

**LENDING POLICIES AND THEIR EFFECTS ON PERFORMANCE OF
COMMERCIAL BANKS IN KENYA**

MERCY MUNYIRI

**A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL
FULFILLMENT FOR THE REQUIREMENTS OF MASTERS DEGREE OF BUSINESS
ADMINISTRATION (MBA) DEGREE, SCHOOL OF BUSINESS**

UNIVERSITY OF NAIROBI

SEPTEMBER: 2010

DECLARATION

This is to declare that this research project is my original work that has not been submitted to any other university or institution of higher learning for examination.

Signed: _____

Date: _____

Mercy Wangari Munyiri

D61/P/8404/2003

This is to declare that this project has been submitted for examination with my approval as the university supervisor

Signed: _____

Date: _____

Jeremiah Kagwe

Lecturer, University of Nairobi

School of Business

ACKNOWLEDGEMENT

I would like to express my sincere thanks to the Supervisor Jeremiah Kagwe, University of Nairobi School of Business for agreeing to supervise this research paper. I am grateful to my family for giving me invaluable support that enabled me to concentrate on this research.

Lastly I thank Almighty God as my source of all inspiration in allowing me to undertake this project that required a lot of time and resources.

DEDICATION

My study is dedicated to the following: My loving husband and our three boys for the sacrifice, support and patience during the entire period of my study. For their encouragement and continued prayers towards successful completion of this course.

Finally I pay glowing gratitude and tribute to my employer and colleagues for understanding me during the entire period of study.

Thank you and God bless you abundantly.

TABLE OF CONTENTS

DECLARATION.....	ii
ACKNOWLEDGEMENT.....	iii
DEDICATION.....	iv
LIST OF TABLES.....	vii
CHAPTER ONE: INTRODUCTION.....	1
1.1 Background of the study	1
1.1.1 Bank Lending Policies	2
1.1.2 Lending Policies and Commercial Banks Performance.....	3
1.1.3 Banking Industry in Kenya	3
1.1.4 Commercial Banks in Kenya	4
1.2 Statement of the Research Problem.....	5
1.3 Objectives of the Study.....	6
1.4 Importance of the Study.....	6
CHAPTER TWO: LITERATURE REVIEW.....	7
2.1 Introduction.....	7
2.2 Concept of Lending Policies.....	7
2.3 Commercial Banks' Performance	8
2.5 Bank Performance and Lending Policies.....	10
CHAPTER THREE: RESEARCH METHODOLOGY	12
3.1 Research Design.....	12
3.2 Population	12
3.3 Data Collection	12
3.4 Pilot Testing.....	13
3.5 Data Analysis	13
CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION OF FINDINGS.	14
4.1 Introduction.....	14
4.2 General Information.....	14
4.3 Commercial Bank Lending Policies	16

4.6 Whether Lending policies adopted by bank greatly influence the performance of the bank.	18
4.8 Factors that contribute to improvement or decline in the level of income in bank lending books within that period.....	20
CHAPTER FIVE: DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS	23
5.1 Introduction.....	23
5.2 Discussions	23
5.3 Conclusion	25
5.4 Recommendation of the study	26
5.5 Recommendation for further study.....	26
References.....	27
Appendix I: Questionnaire.....	31
Appendix II: List of Commercial Banks in Kenya	35

LIST OF TABLES

Table 4. 1: Period the Commercial banks have been in operations	14
Table 4. 2 : Working period the Respondents has been working in the Lending Department.	15
Table 4. 3 : Frequent the Commercial banks Formulates it lending policies	16
Table 4. 4 : Relationship between your organization lending policy and customer service is satisfactory	17
Table 4. 5 : Rating bank lending policy on attracting and retaining customers.....	17
Table 4. 6 : Whether Lending policies adopted by bank greatly influence the performance of the bank.....	18
Table 4. 7 : Approximate Loan and advances made By Bank to your clients	19
Table 4. 8 :What extent do you agree with the following statement concerning effects of lending on bank performance.....	21

LIST OF FIGURES

Figure 4 2: Department Respondents is Based Within Your Organization 14

ABSTRACT

Bank Lending policy in Lending institution's is a statement of its philosophy, standards, and guidelines that its employees must observe in granting or refusing a loan request. These policies determine which retail or corporate clients the commercial banks approved for loans and which will be avoided, and must be based on the bank lending laws and regulations. This study investigated lending policies and their effects on performance in commercial banks in Kenya and to identify lending policies of commercial banks in Kenya. The objective of the study was to establish how lending policies affect commercial banks' performance in Kenya.

For the purpose of this study the research used descriptive survey. This was crucial in determination of lending policies adopted by commercial banks and establishing their effects on bank performance. The population of interest of this study was forty six (46) commercial banks in Kenya. The study being a survey implied that data was collected from all the 46 commercial banks. The researcher used structured questionnaires as the main data collection instrument. The questionnaires had both open and close-ended questions. The close ended questions provided more structured responses that facilitated tangible recommendations. Descriptive statistics was used to summarize the data. Data was presented using Tables and other graphical presentations as appropriate for ease of understanding and analysis.

From the findings, the study concludes that lending policies formulated by the commercial banks are customers friendly, focused on customer capability, prevailing market condition that suit the customer needs and enables their clients to feels comfortable when borrowing from the banks..

The study concludes that bank lending policies have effects on bank performance through attracting and retaining customers increasing the bank customer base, increase shareholder's value, create customer satisfaction, create competitive advantage, reduce loan loss defaults and increase bank profitability.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

The lending function is considered as the most important function of any commercial bank, since most of the banks' earnings are generated from interest income. In the first ten months of 2008, interest on loans and advances accounted for 54 percent of the total revenue generated by banks while fees and commissions and government securities accounted for 23 and 15 percent respectively (Daily Nation 29 December 2009). In the past, large number of non-performing loans had contributed quite significantly to low profits in Kenyan banks. Banks are now reviewing their risk portfolios using the laid down risk criteria such as credit risk modeling by Basel Committee on Banking Supervision. Greenspan (2005) indicated that Basel's goal is to induce bankers to improve their risk management capability. This includes how the institutions price products, reserve for loss, and control their operations, to reduce a bank's operational risk during the lending process (Rehm 2002).

With respect to performance, banks now use various measures to assess bank efficiency and related functions in the bank lending process. Traditionally, banks determined operating efficiency by using measures of bank profitability, such as return on equity, return on assets, and return on investment; also, banks used operational ratios, such as monetary output per staff member, and total operating expenses per unit of output. The goal of establishing the benchmark for banks is to establish drivers of high performance. As reported by Boucher (1996), measuring the productivity of a loan officer is the key to improving commercial lending performance. The productivity measure of a loan officer is quarterly loan sales. The manager can use this information to analyze the loan officers' quarterly productivity.

Perro and Ruof (1997) used the value tree to depict some of the values and risk drivers for commercial lending. The drivers of lending revenue are operating fees and interest income charged on new loans and existing loan volumes. The drivers of lending expenses consist of interest expense, operating expense, loss revenues and unexpected losses in commercial loans.

1.1.1 Bank Lending Policies

A policy is a deliberate plan of action to guide decisions and achieve rational outcome(s) Stafford (2001). A bank's lending policy is a statement of philosophy, standards, and guidelines that its employees must observe in granting or refusing a lending request. Minimum information requirements are outlined as well as the verification process and have to be followed before releasing any facility. There are also post lending policies which include monitoring and control of the existing facilities as well as procedures on how to collect from delinquent loans.

Types of policies tend to be similar across the commercial banks' sector, however requirements under each individual policy are unique to each commercial bank. Credit loss recognition policy ensures timely identification of losses arising from credit facilities. This policy also ensures non-accrual of income on delinquent loans, when to define credit losses as well as when to write off a bad debt. New business policy outline the minimum standards required for any facility to be offered to a new bank customer.

Mortgage lending policy outlines the minimum information requirements to be obtained, the appraisal process, determining affordability, term of loan, the valuation of the collateral as well as loan to value ratio. Personal unsecured loan policy outlines minimum documentation to be availed and how it's verified, method of assessment and credit bureau search. Post approval policy procedures outline collection procedures as well as delinquent customer management.

Business lending policies are categorized as retail or corporate. There are some commercial banks whose focus is corporate customers and their policies are designed to suit the same customer segment, this applies for bank's whose main target customers are the mass market. Business policies will identify the target market, business vintage, documentation, verification, credit bureau checks as well as debt management once a facility is granted.

More customers prefer where minimum documentation is sought and the process of appraisal is fast and lenient such that many applicants are able to qualify. Where the process is too rigorous customers tend to move away to other lenders and this may decrease a significant amount of income that is generated from interest on credit facilities.

1.1.2 Lending Policies and Commercial Banks Performance

Commercial banks performance is measured by different parameters such as market share, branch network, asset base, profitability and the quality of the loan book. For the purpose of this study performance will be measured in terms of customer satisfaction, quality of the loan book in each commercial bank and levels of profitability.

Commercial banks lending policy determine who the target customer is. The business sector is important to banks in its contribution to profitability. Although there are high risks associated with business lending, banks are compensated in terms of fees, interest margins and deposit balances held in the banks (Churchill et al. 1985). Lending policies that are unfavorable to business customers are therefore likely to lower profitability for commercial banks. Deakins et al (1993) have argued that security can be used as a surrogate for more important information concerning the risk of a proposition in the decision-making process.

Attracting and retaining profitable customers, and increasing revenue from those customers, is a priority of the managers of all commercial banks in today's globalised marketplace. It is particularly important in the highly competitive financial services market in Kenya where the core business of banking continues to be the profitable management of risk (Hogan, Lemon and Rust (2001), p. 258). In order to attract and retain profitable customers lending policies need to be formulated in such a way that they are customer friendly. The larger the customer base of borrower the bigger the lending book will be and consequently more interest income and fees and commissions related to credit will be generated.

1.1.3 Banking Industry in Kenya

During the period ended May 31, 2010, the Kenya banking industry comprised 43 commercial banks, 2 mortgage finance companies, 2 deposit taking microfinance institutions and 48 Forex bureaus. Others include 2670 Saving and Co-operative Credit Societies, CBK(2010). The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banking sector's interests.

The Kenyan Banking industry has registered significant growth in assets, driven by growth in deposits, injection of capital and retention of profits. Similarly, the level of non-performing loans declined compared to May 2009 position. The growth has been mainly underpinned by an industry wide branch network expansion strategy both in Kenya and in the East African community region, automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional ‘off-the-shelf’ banking products. Players in this sector have experienced increased competition over the last few years resulting from increased innovations among the players and new entrants into the market (CBK 2010).

1.1.4 Commercial Banks in Kenya

Banking Act (2009) defines a bank as a company which carries on, or proposes to carry on, banking business in Kenya. The same defines banking business as the act of employing money held on deposit or on current account or any part of the money, by lending or investment at the risk of the person so employing the money. In Kenya, the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya CBK (2010), governs the commercial banks in Kenya.

The banking industry aggregate balance sheet grew by 24.7 percent from KSh 1,219.7 billion in May 2009 to KSh 1,520.6 billion in May 2010. The major components of the balance sheet were loans and advances, government securities and placements, which accounted for 51.0 percent, 25.0 percent and 7.4 percent of total assets, respectively. Loans and advances net of provisions stood at KSh 773.9 billion in May 2010, up from KSh 663.2 billion registered in a similar period in 2009 (CBK 2010).

The statistics above show that more than 50% of commercial bank’s balance sheet comprises of loans and advances. Commercial banks have therefore identified interest income as a major source of growth for their balance sheet compared to interest on deposits and transaction fees.

1.2 Statement of the Research Problem.

The adoption of effective lending policies by commercial banks is of great significance. Application of lending policies consolidates supervision and encourages the practice of good governance in the bank. Lending regulations enforce discipline and impose strong incentives on banks to conduct their business in a safe, sound and efficient manner. They also encourage them to allocate resources efficiently and maintain a strong cushion against future losses.

Kenya as a fast developing nation has a large proportion of its economy that comprises of small and medium enterprises. Such businesses are very dependent on bank's financing; consequently disruptions in credit facilities could adversely affect the growth of the economy. This explains why quality lending policies that will support every deserving borrower are needed if the economy will continue to register significant growth. Kenyan banks have identified the potential in lending to retail mass market and they are adopting lenient lending strategies that reach out to the retail customer while less emphasis is directed to the corporate business.

Prior studies have been done on the concepts lending policies and commercial bank's performance. Anangwe (2004) carried out a survey of the lending practices of financial institutions to the agricultural sector in Kenya. Kabiru (2002), Studied the relationship between credit risk practice and the level of non-performing loans in Kenyan banks. Kibe (2003) studied the relationship between interest rate spreads and profitability of commercial banks in Kenya. Kimonga (1981) carried out a study of the mercantile credit policies in Nairobi.

Many studies have been carried out on the context of commercial banks in Kenya. Njihia (2005), studied the determinants of bank's profitability; the case of commercial banks in Kenya. Kigundu (2002), studied factors influencing credit rationing by commercial banks in Kenya. Mugenda (2003) studied the impact of non interest income on the earnings volatility of commercial banks in Kenya.

Though a lot of studies have been carried out on commercial banks in Kenya, the studies have dwelt more on the interest rates, credit policies and profitability as concepts each on it's own. No specific reference has been made to the lending policy and nature of relationship between lending policy and performance of commercial banks in Kenya, Kabiru(2002). There

has been no known study which has focus on lending policies and their effects on performance of banking institutions. This study therefore seek to fill this gap of knowledge by investigating lending policies and their effects on performance in the banking industry in Kenya focusing on commercial banks of Kenya by answering the following questions.

- i. What are the lending policies in commercial banks' in Kenya?
- ii. How does lending policies affect commercial banks performance in Kenya?

1.3 Objectives of the Study

- i. To identify lending policies of commercial banks in Kenya.
- ii. To establish how lending policies affect the commercial banks' performance in Kenya.

1.4 Importance of the Study

The study will positively contribute to commercial banks lending policy formulation. The study is also valuable to the management of commercial banks as they will be able to take appropriate measures to offer lending policy that appeal to their clients and at the same time maintain their profitability. The study will be significant to researchers and scholars as it will provide a back ground for further studies on issues of lending policies and performance of commercial banks especially in the Kenyan context. The study will add into the store of existing knowledge and also fill the gap of the knowledge on the concepts that have not been studied before.

It is important that the strategic leadership of commercial banks understand the most favorable lending policies that should be adopted in their organizations in order to improve on profitability, satisfy their customers and decrease the level of non-performing loans.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews the existing literature on the subject under research. The matter contained in this chapter relates to past studies on bank lending policy and their effect on bank performance. It also narrates research work carried and gives a critical review of these existing literatures.

2.2 Concept of Lending Policies.

Lending policies are the commercial banks set rules and regulations put in place to ensure bank offers credit to retail and corporate parties. Credit policies revolve around a number of credit parameters. Customer affordability is one of such parameters, which is also termed as debt service ratio. The ratio aims to measure the customer's income against the customer's existing and prospective liabilities to evaluate his ability to service any new debt he or she acquires. This ratio is determined by the central bank of a given country and it tends to be the same across banks (Morsman 1993).

Credit scoring is another policy parameter is especially applied in a high volume retail lending environment. It is based on the concept that applicants will perform in a similar way to existing customers with a similar demographic profile. A higher score means that a loan will be approved but those applicants that have a lower score will have their loans declined. Each commercial bank develops its own scorecard and this determines whether the lending policy is stringent or not (Doran, and Hoyle, 19860).

Verification is another important guide to banks credit policies. The process may, depending on the local regulations market practices, channel of acquisition and discretions of the country's credit policy, involve verification of the applicants business and or residential address.

Credit reference bureau is an information bureau that helps the financiers to know more about the customer's borrowing history and consequently will form a basis of a decision on whether lend or not. In Kenya for example central bank requires that all banks list all customers

who have defaulted previously and that no lender should approve a facility unless a confirmation has been done by the credit reference bureau.

Banks need to monitor carefully the risk-return profile of their lending portfolio to meet capital adequacy guidelines and to ensure long-term survival. The objective of the bank is to maximize profits thus maximize the shareholders wealth. If the primary objective of all bank lending policy is to make trouble-free advances, the financial capacity and previous borrowing experience of a loan applicant and their determination to repay their debts is all-important (Doran and Hoyle 1986).

Weinstein and Yafeh, (1998) indicated that applying stringent lending criteria to customer borrowers may, in effect, lead to their exclusion from the financial system is not socially acceptable or legitimate. At the same time, failure to provide for credit risk increases the likelihood of loan default, which in the short term increases financial institution costs and in the long term is passed on to other borrowers in the form of more expensive and or less accessible retail credit. The consumer bankruptcy research emphasizes the need for managers to balance the accessible image and social responsibilities of banks with vigilant assessment and monitoring of the credit risk of individual borrowers (Bofondi and Gobbi, 2003).

2.3 Commercial Banks' Performance

Successful bank operations require managers to weigh complex trade-offs between growths, return, and risk. By forcing line managers to include the opportunity cost of equity when making investment and operating decisions, banks expect to elicit better decision-making by managers. Implementing performance measurement and incentive systems driven by economic profit and allocated equity capital, senior managers also hope to align managerial behavior more closely with the interests of shareholders. To measure banks' creditworthiness and risk exposures is a complicated issue and it is not easy to interpret banks' accounting data, Diamond (1984). argued that "Indicators of business failures and nonperforming loans are also usually available only at low frequencies, if at all; the latter are also made less informative by banks desire to hide their problems for as long as possible. This means that it is needed to use as fully as possible, all available financial information from the official financial statements of banks in making financial analysis of banks' performance (BrownBridge, 1998).

The focus of financial analysis for the management of any bank (or the banking sector as a whole) should be on the efficiency of performance of the bank measured from the viewpoint of investors and shareholders' income maximization. More widely, all stakeholders have to be interested in the performance results of the banks. The concept of a stakeholder monitor is useful to take into account in designing performance analysis of any bank. In carrying out bank performance analysis, it is important to emphasize that banks differ in their corporate governance from firms in other, less regulated industries. These differences, in turn, present their own challenges for bank managers, regulators, depositors, investors, and other stakeholders. Various measures of rates of return are used mainly for that purpose. We fully agree with the opinion that "Relaying too heavily on just a few indicators of bank profitability can be misleading. While interest margin and noninterest expenses to gross income remain the key measures, they should ideally be supplemented by the analysis of other operating ratios (BrownBridge,1998)

The efficiency of the banking system has been one of the major issues in the new monetary and financial environment. The efficiency and competitiveness of financial institutions cannot easily be measured, since their products and services are of an intangible nature. Many researchers have attempted to measure the productivity and efficiency of the banking industry using outputs, costs, efficiency and performance. The scale and scope economies of banking have been one of the issues related to the competitiveness and efficiency of banks which have been studied extensively. Morsman (1993) recognized the multi-product nature of financial intermediaries and used a cost function to evaluate the scale and scope economies of credit unions in Canada. They found that large multi-product credit unions are more cost-efficient than small single-product credit unions. Chijoriga (1997) uses interest margin as a performance measure for U.S. commercial banks. He defines interest margin as the difference between interest income and expense divided by total assets. BrownBridge (1998) measures bank performance using normal correlation analysis. Their multidimensional indexes include indices of profitability, pricing of bank services and loan market share.

2.5 Bank Performance and Lending Policies.

Prior research suggests that banks strongly influence economic development and the efficient allocation of funds resulting in a lower cost of capital to firms, a boost in capital formations, and an increase in productivity (Fama, 1985). The formulation of effective lending procedure and policies heightened the importance of internal regulatory mechanisms of banks such as corporate governance leading to better improve bank profitability. In particular, lending policies in commercial banks are expected to improve banks' valuation, cost of capital, performance, and risk-taking behavior. Notwithstanding, the economic relevance of banks and lending framework within banks which has increase market credibility and subsequently enables bank to collect funds at lower cost and lower risks (Basel ,2004). Stafford(2001) studied bank's performance from 27 developing countries. They find evidence that there is higher valuation of firms in countries with better lending practices.

Given the importance of lending in commercial banks, the efficiency of a bank's lending policies is expected to significantly influence its financial performance (Esty & Megginson, 2003). An extensive body of literature argues that effective lending policies influence better financial performance of banks. Lending policy framework is important function of financial institutions in creating value for shareholders and customers. Bank engages in lending policies formulation if it enhances shareholder value, create customer satisfaction, reduce loan loss defaults and increase ban profitability. Thus, effective lending policies in banking firms are expected to enhance the value of the firm and shareholder wealth.

Perro and Ruoff (1997), indicated that Korean commercial banks and merchant banking corporations had been significantly been affected by poor lending policies, and that the subsequent profitability of financial institutions decline. There is therefore more emphasize on the importance of improving existing lending policies as a precondition for successful financial liberalization.

Lending framework dictates that as long as the demand for liquidity from depositors and borrowers is not too highly correlated, the intermediary should pool these two classes of customers together to conserve on its need to hold costly liquid assets the buffer against unexpected deposit withdrawals and loan take downs. Funding growth through core saving has

become largely a thing of the past. The advent of nonbank competition and the rise of third-party funding, implies that community banks now operate in a dynamic funding market, which requires the use of more sophisticated lending policies. Industry experts point to many different underlying causes for the bank improvement in investment products; new delivery systems such as the internet withstand the competition from other financial institutions (Boucher,1996).

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research Design

Cooper and Schindler (2006), states that research design is the manner in which data is collected, measured and analyzed in order to achieve certain research objectives. For the purpose of this study the research used descriptive survey. This was crucial in determination of lending policies adopted by bank and establishing their effects on bank performance. According to Schindler and Coopers (2004) descriptive studies were more typically structured with clearly stated hypotheses or investigative questions.

3.2 Population

According to Cooper and Schindler (2006), population refers to all units of a particular type of entity. Population may be restricted by age, gender, or any other attribute such as geographical location .The population of interest of this study was forty six (46) commercial banks in Kenya. The study being a survey implied that data was collected from all the 46 commercial banks.

3.3 Data Collection

There are several instruments that were used in collection of primary data. These include questionnaires, interview method, observation method, standardized tests and schedules. The questionnaire method was used as a convenient method for this study because it came in print form and was easy to distribute to respondents, especially, some of whom the researcher could not see directly. The researcher used structured questionnaires as the main data collection instrument. The questionnaires had both open and close-ended questions. The close ended questions provided more structured responses that facilitated tangible recommendations. The open-ended questions provided additional information on the effects of lending regulation adopted by the bank that may not have been captured in the close-ended questions. Secondary data sources were bank journals, banks financial reports and bank's promotional materials in which the researcher collected information on increase or decrease of bank customers, bank profit and return on assets.

In order to establish the effects of lending policy on bank performance in Kenya, self-administered drop and pick questionnaires were distributed to 92 respondents who are customer service managers and credit managers from each commercial bank.

3.4 Pilot Testing

The researcher used the respondents within five banks to aid in pre-testing the questionnaires. This helped in avoiding the chance of any awkward, baffling, biased or unpleasant questions being distributed to respondents. The researcher used ten respondents in a bid to perfect the questionnaire, as they all had divergent opinions and advice. Out of the ten respondents, the researcher intentionally ensured that five of them had already done their post graduate studies as their advice was valuable. These respondents were people that the researcher deemed to be honest and reliable in giving genuine opinions and constructive criticism (Chandran, 2004).

3.5 Data Analysis

Before processing the responses, the completed questionnaires were edited for completeness and consistency. A content analysis and descriptive analysis was employed. The content analysis was used to analyze the respondents' views about the lending policies. The data was coded to enable the responses to be grouped into various categories. Descriptive statistics was used to summarize the data. This included percentages and frequencies. Tables and other graphical presentations as appropriate were used to present the data collected for ease of understanding and analysis.

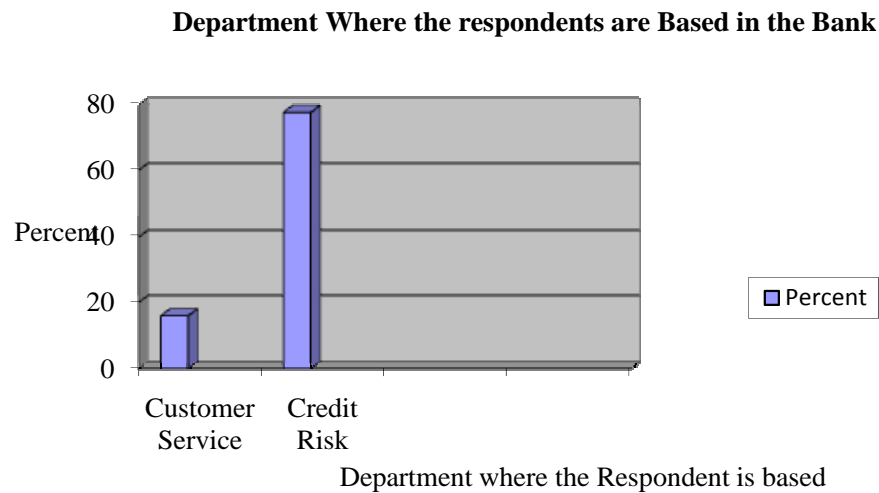
CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION OF FINDINGS.

4.1 Introduction

This chapter presents the discussion and conclusion of the study. From the study, the target population was 92, 78 respondents responded and returned the questionnaire .This constituted 84.3% response rate.

4.2 General Information

Figure 4 1: Department Where Respondents Were Based Within The Banks.



Source: Author (2010)

The figure 4.2 indicates the department where the respondents are based in the bank. From the findings, 77.8 % of the respondents were based in credit risk department while 16.7% were based in customer service department .Others indicated that they were based strategic planning department.

Period the Commercial banks have been in operation

Table 4. 1: Period the Commercial banks have been in operation

Table 4	Frequency	Percent
5 -10 years	1	1.2
11-15 Years	6	7.6
16-20 years	18	23.0
Above 20 years	53	67.2
Total	78	100.0

Source: Author (2010)

The respondents were requested to indicate the period the commercial bank has been in operation as indicated in the table 4.1. From the findings, 67.2% of the banks have been in operation for above 20 years, 23.0 % of the commercial banks for 16-20 years while 7.6 % of the respondents indicated that the commercial bank have been in operation for 11-15 years. This clearly indicates that majority of the commercial banks have been in operation long enough to formulate and mature lending policies. This has had effect on banks performance in terms of attracting customer, creating competitive advantage, improving on profitability of the banks, improving bank network and improving customer relationship.

Table 4. 2 : Working period the Respondents has been in the Lending Department.

	Frequency	Percent
less than one year	1	1.2
1-3years	3	3.8
4-7years	58	73.5
over 10 years	16	20.5
Total	78	100.0

Source: Author (2010)

The respondents were requested to indicate the period of time they had worked in the in lending department in commercial bank as indicated in the table 4.4. From the findings, majority 73.5% of the respondents had worked in their respective lending department for 4-7years, 20.5 % of the

respondents indicated that they had worked in their respective lending department in commercial banks for over 10 years,3.8% of the respondents indicated that they had worked in their lending department for 1-3 years while 2.2 % of the respondents indicated that they had worked in the respective lending department less than 1 years .This clearly indicated that majority of the respondents had worked in their respective lending units in commercial banks for more than three years and therefore they had an experience on effects of lending policies on performance of commercial banks.

4.3 Commercial Bank Lending Policies

Table 4. 3 : How Frequent The Commercial Banks Formulates it's Lending Policies

	Frequency	Percent
Very often	18	23.0
Often	51	65.4
Not very often	9	11.6
Total	78	100.0

Source: Author (2010)

The respondents were requested to indicate how often lending policy is formulated in their respective commercial banks. From the findings, majority 65.4% of the respondents indicated that lending policy are often formulated, 23.0% of the respondents indicated that lending policies are formulated very often while 11.6% of the respondents indicated that lending policies are not very often formulated in their commercial banks.

Table 4. 4 : Relationship Between A commercial Bank’s Lending Policy and the Level Of Customer Satisfaction.

	Frequency	Percent
Yes	31	86.1
No	5	13.9
Total	36	100.0

Source: Author (2010)

The respondents were requested to indicate whether the relationship between the commercial banks lending policy leads to customer satisfaction. From the findings, majority 86% of the respondents indicated that there is relationship between the commercial banks lending policies and customer service which is satisfactory while 13.9% of the respondents indicated that the relationship between the commercial banks lending policies and customer service, in their organization is not satisfactory.

Those respondents who indicated that commercial banks lending policies improve customer service explained that, lending policies formulated by the commercial banks are customers friendly, they focused on customer capability, prevailing market conditions that suit the customer needs and that the lending policies adopted by commercial banks enables their clients to feels valued when borrowing from the banks. The respondents who indicated that lending policies from the banks do not promote customer service satisfaction explain that the lending policies formulated by the commercial banks sometimes makes customers feel limited in obtaining credit facilities from the commercial banks.

4.4 Rating Banks In Attracting And Retaining Customers

Table 4. 5 : Rating bank’s lending policies on ability to attract and retain customers

	Frequency	Percent
Very high	38	48.7
High	27	34.6
Moderate	8	10.2
Low	3	5.7

Very low	2	3.8
Total	36	100.0

Source: Author (2010)

The respondents were requested to rate their bank lending policy on attracting and retaining customers. From the findings, most 48.7% of the respondents rated lending policy on attracting and retaining customers as very high .34.6% of the respondents rated the attraction and retaining of customers by the bank lending policies as high, 10.2% of the respondents rated the attraction and retaining of customer by commercial bank lending policies as moderate,5.7% of the respondents rated the bank lending policy on attraction of customers as low while 3.8% of the respondents rate the bank lending policy in attracting and retaining customer as very low.

4.5 Whether lending policy framework improve bank performance in terms of customer's services

The respondents were requested to explain whether lending policy framework improve bank performance in terms of customer's services. From the findings, the respondents indicated that commercial banks lending policies are formulated to enable the bank to offer credit to both retail and corporate clients who meets the set criteria. The respondents indicated that most of the lending policies that are formulated enable the credit officers to make decisions regarding credit approval and more importantly was to ensure the bank attract more customers. Most of the respondent indicated that lending policy framework enables that bank to increase customer base which is translated to better bank management and customer relations.

4.6 Whether Lending policies adopted by bank greatly influence the performance of the bank.

Table 4. 6 : Whether Lending policies adopted by bank greatly influence the performance.

	Frequency	Percent
Neutral	1	1.0
Agree	19	24.9
Strongly Agree	58	75.0
Total	78	100.0

Source: Author (2010)

The respondents were requested to state to what extent they agree that lending policies adopted by bank greatly influence the performance of the banks. From the findings, majority 75.0% indicated that they strongly agree that lending policies adopted by commercial banks greatly influence the performance of the commercial banks, 24.9% of the respondents agreed that lending policies adopted by the commercial banks greatly influence the performance of the commercial bank while 1.0% of the were neutral on Whether Lending policies adopted by bank greatly influence the performance of the bank. This clearly indicates that the lending policies that the commercial banks formulate and implements have great effects on the commercial bank performance.

Table 4. 7 : Approximate Loan and advances made By Bank to your clients

	Frequency	Percent
10- 15 Billion	17	22.5
16 -20 Billion	25	31.3
21 – 25 Billion	14	18.4
Above 25 Billion	22	28.8
Total	78	100.0

Source: Author (2010)

The respondents were requested to indicate the approximate loan and advances made by bank to their customer clients. From the findings, most 31.3% of the respondents indicated that the approximate loan and advances made by their banks were ranged between KSh 16 -20 Billion,28.8% of the respondents indicated that the approximate loan and advances made to bank client was over KSh 25 Billion .22.3% of the respondents indicated that the approximates loan and advances offered by banks ranged from KSh 10-15Billion while 18.4% of the respondent indicate that the approximate loan and advances made by bank to their clients ranged between KSh 21-25 Billion .This implies that commercial bank in Kenya offers much credit facilities through the formulated and implemented lending policies that influence much lending .

The respondent was requested to explain why the bank offers loans and advances to their clients through lending. From the findings majority of the respondent indicated that commercial banks lend to their clients to significantly influence its financial performance. The respondent further indicated that effective lending create customer satisfaction, reduces loan loss defaults and thereby increasing commercial banks profitability.

The study further found that commercial banks lending to their clients both retails and corporate that because it enables commercial bank to increase shareholder values and improve commercial bank financial banks.

4.7 Compare and contrast the growth of your lending book in the last two years

The respondents were requested to compare and contrast the growth of the commercial bank lending book in the last two years. From the findings, majority of the respondents indicated that over the last two years, the lending book of their bank has improved explaining that the lending policies enable more clients to borrow. Other respondent indicated that the commercial bank lending book declined over the last two years indicating that the bank lending policies need to be revised to be more competitive and enable the bank attracts and retain more customers.

4.8 Factors that contribute to improvement or decline in the level of income in bank lending books within that period.

The respondents were requested to indicate the factors that contributed to the improvement of the level of income in bank lending books with the period of two years. From the findings majority of the respondents indicated that increase in the level of income in lending book within a period of two years was due to effective adoption of efficient lending policies. The respondents also indicated the increase in the level of income was due to commercial bank employing qualifies and experience staff in credit department, better adoption of management of risks facing the clients as well as those that the banks are exposed to. Other respondents indicated that the bank had encouraged the clients to save more greatly and encouraging the clients to repay their loans. still most of the respondents indicated that enables the clients to increase on their investment and formulating lending policies that counter the competition in the market. The respondents also

indicated that adoption of new delivery systems such as use of internet enables the bank to counter competition making the bank to improve on its financial performance.

The respondents indicated that the level of bank books increases due to commercial bank engagement in lending policies formulation to increase shareholder's value, create customer satisfaction, reduce loan loss defaults and increase bank profitability. Most of the respondent also indicated that the level of book values increase due to effective lending policies in banking firms are expected to enhance the value of the firm and shareholder wealth

Table 4.8: What extent do you agree with the following statement concerning effects of lending on bank performance

	Mean	Std dvt
Good lending polices enables the bank to attract and retain profitable customers	4.67	0.25
Through adoption of effective lending policies bank increase income	4.75	0.33
Good lending polices make the bank to attract more customers increasing the bank's clients base	4.58	0.87
Adoption of effective lending policies enables bank to improve on their credit risk portfolio	4.30	0.78
Effective lending improve bank profitability	4.05	0.95

Source: Author (2010)

The respondent was requested to indicate the extent they agreed with the statement concerning effects of lending on bank performance. From the findings, majority of the respondents indicated that they strongly agreed that through adoption of effective lending policies bank increase income good lending polices enables the bank to attract and retain profitable customers and that good lending polices make the bank to attract more customers increasing the bank's clients base as indicated by a mean of 4.75,4.67 and 4.58. The study also found that most of the respondents

agreed that adoption of effective lending policies enables bank to improve on their credit risk portfolio and that effective lending improve bank profitability as indicated by a mean of 4.30 and 4.05 respectively. This clearly indicates that effective lending policies formulated and implemented by commercial banks has positive effects on commercial bank performance as it leads to increase in shareholders' value, attract and retain more customers as well as increase bank profitability.

CHAPTER FIVE: DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

From the analysis and data collected, the following discussions, conclusions and recommendations were made. The responses were based on the objectives of the study. The researcher had intended to investigate lending policies and their effects on the financial performance of commercial banks in Kenya.

5.2 Discussions

The study established that commercial banks often formulate lending policies. From the findings, majority 65.4% of the respondents indicated that commercial banks formulates lending policy often .Effective lending policies improves the relationship between the customer and the commercial bank. From the findings, majority 86% of the respondents indicated that the relationship between the commercial bank lending policies and customer service is satisfactory .They explained that lending policies formulated by the commercial banks are customers' friendly, focused on customer capability, prevailing market condition that suit the customer needs and that the lending policies adopted by commercial banks enables their clients to feel valued when borrowing from the banks. The study established that lending policies from the banks do not promote customer service satisfactorily explaining that the lending policies formulated by the commercial banks sometimes they makes customers feel limited in carrying borrowing operations from the banks.

The study established that bank lending policy has effects of attracting and retaining customers. From the findings, most 48.7% of the respondents rated lending policies on attracting and retaining customers as very high .This implies that if the commercial banks adopt effective lending policies , more customers will be attracted hence increasing the level of lending in the commercial banks.

From the findings, the study established that commercial banks lending policies are formulated to enables the bank to offer credit to both retail and corporate client who meets the set standard. The respondents indicated that most of the lending policies that are formulated enable the credit officers to make decisions regarding credit approval and more importantly was to ensure the bank attract more customers. Most of the respondents indicated that lending policy framework

enables that bank to increase customer base which is translated to better bank management and customer relationship.

The study established that lending policies adopted by bank greatly influence the performance of the banks. From the findings, majority 75.0% indicated that they strongly agree that lending policies adopted by commercial banks greatly influence the performance of the commercial banks. This clearly indicates that the lending policies that the commercial banks formulate and implement have great impact on the commercial bank performance. From the findings, most 31.3% of the respondents indicated that the approximate loan and advances made by their banks ranged between KSh 16 -20 Billion, 28.8% of the respondents indicated that the approximate loan and advances made was over KSh 25 Billion .22.3% of the respondents indicated that the approximate loan and advances offered by banks ranged from KSh 10-15Billion while 18.4% of the respondent indicate that the approximate loan and advances made by bank to their clients ranged between KSh 21-25 Billion .This implies that commercial bank in Kenya offers much credit facilities through the formulated and implemented lending policies that influence much lending .

From the findings, majority of the respondents indicated that over the last two years, the lending books in their respective banks had improved which implies that banks had focused more on lending within the same period. Other respondents indicated that the commercial bank lending book declined over the last two years indicating that the bank lending policies needed to be revised to be more competitive and enable the bank attracts and retain more customers.

Over the last two years most of the commercial banks experienced increase in lending due to various factors which contributed to the improvement of the level of interest income in commercial banks .The study also indicated the increase in the level of income was due to commercial bank employing qualified and experienced staff in credit department, better adoption of management of risks facing the clients as well as those that the banks are exposed to. The respondents also indicated that adoption of new delivery systems such as use of internet enables the bank to counter competition making the bank to improve on its financial performance.

The respondents indicated that the level of bank books increases due to commercial bank engagement in lending policies formulation to increase shareholder's value, create customer satisfaction, reduce loan loss defaults and increase bank profitability. Most of the respondents also indicated that the level of book values increase due to effective lending policies in banking firms are expected to enhance the value of the firm and shareholder wealth.

The study established that there exist effects of lending policies has an effects. From the findings, majority of the respondents indicated that they strongly agreed that through adoption of effective lending policies bank increase income good lending polices enables the bank to attract and retain profitable customers and that good lending polices make the bank to attract more customers increasing the bank's clients base as indicated by .The study also found that most of the respondent agreed that Adoption of effective lending policies that enables bank to improve on their credit risk portfolio and that effective lending improve bank profitability as indicated by a mean of 4.30 and 4.05 respectively. This clearly indicates that effective lending policies formulated and implemented by commercial banks has positive effects on commercial bank performance as it leads to increase in shareholders' value, attract and retain more customers as well as increase bank profitability.

5.3 Conclusion

From the findings, the study concludes that lending policies formulated by the commercial banks are customers friendly, focused on customer capability, prevailing market condition that suit the customer needs and enables their clients to easily access credit facilities from the commercial banks.

The study concludes that bank lending policy has effects on bank performance through attracting and retaining customers increasing the bank customer base. The study established that commercial banks lending policies are formulated to enable the bank to offer credit to both retail and corporate client who meets the set standard. The study also concludes that lending policies that are formulated enable the credit officers to make decisions regarding credit approval and more importantly to ensure the bank attract more customers.

From the findings, the study concludes that lending policies formulated by commercial bank increase the level of bank books and increase shareholder's value, create customer satisfaction,

reduce loan loss defaults and increase commercial bank's profitability. The study further conclude that adoption of effective lending policies bank increase commercial bank interest income, attract and retain profitable customers and increase the bank's clients base, improve on their credit risk portfolio as well as improve bank profitability .

5.4 Recommendation of the study

Lending policies are formulated to enables the bank to offer credit to both retail and corporate client who meets the set standards enabling the credit officers to make decisions regarding credit approvals. The study therefore recommends that commercial bank should formulate lending policies to enable them improve customer relationship and use the lending policies as tool for creating competitive edge over it rival in the market.

The study also recommends that commercial bank should formulate and adopt lending policy increase the level of bank books and increase shareholder's value, create customer satisfaction, reduce loan loss defaults and increase bank profitability, increase commercial bank income, attract and retain profitable customers and increase the bank's client's base and improve on their credit risk portfolio

5.5 Recommendation for further study.

The study investigated the lending policies and effects of lending policies on bank performance. A further study should be carried out to determine the lending strategies adopted by commercial banks in Kenya

References.

- Akella, S.R & Greebaum, S.R (1992). Innovations in Interest Rates, Duration Transformation, and Bank Stock Returns. *Journal of Money, Credit, and Banking* : 27-42.
- Altman, E.I.& Saunders, A. (1998). Credit risk measurement, developments over the last 20 years. *Journal of Banking and Finance, Vol. 21* pp.1721-42.
- Anangwe, N (2004). A survey of the lending practices of financial institutions to the agricultural sector in Kenya. *Unpublished MBA Project in University of Nairobi*
- Banking Act (2009), Laws of Kenya, The Banking Act. Chapter 488. Central Bank of Kenya. <http://www.centralbank.go.ke>
- Basel B,C (2004). Bank failures in mature economies. *Working Paper No. 13, Basel Committee on Banking Supervision, Basel*
- Berger, P.D& Nasr, N.I (1998). Customer Lifetime Value, Marketing Models and Applications. *Journal of Interactive Marketing. 12(1): 17.*
- Binks, M.R., Ennew, C.T.& Reed, G.V. (1993), *Small Businesses and their Banks, 1992*, Knutsford.
- Bofondi, M. & Gobbi, G. (2003). Bad Loans and Entry in Local Credit Markets. Bank of Italy Research Department, Rome.
- Boucher, J. (1996). Management maximizing loan officer productivity with sales analysis. *Commercial Lending Review, Vol. 11 No.1, pp.89-94.*
- Brewer, E. Mondschean T.H & Strahan. P.E. (1993) .Why the Life Insurance Industry Did Not Face an S&L Type Crisis. Federal Reserve Bank of Chicago, *Economic Perspectives: 12-24.*
- BrownBridge, M. (1998).Financial distress in local banks in Kenya, Uganda and Zambia: causes pp.173-89.

CBK (May 2010) The CBK Weekly Bulletin - May 7th 2010: Accessed online on 7th Sept.

<http://www.centralbank.go.ke/downloads/publications/weeklybulletin/2010/May/070510.pdf> & <http://www.centralbank.go.ke>

CBK (2010): The CBK Act: Available online Accessed on 7th September 2010
<http://www.centralbank.go.ke/>

Chandran E. (2004). *Research Methods*. A quantitative approach with illustrations from Christian ministries. Nairobi, Kenya.: Daystar University. Pp 61-63, 114-128

Chijoriga, M.M. (1997). Application of credit scoring and financial distress prediction models to commercial banks lending: the case of Tanzania, *WirtsCHAftsnnversitat Wien* (WU), Vienna,

Central Bank of Kenya . Retrieved 2010. 7th September at www.centralbank.go.ke:

Cooper D.R. & Schindler P.S. (2006). *Business Research Methods*. (9th ed.) New Delhi, India: Tata McGraw-Hill. Pp.

Deakins, D. & Hussain, G. (1991). Risk Assessment by Bank Managers. *University of Central England, Birmingham*.

Diamond, D. W, (1984). Financial Intermediation and Delegated Monitoring. *Review of Economic Studies*, 51, 393-414.

Doran, A & Hoyle, M. (1986), Lending to Small Firms – A Study of Appraisal and Monitoring Methods. *Economists Advisory Group Ltd, National Economic Development Council, London*

Esty, B & Megginson. W.L.(2003). Creditor rights, enforcement, and debt ownership structure: Evidence from the global syndicated loan market. *Journal of Financial and Quantitative Analysis* 38: 37-59

Fama, E. (1985).what's Interest rate about banks? *Journal of Monetary Economics*, 15:29-37

Gertner, R & D. Scharfstein. (1991).A Theory of Workouts and the Effects of Reorganization

Hogan, J., K. Lemon & R. Rust, (2002). Customer equity management Charting new directions for the future of marketing. *J. Serv. Res.*, 5: 4-13

Kabiru (2002), Studied the Relationship Between Credit Risk Practice And The Level Of Non-Performing Loans In Kenyan Banks. *Unpublished MBA Project in University of Nairobi.*

Karangu W., Daily Nation (2009) . Low Profit Not so good For Bank.

Morsman, E. (1993). *Commercial Loan Portfolio Management*, Robert Morris Associates, Philadelphia, 1993.

Mwingi, (2002). A survey of effects of lending rate on performance of commercial banks in Kenya, *Unpublished MBA Project in Nairobi*

Perro, V.C. & Ruoff, S.C. (1997). Improving accountability in banking. *Commercial Lending Review*, Vol. 12 No.3, pp.44-50 Ramakrishnan.

Rehm, B.A. (2002). Chicago fed forum evolves into battle royal on Basel 2", *American Banker*, Vol. 167 No.91, pp.1-3.

Stafford, E, (2001), Managing Financial Policy. Evidence from the financing of major investments, *Working Paper*, Harvard University

Weinstein, D.E & Yafeh Y., (1998), On the Costs of a Bank Centered Financial System Evidence from the Changing Main Bank Relations in Japan. *Journal of Finance* 53 635-672.

Appendix 1: Letter of Introduction

Dear Respondent,

RE: Support on MBA Proposal

I am an MBA student at University of Nairobi and in my final year of study. As part of the requirement for graduation, I'm undertaking a research Lending policies and their effects on performance in the banking industry in Kenya.

In this regard, I'm kindly requesting for your support in terms of time, and by responding to the attached questionnaire. Your accuracy and candid response will be critical in ensuring objective research.

It will not be necessary to write your name on this questionnaire and for your comfort, all information received will be treated in strict confidence.

The findings of the study will surely be used for research purposes and to enhance knowledge in the field of lending policies. If need be the research report may be presented to your organization for information and record.

Thank you for your valuable time on this.

Yours faithfully

Mercy Munyiri

Appendix I: Questionnaire.

**INVESTIGATING THE EFFECT OF LENDING POLICIES ON PERFORMANCE
OF COMMERCIAL BANKS IN KENYA**

Section a: Customer Care And Credit Managers

1. In which department are you based within your organization? (Tick as applicable

- a. Customer Service []
- b. Credit Risk []
- c. Others (specify)

.....

2. Indicate by ticking the period of time your bank has been operation.

- a. Less than 5years []
- b. 5 -10 years []
- c. 10-15 Years []
- d. 16-20 years []
- e. Above 20 years []

3. Indicate the period of time in years you have been working in lending department?

- a. Less than one year []
- b. 1-5 years []
- c. 5-10 years []
- d. Above 10 years []

Section B: To be answered by the Customer Service Managers

4. How frequent do your bank formulate lending policies?

a. Very often []

b. Often []

c. Not very often []

5. What is the relationship between your organization lending policy and customer service satisfaction

a. Yes []

b. No []

Explain your answer

.....

6. How do you rate your bank lending policy on attracting and retaining customers?

a. Very high []

b. High []

c. Moderate []

d. Low []

7. In your opinion, does your lending policy framework improve bank performance in terms of customer's services? Kindly explain.

Section C - (to be answered by the Credit Manager).

8. Lending policies adopted by bank greatly influence the performance of the bank. To what extent do you agree with the statement?

- a. strongly Disagree []
- b. Disagree []
- c. Neutral []
- d. Agree []
- e. Strongly Agree []

9. kindly indicate the approximate loan and advances made by your bank to your clients

- a.** Less than 10 Billion []
- b.** 10- 20 Billion []
- c.** 21 – 25 Billion []
- d.** Above 25 Billion []

Give reasons for your answer

I.....

ii.....

10. What has led to the growth of your lending book in the last two years

11. Kindly indicates the factor that contributes to your improvement or decline in the level of income in your bank lending books within that period.

12. To what extent do you agree with the following statement concerning effects of lending on bank performance

	Strongly disagree	Disagree	Neutral	Agree	Strongly Agree
Good lending policies enables the bank to attract and retain profitable customers					
Through adoption of effective lending policies bank increase income					
Good lending policies make the bank to attract more customers increasing the bank's clients base					
Adoption of effective lending policies enables bank to improve on their credit risk portfolio					
Effective lending improves bank profitability					

Appendix II: List of Commercial Banks in Kenya

1. African Banking Corporation
2. AG Zurich
3. Bank of Africa
4. Bank of Baroda
5. Bank of India
6. Barclays Bank
7. CFC Bank
8. Charter House Bank
9. Chase Bank
10. Citibank NA
11. City Finance Bank
12. Commercial Bank of Africa
13. Co-operative Bank
14. Credit Bank
15. Development Bank
16. Diamond Trust Bank
17. Dubai Bank Ltd
18. ECOBANK/EABS Bank
19. Equatorial Commercial Bank
20. Equity Bank
21. Family Finance
22. Fidelity Commercial Bank
23. Fine Bank
24. First Community Bank
25. Gyro Bank
26. Guardian Bank
27. Gulf African Bank
28. Habit Bank

29. Housing Finance
30. Imperial Bank
31. Investments & Mortgages
32. Kenya Commercial Bank
33. K-Rep Bank
34. KWFT Bank
35. Middle East Bank
36. National Bank
37. National Industrial Credit
38. Oriental Commercial Bank
39. Paramount Universal Bank
40. Prime Bank
41. Trust Bank
42. UBA Bank
43. Southern Credit Bank
44. Stanbic Bank
45. Standard Chartered Bank
46. Victoria Commercial Bank