

**THE EFFECT OF THE LENDING POLICIES ON THE LEVELS OF  
NON-PERFORMING LOANS (NPLs) OF COMMERCIAL BANKS IN  
KENYA**

**BY**

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**D63/79043/2012**

**A RESEARCH PROJECT SUBMITTED IN PARTIAL  
FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF  
THE DEGREE IN MASTER OF SCIENCE IN FINANCE,  
UNIVERSITY OF NAIROBI**

**NOVEMBER 2013**

## **DECLARATION**

I declare that this research project is my original work and to the best of my knowledge it has not been submitted to any other College, University or Institution for academic credit.

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This research project has been submitted for examination with my approval as the University supervisor.

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## **ACKNOWLEDGEMENT**

I would like to thank the Almighty God for the many blessings that He has bestowed upon my life, and through His grace have been able to study and complete this course successfully.

My special appreciation goes to my Supervisor Dr. Josiah Aduda of University of Nairobi, the Chairman – Department of Finance & Accounting, School of Business without whose guidance and support, this work would not have been successfully accomplished. He demanded excellence at every step of this study and without him, the concept would not have grown to become a project.

I would also wish to acknowledge my wife Mrs. Mary-Goretti Mbuge - a friend and a consultant in both academic and personal life. There is not a doubt in my mind that without your support - materially, emotionally and spiritually, I would not have managed to complete my Masters Degree in Finance.

My Parents, Mr. Richard Owino & Mrs. Julia Owino - You taught me from an early age the virtues of honesty, hardwork, diligence, sacrifice and perseverance. My gratitude also goes to my friends and respondents who were very supportive in enabling me collect information relevant to this study.

May the Almighty God Bless You All.

## **DEDICATION**

A special dedication goes my parents Mr. & Mrs., Owino who have nurtured me since childhood, my loving & understanding wife Mary-Goretti, my siblings Fredrick Omondi, Caroline Achieng, Christopher Omondi & Robert Okello for the material and emotional support, and my loving kids – Natalie Rembo & Nathan Emissa, and may this study inspire you to aim even higher in your quest for education and be all that you were ordained by God to be.

## **ABSTRACT**

Bank Lending policy 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. The banking industry plays a major role in economic growth and development through provision of credit to execute economic activities. However, the major concern of any lender while advancing credit is how they will get their money back. Credit risk emanates from the probability that borrowers will default on terms of debt, subsequently leading to high levels of non-performing loans. This concern has resulted into several attempts to manage the increasing levels of NPLs. This study investigates lending policies and their impact on the levels of non-performing loans among commercial banks in Kenya. A descriptive survey was employed in this study with the population of interest of being the forty three (43) commercial banks in Kenya. A questionnaire was used to gather the primary information. The questionnaires were self-administered and drop-and-pick later method was adopted. Descriptive statistics was used to summarize the data and findings presented using tables and other graphical presentations as appropriate for ease of understanding and analysis. The study found that lending policies and non-performing loans are indeed related. Lending policies helps the banks lend prudently and lowers the risk level to the banks, and strict adherence to lending policies therefore has led to reduced non-performing loans.

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## **LIST OF ABBREVIATIONS AND ACRONYMS**

<b>CBK:</b>	Central Bank of Kenya
<b>CBR:</b>	Central Bank Rate
<b>CPG:</b>	Credit Policies Guideline
<b>FOSA:</b>	Front Office Service Activities
<b>KBA:</b>	Kenya Bankers Association
<b>KCB:</b>	Kenya Commercial Bank
<b>LPM:</b>	Loan Portfolio Management
<b>NFA:</b>	Net Foreign Asset
<b>NPLs:</b>	Non-Performing Loans
<b>OMO:</b>	Open market operations
<b>PAR:</b>	Portfolio at risk
<b>SME:</b>	Small and Medium Enterprises

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# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the Study

The banking sector is an indispensable financial service sector supporting development plans through channelizing funds for fruitful purpose, mobilizing and controlling flow of funds from surplus to deficit units and supporting financial and economic policies of government. The success of banking is assessed based on profit and quality of assets it possesses. Even though bank serves social objective through its priority sector lending, mass branch networks and employment of many people, maintaining quality asset book and continuous profit making is important for banks continuous growth. Bank loans are one of the most important long-term financing sources in many countries (Freixas & Rochet, 2008). In some developed countries like Japan, long term bank loans represent more than 70% of its total long-term debt.

Lending institutions play a major role in economic growth and development through provision of credit to execute economic activities. However, the major concern of any lender while advancing credit is how they will get their money back (Fleisig, 1995), and this implies that the engagement between lenders and borrower is accompanied by certain level of risk. The major types of risks faced by lending institutions globally include market risk, operational risk, and performance and credit risks. The level of each type of risk largely depends on the environment that the lending institution is conducting its operation. Credit risk is defined as the change in the value of the asset portfolio of a bank, due to the failure of an obligor to meet his payment commitments (CBK, 2005). The risk attributable to loan default leads to high effective borrowing rates, through a risk

premium that varies with the exposure to default. This is because a bank has to undergo costs to carefully evaluate and closely monitor the risk, especially in an environment where probability of default is high (Parlour & Winton, 2008).

Lending needs to be effectively carried out by the commercial banks since it is the basis for the establishment of sound economic development. The lending operations of commercial banking in any economy constitute a critical sector in the growth and development of any economy. The need for lending arises in view of the apparent financial disequilibrium in the economic system which is the gap arising between the deficit unit and the surplus unit. Thus, lending must be designed in such a way that it could be a total benefit to all different interest group of the bank, which includes the shareholders, depositors and the borrowers. According to Roy and Lewis (1991), giving credit to worthy borrowers is one of the most significant functions of commercial banks that are directly related to the development of the economy. If those loans or credit are not grown, the expansion of the production facilities and operations would almost be impossible and take a longer time.

In the view of Nwankwo (2000), credit constitutes the largest single income-earning asset in the portfolio of most banks. This explains why banks spend enormous resources to estimate, monitor and manage credit quality. This is understandably, a practice that effect greatly on the lending behaviour of banks as large resources are involved. According to Adedoyin and Sobodun (1991), lending is undoubtedly the heart of banking business. Therefore, its administration requires considerable skills and dexterity on the part of the

bank management. While a bank is irrevocably committed to pay interest on deposits it mobilized from different sources, the ability to articulate loanable avenues where deposit funds could be placed to generate reasonable income; maintain liquidity and ensure safety requires a high degree of pragmatic policy formulation and application (Chodechai, 2004).

### **1.1.1 Lending Policies in Commercial Banks**

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), governs the Banking industry in Kenya. The banking sector in Kenya was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance's docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The Central Bank of Kenya (CBK) publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. The Central Bank of Kenya acts as the main regulator of commercial banks in Kenya (CBK Annual Report, 2009).

The CBK operates under a monetary policy programming framework that includes monetary aggregates (liquidity and credit) targets that are consistent with a given level of inflation and economic growth, KIPPRA (2006). For instance, the banks objective for the fiscal year 2005/2006 was to achieve inflation rate below 5% using quarterly reserve targets. To this end, the CBK set a ceiling for reserve money and a floor for the net foreign assets (NFA). This was the mainstay of monetary policy at least until the

introduction of the Central Bank Rate (CBR). The use of monetary targeting as currently used by the CBK has also been criticized. Monetary aggregate targeting policy is more effective where there exists a stable demand for money relationship dependent on overall economic activity and price level, but this may not be the case in Kenya which has a financial sector which is at a period of growth, making demand for money unstable according to KIPPRA(2006)

Commercial banks play an important role in the pass-through of monetary interest rates. Nevertheless, the efficiency of transmission of decisions of central banks is a complicated process and may depend on many factors, such as level of competition in financial industry, perception of credit risk, risk aversion, availability of close substitutes for loans, etc. Moreover, banks may influence the external finance premium not only via the interest rates but also modifying the available maturity of loans or changing collateral requirements. Finally, as evidenced by broad literature on bank lending channel, credit rationing and uncertainty about creditworthiness of borrowers may markedly influence banks' risk taking thereby influencing their willingness to lend. The recent evidence suggest that this aspect of bank lending channel, namely risk taking channel, may play an important role in the monetary transmission (Altunbas et al, 2009).

Credit risk is perhaps the oldest and most challenging risk for financial institutions, leading to innovations geared at addressing this problem (Broll et al., 2002). This risk emanates from the probability that borrowers will default on terms of debt, subsequently putting the capital of a bank in jeopardy. This concern has resulted into several attempts

to manage the exposure of banks to credit risk, with the most outstanding one being the Basel-II accord – later revised to Basel-III. The Basel guidelines aim at entrenching strict culture of managing inherent credit risk by financial institutions globally.

### **1.1.2 Loan Portfolio Performance**

Loan portfolio is the total of all loans held by a bank or finance company. It can also be defined as the loans that a lender is owed, and is usually listed as an asset on the lender's balance sheet. Loan portfolios are the major assets of banks, thrifts and other lending institutions. The value of a loan portfolio depends not only on the interest rates earned on the loans, but also on the quality or likelihood that interest and principal will be repaid.

One of the principal activities of commercial banks is to grant loans to borrowers. Loans are among the highest yielding assets a bank can add to its balance sheet, and they provide the largest portion of operating revenue. In this respect, the banks are faced with liquidity risk since loans are advanced from funds deposited by customers. Hamisu, (2011) notes that credit creation involves huge risks to both the lender and the borrower. The risk of the counterparty not fulfilling his or her obligation as per the contract on due date or anytime can greatly jeopardize the smooth functioning of bank's business. On the other hand, a bank with high credit risk has high bankruptcy risk that puts depositors' funds in jeopardy.

Owojori *et al* (2011) highlighted that available statistics from liquidated banks in Nigeria clearly showed that inability to collect loans and advances extended to customers was a major contributor to the distress of liquidated banks. At the height of the distress in 1995,



when 60 out of the 115 operating banks were distressed, the ratio of the distressed bank's non-performing loans and leases to their total loans and leases was 67%. The ratio deteriorated to 79% in 1996; to 82% in 1997; and by December 2002, the licenses of 35 of the distressed banks had been revoked. At the time, the banking licenses were revoked, some of the banks had ratios of performing loans that were less than 10% of loan portfolios (Hamisu, 2011). This study therefore seeks to evaluate the need to understand the effect of lending policies on the levels of non-performing loans of commercial banks.

### **1.1.3 Lending Policies and Loan Portfolio Performance**

Prior to financial sector deregulation, banks were highly motivated to grant credit facility to clients who could easily express their creditworthiness. Deregulation offered the opportunity to meet the demands for credit across a wide range of borrowers. Large amount of bad credit, as a result of boom time advances in the 1980's, caused the banks to be too cautious in extending credit (Bryant, 1999). Credit risk management processes enforce the banks to establish a clear process for approving new credit as well as for the extension to existing credit. These processes also follow monitoring with particular care, and other appropriate steps are taken to control or mitigate the risk of connected lending (Basel, 1999).

Credit granting procedure and control systems are necessary for the assessment of loan application, which then guarantees a bank's total loan portfolio as per the bank's overall integrity. It is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and

control over credit risk, policy and strategies that clearly summarize the scope and allocation of bank credit facilities as well as the approach in which a credit portfolio is managed (Basel, 1999). Credit scoring procedures, assessment of negative events probabilities, and the consequent losses given to these negative migrations or default events, are all important factors involved in credit risk management systems (Altman, Caouette, & Narayanan, 1998). Most studies have been inclined to focus on the problems of developing an effective method for the disposal of these bad debts, rather than for the provision of a regulatory and legal framework for their prevention and control (Campbell, 2007).

According to (Cuthberston & Nitzsche, 2003) risk management technology has been renovated over the last decade. The swiftness of information flow and the complexity of the international financial markets qualify banks to recognize, evaluate, manage and mitigate risk in a way that was just not possible ten years ago. The most current credit modelling software in place is Basel II Accord. This accord has positively been a substance in leading the drive towards building applicable credit risk modelling and capital adequacy requirements. Banks will have to decide what their risk enthusiasm is, how to assign their resources optimally and how to compete in the market. Generally in competitive market, a bank trade off the risk which allows much more competent risk transfer and portfolio optimization. However, for all these activities, banks must have a good knowledge about risk management, pricing of loan on competitive market, marginal risk adjusted contribution, and monitoring of economic capital (Cuthberston & Nitzsche, 2003).

#### **1.1.4 Commercial Banks in Kenya**

The Kenyan Banking sector constitutes 43 commercial banks and one mortgage financial institution. The banking industry in Kenya is dominated by a few large banks most of which are foreign-owned, though some are partially locally owned. Six of the major commercial banks are listed on the Nairobi Securities Exchange. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banks' interests and addresses issues affecting member institutions. The commercial banks and non-banking financial institutions offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services including investment banking (CBK Annual Report, 2009).

The five most profitable banks in Kenya are KCB, Equity, Barclays, Standard Chartered Bank and Co-operative Bank. The pretax profits for these banks in the financial year 2012 are as follows. KCB 15.1 billion (a 54% increase from the previous year), Equity Bank pre-tax profit of Ksh 12.83 billion (42% increase from the previous year), Barclays Bank rose to Ksh 12.01 billion (11% increase from the previous year), Standard Chartered Ksh 10 billion (18% increase) and Co-operative Bank 9.97 billion (57% increase) (CBK, 2012).

The banking sector plays a significant role in the implementation of government monetary policies. One of the key services rendered by banks is offering credit to the members of public. The rate at which members of the public are able to access loans, and the amounts available for banks to lend are highly guided by the CBK regulations.

The banks also participate in purchase of government securities for example treasury bills and bonds which are aimed at raising funds for the government and maintaining low inflation levels. CBK also acts as a lender of last resort for commercial banks and hence the rate at which banks access credit influences the rate at which they offer credit to the members of the public. Credit risk is cited as a major concern by 95 per cent of the banking institutions (CBK, 2011). The overall observation of risks facing the banking sector is that while market risk can be easily managed through hedging activities, credit risk has emerged as a new management challenge to financial institutions (Gonzalez-Paramo, 2010). According to the results of the risk management survey by the Central Bank of Kenya, the sector largely operates under the traditional model with collateral being the most popular credit risk mitigation technique (CBK, 2011).

## **1.2 Research Problem**

The Central Bank's principal objective is formulation and implementation of monetary policy directed to achieving and maintaining stability in the general level of prices. The aim is to achieve low inflation and to sustain the value of the currency. Interest rate is the price a borrower pays for the use of money they borrow from financial institutions or fee paid on borrowed assets (Crowley, 2007). Interest can be thought of as "rent of money". Interest rates are fundamental to a capitalist society and are normally expressed as a percentage rate over the period of one year (Monetary Policy Statement, 2008).

The banking institutions are faced with the probability of default by counterparties in financial contracts. Loans constitute the biggest assets for banks, thus credit risk is

arguably the biggest risk that banks face. It is therefore necessary for banks to put in appropriate measures to first of all prevent occurrence of these risks, and be able to deal with the risk if and when it occurs. Credit risk mitigation techniques have evolved overtime, courtesy of global financial innovation. Traditionally, collateral and guarantees have remained the most popular credit risk reduction strategies. These are largely ‘ex-ante’ considerations, implying that any loan appraisals that do not pass this test are rejected. Moreover, the bank conducts a monitoring exercise to keep track of adverse changes that might affect the value of the collateral, periodic repayments as well as the total value of the loan (Radevic and Ahmedin, 2010).

Several research studies have been done in relation to commercial banks in Kenya: Aduda (2011) studied the relationship between credit risk management and profitability among the commercial banks in Kenya; Oludhe (2011) studied the effect of credit risk management on financial performance of commercial banks in Kenya; Gitonga (2010) studied the relationship between interest rate risk management and profitability of commercial banks in Kenya; Mbotu (2010) did a study on the effect of the central bank of Kenya rate (CBR) on commercial banks’ benchmark lending interest rates. However, the researcher is not aware of any study on the performance of loan portfolio in commercial banks. This study therefore aims at answering the question: What are the effects of lending policies on the levels of non-performing loans?

### **1.3 Research Objectives**

1. To establish the lending policies adopted by Commercial Banks' in Kenya.
2. To establish how lending policies affect the non-performing loans among commercial banks in Kenya

### **1.4 Value of the Study**

The findings of the study will be important to commercial banks, as they will be able to establish the effect of the various lending policy tools on their lending behaviour and hence understand their role in attainment of desired economic growth for the country.

The study will also be of importance to various stakeholders in the banking sector among them bank's customers who may be keen to know the causes of changes in the cost of borrowing. Understanding the effect of lending policy on cost of borrowing would help the consumers to make borrowing decisions.

The study will also benefit the government as it provides an insight to the effect of lending policies on lending behaviour of commercial banks. The government partners with banks to ensure price, interest rates and exchange rates stability and enhance economic development through provision of affordable credit.

The finding of this study will also be valuable to researchers and scholars, as it will form a basis for further research. Further, this study may contribute to the pool of knowledge into the relationship between lending policies and non-performing loans among commercial banks in Kenya and therefore contribute to academic reference materials.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter will cover theoretical review, empirical review related to the research objectives, and the conceptual framework.

### **2.2 Theoretical Review**

A survey of literature about the theories of credit assessment suggests that theories are commonly grouped according to the nature of subject relations between the borrower and lender as portfolio theory, credit market theory and information theory.

#### **2.2.1 Portfolio Theory**

Since the 1980s, companies have successfully applied modern portfolio theory to market risk. Many companies are now using value at risk models to manage their interest rate and market risk exposures. Unfortunately, however, even though credit risk remains the largest risk facing most companies, the practice of applying modern portfolio theory to credit risk has lagged (Margrabe, 2007). Companies recognize how credit concentrations can adversely affect financial performance. As a result, a number of institutions are actively pursuing quantitative approaches to credit risk measurement. This industry is also making significant progress toward developing tools that measure credit risk in a portfolio context. They are also using credit derivatives to transfer risk efficiently while preserving customer relationships. Portfolio quality ratios and productivity indicators have been adapted (Kairu, 2009). The combination of these developments has vastly accelerated progress in managing credit risk in a portfolio context.

Traditionally, organizations have taken an asset-by-asset approach to credit risk management. While each company's method varies, in general this approach involves periodically evaluating the quality of credit exposures, applying a credit risk rating, and aggregating the results of this analysis to identify a portfolio's expected losses. The foundation of the asset-by-asset approach is a sound credit review and internal credit risk rating system. This system enables management to identify changes in individual credits, or portfolio trends in a timely manner. Based on the changes identified, credit identification, credit review, and credit risk rating system management can make necessary modifications to portfolio strategies or increase the supervision of credits in a timely manner.

While the asset-by-asset approach is a critical component to managing credit risk, it does not provide a complete view of portfolio credit risk, where the term risk refers to the possibility that actual losses exceed expected losses. Therefore, to gain greater insight into credit risk, companies increasingly look to complement the asset-by-asset approach with a quantitative portfolio review using a credit model (Mason and Roger, 1998). Companies increasingly attempt to address the inability of the asset-by-asset approach to measure unexpected losses sufficiently by pursuing a portfolio approach. One weakness with the asset-by-asset approach is that it has difficulty identifying and measuring concentration. Concentration risk refers to additional portfolio risk resulting from increased exposure to credit extension, or to a group of correlated creditors (Richardson, 2002).



### **2.2.2 Credit Market Theory**

A model of the neoclassical credit market postulates that the terms of credits clear the market. The theory postulates that if collateral and other pertinent restrictions remain given, then it is only the lending rate that determines the amount of credit that is dispensed by the banking sector. Therefore with an increasing demand for credit and a fixed supply of the same, interest rates will have to rise. Any additional risk to a project being funded by the bank should be reflected through a risk premium that is added to lending rate to match the increasing risk of default. Subsequently, there exist a positive relationship between the default probability of a borrower and the interest rate charged on the advance. It is thus believed that the higher the failure risks of the borrower, the higher the interest premium (Ewert et al, 2000).

Although this theory does not explicitly discuss how collateral would effect on the risk premium, it creates the impression that collateral has no effect on lending rate, and if a risky borrower would wish to face the same lending rate as a borrower with a lower risk, then all that is required is to pledge more collateral to lower his risk profile and therefore enjoy a lower risk premium. This brings about the ‘moral hazard’ and ‘adverse selection’ phenomena, firstly because of information asymmetry existing between the lender and borrowers. The borrower has a more accurate assessment of the risk profile of this investment that is not known by the lender and thus may perform secret actions to increase the risk of his investment without the realization of the lender. The adverse selection problem appears as lenders raise their interest rates to shield themselves from default and on the other hand attract only high risk borrowers and eliminate low risk borrowers (Mason and Roger, 1998).

### **2.2.3 Information Theory**

Derban, Binner and Mullineux (2005) recommended that borrowers should be screened especially by banking institutions in form of credit assessment. Collection of reliable information from prospective borrowers becomes critical in accomplishing effective screening as indicated by symmetric information theory.

Qualitative and quantitative techniques can be used in assessing the borrowers although one major challenge of using qualitative models is their subjective nature. However according to Derban et al (2005), borrowers attributes assessed through qualitative models can be assigned numbers with the sum of the values compared to a threshold. This technique minimizes processing costs, reduces subjective judgments and possible biases. The rating systems will be important if it indicates changes in expected level of credit loan loss. Brown (1998) concluded that quantitative models make it possible to numerically establish which factors are important in explaining default risk, evaluating the relative degree of importance of the factors, improving the pricing of default risk, screening out bad loan applicants and calculating any reserve needed to meet expected future loan losses.

### **2.3 Empirical Literature**

A lot has been reviewed in terms of lending activities of various commercial banks. Some opinions deliberated on the factor responsible for banks willingness to extend much credit to some sector of the economy, while some discussed effect of such extension of credits on productivity and output. Most of these earlier studies agreed on the fact that it is logical for banks to have some basic lending principles or consideration to act as a check

in their lending activities. Since there are many studies in respect of bank's lending behaviour, it is therefore imperative to highlight and consider some effect of lending policies that economist and professionals alike have proposed as virtually significant in explaining the loan portfolio performance.

According to Amidu (2006), bank credit channel has focused on two issues. The first issue centred whether there are categories of borrowers who depend on bank lending in that any change in banks' willingness to lend immediately affects their investment and spending decisions. The other issue is whether monetary policy changes directly constrain bank lending to borrowers. Both conditions are necessary for bank lending to play a special role in the monetary transmission mechanism. Some recent research provides support for the view that certain borrowers, especially small businesses, are very dependent on banks for financing (Abor, 2004).

There is significant empirical evidence of a negative relationship between the growth in real GDP and NPLs (Salas and Suarina, 2002; Rajan & Dhal, 2003; Fofack, 2005; and Jimenez and Saurina, 2005). The explanation provided by the literature for this relationship is that strong positive growth in real GDP usually translates into more income which improves the debt servicing capacity of borrower which in turn contributes to lower non-performing loans. Conversely, when there is a slowdown in the economy (low or negative GDP growth) the level of NPLs should increase.

The literature also provides evidence of a positive relationship between the inflation rate and non-performing loans. Fofack (2005), for instance, shows that inflationary pressures contribute to the high level of impaired loans in a number of Sub-Saharan African countries with flexible exchange rate regimes. According to this author, inflation is responsible for the rapid erosion of commercial banks' equity and consequently higher credit risk in the banking sectors of these African countries.

There is also evidence in the literature of a positive association between NPLs and real effective exchange rate. Fofack (2005) reveals that changes in the real effective exchange rate have a positive impact on NPLs of commercial banks that operate in some Sub-Saharan African countries with fixed exchange rate regimes. The author argues that this result is due to the large concentration of loans to the export-oriented agriculture sector, which was adversely affected by the appreciation in the currency of these countries during the 80s and early 90s.

S Pasha and T Khemraj (2010) studied the determinants of non-performing loans in Guyanese Banking sector. The empirical results show that GDP growth is inversely related to non-performing loans, suggesting that an improvement in the real economy translates into lower non-performing loans. Additionally, banks which charge relatively higher interest rates and lend excessively are likely to incur higher levels of non-performing loans. However, contrary to previous studies, their evidence does not support the view that large banks are more effective in screening loan customers when compared to their smaller counterparts.

Chernykh and Theodossiou (2011) investigated the determinants of long-term lending by banks to firms in an emerging market using bank-level information from 881 banks in Russia. The variables of concern include bank size, capitalization, liability structure, risk taking, ownership type, managerial expertise and location of individual banks. The findings reveal that the size of the bank (measured by assets) and the bank capitalization are the only determinants of not only loans expended to businesses but also long-term loans. This is attributed to the fact that bigger and well capitalized banks can withstand the risks emanating from long-term lending. The study thus demonstrates that there are supply-side constraints to credit expansion, although it did not consider the role of collateral on bank lending levels.

Ewert et al. (2000) study the determinants of bank lending performance in Germany using credit file information of 260 medium-sized firm borrowers for the period 1992-1998. The study aims at testing the several theories relating collateral to interest rate premiums and therefore lending performance, using a random effects model on panel data analysis to eliminate the borrower and time-specific effects. Two models were estimated with interest rate premiums and probability of distress as the two predicted variables. Interest rate premium was set to be predicted in a random effects model by among other variables: collateral; bank relationships; bank firm rating; firm characteristic and firm size. The highlight of this study's finding was that interest rate premium increased with rise in the collateral pledged. This was contrary to the signaling and firm characteristics theories above, where we would expect higher interest rate premium for firms pledging little or no collateral. However, estimation of distress probabilities of the

same firms revealed that more collateral and covenant in credit contracts lead to lower distress probabilities. Combining the above results, the study gives controversial finding that riskier credit contracts are assigned lower interest rate premiums by banks.

Panagopoulos and Spiliotis (1998) study the determinants of commercial banks lending behaviour to commercial firms in Greece by inferring on the Post-Keynesian notion that banks lend money for purposes of execution of production activities by firms. The study uses firm expenses as well as general macroeconomic monetary indicators to predict the level of loan advances to industrial, hand craft and trade companies in Greece. The loan predictor variables are last period loan amount, employment costs or wage bill, corporate tax expenses, deposits

Olokoyo (2011) examines predictors of the lending behavior of Nigerian Banks. The study considers volume of deposits, foreign exchange, investment portfolio, minimum cash reserve ratio, lending rate, liquidity ratio and GDP. Utilizing time series data for the period 1980-2005, the vector error correction estimates indicate that while the coefficients of foreign exchange, investment portfolio, deposits and liquidity ration have significant effects upon the lending volumes, the coefficients of lending rate and minimum cash reserve ratio were insignificant implying that monetary policy instruments do not affect bank lending volumes in Nigeria. The study does not, however, consider collateral as one of the explanatory variables; thus it is not possible to tell the effect of collateral requirements on the bank lending behavior in Nigeria.

Private Banks are more serious to implement effective credit risk management practice than state owned banks. A study conducted by Kuo & Enders (2004) of credit risk management policies for state banks in China and found that mushrooming of the financial market; the state owned commercial banks in China are faced with the unprecedented challenges and tough for them to compete with foreign bank unless they make some thoughtful change. In this thoughtful change, the reform of credit risk management is a major step that determines whether the state owned commercial banks in China would survive the challenges or not. Research however faults some of the credit risk management policies in place The broad framework and detailed guidance for credit risk assessment and management is provided by the Basel New Capital Accord which is now widely followed internationally (Campbell, 2007). Most countries are implementing the 'better wait' and gradual approaches, in the face of huge challenges posed by Basel II. Significant number of countries has it in mind to suspend execution of Basel II or decide on simple approaches for determining credit risk (Campbell, 2007).

#### **2.4 Lending Regulations and Guidelines**

The first decade after independence can be characterized as passive in the conduct of monetary policy in Kenya, mainly because no intervention was necessary in an environment of 8% GDP growth and below 2% inflation rate (Kinyua, 2001). The first major macroeconomic imbalance arose in the second decade in the form of 1973 oil crisis and the coffee boom of 1977/78. This came at a time when the fixed exchange rate system had just collapsed with the Britton Woods System in 1971. In these first two

decades, monetary policy was conducted through direct tools which were cash reserve ratio, liquidity ratio, credit ceilings for commercial banks, and interest rate controls.

The 1990s brought about the liberalization of the economy where interest rate controls were removed and exchange rate made flexible, ushering in a new era in monetary policy where open market operations (OMO) was the main tool. This was a period characterized by high interest rates and widening interest spread, which inhibited the benefits of flexible interest rate policy such as increasing financial savings and reducing cost of capital. Competing against double digit inflation rate spurred on by excessive money supply and accommodation of troubled banks, CBK used indirect tools to tame inflation in an atmosphere of instability and extreme uncertainty. In 1996, the CBK Act was amended and this allowed the CBK to shift from targeting broad money to targeting broader money as the principal concept of money stock, (Kinyua, 2001).

The banks very frequently suffer from poor lending practice (Koford & Tschoegl, 1999). Monitoring, and other appropriate steps, are necessary to control or mitigate the risk of connected lending when it goes to companies or individuals (Basel, 1999). Therefore, the CBK, has issued guidelines which attention to general principles that are prepared for governing the implementation of more detailed lending procedures and practices within the banks. It is mandatory for a bank to prepare Credit Policies Guidelines (CPG) for making investment and lending decisions and which reflect a bank tolerance for credit risk. Prior to consent to a credit facility, the bank should make an assessment of risk profile of its customers, such as of their business, and which can be done through the



credit procedure. Benedikt et al., (2007) studied the credit risk management policies for ten banks in the United States and found that advance credit risk management techniques help permanent to achieve their target in loan level. The findings confirm the general efficiency enhancing implications of new risk management techniques in a world with frictions suggested in the theoretical literature

#### **2.4.1 Factors Affecting the Lending Decisions**

The loan allocation and the loan portfolio of any individual financial institution e.g. commercial banks will be dictated by lending decisions. The nature, size, and the structure of loan portfolio is a reflection of financial institutions lending decisions. The lending decisions are influenced by the following:

The size of the lending institution: - This is very vital in determining the size of the loan to lend. Further, it also restricts the potential market for borrowers such that if a financial institution is small and therefore its geographical coverage is small, its lending decision will differ from Multinational financial decisions. Its loaning decisions will also depend on the business potential on the areas of its coverage. The small financial institutions should therefore consider their local community and immediate environment when drawing up the lending decisions. Multinationals will consider a wider environment (George & Simonson, 2000).

Economic conditions: - It refers to the economic activities around financial institutions operating environment. Many banks are usually located in areas where economic activities are either dominated by manufacturers or service industry, etc. Lending policies

should therefore be tailored according to the pre-dominant business activity in the bank's environment. Of great importance here is to focus on the flow of business within this environment and design policies that are able to tap the benefits to the business. In periods of corporate bankruptcy, it is also important to notice that certain loan policies are important to help re-organize bankrupt institutions and transform them into highly profitable organizations (Dyer, 1997).

Credit Analysis:-The purpose of credit analysis is to assess the likelihood that a borrower will default on a given loan. Credit analysis consists of evaluating a borrower's needs and financial conditions which includes: Character or the person's traits such as honesty, ethical considerations, integrity, etc. This is usually based on the borrower's past behaviour in both banking & repayments of loans borrowed earlier. Capacity of the borrower which focuses on whether the borrower has the ability to generate sufficient funds to liquidate the loan and still stay financially healthy. This will include assessing the manager's ability, policy documents of the firm, investment policies, strategic plans, credit statements, etc. as well as judge the market potential of the institution. The judgement should be both on liquidity as well as solvency of the institution.

Collateral which is the ability of the borrower to pledge specific assets to secure a loan. According to the provisions of Central Bank, all loans offered by banks must be secured to protect the borrower's funds. The value of the security should be ascertained and title documents charged to the loan which should not exceed  $\frac{2}{3}$  of the value of the securities. Capital or the money personally invested into the business by the loanee and is an indication of how much the borrower has at risk should the business fail. Interested

lenders and investors will expect the loanee to have contributed from their own assets and to have undertaken personal financial risk to establish the business before advancing any credit (George & Simonson, 2000).

## **2.5 Loan Portfolio Management**

Effective management of the loan portfolio and the credit function is fundamental to a bank's safety and soundness. Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled. Because review of the LPM process is so important, it is a primary supervisory activity. Assessing LPM involves evaluating the steps bank management takes to identify and control risk throughout the credit process. The assessment focuses on what management does to identify issues before they become problems. This booklet, written for the benefit of both examiners and bankers, discusses the elements of an effective LPM process. It emphasizes that the identification and management of risk among groups of loans may be at least as important as the risk inherent in individual loans (Chodechai, 2004).

For decades, good loan portfolio managers have concentrated most of their effort on prudently approving loans and carefully monitoring loan performance. Although these activities continue to be mainstays of loan portfolio management, analysis of past credit problems, such as those associated with oil and gas lending, agricultural lending, and commercial real estate lending in the 1980s, has made it clear that portfolio managers should do more. Traditional practices rely too much on trailing indicators of credit quality such as delinquency, non-accrual, and risk rating trends. Banks have found that these

indicators do not provide sufficient lead time for corrective action when there is a systemic increase in risk (Sanchez, 2009).

Effective loan portfolio management begins with oversight of the risk in individual loans. Prudent risk selection is vital to maintaining favorable loan quality. Therefore, the historical emphasis on controlling the quality of individual loan approvals and managing the performance of loans continues to be essential. But better technology and information systems have opened the door to better management methods. A portfolio manager can now obtain early indications of increasing risk by taking a more comprehensive view of the loan portfolio (Hirtle, 2008).

To manage their portfolios, bankers must understand not only the risk posed by each credit but also how the risks of individual loans and portfolios are interrelated. These interrelationships can multiply risk many times beyond what it would be if the risks were not related. Until recently, few banks used modern portfolio management concepts to control credit risk. Now, many banks view the loan portfolio in its segments and as a whole and consider the relationships among portfolio segments as well as among loans. These practices provide management with a more complete picture of the bank's credit risk profile and with more tools to analyze and control the risk (Gonzalez, 2010).

## **2.6 Chapter Summary**

A large body of related research has focused on whether monetary policy might have effects on real economic activity through the market for bank-intermediated credit. If

banks were not able to readily substitute other sources of funding for deposits, then changes in the federal funds rate which affects banks' opportunity cost of issuing certain kinds of deposits would influence the price and supply of bank loans. In turn, this change in credit market conditions would affect investment and consumption decisions of bank-dependent borrowers. This chapter has reviewed existing literature on lending policies and performance of loan portfolio from the global, African and Kenyan perspectives. It has also presented a number of relevant studies done to support the study.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter outlines the research methodology that will be followed in completing the study. Specifically the following subsections were included: research design, target population, data collection and data analysis.

### **3.2 Research Design**

The research will use descriptive survey approach. According to Ngechu (2004), descriptive studies are more formalized and typically structured with clearly stated hypotheses or investigative questions. It serves a variety of research objective such as descriptions of phenomenon or characteristics associated with a subject population, estimates of proportions of a population that have these characteristics and discovery of associations among different variables.

### **3.3 Target Population**

Mugenda & Mugenda (2003) define a study population as consisting of the total collections of elements about which the study wants to make some inferences. The target population of this study will be all heads of credit related departments who are concerned with policies implementation. This will be a census study where all heads of credit department in 43 commercial banks in Kenya as outline in appendix 3 will constitute the sample size to the study (Kenya Bankers Association, 2012).

### **3.4 Sampling Design**

#### **3.4.1 Sample Frame**

Sampling frame is an objective list of the population from which the researcher can make a selection. Cooper and Schindler (2000) add that a sampling frame should be a complete and correct list of population members only. The sampling frame for this study is a list of all head of credit related departments in the 43 commercial banks in Kenya.

#### **3.4.2 Sampling Technique**

According to Mugenda and Mugenda (2003), at times the target population may be so small that selecting a sample is meaningless and therefore taking the whole population in such cases is advisable. Census technique therefore was used.

#### **3.4.3 Sample Size**

Denscombe (1998) posited that, the sample must be carefully selected to be representative of the population and the researcher also needs to ensure that the subdivisions entailed in the analysis are accurately catered for. The sample size constituted the entire total population of 43 commercial banks.

### **3.5 Data Collection**

Data was collected through the use of simple data collection forms which were administered to the 43 commercial banks. A drop and pick later method was used to collect the data. The questionnaires consisted of two parts: Part one addressed the profile of the respondents and the banks, and Part two focused on the effect of lending policies on performance of loan portfolio. Secondary data was also used with focus on already

existing data (publications). This was aimed at having a better understanding and to provide an insightful interpretation of the results from the study.

### **3.6 Data Analysis**

The data from the field was coded according to the themes researched in the study. A statistical package for social sciences (SPSS) package was used to aid in analysis. Quantitative data was analyzed through the use of a combination of descriptive statistics particularly frequency distributions tables, percentage and mean and also measure of dispersion such as variance and standard deviation. The data has been presented in tables and graphs.

### **3.7 Data Validity and Reliability**

#### **3.7.1 Validity of research instrument**

Validity indicates the degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 2003). This study used content validity because it measures the degree to which the sample of the items represents the content that the test is designed to measure. Before processing the data, the questionnaires were checked for completeness and consistency.

#### **3.7.2 Reliability of the research instrument**

Reliability is the degree of consistency (Mugenda and Mugenda, 1999). A pilot study was conducted by the researcher by administering the questionnaires to three micro-finances or banking institutions in Kenya. From the pilot study, it was possible to detect questions



that needed editing and those with ambiguities. The final questionnaires were then printed and dispatched to the field for data collection, and were collected after two weeks.

### **3.8 Chapter Summary**

This chapter has looked at the research design of the study, the target population and outlined the sample size of the research. It has also discussed the validity, reliability and data analysis and presentation.

## CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

### 4.1 Introduction

This chapter presents analysis and findings of the study as set out in the research methodology. The results are presented on the effects of lending policies on the level of nonperforming loans of Commercial Bank in Kenya.

#### 4.1.1 Questionnaire response rate

Out of the forty three (43) questionnaires sent to the target population, thirty two (32) usable responses were collected. This represented a response rate of 74.4 percent and implies that 25.6 percent of the questionnaires were not returned at all. Despite this, the target population was fairly represented considering that key personnel who are relevant to the study were reached. The results are shown in table below.

Table 4.1 Response rate

<b>Instrument</b>	<b>Frequency</b>	<b>Percentage</b>
Response rate	32	74.4
Non response rate	11	25.6
<b>Total</b>	<b>43</b>	<b>100.0</b>

### 4.2 Demographic Information

#### 4.2.1 Gender of the respondents

From the analysis, it occurred that, majority(59.4%) of the respondents were female and male representing 40.6% of the respondents who participated in the study as shown in Table 4.2 below. This implies that, Women are beginning to get a number of significant appointments in the corporate sector. Most of them have qualifications that rival men and

this is in fulfillment of the new constitution seems to be giving women and men equal opportunities for appointment to its various positions.

Table 4.2 Gender of Respondents

<b>Gender</b>	<b>Frequency</b>	<b>Percent</b>
Male	13	40.6
Female	19	59.4
<b>Total</b>	<b>32</b>	<b>100</b>

#### **4.2.2 Position in the bank**

Majority (35%) of the respondents are head of asset finance, 24% of the respondents are in SMEs loan, 20% were in mortgage, 17% were in personal banking while 4% were heads of credits. This indicates that respondents were drawn from all departments of the bank as shown in table below.

Table 4.3 Position in the bank

<b>Position in bank</b>	<b>frequency</b>	<b>Percent</b>
SMEs loan	8	24
Asset finance	11	35
Mortgage	6	20
personal banking	5	17
Head of credit	1	4
<b>Total</b>	<b>32</b>	<b>100</b>

### 4.2.3 Number of years worked

Most of the bank employees who participated in the study have been with the credit department for a long time. From the findings, majority (49%) of them, have been with the bank for between 6 to 10 yrs, 26% had between 11 to 20yrs, 22% had below 5yrs, and 3% had over 20 yrs . This implies that, majority of the employees of the bank have been with the bank for quite some time. An indication that, they understand their work well and any recommendation they give is accurate and they can be relied on.

Table 4.4 Work experience

<b>Work experience</b>	<b>Frequency</b>	<b>Percent</b>
Below 5yrs	7	22
6-10 yrs	16	49
11-20 yrs	8	26
Over 20yrs	1	3
<b>Total</b>	<b>32</b>	<b>100</b>

### 4.2.4 Ownership of your bank

The finding show that majority (61%) of the banks were locally owned 29% of the bank were foreign owned and 10% are jointly owned.

Table 4.5 Ownership of your bank

<b>Bank ownership</b>	<b>Frequency</b>	<b>Percent</b>
Locally owned	20	61
Foreign owned	9	29
Joint venture	3	10
<b>Total</b>	<b>32</b>	<b>100</b>

### 4.3 Loan appraisal in banks

#### 4.3.1 Principles that guide in loan appraisal

Majority (69%) reported the ability to pay as the major guiding principle in loan administration, 15% reported the borrower history, 10% reported availability of adequate security, 4% of the respondents reported knowing the loanee and 3% of the respondents reported competitive pricing.

Table 4.6 Lending principle

<b>Principle of lending</b>	<b>Frequency</b>	<b>Percent</b>
Repayment ability	22	69
Adequate security	4	10
Borrower history	5	14
Competitive pricing	1	3
Knowing the loanee	1	4
<b>Total</b>	<b>32</b>	<b>100</b>

#### 4.3.2 Average turn-around time

The findings illustrate that majority (63%) of the banks had a turn-around time of between 3-5days in the lending policies, 24% report 5 to 7 days turn-around time, 11% of the respondents reported a 1 to 2 days while 1% reported same day loan appraisal. This implies that many bank allow a lapse time to enable proper loan application scrutiny and this can help in reducing bad debts.

Table 4.7 Turn-around time

<b>Bank turn-around time</b>	<b>Frequency</b>	<b>Percent</b>
Same day	1	4
1-2 days	4	11
3-5 days	17	54
5- 6 days	8	24
Over 7 days	3	7
<b>Total</b>	<b>32</b>	<b>100</b>

### 4.3.3 Type of Bank borrowers

The findings reviewed that majority (42%) of the banks borrowers are the loyal customers, 24% are corporate bodies, 19% are societies, 11% constitute the government of Kenya and 4% of the respondent said group and welfares are their main borrowers. This shows that majority of the bank consider lending to customers that they have had a relationship with and this can reduce the rate of non-performing loans.

Table 4.8 Bank major borrowers

<b>Type of borrowers</b>	<b>Frequency</b>	<b>Percent</b>
Loyal customer	13	42
government	4	11
societies	6	19
corporate bodies	8	24
groups	1	4
<b>Total</b>	<b>32</b>	<b>100</b>

#### 4.3.4 Degree of loan risk

Majority(58%) of the respondents perceive unsecured loan as the most risky form of loans among commercial banks in Kenya, 39% reported overdraft facilities as most risky and 3% of respondents perceive secured loan as risky.

Table 4.9 degree of loan risk

<b>Degree of risk</b>	<b>Frequency</b>	<b>Percent</b>
Secured loan	1	3
Unsecured loan	19	58
Overdraft	12	39
<b>Total</b>	<b>32</b>	<b>100</b>

#### 4.3.5 Economic Sector with the highest loans

The economic sector that has the highest loans was found to be Asset Finance as reported by 36.9% of the respondents who participated in the study, followed closely by small and medium enterprises development represented by 32.2%, mortgages represented 29% of the total loans while the lowest were Retail Trade & Wholesale trade representing 1.9% of the bank loans. This shows that, there is rapid growth in the Asset Finance and mortgage sectors giving rise to ownership of assets and properties in the country.

Table 4.10 Loan preference among various sectors

<b>Economic sector</b>	<b>Frequency</b>	<b>Percent</b>
Asset finance	12	36.9
Trade	1	1.9
SME	10	32.2
Mortgage	9	29.0
<b>Total</b>	<b>32</b>	<b>100</b>

## 4.4 Non-performing Loans in Commercial Banks

### 4.4.1 Portfolio at risk

Majority (50%) of the respondents gave the average loan portfolio at risk as between 6 to 10 percent of the total loans, 33% reported below 5 percent portfolio at risks, 10% report between 10 to 15 percent PAR while 7% reported above 15 percent PAR.

Table 4.11 Portfolio at risk

<b>PAR</b>	<b>Frequency</b>	<b>Percent</b>
Below 5%	11	33
6-10%	16	50
10-15%	3	10
Above 15	2	7
<b>Total</b>	<b>32</b>	<b>100</b>

### 4.4.2 Factors that account for bad loans

From the analysis majority (86%) reported that, the main factor that lead to bad loans is lending to borrowers with questionable characters, 67% reported high interest rates that make it hard for some to pay, 59% of the respondents reported diversion of funds by borrowers from what they had intended to work on not being disclosed before the bank, 55% said lack of commitment by the borrower to pay the loan, 50% cited poor planning by the borrowers of what and how they will use the loan, 41% reported lending to serial loan defaulters while 25% reported that it is due to lack of collateral for the bank. These causes make many borrowers not to pay their loans hence leading to increased levels of non-performing loans.



Table 4.12 Cause of non-performing loans

<b>Causes of Non-performing loans</b>	<b>Frequency</b>	<b>Percent</b>
high interest rates	21	67
borrowers with questionable characters	27	86
diversion of funds by borrowers	19	59
lack of commitment by the borrower to pay	18	55
poor planning by the borrowers	16	50
serial loan defaulters	13	41
lack of collateral	8	25

#### 4.4.3 Benefit of Lending Policies to Credit Department

Majority (89%) of the respondents reported that the lending policies are very beneficial to the credit department, 10% said that the policies are at times beneficial while 1% viewed the lending policies as not beneficial. This illustrates that the lending policies are important in guiding the lending processes among banks and ensuring uniformity within a bank credit departments.

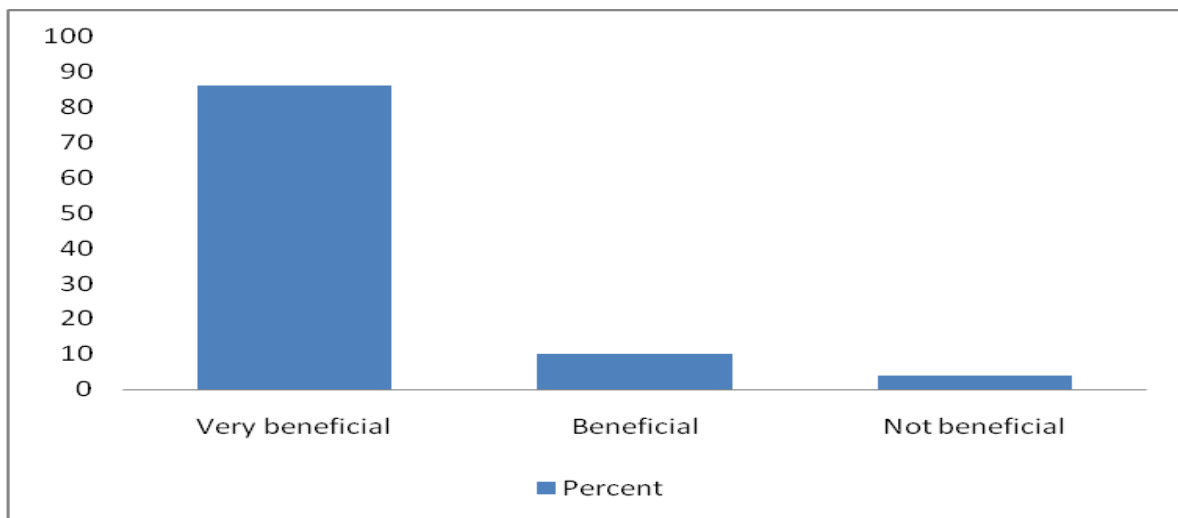


Figure 4.1 Benefits of lending policies

#### 4.4.4 Effects of Lending Policies on Loan Portfolio Performance

**Table 4.13 Lending Policies**

	<b>Mean</b>	<b>Standard deviation</b>
Central bank's lending guidelines influence individual banks policies	4.211	.0788
The individual banks lending policies influences the levels of Non-performing loans	4.571	.1152
Lack of proper information on customer influence loan appraisal process	3.844	.2451
Credit reference bureau reduces the number of loanee	2.111	.7755
Competition in the commercial banks leads to differences in loan policies	3.554	.8542
High interest rates influence the quality of loan repayment	3.453	.0667
The prevailing economic conditions influence loan policies	3.331	.1554
The quality of credit officers determine the nature of appraisal and extent of NPLs	4.152	.2224
Income from loans influence bank profitability	4.002	.7788
There exists a relationship between the interest rate and loan take-up rate	3.750	.8452
Lending policies influences the borrowing behaviour of consumers	2.954	.5322
Lending policies within our bank are tailored to the pre-dominant business activity	1.200	.0551
Changes in disposable income for the loanee influences the repayment ability	3.754	.9310

Majority of the respondents indicated that the lending policies affect loan portfolio performance to a great extent in that the individual banks lending policies influences the levels of Non-performing loans as shown by a mean of 4.571, Central Bank lending

guidelines influence individual banks policies as shown by a mean of 4.211, quality of credit officers determine the nature of appraisal and extent of NPLs as shown by a mean of 4.152, Income from loans influence bank profitability as shown by a mean of 4.002, To a less extent lending policies influences the borrowing behaviour of consumers as shown by a mean of 2.954 and credit reference bureau reduces the number of loanee as shown by a mean of 2.111. Lending policies within our bank are tailored are not at all pre-dominant to business activity as shown by a mean of 1.200.

#### 4.5 Efforts to reduce the high risk in commercial loan

Majority (42%) of the respondents indicated that ascertaining the credit worthiness using all available means like consulting other banks was the only way used to reducing the risk, 30% of the respondents indicated insuring the loan portfolio, 23% of the respondents indicated that they stopped advancing loans to risky sub-sector, 5% of respondents indicated that there was nothing being done.

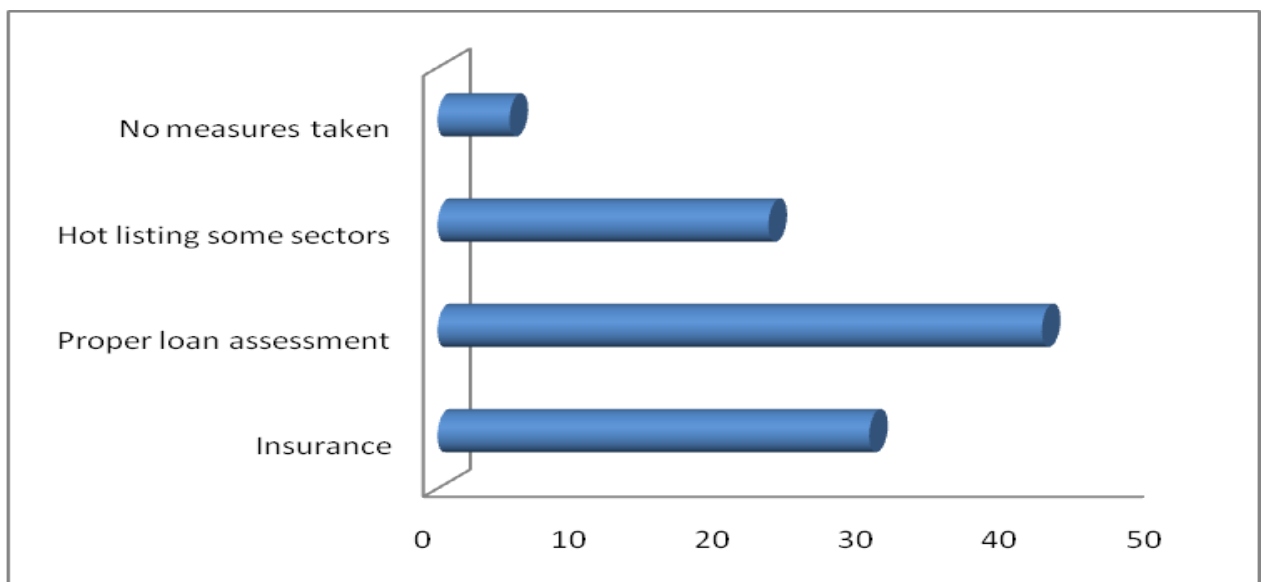


Figure 4.2 Methods of mitigating risks

#### **4.5 .1 Effect of information sharing policy on Non-performing Loans**

From the findings, 35% of the respondents indicated that information sharing policy increases transparency among financial institutions, 23% of the respondents indicated that, it helps the banks lend prudently, 21% of the respondents said it lowered the risk level to the banks, 16% of the respondents said that, it instill borrowers discipline against defaulting, 5 % of the respondents said that, it reduces the borrowing cost i.e. interest charge on loans. This illustrates that credit information sharing has helped many banks to lend with care and therefore has led to reduced non-performing loans.

Table 4.14 Credit information sharing

<b>Credit information sharing</b>	<b>Frequency</b>	<b>Percent</b>
Increase banks transparency	11	35
Bank lend prudently	7	23
Lower risk levels	6	21
Instill discipline in borrowers	5	16
Reduce the cost of borrowing	2	5
<b>Total</b>	<b>32</b>	<b>100</b>

#### **4.6 Interpretation of the findings**

The study found that proper adherence to the lending policies can reduce the level of non-performing loans. This concur with Ranjan (2003) who opined that horizon of development of credit, better credit culture, positive macroeconomic and business conditions lead to lowering of NPLs. The non-performing loans of banks are an important criterion to assess the financial health of banking sector. It reflects the asset worth, credit risk and competence in the allocation of resources to the productive sectors.

Ahmed (2010) noted that since the reform regime there have been various initiatives to contain growth of NPLs to improve the asset quality of the banking sector. Commercial banks have envisaged the greatest renovation in their operation with the introduction of new concepts like prudential accounting norms, income recognition and capital adequacy ratio which have placed them in new platform.

#### **4.7 Key Findings**

The study found that majority of commercial banks being locally owned have customized the lending policies to fit the local market and to gain a competitive edge. However, this is likely to affect the performance of loan, the finding agreed with Swaren (1990) who suggested that the most pervasive area of risk is an overly aggressive lending exercise. It is a hazardous practice to extend lending term beyond the useful life of the corresponding collateral. Besides that, giving out loans to borrowers who are already overloaded with debt or possess unfavourable credit history can expose banks to unnecessary default and credit risk. In order to decrease these risks, banks need to take into consideration several common applicants' particulars such as debt to income ratio, business and credit history and performance record and for individual loan applicants their time on the job or length of time.

According to Getenga (2007), one of the features that banks deliberate when deciding on a loan credit application is the estimated chances of recovery. To arrive at this, credit information is required on how well the applicant has honoured past loan obligations. This credit information is important because there is usually a definite relationship

between past and future performance in loan repayment. Very often, this history is not within the bank's reach because the potential borrower's repayment records are scattered in the various archives of the other financial institutions where the customer has previously borrowed.

Kalberg and Udell (2003) also point out that information exchange from multiple sources improves the precision of the signal about the quality of the credit seeker. As a result, the default rate reduces. Banking competition for borrowers strengthens the positive effect of information sharing on lending: when credit markets are competitive, information sharing reduces informational interest charged and increases banking competition, which in turn leads to increased lending.

## **CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Summary of Major Findings**

The study indicates that majority of the respondents had worked for the banks sampled for long and had beyond 8 years of experience in credit administration. Majority of the banks were locally owned and therefore lending policies were tailored to meet the local needs. The major guiding principles in lending were reported as the ability to pay and borrowers' credit history.

The banks in Kenya have a short turn-around time of 3 to 6 days and they lend mostly to the loyal customers who had a relationship with bank for at least six months. The economic sectors with huge loan portfolio included Asset financing, SME and Mortgage & Construction. Unsecured loans were the most risky type of loan facility causing some banks to a high average PAR of 6 to 10%.

The lending policies were found to be very beneficial to the credit department in that they guide the lending process and that it ring uniformity with the bank network. From the main factor that lead to bad loans is lending to borrowers with questionable characters, high interest rates that make it hard for some to pay and diversion of funds by borrowers from what they had intended to work on not being disclosed to the lender. Lending policies help in ascertaining the credit worthiness of the borrowers. Insuring the loan portfolio and stopping advancement of loans to risky sub-sector are also some measures in mitigating risks.

## **5.2 Conclusion**

The study concludes that lending policies and levels of non-performing loans are indeed related. Lending policies, helps the banks lend prudently and lowers the risk level to the banks. Strict adherence to lending policies therefore has led to reduced levels of non-performing loans.

The study concludes that as the economic sectors grows, the level of lending to these sectors will also increase and in return the level of non-performing loans tends to increase as the sector grows. The study also concludes that proper assessment of creditworthiness of a borrower, listing some risky sectors and insurance services are some of the measures being adopted to reduce the levels of non-performing loans.

The study further concludes that, the main factors that lead to bad loans among commercial banks in Kenya are; lending to borrowers with questionable characters, serial loan defaulters, high interest rates that make it hard for some to pay, and diversion of funds by borrowers. These causes make many borrowers not to honour their obligations as and when they fall due, hence leading to increased levels of non-performing loans. Most of these factors are due to information asymmetry in the banking industry.

The study concludes that emergence of many competitors such as micro finances, FOSAs and changing customer profiles are threatening the future growth of the commercial banks lending. The banking industry is therefore faced with the challenges of abandoning



the tradition methods of lending and embracing the modern technology and innovations such as internet lending to include more borrowers.

The study concludes that as commercial banks have plans to enter in other markets to exploit the international markets. The banks' lending policies are modified to meet the needs of the foreign markets. The strategy implementation therefore must be conducted with good knowledge of the society cultural and economic factors.

### **5.3 Policy Recommendations**

The study recommends that Central bank should provide strict lending policies based on the prevailing economic environment as this will ensure uniformity in administration of credit facilities.

Banks should ensure low PAR through prudent lending and strict loan recoveries. The ability and qualifications of the credit officer is of importance in assessing the credit worthiness of the borrower. Therefore the banks staff should be given occasional training to equip them with the relevant skills as this will go a long way in reducing the levels of non-performing loans among commercial banks.

The study recommends the bank to come up with loan differentiation strategies by segmenting the customers based on their needs, size and type of business and designing products that meet the unique needs of these customer segments and also creating a pricing strategy for each segment. The banks should consider more products and services

which can appeal to the women and youth who form the bulk of the Kenyan population. The youth comprises of 42% of the population in Kenya and have different tastes from the rest of the population. There is an upcoming niche of young generation who are economically powerful and require a financial institution that can best meet their needs. Targeting this niche therefore will enable the bank to broaden its customer base and consequently loan book.

The study further recommends that E-Banking such as M-Shwari and M-Benki should be given more advertisement as it's an area with great growth potential. E-banking enables the unbanked in remote areas to save and acquire loans without visiting a branch. This increases loan book and also the diversification reduces the loan risks.

#### **5.4 Limitations of the study**

The study was limited by the availability of the senior management who were too busy during office hours to fill the questionnaires. To mitigate this problem the researcher gave a lengthy period of data collection further the researcher made numerous phone calls to increase the response rate.

Due to the sensitivity of the banking information the respondent may have had an imaginary fear of giving the information to competitors. This limitation was countered by assuring the respondents that information is purely for academic purposes and would be treated with a lot of confidentiality. An introduction letter from the University of Nairobi, School of Business was attached to the questionnaires to affirm confidentiality.

The study was also limited to the degree of precision of the data obtained from the respondents through the questionnaires. Whereas secondary data is verifiable since it is obtained from the CBK publications & KBA publications, the primary data is prone to the shortcomings of not being able to verify the information provided.

The research was restricted by availability of funds for printing and referring to different study materials that were not available in the library, and travelling to different venues. To mitigate this problem the researcher conducted much of the research activities on his own and engaged friends/former colleagues where inevitable. e.g. KIPPRA, CBK, KBA.

### **5.5 Suggestions for Further Studies**

This study has looked at effect of lending policies on the levels of non-performing loans by commercial banks in Kenya. This study recommends that another study should be done to augment finding in this study; it therefore recommends a study be done on the effect lending policies have on borrowing behaviour for the consumer so as to look at how lending policy influences borrowers decision making.

Further, to augment the research finding of this study, the study recommends that another research on lending policies should be done but include all credit providers namely; micro-finance institutions, mortgage companies, hire-purchase companies and utility companies on a wider geographical area.

The researcher recommends that a study be done in the banking industry so as to find out the different strategies adopted by commercial banks while responding to competition in the industry.

The study recommends that other studies be done to evaluate the sustainability of large loan books, bad debt provision and their effects on overall performance of the Commercial Banks in Kenya.

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## APPENDICES

### APPENDIX I: COVER LETTER

MICHAEL OTIENO  
UNIVERSITY OF NAIROBI  
SCHOOL OF BUSINESS  
P.O. BOX 30197.  
NAIROBI

Dear Respondent,

I am carrying out research on the effect of lending policies on the performance of loan portfolio of Commercial Banks in Kenya. This is in partial fulfillment of the requirement for the award of the degree in Masters of Science in Finance (Msc Finance) degree program at the University of Nairobi.

The result of this study will provide the management with the necessary information on the effect of lending policies on the levels of non-performing loans.

This is an academic research and confidentiality is strictly emphasized, your name will not appear anywhere in the report. Kindly spare some time to complete the questionnaire attached.

Thank you in advance,

Yours sincerely,

Michael Otieno Owino  
*Postgraduate Student*

## APENDIX II: QUESTIONNAIRE

### Section A: General Information

1. Name of your organization? (optional) .....
2. What is your Position in the bank?  
Head of SMEs [  ]      Head of Asset finance [  ]      Head of Mortgage [  ]  
Head of Personal Banking [  ]      Head of Credit [  ]      Other .....
3. What is your work experience in years in your current position?  
Less than 5years      [  ]  
6-10 years      [  ]  
11-20 years      [  ]  
Over 20 years      [  ]
4. Describe the ownership of your bank?  
Locally owned      [  ]  
Foreign owned      [  ]  
Joint venture      [  ]

### Section B:

5. Does your bank have a credit policy?      Yes [  ]      No [  ]
6. What principles guide your bank in loan appraisal?  
Repayment ability [  ]      Adequate security [  ]      Borrowing history [  ]  
Competitive pricing [  ]      Knowing the loanee [  ]      Risk management [  ]
7. Who are the majority borrowers in your bank?  
Loyal customers [  ]      Walk in customers [  ]      Corporate bodies [  ]      Government [  ]  
Societies [  ]      Groups/Welfares [  ]      Others [  ] .....
8. Does the nature of your customer influence the quality of loan portfolio in your bank?  
Yes [  ]      No [  ]      I don't know [  ]  
If Yes in the above, who is the safest borrower, and why? .....

9. Who are the most profitable borrowers for your bank?
- Retail customers [ ]      Corporate customers [ ]      Corporate/ institutions [ ]
- Government/Parastatals [ ]      NGOs [ ]
10. What is the average turnaround time in your bank for loan processing?
- Same day [ ]      1-2 days [ ]      3-5days [ ]      5-7days [ ]
11. What is the average loan portfolio at risk (PAR) for your bank?
- Below 5% [ ]      6-10% [ ]      10-15% [ ]      Above15% [ ]      Not aware [ ]
12. What are the effects of lending policies on loan turn around time?
- Lead to delay in loan disbursement [ ]      Increase the rate of disbursement [ ]
- Has no effects on loan disbursement [ ]      Increased loan book portfolio [ ]
13. What are the effects of central bank lending rates?
- Lead to high interest rates for the bank [ ]      Increases interbank lending [ ]
- Reduces amount for lending to customers [ ]      Leads to increased/reduced NPLs [ ]
- All of the above [ ]      None of the above [ ]
14. Which is the most preferred type of loan in your bank?
- Secured loan [ ]      Unsecured Loan [ ]      Overdrafts [ ]
- Explain the answer above.....
15. Do you think lending policy is beneficial to your bank's credit department/
- Very beneficial [ ]      Beneficial at times [ ]      Not beneficial [ ]
- Explain the answer above.....
16. What percent of the total loan portfolio constitutes the non-performing loans in your bank?
- Below 5% [ ]      6-10% [ ]      10-15% [ ]      Above15% [ ]      Not aware [ ]

17. Rate on a scale of 1 to 5 the extent to which lending policies influence loan portfolio performance in your bank based on the criteria listed on the first (left) column of the matrix presents below. The numbers represents the following: 1- not at all, 2- To a less extent, 3- to a moderate extent, 4-to a great extent and 5- to a very great extent.

	Not at all	To a less extent	To a moderate extent	To a great extent	To a very great extent
a) Central bank's lending guidelines influence individual banks policies					
b) The individual banks lending policies influences the levels of Non-performing loans					
c) Lack of proper information on customer influence loan repayment ability					
d) Credit reference bureau reduces the number of loanee					
e) Competition in the commercial banks leads to differences in loan policies					
f) Bank's deposit level affect the loan portfolio					
g) High interest rates influence the quality of loan repayment					
h) The prevailing economic conditions influence loan policies					
i) The quality of credit officers determine the nature of appraisal and extent of NPLs					
j) Setting of credit targets lead to poor loan portfolio performance					
k) Income from loans influence bank profitability					
l) Weak leading policies can lead to over lending by commercial banks					
m) There exists a relationship between the interest rate and loan take-up rate					
n) Lending policies influences the borrowing behaviour of consumers					
o) Lending policies within our bank are tailored to the pre-dominant business activity					
p) Exceptions to the lending policy affects the loan portfolio performance					
q) Changes in disposable income for the loanee influences the repayment ability					

18. Rate on a scale of 1 to 5 the extent to which the lending policy influences the lending decision and loan portfolio performance in your bank based on the criteria listed on the first (left) column of the matrix presents below. The numbers represents the following: 1- not at all, 2- To a less extent, 3- to a moderate extent, 4-to a great extent and 5- to a very great extent.

	Not at all	To a less extent	To a moderate extent	To a great extent	To a very great extent
a) I know and understands the bank's credit policy					
b) I need more training in credit analysis to improve on the quality of loan portfolio					
c) Non-performing loans are a concern to us as a bank/department					
d) Collateral and guarantees are considered as the most popular credit risk reduction strategies					
e) The Basel guidelines are good for entrenching strict culture of managing inherent credit risks					
f) Repayment ability is second to security while advancing credit					
g) The credit reference bureau report for a loanee affects the lending decision					
h) New customers/loanees constitute the bigger portion of non-performing loans in our loan portfolio					
i) Existing/repeat customers and loanees constitute the bigger portion of non-performing loans in our loan book					
j) Lending policy must always be used when processing loans					
k) There exists an effective monitoring and control mechanisms for loans sanctioned					
l) In lending, it is difficult to fix a poor underwriting decision					
m) Lending procedures and processes influences the performance of loan portfolio					
n) The macroeconomic environment influences the Non-performing loans					
o) lending policies in our bank are geared towards achieving a higher return on investments to the shareholders					

### **APPENDIX III: LIST OF COMMERCIAL BANKS IN KENYA**

1. African Banking Corporation Ltd
2. Bank of Africa (K) Ltd
3. Bank of Baroda (K) Ltd
4. Bank of India Ltd
5. Barclays Bank of Kenya Ltd
6. Chase Bank Ltd
7. CharterHouse Bank Ltd
8. Citibank, N.A.
9. Commercial Bank of Africa Ltd
10. Consolidated Bank of Kenya Ltd
11. Co-operative Bank of Kenya Ltd
12. CFC Stanbic Bank Ltd
13. Credit Bank Ltd
14. Development Bank of Kenya Ltd
15. Diamond Trust Bank Ltd
16. Dubai Bank Kenya Ltd
17. Ecobank Kenya Ltd
18. Equatorial Commercial Bank Ltd
19. Equity Bank Ltd
20. Family Bank Ltd
21. Fidelity Commercial Bank Ltd
22. Fina Bank Ltd
23. First Community Bank Ltd
24. Giro Commercial Bank Ltd
25. Guardian Bank Ltd
26. Gulf African Bank (K) Ltd
27. Habib Bank A.G. Zurich
28. Habib Bank Ltd
29. Imperial Bank Ltd
30. Investment & Mortgages Bank Ltd
31. Jamii Bora Bank Ltd
32. Kenya Commercial Bank Ltd
33. K-Rep Bank Ltd
34. Middle East Bank (K) Ltd
35. National Bank of Kenya Ltd
36. National Industrial Credit Bank Ltd
37. Oriental Commercial Bank Ltd
38. Paramount Universal Bank Ltd
39. Prime Bank Ltd
40. Standard Chartered Bank (K) Ltd
41. Trans-National Bank Ltd
42. UBA Bank (K) Ltd
43. Victoria Commercial Bank Ltd