THE EFFECTIVENESS OF CREDIT RISK MANAGEMENT PRACTICES UTILIZED BY KENYA COMMERCIAL BANK IN SMALL AND MEDIUM ENTERPRISE CREDIT IN KENYA

by

Willy Kimutai Cheruiyot

A thesis presented to the School of Business and Economics of Daystar University Nairobi, Kenya

In partial fulfillment of the requirements for the degree of

MASTER OF BUSINESS ADMINISTRATION in Finance

May 2012
THE EFFECTIVENESS OF CREDIT RISK MANAGEMENT PRACTICES UTILIZED BY KENYA COMMERCIAL BANK IN SMALL AND MEDIUM ENTERPRISE CREDIT IN KENYA

by

Willy Kimutai Cheruiyot

In accordance with Daystar University policies, this thesis is accepted in partial fulfillment of the requirements for the Master of Business Administration degree.

Date:

Evans Amata, M.F.C. (Master of Finance & Control)
Supervisor

Jinnah Waweru, M.A (Economics)
Reader

Thomas Koyier, MSc
Head of Department, Commerce

Muturi Wachira, MPhil, MSc, CPA (K), CPS (K).
Dean, School of Business and Economics
THE EFFECTIVENESS OF CREDIT RISK MANAGEMENT PRACTICES UTILIZED BY KENYA COMMERCIAL BANK IN SMALL AND MEDIUM ENTERPRISE CREDIT IN KENYA

I declare that this thesis is my original work and has not been submitted to any other college or university for academic credit.

Signed: ____________________________  Date: ________________

Willy Kimutai Cheruiyot
DEDICATION

I dedicate this work to my family, for their loving care, support and help during my study, may the Almighty God continue to bless you all abundantly
ACKNOWLEDGMENTS

I would like to give a special consideration to my Wife Hellen and our child Joy for all their love and support. May God keep you and bless you.

My sincere appreciation goes to my parents Wilson Birir and Ann Birir and to all my siblings for their moral support.

I am also particularly grateful to Mr. Evans Amata, my Supervisor for his advice, constructive criticisms, continuous encouragement and firm guidance at all stages of the writing of this thesis paper. I also would like to extend my thanks to Mr. Jimnah Waweru, my Reader who has taken time to devotedly read my work with commitment and patience.

Finally and above all I wish to thank the Almighty God who is merciful and gracious and who has carried me through life to this stage. To God be the glory, great things He has done.
# TABLE OF CONTENTS

DECLARATION..............................................................................................................................................ii
DEDICATION ............................................................................................................................................... iii
ACKNOWLEDGMENT .................................................................................................................................. iv
TABLE OF CONTENTS ..................................................................................................................................... v
LIST OF TABLES .......................................................................................................................................... vii
LIST OF FIGURES ....................................................................................................................................... viii
ABBREVIATIONS AND ACRONYMS ........................................................................................................ix
ABSTRACT .................................................................................................................................................. xi
CHAPTER ONE ............................................................................................................................................... 1
INTRODUCTION AND BACKGROUND OF STUDY .................................................................................. 1

Small and Medium Enterprise .................................................................................................................. 1
Development of SME sector in Africa .......................................................................................................... 2
SME banking in Kenya .................................................................................................................................. 3
Risk Management .......................................................................................................................................... 5
Background of Kenya Commercial Bank ..................................................................................................... 6
Problem Statement ......................................................................................................................................... 7
Purpose statement ........................................................................................................................................... 9
Research Objectives ...................................................................................................................................... 9
Research Questions ....................................................................................................................................... 9
Significance of the study ............................................................................................................................... 11
Assumptions of the study ............................................................................................................................. 11
Scope of study ............................................................................................................................................... 11
Limitations of the study ............................................................................................................................... 12
Definition of Terms ....................................................................................................................................... 12
Summary ....................................................................................................................................................... 13

CHAPTER TWO .............................................................................................................................................. 14
LITERATURE REVIEW ................................................................................................................................... 14

Introduction .................................................................................................................................................. 14
Importance of SMEs ....................................................................................................................................... 15
Challenges Facing SMEs .............................................................................................................................. 17
Access to finance as a constraint to SMEs ................................................................................................. 19
Informal sources of Finance ...................................................................................................................... 19
Credit risk management practises and SME access to Finance ................................................................. 24
Importance of Credit Risk Management ................................................................................................... 25
Credit Risk Management Framework ......................................................................................................... 26
Board and senior management oversight ................................................................................................... 26
Measurement of Credit Risk ....................................................................................................................... 27
Financial performance of KCB .................................................................................................................. 27
Credit Administration .................................................................................................................................. 28
Relationship lending .................................................................................................................................... 29
Stress testing ............................................................................................................................................... 29
Intensive Loan Monitoring and Credit Risk Control Methods ................................................................. 30
LIST OF TABLES

Table 4. 1: Qualification level ............................................................... 49
Table 4. 2: Qualification related to credit risk management ............... 50
Table 4. 3: Training on SME ............................................................... 50
Table 4. 4: Influence of perceived SME credit risk on credit provision to SME ...... 52
Table 4. 5: Factors to consider in appraisal ........................................ 53
Table 4. 6: Frequency of monitoring SME loans .................................. 53
Table 4. 7: Early signs of problematic SME loans ............................... 54
Table 4. 8: Whether credit risk managed practices utilized by KCB are effective or not .... 55
LIST OF FIGURES

Figure 2.1: Conceptual framework .................................................................37
Figure 4.1: Number of years worked for KCB ...........................................48
Figure 4.2: Perceived credit risks faced by KCB when lending to SMEs .......51
Figure 4.3: Credit risk management practices utilized by KCB ...............55
Figure 4.4: Challenges faced by KCB in SME credit risk management ....56
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASCAs</td>
<td>Accumulating Savings and Credit Associations</td>
</tr>
<tr>
<td>ASSOCHAM</td>
<td>Associated Chamber of Commerce and Industry of India</td>
</tr>
<tr>
<td>CAMPARI</td>
<td>Character, Ability, Margin, Purpose, Amount, Repayment, Insurance</td>
</tr>
<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
</tr>
<tr>
<td>EAC</td>
<td>East African Community</td>
</tr>
<tr>
<td>FSD</td>
<td>Financial Sector Deepening</td>
</tr>
<tr>
<td>ICDC</td>
<td>Industrial and Commercial Development Corporation</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GOK</td>
<td>Government of Kenya</td>
</tr>
<tr>
<td>KAM</td>
<td>Kenya Association of Manufacturers</td>
</tr>
<tr>
<td>KCB</td>
<td>Kenya Commercial Bank</td>
</tr>
<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Standards</td>
</tr>
<tr>
<td>KRA</td>
<td>Kenya Revenue Authority</td>
</tr>
<tr>
<td>K-REP</td>
<td>Kenya Rural Enterprise Program</td>
</tr>
<tr>
<td>KWFT</td>
<td>Kenya Women Finance Trust</td>
</tr>
<tr>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>MSE</td>
<td>Micro and Small Enterprises</td>
</tr>
<tr>
<td>MSME</td>
<td>Micro, Small and Medium Enterprises</td>
</tr>
<tr>
<td>NPL</td>
<td>Non Performing Loan</td>
</tr>
<tr>
<td>NGO</td>
<td>Non Governmental Organization</td>
</tr>
</tbody>
</table>
OECD  Organization for Economic Co-operative & Development
PAR  Portfolio At Risk
USAID  United States Agency for International Development
ROSCAs  Rotating Savings and Credit Associations
SACCO  Savings and Credit Corporative Society
SME  Small and Micro Enterprises
WBCSD  World Business for Sustainable Development
WUSME  World Union of Small and Medium Enterprises
ABSTRACT

The purpose of this research was to assess the effectiveness of credit risk management practices utilized by KCB in SME credit in Kenya. The problem addressed by this research was the high rates of non-performing SME loans. The objectives of the study were; to find out the role of credit risk management practices in the provision of SME credit by KCB, to establish the credit risk management practices used by KCB in SME credit, to determine the effectiveness of credit risk management practices utilized by KCB in SME credit and to identify the challenges faced by KCB in SME credit risk management.

The researcher used descriptive research design. The population for this study was 3,914 employees at KCB Kenya while the target population was 115 employees of SME lending and credit risk departments based at head office accessible to be served with questionnaires. Census was carried out on the target population whereby 78 out of the 115 members responded; translating to 68% response rate.

Self administered questionnaires were used to collect primary data while secondary data were collected through extensive reading. Data analysis was done using SPSS software and findings presented using descriptive statistical tools namely: tabulation, graphical presentation, percentages and ratios. In line with the objectives, the researcher found out that credit risk management practices played a key role in identifying the perceived SME credit risks and that KCB relied on credit administration and intensive loan monitoring as the main credit risk management practices at 100% and 80% respectively leading to 53% of the respondents concluding that the practices utilized were not effective since PAR was still high. KCB also faced several challenges while managing SME credit risk, with data integrity and collection strategies the highest at 96% and 86% respectively.