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Factors Contributing to Non-Performing Loans in Commercial Banks in Kenya

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Abstract: This study focuses on assessment of factors contributing to non-performing loans (NPLs) in commercial banks in Kenya. The 1990s and the preceding years trend of NPLs was increasing resulting to collapse of many banks while several were put under statutory management. The survivor banks and those formed after learnt that poor loan management was a major cause of the heavy blow. While the borrowers are to blame, the management of the failed institutions must share the blame because of instituting poor lending practices, as some lacked prudent innovative methods of managing NPLs. Improved credit risk management has however reversed the trend of NPLs. Nonetheless the percentages gross NPLs to gross loans are still high and may cause closure of more banks. The objectives of this study was to establish whether risk assessment methods, the magnitude of lack of awareness by borrowers on products being offered, risk management methods ,economic conditions and technological obsolescence contribute to NPLs. To achieve these objectives primary data was collected by administering questionnaires to credit section staffs of selected banks. Data was analyzed using spearman's correlation coefficient statistical method and was presented by tables. The findings emerged that among the five factors tested risk assessment methods had the highest correlation coefficient hence the main contributor to NPLs, followed by lack of awareness by borrowers on products being offered, while risk management methods had minimal share. The findings will provide banks management with increased knowledge on exposure to credit risk and control of NPLs hence increased profitability.
Keywords: Loan, Non performing loans, borrower, commercial bank, central bank of Kenya, default risk.

INTRODUCTION

The Kenya banking sector as of March, 2014, comprised 43 commercial banks, 1 mortgage finance company, 9 microfinance banks, 7 representative offices of foreign banks, 97foreign exchange bureaus, 3 money remittance providers and 2 credit reference bureaus [1]. This study concentrated on commercial banks only.

The financial sector in Kenya has undergone numerous challenges and transformations but none has elicited so much attention, pain and distress than the spectrum of massive failure of financial institutions in 1980s and 1990s as most of them fell victims of Goldenberg scandal or Euro banks scandal. The early 1990s were characterized by intensive political activity with the resurgence of multi-party politics. An unfortunate by-product of this activity was mushrooming of "politically correct" banks licensed for political exigencies. In 1993 alone, eleven institutions were placed under liquidation. Ten of these were under the Deposit Protection Fund Board while one went into voluntary liquidation. In 1994 two institutions were liquidized, three in 1996, one in 1997, five in 1998, one in 1999, one in 2001, two in 2003, and two in 2005. There were a total of twenty four (24) institutions under liquidation out of which four (4) have been wound up.[2].

The collapse of these banks has made those who survived and those formed afterwards to realize that poor management of loan advanced borrowers is a serious issue of concern. They have realized that loan vetting procedures are not enough to attainment of their expected returns in the long run. Most banks are now appreciating that managing the loans is an effective measure in attaining their objectives and those of their borrowers. Failure to use credit management techniques can lead to lack of foresight by the managers thus resulting to NPLs, and consequently poor profits. Today banks are different from twenty years ago, when they used to lend money with no concern of utilization of the money lent. Some banks go beyond lending money to ensuring all money lent is managed properly so that the bank, the depositor and the borrower benefits in the long run. As such credit risk management is of great concern to all the banks today than it was twenty years ago. This has hence reversed the trend of NPLs despite the fact that they are still high.

The average value for Kenya NPLs during the period 2000-2014 was 15.7% with a minimum of 4.4%

in 2011 and a Maximum of 34.9% in 2003.The annual average NPLs during this period were as shown in table 1 below:

Table-1: Average values for NPLs

Year	2000	2001	2002	2003	2004	2005	2007	2008	2009	2010	2011	2012	2013	March 2014
Gross NPL/ gross loan(%)	33.3	13.1	18.1	34.9	29.3	25.6	10.6	9	7.9	6.3	4.4	4.7	5.2	5.6

(Source: CBK 2014) [3]

As at 31st March 2014 the Kenyan Banking Sector registered loans and advances worth Ksh1.7trillion, while the deposit base was Ksh.2.0 trillion. Over the same period, the number of loan accounts stood at 3,463,900. The stock of gross NPLs increased by 14% from ksh61.57 billion in December 2012 to 16.1% (Ksh81.9 billion) in December 2013 to Ksh.95.1billion in March 2014. Similarly, the quality of assets, measured as a proportion of net NPLs to gross loans deteriorated from 1.5% to 2.0% over the same period. The sector also registered an increase in the ratio of gross NPLs to gross loans from 5.2% in December 2013 to 5.6% in March 2014.

Spill-over effects of high interest rates and delays in payments particularly in the building and construction sectors contributed significantly to the increase in NPLs. However, banks continue to deploy enhanced appraisal standards to mitigate credit risk [4].

One of the catalysts of NPLs was “Serial defaulters”, who thrived in the information asymmetry environment that prevailed due to lack of a credit information sharing mechanism. That's why they borrowed from various banks with no intention of repaying the loans. Thus whenever a credit manager is approached by a borrower seeking huge sums of loan, the first thing that he does is to assess the ability of the borrower to repay the principal plus the interest. In so doing the manager is at some point certain that the given borrower will adequately service his / her loan. However disaster strikes when the borrower defaults in payment. At this point, the credit manager is faced with one dilemma, ‘What factors contributed to NPLs in the lending institutions?’ Obviously different banks in many countries will take varying specific approaches and risk control is conditioned by the fact that commercial bank are highly geared by lenders. A bank thought to have a poor portfolio may lose deposits. Without deposits it cannot continue to fund its loans. It is thus vital for any bank to have an approach to lending which ensures a sound portfolio.

The findings of this study are significant to management of financial institutions as they guide on exposure to NPLs risk thus help management to employ more effective strategies of managing NPLs hence increased profit.

A previous survey carried out by Greuning [5] to analyze credit risk exposure for Islamic banks, found out that despite innovations in the financial services sectors, credit risks is still the major single cause of bank failures. The reason is that more than 70% of a bank’s balance sheet generally relates to this aspect of risk management. They thus recommended that credit managers should perform a comprehensive evaluation of a banks capacity to assess, administer, supervise, control, enforce and recover loans, advances, guarantees and other credit instruments.

The purpose of this survey was to find out the factors contributing to NPLs in commercial banks in Kenya.

The scope of this study covered a population of 43 commercial banks in Kenya. The research was carried out at the headquarters of the selected banks as data from all the branches is usually gathered and analyzed at the head office. The respondents were credit managers and credit officers in respective commercial banks as they are the people vested with information and knowledge that pertains credit in their institutions. The survey was carried from February to April 2014.

METHODOLOGY OF RESEARCH

Sample of Research

The sample was selected using random numbers sampling method. A sample of 39 banks was selected by first picking the first bank randomly and the rest by use of table of random numbers.

Instrument and Procedures

Primary data was collected using self administered questionnaires which were dropped to the respondents and picked them latter for analysis. Secondary data was obtained from the existing literature, bulk of which was from CBK annual reports, journals, magazines, books and newspapers publication.

Data Analysis

Data collected was coded, tabulated, and analyzed using Spearman’s Rank order correlation

coefficient method to obtain descriptive statistic. Qualitative analysis was further used to analyze unstructured questions.

RESULTS AND DISCUSSION

Summary of the Research

32 out of 39 questionnaires were successively answered. The study revealed that among the five factors tested, inadequate credit risk assessment methods are the highest contributors of NPLs, with a correlation coefficient of 0.542. This was even more serious in banks that did not consider loan officials with analytical skills and experience, but only gave emphasis to business qualifications. It also emerged that lack of awareness by borrowers on products being offered by banks has a significant influence on the rate of NPLs as indicated by a positive correlation coefficient of 0.503. Technological changes and economic environment also have their share in the rate of NPLS i.e. 0.343 and 0.174 respectively, thus credit managers should also address them. It also came out clearly that most commercial banks in Kenya have embarked on sound risk management methods as indicated by a low correlation coefficient of 0.058.

Further, it was also evident that most of the particulars discussed in the literature review as banks' requirements from borrowers are not largely exhausted by most banks. Most banks concentrate on financial statements, cash flow statements, and bank statements hence ignoring most of other factors like business plans, compliance with legislation and statement of account from other banks among others. This could be the main cause of the high rate of NPLs as indicated by a correlation coefficient of 0.542.

However, the study also revealed that all the techniques discussed in literature review as credit risk management techniques were widely adhered to by most commercial banks in Kenya. It further come out strongly that capitalization of arrears and reducing of interest rates were the most commonly applied methods while freezing of interests was unfavourable for most banks hence rarely used.

Results of the Research and Interpretations.

Education and Communication to Borrowers

The respondents were asked to state how often they send information/statements to borrowers regarding their credit position.

Table-2: Education and Communication to Borrowers

Duration	Frequency	Percentage
Once a year	4	12.5%
Twice a year	12	37.5%
Thrice a year	2	6%
After one month default	14	44%
Total	32	100%

Source: survey 2014

The results indicated that majority (44%) of commercial banks in Kenya waits until borrowers' defaults in payments for them to communicate to them. Further the respondents were asked to state whether customers complain of lack of communication from them. Out of 32 successful interviews, only 7 or 22% received complaints from customers as a result of their non communication to them. Thus majority (78%) of customers do not complain, may be due to ignorance of the fact that they need to be updated with information on their credit performance.

The respondents were further asked to state whether they carry out public relation activities such as education days, road shows etc to educate members on performance of their credits and to briefly say how they do so. The results indicated that out of 32 commercial banks in Kenya, 56% of them do not venture into aggressive public relation activities, reasons being that banks have a confidentiality clause and that such ventures are expensive, hence clients have to liaise with their respective account relationship managers for information.

Nonetheless, asked to state whether educating customers will help alleviate the problem of NPLs, 83% of the respondents were certain this will do, arguing that it makes borrowers more disciplined in spending the loans for the purpose borrowed for as well as knowing how well to service their loans to avoid legal litigations.

Credit Risk Assessment

Lending policy

Asked to state whether their banks have a lending policy, 100% of the banks admitted having a solid lending policy. Further the respondents were required to state when it was lastly reviewed, who were involved in its review and the reasons why it was reviewed. The results indicated that 94% of the commercial banks in Kenya have updated their lending policy in the last 3 years with the remaining 6% having reviewed theirs' in the last 5 years. Among all the banks interviewed, credit managers, credit analysts, senior management, and chief auditors were some of the officers involved in its review. All the respondents unanimously gave the reason for the review of their lending policy as to update the policy with the changes in the market.

Credit Assessment
Information needed from a borrower

The respondents were moreover asked to state the kind of information they require from a borrower before extending credit to him/her. The results were as given in table 3 below.

Table 3: Information needed from a borrower

Requirement	Frequency	Percentage
Financial Statements	16	18%
Bank statements	16	18%
Cash flow statements	16	18%
Pay slips	11	12%
Statement of account from other banks	2	2%
Security details and Valuation reports	9	10%
Guarantors	5	6%
Company profile	2	2%
Directors' profiles	2	2%
Details of other borrowing	2	2%
Evidence of compliance with legislation	2	2%
Board resolution to borrow	5	6%
Memorandum and article of Association	2	2%
Total	90	100%

Source: survey 2014

From the analysis of table 3 above, it was evident that most of the commercial banks do not carry out enough credit risk assessment. Most of them concentrate on financial statements, bank statements and cash flow statements leaving other vital requirements, such as details of other borrowings, memorandum and articles of association and boards' resolution to borrow among others.

Problems Experienced in Credit Department

The respondents were asked to rate the problems currently being experienced in their credit department. The results were as indicated in table 4 below.

Table-4: Problems Experienced in Credit Department

Problem	Frequency	Percentage
High cost of operation	16	20%
Reduced profits	21	26%
Un-serviced loans	25	31%
Lack of information on customers	12	15%
Delayed rulings by courts	4	5%
Poor credit management	2	3%
Total	80	100%

Source: survey 2014

The results indicated that in most of the commercial banks in Kenya, the major problem experienced is that of un-serviced loans with a high percentage of 31%. With this practical problem in operation, it could be the root cause of the second largest problem of reduced profits as well as the third biggest problem of increased cost of operation as they go hand in hand. On the other hand credit management does not seem to be a big problem in the commercial banks as indicated by a low percentage of 3 %.

Risk Management
Rate of default

The respondents were first required to rate each of the sectors against rate of default. The results were as shown in table 5 below.

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Table-5: Rate of default

Sector	Least likely		Most likely	
	Frequency	Percentage	Frequency	Percentage
Individual borrower	11	34%	21	67%
Joint borrower	18	56%	14	44%
Company	26	81%	5	17%
Employed	25	78%	7	22%
Self employed	12	38%	20	61%

Source: survey 2014

According to table 5 above, individual borrowers have the highest (67%) chances of default in payments while companies have the least (22%) rate of default. Further, the respondents were asked about the rate of default in the first year. 98% stated that it was less than 5% of the total borrowers.

The respondents were further asked to briefly describe how they manage the un-serviced credits. It the results showed 99% of the commercial banks allocate each loan to different loan officers (among them being the relationship manager) who through a computerized program carry out monthly or quarterly review of the loans performance and classify it into different categories depending on the performance.

Modes of Restructuring

The respondents were required to rate the modes of loan restructuring applicable to their banks. The results were as indicated in table 6 below:

Table-6: Modes of Restructuring

Mode	Frequency	Percentage
Increasing term of the loan	21	24%
Freezing interest	18	20%
Decreasing interest	25	28%
Capitalization of arrears	25	28%
Total	89	100%

Source: survey 2014

The analysis indicated that reducing of interest rates and capitalization of arrears are the most commonly used modes of loan restructuring, both tying at 28%. This is however followed closely by increasing the term of the loan while freezing the interest is the least applied mode of restructuring the loans.

Further, the respondents were asked whether they assess the client's possibility to pay before restructuring their accounts and how they achieve this. Of all the interviewed banks, all the respondents admitted assessing the client's possibility to pay before restructuring their loans, they stated that this is achieved through assessing the client's income statements and carrying out site inspection.

The respondents were also required to state whether they hire external debt collectors to manage some of their NPLs, The analysis done indicated that only 7 out of 32 successful interviews or 22% use external debt collectors. The reason given for use of external debt collectors was that they are more efficient in debt collection and they have better monitoring techniques.

Property Sale by Private Treaty

The respondents were asked to state the point at which their banks consider sale by private treaty the property pledged as collateral. The results were as indicated in table 7 below:

Table-7: property Sale by Private Treaty

Cause	Frequency	Percentage
When the customer has refused to communicate	2	6%
When the arrears exceed the capital borrowed.	4	13%
When the customer has no other form of income to service the loan	18	56%
When the customer does not meet hid obligations though capable.	8	25%
Total	32	100%

Source: Survey2014

The results indicated that most banks (56%) sell the attached collateral when the customer has no other form of income to service the loan.

Further, the respondents were asked to state the measures used to correct the shortfalls. The results were as given by table 8 below.

Table-8: measures used to correct the shortfalls

Measure	Frequency	Percentage
Attach property	14	44%
Negotiate for lower figures	7	22%
Take the customer to court	9	28%
Leave the customer	0	0%
Call on guarantors	2	6%
Total	32	100%

Source: Survey 2014

From the table 8 above, the most common measure is to attach property (44%). This is because other measures such as taking customer to court are have long procedures which may take years before settlement, thus causing depreciation in value of collateral pledged. The next common measure is to negotiate for lower figures, which carries 22% of the responses. In none of the cases do banks leave the borrower courts free.

Debt Recovery

The respondents were asked to state how they monitor debt recovery performance. The results were as indicated in table 9 below.

Table-9: Monitoring Debt Recovery

Methods	Frequency	Percentage
Through payments made by borrowers	9	28%
Through special computer generated systems	11	34%
Credit managers monitoring payment and reporting to the manager in charge.	12	38%
Total	32	100%

Source: Survey 2014

The results indicate that the most common (38%) method of monitoring debt recovery is use of credit officers. The reasons given for the uses of this method were that it is timelier, accurate, completeness of information and above all more efficient. However it was also noted that some banks combine more than one of the above methods to achieve efficiency

Finally on risk management, the respondents were asked to say whether according to experiences, risk management is a factor contribution to non performing loans. According the survey of 32 respondents, 20 or 63% denied that risk management contributes to NPLs. They argued that the success of servicing of any debt largely depend on the borrower's willingness and ability to pay. They further said that banks have put into place human resources and capital resources to monitor the performance of the credits. Those who held that risk management contributes to NPLs were 37%. They argued that failure to monitor credit risk early enough may result to recoverable accounts becoming irrecoverable.

Economic Environment.

Interest Rates

According to the survey conducted in 32 commercial banks, all the respondents admitted that interest rate is one of the causes of unserviceable loans. They argued that persistence rise in interest rates increases repayment thus destabilizing the borrower's financial ability to repay debts thus leading to default.

Inflation

Table 10 below indicates the result of inflation on the performance of the loans.

Table-10: Effects of Inflation

Response	Frequency	Percentage
No	7	22%
Yes	25	78%
Total	32	100%

Source: survey 2014

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The respondents were asked whether from their past records inflation has been a significant factor contributing to NPLs. According to the analysis carried out, 78% of the respondent admitted that inflation is one of the main contributors to NPLs. They said that inflation leads to increase in price of commodities thus increasing the borrowers' costs of operation. As a result a huge percentage of the borrower's income is directed to increased prices thus antagonizing the borrower's ability to service his/her debt.

Borrower's Lose of Job

The respondents were asked whether in any way lose of job by the borrower affects the performance of loans. Among all the respondents interviewed, they all agreed that lose of borrowers source of income contributes to NPLs especially in the individual borrowers. When further asked to state the percentage of borrowers affected by lose of jobs, respondents stated this was very minimal giving as low as 2% of the total loans lent.

Technological Changes

The respondents were asked to state whether company sector borrowers complain of technological obsoleteness as a factor influencing their loan payments. The results were as given in table 11 below.

Table-11: Technological Obsoleteness

Response	Frequency	Percentage
No	21	66%
Yes	11	34%
Total	32	100%

Source: Survey 2014

The analysis of the above information indicated that technological obsoleteness is not a major factor contributing to NPLs as given by a higher percentage of 66%. They however though that liberalization of economy had greater impact in the performance of loans in among the company sector than technological obsoleteness.

The minority (34%) who felt that technological obsoleteness contributes to NPLs however said that only a small percentage (below 5%) of the total company borrowers are affected by it.

COMPARING THE LEVELS OF DEFAULT (DEPENDENT VARIABLE), WITH THE INDEPENDENT VARIABLES (i.e. AWARENESS, EMPLOYEE'S SELECTION CRITERIA, CREDIT RISK ASSESMENT, RISK MANAGEMENT, ECONOMIC ENVIRONMENT AND TECHNOLOGICAL ENVIRONMENT).

The Spearman's Rank order correlation coefficient values

1. Rank order correlation coefficient for various variables that influence NPLs was established and tabulated as follows: Criterion for selecting staff was ranked as fair (based on either qualification or experience alone) and unfair (based on a combination of qualification and experience).
2. Communication to borrowers was ranked as averagely fair or below average based on the frequency of communication.
3. Credit policy in place was ranked as adequate or inadequate based on information required from the applicants before credit is granted.
4. Risk management practices were ranked as average or below average based on modes of restructuring used.

Implication of the table

1. There is a positive correlation between the criteria of employing personnel at the credit risk department (coefficient of 0.785 greater than any other on the table)
2. The spearman's correlation coefficient analysis table also indicates that there is a strong relation linear relationship between credit risk assessment policy and the rate of NPLS (coefficient of 0.542)
3. The analysis also implies that awareness of products offered by the bank to their customers is positively and strongly correlated to the rate of NPLs as indicated by a correlation value of 0.503
4. The lowest coefficient of correlation is of the risk management i.e. 0.058 which implies that the rate of NPLS has a weaker positive relationship with risk management methods in place.

Speculations and assessment of future research or prospects.

The study only looked at inflation, interest rates and loses of jobs by borrowers as the economic factors that could cause the risk of NPLs. Thus a study should also be carried out to measure the magnitude of market liberalization on NPLs especially for manufacturing industries. In addition, the study only focused on commercial banks. Thus a similar study should be carried out in mortgage finance companies and microfinance banks so as to cater for the whole banking sector.

CONCLUSIONS

The survey demonstrated that, inadequate credit risk assessment methods are the premier cause of NPLs. This is followed by lack of awareness by borrowers on products being offered by banks, technological changes and economic environment in that diminishing order. Fortunately, most commercial

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banks in Kenya have embarked on sound risk management methods hence the least contributor of NPLs.

The researcher thus advices that the credit management should in future consider hiring credit officers who apart from their business qualifications have strong analytical skills as well as experience in credit department, for there seem to be a less rate of default in those banks with such human resources than those with otherwise. The credit risk manager should also consider exhausting all the methods of assessing credit risk as stipulated by the central bank of Kenya. The loan managers should also consider educating borrowers on where to borrow, how much to borrow, how to spend the loans as well as impacts of un-serviced loans to the borrower, the bank, and the country's economy as a whole. Accordingly the banks should invest in public relation activities such as education days, road shows a well as sending them publications. The banks should also send information to borrowers regarding their loan performance regularly instead of waiting until one month default in payment. A stitch in time saves nine!

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