantitative approaches to analyzing credit risk: structural approach, reduced form approach and incomplete information approach.

Merton (1974) builds a model based on the capital structure of the firm which becomes the basis of the structural approach. In his approach, the company defaults at the loan repayment time $T$ if its value falls below some fixed barrier at time $T$. Thus the default time is a discrete random variable which picks $T$ if the company defaults and infinity if the company does not default. As a result, the equity of the firm becomes a contingent claim of the assets of the firm's assets value.

Reduced form approach, as a counterparty of the structure approach was introduced by Artzner and Delbaen (1995), in this approach, the default event is modeled as either a stopped Position process or a stopped Cox process with intensity $h_t$. The intensity $h_t$ is then called hazard rate in reduced form approach, since the product of $h_t$ and an infinitesimal time period $dt$ is the default probability of the firm at that infinitesimal time period $dt$ given the firm has not default yet before time $t$. According to Lando (1998) that defaultable loan can be calculated as if they were default-free using an interest rate that is the risk-free rate adjusted by the intensity.
Incomplete information approach was developed by Dufie and Lando (2001), which is a combination of structural approach and intensity-based approach. In this approach, the default event is directly modeled as a point process $N_t$ with one jump of size of one at default. This point process $N_t$ is a positive sub martingale and could be decomposed into a martingale plus its compensator. Incomplete information approach generalizes the forms of the compensator which may not be represented as an integration of the hazard rate.

2.2.3 The Theory of Constraints as a Metaphor for Credit Limit Management

One of the most successful of these theories is Eli Goldratt’s Theory of Constraints. Goldratt shows that the performance of a whole system is dictated by the performance of the slowest individual component of that system. It focuses its efforts, therefore, on identifying and alleviating that constrained resource – or the bottleneck in the production process – because the performance of the system is optimized whenever the performance of the constrained resource is optimized. Every system must have at least one such constraint because, in the absence of such, a profit-making organization would make infinite profits. Constraints are seen as positive as their existence represents an opportunity for improvement. Consequently, a continual improvement in system constraints will result in a continual improvement in organizational results. The Theory of Constraints has found broad support from service businesses – including MFIs. However, as with all such theories its application has been limited to opportunities to increase the efficiency of the service delivery processes. A bank might, for example, use it to reduce the time it takes to process a loan application. However, even more value could be created if banks were to use it to improve their products too – in this case the loan itself.
Consider a simple manufacturing business with three machines turning inputs into outputs: one with very high throughput but low accuracy, one with low throughput and high accuracy and one that falls somewhere between those extremes. The first machine creates finished products more quickly than the other but also creates the most scrap. The second machine creates little scrap but also few outputs. Another consequence of the slow throughput rate is a build-up of inventory and its associated costs. The third machine produces a more optimal mix of finished products and scrap.

This set-up can be a better metaphor for an unsecured loan product than might be expected. Instead of machines, MFI's have credit extensions which, in lieu of turning inputs into outputs, turn excess capital into interest bearing balances. Instead of a throughput rate there is a limit utilization rate, risk replaces accuracy and bad-debt write-offs replace scrap. So we can translate the earlier manufacturing example into banking terms.

The first credit portfolio has a very high utilization rate but also very high risk, the second portfolio is of very low risk but has a very low utilization rate and the third portfolio is, once again, a balance of the two extremes. The first portfolio might lead to more balances in a period but it comes at the high cost of significant bad-debt write-offs. The second portfolio might have almost no bad-debt write-offs but it also struggles to create interest bearing balances leading to a build-up of inventory in the form of unproductive capital. The third portfolio creates a better mix of interest bearing balances and bad-debt.

This contrived scenario is clearly overly simplified. However, real data from a major retail bank has revealed a similar pattern. The lowest risk accounts tend to have very low utilization rates and thus carry large inventories of unproductive capital. On the other end of the scale, the utilization rates were at their highest but so was the rate
of bad debt write-offs. The most profitable accounts were found somewhere between these two extremes where an acceptable levels of risk coexisted with an acceptable utilization rate.

Unless a metaphor helps us to more clearly understand a problem it is simply interesting, not useful. So, in order for lenders to gain benefit from the manufacturing metaphor it is important to move past the descriptive stage and actually put theories like the Theory of Constraints to use when designing a loan product so as to achieve a portfolio with a better mix of risk and reward.

2.3 Empirical Literature

Frame et al (2001) in his research in March 2001 on Credit score card concluded that if credit scorecard is thoughtfully developed, flexibly implemented and properly managed which speed loan processing and inform pricing and provisions it will help banks and MFI’s save cost, reduce subjectivity and improve risk management, this will also increase profitability and expand micro borrowers access to credits.

Report by Business Banking Board (2000) indicated that Application credit scoring is used throughout the world to process many types of small-value loan transactions. It has been applied most widely and successfully for personal credit cards and consumer and mortgage loans. Repayment risk for these products is closely linked to verifiable factors such as income, credit bureau information, and demographic factors such as age, education and homeowner status. More recently, credit scoring has been used to evaluate loans to small and micro businesses, but even in the most developed financial markets, credit scoring for small business loans generally works in conjunction with a judgmental process rather than as an independent decision-making tool.
Credit scoring systems help to streamline the lending process, improve loan officer efficiency, increase the consistency of the evaluation process and reduce human bias in the lending decision. Credit scoring system also helps in enabling the bank to vary the credit policy according to risk classification, such as underwriting or monitoring some lower risk loans without on-site business inspections, better quantifying of expected losses for different risk classes of borrowers and reducing time spent on collections, which in some markets claim up to 50 percent of loan officers’ time, (Credit Scoring for Microenterprise Brief - www.accion.org).

Dellien and Schreiner (2005) did a research in December 2005 and noted that one conceptual difficulty with embracing credit scoring for microfinance is that a data-driven business approach does not intuitively seem like a good fit for reaching data-poor clients who have been typically excluded by banks. Some examples of data limitations in the microfinance field are: - The self-employed poor frequently cannot document income and credit history.

Lewis and Edward (1990) research in April 1990 added that Small businesses purposefully misstate tax accounting statements, particularly profit, to reduce their tax burden and microfinance borrowers are rarely included in credit bureaus or credit bureaus themselves are underdeveloped in many markets. In light of such data limitations, thoughtful innovation is required to identify meaningful risk factors for microfinance clients and to measure them in terms of characteristics that are feasible to collect. Credit bureau information if available will definitely enhance the value of credit score system but it is not a pre- requisite for developing scorecard. Similarly the
presence of good bureau data does not eliminate the need to analyze institution’s specific client data and experience.

Salazar (2003) did a further research in March 2007 and developing scorecards appropriate to microfinance require a combination of technical modeling skills and practical knowledge of the credit risks associated with borrowers in the micro segment. Banks and MFIs often lack the technical expertise in-house, but it can be purchased for varying costs from large international credit bureau operators and a wide range of consultancies. However, practical knowledge of the credit risks associated with micro-borrowers should come at least partially from the microfinance organization itself.

Schreiner (2005) argued that growth in consumer credit market can hold either positive or negative implications for the economy and micro finance. Economic activity is stimulated when consumers borrow within their means to buy cars and other major purchases. On the other hand, if consumers pile up too much debt relative to their income levels, they may have to stop spending on new goods and services just to pay off old debts otherwise they may experience financial difficulties to pay the lenders. Lenders, who failure to or less capable to identify consumers’ ability to payback may be associated with having weak CRMP. Altman (1996) established that if the demand to borrow money exceeds the supply of the willing lenders, interest rate rises, if credit demand falls and many willing lenders are fighting for consumers, they may offer lower interest rates to attract business. In order to balance this, an accurate Credit risk management practice and corresponding underwriting credit risk criteria should be established so that lenders can survive in the current price competition in the market.
Fuser and Meier (1997) observed that risk of consumer credit industry consist of two major categories; Credit risk and systematic risk. Credit risk in general is an estimate of the probability that a borrower will not pay all or a portion of a loan on time and a systematic risk is often used to describe the risk of a sudden unexpected event that would harm the financial system to and extent that economy may suffer.

Asarnow (1995) concluded that the assessment of credit risk can be done in two stages in most cases: 1) loan application and underwriting, and 2) during the course of the loan payment. In the first case, the lender can only assess the credit risk by studying the borrower’s credit history, while in the second case, the lender can not only continue to examine the credit history, but also monitor the current payment behavior to better assess the credit risk. Commonly, lenders refer to the first stage as underwriting CRMP, and the second stage as the portfolio CRMP. Portfolio CRMis particularly critical for revolving products, such as credit card, whose loan outstanding is purely driven by the behavior and financial situation of the consumers. Both credit risk and systemic risk management practices are tightly regarded to as the loan losses preventive practices.

2.4 Summary and Conclusion
Even though credit score card has been used by most micro finance institution in speeding up the loan processes, inform pricing and increase risk management on loans. They tend to use a judgmental process which is not accurate rather than independent decision making tool. In the Dellien and Schreiner (2005) report on credit score card, the approach of data driven business is not a good fit as data
collected is limited due to poor data collection client, the self employed poor frequently cannot document income and credit history.

Most micro fiancé institutions do not include tax accounting statements particularly profits in reducing their tax burden, most micro financial institutions are not included in the credit bureaus as they are underdeveloped in the market. This limits them in accessing the necessary data and thoughtful innovation to identify meaningful risk factors for micro client and measure them in terms of characteristics that are feasible to collect. With the availability of credit bureau information, the value of credit score card was enhanced but this is not a prerequisite for developing scorecard.

Microfinance offers significant financial services. MFIs given their mission and outreach are well placed to fulfill the financing gap required for ensuring access to credit services to low income earners especially in the rural areas where many commercial banks find unviable to invest. The intervention of MFIs have been hailed by many as a solution to poverty alleviation, which allows market forces to operate, enabling the poor to invest in their futures and bring themselves out of poverty. The advocacy movement behind these initiatives is powerful and many evaluations highlight the benefits of these services. Widespread experiences and research have shown there is importance of savings and credit facilities for the poor and MSEs. This puts emphasis on the sound development of microfinance institutions as vital ingredients for investment, employment and economic growth.

To the researcher’s understanding no study has been done on the CRMP in relation to loan losses in micro finance institutions in Kenya. Based on this evaluation, there is a
gap in literature that warrants a research to be conducted in this industry. This study therefore sought to determine the CRMP on loan losses in micro finance institutions in Kenya. This study was carried out in October 2012.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter highlights the methods used by the researcher to undertake the research. These methods include research design, population, sampling, and data collection methods and data analysis procedures.

3.2 Research Design
This research project adopted a descriptive survey design to establish the effect of CRMP on loan losses in micro finance institutions in Kenya.

A survey is an attempt to collect data from members of a population in order to determine the current status of the population with respect to one or more variables. It is a method through which data is collected from members of targeted population by use of questioner, interviews and observation schedule (William, 2003). According to Sekaran (2003) a descriptive study is done in order to ascertain and be able to describe the characteristics of the variable in a situation. It aims at finding out the what, where and how of a phenomenon. Descriptive survey tends to produce statistical information and aspect of education that interest policy makers and educators in micro finance institutions.
3.3 Population
The target population for this study was all be the MFIs and banks offering micro credit in Kenya. There are hundreds of institutions that carry out micro finance activities in Kenya, some organized within churches, some organized as cooperatives societies and others operating on part–time basis. The population of registered micro finance institutions in Kenya comprises of 64 according to K-Rep register of MFIs, the Association of Micro Finance Institutions of Kenya and the Central Bank of Kenya. There are also six banks that offer micro credit services. The population targets this study consists the 6 banks and 64 registered microfinance institutions in Kenya.

3.4 Sampling
The sample frame constituted the commercial banks offering micro credit and micro finance institutions. The researcher adopted both the stratified random sampling technique as well as convenience sampling. Stratified random technique was used to select banks and registered MFIs within Nairobi, which are 31 in number. Convenience sampling was used to select the appropriate department within the bank or MFIs to collect the data; this was targeting the credit and loan sections. Two respondents were expected to participate from each bank or MFI. Credit managers were encouraged to participate as they have more information on loan repayment and loan default statistics. The total expected number of respondents was 50 from the MFIs and 12 from the banks offering micro credit. Therefore the total sample was 62 respondents.
3.5 Data Collection Method

The names and addresses of MFIs in Kenya were obtained from the Association of Micro Finance Institutions, Central Bank of Kenya and the K-Rep register. Data was collected from the primary sources through structured and unstructured questionnaires that were administered to the loan or credit section officers and managers of the banks offering micro credit or MFIs. Drop-and- pick-later method was used because it is appropriate in giving the respondents ample time to fill the questionnaire and also gives the researcher an opportunity to review the questionnaires for completeness before picking it. Secondary data from brochures and supplements in newspapers covering microcredit providers was also used.

3.6 Data Analysis

The data was checked for accuracy and completeness of recording of the responses, it was then be coded and checked for coding errors and omissions. The researcher used both quantitative and qualitative data analysis techniques for this study because both approaches complemented each other. Quantitative data analyses included descriptive statistics. Descriptive data analysis was done by use of measures of central tendency which include frequencies, means and percentages. Qualitative data was analyzed by comparing responses and merging those which were alike usually in a textual or narrative form. To present the information, frequency tables, charts, graphs, words and figures was used.
3.7 Model

In this research the relationship between CRMP and loan losses was determined using a Regression analysis. According to Tofallis (2009) regression analysis involves many techniques used for modeling and analyzing several variables the focus being the relationship between a dependant variable and one or more independent variables. This will help in understanding how the typical value of the dependent variable changes when any one of the independent variables is varied while the other independent variable are held fixed. Most commonly regression analysis estimates the condition expected of the depended variable that is the average value of the depended variable when the independent variable is fixed. It is widely used in prediction and focusing.

The relationship between CRMP and loan losses was analyzed using linear regression model. This model shows the relationship between the two variables by fitting a linear equation to observed data. One variable was considered as explanatory variable and the other as dependent variable.

A valuable numerical measure of association between the two variables is the collateral coefficient this quantifies the strength of linear association which is a value between -1 and 1. A positive correlation indicates a positive association between the variables while the negative correlation indicates a negative association between variables. As the lease-square will always pass through the means of x and y, the regression line was entirely described by the means, standard deviation and correlation of the two variables under investigation.
Mathematically, the linear regression line was expressed using the following equation.

\[ y = b + ax + e \]

Where:

- **y** - Loan losses (Dependent variable)
- **x** – Credit Risk Management Practices (Explanatory variable)
- **a** - Slope of the line (gradient)
- **b** - y intercept
- **e** - Error margin

Data for loan losses was collected from 2010/11 financial statements by determining the level of defaulted loans (Questionnaire part 5). CRMP data was derived from the questionnaire (Question 11) using CRMP weighted score. The graph on loan losses against CRMP was drawn. An equation was derived from the graph which was used to estimate the effect of CRMP on loan losses.
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction
Data was collected from the primary sources through structured and unstructured questionnaires that were administered to the loan or credit section officers and managers of the banks offering micro credit and MFIs. Drop-and- pick-later method was used. Questionnaires were checked for completeness before picking it.

4.2 Response Rate
From the 32 registered MFIs offering credit services, 26 MFIs were sampled each given 2 questionnaires to answer. A total of 52 respondents was obtained representing 83.8% response rate. Most of the data was obtained from the staff working in credit section. They included loan and credit officers and managers, branch managers, head of credit sections. In small institutions the accountant and clerks provided the information. List of MFIs that participated in this study can be found at appendix III.

4.3 Micro Finance Institutions Ownership and Source of Funding
According to the respondents majority of the MFIs are either privately owned (50%) or membership owned (50%) none of the MFIs was recognized as being owned by the public share holding or government owned. Apart from the banks offering microfinance services, MFIs, are commonly owned by membership subscription aiming at saving frequently and to obtain loans at competitive rates. Rarely will the government open a micro finance for the citizens. However the MFIs depicted dynamism regarding their major source of funds as shown in the graph below.
Figure 1: Bar graph showing sources of MFIs funds in Kenya

As shown above most MFIs are membership driven and are supported by the membership contribution which also

**4.4 Micro Finance Institutions Credit Activity Performance and Portfolio Provided for Micro Credit**

Most MFIs admitted to have highly depended on the microcredit activities as their sources of funds and acknowledging that the activity as being worth and thriving. Micro credit activity contribution to the total MFIs profits is shown below.
Figure 2: *Pie chart showing the MFIs credit activities profits contribution*

Most MFIs provide the amount earned for the micro credit activities by lending it back to their clients. This is graphically represented below.
4.5 Micro Finance Institutions Loan Default Rate

Generally MFIs are not adversely affected by the loan default problem as most (33.33 %) MFIs had 1-5 % default rate and decreased upward. However there was a significant high default rate in few (0.9 %) of the MFIs sampled recording a 21 -25% default in the 2011 financial year. The main reason cited for loan default rate in the MFIs included
4.6 Strategies Used by Micro Finance Institutions to Reduce Loan Default

MFIs use different strategies to reduce the risk of loan defaulting. The most common as cited by the respondents includes having collateral against the loaned amount and having strict and thorough policies on leading, these two commanded the popularity with each scoring 30.43%. Other MFIs also cited stringent loan evaluation procedures and having provisions to accommodate the default rate would shield them from high unexpected loan repayment default (17.39 %). Very few (4.34 %) MFIs believe and use credit bureaus to check on black listed clients for their credit repayment history. This is probably brought by the high competition within the MFIs sub sector, others includes, insuring loans, use of guarantors.
4.7 Loan Recovery and “Loans write off” provisions

All MFIs experienced some level of unpaid loans or some loan repayment default. MFIs recognized the need for the loanee to provide collateral 52.9 %. Another strategy used includes conducting constant loan default follow-up and recovering the money from the guarantor’s accounts (41.2%). Very few (5.9%) MFIs use legal procedure to recover their loan; instead others strategies preferred as cited by the MFIs included the use of the credit and debt collectors who would raid on the defaulters’ property and auction in case the loanee continues to default.

Loan ‘write off” provisions existed in all the sampled MFIs, to give room for the unrecoverable loan and bad debts. The main reason or circumstances which the loan can be written off includes when the loanee is deceased and therefore not available to repay when the loanee is disabled or cannot be traced through the contacts they provided.

4.8 Cause of Micro Finance Institutions Collapse in Kenya

Most respondents 50.0% indentified poor MFIs management and governance as the main cause of MFIs collapse in Kenya. Although 11.11% cited that the MFIs venture is appropriate in Kenyan business environment, they are faced with the task of high competition that may led to few clients that may not generate enough to run the MFIs. 22.2% identified lack of strategies loan policies that would govern the loan provision services within the MFIs. Only 16.7% cited volatile economic environment as the reason for the MFIs collapse in Kenya. This finding therefore emphasize on the need for the MFIs to have a good management and governance lean that will generate strict and effective loan provision policies that would be attractive to retain the customer base and MFIs sustainability and survival.
4.9 Credit Risk Management Practices in Micro Finance Institutions

CRMP was measured through the weighted score in the following aspects, how strictly MFIs follows CRM policies, how CRM policies determine the amount of loan to be given, how frequent the CRM policies are reviewed, how frequent the loans disbursed are reviewed on monthly basis, the ease of loan accessibility, having qualified CRM staffs, repayment levels in the last financial year, use of credit bureaus to check the clients credit history, use of collateral in giving loans and use of debt collectors to recover defaulted loans.

The following graph indicates the CRMP against the expected credit default levels.

<table>
<thead>
<tr>
<th>Default rate</th>
<th>Mid point (x)</th>
<th>Frequency (f)</th>
<th>CRM score</th>
<th>CRM Mid point (m)</th>
<th>Y =m+(f/n*8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 - 5</td>
<td>2.5</td>
<td>22</td>
<td>50</td>
<td>46</td>
<td>49.4</td>
</tr>
<tr>
<td>6 - 10</td>
<td>7.5</td>
<td>12</td>
<td>42</td>
<td>38</td>
<td>39.8</td>
</tr>
<tr>
<td>11 - 15</td>
<td>12.5</td>
<td>9</td>
<td>34</td>
<td>30</td>
<td>31.4</td>
</tr>
<tr>
<td>16 - 20</td>
<td>17.5</td>
<td>5</td>
<td>26</td>
<td>22</td>
<td>22.8</td>
</tr>
<tr>
<td>21 -25</td>
<td>22.5</td>
<td>3</td>
<td>18</td>
<td>14</td>
<td>14.5</td>
</tr>
<tr>
<td>Above 25</td>
<td>27.5</td>
<td>1</td>
<td>10</td>
<td>6</td>
<td>6.2</td>
</tr>
</tbody>
</table>

n =52 (Total respondents)
Figure 5: The relationship between CRM and loan default rate

From the above graph CRM is directly related to loan default rate, the relation equation is $y = -0.572x + 30.56$ The correlation between the two variables is 0.99, which means that there high negative interrelationship. The higher the CRM score the lower the loan default rate. MFIs therefore should try to score high on the factors listed to reduce the levels loan default rate and therefore decrease the chances of MFI bankruptcy.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Granting credit to the members is an important activity thus the importance of CRM in institutions, coupled with taking necessary measures to reduce loan defaulters while at the same time advancing credit in a fair and undiscriminating manner so as to continue offering service to their members. Weak CRMP are the primary cause of many business (particularly small business) failures. Parrenas (2005) carried out a study of micro finance institutions that failed in the mid 1980s in the U.S.A and found out that the consistent element in the failures was the inadequacy of the micro finances institutions management system for controlling loan quality. Generally institutions are expected to manage their credit risk to avoid exposing their organizations to unnecessarily high level of risk and subsequently a decline in returns.

Since 1990, a few micro finance institutions in Kenya have closed down with court bails and deposit money paid to utility firms such as Kenya Power and Lighting Company. Cent Sacco collapsed and closed its door without refunding over 1,500 members' their savings. The Kisumu-based micro-finance institution, which started three years ago, closed its doors after battling liquidity problems for more than a year. Members accused the management of embezzlement of their funds and poor management. This study therefore soughts to determine the effect of credit risk management on loan losses in micro finance institutions in Kenya.

The sample frame constituted the commercial banks offering micro credit and micro
finance institutions. The researcher adopted both the stratified random sampling technique as well as convenience sampling. Stratified random technique was used to select banks and registered MFIs within Nairobi, which are 31 in number. Convenience sampling was used to select the appropriate department within the bank or MFIs to collect the data, this will target the credit and loan sections. Two respondents were expected to participate from each bank or MFI. There were 52 respondents from various MFIs and banks offering micro credit services, this represented 83.8% response rate. Most of the data was obtained from the staff working in credit section. They included loan and credit officers and managers, branch managers, head of credit sections. In small institutions the accountant and clerks provided the information.

5.2 Conclusion

According to the respondents majority of the MFIs are either privately owned (50%) or membership owned (50%) none of the MFIs was recognized as being owned by the public share holding or government owned. Most MFIs admitted to have highly depended on the microcredit activities as their sources of funds and acknowledging that the activity as being worth and thriving if well managed. Most MFIs provide the amount earned for the micro credit activities by lending it back to their clients. Generally MFIs are not adversely affected by the loan default problem as most (33.33 %) MFIs had 1-5 % default rate and decreased upward. However there was a significant high default rate in few (0.9 %) of the MFIs sampled recording a 21 -25% default in the 2011 financial year. The main reason cited for loan default rate in the MFIs included poor investment of the loan money, change in economic environment, natural causes e.g. disability, death, lack of follow up measures by the leading MFIs and unrealistic terms and schedule of repayment.
MFIs use different strategies to reduce the risk of loan defaulting. The most common as cited by the respondents includes having collateral against the loaned amount and having strict and through policies on leading, these two commanded the popularity with each scoring 30.43%. Other MFIs also cited stringent loan evaluation procedures and having provisions to accommodate the default rate would shield them from high unexpected loan repayment default (17.39 %). Very few (4.34 %) MFIs believe and use credit bureaus to check on black listed clients for their credit repayment history. This is probably brought by the high competition within the MFIs sub sector, others includes, insuring loans, use of guarantors.

MFIs recognized the need for the loanee to provide collateral 52.9 %. Another strategy used includes conducting constant loan default follow-up and recovering the money from the guarantor’s accounts (41.2%). Very few (5.9%) MFIs use legal procedure to recover their loan; instead others strategies preferred as cited by the MFIs included the use of the credit and debt collectors who would raid on the defaulters’ property and auction in case the loanee continues to default.

5.3 Recommendations

The respondents cited that having collateral against the loaned amount and having strict and thorough policies on leading, these two commanded the popularity. Other strategies that MFIs also can use to reduce loan default rate included stringent loan evaluation procedures and having provisions to accommodate the defaulted loans would shield them from high unexpected loan repayment default by having ‘write off’ provisions. MFIs should use credit bureaus to check on black listed clients for their credit repayment history to identify clients who have a tendency of defaulting. The leniency in this area is probably
due to high competition within the MFIs sub sector who may want to have many clients. Other ways of reducing loan default levels is by insuring loans against unforeseen circumstances such as death of a loanee, however use of guarantors and debt collectors proved to be the most effective to recover defaulted loans.

CRMP was found to have direct negative correction, that is, the higher the CRMP weighted score the lower the rate of defaulted loans. The most critical factors to be monitored in CRMP includes: how strictly MFIs follows CRM policies, how CRM policies determine the amount of loan to be given, the frequency in which the CRM policies are reviewed, how frequent the loans disbursed are reviewed on monthly basis, the ease of loan accessibility, having qualified CRM staffs, repayment levels in the last financial year, use of credit bureaus to check the clients credit history, use of collateral in giving loans and use of debt collectors to recover defaulted loans.

5.4 Limitations of the Study

There were several limitations and obstacles faced in the execution of this study which included; the staff in some MFIs were not readily available to fill in the questionnaire due to their nature of their work which found them busy throughout the working periods and therefore difficult to contact them. Other respondents were not ready to provide their credit information and this required more time to convince them by guarantee them privacy of the data they provide.

5.5 Areas for Further Research

This study aimed at establishing the relationship between CRMP in relation to loan losses in micro finance institutions in Kenya. A lot of research has been done in developed countries on CRMP. Haas (2006) studied relationship between micro finance customers
over indebtedness and their characteristics and credit markets, Wisniwski (2010) researched on pilot methodologies for an early warning system to signal loan losses in a microfinance market in Swiss land. Parrenas, (2005) carried out a study of micro finance institutions that failed in the mid 1980s in the U.S.A and found out that the consistent element in the failures was the inadequacy of the micro finances institutions management system for controlling loan quality.

Locally, a few studies have been done on CRM and among them are CRMP by coffee cooperatives societies in Embu district (Njiru, 2003), survey of CRMP by pharmaceutical manufacturing firms in Kenya (Nduku, 2007), CRM and profitability of commercial banks in Kenya by (Kithinji, 2010) and assessment of CRM techniques adopted by firms (Mwirigi, 2006). Calvin et al (2010) did a study on regulations of MFI’s but was only able to come up with assumptions on actual cost benefit of regulations due to lack of sufficient data for tread analysis. This research however calls for more study on why there is high mushrooming of MFIs in Kenya and Africa despite high loan default risks and the study on why successful MFIs evolution to commercial banks and what push them to that, finally study needs to be done to determine whether MFIs can be able to operate interest free loans to its members as nonprofit oriented circumstances.
REFERENCES


Gonzalez, C. & Adrian, S. (2008), Microfinance, incentives to repay, and over Indebtedness: *Evidence from a household Survey on Bolivia*, 1, 256-305. Ohio State University.


QUESTIONNAIRE

The main objective of this questionnaire is to determine the “effect of CRMP on loan losses in micro finance institutions in Kenya”

Please tick ( ) appropriately on the space provided.

1. Please indicate the following.
   a) Name of the institution  ………………………………………………
   b) When was the institution established  ………………………………
   c) Position of the respondent in the institution  ………………………

2. Who owns this MFI / bank?
   □ Private Company
   □ Public Company
   □ Members’ shares
   □ Government

3. How many branches do you have in Kenya?  ……………………………

4. What are your major sources of funds?
   □ Members’ contribution/Savings
   □ Investor
   □ Loan interests
   □ External funding
   □ Government funded
5. In the following table tick the box where appropriate

<table>
<thead>
<tr>
<th>a. What percentage of your annual profits was contributed from the micro credit activity in the last financial year?</th>
</tr>
</thead>
<tbody>
<tr>
<td>☐ 1 – 20%</td>
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<tr>
<td>☐ 21 – 40 %</td>
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<tr>
<td>☐ 41 – 60 %</td>
</tr>
<tr>
<td>☐ 61 – 80%</td>
</tr>
<tr>
<td>☐ 81 – 100%</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>b. What percentage of your total portfolio do you offer for micro credit?</th>
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<tbody>
<tr>
<td>☐ 1 – 20%</td>
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<tr>
<td>☐ 21 – 40 %</td>
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<tr>
<td>☐ 41 – 60 %</td>
</tr>
<tr>
<td>☐ 61 – 80%</td>
</tr>
<tr>
<td>☐ 81 – 100%</td>
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<tr>
<th>c. What was the loan default rate (%) in the last financial year?</th>
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<tbody>
<tr>
<td>☐ 1 – 5%</td>
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<td>☐ 6 – 10 %</td>
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<td>☐ 11 – 15 %</td>
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<tr>
<td>☐ 16 – 20%</td>
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<tr>
<td>☐ 21 – 25%</td>
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<tr>
<td>☐ Above 26%</td>
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</table>

6. What are the common reasons why the clients default to repay loan?
   ☐ Poor investment of the loan money
   ☐ Change in economic environment
   ☐ Natural causes e.g. Disability, death
   ☐ Lack of Follow up Measures
   ☐ Unrealistic Terms and Schedule of Repayment
   Other reason: ..............................................................................................................

..............................................................................................................

7. What strategies do you have for CRM to reduce loan defaulting?
   ☐ Having collateral against the amount loaned
   ☐ Stringent loan evaluation procedures
   ☐ Strict and thorough policy on lending
   ☐ Checking for blacklisted clients in credit bureaus
   ☐ Having provisions to accommodate loan losses
   Other reasons: ..............................................................................................................

..............................................................................................................
8. What CRM strategies do you have for recovering defaulted loans?

- Using loan collateral to recover loans
- Constant follow up with loan defaulter
- Suing for loan non payment

Other reason: ........................................................................................................
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9. Do you have “Loan write off” provisions in your credit management policy? If yes, when is the loan “written off”?

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10. In your own opinion, what are the common causes of collapse of MFIs in Kenya today?

- Poor management and governance
- Lack of stringent loan policies
- High competition in MFIs that lend to lenient loan terms
- Volatile economic environment

Other reasons:
........................................................................................................
........................................................................................................
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11. Use the following scale 1 – 5 (1 being poor and 5 being excellent) to describes the use of CRMP (CRMP) in your organization.

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<tbody>
<tr>
<td>a. Follows CRM policies</td>
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<tr>
<td>b. Credit risk management policies determine the amount of loan to be given.</td>
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<tr>
<td>c. CRM policies are reviewed on yearly basis.</td>
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<tr>
<td>d. Reviews loans disbursed on monthly basis.</td>
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<tr>
<td>e. Ease of loan accessibility</td>
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<td>f. Qualified CRM staffs</td>
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<tr>
<td>g. Rate the repayment levels in the last financial year</td>
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<tr>
<td>h. Use of Credit Reference Bureau (CRB)</td>
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<tr>
<td>i. Use collateral in giving loans</td>
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<tr>
<td>j. Use of debt collectors to recover defaulted loans</td>
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</tbody>
</table>

*****Thanks you *****
### LIST OF MICRO FINANCIAL INSTITUTIONS AND BANKS

<table>
<thead>
<tr>
<th></th>
<th>Institution Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AAR Credit Services</td>
</tr>
<tr>
<td>2</td>
<td>ADOK TIMO</td>
</tr>
<tr>
<td>3</td>
<td>Adok Timo, Kisumu</td>
</tr>
<tr>
<td>4</td>
<td>Agakhan First Microfinance Agency</td>
</tr>
<tr>
<td>5</td>
<td>Akiba Micto Finance Kenya</td>
</tr>
<tr>
<td>6</td>
<td>Bimas Ltd,</td>
</tr>
<tr>
<td>7</td>
<td>Blue Limited</td>
</tr>
<tr>
<td>8</td>
<td>Buruburu Juhudi sacco ltd, Buruburu, Nairobi.</td>
</tr>
<tr>
<td>9</td>
<td>Business Capital Access Ltd, Nairobi</td>
</tr>
<tr>
<td>10</td>
<td>Canyon Rural Credit Limited</td>
</tr>
<tr>
<td>11</td>
<td>Chartis Insurance</td>
</tr>
<tr>
<td>12</td>
<td>CIC Insurance</td>
</tr>
<tr>
<td>13</td>
<td>Co-operative Bank</td>
</tr>
<tr>
<td>14</td>
<td>Crossbridge Credit Ltd, Nairobi</td>
</tr>
<tr>
<td>15</td>
<td>Kenya saving and Credit Co-op, Dandora, Nairobi.</td>
</tr>
<tr>
<td>16</td>
<td>ECLOF Kenya</td>
</tr>
<tr>
<td>17</td>
<td>Ecumenical Loans Fund Kenya</td>
</tr>
<tr>
<td>18</td>
<td>Equity Bank</td>
</tr>
<tr>
<td>19</td>
<td>Eurocrest Microfinance Company Ltd, Nairobi</td>
</tr>
<tr>
<td>20</td>
<td>Faulu Kenya DTM Limited</td>
</tr>
<tr>
<td>21</td>
<td>Faulu Kenya Ltd, Nairobi</td>
</tr>
<tr>
<td>22</td>
<td>Finikiwa Micro Finance Ltd, Nairobi</td>
</tr>
<tr>
<td>23</td>
<td>Full Scale Business Trust, Mombasa</td>
</tr>
<tr>
<td>24</td>
<td>Fusion Capital Ltd</td>
</tr>
<tr>
<td>25</td>
<td>Greenland Fedha Limited</td>
</tr>
<tr>
<td>26</td>
<td>Hamza Micro credit, Hamza, Nairobi.</td>
</tr>
<tr>
<td>27</td>
<td>IndoAfrica Finance</td>
</tr>
<tr>
<td>28</td>
<td>Jitegemea Credit Scheme</td>
</tr>
<tr>
<td>29</td>
<td>Jitegimee Trust Limited</td>
</tr>
<tr>
<td>30</td>
<td>Juhudi Kilimo Company Limited</td>
</tr>
<tr>
<td>31</td>
<td>Kadet Ltd, Nairobi</td>
</tr>
<tr>
<td>32</td>
<td>Kash-Kilo Ltd, Donholm, Nairobi.</td>
</tr>
<tr>
<td>33</td>
<td>Kenya Akiba Micro Finance Ltd, Athi River</td>
</tr>
<tr>
<td>34</td>
<td>Kenya Akiba Micro Finance Ltd, Athi River</td>
</tr>
<tr>
<td>35</td>
<td>Kenya Entrepreneur Empowerment Foundation (KEEF)</td>
</tr>
<tr>
<td>36</td>
<td>Kenya Micro Finance Assistance Programme, Ongata Rongai</td>
</tr>
<tr>
<td>37</td>
<td>Kenya Post Office Savings Bank</td>
</tr>
<tr>
<td>38</td>
<td>Kenya Small Traders and enterprises society</td>
</tr>
<tr>
<td>39</td>
<td>Kenya Women Finance Trust</td>
</tr>
<tr>
<td>40</td>
<td>Kima Sacco Ltd, Kitengela.</td>
</tr>
<tr>
<td>41</td>
<td>Kims Information Services Ltd, Kangundo</td>
</tr>
<tr>
<td>42</td>
<td>K-Rep Advisory Services (Africa) Ltd, Nairobi</td>
</tr>
<tr>
<td>43</td>
<td>K-rep Bank Ltd</td>
</tr>
<tr>
<td>44</td>
<td>K-rep Development Agency</td>
</tr>
<tr>
<td>45</td>
<td>Lions Capital Ltd. Unafric House 3rd floor</td>
</tr>
<tr>
<td>46</td>
<td>Makao Mashinani Ltd., kenya</td>
</tr>
<tr>
<td>47</td>
<td>Mega Micro Finance Ltd, Nairobi</td>
</tr>
<tr>
<td>48</td>
<td>Merchant Capital, Nairobi</td>
</tr>
</tbody>
</table>
47 Micro Africa Limited
48 Microfinance Partners Ltd, Nairobi
66 Migich Investment Co. ltd. Thika
49 Opportunity Kenya Ltd, Nairobi
50 Kenya, Phenny Holding Ltd., Located close to the Mugoya Estate
51 Paddy Micro Investment Ltd, Jasmine Centre, Westlands, Nairobi
52 Pride Limited Kenya
53 Rural Integrated Solidarity Empowerment (Rise) Trust, Suna
54 Small and Medium Enterprises Program Kenya
55 Small and Micro Enterprise Programme, Nairobi
56 Smart Credit Ltd, Nairobi
57 Soft Loan Enterprise, Dandora, Nairobi.
58 The Kenya Savings and Credit Co-operative Society, Dandora
59 Trust, Kenya
60 U & I Microfinance Ltd, Nairobi
61 Unity Investment, Donholm, Nairobi.
62 Ustawi Ltd, Nairobi
63 Wedco Limited Kenya
LIST OF RESPONDENT MFIs

1. AAR Credit Services
2. Agakhan First Microfinance Agency
3. Akiba Micto Finance Kenya
4. Bimas Ltd,
5. Business Capital Access Ltd, Nairobi
6. ECLOF Kenya
7. Equity Bank
8. Faulu Kenya DTM Limited
9. Fanikiwa Micro Finance Ltd, Nairobi
10. Fusion Capital Ltd
11. IndoAfrica Finance
12. Jitegemee Trust Limited
13. Juhudi Kilimo Company Limited
14. Kadet Ltd, Nairobi
15. Kenya Entrepreneur Empowerment Foundation (KEEF)
16. Kenya Women Finance Trust
17. K-Rep Advisory Services (Africa) Ltd, Nairobi
18. Micro Africa Limited
19. Opportunity Kenya Ltd, Nairobi
20. Pride Limited Kenya
21. Small and Medium Enterprises Program Kenya
22. Smart Credit Ltd, Nairobi
23. The Kenya Savings and Credit Co-operative Society,
24. KIMISITU saoco
26. Ustawi Ltd, Nairobi
RAW DATA FOR THE BAR GRAPH AND PIE CHART

Table 1. Major sources of funds

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>FREQUENCY</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members’ contribution/savings</td>
<td>26</td>
<td>50%</td>
</tr>
<tr>
<td>Investors</td>
<td>10</td>
<td>19.23%</td>
</tr>
<tr>
<td>Loan interests</td>
<td>9</td>
<td>17.3%</td>
</tr>
<tr>
<td>External funding</td>
<td>4</td>
<td>7.69%</td>
</tr>
<tr>
<td>Government funding</td>
<td>3</td>
<td>5.76%</td>
</tr>
</tbody>
</table>

Table 2. Percentage of annual profit contributed from micro credit activities

<table>
<thead>
<tr>
<th>FREQUENCY</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 – 20%</td>
<td>7</td>
</tr>
<tr>
<td>21 – 40%</td>
<td>21</td>
</tr>
<tr>
<td>41 – 60%</td>
<td>4</td>
</tr>
<tr>
<td>61 – 80%</td>
<td>17</td>
</tr>
<tr>
<td>81 – 100%</td>
<td>4</td>
</tr>
</tbody>
</table>

Table 3. Percentage of amount earned lending back to their clients

<table>
<thead>
<tr>
<th>FREQUENCY</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 – 20%</td>
<td>4</td>
</tr>
<tr>
<td>21 – 40%</td>
<td>13</td>
</tr>
<tr>
<td>41 – 60%</td>
<td>13</td>
</tr>
<tr>
<td>61 – 80%</td>
<td>18</td>
</tr>
<tr>
<td>81 – 100%</td>
<td>4</td>
</tr>
</tbody>
</table>
### Table 4. Reasons for Loan Default

<table>
<thead>
<tr>
<th>Reason</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor investment of loan money</td>
<td>17</td>
<td>34.78%</td>
</tr>
<tr>
<td>Changes in economic environment</td>
<td>16</td>
<td>30.43%</td>
</tr>
<tr>
<td>Natural cause e.g. Disability, death</td>
<td>9</td>
<td>17.4%</td>
</tr>
<tr>
<td>Lack of follow up measures</td>
<td>8</td>
<td>13.04%</td>
</tr>
<tr>
<td>Unrealistic terms and schedule of repayment</td>
<td>2</td>
<td>4.35%</td>
</tr>
</tbody>
</table>

### Table 5. Strategies used for credit risk management to reduce loan default

<table>
<thead>
<tr>
<th>Strategies</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Having collateral against the amount loaned</td>
<td>13</td>
<td>30.43%</td>
</tr>
<tr>
<td>Stringent loan evaluation procedures</td>
<td>7</td>
<td>17.39%</td>
</tr>
<tr>
<td>Strict and through policy on lending</td>
<td>13</td>
<td>30.43%</td>
</tr>
<tr>
<td>Checking for black listed clients in credit bureaus</td>
<td>2</td>
<td>4.34%</td>
</tr>
<tr>
<td>Having provisions to accommodate loan losses</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Table 6. Strategies used to recover defaulted loans

<table>
<thead>
<tr>
<th>Strategies</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using loan collateral to recover loans</td>
<td>27</td>
<td>52.9%</td>
</tr>
<tr>
<td>Constant follow up with loan defaulters</td>
<td>21</td>
<td>21%</td>
</tr>
<tr>
<td>Suing for loan non payments</td>
<td>4</td>
<td>4%</td>
</tr>
</tbody>
</table>
Table 7. Causes of collapse of MFIs in Kenya

<table>
<thead>
<tr>
<th>CAUSE OF COLLAPSE</th>
<th>FREQUENCY</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor management and governance</td>
<td>26</td>
<td>50%</td>
</tr>
<tr>
<td>Lack of stringent loan policies</td>
<td>11</td>
<td>22.2%</td>
</tr>
<tr>
<td>High competition in MFIs that led to lenient loan terms</td>
<td>6</td>
<td>11.1%</td>
</tr>
<tr>
<td>Volatile economic environment</td>
<td>9</td>
<td>16.7%</td>
</tr>
</tbody>
</table>