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Effect of Credit Policy on Non-Performing Loans: Case of Commercial Banks in Kenya

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Abstract: **Bad loans are one of the key causes of banks breakdown in Kenya commercial banks. The objective of the study was to determine the effect of Credit Policy on non performing loan in commercial banks in Kenya. The study employed descriptive research design where quantitative approach was applied. Data was obtained from 43 commercial banks in Kenya and analysed using SPSS by applying both correlation and regression to show relationship between the variables. The study recommends that Banks should develop credit procedures, policies and analytical capabilities and these efforts should be expanded into full credit management including origination, approval, monitoring and problem management tailored to the needs of each bank.**

Keywords: **Credit policy, Loan Nonperformance.**

1. INTRODUCTION

According to the International Monetary Fund IMF (2010) a non- performing loan is any credit in which interest and principal operating expense are more than 90 days long-ago. Nonperforming loans are loans that are ninety or more days delinquent in payments of interest and/or principal (Bexley & Nenninger, 2012).

Evidence from Klein (2013) states that banks' lending operations in most of the Central and Eastern and South-Eastern Europe (CESEE) countries was affected due to that high and rising levels of NPLs. Banks in Zimbabwe were liquidated one of which include Royal Bank Limited (Monetary Policy Statement, 2012). This was due to high levels of nonperforming loans. Joseph, Edson, Manuere, Clifford and Michael (2012) exposed that external factors are more rampant in causing nonperforming loans in Commercial Bank of Zimbabwe Limited, thus other causes of nonperforming loans were government policy and the integrity of the borrower.

The Central Bank of Kenya do publishes information on Kenya‘s commercial banks and non-banking financial institutions. The Central Bank of Kenya also acts as the main regulator of commercial banks in Kenya. as a result Kenya has 43 Commercial banks in total (CBK Annual Report, 2014).

1.1 Statement of the Problem:

Kenya has shown high rate of Nonperforming loans in due to High Interest rates and growth in loans as some of the causes of non-performing loans in commercial banks in Kenya, which show that Non-Performing loan is influenced by pressure on the banks to retain high lending rates to minimize losses causing borrowers default thus the need to conduct other studies on other determining variables of nonperforming loans on commercial banks (Muriithi, 2013). Weak credit scrutiny, insufficient risk supervision, dishonesty of the borrowers causes an upward trend in non-performing loans on Zimbabwe Commercial Banks attributing to the growth in the loan book by increasing the cost of loans charged on the borrowers leading to NPLs. Thus the need to conduct other studies on management of nonperforming loans on banks (Joseph *et al.*, 2012).

Several studies have been done in relation to commercial banks in Kenya with different ideas regarding credit policy of nonperforming loans on commercial banks. Kwambai and Wandera (2013) did a case study only on Kenya commercial bank on effects of sharing information on credit on nonperforming loans. Further, Billy (2011) argued that Poor credit

analysis contained a significant level of non- performing loans in Kenya. Simon (2012) concludes that credit approval strategy and monitoring of borrowers affect nonperforming loans to a great extent and that clear established process for approving new credits to be very important while managing Credit Risks in banks thus further has to be done on causes and management techniques on impaired loans on banking financial institutions in Kenya. Hence the need of this study to discuss on effect of credit policy on Non Performing loans in commercial banks in Kenya.

1.2 Research Objective:

1. To determine the effect of credit policy on nonperforming loans in commercial banks in Kenya.

1.3 Research Question:

1. How does credit policy affect non performing loans in commercial banks in Kenya?

2. LITERATURE REVIEW

2.1 Conceptual Framework:

Mugenda and Mugenda (2003) term a conceptual framework as a model identifying the concepts under study and their relationships. The dependent variable is Nonperforming Loan and the independent Bank Regulation. The relationship between the variables of concern is shown through Figure 2.1.

INDEPENDENT VARIABLE **DEPENDENT VARIABLE**

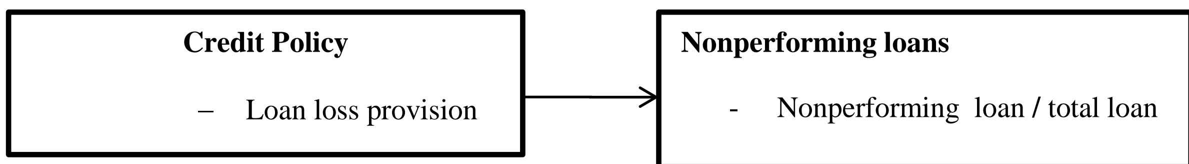

Figure 2. 1: Conceptual Framework

2.2 Review of Variable:

2.2.1 Credit policy:

The lending policy guides banks in giving out loans to customers. Stringent devotion to the policy is by far the cheapest method of credit risk management. The credit policy should be in accordance with the general bank plan and should include factors like the existing credit policy, general economic conditions of the country and the prevailing economic status (Kithinji, 2010). Loan loss provisions are considered as a scheming device over predictable losses of loan. Higher levels of nonperforming loans are associated with high rates of provisioning Under backward looking provisioning practice, where provisions are triggered by default incidents on loans (Hasan & Wall, 2004).

The Banks with high levels of capital reduction create greater provisions to reduce income instability and to strengthen intermediate term bank solvency. The distinguishing features of the bank makes it to incur low nonperforming loans when it has strong policies regarding bad loans (Daniel, 2010).

The source of credit threat involve unsuitable credit policies, unstable interest rates, deprived administration, little capital and liquidity, direct lending, massive licensing of banks, poor loan underwriting, negligence in credit assessment, poor lending practices, government intrusion and inadequate regulation by the central bank (Kithinji, 2010).

There are diverse policies that an organization should adhere for effective credit policies which may include collection policy to avoid nonperforming loans. Few customers complete their payments while others don't pay at all. The collection effort will stimulate the nonpayers to pay does avoiding nonperforming loans (Kariuki, 2010). Further Fawad and Taqadus (2013) by using six years in Pakistan stated that credit policy significant positive show relationship between NPLs and credit growth. This is justified by the fact that banks lend at boom and when it ends the low quality borrowers fail to repay leading to nonperforming loans. Moreover Festi *et al.* (2011) suggested that procyclicality and high economic growth increases credit in the country but sudden slowdown or decline in economic growth leads to the growth in NPLs due to inability of borrowers to repay loans. Thus credit growth during boom results in high growth of NPLs in despair.

Olokoyo (2011) examine Nigerian Banks and found out that quantity of deposits, foreign exchange, investment portfolio, less cash reserve ratio, lending rate and liquidity influence nonperforming loans. The coefficients of lending rate and minimum cash reserve ratio showed insignificant results implying that monetary policy instruments do not affect bank lending volumes in Nigeria. However, Affinito and Tagliaferri (2010) found that banks at high risk especially those burdened with nonperforming loans are more likely to be involved in risky loan collateral. As provisions roughly indicate the probability of loans to become non-performing, higher provisions are expected to be positively related to nonperforming loan.

2.2.2 Nonperforming Loans:

Nonperforming Loans result from the inability of debtors to repay their loans and their interests within the specified time resulting in adverse effects on the financial condition of the creditor (Agu & Okoli, 2013). By the time they are referred to as “bad loans”, there is the fear that the amounts involved and their interest cannot be fully paid by the debtor (Chelagat, 2012; Awunyo-Vitor, 2013). Bad loans need to be avoided in view of the fact that their effects are multidimensional; thus they do not only hinder profitability among commercial banks, but they also limit lending to the defaulting SMEs, individuals and other corporations. This assertion is based on evidences in Ghana (Appiah, 2011; Awunyo-Vitor, 2012)

At large, the main effect of bad loans on banks is the fact that increasing bad loans limit the financial growth of banks (Karim, Chan & Hassan, 2010; Kuo *et al*., 2010). This consequence is as a result of the fact that bad loans deprive banks of the needed liquidity and limit their capability to fund other potentially viable businesses and make credit facilities available to individuals.

3. RESEARCH METHODOLOGY

This study employed descriptive research designs that include quantitative approach. A descriptive study is concerned with finding out the what, where and how of a phenomenon (Ngechu, 2004). Descriptive research design was employed because it enables the researcher to gather the findings to a larger population with high level of exactness. For the purpose of the study, the population of the study was all Commercial Banks in Kenya. These Banks are forty three (43) in number as per the Central Bank of Kenya’s Banking Supervision Report of 2015. The target population for this study based on all the 43 banks in Kenya. A census approach was applied to all the 43 commercial banks in Kenya. Nzambi (2010) used census based on a descriptive Study on factors contributing to nonperforming loans in commercial banks in Kenya. This method was used to describe the area of interest by bringing out the facts as they are without alterations. Data was taken from reliable sources to ensure reliability of the study this included data from Central bank of Kenya annual reports, statements of cashflows, comprehensive income and financial position of the commercial banks. According to Dawson (2009) secondary data involves collecting data using information from studies that others have done in an area or subject.

Data to be used was collected from CBK Annual Reports and Annual Reports of the commercial banks in Kenya that have published account for a five year period from 2010-2014. Emmanuel (2014) studied on Non-performing Loans in Kenya Commercial Banks where secondary data was obtained from Central Bank of Kenya. Data collected was coded, keyed in the computer and analyzed with the aid of the Statistical Package for Social Science (SPSS) computer software for Windows. On the other hand Kaume (2010) studied on factors contributing to nonperforming and used Statistical Package for Social Sciences (SPSS) software and the Excel worksheet for data analysis. The study employed descriptive and inferential statistics. Inferential analysis was in structure of Pearson’s correlation coefficient. The correlation analysis enabled the researcher to determine the power and meaning of relationship between independent variable and the dependent variable. Regression analysis is a technique that can be used to develop an equation showing how variables are related.

Metin and Ali (2013) used regression to investigate whether there are significant long-term effects on non-performing aggregate loan ratio in Turkish banking systems. The study adopts Pearson regression to show relationship between variables. The study adopted Bi- Variate correlation to analyze data. Adela and Iulia (2010) used correlation to study relationship between average interest rate and nonperforming loans in the Romanian banking system. The study adopts a model similar to Gakure, Ngugi, Ndwiga and Waithaka (2012) which studied the effect of risk supervision techniques of unsecured bank loan employed by commercial banks in Kenya

Model:

$Y_{NPLs} = \beta o + \beta_1 X_1 + e$

Where:

Y_{NPLs} = Nonperforming Loans.

β_1, = Regression coefficient

X_1 = Credit policy

e = error term

βo = Constant term

4. RESEARCH FINDINGS AND DISCUSSION

Data obtained was analyzed using Statistical Package for Social Science to show conformity or importance of planned question. The study was conducted for a period of 5 years from 2010 to 2014 where data was obtained from Central Bank of Kenya annual reports and banks specific annual reports.

4.1 Descriptive Analysis:

Table 4.1 Descriptive Analysis

	Minimum	**Maximum**	**Mean**	**Std. Deviation**
Credit policy	36704.20	39973293.80	2004801.6937	7875752.64678
Non-Performing Loan	.02	.46	.0742	.07814

The above table depicts that the variable credit policy measured by loan loss provision ratio has standard deviation 7875752.64 with mean 2004802 and minimum value 36704.20, maximum value 39973293.80. The table describe that NPL was measured using Nonperforming loans to total loan ratio. The standard deviation is 0.7814 with mean 0.742 and minimum value 0.02, maximum value 0.46.

4.2 Correlation Analysis:

Table 4.2 Correlation Matrix

		Bank Regulation	Nonperforming Loans
Credit policy	Pearson Correlation	1	-.531**
	Sig. (2-tailed)		.000
	N	43	43
Nonperforming loans	Pearson Correlation	-.616**	1
	Sig. (2-tailed)	.000	
	N	43	43
**. Correlation is significant at the 0.01 level (2-tailed).			

Correlation analysis enable researcher to determine the strength and significance of relationship between each individual independent variable and the dependent variable. The credit policy has a negative correlation of -.531. The p value (0.000) < 0.01 showing the consistence of credit policy. Thus banks that do not adhere to the credit policy will incur higher NPLs. This result is in line with Olokoyo (2011) who found out that loan loss provision has a negative relation with NPL evidence from commercial banks in Nigeria.

4.3 Regression Analysis:

Table 4.3 Model Fitness

Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**	**Durbin-Watson**
1	.531[a]	.282	.264	1.15927	2.114
a. Predictors: (Constant), Credit policy					
b. Dependent Variable: NPL					

The results indicate that the value of R^2 is 0.282 thus 28.2% of variance in the independent variables can be accounted in the dependent variable NPL. The Durbin Watson value of 2.114 indicates there is no autocorrelation since the value is between 1 and 3.

Table 4.4 Analysis of Variance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	21.597	1	21.597	16.070	.000[b]
	Residual	55.100	42	1.344		
	Total	76.698	43			
a. Dependent Variable: NPL						
b. Predictors: (Constant), Credit policy						

The result shows that *p* value (0.000) < 0.01 confidence level. The F value is significant at 1% level (F= 16.070, *P* <0.01) indicating application of the model. Thus the result shows that Independent variable credit policy is significant in determining NPLs among commercial banks in Kenya

Table 4.5 Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	4.256	.464		9.166	.000		
	Credit policy	-.514	.128	-.531	-4.009	.000	1.000	1.000
a. Dependent Variable: NPL								

The results depicts that there is no multicollinearity because the VIF values are less than 10 (Robert, 2015). The regression equation is $Y_{NPL\,=}$ 4.256 – 0.531CP. These results are inconsistent with Fawad and Taqadus (2013) who used six years panel data of 30 banks in Pakistan to test the validity of 10 banks specific hypotheses provides the validity of procyclical credit policy hypothesis and investigate significant positive association between NPLs and credit policy.

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction:

This chapter deals with the summary of the entire study including the data presented with specific attention given to the objectives and research questions of the study which were used as units of analysis. It includes summary, conclusion and recommendation of the entire study.

5.2 Summary of the Finding:

The study investigated whether credit policy affected NPL among commercial banks in Kenya. Credit Policy determines the banks position by ensuring that the bank follows them accordingly. The results indicate that a decrease in loan loss provision will increase nonperforming loans. Thus commercial banks should strive to increase their loan loss provision to reduce nonperforming loans. The results shows credit policy is negatively significant to nonperforming loans.

5.3 Conclusions:

The findings indicated that Credit policy has a negative correlation to nonperforming loans hence significantly affect nonperforming loans. A bank should have strong credit procedures and policies so as to avoid high nonperforming loans. This result is in line with Olokoyo (2011) who found out that credit policy has a negative relation with NPL evidence from commercial banks in Nigeria. Mwaura (2012) findings indicated that the nature of the credit policies adopted by the banks influence the volumes of the loans procured by the banks and thus the competitiveness of the bank in lending and thus the performance in the bank industry. Joseph *et al*. (2012) studied on Non Performing loans in Commercial Banks, case of Commercial Bank Limited in Zimbabwe and found that credit policy has a negative influence towards non performing loans.

5.4 Recommendations:

Banks should develop credit procedures, policies and analytical capabilities and these efforts should be expanded into full credit management including origination, approval, monitoring and problem management tailored to the needs of each bank. The management and owners of the banks require adhering to the credit policies of its bank to minimize NPLs. The study recommends that there is need for commercial banks to increase their credit policies and monitoring techniques so as to reduce NPLs performance of commercial banks in Kenya.

5.5 Areas for Further Research:

The study also recommends that a study should be done on the managing and causes of credit policy on nonperforming loans among commercial banks. The study collected data for five years since 2010 - 2014. The study therefore recommends that a study be carried with the aim of increasing the period under study.

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