

**THE IMPACT OF NON-PERFORMING LOANS ON THE
PERFORMANCE OF THE BANKING SECTOR IN KENYA**

BY:

D61/70136/2008

BERNARD WAMBUA MUASYA

**A MANAGEMENT PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE
REQUIREMENT OF THE MASTER DEGREE IN BUSINESS ADMINISTRATION,
FACULTY OF COMMERCE, UNIVERSITY OF NAIROBI.**

OCTOBER 2009

DECLARATION

I declare that this is my original work and has not been presented in any university for the award of degree.

Signed.......... Date.....21/11/2009.....

Bernard Wambua Muasya

D61/70136/2008

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

Signed.......... Date.....21/11/09.....

Ondigo

Senior lecturer, department of accounting & finance

University of Nairobi

School of business

DEDICATION

To my Dear Parents

Onesmus Muasya Mutunga and Veronica Kyee Muasya

Mum and Dad, thank you for all your support over the years. This is what has made this possible.

ACKNOWLEDGEMENTS

Much appreciation goes to all those who offered me moral and practical support in the production of this work. I am very grateful to my supervisor Mr. Ondigo, Senior Lecturer department of accounting and finance, University of Nairobi, for the guidance and advice he gave me right from proposal writing to the final project.

To my parents, sisters and brothers for your understanding support and encouragement

To my colleagues in the MBA class (Lwangu, Keith, Ruth, Mwikali and Agnes) and all those whose input was vital I say thank you.

To my friends Maungu, Mulwa, Musyimi, Kalende, Kinyua, and Oriwa for your encouragement

To my colleagues at work (Munyao, Mbogo, Munene, Ayako, Nzioki, Mutie, Nyambura, Orina and Nderitu) for your understanding and sitting in for me when I had to dash to class

ABBREVIATIONS

BOA	Bank of America
CAMEL	Capital & Reserves, Asset Quality, Management Earnings and Liquidity
CBA	Commercial Bank of Africa
C.B.K	Central Bank of Kenya
CBRC	China Banking Regulatory Commission
DTB	Diamond trust Bank
GDP	Gross Domestic Product
I& M	Investments and mortgages Bank
IMF	International Monetary Fund
KCB	Kenya commercial Bank
M.B.A	Masters in Business Administration
NBFI	Non Bank Financial Institutions
NBK	National Bank of Kenya
NPLs	Non-Performing loans
NIC	National Industrial credit Bank
PRC	People Republic Of China
U.S.A	United States of America

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ABSTRACT

This study was carried out with objective of finding out whether the commercial banks in Kenya have been impacted by the problem of non-performing loans in this time of global financial crises.

The findings confirms that nonperforming loans do affect commercial banks in Kenya further analysis of individual commercial banks with more than Ksh 25 billion worth of asset indicated while the impacts are negative the magnitude of nonperforming loans to both interest income and profitability are not adverse for 7 of the 13 analyzed banks and that asset quality of the whole banking sector has been improving to settle at 7.17%. Unlike commercial banks in the America and Europe no bank in Kenya has made losses due to the negative impact of NPLs singled handed even in the first half of the year 2009

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The banking industry has experienced significant changes in the amounts of financial assets it holds in the last decade. Both internal and external factors have affected the amounts of loans that have been issued in the banking industry. This in return has fuelled an increase in the non performing loans. According to central bank of Kenya prudential guidelines, bad loans are facilities whose repayment is not in accordance with agreed terms and are in arrears (Business intelligence Q2 2009)

The existing proportion of gross advances to total industry assets of is 57% and 55% as at December 2008 and December 2007 respectively. The main business of financial institution is to advance credit to customers the inability of customers whether corporate organizations or individuals to pay their loans as per the agreed repayment schedule has contributed largely to the ongoing global financial crisis. Currently the biggest problem facing commercial banks is the increasing amounts of non-performing assets which have to be provided for in the financial institutions income statement or written off thereby impacting on the performances of the banking sector. A robust banking sector should be able to withstand negative economic shocks and contribute to the general stability of the financial sector and the wider economy. (Business intelligence Q2 2009)

Presently, several developed countries including the USA are experiencing a banking crisis for example Citibank group alone has written of more than 39 billion dollars in losses (Elliot 2008).despite the problem facing global financial market, the Canadian banks have remained relatively stable. Elliot (2008) attributes this to a combination of regulatory discipline and cultural mindset among Canadian banks

In the last five years from 2004 to 2008 commercial banks in Kenya have engaged in the aggressive loan marketing. in the same period in the American economy commercial banks were increasing in their lending to both corporate organizations and individuals which then turned bad and several too big to fall commercial banks have had to fall due to the problem

The Kenyan commercial banks have not been spared from the threat of the commercial increased non performing loans especially owing to the fact that a large portion have huge levels of provisions, medium to high asset quality ratios and also have advanced credit card facilities to their customers which was contributor to the American banks increased losses from the global financial crisis

1.1 .1 Non-Performing Loans in Kenya

Meaning of Non-Performing Loans

According to Central Bank of Kenya prudential guideline 2006 advances are classified into five categories:

1. Normal- these are well-documented facilities to financially sound customers where no weaknesses exist. Such advances must not have been rescheduled.

2. Watch- these are good accounts which are normally classified under 1 above but have exhibited some specific weaknesses and hence warrant management attention
3. Sub standard- these are facilities which though still operative involve some degree of risk and there exists possibility of some future loss unless close supervision is given and corrective action is taken to strengthen the position. For instance three months installments in arrears.
4. Doubtful debts- these are advances where major weaknesses exist. The recovery of full amount outstanding might need to be extended or is doubtful and that loss will occur. An example is an overdraft whose turnover has dried up
5. Loss- these are facilities with outstanding arrears that are regarded as being uncollectable and where security is worthless or has been disposed off, the proceeds of which have not covered the total debt and the balance remaining is unlikely to be recovered.

Non- performing loans include substandard, doubtful and loss categories.

1.1.2 Loan provisioning

For normal and watch facilities, only general provisions of 1% and 3% of the outstanding loans are required. Specific provision of 20% is required for sub-standard loans and interest should be suspended. A specific provision of 50% net of interest suspended should be made for doubtful loans while full provisions net of interest is required for loss loans(prudential guidelines CBK 2006)

In the relationship between borrower (customer) and lender (bank) unexpected misfortunes sometimes occur leading to default in schedule repayments. This default on a persistent basis becomes a bad debt to the financial institution. These bad debts are referred to as non-performing loans. Mutie (2006)

According to Kamara et al, (1997), a classic case of financial crises precipitated by bad debts is the financial turmoil that befell East Asia in late 1990's, affecting mainly Thailand, Indonesia, Malaysia and South Korea. At that time, more than 15% of bank loans in the four countries were non-performing compared to only 1% in the United States of America

The high level of non-performing loans continues to be an issue of major supervisory concern in Kenya. The level of non-performing loans has been increasing steadily (Bank Supervision Annual Report 2001). Even the best banks with good lending policies and procedures do become victims of non-performing loans in one way or another. The magnitudes of non-performing loans worry bank policy makers. These loans have made some banks fall into liquidation and closure. (Central Bank Annual Report, 2004).

According to Kiyai (2003), the bank performance and employee remuneration largely depended on the size and quality of banks loan book. Loans form a major component of Banks balance sheet and any change in its composition affects the entire structure. The downside of this is that lending presents the greatest risk exposure should the customer fail to repay. This default on persistent basis becomes bad debt to the banks. One of the greatest challenges facing commercial banks in Kenya today is how to deal with the growing portfolio of bad debts. He concludes that it requires careful appraisal of loan requests and continuous monitoring of customers conditions to overcome the problem of bad debts.

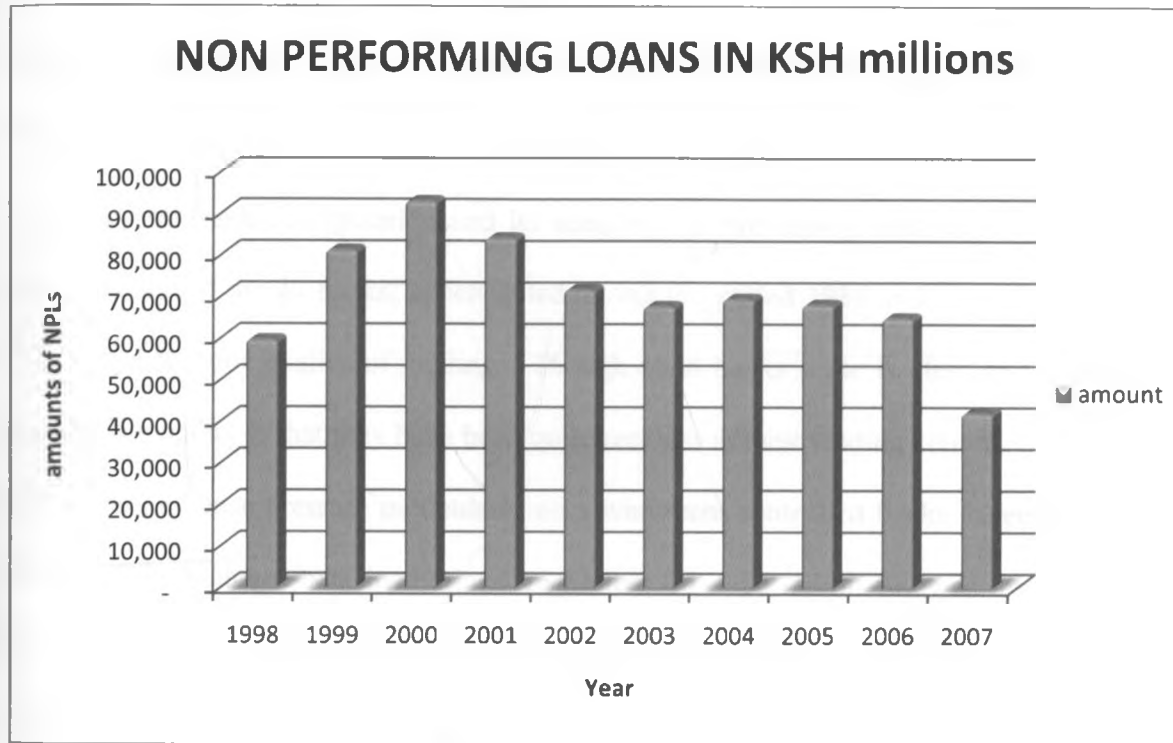
Non-performing loans is the single most important threat that a bank can face. To assess its magnitude, it is weighted against the total portfolio of all loans and advances that the bank has extended. A high ratio of non-performing loans to advances is a reflection of imprudent lending practice and poor credit management. It poses a threat to customer's deposits. A low ratio is

therefore desirable. When loans become non-performing, they hurt the banks liquidity and impact negatively on its earnings.

1.1.3 Trends of non-performing loans in Kenya

The graph below shows the trend of non-performing loans from year 1998 to 2007

Table 1 trends of non-performing loans



Source: Banking Survey 2008

1.2 PROBLEM STATEMENT

The banking industry has improved tremendously in the last decade in the products and size .For instance, total loans have increased by 113.83% from Ksh 252 billion 1997 to Ksh 542 billion in 2007 The industry has seen a sea saw of increases and decreases in the level of non-performing loans from 60 billion in 1998 to a peak of 92 billion in year 2000 and has gradually reduced to a

level 42 billion in 2007 indicating a change of -29%.(Banking survey 2008).Incidentally, there has been a marked increase in real GDP of Kenya from 0.2% in 1998 to 7.0% in 2007(Kenya economic survey 2009).

A stable financial sector is one that the participants are in a position to meet their financial obligation. The general increase in profitability can only be sustained if customers are able to service their loans.

In a study on banking regulation and its adequacy in preventing bank failure Obiero (2002) found that out of the 39 banks, which failed during the period 1984 and 2002, 37.8% collapsed mainly due to poor quality of lending. Though most banks pride is clear and sound lending policies, the reality is that they have been quite reckless in their lending activities. Coupled with this, is the immense pressure particularly on government controlled banks to lend to politically connected individuals and institutions regardless of their credit showed that the greatest precipitator of the banking crisis in the late 1980s and the 1990s were bad corporate governance and poor quality of loan assets

Matu (2001). Showed that the high levels of non-performing loans puts pressure on the banks to retain high lending rates in an attempt to minimize losses associated with these loans.

Kiyai (2003) showed that a combination different techniques of enticing defaulting customers yield better results. he stated debt restructuring by redefining interest rates was the top preferred method of addressing the problem of NPLs. he also found out that no relationship existed between debt restructuring and the levels of non- performing loans

Mutie (2006) found that 61% of Kenya commercial banks had moderate levels of nonperforming loans compared to 39% that had significant low levels of non- performing loans

According to kroszner (2002), non performing loans are closely associated with banking crises .sultana 2002 also links the Japanese financial crisis to non performing loans according to sultana the Japanese economy suffer under the weight of thousands of billions of yens of bad loans resulting from collapse in asset prices a decade ago in the country's financial system

However, little is known about the impact of aggressive loan marketing seen in the last five years and impact of global financial crisis on the banking sector and how sensitive to changes the in both economic conditions or non performing loans can affect the banking sector performance

With respect to the Kenyan banking sector

The research to be conducted will aim at shedding some light on the main reasons for increases in the non-performing loans and their impact on the stability of the banking sector a survey to evaluate the risk that non performing loans pose in Kenyan commercial banks and asses the relationship between these NPLs with the profitability and interest income since non performing loans affect revenue collection and are also increase the cost due to provisioning of loan loss and other general provisions commercial banking will help shed light and prepare the government through central bank of Kenya, in putting in place sound monetary and fiscal policies, banking and financial sector.

1.3 OBJECTIVE OF THE STUDY

To assess the how non-performing loans affects the performance of commercial banks in Kenya

1.4 IMPORTANCE OF THE STUDY

The findings of the study will be beneficial to the following groups in decision-making:

(i) Creditors

To assess the credit worthiness of Commercial Banks based on both financial losses and operational losses reports without ignoring the later as it equally affects profitability.

(ii) Investors

The study will make the investors recognize that the overall level of non-performing loans equally affects their return on investment and hence not ignore the NPLs element when making investment decisions.

(iii) Commercial Banks Manager

The study will make the commercial banks managers appreciate the need to monitor and control non performing loans as it equally affects the profitability though provisions made by the commercial banks.

(iv) Commercial Banks Employees

The staff involved in the day-to-day operating activities will draw inference to the study in appreciating the need for controlling operational losses as it affects profitability and their future benefits in the bank

(vii) Management Consultants

With this study the management consultants can advise on the best investment decisions based on not only the financial losses position but equally considering the inherent non performing loans as they also impacts on the profitability of commercial banks.

(viii) Academicians

The academicians will find the study useful as it will highlight areas for further research and also it will contribute to new knowledge. Also the study will give an insight of how the operational losses affect various stakeholders in the banking sector. The academicians being charged with dissemination of knowledge to various stakeholders will hence find this study useful when doing so.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter will bring together diverse streams of literature in accounting and finance that have touched the performance and non performing loans both locally and internationally. It will also take into account the legal requirements of the regulation of commercial banks by central bank of Kenya and look into the risks and policies that face commercial banks and the studies that have been done in Kenya.

2.1.1 Overview of the Kenyan Banking System

Commercial banking took root in Kenya at the turn of the 20th Century with the partitioning of Africa by the European Imperial Powers. The first bank to establish operations was National Bank of India, which started a branch in Mombasa in 1896. By 1972, there were a total of 12 Commercial Banks operating in the Kenyan – market. As at December 2008, the banking sector comprised 43 commercial banks, 2 mortgage finance companies. (Central Bank of Kenya website 2008).

Commercial banks play a crucial role in an economy. Their traditional role is financial intermediation involving mobilization of deposits from Surplus units in the economy and lending to the deficit units to finance their productive Investments. By lending to Manufacturers, farmers, distributors and traders, banks play a crucial role in the economic development of the country (Metropol, 2002

As profit seekers, commercial banks are inclined to formulate policies that aim at diversifying their portfolio and thus guaranteeing some minimum rate of return. To achieve the objective of profit maximization, banks make decisions to invest excess cash in varying securities, involving not only the amount to invest but also the types of security in which to invest. These decisions are normally based on evaluation of expected net cash flows and the uncertainty associated with the cash flows.

2.2 RISK

Risk refers to the potential variability of outcomes from a decision alternative. It can also be defined as the exposure to change or the probability that some future events will occur making the expected and actual outcome to differ from the expected. The wider and regular the variability, the greater the risk.

2.2.1 CREDIT RISK AND OTHER TYPES OF RISKS

This is the risk that the customer or counter party of the bank will be unable or unwilling to meet a commitment that it has entered into with the bank that is the failure of counter party to perform according to a contractual arrangement. The risk applies not only to loans but also to other on- and off-balance-sheet exposure such as guarantees, acceptances and security investments (Hempele, et al, 1994).

The largest source of credit risk is loans, although the credit risk exists in other activities of the institution, including acceptances, inter-bank transactions, trade financing, foreign exchange transactions, futures, swaps, options and guarantees. On average the size of the loans portfolio constitutes 63% of the bank's assets in Kenya. This renders credit risk currently the most

significant risk to the local banking sector. An effective and sound credit risk management is therefore critical to the success of any banking sector (Central Bank of Kenya Risk management Survey, 2004).

Additional dimensions of credit risk in the context of cross-border transactions include

Transfer Risk: When the currency of obligation becomes unavailable to the borrower regardless of its financial condition.

Country Risk: This is the risk associated with the economic, social and political environment of the borrower's country.

Other risks facing commercial banks are

Operational Risk; these are risks related to the banks overall business. Mostly focuses on capital requirements and the whole operating activities of the bank. Event risk; This is the risk resulting from sudden and unexpected changes in financial market conditions due to events such as war, revolution, or sudden

Yusuf (2005) conducted a survey of operational risks management practices by commercial banks and found that operational risk departments exist only in the big banks. He noted that the most common categories of operational risks in Kenyan Commercial banks are human risks, which arise from failure of employees and conflict of interest or from other internal fraudulent behaviors; external risks, which arise from fraud or litigation by parties external to the firm and weaknesses in processes.

Liquidity risk -This arises from banks inability to meet its obligations as and when they fall due without incurring unacceptable losses. Inadequate liquidity affects profitability and in extreme cases, can lead to insolvency.

Foreign exchange risk- This refers to the risk of losses in on-or off balance- sheet positions arising from adverse movements in exchange rates.

Market risk The risk of losses in banks' on and off-balance sheet positions arising from movements in market prices that change the market value of an asset or a commitment is described as the market risk.

Interest rates risks Refers to the exposure of bank's financial condition to adverse movements in interest rates. This risk arises as a result of a mismatch between a bank's interest rate sensitive assets and liabilities and affects both the earnings of a bank and the economic value of its assets, liabilities and off-balance-sheet instruments.

If commercial banks choose to invest in loans and advances, there is a risk default associated with these investments. Such investments potentially have negative consequences for bank earnings because some of the loans and advances to customers may end up as bad or doubtful debts. This risk may or may not be covered by collateral securities or high rates. If the risk is covered by high lending rates, these compensate for the high risks and the costs incurred in valuing collateral securities, negotiation and debt financing.

2.2.2 RISK ASSESSMENT

The credit decision should be based on a thorough evaluation of the risk conditions of lending and the characteristics of the borrower. Risk is a decision problem, there must be an individual

or group that is faced with a problem, that is, a decision maker. The decision might be whether to award credit or not. The decision maker must be seeking to achieve some objective, like to earn revenue from successfully awarded loans overtime.

Several alternative actions or strategies, which can possibly achieve the stated objective, must be available to the decision maker. In addition, a state of doubt must exist within the decision maker about which alternative action is best in seeking to achieve the desired objectives (Luce, et al 1957).

2.2.3 CREDIT POLICY

A way of improving the credit management and credit analysis decision making involves the borrower being granted credit facilities on the basis of credit worthiness. Credit scoring models are some of the techniques used to determine the credit worthiness of borrowers. Credit scoring refers to the mathematical or statistical process of converting data about a prospective applicant or customer behavior (Bill, 1998). Using historical data and statistical techniques, credit scoring tries to isolate the effects of various applicant characteristics on delinquencies and defaults (Mester Loretta J. 1997).

2.2.4 CREDIT CONTROL POLICY & RISK MANAGEMENT IN COMMERCIAL BANKS

There is a need for an effective credit control policy to manage credit risk and in order to ensure a fairly health credit management program, with minimal expensive bad debts, and minimized credit risk, a company strives to establish an effective credit control and lending policy.

Surprisingly, a few companies do not have any such policy and even more worrying, many of the

companies with credit control policies still fail to operate the policies so much so that the companies' debts sour and seriously affect the companies' very existence, in terms of profitability and health cash flow (Central Bank Risk Management Survey 2004).

Credit control policy is the general guideline governing the process of giving credit to the firm's customers. The policy sets the rules on who should get what credit and when and why one should get credit and why one should get credit including repayment arrangements and necessary collaterals. The method of assessment and evaluation of risk of each prospective applicant are part of credit control policy.

The maintenance of asset quality is fundamental to the sound operation of a commercial bank.

The board and management should establish policies and procedures, which ensure that the bank has a well documented credit granting process, a strong portfolio management approach, prudent limits, effective credit review and loan classification procedures and an appropriate methodology for dealing with problem exposures.

According to Simonson et al (1986), a sound credit policy would help improve prudential oversight of asset quality, establish a set of minimum standards, and to apply a common language and methodology (assessment risk, pricing, documentation, securities, authorization and ethics), for measurement and reporting of non-performing assets, loan classification and provisioning. The credit policy should set out the bank's lending philosophy and specific procedures and means of monitoring the lending activity.

2.2.5 CREDIT POLICY OBJECTIVES

A company's Credit Policy Objectives include: Sales revenue increases through deepening of sales; encourage movement of slow moving stock; a competitive tool to gain a competitive advantage in the market, minimize cost of idle cash; encourage growth; to effectively avoid customers nobody else wants; minimize credit risk taken by the firm; and minimize credit taken by the firm; and minimize non-performing loans in case of commercial banks.

A firm's credit policy may be lenient or stringent.

Lenient; with this form of credit policy, the firm lends liberally even to those whose credit worthiness is questionable. This leads to higher borrowing, high profits, assuming full collections of the debts owed.

Stringent; under this type of credit policy, credit is restricted to carefully determined customers, through credit appraisal systems. This minimizes costs and losses from bad debts; however, it may reduce revenue earnings from credit, profitability and cash flow.

Every financial institution bears a degree of risk when the institution lends to businesses and consumers and hence experiences some loan losses when certain borrowers fail to repay their loans as agreed. Principally, the credit risk of a bank is the possibility of loss arising from non-repayment of interest and the principal, or both or non-realization of securities on the loans.

2.3 CAUSES OF NON-PERFORMING LOANS IN KENYA

The high level of non-performing loans continues to be an issue of major supervisory concern in Kenya. The level of non-performing loans has been increasing steadily (Bank Supervision Annual Report 2004)

Even the best banks with good lending policies and procedures do become victims of non-performing loans in one way or another. The magnitudes of non-performing loans worry bank policy makers. These loans have made some banks fall into liquidation and closure. (Central Bank Annual Report, 2004).

The causes of non-performing loans are:

1 Poor and unprofessional Credit evaluation

With the due respect to lending decisions made in the past by the financial sector, a lot of emphasis has been put on security than other similar important considerations. There are instances in the past when it was easier to get a loan from financial institutions as long as the borrower has security to be charged than the ability to service the loan. Cash flow projections, viability of the projects, character of the borrowers, previous loans completion and ability to repay were not considered as important. This way a number of banks ended up with many non-performing loans due to incomplete, poor and unprofessional credit risk assessment and evaluation.

2 Adverse economic conditions

Kenyan economy has been performing very poorly in the last decade or so and continues to decline. This has to a large extent been a major contributor to the bad loan scenario. The poverty affected, especially the capacity to pay and collateral values.

3 Insider borrowing

Major shareholders, directors and members of staff in many instances contribute to non-performing loans problems because they are not subjected to normal objective credit assessment before disbursement of loans to them.

2.3.1 STUDIES DONE IN KENYA

High interest rates reduce the borrower's net worth, which has a negative impact on investment and financial intermediation leading to rising non-performing loans and bank failures. In these circumstances, it is high-return, high-risk projects that are financed suggesting instances of adverse selection and moral hazard. Ndii (2000) argues that high interest rates contribute to high default rates and the decline in interest margins implies bad borrowers may be able to resume servicing their facilities. It also means a shift in strategy among the banks with emphasis on margins from volumes and diversification to non-interest income streams. This scenario persisted for much of the last decade and while the Government had managed to control inflation by 1994, real interest rates remained high, indicating a continued high cost of investment. Mucheke (2001) also cites interest rates as one of the contributory factors to non-performing loans

Bindra (1998) argues that the true underlying cause of non-performing Loans is entirely of our own making: poor risk mismanagement. This is a situation whereby the bank credit officials do not properly assess the suitability of advancing credit to their customers; they do not adhere to the good lending principles. Practically all affected banks display similar symptoms: insider lending; poor monitoring of loan accounts, under-qualified staff, little or no cash flow appraisal of loan projects. He concludes that loan losses can be minimized through professional

management of the lending function. This requires careful appraisal of loan requests, continuous monitoring of customer conditions and proper follow up on how the loan has been utilized as there is a possibility that the loan may not be utilized for the intended purpose leading to project failures.

Wagacha (2000) asserts that a depressed macroeconomic environment ensures that lending and loan collection are operated in a contracting economy. The un-availability of donor funds both from IMF, World Bank and the European Union has further aggravated the problem of declining growth of the economy. With this situation, little activity goes on in the banking sector, as most people cannot afford credit. Anyanzwa (2004) attributed the increased provisioning for bad loans by Barclays bank from Ksh 1 billion to 1.4billion for the period second quarter 2003 and same period 2004 to the difficult national economic environment that has adversely affected the financial performance of the banks customers. He said that any further delay in resumption of donor support is likely to put upward pressure on interest rates, ultimately impacting negatively on the already sluggish economic growth.

He also argues that insider lending and fraudulent activities by directors of some Banks have led to the problem of non-performing loans and final collapse of some Banks, collapse of Trade Bank serves as a good example of his argument. He further reiterated that poor lending by political Banks has added to non- performing loans as related party lending to dominant shareholders has led to a situation whereby prominent people are advanced credit with no intention of paying back. He also observed that failed banks were lending at high interest rates

Muthuma (1997) argues that the poor fiscal policy had resulted to high inflation rates and that this could be one of the contributors of non-performing loans. Inflationary expectation is a factor that is embedded in the interest rate. Interest will remain high if investors believe that the government will introduce inflation in the future by adding money in circulation through extended credit from the Central Bank. He was however perplexed on how we would justify a case as that of leading foreign Banks, Barclays Bank and Standard Chartered who continue to reap huge profits while recording a decline in their level of non performing loans and yet operate in the same economy as other banks.

Bindra (1998) questioned why Kenya had 55 banks in the first place in an economy this small and why so many of them were allowed to build up huge stocks of non-performing loans by lending to "connected" individuals, with little or no security without any intervention from Central Bank. He concluded that the problem of non-performing loans was precipitated by poor regulation and supervision by the Central Bank of Kenya.

Mohua (1998) argues that if the legal framework worked and there was a tradition of honoring contracts, disputes would likely not be tied up in courts for years. The failure to enforce rules and regulations now afflicts every sector of the Kenyan economy and even deny justice to banks who are eager to liquidate collateral security. He further lamented that nowhere can we see transparency and accountability; instead, graft and cronyism are pervasive, an economy built on patronage and underhand dealing does not produce world-class managers or competitive products, it produces charlatans and rejects. He concluded that ineffective administration of

justice was indeed a major cause of non-performing loans as court cases take a longer period to be concluded.

In conclusion, the key causes of non-performing loans in the banking industry are three-pronged. These are factors specific to internal organization, factors relating to the macro-economic policies, which ultimately determine how the economy works, and finally those factors relating to the actual management of business, Muccheke (2001).

2.3 .2 EARLY WARNING SIGNS OF LOAN DELINQUENCY

According to Rouse (1989), information which leads a lender to suspect that a borrower is in financial difficulty can come from many sources but will usually arise from carrying out monitoring and control procedures. Some of the signs of possible delinquency are late payment of principal and interest, unauthorized overdraft excess, significant changes in account turnover, hardcore balances, and unpaid cheques (in and out), high gearing ratio, operating losses, abnormal delays in submitting periodic financial statements, unexplained change of borrowers attitude towards the bank among others.

The information may be obtained from internal records, through interviews with the borrower, audited accounts and management accounts. Taken individually, one sign may not cause undue concern, but careful investigations will be necessary where a number of them appear together.

2-4 CONTROLLING LOAN LOSSES

kiyai (2003) states that credit analysis has not progressed to the point where it is possible to predict with absolute accuracy whether or not a loan will be repaid as agreed. Invariably, commercial banks find a certain proportion of their loans become delinquent.

According to Matu (2001), the basic risk of the lending function is not entirely bad; commercial banks would be remiss in not bearing such risk in the course of underwriting a variety of business enterprises and consumer needs,

Sinkey (1992) states that commercial Banks must maintain surveillance of its loans. The frequency of reviewing individual loan exposures depends on the size and quality of the loan. Large poor-quality loans must be reviewed frequently. Aspects that should be of interest to the loan reviewer include perfection of securities, completeness of documentation, financial condition and repayment ability of the customer, consistency with loan policy, legal and regulatory compliance and profitability of the loan arrangement.

The importance of periodic loan review is that the bank is able to detect actual or potential problem loans as early as possible, enforce uniform loan documentation, ensure that the bank's loan policy is followed and determine the overall condition of the loan portfolio.

Once a loan exposure has been found to be facing difficulties, immediate action should be taken (Sinkey, 1992). If it is clear that the account is not going to improve, then it is advisable that the bank goes for a break up solution through realization of securities. The bank should go for a work out solution only if there is clear evidence the customer is able to regain his financial health and resume loan repayment.

2.5 REDUCING LEVELS OF NON-PERFORMING LOANS

1 Restructuring

Faced with an increasingly competitive operating environment, high overhead costs, reduced interest rate margins and high levels of non-performing loans, the banks have reacted by

restructuring their operations argues Kiyai (2003). This involves right sizing of establishment, greater focus on customer service through tailored propositions and restructuring of non-performing loans with the aim of turning them to performing status. The multinational banks have also withdrawn from marginal areas and tended to concentrate their operations in high potential urban areas. To upgrade service quality and delivery, many financial institutions have invested in modern information technology.

2 Reduce high interest rates

The central bank has reduced the cash reserve ratio CRR from 5% to 4.5% and also reduced their lending rates to commercial banks from 8% to 7.75% in June 2009. by taking this move the central bank anticipated that commercial banks will lower their lending interest rates at that has not yet to have happen which indicates there might be a problem in the provisioning of the commercial banks

To reduce compliance pressure, the minimum core capital requirement has also been reduced from Ksh 500 Mn and Ksh 375 Mn to Ksh 250 Mn and Ksh 200 Mn for banks and Non-Banking Financial Institutions respectively. To reduce information asymmetry between the banks, depositors and customers, it's now a requirement for banks to periodically advise CBK their commission tariffs and interest rates. This information is then published for public consumption.

Other measures might include

- a) Formation of a Credit Reference Agency, to ensure defaulters are not extended credit by other lending institutions thereby increasing nonperforming loans
- b) Improvement in the Court System. To aid in the recovery of assets once loans go bad
- c) Non- Performing Assets Recovery Trust

- d) Co- Financing in case of large exposures. By having several commercial banks advance credit to the one customer and thereby reducing/sharing credit risk
- e) Strict Supervision by Central Bank to ensure that proper procedures are followed by Commercial Banks for any Credit advanced
- f) Renegotiated debt. To give customers better repayment time lines especially in hard economic times

2.6 MEASURES OF ASSET QUALITY

Non-performing loans are those loans that are not being serviced as per the loans contracts and expose the banks to potential losses (Central Bank annual Report, 2008). A mismatch in management of major balance sheet items can cause banks to close down. Changes in the relative structure of assets and liabilities should be a conscious decision of banks policy makers, in most cases the Board of directors. According to Simonson et al (1986), what differentiates well managed banks from badly managed banks is the proportion of the delinquent loan books. Banks must do everything they can to minimize loan delinquency. This requires them to continuously review individual exposures in order to monitor loan quality and reduce losses. The success of individual banks in credit risk management is largely reflected in the proportion of NPL's loans to gross lending. Asset quality which is measured by the Asset quality ratio is an indicator of the level of non-performing loans (Thygerson, 1995) calculated as:

$$\text{Asset quality} = \frac{\text{Total non- performing loans}}{\text{Total Loans}}$$

The smaller the ratio, the better the asset quality.

2.7 INTERNATIONAL EXAMPLES OF BANKING CRISIS

AMERICA USA

According to Jason Goldberg, America is facing a revolt by shareholders, delivered a gloomy assessment of economic conditions as a surge in bad loans forced it to set aside \$13.4bn (£9.2bn) to cover credit losses.

BoA reported a first-quarter profit of \$4.2bn, compared with \$1.2bn for the same period a year ago. But analysts said that after stripping out a series of large one-off gains, the bank's underlying performance was closer to break-even. Shares in BoA plunged more than 24%, dragging down market indicators by over 3% on worries about the US financial sector. Citigroup fell by more than 16% after analysts said that credit losses continued to grow. Reports that the US government may swap its support for ailing banks for share stakes as its bailout funds dwindle added to the downward impetus. The drop put paid to a week-long rally in US banking shares, built on fragile hope that the worst may be over in the ongoing financial crisis.

BoA has faced severe criticism over its takeover of Merrill Lynch in September, the chairman of Merrill Lynch "gratified" with the performance of both Merrill and the mortgage company Countrywide Financial, which BoA rescued from the brink of bankruptcy a year ago. But he offered little optimism over short-term market conditions as cash-strapped consumers default on loans and credit card payments: "Make no doubt about it, credit is bad and we believe credit is going to get worse before it will eventually stabilize and improve."

Merrill contributed \$3.7bn to its profits to BoA, before taking into account merger costs of \$510m. The company benefited from a \$2.2bn gain on the upward revaluation of certain of Merrill's structured notes, together with a \$1.9bn exceptional profit on the sale of shares in China Construction Bank. About \$45bn of government funds have been pumped into BoA. The bank is awaiting the results of government "stress tests" being applied to all major US financial institutions.

USA Bank in Port Chester reported larger losses last quarter of 2008 in the face of flat revenue and a sharply larger portfolio of bad loans. The bank had 10 nonperforming loans that it valued at \$11.9 million by the end of last quarter, up from \$3.7 million a year earlier. The loans represented 7.3 percent of the bank's loan portfolio, according to the bank's president and chief executive officer Ronald Gentile, the collateral underlying the bad loans exceeded their outstanding balance, however. The bank increased its loan-loss provision to \$2.41 million, up 46 percent from a year earlier.

Most of the troubled loans were for house construction and other land development. The bank stopped providing loans for construction of property for which the developer hasn't found a secure buyer or tenant. Loans that were past due 30 through 89 days rose sevenfold year over year, to \$21.1 million, according to a bank filing with regulators.

USA Bank also is feeling the pressure of lower interest rates. Gentile said the bank may lower interest rates on its six-month and one-year certificates of deposit by one-quarter percentage point over the next few months.

BULGARIA -EUROPE

The problem of bad enterprise and bank debts has developed into one of the most acute economic problems Bulgaria. The general delay in implementing comprehensive policy measures to combat this issue as well as mismanagement contributed to the snow-balling of bad loans. In the case of Bulgaria this led to a major financial crisis and the authorities had to undertake a large-scale rescue operation.

The experience of the past three years or so indicates that there are no ideal definitive solutions to the bad-loan problem. So the bad-loan problem has turned into one of the many dilemmas that economic policy makers of the PETs have to face up to.

The Bulgarian approach to the bad loans issue builds on ideas that have been debated in the literature and adds some new and original aspects. It is an attempt to link the process of cleaning up the bad loans to the recapitalization of commercial banks and to the process of privatizing In this respect it can be regarded as an element of a broader policy aimed at speeding-up the process of economic transformation of the country. He also found out that the Bulgarian approach has a number of weak features that may have undesirable consequences.

ASIAN EXAMPLES

Japanese banks have weathered the U.S. subprime mortgage crisis with smaller losses than their Western counterparts, but they have been hurt by the fallout from the global slowdown for instance, Major Japanese bank Mizuho Financial Group stayed in the red last quarter, posting a 4.49 billion yen (\$47.3 million) loss as derivatives trading soured and bad loans surged

The bank's bad loans stood at 76 billion yen during the April-June quarter, up from 4.7 billion yen a year earlier. Losses on derivatives trading totaled over 87 billion yen in the quarter.

Mizuho's April-June revenue sank 26.5 percent to 703.47 billion yen (\$7.4 billion) but it noted signs the downturn may be slowing and stock prices are recovering.

All of Japan's "Big Three" banking groups, which include Mizuho, sank into losses for the fiscal year ended March 31, battered by a stock market plunge.

TAIWAN

Financial crises have been a worldwide phenomenon in the last decade. This study tries to investigate how the 1997 Asian financial crisis affects the non-performing loans of Taiwan. We adopt a panel data set with 40 Taiwanese commercial banks (established before 1996) for the period of 1996-1999 for empirical analysis. We find that both banks' loans and sizes are positively related to the rate of non-performing loans, but at a diminishing rate; rates of non-performing loans steadily increased from 1996 to 1999, possibly resulting from the 1997 Asian financial crisis; banks established after ...

According Michael Pomerleano, A healthy financial system is said to be the lifeblood of a country's economy. We have witnessed Japan's moribund economy in the 1990s where ailing banks kept afloat by public money peppered the economy. With some signs of an economic turnaround, Mr. Pomerleano's discussed risk analysis of Asia's banking systems using the standard supervisory framework, which assesses capital and reserves adequacy, asset quality,

management earnings, liquidity, sensitivity to market risk; also known by the acronym

CAMELS.

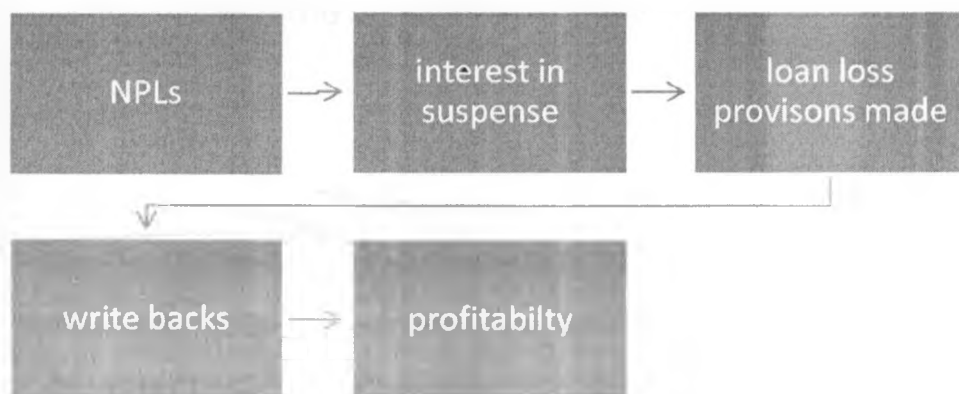
Using the International Monetary Fund's 2009 Financial Stability Indicators data, the CAMELS test revealed that Asia's banking system is reasonably capitalized except for Japan and the People's Republic of China (PRC), whose capital quality and rapid credit growth respectively, could be causes for concern. While asset quality has markedly improved in the region, government pressure on banks to boost lending may increase future non-performing loans (NPLs); yet allowance for loan losses varies among countries in the region. Earnings are modest, except in highly competitive environments, like Japan where it remains low. Only the Republic of Korea faces liquidity issues, as its loan-to-deposit ratio is found to be high. Finally, unlike their counterparts in the United States and Europe, Asian banks are less exposed to credit and market risks. Overall, asset quality is expected to deteriorate, eroding profits and shrinking capital base. Given this scenario, contraction in lending is the likely outcome, painting a dim picture of Asia's banking system as downgrades by rating agencies are expected to continue in 2009. Mr. Pomerleano then discussed major forms of bank support in the Asia-Pacific region, namely (1) blanket deposit guarantees, (2) removal and guarantees of bad assets, (3) direct capital and liquidity support, (4) obligation guarantees, and (5) regulatory forbearance measures.

He pointed out their limitations, such as moral hazard and exit problems. He recommended full disclosure on the rare instances that they are employed. As for (2), resolution process of bad assets should rely on market forces as governments lack the expertise to handle this problem. Banks should meet certain prerequisites prior to receiving direct capital support to minimize

moral hazards. Currently, (3) mainly serves to maintain the public's confidence in banks and to keep the flow of bank lending while (5) is primarily designed to increase liquidity.

He then employed stress tests to better understand the region's capital shortfall. He assumed NPLs of 8% of assets, a 100% coverage ratio of reserves to NPLs, and a leverage ratio of capital to assets at 5%. Surprisingly, Asia's largest economies face a capital shortfall of US\$758 billion, of which US\$518.8 billion are needed by Japan and US\$109 billion by the PRC. Other countries that face capital shortfalls are Hong Kong, China (US\$30 billion); Republic of Korea (US\$44 billion); Taipei, China (US\$37 billion); New Zealand (US\$14 billion); Indonesia (US\$5 billion); Malaysia (US\$3 billion); and Singapore (US\$5 billion); while Thailand and the Philippines will not need additional capital. It takes about 3.5 years for credit to resume growth. To meet long-term finance, equity and debt markets could offer the needed funding in lieu of banks

2.8 CONCEPTUAL FRAMEWORK



A chart of conceptual frame work

2.9 CONCLUSION OF LITERATURE REVIEW

Controlling risk should be a key management goal in commercial banks .this is because there nature of their main business lending has is faced with default loan default risk which according to the prudential guideline by the central bank of Kenya should affect their performance .being able to forecast and anticipate the risks with certainty may be a problem Kiyai (2003) established economic conditions have a link with levels of nonperforming loans. No current research has been carried recently on the impacts of non-performing loans on performance

No research has been carried out on the sensitivity of the of the major assets risk that and how forecasted losses may affect the performance of the a certain bank

This study will identify the impacts of non-performing loans to banking sector as it among the sectors which registered growth in the 2008/2009 economic review forecast the and analyze the sensitivity of performance of each as using forecasted GDP growth

CHAPTER THREE:

RESEARCH METHODOLOGY

3.1 INTRODUCTION

This chapter presents the research design and the methodology that will be used to carry out the research .it presents the research design, the population the data collection and analysis

3.2 RESEARCH DESIGN

The study is a survey, which sought to identify the level of nonperforming loans in Kenya for the period between 2004 and 2008 and their impact on profitability and interest income of commercial banks in Kenya. This because the in this period dynamic changes in both NPLs and profitability

3.3 POPULATION OF STUDY AND SAMPLING

A survey was conducted on all the commercial banks in Kenya as at 31st December 2008 as per the Central Bank of Kenya. The population of interest was the 43 commercial banks registered and licensed under the Banking Act. (Provided in appendix 1) sampling will be done based on the value of assets

A sample of commercial banks with more than Ksh 25 billion as at 31 December was selected. This sample was selected to capture all the commercial banks with more than 20 billion of loans and it was based on the industry average of Ksh 28 billion in total assets foe all commercial banks

The banks were analyzed separately to find out how the commercial banks may be affected by the problem of the non performing loans

3.4 DATA COLLECTION

The study used secondary data to achieve its objective.

The secondary data sources are periodically released by the central bank of Kenya, statistical documents, banking surveys of various years; Kenya national bureau of statistics publications, annual published accounts among other sources like euro money publications.

Data on the amounts of non-performing loans was obtained from the banking survey and published financial statements

Data on performance of commercial banks was obtained from the published financial statements and annual statements of the selected commercial banks. This data will be profitability and interest income.

3.5 DATA ANALYSIS AND PRESENTATION

Data was be analyzed using statistical package for social sciences (SPSS) and strata software for content analysis which was used in summarizing findings. The data was be presented in the form of graphs and tables

Forecasting of the trend of NPLs was be from the estimated economic growth from the Kenya commercial banking report Q2 2009 be used to analyze the impact of any changes in the non performing loans on performance

The research used a single regression equation approach to analyze the impact of non-performing loans to financial sector stability

The equation is $Y=B_0+B_1 \cdot X_i$ Where

Y is the dependent variable the banking sector performance

B_0 is the constant

B is the regression coefficient

X_i are the various variables such interest income, loans, NPLs, write backs and provisions

Several regressions were run with the primary one being profit and non-performing loan

A second one with all the variables was run and finally one with just NPLs interest income and provision as per the study framework Tests of significance was be done to determine whether the effect of nonperforming loans on profitability is significant. Also industry average was computed to determine the benchmark. The industry average is taken as a simple average of the banks under the study so as to see the impact of the current economic problems to total performance.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND INTERPRETATIONS

4.1 INTRODUCTIONS

The purpose of this study was to determine whether non performing loan have any impact on aspects of performance for this reason only profit before tax, interest income and write backs were used.

A regression of profit before tax and interest income, provisions, total non-performing loans was run and the results are presented in the tables below

Separate graphical representation of individual commercial banks with more than Ksh 25 billion worth of assets and how they can be affected by the problem of nonperforming loans has also been presented in this chapter

4.2 REGRESSION RESULTS AND ANALYSIS

The results presented in the tables below represent the SPSS regression and other descriptive statistics that have been done

TABLE 1 MODEL SUMMARY

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.947 ^a	.897	.846	5384.8301

a. Predictors: (Constant), LOSS, PROVISIO, NPLS

From the model summary the R is 0.947 shows how much the variable varies with the independent variable. The R squared and the adjusted R is 0.897 and 0.846.

This means that the non performing loans, loan loss and provisions do explain 84.6% of the changes that do occur in the banks performances .This kind of relationships are negative in that an increase in loan loss will impact negatively on the banks performance

This therefore leads to the conclusion that as expected the non performing loans through their influence in provision, interest suspended and loan loss have negative influence in level of performance as far as both interest income and profitability

The analysis of the variables is presented below in the ANOVA table

TABLE 2 ANALYSIS OF VARIABLES

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.52E+09	3	505556395.8	17.435	.002 ^a
	Residual	1.74E+08	6	28996395.38		
	Total	1.69E+09	9			

a. Predictors: (Constant), LOSS, PROVISIO, NPLS

b. Dependent Variable: PBT

Table 2 the p-value of the regression model non performing loans to income equals 0.002 while that for the profit is 0.004 implying that the model is statistically significant at 5% level of significance.

The coefficients have been presented in the table below,

TABLE 3 COEFFICIENTS OF REGRESSION

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	56637.553	7448.556		7.604	.000
	NPLS	-1.346	.299	-2.047	-4.498	.004
	PROVISIO	1.205	.416	.922	2.895	.028
	LOSS	1.417	1.117	.387	1.268	.252

a. Dependent Variable: PBT

From The Coefficients With A Significant Level Of 5% Shows That As Far As Profit Before Tax In Commercial Banks Is Concerned Non Performing Loans, Provisions And Loan Loss Are Significant Contributors to the performance of commercial banks

NPLS which represents non performing loans is negative hence representing the negative relationship between growth in bad loans and the performance of commercial banks for the last 10 years

A regression equation can be determined from the coefficients as follow

$$\text{Profitability} = 56637.553 + 1.205 \text{ provisions} + 1.417 \text{ loan loss} - 1.346 \text{ NPLs}$$

A more representative equation would be

$PBT = 56637.553 - 1.346NPLs$

The constant in this case is large which explains all other factors affect commercial banks performance for instance fees and commission exchange gains, trading in treasury bonds and other investments

A regression for interest income from loans and the level of nonperforming loans was also run and the results showed an R squared of 0.743 and an adjusted R of 0.684 this shows that the interest income of a commercial banks are impacted more than the overall profit for the organization

The coefficients also indicated significant results in terms with both NPLs having more than 95% significance towards contribution interest income

In both regression the standard deviation were not significant hence the conclusion that commercial banks can expect to be impacted negatively by the growth

4.3 ANALYSIS OF INDIVIDUAL COMMERCIAL BANKS

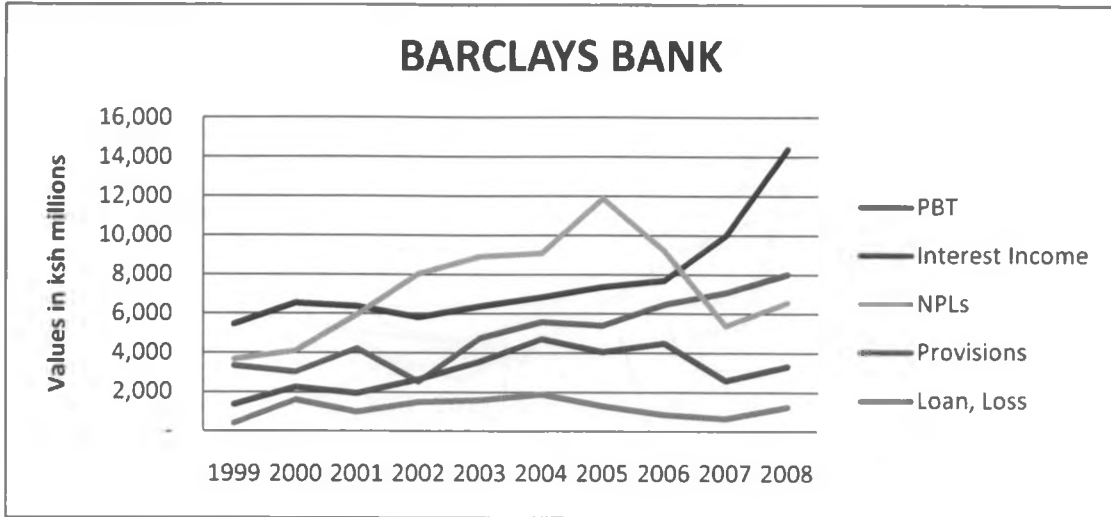
Commercial banks were analyzed individually to assess whether as a single entry in the banking sector the commercial banks are facing bigger risk or may be impacted more as an individual bank than when analyzed as a whole

Only commercial banks with an asset base of more than Ksh 25 billion were analyzed. The selection were for the banks that have been classified as large by central bank of Kenya

The findings are as below

There industry averages as at 31 December 2008 are as follows: Net interest income Ksh 1,852 million, Total loans Ksh 12,904 million total assets Ksh 28,907 non-performing loans Ksh 1161 million provisions Ksh 766 million while loan loss is Ksh 122 million

GRAPH 2 BARCLAYS BANK OF KENYA

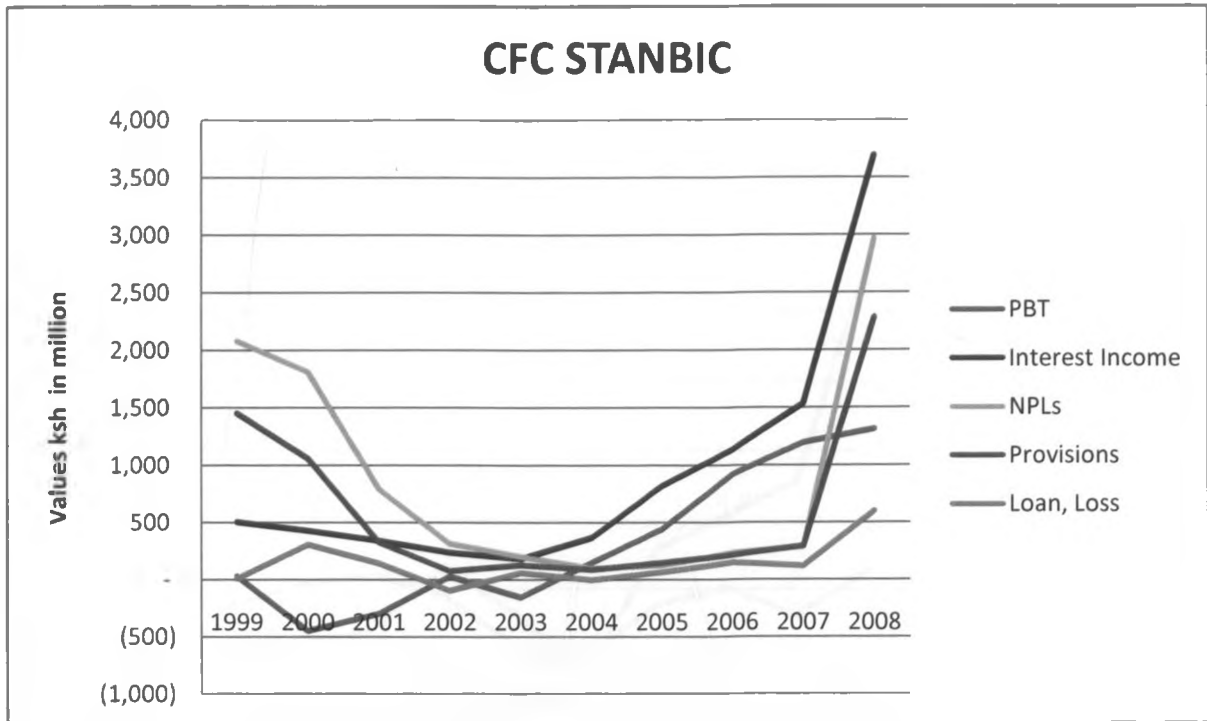


Data source kenya banking suvey 2009

The bank seen a sea saw of profit and non performing loan and between 2001 and 2006 it had more bad loans than the profit .the amount that have been lost due to bad loans have remained below ksh 2. bllion for the duration between 1999 and 2008 .the amount of provission and interest in suspense has been maintained below the profitabilty margin

The amount of non performing loans that have been held by the bank have been reducing with slight increase in year 2008 while the instest from loans and advances heve been growing for the same duration The bank may not be impacted badly in future by the amount of non performing loans

GRAPH 3: CFC STANBIC BANK

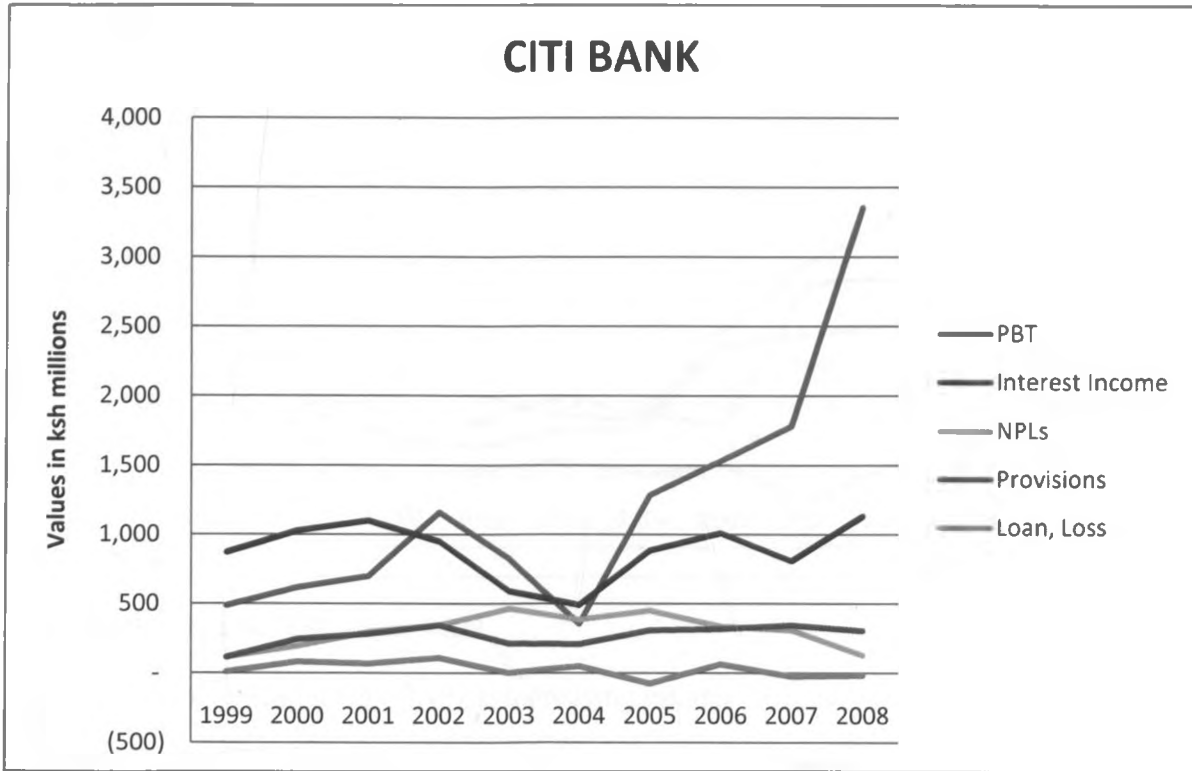


Data source Kenya banking survey 2009

CFC and Stanbic banks used to operate as different commercial banks a merger combined the two banks now CFC Stanbic bank. The level of interest income in the bank has been increasing since 2006 and so have been the level of profits and NPLs. The bank has managed its loan loss and some years it has had recoveries more than the losses hence having negative loan losses.

The increasing level of NPLs should be a cause of concern for the bank although the provisions are also increasing indicating that the performance would have been better had the levels of nonperforming loans not increased. The nonperforming loans to loans ratio is 0.16 which means nonperforming loans constitute 16% of the total loans for the bank. The ratio of NPLs to profit is 2.25 NPLs are above the bank's profit.

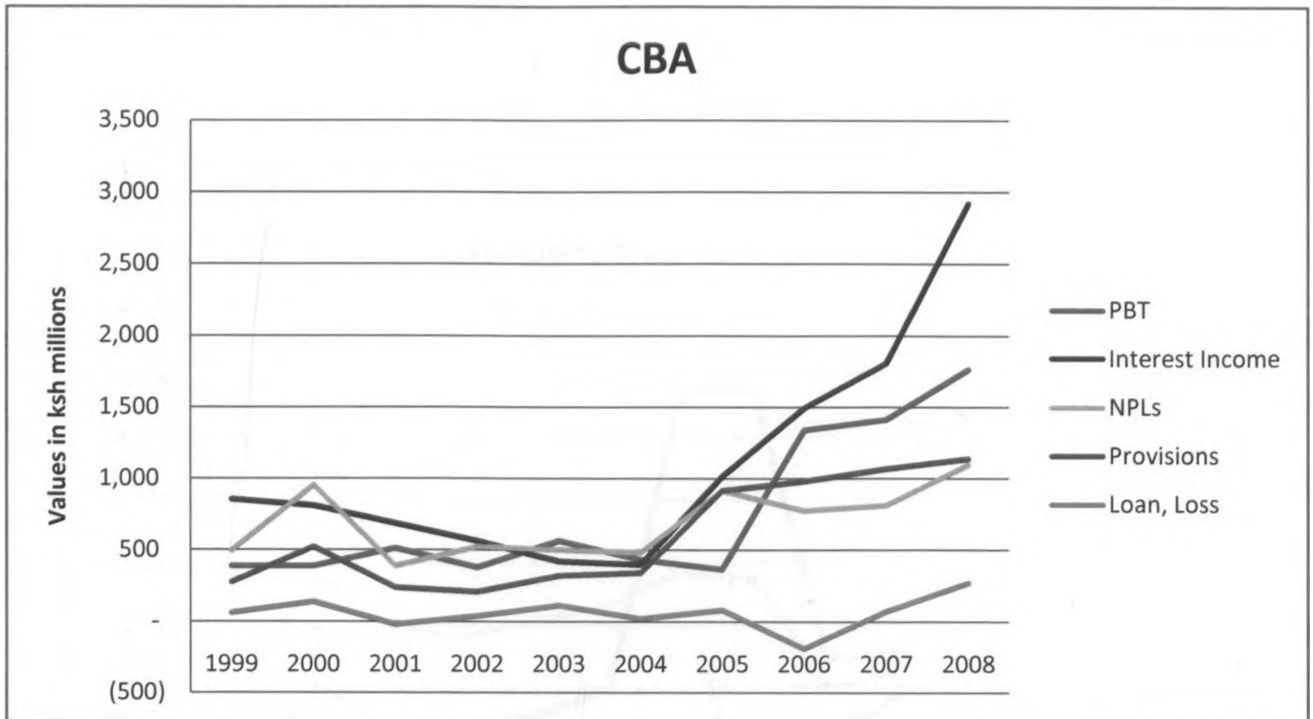
GRAPH 4: CITIBANK



Data source Kenya banking survey

CITI bank seems not to have problems with non performing loans and loan loss for the period between 1999 and 2008 the amount of profit in the bank is even higher than the interest income from loans hence the performance in the bank may not be affected by NPLs .the banks provision and interest in suspense remains constant while NPLs are reducing .Most of the banks income is from other source other than interest income

GRAPH 5: COMMERCIAL BANK OF AFRICA

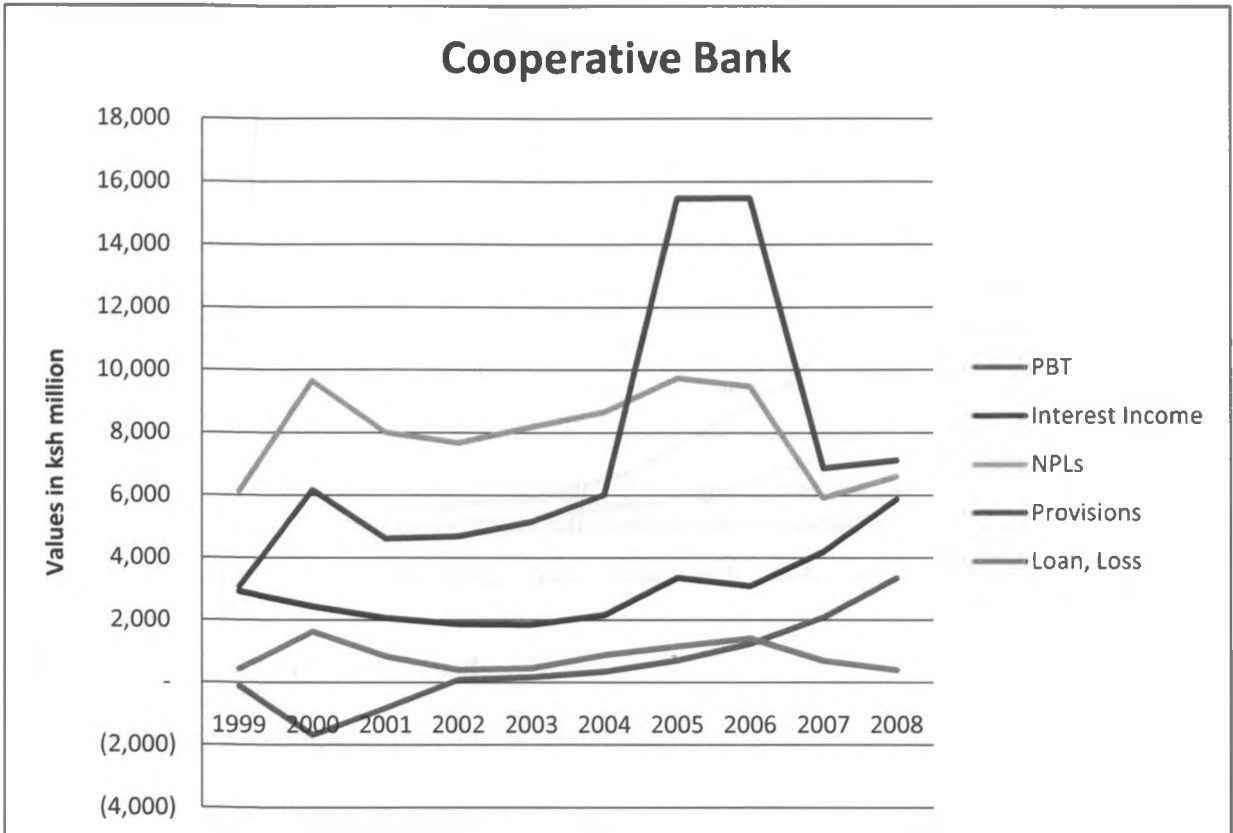


Data source Kenya banking survey 2009

CBA has an increasing level of NPLs, increasing interest income, increasing provisions and interest in suspense. The magnitude of increase in interest income from loans is however higher than the increase in NPLs .the ratio of NPLs to loans and advances is 0.06 meaning only 6% of the total loans and advances to customers constitute bad loans The loan loss for the bank has remained low which can also be explained by the low NPLs to loans ratio

GRAPH 6:CO-OPERATIVE BANK OF KENYA

Data source kenya banking survey 2009

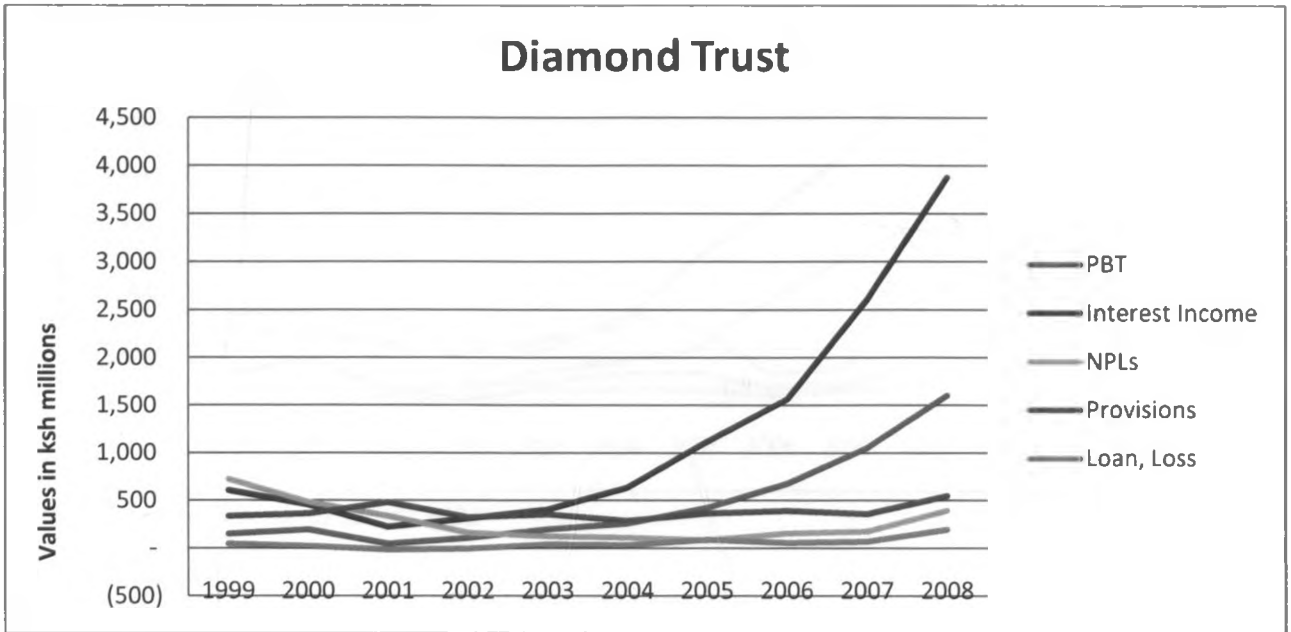


Co-operative bank has for the last ten year had more than interest income, profit in fact the bank made losses in 1999, 2000 and 2001 when the amount of NPLs were increasing. There has been a slight decrease in the level of NPLs. The levels of provision and interest in suspense increased to more than 15 billion in 2006 a period in which the profit also increased.

The bank is threatened by nonperforming loans and as at 31 December 2008 the ratio of NPLs to loans and advances to customers was 14.58 which indicates that the bank has been negatively impacted by NPLs. This is also evidenced by the level of loan loss by the bank which have been

avearging ksh 1 billion for the duration .The profitability of the bank improved from 2003 the period which the bank began to have lower NPLs

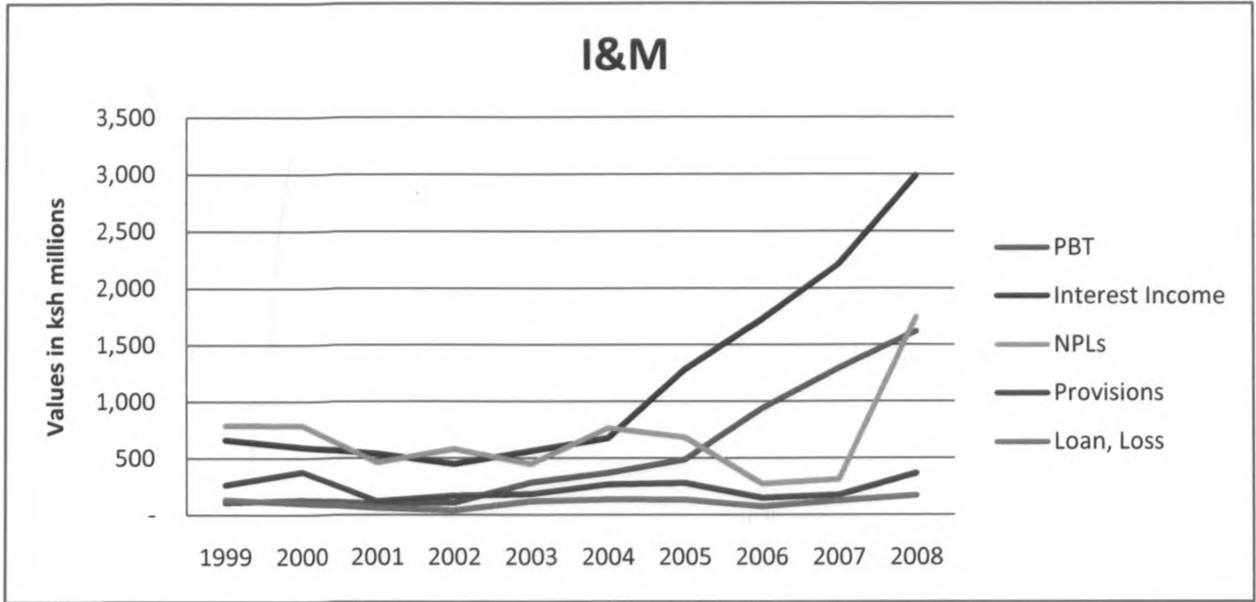
GRAPH 7:DIAMOND TRUST BANK



Data source kenya banking survey 2009

DTB does not seem to have a problem with non performing loans .the banks npls are below the banks provision and intest in suspense while the intest income from loans has been increasing. in terms of profitabilty the bank has seen a sustained growth which can be attributed to growth intest income,fees and comission and foreign excahenge

GRAPH 9: I&M BANK

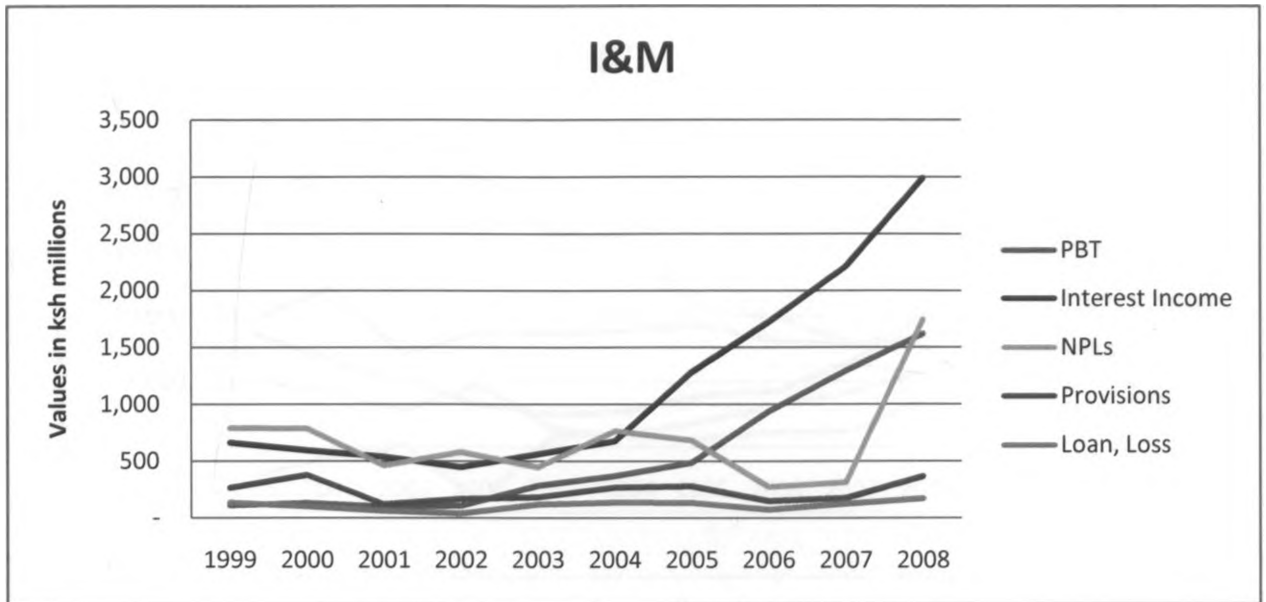


Data source Kenya banking survey 2009

I& M bank has had higher NPLs than both interest income and profit for the period between 1999 to 2003. The levels of the provisions and interest in suspense which directly affect interest income and profitability have however remained significantly low and so have the amounts of loan loss. The bank can be negatively be impacted by the levels of NPLs which by end of 2008 were above the banks profit

The ratio of NPLs to loans to customer is 6.74 which low while provision and interest in suspense to interest income from loans is 12.25 This therefore means that the bank is secure from the problem of non-performing loans. the increasing interest income from loans also indicates that the bank holds a portfolio of good loans which is echoed by the low rate of loan loss

GRAPH 9: I&M BANK

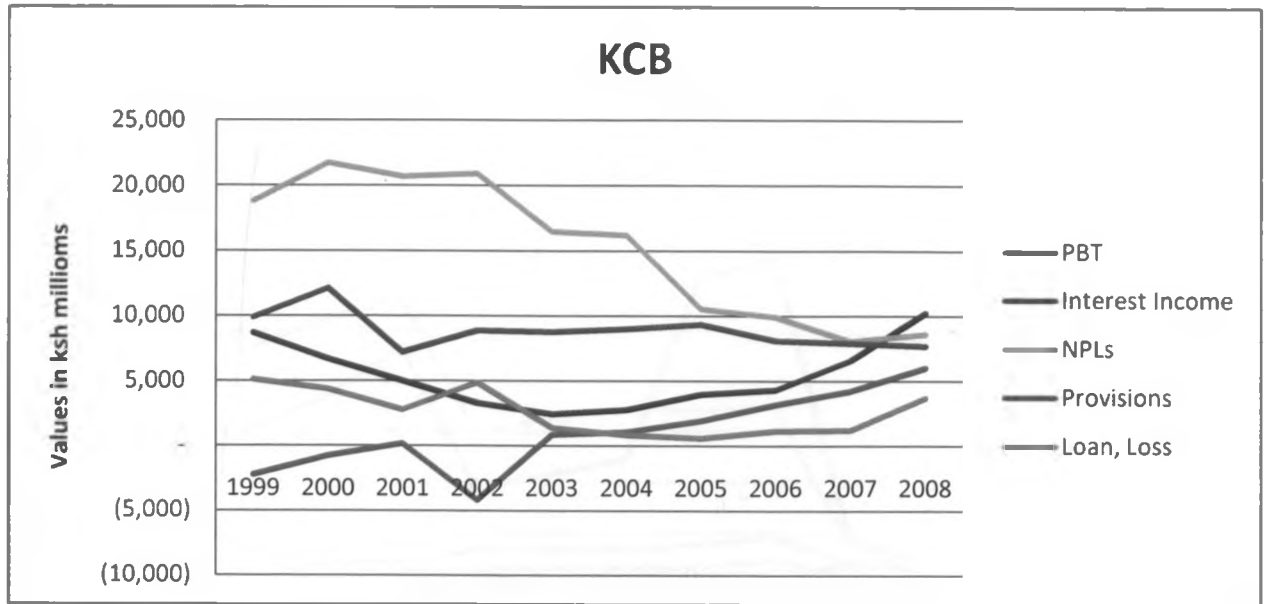


Data source Kenya banking survey 2009

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GRAPH 10: KENYA COMMERCIAL BANK



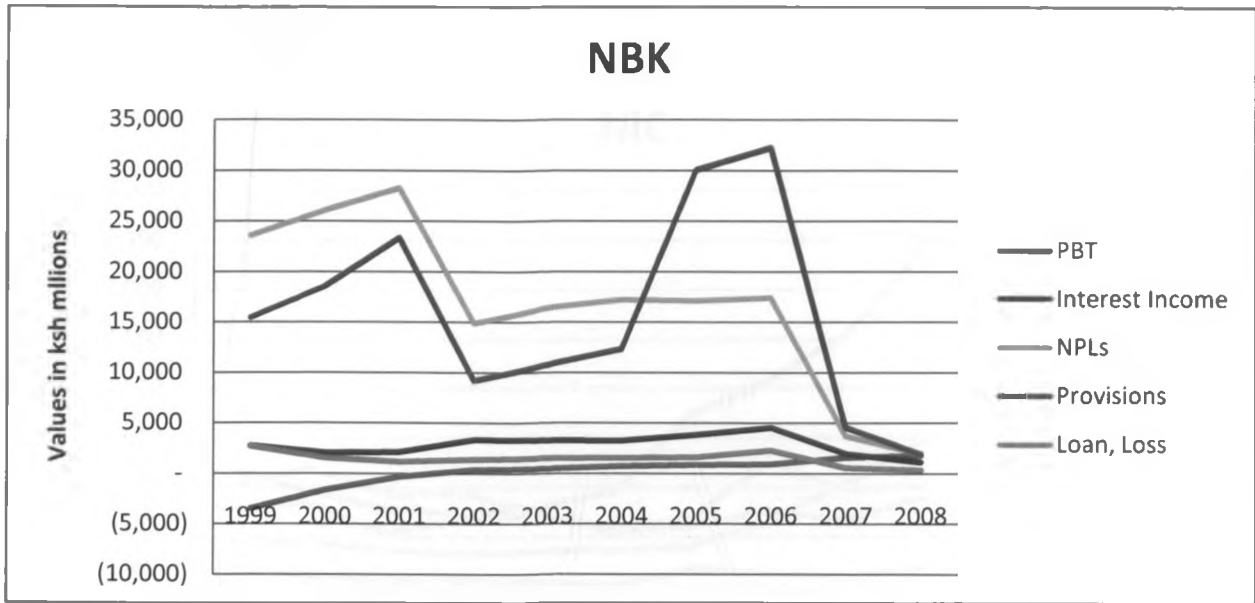
Data source Kenya banking survey 2009

KCB has had high levels of NPLs which by industry standards and average are still high as at end 2008. The bank made a huge loss of Ksh 4.2 billion in year 2002 when the NPLs were as high as ksh21 billion. The bank has since the been reducing the NPLs which has correspondent with increase on the profits .the amounts of provision and interest in suspense has also been high averaging above the banking sector average which indicates a problem of NPLS to in overall performance. Interest income from loans has remained lower than the NPLs while loan losses have been higher than the industry average

KCB has hugely been negatively affected by non performing loans but still remains among the top 3 Kenyan banks in terms of profitability and assets held .This implies that but for the huge problem of bad loans which have to written off against income and appropriate provisioning

made the bank would be performing better. Currently a loan of Ksh 2 Billion went bad and had to be written off hence the banks is still dogged by NPLs

GRAPH 11: NATIONAL BANK of KENYA

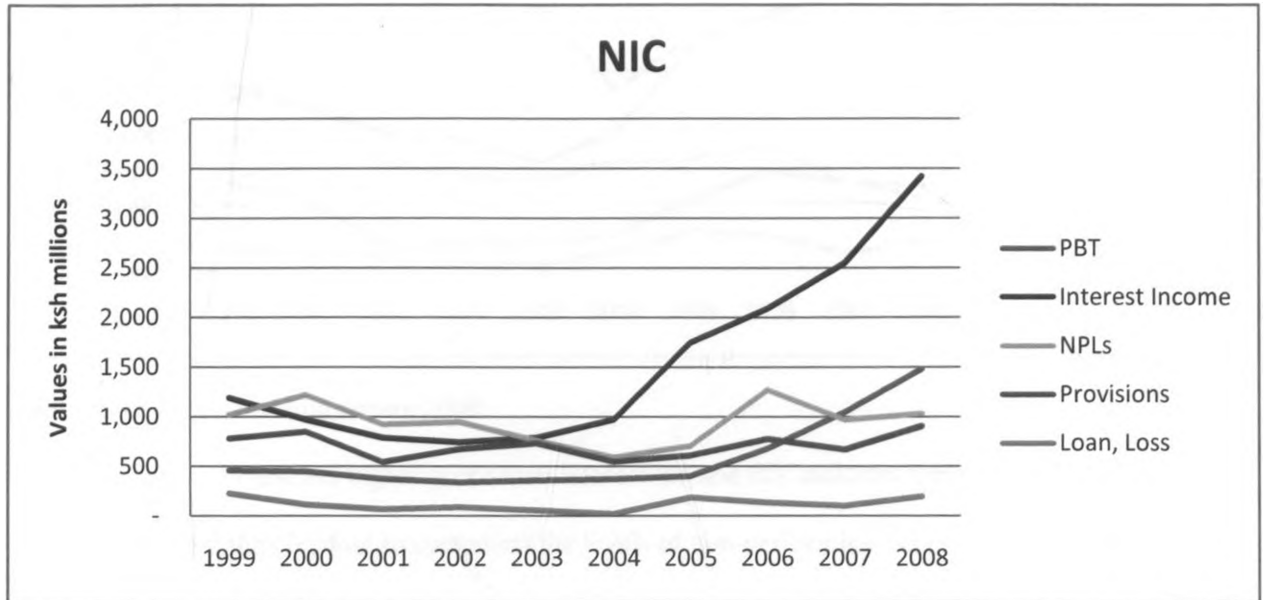


Data source Kenya banking survey 2009

NBK is the commercila bank in kenya which has seen the highest levels of non performing loans.the levels of the banks NPLs has risen to record highs of ksh 27 billion in 2001 a year in which the government had to bail out the bank from imminent collapse .the amounts of provisions and interest in suspense have been high raising to over 30 billion shillings in year 2006.the bank has for the last decade seen declineing intest income from loans owing to the high levels of NPLs hence having to suspense too much intest and provide for losses in the income statement however due to government bail out and renegotiation of loans the amounts of loan loss have remained well within the industry average .

The bank has managed to lower both the npls and provisions and by the end of year 2008 NPLs were below ksh 3 billion which represents a 1200% reduction in the level of NPLs .The bank shows signs of recovery and was able to make a profit despite a decline in interest income

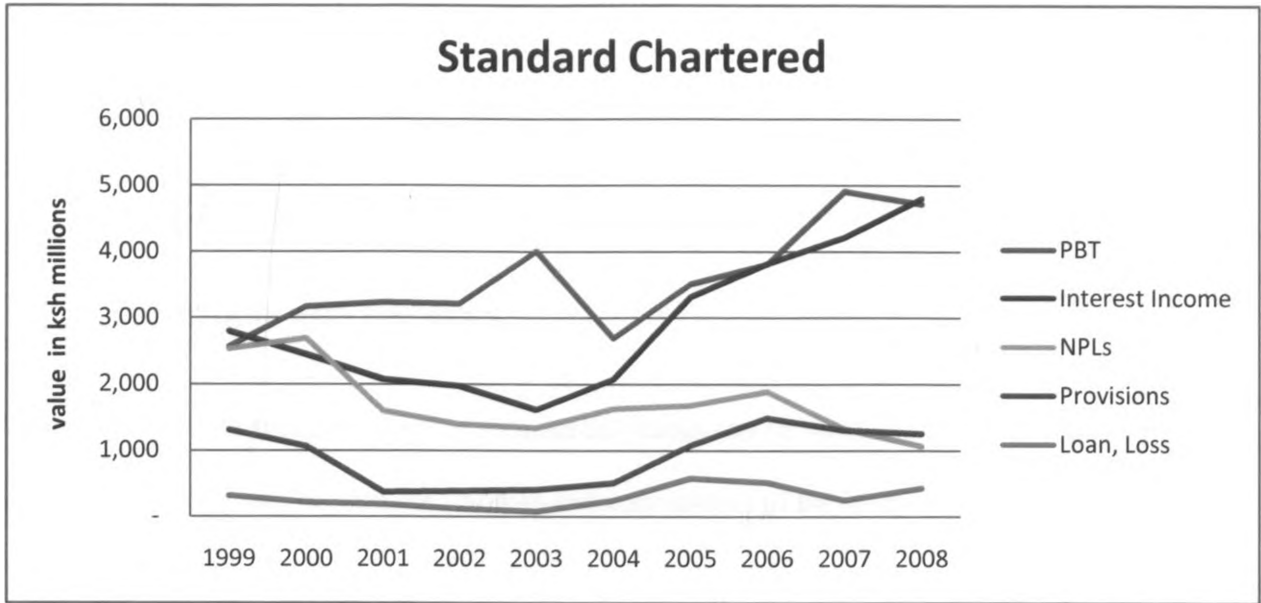
GRAPH 12: NIC BANK



Data source Kenya banking survey

NIC does not seem to have a problem of NPLs as the bank NPLs to loans ratio is 0.0345 indicating only 3.45% of the total loans are not performing .The bank also has minimal or at some point non existence loan loss which indicates that even the loans that at some point are not performing loans do turn into performing .The bank also has increasing Interest income and profits

GRAPH 13: STANDARD CHARTERED BANK K LTD



Data source Kenya banking survey 2009

Standard chartered bank has higher profit than interest income this indicates that the bank has other sources of income than lending to customers the levels of non-performing loans have been reducing while interest income and profit increase, loan loss and provision and interest in suspense are low income .the bank however has loans worth Ksh 43 billion against a NPLs amount of Ksh 1 billion .this indicates that the bank may not adversely be affected by increasing levels of non-performing loans

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 SUMMARY AND FINDINGS

The study set out to find how Kenyan commercial banks can be impacted by the non performing loans. This chapter will present the findings and conclusions of the study and give further recommendations

From the equation in chapter for the findings indicate that commercial banks will be negatively affected by raising levels of non-performing loans through provisioning made and interest in suspense. The coefficients for provisions and NPLs on both interest income from loans and profit were significant (having 0.004 and 0.0252) taking into account a significance level of 95%. The R squared and adjusted R also showed that changes in NPLs will affect the banking sector.

Non- performing loans are not equally distributed among the commercial banks in Kenya a details analysis of commercial banks with more than Ksh 25 billion worth of assets which are classified as large by central bank of Kenya were further analyzed

A commercial bank decision to lend is arrived at by that bank and not the whole industry .they only play by the industry rules in lending. This further analysis showed that 7 of the 13 analyzed banks did not have potential to be impacted negatively by non performing loans. The other 6 banks had at some point or still having to declare lower earning because of having increase high amounts of NPLs to profits and interest income

In provisioning commercial banks have adequately provided for anticipated losses and suspended income than can arise from loans that have already been declared as non-performing.

Commercial banks however still continue to have loan losses with 9 of the 13 banks having to make on average more than Ksh 1 billion of lost loans every year.

No commercial bank has declared operating losses has on the onset of the global financial crises and no major loans migration to bad loans were reported by December 2008 with an exception of KCB which made a Ksh 2.billion loan loss in year 2009.

Kenya commercial banks continue to make profits in the first half of year 2009 as per there unaudited half years results an indication that the global financial crisis might not have affected them adversely affected unlike their counterparts in America, Europe and Asian countries

A critical look at asset portfolio held by commercial banks in Kenya through asset quality rating of proportion of loans and advances to total assets, provision charge on nonperforming loans to operating income and non performing loans to total loans clearly shows that the banks are have adequately made provisions and managed there loans .The banks as a whole have become more prudent in their lending having a provision to operating income of 7.17% indicating a decline in impacts of non-performing loans on overall performance.

5.2 RECOMMENDATION FROM THE STUDY

From the study the following recommendation can be made;

Central bank of Kenya being the regulator of banking sector should ask from individual commercial banks on a quarterly basis an calculation of loans that have migrated from good book to bad book to avoid a situation were a commercial bank can have a compounding effect huge bad loan beginning to receive payments hence migrating from bad book to good book and

at the same time bad good loans migrating to be bad hence a net effect of reduction in bad loans yet a bank is still having NPLs growth

Management of commercial banks should have a catalogue of remedies to correct bad loans from different situations that have lead to the loans being bad to reduce the impact of prolonged npls which reduces the income from already funded facilities not performing

Strict adherence to the know your customer (KYC) policy by regulator my help a commercial bank to predict and avoid issuing fresh loans to a client that is in problems

Commercial banks should engage a credit bureau for assistance in credit assessment and provision of information about susceptible defaulters

5.3 LIMITATIONS OF THE STUDY

The data used for conducting this research was for a period in which the Kenya economic performance was doing exemplary well and as it has been established by Mucheke (2001) and Kiyai (2003) that economic conditions mostly economic growth as the main determinant of the levels of NPLs, the impacts of NPLs on operating performance of commercial banks may be minimal due to the a robust economic growth from year 2003 up to 2008

Only one year of the global financial crises have been factored in the study and the findings may vary as the country continues to receive shocks from the developed countries and business for Kenyan corporate that have on their ability to pay loans they have with commercial banks

5.4 RECOMMENDATIONS FOR FURTHER RESEARCH

Further research can be done on measures that commercial banks in Kenya have put in place to caution them from the impacts of the global financial crises. The following areas in the income statements should be of great concern

Exchange income

Commercial banks are faced with exchange risk. With the global financial crises here with us fluctuating exchange rates could lead to losses for the banks while reduced remittances from developed countries could also lead to reduced fees and commission.

Credit cards

In the USA credit cards have been put forward as a contributing factor to the problems that commercial banks. Research can be done in Kenya to find out the approval criteria, the limits setting and how much of the breach of payments are for Kenyan banks that have issued credits cards to find out whether there impacts on profitability and the amounts of bad credits and provisioning made by these banks.

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List of commercial banks in Kenya as at 31 December 2008 as per CBK

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