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EFFECTS OF CREDIT RISK MANAGEMENT ON LOAN PERFORMANCE IN KENYAN COMMERCIAL BANKS

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Abstract

The study was focused on the effect of credit risk management on loan performance in Kenyan commercial banks. The objective of the study was to examine the relationships between loan appraisal and non performing loans. Loan performance was the dependent variable while loan appraisal was the independent variable. A cross sectional survey design was employed. A case study of respondents comprising of all the credit department staff from the commercial banks in Bungoma town; Co-operative bank (k) limited, Kenya commercial bank, Barclays bank, Equity bank, Standard chartered bank, National bank, Diamond trust bank, Bank of Africa and K rep bank. The target population constituted 70 respondents drawn from the nine commercial banks in the town. A structured questionnaire was used to collect data from the respondents. The collected data was analyzed both descriptively and inferentially. The study established that there existed a statistically significant relationship between credit appraisal and non-performing loans. The relationship between credit appraisal and non-performing loans was found to be positive, strong and statistically significant.

Keywords: Commercial Banks, credit risk management, non performing loans, credit appraisal

INTRODUCTION

Loan portfolio is naturally the largest asset and the largest source of income for banks. In view of the significant contribution of loans to the financial health of banks through interest income generated, these assets are considered the most important assets of banks. As a result of

commercial banks and financial institutions business, they expose themselves to the risks of default from loan borrowers. A major threat to banking business is non performing assets. NPA represent bad loans, the borrowers of which failed to satisfy their repayment obligations. Michael et al (2006) emphasized that NPA in loan portfolio affect operational efficiency which in turn affects the profits of the bank, liquidity position and solvency position of banks. Batra, S (2003) noted that NPA also affect the psychology of bankers in respect of their disposition of funds towards credit delivery and credit allocation. There are lots of factors responsible for these non performing loans. Some of them belong to firm level issues and some are from macroeconomic measures. Loan appraisal criteria, bank's legal framework and loan arrears follow up procedures are some of the factors in this blend. This study will seek to establish the effects of these factors in reducing the rate of default in loans in Kenyan commercial banks.

Non-Performing Loans (NPLs)

Greuning *et al.,* (2000) described non performing loans as those assets that are no longer generating income. NPLs in general terms refer to bad debts, whose recovery is highly doubtful, because they are not being serviced as required (CBK, 1997). The problem of NPL is not unique to Kenya alone. Gupta (1998) observed that banking problems precipitated by NPLs are not confined to the developing world alone. Sweden, Japan and USA have at one time faced severe banking crisis. However he points out that it is in the developing world that the problem wrecks the greatest havoc. This undermines the banks' financial intermediation.

The high level of non-performing loans in the banking industry has been a hindrance to economic stability. According to CBK bank supervision annual report (April 2009), the stock of NPLs expanded by 7.8% to Ksh 64.9 billion by March 31st, 2009 from Ksh 58.3 billion in 2008. In the year 2006, the NPLS were Kshs. 56.4 billion from Kshs. 68.6 billion in 2005. (Bank Supervision Annual Report 2006) In 2003 and 2004, the average non-performing loan to total loans for the industry was 25% and 24% respectively (Market Intelligence 2004). NPLs in Kenya stood at Kshs. 107.4 billion at the end of 2001. This represented 38% of total loan of Kshs. 281.7 billion in the banking sector (Oloo, 2003). When loans become non-performing, banks liquidity and its earnings are adversely affected.

NPLs have been cited as the primary cause of bank failures in Kenya. Between 1984 and 1991 there were a total of 29 bank failures reported. This is an alarming rate given that it represents on average two or more bank failures per year during that period. Though this trend has been reversed, NPL continue to be a major challenge among banks (Njuguna *et al.,* 2000). Banks that collapsed during that period include Trust Bank, Kenya Finance Bank, Reliance Bank, Prudence Banks and Bullion Bank. Further National Bank of Kenya almost folded

following a run on the bank on two separate occasions by panicky customers (Oloo, 2001). The most recent was Euro Bank Ltd which was placed under liquidation in February 2003 following substantial losses as a result of huge NPLs among other things (Kanyiri, 2005).

When a bank classifies a facility as non-performing, CBK guidelines indicated that banks should start to make specific provisions (CBK, 2002). The specific provisions require banks to forego interest received besides allocating provisions for the NPLs for their own resources. Provisions for bad debt eat into banks profits. But the problem of NPL goes beyond mere loss of income on the part of banks. Njuguna and Ngugi (2000) observed that to reduce credit risk, Kenyan banks charge a premium. This tends to increase the interest rates to borrowers which in turn reduces the demand for loans. These factors produce an unstable macro economy environment which serves to widen the interest spread between the deposit taking and lending rates.

Credit Risk Management Practices

According to Nzuve (2013), Credit risk management models include the systems, procedures and control which a company has in place to ensure the efficient collection of customer payments and the risk of non-payment.

Credit risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest (coupon) or both). Risk management is the practice of creating economic value in a firm by using financial instruments to manage exposure to risk, particularly credit risk and market risk. The Royal Society Study Group (1992) considers that risk management is the making of decisions concerning risks and their subsequent implementation, and flows from risk estimation and risk evaluation. Similar to general risk management, financial risk management requires identifying its sources, measuring it, and plans to address them (Fuser and Meier, 1997).

According to Fuser *et al.,* (1997), banks use various credit risk management methods such as credit limits, taking collateral, diversification, loan selling, syndicated loans, credit insurance, and securitization and credit derivatives. This can be summarized into loan appraisal, credit legal framework and debt recovery procedures. Credit risk management practices employed by a bank have an importance place. It is important for staff of banking institutions to understand the aspect of risk in the banking operations and the risks that are inherent and exposed in their business operations. Better understanding of risk management is also necessary especially in the financial intermediation activities where managing risk is one its important activities.

Problem Statement

There is an ever increasing rise in the level of NPA's in financial institutions in Kenya especially banks under tier I (CBK, 2014). Financial records show a rise in nonperforming loans of tier I commercial banks over the years. Evidence from the CBK annual report 2014, show a rise in the level of tier I NPA'S over recent years. The years 2013, 2012, 2011,2010, 2009 saw NPAs ratio change from 4.11,3.44,3.42,5.4&7.5 respectively. Despite employing credit risk management strategies responsible for managing risks related to lending, banks are still experiencing a sharp rise in the level of NPA'S in their books. If the non performing assets are not brought into control, they have a potential of eroding the asset book and eventually affecting the profitability and general performance of the banks (Tetteh, 2012). Hennie, (2003) states that despite innovations in the financial services sector over the years, credit risk is still the major single cause of bank failures, for the reason that "more than 80 percent of a bank's balance sheet generally relates to this aspect of risk management. A research by Kithinji (2010) has been conducted on credit risk management but the focus of the researches has been on how it affects performance, profitability and survival of banks. Rarely have these researches focused on the specific credit risk management variables that affect quality of the loan portfolio and eventually the profit of the banks in Kenya. This research therefore investigated the reasons for the continued rise in level of nonperforming assets and determined which among the variables in the study had a higher effect on the quality of the book.

Objective of the study

The general objective of the research was to establish the effects of credit risk management on non performing loans in Kenyan commercial banks. The specific objective was to evaluate the effect of loan appraisal on non performing loans.

Research Question

The study answered the following question: What is the effect of loan appraisal on non performing loans?

LITERATURE REVIEW

Financial Intermediation Theory

Financial intermediation is a process which involves surplus units depositing funds with financial institutions who then lend to deficit units. Matthews and Thompson (2008) identify that financial intermediaries can be distinguished by four criteria: first their main categories of liabilities (deposits) are specified for a fixed sum which is not related to the performance of a portfolio.

Second the deposits are typically short-term and of a much shorter term than their assets. Third a high proportion of their liabilities are chequeable (can be withdrawn on demand).And fourth their liabilities and assets are largely not transferable. The most important contribution of intermediaries is a steady flow of funds from surplus to deficit units. According to Scholtens and van Wensveen (2003), the role of the financial intermediary is essentially seen as that of creating specialized financial commodities. These are created whenever an intermediary finds that it can sell them for prices which are expected to cover all costs of their production, both direct costs and opportunity costs. Financial intermediaries exist due to market imperfections. As such, in a 'perfect' market situation, with no transaction or information costs, financial intermediaries would not exist. Numerous markets are characterized by informational differences between buyers and sellers. In financial markets, information asymmetries are particularly pronounced.

Borrowers typically know their collateral, industriousness, and moral integrity better than do lenders. On the other hand, entrepreneurs possess inside information about their own projects for which they seek financing (Leland and Pyle, 1977). Moral hazard hampers the transfer of information between market participants, which is an important factor for projects of good quality to be financed

The Commercial-Loan Theory

According to the theory, the bankers can take a position at the other extreme in order to earn some profit other than being a mere warehouse for its clients. They could employ all the funds deposited with them to make a loan to finance a high-risk venture. Such a loan might have a high earnings potential for the bank, but the loan probably will not be liquid. It would be difficult to liquidate to obtain cash when depositors want to make withdrawals. To resolve the liquidity-earnings problems, bankers must recognize the advantage of making self-liquidating loans (real bills). A loan is considered self-liquidating if it is secured by assets which can be resold to repay the loan. Loans of this type could ensure the banks continues liquidity and earn profits. Thus, liquidity and earnings are simultaneously gained.

Credit Appraisal

This is basic stage in the lending process. Anjichi (1994) describes it as the 'heart' of a high quality portfolio. This involves gathering, processing and analyzing of quality information as way of discerning the client's creditworthiness and reducing the incentive problems between the lenders as principals and the borrowers as agents. The bank's credit policy, procedures and directives guide the credit assessment process. Banks should base their credit analysis on the

basic principles of lending which are Character, Capacity, Capital, Collateral and Conditions (Matovu and Okumu, 1996). It is designed to ensure lenders take actions which facilitate repayment or reduce repayment likely problems. This information about the riskiness of the borrower makes the financial institution to take remedial actions like asking for collateral, shorter duration of payment, high interest rates and other form of payment (Stiglitz and Karla, 1990) when a financial institution does not do it well, its performance is highly affected. Edminster (1980) stressed the importance of credit analysis when he observed that its abandonment often resulted into several banks using credit card to process. The variable we have, according to Hunte (1996) included the length of time taken to process applications, credit experience, proportion of collateral security to the loan approved. It was found out that long waiting time reflected a shortage of credible credit information required to make informed credit decisions.

This in turn leads to greater risk more intense credit rationing and low repayment rates. Hunte (1996) also observed that loan experience indicated the ability to manage the business loans better hence good quality borrowers for the business. A less experienced borrower has less ability to manage a business loan and therefore is not credit worthy (Devaney, 1984; Robinson, 1962; Hunte, 1996). This implies that there are big risks associated with new borrowers since the loan officer has no familiarity of recovery from them.

According to Basel committee (1999) on the management of credit risk, the following was observed: Many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process. They noted too that many banks find carrying out a thorough credit assessment (or basic due diligence) a substantial challenge. For traditional bank lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence. Globalization of credit markets increases the need for financial information based on sound accounting standards and timely macroeconomic and flow of funds data. When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with simple indicators of credit quality, especially if they perceive a need to gain a competitive foothold in a rapidly growing foreign market. Finally, banks may need new types of information, such as risk measurements, and more frequent financial information, to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions.

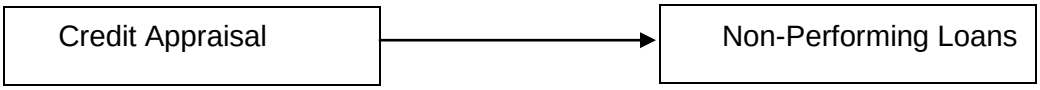
Daniel and Wandera (2013) argue that credit criteria are factors used to determine a credit seeker's creditworthiness or ability to repay debt. The factors include income, amount of existing personal debt, number of accounts from other credit sources and credit history.

Swaren (1990) suggested that giving out loans to borrowers who are already overloaded with debt or possess unfavourable credit history can expose banks to unnecessary default and credit risk. In order to decrease these risks, banks need to take into consideration several common applicants' particulars such as debt to income ratio, business and credit history and performance record and for individual loan applicants their time on the job or length of time. According to Jared Getenga (2007), one of the features that banks deliberate when deciding on a loan credit application is the estimated chances of recovery. To arrive at this, credit information is required on how well the applicant has honoured past loan obligations. This credit information is important because there is usually a definite relationship between past and future performance in loan repayment.

Mathara (2007) in a study of the response of National Bank of Kenya Ltd. to challenges of non-performing loans concludes that the reliance of the bank on qualitative credit analysis methods that entails such factors as character of the borrower, reputation of the borrowed and the historical financial capability of the borrower as opposed to the used of quantitative techniques that emphasized on the borrowers projected cash flows and analysis of audited financial books of accounts have contributed to immensely to the non-performing loan portfolio.

Conceptual framework

Figure 1:Conceptual framework



The conceptual model suggests that the dependent variable is conceptualized as loan portfolio quality and is represented by Non-performing Asset while the independent variable credit appraisal was conceptualized as the cost of borrowing.

RESEARCH METHODOLOGY

Research design

The study adopted the use of a descriptive case research design. The case study approach was preferred by the researcher due to time constrain. This descriptive case research was aimed at getting detailed information regarding the effects of credit management system on non

performing loans in Kenyan commercial banks. A descriptive study was concerned with finding out the what, where and how of a phenomenon (Ngechu, 2004). Descriptive research design was chosen because it enabled the researcher to infer the findings to a larger population with high level of accuracy. The focus of the study was quantitative in order to gain a better understanding and more insightful interpretation of the results. According to Coopers and Schindler (2004) descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions.

Target Population

The target population comprised of all the staff in different capacities employed in the various commercial banks of Kenya at the branch level where decisions regarding lending are made and measured and these were the people who meet face to face with borrowers and were in a better position to make unbiased judgments. The population was selected since the day today lending of the company originates from the branches by staff who handle the initial appraisals and forward to head office either for disbursement or for further analysis to determine the fate of an application and thus were well conversant with the subject matter of the study. Mugenda & Mugenda (2003) define a study population as consisting of the total collections of elements about which the study wants to make some inferences.

Census Design

According to Mugenda and Mugenda (2003), at times the target population may be so small that selecting a sample is meaningless and therefore taking the whole population in such cases is advisable. Census technique therefore was used using a list of all credit staff at the branch level in the 10 commercial banks in Bungoma, Kenya.

Data Collection Instruments

Instruments of data collection involved questionnaires for primary data. Journals, research papers were used to collect secondary data.

A questionnaire was the primary tool for collecting data. Kothari (2004) 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 and economical manner. It guaranteed confidentiality of the source of information through anonymity while ensuring standardization. In addition all the respondents were educated staff to tertiary/university level. It was for the above reasons that the questionnaire was chosen as an appropriate instrument for this study. The questionnaire to be used to collect primary data consisted of open and closed ended questions.

The open-ended questions were to enable the researcher collect qualitative data. This was to be used in order to have a better understanding and possibly enable a better and more insightful interpretation of the results from the study. To establish the validity of the research instrument the researcher had to seek opinions of experts in the field of study especially the researcher's supervisor. The questionnaire was administered using a drop and pick later method.

Data Analysis and Presentation

Data was analyzed both quantitatively and qualitatively. Data analysis was facilitated by use of SPSS (Statistical Package for Social Science) Computer package. Qualitative data was analyzed using thematic analysis. Descriptive method was employed in analyzing qualitative data where frequencies and proportions were used in interpreting the respondent's perception of issues that were raised in the questionnaires so as to answer the research questions. Descriptive statistics such as frequency distribution, percentages, means and standard deviations were calculated and data presented in form of tables. Inferential statistics was used to draw implications from the data using Chi-square or fisher exact tests to test for the strength of association between categorical variables. Independent factors were associated with the dependent variable.

ANALYSIS AND DISCUSSION OF FINDINGS

Demographic characteristics

From the findings tabulated, 50% of the banks have been in operation for 6 to 10 years, 40 % have been operation for more than 16 years while only 10% have been in operation for 1 to 5 years. More than three quarter (75%) of the respondents had worked for between 1 and 5 years, 12% had between 6 and 10 years, 6% less than one year, 4% had between 11 and 15 years and 2% less than 16 years.

Loan appraisal

It is clear from the findings (Table 1) that respondents on more than average concurred (mean=3.12; std dev. <1.00) that borrowers capacity, character, condition and credit history were somehow considered in loan appraisal and approval. It was further established that borrowers collateral (mean=4.02; std dev. <1.00) is much considered in loan appraisal and approval.

Table 1: Factors considered important in loan appraisal and subsequent approval

	N	Min	Max	Mean	Std. Dev.
Borrowers capacity	50	2.98	3.24	3.12	.480
Borrowers character	50	2.80	3.16	3.00	.670
Borrowers condition	50	3.34	3.86	3.60	.969
Borrowers credit history	50	4.02	4.80	4.02	.795
Borrowers collateral	50	4.02	3.78	4.02	.795

Effect of credit approval / sanctions on the performance of the bank

As outlined in table 2 it was strongly agreed (mean= 4.40; std dev. <1.000) that clear established process for approving new credits and extending existing credits is important while managing credit risks in banks. Respondents further admitted (mean=4.54; std dev. <1.000) that monitoring of borrowers is very important as current and potential exposures change with both passage of time and movements in underlying variables. The study established that banks must have in place written guidelines on credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions (Mean=4.40, std dev <1). The study also established the importance of some approval authorities to be reserved for the credit committee in view of the size and complexity of the credit transaction (Mean=3.98, std dev >1). It was further established Credits to related parties should be closely analyzed and monitored so that no senior individuals in the institution are able to override the established credit granting process (mean= 4.4; std dev. <1.000).

Table 2: Effect of credit approval/approval/sanctions on the performance of the bank

	N	Min	Max	Mean	Std. Dev.
Clear established process for approving new credits and extending existing credits important while managing credit risks in banks	50	4.26	4.52	4.40	.495
Monitoring of borrowers very important as current and potential exposures change with both the passage of time and the movements in the underlying variables	50	4.40	4.66	4.54	.503
Written guidelines on credit approval process and approval authorities of individual or committees as well as the basis of those decisions	50	4.22	4.58	4.40	.670
Prudent credit practice requires that persons empowered with the credit approval authority should not also have the customer relationship responsibility.	50	2.14	2.76	2.42	1.144

Table 2...

Some approval authorities will be reserved for the credit committee in view of the size and complexity of the credit transaction	50	3.68	4.26	3.98	1.078
Credits to related parties should be closely analyzed and monitored so that no senior individual in the institution is able to override the established credit granting process.	50	4.26	4.60	4.44	.644

Relationship between credit appraisal and non-performing loans

According to the findings the relationship between credit appraisal and non-performing loans is positive, strong and statistically significant at 0.05 level of significance ($X^2 = 18.50$, $p<0.05$). Good credit appraisal prevents non-performing loans and vice versa (Table 3).

Table 3: Relationship between credit appraisal and non-performing loans

		Non-performing loans
Credit appraisal	Chi square	18. 550
	Sig (2 tailed)	0.002
	Df	1
	N	50

*p value <0.05

Table 4: Regression Results

R Square	0.507				
Adjusted R2	0.484				
ANOVA(F)	19.631				
Sig.	0.000				
	B	**Std. Error**	**Beta**	**T**	**Sig.**
(Constant)	-5.750	.810		-4.312	0.000
Credit appraisal	0.103	0.024	0.303	4.952	0.000

Credit appraisal accounts for 50.7% variation in non performing loans

CONCLUSIONS AND RECOMMENDATIONS

It was inferred that credit appraisal has a positive and strong relationship with non performing loans. Good credit appraisal lowers the rate of nonperforming loans. The study established that Banks must have in place written guidelines on credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions. The study established that the ability and qualifications of the credit officer is of importance in assessing

the credit worthiness of the borrower. Therefore the banks' staff should be given occasional training to equip them with the relevant skills as this will go a long way in reducing the levels of nonperforming loans. Credit standards for commercial banks should be customised to the credit worthiness of the respective borrower.

This study recommends that another study should be done to augment findings in this study; it therefore recommends a study to be done on the effect of credit management practices on the borrowing behaviour of consumers so as to look at how credit management practices influence borrowers' decision making. Further to augment the research finding of this study, the study recommends that another research on credit management practices be done to include all credit providers namely; microfinance institutions, mortgage companies, higher purchase companies and utility companies on a wider geographical area.

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