FACTORS INFLUENCING THE CREDIT RISK MANAGEMENT TECHNIQUES USED BY MICROFINANCE INSTITUTIONS IN KENYA

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Factors influencing the credit risk
DECLARATION

I declare that this research project report is my original work and it has never been submitted to any other institution for any award.

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DEDICATION

This work is especially dedicated to my beloved husband, Josphat Mwaura and our two children Cynthia and Justin. I pray all will enumerate their mother and will be great scholars and hard working better than Mummy and Daddy.
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ABSTRACT

This study sought to investigate the credit risk management techniques used by Microfinance Institutions in Kenya. The objectives of this study were, to determine credit risk management techniques employed by microfinance institutions in Kenya, to identify any differences in credit management techniques employed by commercial banks in micro credit versus those employed by other MFls, to determine if the commercial banks' 6 C's (Character, Capacity, Conditions, Collateral, Contribution, and Common sense) model for assessing credit risk is important in the credit appraisal process of microfinance institutions in Kenya and to determine whether there is a relationship between credit management techniques and the default rate of institutions offering Microfinance services.

The scope of this study was limited to Nairobi. The study adopted both the descriptive and exploratory research designs. The target population of this study was the microfinance institutions (MFIs) and banks offering micro credit in Kenya. There are well over 36 microfinance institutions in Kenya. The study was carried out by use of questionnaires sent out to the respondents, the responses of which were analyzed to reach a set of conclusions. Stratified random sampling technique was used. The researcher also employed some elements of convenience sampling to come up with a sample of 36 institutions. Data for this study was analyzed by the use of descriptive statistics that is, mean mode median and further, with the use of the Statistical Package for Social Sciences, (SPSS) and excel computer packages. The data was then presented in form of tables, charts and graphs.
LIST OF ABBREVIATIONS USED

MFIs- Microfinance Institutions
SMEs- Small and Medium Enterprises
MSEs- Micro and Small Enterprises
NGOs- Non Governmental Organizations
ILO- International Labour Organization
CBK- Central Bank of Kenya
SPSS- Statistical Package for Social Sciences
AMFI- Association of Microfinance Institutions
6 “Cs”- Character, Capacity, Conditions, Collateral, Contribution, and Common sense
SACA- Smallholder Agricultural Credit administration
OPERATIONAL DEFINITION OF TERMS

**Loan Products:** Types of credit from lenders with particular sets of terms and conditions, and often for a particular use.

**Micro Credit:** Micro credit may be defined as the credit given mainly to low-income entrepreneurs or the informal sector to finance them in their businesses. The loans may be provided by both the formal sector and the informal sector.

**Micro and Small Enterprise:** A small enterprise is one that employees between 11 and 50 persons (CBS 1999). Employment here refers to people working in the enterprise whether paid or not. Also, an economic unit producing goods or providing services, for example salons, kiosks, among others.

**Microfinance:** The Association of Microfinance Institutions (AMFI) defines Microfinance as the provision of micro credit as well as other services such as savings, deposits, insurance services and other financial instruments/products aimed at the poor or low-income people. This study focuses on the micro credit aspect.

**Microfinance Institution:** This is an institution set up and primarily dealing with the provision of micro finance services.

**Banking Institution or Bank:** An institution licensed as such by the Central Bank of Kenya to accept deposits and give advances under various statutes.
**Development banks:** Banks that are constituted to deal with specific sectors such as agriculture etc. They give directed credit. This study is not concerned with development banks.

**Default Rate:** The rate at which loans become bad and cannot be collected unless legal process commences.
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Micro finance, the provision of financial services to poor people, holds enormous potential to support their economic activities and thus contribute to the alleviation of poverty. Widespread experiences and research have shown the importance of savings facilities for the poor. Micro credit systems have been developed in response to the needs of small-scale entrepreneurs who do not have access to finance. Without money, it is not possible to purchase inputs that are required to establish business and improve on productivity. Therefore those people who operate with the least amount of surplus income to finance their businesses are in need of this external credit and yet they are considered to be least credit worthy (Khandker, 1990).

The Grameen bank in Bangladesh pioneered micro – credit through lending to members of groups. Group members provided security and due to peer pressure within, group members encouraged each other to ensure prompt payment of the loans. The main objective of MFI’s is to provide financial assistance through establishing saving schemes, offering loan products to the general public and the Small and Medium Enterprises (SMEs). The key function of MFI’s is to provide a way to transfer economic resources through time, across borders and among individuals. MFI’s can take the form of Government institutions and Non Governmental Organizations (Yunus, 1998).
In Kenya the idea of micro credit can be traced back before independence. The colonial government did not provide credit facilities to the African people, and hence informal credit groups such as merry go-rounds were formed within the societies in rural areas and clan levels. During the 1970s, government agencies were set up and their main responsibility was focused to provide credit to those who had no previous access to credit facilities (Dondo, 1999).

The government and donor community assumed the poor required cheap credit, and as a result credit unions were set up in an effort to mobilize savings amongst poor people. The favourable attitudes and policies towards micro-enterprise both worldwide and locally, owe much to the 1972 ILO mission to Kenya. The report highlighted the limitations of the previous industrial development policies in Kenya and by a large extent, much of the developing world (Henry, 1991).

Micro credit arose in the 1980’s as a result of research recommendations about government delivery of subsidized credit to poor people. Micro finance projects were set up by international aid organizations and local institutions, such as Micro Finance Institutions in Poland with a sole purpose of promoting small business enterprises. In the developing world the aim of micro finance is that of helping others help themselves (Hulme, 1997).

While MFIs and commercial banks have faced difficulties over the years, for a multitude of reasons, the major cause of serious financial problems continues to be directly related
to tax credit standards for borrowers, poor portfolio risk management or lack of attention to changes in the economic circumstances and competitive climate. In the framework of the financial system approach, adequate credit risk management techniques of the microfinance institutions increasingly move into the centre of attention to ensure the safety of their clients' deposits and the institutions' revenue generation (Littlefield, 2003).

A large portion of Kenyan financial institutions' revenue is generated from credit extended to various individuals and organizations. This revenue is in the form of interest earned and charges on the preparation and management of the credit process (Central Bank Annual Report, 2001). According to Clarke (1999), awarding credit is a journey, the success of which depends on the methodology applied to evaluate and to award the credit. This journey starts from the application for credit and ends at the time the loan from the credit process is fully paid. Like any human journey, the credit management process has got smooth paths, impediments and detours before the destination is reached. Therefore the credit needs to be effectively controlled for it to succeed eventually. Credit control can rightly be said to start when the client walks into the office. If during the discussion, with the client, the credit manager finally agrees to grant credit or lend money the lender has embarked on the journey called credit control and the nature of that journey will directly be influenced by the quality of that decision (Clarke et al, 1999).

The credit decision should be based on a thorough evaluation of the risk conditions of the lending and the characteristics of the borrower. Risk is a decision problem including a lending one that has several basic elements. First, there must be an individual or group
that is faced with a problem, that is, a decision maker. The problem might be whether to
award credit or not. The decision maker must be seeking to achieve some objective or
desired outcome, like to earn revenue from a successfully awarded loan over time.
Several alternative actions or strategies, which can possibly achieve the stated objective,
must be available to the decision maker. In addition a state of doubt must be available to
the decision-maker about which alternative action is best in seeking to achieve the
desired objectives. Finally the problem exists within an environment consisting of all
factors that the outcome cannot be controlled completely by the decision maker (Luce, et
al, 1957).

This framework is applicable in a wide variety of decision-making situations on the
basis of whether the decision is made by an individual or a group and according to
whether it is effected under conditions of certainty, risk, uncertainty, or a combination of
uncertainty and risk. The characteristic of decision-making problems, among the four
categories, is determined by the knowledge of the possible outcomes that will occur when
one or more alternative actions are chosen in a decision problem. Luce and Raiffa (1957)
assert that lenders make decisions on the basis of risk. Risk is a decision-making situation
in which there is variability in the possible outcomes and the decision maker can specify
the probabilities of these outcomes. It refers to the potential variability of outcomes from
a decision alternative. The more variable these possible outcomes are, the greater is the
risk associated with the decision alternative. Risk is the possibility that the actual return
on an investment or loan lent will deviate from that, which was expected. Risk
management, in the broadest sense, means protecting all of the institution’s assets: -
monetary, physical and human, from all potential dangers. For financial institutions, the more subtle risks to consider are embezzlement, misuse of information and damage to the institutions through irresponsible acts of a director or an employee.

Numerous approaches have been developed for incorporating risk into decision-making process by lending organizations. They range from relatively simple methods, such as the use of subjective or informal approaches, to fairly complex ones such as the use of computerized simulation models (Luce and Raiffa 1957). Many lending decisions by financial institutions are frequently based on the decision maker's subjective feelings about the risk in relation to expected repayment by the borrower. Financial institutions commonly use this approach in decision-making because it is both simple and inexpensive (McGrugan et al. 1993).

As at the year 2000, Kenya's financial institutions had been hit by a crisis that led to the collapse of indigenous financial institutions and contributed to a crisis of confidence that threatened to permanently damage the sector (CBK Annual Supervision Report, 2000). That crisis coming at a time of serious economic hardships was a great impediment to economic expansion. The answer to the crisis of confidence was risk management.

Many people consider risk management in financial institutions as an unpleasant task. After all it means looking at potential events that are negative or undesirable. Nonetheless, risk management is inescapable direct responsibility of the financial institution's officials, particularly the risk involving credit management. Many MFI s find
carrying out a thorough credit risk assessment and evaluation, a substantial challenge. For traditional bank lending, competitive pressures and the desire for growth create time constraints that interfere with basic due diligence (Greuning and Bratanovic, 1999).

While each company would have its own method of determining risk and quality of its clients, depending on the large group, the following risk evaluation concepts are useful for most occasions. The concepts the researcher will study in this survey are referred to as the 6 C's in credit appraisal (Edward, 1997). Many financial institutions and other business organizations use the 6 Cs Model to evaluate credit applications from their existing and prospective customers. As the name suggests, the 6 Cs model has six elements in appraising the credit worthiness of a prospective customers; namely character, capacity/completion, condition, collateral, contribution and common sense (Edward, 1997).

Measurement of credit risk can be considered from the perspective of probability theory. The process of measuring loss potentials and assessment and evaluating their impact on banks and financial institutions leads to credit risk control and financing and a thorough risk analysis, assessment and evaluation before granting credit to prospective customers.

1.2 Statement of the Problem

There is increasing competition in the banking industry. There is stiff competition at the retail end and an increasing interest in the micro credit model of the business. Survival in
banking is largely influenced by good credit decisions. Subjective decision making by the management of microfinance institutions may lead to non performing loans.

The goal of credit risk management is to maximize a financial institution’s risk-adjusted returns by maintaining credit risk exposure within acceptable parameters. Financial institutions need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. 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 financing organization (Sinkley, 1992).

There are indications that borrowers from microfinance institutions have a lower default rate than borrowers within commercial banks. (Annual Reports K-REP, 2007; Annual Reports KCB, 2006). Given this rate, commercial banks might benefit from understanding how best to employ the methods adopted by the MFIs so as to reduce their default rate. The relatively high default rate could be as a result of the credit management techniques employed by the commercial banks. This study was therefore aimed at finding out the factors that affect or influence the credit risk management techniques that are applied by the MFIs in Kenya while extending credit facilities to their customers.
1.3 Objectives of the Study

1.3.1 General Objective

The main objective of this study was to determine the Credit Risk Management techniques applied by Microfinance Institutions in Kenya with a special reference to some selected MFls in Nairobi.

1.3.2 Specific Objectives

The objectives of the study were

i. To determine credit risk management techniques employed by microfinance institutions in Kenya and how effective these techniques are in managing the risks that are associated with borrowing of credit by customers from the MFls.

ii. To identify any differences in credit management techniques employed by commercial banks in micro credit versus those employed by other MFls.

iii. To determine if the commercial banks’ 6 C’s model for assessing credit risk is important in the credit appraisal process of microfinance institutions in Kenya.

iv. To determine whether there is a relationship between credit management techniques and the default rate of institutions offering Microfinance services.

1.4 Research Questions

i. What are the credit risk management techniques employed by microfinance institutions in Kenya?

ii. Are there differences in credit management techniques employed by commercial banks in micro credit compared to those employed by other MFls?

iii. Is the commercial banks’ 6 C’s model for assessing credit risk important in the credit appraisal process of microfinance institutions in Kenya?
iv. Is there a relationship between credit management techniques and the default rate of institutions offering Microfinance services?

1.5 **Significance of the Study**

The study would be of importance to the following:

**Banks** - The study will assist banks in their endeavour to cultivate better methods of managing credit for the SME sector. Banks will understand the issues that are faced within the sector and the factors that determine success.

**Microfinance Institutions** - Microfinance Institutions (MFIs) in Kenya will use the research findings and the knowledge gained to assist them as they commercialize. Microfinance institutions are faced with the need to adopt sustainable methods of delivering services which can be achieved by offering sustainable products, of which the default rate is a crucial part.

**Government policy makers** - To formulate policies and regulations to guide the micro credit activities.

**Future researchers and scholars** – The study will help in facilitating an increase in the general knowledge of the subject and will act as a reference material to future researchers and scholars who may wish to embark on related studies. Research in the various
components of the sector will help to unearth hitherto unknown information that will go along way in facilitating further understanding of the micro credit sector.

1.6 **Scope and limitations of the Study**

The scope of this study will cover 30 MFIs in Nairobi. This is because Nairobi is the capital city and majority of these MFIs have their head offices in Nairobi. The researcher also works in Nairobi and it will be convenient for her to collect data.
CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

In Chapter one above the background to the problem was brought out and the need for a research and significance of the anticipated results discussed.

In this Chapter related literature on the same topic, is reviewed, the purpose of the review is to examine books and past studies on types of risks that microfinance providers are exposed to and the credit risk management techniques that can be applied.

Risk refers to the potential variability of outcomes from a decision alternative. It can also be defined as the exposure to change or the probability that some future events will occur making the expected and actual outcome to differ from the expected. The wider and regular the variability, the greater the risk.

2.1 Types of Risks Faced by Financial Institutions

According to Butterworths (1990), there are numerous risks facing today's financial institutions. These risks are interrelated hence their effective management is of utmost importance to the performance of financial institutions. Some of these risks are explained below.
2.1.1 Market Risk

The risk of losses in financial institutions on and off-balance-sheet positions arising from movements in market prices that change the market value of an asset or a commitment is described as the market risk. This type of risk is inherent in banks holding of trading portfolio securities, financial derivatives and open foreign exchange positions and in interest-sensitive bank assets and liabilities. As explained bellow, examples of market risk include foreign exchange risk, interest rate risk, liquidity risk and risk involved in derivative transactions.

2.1.2 Foreign exchange Risk.

This refers to the risk of losses in on-or-off-balance-sheet positions arising from adverse movements in exchange rates. The risk tends to be most closely identified with cross border capital flows, (Thygerson, 1995). Banks are exposed to this risk in acting as market makers in foreign exchange by quoting rates to their customers and by taking unhedged open positions in foreign currencies. This may occur when; first, banks are involved in spot and forward exchange markets and secondly banks taking unhedged open positions in foreign currencies (e.g. bank borrowing from abroad).

2.1.3 Interest Rate Risk

This refers to the exposure of a bank's financial condition to adverse movements in interest rates. This risk arises as a result of a mismatch (gap) between a bank's interest rate sensitive assets and liabilities, and affects both the earnings of a bank and the economic value of its assets, liabilities, and off-balance-sheet instruments. Excessive
interest rate risk may erode a bank’s earnings and capital base (Hempel, el al. 1994). The primary forms of interest rate risk are: first, repricing risk, which arises from the liming differences in the maturity and repricing of bank assets, liabilities, and off-balance-sheet positions and secondly, yield curve risk, which arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments otherwise similar repricing characteristics.

2.1.4 Liquidity Risk

This risk arises from financial institution’s inability to meet its obligations as and when they fall due without incurring unacceptable losses. Inadequate liquidity affects profitability, and in extreme cases, can lead to insolvency. In the case of cross-border transactions, there is an additional foreign exchange liquidity risk that may arise form first, a sudden interruption to banks access to foreign funding and .secondly, absence, in general, of a lender-of-last-resort facility by the Central Bank for foreign exchange transactions.

2.1.5 Risk in Derivative Transactions.

Derivatives are an increasingly common method of taking or hedging risks. The actual cost of replacing a derivative contract at current market prices is one measure of a derivative position’s exposure to market risk. (Saunders, 2002). Since many of these transactions are registered off-balance sheet, supervisors need to ensure that banks active in these transactions are adequately measuring, recognizing and managing the risks involved. Examples include the interest and foreign exchange rate domain e transactions
(swaps, options, forward, futures, etc.) of residents with other residents and non-residents and technology risk, which occur when technology investments do not produce the anticipated cost savings in operating costs and increased profits.

2.1.6 Credit Risk

This is the risk that the customer, or counter party of the bank will be unable or unwilling to meet a commitment that it has entered with the bank that is the failure of counter party to perform according to a contractual arrangement. The risk applies not only to loans but also to other on-and off-balance-sheet exposures such as guarantees, acceptances, and security investments (Hempel, el al. 1994). Additional dimensions of credit risk in the context of cross-border transactions include:

2.1.7 Transfer risk: When the currency of obligation becomes unavailable to the borrower regardless of its financial condition.

2.1.8 Country Risk: This is the risk associated with the economic, social, and political environment of the borrower’s country.

2.1.9 Other types of risks include:

Operational Risk, which are risks related to the banks overall business. It mostly focuses on capital requirements' and the whole operating activities of the bank. (Gruenning and Bralanovic, 1999); Country Risk: which is the risk that repayment from foreign borrowers may be interrupted because of interference from foreign governments; and;
Event Risk, which is the risk resulting from sudden and unexpected changes in financial market conditions due to events such as war, revolution or sudden collapse of stock market and breach of fiduciary trust.

The above are some of the major types of risks faced by commercial banks. However, the most significant and the major focus of this study is the Credit Risk. This study will focus on credit risk in terms its appraisal, assessment and evaluation using the 6 C's model.

2.2 Microfinance Institutions

Microfinance Institutions have provided the largest volume of credit to the SMEs. The market for small loans in Kenya has remained under-served for a long time and therefore filled by the Microfinance Institutions (Coetzee et al. 2007). The Government of Kenya is also in the process of developing a framework within which Microfinance providers will fall (Budget speech, 2006/2007).

2.3 Financial Needs for SMEs

Small and micro enterprises have faced persistent pressure when seeking funds for investment. The SMEs cannot easily access funding because they have underdeveloped businesses that have a very short history hence banks are often not willing to lend using conventional methods. Furthermore, the promoters lack securities that can be given to lenders or guarantee other investors into other business and, the promoters have neither the education nor the ability to convince investors or financial intermediaries. Owners may also not have a saving history with a financial intermediary that can form the basis
for savings-led credit. This possibly explains why banks in the past few years have relocated from rural and suburban areas rendering potential customers in these areas to have no access to credit (Coetzee et al, 2007). SMEs need credit for new investment in business, operational activities, and for growth of the business.

Investment in business: SMEs require funds as start up capital for investing in new ventures that they may have come up with. Rukwaro (2007) observes that most SMEs obtain funds from own sources, including savings and from friends, citing the fact that few creditors are willing to tend for start up businesses.

Operational purposes: SMEs need funds so that they can purchase raw materials, supplies and carry out activities that facilitate the production process. SMEs may make sales on credit hence need to bridging funds as they await repayment. Studies have found that most funds; received from credit institutions are used for working capital (Gatune, 2002).

Growth of Business: As SMEs grow, they require funds to finance growth in fixed assets and increase working capital. SMEs therefore require longer-term credit in ever increasing amounts. SMEs obtain such funds from formal institutions as well as own funds since many micro credit institutions lack the appropriate programs to finance such growth. Studies indicate a high drop out rate from MFIs is caused by the fact that they remain rigid, insisting on group methodology and lower amounts of loans for customers,
who have progressively graduated to higher loan requirements (Graham, 2007; Gatune, 2007; Rukwaro, 2007).

Other purposes: Promoters of SMEs need lumpsum funding to finance personal issues so that they can repay the credit using income generated from business. “Often, loans are diverted to “providential” or “non-productive” purposes, to meet emergency medical or education expenses. It is increasingly clear that to tie loans to specific uses without addressing other needs and opportunities is naïve at best” (Graham, 2000).

2.4 Sources of Funds for SMEs

SMEs source funds through equity/own funds or, through debt. Internal/own funds include accumulated savings from likely strategic investors who become part owners (Rukwaro, 2001; Atieno, 1998). SMEs also access credit, which requires repayment with interest or when given as a grant, with no interest. In a few situations the SMEs may be awarded grants and they may not be required to repay. Studies show that commercial banks provide the lowest amount of financing to SMEs and where it is provided, the credit is rationed (Atieno, 1998).

2.5 Classification of MFIs

Financial institutions offering micro credit are classified as follows; those that emphasise on micro credit at the time of establishment; those that started out purely as micro finance institutions, but have since evolved and operate as commercial banks offering both formal and micro credit services (Glosser 1994); those institutions that started out as
banks and have since diversified into offering either, more credit alongside conventional banking products or, strictly micro credit products such as Bank Raykat Indonesia (Boomgard et al, 1994); and lastly, banks that were set up primarily as microfinance banks e.g. Centenary Bank in Uganda (Baydas et al, 2006).

The SME sector is ripe for entry of more banks because banks have the network necessary to offer loans to the sector. The commercial banks are therefore stable and can lend, given appropriate lending methodologies, to a larger number of people hence realizing a bigger impact. Moreover, banks have the resources to expand further and lend more money. They are unlike most NGOs that rely heavily on donor and government support, which is dying up. Governments are beginning to realize the impact of the small and micro enterprise sector on the economy and are therefore availing mechanisms that will facilitate its growth (Budget speech. 2006/2007).

Governments have realized the need to de-link themselves from competing with the private sector and that subsidizing the sector has worked to its disadvantage. There is effort towards regulation as well as encouraging private banks to get more involved in the sector (Coetzee, 2007), The Kenyan Government is in the process of finalizing a sessional paper on the SME sector, which will encourage entry of more players (Budget speech, 2006/2007).
2.6 Requirements for Successful Micro Credit Providers

Successful micro credit activities for financial institutions must be driven by among others the following; Commitment and the institution’s culture (Oketch, 2001). Oketch further states that financial institution must treat the micro credit sector as part of the areas within the institution where profits will be made; staff must be appropriately rewarded and motivated to work towards improving business and to limit delinquencies. Administrative structures should be put in place to ensure that the institutions are able to monitor their loans from analysis to repayment; development of appropriate lending technologies that fit the particular clientele so that the borrowers can benefit from the loan programs as well as repay the loans with interest to limit default rates. The necessary capacity in terms of human resources must be in place to ensure that staff are able to appraise loanees, and follow up on loans made (Otero et al, 1994).

Successful institutional performance has been the objective and overriding concern of virtually all entities in the corporate world. This is more particular to micro financing institutions. The concept of the micro-financing institutions can be traced back in 1980’s with the Grameen bank of Bangladesh, which was established as a pro-poor bank (Yunus, 1998). Micro financing organizations were supposed to meet the financing needs of itinerant traders of the informal sectors enterprises especially in the areas where formal banks could not operate. Since then these institutions have occupied a central place in the socio economic development and empowerment of the poor in both the developed and under developed countries (Dondo, 2000).
Management, including that of microfinance institutions, entails developing sustainable competitive strategies and ultimately to efficiently and effectively plan and organize business activities and control use of resources, in order to achieve desired objectives. The main objectives of organizations, including MFIs, are to maximize owner's equity. Successful management of all such plans and organizations may be upset by the occurrence of unseen events, hence risk (Abedi. 2000). Therefore, continuous planning, coordinating, organizing and controlling of activities and resources, including effective credit appraisal and evaluation, in order to minimize risk of lent funds, are the major concerns of risk management among microfinance institutions in Kenya (Annual Reports K-REP, 2001; Annual Reports KCB, 2001).

2.7 Risk Management

Butterworths (1990) asserts that effective risk management, from the viewpoint of financial institutions, is the key to the future success in banking and therefore these institutions should focus on professional management of risk. The successful financial institutions are, and will increasingly be, those that develop focused strategies, lower their overhead ratios, ingeniously exploit their advantages and know how to calculate their risks.

The most important areas of concern to MFIs in credit risk management is integrative in terms of risk an MFI is taking in doing business by client, by channel, by product, by business, by industry, by currency and by country. MFIs will put out of lines of business
as well as of areas, where the risk they are taking is disproportionate compared to the profits they make or hope to make (Hempel, et al. 1999)

2.7.1 Prerequisites to Risk Management:

One of the most important prerequisites of risk management is that of planning for the unknown. This requires asking questions such as how do we know when a diversity will hit and how hard? Have we examined ahead of time where our financial staying power lies? Do we know what is to be our line of defence against any risk associated with a line of business we are entering into? Secondly, can we anticipate, rapidly respond and cope with changes in the business environment?

Operating a financial business has always been a matter of foreseeing and rapidly coping with change. Banks and other financial institutions and their customers keep constantly changing. Therefore all financial institutions should focus on providing quality services in the areas of financial service, investment advice, mergers or acquisitions, corporate finance, restructuring, arbitrage, sovereign lending, recycling, and rescheduling.

Every one of these product titles suggests activities quite different from classical money lending; yet the banking business is still basically the same as that of lending money to make money. This creates a tremendous conceptual gap and sometimes leads to unwarranted risk taking. To a large measure adapting to the new environment means
changing culture, altering not only the way they have been operating in the past, but adapting new ways of thinking and doing business (Thygerson. 1995).

2.7.2 Taking Risk for the Competitive Reasons:

In more than one reason, risk is a corollary to competitiveness. To be properly managed money needs brains, open perspectives and adequate tools. Risk management has the same requirements but not every financial institution seems to be convinced that risk control policies can both limit undue exposure and give the financial institution a competitive edge. Risks are significantly increased when a financial institution loses its grip in the market as well as when it falls back in skills and technology.

Bank Liquidity: Liquidity is the protection against the risk that losses may develop if banks are forced to sell or liquidate credit-worth assets in an adverse market. Some of the questions raised to answer liquidity problems are. What is the necessary percentage of cash holding to guarantee liquidity without curtailing profits? What is the proper mix of current assets and current liabilities?

A bank should be carrying sufficient capital to meet its asset growth objectives, cover unexpected account loan losses, underwrite interest rate risk, account for fraud when it happens and support long-term operating needs. There is a balance to observe as the less liquid a bank is, the greater the risk of failure and the more liquid the bank, the less capital is used for more remunerative purposes (Omulunde. 2006).
Deposit reliability: This refers to that core, or minimum amount of deposits upon which a bank believes it can depend on with little risk of deterioration. Just because many factors influence the movement of deposit funds from time to time and from bank to bank, the degree of deposit dependability should be determined by examining deposits both by specific class and as a total.

2.8 Credit Control Policy and Risk Management in Microfinance Institutions

"Credit like the honour of a female is too delicate a matter to be treated with laxity—the slightest hint may inflict an injury which no subsequent effort can repair" (The Kenya Banker, 2007). The warning given by the above quote must simmer well into the fabric of every financial institution, or corporate clients, seeking to be safe from losses or failures arising from credit failure, if profitability and efficiency are their core operational values.

Therefore, there is need for an effective credit control policy to manage credit risk. Hence, in order to ensure a fairly healthy credit management program, with minimal expensive bad debts, and minimized credit risk, a company strives to establish an effective credit control and lending policy. Surprisingly, a few companies do not have any such policy and even more worrying, many of the companies with credit control policies still fail to operate the policies so much so that the companies’ debts soar and seriously affect the companies’ very existence, in terms of profitability and a healthy cash flow (CBK Survey, 2007).
Credit control policy is the general guideline governing the process of giving credit to the firm's customers. The policy sets the rules on who should get what credit and when and why one should get the credit including repayment arrangements and necessary collaterals. The method of assessment and evaluation of risk of each prospective applicant are part of a credit control policy (CBK Survey, 2007).

2.8.1 Credit Policy Objectives:
A company's credit policy objectives include: sales revenue increases through deepening on sales; encourage movement of slow moving stocks; a competitive tool to gain a competitive advantage in the market; minimize cost of idle cash; encourage growth; to effectively avoid customers nobody else wants; minimize credit risk taken by the firm; and minimize non-performing loans in the case of microfinance institutions (Omulunde. 2006).

2.8.2 Factors Considered in Establishing a Credit Control Policy
Financial institutions usually consider many factors when setting up a lending policy. However, the lending policy should be in line with the overall organizational strategy. Nevertheless, the factors considered include: the existing credits policy, industry norms, general economic condition in the country and the prevailing economic climate. Further to the general trend of credit extended by other leaders: the more generous the credit they give their customers; hence the more a firm can afford to be lenient with its debtors. The cost of a firm's overheads and the costs of credit management may influence the credit control policy in that if these costs are heavy then the firm may not wish to extend too
much credit, assessment, evaluation and monitoring tools available, credit risk to the organization, including pace of technological development and changes that will enhance credit follow up as well the 6 C”s characterization of the customers will impact on the firm's credit control policy (Omulunde. 2006).

A firm’s credit policy may be lenient or stringent.

Lenient: With this form of credit policy, the firm lends liberally even to those whose credit worthiness is questionable. This leads to higher borrowing, high profits, assuming full collections of the debts owed.

Stringent: Under this type of credit policy, credit is restricted to carefully determined customers through a thorough credit appraisal system. This minimizes costs and losses from bad debts; however it may reduce revenue earnings from credit profitability and cash flow.

Every financial institution bears a degree of risk when the institution lends to businesses and consumers and hence experiences some loan losses when certain borrowers fail to repay their loans as agreed. Principally, the credit risk of a bank is the possibility of loss arising from non-repayment of interest and the principal, or both, or non-realization of securities on the loans. This concept is not different from non-banking institutions Credit perspective (Omulunde. 2006).
2.9 The Six C's of Credit Risk Assessment and Evaluation Model

According to Abedi (2000), banks use the 6 C’s to evaluate a customer as a potential borrower. The 6 C's help banks to decrease the risk of default, as they get to know their customers. According to Abedi (2000), this 6 C’s are:

**Character:** Character is the maturity, honesty and trustworthiness, integrity, discipline, reliability and dependability of a customer. Character is no doubt the most important quality of any client. A person of good character will pay his debt whether it is secured or not. Such a person will disclose all the facts of his deal because his intentions are to seek guidance and help from the organization. When in problems, such borrowers will adhere to the credit manager's request for alternative arrangements to pay his debt instead of hiding from the bank. The business of charge and credit cards is based primarily on the character of the cardholders. A person’s character can be determined through: Personal interview, reference from people who know the client well, personal knowledge of the client and record of past performances.

**Capacity/completion:** capacity refers to a client's ability to service his debt fully. Even if one had good intentions but has no funds he will not be able to keep his loan repayment up to date. A client's capacity can be determined by retrieving his resources of income and netting off the commitments. In the case of a company, an analysis of the Audited Accounts for the past three years could reveal the surplus available to service the loan. For hire purchase, bank loan or charge card, the practice is to determine a client’s current capacity, since injection of the loan may not have sufficient influence on the client's
capacity to generate income. For venture capital, the picture is completely different. Capacity is based on projections and hence integrity of such projections is quite crucial.

Capacity also refers to a client's record of performance. A client who has borrowed money from various institutions and paid regularly over long periods can be described as having experience of borrowing and paying. The client is disciplined and is likely to keep the good record. Occasionally, credit managers come across clients who will tell them that they are good borrowers because this is their first loan. Unfortunately, one cannot say so because the client’s are inexperienced. They are virgins in loan management and repayment.

**Condition**: condition refers to the overall environment. Is the commercial socio-economic, technological and political environment conducive to a successful implementation of the project? Are there any illegal impediments and detours to the successful implementation of the project? For example, if someone wants a loan to invest in drugs business, a very profitable but illegal undertaking, would he qualify for a loan?

**Collateral**: This is the security given to secure the loan, in terms of non-encumbered assets. Perhaps the most talked about, but the least important, in terms of eventual credit success of the six C’s is collateral or security. Businesses like credit and charge card’s, do not even consider collateral thus the least important (CBK. 2002). Further more, some collateral are difficult to dispose of to recover the loans and in some industries and
situations there are lots of indifference's that make it almost impossible to dispose of the collateral.

**Contribution:** is the client committed to the project at hand. Is he willing and able to make contribution? If it is a hire purchase, is he able to raise the 40% deposit or is the deposit borrowed from a third party making the project 100% loan financed. If a client is having difficulty raising the deposit, he is likely to be unable to pay his instalments regularly. Is the client willing to contribute his time to the management of the projects or asset? Absentee management has been the main cause of failure of many projects in this country. For example, oil companies are insisting that petrol stations must be owner managed. What about where large sums of money are involved? Shouldn't owner management be mandatory?

**Common Sense:** This is the natural ability to make good judgement and behave in a practical and sensible way. Being prudent and reasonable in analyzing, presenting, using and interpreting financial, data and other related business information.

Additionally, common sense is the reasonableness of the financial information provided to support the case for financing a project as an indication of the ability of the project to pay for itself.

While each of the above factors is important on their own right, they, however, should not be considered in isolation. While adverse record on each one is enough to reject an
application, good reports on all the aspects improve the probabilities of success. Therefore, these elements can be used individually or in combination, depending on the level of quality of credit appraisal required and the amount of credit involved. The 6 C's model is meant to help financial institutions in Kenya to thoroughly evaluate and assess the credit worthiness of existing and potential customers before awarding them new or further credit and hence exposure of banks and the avoidance of non-performing loans. The 6 C's model covers the entire area of credit risk and hence its application in credit risk appraisal will ensure that banks and financial institutions protect their assets against loss (Abedi. 2000).

2.10 Credit Appraisal Criteria in MFIs

The guiding principle in credit appraisal is to ensure that only those borrowers who require credit and are able to meet repayment obligations can access credit. Lenders may refuse to make loans even though borrowers are willing to pay a higher interest rate or make loans but restrict the size of loans to less than the borrowers would like to borrow (Mishkin, 1997). Financial institutions engage in the second form of credit rationing to reduce their risks.

There are two arguments on how much credit the SMEs should be given. One school of thought argues that the SMEs know best what they want to invest in and thus they should be given what they apply for (Reinke, 2001). The author further argues that some credit schemes assume that the poor people themselves know best how to better themselves and thus, credit should be targeted to particular activities. In Cameroon and Togo, consumer
and investment credit is provided and there is no constraint on how loans are used (Gurgand, 1994).

The other argument contends that credit should be made available according to repayment capability based on current performance. Some of the factors of determining the size and target for credit include:

**Savings:** Gurgand (1994) notes that mandatory and voluntary savings schemes have been used effectively by Rural Finance Institutions (RFIs) where savings play a significant role in gaining access to credit. Credit épargne-logement in Rwanda provides 5 to 15 years credit for home construction after one year of recorded saving efforts. Reinke (2001) identifies savings as a means of determining who to give credit and how much, whereby a borrower is required to accumulate savings both prior to and after borrowing. The borrower may also be required to pledge such savings as collateral. This excludes the potential borrowers and contradicts logic of micro lending in that the borrowers may not have funds to save.

**Ability to pay:** In Burkina Faso and Malawi, failure of one member to repay was used to block access to new credit for all group members, increasing repayment performance due to social pressure (Gurgand 1994). Reinke (2001) notes that instead of blocking all the group members, access to future larger loans may be made dependent on punctual and full payment of small initial loans.
Evaluation of business ability: This approach is practiced in Burkina Faso whereby a careful analysis of the economic opportunities available in the villages where credit is provided is carried out. Use of credit is discussed with borrowers and includes a variety of firm or non-firm investments. The scheme is flexible allowing reallocation of funds to activities that had not been previously planned.

Target group: Target groups are also used to allocate credit. Gurgand (1994) found that Smallholder Agricultural Credit administration (SACA) in Malawi concentrates on small holder farmers, credit soudure in Burkina Faso concentrates on poor people in rural Sahel that suffer lack of capital with emphasis on women. Other organizations target group. Among the ways identified include, target women who are seen as economically less independent, the youth due to high unemployment and insufficient jobs and the rural people who are seen not to benefit from development and employment creation in the cities and towns. A lender has to decide how to reach his target group and ensure that targeting objectives are met. A number of micro finance loans are targeted towards the employed class in order to minimize default.

Others: other factors identified by Reinke (2001) include such factors like ethnicity, nationality or factors of social disadvantage such as physical disability, location and objective of the micro credit institution and mandatory framing. Objective of the lender may be to fund activities away from the trading activities so as not to dilute the sector's profit thus undermining the viability of all trading activities An MFI serving the poor may locale its offices where the poor live. Such criterion may sometimes lead to poor
choices as cities and towns have the best infrastructure connections. Access to credit may be conditioned on undergoing credit Training. This may be worthy as more borrowers will succeed in their business and be able and willing to repay their loans. However, training is costly and it will exclude some potential borrowers.

2.11 Review of Past Studies

Oketch, (1995), when studying the demand and supply of MSEs finance in Kenya established that the size of loans to various borrowers depends on the lending technology where funds are lent to individuals; appraisal depended on business assessment, collateral, business needs and replacement capacity, type of business and availability of funds. For group based loans it depends on age of the group appraisal of the project, past repayment records, demand by clients and availability of funds.

Oketch used the SMEs financiers and did not consider the influence of rationing on MSEs operations. Oketch's findings contribute to this study in defining the possible variables from the perspective of the SMEs such as credit size and security. Rukwaro (2007) took the perspective of both the SMEs and their financiers and went further to determine the influence of credit rationing on operations of SMEs and indeed concluded that credit rationing impacts negatively on operations of SMEs.
2.12 Conceptual Framework

The study was based on the assumption that the independent variables affect the dependent variable. The independent variables have been extensively discussed in the literature review.

{Types of Risks Faced by Financial Institutions (Market Risks, Foreign exchange Risks, Interest Rate Risks, Liquidity Risks, Risks in Derivative Transactions and Credit Risks \(x_1\)} + { Financial Needs for SMEs and Sources of Funds for SMEs \(x_2\)} + { Credit Appraisal Criteria in MFIs \(x_3\)} are **functions of** Credit Risk Management Techniques by Microfinance Institutions in Kenya \(y\).

\[(x_1) + (x_2) + (x_3) = (y)\]

**Figure 2.12:-The Conceptual Framework**

**Types of Risks Faced by Financial Institutions**
- Market Risks
- Foreign exchange Risk
- Interest Rate Risks
- Liquidity Risks
- Risks in Derivative Transactions
- Credit Risks \(x_1\)

**Financial Needs for SMEs and Sources of Funds for SMEs \(x_2\)**

**Credit Appraisal Criteria in MFIs \(x_3\)**

**Independent variables**

**Credit Risk Management Techniques by Microfinance Institutions in Kenya \(y\)**

**Dependent variable**

**Source:** Researcher (2008)
CHAPTER THREE
RESEARCH METHODOLOGY

3.0 Introduction
The section covers the research design, population and sample size, data collection methods and procedures and data analysis.

3.1 Research Design
In this study, the following types of procedures or methods were considered suitable due to the nature of investigation. An exploratory research study was adopted, as it will be imperative to gathering important primary data. A survey design was also incorporated based on a descriptive study. This method was used to describe the area of interest by bringing out the facts on the ground as they are without alterations. The descriptive study attempted to provide information on the current status of the organizations under study and provided a description of the characteristics of Micro Finance Institutions as far as their credit risk management techniques were concerned. The design also had an exploratory aspect in that; the researcher collected data from a cross-section of respondents chosen to represent the MFIs.

3.2 Target Population
The target population of this study was the 30 micro finance institutions (MFIs) and 6 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 cooperative societies, and others operating on part-time basis. The population of
registered micro-finance institutions in Kenya comprise of 64, according to the K-REP register of MFIs, the Association of Microfinance Institutions of Kenya and the Central Bank of Kenya. There are also six other banks offering micro credit services, that is, two building societies, one specialized microfinance bank and three commercial banks. The population targeted by this study constituted the banks and registered microfinance institutions.

3.3 Sampling

The sample frame constituted the 6 commercial banks and 64 microfinance institutions, (However, there are only 30 MFIs that operate in Nairobi). The stratified random sampling technique was used. The researcher also employed some elements of convenience sampling. The strata included the banks, and microfinance institution. Convenience sampling was used to select the registered microfinance institution within Nairobi, which are 30 in number. These MFIs were studied as well as the 6 banks offering micro credit. The sample therefore comprised of 36 institutions.

3.4 Data collection method

The names and addresses of Microfinance Institution (MFIs) in Kenya were obtained from the Association of Microfinance Institutions, Central Bank of Kenya and the KREP register. The main instrument for data collection was a questionnaire, which contained both open, ended and closed ended questions. Data was collected form primary sources through questionnaires distributed to the managers of the commercial banks and microfinance institutions. Follow-up was done through a research assistant who assisted
in administering of questionnaires. Secondary data was obtained to reinforce collected data from brochures and supplements in newspapers covering micro credit providers.

3.5 Data analysis

Data was analysed using descriptive statistics such as means, percentages and tabulations with the help of the Statistical Package for Social Sciences (SPSS) Package. The analysis was carried out on the credit risk management approaches of different microfinance institutions when offering micro credit. Data was also analysed using descriptive statistics such as measure of central tendencies, frequencies and percentages. The analyses would help determine if there are significant differences in credit management approaches used by the bank based micro credit institutions versus those used by other microfinance institutions.
CHAPTER FOUR
DATA ANALYSIS AND INTERPRETATION

4.0 Introduction

This chapter presents the analysis of the data collected and interpreted on the assessment of credit risk management techniques adopted by Micro Finance Institutions and banks offering micro credit services in Kenya.

4.1 Overview Data Collected and Analysed

Data was collected from 31 institutions located in Nairobi and its environs out of the 36 institutions targeted. The questionnaire was administered using the drop-and-pick later method. The data was collected from heads of Finance, accounting, and/or credit department at the MFIs as well as heads of various unit- handling micro credit at the selected banks. The institutions that did not respond gave various reasons including sensitivity of financial information requested; only a few senior officers could authorise release of information and the said officers were out of office on official matters, while others feared misuse of the information requested. Brochures were obtained from specific institution to clarify information on products offered.

Out of the 62 questionnaires that were distributed, 40 were returned. This represents response rate of 65%, which is considered significant enough to provide a basis for valid and reliable conclusions with regard to credit risk management techniques adopted by Micro Finance Institution's and banks offering micro credit service in Kenya.
4.2 Background Information of the Institutions Studied

4.2.1 Ownership of the institutions

When respondents were asked about ownership of their organizations, a majority of 57.5% said institutions were private, 20% were owned by the public, government owned another 12.5% while NGOs owned the remaining 10%. This shows that most of the institutions are mostly managed by private firms and individuals in Kenya.

<table>
<thead>
<tr>
<th>Ownership</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>5</td>
<td>12.5</td>
<td>12.5</td>
<td>12.5</td>
</tr>
<tr>
<td>NGO</td>
<td>4</td>
<td>10.0</td>
<td>10.0</td>
<td>22.5</td>
</tr>
<tr>
<td>Private</td>
<td>23</td>
<td>57.5</td>
<td>57.5</td>
<td>80.0</td>
</tr>
<tr>
<td>Public</td>
<td>8</td>
<td>20.0</td>
<td>20.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Research Data

4.2.2 Involvement in micro credit

All the 40 respondents (100%) indicated that they were involved in micro credit services. The analysis further showed that all the MFIs and banks offer micro credit to small scale entrepreneurs, a clear indication of a better future in terms of entrepreneurial behaviour and thus better living standards for the Kenyan citizens.

<table>
<thead>
<tr>
<th>Involvement of your organisation in micro credit?</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid Yes</td>
<td>40</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Research Data
4.2.3 When micro credit was introduced

When asked when micro credit was introduced in their institutions all the respondents (100%) indicated that micro credit was introduced right on the inception of the institutions. From this response, we can say that the MFls were formed with the aim of offering Micro credit.

<table>
<thead>
<tr>
<th>If yes, when was the micro credit introduced?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Valid</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>On inception</td>
</tr>
</tbody>
</table>

Source: Research Data

4.2.4 The Number of outlets offering micro credit

As can be seen in figure 4.1 below, 67% of the MFls studied have 31-40 outlets 20% of MFls own between 20-30 outlets while only 13% of these institutions between 11-20 outlets. This shows a positive growth of Micro Finance Institution outlets.

Figure 4.2.4 The Number of Outlets Where Micro Credit is offered

Indicate the number of outlets where micro credit is offered in your institution?

67% 20% 13%

Source: Research Data
4.2.5 The reasons why micro credit services were introduced in the organization

When asked the reasons why micro credit services were introduced in their institutions a majority of the respondents, indicated the most important reason was to assist the poor (47.5%), to increase profitability of the institution (37.5%), to satisfy a government requirement (15%) and to satisfy a powerful promoter within the organization (5%).

On the same question, the respondents indicated the fairly important reason for introducing micro credit in their institutions was to increase, profitability of the institution (55%), to satisfy a government requirement (52.5%), to assist the poor (10.0%), and to satisfy a powerful promoter within the organization (10.0%).

Table 4.2 Reasons as to why Micro Credit was introduced in Organization

<table>
<thead>
<tr>
<th>Ranking</th>
<th>To assist the poor</th>
<th>To increase profitability of the institution</th>
<th>To satisfy a government requirement</th>
<th>To satisfy a powerful promoter within the organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most Important</td>
<td>47.5</td>
<td>37.5</td>
<td>15</td>
<td>5</td>
</tr>
<tr>
<td>Fairly Important</td>
<td>10</td>
<td>55</td>
<td>52.5</td>
<td>10</td>
</tr>
<tr>
<td>Important</td>
<td>25</td>
<td>5</td>
<td>25</td>
<td>60</td>
</tr>
<tr>
<td>Least Important</td>
<td>12.5</td>
<td>2.5</td>
<td>2.5</td>
<td>15</td>
</tr>
<tr>
<td>Not Important</td>
<td>5</td>
<td>2.5</td>
<td>5</td>
<td>10</td>
</tr>
</tbody>
</table>
4.3 Management of Micro Credit Activities

4.3.1 Existence of a specific micro credit policy

It was revealed that a significant number of 92.5% (37 out of 40 respondents) have guiding policies while only an insignificant number of only 3 respondents (7.5%) have lot yet come up with the same. This is a positive trend, and will enhance performance since policies leads to a formalized credit evaluation process and specifics how ever)
Table 4.3  Existence of Specific Micro Credit Policies

<table>
<thead>
<tr>
<th>Has specific policies</th>
<th>Mo specific policies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of respondents</td>
<td>37</td>
<td>3</td>
</tr>
<tr>
<td>Percentage</td>
<td>92.5%</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

Source: Research Data

Existence specific micro credit policies

```
8%

92%
```

Source: Research Data

4.3.2 Involvement in the formulation of credit policy

When respondents were asked about their level of involvement in the micro credit policy formulation, a majority of 67.5% of them indicated that they involve their institution, 27.5% involve third parties while only 5% involved other concerns in the micro credit policy formulation. See table 4.4 below.
Table 4.4  Involvement in Formulation of Micro Credit Policies

<table>
<thead>
<tr>
<th></th>
<th>No. of respondents</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>The institution</td>
<td>27</td>
<td>67.5%</td>
</tr>
<tr>
<td>Third parties</td>
<td>11</td>
<td>27.5%</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>40</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

Source- Research Data

The involvement in formulating the micro credit Policies

4.3.3 Setting of specific targets on micro credit services

When respondents were asked whether they work with pre-set targets, 35 out of 40 (87.5%) said they work with pre-set targets while an insignificant number (5 out of 40) comprising 12.5% does not work with targets. The trend is impressive and shows that MFIs and banks offering micro credit set targets to enable performance monitoring of the services thus leading to better management.

43
Table 4.5  Whether the Institution Sets Targets for Micro Credit Services

<table>
<thead>
<tr>
<th>Has set specific targets for micro</th>
<th>No specific targets set for micro credit</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of respondents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>5</td>
<td>40</td>
</tr>
<tr>
<td>Percentage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>87.5%</td>
<td>12.5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Research Data

Setting of Targets for Micro Credit Services

87%

Source: Research Data

4.3.4 Monitoring of the set targets as compared to monitoring of other services

When asked how the monitoring of the set targets compared with monitoring of targets of other types of services, a reasonable number of 75% observed that the pre-set targets compares favourably with the other types of services, while a small percentage (20%) of the respondents indicated that there is lower emphasis on targets than on the other Product/services in their MFLs, and lastly an insignificant 5% indicate of other options which they did not specify.
4.3.5 Existence of credit officers

It appears that somehow a number of micro credit institutions do have credit officers, 62.5% of the respondents implied that their micro credit departments had specific credit officers while only 37.5% did not have these officers. This is an indication that the micro credit institutions are moving towards reasonable levels of perfection.

<table>
<thead>
<tr>
<th>Does the micro credit department have specific credit officers?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frequency</td>
</tr>
<tr>
<td>-----------</td>
</tr>
<tr>
<td>Valid</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Research Data
Does the micro credit department have specific credit officers?

Source: Research Data

4.3.6 Organization of the micro credit activities.

Table 4.8 Organization of the Micro Credit Activities

<table>
<thead>
<tr>
<th>Variables</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Within a separate department</td>
<td>27</td>
<td>67.5</td>
<td>67.5</td>
<td>67.5</td>
</tr>
<tr>
<td>A unit within a department</td>
<td>12</td>
<td>30.0</td>
<td>30.0</td>
<td>97.5</td>
</tr>
<tr>
<td>Any other</td>
<td>1</td>
<td>2.5</td>
<td>2.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Research Data

From the analysis above (table 4.8), most institutions have distinctive separate departments where micro credit activities are organized as indicated by 67.5% of the respondents, as opposed to 30% who indicated that micro credit activities are offered by a
unit within a department. This is an indication of growth in the development of micro credit institutions in the county.

4.3.7 Factors to consider in establishing a credit control policy

When asked to rank the factors to consider in establishing a credit control policy, majority of the respondent indicated that they mostly consider overhead cost (47.5%), the general trend of credit extended to the organization (27.5%), the state of the economy (30%) and the existing credit policy (25%) in that order.

Table 4.9 Factors to Consider In Establishing a Credit Control Policy

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Existing credit policy</th>
<th>Overhead costs</th>
<th>General trend of credit extended to your organization</th>
<th>The state of the economy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Least considered</td>
<td>75</td>
<td>52.5</td>
<td>72.5</td>
<td>70</td>
</tr>
<tr>
<td>Most considered</td>
<td>25</td>
<td>47.5</td>
<td>27.5</td>
<td>30</td>
</tr>
</tbody>
</table>
Factors to Consider In Establishing a Credit Control Policy

![Bar Chart](image)

Factors considered in establishing a credit control policy:
- **Least considered:**
  - General trend of credit extended to your organization
  - The state of the economy
- **Most considered:**
  - Overhead costs
  - Existing credit policy

Source: Research Data

**4.3.8 people who formulate your credit policy**

When asked to rank the people who formulated the credit policy in their institutions, majority of the respondents indicated that in most cases executive management formulated policies (90%), while others felt (60%) said that credit managers or equivalent made the credit policies, others felt that employees suggestions (45%) and credit analyst (45%) led the formulation of policies, still others felt that the board (32.5%) and the credit committee (22.5) led in formulation of policy. This clearly shows that the practice is diverse and there was a mix of who formulated credit policies.
4.3.9 Regularity of review of credit policy

When asked how regularly they reviewed their credit policies most respondents (52.5%) indicated that this was done quarterly while another 32.5% indicated that the review was yearly. There were others (10%) who reviewed their policies half-yearly while another insignificant 5% did not indicated how regular the review was.

Table 4.11 Regularity of Review of Credit Policy

<table>
<thead>
<tr>
<th>How often do you review your credit policy?</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid Quarterly</td>
<td>21</td>
<td>52.5</td>
<td>52.5</td>
<td>52.5</td>
</tr>
<tr>
<td>Half yearly</td>
<td>4</td>
<td>10.0</td>
<td>10.0</td>
<td>62.5</td>
</tr>
<tr>
<td>Yearly</td>
<td>13</td>
<td>32.5</td>
<td>32.5</td>
<td>95.0</td>
</tr>
<tr>
<td>Others</td>
<td>2</td>
<td>5.0</td>
<td>5.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>
How often do you review your credit policy?

4.4 Credit appraisal process

When asked about the credit appraisal process, a reasonable number of 67.5% agreed that it is very objective as compared to only 32.5% who said it is very subjective in nature. This shows that the credit is appraised in most of the cases in an objective manner.

Table 4.12

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valid</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Very subjective</td>
<td>13</td>
<td>32.5</td>
<td>32.5</td>
<td>32.5</td>
</tr>
<tr>
<td>Very objective</td>
<td>27</td>
<td>67.5</td>
<td>67.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>
How subjective or objective is your credit appraisal process?

- Very subjective: 67%
- Very objective: 33%

4.4.2 How to make employees aware of credit risk

When asked how they sensitized on credit risk, a majority of the respondents (67.5%) said they used the credit manual while another 62.5% said they used 'one-to-one' supervision to make employees aware of credit risk issues. There still other (47.5%) who used regular training as a way of communication on credit risk to employees. The least used method was regular meeting (42.5%).

Table 4.13: How to make Employees Aware of Credit Risk

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Regular meetings</th>
<th>Regular training</th>
<th>Using supervision on one-to-one basis</th>
<th>credit manual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Method least used</td>
<td>57.5</td>
<td>52.5</td>
<td>37.5</td>
<td>32.5</td>
</tr>
<tr>
<td>Method most used</td>
<td>42.5</td>
<td>47.5</td>
<td>62.5</td>
<td>67.5</td>
</tr>
</tbody>
</table>

How to make Employees Aware of Credit Risk
Table 4.13 Credit appraisal using the 6 C’s criteria

4.4.3 Credit appraisal using 6C’s criteria

To establish the criteria used by the institution in evaluating credit risk, the respondents were asked to specify which factors they considered when appraising, assessing and evaluating credit risk to their customers. As shown in figure 4.14 below, the factors most considered were capacity/completion (65%), contribution (65%), and character (62.5%) reasonableness of cash flow from business (62.5%), condition (52.5%) and finally collateral/security (52.5%).
4.4.4 Credit risk assessment and credit approval levels.

The respondents were asked to indicate who does the credit risk assessment in their institutions and who approves credit risk at various levels. As shown on table 4.15 below, the credit risk assessment is mostly done by the Credit Manager (67.5%), followed by the Credit Committee (62.5%), Branch Manager (57.5%), then Managing Director/General Manager (37.5%) and least by the Chairman (20.0%).

Table 4.15 Credit Risk Assessment

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Chairman</th>
<th>Managing director</th>
<th>General manager</th>
<th>Branch manager</th>
<th>Credit manager/ Head of credit</th>
<th>Credit committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most involved</td>
<td>20</td>
<td>37.5</td>
<td>37.5</td>
<td>57.5</td>
<td>67.5</td>
<td>62.5</td>
</tr>
<tr>
<td>Least involved</td>
<td>80</td>
<td>62.5</td>
<td>25</td>
<td>42.5</td>
<td>32.5</td>
<td>37.5</td>
</tr>
</tbody>
</table>

Most of the respondents stated that the Managing Director mainly approves credit amounting of less than Kshs. 1.5 million. The branch Manager approves credit of between 500,000 to 1million.

4.4.5 Dealing with difficult to repay clients

When the respondents were asked how they deal with difficult to repay clients a majority indicated the preferred method is sale of property to recover the money (67.5%) followed
by write-off of the balance (55%) while another 32.5% would consider writing off the interest and allowing defaulters to repay the principal loan only.

Table 4.18 Dealing with Loan Defaulters.

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Use auctioneers to recover the debts</th>
<th>Sale of their property to recover the money</th>
<th>Leave them alone to decide when to pay</th>
<th>Write the debt off and account it as bad debts</th>
<th>Write off interest and allow them to pay the principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Least done</td>
<td>25</td>
<td>32.5</td>
<td>72.5</td>
<td>45</td>
<td>67.5</td>
</tr>
<tr>
<td>Most done</td>
<td>15</td>
<td>67.5</td>
<td>27.5</td>
<td>55</td>
<td>32.5</td>
</tr>
</tbody>
</table>

**Source:** resource data
CHAPTER FIVE
SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.0 Summary of findings and conclusions
The summary of the study on the assessment of credit risk management techniques adopted by micro finance institutions in Kenya was carried out as follows. To satisfy the objective of the study, primary data was collected, by use of questionnaires from 25 MFIs and 6 banks offering micro credit.

The primary data was supplemented by information obtained from brochures and direct interviews to clarify answers to the questionnaires. The data was analyzed by use of statistical package of social sciences (SPSS) that is used internationally for statistical analysis. The results have been presented in form of frequency tables, graphs and percentages.

5.1 Summary of Findings
The research findings reveal that: All the 31 institutions studied (100%) indicated that they were involved in micro credit services. The analysis further showed that all the MFIs and bank offers micro credit to small scale entrepreneurs, a clear indication of a better future in terms of entrepreneurial behaviour and thus better living standards for the Kenyan citizens.

The institutions studied also indicated that they started offering micro credit services right from inception, an indication that MFIs were set up with micro credits as one of their principle services.

A majority (67.5%) of the MFIs studied having a bigger number of 31 outlets showing a positive growth of Micro Finance Institutions outlets. A majority of the respondents indicated the most important reason why micro credit services were introduced was to assist the poor (47.5%), to increase profitability of the institution (37.5%), to satisfy a government requirement (15%) and to satisfy a powerful promoter within the organization (5%).
A significant number of 92.5% (37 out of 40 respondents) have credit management policies as a basis for objective credit risk appraisal. A majority (67.5%) indicated that they involve their institutions to develop credit management policies. Also a majority of the respondents (67.5%) said they used the credit manual to sensitize their employees about credit risk. A majority (47.5%) of the respondents indicated that they mostly considered overhead costs when setting up the credit policies.

Most institutions (67.5%) have distinctive separate departments where micro credit activities are organized. This is an indication of growth in the development of micro credit institutions in the country. 87.5% said they work with pre-set targets and that 75% observed that the monitoring of the pre-set targets compared favourably with the other types of services. 62.5% of the respondents indicated that their micro credit department had specific credit officers. Majority of the respondents indicated that the credit risk assessment is mostly done by the Credit Manager, followed by the Credit Committee, Branch Manager, then Managing Director/General Manager and least by the Chairman.

A majority (62.5%) indicated that as early as one late repayment, a loanee was considered a defaulter and thus the collection effort was intensified. This partly explains why micro finance institutions command low default rates. On dealing with difficult-to-repay-on-time-clients, a majority indicated the preferred method was sale of property to recover the money (67.5%) followed by write-off of the balance (55%) while another 32.5% would consider writing off the interest and allowing defaulters to repay the principal loan only.

Most of the institutions used the 6C’s criteria and used all the C’s appraising their borrowers in the following order: capacity/completion (65%), contribution (65%), and character (62.5%), reasonableness (common sense) of cash flows from business (62.5%), condition (52.5%) and finally, collateral/security (52.5%).
Majority of the institutions ranked credit risk as most important risk followed by interest rate risk and technology risk, market risk and lastly foreign exchange risk. This finding is consistent with Abedi (2000) who found that liquidity risk and credit risk are the most important risks that banks in the USA face.

On management of various risks, a majority of the institutions (60%) said that they used swaps followed by forwards, futures and lastly options.

5.2 Recommendations
Effective credit risk management is critical for the success of MFIs in these days of global competition. It is therefore recommended that:

To fulfil the key objectives of MFIs mainly to assist the poor and increase profitability of the institution, the micro credit products will need to be managed in a more robust manner.

MFIs should, in addition, have credit management policies as a basis of objective credit risk appraisal. They should involve their employees in developing credit management policies to ensure ownership and home grown credit policies. MFIs should use the credit manuals to sensitize their employees about credit risk. MFIs are encouraged to train in-house credit officers for effective risk management.

MFIs considered a loanee too have defaulted as early as one late repayment and immediately set up steps to intensify collection efforts. This partly explains why micro finance institutions command low default rates. While many MFIs preferred methods of dealing with defaulters was sale of property to recover the money, a number wrote off the off the interest and allowed defaulters to repay the principle loan only. This ensures that one does not lose the principal sum and in a way helps meet the objective of supporting the poor.
MFIs are encouraged to apply the 6C’s of credit risk appraisal model in their credit risk evaluation as applied in Commercial Banks. In a study of applying the 6C’s model of commercial banks, Mutwiri (2003) found that character was the most considered followed by capacity/completion and common sense/reasonableness, collateral and least considered was contribution.

MFIs should continue to rank the most important risk in their business.

5.3 Limitations of the study

The extent of study was limited by time to collect all the questionnaires from the respondents, which may have led to different and improved conclusions. Furthermore, time also limited the degree of analysis of the data that could have improved the conclusions reached in the study.

Financial resources were also limiting factors, in that with more resources a more sophisticated study would have been carried out. Further, 22 questionnaires were not received back, their inclusion of which might have led to different conclusions.

The study was limited in that it only focused on the MFIs located in Nairobi thereby introducing an element of geographic bias, however due to nature of information required it was not possible to get data out of Nairobi. Inclusion of the other MFIs located in various parts of the country could have changed the findings reached.

5.4 Suggestions for further research

MFIs are slowly expanding their activities and recruiting more clients for their micro credit products, due partly to more donors’ funds and as a result of building up internal funds. A study on the internal control systems in place at the MFIs recommended.

With the current debate on the micro finance bill, the regulatory framework of MFIs should be of concern to researchers.
There is also need to conduct and study the group dynamics in the group lending methodology while it would also be of interest to study whether borrowers from MFIs graduate to borrow from formal commercial banks especially now that banks are offering microcredit.
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APPENDICES

APPENDIX I

LIST OF MICRO FINANCE INSTITUTIONS IN NAIROBI

1. Action Aid
2. CARE International in Kenya
3. Charity Development For family
4. Council of International Development pride
5. Cross bridge Credit Ltd
6. Dandora Catholic Church
7. Daraja Trust Co. Limited
8. ECLOF
9. Faulu Kenya
10. Food for the Hungry International
11. Fridrich Ebot Stiftung
12. Hope Africa
13. Horizon Kenya Co. Ltd
14. Imani Marianists
15. K – MAP: Kenya Management Assistant Programme
16. Kenya Rural Enterprise programme
17. Kenya Small Traders Society
18. Kenya Women Finance Trust
19. Kenya Agency for Development of Enterprise and Technology
20. Micro save – Kenya Ltd
21. Partnership for productivity Kenya
22. Pride Africa Ltd
23. Pride Management Services Ltd
24. Provide International
25. SISDO micro finance
26. Small Micro Enterprise Programme (SMEP)
27. Undugu society of Kenya
28. Techno Serve International
29. Women enterprise Development
30. Young Women Christian Association

Dear Sir/Madam,

REF: REQUEST FOR RESEARCH DATA

I am a postgraduate student at Kenyatta University undertaking research in the topic; “An Assessment of Credit Management Techniques Applied by Micro Finance Institutions in Kenya”.

Your institution has been selected randomly for this study. I would therefore highly appreciate if you could provide me with information requested in the questionnaire at the earliest convenience.

I wish to guarantee that information that the information provided would be treated confidentially. And used only for research purposes.

I look forward to your favourable response.

Thank you.

Yours sincerely,

Ruth Mwaura
APPENDIX III

QUESTIONNAIRE

1. INSTITUTIONAL INFORMATION

Please indicate;

a) Name of institution .................................................................

b) Location of main office ............................................................

c) When the institution was established ........................................

d) How many outlets the institution has ......................................

e) Position of the respondent: ....................................................

31.2. OWNERSHIP

a) Please indicate the proportion of ownership by each of the following

- Government ( )%
- Churches ( )%
- NGO ( )%
- Private ( )%
- Other, specify ( )%

b) Is your organization involved in micro credit?

Yes [ ] No [ ]

c) If yes, when was the micro credit introduced?

- On conception.........................
- Any other (State the year) .................
d) Please indicate the number of outlets where micro credit is offered in your institution.


e) Does the institution have specific micro credit policies?

Yes [ ] No [ ]

If yes, please highlight the percentage of involvement of your institution in formulating the micro credit policies for the micro credit products? (Use relative percentages)

- The institution ( )
- Third parties ( )
- Other, please specify ( )

f) Does the institution set targets for micro credit services?

Yes [ ] No [ ]

If yes, how does monitoring of these targets compare with monitoring of targets of other types of services?

- Favourably comparable ( )
- There is lower emphasis on targets than the other products. ( )
- Any other, (Specify) ( )

g) Does the micro credit department have specific credit officers?

Yes [ ] No [ ]

h) Please rank the following in ascending order (i.e. with 1 as the main reason) the reasons why micro credit services were introduced in your organization.

- To assist the poor ( )

69
• To increase profitability of the institution ( )
• To satisfy a government requirement ( )
• To satisfy a powerful promoter within the organization ( )
• Any other reason. (Specify) ( )

3. MANAGEMENT OF MICRO CREDIT ACTIVITIES

a) Does your institution have a long-term strategy to maintain micro credit activities? (Please tick where appropriate).
   Yes [ ] No [ ]

b) If the answer above is yes, please highlight the main objective of your strategy

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

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

c) How are your micro credit activities organized? (Tick as appropriate)

   Within a separate department ( )
   A unit within a department ( )
   Any other, specify ( )

d) Please indicate the proportions of funds sourced for micro credit activities. (Give relative percentages)

   • Internally generated funds .................
   • Customer savings ......................
   • Donor funds. .......................
e) Which, among the following, factors do you consider in establishing a credit, control policy? Please tick appropriately.

<table>
<thead>
<tr>
<th>Least considered</th>
<th>Most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Existing credit policy
- Overhead costs
- General trend of credit extended to your organization
- The state of the economy
- Any other, specify

f) i) Do you have a credit policy manual?

Yes ( ) No ( ).

ii) If not tick appropriately the reasons why you do not have the manual

<table>
<thead>
<tr>
<th>Least reason</th>
<th>Most reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Too complicated to develop
- Not necessary
- Too costly to make
- Too rigid
- Any other, specify
g) Please indicate your credit policy objectives by ticking appropriately in the below.

<table>
<thead>
<tr>
<th>Least considered</th>
<th>Most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- A competitive tool to gain competitive advantage
- Minimizing credit costs
- Encourage movement of surplus money
- Earn interest from this surplus money
- Any other, specify

h) What are the factors you consider when setting up your credit policy?

<table>
<thead>
<tr>
<th>Least considered</th>
<th>Most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Products/services to cover
- Credit terms
- Clients to grant credit
- Average turn around period
- Cost of debtors
- Any other, specify
32. 4. CREDIT APPRAISAL

(a) i) How subjective or objective is your credit appraisal process?

(  ) Very subjective. (  ) Very objective

ii) How regularly do you review your credit policy?

- Quarterly (  )
- Half yearly (  )
- Yearly (  )
- Others, specify (  )

iii) Through what way do you make your employees aware of credit risk?

<table>
<thead>
<tr>
<th>Method</th>
<th>Least used</th>
<th>method</th>
<th>Most used</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Regular meetings.</td>
<td>(  )</td>
<td>(  )</td>
<td>(  )</td>
</tr>
<tr>
<td>Regular training</td>
<td>(  )</td>
<td>(  )</td>
<td>(  )</td>
</tr>
<tr>
<td>Using supervision on one to one basis</td>
<td>(  )</td>
<td>(  )</td>
<td>(  )</td>
</tr>
<tr>
<td>Credit manual</td>
<td>(  )</td>
<td>(  )</td>
<td>(  )</td>
</tr>
<tr>
<td>Any other, specify</td>
<td>(  )</td>
<td>(  )</td>
<td>(  )</td>
</tr>
</tbody>
</table>

b) Which aspects, among the following, do you consider before availing credit? Tick appropriately

<table>
<thead>
<tr>
<th>Least considered</th>
<th>Most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

i) Character of borrower:
<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Customer willing to repay</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Past repayment experience</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>High credit discipline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Past performance in repayment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other, specify</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**ii) Capacity/completion:**

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash in bank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Projected cash earnings</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business skills</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other specify</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**iii) Conditions:**

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Poor economic conditions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>High credit discipline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Interest prevailing in the economy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other specify</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**iv) Collateral/security:**

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Has assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Capital invested in the business</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Size of security</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Has cash in the bank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other specify</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
v) Common sense/reasonableness:

- Reasonableness of cash flow
- Projected cash flow
- Other (Please specify) ................................ ( )

vi) Contribution

- Has assets
- Capital invested in the business
- Willingness to do business correctly
- Other, specify...........................

---

c) Tick below the people who formulate your credit policy.

<table>
<thead>
<tr>
<th>Least formulate</th>
<th>Most formulate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

- Executive management
- Employee suggestions
- Board of directors
- Credit manager
- Credit analyst
- Credit committee
- Any other, specify.......................... ( )
a. 5. ORGANIZATIONAL PERFORMANCE

a) Kindly provide below your business performance during the following years

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turn over (KES)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating profit (KES)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit margin (KES)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

b). What do you think contributed to this performance?

<table>
<thead>
<tr>
<th></th>
<th>Least considered</th>
<th>Most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Improved loan collection methods</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Customer not willing to repay MFI loan</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Charged too high interest rate</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Poor economic conditions</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Improved credit appraisal</td>
<td>( )</td>
<td>( )</td>
</tr>
<tr>
<td>Am other, specify</td>
<td>( )</td>
<td>( )</td>
</tr>
</tbody>
</table>
### i. 6. STRATEGIC MANAGEMENT FACTORS

#### a) How do you describe your business environment?

<table>
<thead>
<tr>
<th>Turbulent</th>
<th>Very stable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

#### b) How do you react to your business environment?

<table>
<thead>
<tr>
<th>Most proactive</th>
<th>Very reactive</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

#### c) i) Do you lend to both short term and long term borrowers: Yes ( ) No ( )

#### ii) What is your lending period? ;

<table>
<thead>
<tr>
<th>Least period</th>
<th>Most period</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Up to 5 years
- Between 3 and 5 years
- Up to 3 years
- Less than 2 years
- Any other specify

#### iii) Tick the types of loan/credit facilities you give to your clients

<table>
<thead>
<tr>
<th>Least given</th>
<th>Most given</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Working capital

---

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iv) When does the MFI decide that the client is defaulted in loan repayment?

v) How does the MFI deal with difficult to repay the loan on time clients?

<table>
<thead>
<tr>
<th>Least</th>
<th>Most</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- One late payment
- Two late payments
- Three late payments
- Four late payments
- Five late payments
- Any other, specify

- Use auctioneers to recover the debt
- Sale of their properly to recover the money
- Leave them alone to decide when to pay
- Write the debt off and account it as bad
Debts

- Write off interest and allow them to pay the principal

- Any other, specify

---

d) i) Who are involved in credit risk assessment in the MFI?

<table>
<thead>
<tr>
<th>Least involved</th>
<th>Most involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
</tbody>
</table>

- Chairman
- Managing director
- General manager
- Branch manager
- Credit manager
- Credit committee
- Any other, specify

---

ii) Who approves, the amount of credit or loan given to a client? Tick appropriately.

Amount scale | Approving authority
--------------|---------------------|
- 500,000     | Managing Director   | Credit Manager      | Branch Manager |
- 5000,000-1M | Managing Director   | Credit Manager      | Branch Manager |
- 1M- 1.5M    | Managing Director   | Credit Manager      | Branch Manager |
- 1.5M-2M     | Managing Director   | Credit Manager      | Branch Manager |
- 2M and above| Managing Director   | Credit Manager      | Branch Manager |

---

e) How important are the risks listed below useful to your MFI?
<table>
<thead>
<tr>
<th></th>
<th>Least important</th>
<th>Most important</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Foreign exchange risks</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Technology risks</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Interest rate risks</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Market risks</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Liquidity risks</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Credit risk</td>
<td>(</td>
<td>(</td>
</tr>
<tr>
<td>Any other specify</td>
<td>(</td>
<td>(</td>
</tr>
</tbody>
</table>

e) Which of the following methods do you use against these risks?

|                              | Least used | Most used |
|------------------------------|           |           |
|                              | 1   | 2   | 3   | 4   | 5   |
| Futures                      | (   | (   | (   | (   | (   |
| Forwards                     | (   | (   | (   | (   | (   |
| Swaps                        | (   | (   | (   | (   | (   |
| Options                      | (   | (   | (   | (   | (   |
| Any other options            | (   | (   | (   | (   | (   |