A SURVEY OF THE CAUSES OF NON - PERFORMING LOANS OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This is my original work and has not been submitted for a degree in any other university.

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

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DEDICATION

This work is dedicated to my parents Mr. and Mrs. Gaitho for support and guidance throughout my study.

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I wish to express my sincere and unalloyed gratitude to my supervisor, Luther Otieno for reading, criticizing and contributing to this work constructively.

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Above all, I am most grateful to the ALMIGHTY GOD for strength to complete this work.

ABSTRACT

The purpose of this research was to investigate the causes of non-performing loans in Kenyan banks. The research questions used to guide the research included:

1. What are the causes of non- performing loans in Kenyan banks?
2. What specific steps have bank managers taken to deal with the problem of non-performing loans'?
3. What is the level of success of the actions taken?

This is an explanatory research that adopted the survey research design. Data was collected with the help of a questionnaire sent to 30 bank officers. The officials were purposively sampled from the ten leading banks ranked according to the value of their net assets as available from the Central Bank of Kenya listing.

Recommendations of this study are that loan officials must grant loans basing their appraisal on loan analysis principles, using their discernment as well as experience to verify debtor credibility i.e., debt repayment ability, capital management and collateral suitability. More importantly, loan officials should strictly monitor and control how the loan is used in order to be able to promptly handle arising problems. The study found that the actions had proved useful in minimizing bad loans in the banks surveyed as reported by the credit managers. In addition, banks should continue to invest in the training of loans officials since most of the respondents confirmed that it was a new trend.

The findings of this study will help the management in Kenyan banks to improve their management of non-performing loans. These study findings will encourage bank managers to participate more in policy formulation at the micro and macro levels as far as bad debt management is concerned and also to diversify banks investment portfolios. Other stakeholders such as researchers can use the findings as a basis for further research.

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LIST OF ACRONYMS

ATM	Automated Teller Machine
CBK	Central Bank of Kenya
COMESA	Common Market for Eastern and Southern Africa
GDP	Gross Domestic Product
IAS	International Accounting Standards
ICPAK	The Institute Certified Public Accountants of Kenya
IMF	International Monetary Fund
KCB	Kenya Commercial Bank
NPART	Non-performing Assets Recovery Trust
NPL's	Non-Performing Loans
USD	United States Dollar
NPART	Non performing Assets Recovery Trust

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

A Commercial bank is a profit making institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses (WebFinance, 2010).

Loans are the major outputs provided by the bank. However, the loan is a risk output. Analysts say that living with low interest rate regime is expected to hurt the earnings of the entire banking sector in Kenya whose core source of income is high yield on government debt. They add that diversification is the only way back to growing profitability.

A non-performing loan is a loan that is in default or close to being in default. A loan is nonperforming when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full (IMF, 2009).

There is always an ex-ante risk for a loan to finally become non-performing. Non-performing loans can be treated as undesirable outputs or costs to a loaning bank, which decreases the bank's performance. The risks of non-performing loans normally arise as the external economic environment becomes worse off such as economic depressions. Controlling non-performing loans is very important for both the performance of an individual bank and the economy's financial environment.

Non-Performing Loans (NPLs) reduces the liquidity of banks, credit expansion, it slows down the growth of the real sector with direct consequences on the performance of banks, the firm which is in default and the economy as a whole. According to the theory of finance, there are various risks facing financial institutions. They include: credit risk, liquidity risk, market risk, operating risk, reputation risk and legal risk. The system is highly sensitive while the activities of the operators need to be conducted within the laid down and agreed rules and procedures, in order to achieve a reasonable level of efficiency.

Due to the nature of their business, commercial banks expose themselves to the risks of default from borrowers. Prudent risk assessment and creation of adequate provisions for bad and doubtful debts can cushion the banks risk. However when the level of non-performing loans is very high, the provisions are not adequate protection.

Banking crises have a long history. The Great Depression of the 1930s was exacerbated by bank failures in the United States and elsewhere. In recent decades, a large number of countries have experienced financial distress of varying degrees of severity, and some have suffered repeated bouts of distress (Hardy, 1998).

In the early 1980s, the governments of several Latin American countries, including Chile and Mexico, felt compelled to make up for losses in the banking system-for instance, by buying substandard loans from the banks for more than their true worth-to preserve its solvency. Likewise, many African countries also had to restructure and recapitalize their banking systems, which in the past had suffered large losses on loans to parastatal companies (companies at least 50 percent owned by the state) and on crop loans. Shirazi (1998), contents that the severity and duration of the Asian Financial crisis surprised nearly all observers. The loss of income and wealth and the associated social and political stresses created in the region are unprecedented. Hardy believes that in all cases, banking crises resulted, at a minimum, in large losses of wealth and disruptions in the supply of credit for investment and commerce. Resolving the crises often involved large outlays of public funds.

Pazarbasioglu (1999) believes that the best warning signs of financial crises are proxies for the vulnerability of the banking and corporate sector. He showed that full-blown banking crises are associated more with external developments, and domestic variables are the main leading indicators of severe but contained banking distress. He adds that the most obvious indicators that can be used to predict banking crises are those that relate directly to the soundness of the banking system. Items from banks balance sheets or statements of revenue and expenses may make clear when risks are increasing and, thus, when problems are emerging he explains. An example he gives of a primary direct indicator of banking sector soundness and the likelihood of difficulties is the level of bank capitalization. This is the amount by which a bank’s assets exceed its liabilities.

Capital acts as a cushion against shocks and allows a bank to continue honoring claims According to Kroszner (2002); non-performing loans are closely associated with banking crises. Sultana (2002) in a paper with the key words “The Japanese Economy”, “Banking Crises” and “Bad loans” also links the Japanese Financial crisis to non-performing loans. According to Sultana (2002), Japanese banks still suffer under the weight of thousands of billions of yen of bad loans resulting from the collapse in asset prices a decade ago in the countries financial system.

1.2 Statement of the Problem

The failures in lessening the poor performance of the banks can be tested through the procedures and the processes involved in their nature of work. From the simple transaction, different problems may arise. The failure of the customer to disclose any personal information during the application can be the greatest reason that might influence the overall performance of the banks. It is a specific factor that a customer should give the honest information during the loan application to avoid or prevent any further casualties on the side of the banks. However, in the loan processes of the banks, there are still internal procedures that the entire system should provide.

Interest income generally constitutes the major income for the banks. Analysts agree that interest rate regime put in place in a banking system should be expected to determine the earnings of the entire banking sector, whose core source of income is interest income (CBK, January, 2003). Since Non-performing loans are those that are not being serviced according to loan contracts, they represent potential losses to financial institutions.

Write offs of bad loans is also a major area of concern for banks. According to KPMG (2002), as banks charge off bankruptcy cases, they affect the profit and loss account. Thus the write off of bad debts eats into bank profits. A high level of non-performing loans in a banks portfolio of investments affects the level of interest income. According to the Government of Japan [GOJ], (2001) with the cost for disposal of non-performing loans (direct write-off costs, provisions for credit losses, etc.) eating into the profits from the core banking business (net business profits), the continued presence of non-performing loans will continue to erode banks profitability unless corrective measures are taken.

Even though managers may have very little control over prevailing rates of interest in the market place, there are other conscious decisions they make that could reduce the impact of bad debts on bank profits. In addition, individual banks may not have meaningful influence over macroeconomic factors that lead to bankruptcy of their borrowers. However, as agents of the shareholders, managers have the responsibility to adopt management decisions that are in the best interests of shareholders. Such decisions should ensure wealth maximization. This is in accordance with the agency theory McColgan, 2001).

In order to minimize their occurrence, there is need to identify the root causes of nonperforming loans in Kenyan banks. There is also need to examine the mechanisms put in place by bank management in order to ensure continued generation of income. Current literature or studies in this area in Kenya is limited.

The findings of the study will help the management in Kenyan banks to improve their management of non-performing loans. The study findings will encourage bank managers to participate more in policy formulation at the micro and macro levels as far as debt management is concerned and also to diversify banks investment portfolios.

Other stakeholders such as researchers can use the findings as a basis for further research.

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1.3 Objectives of the study

The objective of this study is to identify causes of non-performing loans.

1.4 Importance of the study

The findings of this study will help the management in Kenyan banks to improve their management of non-performing loans.

1. The study will present the real effects of this undesirable trait in banks asset quality.
2. This will help managers to give more importance to prudent management of bad debts.
3. This study will encourage bank managers to participate more in policy formulation as far as bad debt management is concerned and also the need to diversify banks investment portfolios.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter discusses the empirical studies of non – performing loans, the general causes of non- performing loans in banks, and the relative importance of each of these causes. The chapter discusses the documented impact of high levels of non-performing loans on the operations of the banking industry. The policy and operational adjustments done by banks as a result are also discussed in this chapter as well as the specific steps bank managers have taken to improve the management of non- performing loans in their respective banks as a way of improving bank performance. Lastly, the level of success of each of these remedies is discussed.

2.2 Empirical evidence of non-performing loans in some countries

Researchers suggest that what is largely missing from the research literature related to the field of financial institutions is an analysis of the relationships between problem loans and cost efficiency. Recent empirical literature suggests at least three significant links between these two topics.

First, a number of researchers have found that failing banks tend to be very cost inefficient, that is, located far from the best-practice frontiers. Cost-inefficient banks may tend to have loan performance problems for a number of reasons; For example, banks with poor senior management may have problems in monitoring both their cost and their loan customers, with the losses of capital generated by both these phenomena potentially leading to failure. This has been referred to as the "bad management" hypothesis. Alternatively, loan quality problems may be caused by an event exogenous to the bank, such as unanticipated regional economic downturns. The expenses associated with the nonperforming loans that results can crate the appearance, if not the reality, of low cost efficiency. This has been referred to as the "bad luck" hypothesis.

The second empirical link between problem loans and productive efficiency appears in studies that use supervisory examination data. A relationship between asset quality and cost is consistent with the failed bank data, and suggests that the negative relationship between problem loans and cost efficiency holds for the population of banks as a whole as well as for failing banks.

Third, some recent studies of bank efficiency have directly included measures of non - performing loans in cost or production relationships. Whether this procedure improves or hinders the estimation of cost efficiency depends upon the underlying reason for the relationship between costs and nonperforming loans.

Empirical evidences and results from studies show similar trends on the negative effect of non-performing loans on bank performances. Current global financial crisis attests to this direction.

In Turkey, Karabulut and Bilgin (2007) carried out a study with the purpose of examining the impact of the unlimited deposit insurance on Non-performing Loans (NPLs) and market discipline. They argued that deposit insurance program play a crucial role in achieving financial stability. Governments in many advanced and developing economies established deposit insurance schemes for reducing the risk of systemic failure of banks.

The report shows that deposit insurance has a beneficial effect of reducing the probability of a bank run. However deposit insurance systems have their own set of problems. Deposit insurance systems create moral hazard incentives that encourage banks to take excessive risk. Turkey established an explicit deposit insurance system in 1960. Until 1994, the coverage was determined by a flat rate but in that date, Turkey experienced a major economic crisis. In April 1994, Turkish government had to establish an unlimited deposit insurance scheme to restore banking system stability. In conclusion, the study shows that unlimited deposit insurance caused a remarkable increase at Non-performing Loans (NPLs). What this means is that deposit insurance institutions established by monetary authorities must re-examine the current policy of blanket guarantee of deposits in the banking sector.

In Taiwan, Hu, Li and Chu (2004) carried out their own study examining how ownership structure affects Non-performing Loans (NPLs). Their findings revealed that an increase in the government's shareholding facilitates political lobbying. On the other hand, private shareholding induces more Non-performing Loans (NPLs) to be manipulated by corrupt private owners. The results show that the rate of NPLs decreased as the ratio of government shareholding in a bank rose (up to 63.51%), while the rate thereafter increased. The report posits further that joint ownership has the lowest rate of NPLs among Taiwanese public, mixed and private commercial banks. The joint ownership effect on NPLs ratios is negative and its magnitude is sufficiently large in Taiwan's banking industry. Bank size is negatively related to the rate of NPLs, which supports their argument that larger banks have more resources for determining the quality of loans.

In Africa, Fofack (2005) investigated the determinants of non-performing loans in sub-Saharan Africa using correlation and causality analysis. The analysis was based on data drawn from 16 African countries. The sample selection was dictated by the scope of the database and availability of financial information on these countries. The data are provided on an annual basis end-of-period, between 1993 and 2002, included. The minimum length of the panel covers a period of 3 years for the shortest series (Chad and Rwanda), and up to 10 years for the longest series, producing an unbalanced panel. The correlation and causality analysis focuses on a number of macroeconomic and microeconomic (banking-sector) variables.

At the macroeconomic level, the study investigates the correlation between non-performing loans and a subset of economic variables: per capita GDP, inflation, interest rates, changes in the real exchange rate, interest rate spread and broad money supply. At the microeconomic level, it focuses on the association between Non-performing Loans (NPLs) and banking-sector variables. The key banking variables include return on asset and equity, net interest margins and net income, and inter-bank loans. These variables were chosen in the light of theoretical considerations and subject to data availability. Non-performing Loans (NPLs) are adjusted for specific provisions (non-performing loans as a proportion of loans loss provisions) to provide the basis for cross-country comparisons.

In the correlation analysis, the results showed a negative association between real GDP per capita and non-performing loans expressed as a percentage of loans loss provision.

This implies that falling per capita income is associated with rising scope of Non-performing Loans (NPLs) to the extent that changes in per capita income is proxy for changes in economic growth. The negative association with non-performing loans may reflect the impact of cyclical output downturns on the banking sector; a result that is expected in the literature (Gonzalez-Hermosillo (1997)). The sign of the coefficient is consistent across state and private banks, though the magnitude of the correlation is stronger for state banks and financial institutions.

2.3 The causes of non- performing loans in banks

According to a study by Brownbridge (1998), most of the bank failures were caused by non- performing loans. Arrears affecting more than half the loan portfolios were typical of the failed banks. Many of the bad debts were attributable to moral hazard: the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at high interest rates to borrowers in the most risky segments of the credit markets.

2.3.1 Insider Lending

According to Brownbridge, the single biggest contributor to the bad loans of many of the failed local banks was insider lending. In at least half of the bank failures, insider loans accounted for a substantial proportion of the bad debts. Most of the larger local bank failures in Kenya, such as the Continental Bank, Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians. The threat posed by insider lending to the soundness of the banks was exacerbated because many of the insider loans were invested in speculative projects such as real estate development, breached large-loan exposure limits, and were extended to projects which could not generate short-term returns (such as hotels and shopping centers), with the result that the maturities of the bank's assets and liabilities were imprudently mismatched. He sites three forces behind insider lending and lists them as political pressure, under-capitalization, over concentration in ownership.

2.3.2 High Interest rates

In the study the second major factor contributing to bank failure was lending, at high interest rates, to borrowers in high-risk segments of the credit market. This involved elements of moral hazard on the part of both the banks and their borrowers and the adverse selection of the borrowers. It was in part motivated by the high cost of mobilizing funds.

2.3.3 Macroeconomic Instability

Brownbridge cited macroeconomic instability as the third most important cause. During the l990s, inflation reached 46% in Kenya. High inflation increases the volatility of business profits because of its unpredictability, and because it normally entails a high degree of variability in the rates of interest, there is increase of the prices of the particular goods and services which make up the overall price index. This intensifies both adverse selection and adverse incentives for borrowers to take risks, and thus the probabilities of loan default.

2.3.4 Liquidity support and prudential regulation

The fourth most important factor is liquidity support and prudential regulation. The willingness of the regulatory authorities (CBK) to support distressed banks with loans, rather than close them down, was probably an important contributor to moral hazard. Miyakodayori (2002) believes that solving the bad loan problem is indispensable to the recovery of an economy. Once the bad loan problem of the private sector settles, the real economy gradually regains strength and returns to a path of sustainable growth.

The problem of NPL's is widespread. Nishimura, Kazuhito, and Yukiko, (2001) state that one of the underlying causes of Japan's prolonged economic stagnation is the non-performing or bad loan problem. They explain that some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This delayed structural reform and prevented the financial intermediary system from functioning properly.

2.3.5 Inadequate management of credit risk

In their study, Fernández, Jorge and Saurina, (2000) state that the growth of bank credit in Spain and its prudential implications is an ever-present item on the agenda of banking supervisors, since most banking crises have had as a direct cause the inadequate management of credit risk by institutions. They further assert that even though bank supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. They claim that even conservative managers might find market pressure for higher profits very difficult to overcome.

2.3.6 Economic mismanagement and political interference

In China it was estimated that, by 1997, *35* percent of state owned enterprises had debts greater than assets. Despite that government had since then set up asset management companies to take over about RMB 1.4 trillions (USD 169 billions) had debts off the state banks accounts, Dai Xianlong, China's Central Bank Governor, disclosed in February 2001 that the Chinese banks' non-performing loans (NPL) ratio was alarmingly high: a quarter of the state banks' loans were still overdue (Ding, Shandre and Qing, 2001) Coming closer home, according to a World Bank report (1994) in Uganda the country's banking industry was described as extremely weak, with huge non-performing loans and some banks teetering on the verge of collapse. Mukalazi (1999) says that reeling from years of economic mismanagement and political interference, Uganda's banking industry posted huge losses in the early 1990s.

One important impact that non-performing loans have had on banks is the attempted improvement on the management of credit risk. In China for example, in a bid to help the banks get rid of the NPLs accumulated over past years, the Chinese government in 1998 established four state-sponsored asset management companies to take over bad debts from the banks' balance sheets. On top of that, the government injected RMB 270 billions into the four major banks to strengthen their capital bases (Ding et al, 2001) To help address credit risk management in Ugandan banks, the government has introduced a statute that deals with several issues such as insider lending, following the recent scandal in which billions of shillings were lent without sufficient collateral to Greenland Bank by the newly privatized Uganda Commercial Bank Ltd. The statute further seeks to reduce owner concentration (Mukalazi, 1999).

According to Gorter and Bloem (2002) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of nonperformance in the form of bad loan provisions, or they may spread the risk by taking out insurance.

Loans are one of the major outputs provided by the bank. However, the loan is a risk output. The central bank of Kenya defines NPLs as those loans that are not being serviced as per loan contracts and expose the financial institutions to potential losses (CBK, 1997). It is important to note that non-performing loans refer to accounts whose principal or interest remains unpaid 90 days or more after due date. According to the Central Bank of Kenya Annual Report (CBK, 2008), Non-performing loans (NPLs) declined by 17.5 percent, from Ksh 70.7 billion in June 2007 to Ksh 58.3 billion at the end of June 2008. This was attributed to write-offs and recoveries by some institutions. The ratio of gross non-performing loans to gross loans was 9.6 percent in June 2008 compared with 15.1 per cent as at the end of June 2007. Though NPLs have been declining, the impact of the December 2007 post-election crisis reversed the gains in the first half of year 2008. Consequently, NPLs increased from Ksh 57.2 billion in December 2007 to Ksh 58.3 billion at the end of June 2008. Despite the increase in NPLs, the ratio of net non-performing loans to gross loans improved from 4.8 percent in June 2007 to 3.4 percent in June 2008.

According to Central Bank of Kenya [CBK], (2003), there was a 4.5 per cent decline in pretax profit for the banking industry. Analysts say living with a low interest rate regime was expected to hurt the earnings of the entire banking sector in Kenya whose core source of income is high yield on Government debt. They add that diversification is the only way back to growing profitability

During the last decade, the performance of the Kenyan economy has seen a downward trend. According to CBK (July, 1989) real growth in gross domestic product (GDP) for 1988 was 5.2% This decline in GDP has affected many sectors of the economy among them financial markets (commercial Banks) and other business units that borrow funds from the banks for investment purposes.

According to the CBK (July, 1999) the level of NPLs in 1998 was estimated at Ksh 80 billion or 30% of advances, up from 27% in1997 as compared to 81.3 billion or 33.4% of total loans in November 2001. This can be compared with levels of NPLs in other countries. According to Taiwan News (2002), the NPL ratio among Taiwanese banks was estimated at 7.7 percent by the end of 2001, while the ratio among grassroots financial institutions was 16.37 percent. It is noticeable that this is approximately half the level in Kenya. One more example, stresses this point further. The Philippines banking system's non-performing loans ratio in July 15, 2001 stood at 16.81 percent of the total loan portfolio up from 16.76 percent a month before, (Batino, 2001).

The management of loans in banks operations is very important. According to Mikiko (2002), during the past several years, major Japanese banks have struggled in the red, with business profits swallowed by the disposal of NPLs. This has seriously dented public confidence in the deposit system. We witnessed the collapse of several banks in Kenya in the last decade. One recent case involved the Collapse of Euro bank, a privately owned Bank. The Delphis Bank, which had been under statutory management re-opened for normal banking business on 5th December 2002 after a restructuring process that involved conversion of deposits into equity and fresh capital injections. In essence, the bank is now largely owned by depositors and has converted from a private company to a public institution. Daima bank, according to Mullei (2003) was placed under statutory management for failing to meet the minimum core capitalization threshold - among as well as poor management of loan portfolios.

2.4 Specific steps taken to deal with the causes

The most profound impact of high non-performing loans in banks portfolio is reduction in the bank profitability especially when it comes to disposals. According to the International Monetary fund [IMF] (2002), banks' net profits had been sluggish for the last ten years. The actual steps taken by banks in response to the challenges presented by non -performing loans will be brought out by the actual study. However literature reviewed shows deliberate efforts by bank managers to control non-performing loans. According to Nagarajan (2003) a general awareness of the significance of structured risk management system is discernible. In the wake of mounting level of non-performing loans and sporadic instances of scams and systemic hiccups, the area of risk management has caught the closer attention of regulators. Nagarajan further points out that the Reserve Bank of India has set out detailed guidelines for credit risk management of Indian banks. The banks in India, no longer content with traditional measures like exposure limits and credit rating, are in the process of overhauling their entire system of risk management. The banks will be moving towards Risk-Adjusted Return on Capital framework for appraising of loans which calls for data on portfolio behavior and allocation of capital commensurate with credit risk inherent in loan proposals.

A study conducted in Israel by Ruthernberg (2003) showed that foreign owned banks had a higher provisioning and higher reserve coverage than local banks. He argues that managers of local banks have a better knowledge of risky borrowers in the local market and therefore suffer smaller losses on non-performing loans. This he says is in addition to maintaining a high quality of assets such that about 60% of assets are in the risk free category (Deposits at the Bank of Israel and Investment in Government Treasury Bills). Only 40% are loans but concentrated only in High Grade customers.

Gondwe (2001) (The East and Southern African Trade and Development Bank's acting President) in an interview with The East African stated that his bank had made significant levels of loan provisions in 1999. These amounted to UAPTA 15.18 million (USD 19.6 million) compared to UAPTA 2.19 million (USD 2.8 million) made in the previous year. The significant level of loan provisions made in 1999 was intended to reflect the impact of the general economic slowdown in the COMESA sub-region over the last two years. According to the Central Bank of Kenya supervision report (Central Bank of Kenya Supervision Report, 1999) profitability of the banking sector declined sharply from shs.4.4bn in 1998 to only Shs 0.2 billion in 1999. This was due to increased provisions for the non- performing loans by most institutions.

Goulet and David (1996) stated that the banking industry has changed dramatically over a relatively short period, from being a virtual cartel to a highly competitive market.

Financial deregulation and increasing globalization have brought new competition to domestic banking, and allowed considerable diversification by banks, insurance companies and cooperatives. Information technology has provided many opportunities for creating new financial products and distribution methods, for example Automatic Teller Machines (ATMs), Telephone Banking and Computer Banking, and reduced the need for investment in conventional branch infrastructure Non-performing loans remained a major problem for the co-operative Bank of Kenya Ltd. for instance.

Although the volume of total non- performing loans declined, provisions on loan losses increased in 2002. The bank made provisions to the tune of Ksh 4.7 billion showing that it is still adversely weighed down by non-performing loans. Besides the impact of these provisions on profitability, the concentration of such loans made recovery hard owing to the poor state of the economy (Co-operative Bank, 2003).

In his address to the Annual General Meeting the Kenya Commercial Bank [KCB] Chief Executive, Davidson (2003) observed that the bank had reported a loss principally caused by an increase in loan loss provisions, which increased from Shs 2.8 bn in 2001 to Shs 4.9 bn in 2002. These provisions were largely applied to the non-performing loans that were booked in the nineties. Davidson further observed that KCB has gone a further step and segregated the non-performing loans into a separate area. The aim is to centralize all the non-performing loans into one unit in order to be accounted for separately. The end result will be a computerized debt management system, which will enable the bank to monitor progress far more accurately.

In response to the challenge of non-performing loans, banks have been forced to become innovative in their efforts to remain in business. According to Chudasri (2002) retail customers have now taken centre stage in Bangkok in banking business. State banks have moved aggressively to increase new lending, in line with government policy. All banks, private and state-owned alike, have also sharply increased their efforts in the consumer market, leading to a boom in credit cards, personal loans and hire-purchase lending. An International Monetary Fund Report (2003) on Singapore states that despite falling overall loan volume and interest rates, banks have generally managed to maintain their net interest margins in 2002 through lower deposit rates. The sustained demand for loans from households has also helped partially offset the decline in corporate loan demand. According to a report by KPMG (1999) in Hong Kong, the other operating income of majority of the banks decreased by 2% to 4%. The decline was generally due to a contraction in lending portfolios, in particular in commercial lending and trade finance business. Banks, which have the capacity to diversify into areas such as investment banking and insurance. Recorded a growth in the income derived from these businesses. This helped offset the decline in income driven by traditional lending products. The demand for corporate lending is still low. Consequently banks have turned to other business areas to compete, most notably the mortgage market.

In Kenya, banks have also responded to the competitive environment. According to the Cooperative Bank of Kenya Ltd. (2003), the bank signed a partnership with International Money gram Worldwide Network for the provision of cash transfer services across the world and this product has grown remarkably. The bank followed this by launching the

Co-op Cash Visa Electron Card, popularly known as Co-op Cash. The bank has completed the centralization of banking services by networking all its branches and operations countrywide, making it a branchless operation. This achievement has been extremely vital in the consolidation of the banks business. Muriuki (1998) adds that the bank has developed high quality products through its personal and consumer-banking department to meet the needs of its retail customers and other emerging markets. These products include the Personal Loan, the launch of ATMs and the friendly service structure among others.

According to Omuodo (2003), as pressure mounts on the banking industry's profitability resulting from over reliance on interest income by banks, it is strategically imperative that banks focus on other revenue streams. National Industrial Credit Bank, NIC, has introduced new products to diversify revenue and to keep its head above the water. Omoudo adds that part of NIC Bank's strategy has been to diversify revenues, by expanding the scope of its activities in addition to its predominant asset finance focus and offering more general commercial banking facilities and other products. Premium financing and provision of custodial services have reduced over reliance on interest income.

According CBK (2002), public sector banks that gave loans without proper documentation are finding the loans difficult to recover. They have now shifted away from security based lending. Other actions that banks have taken include in the last two years shifting away from government securities due to especially the Treasury bill rate falling dramatically. This has compelled the banks to look for alternative sources of income to meet operational costs and report profits for shareholders. Increased fees and commissions have placed with in a collision course with the public. Cost cutting measures such as staff retrenchments and rationalization of branch networks have also proved unpopular with the public. According to CBK (2002), the average interest rates declined from 20 % in 2001 to 8 % in December 2002. According to Brownbridge (1998), Kenyan banking system provided deposit insurance since the late l980s in addition to loan insurance.

2.5 The level of success of the actions

Since banking crises in emerging economies has multiple causes, there is no single solution to them (Tirapat 1999). However, Goldstein and Turner (1996) suggest that there are several measures that can significantly reduce the incident of each of the factors underlying banking crises. For example, greater macroeconomic stability, a larger role for foreign owned banks, the wider use of market-based hedging instruments and higher levels of bank capital would help to make the consequences for the domestic banking system less damaging.

Limiting the allocation of bank credit to particularly interest-rate-sensitive sectors, close monitoring of lending by weakly capitalized banks and employing the right mix of macroeconomic and exchange rate policies would similarly limit vulnerability to lending booms, asset price collapses and surges of capital inflows, content Goldstein and Turner (1996). Strict asset classification and provisioning practices could reduce the increases of bad loans and protection against loan losses Tirapat (1999) agrees with Goldstein and Turner on the role of Government in determining to a great extend the success of efforts to managing such crises. It starts out by reviewing the banking structure, problems faced and some of the causes of recent banking crises. Drawing from the experience of 23 countries Tirapat gives some of successful guidelines all of which show the important role of government in its regulatory role.

According to the Bank of Japan (2003), the remedies to the problem of Non-performing loans can be grouped into three broad categories, all of which work towards enhancing the banks' earning power. First is to further improve efficiency through cost reduction. Secondly is to pursue a new lending strategy backed by appropriate credit risk evaluation, and third is to provide new financial services to increase fee income.

In china for example, one method that has been successfully used is turning over the non-performing assets to Asset management companies (China Daily, 2002). According to Reddy (2002), appropriate provisioning for non-performing assets (up to 50% of gross non performing assets) has been successfully used to cushion banks agents the debilitating effects of non-performing loans.

According to the Central Bank of Kenya (1999), Formation of a Credit Reference Agency where banks can exchange information on the bad borrowers is one method on trial. While a private sector credit reference bureau is in operation, its full operation has been hampered by lack of legislation to allow banks to exchange information but enactment of the necessary legislation is in process.

This brings in the other important step in dealing with non-performing loans. According to CBK, improvement in the Court system is critical. While formation of Credit Reference Bureaus and improvement in the credit risk assessment may prevent future loans becoming delinquent, the current stock of the non-performing loans needs to be quickly resolved. The success of this would be possible if the judicial and court systems are operating efficiently. A number of initiatives have been taken to improve the judicial system through appointment of more judges, provision of physical facilities and amendment of the relevant laws.

The Institute of Certified Public Accountants of Kenya (ICPAK) adopted the International Accounting Standards (IAS) in 1998 and many companies started its implementation in 1999. With respect to the banking institutions, the applicable accounting standards is IAS 30 and except for a few issues in interpretation relating to provisioning for bad and doubtful debts, there has not been any problem in the implementation of the standards and most of the banking institutions have implemented them (CBK, 1999).

Non-performing Assets Recovery Trust (NPART) - proposals have been made on forming a body to take over the non-performing assets from the banking system. Such bodies have worked relatively well in several countries where the government has issued bonds to fund

The non-performing loans from government owned banks. In Kenya, a similar move could he adopted to resolve the Government owned banks saddled by non-performing loans. However, it would be difficult to adopt in the case of private sector banks (CBK, Bank supervision Report 1999).

As a result of the debate among the political and business on the negative effects of high interest rates to the growth of the economy, interest rates have reduced from 20 % in 2001 to 18% in December 2002 (CBK, 2002). The hope is that the positive impact of this action will be seen in increased borrowing for investment. The shift to increased charges and other services offered to customers has seen an increase of 2.2 billion in non- funded income in the banking sector over 2002.

Due to increased customer awareness and availability of choice in the sector, institutions in order to retain their customers have been forced to invest in modern information systems in order to offer better quality services. Greater use of automated technology has reduced risks of manual processing errors. However these have been transformed to system failure risks (CBK, 2002). Internationally active institutions have moved into new products especially financial derivatives in line with international trends in demand. In attempt to equip their staff with the understanding of these products, the banks have had to invest in staff training (CBK, 2002).

Several banks in Kenya are already harvesting the fruits of prudent risk management. As reported by Wahome (2004), The Cooperative Bank of Kenya announced a 70 per cent rise in its pre-tax profitability for year 2003 and declared its first dividend in six years. The bank said its profit rose from Sh104.9 million to *Shl80.5* million in the year ending December 2003. This is the second straight year of profitability for the bank, which made Sh2 billion loss in 2000. The chief executive officer attributed the impressive results to aggressive cost management, focus on non-funded income, debt recovery and prudent liquidity management contributed significantly to the bank's performance in the year. Standard Chartered Bank recorded a 25 per cent increase in pre-tax profit to Sh4 billion for year 2003, and unveiled a new plan to fatten its capital base. The profit take presents a labored improvement on the Sh3.2 billion take for the previous year and one which the bank will be keen to flaunt, having been attained during a period when interest earnings were severely constrained, (The Post, 2004). During the year, the firm was able to grow its loans and advances by 13.6 per cent to Sh18.9 billion on the back of an aggressive push for personal loans that saw the bank even "take over" loans originally taken from competitors (The Post, 2004).

2.6 Chapter summary

The objective of this chapter is to provide a critical and constructive theoretical background of the causes of non- performing loans in banks, and the relative importance of such causes. The first section dealt with the causes of non- performing loans in Kenyan banks, and the relative importance of each of these causes. The second section discussed the specific steps bank managers have taken to deal with the problem of non- performing loans. The third section was theory on what has been the level of success of each of these steps. This research seeks shed more light on extend to which bank supervisors and managers have consciously dealt with this problem of non - performing loans in Kenya.

The next chapter looks at the research methodology to be used. It adopts the following structure: the research design, population and sample, data collection methods, research procedures and data analysis and presentation methods to be used in the study and finally the research process.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

The objective of the study was to point out the impact of non-performing loans on bank operations in Kenya. This chapter looked at the overall methodology used in the study. It will adopt the following structure: First the research design was described, then population and sample, data collection methods, research procedures and data analysis methods to be followed in the research process. A summary of the chapter is presented at the end.

3.2 Research design

This was an explanatory research that adopted the survey research design. Schindler and Cooper, (2001) explain that explanatory studies go beyond description and attempt to explain the reasons for the phenomenon that the descriptive study only observed. According to Grover (2003) explanatory research is devoted to finding causal relationships among variables. It does so from theory-based expectations on how and why variables should be related. Hypotheses could be basic (i.e., relationships exist) or could be directional (i.e., positive or negative). For instance, an explanatory study could explain, hypothesize, and test for a positive relationship between the existence of an MRP system and success in materials management. Results are then interpreted and in turn this contributes to theory development.

Grover (2003) goes ahead to give the limitations of this design. Drawing causal inferences (i.e., a change in variable a causes a change in variable B) is very difficult given survey research designs. The most common design is cross-sectional in which information is collected at one point in time from a sample chosen to represent the population. The lack of a temporal dimension makes it difficult to establish causality, but the design is appropriate to test differences in population subsets. In contrast, longitudinal designs are appropriate for studying phenomenon that change (e.g., the impact of CAD implementation on work design over time) by collecting data in the same organization at two or more points over time. These designs are difficult to implement, hut can provide greater confidence regarding causality.

The justification for this method was that it assisted the researcher to explain the reasons behind the phenomenon of NPLs in Kenya. The other advantage is that it will go beyond the description of the situation in the industry about NPLs because this information is readily available from literature reviewed. As Grover (2003) stated it allows the researcher to use theory-based expectations on how and why variables should be related.

3.3 Population and Sample

A population is the total collection of elements about which we wish to make some inferences. The collection of all possible observations of a specified characteristic of interest is called a population while a collection of observations representing only a portion of the population is called a sample.

The population to be used in this research comprised of the top ten commercial banks in Kenya that have been in existence in the last five years, licensed and registered under the Banking Act. This therefore excludes any banks that may have gone under during the period, or been brought under statutory management of the Central Bank of Kenya. The Central Bank of Kenya has listed these banks. Micro- Finance institutions are not included in the population.

The sampling technique used in this research is purposive sampling. This form
Cooper and Schindler (2001) define the sampling frame as a list of elements from which the sample is actually drawn, which is closely related to the population. The sample of the top ten banks is drawn, based on the value of their net assets, from all the banks listed by the CBK.

This method was used because it enabled the researcher to use judgment in selecting cases that best enable the researcher to answer the research questions and to meet the objectives (Saunders et al, 2000). More specifically, critical case sampling was used. According to Saunders et al, this method selects critical cases on the basis that they can make a point dramatically or they are important. The focus of data collection was to understand what happens in each critical case so that logical generalizations could be made. The research findings can then be applied to other banks.

The sample size was determined using purposive technique. It comprised of officials from the top ten banks in Kenya. The ten large banks were selected on the basis of the level of capitalization. The people responding will be managers, and two credit analysts from each of the respective banks. This gave a sample size of 30 respondents

3.4 Data Collection Methods

Primary data was collected through questionnaires that were distributed to the respondents. The respondents were informed about the intended study through e-mail. The researcher will rely on referral from senior personal acquaintances in the banks to get to the relevant managers. The data collected was aimed to provide answers to the research questions as to the causes of non performing loans in Kenyan banks, the steps bank managers have taken as a result of the effects of the NPL's problem and how successful the steps have been.

The questionnaire instrument was designed on the basis of the research questions, namely as to the causes of non performing loans in Kenyan banks, the steps bank managers have taken as a result of the effects of the NPL's problem and how successful the steps have been. In addition, they were categorized according to the categories of respondents; between credit managers and two assistant credit managers in each case.

3.5 Research Procedures

3.5.1 Pilot Study

A pilot study was conducted to pretest the research instrument to reveal any gaps, inconsistencies or contradictions. The respondents at this stage included managers from a bank not included in the sample. The data obtained from these was only used to fine-tune the research instrument. The data does not form part of the data used for the final analysis.

3.6 Data Analysis and Presentation

The collected data was subjected to a process of cleaning to get rid of any overlaps or unnecessary data.

The collected data was analysed using the SPSS software package. These included frequencies, total scores, means and percentages. Spreadsheets will be used in order to come up with appropriate charts and tables for data presentation, while total scores will be used to rank the responses.

CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

The objective of this chapter is to present and explain the data collected from the survey. The findings are presented and analyzed on the basis of research questions, which are causes of non- performing loans in Kenyan banks, the specific steps actions bank managers have taken to deal with these causes and the level of success of the actions.

4.2 The causes of non- performing loans in Kenyan banks

4.2.1 Factors attributed to non-performing loans

Table I below summarizes the general factors considered to have led to the increase in non- performing loans in Kenyan banks. General factors are described as those considered to be outside the direct scope of the bank management.

Table 1: General Factors

	Distribution											
Factor	**Strongly disagree**		**Disagree**		**neutral**		**agree**		**strongly agree**		**Total**	
	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%
a) National Econ. Downturn and depression for business	0	0	0	0	0	0	17	56.7	13	43.3	30	100
b) Reduced buying ability of customers	0	0	0	0	0	0	18	60	12	40	30	100
c) Legal issues	0	0	0	0	3	10	19	63.3	8	26.7	30	100

According to table I, 43.3 % of the respondents strongly agreed that the national economic downturn that led to depression for business in general was a cause of NPLs. In addition, 56.7 % agreed. Therefore the whole sample agreed with this cause. Further all the respondents agreed that the reduced buying ability of consumers was an important factor. Forty percent strongly agreed while the remaining 60% agreed. According to the results most of the respondents (90%) agreed that legal issues contributed to the increase in levels of NPLs. Twenty six point seven percent (26.7%) strongly agreed and 63.3% only agreed. Ten percent were neutral in their response.

The table below summarizes bank specific factors that were considered to have led to the deterioration in the asset quality in the banks surveyed. These factors are described as those considered to be within the direct scope of the bank management.

Table 2: Bank Specific Factors

	Distribution											
Factor	**Strongly disagree**		**Disagree**		**neutral**		**agree**		**strongly agree**		**Total**	
	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%
a) Lax procedures used for credit risk assessment	0	0	3	10	3	10	18	60	6	20	30	100
b) Lack of aggressive credit collection	0	0	0	0	7	23	17	56.7	6	20	30	100
c) The speedy process in granting loans	1	3.3	1	3.3	2	6.7	23	76.7	3	10	30	100
d) Insider lending and owner concentration	1	3.3	9	30	4	13	8	26.7	8	26.7	30	100
e) Lack of well trained lending personnel	0	0	3	10	3	10	18	60	6	20	30	100

According to table 2, of the 30 respondents 80% agreed that lax procedures used for credit risk assessment and lack of trained lending personnel are important causes of NPLs. Only 10% disagreed while another 10% were neutral. Most of the respondents (76.7%) agreed that lack of aggressive credit collection methods contributed to bad loans while 23.3% neither agreed nor disagreed. Of those who agreed, 56.7% merely agreed while 20% strongly agreed.

Most of the respondents (86.7%) agreed that speedy consideration in granting process of loans is a cause, while 6.6% disagreed. The remaining 6.7% were neutral in their response. Insider lending and owner concentration as a cause of NPLs had 53.4% of the respondents agreeing and 33.3% disagreeing while 13.3% were neutral in their response.

Table 3 below summarizes factors characterizing the attributes of borrowers that are considered to have favored their increased default rate.

Table 3: Client specific factors

	Distribution											
Factor	**Strongly disagree**		**Disagree**		**neutral**		**agree**		**strongly agree**		**Total**	
	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%
a) Clients who start new business whose experience lacked	0	0	1	3.3	6	20	16	53.3	7	2.3	30	100
b) The simultaneous operation many kinds of businesses	0	0	0	0	7	23	23	76.7	0	0	30	100
c) The inappropriate use of the loans	0	0	0	0	0	0	25	83.3	5	16.7	30	100
d) Debtors conceal vital data in their applications	0	0	0	0	2	6.7	16	53.3	12	40	30	100
e) Insufficient collateral	0	0	1	3.3	9	30	19	63.3	1	3.3	30	100

Of the managers who responded 76.6% felt that bank clients started new businesses in which they had no experience. According to table 3, only 3.3% disagreed while 20% were not sure.

Most of the managers (76.75%) felt that the simultaneous operation of too many kinds of business by their clients was as a cause of NPLs. The remaining 23.3% were neutral. All the respondents felt that the inappropriate use of the loan was a cause for NPLs. Of these, 83.3% merely agreed while 16.7% strongly agreed.

Most of the respondents (93.3%) felt that debtors conceal some vital data in their applications and this was a cause of NPLs. Forty percent of these strongly agreed while 53.3 % merely agreed. The remaining 6.7% were not sure.

As shown in the table 3, of the thirty respondents, majority (66.6%) felt that the provision of poorly valued collateral or difficulties in its disposal was a cause of bad debts. Only 3.3% disagreed while the remaining 30% neither agreed nor disagreed.

4.3 Specific steps/ actions taken by bank managers

Table 4 summarizes thirteen different actions that banks have adopted over time in order to minimize the occurrence of non- performing loans in their respective banks. These findings from the survey are as reported from the ten banks surveyed.

The majority 70% of the managers interviewed felt that the banks were not involved enough in government policy formulation as indicated in the table shown below. Only 30% said the banks were involved. Reduction of interest rates received a majority "yes" with 96.7% of the respondents saying it was an action taken by the banks. Only 3% said there was no reduction of lending rates.

As shown in the table, majority (93.3%) of the managers agreed that there had been improvement in quality of credit information asked for during the loan application request. Only 6.7% felt there was no improvement

Table 4: Specific actions of managers

Factor	**Distribution** Yes		NO		Total	
	Fre	%	Fre	%	Fre	%
(a) Involvement of the Bank in Govt. fiscal policy formulation	9	30	21	70	30	100
(b) There is reduction of interest /Lending rates	29	96.7	1	3.3	30	100
(c) Improved credit information during loan application	28	93.3	2	6.7	30	100
(d) Increased use of credit reference bureaus	9	30	21	70	30	100
(e) Info, sharing among banks about borrowers	16	53.3	14	46.7	30	100
(f) Emphasis on creditworthiness of borrowers	27	90	3	10	30	100
(g) Use specific limits, ratios in the evaluation process	27	90	3	10	30	100
(h) Emphasis on forecasts and feasibility studies	23	76.7	7	23.3	30	100
(i) Use of specific lending & project appraisal techniques	24	80	6	20	30	100
(j)The use of procedures for management of problem loans	27	90	3	10	30	100
(k) Instrument use ensures borrowers repay their loans	30	100	0	0	30	100
(l) Use of contents of loan files to monitor loan quality.	29	96.7	1	3.3	30	100
(m) Standard loan process from enquiry to lending decision	26	86.7	4	13.3	30	100

Unlike the above actions, the majority of the respondents (70%) felt that the use of credit reference bureaus was not an action taken by banks to deal with NPLs. However, as shown, 30 % said that this was a valid action being taken by banks to mitigate defaulting by borrowers. Fifty-three point three of the respondents reported the increased use of information sharing among banks about credit worthiness of borrowers as an action against loan defaulting. The remaining 46.7% did not agree.

Emphasis on creditworthiness of borrowers is widely used as a way of reducing the risk of default according to 90% of the respondents. As indicated, most of the managers (90%) agreed that the use of specific limits, ratios, based on cash flows used by the bank in the evaluation process was a valid action. The respondents were divided as to whether there was emphasis on forecasts and feasibility studies. However majority (76.7%) felt this was a method used by their respective banks to manage lending risk. Twenty three percent disagreed.

As shown in the table, 80% of the managers felt that their respective banks used specific lending procedures and techniques for project appraisal, approvals and legal finalization of projects, procurement and disbursement, as well as follow-up and supervision of such projects. Only 20% disagreed. As far as procedures for management of problem loans are concerned, the majority of the respondents (90%) felt it was a useful action being taken by the banks.

Incase borrowers defaulted on their loans, all the managers responding felt that instruments and remedies available to ensure that borrowers repaid their loans to the bank were adequate. The study also noted that most of the managers (96.7%) felt that the contents of loan files, the use of the information to monitor the quality of loans was clear. However 3.3% disagreed as shown.

The table indicates that 86.7% of the respondents felt that the standard loan process from the client's initial enquiry or the bank's marketing efforts, to the final lending decision, and the edit decision process was proper and described. Thirteen percent said "No".

Majority of the managers (83.3%) said that as a way of improving management of loans, there was increased training of loan officials. The remaining 16.7% did not agree there was increased training.

Table 5: The level of success of the actions

	Distribution											
Factor	**Very poor**		**poor**		**Average**		**Good**		**Very good**		**Total**	
	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%	Fre	%
a) Involvement of Bank in Govt. fiscal policy formulation	3	10	9	30	16	53.3	2	6.7	0	0	30	100
b) There is reduction of interest/lending rates	0	0	0	0	3	10	14	46.7	13	43.3	30	100
c) Info. Sharing among banks about borrowers	0	0	17	57	8	26.7	5	16.7	0	0	30	100
d) Increased use of credit reference bureaus	1	3.3	18	60	6	20	5	16.7	0	0	30	100
e) Improved credit info. Requested in loan application	0	0	2	6.7	1	3.3	26	86.7	1	3.3	30	100
f) Emphasis on creditworthiness	0	0	0	0	4	13.3	18	60	8	27.7	30	100
g) Use of specific limits, ratios in evaluation process	0	0	0	0	2	6.7	18	60	10	33.3	30	100
h) Emphasis on forecasts and feasibility studies	0	0	3	10	11	36.7	12	40	4	13.3	30	100
i) Use of specific lending & project appraisal techniques	0	0	4	33	7	23.3	12	40	7	23.3	30	100
j) Use of procedures for management of problem loans	0	0	3	10	8	26.7	14	46.7	5	16.7	30	100
k) Use instruments to ensure borrowers repay their loans	0	0	5	17	6	20	13	43.3	6	20	30	100
l) Use of loan files to monitor the quality of loans	0	0	3	10	4	13.3	13	43.3	10	33.3	30	100
m) Standard loan process from enquiry to lending decision	0	0	1	3.3	8	26.7	17	56.7	4	13.3	30	100

As indicated, most of the respondents (90%) evaluated the success of emphasis on forecasts and feasibility studies in the evaluation process as average and above. Thirty six percent felt it was good while 33.3% said it was very good. Another 6.7% said it was average. Only 10% felt it was poor.

As for the use of specific lending procedures and techniques for project appraisal, approvals and legal finalization of projects, procurement and disbursement, 23.3% said the success was very good. Forty percent reported that it was good while those who thought it was average were 23.3%. Only 13.3% respondents rated the action as unsuccessful.

As shown in the table, the success in the use of procedures for management of problem loans, describing specialized workout departments or intensive care units and detailing scope, skill, resources, and efficiency was rated as very good by 16.7% of the respondents. Another 46.7% indicated that the success was good while 26.7% said the success was average. Only 10% of the managers said it was poor.

As for the use of instruments and remedies available to ensure that borrowers repay their loans to the bank, table 8 shows the breakdown of the responses as follows; 20% of the respondents rated its success as very good, 43.3% rated it as good, 20% rated it as average and 16.7% said it was poor.

As shown in the table, of the respondents interviewed, 33.3% said the success of this action was very good. Another 43.3% rated the success as good while 13.3% and 10% rated it as average and poor respectively. Concerning the use of a clearly described standard loan process from the client's initial enquiry or the bank's marketing efforts, to the final lending decision, and the credit decision process, only 13.3% of the managers felt it was very good. The majority *(56.77c)* however felt it was good while 26.7% said it was average. Only 3.3% respondent rated it as poor.

4.5 Chapter summary

In this chapter the data collected was presented and explained. The findings were presented and analyzed on the basis of research questions. It documented the causes of non- performing loans in Kenyan banks, including ranking them according to their level of importance. The respective main factors contributing to non performing loans were the national economic downturn which leading to depression for business in general; reduced buying ability of consumers; insider lending and owner concentration; inadequate procedures for credit risk assessment and credit management; misuse of the loan; and legal delays. The other factors included bank clients starting new businesses in which they had no experience, the simultaneous operation of too many kinds of business and the inappropriate use of the loan. The data presented also showed the specific steps/actions bank managers have taken to deal with the causes of non-performing loans which include improvement in techniques for credit risk assessment as well as improved credit management. The level of success of the actions was also documented. The next chapter presents a summary of the important elements of the research including a discussion of the major findings, major conclusions and recommendations for the study.

CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the important elements of the research including the purpose of the study and research questions, methodology used and the major findings. The chapter also gives a discussion of the major findings of the study organized according to the research questions and the major conclusions drawn from the research. Recommendations for practice or improvement and for further studies are included in the final section.

5.2 Summary

The research found out that the main factors contributing to non performing loans were the national economic downturn which led to depression for business in general; reduced buying ability of consumers; insider lending and owner concentration; inadequate procedures for credit risk assessment and credit management; misuse of the loan; and legal delays. The other factors included the bank clients starting new businesses in which they had no experience, the simultaneous operation of too many kinds of business and the inappropriate use of the loan. The data presented also showed the specific actions bank managers have taken to deal with non-performing loans. These include improvement in techniques and procedures used for credit risk assessment. Improved procedures used for monitoring loans such as project appraisal and supervision were also reported. Other major actions reported were reduction in interest rates, increased training of loans officials and the improvement in techniques to monitor the quality of loans and to ensure that borrowers repay their loans. The reduction of interest rates was reported to have been the most successful action. The improvement in the procedures used for credit risk assessment was reported to be very successful. Improved procedures used for monitoring loans such as project appraisal and supervision were also reported to have been successful. The increased training of loans officials was considered to have been successful too. Unsuccessful actions were mainly the use of credit reference bureaus and information sharing among banks to determine the creditworthiness of borrowers.

5.3 Discussion

5.3.1 The causes of non-performing loans in banks

The factors discussed in this section are intertwined. For example, legal issues as a cause of NPLs are considered as being outside the scope of the bank management. But in practice, they do affect internal matters of management since they cover regulatory issues that directly impact on the procedures used by respective banks. For the purposes of discussion, the internal and external factors will be handled as separate factors. The findings of the study were in line with studies conducted in other parts of the world. As pertains to external factors, one cause that most of the respondents unanimously agreed on as an important cause of non-performing loans was the existence of an unfavorable economic environment. Specifically, the national economic downturn leading to the depression of business in general was found as an important factor. In a similar vein, a study conducted by Brownbridge (1998), macroeconomic instability was found to be an important cause of NPLs. In the current study, the majority of respondents felt it was an extremely important factor.

The reduced buying ability of consumers is another important cause of non-performing loans singled out in the study. In a study conducted by Gorter & Bloem (2002), they content that non-performing loans are mainly caused by inevitable factors such as unexpected price changes for certain products.

There are other important factors that are considered beyond the direct scope of the banks. They include legal issues such as delays in settling commercial disputes. In Uganda for example, Mukalazi (1999) stated that the government moved in and introduced a statute that deals with several issues such as insider lending and lending without adequate collateral. The current study also identified these as important factors. Internal factors affecting non-performing loans were also documented in the current study. Among the important ones are the procedures used in banks for credit risk assessment including the skills of loans officials. This study found this to be an important factor with most respondents saying so. The study went further to break this down into finer factors such as the speedy process of consideration in granting loans, the interest rates charged, insider lending and owner concentration among others. These have been documented in other studies such as one by Fernández, Jorge and Saurina (2000), in which they found that most banking crises have directly led to the inadequate management of credit risk by institutions. They further assert that even though bank supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. They claim that even conservative managers might find market pressure for higher profits very difficult to overcome.

As concerns the levels of interest, Brownbridge (1998) found out that lending to borrowers in high-risk segments of the credit market at very high rates led to moral hazard on the part of both the banks and their borrowers and the adverse selection of the borrowers. The moral hazard is linked to such factors as debtors concealing vital data in their applications and the provision of poorly valued collateral in addition to inappropriate use of the loan and the simultaneous operation of too many kinds of businesses. The current study also found these as important factors leading to the presence on NPLs in bank portfolios.

5.3.2 Specific steps taken to deal with the causes

The major findings about the steps taken to deal with the causes of non-performing loans will also be split into general ones and those that are bank and customer/client specific. The general ones are generally those considered to be outside the direct control of bank managers while the reverse is true for the bank specific factors.

The only general action investigated in this study was the involvement of the bank management in government policy formulation regarding economic matters. The findings showed that this was not an action that bank managers have emphasized as a solution to NPLs.

As pertains to solutions to internal causes, the reduction of interest rates came out strongly in this study as an important action taken by bank management to deal with bad debts. In the study by Brownbridge (1998), the researcher had identified lending at high interest rates, to borrowers in high-risk segments of the credit market this as major a factor contributing to bank failure. The current study also revealed that the area of risk management has caught the closer attention of bank managers.

These findings are congruent with the findings of a study carried out in India by Nagarajan (2003). In the study Nagarajan itemizes detailed guidelines on credit risk management for Indian banks provided by the reserve bank of India, which goes beyond traditional measures like exposure limits and credit rating. The current study showed that there is emphasis on creditworthiness of borrowers, forecasts and feasibility studies, specific lending procedures and techniques for project appraisal and legal finalization of projects. The study also revealed that there was emphasis on the use of specific limits and ratios, based on cash flows used in the evaluation process.

Another important aspect that came out was that there are procedures for management of problem loans, as well as the availability of instruments and remedies to ensure that borrowers repay the bank. The study also found training of loans officials to be increasingly practiced in the banks according to majority of the respondents.

5.3.3 The level of success of the actions of managers

Previous studies conducted in other regions have generally focused on the causes and not actions taken in response to the causes. The current study investigated this area. The major findings about the success of the steps taken to deal with the causes of non-performing loans will also be split into general ones and those that are bank and customer specific. The general ones are generally those considered to be outside the direct control of bank managers while the reverse is true for the bank specific factors.

The only general action investigated in this study was the level of success of the involvement of the bank management in government policy formulation regarding economic matters. The findings showed that this was not an action that bank managers have emphasized as a solution to NPLs. Congruent to other studies on solutions of NPLs, this mode of action does not seem to feature strongly. Surprisingly, it was found to be of average success. Managers felt that this is an area that is important in as far as management of NPLs is concerned.

The Bank of Japan (2003) documented one of the remedies to the problem of Non-performing loans as the pursuance of a new lending strategy backed by appropriate credit risk evaluation used successfully in Japan. The current study revealed that reduction of interest rates, as a new lending strategy has been a success. The Central Bank of Kenya (2002) has also documented that interest rates in Kenya have reduced significantly. As a result of the debate among the political and business fraternities on the negative effects of high interest rates to the growth of the economy, interest rates have reduced from 20 % in 2001 to 18 % in December 2002.

As pertains to credit information asked for during the loan application process, the study found that the success ranged from average to very good. This includes the findings on such specific areas of credit risk assessment such as the use of specific limits and ratios, based on cash flows as well as the use of forecasts and feasibility studies, the use of a standard lending procedure and the use of clear loan files to monitor the quality of loans. According to the CBK (2002) there is a private sector credit reference bureau in operation in Kenya. Its full operation has however been hampered by lack of legislation to allow banks to exchange information with third parties. The findings of the study were congruent to the findings by CBK. The current study found that information sharing among individual banks as to the creditworthiness of borrowers was poor. However, the use of credit reference bureaus was found to have greatly improved over time. It also found that the success in the use of instruments and remedies at the disposal of banks to ensure debtors paid their debts was good.

5.4 Conclusions

5.4.1 The causes of non-performing loans in banks

According to the research findings, it was possible to document the causes of non-performing loans in Kenyan banks as perceived by credit managers in the different banks surveyed. It is noteworthy that the research findings compare closely with previous findings in other parts of the world as well as findings of similar studies in Kenya. A study by Brownbridge (1998) found similar causes of NPLs in Kenya. The current study was more specific on the causes breaking the four wider causes investigated by Brownbridge into finer ones.

The causes can be classified into three major categories based on their source. Firstly, the research identified general factors which were considered to be beyond the direct control of the banks. The results showed however, that the managers felt that banks could still exert some meaningful influence on these to minimize their impact on NPLs. These are:

- National economic downturn which led to depression for business in general
- Reduced buying ability of consumers
- Legal issues

The importance attributed to each of these varied. An unfavorable economic environment can be said to be most important as it will tend to influence all other factors. The second category comprises of bank specific factors. These are the factors which relate to the risk management structures and tools put in place by the banks. They include:

- Lax procedures used for credit risk assessment and lack of trained lending personnel
- Lack of aggressive credit collection methods
- Banks negligence in monitoring performing loans
- The speedy consideration in granting process
- Insider lending and owner concentration

All these factors were found to contribute to bad loans. Their importance was identified to be of varying degrees. The third category comprises of client specific factors. These are also factors which relate to the risk management structures and tools put in place by the banks but focused on the customer. They include:

- Bank clients started new businesses in which they had no experience
- The simultaneous operation of too many kinds of business
- The inappropriate use of the loan
- Debtors conceal some vital data in their applications
- Provision of poorly valued collateral or difficulties in recovery

All these factors were also found to contribute to bad loans. Their importance was identified to be of varying degrees. By strengthening their management of these factors, banks should be able to significantly reduce the losses accruing from NPLs.

5.4.2 Specific steps taken to deal with the causes

The research identified specific steps taken by bank management to deal with NPLs. Most of those identified were corroborated by literature about steps that are already in full use or on trial either in Kenya or in other parts of the world. They include:

- Involvement of Bank Management in Government fiscal policy formulation
- Reduction of interest / Lending rates
- Improvement in quality of credit information asked for during the loan application request
- Increased use of credit reference bureaus

- Information sharing among banks about credit worthiness of borrowers
- There is emphasis on creditworthiness of borrowers
- Use of specific limits, ratios, based on cash flows used by you in the evaluation process
- There is emphasis on forecasts and feasibility studies
- Use of specific lending procedures and techniques for project appraisal and supervision
- The use of procedures for management of problem loans
- The use of instruments and remedies to ensure that borrowers repay their loans to the bank
- The contents of loan files, the use of its information to monitor the quality of loans is clear.
- Use of a standard loan process from the client's initial enquiry to the final lending decision
- Increased training of loans officials

Each of these actions was identified as having been adopted by the banks as a way of minimizing the negative effects of high levels of poor asset quality. Some were identified as more important than others. The training of loans officials was thought to be very important because the efficiency of the other measures depends on the skills of the official. Bank management stands to gain from ensuring that these measures are maximized.

5.4.3 The level of success of the actions of managers

Most studies carried out on the causes of NPLs have neither addressed the solutions nor the effectiveness of such solutions. In this particular study it was possible to identify the actions as well as to evaluate their level of success as perceived by the credit staff in the banks surveyed.

The level of success of the each of the actions identified as having been adopted by the banks as a way of minimizing bad loans was documented. Some were identified as more important than others. The training of loans officials was thought to be very important because the efficiency of the other measures depends on the skills of the official. Bank management stands to gain from ensuring that these measures are maximized.

5.5 Recommendations

This study identified causes of NPLs in Kenyan banks. These include the national economic downturn which led to depression for business in general; reduced buying ability of consumers; insider lending and owner concentration; inadequate procedures for credit risk assessment and credit management; misuse of the loan; and legal delays. The other factors included the bank clients starting new businesses in which they had no experience, the simultaneous operation of too many kinds of business and the inappropriate use of the loan.

The study also showed the specific steps/actions bank managers have taken to deal with the causes of non-performing loans which include improvement in techniques for credit risk assessment as well as improved credit management as well as involvement without the firm in financial policy formulation by government. The level of success of the actions was also discovered to range between very good and poor according to the respondents surveyed.

Recommendations of this study are that loan officials must carefully grant loans by basing their consideration on loan analysis principles, using their discernment as well as experience to verify debtor credibility; i.e., debt repayment ability, capital management and collateral sufficiency. More importantly, loan officials should strictly and regularly monitor how the loan is used in order to be able to promptly handle arising problems. The justification for these recommendations is borne by the fact that the respondents were of the opinion that these were important causes for NPLs. The study also found that the actions had proved useful in the banks surveyed as reported by the credit managers. In addition, banks should continue to invest in the training of loans officials since most of the respondents confirmed that it was a new trend. The training of loans officials was thought to be very important because the efficiency of the other measures depends on the skills of the official.

This study did provide insight into the causes of non-performing loans in Kenyan banks as well was the actions put in place by managers in banks. The research also evaluated the success achieved in the management of NPLs through these actions. However, the research was by no means comprehensive as it was a survey that covered only ten of the 46 banks registered in Kenya. Recommendations are for a study of all the banks.

Secondly, the study did not focus on the causes of default as perceived by the creditors or borrowers. It is considered that their view could be compared with those of the bank managers to give a more objective position. It is therefore recommended that a similar study incorporating the views of borrowers is desirable.

Thirdly, the sample did not cut across the different levels of staff involved in the management of loans. A more comprehensive research seeking the views of all officials is recommended.

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APPENDICES

Appendix A: The causes of non – performing loans in Kenyan banks

Instructions:

Please mark the appropriate box to indicate whether you agree or disagree to the validity of the cause.

Key

1. **SA – Strongly agree**
2. **A – Agree**
3. **N – Neutral**
4. **D – Disagree**
5. **SD – Strongly disagree**

(a)	1	2	3	4	5
	SA	**A**	**N**	**D**	**SD**

General Factors

	Areas of Measure	SA	A	N	D	SD
1	Did National Economic downturn which led to depression for business in general contribute to NPL's?					
2	Does the reduced buying ability of consumers contribute to NPL's?					
3	Legal Issues such as court delays in handling issues contribute to NPL's?					

Bank Specific factors

	Areas of Measure	SA	A	N	D	SD
1	Do Lax Procedures used for credit risk assessment contribute to NPL's?					
2	Does the Lack of aggressive credit collection methods contribute to NPL's?					
3	Does the speedy consideration in granting process in order to serve the bank target ahead of competition contribute to NPL's?					
4	Does Insider Lending & Owner Concentration contribute to NPL's?					
5	Is the Lack of well trained lending personnel a contributor to NPL's?					

Client Specific factors

	Areas of Measure	SA	A	N	D	SD
1	Do Bank clients who have started new businesses which they have no experience in contribute to NPL's?					
2	Does the simultaneous operation of too many kinds of business contribute to NPL's?					
3	Does the inappropriate use of the loan contribute to NPL's?					
4	Does the fact that Debtors conceal some of the true data in their applications act as a contributor to NPL's?					
5	Does the provision of poorly valued collateral contribute to NPL's?					

Appendix B: The actions that have been taken to deal with non – performing loans (NPL's).

Instructions:

Please mark the appropriate box to indicate whether you agree or disagree

Key: **Yes** **No**

Y **N**

1. Does the involvement of the Bank in Government policy on fiscal / economic matters help reduce NPL's?

Y **N**

☐ ☐

2. Has the Reduction of interest / Lending rates led to a decrease in NPL's?

Y **N**

☐ ☐

3. Is there an improvement in quality of credit information asked for during the loan application request?

Y **N**

☐ ☐

4. With the increased use of credit reference bureaus, has this resulted in a decrease in NPL's?

Y **N**

☐ ☐

5. Has the increased use of information sharing among banks about credit worthiness of borrowers helped reduce NPL's?

Y **N**

☐ ☐

6. Has the emphasis on credit worthiness of borrowers had an impact in reducing NPL's?

Y **N**

☐ ☐

7. Has the emphasis on the use of specific limits, ratios, based on cash flows used by you in the evaluation process led to the decrease of NPL's?

Y **N**

☐ ☐

8. Has the emphasis on forecasts and feasibility studies helped in reducing NPL's?

Y **N**

☐ ☐

9. There are specific lending procedures and techniques for project appraisal, approvals and legal finalization of projects, procurement and disbursement, as well as follow-up and supervision of such projects. Has this had an impact on the decrease of NPL's?

Y **N**

☐ ☐

10. There are projects for management of problem loans, describing specialized workout departments or intensive care units and detailing scope, skill, resources and efficiency. Has the impact reduced NPL's?

Y **N**

☐ ☐

11. There are instruments and remedies available to ensure that borrowers repay their loans to the bank; describe also the mechanisms that exist for legal recovery, foreclosure and repossession of collateral, and transmission of legal rights? Have these had an impact in reducing NPL's?

Y	**N**
☐	☐

12. Have the contents of loan files, the use of its information to mentor the quality of loan to clear contributed to reducing NPL's?

Y	**N**
☐	☐

13. Is the standard loan process form the client's initial enquiry or the bank's marketing efforts to the final lending decision, and the credit decision process proper and described?

Y	**N**
☐	☐

Appendix C: The level of success of each of the actions taken

Instructions:

Please mark the appropriate box to indicate the level of success

Key:

VP – Very Poor P – Poor A – Average G – Good VG – Very Good

1	**2**	**3**	**4**	**5**
VP	**P**	**A**	**G**	**VG**

	Areas of Measure	**VP**	**P**	**A**	**G**	**VG**
1	Involvement of Bank in Government in policy on fiscal / economic matters					
2	Reduction of Interest / Lending rates					
3	There is improvement in quality of credit information asked for during the loan application request					
4	Increased use of credit reference bureaus					
5	creased use of information sharing among credit worthiness of borrowers					
6	nphasis on credit worthiness of borrowers					
7	nphasis the use of specific limits, ratios, based on cash flows used by you in the evaluation process					
8	nphasis on forecasts and feasibility studies					
9	ıere are specific lending procedures and techniques for project appraisal, approvals and legal finalization of projects, procurement and disbursement, as well as follow-up and supervision of such projects					
10	ıere are projects for management of problem loans, describing specialized workout departments or intensive care units and detailing scope, skill, resources and efficiency					
11	ıere are instruments and remedies available to ensure that borrowers repay their loans to the bank; describe also the mechanisms that					

	exist for legal recovery, foreclosure and repossession of collateral, and transmission of legal rights?					
12	ıe contents of loan files, the use of its information to mentor the quality of loan is clear.					
13	The standard loan process form the client's initial enquiry or the bank's marketing efforts to the final lending decision, and the credit decision process is proper and described.					

Appendix D

a) List of Kenyan commercial banks (Source CBK)

No	NAME OF INSTITUTION	TOTAL NET ASSETS
1	Barclays Bank of Kenya Ltd	74,178
2	Kenya Commercial Bank Ltd	61,115
3	Standard Chartered Bank Ltd	54,410
4	Citibank, N.A.	27,710
5	National Bank of Kenya Ltd	23,956
6	Co-operative Bank of Kenya	21,338
7	Commercial Bank of Africa	16,156
8	National Industrial Credit Bank	8,408
9	CFC Bank Limited	8,300
10	Investment & Mortgages Bank	7,100
11	Stanbic Bank Kenya Limited	6,653
12	First American Bank Limited	6,458
13	Credit Agricole Indosuez	5,794
14	Diamond Trust Bank Kenya	5,417
15	Fina Bank Limited	4,689
16	Giro Commercial Bank	4,131
17	Middle East Bank of Kenya	4,075
18	Bank of Baroda	3,829
19	Imperial Bank Limited	3,645
20	Development Bank of Kenya	3,630
21	Guardian Bank	3,625
22	Habib AG Zurich	3,514
23	Akiba Bank Ltd	3,268
24	Consolidated Bank of Kenya	3,176
25	Prime Bank Limited	3,163

26	Bank of India	3,131
27	African Banking Corporation	2,961
28	Habib Bank Limited	2,911
29	Southern Credit Banking Corp.	2,905
30	Victoria Commercial Bank Ltd	2,760
31	Biashara Bank of Kenya Ltd	2,402
32	Co-operative Merchant Bank	2,372
33	Equatorial Commercial Bank	2,284
34	Charterhouse Bank Limited	1,907
35	Industrial Development Bank	1,862
36	Delphis Bank Limited	1,826
37	Credit Bank Limited	1,566
38	Transnational Bank Limited	1,550
39	Euro Bank Limited	1,435
40	Paramount-Universal Bank	1,354
41	Fidelity Commercial Bank	1,252
42	K-REP BANK	1,173
43	Chase Bank Limited	972
44	Dubai Bank Limited	820
45	City Finance Bank	800
46	Daima Bank Limited	750
TOTAL		**406,731**

b) List of top ten Kenyan Commercial Banks (Source: CBK)

1	Barclays Bank of Kenya Ltd	74,178
2	Kenya Commercial Bank Ltd	61,115
3	Standard Chartered Bank Ltd	54,410
4	Citibank, N.A.	27,710
5	National Bank of Kenya Ltd	23,956
6	Co-operative Bank of Kenya	21,338
7	Commercial Bank of Africa	16,156
8	National Industrial Credit Bank	8,408
9	CFC Bank Limited	8,300
10	Investment & Mortgages Bank	7,100