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# Lending technologies and benefits of small and medium enterprise lending: a multiple case study of commercial banks in Kenya

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**Lending Technologies and Benefits of Small and Medium Enterprise  
Lending: A Multiple Case Study of Commercial Banks in Kenya**

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B.Com (Hons), MBA Finance**

**A Thesis Submitted in Total Fulfilment of the Requirements for the  
Degree of Doctor of Philosophy in Finance at  
Strathmore University  
Nairobi, Kenya**

**March, 2017**

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SIGNED

DATE: 28<sup>th</sup> March 2017

LILIAN WANGUI MURIITHI-OLLOWS

This thesis has been submitted for examination with our approval as the Supervisors.

SIGNED

DATE: 28<sup>th</sup> March 2017

DR. ANDREA MORO

SIGNED

DATE: 28<sup>th</sup> March 2017

DR. FRESHIA MUGO-WAWERU

## **ABSTRACT**

A review of research on bank financing reveals that banks can either engage in transaction and/or relationship lending when financing firms. However, when dealing with small and medium enterprises (SMEs), studies suggest that relationship lending is the suitable methodology due to the information opacity of these firms while transaction lending is preferred for larger firms which are considered more information transparent. Studies also suggest that there are mutual benefits to be gained by both borrowers and lenders when they engage in relationship lending yet most studies emphasize demand side or borrower benefits and largely ignore lender benefits. With the increased interest in the SME sector by commercial banks, it is important to determine supply side or lender benefits if lenders are to continue serving these firms whether by use of the relationship lending method or any other suitable method. The main objective of this study was to determine the benefits that commercial banks gain and the role played by the relationship the bank has with the customer, when they finance small and medium enterprises. Data was collected through semi structured interviews conducted with SME bank managers who work closely with SMEs and analysed using content analysis. The study finds that commercial banks employ both relationship lending and transaction lending when dealing with the SME customer but more importantly establishes that relationship lending is only employed together with transaction lending. This leads to the suggestion of the use of the term “relational transaction lending” when referring to the use of relationship lending as it is always employed together with transaction lending. The study also establishes how soft information is processed for use in the SME lending decision and finally, articulates fourteen benefits that commercial banks are enjoying from engaging in SME lending. In summary, this research has made three significant advances to knowledge through the use of a qualitative research methodology. The development of a conceptual framework for borrower knowledge processing in SME lending; the development of a conceptual framework for the interplay between transaction and relationship lending methodologies resulting in the proposal of the use of the term relational transaction lending and, the establishment of the benefits generated from engaging in SME lending by commercial banks in Kenya.

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## **DEDICATION**

To Anduro and Awino.

For your encouragement and patience on the many evenings I had just arrived home and proceeded to open my laptop, “thank you Double A”.

## **List of Abbreviations**

|                |  |
|----------------|--|
| <b>BM</b>      | Bank Manager                           |
| <b>CBK</b>     | Central Bank of Kenya                  |
| <b>IFC</b>     | International Finance Corporation      |
| <b>KYC</b>     | Know Your Customer                     |
| <b>LC</b>      | Letter of Credit                       |
| <b>LT</b>      | Lending Technology                     |
| <b>MEMARTS</b> | Memorandum and Articles of Association |
| <b>MENA</b>    | Middle East and North Africa           |
| <b>OD</b>      | Overdraft                              |
| <b>RL</b>      | Relationship Lending                   |
| <b>RM</b>      | Relationship Manager                   |
| <b>RO</b>      | Relationship Officer                   |
| <b>SME</b>     | Small and Medium Enterprise            |
| <b>TL</b>      | Transaction Lending                    |

# CHAPTER ONE: INTRODUCTION TO THE STUDY

## 1.1 Background of the Study

Commercial banks around the world have been facing significant competition in the corporate and retail sectors which has led to increased interest in the previously underserved small and medium enterprise (SME) market (Calice, Chando, & Sekioua, 2012; De la Torre, Peria, & Schmukler, 2010). According to the International Finance Corporation (IFC) the gap in financial services (referred to as “the missing middle”) provided to SMEs appears to be shrinking the fastest in emerging markets (low and middle-income countries) where this gap has been the widest (IFC, 2010). This indicates that there is growth in the banking of SMEs and as such, contrary to the conventional perception that financial institutions are not interested in the SME segment, banks now perceive this segment as large, unsaturated and with good prospects, even considering this segment as strategically important (Calice et al., 2012). Small and medium enterprise (SME) financing has been a topic of keen interest in research because of the key role that SMEs play in economic development and their potentially important contribution to economic diversification and employment (Ayyagari, Beck, & Demirguc-Kunt, 2007; Beck, Demirguc-Kunt, & Levine, 2005a; UN/ECE, 2007). In developing economies, including Sub-Saharan Africa, SMEs are typically more credit-constrained than large firms, severely affecting their possibilities to grow (Ayyagari, Demirgüç-Kunt, & Maksimovic, 2008; Ayyagari, Demirgüç-Kunt, & Maksimovic, 2012; Beck et al., 2005a; Beck, Demirguc-Kunt, & Maksimovic, 2008; Beck & Demirguc-Kunt, 2006).

In Sub-Saharan Africa, banks have an important role to play due to their dominance in the financial systems and the limitations of informal finance, especially in regard to serving the higher end of the SME market (Ayyagari et al., 2012). SMEs depend on these financial institutions for their external financing needs because their small size and lack of substantial public information about their quality prevent them from accessing public

capital markets such as through the issuance of commercial paper, bonds, or publicly traded equity (Beck et al., 2008a; Holod & Peek, 2013; Santikian, 2014).

A bank is an institution whose primary activities are receiving of deposits and the granting of loans (Ongena & Smith, 2000). In its simplest form, the primary role of a bank is to bring together those who have excess funds to save and those who need to borrow. This role of a bank as an intermediary can be compared to a securities market where financial contracts are created to facilitate the movement of funds between savers and borrowers (Ongena & Smith, 2000). To ensure its credibility as a savings institution, a bank is also counted on to quickly redeem deposits to savers on demand. As such, a bank not only provides safety, but also liquidity. This ability to continuously offer liquidity to both savers and borrowers is what distinguishes a bank from “arm’s-length” securities markets (Rajan, 1996). However, informational frictions (asymmetric and proprietary information) provide the most fundamental explanation for the existence of financial intermediaries (Bhattacharya & Thakor, 1993, Boot, 2000). Boot (2000) refers to this as the *raison d’être* of banks. Informational asymmetry refers to a situation in which one party in a transaction has more or superior information compared to the other party (Akerlof, 1970). This often happens in transactions where the seller knows more than the buyer, although the reverse can also happen. Where banks are concerned, a borrower knows more than the lender about his creditworthiness and this could potentially be a harmful situation because the borrower can take advantage of the lender's lack of knowledge (Williamson, 1986).

In their intermediary role of minimizing risks between savers and borrowers, banks have to screen potential borrowers to mitigate adverse selection and subsequently monitor borrowers to reduce moral hazard (Diamond, 1984; Miwa & Ramseyer, 2005). This ability of a bank to reduce information asymmetries between borrowers and savers makes it unique relative to other financial institutions (Bhattacharya & Thakor, 1993; Diamond, 1984; Leland & Pyle, 1977). Further, the fact that a bank has wide access to private information about its borrowers makes the bank an “inside debt holder” distinguishing bank loans from other market loans (Fama, 1985). This suggests that the intermediary role performed by banks is more than just an arms-length transaction and has led to the existing

research on the use of relationship lending especially when lending to SMEs. Banks can extend financing to SMEs through two distinct technologies; transaction lending and relationship lending (Bartoli, Ferri, Murro, & Rotondi, 2013; Berger & Udell, 2006).

Berger and Udell (2006) define a lending technology as a unique combination of primary information source, screening and underwriting policies/procedures, loan contract structure, and monitoring strategies/mechanisms. Even though they distinguish between the two main lending technologies when dealing with SMEs, Berger and Udell (2006) suggest that lending technologies are not necessarily mutually exclusive.

### **1.1.1 Transaction Lending**

Transaction lending relies on information that can easily be quantified, commonly referred to as ‘hard’ information that is relatively easily available at the time of loan origination (Berger & Udell, 2006). According to Elyasiani and Goldberg (2004), lending decisions are made after borrowers go through a formally structured application process where they are required to provide specific financial information and security in order to qualify for loans. Transaction-oriented lending focuses on one transaction with a customer, or many identical transactions with various customers (Boot & Thakor, 2000). In a transaction-based system, many banks bid competitively for each transaction that a firm undertakes (Rajan, 1992) and as such Boot and Thakor (1994) propose that transaction lending be viewed as arm’s-length finance as it focuses on a transaction rather than on information gathered over time from a customer. Berger and Udell (2006) distinguish between transaction lending technologies used by financial institutions. They propose that transaction lending is not a single homogeneous lending technology but should be separated into a number of distinct transaction technologies used by financial institutions which include; asset-based lending, fixed-asset lending, financial statement lending, small business credit scoring, factoring and leasing. Transaction lending is generally focused on informational transparent borrowers (Carbo’-Valverde et al., 2009; Elyasani & Goldberg, 2004; Ono & Uesugi, 2009) however Berger and Udell (2006) find that while financial statement lending is focused on transparent borrowers, the other transaction lending technologies are all targeted to opaque borrowers.

Berger and Udell (2006) describe asset-based lending as that type of lending involves pledging a firm's underlying assets as collateral as the primary source of repayment. Generally, the firm has to have high-quality receivables and inventory available to pledge and requires that the bank intensively monitor the turnover of these assets making it a relatively expensive method. The pledging of collateral by itself, however, does not distinguish asset-based lending from any of the other lending technologies because collateralisation is also common with for example financial statement lending, relationship lending and credit scoring where collateral is used as a secondary source of repayment. What distinguishes this method from the other transaction based technologies is that the extension of credit is primarily based on the value of the collateral rather than the overall creditworthiness of the firm.

Fixed asset lending is similar to asset-based lending in the sense that fixed assets are pledged to the lender as collateral. For fixed-asset lending, the main data are appraised values of the real estate, motor vehicles, or equipment leased, that is, assets that are long-lived and not sold in the normal course of business (Berger & Black, 2011; Berger & Udell (2006). However, unlike accounts receivable and inventory, the pledged assets are virtually always uniquely identified by a serial number or a deed. The long life and unique identification of fixed assets leads to very different underwriting processes, contract structures, and monitoring mechanisms (Berger & Udell, 2006).

Financial statement lending places most of its emphasis on evaluating information from the firm's financial statements. The decision to lend and the terms of the loan contract are principally based on the strength of the balance sheet, income and cash flow statements. The lender views the expected cash flows as the primary source of repayment. Financial statement lending is best suited for relatively transparent firms with certified audited financial statements and as such, it is likely to be the technology of choice in bank lending to large firms. However, some small firms with long histories, relatively transparent businesses and strong audited financial statements also qualify for financial statement lending (Berger & Udell, 2006).

Small business credit scoring is an adaptation to business lending of discriminant analysis and other statistical techniques. In addition to using information from the financial statements of the SME, heavy weighting is also put on the financial condition and history of the principal owner, given that the creditworthiness of the firm and the owner are closely related for most small businesses (Feldman, 1997; Mester, 1997 in Berger & Udell, 2006). This technology may be applied when there is insufficient information about the SME (Berger & Udell, 2006).

Factoring involves the purchase of accounts receivable by a “lender” known as a factor. The borrower obtains financing by outsourcing its credit and collections activities and as such, factoring is a bundle of three financial services: a financing component, a credit component and a collections component. Factoring is a transactions technology because the underwriting process is based on hard information about the value of a “borrower’s” accounts receivable. This lending technology addresses the opacity problem by focusing primarily on the quality of the obligor, rather than the “borrower” (Berger & Udell, 2006).

Leasing involves the purchase of fixed assets (equipment, motor vehicles or real estate) by a “lender” known as a lessor who then simultaneously enters into a rental contract with the lessee (the “borrower”) that specifies the payment schedule. The contract often contains an option whereby the lessee can purchase the assets at the end of the lease period at a pre-specified price. This arrangement can mitigate an adverse selection problem either in the new product market or in the used equipment market by encouraging a higher quality of product sold “off-lease” (that is, sold by lessors when the purchase option is not exercised) (Chemmanur & Yan, 2000; Hendel & Lizzeri, 2002). Berger and Udell (2006) observe that similar to asset-based lending, factoring, and fixed-asset lending; leasing is a transactions technology because underwriting is substantially based on hard information about the value of the underlying asset.

### **1.1.2 Relationship Lending**

Relationship lending is based on the acquisition and use of “soft” qualitative data which is information that cannot be easily quantified and is gathered over time through consistent

interaction between a bank and, a business and its stakeholders (Berger & Udell, 2006; Elyasani & Goldberg, 2004; Schwarze, 2006). Essentially, banks engage in producing or gathering information beyond that which is readily available (Garriga, 2006). These continued bank-firm interactions tend to create a rich inventory of information (Fama, 1985). Berger and Udell (2002) posit that soft information may include the payment and receipt history of the SME gathered from the past provision of loans, deposits, or other services to the SME by the institution; or the future prospects of the SME garnered from past communications with SME's suppliers, customers, or neighbouring businesses. Further, Schwarze (2006) adds that soft information may include the character and reliability of the SME owner, gathered through direct contact over time with the bank's loan officer. The soft information may often be proprietary to the loan officer and may not be easily observed by others, verified by others, or transmitted to others within the financial institution (Boot, 2000).

Relationship lending focuses on asymmetric information problems associated with firms, especially small firms (McNulty, 2002). In most cases, small firms are relatively young and therefore have no past history from which banks can make decisions about expected future performance. Additionally, most of these small firms lack collateral to pledge for loans (Garriga, 2006). These firms therefore have often been labelled as informational opaque compared to their larger counterparts who compete for the same funds. As such, transaction lending is generally viewed as being focused on informationally transparent borrowers (Carbo'-Valverde et al., 2009; Elyasani & Goldberg, 2004; Ono & Uesugi, 2009). Due to their small size and lack of substantial public information about their quality, such firms lack access to external funds, for instance, through issuance of debt or equity securities. They therefore tend to be dependent on banks for external funds. However, banks do not have sufficient information to assess the credit risk associated with these informational opaque firms when they receive an initial loan application. Thus, banks which are interested in such firms need to first invest in acquiring information and processing the same, as well as subsequent monitoring of firm activities (Boot, 2000; Freixas, 2005). Over time, the payment history of a loan customer accumulates and the

firm develops a “private reputation” with its lender or in other words a bank-firm relationship.

Relationship lending is a complex phenomenon that is difficult to measure and thus has been proxied by different aspects (Presbitero & Zazzaro, 2009). Elsas (2005) argues that it is not clear which proxies should be used for relationship lending and suggests that directly asking one of the involved parties is a straightforward way to generate a criterion for assessing whether a given bank-borrower relationship is “special” in the sense of relationship lending. More recently, Santikian (2014) emphasizes that even though banks are a primary source of capital for small, private firms, the inner workings of small firms’ bank relationships remain obscure. The most commonly used proxies for relationship lending are; duration, scope and concentration of borrowing (Degryse & Van Cayseele, 2000; Elsas, 2005; Iturralde et al., 2010; Lehmann & Neuberger, 2001; Ongena & Smith, 2000).

Duration is the most widely used measure of relationships and reflects the length of time that the bank has provided loan, deposit, or other services to the firm (e.g. Petersen & Rajan, 1994, 1995; Berger & Udell, 1995; Ongena & Smith, 2000; Elsas, 2005). Theoretically, there is a positive relationship between duration and information flow which should improve the bank’s willingness to provide funds and thus availability of finance to the borrower (Berger & Udell, 2002; Degryse & Van Cayseele, 2000).

Scope reflects the breadth of the relationship, that is, the number of different services or interaction over multiple services between the bank and the customer (Nakamura, 1993; Cole, 1998; Degryse & Van Cayseele, 2000). Information gathered from the interaction may not only have an effect on the credit terms with the borrower, (Degryse & Van Cayseele, 2000; Santikian, 2009) but may also affect the bank’s comparative advantage in lending. Boot (2000), for instance, suggests that a bank may use a firm’s checking and deposit accounts to assess loan repayment capability.

Concentration of borrowing is the number of bank relationships that a borrower maintains (Harhoff & Körting, 1998; Ongena & Smith, 2000). Elsas (2005) argues that having one

exclusive relationship promotes closer ties between the bank and borrower. Iturralde et al. (2010) suggest that the number of relationships may be influenced by the characteristics of companies and the social and economic environment of a particular country. To determine whether a bank qualifies as a main bank (one which provides 80 percent or more of a firm's products), Degryse and Van Cayseele (2000), look at the scope of the relationship. They further suggest that a main bank relationship should lead to more accurate information and therefore reduce the bank's monitoring costs in tandem with Diamond's (1984) proposition that a single bank relationship is optimal because it avoids duplication of screening and monitoring efforts. Foglia, Laviola and Reedtz (1998) concur that the larger the number of bank relationships, the higher the riskiness of the borrowers because monitoring of the borrower tends to be weaker.

Relationship lending is emphasized in previous studies as being the most suitable technology to use when dealing with SMEs because these enterprises are considered informationally opaque (Carbo'-Valverde, Rodri'guez-Ferna'ndez, & Udell, 2009; Ono & Uesugi, 2009). Earlier, Elyasiani and Goldberg (2004) posit that SMEs are less transparent (more informational opaque) than their larger counterparts because, apart from having insufficient collateral to pledge, they do not have audited financial statements. Due to the SMEs' opaque nature in terms of ascertaining the reliability of information provided, it has conventionally been assumed that small and domestic banks applying relationship lending are better equipped to lend to SMEs (Berger, Goldberg, & White, 2001; Berger & Udell, 1995). However, there is also evidence that transaction-based or arms-length lending can be more cost-effective (Berger & Udell, 2006). Beck, Demirguc-Kunt, and Peria (2011) add that using transaction based lending also allows larger and non-local banks to lend to SMEs.

There is considerable evidence supporting the incidence of lender/borrower relationships (Boot, 2000; Iturralde, Maseda, & San-Jose, 2010), however these relationships depend on various factors that influence both the lender and the borrower, and on the characteristics of the financial market where the relationship is established.

### **1.1.3 Benefits of SME Lending**

In order to determine whether SME lending is viable in future, it is important to understand the benefits to both parties involved; the lender and the borrowers. A benefit is defined as “an advantage that something gives you; a helpful and useful effect that something has” (Benefit, n.d.). Most studies on SME lending focus on the benefits that accrue to the borrower; largely ignoring the commercial banks who take the initiative to invest in SME lending (see Berger & Udell, 1995; Bharath et al., 2005; Cole, 1998; Elsas & Krahen, 1998; Harhoff & Körting 1998; Petersen & Rajan, 1994, 1995). Additionally, these studies tend to focus on benefits of the use of the relationship lending technology as this method is widely suggested as suitable when lending to SMEs. Elsas (2005) and; Greenbaum and Thakor (1995) suggest that relationship lending is economically beneficial to both lenders and borrowers but the comparatively few studies that focus on lender benefits tend to provide only indirect evidence about the value-enhancing effects of lending relationships to banks (Holod & Peek, 2013).

Beck, Demirguc-Kunt, and Peria (2008), (2011); Calice et al. (2012) and De la Torre et al. (2010) are amongst the first studies to provide a lender perspective of SME lending and more so in Sub Saharan Africa. These studies provide evidence of the extent of bank lending to SMEs as well as the drivers and obstacles to further SME lending. Overall, these studies find that banks perceive the SME segment as large, unsaturated, with good prospects and strategically important. Additionally, these studies find that the common drivers of bank involvement with SMEs are; perceived profitability, reduction of information asymmetry and reverse factoring. Perceived profitability is ranked as a major driver of bank involvement in the SME segment (Calice et al., 2012; De la Torre et al., 2010). Similarly, Ochieng (2010) emphasizes that investment by commercial banks in intricate relationships with clients, could lead to growth in their customer base and loan book value, which translates into increased profitability.

### **1.1.4 The Kenyan Banking Sector**

The Kenyan Banking sector is comprised of 43 commercial banks and one mortgage financial institution (Central Bank of Kenya (CBK), 2016). These commercial banks are

regulated by the Central Bank of Kenya under a set of statutes known as the Banking Act, as well as prudential guidelines and regulations issued by the Central Bank pursuant to this legislation. Kenya's financial system is categorized as bank-based (as in Germany and Japan) since banks play a leading role in mobilizing funds and providing risk management vehicles (Demirguc-Kunt and Levine, 1999). This is in contrast to a market based system (such as in England and the United States) where securities markets share a role with banks in mobilizing funds, exerting corporate control and easing risk management. Compared to other Sub-Saharan and low income countries, Kenya is a developing country with a financial system that sees higher deposits in financial institutions and higher levels of credit channelled to the private sector (Beck & Fuchs, 2004). Most of the businesses in Kenya are SMEs and these provide most of the employment opportunities (Katua, 2014). Consequently, the highest contributor to GDP in Kenya is the SMEs and there is widespread agreement among financial sector stakeholders that increasing access to financial services for SMEs is a key pillar of the Comprehensive Financial Sector Reform and Development Strategy (Kenya Treasury, 2011).

Berg and Fuchs (2013) find that bank competition in the SME market segment is strongest in Kenya compared to most Sub-Saharan African countries with all banks interested in developing their engagement with SMEs regardless of size (small, medium or large) or ownership (domestic or foreign). According to a study by FSD (2015), SME finance has continued to increase gradually both in absolute terms and relative to the banks' total lending portfolio. In 2009, it represented 19.5 per cent of the total portfolio, in 2011; it was 20.9 per cent and 23.4 per cent in 2013. Between 2009 and 2013, SME lending by foreign banks increased in absolute terms but decreased relative to domestic banks, confirming a growing role played by local players in the SME market. In an earlier study, Berg and Fuchs (2013) attributed this trend to innovation in Kenya, compared to other Sub-Saharan African countries, that started through a combination of microfinance-rooted institutions scaling up to become commercial banks and innovation with lending models and technology in the retail banking segment by other institutions.

Similar to the results of Beck et al. (2008; 2010), FSD (2015) shows that commercial banks in Kenya tend to differ in terms of lending technologies, customer acquisition strategies, and risk management mechanisms. Risk management strategies vary widely across banks and may be based on ‘hard information’, ‘soft information’, or a combination of the two. Hard information may consist of financial ratios calculated from certified audited statements and data assembled by credit bureaus. Soft information consists of non-financial information about the firm or entrepreneur, such as the sources of revenue or the borrower’s historical relationship with the bank. This study concludes that while there have been positive developments over the last few years; there is still considerable room for product innovation in the SME finance space.

The Kenyan economy is expected to grow by 6–7 per cent in 2015–17 (World Bank, 2015). Given the pivotal role SMEs play in fuelling innovation and employment-creation, understanding the opportunities, gaps and challenges in the SME finance market is crucial to maintaining the current growth momentum. The financial sector’s role to channel credit affordably and efficiently to these enterprises is therefore very central for inclusive and sustained economic development (FSD, 2015).

## **1.2 Problem Statement**

The topic SME finance has gained worldwide importance because SMEs are regarded as drivers of economies; however, there is still a paucity of studies on why and how banks lend to SMEs around the world (Bharath, Dahiya, Saunders, & Srinivasan, 2005; Calice et al., 2012; Holod & Peek, 2013). Even though SMEs tend to be dependent on banks for external funds, relatively little research focuses on the supply side of bank finance (Holod & Peek, 2013). The World Bank underscores the importance of ongoing efforts to study SME financing from a supply side perspective and particularly in Sub-Saharan Africa as SMEs in this region are more financially constrained than in any other developing region (IFC, 2010). Calice et al., (2012) observe that only 20 percent of SMEs in Sub-Saharan Africa have a line of credit from a financial institution compared, for example, with 44

percent in Latin America and Caribbean, and only 9 percent of their investments are funded by banks versus 23 percent in Eastern Europe and Central Asia.

Literature emphasizes the use of the relationship lending methodology when dealing with SMEs but for banks to employ this methodology, sufficient investment is required on their side in acquiring information on and monitoring these enterprises (Carbo' –Valverde et al., 2009; Ono & Uesugi, 2009). It is the banks that take the initiative to develop a relationship with the borrowers ((Bharath et al., 2005; Carbo' –Valverde et al., 2009; Ono & Uesugi, 2009). Santikian (2014) emphasizes that even though banks are a primary source of capital for small, private firms, the inner workings of small firms' bank relationships remain obscure.

Boot (2000) suggests that relationship banking has a distinct role to play and can be a value-enhancing intermediation activity. Similarly, Elsas (2005) and Greenbaum and Thakor (1995) suggest that relationship lending is economically beneficial to both lenders and borrowers yet those studies that focus on benefits do not provide direct evidence of the benefit to banks (Holod & Peek, 2013). In an earlier study, Boot (2000) underscores that as banking becomes increasingly competitive it is necessary to distinguish between the distinct costs and benefits of relationship banking in order to predict its viability and scale in the future.

This study sought to determine how and why commercial banks engage in SME lending. In determining how banks engage the SME customer, the lending technologies employed were examined and specifically whether the highly preferred technology of relationship lending is employed. In determining why banks engage in SME lending, the benefits that accrue to commercial banks that engage in SME lending were established. As such, in a bid to determine the viability of SME lending in the future, the usefulness or advantage it gives commercial banks was studied. Further, as most of the previous research on SME lending (see Beck, Demirguc-Kunt & Peria, 2008, 2011; Calice et al., 2012 and De la Torre et al., 2010) employs a quantitative approach, with the dominant paradigm (or theoretical lens) being positivist, a departure from previously used research methods was

taken. The positivist lens can only tell us — "the what," but it cannot tell us "why" and "how" SME lending is practiced. Previous studies give more attention to what SME lending is, how it is categorised and how it is measured, giving little attention to the process surrounding SME lending, that is, "how and why" banks practice SME lending. This provides the impetus to conduct this study by use of a qualitative probing approach to seek abundant information and deeper knowledge of SME lending in its natural setting (Creswell, 1994; Howitt & Cramer, 2005).

### **1.3 Main Objective of the Study**

The main objective of the study was to determine the lending technologies employed with specific reference to the commonly referred technology of relationship lending in SME lending and the benefits that commercial banks gain in financing small and medium enterprises. In order to achieve the main objective, it was divided into three specific objectives which were subsequently restated as research questions.

#### **1.3.1 Specific Objectives**

1. To examine how soft information about the borrower is acquired, transferred and used by a bank to make the SME lending decision.
2. To investigate the role of transaction lending and relationship lending, more specifically, the importance and interplay of the two methods in making the SME lending decision.
3. To establish the benefits generated from engaging in SME lending by commercial banks in Kenya.

#### **1.3.2 Research Questions**

1. How is soft information about the borrower acquired, transferred and used by a bank to make the SME lending decision?
2. When making the SME lending decision, what is the role of transaction lending and relationship lending, how important is each technology and how do they interplay?

3. What benefits do commercial banks in Kenya generate by engaging in SME lending?

#### **1.4 Scope and Delimitation of the Study**

The scope of this study is limited to commercial banks in Kenya that are prominent in SME lending. The commercial banks for the study are selected from an annual survey carried out by Think Business Limited which ranks banks in several categories including “best SME bank”. The category “best SME bank” is open to all commercial banks that focus mainly on SME banking. The survey culminates in the publication of the top three banks (Banking Survey, 2013) in each category. Since this information is released to the public or can be regarded as public information, the researcher was able to use this information to form a database of commercial banks that mainly focus on SME banking. All commercial banks that have been ranked top three in the category “best SME bank” for the last five years (2010-2014) are included in this study (Banking Survey 2010-2014). Additional considerations for inclusion in this study are those banks which are considered as competitors in the SME market by the ranked banks and finally, the willingness to participate and allow the research to take place in their premises or natural environment. The additional banks for the study were identified during the interview process with respondents from the ranked banks. As some banks have featured more than once amongst the top three in the five years under study, while others when contacted indicated that they had shifted focus from the SME market, this resulted in a total of seven commercial banks being used for this study

As the SME view (or demand side or borrower view) has been widely researched and documented in literature, this is not considered and does not form any part of the current study. Literature suggests that commercial banks are the ones that take the initiative to invest in the relationship with SMEs yet there is a dearth of studies on how and why these banks finance SMEs. This study therefore solely focuses on the supplier side/lender view of how SME lending transpires and benefits banks.

## **1.5 Significance of the Study**

For commercial banks, the results of this study may provide a useful reference point to consider the appropriateness of the different lending technologies in different lending situations. This information is not only important for loan product innovations for the SME sector but may also assist banks make the decision on whether and how to continue contracting with the SME segment, in effect determine whether SME financing is viable for them in future.

SME owners/managers may find this study useful as it will provide greater knowledge on how commercial banks assess the borrower for lending and the requirements thereof which should enable the SME be better prepared when seeking finance. This information will likely enable SMEs make applications that will most likely be successful and as such enhance SME access to credit which is necessary for their growth and success, and which should translate to greater economic growth for the country given that these enterprises are widely known as drivers of economies.

Regulators and policy makers will be better informed on the methods or technologies that are currently being employed in SME lending. This should improve policy making in promoting SME lending; for instance through tax incentives, policies that enhance sharing of SME credit data among SME lenders to alleviate information asymmetry, formulate codes of conduct when lending to SMEs to ensure and enhance timely availability of credit and, incentives to lenders that invest in information gathering and take risks in SME lending. This should in the long run translate to better access to financial services by SMEs, and indeed overall financial development that is crucial to economic growth and poverty reduction.

The results of this study may also provide useful information for capital providers such as the government and other agencies aimed at promoting access to finance for SMEs. The government will find this study useful in the structuring of incentives for banks that lend to SMEs such as through the provision of government loan guarantees/credit guarantees.

Researchers interested in the area of SME lending will find this study useful as it has added to the existing body of knowledge on SME lending by exploring the supply side or lender's perspective in commercial banks in Kenya (a developing country in sub Saharan Africa). This study will also make a methodological contribution by using a qualitative approach in the study of SME lending methods employed and benefits to commercial banks.

## **1.6 Overview of Methodology**

A qualitative research approach, which is rarely seen in SME lending literature, was employed for this study and within it a multiple case study design was selected to conduct the study. A case study design is advocated for when the researcher has little control over events and the focus is on a contemporary phenomenon within a real-life context (Woodside, 2010; Yin 2012). Using multiple case studies can identify consistent patterns of behavior and uncover new and/or divergent themes and also increases the level of assurance of the findings making the overall study robust (Herriot & Firestone, 1983; Miles & Huberman, 1994; Yin 2004).

Data was collected through semi-structured face to face interviews, lasting from forty five minutes to two hours, with bank's managers/officers in the selected commercial banks. The interviews were recorded and transcribed soon after. Data analysis was conducted using content analysis which resulted in a series of 'thick' narrative descriptions of the SME lending process and benefits to commercial banks thereof. More detail of the methodology employed to conduct this study is provided in Chapter 3 of this thesis.

## **1.7 Thesis Outline**

This thesis is based on six chapters as follows:

Chapter one (introduction) provides the background to the study that leads to the identification of the research problem. The importance or justification of the research is provided and finally, an outline of the thesis is provided.

Chapter two (literature review) provides a detailed review of the theoretical and empirical literature relating to SME lending. The primary output of the literature review is the identification of two gaps in the existing SME lending literature; the absence of a supplier side/lender perspective on how and why commercial banks lend to SMEs around the world.

Chapter three (methodology) provides a justification for the research methodology adopted for this study. It reviews four research paradigms: i) positivism; ii) post-positivism; iii) interpretivism/constructivism and iv) pragmatism, and provides a justification as to why this study falls under the interpretivism/constructivism paradigm. The review is followed by a discussion of the three key research approaches: i) quantitative; ii) qualitative and iii) mixed methods, and a rationale provided as to why the qualitative approach was most appropriate in resolving the identified research problem. The appropriate research design is then discussed including a detailed description of the procedure for the conduct of the semi-structured interviews. Finally, issues relating to research validity, reliability and ethics are addressed.

Chapter four (data presentation) presents the findings from the semi-structured interviews.

Chapter five (discussion of findings) discusses the findings from the interviews in the context of the literature review. The outcomes from these findings are summarised and used to develop models of the SME lending process, the SME lending technology decision making process and the benefits of SME lending.

Chapter six (conclusions and recommendations) draws conclusions and provides the contributions to knowledge of the study, provides the implications of the research, limitations of the study and finally makes recommendations for further study.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter provides a review of the theoretical and empirical literature relating to SME lending. Within the theoretical review is a general review of financial intermediation theories that have prompted interest in bank lending followed by a review of relationship banking theory. The empirical review of related studies is divided into three sections. The first section discusses the state of SME financing around the world. The second section discusses SME financing technologies that are employed, soft information acquisition and use in SME lending decision making. The third section discusses the benefits of SME lending to commercial banks. Finally, a summary of the literature is presented that highlights the emerging gaps in knowledge. The primary output of this literature review is the identification of three gaps in the SME lending literature; the lack of knowledge about, how soft information is collected and transferred within a commercial bank for use in the SME lending decision, whether banks use relationship lending or how this method interplays with transaction lending to make the SME lending decision and the actual benefits for commercial banks that engage in SME lending.

### **2.2 Theoretical Review**

This section begins with a general review of the traditional financial intermediation theories, followed by the modern literature on financial intermediation which has shifted focus to the role of banks as relationship lenders (Boot (2000)). A review of small business lending technologies is also provided, followed by a more detailed focus on the view of banks as relationship lenders.

### 2.2.1 Theories of Financial Intermediation

The existing theories of financial intermediation stress that there is an important role of financial intermediaries in reducing informational asymmetries and transaction costs. In simple terms, information asymmetry refers to the case where one side of the market has better information than the other. In other words, the borrower knows more than the lender about his credit worthiness. Information asymmetry can occur “ex ante” or “ex post”. An ex-ante information asymmetry problem arises when lenders cannot differentiate between borrowers with different credit risks before providing loans and leads to an adverse selection problem (Claus & Grimmes, 2003). In other words, it is the immoral behaviour that takes advantage of asymmetric information before a transaction. An information asymmetry problem occurs ex post when only borrowers, but not lenders, can observe actual returns after project completion. In other words, it is the immoral behaviour that takes advantage of asymmetric information after a transaction. This leads to a moral hazard problem. In the credit markets, moral hazard arises when a borrower engages in activities that reduce the likelihood of a loan being repaid.

Akerlof (1970) develops a classical example of adverse selection in his paper, “*The Market for Lemons*”, when he uses a second hand car market in which the seller is the only one that truly has complete information about the quality of the car. Sellers of low quality cars will try to sell bad cars (lemons) as if they were high quality cars. This will cause potential buyers to be suspicious of all cars and thus make it difficult for those sellers that are trying to sell good quality second hand cars. Sellers with high quality cars would then exit this market, leaving only an adverse selection of low quality cars. Then, a distinction of quality will be made within the remaining low-quality cars, which will start the process again. In the end, the market of second hand cars will disappear.

Jaffe and Russell (1976) develop a theoretical model that analyses the behaviour of a loan market in which borrowers have more information than lenders about the likelihood of default. They posit that imperfect information and uncertainty can lead to rationing in loan markets, that is, some borrowers do not receive the loan they applied for. They focus on the relationship between default proportions and contract sizes and show that there is a

minimum loan size at which no default is observed beyond which the proportion of borrowers who default increases with the contract size.

Stiglitz and Weiss (1981) in their paper, “*Credit Rationing in Markets with Imperfect Information*”, define a situation similar to the case of Akerlof’s 1970 paper, except in the financial markets. They develop a model of credit rationing, where some borrowers receive loans and others do not. Stiglitz and Weiss (1981) focus on interest rates charged to borrowers and how the interest rate can affect the quality of loans because of an adverse selection or moral hazard effect. They explain how raising interest rates will make indebted people take higher risks. Adverse selection problems arise when an increase in interest rates leaves a more risky pool of borrowers in the market for funds. Borrowers with weak repayment prospects could crowd out everyone else from their side of the market meaning financial intermediaries are then more likely to be lending to high-risk borrowers, because those who are willing to pay high interest rates will, on average, be worse risks. Interest rates may act as a screening device, with those willing to pay high interest rates being on average worse risks. A change in these interest rates may also lead to a moral hazard effect by changing the behaviour of borrowers.

Diamond (1984) argues that the main reason financial intermediaries exist is because of diversification within the financial intermediary. Diamond (1984) argues that since the outcome from firms investment project is not known ex post to external agents, this leads to a moral hazard problem because it provides an incentive for borrowers to default on a loan even when the project is successful. Financial intermediaries must therefore gather information to assess the outcome and as such, they are delegated the costly task of monitoring loan contracts. The information production task delegated to the intermediary gives rise to incentive problems for the intermediary which Diamond (1984) refers to as delegation costs. In other words, the financial intermediary must choose an incentive contract such that it has incentives to monitor the information, make proper use of it, and make sufficient payments to depositors to attract deposits. Providing these incentives is costly and diversification can reduce these costs. The optimal contract is a debt contract (an agreement by the borrower to pay the lender a fixed amount) with a non-pecuniary

bankruptcy penalty. Diamond (1984) develops a model in which a financial intermediary has a net cost advantage relative to direct lending and borrowing. In other words, an intermediary (such as a bank) is delegated the task of costly monitoring of loan contracts written with firms who borrow from it but generally at some cost advantage for the intermediary (Diamond, 1984). Schumpeter (1939) assigned such a "delegated monitoring" role to banks when he stated,

*... the banker must not only know what the transaction is which he is asked to finance and how it is likely to turn out but he must also know the customer, his business and even his private habits, and get, by frequently "talking things over with him", a clear picture of the situation (Schumpeter (1939), p. 116).*

Williamson (1986) also develops a model of credit rationing similar to those developed by Jaffe and Russel (1976), and Stiglitz and Weiss (1981); and posits that since a borrower and lender are asymmetrically informed ex post about the return on the borrower's investment project, the borrower will have an incentive to falsely default on the loan. Williamson (1986) suggests that the costly monitoring of borrowers implies that there exist increasing returns to scale in lending and borrowing which can be exploited by financial intermediaries and that the optimal contract between a lender and a borrower is a debt contract. This concurs with Diamond's (1984) earlier study focusing on the costs incurred by the intermediary that engages in monitoring borrowers.

The informational asymmetry theories above underpin the current study because in the bank-borrower relationship, the borrower knows more about themselves than the bank does (Akerlof, 1970; Jaffe & Russell, 1986; Stiglitz & Weiss, 1981). In this relationship the borrower requires funding from the bank and the bank performs its intermediating activity by providing funds it has collected from savers. In doing this, the lender needs to protect itself from lack of full information about the borrower/borrower behaviour and as such a contract has to be put in place (Diamond, 1984). Interestingly Schumpeter (1939), in addition to assigning a delegated monitoring task to banks, alludes to the concept of relationship lending when he posits that a lender needs to know not only information that

is readily available and exchanged when transacting with the borrower but also needs to collect soft information.

The financial intermediation theories above focus on the bank and borrower relationship and have led to more specific theories that focus on this relationship. In bank lending, one can basically distinguish transaction based lending and relationship lending which is a sub-set of relationship banking (Berger & Udell, 2006).

### **2.2.2 Banking Theory**

The concept of relationship banking has been forged in the theory of banking to reflect the sharing of private information between a bank and its clients and the benefits of a continuing relationship Freixas (2005). Boot (2000) defines relationship banking as the provision of financial services by a financial intermediary that invests in obtaining customer-specific information, often proprietary in nature; and evaluates the profitability of these investments through multiple interactions with the same customer over time and/or across products. Boot's (2000) definition centres around two critical dimensions: proprietary information and multiple interactions. The definition emphasizes that relationship banking involves borrower specific, often proprietary, information available only to the intermediary and the customer. In the context of lending, this information is obtained when banks provide screening (Allen, 1990; Ramakrishnan & Thakor, 1984) and/or monitoring services (Diamond, 1984; Rajan & Winton, 1995). Moreover, as stated in the definition, the information can be used in multiple interactions with the same customer, creating an opportunity to benefit from inter temporal information reusability (Greenbaum & Thakor, 1995). Freixas (2005) also refers to relationship banking as the investment in providing financial services that will allow one to repeatedly deal with the same customer. In contrast, transaction-oriented banking focuses on a single transaction with a customer, or multiple identical transactions with various customers. What is interesting is that this way of looking at relationship banking takes us beyond the traditional focus on commercial bank lending (Boot, 2000).

Relationship banking has its theoretical foundation in the theory proposed by Hodgman (1961). Hodgman (1961) hypothesizes that a customer's deposit relationship with the bank influences the availability and cost of credit to that customer and leads to more favourable loan conditions for a customer than a non-customer. He posits that this deposit relationship arises in response to competition between banks and for banks to survive; they offer favourable loan rates to their deposit customers. Since interests earned on deposits are capped by regulation, banks cannot increase interests earned by their loyal depositors but can compensate loyal depositors by offering lower rates on loans. Strong deposit relationships also reduce the variability in loanable funds, which in turn increases the return-per unit of risk of the bank's loan portfolio (Kane & Malkiel, 1965). An incumbent bank gains an informational advantage over competitors by privately observing the payment behaviour of its depositors. This bank is therefore able to offer cheap loans to its best depositors driving away competing loan offers because competing banks are unable to offer the same loan rates without also attracting unprofitable, poor depositors (Kane & Malkiel, 1965).

While Hodgman (1961) focuses on deposit relationships, Wood (1975) proposes that a lending relationship may develop independently of a deposit relationship. Wood (1975) recognises that banks may want to accommodate prospective borrowers so that they can capture these customers for future credit. He proposes that a bank may find it profitable to offer easy or low-cost credit in one period in the hope of charging higher rates to a customer in the future. In order for the bank to have the ability to charge higher rates in the future, some mechanism must lock the customer into the current relationship. This gives rise to an informational monopoly to the single informed bank. Wood (1975) assumes that there are costs that must prevent the customer from transferring business to a competing lender and thus locks in the customer to the bank that provided the initial loan. Howorth, Peel and Wilson (2003), clarify this when they find that firms will only be informationally captured when the costs of switching banks, including the costs of conveying an accurate picture of their performance to prospective bankers, outweigh the benefits.

In line with Wood's (1975) proposition, Sharpe (1990) recognises that since an incumbent lender learns more about a borrower's characteristics than do other banks, this generates an asymmetry of information among banks resulting in informed (relationship) banks and uninformed (transactional) banks. Rather than take relationships as a given, Sharpe (1990) theorizes that customer relationships arise endogenously as a consequence of the asymmetric evolution of information sets generated by the history of bank-firm interactions. Other researchers reason similarly as there is considerable literature that suggests the existence of the concept of relationship lending as is evidenced by the complementary definitions which include, "when a firm has close ties to a financial institution", (Petersen & Rajan, 1994); "a long term implicit contract between a bank and its debtor", Elsas (2005); while Ongena and Smith (2000) define it as "the connection between a bank and a customer that goes beyond the execution of simple, anonymous financial transactions".

Memmel, Schmieder, and Stein (2008) define relationship lending as simply, "lending relationships between firms and banks". Berger and Udell (2006) provide a more comprehensive definition as the lending technology where "decisions are primarily based on soft information gathered over the course of a relationship." Earlier, Berger (1999) posits that the financial intermediary gathers confidential information through interaction with the borrower over time and usually through the use of multiple financial products/services. Similarly, Freixas (2005) emphasizes that the bank is the one that makes the necessary investment to obtain borrower-specific (often proprietary) information while the borrower has a choice to invest or not. This borrower-specific information is obtained when banks provide screening (Ramakrishnan & Thakor, 1984) and/or monitoring services (Diamond, 1984). This information which is normally referred to as "soft" information is not easily quantified and consists of information gathered over time through contact with the firm and its stakeholders (Berger & Udell, 2006).

Petersen (2004) distinguishes soft from hard information as that information which is difficult to completely summarize in a numeric score while the latter is easily reduced to numbers. Schwarze (2006) suggests that the more qualitative information is used in credit

decision making, “the more one can speak of the granting of credit under relationship aspects”. Using this information over several interactions can be beneficial to both bank and customer (Diamond, 1984; Elsas, 2005; Greenbaum & Thakor, 1995; Ongena & Smith, 2000; Rajan, 1997; Schumpeter, 1939). As relationship lending is aimed at resolving information asymmetry problems, it is suited to SMEs which are considered as informationally opaque enterprises (Carbo’ –Valverde et al., 2009; Ono & Uesugi, 2009).

This study combines Berger and Udell’s (2006) and, Greenbaum and Thakor’s (1995) definition to provide a working definition of relationship lending as, “the lending technology where decisions are primarily based on soft information gathered over the course of a relationship between a lender and borrower and results in mutual economic benefit.” This forms the basis of part of the research problem which investigates whether and how relationship lending is practised.

## **2.3 Review of the Empirical Research**

This section provides empirical evidence on the state of SME financing around the world, the SME financing technologies that are employed, soft information acquisition and used in SME lending decision making and, the value of SME lending to commercial banks.

### **2.3.1 The State of SME Financing around the World**

The importance of access to finance for SMEs is a widely recognized subject among academics and policymakers. SMEs play a key role in economic development, diversification, and employment creation, contributing 49 per cent of GDP on average in high-income countries and 29 per cent in low-income countries (Ayyagari et al., 2007 in FSD, 2015). However, SMEs are more credit constrained than large firms which severely affects their possibilities to grow and innovate (Beck & Demigurc-Kunt, 2006; Beck, Demigurc-Kunt, Laeven, & Maksimovic, 2006).

Based on the significant role of SMEs in economic growth and creation of employment, the financial sector's role of channelling credit affordably and efficiently to SMEs is very central for inclusive and sustained economic development. There has been increased interest in the small and medium enterprise (SME) sector by commercial banks around the world. Previously, in the not so distant past, the SME market was perceived by banks as risky, costly and difficult to serve. Commercial banks are now facing significant competition in the corporate and retail sectors (Calice, et al., 2012; De la Torre et al., 2010) and this has shifted their focus downstream to serve the previously underserved SME market. In a study commissioned by the World Bank, Berg and Fuchs (2013) survey a total of 62 commercial banks in five countries, including Kenya, and find that SME's share of total bank lending ranges between 5% and 17.4% with banks in Kenya, Rwanda, and Tanzania being more involved than banks in South Africa and Nigeria.

Banks perceive the SME segment as large, unsaturated and with good prospects, even considering this segment as strategically important (Calice et al., 2012). Many banks now report that they perceive significant opportunities in the SME sector with survey data from multiple studies showing that rather than overlooking or avoiding SMEs, they have begun to target SMEs as a profitable segment (IFC, 2010). For instance, Beck et al. (2011) provide the first attempt to understand SME financing from the supply side. Based on a survey of 91 banks in 45 countries (38 developing and 7 developed), they find that banks serve the SME segment through a number of lending technologies and organisational setups. They also observe few differences in the extent SMEs are reached out by banks based on their ownership structure (i.e. public, private or foreign-owned). However, they also find significant differences across banks based in developed and developing economies; for instance, a firm's credit history and owner characteristics are more important in developing economies, whereas loan size is the key factor driving small business lending in developed economies. Beck et al. (2008; 2011) conclude that the enabling environment is more important than the size of the firm or bank ownership in shaping bank financing to SMEs. A similar, though a single country study by Stephanou and Rodriguez (2008) analyses both the trend and structure of the SME financing market in Colombia. Their results reveal that banks in the country regard the SME segment as an

attractive business opportunity though their level of sophistication in terms of business models and risk management tools remains modest. Similar to Beck et al.'s (2008; 2011) conclusion, Stephanou and Rodriguez (2008) also conclude that the market is characterized by a number of institutional and policy constraints, which inhibit further growth of SME lending.

Also consistent with Beck et al. (2008; 2011), De la Torre et al. (2010) investigate banks approaches to SMEs in terms of business models and risk management systems. Based on surveys of 48 banks and one leasing company in 12 countries, they find that all banks in the sample are interested in serving the SME segment. To do so, almost all have separate organizational units and offer a wide range of products, applying different transactional technologies such as credit scoring. Additionally, De la Torre et al. (2010) find that most banks want to serve SMEs because they find this segment profitable, especially as margins in other banking markets narrow due to intensified competition.

According to the IFC (2010), the gap in financial services (referred to the missing middle) provided to SMEs, appears to be shrinking the fastest in emerging markets (low- and middle-income countries) where this gap has been the widest. More and more emerging market banks are developing strategies and creating SME units. Banks are starting to understand the particular needs and preferences of SMEs and are developing tailored approaches to overcome the historical challenges of high credit risk and cost to serve (IFC, 2010). Banks have also found that SMEs actually value relationships more than any other segment, whereas large corporates take it for granted. SMEs are also willing to pay a higher price for this relationship as they do not want to be treated like an account number (IFC, 2010). This is confirmed by a KPMG (2013) survey that finds that commercial banks are also increasingly realizing that it is easier to retain than acquire customers and now substantially invest in customer relationship management.

### **2.3.2 Soft Information and the SME Lending Decision**

Boot (2000) suggests that in originating loans, banks develop proprietary information and subsequent monitoring of borrowers yields additional private information. García-

Appendini (2007), in a survey of small business finances (SSBF) which targeted US for-profit firms, finds that hard public information may not be used in loan underwriting when banks have a strong relationship with the borrower and that soft information if available is the driving determinant in loan underwriting. Puri, Rocholl, and Steffen (2010) concur when they find that prior relationships not only allow the bank to produce information that goes beyond publicly available information, but also allow it to better assess loan applicants' creditworthiness.

Berger and Udell (2002; 2006) argue that as loan officers have the most frequent and personal contact with the firm, its owner, its employees, and the local community, they are able to obtain soft as well as hard information about the borrowers. Further, they suggest that the loan officer is able to collect relevant information about the firm, its owner and business conditions in local market from other local firms and individuals because they typically live in the local community. Berger and Udell's (2002) model is recently confirmed at least in part by Hattori, Shintani, and Uchida (2015) who using unique data from heterogeneous banks in Japan, find that loan officers (located at the bottom of the banks' hierarchy) collect soft information. This is because they are the person with whom a borrower has the initial and most frequent contact among bank staff. Even though existing studies find that loan officers indeed play an important role in the production of soft information, this does not rule out the possibility of someone else producing soft information. At smaller banks where job assignments are more flexible and the collection of information is not routinized by strict internal rules, decision makers might also directly acquire soft information through their own personal contact with borrowers while at large banks, loan officers might be the sole producers of borrower information (Agarwal & Hauswald, 2011; Liberti & Mian, 2009). Hattori et al. (2015) also find that especially at smaller banks, branch managers who have direct contact with the borrowers also collect soft information, although less frequently. Further, other bank employees in the branch apart from the account loan officers also have direct and frequent contact with borrowers.

Berger and Udell (2002; 2006) suggest that additional information may also be gathered through contact with other members of the local community, such as suppliers and

customers, who may give specific information about the firm and owner or general information about the business environment in which they operate. Similarly, Schwarze (2006) gives examples of soft information which may be collected from the SME owner or other sources as; the character and reliability of the SME's owner, communication with customers of the SME or neighbouring businesses.

Soft information is transferred through direct personal interaction and communication between loan officers and credit decision makers. Soft information is hardened (that is, quantified or digitized) so that it can be transmitted to a higher level (Agarwal & Hauswald, 2011; Liberti & Mian, 2009).

Moreover, while the soft information produced by loan officers is often coded into hardened soft information and transmitted (with loss) to an upper level for decision making, it does not rule out the possibility that soft information is communicated and used in other forms. Further sharing of soft information can occur during the decisions making process by loan committees that consist of multiple bank employees. Paravisini and Schoar (2012) conduct research with BancaMia, a for-profit bank in Colombia specialized in loans to small enterprises and find that loan officers upload borrower information and the bank's management information system compiles in a single application file all the available borrower information for review by a credit committee. This information includes: the first-hand information collected by the loan officer, the borrower's past credit history in BancaMia and any available third-party information (e.g., the borrower's credit score from a private credit bureau). Similarly, Nemoto, Ogura, and Watanabe (2011) provide evidence from Japan and show that in small and medium sized banks, any information collected by employees in the branch is filed in a loan proposal, which even includes a record of casual conversations held with borrowers. This loan proposal is circulated within the branch with every staff of the branch having access to it resulting in communication and information sharing between account loan officers and other staff in the branch.

Mocetti, Pagnini, and Sette (2010) find that investment in information and communication technologies has made it easier to share documentation and to combine information stored in different database. Hattori et al. (2015) find that at least for smaller banks, it is the branch managers (who are likely to be decision makers) who are the most important repository of soft information. This is inconsistent with the conventional view that loan officers are the sole repository of soft information (Berger & Udell, 2002; 2006; Scott, 2006). Scott (2006) provides a different perspective of looking at how loan officers may be the repository of soft information. Using data on SME lending from a survey of small businesses conducted by the National Federation of Independent Business (NFIB) in the U.S., Scott (2006) finds that greater loan officer turnover has a more adverse effect on the availability of credit for borrowers suggesting the importance of loan officers in the collection and transfer of soft information or alternatively that the repository of this information is the loan officer.

Hattori et al., (2015) conclude their study by suggesting that there are many important issues that remain untested concerning the collection, processing, and use of soft information within heterogeneous bank organizations.

### **2.3.3 Transaction and Relationship Lending in SME Lending**

Uchida, Udell, and Yamori (2006) suggest that among others, two main lending technologies are used to finance small and medium sized enterprises (SMEs) and the two can be primarily distinguished by the type of information that a bank uses in granting and monitoring the loan. This concurs with Berger and Udell's (2006) classification of SMEs lending technologies. While most studies argue that small banks are more likely to engage in SME financing using relationship lending (see Berger & Udell, 1995; Berger & Udell, 2002; Strahan & Weston, 1996) recent evidence questions this traditional view and suggests that larger banks can have a comparative advantage at financing SMEs through transactional lending technologies (Berger & Udell 2006; De la Torre et al., 2010).

Uchida et al., (2006) use data from a unique survey in Japan to investigate the different lending technologies and find that although financial statement lending is the most

commonly used technology, multiple lending technologies are usually used at the same time; suggesting the existence of complementarity among lending technologies. Similarly, De la Torre et al. (2010) suggest that relationship lending is not the only way in which banks can extend financing to SMEs as banks are increasingly applying different transactional technologies. This is also confirmed by Albareto, Benvenuti, Mocetti, Pagnini, and Rossi (2008) when in a survey on Italian banks, they find that medium and large banks do use soft information (like qualitative information on the firm's governance) in their credit scoring models. Another study by Columba, Gambacorta, and Mistrulli (2010) and Bartoli, Ferri, Murro, and Rotondi (2012) suggests that banks, especially large ones, appreciate group lending technology in order to lend to SMEs. They find that group lending Mutual Guarantee Institutions (MGIs), through peer monitoring and joint responsibility, help banks to mitigate SMEs' asymmetric information problems. Finally and more recently, Bartoli, Ferri, Murro, and Rotondi (2013) investigate SME financing in Italy and find that banks lend to SMEs by using both transaction and relationship lending, independent of the size and proximity of borrowers. These results not only provide a test of the importance of the various lending technologies proposed by Berger and Udell (2006) they also support the earlier views of Berger and Udell (2006) and Uchida et al. (2006) that lending technologies can be complementary.

Those studies that provide evidence of the use of relationship lending through application of the different measures that proxy relationship lending (duration, scope and concentration of borrowing) include; Berger and Udell (1995) who examine the role of relationship lending in small firm finance and find that borrowers with longer banking relationships pay lower interest rates and are less likely to pledge collateral. Overall, the analysis on a U.S. National Survey of Small Business Finances by Berger and Udell (1995) shows that the longer the relationship between the banker and the borrower, the easier the loan terms are for the borrower. Similarly, Boot (2000) finds that apart from a fall in interest rates and collateral requirements over the life of the relationship, duration positively affects the availability of credit, concurring also with the earlier findings of Petersen and Rajan (1994) and Cole (1998) who find that in the US, a lender is less likely to grant credit to a firm if the customer relationship has lasted for one year or less.

Contrasting evidence is provided by Degryse and Van Cayseele (2000) in a study of Belgian enterprises on the impact of relationship banking when they find that borrowing rates increase as the bank-firm relationship lengthens, while borrowing rates decrease when the scope of the bank-firm relationship increases. Using a sample of small- and medium-sized corporate borrowers of five major German universal banks, Elsas (2005) also finds that the duration of the bank-borrower relationship is not related to Hausbank status but as a bank's share of debt financing or its share of payment transactions increases, it is more likely to be a Hausbank.

On the effect of multiple bank relationships, Cole (1998) finds that a lender is less likely to grant credit to a firm if the firm deals with other financial counterparts. Similarly, Bharath, Dahiya, Saunders, and Srinivasan (2007) find that the existence of a prior relationship is important and banks favour firms with pre-existing banking relationships at the time of loan renewal and approval. This prior relationship is favourable for a loan applicant because it provides more information about the applicant for the bank. Additionally, this prior loan relationship gives the bank additional information about the applicant and small banks rely more heavily on it as it provides insights into the character of a borrower (Cole, Goldberg, & White, 2004). Elsas (2005) concurs when he also finds that as a bank's share of debt financing or its share of payment transactions increases, it is more likely to be a Hausbank (Hausbank often serves as a prime example of relationship lending). Elsas (2005) finds a negative correlation between the number of banks and Hausbank status but clarifies that Hausbank status is not equivalent to exclusivity as on average, borrowers in the study with a Hausbank relationship had 5 bank relationships with a median of 4.3. Hernandez-Cánovas & Martinez-Solano (2006) in a study of small Spanish firms find that SMEs that work with fewer financial intermediaries obtain debt at a lower cost.

Houston and James (1999) explain the existence of multiple bank relationships by focusing on the anticipated funding needs and show that the desirability of multiple bank relationships crucially depends on the size of the funding needs. Their empirical evidence indicates that firms with a single bank are at a disadvantage ("cash flow constrained")

only when large funding needs are anticipated. In the case of more modest funding needs, single bank firms are less cash flow constrained than firms with multiple bank relations are.

In their conclusion, Bharath et al. (2007) report significant benefits of borrowing from relationship lenders that include; lowering pricing of loans (10 to 17 bps lowering of loan spreads), relationship loans are significantly less likely to be secured by collateral and relationship borrowers also obtain larger loans (scaled by the borrower's asset size or long-term debt) compared to non-relationship borrowers.

#### **2.3.4 Benefits of SME Lending to Commercial Banks**

Empirical evidence on the benefits of SME lending tends to focus on the benefits that accrue to the borrower and obviously so as prior studies focused on the lack of credit for SMEs and why SMEs needed finance (Berger & Udell, 1995; Bharath et al., 2007; Cole, 1998; Elsas & Krahn, 1998; Harhoff & Körting, 1998; Petersen & Rajan, 1994, 1995). A few of the recent studies relating to the subject of value of SME lending to commercial banks are highlighted here. Many studies have posited that in order to engage the SME sector, relationship lending is the preferred technology and as such, a number of these studies tend to refer to the benefits to commercial banks that employ the relationship lending technology (for instance, Holod and Peek, 2013). While cross-country evidence on the drivers of bank financing for SMEs is extensive, detailed information for Sub-Saharan Africa remains limited (IFC, 2010).

In their survey of 91 banks in 45 countries, Beck et al. (2011) find that banks perceive the SME segment as highly profitable. Similarly, Calice et al. (2012) study the extent of bank lending to SMEs in Kenya, Uganda, Tanzania and Zambia and find that banks perceive the SME segment as large, unsaturated, with good prospects and strategically important. Like De la Torre et al. (2010) who use data from bank surveys for a total of 48 banks (plus one leasing company) in 12 countries, Calice et al. (2012) also find that the common drivers of bank involvement with SMEs are, perceived profitability, reduction of information asymmetry and reverse factoring.

Perceived profitability is cited as a major driver of bank involvement with the SME segment (Calice et al., 2012; De la Torre et al., 2010) which concurs with the earlier findings of Bharath et al. (2005). Calice et al. (2012) find that sixty-three percent of the banks they interviewed (in Kenya, Uganda, Tanzania and Zambia) expect high profits from working with SMEs. In Kenya, specifically, fifty percent of banks were motivated to participate in the SME market in view of its profitability. De la Torre et al. (2010) find that a majority of banks consider that the SME segment's profitability will more than compensate for the higher costs and risks of the segment. Furthermore, De la Torre et al. (2010) find that many banks perceive the SME segment to be more profitable than corporate banking. They explain this by the fact that spreads on corporate lending are near zero (due to high competition) and as such banks are looking for new markets to diversify their income sources. The perceived profitability of working with SMEs not only derives from lending products, but also from the potential for cross-selling other products. Once a bank has established a relationship with the borrowing SME, the bank may offer a variety of other services and obtain revenues from the fees they charge for these services (De la Torre et al., 2010). This coincides with the later findings of Holod and Peek (2013) that banks may profit from relatively inexpensive core deposits placed with the bank by their relationship borrowers in addition to the earlier findings of Boot (2000) that rate-insensitive core deposits allow for intertemporal smoothing in lending rates. This suggests a complementarity between deposit taking and lending. More recently, Fredriksson and Moro (2014) analyse 4285 firm-year observations from Finnish banks and find that the length and scope of a relationship, and the loan dimensions, are important in explaining the risk-adjusted profitability of banks.

The development of lender-borrower relationships should also reduce information asymmetry especially where borrowers are considered information opaque as in the case of SMEs (Holod & Peek, 2013). This perceived benefit concurs with the basic premise of the theories of financial intermediation (Diamond, 1984; Diamond, 1991; Fama, 1985; Leland & Pyle, 1977; McNulty, 2002; Ramakrishnan & Thakor, 1984). Boot (2000) suggests that relationship banking can facilitate a Pareto-improving exchange of

information between the bank and the borrower, where a borrower might be inclined to reveal more information than in a transaction-oriented interaction and the lender might have stronger incentives to invest in producing information. The continuous contact between borrower and lender in the provision of various financial services can produce valuable information which the lender can use in making decisions. These decisions include; whether to extend credit or not, how to price loans, whether to require collateral and whether to attach other conditions to the loan (Elyasiani & Goldberg, 2004). Puri, Rocholl, and Steffen (2010) concur and find that relationships provide value to banks in the screening process of loan applications by retail customers as well as in the monitoring process even after the improvement in the initial screening process. This agrees with the earlier studies of Boot (2000) and Rajan (1996). Boot (2000) concludes that relationship lending can pave the way for more informative credit contracting decisions based on a better exchange of information and also increase the availability of credit to information-sensitive borrowers. Rajan (1996) suggests that the benefits of a relationship may include the transfer of proprietary information, a commitment to continue doing business together through financially tough times, or the offer and delivery of services at prices different from costs.

On the contrary, Von Thadden (2004) suggests that even though a relationship may lead to one bank having a monopoly of information over other banks, this would be unfavourable for the borrower. In an earlier study, Boot (2000) highlights this monopoly problem when he proposes that relationships are the primary cause of an incumbent bank's comparative advantage over new lenders. Garriga (2006) refers to this as the "dark side" of relationship lending where one bank may end up having a monopoly of information over other lenders and thus be able to extract more interest income from borrowers. Lehmann and Neuberger (2001) and, Hernandez-Cánovas and Martinez-Solano (2006) confirm this when they find evidence of this higher cost of credit. Holod and Peek (2013) explain that this higher cost of credit though higher than is justified by the level of credit risk perceived by an informed lender, is lower than the interest rate that would be charged by other potential lenders to the firm due to the higher risk premium required to compensate them for the added risk associated with being less informed about the firm.

Thus, the firm does not have an incentive to defect from the relationship and begin a new relationship with another lender because it is costly and time consuming to establish new lending relationships. Therefore, firms are subject to a “lock-in” effect with their current relationship lender (Holod & Peek, 2013). This concurs with the earlier findings of Howorth, Peel, and Wilson (2003) that firms will only be informationally captured when the costs of switching banks, including the costs of conveying an accurate picture of their performance to prospective bankers, outweigh the benefits.

Greenbaum, Kanatas, and Venezia (1989), Rajan (1992) and Sharpe (1990) provide another explanation for the higher cost of credit charged by banks who have established a relationship when they predict that interest rates increase as the relationship lengthens because lenders subsidize the borrowers initially but are reimbursed with higher rates later. Bharath et al. (2007) find contrasting evidence that lenders do not extract monopoly rents through higher interest rates and fees (spreads) on loans to their relationship borrowers. Similarly, Petersen and Rajan (1994) find higher credit costs related to firms’ simultaneous multiple bank relationships in contrast to the view that this higher cost of credit occurs when a bank has a monopoly of information, or is the main/sole bank.

Bharath et al. (2007) find that a lender that has a strong relationship with a borrower is able to lend more and has a greater probability of providing future loans compared to a lender lacking such a relationship. Many bankers view the generation of additional business as the principal reason for engaging in relationship lending. Holod and Peek (2013) concur and add that additional sources of value for the relationship lender would arise through the opportunities for cross selling additional products and services to its relationship borrowers. Such value would reflect not only the profitability from current business with the firm, but the profits that might accrue to the bank from future opportunities to continue and expand the menu of products and services provided to the firm as the firm expands, both in terms of size and activities. Santikian (2014), in a study of the small business loan portfolio of a mid-sized bank in the United States, finds that the source of value in relationships in banking is not limited to enhanced monitoring but relationships also enable banks to sell borrowers a variety of other profitable financial

services, as well as gain access to additional borrowers to whom they can sell these services. These findings are similar to Bharath et al. (2007) and Holod and Peek (2013).

Holod and Peek (2013) provide direct evidence on the value of relationship lending to banks. By using data from a small business loan survey in U.S., they find that small commercial and industrial loans do, in fact, add value for smaller banking organizations, both in absolute terms and relative to the value contributed by larger commercial and industrial loans. Interestingly, the value-enhancing effect emanates primarily from the smallest loans, those with original values of \$100,000 or less. On the other hand, small commercial real estate loans, being transactional rather than relationship in nature, do not contribute additional value to banking organizations relative to larger commercial real estate loans (Holod & Peek, 2013).

The need to seek out SME relationships from existing large corporate clients (reverse factoring) is also cited as another driver of bank involvement in the SME segment. This is reported by almost 70% of the banks in Argentina and 25% of the banks in Chile (De la Torre et al., 2010); and 50 percent of banks in Kenya (Calice et al., 2012). Banks systematically ask large clients for references on their best clients and suppliers which in many cases are SMEs. With a list of potential clients, banks contact these companies and try to on board them by offering services or lending products, depending on the banks' strategy. The benefit banks reap from this is not only that banks obtain an assessment of the quality of these SMEs from large clients, but also that these SMEs are supported by operating with these large corporations, who in some cases also provide guarantees (Elyasiani & Goldberg, 2004). McNulty (2002) concurs and adds that these banks are also able to monitor borrowers and diversify their risk by contracting with a large number of borrowers. Thus, banks gain very useful information and reduce the risk of seeking new clients and in this way, exploit the synergies of working with different types of clients.

More recently, Fredriksson and Moro (2014) state that one of the major shortcomings of previous research on bank profitability is that it tends to look for the determinants of the overall profitability, whereas overall profitability depends on the profitability that a bank

can extract from its financial relationship with each individual customer. After analysing 4285 firm-year observations from Finnish banks, Fredriksson and Moro (2014) find that the major factor in explaining the risk-adjusted profitability of banks is the quality of a SME's performance although the length and scope of a relationship and the loan dimensions also play an important role.

What emerges from the empirical studies above is that SME lending is carried out (see Calice et al., 2012; De la Torre et al., 2010), which implies that the question on whether SME lending is carried out is answered. What remains is to answer the questions, "how" and "why" SME lending is carried out. The empirical studies above resulted in perceived or potential benefits that lenders could enjoy by engaging in SME lending. Boot (2000) concludes that there is still much more work required to determine the precise sources of value of SME lending, because existing work falls short in measuring the precise sources of the added value of relationship banking (see also Boot, 1991 & Boot, 2002). This conclusion is also later echoed by Calice et al. (2012) when they point out that relatively little research exists on whether, why and how banks finance SMEs around the world.

## **2.4 Research Gaps**

The theoretical literature suggests that financial intermediaries play an important role in credit markets because they reduce information asymmetries between borrowers and lenders. Resulting from information asymmetry, banks are able to mitigate adverse selection by screening applicants for loans, and do the same for moral hazard by monitoring borrowers (Diamond, 1991; Miwa & Ramseyer, 2005; Rajan & Winton, 1995). The resulting bank borrower relationships have led to increased interest in the area of relationship lending. The empirical literature shows that banks have become increasingly interested in engaging the SME sector and suggests that banks prefer to employ relationship lending when dealing with SMEs. The empirical literature on the benefits of SME lending has tended to emphasise benefits that accrue to borrowers. Those studies that focus on SME financing from the supply side have only provided results about

the status of SME financing and what the perceived benefits would be (Beck et al., 2008; 2010; Calice et al., 2012; De la Torre et al., 2010). Earlier, Boot (2000) suggests that in this increasingly competitive environment of banking, the differentiation of distinct costs and benefits (and the empirical verification of it) is crucial in order to predict the viability and scale of relationship banking in the future. Boot (2000) concludes that much more research is needed, as existing work falls short in that it has not measured the precise sources of the added value of relationship banking (see also Boot, 1991 & Boot, 2002). This conclusion is later echoed by Calice et al. (2012) when they point out that relatively little research exists on whether, why and how banks finance SMEs around the world. This results in the two knowledge gaps which emerge from the review of literature and motivate this study. The two knowledge gaps are detailed below.

There is an absence of detailed descriptions of how banks are engaging the SME sector. In literature, the lending technology of relationship lending is regarded as the most appropriate technology of lending to SMEs but as Calice et al. (2012) underscore, relatively little research exists on how banks finance SMEs around the world. Further, there has been very little empirical research on how soft information which forms the basis of relationship lending, is produced/acquired, transmitted and used in making the SME lending decision. As Hattori et al. (2015) conclude there are many important issues that remain untested concerning the collection, processing and use of soft information within heterogeneous bank organizations. This motivates the question; how do banks employ relationship lending in the financing of SMEs and what role do each of the lending technologies, that is relationship and transaction lending, play in the SME lending decision? In the Kenyan context, it is not clear to what extent banks make use of relationship lending to increase lending to SMEs.

There is a dearth of studies on the specific benefits enjoyed by banks that have ventured into SME lending. Previous research (see Bharath et al., 2005; Calice et al., 2012; De la Torre et al., 2010; Fredriksson & Moro, 2014) has tended to look at the determinants of the overall profitability of a bank instead of the profitability that a bank can extract from its financial relationship with each individual customer. A differentiation of the specific

components of profitability is necessary. Additionally, even though relationship lending is based on the premise of mutual benefit between the bank and borrower (see Elsas, 2005; Greenbaum & Thakor, 1995), most studies have mainly concentrated on the demand side of finance or borrower benefits (Bharath et. al., 2007). On the other hand banks, which form the supply side of finance and who take the initiative to invest in the relationship with the borrowers, have not received much attention (Bharath et al., 2007). Calice et al. (2012) echo Boot's (2000) earlier conclusion that much more research is needed to determine the precise sources of the added value of relationship banking in order to predict the viability and scale of relationship banking in the future.

This study therefore sought to explore the use of the preferred relationship lending technology in SME lending and to determine the benefits of SME lending to commercial banks in Kenya. Further, as the gaps highlighted above were experienced from studies that employed a quantitative approach (see Beck, Demirguc-Kunt, & Peria, 2008, 2011; Calice et al., 2012 and De la Torre et al., 2010), this study opted to employ a qualitative approach to gather rich, in-depth information about how SME lending transpires and the benefits that lenders gain.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

Chapter three begins with a discussion of research paradigms in section 3.2 which provides a justification for the research paradigm used to conduct this study. This is followed by a discussion on the different research approaches in section 3.3 providing also a justification for the chosen research approach. Section 3.4 presents a general discussion on research designs followed by a detailed discussion of the specific research design suited to this study. The next section, 3.5 presents the data collection methods followed by a discussion of how data was analysed in section 3.6. In section 3.7, measures of validity, reliability and objectivity are discussed under research quality in and section 3.8 discusses the ethical considerations of the study. Finally, to conclude the chapter, section 3.9 provides a summary of the chapter.

### **3.2 Research Paradigm**

A paradigm or world view is a conceptual framework comprising a basic set of beliefs or assumptions that act as a guide to the researcher (Creswell 1994; Guba & Lincoln, 1994; Healy & Perry, 2000; Lincoln & Guba, 2000; Mertens, 1998). These beliefs might be called philosophical assumptions, epistemologies and ontologies (Crotty, 1998); or broadly conceived research methodologies (Neuman, 2000). Deciding on a research paradigm to be applied in conducting research is important as it substantially influences how one undertakes a social study (Berry & Otley, 2004; Creswell, 2009; Neuman, 2011; Saunders, Lewis, & Thornhill, 2009). Guba and Lincoln (1994) break down paradigms into three aspects; ontology, epistemology and methodology.

Ontology is an assumption about the form and nature of reality, for instance, is there a "real" objective world out there, or is reality constructed through human relationships?

Epistemology is a set of assumptions about the relationship between the knower and what can be known, for instance, does the knower need to be "objective" and affect the outcome as little as possible, or does the knower actively co-construct knowledge with others? It is important to note that ontology and epistemology overlap and are sometimes impossible to divide. Many who talk about an "epistemology" may be referring to both together. Finally, methodology is the set of assumptions about how the inquirer can go about finding out whatever he or she believes can be known.

The paradigm dialogue, that became a worldwide phenomenon by the 1990s, continues to play an important part in educational and management research today with differences in terminology used to describe paradigms and also debate as to the number of paradigms that exist.

### **3.2.1 Positivists**

Positivists assume that there is a real objective reality that is knowable. Within the positivist paradigm, questions and/or hypotheses are proposed by the researcher and subjected to empirical testing within a controlled environment that ensures the research outcomes are not influenced (Guba & Lincoln 1994). Creswell (2009) explains that positivists believe that different researchers observing the same factual problem will generate a similar result by carefully using statistical tests and applying a similar research process in investigating a large sample. Positivists believe that research needs to be carried out in a scientific nature, following a strict set of guidelines and should be carried out by appropriately trained scientists. The carrying out of this research is usually based on a deductive approach, moving from theory to observation (Wilson, 2013). Their common belief is the existence of a universal generalisation that can be applied across contexts, which is now called naïve realism. The research methodology is primarily quantitative and consists of controlled experiments and surveys conducted on representative samples of a population

The positivist research paradigm was not considered an appropriate paradigm within which to conduct this research for three reasons. First, the research question was not posed

in terms of verification of hypotheses. Secondly, in relation to the research question, the research methodology that was considered suitable was qualitative and not quantitative which consists of controlled experiments and surveys conducted on representative samples of a population. Third, the researcher assumed that reality is subjective and not objective and as such did not believe in the existence of a universal generalisation that could be applied across contexts.

### **3.2.2 Post-positivists/Realism**

Post-positivists challenge the positivist belief of absolute truth (Phillips & Burbules, 2000 in Creswell, 2009), especially in relation to studying human behaviour in social science. This is called the critical realist stance, which means that understanding social reality needs to be framed in a certain context of relevant law or dynamic social structures which have created the observable phenomena within social world. Post-positivists hold a deterministic philosophy in which causes probably determine effects or outcomes. Thus, the problems studied by post-positivists reflect the need to identify and assess the causes that influence outcomes, such as found in experiments (Creswell, 2009). Post-positivism is also reductionist in that the intent is to reduce the ideas into a small, discrete set of ideas to test, such as the variables that comprise hypotheses and research questions and as such would be suited to a quantitative study. Thus, the accepted approach to research by post-positivists is that an individual begins with a theory, collects data that either supports or refutes the theory, and then makes necessary revisions before additional tests are made. Realists recognise all research methods as inherently imperfect and therefore believe a combination of both qualitative and quantitative research methods is required to generate and test theory (Patton, 2002).

This research did challenge the existence of an absolute truth especially as it was aimed at studying a social phenomenon. As this research attempted to understand the lending practices of banks within a single economic system (banking), realism was considered an appropriate paradigm within which to conduct this research. However, this research did not seek to reduce ideas into a small, discrete set of ideas to test, such as the variables that comprise hypotheses and research questions. The aim of this research was to get an insider

perspective of a business phenomenon; which this and the relatively small population of commercial banks engaged in SME lending did not lend itself to quantitative research, which is also an appropriate methodology within the realist paradigm, particularly for purposes of triangulation. Therefore it was concluded that the realist paradigm was not an optimal paradigm within which to conduct research of this nature.

### **3.2.3 Interpretivism/Social Constructivism**

Interpretivists assume that individuals seek understanding of the world in which they live and work; and believe that reality is constructed by social actors and people's perceptions of it. Therefore, in contrast to the post-positivist's belief, interpretivists reject the concept of objectivism and a single truth. To understand the social world from the experiences and subjective meanings that people attach to it, interpretivist researchers favour to interact and to have a dialogue with the studied participants. As opposed to generalisation or the nomothetic approach adopted by post-positivist researchers, interpretivists use a narrative form of analysis to describe specifics and highly detailed accounts of a particular social reality being studied, which is termed as the idiographic approach (Neuman, 2011). They also prefer to work with qualitative data which provides rich descriptions of social constructs. The goal of the research is to rely as much as possible on the participants' views of the situation being studied. The questions become broad and general so that the participants can construct the meaning of a situation, typically forged in discussions or interactions with other persons. The more open-ended the questioning, the better, as the researcher listens carefully to what people say or do in their life settings (Creswell, 2009). Thus, qualitative researchers seek to understand the context or setting of the participants through visiting this context and gathering information personally, focusing on the full complexity of human sense making as the situation emerges (Kaplan & Maxwell, 1994). Wilson (2013) observes that rather than starting with a theory (as in post-positivism), inquirers generate or inductively develop a theory or pattern of meaning. The basic generation of meaning is always social, arising in and out of interaction with a human community. The experiences and values of both research participants and researchers substantially influence the collection of data and its analysis. Positivist scholars believe in the power of replication research. Interpretivist researchers vote a study that uncovers

inside perspectives or real meanings of social phenomena from its study participants as a good social knowledge.

As the aim of the study was to establish the meaning and process of a business phenomenon (SME lending) from the perspective of the participants (SME bank managers) involved in their natural setting (bank premises), it adopted a subjective stance as opposed to an objective one as proposed by positivists. The researcher sought to interact and have a dialogue with the study participants so as to get a detailed account about the process of SME lending. This interaction and dialogue led to the construction of knowledge about SME lending. The knowledge was generated inductively as opposed to starting with a theory and the aim was to get rich descriptions of the social reality that was being studied. The method employed was qualitative making it well suited to the qualitative methodological focus of the interpretivism/constructivism paradigm. Interpretivism/constructivism was therefore considered the most appropriate paradigm within which to conduct this research.

#### **3.2.4 The Pragmatic Worldview**

Cherryholmes (1992) explains that pragmatism derives from the works of Peirce (1905) and James (1907), amongst others and proponents of this worldview include Patton (1990). Pragmatism is not committed to any one system of philosophy and reality. Pragmatists do not see the world as an absolute unity. This applies to mixed methods research in that inquirers draw liberally from both quantitative and qualitative assumptions looking to many approaches for collecting and analysing data rather than subscribing to only one way. Truth is what works at the given time. It is not based in a duality between reality, independent of the mind or within the mind. Pragmatists focus on practical applied research integrating different perspectives to help interpret the data. Thus, in mixed methods research, investigators use both quantitative and qualitative data because they work to provide the best understanding of a research problem. The pragmatist researchers look to the “*what*” and “*how*” to research, based on the intended consequences—where they want to go with it. Mixed methods researchers need to establish a purpose for their mixing, a rationale for the reasons why quantitative and qualitative data need to be mixed

in the first place. Pragmatists agree that research always occurs in social, historical, political, and other contexts. In this way, mixed methods studies may include a postmodern turn, a theoretical lens that is reflective of social justice and political aims.

As this research was committed to one system of philosophy, which is to interpret the research problem from the social actors' perspective, it was not amenable to the pragmatists' philosophy.

Table 3.1 below presents the paradigms discussed above and the three aspects of each.

Table 3.1 Research Paradigms

| Paradigm               | Aspects  |
|------------------------|--|
| <b>Positivism</b>      | <p><b>Ontology:</b> Naïve Realism. External, objective and independent of social actors.</p> <p><b>Epistemology:</b> Dualist/ Objectivist. Focus on causality and law like generalisations, reducing phenomena to simplest elements. Findings true.</p> <p><b>Methods:</b> Highly structured, large samples, measurement, experimental, verification of hypotheses. Chiefly quantitative methods.</p>  |
| <b>Post-positivism</b> | <p><b>Ontology:</b> Critical Realism. Is objective. Exists independently of human thoughts and beliefs or knowledge of their existence (realist), but is interpreted through social conditioning (critical realist).</p> <p><b>Epistemology:</b> Modified Dualist/Objectivist. Findings are "probably" true.</p> <p><b>Methods:</b> Modified experimental. Theory verification. Methods chosen must fit the subject matter, quantitative or qualitative.</p> |

|   |   |
|---|---|
| <p><b>Constructivism/Interpretivism</b></p> | <p><b>Ontology:</b> Relativist. Multiple participant meanings. Socially constructed, subjective, may change.</p> <p><b>Epistemology:</b> Subjectivist/transactional, created findings. Focus upon the details of situation, the reality behind these details.</p> <p><b>Methods:</b> Small samples, in-depth investigations, Qualitative. Theory generation.</p>  |
| <p><b>Pragmatism</b></p>                    | <p><b>Ontology:</b> External, multiple, view chosen to best enable answering of research question.</p> <p><b>Epistemology:</b> Focus on practical applied research, integrating different perspectives to help interpret the data. Pluralistic.</p> <p><b>Methods:</b> Problem centered. Real-world practice oriented by whatever methods are most appropriate, and tends toward changes in practice. Mixed or multiple method designs, quantitative and qualitative.</p> |

*Created from the work of Guba and Lincoln (1994, pp. 109 & 112), Creswell (2009) and Saunders et al. (2009, p.119).*

### 3.2.5 Paradigm for this Study

As researchers, we come to our inquiry with particular beliefs about what knowledge is, what is knowable, and how we can go about gaining knowledge. This leads to the selection of a framework within which to conduct research. The interpretivism/constructivism paradigm was deemed as the most appropriate framework for conducting this research as it was concerned with understanding the meanings behind social actions from the subjective experiences of individuals. Additionally, the study sought to use meaning (versus measurement) oriented methodologies without predefining dependent and independent variables, focusing on the full complexity of human sense making as the

situation emerged (Kaplan & Maxwell, 1994). The interpretive approach can generate new knowledge and provide valuable information for future work and practice.

Having selected the interpretivism/constructivism paradigm as the most appropriate framework for this research, it was necessary to choose an approach with which to conduct the research.

### **3.3 Research Approaches**

Research approaches can be classified as quantitative, qualitative and mixed methodology (Creswell, 2009). In selecting an approach, researchers must consider the research approaches that are suitable for their particular research problem. Evered and Louis (1981) clarify the assumptions that ground each by distinguishing two research stances: “inquiry from the outside”, often implemented via quantitative studies and “inquiry from the inside” via qualitative studies.

#### **3.3.1 Qualitative research**

Qualitative research is a form of systematic empirical inquiry into meaning (Shank, 2002 p. 5). Systematic refers to “planned, ordered and public” that is, following rules agreed upon by members of the qualitative research community. Empirical, means that the type of inquiry is grounded in the world of experience. Inquiry into meaning, says researchers try to understand how others make sense of their experience. Similarly, Denzin and Lincoln (2000) claim that qualitative research involves an *interpretive and naturalistic* approach: “This means that qualitative researchers study things in their natural settings, attempting to make sense of, or to interpret, phenomena in terms of the meanings people bring to them” (Denzin & Lincoln, 2000 p. 3). A qualitative research approach is used to acquire knowledge and have an in-depth understanding of a problem in its natural setting (Creswell, 1994; Howitt & Cramer, 2005). It is therefore a means for exploring and understanding the meaning individuals or groups ascribe to a social or human problem. This approach investigates the *why* and *how* of decision making, not just *what*, *where* and

when with the researcher's role being that of an *active learner* who can tell the story from the participants' view rather than as an "expert" who passes judgment on participants.

The process of research involves emerging questions and procedures, collection of participant meanings, data typically collected in the participant's setting, data analysis inductively building from particulars to general themes, and the researcher making interpretations of the meaning of the data. The final written report has a flexible structure. Those who engage in this form of inquiry support a way of looking at research that honours an inductive style, a focus on individual meaning, and the importance of rendering the complexity of a situation (adapted from Creswell, 2007).

An inductive approach involves collecting data and developing theory as a result of data analysis, in other words, it is 'a theory-building process'. The qualitative approach is more interested in gaining a large amount of information from a small number of people or organisations (utilising qualitative data gathering techniques such as one-on-one interviews) than gathering a small amount of data from a large sample of people or organisations (utilising quantitative data gathering techniques such as phone surveys) (Ticehurst & Veal, 2000). Hence, smaller but focused samples are more often needed than large samples. This approach "is based on the belief that a full and rounded understanding of the organisational experiences and situations of a few individuals, however unrepresentative they may be, is of more value than a limited understanding of a large representative group" (Ticehurst & Veal, 2000, p. 21).

### **3.3.2 Quantitative research**

Quantitative research is a means for testing objective theories by examining the relationship among variables. A quantitative approach is one in which the researcher primarily uses postpositive claims for developing knowledge (i.e., cause and effect thinking, reduction to specific variables and hypotheses and questions, use of measurement and observation, and the test of theories) (Creswell, 2008). These variables, in turn, can be measured, typically on instruments, so that numbered data can be analysed using statistical procedures.

Those who engage in this form of inquiry have assumptions about testing theories deductively, which are concerned with developing a hypothesis (or hypotheses) based on existing theory, and then designing a research strategy to test the hypothesis. It also involves building in protections against bias, controlling for alternative explanations, and being able to generalize and replicate the findings. In a nut shell, quantitative research seeks to establish a comparison of groups or relationships between variables, with the intent of establishing an association, relationship, or cause and effect with the aim of a generalisation (Creswell, 1998). A deductive approach ‘begins with and applies a well-known theory’ and this type of approach is often associated with the quantitative type of research’ (Ghuri & Grøhaug, 2005: 15). This type of research uses standards of validity and reliability (Creswell, 2008). A potential weakness of quantitative research is “the reduction of what are essentially human processes in business to numbers may miss identifying the real forces at work surrounding the research problem”, (Cavaye et al., 2002, p. 7-1). This weakness can be addressed by adopting a qualitative approach to data gathering.

### **3.3.3 Mixed methods research**

This approach to inquiry combines both qualitative and quantitative forms. It involves more than simply collecting and analysing both kinds of data but uses both approaches in tandem so that the overall strength of a study is greater than either qualitative or quantitative research (Creswell & Plano Clark, 2007). The mixed methods approach is used when the researcher wants both generalisation and a detailed view of the meaning of phenomenon or concept for individuals (Creswell, 2008). The three approaches are summarised in the Table 3.2 on the following page.

Table 3.2 Qualitative, Quantitative and Mixed Method Approaches

| <b>Tend to or Typically</b>                | <b>Qualitative Approaches</b>  | <b>Quantitative Approaches</b>                                 | <b>Mixed Method Approaches</b>   |
|--|--|--|--|
| <i>Use these philosophical assumptions</i> | Post-positivist, Constructivist,                                       | Positivist, post-positivist                                    | Constructivist, Pragmatic  |
| <i>Employ these strategies of inquiry</i>  | Phenomenology, grounded theory, ethnography, case study, and narrative | Surveys and experiments  | Sequential, concurrent, and transformative   |
| <i>Employ these methods</i>                | Open-ended questions, emerging approaches, text or image data          | Closed-ended questions, Predetermined approaches, numeric data | Both open- and closed-ended questions, both emerging and predetermined approaches, and both quantitative and qualitative data and analysis |

Source: Creswell (2008, p. 17)

### 3.3.4 Conclusion

This study was best suited to a qualitative research approach as it sought to acquire knowledge and have an in-depth understanding of a problem in its natural setting (Creswell, 1994; Howitt & Cramer, 2005).

Qualitative research was also suitable for this study because firstly, the research question sought to answer “*how*” and “*why*” questions. Secondly, the researcher’s role was that of an *active learner* who can tell the story from the participants' view rather than as an "expert" who passes judgment on participants. Finally, as most previous studies on this topic have been quantitative in nature and have resulted in contrasting and inconclusive

results, the researcher felt the need to present a detailed view of the topic which a qualitative study would provide.

Quantitative research seeks to establish a comparison of groups or relationships between variables, with the intent of establishing an association, relationship, or cause and effect with the aim of a generalisation (Creswell, 1998). As this study sought to get a detailed view of the phenomenon under study as opposed to a generalisation, a quantitative approach was not considered appropriate.

Mixed methods research was also rejected as a research approach because it had been established that quantitative research, which is a significant component of mixed methods research, is unsuited to this research. The mixed methods approach is used when the researcher wants both generalisation and a detailed view of the meaning of a phenomenon.

### **3.4 Research Design**

Apart from selecting an approach to a study, a researcher also decides on the strategy of inquiry or research design to employ within the approach chosen (Creswell, 2008). A research design is a plan or proposal to conduct research which spans the decisions from broad assumptions to detailed methods of data collection and analysis (Creswell, 2008). In planning a study, researchers need to think through the philosophical worldview assumptions that they bring to the study, the strategy of inquiry that is related to this worldview, and the specific methods or procedures of research that translate the approach into practice. In literature, the term design is sometimes used to refer to strategies of inquiry (Denzin & Lincoln, 2011), approaches to inquiry (Creswell, 2007) and research methodologies (Mertens, 1998). Within the qualitative research approach, there are five specific types of research design: phenomenology, ethnography, case study, grounded theory and historical research. The key ideas of each of these is provided and a detailed discussion of the research design chosen for this study.

Phenomenology involves an attempt to understand how one or more individuals *experience* a phenomenon. It is the study of the subjective experiences of others. It researches the world through the eyes of another person by discovering how they interpret their experiences. The researcher's goal is to enter the inner world of each participant to understand his or her perspectives and experiences.

Ethnography literally means "writing about people." Ethnography is the study of human interaction and communities through direct participation and observation within the community you wish to study. Ethnographers are interested in describing the culture of a group of people and learning what it is like to be a member of the group from the perspective of the members of that group and as such document things like the shared attitudes, values, norms and practices. Ethnographers try to use holistic descriptions; that is, they try to describe how the members of a group interact and how they come together to make up the group as a whole. In other words, the group is more than just the sum of its parts.

Grounded theory research is a qualitative approach to generating and developing a theory from the data you collect in a research study. Historical research is about people, places, and events in the past. This type of research is sometimes called narrative research because it studies "the text of history," and it often presents its results through stories or narratives.

In case study research, the researcher provides a detailed account of one or more cases. Although case study research usually relies on qualitative data, multiple methods are also used. Case study research can be used to address exploratory, descriptive, and explanatory research questions (Stake, 1995; Yin, 1994). Case study research is more varied than phenomenology, which focuses on individuals' experience of some phenomenon; ethnography, which focuses on some aspect of culture; historical research which focuses on events in the past; or grounded theory, which focuses on developing an explanatory theory. What all pure case studies do have in common, however, is a focus on each case as a whole unit (i.e., case study research is holistic) as it exists in its real-life context.

### 3.4.1 Case Study

Consistent with the constructivist research paradigm and qualitative research approach, a case study design was employed for this study. Case studies are used when a researcher wishes to explore in depth a program, an event, an activity, a process, or one or more individuals. In the current study the researcher wished to explore in depth the SME lending process and allow alternative findings to be found; which is a key difference from the hypothetico-deductive approach that guides quantitative research. In trying to verify hypotheses, quantitative researchers have finite ideas, prior to starting research, about the scope and aims of their projects. Qualitative researchers, working in the context of discovery, are more open-ended, and often follow emergent empirical and conceptual findings in unexpected ways. Both research strategies offer possibilities for generalization, but about different things, and both approaches are theoretically valuable (Adler & Adler in Baker & Edwards, 2012).

Yin (2009) advocates that a case study design should be considered when the research question is in the form of “*why*” or “*how*”, the researcher has little control over events and the focus is on a contemporary phenomenon within a real-life context. A case study provides a deep investigation of a real-life contemporary phenomenon in its natural context (Woodside, 2010; Yin 2012) and gives an emic or insider’s view of the practices of the case organizations (Sarantakos, 2005). The case study design also suited the current study as the research question was in the form of “*why*” or “*how*”, the researcher had little control over events and the focus was on the SME lending process. Further, the study was carried in the natural context of the SME lending process, the bank premises. Yin (2004) and Stake (1995) describe a variety of case studies by using different terms. Yin (2004) categorizes case studies as explanatory, exploratory, or descriptive. He also differentiates between single, holistic case studies and multiple-case studies. Stake (1995) identifies case studies as intrinsic, instrumental, or collective. These types of case studies and their definitions are provided in Table 3.3 on the next page.

Table 3.3 Types of Case Studies

| Case Study Type       | Suitability  |
|-----------------------|--|
| Explanatory           | This type of case study would be used if you were seeking to answer a question that sought to explain the presumed causal links in real-life interventions that are too complex for the survey or experimental strategies. In evaluation language, the explanations would link program implementation with program effects.  |
| Exploratory           | This type of case study is used to explore those situations in which the intervention being evaluated has no clear, single set of outcomes.  |
| Descriptive           | This type of case study is used to describe an intervention or phenomenon and the real-life context in which it occurred.  |
| Multiple-case studies | A multiple case study enables the researcher to explore differences within and between cases. The goal is to replicate findings across cases and because comparisons will be drawn, it is imperative that the cases are chosen carefully so that the researcher can predict similar results across cases, or predict contrasting results based on a theory.  |
| Intrinsic             | Researchers who have a genuine interest in the case should use this approach when the intent is to better understand the case. It is not undertaken primarily because the case represents other cases or because it illustrates a particular trait or problem, but because in all its particularity and ordinariness, the case itself is of interest. The purpose is NOT to come to understand some abstract construct or generic phenomenon. The purpose is NOT to build theory (although that is an option). |

|              |   |
|--------------|---|
| Instrumental | Is used to accomplish something other than understanding a particular situation. It provides insight into an issue or helps to refine a theory. The case is of secondary interest; it plays a supportive role, facilitating our understanding of something else. The case is often looked at in depth, its contexts scrutinized, its ordinary activities detailed, and because it helps the researcher pursue the external interest. The case may or may not be seen as typical of other cases. |
| Collective   | Collective case studies are similar in nature and description to multiple case studies.   |

*Adopted from Baxter and Jack (2008)*

A multiple case study was selected to conduct this study so as to explore differences within and between cases in order to obtain a more comprehensive understanding of the phenomenon under study (Wahyuni, 2012). The goal was to replicate findings across cases and because comparisons were to be drawn, it was imperative that the cases were chosen carefully so that the researcher could predict similar results across cases, or predict contrasting results based on a theory (Yin, 2004). Using multiple case studies can identify consistent patterns of behavior and uncover new and/or divergent themes. Apart from enabling the researcher to see the differences and similarities among the cases, it will also increase the level of assurance of the findings. Miles and Huberman (1994) argue that evidence from multiple cases adds “confidence” to the research findings while (Herriot & Firestone, 1983; Yin 2004) add that the evidence from multiple cases is often more compelling and the overall study is therefore considered more robust.

The benefits of using a multiple case study design are firstly, it can identify consistent patterns of behaviour and uncover new and/or divergent themes. Secondly, it enables the researcher to see the differences and similarities among the cases and increases the level of assurance of the findings. Thirdly, even though the purpose of a case study is not to generalise the findings, this may be possible with the use of multiple cases.

Finally, a cross sectional multiple case study was employed as data was collected from each case at one point in time.

### **3.5 Data Collection Procedure**

#### **3.5.1 Case Sites**

Case study research is not sampling research (Yin, 1994). However, selecting cases must be done so as to maximize what can be learned in the period of time available for the study (Tellis, 1997).

The focus of this study was commercial banks in Kenya that are involved in SME lending. As there is no public database of commercial banks in Kenya that are engaged in SME lending, the study used an annual survey of commercial banks in Kenya that includes a category of banks whose main focus is SMEs. This annual survey, which is carried out by Think Business Limited, ranks banks based on their significance in the Kenyan SME market. Think Business Limited is a leading strategic business intelligence, research and publishing company in Kenya that specializes in the financial sector. Their objective is to encourage prudence and stability in the banking sector by recognizing, awarding and celebrating exemplary performers and successes of the sector, consequently encouraging competition. Think Business Limited also publishes “Banking Survey”, which has been in publication annually for fourteen years (Banking Survey, 2013).

Commercial banks are ranked in various categories with Think Business publishing the top three banks in each of these categories. The category “Best Bank in SME Banking” is open to all banks whose focus is mainly on SME banking. First, they are assessed on the basis of their financial soundness using eight key financial ratios which measure asset quality, liquidity and earnings. These eight parameters are return on average assets, return on average core capital, cost of funds, efficiency ratio (cost income ratio), total non-performing loans to total advances, non-performing loans provision to operating income, core capital to total deposits and quick assets to total liabilities. The judges then subject a

shortlist of the top ten, to further scrutiny based on the following weighted scores: customer numbers, average loan size, product offering to SME segment, ICT application, customer satisfaction and tariff rates to SME customers (Banking Survey, 2013).

Commercial banks that have for the last five years (2010-2014) ranked top three in the category “Best SME Bank” were considered for this study (Banking Survey, 2010-2014). However, as there was no ranking for 2010 because of a lack of entries for that category, the year 2009 was incorporated in the study. As some banks have consistently been ranked amongst the top three in the five years under study, this resulted in a total of eight commercial banks for this study. Apart from the banks ranked as a result of this survey, additional considerations for inclusion in this study were those banks that were considered as competitors in the SME market by the ranked banks and finally, their willingness to participate and allow the research to take place in their natural environment. These additional banks were identified during the interview process with respondents from the ranked banks. This resulted in an additional one bank for inclusion in the study as respondents also stated some of the already ranked banks as their competitors. In consideration of all of the above, one bank out of those ranked had been closed by the Central Bank of Kenya and one bank was not willing to participate in the study, therefore these two banks were excluded from the study. As such the final tally for inclusion in the study was seven commercial banks.

### **3.5.2 Unit of Analysis**

The unit of analysis is a critical factor in the case study. It is typically a system of action rather than an individual or group of individuals. Case studies tend to be selective, focusing on one or two issues that are fundamental to understanding the system being examined (Tellis, 1997).

The unit of analysis was the SME lending process from beginning (introduction of SME client) to the end (disbursement of loan).

### **3.5.3 Participants/Respondents of the Study**

SME bank managers were the preferred participants/respondents and in order to access these participants, the researcher used snowball purposive sampling which is an approach for locating information-rich key informants or critical cases (Patton, 1990). This involved initially seeking a known banker to recommend and refer an SME bank manager in one of the case sites.

The number of interviews required to ensure a credible research picture has been the subject of much debate and comment within literature. De Ruyter and Scholl (1998) suggest a range of 15 to 40 interview participants, which agrees with Bertaux's (1981) earlier guideline of 15 being the smallest number of participants for a qualitative study irrespective of the methodology; while Ritchie, Lewis, & Elam (2003) suggest that samples should "lie under 50". Mason (2010) carry out a content analysis to identify the number of interview participants in PhD studies which used qualitative (i.e. structured; semi-structured or unstructured) interviews as a method of data collection. They use a comprehensive published listing of 532,646 British theses accepted annually for higher degrees by some of the most prestigious educational institutions in the world; the Universities of Great Britain and Ireland. The results indicated that eighty per cent of the total proportion of qualitative studies met Bertaux's (1981) guideline of 15 being the smallest number of participants, while 45% met Charmaz's (2006) guideline of up to 25 participants being "adequate" (p.114). A third of the studies (33%) used sample sizes of 20 or under (Green & Thorogood, 2009) while 85% met Ritchie et al.'s (2003) assertion that qualitative samples "often lie under 50" (p.84).

Further, to resolve the numbers debate, Patton (1990) suggests that as qualitative inquiry is rife with ambiguities, there are no rules for sample size and it depends on "what you want to know, the purpose of the inquiry, what's at stake, what will be useful, what will have credibility, and what can be done with available time and resources" (Patton, 1990, p. 244). It is in this line that Lincoln and Guba (1985) and, Green and Thorogood (2009) recommend sampling to the point of redundancy. Green and Thorogood (2009) find that the experience of most qualitative researchers is that they find little new information after

interviewing 20 or so people. Similarly, Mason (2010) posits that although a number of issues can affect the sample size in qualitative research, the guiding principle should be the concept of saturation.

In order to reach a consensus on participant numbers, this study gave strong consideration to Patton's (1990) and Mason's (2010) recommendations. While carrying out the interviews for this study, the point of redundancy or saturation began to be felt during the 12<sup>th</sup> interview, as there was little new information emerging. Interestingly, this number is deemed sufficient by Guest, Bunce, and Johnson (2006) who argue that twelve interviews suffice for most researchers when they aim to discern themes concerning common views and experiences among relatively homogeneous people. However, so as to keep in line with the minimum number of interviews recommended in literature for such a study, the researcher undertook four more interviews and carried out sixteen interviews in total which was in agreement with the recommendations of Bertaux's (1981), De Ruyter and Scholl (1998) and Ritchie et al. (2003).

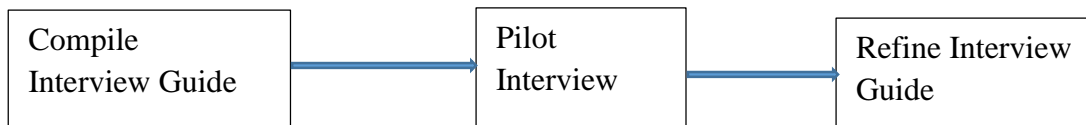
#### **3.5.4 The Research Instrument**

According to Yin (2004), interviews are one of the most important sources of evidence and defines it as a two- way conversation that gives the interviewer the opportunity to participate actively in the interview and allows the participant to interpret and describe the phenomenon in their own way. The semi-structured interview, often referred to as 'qualitative research interview' (King, 2004), is 'non standardised' in the sense that researcher will have a list of themes and questions to be covered, although these may vary from interview to interview. This means that some questions may be omitted in particular interviews, given a specific organisational context that is encountered in relation to the research topic. The order of questions may also vary depending on the flow of the conversation. Further, additional questions may be required to explore your research question and objectives given the nature. This quality of semi structured interviews is an advantage that allows the researcher to explore interesting insights as they arise. Another advantage of semi-structured interviews is that they provide the researcher with an opportunity to 'probe' answers, where you want your interviewees to explain, or build on

their responses. This is important when adopting an interpretivist epistemology, where your concern is to understand the meanings that participants ascribe to various phenomena. The disadvantage is that there may be concerns about confidentiality by respondents and a reluctance to share sensitive information regarding the research topic.

Guided by the gaps in literature, the researcher compiled a set of semi structured interview questions and selected the participants. Pilot interviews were then conducted in order to validate the qualitative interview approach, to test the usability of the interview guide and to test the level of understanding of the interview questions by the interviewees (Ghauri et al., 1995). The outcome of this process was the preparation of the final interview guide (see Appendix 4). The process the researcher went through in preparing the interview guide is illustrated below:

Figure 3.1 Interview Guide Preparation



*Source: Researcher's own*

### 3.5.5 Data Collection

Primary data was collected through in-depth semi structured interviews with SME bank managers in the selected commercial banks. The interviews were pre-arranged through an email and/or telephone call to confirm the date and time and were conducted over a period of eight months between January 2015 and August 2015. The interviews were all conducted in English and held at the respective bank offices to preserve the business atmosphere and maintain the language of banking. The researcher first thanked the participant for according the time to hold the interview and then started off the interview with a brief explanation of the aim of the study and why the interview method of data collection was preferred while emphasising the confidentiality, anonymity and the voluntary nature of the study. The researcher also explained why the interview needed to be recorded and then proceeded to request to record interviewee. The participant was then

given a consent form which was signed off by both respondent and the researcher. Besides recording the interview, the researcher also took notes during and soon after each interview to record salient information in the form of research memos. Where audio recording was not permitted, the interviewer took substantial notes. The duration of the interviews was between forty five to one hundred and twenty minutes (two hours). After each interview, a debriefing was performed during which the participants were given the opportunity to ask questions, make comments or add any information that was not discussed during the interview and may be relevant to the discussion held (Wahyuni, 2012). Triangulation, through further interviews with at least two other SME bank managers in the same bank, provided verification of the key findings (Miles and Huberman, 1994).

### 3.6 Data Analysis

The nature of the qualitative data has implications for its analysis. The non-standardised and complex nature of the data that is collected means that it needs to be condensed (summarised), grouped (categorised) or restructured as a narrative to support meaningful analysis; otherwise the most that may result may be an impressionistic view of what they mean. Table 3.4 below highlights three distinct differences between quantitative and qualitative data.

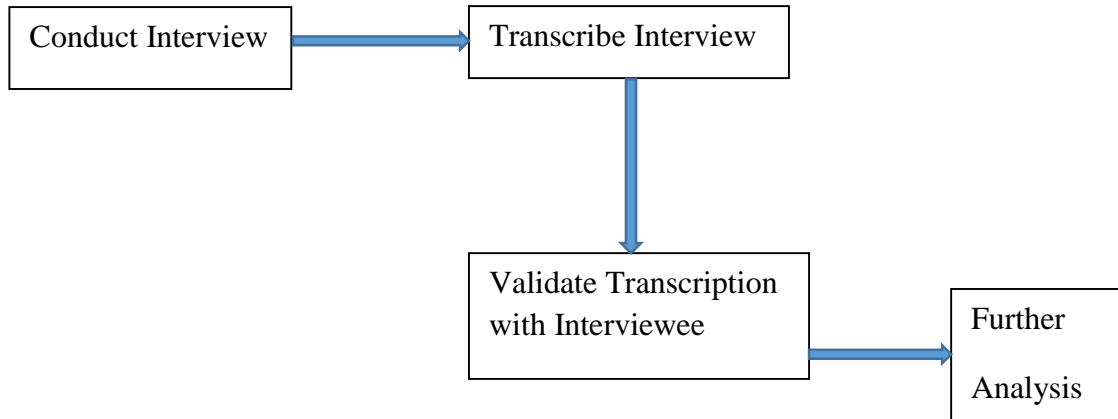
Table 3.4 Differences between Quantitative and Qualitative Data

| Quantitative   | Qualitative   |
|--|---|
| <b>Based on meanings derived from numbers</b>                        | Based on meanings expressed through words   |
| <b>Collection of results in numerical and standardised data</b>      | Collection of results in non-standardised data requiring classification into categories |
| <b>Analysis conducted through the use of diagrams and statistics</b> | Analysis conducted through the use of conceptualisation                                 |

*Developed from Dey (1993) and Healey and Rawlinson (1994).*

Qualitative data analysis begins at the same time as data is collected and continues afterwards (Kvale, 1996). All interviews were first transcribed verbatim. At this stage the researcher also used two research assistants to assist with the transcription of the interviews. The researcher read through all the transcripts while listening to the recorded interviews to ensure they were correctly transcribed. The transcripts were then sent to the respondents/participants for validation. None of the participants expressed concern with the content of the transcription and therefore no changes were made to the transcripts. Upon validation of the transcripts, further data analysis proceeded. This process is illustrated in figure 3.2 below.

Figure 3.2 Interview Validation (Initial Data Analysis)



*Source: Researcher's own*

Miles and Huberman (1994) explained qualitative data analysis as consisting of three concurrent flows of activity: data reduction, data display and conclusion drawing and verification. Data reduction refers to the process of selecting, focusing, simplifying, abstracting and transforming the data that appear in written-up field notes or transcription. Data display refers to assembling organised information into immediately accessible, compact form so that the analyst can see what things mean (Miles & Huberman, 1994, p.11). Conclusion drawing and verification is where the qualitative analyst begins to decide what things mean; noting regularities, patterns, explanations, possible configurations, causal flows and propositions (Miles & Huberman, 1994, p.11). Another important process after conclusions are made is to verify them. According to Miles &

Huberman (1994. p.11) “The meanings emerging from the data have to be tested for their plausibility, their sturdiness, and their “conformability”-that is their validity.” They further pointed out that there are two types of data analysis: within case analysis and cross-case analysis. The within case analysis is carried out when collected data in a single case is compared with the theory included in the frame of reference to identify the differences and similarities. In the cross-case analysis where several cases are involved, the objective is not only to compare those cases with each other but also to be able to generalize. The study employed Miles and Huberman’s (1994) three concurrent flows of activity: data reduction, data display and conclusion drawing and verification and further carried out a cross case analyses as several cases were involved. The first step of analysis involved a within case analysis to identify differences and similarities between respondents and also as a way of validating the data collected for each case (bank). The second step was the cross-case analysis which involved comparing data between the cases so as to further reduce the data and also compare the resulting data with the theory included in the frame of reference to identify the differences and similarities.

Content analysis was the preferred method for analysing the interview data collected for this study. Julien (2008) defines content analysis as the intellectual process of categorizing qualitative textual data into clusters of similar entities, or conceptual categories, to identify consistent patterns and relationships between variables or themes. This definition places content analysis in the scope of the interpretative research paradigm. Further Mayring (2000) in Wahyuni (2012) specifies that qualitative content analysis is an approach of empirical, methodological controlled analysis of texts within their context of communication, following the step by step content analysis rules. Content analysis is a method that is independent of theoretical perspective or framework (e.g., grounded theory, phenomenology) but has its beginnings as a quantitative method. Where quantitative content analysis is helpful in answering “what” questions, qualitative content analysis can be helpful in answering “why” questions and analyzing perceptions. Qualitative content analysis concentrates on portraying reality by discovering meanings from the textual data (Silverman, 2011 in Wahyuni, 2012).

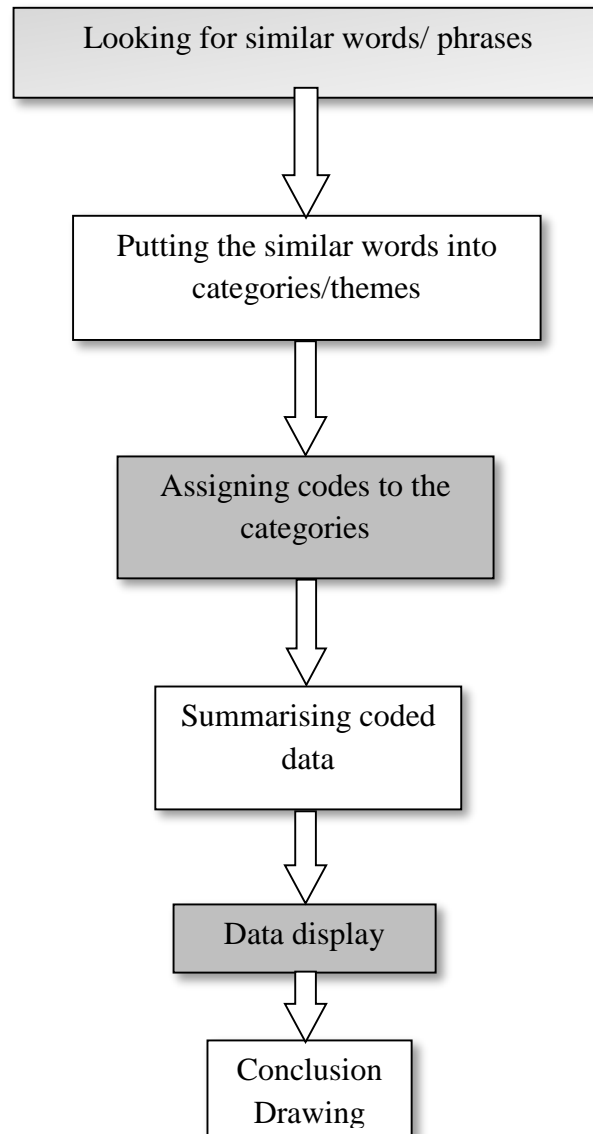
When analyzing qualitative data such as interview transcripts, analyses across the whole set of data typically produce clusters or codes that translate into “themes.” Themes may have been identified a priori, so that the researcher seeks evidence for participants’ expressions relating to those themes, or may simply emerge from the analysis of the transcripts (Julien, 2008). The level at which content analysis occurs varies widely, from obvious surface-level groups of similar responses to a particular interview question to deeper inductive insights inferred from more sustained, iterative, and recursive interaction with textual data. For example, the varying connotations associated with particular words used by participants, or the degrees of enthusiasm expressed about an issue, are open to content analysis. Regardless of the level at which analysis occurs, the fundamental principle is that content is recognized. In the case of the written word, that content is often subject related (i.e., analyses refer to the “aboutness” of text). Thus, content analysis is useful for identifying both conscious and unconscious messages communicated by text (i.e., what is stated explicitly as well as what is implied or revealed by the manner in which content is expressed). This is typical with the inductive style or nature of the qualitative approach; to begin with deep close reading of text and attempt to uncover the less obvious contextual or latent content therein. The results of a content analysis may reveal recurrent instances of “items” or themes, or they may reveal broader discourses. The “categories” or clusters of data identified may represent discrete instances (i.e., something is apparent or not), or they may be represented as degrees of attributes, such as direction and intensity, or qualities (i.e., a quality such as joy is evident to some degree rather than simply present or absent). Identifying themes or categories is usually an iterative process, so the researcher spends time revisiting categories identified previously and combining or dividing them, resolving contradictions, as the text is analyzed over and over.

Sarantakos (1998) suggests a five step qualitative data analysis methodology which is consistent with the approaches espoused by Miles and Huberman (1994), yet is designed specifically for the analysis of qualitative interview data. These five steps are transcription, checking and editing, analysis and interpretation, generalisation and, verification. Marshall and Rossman (1999, p. 152) outlined a six step qualitative data analysis model: i) organising the data; ii) generating categories, themes, and patterns; iii)

coding the data iv) testing the emergent understandings; v) searching for alternate explanations; and vi) writing the report.

Incorporating the approaches proposed above, the content analysis for this study proceeded as follows: first, the researcher began by a deep reading of the text followed by a search for similar words or phrases that were stated by the interviewees. Second, the similar words and phrases were put into categories/themes. The generation of themes was twofold; some themes had been identified a priori and the researcher sought evidence for participants' expressions relating to those themes, additionally the researcher also allowed new themes to emerge from the analysis of the transcripts. The third step in the analysis involved the assignment of codes representing the core topic of each category. The assignment of codes was followed by the fourth step which involved the reduction of data by condensing it into summaries/paraphrases. Finally, the resulting data was displayed in rich verbatim text in tables and from these tables, data was further analyzed to produce summaries that enabled conclusions to be drawn. The steps described above, which were followed in the analysis of the content from the interview transcripts, are diagrammatically represented in figure 3.3 on the following page.

Figure 3.3 Steps in the Content Analysis



*Researcher's own*

### **3.7 Research Quality-Validity, Reliability and Objectivity of Research**

The traditional concepts of validity and reliability fit well in the quantitative research landscape whose results aim at replicability and generalizability. Qualitative research operates in a completely different domain as it seeks to produce credible knowledge of interpretations on organisation with an emphasis on uniqueness and context (Parker,

2012). As such, the rigour of qualitative research has been the subject of continuous discussion in literature (Denzin & Lincoln 2005). Lincoln and Guba (1985) and, Guba and Lincoln (1989) developed four criteria for judging the soundness of qualitative research; credibility, transferability, dependability and confirmability. They felt that these criteria better reflected the underlying assumptions involved in much qualitative research and explicitly offered these as an alternative to more traditional quantitatively-oriented criteria. The proposed criteria and the "analogous" quantitative criteria are listed in the table below.

Table 3.5 Traditional and Alternative Criteria for Judging Qualitative Research

| <b>Traditional Criteria for Judging Quantitative Research</b> | <b>Alternative Criteria for Judging Qualitative Research</b> |
|---|--|
| <b>Internal Validity</b>                                      | Credibility  |
| <b>External Validity</b>                                      | Transferability  |
| <b>Reliability</b>  | Dependability  |
| <b>Objectivity</b>  | Confirmability   |

Source: Lincoln and Guba (1985)

### 3.7.1 Research Validity

Validity refers to the extent to which the results of a study reflect the social phenomena being observed and is reflected by the credibility and transferability of the study (Bryman, 2012; Kalof, Dan, & Dietz, 2008). *Credibility* parallels internal validity while *transferability* resembles external validity. *Credibility* deals with the accuracy of data to reflect the observed social phenomena, in other words, whether the study actually measures or tests what it is intended. The careful selection of case organisations is considered as the first practical step towards credibility in case study research. The cases selected for this study were those that voluntarily participated in an annual banking survey of banks that included a category of banks that deal with SMEs. Bryman (2012) suggests that in subsequent meetings with participants, the interim results from the previous interview can be discussed as a method of respondent validation. The transcribed interview was sent to the interviewee for validation before continuing with the data

analysis process. Further, the triangulation approaches of *data triangulation*, *method triangulation* and *evaluator triangulation* enhance the credibility of research findings. Evaluator triangulation, also known as peer debriefing, is not only useful at the data analysis stage to check the consistency of data coding but also in identifying other perspectives which may have been overlooked by the researcher. The researcher attempted to carry out three interviews in each case site with three different respondents to enhance evaluator triangulation. The table below illustrates the strategies that were used to enhance credibility of the study.

### 3.7.1.1 Credibility

Table 3.6 Credibility

| Strategy                     | Description   |
|------------------------------|---|
| Selection of case banks      | Ranked top three in the category “Best SME Bank” in annual banking survey                             |
| Respondent review/validation | Ask each respondent to review researcher's synthesis of all interviews for accuracy of representation |
| Evaluator Triangulation      | Carry out further interviews with at least two other respondents in the same institution              |

*Adapted from: McMillan and Schumacher (1997)*

### 3.7.1.2 Transferability

*Transferability* refers to the level of applicability into other settings or situations. Lincoln and Guba (1985) suggest that a rich and thick explanation of research sites and characteristics of case organisations should be provided to enhance transferability. While it is certain that the data from a qualitative study is not reproducible, it is not impossible to apply a qualitative study in a different setting. In line with McMillan and Schumacher (1997), the strategies that were used to enhance transferability of this study were maintaining a field log containing a log of dates, time, places, persons and activities carried out to obtain access to informants for each data set collected.

### **3.7.2 Reliability and Confirmability**

Reliability refers to the consistency of measures used. The traditional quantitative view of reliability is based on the assumption of replicability or repeatability. Essentially, it is concerned with whether we would obtain the same results if we could observe the same thing twice. But we cannot actually measure the same thing twice as by definition if we are measuring twice, we are measuring two different things. In order to estimate reliability, quantitative researchers construct various hypothetical notions (e.g., true score theory) to try to get around this fact. Qualitative research requires a more refined elucidation of reliability. Terms such as “rigour”, “trustworthiness”, “defensibility” and “dependability” may better describe the pursuit of reliability in qualitative studies (Golafshani, 2003; Wahyuni, 2012).

The idea of dependability, on the other hand, concerns taking into account all the changes that occur in a setting and how these affect the way research is being conducted. Dependability can be achieved by a detailed explanation of the research design and process to enable future researchers to follow a similar research framework. It should be noted that the application of the research model by a future researcher is not necessarily targeted at getting a similar result. Dependability was first assured by offering a detailed explanation of the research design and process so that future researchers could follow a similar research framework. Secondly, dependability was assured by using an accurate research instrument that had been pretested in a pilot study, and refinements and clarifications made, prior to using it for the final interviewees at the selected commercial banks.

Confirmability refers to the extent to which others can confirm or corroborate the findings in order to ensure that the results reflect the understandings and experiences from observed participants, rather than the researcher’s own preferences. In addition to triangulation methods, Lincoln and Guba (1985, p.317) suggest using an ‘inquiry audit’ to enhance confirmability. Documentation on data and progress of research therefore should be carefully kept in the form of research memos and interim summaries as parts of the research working book. This research record serves to provide an audit trail which enables

an examination of both the research process and research outputs by tracing out the step-by-step course of the research. Peer assistance to cross check the coding development and application can also be aimed at confirmability. To ensure confirmability, the researcher kept a research record of the research process. Peer cross check during the research process was also carried out during the supervision process by both supervisors of the researcher.

### **3.8 Ethical Considerations**

Participants were well informed about the study, most importantly; who the researcher was, the purpose of the research and what the research was about. The researcher also informed the participants of the potential benefits of participating in the study which encouraged the free flow of information without fear of negative consequences. Participants were also informed that data needed to be collected using the interview method, preferably in the respondent's business premises. They were assured of confidentiality through a letter from the university, given to them, providing assurance that the results of the research would be used for no other purpose than for the said research. Finally, they were requested to give an informed consent that allowed the researcher to use the data collected after verification of the same.

The following procedures were also used to help reduce risk and maximize confidentiality: *Firstly*, raw and processed data was kept under lock and key and if in soft form, it was password protected. *Secondly*, after transcription of each interview and validation of the same, the interview data was displayed in rich text with an identification given that cannot be traced back to the actual bank or participant. *Thirdly*, data was reported in an aggregate manner without disclosing the position of an individual bank. *Lastly*, data was only shared with those who are part of the study team (researcher, research assistant and the two supervisors).

### **3.9 Chapter Summary**

This chapter provided a justification for the research paradigm within which this study was considered. Having selected the interpretivist research paradigm, an appropriate research approach, and research design within this approach, was selected. As the research sought to explore whether relationships do matter in the SME lending process and to determine the benefits that banks gain from lending to SMEs, the case study methodology was found to be the most suitable design to conduct this study using a qualitative approach within the interpretivist research paradigm. The research instrument found most suitable to conduct this study was the semi structured interview as a two- way conversation gave the interviewer the opportunity to participate actively in the interview and allowed the participant to interpret and describe the phenomenon in their own way. Finally, data was analysed by way of content analysis. The chapter concluded with a discussion on research quality and the ethical considerations made while conducting the study.

## **CHAPTER FOUR: PRESENTATION OF RESEARCH FINDINGS**

### **4.1 Introduction**

This chapter presents data collected from sixteen respondents representing the seven banks in the study and follows the data analysis process prescribed by Miles and Huberman (1994) in section 3.6 of this thesis. Miles and Huberman (1994) explain qualitative data analysis as consisting of three concurrent flows of activity: data reduction, data display and conclusion drawing and verification. This chapter comprises of the first two flows of activity, data reduction and data display where the output of the semi-structured interviews is reduced and displayed in accordance to their relevance to the three research questions of the study. Data is presented in this section as follows: section 4.2 presents data on the background of the respondents and 4.3 the SME lending process. Sections 4.4 through to 4.6 present data relevant to the three research questions as follows; 4.4 examines how borrower knowledge is acquired, transferred and used by a bank to make the SME lending decision, 4.5 investigates the role of transaction lending and relationship lending and the interplay of the two methods in making the SME lending decision and 4.6 establishes the value generated from engaging in SME lending by commercial banks in Kenya. In presenting the data, any identifiers of the bank or respondent that is words or phrases, are replaced (for instance actual bank name is replaced with “our bank”) or completely omitted in a way that does not alter the results. The findings are then discussed in chapter five.

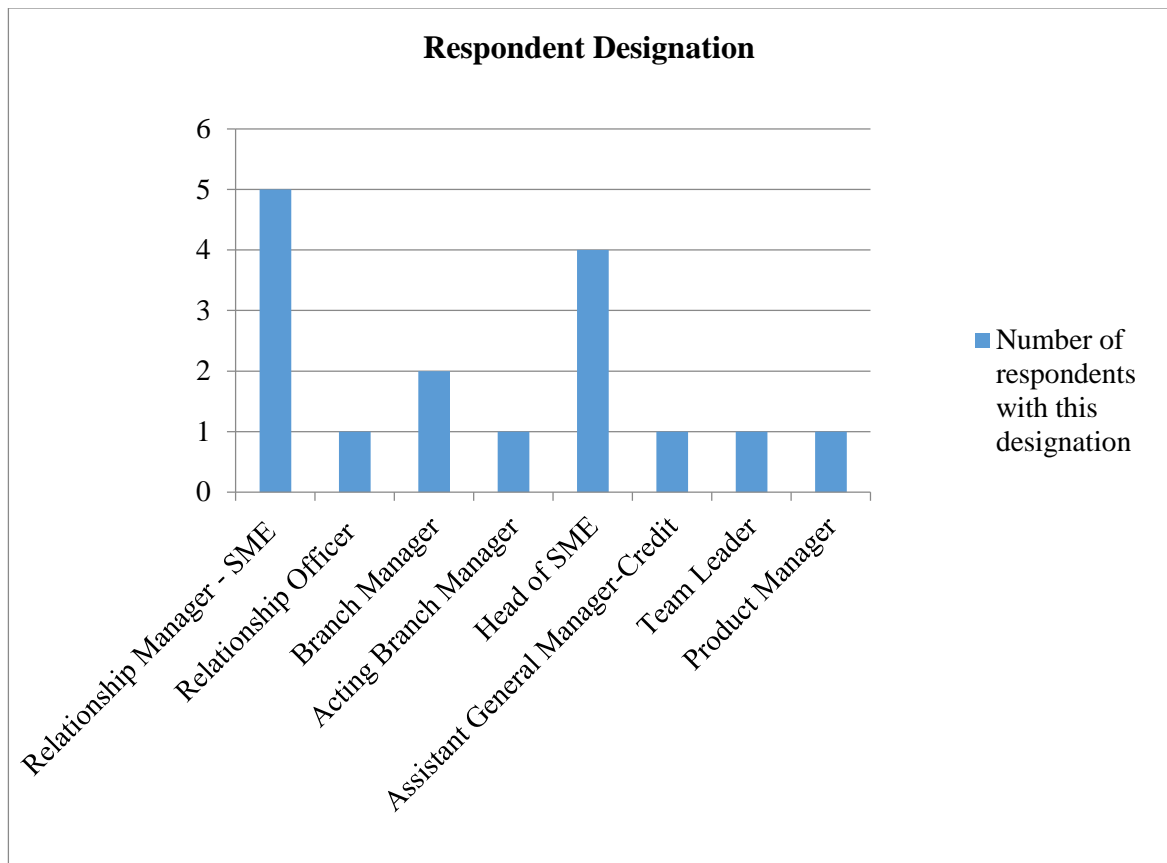
### **4.2 Background Information**

All the respondents interviewed were first asked to provide a brief background of their career including their designation, years in SME lending and current responsibilities. This

information would confirm the suitability of the respondent as a participant in this study. The responses are summarised below.

#### 4.2.1 Respondent Designation and Years in SME Banking

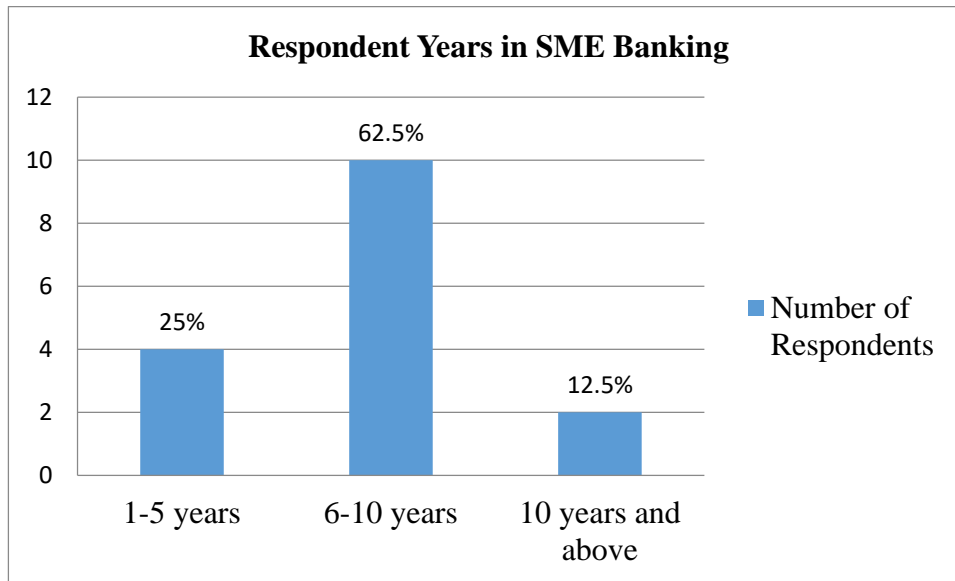
Figure 4.1 Respondent Designation



The table above shows that the respondents interviewed represented eight different designations with the most prevalent designation being Relationship Manager-SME. Nine out of the sixteen respondents have a designation which specifically assigns them the SME which implies that they specialise in dealing with the SME customer and as such were suitable respondents for the study. The other respondents have various designations but all work in or closely with the department within the bank that deals with SMEs which also makes them suitable participants for this study. For the purpose of this study, when

referring to the above respondents/participants in general, the term SME bank manager(s) shall be used.

Figure 4.2 Respondent Years in SME Banking



From figure 4.2 above, twelve out of the sixteen respondents have been dealing with SMEs for over six years with two having been in the role for over ten years. This indicates significant experience in dealing with the SME customer and further confirms the respondents' suitability as participants in this study.

#### 4.2.2 Respondent Responsibilities

The following table categorises the respondents' responsibilities.<sup>1</sup>

---

<sup>1</sup>The following key is used to identify responses from each bank and specific respondents:

**Key:**

B1: Bank One;

B1a: Respondent "a" (or first respondent) from Bank One;

B1b: Respondent "b" (or second respondent) from Bank One;

B6c: Respondent "c" (or third respondent) from Bank Six.

Table 4.1 Respondent Responsibilities

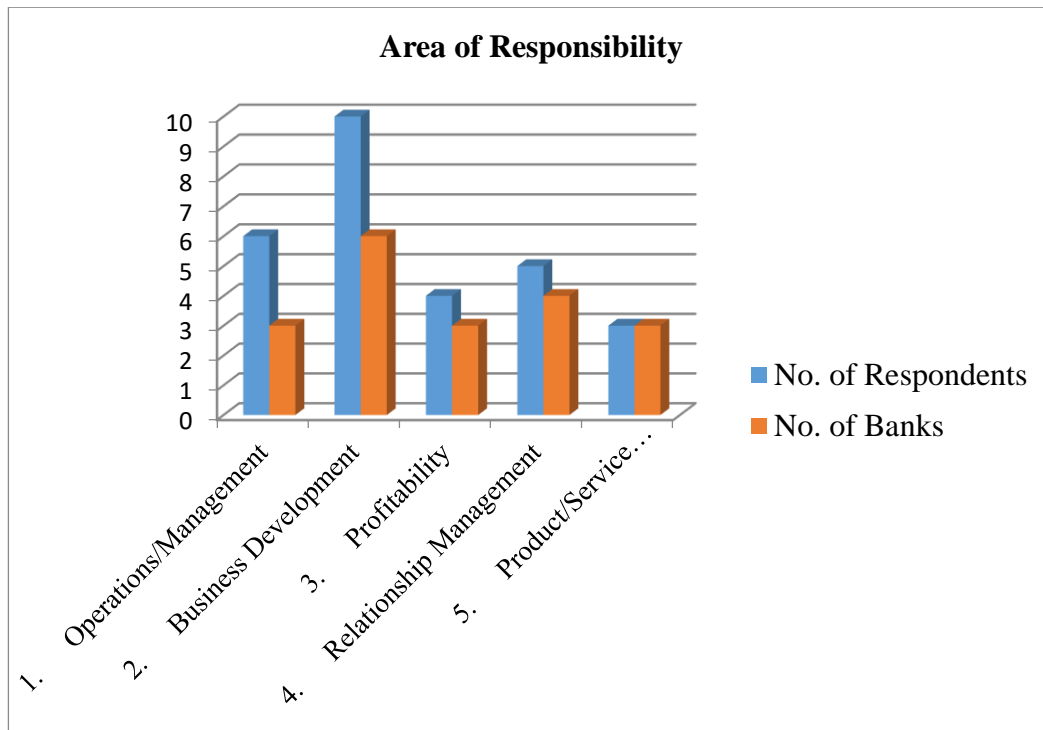
| Area of Responsibility    | Responsibility  | No. of Respondents | No. of Banks |
|---------------------------|---|--------------------|--------------|
| 1. Operations/ Management | <ul style="list-style-type: none"> <li>▪ Managerial, managing a team of relationship officers (RO) (B1a)</li> <li>▪ Head credit for the bank (B1c)</li> <li>▪ Strategy direction for SME (B6a)</li> <li>▪ Managing (B6b)</li> <li>▪ Management of the branch-administrative, overseeing the operation side and of course management (B7a)</li> <li>▪ Business center manager (B7c)</li> </ul>   | 6                  | 3            |
| 2. Business Development   | <ul style="list-style-type: none"> <li>▪ Maintaining the loan book, deposit book, (B1a)</li> <li>▪ Manage the book; end to end process, from getting the client to managing the client (B1b)</li> <li>▪ Customer acquisition and satisfaction (B3a)</li> <li>▪ Drive the business (B4a)</li> <li>▪ Manage portfolios and they are a mix of asset and liability customers i.e. borrowing and just people who run regular current accounts or place deposits and other investments (B5a)</li> <li>▪ Growing the SME book both assets and liabilities (B5b)</li> <li>▪ Business development for existing and new business clients, my key focus is on growing the share of wallet (B5c)</li> </ul> | 10                 | 6            |

|                            |   |   |   |
|----------------------------|---|---|---|
|                            | <ul style="list-style-type: none"> <li>▪ Business development - grow the book (B6c)</li> <li>▪ SME banking (B7a)</li> <li>▪ Business development (B7b)</li> </ul>   |   |   |
| 3. Profitability           | <ul style="list-style-type: none"> <li>▪ Ensuring profitable relationships between the bank and customers, increasing transactional income, ensuring profitability for the sector (B1b)</li> <li>▪ In terms of day to day - what kind of prices should we charge (B6a)</li> <li>▪ Profitability ... the bottom line (B7a)</li> <li>▪ We are supposed to increase revenue in our book, the bank wants to maximize profit (B7b)</li> </ul>  | 4 | 3 |
| 4. Relationship Management | <ul style="list-style-type: none"> <li>▪ Go between the client and the bank so anything you need as a client comes to your relationship manager. Nurturing the business, overseeing how customers are managed so as to retain and get value and shift from a product based to a need based service (B1b)</li> <li>▪ Relationship management (B2a)</li> <li>▪ A typical day would be first of all you monitor your relationship portfolio; it's a relationship banking sort of module. We are hands on with our customers' queries, we are like trusted advisers to our customers, we keep them informed on any customer updates in the market,</li> </ul> | 5 | 4 |

|                                 |   |   |   |
|---------------------------------|---|---|---|
|                                 | <p>if they have any query they refer it to us (B5a)</p> <ul style="list-style-type: none"> <li>▪ Relationship management, value addition to our SMEs. Ensuring that they get our best services and also enjoy a variety of our products to make sure that the relationship is not just transaction, you have to of course add the human aspect to it. See the customer beyond what he is giving us. Contact person between clients and the bank (B6b)</li> <li>▪ Relationship management (B6c)</li> </ul> |   |   |
| 5. Product/ Service Development | <ul style="list-style-type: none"> <li>▪ Overseeing how customers are managed so as to retain and get value and shift from a product based to a need based service (B1b)</li> <li>▪ Research, tailor make products for SME business (B3b)</li> <li>▪ In terms of day to day - products we offer to SME, what kind of service should we give them (B6a)</li> </ul>   | 3 | 3 |

The areas of responsibility identified above are summarized in Figure 4.3 on the next page.

Figure 4.3 Area of Responsibility



The data collected on the responsibilities of the respondents resulted in five areas as follows; operations/management, business development, relationship management, profitability and, product/service development. The consensus is that the SME manager's role mainly involves business development which was indicated by ten respondents from six banks. Other interspersing roles are, operations or management of other officers in the SME department, ensuring profitable relationships between the bank and customers and tailor making products or services to meet the SME needs.

### 4.3 The SME Lending Process

The SME lending process was initially not indicated as a research issue, but as the data collection and analysis process progressed it emerged as an important aspect as it is the process within which two of the research objectives occur, specifically the objective of borrower knowledge acquisition, transfer and use; and the SME lending methodologies

employed by commercial banks. As such, the SME lending process is presented here as a research issue that emerged as a result of the analysis of the data.

### 4.3.1 Source of Customer

The following table presents the various sources of the SME customer.

Table 4.2a Source of Customer

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | An SME client is sought and brought by a RO or RM. The client could also just be a walk in or a referral by another client/relative.   |
| B1b                        | Walk-in client, poached client.  |
| B2a                        | A client is introduced or through cold calling.  |
| B3a, B3b                   | Customers are usually from one of three sources; walk-ins, value chain referrals from a key customer or, a segment campaign, for instance an import facility targeted finance.   |
| B5a                        | They walk in   |
| B5b                        | There is the marketing bit where we go look for the customers or the customers come looking for us.  |
| B5c                        | Walk-in  |
| B6a, B6b                   | You come in or we come and find you because we do both outside marketing or there will be clients who walk in to us.   |
| B6c                        | Walk-in  |
| B7a                        | They can walk in, we also approach them. You can just see a good business and go out and direct them and market what we have as a bank, you talk to them and maybe they will tell you then what they need. Then through referrals also, sometimes we have events where we go and get to meet different people and they will talk to you and tell you I am thinking about this. |
| B7b                        | Walk in, a referral or we go out looking for business.   |
| B7c                        | The branch manager, he's the boss, he looks out...   |

From table 4.2a, we find evidence of corroboration amongst respondents in the same bank of the various ways of sourcing for customers. The various ways of sourcing for a borrowing customer as indicated by the respondents are summarised in the table 4.2b below.

Table 4.2b Summary Source of Customer

| Source of Customer | Bank and Respondent  | No. of Respondents | No. of Banks |
|--------------------|--|--------------------|--------------|
| Referral           | B1a, B2a, B3a, B3b, B7a, B7b                               | 6                  | 4            |
| Walk-in            | B1a, B1b, B3a, B3b, B5a, B5b, B5c, B6a, B6b, B6c, B7a, B7b | 12                 | 5            |
| Cold calling       | B1a, B2a, B7a, B7b, B7c                                    | 5                  | 3            |
| Marketing          | B3a, B3b, B5b, B6a, B6b, B7a                               | 6                  | 4            |
| Poaching           | B1b  | 1                  | 1            |

The top two sources of potential borrowing customers are; a walk-in as indicated by twelve respondents from five banks, followed by referrals from existing customers and marketing campaigns held by the bank. This was closely followed poaching and the least popular source of customer, which is mentioned by only one respondent, is poaching.

### 4.3.2 Initial Discussion and Business Visits

After sourcing for the customers, banks interviewed indicated that they need to have an initial discussion with customers and also make a business visit(s).

Table 4.3a Initial Discussion and Business Visits

| Bank and Respondent | Respondent Response   |
|---------------------|---|
| B1a                 | Visit of the business by the relationship officer to establish is there really a business, see the need, establish whether there really is a need, agree and discuss. |

|          |  |
|----------|--|
| B1b      | Vet –visit the client, what does the client deal in...know your customer (KYC)   |
| B1c      | Then, sometimes the bank can determine the need to visit the customer...today with growth in everything; there are customers you don't need to visit. There are some you will not even have to see. Their visit to the bank could be enough. But there are customers we must visit –depending on how much they have borrowed and the nature of business, and how well we - how comfortable we are. We are encouraged to call –know your customer: the physical identity of that person or that entity; and determining where the entity resides or where that person resides...that done, there is that information in the bank so you do not have to keep on visiting the business premises to determine whether you want to lend or not.                             |
| B3a, B3b | In carrying out our business checks, someone known to the customer would visit the premises at an agreed date and time. Additionally, an independent verification is done by someone unknown to the customer on an unknown date and time, an ad hoc visit.   |
| B5a      | <p>They walk in, we discuss, they show us their need because one thing we do, we don't pull products out of a bag and say this what you need we have to fully understand their business and their business cycle ... you may find when they initially came for an overdraft it may end up being.... it could invoice discounting.</p> <p>We visit the customer premise because SMEs fear banks and get closed in, so sometimes they tell you what you want to hear, but when you meet them at their premise you will still get a lot of information that would be helpful to meet their need...I need to ascertain that he's based somewhere and he's doing what he's saying he's doing because sometimes we've found we have briefcase SMEs and their business is</p> |

|     |  |
|-----|--|
|     | in their car, where would I find him if he defaulted, you need to know he's established somewhere.   |
| B5b | And once you identify the customer then you go into identifying what is their need; that is the credit appraisal process.  |
| B5c | Then I would be required to visit their business premises to get to know them much more than the interface of the interviews I conducted at the branch. That would then lead me to do what we call a call report. I arrange a visit to their premises to be comfortable that actually I am lending to a business that is existing.   |
| B6a | So when you come in at that time you will come with the information that you have...based on the information we then have, we are then able to analyze and see if it is a business we would want to finance depending again on what is your need...the banker is expected of course to have done a site visit to be able to assess whether what the customer said he is doing is actually what he is doing on the ground.  |
| B6b | You have to have a discussion with them first, you will determine the need and then you sort out the need.   |
| B6c | An SME will come and you will have a discussion...they will come in and tell you I want loan for this purpose, I want this amount... so you calculate the amount and tell them the repayment per month, then they tell you I can afford it but I look at their bank statements and I realize no...and now based on that sometimes, at that point you might not be able to lend them what they wanted... You tell them now because I cannot be able to lend you but we can work on building a relationship where I can start... so you start small then graduate. |

|     |   |
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| B7a | Of course they meet the customer they agree discuss whatever it is they want based on that discussion and negotiations, the customer applies for the facility So in the process of getting to know what the purpose is of course they will also give a background of what they do and now why do they need this money... so they really have to have a specific need, then you will be able to know how to structure that facility and to advice accordingly.   |
| B7b | So I go out, meet a client. I will discuss with the client, the client will give me this information, I will do them a term sheet –you know that is quite important –a term sheet simply shows what the bank can offer to the customer. Yeah, I have sat with you, I have listened to you, I think you need one, two, three and I will price what you need. Before I proceed with it, the customer has to be agreeable to the terms in that term sheet and tell you if you agree to this term sheet, I will need you also to provide me with the following. So now the customer comes back to provide you with all the information that you need to prepare the credit paper. |
| B7c | Understand the need help them structure it.   |

From the table above, the results from the different respondents in each individual bank corroborate. These results above are summarised in the table 4.3b below.

Table 4.3b Initial Discussion and Business Visit

| Strategy Employed            | Respondents   | No. of Respondents | No. of Banks |
|------------------------------|---|--------------------|--------------|
| Discussion to establish need | B1a, B1c, B5a, B5b, B6a, B6b, B6c (ability to pay), B7a, , B7b, B7c | 10                 | 4            |
| Visit to check for existence | B1a, B1b, B1c (not always), B3a, B3b, B5a, B5c, B6a                 | 8                  | 4            |

|  |  |   |   |
|--|--|---|---|
| Visit to confirm need                        | B1a, B1c (not always), B3a, B3b, B5a, B5c, B6a | 7 | 4 |
| Visit to cross check by another staff member | B3a, B3b                                       | 3 | 1 |

Respondents in four out of the seven banks in the study indicated that after the banks source for the customers, they have an initial discussion with the potential borrowing customer to establish the customer’s need; B6c also adds that this discussion is also held to determine ability to pay. This is followed by a visit to the business premises to confirm that a business does actually exist and also confirm the need as indicated by four banks. However, B1c states that they do not need to visit all customers and that the visit is dependent on the amount borrowed, nature of business and how comfortable the bank is; to note is that the respondent B1c is a senior manager. Further B3a, B3b add that apart from the business visit to confirm the existence of the business and also confirm the need, an independent verification is also carried out by someone unknown to the customer on an unknown date and time in other words, an ad hoc visit.

The determination of the “need” appears very important for banks as this is a subject of the initial discussion held with the customer as indicated by ten respondents and also a reason for the business visits as indicated by seven respondents, all from five banks in total. This determination of need assists the bank in structuring the appropriate solution/product for the customer as indicated by B5a, B6a, B6b, B7a, B7b and B7c. A look at the earlier results on responsibilities reveals that B6a indicated that they do develop products or services for their SME customers indicating some consistency.

### 4.3.3 Bank Requirements

After the initial discussion with the customer and assessment of a need which the bank can meet, banks emphasized the need to provide certain documents and proof of minimum duration of existence of the business. Table 4.4a presents the bank requirements.

Table 4.4a Bank Requirements

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | Requires statements from other banks.  |
| B1b                        | Must have banked with us for 3 months.   |
| B2a                        | Financial statements and collateral.   |
| B3a, B3b                   | Must have banked with us for at least 3 months. Required - financial statements, registration documents (i.e. registered name to verify existence of business).  |
| B4a                        | You'll apply for the loan we'll do the vetting we'll say we're giving you this much but the condition of this disbursement is you open an account with us so at the point of applying for the loan you don't have to have the account.   |
| B5a                        | Guarantees of the directors, security ... contracts depending on whether it's based on contracts that they have, financial information, statements if they're not banking with us, sometimes you ask for 12 months but if it's an Mpesa agent there's no way you're asking for 12 you just have a general idea because it would be too long. |
| B5b                        | ...we still consider the other banks statements as proof of transactions...so once they meet the requirements, you do the credit application.  |
| B5c                        | The bank statements for twelve months...yes for a non-customer, but if you have been banking with us, 6 months would be ideal then we annualize it. Any asset or any facility proposal provided by an SME we   |

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|     | require it to be backed by a security. For our SMEs we don't really commit them to filling in a loan application form. All they need to do is just draft a letter signed, indicating the type of facility they would want to take.  |
| B6a | ...we assess you based on your six months' bank statements...a loan application form which you will fill in.  |
| B6b | For a new customer of course either you bank with us for six months or you provide security.  |
| B6c | Bank statements   |
| B7a | Months but depending on the amount ...if it is a larger amount we would want one year, we take up to one year   |
| B7b | Three years financials to compare the trend. We need projections, mostly if it is a term loan, like if they give me a term for three years I will need projections for three years. The others are KYC (Know Your Customer) documents.  |
| B7c | We lend them on a checklist. I have a document which says; date of incorporation, have you been in business for more than three years, do you have the memorandum of articles...it's about governance, do you have an organization that's in existence, do you have some experience in what you're doing? ... then you look at compliance- tax compliance, can I see your PIN (Personal Identification Number), can I see your ID (Identity Document)... if you have another bank, can I see the bank statements. |

The bank requirements are summarised below:

Table 4.4b Summary Bank Requirements

| <b>Bank Requirements</b>  | <b>Respondents</b>  | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|---|---|---------------------------|---------------------|
| First bank then lend<br>Duration:<br>3 months<br>6 months                     | B1b, B3a, B3b, B4a, B5c,<br>B6b<br><br>B1b, B3a; B3b<br>B5c, B6b                                  | 6                         | 5                   |
| Provide statements then lend<br>Duration:<br>6 months<br>12 months<br>3 years | B1a, B2a, B3a, B3b, B5a,<br>B5b, B5c, B6c, B7a, B7b,<br>B7c<br><br>B6a<br>B5a, B5c and B7a<br>B7b | 12                        | 6                   |
| Provide security then lend  | B2a, B5a, B5c, B6b  | 4                         | 3                   |
| KYC documents   | B3a, B3b, B7b, B7c  | 4                         | 2                   |

The above table indicates that the most popular bank requirement is the provision of bank statements whether from bank customers or non-customers. Ten respondents from five banks indicate that banks prefer a borrowing customer to provide bank statements before they can consider financing them while six respondents, also from four banks indicate that they prefer a borrowing customer to first bank with them. In addition to bank statements, the requirement of security was indicated by three banks and KYC documents by one. Interestingly, one respondent (B5c) indicates that they do not require an applicant to fill a form but only to draft a letter indicating the type of facility they require which is inconsistent with B5b requirement of filling a credit application.

The results however, show some differences within and between banks as to whether banks prefer a borrowing customer to first bank with them before they can consider financing them and also as to the required period of the bank statements for both existing and non-customers which ranges from three months to three years (for the customer, read – number of months of banking with the bank). B1b, B5c and B6b indicate that one needs to first bank with them before they can consider financing them while B1a, B5a, B5b, B5c and B6c indicate that the bank can finance non-customers that provide bank statements. For the existing customer, B1b, B3a and B3b state that they need bank statements for a minimum of three months while B5c and B6b require six months. To consider lending to the non-customer, B6a requires three months’ statements which although consistent with B6c, is inconsistent with B6b’s indication that to be financed one needs to be an existing customer), B5a, B5c and B7a require twelve months’ statements while B7b indicates a requirement of three years’ statements (inconsistent with B7a’s requirement).

Business duration or how long a business needs to have been in existence was also a consideration that was analysed and the results are presented in table 4.5a below:

Table 4.5a Business Duration

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | The bank does not lend to start ups. The enterprise has to have been in operation for six months and one year in registration. However if these start-ups do not meet the two requirements but have a seasoned businessman as the promoter then the bank may reconsider their decision and lend to such an enterprise.                                     |
| B3a, B3b                   | If the COO (chief operating officer) of an established company that banks with us starts his own small outfit and would like a facility, he is likely to get it without say meeting the 3 month account requirement because we say “a business is as good as the owners.” We can say we know the owner of the business from the experience he has and what |

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|     | he has achieved by working in the established company that banks with us.  |
| B5b | Incidentally we don't deal with start-ups...you must have been in business for at least two years.   |
| B5c | At least your business should have been in operation for at minimum one year to be safe. Start-ups are a bit tricky...It is very tricky to lend to start-ups because of the probability of that loan performing in the long run. Reason being, the bank would be making a decision to lend or not to lend based on past incomes. Because you can only judge performance of a business when you do a trend analysis on the income that has been received in the past...but we don't say we don't lend to start-ups...if you have a security that the bank may consider and other sources of income that you are currently earning, that the bank could actually then appreciate by way of looking at the receivables on a bank statement. |
| B6a | Most likely you need at least not to be a start-up business, if you're a start-up business you need a very high percentage of your own contribution, we want you to come in when you already know what you want to do .... At least about 50% is your commitment in the business and also along with that we've got to see that you've got the management experience to run the business.  |
| B7a | However even with the six months statement the business should not only have been operational for six months, ideally it should be two years...why I am saying ideally is...at some point I said we can be flexible on a number of things so it doesn't have to be two years but three months is really too short to have gone through the ups and downs of a business cycle.  |

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| B7c | The first question you ask, how many years have you been in business, have you been in business for more than three years? |
|-----|--|

The business duration is summarised in the table below:

Table 4.5b Business Duration

| Business Duration       | Respondents             | No. of respondents | No. of Banks |
|-------------------------|-------------------------|--------------------|--------------|
| No Start-up             | B5b, B7a, B7c           | 3                  | 2            |
| Start-up with exception | B1a, B3a, B3b, B5c, B6a | 5                  | 4            |

The data above shows that there is some discrepancy amongst respondents in the same bank as regards to the duration of time a business needs to have been in existence to qualify for lending. This discrepancy is evident between banks 5 and 7. B5b states that they don't lend to start-ups yet B5c gives an exception when they do. B7a presents the ideal duration as two years and also qualifies that this can be reconsidered although the business should not be a start-up, while B7c places the ideal duration as three years. Instances when a bank may reconsider the no start-up rule are: if the business is being run by a seasoned businessman as stated by B1a; B3a and B3b; if the business provides security for the loan (B5c); if the business provides other sources of income (B5c); and at least about 50% is the owner's commitment in the business and; management experience (B6a). However even B7a; states that the ideal would be a business that has been operational for two years but could be flexible on that term though three months would be too short, however still adhering to the no start-up rule.

#### 4.3.4 Loan Approval Process

The loan approval process was also discussed to appreciate how customer information necessary to make a lending decision was transmitted in the bank.

Table 4.6a Loan Approval Process

| <b>Bank and Respondent</b> | <b>Respondent Response</b>  |
|----------------------------|---|
| B1a                        | Branch managers and RM analyse application and may restructure facility. Credit of up to Ksh.100Million does not require a credit committee. Loan goes through the 1st, 2nd and, 3rd and final approver. If ok, credit is granted but it can also be declined at any point. Any application above Ksh.100Million goes to a board committee after the 3rd approver. The board committee is comprised of at least 2 directors of the bank, may give conditions to be adopted before approval of the loan. |
| B1b                        | Credit analyst officer sits in all branches. Credit questions; upload on analysis to manager-department for asset finance-branch manager. Credit department section, credit approvers at each stage must return within 48 hours. There are 3 of them depending on approval amounts. Credit administration-offer letters (documentation) back to Relationship Manager.   |
| B1c                        | ...to take a decision to lend...there are credit managers or approvers.   |
| B2a                        | Loan amounts up to Sh.5Million are approved by Head of Credit and the CEO, amounts above Sh.5Million up to Sh.100Million are approved by in addition a management credit committee and amounts above Sh.100Million need the additional board approval.  |
| B3a, B3b.                  | Decision making is centralized.   |
| B5a                        | Analyst assesses...can go back to RM for review who can question the analyst's assessment as analyst may have misrepresented the RM's   |

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|     | <p>position. RM then sends it to the approvers depending on level of facility...there's a limit so either Level 1 or 2, amounts over Sh40M go to a committee approver. At this stage approved – letter of offer (LO) or returned for rework with certain conditions or clarification sought or questioning the structure- sent back to analyst because he is the one who prepares it.</p>   |
| B5b | <p>Once you do the credit application, you go through the appraisal process and then the approval finally.</p>  |
| B5c | <p>The call report would then now enable the analyst to see the person in totality.</p>   |
| B6a | <p>...our credit analyst who will then check to see whether that proposal is valid, if it is valid from thereon then they can recommend for approval but they also have some limits or then they will recommend to the head of credit or SME who will then approve depending on the limits that he also has. So it goes through the chain.</p>  |
| B6b | <p>But mostly ours are approvals. You know before the customer applies you are sure of what you are doing...don't mislead the customer that you can qualify, apply, then you give the customer a decline. First based on the discussions, let that customer understand what's on the table (Researcher note: implying that the loan manager only allows the customer to go ahead and apply when they are sure that the application will get approved.</p> |
| B6c | <p>There is an analyst and there is an approver and it goes to both. Decisioning in a bank at least is not one person, it is not one level. So RM, analyst, credit, approver and sometimes it goes through different approval levels.</p>   |

|     |   |
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| B7a | <p>We have a system whereby now as the initiator maybe the branch manager, the relationship officer... you key in the details of the application, attach the supporting documents... we do it on a soft system. Then from the branch it will go to the regional branch manager who will either recommend or not... if there are any questions, they will send it back to you and if there is any information you need you can still go back to the customer and get the information to fill in the gaps and everything. From there, head of retail then to the credit department where it will be analysed based on the amount (as much as it is a credit department which will say approve or decline we are the first level) different people have different limits above 30 million there's a credit committee, then beyond 55 million we send that to our head office to give a final approval.</p> |
| B7b | <p>... we call it a credit file, I will come and prepare. So it will be held with my boss and everything, and we present to the credit committee...the credit committee is a risk mitigant, for the bank. So if the credit committee approves it, then we are good to go. I will go back to the customers and tell them, this was approved, and this was not approve and if it was approved, it was approved with some conditions I will tell the customer the conditions.</p>  |

A summary of the loan approval strategies is provided in the table below.

Table 4.6b Summary Loan Approval Process

| <b>Step No.</b> | <b>Approving Authority</b> | <b>Respondents</b>                     | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|-----------------|----------------------------|--|---------------------------|---------------------|
| 1               | Relationship Manager       | B1a, B1b, B5a, B5b, B6b, B6c, B7a, B7b | 8                         | 4                   |
| 2               | Branch manager             | B1a, B1b, B7a                          | 3                         | 2                   |

|   |   |                              |   |   |
|---|---|------------------------------|---|---|
| 3 | Regional branch manager                                       | B7a                          | 1 | 1 |
| 4 | Analyst   | B1b, B5a, B5c, B6a, B6c      | 5 | 3 |
| 5 | Head of Credit/SME/Retail or Centralised decision/Head office | B1b, B2a, B3a, B3b, B6a, B7a | 6 | 5 |
| 6 | Management credit committee/ credit committee                 | B1a, B2a, B7a, B7b           | 4 | 3 |
| 7 | Different approval level depending on amount                  | B1a, B1b, B1c, B5b, B6c      | 5 | 3 |
| 8 | Board committee   | B1a, B1b, B2a                | 3 | 2 |

The results of the loan approval process yielded about eight distinct steps. To note is that some of the steps although termed differently, might refer to the same step in another bank the difference perhaps being due to bank organisation structures.

The most common step is the beginning of the approval process where 8 respondents from 4 banks indicate that the approval process begins with the Relationship Manager. The next common step is “Head of Credit/SME/Retail or Centralised decision/Head office” which is indicated by 6 respondents from 5 banks. In addition, at least two banks in each case indicate that the loan approval process involves the following: Branch Manager, Analyst, Credit Committee, Different approving authorities depending on the amount and the Board Committee.

Once all the necessary information is keyed into a system and forwarded to the analysts, there could be a back and forth process until the analyst is satisfied enough to forward the application to the approvers. B5a qualifies that the approvers may return the application to the analyst as he is the one who prepares it, for rework with certain conditions or clarification. This concurs with B7a’s approval process where the regional branch manager can recommend, or not and send back an application to the relationship manager for additional information who in turn may need to go back to the customer to get the information to fill in the gaps. This indicates an iterative approval process. Finally a

decision is made on whether to approve, approve with conditions or decline an application (B1a, B5a, B7a & B7b). What is clearly evident is that the commercial banks studied typically follow a formal lending application and approval process.

#### **4.3.5 Summary**

In summary, all banks were found to have a structured loan application and approval process that begins from sourcing and initial discussion with the potential credit customer, followed by business visits, after which the customer completes and submits the required documentation. This package of documents is then put through an analysis process that involves a credit analyst and finally an approval process where a decision is made on whether to approve or decline the application. Generally the results reveal corroboration amongst respondents in the same bank about the different stages of the SME lending process. The exception to this is the data on the duration of time a business needs to have been in existence to qualify for lending which indicates some discrepancy amongst respondents in two banks.

The first stage in the SME lending process is sourcing for customers where the consensus from most banks is that the main source of a potential borrowing customer is a walk-in with the least popular source being poaching. The second stage is the initial discussion where respondents in four out of the seven banks in the study indicated that after the banks source for the customers, they have an initial discussion with the potential borrowing customer to establish the customer's need. In most cases this is followed by a visit to the business premises to confirm that a business does actually exist and also confirm the need; one bank however states that they do not need to visit all customers with such a visit dependent on the amount borrowed, nature of business and how comfortable the bank is. This determination of need assists the bank in structuring the appropriate solution/product for the customer. To be considered during the second and third stage is the meeting of bank requirements by the potential credit customer. Most banks prefer a borrowing customer to first bank with them before they can consider financing them. The exceptions to this are banks that are willing to consider a non-customer who meets certain specific bank requirements such as bank statements for a certain given duration and security. The

results however, show differences between banks as to the required period of the bank statements for both existing and non-customers which ranges from three months to one year (for the customer, read – number of months of banking with the bank). The results also indicate some discrepancy amongst respondents in two of the banks as regards to the duration of time a business needs to have been in existence to qualify for lending.

After having gone through the first and second stage and consideration of the bank requirements, the package of documents is then put through the loan approval process. Most banks indicate that this process starts with the relationship manager and involves a good number of the following approving authorities; Head of Credit/SME/Retail or Centralised Decision, Analyst, Different Approvers depending on the amount, Credit Committee and a Board Committee. The application may move back and forth within the approval chain for instance approvers may return the application to the analyst for rework with certain conditions or clarification, or to the relationship manager for additional information who in turn may need to go back to the customer to get the information to fill in the gaps. As such the loan approval process is also an iterative process (B5a, B7a). Finally a decision is made on whether to approve, approve with conditions or decline an application (B1a, B5a, B7a & B7b). It was evident that the commercial banks studied typically follow a formal lending process to assess a loan application.

#### **4.4 Borrower Knowledge Acquisition, Processing and Transfer**

This research objective was aimed at determining how soft information is collected from borrowers, how it is processed and the bank structure within which it is transferred for use in making the SME lending decision. Additionally, information is also gathered on how this soft information is stored and whether there are any social ties between loan managers and the local community.

#### 4.4.1 Borrower Knowledge Acquisition

**Research sub-issue: What are the sources of soft information and how formal/informal is the collection process (i.e. do you pay attention to rumours about the borrower or use only very reliable and sound sources even if they provide soft information)?**

Table 4.7a Sources of Soft Information

| Bank and Respondent | Respondent Response  |
|---------------------|--|
| B1a                 | SMEs lack data. You have to make the books yourself because if you cannot make them then you will have a very bad book, search the credit reference bureau (CRB) for company and directors credit history, character – this can be determined if for instance these are people known in the society. Politically exposed persons (PEPs) are also easy to determine. Caution countries – this is a confidential list for banks that has countries that the bank may not deal with or persons associated with those countries. |
| B1b                 | If the client can actually prove that they are actually in business as much as it is not registered...you tell them...bring the invoices, a shop will always have a certificate for City Council, or let us see your electricity bills. Even if it's a kibanda (a makeshift shop), there is a fee that they will pay... even in the market they pay. You can even use their Mpesa (M for mobile, pesa is Swahili for money) transaction statements.  |
| B1c                 | Credit application forms-getting them to answer those questions provided on an application form. When we visit the customer, there are specific reports that are done. What I am trying to say is the character is critical; it is the most important thing, because bad character is what makes them not pay. No...No...there is no room for rumours and hence the need for a standardized information profile - Who are you? What  |

|          |  |
|----------|--|
|          | do you do? How much do you earn? Where do you rent? Have you ever paid a loan? Do you have your own house? There is no room for rumours. Because some of these people you may have rumours about – they are good people.   |
| B2a      | Do CRB checks of character of the owners. Personal information matters as the SME and owner are treated as one.  |
| B3a, B3b | In carrying out our business checks, someone known to the customer would visit the premises at an agreed date and time. Additionally, an independent verification is done by someone unknown to the customer on an unknown date and time, an ad hoc visit. SME lending is intuitive based i.e. manual intervention is required and depends on the person the client first interacts with to establish the need. Soft information is collected by the relationship manager assigned to the customer. We are able to collect information even in informal sectors for instance in Gikomba market that deals with second hand goods. In the rare cases where there has been a rumour, we use private investigators to verify the same. We can extract the information required through other means e.g. Mpesa statements to verify transactions' history. |
| B4a      | Yes there's a provision, there's a provision actually on this application form once you're done if you have any extra information that might be material.  |
| B5a      | A call report, a document that records information from the first, second interview and includes profiling of the customer, where their premises are, my (the RMs) view of the business; they get that soft information. Call report-who are your customers and what are the credit terms you have given them, who are your suppliers and what are the credit terms, who are your top five and what are the challenges you are facing.   |

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| B5b | <p>I will also pay you a visit at your business premises just to collect that rather soft information which is not documented...We do the customer visits. We visit the business premises and have a discussion with the business manager and with the employees of the business...there is also the observation where if it's a factory you can tell a factory that is busy and one that is not really busy. We also would look at customers walking in, that is if they depend more on the walk-in customers and we are with them for three or four hours, then we are able to observe how the traffic to the business is. So you are able to know whether it is a busy business or not very busy.</p>  |
| B5c | <p>Then (RM) would be required to visit their business premises to get to know them much more than the interface of the interviews I conducted at the branch. That would then lead me to do what we call a call report, because the call report would then now enable the analyst to see the person in totality. The call report will basically breakdown the background of this particular SME. I mean background touching on qualification, how long the business has been in existence, their main bankers, economic outlook for that particular industry where particular that SME operates in, then basically to touch on the licenses this SME currently has, because we wouldn't be interested to lend to someone who is not within the law bit.</p> |
| B6a | <p>The banker is expected of course to have done a site visit to be able to assess whether what the customer said he is doing is actually what he is doing on the ground also you try and get some references if you've gone to the site maybe from the person who is next to them just to see whether what they said they're doing is actually because you could find it's some briefcase guys who just pose for you with good pictures which is, an SME is trying to survive so there are some good ones, there are</p>   |

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|     | <p>some who are out to defraud so of course key thing is make sure that you find a customer who is willing to pay.</p>  |
| B6b | <p>We use Mpesa but as additional not the primary because of the CBK rules... because of CBK limitations, Mpesa is not a main stream banking... but we use them as additional ... The traders in Gikomba are using Mpesa... so it is an additional to the already main stream account they have.</p>  |
| B6c | <p>I run a CRB on the company and run a CRB on all the directors...character in a bank is very important; it is not easy to quantify, but it becomes very important in lending. Let's say for example, you could see a guy that has been, I mean it has been in the papers, they have been arraigned in court because it has been several times or you see another bank has sued another bank because of a debt which is in contention, but you see it is evidence that I have seen. It is not a rumour. We try to avoid working with rumours because everything you do in the bank, you have to be able to prove it, it has to be verifiable. So for as long as there is information and especially if this information is going to be communicated to the customer, if you don't have evidence for it, it becomes very hard to make a final decision on it. You can't rely on media especially because some of it is incorrect... I mean we have seen media houses apologizing after.</p> |
| B7a | <p>The instinct is very important and being relational; so that when someone is talking to you they don't just talk to you about figures you get more information when you have a discussion with them... even if you go personal and you know there are so many personal things which affect business or sometimes someone is doing the business with their wife but they don't get along. You ask them questions which are not necessarily related to what they are borrowing... for example how did</p>  |

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|            | <p>you get into this business, so why did you decide, were you employed before? You always get more information which always helps you make a decision or gives you information which you can use to advise the client.</p> <p>Sometimes in some places, you can even talk to their former banker...of course depending with your relationship with them...in some places that information is public like maybe in a small town, everyone knows this person borrows, this one doesn't pay. Sometimes you would definitely ask why they are not getting from their bank, as much as I want business... and based on that answer then you can do your own further investigations as an RM to help make a decision whether you want to proceed with that or not. So sometimes there is some soft information like you said which might not be on paper but it will definitely help you make a decision. I have had such experiences before, where you would rather not take up that person as a client based on the soft information that you get to hear ...even as a bank sometimes at some point we stop lending to or we slow down lending to maybe employees of a certain institution because we know they are having these challenges or there is retrenchment that is going to come in... you know some public information. Sometimes you have even done the application and you read somewhere that or somebody in credit has information that you don't have then they tell go slow on this or ask the client.</p> |
| <p>B7b</p> | <p>A credit quest... will capture all the information. So this one, you get to this after you have done everything with the client. I discuss with the client— maybe something I left out —I will discuss with the client, the client will give me this information. Some of these are what we do internally here —the customer doesn't, actually the customer is not even allowed to even see this, what I am doing because it is quite candid and quite open and what I think of a customer, of which the customer may</p>   |

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|  | not be agreeable to...that is what I have observed and been able to collect from the documents. For example if you meet a client in their offices, there are some other things you look in terms of are they organized, in most cases. You talk to them like this – are they people you can trust? Can you trust their word for it? |
|--|---|

Even though the discussion was centred on sources of soft information, some of the respondents provided sources of hard information. The table below provides a summary of these sources and categorises them into four knowledge acquisition strategies.

Table 4.7b Summary Sources of Soft Information

| <b>Knowledge Acquisition Strategy<br/>(F-Formal/ I- Informal)</b> | <b>Respondents</b> | <b>Frequency</b> | <b>No. of<br/>Banks</b> |
|---|--------------------|------------------|-------------------------|
| <b>1) Externally Generated Hard Information</b>                   |                    | <b>13</b>        | <b>4</b>                |
| • Certificate for city council/evidence of fee paid for shop (F)  | B1b                | 1                | 1                       |
| • Electricity bills (F)   | B1b                | 1                | 1                       |
| • Mpesa statements (F)  | B1b, B6b           | 2                | 2                       |
| • Invoices (F)  | B1b                | 1                | 1                       |
| • Credit reference bureau (CRB) for company credit history (F)    | B1a, B6c           | 2                | 2                       |
| • Credit reference bureau (CRB) for directors credit history (F)  | B1a, B2a, B6c, B7b | 4                | 4                       |
| • Politically exposed persons (PEP) List (F)                      | B1a                | 1                | 1                       |
| • Caution countries list (F)                                      | B1a                | 1                | 1                       |

|   |   |  |  |
|---|---|--|--|
| <p>2) <b>Externally Generated Soft Information</b></p> <ul style="list-style-type: none"> <li>• Rumours (verified) (I)</li> <li>• Information in the Public Domain (F/I)</li> <li>• Credit reference bureau (CRB) for directors character (F)</li> </ul>  | <p>B3a, B3b, B7b<br/>B7a<br/>B1a, B2a, B6c, B7b</p>   | <p><b>8</b><br/>3<br/>1<br/>4</p>  | <p><b>5</b><br/>2<br/>1<br/>4</p>  |
| <p>3) <b>Internally Generated Hard Information</b></p> <ul style="list-style-type: none"> <li>• Make books (F)</li> <li>• Context information from informal Sectors (F)</li> </ul>  | <p>B1a, B3a, B3b<br/>B3a, B3b</p>   | <p><b>5</b><br/>3<br/>2</p>  | <p><b>2</b><br/>2<br/>1</p>  |
| <p>4) <b>Internally Generated Soft Information</b></p> <ul style="list-style-type: none"> <li>• Instinct (I)</li> <li>• Credit application form/standardized information profile (F)</li> <li>• Former banker (F)</li> <li>• Other bank staff (I)</li> </ul> <p><b>Business visit summary frequencies</b></p> <ul style="list-style-type: none"> <li>• Business visit report/ Call report from business visit (F/I)</li> <li>• Observation during business visit (I)</li> <li>• Discussion with employees of business (I)</li> <li>• During business visit, discussion with person operating neighbouring business (I)</li> <li>• Other people in the small town (I)</li> </ul> | <p>B7a, B7b<br/>B1c, B4a<br/>B7a<br/>B7a<br/>B1c, B3a, B3b, B5a, B5c<br/>B5b, B7b<br/>B5b<br/>B6a<br/>B7a</p> | <p><b>16</b><br/>2<br/>2<br/>1<br/>1<br/><b>10</b><br/>5<br/>2<br/>1<br/>1<br/>1</p> | <p><b>6</b><br/>1<br/>2<br/>1<br/>1<br/><b>5</b><br/>3<br/>2<br/>1<br/>1<br/>1</p> |

The enquiry on the sources of soft information for banks resulted in the identification of four main categories; externally generated hard information, externally generated soft information, internally generated hard information and internally generated soft information. Within these categories, information could be collected formally or informally, the distinction being that informal collection is primarily that which results from the personal evaluation of the loan manager.

As the interest of the enquiry was to determine how soft information is collected, the results reveal that internally generated soft information is the most preferred strategy for collecting soft information having garnered sixteen responses, compared to eight for externally generated soft information. The sixteen responses were received from respondents in six out of the seven banks, the only bank missing, B2a, had earlier indicated that they do not employ relationship lending which relies on soft information and as such this was a consistent result. The consensus therefore is that banks prefer internally generated soft information or that which is primarily generated by the RO/RM, as opposed to soft information generated or collected by parties external to the bank. Further, of the sixteen responses, the most frequent source of internally generated soft information is business visits which had ten responses. This shows that banks gather more soft information from the business visits made to their clients' premises than any other internally generated source. Further this also indicates that the primary collector of soft information is the SME bank manager who makes the visit to the customer's business premises. The methods cited for collecting soft information during the business visits are; observation during business visit(s), discussion with employees of the business, discussion with the person operating the neighbouring business and other people in the small town (B1c, B3a, B3b, B5a, B5b, B5c, B6a, B7a & B7b). To note is that four respondents representing four banks; B1a, B5a, B5c and B6a, had earlier indicated that during the business visits they have an opportunity to collect more information about the client that would not be evident during the customer call to the bank. B5a, B5c and B6a remain consistent as they also indicate in this section that they collect soft information during the business visits.

Other sources of internally generated soft information cited are; instinct, credit application form/standardized information profile, former banker and other bank staff while externally generated sources are; verified rumours, information in the public domain and CRB check for directors' character.

#### 4.4.2 Soft information Processing and Transfer

**Research sub-issue: How is the soft information processed? How does the loan manager transfer her/his opinion and personal evaluation based on the soft information to the next level? Does s/he formalize this soft information in some way or is the repository the loan manager?**

This section gathered data on how the soft information which is collected is transformed to a form that can be conveyed or transmitted in loan process. Additionally it gathered evidence on how this information is then transferred to be used for making the SME lending decision.

Table 4.8a Soft Information Processing and Transfer

| Bank and Respondent | Respondent Response  |
|---------------------|--|
| B1b                 | For business continuity, we have shadows ( <b>Researcher note: this is the use of another RM/RO to verify information</b> ).   |
| B1c                 | Ultimately when the application comes here, to determine whether you want to do it or not, you will have to re-verify what they have given, sometimes some of the information can be verified by looking at the financial information. Let me give an example. If the customer visited says he has a block of flats, the rental income should be shown in the documents; the audited accounts should show he has an asset. So you don't look at one ignoring the other. You try and correlate. |

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| B3a, B3b | <p>We are able to collect information even in informal sectors for instance in Gikomba market that deals with second hand goods...We compile information about such markets; more specifically product based by collecting figures/information from a random sample of the market and we have experts who actually know the workings in these sectors. With this information we are able to calculate averages and variances. In the rare cases where there has been a rumour, we use private investigators to verify the same. In carrying out our business checks, an independent verification is done by someone unknown to the customer on an unknown date and time, an ad hoc visit.</p> |
| B5a      | <p>A call report is a document that records information from the first, second interview includes profiling of the customer, where their premises are, my view of the business, the bank gets that soft information. Those are the probing questions you ask which then read actually into responding to the financials so that if your debtors are talking of 120 days which could be alarming, I have as an RM, having prompted those questions I do understand, it may be 120 days however they are supplying to high end corporates so payment is still assured though delayed. You see those are the mitigating facts so I tend to come with the information for mitigation.</p>         |
| B5b      | <p>Yeah we have a questionnaire that we walk with...that has some specific information which we deem vital for an application. Then there is also a call visit report we shall file...that report is about me giving a report of whatever discussions we had, whatever observations I had and all that.</p>   |
| B6c      | <p>Or somebody walks into the bank and says, this person owes me money and they have never paid it or other subsequent people that probably write and say you owe them money. At that point we will call you because you have to still confirm that it is true so that it is not based on rumour. There are other</p>   |

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|     | <p>ways quantifiable that we are able to pick character issues, unpaid items, bouncing cheques.</p> <p>In the bank also there is a way the bank treats different people. There are sectors that the bank would rate or risk profile as high risk. Politically exposed persons, they probably do further more due diligence before lending, public figures. So there is already a very defined way ... either pricing or guarantee or even level of approval.</p> <p>Decisioning in a bank at least is not one person. It is not one level. So as an RM you will put and say... remember I said analyst, credit, approver and sometimes it goes through different approval levels. All we try in the whole process is to avoid in as much as possible subjectivity. Because we don't want somebody to walk in and they qualify and based on everything else they qualify, the only reason you have told them no is based on a statement or based on a rumour... and that is why sometimes we will still lend. I mean look at Uchumi (a local supermarket chain). It is down and there is a lot of press. If we were to rely on what's going out in the press we would not lend to them... but we have more data that gives us more information in terms of where Uchumi is going and how. First you look at the customer's interest but you also have to protect the bank's interest and the question you ask yourself is... is for the bank? Are we doing anything that is against the bank's values or against the bank's policies or is it a perceived risk or it is an inherent risk or is it an actual risk? And each of those risks there is away the bank has advised on how to treat, so you know.</p> |
| B7a | <p>Though sometimes, like I said...we can discuss with our colleagues... you can discuss with the more experienced people like your boss. You can even discuss with someone from the credit department, it helps you make that decision.</p>  |

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| B7b | For example me I come and look for a client, I will come discuss with my boss and everyone...but may or may not visit to countercheck and see the information. |
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Table 4.8b Summary Soft Information Processing and Transfer Strategies

| <b>Processing and Transfer Strategies</b>               | <b>Respondents</b> | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|---|--------------------|---------------------------|---------------------|
| Visit by shadow or other bank staff                     | B1b,B3a,B3b, B7b   | 4                         | 3                   |
| Cross check with financial data                         | B1c , B5a, B6c     | 3                         | 3                   |
| Verification of rumours by private Investigator         | B3a, B3b           | 2                         | 1                   |
| Multiple visits by RO/RM                                | B5a                | 1                         | 1                   |
| Call report/questionnaire                               | B5a, B5b           | 2                         | 1                   |
| Cross check with politically exposed persons (PEP) list | B6c                | 1                         | 1                   |
| Consult with other bank staff                           | B6c, B7a, B7b      | 3                         | 2                   |

The enquiry on how soft information is processed and transferred yields seven strategies as shown in the table above. The results indicate that soft information is processed by way of verifying it and transferred through the channels in the formal application process. The most common strategy of processing soft information is the visit by a shadow and other bank staff which is indicated by four respondents from three of the banks in the study. This strategy is closely followed by the cross check with the formal information, in this case the financial data of the SME, which is indicated by three respondents from three banks as well. Ranking third is the consultation with other bank staff which is also indicated by three respondents but from two banks in the study. A closer look at the respondents listed under each strategy reveals that a bank may employ multiple strategies to verify soft information, for example, B6c indicates the use of three strategies; the cross check with financial data, the cross check with politically exposed persons (PEP) list and consultation with other bank staff. Similarly respondents in the same indicate the use of different strategies, for instance, B1b indicates the verification by a visit by shadow or other bank staff while, B1c indicates a cross check with financial data.

These top three strategies indicated by 5 banks in total go to show that banks again prefer to rely on their own internal mechanisms to process/verify soft information collected. Further, to note is that these processes of verification also allow for the transfer of such information. Additional means of transfer is through the call report and questionnaire (B5a and B5b) which capture information collected during the visit to the customer's premises. Interestingly Bank 5's verification by making multiple visits by the RO/RM suggests that even though loan managers do not make the final lending decision they transfer a lot of information (formal and informal) and as such may have a lot of power to indirectly influence the decision.

### 4.4.3 Soft Information Storage

Table 4.9a Repository of Soft Information

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1b                        | The customer files are in a common system, accessible to all.  |
| B1c                        | Previously, before technology was employed, we had physical files. If you want to know about this person, you go pull out his file. Today, there are systems to do support like that.  |
| B3a, B3b                   | This information is collected and stored for reference so that anyone dealing with the client has access to it. The repository is not the SME loan manager.  |
| B5b                        | The call report is in a shared... we post that information in a shared system and everyone has access to that system. If it is about the credit information, the financial data and everything, the credit analyst will capture that information in that system.                     |
| B7b                        | ...this is called a CQ – by CQ I mean a credit quest, I mean it is like process flow, say like a system, I will analyse the financials, I will do everything, so I will capture all the information. It is like a pre-done system where I will just input things, input information. |

Table 4.9b Summary Repository of Soft Information

| <b>Repository</b> | <b>Respondents</b>              | <b>No. of respondents</b> | <b>No. of Banks</b> |
|-------------------|---------------------------------|---------------------------|---------------------|
| Common system     | B1b, B1c, B3a, B3b, B5b,<br>B7b | 6                         | 4                   |

There is agreement that the soft information collected and processed is stored in a common system that is accessible by all authorized bank staff. This is the same system that records information from the application form and the call report and as such any soft information

captured, especially in the call report, is also stored in this system. This system also captures credit information prepared by the credit analyst. The repository of soft information is therefore not the RM that is close to the customer but a system which is accessible by all authorized bank staff.

#### 4.4.4 Social Ties

**Research sub-issue: What are the social ties in which the lender-borrower relationship is embedded? Is there a link between the local loan manager and the local community? Does he/she live there?**

The purpose of this sub issue was to determine if the lender-borrower relationship was embedded in any social ties. Whether there was any link between a local loan manager and customer in terms of whether the local loan managers could deal with only customers in his area or whether the loan manager was equipped to deal with customers from any area.

Table 4.10a Link between Local Loan Manager and Local Community

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1c                        | There are categories of SME customers. There is what we call small enterprises, we have middle sized enterprises and we have large sized enterprises. For the small end enterprises, you may not be effective as an institution if you assign each of them a relationship manager. An assigned relationship manager is an expensive resource. And this is where the two sectors come –medium sized enterprise require a relationship manager to help service them and to help advise them. For the larger ones, they need more decisions managers. Why? Because too many things depend on the managers understanding - whether that is the right thing to do or not. Plus their service requirements are complicated for just anyone to do it like they would do it for lower end. |

|          |   |
|----------|---|
| B3a, B3b | <p>The customer is assigned a loan manager that is in close proximity to the customer's location however, if a particular loan manager prefers certain customers even though his branch is not located close to the customer they would still be able to serve the customer. Also if a customer prefers a certain loan manager who may not be in close proximity this is still possible. The preference is two way...this assignment is also dependent on the competence of loan officer and specialization –asset finance, working capital, trade finance, invoice discounting etc.</p>  |
| B5c      | <p>I can deal with any sector. It happens you get scenarios where an application, let me say it is a bit complicated in terms of the proposal being presented vis a vis the business backing the proposal. So if I am not comfortable as an RM to walk the customer from end to end, I would then look for someone who is more experienced, someone who has been in the team longer than I have. Then the other option would then be for me to pick another RM who we are with, in the same team who is at least more versed than me to rope them in or sometimes we even walk in to get a credit analyst to understand the client.</p> |
| B6a      | <p>No, I don't think so because what happens is as long as you're in a particular area like for example the branch manager, he's in touch with all the local leaders and they know what's going in that market that is around them, they know what's going on in their area, for example if I was to call a forum each branch conducts a business forum for their own branch so they know who are the players.</p>  |
| B6b      | <p>How we equip our resources at the branch, they are able to of course they understand all our products. So someone in Gikomba is able to sell even bank guarantees... our trade finance product. The same, same</p>   |

|     |   |
|-----|---|
|     | person in Gikomba and the same, same person in Masai Mara branch underwent the same training.   |
| B6c | No for as long as there is an SME banker in the branch, they should be able to manage and that is how the business is segmented. Per branch you will find there is a mortgage banker, there's an SME banker... because again all these are specialists in it... but you find that within the SME, there is a unit that takes care of the SME just the same way there is a unit here that is taking care of the mortgage.  |
| B7a | It should be any because; well at the end of the day you might not always be in Gikomba. But based on the place you are, you learn from the customers, you learn from the business that is there, and then you can become strong in that sector ... we are basically all equipped because we all go for the same training but then again everyone has different experiences. Maybe where you used to work before you had different experiences but you combine...and you consult a lot. |
| B7b | Yeah, you can serve from wherever, just the other day we funded a customer from Embu. We have a branch there, but they approached us from here and we were able to.   |

The table below summarises the loan manager assignment strategies generated from the interview responses above:

Table 4.10b Summary Link between Local Loan Manager and Local Community

| <b>Loan Manager Assignment Strategies</b> | <b>Respondents</b> | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|---|--------------------|---------------------------|---------------------|
| Based on size of SME                      | B1c                | 1                         | 1                   |
| Based on proximity                        | B3a, B3b           | 2                         | 1                   |

|   |                              |   |   |
|---|------------------------------|---|---|
| Based on customer preference                        | B3a, B3b                     | 2 | 1 |
| Based on loan manager competence and specialisation | B3a, B3b                     | 2 | 1 |
| No preference                                       | B5c, B6a, B6b, B6c, B7a, B7b | 6 | 3 |

The table above shows that the highest numbers of respondents indicate that there is no link between the local loan manager and local community and as such all SME managers at a bank branch are equipped to handle any SME issue or query. This is indicated by six respondents from 3 banks. Interestingly, the results also show corroboration within banks as indicated by respondents in banks 3 and 6. However, three respondents from two banks indicate that there is a link between the local loan manager and local community and give these instances as based on; proximity, customer preference, loan manager competence and specialisation (B3a, B3b) and, based on SME size (B1c).

#### **4.4.3 Summary**

This section presented the responses to the research question on how commercial banks collect, process, transfer and store soft information and whether there is any link between the loan manager and the local community. The results reveal that banks prefer to use soft information that they have primarily generated and more so from the business visits made to their clients' premises. The onus of collecting soft information lies with the SME bank manager assigned to the customer and this information is collected when the customer calls on the bank and also during the business visit(s) made by the RM or RO to the customer's business premises.

The enquiry on how soft information is processed and transferred reveals that soft information is processed by way of verifying it and is transferred through the channels in the formal loan approval process. The most common strategy of processing soft information is the verification through the visit to the customer's business premises by a shadow or other bank staff. As regards transfer of soft information it was noted that even though loan managers do not make the final lending decision, they transfer a lot of

information (formal and informal) and as such may have a lot of power to indirectly influence the decision. As regards how soft information is stored, the results indicate a consensus among all banks that the soft information collected and processed is stored in a common system that is accessible by all authorized bank staff and as such, the repository of soft information is not the loan manager.

Finally, most respondents indicate that all SME managers at a bank branch are equipped to handle any SME issue or query and as such there is no link between the local loan manager and the local community.

#### **4.5 Role of Transaction Lending (TL) and Relationship Lending (RL) in SME Lending**

The determination of whether a bank uses or employs transaction lending (TL) or relationship lending (RL) is mainly linked to the type of information used (hard versus soft/formal versus informal), how information is processed, transferred and stored (loan manager versus centralised system) and the role of personal ties (formal versus informal). As such the previous section on soft information collection, transfer and storage greatly informs the type of lending methodology that is employed and this should be evident in the lending methodology that banks indicate they employ in this section. This section presents data on how commercial banks make a decision on which lending methodology or technology to use when dealing with the SME customer and especially whether relationship lending, the preferred technology found in literature, is employed.

##### **4.5.1 Lending Methodologies Employed**

**Research sub-issue: What lending methodologies are employed by your bank when dealing with SMEs and how do you make a decision on when to use each?**

According to literature, commercial banks employ either of two lending methodologies or technologies; transactions lending or relationship lending. This section endeavours to

identify the lending technologies employed by the commercial banks interviewed when dealing with SMEs.

Table 4.11a Lending Methodologies Employed

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | Relationship lending is employed for existing clients. Cash flow lending is employed for new businesses referred by a key client. Relationship lending is based on relationship management. How well do you know the customer, before we even give out the money? We move from softer factors to hard. We look at the character of the directors, cash flows, is it in business, business knowledge of the customer, does the client chase for tenders, how many tenders have they won, is he passionate about the business? These facts are looked at before the bank considers what the security is, is it corporate guarantees that the bank can fall back on. When there is no RL, in the first 5 minutes of meeting with the client there is mention of security. |
| B1b                        | Actually we use both... that is the reason why in most times you will find cases where, if a new client was to come walking in..., it would be harder for me to give someone who is a walk in client than someone who has been banking with us.  |
| B2a                        | The bank does not engage much in relationship lending, relies on transaction lending. Transactions lending methodologies which include asset based lending, credit scoring which is done by checking the character and borrowing history, for instance if the borrower has delayed in making payment, and industry you are in. SMEs need to provide financial statements and collateral.   |
| B3a, B3b                   | We have about 14 loan products including asset financing, invoice discounting, loan overdraft, trade finance, working capital, insurance   |

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|     | <p>premium financing, among others. We establish what suits your need. There is no rule of thumb, we can proceed from soft to hard information or hard to soft information, this depends on the level of comfort.</p>  |
| B4a | <p>Mainly what we do we structure their products to fall within a loan or O/D (overdraft).</p>   |
| B5a | <p>A loan is a loan I may call it whatever name, but the main fact it's a loan. So when you say you have 15 products or 20 really they are either loans or contingent like LCs (letters of credit) or guarantees. Basically, we have generic loans like construction loans, business mortgages, term loans both short term and long term, stock financing, post import finance.</p>  |
| B5b | <p>We use a combination...because we do the transaction we look at the transactions in the bank statements and that is why we ask for the bank statements, the transactions. If it is about the credit scoring we also do credit scoring, if it is relationship we also do because once you give me the statements for transactional lending then I will also pay you a visit at your business premises just to collect that rather soft information which is not documented. So that is why I said it is a combination of all.</p>  |
| B5c | <p>If for example I receive the financial statement...I mean, the bank statements and I sight very many unpaid cheques, at the end of the day when I am making a lending decision, I would be basically be making a lending decision based on monies coming into the account. But if the expected monies coming into the account are questionable based on... there is a character element at the back of it then I would be very cautious to lend to such a person. So on that aspect of relationship then there are key...it is not really something you have to sit down and in a</p> |

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|     | <p>classroom to be taught. Financial statements you actually have to get some knowledge background on how to analyse them... but the relationship bit of it...it is something you can feel and see based on what you hear at that particular interview table.</p>  |
| B6a | <p>We have behavioural scoring more for short term facilities like up to three months we can be able to score you and say ok fine you qualify for this...behaviour it's how many unpaid cheques do you have in your account are you consistent in your banking then if there's a consistent turnover in your account in terms of because there you won't get management it's really most of what you bank, what's your behaviour, how much do you leave in your account at the end of the month so that gives you some scores that we use internally for knowing how much to lend to you.... Other than that we then also use just the normal analysis of a business. We put through the statements in the system then we're able to see what's the highest and the lowest we get averages and then we're able to see what's the turnover for the business based on that then we're able to know how much is it that we can lend so we use those two types, we do paper analysis of their papers or we can use behavioral scoring. We have asset based which is really asset finance but then again we also take collateral.</p> |
| B6b | <p>We are doing both. Because you know we are serving even customers who are not banking with us. For instance asset based finance loans ...where we buy you a vehicle ...You don't have to have been a customer with us. You don't have to bank with us.</p>  |
| B6c | <p>It is arm's length because they have provided you with the documentations and all that you need but again based on the relationship that you have because it is repeat business, you know them... then there are some concessions. For example we don't give...</p>   |

|            |  |
|------------|--|
|            | <p>you can't come to us with land that you have and ask us to give you money against it... but if we helped you buy that land then we can consider.</p>  |
| <p>B7a</p> | <p>I think we employ a combination, but bottom line... I would say transaction. Relationship lending assuming is based on relationship with the client...there is relationship with the client but that cannot be standalone reason for you to lend. Let me say we use a combination of that, a mix of them. Some clients may not have some of these documentation... they may not have financials, maybe if you don't have financials, we look at your account transactions, we look at your relationships, we look at your account conduct...I think I would say it is a combination.</p>  |
| <p>B7c</p> | <p>I think a small SME doesn't have time for relationship lending, they want advice, they want quick advice, I don't need a relationship lending there, there a need is transaction based so SME tends to be transactional especially the small ones it tends to be transactional based until they grow to a certain point. That means they want to have a contact point, I've got this transaction, remember their objective, remember a typical SME has a transaction in their hand and they want money, they don't have time for relationship. It's later on when they get two or three transactions or two or three contracts which they're running simultaneously, that's when they now need to reorganize themselves. So relationship lending will come later. When you grow to a certain point where you have multiple transactions is when now you need someone to guide you, to help you, talk about your facilities, optimization of borrowing because that's what the relationship lending is all about. The relationship lending comes in by introducing transactional products to help him pay his tax on time, to pay suppliers on time, efficiently from his desk, cashless solutions, reducing his risk,</p> |

|  |   |
|--|---|
|  | that's where relationship management...but before if you rewind to two years ago where he was just supplying tomatoes to one supplier, and all he needed was to pay one supplier and then load one truck and have one end buyer, he did not need a relationship. All he needed was can I borrow when I need it? |
|--|---|

A summary of the discussions above on lending methodology employed is provided in the table below:

Table 4.11b Summary Lending Methodologies Employed

| Lending Strategy          | Respondents                            | No. of Respondents | No. of Banks |
|---------------------------|--|--------------------|--------------|
| Transaction Lending (TL)  | B1a, B1b, B2a, B4a, B5a, B6b, B6c, B7c | 8                  | 6            |
| Relationship Lending (RL) | B1a, B1b, B2a, B6b                     | 4                  | 3            |
| Combination of TL and RL  | B3a, B3b, B5b, B5c, B6a, B6c, B7a, B7c | 8                  | 4            |

The summary of the results shows evidence of the use of transaction lending, relationship lending and a combination of both lending technologies within the banks in the study. A detailed look at the summary shows evidence of the sole use of transactions lending (B4a), the use of both technologies (B1a, B1b, B2a, B6b) and a combination of both technologies which elicited 8 responses. An observation from the results is that one bank can apply different technologies; for instance B1a indicates that they can apply TL and RL, while B6c can apply TL or a combination of TL+RL. Additionally two banks indicate the use of both hard and soft factors (B1a, B3a, B3b) suggesting the use of both transaction and relationship lending. To note is that those banks that indicate the use of relationship lending were banks that had, in the previous section, indicated that they gather soft information. Two banks (B2a and B4a) that indicate the sole use of transaction lending had also not indicated the use of soft information in the previous section on soft

information collection which is consistent with the use of transaction lending. Interestingly, one respondent (B2a) out rightly states that they do not use relationship lending but alludes to the use of relationship lending when they later state that they check the character and behaviour of the borrower when making the lending decision and as such this respondent has been also been tallied as a user of relationship lending in the table above.

The use of transaction lending is the most common lending technology which elicited 8 responses from 6 banks. The least common methodology is the sole use of relationship lending which elicited 4 responses from 3 banks. The transaction lending technologies cited by respondents in this study include; asset financing, invoice discounting, LCs, loans and overdrafts. Additionally some the banks in the study state they used both hard and soft factors (B1a, B3a, B3b) suggesting the use of both transaction and relationship lending. Examples of soft factors cited are; character of the directors, cash flows, is it in business, business knowledge of the owner, does the client chase for tenders, how many tenders have they won, is he passionate about the business, behaviour, account transactions, relationships and conduct. However, as indicated above, those banks that indicate the use of relationship lending also use the transaction lending methodology. Further, when these banks give examples of when they do employ each methodology, it is evident that when they employ relationship lending, it is usually together with transaction lending and relationship lending is only considered after meeting requirements under transaction lending. This is also evident in banks that indicate the use of a combination of both methods. For instance, B7a qualifies that relationship lending cannot be used exclusively, similarly B3a and B3b state that they move from soft to hard factors or vice versa within loan products that fall under transaction lending suggesting that they consider soft factors but only within transactions lending.

#### **4.5.2 Measures of Relationship Lending**

According to literature, relationship lending is difficult to measure and as such is proxied by several aspects or measures the most common being; duration, scope and concentration of borrowing. Duration is the length of time that the bank and the borrower have known

each other, scope is breadth of the relationship, that is, the number of different services or interaction over multiple services between the bank and the customer and; concentration of borrowing is the number of bank relationships that a borrower maintains.

**4.5.2.1 Duration**

**Research sub-issue: How does Duration (length of time that the bank and the borrower have known each other) impact lending decisions?**

Table 4.12a Duration

| <b>Bank and Respondent</b> | <b>Respondent Response</b>  |
|----------------------------|---|
| B1a                        | Positive impact – if there are two different applications, of course the one we know gets approved.   |
| B1b                        | It is going to affect how much that you’re going to qualify for, and how long as in the duration of time. For someone who has been banking with us for more than five or six years and they have always borrowed and repaid and for someone who walks in and banked here for one year and someone who walks in... all of them will be treated differently. Chances are the person who has banked with us for six years has the highest of all the rest to be given that money...so you see you have actually studied the client and seen how well the capacity of them to pay hence now why the bank will be more comfortable when the next time, the person comes to borrow...the amount is higher and the tenure is more increased and the rate is even less. |
| B1c                        | Customers, who have had an account with an institution for a long period of time, are easier to understand even their financial mannerisms.   |

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|----------|---|
| B3a, B3b | <p>The activity in your account matters; this is looked at together with duration because duration alone does not necessarily tell us about the activity on the account. You may have had an account for a longer period than another customer but with less activity. An example of how duration impacts lending decisions is; if your dad has been banking with us and you want a facility and have not met the 3 month account operation period requirement, we can look at you favourably. What we simply do is draw up a guarantee with a call option in case you default.</p>   |
| B5a      | <p>You know I could have had a ten year, high maintenance, not good performer. I have the comfort of the information, the information is available to me so this one who is my insider cannot tell me otherwise I can tell by their trading but in terms of the way they operate the account, they've not been writing bouncing cheques there is an advantage of the credit history. The easiest people to lend are those already in your database because it's not just what they say but it's also what you see.</p>  |
| B5c      | <p>It is a catch 22, reason ...the guy of five years could be doing very good turnovers compared to the guy of 12 years and the client of 12 years can be doing very good turnovers in their account compared to the guy of 5 years. So in terms of lending you would only lend based on the amount being sought for and your decision is based on the turnovers presented on the both accounts...I would do a profitability report for this 5 year guy and the profitability report for the 12 year guy... to try and see who is more profitable to the bank than the other. Profitability here is how much income are you giving to the bank based on the transactions you are doing on your account with us.</p> |
| B6b      | <p>Slightly. Concessions, one has bargaining power than the other... exactly on the interest. Ok they both enjoy the same terms, same</p>   |

|     |   |
|-----|---|
|     | <p>treatment... everything the same. They both have of course bargaining powers but someone who has banked with you for 15 years has more bargaining powers than someone who has been with you for 2 years. So, of course that applies to either mostly on interest rates or fees. So if we're lending at maybe 19%, this person can negotiate for even 17% or 16%.</p>   |
| B6c | <p>Repeat business always attracts better pricing, even when an analyst is making a decision they make a faster decision. Even in terms of what they need to provide is less than the person that is coming in new because you already have a history. You probably already have some of the key things. Yes, so we don't ask you again for as long as your record has been good. Your record determines... a longer term, even discounts on fees that we charge. In fact for most products, there is a discount for repeat business on what you are charge on appraisal fee.</p> |
| B7a | <p>Maybe slightly, not so much... not that much.</p>  |
| B7b | <p>.. the operations will ask us to advice they pay or they don't pay...because the customers don't have sufficient cash in the accounts. So depending on what I know, how I know the customer, and how long we have been with the customer and our relationship, I will just say, pay those cheques. So that is still part of our relationship. But this is based on what – I know them, I have interacted with them, we have done this before, they have kept their word.</p>   |

The results on how duration impacts lending decisions are summarized in the table below:

Table 4.12b Summary Duration Effects

| <b>Duration Effect</b><br><b>Borrower benefit (B)</b><br><b>Lender benefit (L)</b> | <b>Respondents</b>  | <b>No. of Respondents (without activity)</b> | <b>No. of Respondents (with activity)</b> | <b>Total Frequency</b> |
|--|---|--|---|------------------------|
| Approval (B)   | B1a, B5a (with activity), B5b (with activity), B6c (with activity), B7b (with activity) | 1  | 4   | 5                      |
| Loan amount (B)  | B1b   | 1  | 0   | 1                      |
| Loan term (B)  | B1b, B6c (with activity)  | 1  | 1   | 2                      |
| Lower rate (B)   | B1b, B6b, B6c (with activity)   | 2  | 1   | 3                      |
| Information (L)  | B1c, B5a (with activity)  | 1  | 1   | 2                      |
| Waiver on start-up (B)   | B3a, B3b (with activity)  | 0  | 2   | 2                      |
| Lower fees (B)   | B6b, B6c (with activity)  | 1  | 1   | 2                      |
| Lower requirements (B)   | B6c (with activity)   | 0  | 1   | 1                      |
| Slight effect (B)  | B7a   | 1  | 0   | 1                      |
| <b>Totals</b>  |   | <b>8</b>                                     | <b>11</b>                                 | <b>19</b>              |

The summary of the interviews show that duration, or the length of time that the bank and the borrower have known each other, is a consideration in making the SME lending decision for banks as it is considered by five out of the seven banks in the study. However duration is not considered in isolation, the banks stipulate that the activity in the account

(indicated as with activity – WA) is what matters more and this is indicated by 11 out of the total 19 responses received regarding the impact of duration on the SME lending decision. The activity in the account is more important than duration because as B3a and B3b put it, “duration alone does not necessarily tell us about the activity on the account, you may have had an account for a longer period than another customer but with less activity.”

The results also reveal that there are benefits of duration for both banks and for customers and more so benefits customers as only one benefit is indicated for lenders. The most common benefit of duration, indicated by five respondents, is that it impacts approval of the loan. Four of these respondents qualify that duration is not considered in isolation in fact activity is what matters and this is then looked at together with duration. Of all the 19 responses received, 18 indicate that duration is important with only one loan manager arguing that duration is only slightly important. The benefits for customers in order of preference are; lower rates (3 respondents from 2 banks), longer tenure (2 respondents from 2 banks), lower fees (2 respondents from 1 bank) and waiver on start-ups (2 respondents from 1 bank). The only benefit of using duration for banks is information as indicated by two respondents from 2 banks.

Duration is one of the measures of relationship lending and as such banks that do not practice relationship lending, as seen from the earlier results on lending methods employed, would not be expected to indicate an impact of duration on their lending decisions. Two banks (B2a and B4a) do not indicate an impact of duration on lending decisions which is consistent with the earlier results where B2a state they do not use relationship lending and B4a indicates the use of only transaction lending.

#### *4.5.2.2 Scope*

**Research sub-issue: How does Scope (breadth of the relationship, that is, number of different services or interaction over multiple services between the bank and the customer); impact lending decisions?**

Table 4.13a Scope

| <b>Bank and Respondent</b> | <b>Respondent Response</b>  |
|----------------------------|---|
| B1a                        | This is defined by the products the customer uses for instance credit cards, debit cards, internet banking, cheque books, loans, salary processing and so on. The relationship is deepened by the scope of products that you use. The bank has a holistic approach to the business; it does not look at the amounts but seeks to understand the business. |
| B1b                        | The more products you have the more intake or activity...at the end of the day it depends with which product that you hold. Mostly the products that are more of credit will be an added advantage when it comes to borrowing.  |
| B1c                        | When you are making a lending decision, it is not about other services the customer is enjoying. It is more about whether he qualifies and if he has serviced a similar amount in the past. You see a customer could be having very many other products, but those products do not necessarily make him to be able to demonstrate ... be able to pay.     |
| B2                         | These do not impact as the bank relies on transaction lending.  |
| B4a                        | Yes, it would probably boost your chances, it's a plus for you as long as you have a number of products and they're all performing well, then it's definitely a plus for you.   |
| B5a                        | Yep, this one has a better position...a better position even in terms of pricing of their facilities, because what we do is that the bank makes quite some revenue in terms of non-funded income which comes from fees and commissions than from interest income because interest income is funded and it has a cost implication to it because probably   |

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|     | <p>you're taking deposits to feed into the need for the lending but non-funded income is it's just easy income you're making much more. When am pricing a facility we have pricing tools, one of the major components of that pricing tool is non-funded income even if it's a loan we take non-funded income for that year 1 what about year 2, 3,4and 5 even for a non-customer if I factor in fees and commissions assuming this business will move to me am able to move pricing downwards so they're just entrenching themselves.</p> |
| B5b | <p>In terms of approving or not approving they will not have an advantage... but in terms of now pricing it will be different. A person who is taking more than one product can get a lower interest rate then a person who is just taking one product, simply because the bank will be earning more from this person who is giving us more products than a person who is just giving us one product.</p>  |
| B5c | <p>Yeah a product can really come in to confirm... the product no...not really the product itself but based on the business that each and every one of them has given to us. There is much more in terms of income that we would benefit and that actually can also inform a lending decision...duration we'd still stick to the same... it is just the price component that would be affected.</p>  |
| B6c | <p>We look at the wallet... the basket... what have you invested yourself with in the bank. So if you are an SME and you are doing all your LCs with me, you are doing all your forex with me, all your borrowings with me. Your employees' salaries come to me... I am able to give you concessions.</p>  |
| B7a | <p>Yeah they might get a cheaper loan... maybe based on the business that you are already getting from them. They might be already quite</p>   |

|     |   |
|-----|---|
|     | profitable to you. Maybe it is a company that has staff who are banking with you. Yeah sometimes there is the commitment or the attachment of the client to the bank is really evident so then you are able to make a better decision or give them discounts or something like that. They have their personal accounts here, they have this other business, this other business... so really you are not like scared that this guy will just up and go. |
| B7b | In most cases, because a customer can come like yesterday and they take all the products the bank can offer, and then today they want something like this, I think I will be hesitant... I would say in terms of product it is more on a relationship; it's more of our past experiences with this client.  |

The results on how scope impacts lending decisions are summarized in the table below:

Table 4.13b Summary Scope Effects

| <b>Scope Effect</b>          | <b>Respondents</b>                                      | <b>No. of Respondents</b> | <b>No. of Respondents (with activity)</b> | <b>Total Frequency</b> |
|------------------------------|---|---------------------------|---|------------------------|
| <b>Borrower benefit (B)</b>  |   |                           |   |                        |
| <b>Lender benefit (L)</b>    |   |                           |   |                        |
| Deepens relationship (B & L) | B1a   | 1                         | 0   | 1                      |
| Borrowing advantage (B)      | B1b (with activity and type of product), B4a (activity) | 0                         | 2   | 2                      |
| No effect                    | B1c, B7b  | 2                         | 0   | 2                      |
| Lower pricing(B)             | B5a, B5b, B5c, B7a                                      | 4                         | 0   | 4                      |
| Concessions (B)              | B6c   | 1                         | 0   | 1                      |
| <b>Totals</b>                |   | <b>8</b>                  | <b>2</b>                                  | <b>10</b>              |

The results reveal that eight respondents, from five out of seven banks in the study, indicate that scope does have an impact on the SME lending decision. However in two of these banks, two respondents state that scope does not impact the lending decision. Additionally, similar to the duration measure, scope is also qualified by some respondents. Two respondents from 2 banks, qualify that scope is considered together with the activity in the accounts, while one respondent from 1 bank, qualifies that it is not only scope that matters but also the type of products, preferring loan products.

The results also show that there are benefits of scope for the bank and for the borrower; however benefits for the borrower are more prevalent as only one out of the total ten responses indicates a benefit for the bank. The most common benefit for borrowers is that scope leads to lower pricing. This is explained earlier that since scope of products may lead to higher earnings for the bank, from the array of products that the customer is already enjoying, this determines the bank’s decision to consider lowering the price of loans or offering some concessions. Other benefits are borrowing advantage, concessions and a deeper relationship (which is seen as an advantage for both borrower and bank due to the additional benefits that may be gained due to such a relationship).

#### *4.5.2.3 Concentration of Borrowing*

**Research sub-issue: How does Concentration of borrowing (number of bank relationships that a borrower maintains) impact lending decisions?**

Table 4.14a Concentration of Borrowing

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | Being multi banked is a negative. Banks that have had clients that are multi banked have ended up with non-performing loans (NPLs) because these customers can over borrow from the various banks. Being multi banked means there is no control of borrowing, when you do not repay, the bank sells your assets and this strangles the company and tarnishes the relationship with the bank. Businesses will never build a turnover in more than one bank. |

|          |  |
|----------|--|
| B1b      | <p>It automatically boils down to your turnovers. You see you can be multi banked but the statements at the end of the day and your turnovers are the basic thing that the credit approver will look at. You have to check case to case, because you see if you look at the multi nationals, we already know you are multi banked but it is an advantage to us that you are actually here ...so why shouldn't I not take over and later on we can have discussions about taking over the facility in the other bank so that you combine it as one.</p>   |
| B1c      | <p>If they are fully banking with you, you can be able to tell what their business is and what it is not but you would not do it for a customer who doesn't have a relationship with you, you can't. Today you cannot stop multi-banking because customers are in it for different reasons. The first one is there are customers who have businesses in places where preferred bankers don't have branches, so they will have to trade by banking there. There are other products that a bank will offer, certain banks do not offer, so a customer will ask to open an account with the other bank. So with banking, it is sometimes a high risk indicator, but it is not a determinant to whether the customer is able to service a debt or not.</p> |
| B3a, B3b | <p>We use the term "share of wallet" in banking to imply that for us to consider you as seriously banking with us; you need to do a minimum of 50% of your banking with us. The bank statements you provide can indicate to us what share we have. We can also tell whether you are doing this by checking your financials/transactions and establishing your turnover and income.</p>   |
| B4a      | <p>Yes, because if your facility is not performing at another bank even if you're qualifying at here why should I take the risk because I might not be sure why you've not been performing because maybe you've moved</p>  |

|     |  |
|-----|--|
|     | banking here, cosmetic banking to cover up ABCD and two or three banks are chasing you for collections you've not been listed formally yet but yeah.   |
| B5a | 50% of business needs to come through us. When you get statements even from someone who doesn't bank with us you can tell who is their main banking by running statements.   |
| B5b | They will not be running the account as per our requirements because they will not be banking with us 100%...It is one of the recommendations.   |
| B5c | If one is multi banked... that is again when relationship management comes into play. Part of my conditions to ensure that I on-board you, I would ensure that you do 80% of your banking with us. You have to move... for us to give you the entire amount.... So that you only have one point of repaying your loan...and then we also ensure that we get more business from you other than what you have been giving us.  |
| B6a | All of them are multi banked, I haven't found one, not unless you're starting, 10% maybe, very few. It doesn't factor, the only thing we'll do if we then give you flexibility we'll want you to move more banking to us so we'll give you a condition for 70% must be with us.  |
| B6b | Treatment is same, treatment is same ... because you know this may vary they are not both maybe having the same income or same cash flow. Yes you can have your customer who is faithful to you, who has never banked elsewhere and is just banking his salary from employment. You can have one person who is multi banked but has a cash flow of maybe 200 million a month. So when it comes to how you relate to them... these are people in different business of course earning |

|            |  |
|------------|--|
|            | <p>their genuine incomes separately... treatment will be the same. We cannot stop these people from banking elsewhere especially in the current business world, they are all multi banked, just to get solutions.... a better solution all over... that is why you mostly insist on the relationship thing...This one customer why is he multi banked? What are we not giving him? Can we give this person everything we have? Because we have all the solutions, once he enjoys all the solutions from us, then of course he will be more comfortable banking at one place.</p>   |
| <p>B6c</p> | <p>SMEs build loyalty. One, they feel you can meet their needs then that loyalty is built and they will still continue to be multi banked but they will have you as their main bank. An SME will never, part of it is from the experience they have learnt that they have lost tenders just because the bank delayed. So they always have another bank that they can look at... they have a plan B, C, D and E ... and you see each bank has built a niche. SMEs would want to try this bank,...this bank,...this bank because they say this one is strong in this one, this one isn't strong in this one... So you attract it but then with conditions.</p>   |
| <p>B7a</p> | <p>Of course the one who is not multi banked you are more confident, however in Kenya most people are multi banked. So for the one who is not multi banked they have better bargaining power. However even for the one who is multi banked, you giving a better offer can bring them over from the other side. So that is also a way to bargain but of course you have to be able to establish that from your discussion with the client. You have to be able to see that indication from them, their sort of commitment or their commitment to us and sometimes in the letter of offer, as you are giving the offer you're making it clear that ok we expect that now you will provide a certain percentage of your income... you need to give us a bigger share of your banking.</p> |

|     |   |
|-----|---|
| B7b | I will be hesitant to give someone who is multi-banked by choice, I mean you know, these big they don't have a choice, because they have to, because the nature of business, because the size, and because of their needs in terms of financial needs, and everything. I will understand these. But this other one, I will be quite hesitant. |
|-----|---|

The results on how concentration of banking impacts lending decisions are summarized in the table below:

Table 4.14b Summary Concentration of Borrowing

| <b>Concentration Effect</b> | <b>Respondents</b>   | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|-----------------------------|--|---------------------------|---------------------|
| Negative                    | B1a, B4a, B5b,   | 3                         | 3                   |
| No effect                   | B1c, B6b   | 2                         | 2                   |
| Considered with conditions  | B1b (based also on turnovers), B1c, B3a, B3b, B5a, B5c, B6a, B6c, B7a, B7b | 10                        | 5                   |

There are mixed responses regarding the impact of concentration of borrowing on the SME lending decision. There are those respondents that indicated that being multi-banked is a negative, that is banks would not lend to such a customer; those that are neutral, that treat the multi-banked customer just like any other that is not; and those that consider the multi-banked customer but with conditions. The consensus, which is evident from 13 out of the 15 responses, is that being multi-banked impacts the SME lending decision. 10 out of the 13 responses reveal that the multi-banked borrower is only considered based on certain conditions. The most prevalent condition that is cited by all 10 respondents is the requirement that a minimum percentage of their banking be rerouted to the bank. In most cases this minimum percentage 50% (B3a, B3b & B5a), 70% (B6a) and 80% (B5c) results in the bank ending up being their main banker. One of these respondents also cites that being multi-banked does not matter as much as the turnovers.

Three respondents from three banks consider being multi banked as a negative, citing as one of the reasons that banks that have had clients that are multi banked have ended up with non-performing loans (NPLs) because these customers can over borrow from the various banks and because being multi banked means there is no control of borrowing (B1a).

Two respondents from two banks indicate that the treatment would be same between a multi banked and a non multi banked customer and therefore being multi banked would not factor into the SME lending decision. This least popular category was further examined in detail and the results reveal that the respondents, even though from different banks, appreciate that in the current business world customers may be multi banked for various reasons for instance, having businesses in places where the bank does not have branches or because of looking for solutions which may not be offered by all banks.

What is evident from the above results is that banks, because of the need to grow their business, do not outrightly refuse to deal with a multi banked customer. They listen to the customer, understand their need and agree to lend based on certain requirements. In this way banks are able to on board the customer with a view of eventually attracting most of their banking to them. B6b rationalize this by looking at it from another perspective; that you can have a customer who is faithful to one bank and does banking that are much less than a multi banked customer. What emerges from the impact of concentration of banking on the SME lending decision is similar to the conclusion for the other two measures of relationship lending discussed earlier, duration and scope; that concentration of banking is not considered in isolation but other factors such as turnovers, reasons why the customer is multi-banked and whether they agree to meet certain conditions come into play.

### **4.5.3 Role of Relationship in Lending**

**Research sub-issue: What is the role of the “relationship” in the SME lending decision (especially between an existing customer and a new customer)?**

In the following discussion, banks were asked to detail the role of relationships in the SME lending decision. Literature suggests that relationship lending is the preferred methodology when dealing with SMEs due to their opaque nature. Literature also highlights that transactions lending is easily detectable than the employment of relationship lending, as the information required under transactions lending is easily available or appreciable at the time of loan origination which may not be the case for soft information. As such this sub-issue was a further probe to determine whether relationships exist between bank and customers and if they do what role they play in the lending decision. This would further provide evidence or be an indication of the practice of relationship lending.

Table 4.15a Role of the Relationship in Lending

| <b>Bank and Respondent</b> | <b>Respondent Response</b>   |
|----------------------------|--|
| B1a                        | <p>You cannot have SME lending without relationship management...existing customer is on a scale 70% more likely to get an approval. When you know the client and the business they do, decision making is very quick especially if the customer has a positive relationship with the bank, in a sense, they “earn marks”.</p> <p>Existing clients also enjoy special products for instance cheque discounting where a client may have a post-dated cheque and needs cash, the bank may pay cash on the strength that this is a client whose cheques are usually paid.</p> <p>The bank can even bend back and require 50% of the security if the soft factors are favourable.</p> <p>The bank does not lend to start-ups; the enterprise has to have been in operation for six months and one year in registration. However if these start-ups do not meet the two requirements but have a seasoned businessman as the promoter, then the bank may reconsider their decision and lend to such an enterprise.</p> |

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| B1b      | <p>It is actually an added advantage to the bank. How you treat and personalize the experience for that one client will speak louder to other people than you leaving the client alone... so it plays a very, very important role.</p> <p>When asking for collateral, an existing client may be required to meet 50-70%, while a walk in client 110%; however this is done on a one on one case basis.</p>  |
| B1c      | <p>If you look at relationship as being the data of the SME customer, being a bank customer, because you cannot have a relationship when you are not a customer, then it is very critical...a different reality to lend a new to bank customer and a customer. The reason is very simple. For a customer you have banked with, there are very many things you can determine about their behavioural habits when it comes to financial management, even understanding their business...but you would not do it for a customer who doesn't have a relationship with you.</p> <p>Relationship between the bank and the client significantly determines the likelihood that the customer will be determined to be good or not good for a certain amount...there is an end value in critical information in terms of determining whether you can lend that may not be got by looking at the customers documents. And I have talked about the history. If you are servicing your debt you are better off than a guy who does nice business but has no loans. So the role of relationship is very good, to service debt.</p> |
| B2a      | <p>The bank does not engage much in relationship lending, relies on transactions lending.</p>   |
| B3a, B3b | <p>If the COO (Chief Operating Officer) of an established company that banks with us starts his own small outfit and would like a facility, he is</p>   |

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|     | likely to get it without say meeting the 3 month account requirement because we say “a business is as good as the owner”.  |
| B4a | <p>...we can work around something that’s not strictly within the guidelines because if you’re a new to bank client we might not do any waivers on documentation or anything (but an existing one) yeah, they’ve not met a certain criteria fully but based on the history and length of time then you can consider them.</p> <p>Repeat borrowers also have an advantage compared to new borrowers. For an existing person we can do a few concessions even if your statements are not that strong but we can see you’ve been with us for this period and it’s also easier for the existing guy to explain why this statement is like this or why this business is like this.</p>                                    |
| B5a | <p>Maybe 30% of our applications would be declined; relationship lending is key...there are different sections in the application and one of the sections is who are the owners and their profile, the management team and its profile and then also the business itself and its profile, those, other than financials, also play a part in the decision making.</p>   |
| B5b | <p>It has a big role to play... one, a person whom we have a very good relationship we are able to negotiate..., we are able to discuss; from the period of the loan, the pricing and the security requirements. We can discuss with a person who has a strong relationship... so we are able to give concessionary provisions for a person who we have a relationship than a person who we do not have... You might find a customer who has a logbook for example, we can seek for exemption approval to accept the logbook as security because we already have a very strong relationship with the customer... as opposed to someone who just walks in with their logbook we will not accept that as security.</p> |

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| B5c | <p>From a lending point of view... you the relationship manager... you know the customer more than the approver and the credit analyst who is going to support or decline the case. So the relationship aspect goes beyond the documents that are provided by the client, because based on the existing relationship that you have with the client there is a character element attached to it which also now then informs the decision to lend.</p>  |
| B6a | <p>If you've been banking with us we already have the benefit of having received some revenues from you whether it's through the fees for RTGS (Real Time Gross Settlement) or whatever it is the transaction fees, we're already earning something from you so if you were to even ask for a concession, you're a better candidate for us in terms of giving you flexibility because we know you and we're already receiving a return, we have a mutual relationship so to speak with you as opposed to a brand new customer...but a brand new customer again it depends on who you are and what level of turnovers you're willing to push to us.</p>                      |
| B6b | <p>There are two basic roles... one and I will repeat...it is value addition. The customer enjoying the whole basket of what we offer and two, customer retention.</p>  |
| B6c | <p>It is very; very critical... because again it is through relationships that you are able to dig out ... the banks that are being successful with SME are the ones that have realised that they have to invest into the process. You realize for an SME you are not just the banker. There are many times you can be the advisor. So times have changed where people used to come to the bank to deposit or to with draw cash... There are other channels. So what happened is that the person that goes to the bank is the person that wants to discuss a structure. I said business is driven by SMEs, so an SME will come in and you discuss all these things that</p> |

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|            | <p>they are doing and they are looking for advice ... so relationship management becomes critical and it is the only way to go.</p> <p>Repeat business always attracts better pricing, even when an analyst is making a decision they make a faster decision. Even in terms of what they need to provide is less than the person that is coming in new... because you already have a history. Your record determines... a longer term, even discounts on fees that we charge. In fact for most products, there is a discount for repeat business on what you are charged on appraisal fee.</p> |
| <p>B7a</p> | <p>I think it does play a major role...in case of a person that you already have it is much safer and it's much easier to make a decision. But relationships have to start somewhere, so at some points you will still have to take a risk and bring in new guys who you don't know.</p> <p>They can bargain lower rates and everything ...so definitely with the relationship it is better.</p>   |
| <p>B7c</p> | <p>The relationship lending comes in by introducing transactional products to help him pay his tax on time, to pay suppliers on time efficiently from his desk, cashless solutions, reducing his risk but before if you rewind to two years ago where he was just supplying tomatoes to one supplier, and all he needed was to pay one supplier and then load one truck and have one end buyer, he did not need a relationship. All he needed was can I borrow when I need it?</p>   |

The table below summarises the role of the relationship in lending.

Table 4.15b Summary Role of Relationships in Lending

| <b>Role of Relationships in Lending</b> | <b>Beneficiary</b> | <b>Respondents</b>           | <b>No. of Respondents</b> | <b>No. of Banks</b> |
|---|--------------------|------------------------------|---------------------------|---------------------|
| 1) Approval                             | Customer           | B1a, B1c, B5a, B5c, B6c, B7a | 5                         | 4                   |
| 2) Markets the bank                     | Bank               | B1b                          | 1                         | 1                   |
| 3) Special products                     | Customer           | B1a                          | 1                         | 1                   |
| 4) Waivers on:                          |                    |                              | 8                         | 4                   |
| Documentation                           | Customer           | B4a, B6c                     | 2                         | 2                   |
| Security                                | Customer           | B1a, B1b, B5b                | 3                         | 2                   |
| Start-up                                | Customer           | B1a, B1b, B5b                | 3                         | 2                   |
| 5) Concessions:                         |                    |                              | 6                         | 3                   |
| Concessions                             | Customer           | B6a                          | 1                         | 1                   |
| Longer term                             | Customer           | B5b, B6c                     | 2                         | 2                   |
| Fee discounts                           | Customer           | B6c                          | 1                         | 1                   |
| Bargain lower rates                     | Customer           | B5b, B6c, B7a                | 3                         | 3                   |
| 6) Value addition                       | Customer           | B6b                          | 1                         | 1                   |
| 7) Customer retention                   | Bank/Customer      | B6b                          | 1                         | 1                   |
| 8) Advisor                              | Bank/Customer      | B6c                          | 1                         | 1                   |

On the role of relationships in SME lending, the general theme is that the banks acknowledge that relationships do play a major, if not a critical role especially when dealing with SMEs “you cannot have SME lending without relationship management” (B1a), “big role” (B5b), “critical role” (B6c), “major role” (B7a). In comparing how relationships affect decision making between an existing customer and a new customer, the consensus is that it favours existing over new customers. The results reveal that relationships lead to benefits for both customers and banks.

The most popular of these benefits are “waivers” which are cited by eight respondents from 4 banks. These waivers are on required documentation, security requirements and

start-up requirements, implying that if a relationship exists between a bank and customer, the customer may not be required to present some of the requirements as would a new to bank customer. This benefit was closely followed by “approval” which had 5 responses from four banks, implying that relationships led to faster decision making and most likely approval of application. The other benefits for customers resulting from relationships are concessions and value addition.

A specific benefit accruing to the bank is marketing for the bank which was cited by 1 respondent who claimed that relationships are an added advantage to the bank because how you treat and personalize the experience for that one client will speak louder to other people.

The mutual benefits, for both customer and bank are “advisor” and “customer retention”. It can be argued that benefits for the customer also lead to benefits for the bank; for instance the “approval “ benefit cited by banks for customers may conversely be looked at an increase in loan income for the bank, customer numbers and so on. In fact in all cases where a customer is enabled to borrow from the bank, this may lead to more business for the bank and eventually translate to higher profitability.

#### **4.5.2 Summary**

The summary of the results shows evidence of the use of transaction lending, relationship lending and a combination of both lending technologies within the banks in the study. Each bank gives instances when they use a method and what emerges is that transaction lending can be employed exclusively while relationship lending is employed together with transaction lending and is only considered after borrowers meet requirements under transaction lending. Interestingly, the one respondent that out rightly states that they do not use relationship lending; alludes to the use of this method when they indicate their consideration of borrower character and behaviour in their lending decisions.

To confirm and inform on the practice of relationship lending, a further investigation is carried to determine banks’ use of the traditional measures of relationship lending found in literature. The study reveals that these measures even though considered by banks, are not used in isolation but together with other considerations. Duration on its own has no

effect and is based on the activity in the account, scope in isolation also has no effect but is based on activity and type of products and finally, concentration of banking has an effect in the decision making so long as the borrowing customer agrees with the requirements percentage of banking of each bank. The results also reveal that the consideration of duration results in benefits for both banks and for borrowers and more so benefit borrowers as only one benefit is indicated for lenders. The most common benefit of duration, indicated by five respondents, is that it favourably impacts approval of the loan. Other benefits for borrowers in order of frequency are; lower rates, longer tenure, lower fees and waiver on start-ups. The only benefit of using duration for banks is that it adds to information. The results on the impact of scope on the SME lending decision reveal that similar to the duration measure, the consideration of scope yields benefits for both banks and borrowers, however benefits for the borrower are more prevalent as only one out of the total ten responses indicates a benefit for the bank. The most common benefit for borrowers is that scope leads to lower pricing, while others are borrowing advantage, concessions and a deeper relationship (which is seen as an advantage for both borrower and bank due to the additional benefits that may be gained due to such a relationship). There are mixed responses regarding the impact of concentration of borrowing on the SME lending decision. There are those respondents that indicated that being multi-banked is a negative, that is banks would not lend to such a customer; those that are neutral, that treat the multi-banked customer just like any other that is not; and those that consider the multi-banked customer but with conditions. The most prevalent response is that being multi-banked impacts the SME lending decision with the multi-banked borrower only considered based on certain conditions. To note also is that what emerges from the inquiry on the impact of concentration of banking on the SME lending decision, is similar to the conclusion for the other two measures of relationship lending discussed earlier, duration and scope; that concentration of borrowing is not considered in isolation but other factors such as turnovers, reasons why the customer is multi-banked and whether they agree to meet certain conditions come into play.

On the role of relationships in SME lending, the general theme is that the banks acknowledge that relationships do play a major, if not a critical role especially when

dealing with SMEs. In comparing how relationships affect decision making between an existing customer and a new customer, the consensus is that it favours existing over new customers. Further the results reveal that relationships may result in benefits for customers, benefits for the bank and mutual benefits. The benefits for customers resulting from relationships are; in order of preference, waivers, approvals, concessions, and value addition. Benefits accruing to the bank are marketing for the bank, while the mutual benefits, for both customer and bank are “advisor” and “customer retention”.

#### **4.6 Benefits Generated from Engaging in SME Lending by Commercial Banks in Kenya**

The potential benefit of SME lending has been documented in several recent studies. As commercial banks have been involved in SME lending for some time, a sector which was previously ignored or avoided due to its high risk, this was an attempt to understand whether banks are reaping actual benefits.

Table 4.16a Benefits of SME lending to commercial banks

| <b>Bank and Respondent</b> | <b>Respondent Response</b>  |
|----------------------------|---|
| B1a                        | <ul style="list-style-type: none"> <li>• The bank grows its SME book and grows deposits when these enterprises bank their sales through the bank...the more you have, the more the cheaper deposits because these are not large amounts that are deposited by any one SME customer such that they cannot demand a higher deposit rate.</li> <li>• Interest income from the loans...transactional income from for instance, RTGS, cheque book processing, TT.</li> <li>• Successional business growth – growing to corporate with them still means we get their retail income.</li> <li>• SMEs have income tentacles; we capture their employees in retail business without marketing for it.</li> </ul> |

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|     | <ul style="list-style-type: none"> <li>• SMEs assist the bank to serve the country in every sector. When you are the key bank with SMEs you will get 80% of the businesses. It enables the bank penetrate to all sectors of the economy e.g. technology, media, manufacturing; whereas banking big corporates limits the bank's penetration to only a few sectors e.g. agriculture and pharmaceuticals. SMEs are everywhere.</li> </ul>   |
| B1b | <ul style="list-style-type: none"> <li>• Referrals for instance if a customer is in the transport business he can have 5 other referrals who deal in different aspects of transport for instance, logistics. You can get Sh.30M from 1 person in a year.</li> <li>• There are also the workers, staff accounts from this one customer.</li> <li>• SMEs market for you as the brand sells itself</li> </ul>  |
| B1c | <ul style="list-style-type: none"> <li>• There are direct benefits and indirect benefits, the drive to go for SMEs is derived from the perceived risk levels currently and the opportunity there is for the bank. The opportunity for the bank always is to be able to intermediate profitably. Today, banks have already determined that there are some customers who don't have collateral and can borrow and service their facilities promptly. Never mind some will not pay. Some will pay and will pay profitably to the extent that if you are lending an unsecured facility because the risk is high, you price higher.</li> <li>• There are other benefits of course that banks have from SMEs. SMEs are known to be net borrowers...the minute that you have a salary coming in but the loan is more than the salary, then you are a net borrower. SMEs have a tendency to keep borrowing. Now, corporates are the opposite. Very little customers are the opposite. Now SMEs, from their activity of borrowing, they benefit from what we call gearing, you have a market that is not saturated, so you can trade more, you can gear up your profits. It is because from that trade activity, the bank generates more revenue from SMEs;</li> </ul> |

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|          | <p>because there are other services they come for which we charge them and which they cannot come for when they are not trading actively or more actively.</p> <ul style="list-style-type: none"> <li>• So there are very many benefits but very generally see it from the perspective of income and their being lucrative, to be the main reason why banks are very interested in SMEs.</li> </ul>   |
| B2a      | <ul style="list-style-type: none"> <li>• Interest income...non-funded income which is any income not generated from borrowing which includes commissions from other services offered e.g. bid/performance bonds as these enterprises supply government, transactional income from normal operations of account-withdrawals, cash handling fees (small but many transactions), commitment fees on loans. To note is that in comparison the larger firms have negotiated for a lot of concessions as they have bigger bargaining power and may not pay some fees.</li> <li>• Referrals to other SMEs who are suppliers or clients of the SME client, essentially SMEs can generate a pipeline</li> <li>• Generate products out of the relationship with SMEs as they are a source of ideas. One may develop a product and test it with a particular client and if it does work may roll it out as a product for all SMEs.</li> <li>• They are a source of foreign exchange for those that deal in foreign currency...this is an untapped market that is huge/big and has potential for growth.</li> <li>• It is a market that is not sensitive to pricing as their deposits are not huge and therefore do not have bargaining power but they do need loans, in essence this market needs the bank.</li> </ul> |
| B3a, B3b | <ul style="list-style-type: none"> <li>• It enables the bank to serve a full spectrum, all biggies have side businesses; it is a fulfillment game...penetration strategy- the SME</li> </ul>  |

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|     | <p>may offer leads to a big corporate though this may also work the other way, i.e. big corporate to SME.</p> <ul style="list-style-type: none"> <li>• Finance SMEs to meet needs of distribution...SMEs are a lever as they interdependent on so many other existing and potential clients...at the end of the day enables us make profit.</li> </ul>   |
| B4a | <ul style="list-style-type: none"> <li>• Benefit returns more in SME sector because big corporate bargain for concessions can push on rates.</li> <li>• For them it's more I need the money, they take loans more seriously than the bigger corporates (scared of implications) unlike a corporate who will know the bank will take 90 days before they send an auctioneer.</li> <li>• You might be able to get a higher return on SMEs.</li> <li>• New upcoming guys, winning tenders they don't have capital, take smaller loans, pay, take.</li> </ul>  |
| B5a | <ul style="list-style-type: none"> <li>• Revenues – lending, we are revamping SME strategy- e-channels, we have not reaped yet.</li> </ul>   |
| B5b | <ul style="list-style-type: none"> <li>• The value is the incomes we get from the customers.</li> <li>• The reputation. When you deal with these SMEs, the communities decide that you really care about them... so your reputation will also be...the brand name is stronger than someone who is not dealing with the SMEs.</li> <li>• The government also appreciates the financial institutions that support SMEs, since you are contributing to the economic growth of the country of the nation. So you find that the government will also invite you for conferences, meetings to discuss SMEs lending on the strength that you are in that particular market. There is also the issue of... sometimes government disburses funds targeted to</li> </ul> |

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|     | <p>the SMEs. So they would channel those funds through banks that they know are dealing with the SMEs and that is a source of cheap deposits for the bank... when the government disperses money through your bank.</p> <ul style="list-style-type: none"> <li>• Yes also the commissions and the ledger fees... everything is about profitability.</li> </ul>  |
| B5c | <ul style="list-style-type: none"> <li>• There is a profitability component assigned.</li> </ul>  |
| B6a | <ul style="list-style-type: none"> <li>• It affects profitability for sure but remember you only are profitable to the extent your customers are profitable, so the two of you are linked so if am lending to unsuccessful businesses it will also come back and affect me in provisioning and my cost of actually making sure that your loan is performing because it means your loan will not be performing because you don't know how to operate your business, you're not growing so to speak so you're not increasing your revenue generation so it's all interlinked and that's why we say we want to capacitate them so that then our work is easier in terms of monitoring we know you'll do your thing because you know how to do it.</li> </ul> |
| B6b | <ul style="list-style-type: none"> <li>• A lot ranging from transactional accounts, of course those are the normal account you have...your current account, your savings account we have fixed deposits, we have call deposits.</li> <li>• Apart from the loans we also have workshops. We do workshops a lot of workshops for the SMEs...we also do trips for our customers to expose them to external markets...what we are getting from our customers is the relationship...you see that is our key focus in relationships because you see banking is changing and now we are focusing more on other items apart from just getting income from the customer... the rest of course will just come in handy because</li> </ul>                           |

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|     | <p>you see if you have that relationship with a business, tomorrow the business person will ask you... I have this shortfall in cash...are you able to come in? You know when you relate with your customers you tend to keep them longer in your bank as opposed to when the relationship is just transactional.</p> <ul style="list-style-type: none"> <li>• If you are in business there is competition. The more you relate to this customer the more you are better placed to understand the current needs... so that of course even to your end as a bank we become even more innovative. By becoming more innovative that will give you a competitive advantage to serve them more... and of course now if you have a competitive advantage, let me say it... there is income to it.</li> </ul>  |
| B6c | <ul style="list-style-type: none"> <li>• SMES are very simple, they want things done fast... an SME will rarely sit down to negotiate with the bank. The corporate are very... the business up there at the corporate level is very competitive...have bargaining power. So even in-terms of margin that you can get are very slim but an SME...they all want...want working capital... give me working capital I move on, move my business... so there is a lot of money that a bank can make from the SMEs.</li> <li>• They do a lot of trading so even in terms of what we call non-funded income...all these other things like LCs (letters of credit) when you are importing things and trading FX (foreign exchange). Sometimes you need to change dollars to Kenyan shillings... the bank makes some money there on the exchange. That is where SMEs are operating... because they are trading. So it's a huge opportunity and unfortunately not many banks have taken time to understand SMEs. Because an SME... you just have to understand them based on their activity. So it is an investment that is worthwhile even for the bank to take it.</li> </ul> |

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|     | <ul style="list-style-type: none"> <li>• It is the most profitable sector for the bank...in short what I am saying is that SME is the engine of the economy. So even as a bank if you ignore that sector you are setting yourself up for failure. There are the people that drive the profitability that you see here.</li> </ul>  |
| B7a | <ul style="list-style-type: none"> <li>• To answer ... I mean ...like how many corporates are there vis-a-vis how many of them can you get vis-a-vis SMEs. Competition for them may not be as high as for corporate. Corporates are fewer but probably more strict in terms of where they also want to bank or if you are a multi-national maybe you have regulations you can only bank with this kind of bank... so then for a bank like us we may not be able to have as many corporate maybe as other banks. But SMEs is a playing field out there which is open... open market.</li> <li>• Another thing is also profit margins...margins in terms of what you can make out of the business...for corporate like I said they have large bargaining power, they give you huge deposits...billions, billions and they say lend us at this rate or we will go...and you know there is so much competition. They go with the deposits you are left without and you need the deposits to lend. The interest margins for corporate are much, much slimmer than SMEs. SMEs of course have the best margins because of demand.</li> <li>• Then of course in Kenya, SMEs are the ones who drive the economy. They employ many people and everything that is where the money is circulating. They are the ones that need to grow so they need to borrow so that is where there is a lot of business...focus for the bank. And even people who borrow as retail...retail borrowers...still borrow as SMEs. You know the way Kenyans are...you are employed and you still have a business. They also have employees so we are still able to grow on our retail avenues and they are always growing so there is so much more that you can do for them.</li> </ul> |

|            |   |
|------------|---|
| <p>B7b</p> | <ul style="list-style-type: none"> <li>• SMES are profitable, they are a good market, if they are handled well they can give you maximum returns. The bank wants to maximize profit essentially.</li> <li>• This segment doesn't care how much you charge, they don't care as long as you give them the money. SME don't care about the pricing. So we can be able to get more, I mean more returns to the facility to which we have given to them.</li> <li>• In terms of utilization, in most cases you realize that we give things like ODs (overdrafts). An OD is essentially an overdraft, and SMEs are usually constrained in terms of cash flows as compared to big corporates. If I come to a big corporate and I give them an overdraft of 1 billion, they might never use that for the whole year. They never utilise compared to an SME who I give sh.10million they are always at sh9.999million. They are close, yes, always utilizing that. So I think that it is a benefit as well.</li> <li>• They are easy to convince and they are a bit, they trust easily. In most cases they are easy to tell, for example the KBRR rates increased their rates the other day. We had difficulty to convince the big corporates that we are pricing this at 11% we want to increase the rate at least to match with the market.</li> </ul> |
| <p>B7c</p> | <ul style="list-style-type: none"> <li>• An SME is a driver to the economy; an SME will always look for opportunities on where they can service the end user either directly or indirectly. They are more flexible, they have more risk appetite. Now what's then happening in the banking sector, the banking sector is becoming extremely competitive which means that banks are then having to accommodate SMEs and having to come up with products where SMEs can be able to benefit.</li> <li>• An SME wants to know, I need money, when can I get it? Interestingly not even concerned about how much does it cost me, it's where can I get it ... where and when?</li> </ul>   |

Table 4.16b Summary: Benefits of SME lending to commercial banks

| <b>Benefits</b>                                  | <b>Respondents</b>                          | <b>No. of Respondents</b> | <b>No. of Banks</b> | <b>Rank</b> |
|--|---|---------------------------|---------------------|-------------|
| 1) Banking the economy                           | B1a, B7a, B7c                               | 2                         | 2                   | 9           |
| 2) Growth in the SME bank book                   | B1a, B2a, B6b                               | 3                         | 3                   | 6           |
| 3) Cheap deposits                                | B1a, B2a, B7a                               | 3                         | 3                   | 7           |
| 4) Higher interest                               | B1a, B1c, B2a, B4a, B5b, B6c, B7a, B7b, B7c | 8                         | 6                   | 1           |
| 5) Not yet reaped any                            | B5a   | 1                         | 1                   |             |
| 6) Reputation building and a stronger brand      | B1b, B5b, B6a                               | 3                         | 3                   | 5           |
| 7) Government recognition and support            | B5b   | 1                         | 1                   | 14          |
| 8) Non-funded income                             | B1a, B1c, B2a, B5b, B6b, B6c                | 4                         | 4                   | 4           |
| 9) Successional business growth                  | B1a   | 1                         | 1                   | 13          |
| 10) Income tentacles                             | B1a, B1b, B2a, B3a, B3b, B6c, B7a           | 7                         | 5                   | 3           |
| 11) Innovation of products/competitive advantage | B2a, B6b, B7c                               | 3                         | 3                   | 8           |
| 12) Source of foreign exchange                   | B2a, B6c                                    | 2                         | 2                   | 10          |
| 13) Relationship                                 | B6b   | 1                         | 1                   | 12          |
| 14) Less competition                             | B7a   | 1                         | 1                   | 11          |
| 15) Profitability                                | B1c, B3a, B3b, B5c, B6a, B6c, B7a, B7b      | 8                         | 5                   | 2           |

#### **4.6.1 Benefits of SME Lending**

There is agreement that there is value in lending to SMEs and the value is articulated as below:

##### **1) Banking the economy**

B1a states that banking SMEs implies banking almost all businesses in the economy as SMEs form 80% of the businesses. B7a agrees and explains that SMEs allow banks to penetrate all sectors of the economy, an aspect that is not present when banks concentrate only on the big corporates. SME banking enables the bank meet its target in terms of what they refer in a soft way as corporate social responsibility, as this is one of the sectors that the bank strategically tries to support (B6c). B7a concludes that as SMEs are driving the economy, that is where money is circulating.

##### **2) Growth in the SME bank book**

As the SME market is huge and untapped it has potential for growth (B2a) concurring with B1a's assertion that there is value in banking SMEs as they grow the bank's SME book. B6b adds that being relational helps retain customers as opposed to being just a transactional.

##### **3) Cheap deposits**

SMEs are a source of cheap deposits to the banks as compared to deposits placed by large corporates. This is because the amount deposited by any one SME customer is not that large compared to corporate deposits and as such SMEs are not able to negotiate for high deposit rates (B1a, B2a & B7a). Banks are therefore able to save on SME deposits.

##### **4) Higher interest**

B1c highlights that the higher the risk as is the case with SMEs the higher the return and as such banks that bank SMEs have an opportunity to price higher. B4a finds that as SMEs need the money, they take loans more seriously than the bigger corporates (scared of implications) unlike a corporate who will know the bank will take 90 days before they send an auctioneer. The lack of bargaining power by SMEs due to the small amounts of deposits placed means that SMEs are also unable to negotiate for lower rates on lending and as B6c puts it, SMEs are very simple and all they want is to get a loan and fast, are easy to convince (B7b) and will rarely sit down to negotiate with a bank that does accommodate them (B7c). B2a agrees when they emphasize that the SME market is not

sensitive to pricing as their deposits are not huge and therefore do not have bargaining power but they do need loans. Corporate are able to negotiate for lower lending rates (B4a) and concessions (B2a) due to the huge deposits they place at banks and to some extent banks' hands are tied because competition for the big corporates is so high. The interest margins for corporates are much, much slimmer than SMEs and as such banking SMEs allows banks to enjoy higher interest margins as SMEs of course have the best margins because of demand (B7a).As such interest income is a prevalent benefit for banks that lend to SMEs (B1a, B2a, B4a, B5b, B6c,B7a, B7b&B7c).

#### **5) Reputation building and a stronger brand**

According to B5b, banks can also build a reputation and a stronger brand through dealing with SMEs. B6a agrees and explains that capacitating SMEs to grow translates to easier monitoring of these enterprises which translates to lower risk and costs, and eventually more revenue for the bank. B1b summarizes that SMEs market for the banks, as the brand sells itself.

#### **6) Government recognition and support**

Banks that support SMEs also get government recognition and support as these banks are contributing to the economic growth of the country, of the nation (B5b). B5b gives the example of such recognition and support by government; invitation to conferences and meetings to discuss SMEs lending. Further, the government may also choose to disburse funds targeted to the SMEs through these banks resulting again in cheap deposits for the bank and additionally, earnings on commissions and ledger fees.

#### **7) Non-funded income**

Bank lending to SMEs also results in additional income that arises from transactions (transactional income) for instance, RTGS (Real Time Gross Settlement), cheque book processing, TT (Telegraphic Transfer) amongst others, which banks refer to as non-funded income (B1a, B1c). B2a explains that non-funded income is any income not generated from lending which includes commissions from other services offered and adds examples of these; bid /performance bonds, transactional income from normal operations of account-withdrawals and cash handling fees (small but many transactions).These also include commissions and ledger fees (B5b). As SMEs do a lot of trading, banks are able to make some money through collection of non-funded income (B6c). Trading may also

see these SMEs deal in foreign currency and thus are a source of foreign exchange for the bank (B2a, B6c). B2a adds that this is an untapped market that is huge/big and has potential for growth.

#### **8) Successional business growth**

B1a adds that banks also benefit through successional business growth, growing with SMEs to corporate implies that banks continue to enjoy their retail income.

#### **9) Income tentacles**

According to B1a, SMEs have income tentacles, which B2a agrees to and refers to as a “pipeline” and B3a, B3b call a “penetration strategy”. Apart from non-funded income, SMEs open up avenues to additional sources of income for the bank. These income tentacles include; banking SME employees without necessarily incurring costs marketing for it (B1a, B1b& B7a). Whereas banking big corporates limits the bank’s penetration to only a few sectors e.g. agriculture and pharmaceuticals, SME banking enables banks penetrate to all sectors of the economy e.g. technology, media and manufacturing. This occurs through referrals, for instance if a customer is in the transport business he can have 5 other referrals who deal in different aspects of transport for instance, logistics (B1b) and referrals to other SMEs who are suppliers or clients of the SME client (B2a). B3a, B3b further state that SMEs may offer leads to a big corporate, just like a big corporate may offer leads to a SME and conclude that it is important to finance SMEs to meet needs of distribution as SMEs are a lever, because they are interdependent on so many other existing and potential clients. B6c agrees and adds that since the environment we operate in is based on value chains, and most SMEs will probably be the primary mover in their independent value chain, a bank that ignores this sector is setting itself up for failure (B6c).

#### **10) Innovation of products/competitive advantage**

B2a and B7c add that another benefit of banking SMEs is that they are a source of ideas and out of the relationship, drive bank innovation of products which B6b agrees and adds that this may lead to the bank having a competitive advantage. Further, B2a states that when such a product is rolled out, it can be tested with the same SMEs before rolling it out for all SMEs. Related to product innovation, B6b mentions that one source of value they are getting from their customers is the relationship as they recognise that this leads

to fulfilment of a customer need in future which may lead to an innovation and ultimately give the bank a competitive advantage to serve them more.

### **11) Source of foreign exchange**

B2a indicates that SMEs are a source of foreign exchange for those that deal in foreign currency...this is an untapped market that is huge/big and has potential for growth. A similar benefit is stated by B6c that SMEs do a lot of trading, importing things and trading FX (foreign exchange) and the bank makes some money there on the exchange which is a huge opportunity and unfortunately not many banks have taken time to understand SMEs.

### **12) Relationship**

B6b states that they get a relationship form their customers because such a focus ensures continued business with these customers...you see that is our key focus in relationships because you see banking is changing and now we are focusing more on other items apart from just getting income from the customer... the rest of course will just come in handy ... you know when you relate with your customers you tend to keep them longer in your bank as opposed to when the relationship is just transactional.

### **13) Less competition**

According to B7a, another benefit from banking SMEs is that competition for them may not be as high as for corporates. Corporates are fewer and may have restrictions as to where they can bank for instance in the case of multinationals.B7a refers to the SME market as an open playing field.

### **14) Profitability**

Respondents were found shy to state that the end result of banking SMEs is the profits they make. Those that out rightly state it include B1c that states that with SMEs there is an opportunity for the bank to be able to intermediate profitably, while B3a, B3b refer to SMEs as levers that enable them make profits. The only value B5c indicates is profitability. B6c states that it is the most profitable sector for the bank which is echoed by B7a and B7b. However, B6a qualified that it is important to remember that banks are only profitable to the extent their customers are profitable.

#### **4.6.2 Summary**

The data collected on SME lending benefits yields about fourteen benefits that banks enjoy due to lending to SMEs. Respondents from each of the seven banks in the study indicated one or more benefits they enjoy from lending to SMEs. Interestingly, one respondent, B5a, indicates that their bank has not yet started reaping the benefits of SME lending which is in disagreement with other respondents from the same bank who detail benefits they are already enjoying. The most prevalent is higher interest which is indicated by 8 respondents from 6 banks and this benefit is closely followed in popularity by profitability indicated by 8 respondents from 5 banks. It can be argued that higher interest may lead to higher profits and as such these two benefits may be related. The least popular benefits, as these were indicated by only one respondent in each case, are; government recognition and support, successional business growth, relationship and less competition. Again some, if not most, of the benefits may be interlinked. For instance, the relationship may lead to product innovation which may in turn lead to government recognition that results in growth of the SME book, higher returns and increased profitability for the bank. This implies that there are indirect and direct benefits with the ultimate benefit being increased profitability as would be the case for any for profit organization. The conclusion is that there are actual benefits being enjoyed by banks that engage in SME lending which directly or indirectly translate to increased profitability.

## **CHAPTER FIVE: DISCUSSION OF FINDINGS**

### **5.1 Introduction**

This chapter provides a discussion of the findings of the study that are presented in chapter four. The findings are discussed in accordance with the research objectives that this study intended to achieve and within the context of the literature reviewed.

The broad result of this work is that both relationship lending and transaction lending matter because they allow the loan manager to evaluate both the ability and the willingness to repay the loan. The ability to pay is checked by hard information and the willingness to pay by soft information. Hard information as determined by this study and as suggested in previous literature is easily identifiable, whereas soft information is importantly collected by the bank and is critical in the determination of the character of the borrower. Once these two factors about the borrower are established by the commercial bank, they are combined to come up with a transactional product that suits the client's needs. As a result, relationship lending is not used in isolation but always together with transaction lending and hence the suggestion that the lending methodology that employs some relationship aspects be referred to as relational transaction lending.

The study also establishes the actual benefits being enjoyed by banks engaged in SME lending and that these benefits are interlinked and directly or indirectly translate to value for the bank in terms of increased profitability. The immediate and direct benefit of SME lending is that it adds to the SME book. Lending to an additional SME may then indirectly lead to three benefits; interest income perhaps from higher priced loans due to the higher risk, cheap deposits (due to lack of bargaining power by SMEs since deposit amounts are small relative to corporate deposits) and non-funded income arising from transactions. The three benefits may translate to greater profitability for the bank. Alternatively, growing the SME book by adding an SME customer may indirectly result in several income tentacles; for instance; referral to a firm (both SME or big corporate) in the SMEs

value chain or referral to other SMEs or banking of the SME employees. These income tentacles may market the reputation or brand of the bank or form part of the corporate social responsibility strategy for the bank. However, the converse may also occur such that the reputation, brand and CSR activities of the bank result in the income tentacles. As a result, the income tentacles also lead to interest income, cheap deposits and non-funded income arising from transactions which may translate to greater profitability for the bank. The indirect benefit of income tentacles may imply that a bank gets to support more SMEs and banks that support SMEs may get government recognition and support as these banks are contributing to the economic growth of the country. Also, the reputation or brand and CSR activities of the bank may lead to such recognition by the government. An example of such recognition and support by government is invitation to conferences and meetings to discuss SMEs lending. Banks may benefit if the government chooses to disburse funds targeted to the SMEs through them, resulting again in cheap deposits for the bank and non-funded income which translates to greater profitability.

The rest of the chapter is organised as follows: section 5.2 discusses the background of the respondents while section 5.3 discusses the SME lending process. Sections 5.4 to 5.6 discuss the results in accordance with the three research questions; borrower knowledge acquisition, processing and transfer; lending technologies employed and, the value generated from engaging in SME lending by commercial banks in Kenya. Finally section 5.7 provides a summary of the chapter. The outcomes of the findings are the development of models representing the SME lending process, how banks make decisions on SME lending technologies to be employed and finally, a flow diagram representing the actual sources of value for banks engaged in SME lending.

## **5.2 Respondents' Background**

This section discusses the respondents' background by detailing their designations, the duration they have been working with the SME customer, and their responsibilities. This information was collected to determine their suitability as participants for this study.

Most of the respondents interviewed have a designation that specifically assigns them the SME or work in or closely with the department within the bank that deals with SMEs. Additionally, most of the respondents have been dealing with SMEs for over six years, indicating significant experience in dealing with the SME customer and further confirming their suitability as participants for this study. The most prevalent designation is Relationship Manager-SME.

The data collected on the responsibilities of the respondents resulted in five key areas; operations/management, business development, relationship management, profitability and, product/service development, with the consensus being that the SME manager's role mainly involves business development.

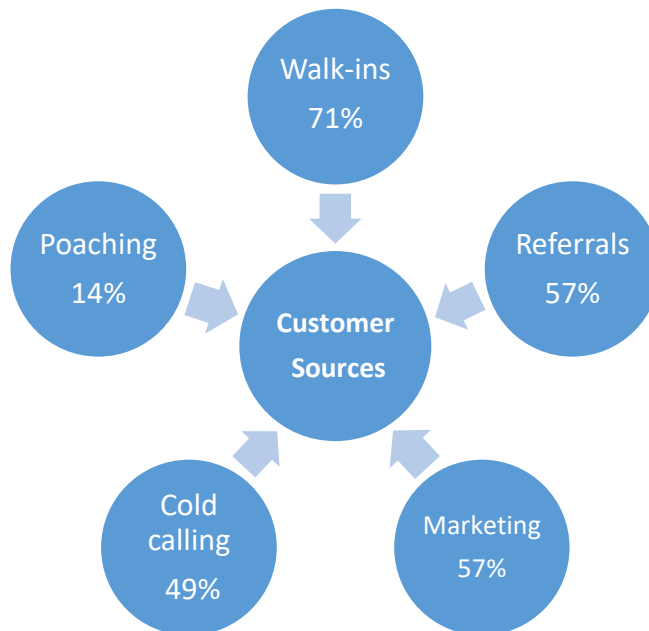
### **5.3 The SME Lending Process**

This section discusses the SME lending process because it is the process within which two of the research objectives occur; specifically the objective of borrower knowledge acquisition, transfer and use; and the SME lending methodologies employed by commercial banks.

#### **5.3.1 Source of Customer**

The SME lending process begins with the sourcing of the potential borrower customer. The study revealed that the sources of potential borrowing customers in order of frequency are; walk-in (71% of banks), referrals from existing customers (57%), marketing campaigns (57%), cold calling (49%) and poaching (14%). However, it can be argued that the least popular source, poaching, which involves attracting a competitor's customer, can be as a result of any one of the other three sources that is the referrals, marketing campaigns or cold calling. Banks were also found to employ more than one customer acquisition strategy. These sources are represented in figure 5.1 on the next page.

Figure 5.1 Customer Acquisition Strategies



*Source: Researcher's own*

The customer acquisition strategies revealed from the investigation concur with those established by Beck et al. (2008) and IFC (2007). Beck et al. (2008) use data from a survey of 91 banks in 45 countries to characterize bank financing to SMEs around the world and find that banks in developing countries focus on attracting SMEs that are clients/suppliers of existing clients or rely on existing deposit clients. The IFC (2007) “*Benchmarking Banks*” report ranks client acquisition channels in the following order; direct visits by bank sales staff to SMEs’ premises to present the bank’s offering to prospective clients, referrals from existing customers and, mass communication techniques such as direct mail and telemarketing to reach new clients. The current study agrees with prior studies that the acquisition strategies of marketing of product offerings by bank staff and referrals by existing customers play an important role in client acquisition. On the other hand, contrary to IFC (2010) that finds that SMEs are less likely to be actively seeking bank products and services because many SMEs lack basic knowledge of how they can benefit from banks, the most frequent source revealed by the current study is the walk-in customer. The IFC

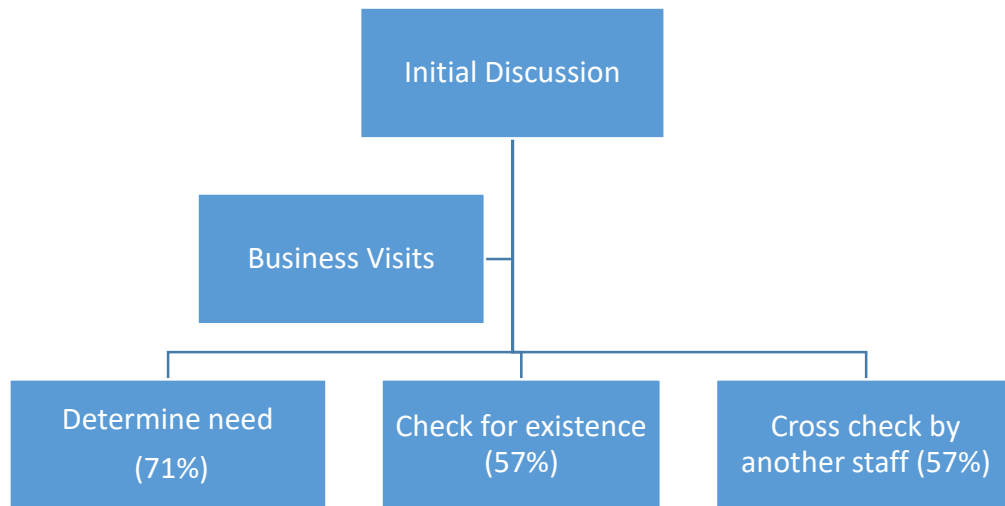
(2010) study also emphasizes that this is especially true for developing countries which again is contrary to the findings as Kenya is a developing country.

### **5.3.2 Initial Discussion and Business Visits**

After sourcing for customers, the banks indicated that they have an initial discussion with the potential borrowing customer to establish the need. The initial discussion is usually followed by a visit to the customer's business premises by the SME bank manager. One bank indicated that they do not always carry out a visit as it depends on the amount borrowed, nature of business and how comfortable the bank is. These business visits enable the bank not only to confirm that a business does actually exist and to confirm the need, but also allow the bank to collect more information that would not be evident during the customer call or visit to the bank. The initial discussion and subsequent business visits which banks in the study invest in so as to establish a "need" concur with Freixas (2005) who emphasizes that the bank makes the necessary investment to obtain borrower-specific (often proprietary) information. Additionally, banks in the study invest in acquiring information at the onset of a relationship which concurs with IFC's (2010) suggestion of the importance of acquiring borrower specific information at the point of loan origination as a way of borrower screening to manage credit risk. Two banks in the study added that the visits are undertaken more than once and could be on an ad hoc basis indicating that banks not only initially screen customers, but also subsequently monitor them. This is in agreement with Boot (2000) and Freixas (2005) who argue that banks need to invest in acquiring information and processing of the same, as well as subsequent monitoring of firm activities. This also concurs with Diamond (1984) and, Rajan and Winton (1995) who affirm that banks obtain borrower specific information when they provide monitoring services.

The determination of the "need" appears very important for banks (71% of banks) as this is a subject of the initial discussion held with the customer and also a reason for the business visits. Figure 5.2 illustrates the process.

Figure 5.2 Initial Discussion and Business Visits



*Source: Researcher's own*

The figure above illustrates that the initial discussion and business visits are activities primarily held to establish the customer need which the bank may be able to fill. This determination of need assists the bank in structuring the appropriate solution/product for the customer which concurs with IFC (2010) that banks are starting to understand the particular needs and preferences of SMEs and are developing tailored approaches to overcome the historical challenges of high credit risk and cost to serve. Business visits are also carried out to confirm that a business really exists and also cross check information collected during the initial discussion with the customer.

### **5.3.3 Bank Requirements**

During the process of sourcing for the SME customer and, the initial discussion and business visits, the RM/RO also considers whether the potential credit customer meets certain bank requirements for lending. The investigation found out that the most prevalent bank requirement as cited by 86% of the banks, is the provision of bank statements, whether from bank customers or non-customers which concurs with Beck et al. (2008) who find that 49% of banks in developing countries included in their study, consider the financial assessment of a business as the important factor in SME lending. In addition to bank statements, the requirement of security was indicated as well as Know Your

Customer (KYC) documents such as PIN (Personal Identification Number) and ID (Identity Document). This concurs with Elyasiani and Goldberg (2004) who find that borrowers go through a structured application process which requires borrowers to provide specific financial information and security in order to qualify for the loans. Further and in agreement with the current study, Beck et al. (2008) find that in developing countries, 87% and 93% of the banks require collateral to make business loans to small-sized enterprises and medium sized enterprises respectively.

The results also reveal differences in requirements not only between but also within banks. What emerges is that banks do not have standard similar requirements for SMEs and as such, SMEs must be aware that different banks have different requirements. Further and more intriguing is that respondents in the same bank cited different requirements, indicating either flexible requirement criteria which may depend on the customer involved or the SME manager. For instance, one respondent stated that they always make business visits while another respondent from the same bank indicated it is not always the case. What is worth noting here is that the two respondents occupied different hierarchical levels which may suggest that the strategy implemented depends on the loan manager involved. Other examples of enquiries that yielded contrasting results were on business duration. This refers to whether banks lend to start-ups and if not, how long a business needs to have been in existence to be considered for financing by a bank. There were differences between banks in that regard but even more interesting within banks. The bank requirements are represented in table 5.1.

Table 5.1 Bank Requirements

| Bank Requirements        |                               |                              |                        |
|--------------------------|-------------------------------|------------------------------|------------------------|
| Open an Account<br>(71%) | Financial Statements<br>(86%) | Security/Collateral<br>(43%) | KYC Documents<br>(29%) |

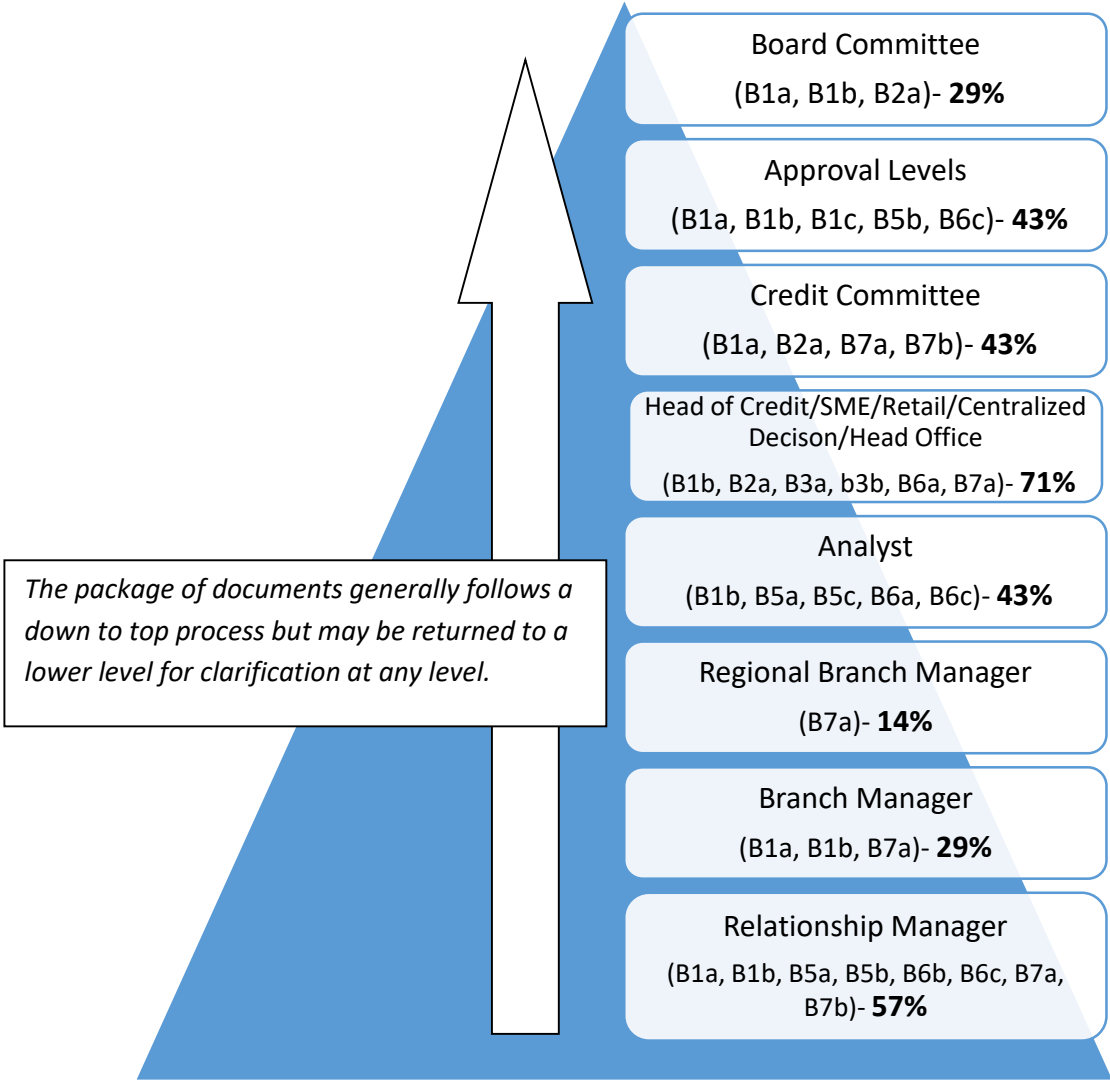
*Source: Researcher's own*

The table above shows that the highest rated requirement for lending consideration is the provision of bank statements. The results also reveal that banks may require a customer to meet more than one requirement.

#### **5.3.4 Loan Approval Process**

After having gone through the first and second steps and consideration of the bank requirements, the RM/RO puts together a package of documents that goes through the loan approval chain. This concurs with Elyasiani and Goldberg (2004) who find that borrowers go through a structured application process in order to qualify for the loans. Most banks indicate that this process starts with the Relationship Manager and depending on the bank structure, goes through the following steps; Branch Manager, Regional Branch Manager, Analyst, Head of Credit/SME/Retail or Centralized Decision, Credit Committee, Approval Levels and Board Committee. Even though the results yielded about eight distinct steps in the loan approval process, it should be noted that some of the steps, although termed differently, might refer to the same step in another bank, the difference perhaps being due to bank organization structures. Finally, a decision is made on whether to approve, approve with conditions or decline an application. The loan approval process is represented in detail in figure 5.3 on the next page.

Figure 5.3 Loan Approval Process



Source: Researcher’s own

The loan approval process is also an iterative process as approvers may return the application to a lower level for clarification or to the analyst, for rework. After the package of documents goes through to the highest level, depending on the loan amount applied for, a decision is made on whether to approve, approve with conditions or decline an

application. The most prevalent approving authorities in order from the first step are; the relationship manager (57%), analyst (43%), head of credit (71%), credit committee (43%) and approval levels (43%). The least prevalent steps are the branch manager (29%), regional branch manager (14%) and the board committee (29%). The few banks that indicated that the approval chain involves the branch manager and the regional branch manager (having a representation of 29% and 14% respectively) also indicated that the application first originates from the relationship manager. Finally, of the two banks that indicated the use of a board committee, one bank followed 88% of the steps in the process detailed above and the other bank 25% of the steps in the figure above. The results indicate that banks do not necessarily go through all the steps in the approval chain represented above because first, the approval levels an application will go through depends on the amount borrowed and secondly, some of the steps although termed differently, might refer to the same step in another bank. The difference perhaps, is due to bank organisation structures.

### **5.3.5 Summary**

All banks in the study were found to have a structured loan application and approval process that begins from sourcing for the customer to submission of a package of documents through an approval process. The information from the results enabled the researcher model a process flow chart for SME lending within the Kenyan banking industry which is represented in figure 5.4 and is further summarised in figure 5.5.

Figure 5.4 The SME Lending Process  
Customer Acquisition Strategies

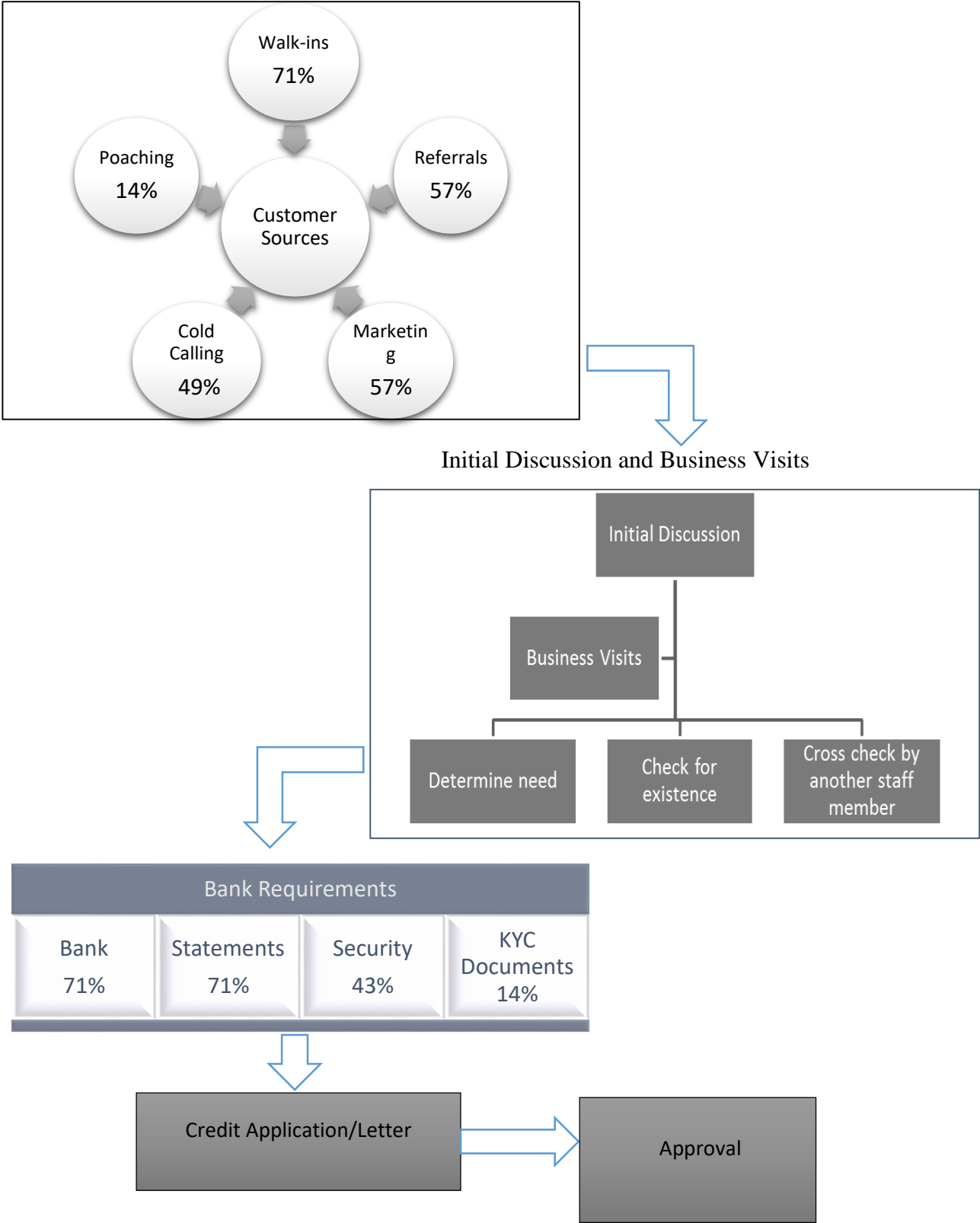
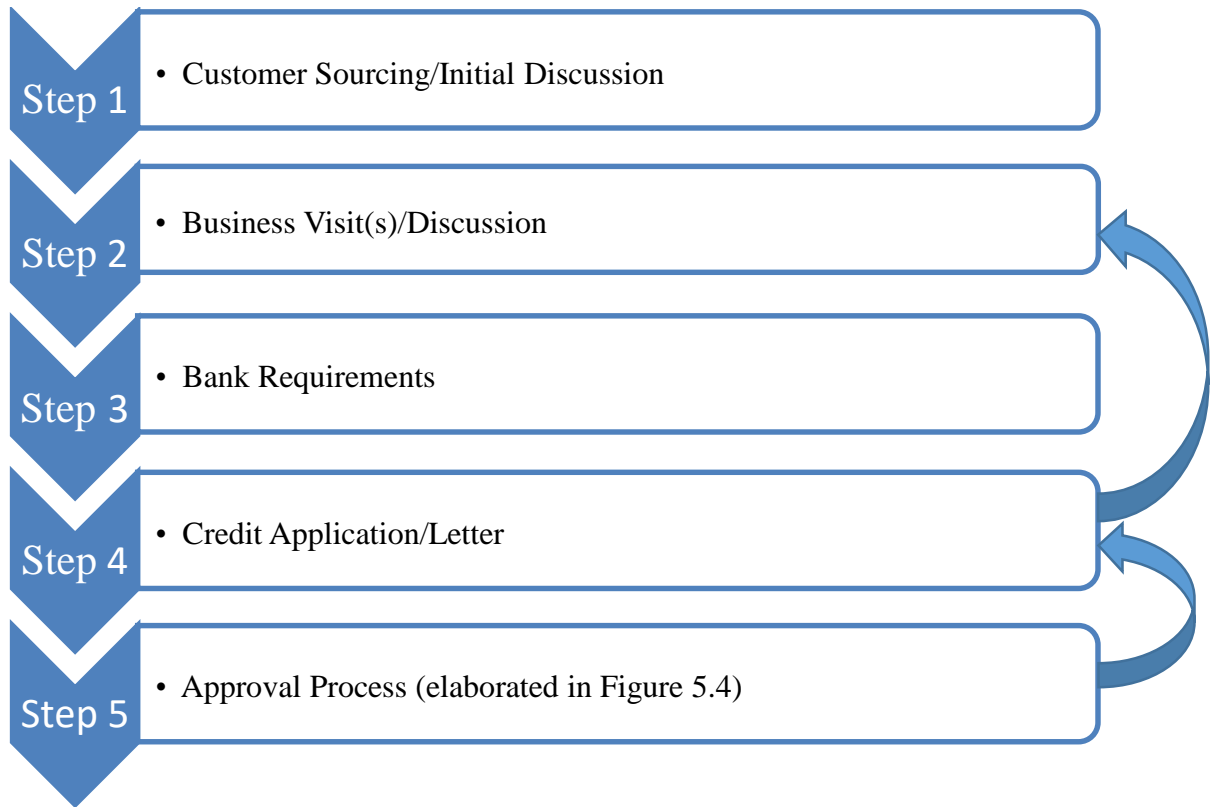


Figure 5.5 Summary SME Lending Process



*Source: Researcher's own*

The figure above summarizes the SME lending process as discussed in the previous pages, from the sourcing of the customer through to the approval of the loan. The study concludes that banks go through each of the five steps above but may differ in the method of execution of each stage. For instance, some banks indicated that they require a customer to complete a credit application form while another bank indicated that they only require a letter from the customer. Interestingly, respondents in the same bank also showed differences in requirement indicating either flexibility to make a decision or that the decision was dependent on the bank staff involved. For instance, one respondent from the same bank indicated that bank visits are a necessity while another indicated that visits are not always carried out.

The SME lending process is an iterative process as approvers may return the application to the relationship manager for additional information who in turn may need to go back to the customer to get the information to fill in the gaps (as shown in figure 5.5); similarly, approvers may return the application to a lower level of approval for clarification or to the analyst, for rework.

## **5.4 Borrower Knowledge Acquisition and Transfer**

This section discusses the findings in relation to the research objective aimed at determining how soft information is collected from borrowers, how it is processed, and the bank structure within which it is transferred for use in making the SME lending decision. Further, there is a brief discussion on how soft information collected is stored and the social ties between loan managers and the local community.

### **5.4.1 Borrower Knowledge Acquisition**

The study revealed that the RM/RO is not only the primary collector of hard information about the borrower as indicated in section 5.3.3, but also of soft information which concurs with Berger and Udell (2002; 2006) and to some extent with a more recent study by Hattori, Shintani, and Uchida (2015). Berger and Udell (2002) model the inner workings of relationship lending and suggest that loan officers, who have the most frequent and personal contact with borrowers and their stakeholders, obtain soft as well as hard information about the borrowers. Hattori, et al. (2015) conduct a survey on heterogeneous banks in Japan and find that loan officers (those who are at the bottom of the bank's hierarchy) collect at least some soft information and at smaller banks, branch managers may have direct contact with the borrowers and collect soft information although less frequently.

As the interest of the enquiry was on collection of soft information, the results revealed that soft information may be externally generated or internally generated. 86% of the banks in the study (the exception being the one bank that indicated they did not employ

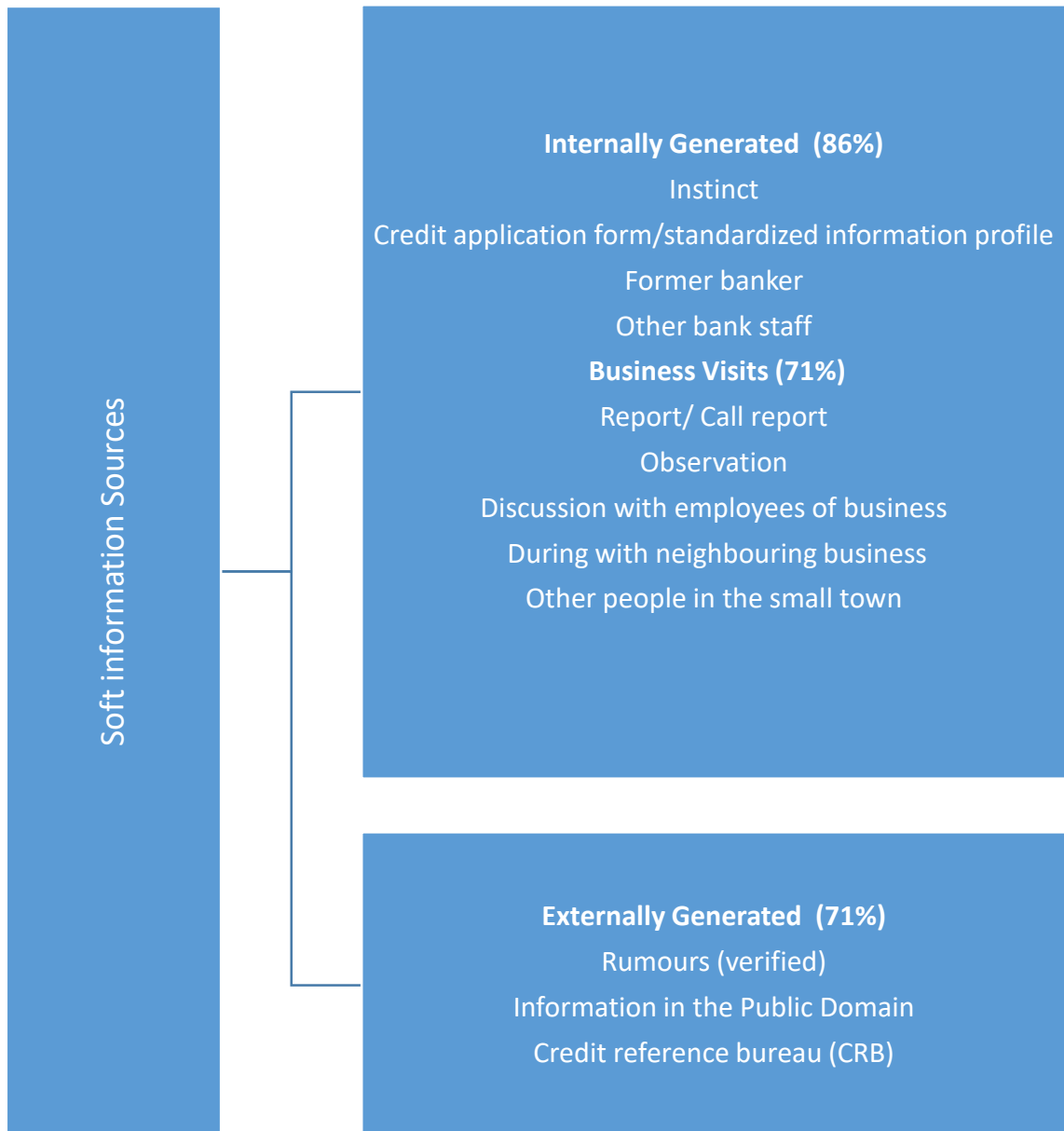
relationship lending) indicated that they generate soft information internally or that which is primarily generated by the RO/RM. 71% of the studied banks indicated that they collect soft information generated by parties external to the bank or non-bank staff. This indicates that banks do invest in obtaining borrower specific information which is in agreement with Freixas (2005) who argues that banks which are interested in such firms need to first invest in acquiring information and processing of the same, as well as subsequent monitoring of firm activities.

The most frequent source of internally generated soft information is the business visits made by the RM/RO which was cited by 71% of the banks. During the business visits, information is collected through observation, discussion with employees of target business, discussion with the person operating the neighbouring business and other people if the business is in a small town. These sources of soft information correspond with those suggested by Berger and Udell (2002; 2006) and Schwarze (2006) that additional borrower information may be gathered through communications with SME's suppliers, customers, or neighbouring businesses who may give specific information about the firm and owner or general information about the business environment in which they operate. The earlier discussion on customer acquisition strategies also suggests the use of soft information when loan managers use referrals in customer acquisition. The use of referrals imply that the loan manager uses the assessment (soft information) of the existing customer as a lead to new customers which further implies that loan manager must have a level of trust (soft information about the existing customer) in the existing customer.

What also emerges from the current study is that since 86% of the banks in the study indicated that they collect and use soft information, this may indicate the use of relationship lending because in line with Berger and Udell (2006); relationship lenders collect information beyond that which is available on the firm's financial statements and that which is readily available to the public. Further support that banks in the study employ relationship lending is confirmed from the suggestions of Elyasiani and Goldberg (2004) and Schwarze (2006) that relationship lending is based significantly on soft qualitative data gathered over the course of a relationship with the borrower.

The sources of soft information are represented in the figure 5.6 below which highlights the most prevalent sources of soft information.

Figure 5.6 Sources of Soft Information



Source: Researcher's own

#### 5.4.2 Soft Information Processing and Transfer

The current study finds that soft information is first processed by way of verifying (71% of banks) it after which it is then transmitted through the channels of the loan application

process. The top three strategies for processing soft information are; visit by a shadow and other bank staff, cross check with formal information and consultation with other bank staff. A closer look at the respondents listed under each strategy revealed that a bank may employ multiple strategies to verify soft information suggesting that the information being collected may not be easily observed or verified by others which concur with Berger and Udell (2006) that soft information may not be easily observed or verified by others.

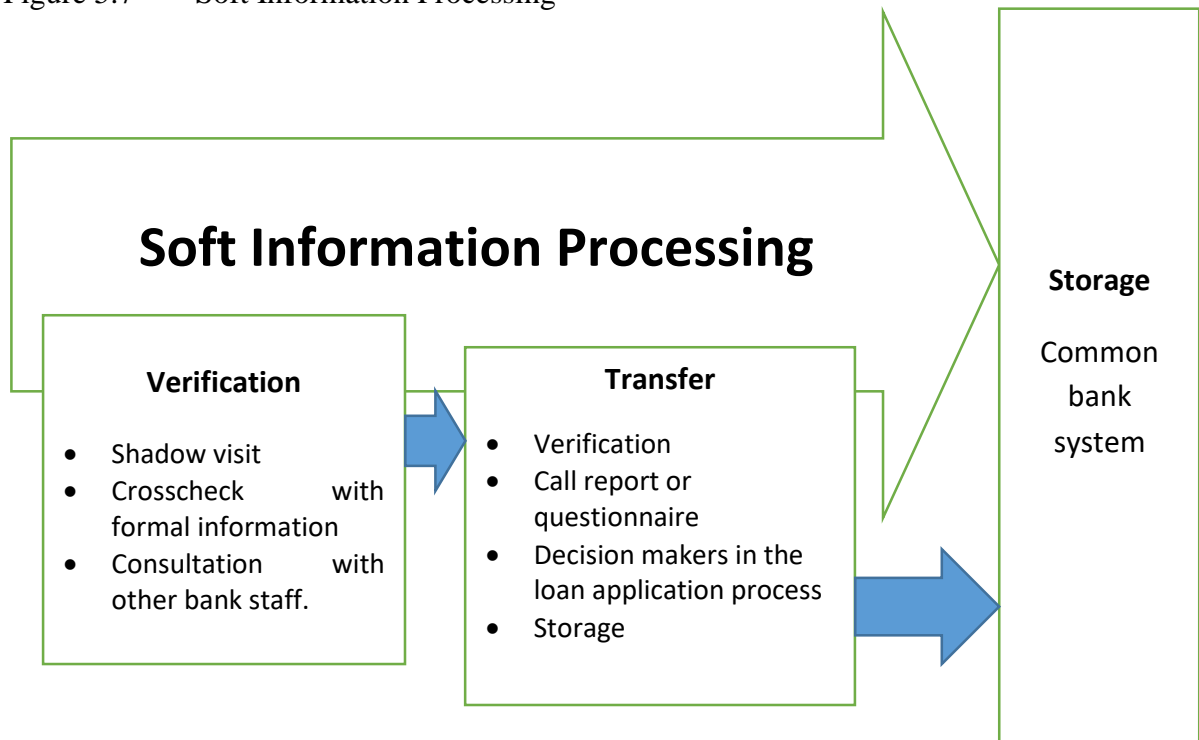
The process of verification also acts as a first step in the transmission or transfer of soft information. Interestingly, most of the verification strategies include the involvement of another bank staff, who is not the primary collector of the soft information, to ensure that the information eventually used is objective and valid. This also indicates that banks not only prefer to generate their own soft information but also prefer to rely on their own internal mechanisms to process or verify the soft information collected. This implies that soft information remains proprietary to the bank that collects it but more importantly, is not proprietary to the loan officer who collects or first comes into contact with it. This contradicts Boot (2000) and Freixas (2005) who suggest that soft information may often be proprietary to the loan officer and may not be easily transmitted to others within the financial institution.

The analysis reveals that soft information is also transferred through documents such as the call report or questionnaire that captures information collected during the business visit(s). This is consistent with the evidence from Japan by Nemoto, Ogura, and Watanabe (2011) that shows that any information collected by employees in the branch is filed in a loan proposal, which even includes a record of casual conversation with borrowers. The call report or questionnaire is part of the package of documents that goes through the loan approval chain and as such, the transfer of soft information also occurs within the loan application process which agrees with the findings of Paravisini and Schoar (2012), when they find that sharing of soft information can occur during the decision making process by credit committees that consist of multiple bank employees including loan officer who collects the information, the branch manager (the loan officer's immediate superior), and one or two additional credit specialists.

### **5.4.3 Soft Information Storage**

Contrary to the conventional view that loan officers are the sole repository of soft information (Berger & Udell, 2002; 2006; Scott, 2006), the current study found that the repository of soft information is the common system in the bank, and soft information is accessible to all authorized staff. Information from the application form and the call report is recorded in this system and as such any soft information captured is also stored in this system. This coincided with the findings of Nemoto, Ogura, and Watanabe (2011) for banks in Japan that the loan proposal which captures all, even casual conversations with borrowers, is circulated so that all staff in a branch have access to it. The findings of the study agree with Hattori et al. (2015) up to the point that the loan officer may not be the repository of soft information but differ when they find that at least for smaller banks, it is the branch managers (who are likely to be decision makers) who are the most important repository of soft information. In an indirect way, Scott's (2006) findings in the U.S., greater loan officer turnover has a more adverse effect on the availability of credit. This suggests that the loan officer is the repository of soft information which contradicts the results of this study. A summary of the process of soft information processing, transfer and storage is illustrated by figure 5.7.

Figure 5.7 Soft Information Processing



*Source: Researcher's own*

Figure 5.7 shows that soft information is first processed by way of verifying it after which it is then transmitted through the decision making channels of the loan application process. As the process of verification also involves exchange of information, it acts as a first step in the transfer of soft information. Once information is verified and subsequently transmitted through the loan decision making process, it is then stored in a common system in the bank. This storage of information also acts as a further transfer mechanism because any authorized bank staff can access this information.

#### **5.4.4 Link between the Local Loan Manager and Local Community**

Most respondents indicated that all SME managers at a bank branch are equipped to handle any SME issue or query and as a result, there is no link between the local loan manager and the local community. There was an exception on two respondents from the same bank who indicated that there is a link between the local loan manager and local community in the case where loan managers are assigned to customers in their proximity and required to deal with their "local community". The study's analysed results disagree

with Berger and Udell (2002; 2006) who argue that the loan officer is only able to collect relevant information about the firm, its owner and business conditions in local markets from other local firms and individuals because they typically live in the local community.

#### **5.4.5 Summary**

In summary, soft information is generated externally or internally with banks preferring to generate this information internally, or primarily through their own SME bank managers. The soft information is more frequently collected during the business visits made by the RM/RO to the clients' premises suggesting that the RM/RO is the primary collector of soft information.

As regards soft information transfer, information is first processed by way of verifying it and then transferred through the channels of the loan application process. The verification strategies suggest that banks not only prefer to generate their own soft information but also prefer to rely on their own internal mechanisms to process or verify the soft information collected. To note is that the verification strategies employed also become a first step in the process of transmitting or transferring soft information. In most banks, soft information is not proprietary to the loan manager who comes into contact with the customer, but is made available to other relevant decision makers when this soft information is shared for decision making. Even though the primary collector of soft information is the RM/RO that comes into contact with the customer, there is agreement among all banks that the soft information collected and processed is stored in a common system that is accessible by all authorized bank staff.

Finally, 43% of the banks indicated that all SME managers at a bank branch are equipped to handle any SME issue or query and as a result, there is necessarily no link between the local loan manager and the local community. 29% of the banks gave exceptions in the case where loan managers are assigned customers that are in close proximity to the bank branch.

## **5.5 Role of Transaction Lending (TL) and Relationship Lending (RL) in SME Lending**

This section presents a discussion on how commercial banks make a decision on which lending methodology or technology to use when dealing with the SME customer and especially whether relationship lending, the preferred technology found in literature, is employed.

### **5.5.1 Lending Methodologies Employed**

The summary of the results show evidence of the use of transaction lending, relationship lending and a combination of both lending technologies in financing SMEs within banks in the study. This adds to the findings of Uchida et al. (2006) who, using data from a unique survey in Japan, find that multiple lending technologies are usually employed at the same time. Also, De la Torre et al. (2010) in bank surveys for a total of 48 banks (plus one leasing company) in 12 countries establishes that apart from relationship lending, banks are increasingly applying different transactional technologies. Other studies that present similar results are Columba, Gambacorta, and Mistrulli (2010) and Bartoli et al. (2012) who find that group lending Mutual Guarantee Institutions (MGIs), through peer monitoring and joint responsibility, help banks to mitigate SMEs' asymmetric information problems. Finally and more recently, Bartoli et al. (2013) investigate SME financing in Italy and find that banks lend to SMEs by using both transaction and relationship lending, independent of the size and proximity of borrowers. The results of the study support the earlier views of Berger and Udell (2006) and Uchida et al. (2006) that lending technologies can be complementary.

The most common lending technology employed by banks in the current study is the exclusive use of transaction lending while the least common technology is the exclusive use of relationship lending. This agrees with Uchida et al. (2006) who find that financial statement lending, a transaction technology, is most commonly used and contradicts traditional literature such as in Berger and Udell (2002) who focus on relationship lending as the prime lending methodology for SMEs.

The transaction lending technologies cited by respondents in this study include; asset financing, invoice discounting, LCs, loans and overdrafts, which confirm Berger and Udell's (2002; 2006) classification of these methods of financing as transaction lending technologies. Additionally, some banks in the study stated they use both hard and soft factors suggesting the use of both transaction and relationship lending. Examples of soft factors cited are; character of the directors, business knowledge of the owner, whether the client chases for tenders, how many tenders they have won, whether he or she is passionate about the business, behaviour, and account transactions. These examples concur with Berger and Udell's (2002; 2006) examples of soft information which confirms that banks in the study do use qualitative "soft" data about the borrower and further suggesting the use of relationship lending. Further evidence that suggests the use of relationship lending is the use of referrals in customer acquisition. The use of referrals indicates that loan managers use soft information in two ways; by trusting the current customer who provides the names of potential new customers and by the use of referrals which imply the use of soft information provided by the existing customer to acquire new customers. As a consequence, apart from the soft factors cited by respondents in the study, there is evidence of the use of soft information which implies the use of relationship lending, corresponding with Schwarze's (2006) proposal that the more qualitative information is used in credit decision making, the more one can speak of the granting of credit under relationship aspects

All banks in the study that indicated the use of relationship lending also indicated the use of the transaction lending methodology. Further, when these banks gave examples of when they employ each methodology, it was evident that when they employ relationship lending, it is usually together with transaction lending and relationship lending is only considered after meeting requirements under transaction lending. This adds to the findings of Uchida et al. (2006) that financial statement lending and relationship lending are often used in tandem. The findings also confirm Berger and Udell's (2006) proposal that lending technologies are not necessarily mutually exclusive and De la Torre et al.'s (2010) findings that banks can apply both relationship lending as well as different transactional

technologies. It can therefore be concluded that banks can either employ transaction lending exclusively or a combination of both transaction and relationship lending.

As regards lending technologies employed in SME lending, this study makes two conclusions; first it concurs with Berger and Udell (2006) and Uchida et al. (2006) that lending technologies are complementary and not necessarily mutually exclusive. Secondly, contrary to amongst others, Berger and Udell (2006), Bhattacharaya and Thakor (1993), Elsas (2005), Memmel, Schmieder, and Stein (2008), Ongena and Smith (2000) and Petersen and Rajan (1994) who define relationship lending as a distinct lending technology; this study finds that relationship lending is not used as a distinct methodology or exclusively but always together with transaction lending. The findings from the current study show that the consideration of soft qualitative data in lending is only after borrowers provide hard quantitative information as required by the banks. Therefore banks are seen to consider employing “relationship lending” only when a borrower has met requirements under transaction lending. This study therefore proposes the use of the term “relational transaction lending” to refer to the transaction lending method that considers qualitative soft information in decision making.

## **5.5.2 Measures of Relationship Lending**

### ***5.5.2.1 Duration***

The study reveals that duration, or the length of time that the bank has provided loan, deposit, or other services to the firm, is a consideration in making the SME lending decision for banks as it is considered by 71% of banks in the study. Interestingly, the study reveals that in 80% of these banks, duration is always considered together with activity; represented by turnover and profitability. The banks explain that the activity in the account matters more or is more important than duration because the tenure or duration alone does not necessarily show the activity on the account as a bank may have better information about an account with a shorter duration than one with a longer duration. This alludes to the definition of relationship lending by Boot (2000) who suggest that relationship lending centers around two critical dimensions; proprietary information customer and multiple interactions. Activity implies multiple transactions which may give better information

about the borrower than simply looking at duration. In other words activity reduces information asymmetry between banks and customers.

The results of the current study concur with those of Elsas (2005). Using a sample of small- and medium-sized corporate borrowers of five major German universal banks Elsas finds that the duration of the bank-borrower relationship is not related to Hausbank status but as a bank's share of payment transactions increases, it is more likely to be a Hausbank. Overall, the current study differs with Petersen and Rajan (1994, 1995), Berger and Udell (1995), and Ongena and Smith (2000), who posit that duration is the most widely used measure of relationships.

The results also reveal that the consideration of duration, together with the activity in the account, results in benefits for both banks and for customers and more so benefits customers as only one benefit is indicated for lenders. The most common benefit of duration is that it impacts approval of the loan, which confirms Degryse and Van Cayseele (2000) proposition that the positive relationship between duration and information flow should improve the bank's willingness to provide funds and thus availability of finance to the borrower. Further, the current study's findings also coincide with those of Boot (2000) and, Berger and Udell (2002) that duration positively affects the availability of credit.

The other benefits for customers in order of preference are; lower rates, longer tenure, lower fees and waiver on start-ups. This result agrees with Berger and Udell (1995) who examine the role of relationship lending in small firm finance and find that borrowers with longer banking relationships pay lower interest rates. Boot (2000) also found that duration results in a fall in interest rates over the life of the relationship. However, the study's results differ from those of Degryse and Van Cayseele (2000) who, in a study of Belgian enterprises, find that borrowing rates increase as the bank-firm relationship lengthens.

The current study finds that the benefit of using duration for banks is that it provides information; which agrees with Berger and Udell (1995) who support the proposition that bank-borrower relationships provide important information about borrower quality.

Additionally, in later studies, Berger and Udell (2002) and; Degryse and Van Cayseele (2000) posit that theoretically, there is a positive relationship between duration and information flow which should improve the bank's willingness to provide funds and thus availability of finance to the borrower.

What emerges in this subsection is that duration is a consideration in SME lending so long as it is considered together with the activity in the account.

#### ***5.5.2.2 Scope***

The results reveal that respondents from seventy percent of the banks indicate that scope or the number of different services or interaction over multiple services between the bank and the customer is a consideration in making the SME lending decision. This is consistent with Fredriksson and Moro (2014) that banks try to make money by also diversifying their product offering. Additionally, similar to the duration measure, scope is also qualified by some respondents who indicate that it is not considered in isolation but together with the activity in the account and type of products the customer enjoys, with a preference for loan products.

The consideration of scope results in benefits for both the bank and the borrower. In this case, benefits for the borrower are more prevalent. The most common benefit for borrowers is lower pricing. The reason behind this is that since scope of products may lead to higher earnings for the bank from the array of products that the customer is already enjoying, the bank considers lowering the price of loans or offering some concessions. This result concurs with evidence provided by Degryse and Van Cayseele (2000) who, in a study of the impact of relationship banking on Belgian enterprises, found that borrowing rates decrease when the scope of the bank-firm relationship increases. Other benefits cited for borrowers are; borrowing advantage (cited also by the one bank that indicated the sole use of transaction lending which may imply minimal use of relationship lending), concessions and a deeper relationship (which is seen as an advantage for both borrower and bank due to the additional benefits that may be gained from such a relationship). These results provide specific benefits of considering scope in the lending decision and add to

those of Cole (1998) who found that scope of a relationship as proxied by the purchase of multiple information-sensitive products (such as checking accounts) from a bank, increased the probability of getting loans from that bank. This is also consistent with Degryse and Van Cayseele (2000) and Santikian (2009) who report that information gathered from the interaction over multiple services between the bank and the customer may have an effect on the credit terms with the borrower.

In this subsection, what emerges is that even though a larger scope may be a sign of more entrenchment, commitment and attachment by a customer to a bank; positive activity is a consideration. Following that argument, if activity and performance of the account is what is more important; then a strong lending relationship is possible even without additional financial services. This concurs with Wood's (1975) position that a lending relationship may develop independently of a deposit relationship.

#### ***5.5.2.3 Concentration of Borrowing***

With the exception of one bank that indicated that concentration of banking had no impact as the bank relies on transaction lending, there was consensus that being multi-banked impacts the SME lending decision. The impact could be threefold: negative (banks would not lend to such a customer); neutral (banks indifferent between a multi banked and non multi banked customer) and positive (banks consider the multi-banked customer but with conditions). The results also reveal that similar to the conclusion for the other two measures of relationship lending; duration and scope, concentration of borrowing is not considered in isolation but together with other factors such as turnovers (again alluding to the activity in the account), reasons why the customer is multi-banked and whether they agree to meet certain conditions. Again this implies that concentration of borrowing is useful in reducing information asymmetry problems associated with SMEs concurring with Cole, Goldberg, and White (2004) that prior loan relationships give banks additional information about the applicant.

The most prevalent impact is the positive impact, where banks consider the multi-banked borrower based on the agreement to meet certain conditions. Further, the most frequent

condition is the requirement that the borrower maintains a minimum percentage of banking. The minimum percentages differ for banks as evidenced by the three possible percentages determined in the current study as; 50%, 70% and 80% and with the bank having such proximity to the customer, the aim is to eventually end up being the main banker which concurs with Elsas (2005) that having one exclusive relationship promotes closer ties between bank and borrower. Further, the study revealed that bank concentration is a way of accessing additional information, as well as monitoring the borrower performance and being able to spot any emerging issue as soon as possible. This concurs with Foglia, Laviola, and Reedtz (1998) who, in a study of an Italian bank find that the larger the number of bank relationships, the higher the riskiness of the borrowers because monitoring of the borrower tends to be weaker. The results also concur with the proposal of Diamond (1984) that a single bank relationship is optimal because it avoids duplication of screening and monitoring effort. Interestingly, most respondents indicated that because of the need to grow their business, they do not outrightly refuse to deal with a multi banked customer. This suggests that even though banks may not want to deal with a multi banked customer because of the increased information asymmetry, they generally do end up dealing with such a customer because they realise that SMEs will in most cases be multi banked. Commercial banks have realised that this characterizes the SME market that even if you are their main banker, SMEs will be multi banked. Banks look at it from the point of view of the customer and understand that SMEs are multi banked to avoid being let down by one bank when they most need funds, the SMEs make sure they have options. Some respondents also rationalized this by looking at it from another perspective; that you can have a customer who is faithful to one bank and does banking that is much less than a multi banked customer.

The second most prevalent category is the negative impact, where banks would not lend to a multi banked customer and which agrees to the findings of Cole (1998) that in the US, a lender is less likely to grant credit to a firm if the firm deals with other financial counterparts. One respondent justifies that their reluctance to lend to a multi banked customer is based on the fact that there is no control of borrowing and emphasizes that a bank needs all the information to be able to assess the need which again concurs with

Diamond (1984) that a single bank relationship is optimal because it avoids duplication of screening and monitoring efforts. In agreement with the results of the current study and Diamond's (1984) preposition, Foglia et al. (1998) reason that multiple bank relationships increase the riskiness of the borrowers as borrower monitoring tends to weaken. However, regarding a multi banked customer as a "negative" contradicts the results of a study by Dahiyab, Saunders, & Srinivasan (2003) that shows the existence of a prior relationship is important since banks favour firms with pre-existing banking relationships at the time of loan renewal and approval because it provides more information about the applicant for the bank. Similarly; Cole, Goldberg, and White (2004) in agreement with Dahiyab et al. (2003) add that a prior loan relationship gives the bank additional information about the applicant and small banks rely more heavily on it as it provides insights into the character of a borrower.

The least popular category, neutral, implies that banks are indifferent about being multi banked and not being multi banked. This was examined in more detail. The results revealed that banks appreciate that in the current business world, customers may be multi banked for various reasons such as, having businesses in places where the bank does not have branches, and looking for solutions which may not be offered by all banks. This concurs with Iturralde et al.'s (2010) suggestion that the number of relationships may be influenced by the characteristics of companies and the social and economic environment of a particular country because the characteristics of a company determines the "need" for which the bank provides a solution. Also, the social and economic environment determines investment of these banks in particular parts of the country.

### **5.5.3 Role of Relationship in Lending**

On the role of relationships in SME lending, the general theme is that the banks acknowledge that relationships do play a major, if not a critical role especially when dealing with SMEs. "you cannot have SME lending without relationship management" (B1a), "big role" (B5b), "critical role" (B6c), "major role" (B7a). This concurs with García-Appendini (2007) who in a survey of small business finances (SSBF) for U.S. firms showed that hard public information may not be used in loan underwriting when

banks have a strong relationship with the borrower, and that soft information, if available, is the driving determinant in loan underwriting.

In comparing how relationships affect decision making between an existing customer and a new customer, the consensus was that it favours existing over new customers and that relationships may result in benefits for customers, benefits for the bank and also mutual benefits. The benefits for customers resulting from relationships are; in order of preference, waivers (on documentation, security requirements and start-up requirements), approvals (including faster decision making), concessions, and value addition. This is in agreement with Bharath et al. (2003) who determine that the existence of a prior relationship is important and banks favour firms with pre-existing banking relationships not only at the time of loan renewal but also for approval as is determined by Sohn and Choi (2004) and Chakravarty and Yilmazer, (2008). More specifically, the respondents indicate that relationships inform the decision and as such improve the chances of approval concurring with Puri, Rocholl, and Steffen (2010) that prior relationships allow the bank to produce information that goes beyond publicly available information and allows it to better assess loan applicants' creditworthiness. This also concurs with Elyasiani and Goldberg (2004) that continuous contact between borrower and lender can produce valuable information which the lender can use in making decisions on whether to extend credit or not, how to price loans, whether to require collateral and whether to attach other conditions to the loan.

The specific role of relationships for banks was "marketing for the bank"; which was cited by one respondent who claimed that relationships are an added advantage to the bank because the way they treat and personalize the experience for that one client will portray a better image to other people. The mutual benefits for both customer and bank are "advisor" and "customer retention". It can be argued that benefits for the customer also lead to benefits for the bank; for instance the "approval " benefit cited by banks for customers may conversely be looked at an increase in loan income for the bank, and growth of the loan book amongst other benefits. In fact, all cases where a customer qualifies for borrowing, may lead to future business with the same customer, translating to more business for the bank and eventually higher profitability. This conforms with the

suggestion by Bharath et al. (2005) that relationships may result in a greater probability of providing future loans compared to a lender lacking such a relationship.

The results of the study also revealed that relationships do lead to some concessions and especially so for existing clients of the bank as these are the ones most likely to have a relationship with the bank. Only one bank gave an indication of when a new customer may also be considered for concessions. The banks further indicated that these concessions were considered on a case by case basis and were qualified, that is, were dependent on soft factors and performance. This result is similar to the results of how duration, scope and concentration of borrowing are considered, not in isolation but together with the activity in the account which further emphasizes that what is important in relationships is the activity in the account.

Examples of concessions cited as having been enjoyed by existing clients were; lower rates, longer term and fee discounts concurring with Elyasiani and Goldberg (2004) and in agreement with Bharath et al. (2003) that continuous contact between borrower and lender can produce valuable information which the lender can use in making decisions on how to price loans. Generally, most banks were in agreement that for an existing customer, things would move faster and requirements may not be as stringent. This is consistent with Hodgman (1961) who posited that a customer's deposit relationship with the bank influences the availability and cost of credit to that customer and leads to more favourable loan conditions for a customer than a non-customer.

#### **5.5.4 Summary**

On the lending technology employed by commercial banks in SME lending, this study makes two conclusions. Firstly, that lending technologies are complementary and not necessarily mutually exclusive. Secondly, in agreement with the first conclusion, and more importantly contrary to amongst others, Berger and Udell (2006), Bhattacharaya & Thakor (1993), Elsas (2005), Memmel, Schmieder, and Stein (2008), Ongena and Smith (2000) and, Petersen and Rajan (1994) who define relationship lending as a distinct lending technology; this study finds that relationship lending is not used as a distinct

methodology or exclusively but always together with transaction lending. Even though some banks in the study indicated that they do employ relationship lending, it was found that these same banks also used transaction lending and as a result, no bank showed evidence of the exclusive use of relationship lending. Further, the consideration of soft qualitative data in lending (which is used in relationship lending) was only after borrowers provided hard quantitative information (which is used in transaction lending) as required by the banks. Therefore, banks are seen to consider employing relationship lending only when a borrower has met requirements under transaction lending. This implies that relationship lending has to be considered as a contributor to transaction lending and not as an alternative. In other words, relationship lending is only synergistic with transaction lending and not orthogonal nor antithetical to transaction lending. As such, the resulting method should not be referred to as relationship lending but instead, this study proposes the use of the term “relational transaction lending” to refer to the transaction lending method that considers qualitative soft information in decision making.

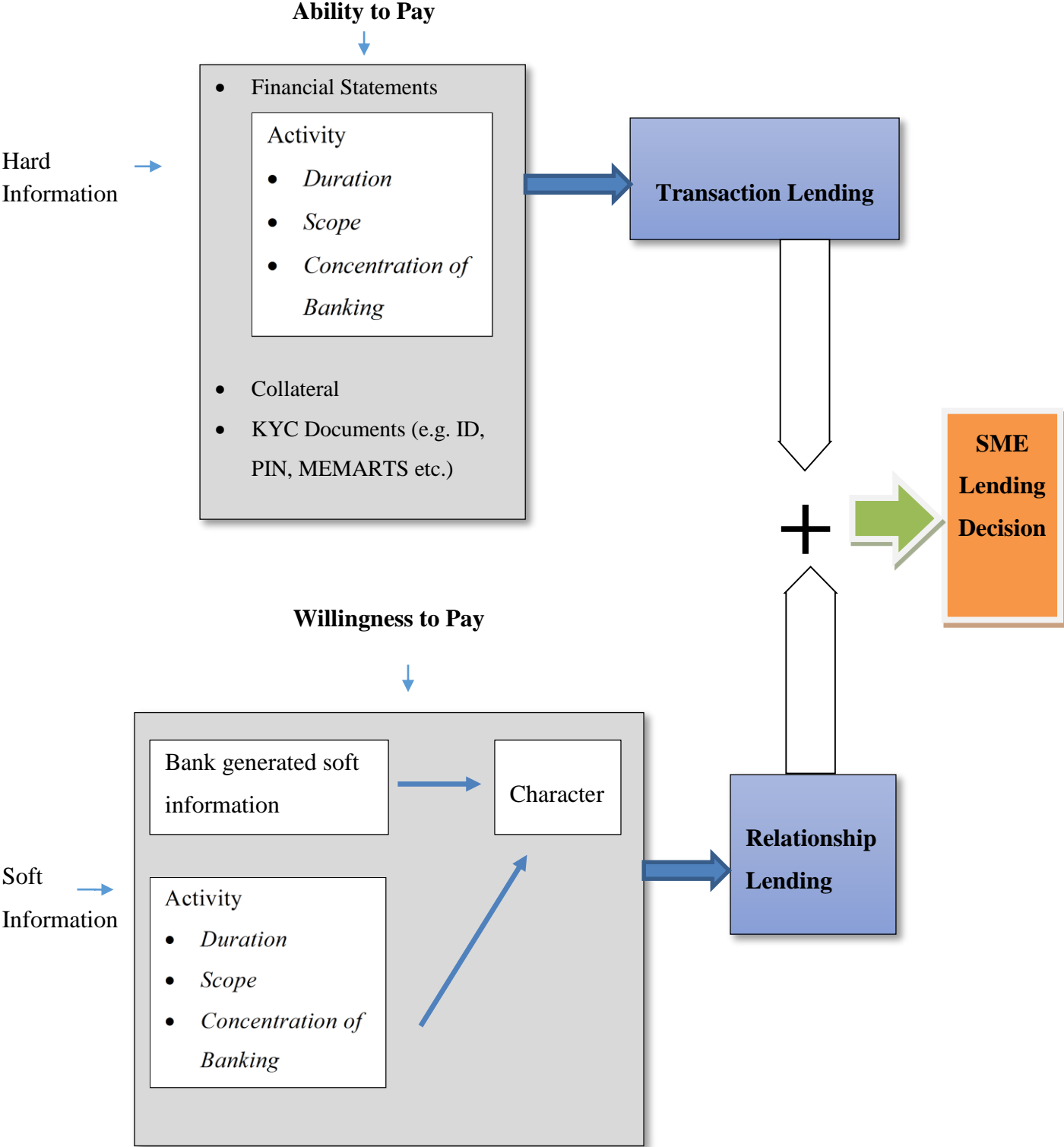
On the measures of relationship lending, the study establishes that banks do not apply duration, scope and concentration of borrowing as is suggested in literature, but apply these measures together with other considerations. Duration on its own has no effect and is based on the activity in the account. Scope, in isolation also has no effect but is based on performance and finally, concentration of borrowing has an effect and is considered together with the percentage banking requirements for each bank. This leads to the conclusion that what actually matters most is the activity in the account and the performance of the account and not duration and scope of products. Activity in the account can also give information about the behaviour or character of the borrower and provides much more information for decision making than duration, scope or concentration of borrowing. Duration on the other hand can be likened to the minimum term that banks require borrowers to have had an account to be considered for borrowing, hence it may be argued that it does not provide soft information for use in relationship lending but is actually hard information that can be used when employing transactional lending. Furthermore, when banks require financial statements from potential borrowers, they are interested in determining the activity. These financial statements are an example of “hard”

information and as such can be considered when banks employ transaction lending. As such, it can also be argued that the determination of activity is the use of hard information and hence the application of transaction lending.

This study therefore concludes that the way the measures of duration and scope are considered in the current study may not only imply that they are measures of relationship lending or the evidence of the use of soft information, but also of hard information. This is because in reality, what is under consideration is the activity, turnovers or performance which represent hard information used in transaction lending, further endorsing our earlier suggestion that relationship lending cannot be used exclusively.

After consideration of the above findings, a model of how commercial banks make a decision on SME lending method to employ is developed and provided in figure 5.8 on the following page.

Figure 5.8 SME Lending Methodologies



Source: Researcher's own

Combining the results on borrower knowledge and lending methodologies employed leads to the suggestion that two major factors are considered by commercial banks when lending to SMEs; the ability to pay and the willingness to pay. The ability to pay is proxied by hard information and the willingness to pay by soft information. Hard information as determined by this study and as suggested in previous literature is easily identifiable, whereas soft information is importantly collected by the bank and is critical in the determination of the character of the borrower. Once these two factors about the borrower are established by the commercial bank, they are combined to come up with a transactional product that suits the client's needs. As a result, relationship lending is not used in isolation but always together with transaction lending and hence the suggestion that the lending methodology that employs some relationship aspects be referred to as relational transaction lending.

### 5.6 Benefits of Engaging in SME Lending by Commercial Banks in Kenya

This section provides detailed information on the actual benefits that the commercial banks in the study indicated as arising from engaging in SME lending which adds to literature. A vast prior literature has either tended to focus on borrower benefits or only provided potential benefits (see amongst others Bharath et al., 2005; Berger & Udell, 1995; Calice et al., 2012; Cole, 1998; De la Torre et al., 2010; Elsas & Krahn, 1998; Harhoff & Körting 1998; Petersen & Rajan, 1994, 1995). Table 5.2 below shows the benefits and rankings based on the responses.

**Table 5.2 Benefits to Banks of SME Lending**

| <b>Benefits</b>                             | <b>Rank</b> |
|---|-------------|
| 1) Banking the economy                      | 9           |
| 2) Growth in the SME bank book              | 6           |
| 3) Cheap Deposits                           | 7           |
| 4) Higher interest                          | 1           |
| 5) Reputation building and a stronger brand | 5           |
| 6) Government recognition and support       | 14          |

|  |    |
|--|----|
| 7) Non-funded income                             | 4  |
| 8) Successional business growth                  | 13 |
| 9) Income tentacles                              | 3  |
| 10) Innovation of products/competitive advantage | 8  |
| 11) Source of foreign exchange                   | 10 |
| 12) Relationship                                 | 12 |
| 13) Less competition                             | 11 |
| 14) Profitability                                | 2  |

The enquiry on the benefits of SME lending to commercial banks resulted in fourteen benefits that banks enjoy due to lending to SMEs. Respondents from each of the seven banks in the study indicated one or more benefits they enjoy from lending to SMEs. One respondent indicated that their bank has not yet started reaping the benefits of SME lending which is in contrast with other respondents from the same bank who detail benefits they are already enjoying. The most prevalent benefit is higher interest which is closely followed by profitability and the least popular benefits are; government recognition and support, relationship, successional business growth and less competition. Some, if not most of the benefits may be interlinked. For instance, it can be argued that higher interest may lead to higher profits; hence these two benefits may be related. Another example is that the relationship between borrower and bank may result in product innovation which may in turn lead to government recognition of the bank's support of SMEs. Eventually, this may lead to growth of the SME book, higher returns and increased profitability for the bank. As the aim of this study was to determine the benefits that commercial banks in SME lending enjoy, the benefits established, in order of frequency were; higher interest, profitability, income tentacles, reputation building and a stronger brand, non-funded income, growth in the SME bank book, cheap deposits, innovation of products/competitive advantage, banking the economy, source of foreign exchange, relationship, less competition, successional business growth and government recognition and support. Each of these benefits is discussed below.

Interest earned from SME lending was the most prevalent benefit for lenders and was cited

by 86% of the banks in the study. As one bank highlights the higher the risk, as is the case with SMEs, the higher the return. In that case, banks that bank SMEs have an opportunity to price loans higher which concurs with the findings of Holod and Peek (2013). The lack of bargaining power by SMEs due to the small amounts of deposits placed means that SMEs are also unable to negotiate for lower rates on lending and as one bank states, SMEs are very simple and all they want is to get a loan fast, they are easy to convince and will rarely sit down to negotiate with a bank that accommodates them. The banks explain that corporates are able to negotiate for lower lending rates and other concessions due to the huge deposits they place at banks and to some extent; banks' hands are tied because of intense competition for the big corporates. The interest margins for corporates are much, much slimmer than for SMEs. Thus, banking SMEs allows banks to enjoy higher interest margins. As one bank puts it, SMEs have the best margins. Several studies in literature have argued against the high interest margins enjoyed by banks from SME lending, for instance, Garriga (2006) who states that a bank may end up having a monopoly of information over other lenders and thus be able to extract more interest income from borrowers. Others studies that concur with Garriga (2006) include Lehmann and Neuberger (2001) and, Hernandez-Cánovas and Martinez-Solano (2006) who also find evidence of higher cost of credit. Holod and Peek (2013) differ and explain that this higher cost of credit, though higher than is justified by the level of credit risk perceived by an informed lender, is lower than the interest rate that would be charged by other potential lenders to the firm, due to the higher risk premium required to compensate them for the added risk associated with being less informed about the firm.

Another benefit indicated by 29% of the banks is that SME lending leads to banking the economy. Banking SMEs implies banking almost all businesses in the economy because SMEs form 80% of all businesses in the economy, allowing the bank the opportunity to penetrate all sectors of the economy. Whereas banking big corporates limits the bank's penetration to only a few sectors, for instance, agriculture and pharmaceuticals, SME banking enables banks penetrate to all sectors of the economy such as technology, media and manufacturing as most SMEs will probably be the primary mover in their independent value chains. Hence, the SME market is huge and untapped and as a result, competition

for SMES may not be as high as for corporates, which means it has potential for growth. For one bank, banking the SME sector is strategic and supporting this sector meets their target in terms of what they refer to, in a soft way, as corporate social responsibility. This confirms the findings of Calice et al. (2012) who in their study to establish the extent of bank lending to SMEs in Kenya, Uganda, Tanzania and Zambia, find that banks perceive the SME segment as large, unsaturated, with good prospects and strategically important.

Banks also benefit from cheap deposits from SMEs. As indicated by 43% of the banks, this is because SMEs do not have bargaining power as do the large corporates that make huge deposits. These deposits enable banks to lend which results in interest income for the bank and therefore, having cheap deposits implies that the bank is able to save on returns to depositors which may result in greater profitability. This benefit concurs with Holod and Peek (2013) who suggest that banks may profit from relatively inexpensive core deposits placed by their relationship borrowers. Additionally, this confirms De la Torre et al.'s (2010) perception from a bank survey of 48 banks (plus one leasing company) in 12 countries that the SME segment is more profitable than corporate banking because of near zero spreads on corporate lending.

Respondents from 57% of the banks indicated that bank lending to SMEs also results in additional non-funded income which is any income not generated from lending. This includes; transactional income from normal operations of account-withdrawals and cash handling fees (small but many transactions), commissions, ledger fees, RTGS (Real Time Gross Settlement) transfer charges, cheque book processing and TT (Telegraphic Transfer). 29% of the banks also indicated that some SMEs may also be engaged in foreign trade and may need foreign exchange. As SMEs do a lot of trading, banks are able to make some money through collection of non-funded income, confirming the supposition of Calice et al. (2012) and De la Torre et al. (2010) that the perceived profitability of working with SMEs not only derives from lending products, but also from the potential for cross-selling other products. Further, this findings concur with Fredriksson and Moro (2014) who find that bank profitability is not only dependent on interest margins but also on

charges from additional services that SMEs enjoy from banks, for instance, from cash management, risk management and payment management.

Banks also benefit from the income tentacles provided by SMEs which banks also refer to as a pipeline or penetration strategy. This was a benefit enjoyed by 71% of banks in the study and gave examples of income tentacles as including; banking SME employees, referrals to other SMEs or even referrals to big corporates, confirming De la Torre et al.'s (2010) finding that one of the common drivers of bank involvement with SMEs is reverse factoring. Whereas banking big corporates limits the bank's penetration to only a few sectors e.g. agriculture and pharmaceuticals, SME banking enables banks penetrate to all sectors of the economy such as technology, media and manufacturing; again linking back to the benefit of banking the economy. Most SMEs will probably be the primary mover in their independent value chain and it is worthwhile for a bank to be a part of that channel. Banking the SME pipeline leads to a multiplication of the benefits already being enjoyed from the one SME such as additional cheap deposits and additional non-funded income which translates to greater profitability. This concurs with Ochieng (2010) and, Elyasiani and Goldberg (2004) who emphasize that investment by commercial banks in intricate relationships with clients could lead to growth in their customer base and loan book value, which translates into increased profitability. One respondent added that as SMEs experience successional business growth. This implies that banks continue to enjoy their retail income which again results to the benefits as articulated above.

Banks also benefit from the relationship with the SME customer, which was cited by 14% of the banks, who explained that focusing on relationships is key because everything else depends on the relationship. Further, SMEs take loans more seriously than the bigger corporates because more than anything else, they need the money and are afraid of the implications of not paying back. This is unlike a corporate that knows for instance, the bank will take 90 days before they send an auctioneer. This finding agrees with a study by IFC (2010) that established that banks have found that SMEs actually value relationships more than any other segment, whereas large corporates take it for granted.

Another benefit closely related to the one above on relationships is that SMEs are a source of ideas and out of the relationship, drive bank innovation of products which may lead to a bank having a competitive advantage. This benefit was indicated by 43% of the banks and is in agreement with Holod and Peek's (2013) suggestion that profits might accrue to the bank from future opportunities to continue and expand the menu of products and services provided to the firm as it expands.

Banks can also build a reputation and a stronger brand through dealing with SMEs. In other words, SMEs market for the banks, as the brand sells itself. This benefit was cited by 43% of the banks in the study; 67% of these banks use marketing and walk-ins as customer acquisition strategies, while 33% use poaching and walk-ins, indicating the importance of these banks in selling their brand well so that subsequently, SMEs do the same. Additionally, banks that support SMEs may also benefit from government recognition and support as these banks are contributing to the economic growth of the country. An example of such recognition and support by government is invitation to conferences and meetings to discuss SME lending. Further, the government may also choose to disburse funds targeted to the SMEs through these banks resulting again in cheap deposits for the bank and additionally, earnings on commissions and ledger fees.

Finally, 72% of the banks in the study indicated that greater profitability is a benefit of lending to SMEs. Even though respondents were shy of stating that the end result of banking SMEs is the profits that banks make. They indirectly alluded to the fact that SME lending leads to greater profitability for the bank and evidently so from the other benefits which they specified and discussed above. For instance, a respondent stated that with SMEs, there is an opportunity for the bank to be able to intermediate profitably, while other respondents referred to SMEs as levers that enabled them make profits while another qualified that it was important to remember that bank profitability depended on customer profitability indicating the dual benefit. With all these factors considered, SME lending adds to the profitability of the bank, with even one bank emphasizing that it is the most profitable sector for the bank. This provides empirical evidence to support Calice et al.

(2012) and De la Torre et al.'s (2010) findings that perceived profitability is a major driver of bank involvement with the SME segment.

To summarise, as previous studies that focus on the benefits of SME lending to lenders tend to provide only indirect evidence about the value-enhancing effects of lending relationships on the banks (Holod & Peek, 2013), this study establishes the actual benefits being enjoyed by banks engaged in SME lending. Further, the study shows that these benefits are interlinked and directly or indirectly translate to value for the bank in terms of increased profitability. The immediate and direct benefit of SME lending is that it adds to the SME book. Lending to an additional SME may then indirectly lead to three benefits; interest income perhaps from higher priced loans due to the higher risk, cheap deposits (due to lack of bargaining power by SMEs since deposit amounts are small relative to corporate deposits) and non- funded income arising from transactions. The three benefits may translate to greater profitability for the bank.

Alternatively, growing the SME book by adding an SME customer may indirectly result in several income tentacles; for instance; referral to a firm (both SME or big corporate) in the SMEs value chain or referral to other SMEs or banking of the SME employees. These income tentacles may market the reputation or brand of the bank or form part of the corporate social responsibility strategy for the bank. However, the converse may also occur such that the reputation, brand and CSR activities of the bank result in the income tentacles. As a result, the income tentacles also lead to interest income, cheap deposits and non- funded income arising from transactions which may translate to greater profitability for the bank.

The indirect benefit of income tentacles may imply that a bank gets to support more SMEs and banks that support SMEs may get government recognition and support as these banks are contributing to the economic growth of the country. Also, the reputation or brand and CSR activities of the bank may lead to such recognition by the government. An example of such recognition and support by government is invitation to conferences and meetings to discuss SMEs lending. Banks may benefit if the government chooses to disburse funds

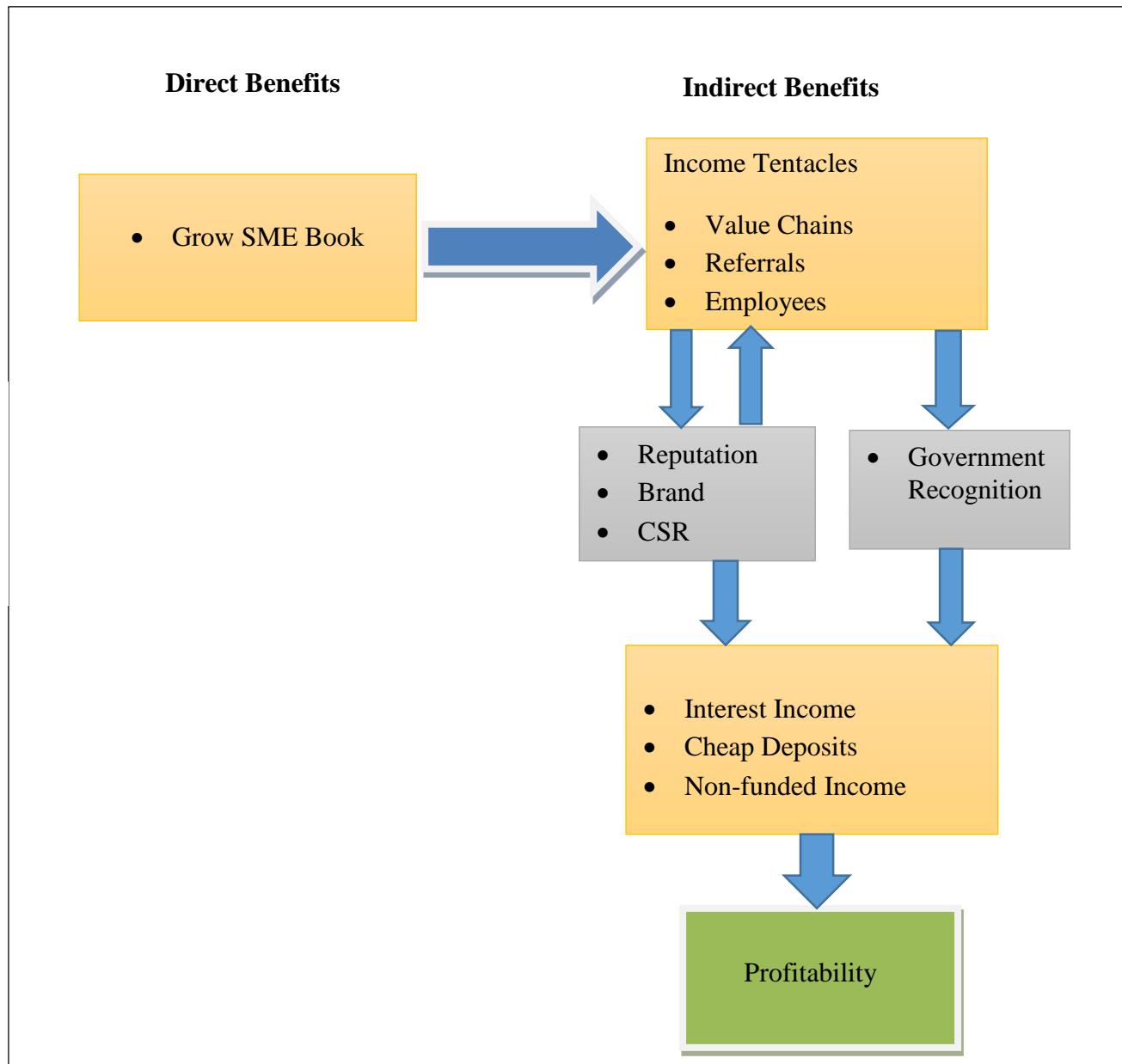
targeted to the SMEs through them, resulting again in cheap deposits for the bank and non-funded income which translates to greater profitability.

A diagrammatic representation of these benefits and their interconnectedness is presented in Figure 5.9 below.

Figure 5.9 Benefits of SME Lending to Commercial Banks

**UNLIMITED MARKET**

**ALL  
SECTORS**



Source: *Researcher's own*

The benefits determined in this study confirm the perceived benefits in prior studies and add to the existing knowledge on the benefits of SME lending to commercial banks. With these actual benefits, it may be possible to predict the viability and scale of relationship banking in the future as suggested by Boot (2000).

## **CHAPTER SIX: CONCLUSIONS AND RECOMMENDATIONS**

### **6.1 Introduction**

This final chapter of the thesis engages in the third activity according to Miles and Huberman (1993) which is conclusion drawing. The chapter is organised as follows; Section 6.2 presents the major conclusions for each of the research objectives that guided this study. Section 6.3 presents the contribution to knowledge of the study and section 6.4, the implications of the study. Section 6.5 discusses the limitations of the study and finally, section 6.6 provides recommendations for further research.

### **6.2 Major Conclusions**

The main objective of the study was to determine the lending technologies employed with specific reference to the commonly referred technology of relationship lending in SME lending and the benefits that commercial banks enjoy from engaging in SME lending. This main objective was further broken down into three specific objectives whose major conclusions are discussed below.

**Objective 1: To examine how soft information about the borrower is acquired, transferred and used by a bank to make the SME lending decision.**

The first research objective sought to find out how banks acquire borrower knowledge, specifically soft information, that can be used in making the SME lending decision and to examine how the same knowledge is transmitted to other relevant decision makers. The major conclusion that is drawn is that commercial banks mainly prefer to collect their own soft information as opposed to that which is collected by non-bank staff; as such banks prefer to use internally generated soft information. The internally generated soft information is more frequently collected during the business visits made by the RM/RO to the clients' premises, suggesting also that the RM/RO is the primary collector of soft

information. Soft information is first transferred to other bank staff in the organisation through the verification process and subsequently through the sharing of this information for decision making. As such, even though the primary collector of soft information is the RM/RO that comes into contact with the customer, there was agreement from all banks that soft information is not proprietary to the loan manager but is stored in a common system that is accessible by all authorised bank staff.

**Objective 2: To investigate the role of transaction lending and relationship lending, more specifically, the importance and interplay of the two methods in making the SME lending decision.**

The second research objective sought to distinguish between the research methodologies employed by commercial banks when lending to the SME customer. More specifically, this objective sought to establish whether the preferred method of relationship lending, suggested in literature as appropriate while dealing with SMEs, is employed. The study makes two conclusions; first, that lending technologies are complementary and not necessarily mutually exclusive. Second, in agreement with the first conclusion and more importantly contrary to previous research that refers to relationship lending as a distinct lending technology, this study finds that relationship lending is not used as a distinct methodology or exclusively but always together with transaction lending. As such, commercial banks employ either transaction lending exclusively or a mix of relationship and transaction lending technologies when contracting with SMEs. This implies that relationship lending has to be considered as a contributor to transaction lending and not as an alternative. In other words, relationship lending is only synergistic with transaction lending and not orthogonal nor antithetical to transaction lending. As such the resulting method should not be referred to as relationship lending but instead this study proposes the use of the term “relational transaction lending” to refer to the transaction lending method that considers qualitative soft information in decision making.

On the measures of relationship lending, the study establishes that banks do not apply duration, scope and concentration of borrowing as is suggested in literature, but apply these measures together with other considerations. Duration on its own has no effect and

is based on the activity in the account, scope in isolation also has no effect but is based on performance of the account and finally, concentration of borrowing has an effect and is considered together with the percentage banking requirements for each bank. This study makes the following suppositions; that on the one hand, activity in the account can give information about the behaviour or character of the borrower and on the other hand, activity can also be considered as hard information; to illustrate this we can use financial statements that banks require from potential borrowers. When banks request for financial statements, which is considered as hard information, they are interested in determining the activity in the account. As such, it can also be argued that the determination of activity is the application of hard information which is useful for transaction lending. Also, duration can be likened to the minimum term that banks require borrowers to have had an account to be considered for borrowing and as such may be argued that it does not provide soft information for use in relationship lending but is actually hard information that can be used when employing transaction lending. This study therefore concludes that duration, scope and concentration of banking may not only be measures of relationship lending but also of transaction lending because in reality what may be under consideration is the activity and performance which are all “hard” information, further confirming our earlier argument that relationship lending cannot be used exclusively but always together with transaction lending.

Combining the results on borrower knowledge and lending methodologies employed leads to the conclusion that two major factors are considered by commercial banks when lending to SMEs; the ability to pay and the willingness to pay. The ability to pay is proxied by hard information and the willingness to pay by soft information. Hard information as determined by this study and as suggested in previous literature is easily identifiable, whereas soft information is importantly collected by the bank and is critical in the determination of the character of the borrower. Once these two factors about the borrower are established by the commercial bank, they are combined to come up with a transactional product that suits the client’s need and as such relationship lending is not used in isolation but together with transaction lending and hence the suggestion that the lending

methodology that employs some relationship aspects be referred to as relational transaction lending.

**Objective 3: To establish the benefits generated from engaging in SME lending by commercial banks in Kenya.**

The third research objective sought to establish the benefits being enjoyed by commercial banks engaged in SME lending in Kenya. As previous studies that focused on the benefits of SME lending to lenders tended to provide only potential benefits or indirect evidence about the value-enhancing effects of lending relationships on the banks, this study established the actual benefits being enjoyed by banks engaged in SME lending.

The study established fourteen benefits being currently enjoyed by commercial banks engaged in SME lending in Kenya which in order of frequency are; higher interest, profitability, income tentacles, reputation building and a stronger brand, non-funded income, growth in the SME bank book, cheap deposits, innovation of products/competitive advantage, banking the economy, source of foreign exchange, relationship, less competition, successional business growth and, government recognition and support.

The study concludes that these benefits are interlinked and directly or indirectly translate to value for the bank in terms of increased profitability. The immediate and direct benefit of SME lending is that it grows the SME loan book and the other benefits, categorised as indirect benefits, arise from lending to that one SME customer and all may lead to greater profitability for the bank.

### 6.3 Contributions of the Study

The major conclusions presented in the preceding section enable the determination of the contributions of the study which are presented in the table below and thereafter discussed in terms of theoretical, methodological and empirical contributions.

Table 6.1 Contributions of the Study

|  |   |
|--|---|
| <b>Objective 1: To examine how soft information about the borrower is acquired, transferred and used by a bank to make the SME lending decision.</b>   |   |
| <b>Confirmed Knowledge that:</b>   | <b>Advanced Knowledge that:</b>   |
| <ul style="list-style-type: none"> <li>• The primary collector of soft information is the RM/RO.</li> <li>• Soft information is transferred during the loan decision making process.</li> </ul>  | <ul style="list-style-type: none"> <li>• Commercial banks prefer to use soft information that they have primarily generated.</li> <li>• Soft information is transferred during the verification process,</li> <li>• The repository of soft information is not the RM/RO but a common system in the bank accessible to all authorised bank staff.</li> </ul> |
| <b>Objective 2: To investigate the role of transaction lending and relationship lending, more specifically, the importance and interplay of the two methods in making the SME lending decision.</b>  |   |
| <b>Advanced Knowledge that:</b>  |   |
| <ul style="list-style-type: none"> <li>• The two SME lending technologies are complementary and not necessarily mutually exclusive.</li> <li>• Contrary to previous research that refers to relationship lending as a distinct lending technology; this study finds that relationship lending is not used as a distinct methodology or exclusively but always together with transaction lending. As such,</li> </ul> |   |

|   |  |
|---|--|
| <p>commercial banks employ either transaction lending exclusively or a mix of relationship and transaction lending technologies when contracting with SMEs.</p> <ul style="list-style-type: none"> <li>• Ability to pay is proxied by hard information and the willingness to pay by soft information. Hard information as determined by this study and as suggested in previous literature is easily identifiable, whereas soft information is importantly internally generated by a bank and is critical in the determination of the character of the borrower.</li> <li>• On the measures of relationship lending, duration and scope may not only be measures of relationship lending but also of transaction lending because in reality what may be under consideration is the activity, turnovers or performance which are all “hard” information used in transaction lending.</li> </ul> |  |
| <p><b>Objective 3: To establish the benefits generated from engaging in SME lending by commercial banks in Kenya.</b></p>   |  |
| <p><b>Confirmed Knowledge that:</b></p>   | <p><b>Advanced Knowledge that:</b></p>   |
| <ul style="list-style-type: none"> <li>• Confirmed the perceived benefits cited in prior studies as resulting from SME lending.</li> </ul>  | <ul style="list-style-type: none"> <li>• Advanced knowledge by establishing fourteen benefits enjoyed by commercial banks engaged in SME lending.</li> </ul> |

### 6.3.1 Theoretical Contribution

The primary contribution this study makes is an enhanced theoretical perspective of the SME lending process and especially in relation to the use of the relationship lending technology. The study reveals that relationship lending is not a distinct lending technology that can applied on its own or exclusively but is always applied together with transaction lending. Commercial banks employ either transaction lending exclusively or a mix of relationship and transaction lending technologies when contracting with SMEs.

In previous studies when banks have employed relationship measures in a lending decision, this has been referred to as using relationship lending, a distinct lending

technology which is separate from transaction lending. However, as this study finds that relationship lending is always used together with transaction lending, this study suggests that when banks employ relationship aspects to a lending decision the resulting method should not be referred to as relationship lending but instead proposes the use of the term “relational transaction lending”.

Based on the above primary contribution, the study also finds a link between typologies used in lending. Hard information as determined by this study and as suggested in previous literature is easily identifiable whereas soft information is importantly internally generated by a bank and is critical in the determination of the character of the borrower. This study suggests that the ability to pay is proxied by hard information and the willingness to pay by soft information.

### **6.3.2 Methodological Contribution**

The research used a qualitative multiple case study methodology to consider the SME lending process, an approach that has rarely been used in similar research. This enabled the researcher gather rich descriptions of the lending process, the lending technologies employed, including whether and how relationship lending is applied and, the benefits enjoyed by commercial banks engaged in SME lending. The semi structured interview process used to collect the data and subsequent analysis enabled the gathering and discovery of detailed information and knowledge about the research problem. Deviating in this manner from the commonly employed quantitative approach has enabled confirmation of some of the current knowledge around commercial bank lending to SMEs and also the advancement of knowledge about SME lending.

### **6.3.3 Empirical Contribution**

By addressing the gaps in literature which were highlighted, the study has contributed to a greater understanding of the SME lending process, how relationship lending is used and benefits enjoyed by commercial banks engaged in SME lending.

The study has now provided detailed descriptions of how banks are engaging the SME sector from the time of engagement with the potential customer to approval of the loan and subsequent monitoring.

The study has established that not only do the relationship measures suggested in prior studies play a role in SME lending but they are the same measures that are also applied in transaction lending.

The study has established the actual benefits enjoyed by commercial banks engaged in SME lending.

#### **6.4 Implications of the Study**

Researchers interested in the area of SME lending will find this study useful as it has added to the existing body of knowledge on SME lending by exploring the supply side or lender's perspective in commercial banks in Kenya (a developing country in sub Saharan Africa) and has also made a methodological contribution by using a qualitative approach in the study of SME lending methods employed and benefits to commercial banks.

For commercial banks interested or already involved in SME lending this study has provided information on the lending technologies and how they are applied by the various banks. Additionally, benefits that can accrue due to SME lending are articulated. This information will enable banks make decisions on whether and how to continue contracting with the SME segment; as such whether SME financing is viable for them in future.

SMEs owners/managers will find this study useful as it has provided information on the steps involved and requirements for successful SME lending. Further, some commercial banks offer training to SMEs on what banks look for so as to enable these customers be better prepared when they need financing. Put together, this information should enable SMEs prepare applications that will most likely be successful and as such enhance SME

access to credit which is necessary for their growth and success. The successful growth of SMEs should translate to greater economic growth for the country given that these enterprises are widely known as drivers of economies.

Regulators and policy makers will find the knowledge gained, especially on the methods or technologies that have worked in SME lending that benefit both borrower and lender, useful in policy making that improves the effectiveness of SME lending. This can be achieved for instance through legal, regulatory or tax initiatives which should in the long run translate to better access to financial services and indeed overall financial development that is crucial to economic growth and poverty reduction.

Capital providers such as the government and other agencies aimed at promoting access to finance for SMEs will find this study useful as the information on SME lending can enhance the incentive structuring by these bodies to boost financing to SMEs.

## **6.5 Limitations of the Study**

The limitations of the study are first addressed in terms of general limitations that are commonly levelled against qualitative studies that employ a case study design and the interviewing technique. Further, two limitations specific to this study are addressed.

The first limitation relates to the generalisability of qualitative studies and more specifically, the case study design. The common criticisms of case studies are that one cannot generalise from a single case and a single case does not add to scientific development. As the nature of the study is qualitative, it does not claim to be generalisable and is based on specific epistemological foundations that have a way of contributing knowledge (Adelman, Jenkins & Kemmis, 1980). The knowledge generated by this study is thus significant in its own right. However being that it was a multiple case study there was the possibility to generalise through the cross case analysis (Miles & Huberman, 1994).

Another common limitation is related to the cost and time associated with qualitative interviewing. Qualitative interviewing is generally held to be more resource hungry than other data collection techniques (e.g. email surveys). It is true that a significant amount of time was required to carry out this study but this was expected for a study at PhD level and as such was not seen as a limitation but a necessity in order to fulfil the research objectives.

The third limitation is related to the difficulty associated with organising research interviews with corporate executives (Adler & Adler, 2003). This limitation had minimal impact as all except one participant could not be available during working hours and suggested for a meeting outside the bank premises. Given the nature of the research and the need to carry out the interviews in the “natural environment” of the bank premises, in this case the interviewer had to look for an alternative respondent in the same institution who was available to be interviewed in the bank premises.

A fourth criticism routinely levelled at qualitative interviewing is that the interviewer may exert bias throughout the course of the interview and may ask certain questions differently or probe more intensively with some respondents than with others (Dooley, 1990). Prior to and after each interview, the researcher reflected on the issue of interviewer bias in order to reduce the likelihood of such bias occurring. A standardised, comprehensive interview guide was also of assistance in reducing the impact of interviewer bias. This process is articulated in chapter three.

Having addressed the common limitations levelled towards such a study, there were two specific limitations:

Four interviewees were reluctant to have the interview recorded. This had already been noted in chapter three, as one of the disadvantages of using this method of data collection and may have resulted in some information not being captured. As these respondents had already expressed their willingness to participate in the study, in these cases, the

researcher requested to take notes during the interview process and all the respondents agreed. To further allay their concerns about confidentiality of the information, the researcher assured them that the reporting of the results would be such that it would not be possible to identify the bank. Further they would be given an opportunity to validate the interview by confirming that what was represented in the interview transcript was what was discussed and where they had an opportunity to amend the transcript; including and removing any data.

This study was carried out in banks that operate only in Kenya and as such can only be applicable to other countries or financial markets after due consideration of the differences in financial and regulatory environment. However as the basis of this research was to gain knowledge and not to generalise to other contexts, it forms a basis for building theory.

## **6.6 Recommendations for Further Study**

In this section recommendations for further research are made based on the knowledge gaps that remain.

It would be insightful to have an in-depth qualitative exploration to understand the relationship investment from the customer's/borrower's perspective. This may enable banks to develop a better understanding of the way customers make judgments about using and retaining particular banks.

As this study determines benefits that commercial banks are enjoying from SME lending, it would be useful to also consider the attendant costs so as to have a complete picture to be able to predict the viability and scale of SME lending in future.

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**APPENDICES**

**Appendix 1: Letter of Introduction**

NAME OF BANK (optional) .....

Date: .....

Dear (Respondent) .....,

My name is Lilian Ollows, a lecturer and doctoral candidate at Strathmore University, Nairobi. In this respect, I am carrying out a study to understand the value that commercial banks in Kenya gain from engaging in SME financing. My study is titled, **“Does Relationship Lending Really Matter? The Value of Small and Medium Enterprise (SME) Lending to Commercial Banks: Evidence from Kenya.”**

I would like to request your participation in this study by way of availing some time for an interview. The interviews will be carried out from mid-February to mid-August, 2015 at a date and time that is most convenient to you and will generally take 60-75 minutes. With your permission, I would like to tape record the interview for analysis purposes only. I assure you that the data collected will be treated with utmost confidentiality and only used for academic purposes. The results from the interview will be used to develop general findings and conclusions without specific reference to your institution or clients except where information may be independently available in the public domain or where permission has been granted. The findings of this study will be availed to you upon your request.

Kindly let me know whether you would be willing to participate in this study.

Thank you for your assistance.

Yours sincerely,



**Lilian Ollows (Doctoral candidate – Strathmore University, Nairobi)**

**Appendix 2: Informed Consent to Participate**

To (Respondent) .....  
(COMMERCIAL BANK).....

From: Lilian Ollows  
Strathmore University, Nairobi  
Date: .....


**Subject: Informed Consent to Participate in the Study**

Dear (*Respondent*).....

Thank you for your willingness to participate in the interview. Your participation is voluntary. You understand the intent and purpose of this research. If for any reason, at any time, you wish to stop the interview, you may do so without having to give an explanation. Your time and involvement is profoundly appreciated. The entire interview will take approximately one to one and a half hours.

To maintain the essence of your words for the research, the interview will be tape-recorded and the interviewer will take notes. This is done for data analysis. At any time you may request to see or hear the information I collect. The tape will be transcribed by the interviewer and kept confidential in a password-protected computer. Participant identity and confidentiality will be concealed using coding procedures. Excerpts from the interview may be included in the final dissertation report or other later publications. However, under no circumstances will your name or identifying characteristics appear in these writings. As per the Strathmore Graduate School procedures, data will be retained intact for a period of at least five years from the date of any publication which is based upon it.

If you have any questions about this study, you are free to contact the student researcher (Lilian Ollows, [lollows@strathmore.edu](mailto:lollows@strathmore.edu), +254 710 109 302) or the internal supervisor (Dr. Freshia Mugo-Waweru, [fwaweru@strathmore.edu](mailto:fwaweru@strathmore.edu), +254 712 874 055). I would be grateful if you would sign this form to show that you have read and agree with the contents.

| <hr/>                      | <hr/>       | <hr/>   |
|----------------------------|-------------|---|
| <b>Name of Participant</b> | <b>Date</b> | <b>Signature</b>  |
| Lilian Ollows              |             |  |
| <b>Name of Researcher</b>  | <b>Date</b> | <b>Signature</b>  |

### **Appendix 3: Interview Guide for the SME Relationship/Loan Manager**

#### 1. Introduction

- a) Purpose of the research – to establish the value of small and medium enterprise (SME) lending to commercial banks in Kenya with emphasis on relationship lending.
- b) Research will be confidential, with tape recorder for analysis purpose only, and will be undertaken by the doctoral researcher.

#### 2. Respondent background

- a) Job title
- b) Length of service
- c) Responsibilities

#### 3. Technical/functional aspects

- a) How does your bank define an SME?
- b) For how long has your bank been engaging with SMEs?

#### 4. SME Lending

- a) Kindly elucidate why your bank engages in SME lending.
- b) Describe in detail how a decision to lend to an SME is made (how you collect information, how you analyse it and how you make the decision according to differences in the client/analysis results/evaluation/etc).
- c) Distinguish between the lending methodologies that are employed by your bank when dealing with SMEs and how you decide when to you use each?

#### 5. Relationship Lending (soft information)

- a) Discuss how the following factors impact the SME lending decision:
  - i. Personal information about the owners of the SME,
  - ii. Duration (length of time that the SME has had an account),
  - iii. Scope (breadth of the relationship, that is, number of different services or interaction over multiple services between the bank and the SME);
  - iv. Concentration of borrowing (number of bank relationships that the SME maintains).

- b) What are the sources of soft information and how formal or informal is the collection process (i.e. do you pay attention to rumours about the borrower or stick only to very reliable and sound sources even if they provide soft information)?
  - c) How is the soft information processed? Do you formalize this soft information in some way or is the repository the loan manager?
  - d) How does the loan manager transfer his opinion and personal evaluation based on the soft information to the next level? How much of the soft information is lost in the process?
  - e) What is the link between the local loan manager and the local community? Does he/she live there?
  - f) Overall what role does the relationship play in the lending decision with SMEs?
6. Value/Benefits
- a) What is the value or benefit that the bank generates from lending to SMEs?

**Thank you very much for your time and participation in this study**

#### **Appendix 4: Confidentiality Agreement for Research Assistant**

I understand that at all times I must maintain the confidentiality of information that I become aware of during the course of my role as research assistant and agree:

1. To keep all the research information shared with me confidential by not discussing or sharing the research information in any form or format (e.g. disks, tapes, transcripts) with anyone other than the Principal Investigator;
2. To keep all research information in any form or format secure while it is in my possession [make sure that research information is not accessible to unauthorised people, i.e. no discussion of information in a public place; papers and records will be kept secure and not able to be accessed by the public; careful emailing of information; transporting information securely using formal processes; turning screens away from public viewing and using screen lock-out];
3. Not to keep any copies of the research information and return all research information in any form or format to the Principal Investigator when I have completed the research tasks;
4. After consulting with the Principal Investigator, to permanently delete all files related to this research from my computer and any other research information in any form or format regarding this research project that is not returnable to the Principal Investigator (e.g. information stored on computer hard drive, flash disks, external hard drive etc.).

#### **I have read and understand my responsibilities**

Research Assistant's signature: \_\_\_\_\_

Research Assistant's name: \_\_\_\_\_

Date: \_\_\_\_\_

Signature of Principal Investigator: \_\_\_\_\_

Name of Principal Investigator: \_\_\_\_\_

Date: \_\_\_\_\_

Note: The Research Assistant will be given a copy of this form to retain for her/his records.