EFFECTS OF RELATIONSHIP LENDING ON PROFITABILITY OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This is my original work and has not been presented for a degree award in any other university.

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This research project has been presented for examination with my approval as the university supervisor.

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DEDICATION

I dedicate this entire effort to my daughters Cess and Maryabel as a piece of inspiration to their future.

ABSTRACT

As a result of the increased competition among financial institutions coupled with financial distress and unpredictable economic conditions commercial banks are now taking to relationship lending to increase their profits. This study specifically sought to;to find out the effect of Credit supply on bank's profitability, To establish the effect of Cross selling on bank's profitability, to find out the effect of competition on bank's Profitability and lastly to examine the effect of the default risk of borrowers on Bank's profitability.This study adopted a descriptive survey design. The target population for this study was all the commercial banks in Kenya licensed and registered under the Banking Act. The target respondents comprised of the relationship managers based at the head office of the selected Banks. Primary data was collected using a questionnaire and analyzed using descriptive statistics, correlations, and linear regression analysis.The study established that bank relationship lending has a significant effect on the profitability of banks in Kenya. Thestudy recommended that a similar research should be carried out across East Africa and beyond and establish whether the same results would be replicated.

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ABBREVIATIONS AND ACRONYMS

ATMs	-	Automated Teller Machines
CBK	-	Central Bank of Kenya
ES	-	Efficiency Structure
GDP	-	Gross Domestic Product
RMP	-	Relative Market Power
SPSS	-	Statistical Package of Social Sciences
SCP	-	Structure-Conduct-Performance
US	-	United States

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In the global competitive business scenario where banks termed as the backbone of financial and economic system of a country, among other organizations, have been facing many changing challenges caused by globalization, liberalization, technological advancements, and changing customers' expectations (Moreno, Grant and Gerhard, 2005). Banks have been facing a dynamic business environment that is technologically driven, globally unbounded and customer focused (Peschel, 2008). These challenges, among many others, called for extensive search for suitable strategies to be adopted by organizations for growth and survival in the changing and turbulent market place (Al-Mansour, 2007).

Agier and Assuncao (2009) contend that financial relations all over the world, have been deeply transformed in the last two decades. This has been characterized by new products, new markets and new regulatory systems which have radically altered the environment in which financial institutions operate, opening new profit opportunities but also creating new risks. Today's modern and competitive financial atmosphere influence banks to improve their service quality and follow new technologies all over the world. Kenya is no exception to these effects and almost all industries including the banking sector.

Commercial banks including private and nationalized banks are providing varied services to attract the customers' community since it is treated as assets of banks (Moya 2009). Shatto& Singer (1996) points out that for retail bankers to meet the changing preferences of the customers and to stay ahead of competitors they are bound to provide quality and efficient services.

In the lending business relationship banking has to be distinguished from transaction-based lending in particular. Both variants are reflected in the underlying credit processes. The distinguishing feature of banks with a relationship approach is the ability to gain and to use qualitative information for customer evaluations. In contrast, the granting of credit in transaction-based lending occurs based only on "hard," quantitative information (Berger, 2002). The theory of financial intermediation suggests that relationship lending has a bright side and a dark side (Boot 2000). Strong bank-borrower relationships help reduces asymmetric information between lenders and borrowers, the bright side. But, at the same time, these relationships can create hold-up problems whereby the lender captures the borrower to extract rents, the dark side. Hence, the overall effect of strong bank relationships is a trade-off in costs and benefits between lenders and borrowers through interactions across time, space, and financial products. Bank relationships produce an asymmetric evolution of the information between the relationship bank, who acquires private information on the borrower, and the rest of financial intermediaries outside the relationship. This results in an informational monopoly of the former. Sharpe (1990) and Rajan (1992) argue that informed banks endogenously gain bargaining power and are able to extract monopoly rents from borrowers. The hold-up problem *per se* does not imply that an informed lender earns positive rents over the lifetime of the bank-

borrower relationship. Rather, the single bank can offer below-cost interest rates because it expects to recover the investment later on.

The traditional theory of banks as delegated monitors implies that the optimal number of relationship banks is one. Diamond (1984) argues that a single banking relationship is optimal because it avoids duplication of screening and monitoring efforts and, at the same time, gives greater incentives to the lender to supervise, thus minimizing free-riding. Having a single relationship gives an informational monopoly to the single informed bank. Banks are able to expropriate some rents from borrowers which distort firms' incentives to make proper investment choices. Firms anticipating a potential hold-up problem may opt for multiple banking relationships. Sharpe (1990) and Rajan (1992) show that competition from an additional informed bank eliminates such hold-up costs. It is worth noting though, that Von Thadden (1995) shows that it is possible to avoid the hold-up problem even with a single lender. Dewatripont and Maskin (1995) regard multiple banking as a solution to the soft-budget-constraint problem inherent with single banking relationships.

The modern literature on financial intermediation has long emphasized the value creation function of lending relationships. In a context of asymmetric information in the credit markets, lending relationships facilitate the information exchange between the borrower and the lender through repeated interaction over the duration of the relationship and through the provision of multiple financial services. Lenders invest in generating information from their client firms and borrowers are more inclined to disclose information (Boot 2000). In consequence, the information asymmetries between the bank

and the firm are lessened as time goes by. This enhances economic efficiency through many channels. First, having a long-term horizon permits the design of implicit credit contracts over the duration of the relationships that increase value. This is achieved, for instance, through reduction in welfare-dissipating collateral requirements (Berger and Udell 1995), through the deployment of welfare enhancing intertemporal tax-subsidy schemes in loan pricing (Petersen and Rajan, 1995), as well as through more flexible contracting terms (Boot, Greenbaum and Thakor 1993).

Second, the reusability of the information generated by the lender over repeated transactions and over time is also beneficial in terms of savings on the fixed cost of screening and monitoring (Boot, Greenbaum and Thakor 1993). Third, it avoids the free-rider problem of monitoring since the bank internalizes the benefits of such investments. Higher monitoring levels increase value since, for instance, they help solve principal-agent problems of managerial behavior. Additionally, relationship banks develop sector-specific expertise that enhances the value of financed projects (Boot and Thakor 2000). What is more, relationship lending contributes greatly to economic growth by promoting the eficient allocation of capital as long as better informed banks provide credit to the most productive projects first (Northcott 2004). At the same time, close bank-firm relationships entail some costs to the firm. The most significant cost is that having a single relationship gives an informational monopoly to the only informed bank, which can impose hold-up costs for the firm (Sharpe 1990, Rajan 1992).

Additionally, the soft-budget constraint problem, that is inefficient loan renewal decisions, is more likely to happen when only one lender has to option to bail out the firm in case of distress (Dewatripont and Maskin 1995); managers are more inclined to default

strategically to divert cash to themselves when there is only one creditor than when there are many creditors (Bolton and Scharfstein 1996). In spite of these problems, existing empirical research on relationship lending stresses that benefits outweigh the costs, that is, relationships generate value. Only to the extent that such value created is passed on to or shared with the borrower, through lower cost of borrowing, more flexible contract terms, and so on, a relationship will also be valuable for a firm that borrows from its relationship lender. That is to say, a firm will benefit from relationship lending as long as the bank shares the value with the borrower. In consequence, if lending relationships are valuable, it should be reflected in the overall firm performance through increased profitability.

1.1.1 Relationship Lending

There are two core elements of relationship lending, namely that relationship banks enagage in multiple interactions with respective borrowers through multiple products over time and thereby invest in obtaining costly, proprietory information on borrowers that remains confidential (Boot 2000).According to recent theories of financial intermediation, one of the main roles of a bank is serving as a relationship lender. As a bank provides more services to a customer, it creates a stronger relationship with the customer and gains more private information about him or her. Such relationships can potentially benefit both banks and their customers. For instance, relationship banking can help banks in monitoring the default risk of borrowers, providing the banks with a comparative advantage in lending. Relationship banking can also lower banks' cost of information gathering over multiple products. Depending on the competitiveness of the

banking sector, such benefits to banks can lead to increased credit supply to customers, through either greater quantities and/or lower prices of credit (Boot and Thakor, 1994). Empirical studies of the benefits of the relationship banking have largely focused on the benefits to customers, corporate customers in particular. Early studies documented that the existence of a bank relationship increases the value of a firm (Slovin et al., 1993).

Subsequent studies have sought to measure the effects of relationships on credit supply to firms. These studies have emphasized different aspects of relationships, such as their breadth such as number of services provided, depth, length, and proximity. However, the results of the studies have been mixed. For example, Petersen and Rajan (1994) find that relationship lending affects the quantity of credit more than the price, while other studies find that customers get either lower future contract prices (Burger and Udell, 1995; Chakravarty and Scott, 1999) or higher future contract prices (Ongena and Smith, 2002). Boot (2000) provides an excellent review of the literature on relationship banking. There can also be costs to relationship lending. For example, it can potentially create a "soft budget-constraint" problem, in which the customer exploits the relationship in bad times (Dewatripont and Maskin, 1995; and Bolton and Scharfstein, 1996). Or, relationship lending can potentially create a hold-up problem, providing a bank with an information monopoly that could allow it to price contracts at non-competitive terms (Sharpe, 1990; Rajan, 1992; and Wilson, 1993).

Close bank-borrower relationships might create benefits for both sides if the inefficiencies stemming from informational problems are reduced. Hence, the effects of a

strong bank-firm relationship are not necessarily a zero-sum game. On the one hand, banks can better assess the risk of default for existing borrowers, while the latter might benefit from improved credit availability and more favorable borrowing terms over time. On the other hand, banks might follow an intertemporal pricing strategy by offering attractive lending terms at the beginning of a relationship to win over a customer and then raising the loan rates and fees on subsequent business. Since the bank observes proprietary information about the borrower and the borrower cannot transfer this private information to another lender, the bank acquires an informational monopoly over the borrower. In particular, a close bank-borrower relationship might create a lock-in effect if the borrower does not have sufficient alternative banking relationships (Degryse and Ongena 2005), or if the borrower faces high switching costs (Ioannidou and Ongena 2010; von Thadden 2004; Kim, Kliger, and Vale 2003; Rajan 1992; Sharpe 1990; Greenbaum, Kanatas, and Venezia 1989). But, borrowers might have incentives for moral hazard in both strong and weak bank relationships. If an important borrower is in financial distress and the relationship with the bank is relatively strong the borrower has incentives to rely on a “too-big-to-fail” effect. Instead of making an effort to improve its financial conditions the borrower might simply gamble on getting more funds from the bank. Or, a relatively risky borrower has incentives to hide private knowledge about the risk of default in a weak bank relationship, as long as the possibility exists to benefit from lending terms that are more favorable compared to the true default risk.

1.1.2 Bank Profitability

Different empirical evidences suggested that profitability of financial institutions specifically banks are affected by internal and external factors. Andreas and Gabrielle

(2009) stated that Bank profitability is usually measured by the return on average assets and is expressed as a function of internal and external determinants. The internal determinants include bank-specific variables. The external variables reflect environmental variables that are expect to affect the profitability of banks. Internal factors such as capital adequacy ratio, asset size, asset quality, net-worth, liquidity, earnings quality, loan performance, business risk, management quality, people, technology and operating environment are major determinant that are used to analyzed the determinants of bank profitability. An external macroeconomic and industry-specific factor includes Effective tax rate, Real GDP growth, inflation, regulation and Bank concentration.

Banks profitability is given due attention after the great economic depression is experienced in the United States of America in 1940s. Due to United State sub-prime mortgage crisis that happened recently in 2007-2009, the banking sectors of many countries suffer huge losses, especially United State of America and European Union countries. The poor performance of the banking industry has slowed down the United State of America economy and also the growth of global economy until current period. In Asia, although the losses in banking sectors are not as serious as U.S., it is also hurting the economy. If the banking industry does not perform well, the effect to the economy could be huge and broad. Because, banks are the critical part of financial system, play a pivotal role in contributing to a country`s economic development (Rasidah and Mohd 2011).

The recent global financial crisis of 2007-2009 also demonstrated the significance of bank profitability both in national and international economies and the need to keep it

under surveillance at all times. However, there is general agreement that bank profitability is a function of internal and external factors. The internal determinants refers to the factors originate from bank accounts (balance sheets and/or profit and loss accounts) and therefore could be termed micro or bank specific determinants of profitability (Tobias and Themba 2011). The external determinants are variables that are not related to bank management but reflect the economic and legal environment that affects the operation and profitability of banks. Athanasoglou*et al*. (2006) stated that the importance of banks is more pronounced in developing countries because financial markets are usually underdeveloped, and banks are typically the only major source of finance for the majority of firms and are usually the main depository of economic savings.

1.1.3 Effect of Relationship Lending on Banks Profitability

Relationship lending adds value through various channels. Relationship lending facilitates the information exchange between the borrower and the lender. Lenders invest in generating information from their client firms and borrowers are more inclined to disclose information because of the preservation of certain confidentiality (Yosha, 1995). The lower informational asymmetries make it possible to overcome problems of moral hazard and adverse selection otherwise inherent in credit markets. For instance, they ameliorate the project-choice moral hazard (Diamond 1991) and solve agency problems of managerial behavior (Weinstein and Yafeh 1998). Relationship lending allows for loan contracts that are welfare enhancing which otherwise could not be contractible.

Boot (2000) argues that relationship lending allows for implicit long-term contracts, more flexibility in renegotiation and some discretion in order to make use of soft information disclosed during the relationship. When a firm experiences a temporary negative shock which prevents it meeting the contracted loan payments, renegotiability of contracts *ex post* can help accommodate the firm with delayed payment or new lending (Boot, Greenbaum and Thakor 1993, Greenbaum and Thakor 1995, Von Thadden 1995). Relationship lending permits the funding of loans that are not profitable from a short-term perspective but may be profitable in the long-run. Therefore, relationships increase credit availability, in particular to the youngest and informationally opaque borrowers, which may have projects that generate few rents in the first period but may be profitable from a long term perspective (Petersen and Rajan 1995). Even more, relationships permit smoothing the loan interest rate over the duration of the relationship (Petersen and Rajan 1995) and over the interest rate cycle (Berlin and Mester 1998, Ferri and Messori, 2000).

Boot and Thakor (2000) argue that banks invest in developing expertise or sector specialization". Therefore, a relationship loan adds more value to the borrower than a transaction loan because the bank uses its expertise to improve the borrower's project payoff. Another benefit of relationship lending that has been highlighted in the literature is that repeated lending from a bank provides credible certification of payment ability. This permits borrowers to build a reputation that would allow eventual borrowing through public markets (Fama, 1985, Diamond, 1991).

Relationship lending leads to the creation of proprietary information.It takes place when banks are originating and pricing loans. Subsequent monitoring of borrowers yields additional private information. Proprietary information generated during the relationship produces rents for the bank later in the relationship and permits early losses to be offset. Bhattacharya and Thakor (1993) determine that informational frictions asymmetric (and proprietary) information "provide the most fundamental explanation for the existence of (financial) intermediaries. The access to information is inherently linked to relationship banking and may point to a comparative advantage of banks. Then, relationship lending facilitate a continuous flow information between debtor and creditor that could guarantee uninterrupted access to funding (Uchida et al., 2006).

Relationship lending is a mechanisms that allows to getmore informative credit contracting decisions based on a better exchange of information, and also increase the availability of credit to information-sensitive borrowers.Bank loan contracts include extensive covenants to guide the bank–borrower relationship. Covenants help control potential conflicts of interest and reduce agency costs (Berlin and Mester, 1992; Dennis and Mullineaux, 1999; and; Boot, 2000). In this regard, bank loan contracts can easily accommodate collateral requirements that can mitigate moral hazard and adverse selection problems in loan contracting (see Chan and Thakor (1987) and Stiglitz andWeiss (1981)). Berlin and Mester (1998) mention that in this context, inter-temporal transfers in loan pricing is also present (Boot, 2000).

In contrast to the accumulation of soft information, if the lender anticipates a short-term relationship with the borrower, it may lead to a reduction on their relationship-specific investments. More specifically, anticipated shorter relationships inhibit the reusability of

information and thus diminish the value of information (Chan et al., 1986). Banks may then find it less worthwhile to acquire costly proprietary information, and relationships suffer (Uchida et al., 2006).

1.2 Research Problem

Increased competition among financial institutions coupled with financial distress and unpredictable economic conditions there is need for these firms to understand how well they can use the concept of relationship lending to increase their profits. The modern literature on financial intermediation has primarily focused on the role of banks as relationship lenders. In this capacity, banks develop close relationships with borrowers over time. Such proximity between the bank and the borrower has been shown to facilitate monitoring and screening and can overcome problems of asymmetric information and the end result in most cases is the bank profitability. Long-term ties between main banks and their client firms generate value and increase economic efficiency. Little is known, though, on how this value is divided among the stakeholders involved in such relationships. The asymmetric role played by the lender and the borrower while building the relationship implies that the direct recipient of the benefits of close relationships is the lender. To the extent that the lender passes these benefits to the borrower, relationships will also be valuable from the borrower's point of view.

There has been limited research on the underlying of relationship lending to banks profitability. Mester, Nakamura, and Renault (2005), used a sample of 100 Canadian small-business borrowers to investigate the benefits of particular relationship information in monitoring the risk of corporate loans. They find that information about customers'

collateral, in particular their inventory and accounts receivable, which might not be available to banks outside of a relationship, is useful for loan monitoring. Also, changes in transaction account balances are informative about changes in this collateral. Petersen and Rajan (1994) find that relationship lending affects the quantity of credit more than the price, while other studies find that customers get either lower future contract prices (Burger and Udell, 1995; Chakravarty and Scott, 1999) or higher future contract prices (Ongena and Smith, 2002). Boot (2000) provides an excellent review of the literature on relationship banking. Kiruri, (2010) also did some work on the effects of ownership structure and relationship lending on bank profitability in Kenya, Maina (2010) did a study on exchange rate variability and investment decisions and they found out that there was a positive relationship between relationship lending and ownership structure on banks performance. While the above studies analyze relationship lending banking in the context of firm-lender relationships, it can also potentially matter for consumer-lender relationships. These studies while shading so much light on the impact of relationship lending they did not cover the impact on banks` profitability and more specifically Commercial Banks in Kenya. They were also carried out in developed countries. To address this gap in knowledge and address the time variance there is indeed a need for a study on the same. The question to be addressed was; what is the effect of relationship lending on bank profitability?

1.3 Objectives of the Study

The main objective of the study was to investigate the effects of relationship lending on profitability of commercial banks in Kenya. The study specifically sought to;

i) To find out the effect of Credit supply on bank's profitability.

ii) To establish the effect of Cross selling on bank's profitability

iii) To find out the effect of competition on bank's Profitability

iv) To examine the effect of the default risk of borrowers on Bank's profitability.

1.4 Importance of the Study

It is hoped that the findings of the study would be significant to various groups:-

Banks would be able to have information that would guide it to improve on their profitability through relationship. The findings would enable banks to champion its relationship lending to all the stakeholders so that they can improve on their profits as a result of this concept.

Other banking institutions would be able to understand the concept of relationship lending from this study so that they can use the same to improve on the profits. The findings of this study would help institutions to be able to make relevant decisions based on the concept of relationship lending.

The regulators and the policy makers can use the finding as reference for policy guidelines on management and control of such organizations. They would be able to use the findings of the study to formulate viable policy documents that effectively address problems faced by the banking sector. These may relate to regulating those aspects that threaten to adversely impact on the operations and development of such organizations. This study would be important to the present theory because it would furnish those who are interested in this study area with relevant information.

Researchers would find the findings of this study important as it would act a reservoir of knowledge for further research. Future studies would base their literature on the findings of this study.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter covered various sections. The chapter captured the theoretical literature as well as the empirical literature**.** The chapter also highlightedthe impact of relationship lending on banks` profitability and the summary of the chapter.

2.2 Theoretical Literature

The theoretical foundations of relationship banking are found in the modern literature of financial intermediation that acknowledges the special role of banks in alleviating the informational asymmetries in the credit markets. Early works of Leland and Pyle (1977), Diamond (1984, 1989, 1991), Ramakrishnan and Thakor (1984), Fama (1985), Boyd and Prescott (1986) and Hellwig (1989) stress the information production function of banks. Screening and monitoring procedures give an information advantage to banks that allow them to overcome information and incentive problems between the bank and the borrower. Therefore, the main benefit attributed to bank financing with respect to other sources of finance is that banks help overcome problems of asymmetric information by producing and analyzing information and by designing loan contracts that improve borrowers' incentives.

Theoretical contributions offer opposite results on the relation between banking market competition and the incentives of lenders and borrowers to engage in relationship lending. A first set of theories argues that competition and relationship lending are incompatible. The reasoning is that with competition, borrowers might be tempted to switch to other banks or to the financial market. When banks anticipate shorter relationships, they may respond by reducing their relationship-specific investments and thus diminish the value of relationships. Chan, Greenbaum and Thakor (1986) propose a model in which banks screen loan applicants at a (exogenous) cost. The information gathered by screening the first loan can be re-used for second-period loans. That gives an informational advantage to the incumbent bank who can gain a positive surplus. Hence, investment on screening in the first period depends on the anticipated informational surplus obtained later on. When banking market competition increases, the informational surplus in the second-period is reduced. Since the value of information acquisition decreases, the investment in screening is reduced. Therefore, bank investment in generating information decreases with competition.

2.2.1 Theories and Models of Bank Profitability

Studies on the performance of banks started in the late 1980s/early 1990s with the application of two industrial organizations models: the Market Power (MP) and Efficiency Structure (ES) theories (Athanasoglou*et al*, 2006). The balanced portfolio theory has also added greater insight in to the study of bank profitability (Nzongang and Atemnkeng, 2006).Applied in banking the MP hypothesis posits that the performance of bank is influenced by the market structure of the industry. There are two distinct approaches within the MP theory; the Structure-Conduct-Performance (SCP) and the

Relative Market Power hypothesis (RMP). According to the SCP approach, the level of concentration in the banking market gives rise to potential market power by banks, which may raise their profitability. Banks in more concentrated markets are most likely to make „abnormal profits` by their ability to lower deposits rates and to charge higher loan rates as a results of collusive (explicit or tacit) or monopolistic reasons, than firms operating in less concentrated markets, irrespective of their efficiency (Tregenna, 2009). Unlike the SCP, the RMP hypothesis posits that bank profitability is influenced by market share. It assumes that only large banks with differentiated products can influence prices and increase profits.

The ES hypothesis, on the other hand posits that banks earn high profits because they are more efficient than others. There are also two distinct approaches within the ES; the X-efficiency and Scale–efficiency hypothesis. According to the X-efficiency approach, more efficient firms are more profitable because of their lower costs. Such firms tend to gain larger market shares, which may manifest in higher levels on market concentration, but without any causal relationship from concentration to profitability (Athanasoglou*et al*, 2006). The scale approach emphasizes economies of scale rather than differences in management or production technology. Larger firms can obtain lower unit cost and higher profits through economies of scale. This enables large firms to acquire market shares, which may manifest in higher concentration and then profitability. They are able exercise market power and earn non-competitive profits.

The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Nzongang and Atemnkeng, 2006). According to the Portfolio

balance model of asset diversification, the optimum holding of each asset in a wealth holder`s portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio. It implies portfolio diversification and the desired portfolio composition of commercial banks are results of decisions taken by the bank management. Further, the ability to obtain maximum profits depends on the feasible set of assets and liabilities determined by the management and the unit costs incurred by the bank for producing each component of assets (Nzongang and Atemnkeng, 2006).

The above theoretical analysis shows that MP theory assumes bank profitability is a function of external market factors, while the ES and Portfolio theory largely assume that bank performance is influence by internal efficiencies and managerial decisions. Several models of the banking firm have been developed to deal with specific aspects of bank behavior but none is acceptable as descriptive of all bank behavior. Some of these approaches are: univariant analysis, multiple discriminant analysis, multiple regression analysis, canonical correlations analysis and neural network method. Olugbenga and Olankunle (1998) noted that a major limitation of the univariant analysis approach is that it does not recognize the possibility of joint significance of financial ratios, while the canonical correlations method precludes the explicit calculation of marginal value of independent variables on the dependent variable. Nor can the significance of individual explanatory factors be ascertained. They noted that multiple regression approaches correct for these limitations and they produce comparable results to the discriminant

analysis method. Bakar and Tahir (2009) evaluated the performance of the multiple linear regression technique and artificial neural network techniques with a goal to find a powerful tool in predicting bank performance.

2.3 Empirical Literature

The modern literature on financial intermediation has primarily focused on the role of banks as relationship lenders. In this capacity, banks develop close relationships with borrowers over time. Such proximity between the bank and the borrower has been shown to facilitate monitoring and screening and can overcome problems of asymmetric information (Boot, 2000). According with some scholars (Diamond (1984) and Bhattacharya and Thakor (1993)), relationship banking is most directly aimed at resolving problems of asymmetric information. It allows for several special contractual features, including flexibility and discretion, the extensive use of contracts, and the inclusion of collateral requirements which may facilitate implicit long-term contracts and resolve agency and information problems (Boot, 2000).

Some authors as Carey *et al*. (1998) have shown that relationship lending is not unique of banks. It is important also in non-bank financial institutions as finance companies, venture capitalists, investment banks, private equity and debt markets (Boot, 2000). All this financial institutions provide a full menu of financing options for borrowers (letters of credit, deposits, check clearing, and cash management services) with varying degrees of relationships that allow them to acquire proprietary information on their clients and reduce risk through multiple interactions, which are the basis for relationship lending.

According with Stein (2002), small banks rely on relationship lending to produce more soft information on their customers than large banks. In the same line, small firms that do not have audited financial statements or sufficient pledgeable collateral rely on relationship lending. In our view, the fact that small banks and firms rely on relationship lending deserves indeed research. This can be particularly well-suited in the context of microfinance organizations as the majority of institutions are small and are working with firms that lack pledgeable collateral to access credit markets.

Berger (1999) states three conditions are met when relationship banking is present: The lender collects information outside freely accessible public information; the collection of information takes place by means of repeated interactions with the borrower generally through the provision of various financial services and the information remains proprietary or confidential to the lender.

The empirical literature on relationship lending does not clearly states the value added of relationship banking. Although, banks acquire confidential (or proprietary) information thought multiple interactions with their customers, little is known about howbanksobtain these information, what type of information is, and the use they give to this information. In the literature, various benefits emanating from relationship banking have been documented. First, different from transaction-oriented banking, relationship lending can facilitate a Pareto-improving exchange of information between the bank and the borrower. It is because the borrower might reveal proprietary information to its bank that it would never have to tell it to the financial markets (Bhattacharya and Chiesa, 1995).

Under these circumstances, the bank might also have better incentives to invest in information production about the borrower. While such information production is costly, it may be worthwhile due to the substantial stake that the bank has in the funding of the borrower and the valuable inter-temporal information reusability that accompanies a long relationship with the borrower. These effects can generate an improved information flow between the bank and the borrower, accentuating the value added by relationship banking (Uchida, Yamori, & Udell, 2006).

In general, relationship banking can improve welfare by several channels: It can facilitates implicit long term contracting and leaves scope for flexibility and discretion of subtle information; allows for a better control of potential conflicts of interest by conveying extensive contracts; relationship may involves collateral that needs to be monitored and that makes the proximity of a relationship essential and it permits funding loans that are not profitable for the bank in the short-term but that make possible value-enhancing inter-temporal transfers in loan pricing (Uchida et al., 2006).

Boot and Thakor (2000) distinguish generic (information-extensive) transaction lending by banks for relationship lending. Transaction lending is most similar to direct funding in the financial market. Boot and Thakor's analysis attaches two dimensions to relationship lending: volume and intensity or quality. That is, banks can choose to offer more relationship loans (at the expense of transaction loans) but also have to decide on the intensityof their relationship loans. Intensity points at, for example, sector specialization: how much does a bank invest in specific knowledge of a firm or industry? The more the bank invests, the better it can fine-tune its services to the needs of its relationship borrowers. Boot and Thakor's main finding is that competition induces banks to make

more relationship loans at the expense of (generic) transaction loans. However, the quality (or intensity) of the relationship loans is lower when interbank competition heats up.

Furthermore, the bank–borrower relationship is typically less rigid than a capital market funding arrangement, making easier the renegotiation of contract terms. This greater flexibility with relationship finance can improve welfare because discretion has value (Boot *et al.* (1993). This is part of the important ongoing discussion in economic theory about rules versus discretion, where discretion allows decision making based on more subtle potentially non-contractable information. A bank–borrower relationship is in many ways a mutual commitment based on trust and respect. This may allow implicit no enforceable long-term contracting with a bank in circumstances in which information asymmetries and the non-contractibility of various pieces of information would rule out long-term access to alternative capital market funding sources as well as *explicit* long-term commitments by banks. Therefore, both the bank and the borrower may realize that their relationship produces value unattainable through other means and thus should be fostered (Uchida *et al*., 2006).

The banking environment in Kenya has, for the past decade, undergone many regulatory and financial reforms. These reforms have brought about many structural changes in the sector and have also encouraged foreign banks to enter and expand their operations in the country (Kamau, 2009). Kenya`s financial sector is largely bank-based as the capital market is still considered narrow and shallow (Ngugi*et al*, 2006). Banks dominate the financial sector in Kenya and as such the process of financial intermediation in the country depends heavily on commercial banks (Kamau, 2009). In fact Oloo (2009)

describes the banking sector in Kenya as the bond that holds the country`s economy together. Sectors such as the agricultural and manufacturing virtually depend on the banking sector for their very survival and growth. The performance of the banking industry in the Kenya has improved tremendously over the last ten years, as only two banks have been put under CBK statutory management during this period compared to 37 bank-failures between 1986 and 1998 (Mwega, 2009).

The overall profitability of the banking sector in Kenya has improved tremendously over the last 10 years. However despite the overall good picture a critical analysis indicates that, not all banks are profitable. For example the small and medium financial institutions which constitute about 57 % of the banking sector posted a combined loss before tax, of Ksh 0.09 billion in 2009 compared to a profit before tax of Ksh 49.01 billion posted by the big financial institutions (CBK, 2009). The huge profitability enjoyed by the large banks vis-a-avis the small and a medium bank indicates that there are some significant factors that influence the profitability of commercial banks.

Flamini*et al* (2009) and other several studies have shown that bank profitability is influenced by bank-specific factors and industry specific factors. However, these studies were based on data from other countries and their findings may not be applied to the local banking sector. Locally, to the researcher`s knowledge, no studies have been done to determine the key factors that influence the profitability of commercial banks.

2.4 Chapter Summary

The theoretical foundations of relationship banking are found in the modern literature of financial intermediation that acknowledges the special role of banks in alleviating the informational asymmetries in the credit markets. Theoretical contributions offer opposite results on the relation between banking market competition and the incentives of lenders and borrowers to engage in relationship lending. A first set of theories argues that competition and relationship lending are incompatible. The reasoning is that with competition, borrowers might be tempted to switch to other banks or to the financial market. When banks anticipate shorter relationships, they may respond by reducing their relationship-specific investments and thus diminish the value of relationships.

Studies on the performance of banks started in the late 1980s/early 1990s with the application of two industrial organizations models: the Market Power (MP) and Efficiency Structure (ES) theories (Athanasoglou*et al*, 2006). The balanced portfolio theory has also added greater insight in to the study of bank profitability (Nzongang and Atemnkeng, 2006). The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Nzongang and Atemnkeng, 2006). According to the Portfolio balance model of asset diversification, the optimum holding of each asset in a wealth holder`s portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio (Nzongang and Atemnkeng, 2006).

Some of these approaches are: univariant analysis, multiple discriminant analysis, multiple regression analysis, canonical correlations analysis and neural network method.

Olugbenga and Olankunle (1998) noted that a major limitation of the univariant analysis approach is that it does not recognize the possibility of joint significance of financial ratios, while the canonical correlations method precludes the explicit calculation of marginal value of independent variables on the dependent variable. Nor can the significance of individual explanatory factors be ascertained. They noted that multiple regression approaches correct for these limitations and they produce comparable results to the discriminant analysis method. Bakar and Tahir (2009) evaluated the performance of the multiple linear regression technique and artificial neural network techniques with a goal to find a powerful tool in predicting bank performance.

The modern literature on financial intermediation has primarily focused on the role of banks as relationship lenders. In this capacity, banks develop close relationships with borrowers over time. Such proximity between the bank and the borrower has been shown to facilitate monitoring and screening and can overcome problems of asymmetric information (Boot, 2000). According with some scholars (Diamond (1984) and Bhattacharya and Thakor (1993)), relationship banking is most directly aimed at resolving problems of asymmetric information. It allows for several special contractual features, including flexibility and discretion, the extensive use of contracts, and the inclusion of collateral requirements which may facilitate implicit long-term contracts and resolve agency and information problems (Boot, 2000).

Berger (1999) states three conditions are met when relationship banking is present: The lender collects information outside freely accessible public information; the collection of information takes place by means of repeated interactions with the borrower generally through the provision of various financial services and the information remains

proprietary or confidential to the lender. The empirical literature on relationship lending does not clearly states the value added of relationship banking. Although, banks acquire confidential (or proprietary) information thought multiple interactions with their customers, little is known about howbanksobtain these information, what type of information is, and the use they give to this information. In the literature, various benefits emanating from relationship banking have been documented (Bhattacharya and Chiesa, 1995).

The overall profitability of the banking sector in Kenya has improved tremendously over the last 10 years. However despite the overall good picture a critical analysis indicates that, not all banks are profitable. For example the small and medium financial institutions which constitute about 57 % of the banking sector posted a combined loss before tax, of Ksh 0.09 billion in 2009 compared to a profit before tax of Ksh 49.01 billion posted by the big financial institutions (CBK, 2009). The huge profitability enjoyed by the large banks vis-a-avis the small and a medium bank indicates that there are some significant factors that influence the profitability of commercial banks. Flamini*et al* (2009) and other several studies have shown that bank profitability is influenced by bank-specific factors and industry specific factors.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter described the methods that would be employed to provide answers to the research questions in this study as listed in chapter one. The following aspects of research methodology are discussed; the research design used to conduct the study, data collection methods that were used, population and sample the analysis and presentation of data in order to generate the findings of the research.

3.2 Research Design

This study adopted a descriptive survey design. Churchill (1991) contends that the descriptive survey design is appropriate where the study seeks to describe the characteristics of certain groups, estimate the proportion of people who have certain characteristics and make predictions. The study aimed at collecting information on the effects of relationship lending on banks profitability. According to Mugenda and Mugenda (1999) the purpose of descriptive research is to determine and report the way things are and it helps in establishing the current status of the population under study. The design is chosen for this study due to its ability to ensure minimization of bias and maximization of reliability of data collected.

3.3 Population and Sample

A population refers to an entire group of individuals, events or objects having a common observable characteristic (Mugenda&Mugenda, 2003). A population describes the parameters whose characteristics the research will attempt to describe. The target population for this study was all the commercial banks in Kenya licensed and registered under the Banking Act as at 31.12.12. The respondents were relationship managers based at the head office of selected Banks. The Relationship Managers handle different portfolios of corporate customers.

3.4 Data Collection

Methods of data collection involved both primary and secondary data. Primary data was derived from questionnaires distributed to those targeted in this study. Kothari (2007) terms the questionnaire as the most appropriate instrument due to its ability to collect a large amount of information in a reasonably quick span of time. It guarantees confidentiality of the source of information through anonymity while ensuring standardization. The questionnaires had questions covering all the issues relating to the effects of relationship lending on the bank profitability. The researcher personally administered the questionnaires to the 30 respondents targeted for this study. Secondary data was gathered from library material, corporate customers' database from the bank's reports and various Internet search engines covering the impact of relationship lending on bank profitability.

3.5 Data Analysis and Presentation

The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis. This was achieved through the use of Statistical Package for Social Sciences (SPSS) version 17.0 software package. The analysis sought to answer research questions and explain the associations and dependencies between the variables of the study. The output was presented in form of tables and figures. Multivariate regression analysis resulted in a prediction equation that described the relationship between the dependent variable and independent variables. The model was as explained below;

$Y = \beta_0 + \beta_{ij}X_{ij} + Є$

Where:

Y -dependent variable- Banks Profitability

β_0 -is the constant (y intercept)

X_{ij} is a set of - independent variables *i* for company *j*

B_{ij}-regression coefficient *i* for variable *j*

Є -the stochastic error term

In relation to the objectives of the study the researcher used SPSS to estimate the following multivariate regression analysis covering the impact of relationship lending on bank profitability as shown below:

$$P = \beta_0 + \beta_1 CSC + \beta_2 VCS + \beta_3 CELR + \beta_4 DR + \varepsilon$$

Where:

P: Banks` profitability at time (t). Profitability was measured using ROA = Loan amount granted/Revenues earned.

CSC: Credit Supply to Customers. This was measured by the total loan facilities granted to corporate customers in a given portfolio managed by the relationship manager.

VCS: Value of Cross Selling. This was measured using the non – interest income from the relationship and the number of products in the relationship.

CELR: Competition Effect on Relationship Lending. This was measured by the number of deals lost or acquired from the competition and their respective asset and revenue value.

DR: Default Risk. This will be measured by the portfolio at risk given by; Total amounts granted/ amount of non – performing loans in the portfolio.

$\beta 0$ is the intercept; and reflects the constant of the equation.

$\beta 1$ is the sensitive coefficient of each independent variable (i=1,2,3,4,5).

ε is the error term.

3.6 Data Reliability and Validity

Validity indicates whether the items measure what they are designed to measure (Borg and Gall 1989). The study used content validity to examine whether the instruments answer the research questions. Adjustments and additions to the research instruments consultations and discussions with the supervisor was done to establish content validity.

Instrument reliability is the dependability, consistency or trustworthiness of a test. Cronbach's Coefficient Alpha approach was used to measure internal consistency of the research instruments. This approach is recommended by Cohen, Manion and Morrison, (2007) for its ability to give average split-half correlation for all possible ways of

dividing the test into two parts. Cronbach's Coefficient Alpha is a scale measurement tool appropriate in measuring internal consistency in descriptive survey researches.

The study employed self administration approach of data collection and monitored the process to ensure that the unintended people do not fill the questionnaire or are not interviewed. The questionnaires were filled and assistance sought where possible thus raising the reliability.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introductions

This chapter presents the findings of the study and the analysis of the data collected from the questionnaires administered to the relationship managers based at the head office of the thirty selected banks. According to the data found, twenty (28) out of the thirty questionnaires administered were returned which makes a response rate of 87%. The commendable response rate was achieved after the researcher made frantic effort at booking appointments with the relationship mangers despite their tight schedules.

The study sought to find out the number of customers the respondents managed. According to the findings, majority (78%) indicated that they manage 15 – 25 customers. Also the study sought to establish the size of the portfolio the respondents handled. According to the findings as shown in table 4.1, 39.3% of the respondents indicated that they handled a portfolio size ranging Ksh1 Billion to Ksh 5 Billion, 28.6% indicated above 5 Billion, 17.9% indicated Ksh 500 Million to ksh 1 Billion.

Table 4.1: Size of Portfolio Handled

Portfolio Size	Frequency	Percentage
Less than 500million	4	14.3
500million – 1 Billion	5	17.9
1Billion - 5Billion	11	39.3
Above 5Billion	8	28.6
Total	**28**	**100**

Source: Primary Data

The study sought to establish the average monthly revenue from the portfolio the respondents handled. According to the findings, 44.3% of the respondents indicated monthly revenue ranging between Kshs 500 Million to Kshs1 Billion, 24.3% indicated less than 100 million, 12.9% indicated Kshs 100million – Kshs 500 million and lastly a few (8.6%) indicated aboveKshs 1 Billion.

Table 4.2: Portfolio Average Monthly Revenue

	Frequency	Percentage
Less than 100 million	4	24.3
100million – 500 million	5	12.9
500 Million – 1 Billion	11	44.3
Above 1 Billion	8	8.6
Total	**28**	**100.0**

Source: Primary Data

Further, the study sought to establish the average yield for customers in the respondents' portfolio. According to the findings as shown in table 4.3, 44.3% of the respondents

indicated that the average yield for customers in their portfolio ranged between 5% - 10%, 25.0% indicated0 – 5%, 8.6% of the respondents indicated that the average yield for customers in their portfolio ranged between 10% - 15% while 7.1% of the respondents indicated that the average yield for customers in their portfolio was above 15%.

Table 4.3: Average yield for Customers in the Respondents' Portfolio

	Frequency	**Percentage**
0 – 5%	7	25.0
5% -10%	11	44.3
10%- 15%	8	8.6
Above 15%	2	7.1
Total	**28**	**100**

Source: Primary Data

The respondents were asked the average number of cross sell in their portfolio, majority of the respondents indicated that they had five while a few had an average number of cross sell less than five. Further, the study sought to establish whether the respondents had any customers who were in default for the last 6 months. According to the findings as shown in table 4.3 below, majority of the respondents (92.8%) indicated yes while a few (7.2%) indicated no.

Table 4.4: Customers in Default

	Frequency	**Percentage**
Yes	26	92.8
No	2	7.2
Total	**28**	**100.0**

Source: Primary Data

The study sought to establish the volume of the book in default, form the findings as shown in table 4.5, the study also sought to establish whether the respondents had lost any customer/deal to the competition in the last one year. According to the findings as shown in table 4.5 below, majority of the respondents (96.4%) indicated yes while a few (3.6%) indicated no.

Table 4.5: Lost Customer/Deal to the Competition

	Frequency	**Percentage**
Yes	27	96.4
No	1	3.6
Total	**28**	**100.0**

Source: Primary Data

The study further asked the respondents the volume of business (assets) lost to the competition. According to the findings as shown in table 4.6, 53.6% of the respondents indicated that the volume of business (assets) lost to the competition ranged between Kshs 100 Million to Kshs 500 million, 21.4% indicated that the volume lost ranged between 50 Million to 100 million, 14.3% indicated Kshs less than 50 Million and lastly a 10.7% indicated that the volume of business (assets) lost to the competition was above Kshs 1 Billion.

Table 4.6: Volume of Business (assets) Lost

	Frequency	**Percentage**
Less than 50 million	4	14.3

50million – 100 million	6	21.4
100 Million – 500 Million	15	53.6
Above 1 Billion	3	10.7
Total	**28**	**100.0**

Source: Primary Data

Further, the study sought to establish the estimated income lost. According to the findings as shown in table 4.6, majority (67.9%) indicated that the estimated income lost ranged between Kshs 5 Million – Kshs 10 Million, 17.9% indicated that the estimated income lost wasKshs10 Million and above while 14.3% indicated that the estimated income lost was less than Kshs 5 Million.

Table 4.7: Estimated Income Lost

	Frequency	**Percentage**
Less than 5 million	4	14.3
5 Million – 10 million	19	67.9
10 Million and above	5	17.9
Total	**28**	**100.0**

Source: Primary Data

The respondents were asked why they lost the business; the respondents cited that the business required longer repayment period and stiff competition from the rivals banks offering affordable interest rates.

The study sought to establish whether, the respondents were able to take over any deals from the competition. From the findings, majority (76%) indicated yes, that they were able to take over the lost deals from the competition while 24% indicated no. The study further, asked the respondents if it was important for banks to manage relationships in

light of competition. According to the findings all the respondents indicated yes that banks should manage relationships in light of competition so that the bank can plan for the future, safeguard less of business and retain their market share, to avoid competition threats since customers value the relationship they have with the bank of choice.

The respondents were asked how their banks responded to competition forces. The respondents cited the adoption of a low-cost strategy resulting from process and product innovations, adoption of market focus strategy and concentrating on a narrow segment and attempting to achieve either a cost advantage or differentiation. Some respondents indicated that their banks responded to the competition forces by developing products or services that offers unique attributes that are valued by customers and that customers perceive to be better than or different from the products of the competitors. The value added by the uniqueness of the product allows the banks to charge a premium price for it. The banks hope that the higher price will more than cover the extra costs incurred in offering the unique product.

4.2 Regression Analysis Results

Table 4.8: Regression Analysis Results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.887(a)	.787	.761	4.605	.009	.009	1	27	.048

Source, Research Data

a Predictors: (Constant), credit supply, cross selling, competition and default risk on borrowers

Adjusted R^2 tells us how the profitability of commercial banks in Kenya varied with variation in credit supply, cross selling, competition and default risk on borrowers. From table above, the value of adjusted R^2 is 0.761. This implies that, there was a variation of 76.1% of profitability of commercial bank with credit supply, cross selling, competition and default risk on borrowers at a confidence level of 95%. This means that 76.1% of the profits of commercial bank are attributable to relationship lending by the commercial banks.

Table 4.9: Regression coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.918	1.715		3.133	.042
Credit supply	1.451	.61	.074	.082	.028
Cross selling	0.200	.063	.051	.064	.015
Competition	1.179	.057	.075	.023	.028
Default risk on borrowers	.823	.61	.067	.048	.018

Source, Research Data

a Predictors: (Constant), credit supply, cross selling, competition and default risk on borrowers

The established regression equation was

$$\mathbf{P = 1.918 + 1.451\ X_1 + 0.200\ X_2 + 1.179\ X_3 + 0.823\ X_4 + 0.000}$$

The coefficient of the constant term is 1.918. The sign borne by the regression coefficient of constant is positive implying at zero performance of the independent variable, the bank's profitability increases. The regression coefficient of the independent variables

carries positive signs and their t-values are statistically significant at 5% level. This implies that relationship lending affects the banks' profitability significantly. The t-value for the regression coefficient of (supply, cross selling, competition and default risk on borrowers) is significant as confirmed by the t-probability (0.0000). It is estimated from the result that 1% increase in credit supply on the average, will lead to 1.451% increase in profitability, 1% increase in cross selling on the average, will lead to 0.200 % increase in profitability, further a 1% increase in competition on the average, will lead to 1.179 % increase in profitability and lastly 1% increase in cross selling on the average, will lead to 0.823 % increase in profitability. Further, the regression analysis results show that the relationship between relationship lending (credit supply, cross selling, competition and default risk on borrowers) and banks profitability at 95% confidence level is statistically significant with p values < 0.05.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the discussions drawn from the data findings analyzed and presented in the chapter four. The chapter is structured into summary of findings, conclusions, recommendations and areas for further research.

5.2 Summary

The study revealed that that the number of customers managed ranged between 15 – 25 customers. Also the study showed that the respondents handled a portfolio size ranging Ksh1 Billion to Kshs 5 Billion with monthly revenue ranging between Kshs 500 Million to Kshs1 Billion. Further, the study revealed that the average yield for customers in the respondents' portfolio ranged between 5% - 10% and 0 – 5%, a few had the average yield for customers in their portfolio above 15%.In regard to the average number of cross sell in respondents' portfolio, the study found that majority of the respondents had five while a few had an average number of cross sell less than five.Further, the study found that the respondents had had customers who were in default for the last 6 months.

From the findings, it was established that bank relationship lending has a significant effect on the profitability of banks in Kenya. This finding is confirmed by the p-value of the regression coefficient which is seen to be less than 0.05 (5%) level of significance. It is estimated from the result that 1% increase in credit supply on the average, will lead to 1.451% increase in profitability, 1% increase in cross selling on the average, will lead to 0.200 % increase in profitability, further a 1% increase in competition on the average, will lead to 1.179 % increase in profitability and lastly 1% increase in cross selling on the average, will lead to 0.823 % increase in profitability. Should there be more and higher relationship lending, banks'profitability will be enhanced. The computed coefficient of determination (0.761) shows a high proportion of variation in the dependent variable(banks' profitability). Thus, there are 76.1% of the total changes inthe Bank profitability (BP) which is explained by RL.

5.3 Conclusions

This study examines the effects of relationship lending on bank profitability. The results offer new insights on the channels that lead to repeated interaction between a firm and a bank. In contrast to earlier work that focuses on the role of relationships in alleviating information and incentive problems in lending, the study finds that the source of value in relationship banking is not limited to enhanced monitoring. Relationships 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.

This study shows that non-lending income incentives interact with the terms of credit to create a profit channel of relationship strength that gives weight to the borrower's

aggregate profitability as a non-credit customer. The study indicates that the higher the borrowing and cross – sell the higher the bargaining power and thus lower yields.

The study finds that relationship lending will continue to be important into the future as banks compete for the same market. Banks continue to use price wars and service to takeover corporate customers from the competition. This as shown in the findings has an impact in the assets as well as income from the lost deals and ultimately the overall bank profitability.

The study concludes that credit supply, cross selling; competition and default risk affect banks profitability.

5.4 Recommendations

Having seen that there exists a relationship between bank profitability and relationship lending; banks should adopt policies that will help banks to improve on their performance. Also the study recommends that that there is need to strengthened the cross selling efforts as this will increase the wallet size of the corporate customers leading to increased profitability. Lastly, banks should try as much as possible to strike a balance in their loan pricing decisions. This will help them to be able to cover cost associated with lending and at the same time, maintain good banking relationship with their borrowers and thus ease response to the stiff competition in the industry.

5.5 Recommendations for Further Research

While this study successfully examines the effects of relationship lending on banks profitability, it also presents rich prospects for several other areas to be researched in future.

This study recommends that a research should be done on the impact of relationship lending to the Growth of the Small and Medium Size Enterprises in Kenya given that they are faced a number of challenges such as lack of collateral.

This study was confined to only banks in Kenya. It would be useful to carry out the same type of research in other organizations and across East Africa and beyond and see whether the same results would be replicated.

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APPENDICES

APPENDIX I: BANKS LISTED AT THE NAIROBI STOCK EXCHANGE

	Name of the Bank
1.	African Banking Corporation Ltd
2.	Bank of Africa Ltd
3.	Bank of Baroda Ltd
4.	Bank of India
5.	Barclays Bank of Kenya Ltd
6.	Charterhouse Bank Ltd
7.	National Bank of Kenya Ltd
8.	Chase Bank K Ltd
9.	Citibank N.A Kenya
10.	Commercial Bank of Africa Ltd
11.	Consolidated Bank of Kenya Ltd
12.	Co-operative Bank of Kenya Ltd
13.	Credit Bank Ltd
14.	Development Bank of Kenya Ltd
15.	Diamond Trust Bank Kenya Ltd
16.	Dubai Bank Kenya Ltd
17.	Ecobank Kenya Ltd
18.	Equatorial Commercial Bank Ltd
19.	Equity Bank Ltd
20.	Family Bank Ltd
21.	Fidelity Commercial Bank Ltd
22.	Fina Bank Ltd
23.	First community Bank Ltd
24.	Giro Commercial Bank Ltd
25.	Guardian Bank Ltd
26.	Gulf Bank Ltd

27.	Habib Bank A.G. Zurich
28.	Habib Bank Ltd
29.	Imperial Bank Ltd
30.	I & M Ltd
31.	Jamii Bora Bank Ltd
32.	Kenya Commercial Bank Ltd
33.	K-Rep Bank Ltd
34.	Middle East Bank K Ltd
35.	National Bank of Kenya Ltd
36.	NIC Bank Ltd
37.	Oriental Commercial Bank Ltd
38.	Paramount Universal Bank Ltd
39.	Prime Bank Ltd
40.	Standard Chartered Bank K Ltd
41.	Trans-National Bank Ltd
42.	UBA Kenya Bank Ltd
43.	Victoria Commercial Bank Ltd

Source; (***CBK report 2013)***

APPENDIX I: LETTER OF INTRODUCTION

Christopher Marwa,

P.O Box 48400-00100,

Nairobi,

August 2013.

Dear Respondent,

RE: **DATA COLLECTION**

I am an MBA student from University of Nairobi carrying out a research on the **effects of relationship lending on bank profitabilityof commercial banks in Kenya** of which you are part of. Your contribution towards this research is highly valued and appreciated. Your response will be treated with utmost confidentiality and will be used only for research purposes of this study only.

Thank you in advance for your co-operation.

Yours faithfully,

APPENDIX II: STRUCTURED QUESTIONNAIRE

Instructions: Please respond to the following questions and where applicable, mark the relevant box with a tick (√).

Confidentiality: The responses you provide will be strictly confidential. No reference will be made to any individual(s) in the report of the study.

1. Kindly indicate the bank which you work for (Optional)……
2. Kindly indicate the section or department of the bank you work in…….
3. How many customers do you manage……
4. What is the size of the portfolio you are handling (amount in Kes.)

   [ ] < 500m
   [ ] Between 500m to 1b
   [ ] Between 1b to 5b
   [ ] Above 5b
5. Kindly indicate the average monthly revenue from the portfolio you are handling (figure in Kes. Millions)

   a) Interest Income ---------- b) Fees and commission……
6. Kindly indicate the average yields for customers in your portfolio (%) ……..
7. What is the average product utilization in your portfolio? .....
8. Kindly indicate the average number of cross sell in your portfolio……..
9. Do you have any customers who are in default for the last 6 months? [ ] Yes [ ] No

If your answer is Yes, Please indicate the following

a) Volume of the book in default……b) Average monthly income lost…….

10. Kindly indicate the PorfolioAt Risk (PAR) in your potfolio……..

11. Do you consider Corporate to be higly risky to extend credit to?.....

Please explain your response

12. Have lost any customer / deal to the competition in the last one year? [ ] Yes [ ] No

If Yes, Kindly indicate the following

a) Volume of business (Assets) lost to the competition…….. (provide figure in Kes.millions)

b) Estimated income lost…… (In Kes. Millions)

c) Reasons why you lost the business……
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13. Have you acquired any deal(s) from the competition? [ ] Yes [ ] No

If Yes, Kindly indicate

a) Volume (assets) acquired from the competition……provide figures in Kes. Millions)

b) Estimated income earned from the deal(s)…….(in Kes. Millions)

14. Is it important for banks to manage relationships in light of competition

[ ] Yes [ ] No

Explain your choice above

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15. How does the bank respond to the completion forces?

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16. How do you gauge your customer retention?

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17. Kindly give suggestions as to future of relationship lending in the Kenyan banking industry

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THANK YOU FOR YOUR TIME AND COOPERATION