European Journal of Economic and Financial Research
ISSN: 2501-9430
ISSN-L: 2501-9430
Available on-line at: http://www.oapub.org/soc

doi: 10.5281/zenodo.572281 Volume 2 | Issue 2 | 2017

EFFECTS OF CREDIT RISK MANAGEMENT PRACTICES ON LOAN PERFORMANCE OF COMMERCIAL BANKS IN NYERI COUNTY, KENYA

Wachira, Alexander Kinyua[i]
School of Business and Economics,
Department of Accounting and Finance,
Meru University of Science and Technology, Kenya

Abstract:
This study sought to establish how various credit risk management practices affect performance of commercial banks in Nyeri County in Kenya. Even though commercial banks face several types of risks, credit risk stands out as the most severe. Credit risk is the possibility of loss to the lender on non-performing loans. Financial practice as well as theory provides a scientific process of credit risk management in financial institutions. However, lenders still face loan default and consequently this study sought to find out how those practices affect the performance of commercial banks in Nyeri County, Kenya. A census study was conducted where a population of 86 respondents was targeted comprising of branch managers, credit managers and credit officers. The findings of the study were that all commercial banks had a well written credit policy which is strictly and consistently followed. Only few commercial banks conduct a quantitative credit scoring model. In all banks, initial screening is done by credit officer and approval done at different levels depending on the amount. Majority of the banks check post borrowing activities of the borrower. In conclusion, credit risk management has an effect on loan performance amongst commercial banks. Thus, managers should evaluate more accurately the ability to pay back of a customer since the better the screening the better the performance of commercial banks.

JEL: G31, E51, G21

Keywords: credit risk, credit risk management, commercial banks, loan performance

[i] Correspondence: email kinyuaaw@gmail.com

1. Introduction

Commercial Banks are financial institutions and play a very important role in an economy. Specifically, they channel financial resources from savers (surplus inits) to lenders (deficit units). In developing economies, they help borrower to have no access to capital markets, (Barth et al, 2004). According to Cornett and Saunders, (1999), commercial banks face three types of risks, financial risk – with credit risk being a component, operational and strategic risk. These risks have different impact on performance of commercial banks. The magnitude and the level of loss caused by credit risk compared to others are severe in causing bank failures.

Bridge (1998) observed that credit problems have been identified to be a part of the major reasons behind banking difficulties. Loans constitute a large proportion of credit risk as they normally account for 10-15 times the equity of a bank, (Barth et. al. 2004). Poor loan quality stems from the information processing mechanism. It begins right at the loan application stage and increases further at the loan approval, monitoring and controlling stages especially when credit risk management guidelines in terms of policy and procedures for credit processing do not exist or are weak or are incomplete.

For commercial banks to minimise loan losses, it's essential they develop an effective credit risk management system (Basel, 2004). As a result of asymmetric information that exists between lenders and borrowers, commercial banks are exposed to adverse selection and moral hazards. This calls for commercial banks to have a mechanism in place to not only assess default risk that is unknown to them in order to avoid adverse selection and also one that can evolve after lending to avoid moral hazard.

According to Coyle (2000), credit management process involves various steps namely, credit risk identification, measurement, monitoring and control and finally credit monitoring. Credit identification involves singling out of the risks associated with a particular credit. Credit risk arises from potential changes in the credit quality of a borrower. The financial institution should identify risk of loss that it considers that the obligor is unlikely to pay its credit obligations in full or the obligor is more than 90 days past due on any material credit obligation.

Credit risk measurement involves the process of credit rating/scoring. Credit rating of an account is done with primary objective being to determine whether the account after the expiry of a given period of time would remain a performing asset, i.e. it will continue to meet its obligations as and when they arise. The credit rating exercise seeks to predict whether the borrower will have the capability to honour his/her financial commitments in future. In reality, there are no mathematical or empirical models that can predict accurately the future capability of a borrower to meet his/her financial obligations.

Similarly, Commercial banks can use credit reference bureau which is an organization that provides information on individual's borrowing and bill-paying habits. Consumers with poor credit repayment histories or court adjudicated debt obligations like tax liens or bankruptcies will pay a higher annual interest rate than consumers who don't have these factors.

Next, a commercial bank should undertake credit monitoring. The financial institution should also assign specific individuals for monitoring the credit portfolio including ensuring information is disseminated to those responsible for taking corrective action and assigning adequate reserves for loan losses. An effective monitoring system will ensure that the financial institution understands the current financial condition of the borrower, monitors compliance with the existing terms and conditions, assesses collateral in relation to the borrowers current condition, identifies non-performing accounts and enforces proper classification and loan loss provisioning. Lastly, institutions should use various techniques of mitigating credit risk. The most common are collaterals, guarantees and netting off of loans against deposits of the same counter-party. A collateralised transaction is one in which institutions have a credit exposure or potential credit exposure and the exposure is reduced in whole or in part.

2. Statement of the Problem

Lending is the core business of commercial banks, and this is more so in an emerging economy like Kenya where the capital markets are still developing. However, lending has been a challenging matter because business firms on one hand are complaining about difficulty in accessing credit and excessively stringent conditions set by banks, while the banks on the other hand continue to suffer large losses on non-performing loans (Richard, 2006). "*The default of a small number of customers may result in a very large loss for the bank*" (Gestel & Baesems, 2008). Further, if a borrower with high credit quality has deteriorated profile, it can also cause credit risk loss to the banks.

According to Psillaki, Tsolas, and Margaritis, (2010), when commercial banks effectively manage their credit risk, they do not only enhance the viability and profitability of their own business but also support the systemic stability and an efficient allocation of capital in an economy. According to Ahmad and Ariff (2007), most banks in economies such as Thailand, Indonesia, Malaysia, Japan and Mexico experienced high non-performing loans and significant increase in credit risk during financial and banking crises, which resulted in the closing down of several banks in Indonesia and Thailand. Such a situation erodes investors' confidence and saving is discouraged and without savings, investment is adversely affected. This in turn affects the economic growth a nation.

The central bank of Kenya annual supervision of 2016 has reported that non-performing loans have been increasing in the past three years. Should this trend continue, profitability of the banks in the short run and sustainability of these banks in the long run would be adversely affected. In total support of this, Kithinji (2010) assessed the effect of credit risk management on the profitability of commercial banks in Kenya and found that banks' profitability is affected by credit risk management. Further, Kolapo et al. (2012) observed that the poor quality of the banks' loan assets in Nigeria hindered banks to extend more credit to the domestic economy, thereby adversely affecting economic performance.

However, should commercial banks prudently adhere to credit risk management practices available in the financial literature; they would have a clean loan book and hence improved profitability. Credit risk management, therefore, is very essential in optimizing the loan performance of commercial banks. It is against this background that this study focused on establishing how the credit risk management practices affect the loan performance of commercial banks in Nyeri County, Kenya.

3. Objectives of the Study

The general objective of this study was to establish the effect of credit risk management practices on loan performance of commercial banks in Nyeri County Kenya.

4. Literature Review

4.1 Theoretical Literature Review

Credit risk management involves creating an appropriate credit risk environment; operating under a sound credit granting process; maintaining an appropriate credit administration that involves monitoring process as well as adequate controls over credit risk (Basel, 1999; Greuning and Bratanovic, 2003; IAIS, 2003). It requires top management to ensure that there are proper and clear guidelines in managing credit risk, i.e. all guidelines are properly communicated throughout the bank; and that everybody involved in credit risk management understand them.

According to Coyle (2000), credit risk is loss from the refusal or inability of credit customers to pay what is owed in full and on time. Credit risk is the exposure faced by banks when a borrower (customer) defaults in honouring debt obligations on due date or at maturity. This risk can put a bank in distress if not satisfactorily managed. Kargi, (2011) asserts that credit risk management maximizes bank's risk adjusted rate of return by maintaining credit risk exposure within acceptable limit in order to provide framework for understanding the impact of credit risk management on banks' profitability. Increase of non-performing loans in the credit portfolio affects banks profitability. Non-performing loan is the percentage of loan values that are in default for three months and above (Ahmad and Ariff, 2007).

Owing to high default rates, Basel II Accord spelt out various credit risk management practices. Commercial banks are expected to follow these practices in managing their credit risk and therefore improving their performance. With effective credit risk management, banks enhance their viability and profitability; and this in turn results in systemic stability and efficient allocation of capital in an economy (Psillaki, Tsolas, and Margaritis, 2010). Kithinji, (2010) observed that increase in bank credit risk eventually results in liquidity and solvency problems.

4.2 Empirical Literature Review

Kolapo et al (2012) carried out a research on credit risk and commercial banks performance in Nigeria and established that a 100% increase in non-performing loans reduces profitability as measured by return of assets by 6.5 %. Their study therefore recommended that banks in Nigeria should enhance their capacity in credit analysis and loan administration while the regulatory authority should pay more attention to banks' compliance to relevant provisions of the Bank and other Financial Institutions Act (1999) and prudential guidelines.

Gakure et al. (2012) also conducted a study on effects of reedit risk management practices on unsecured bank loans in Kenya and concluded that credit risk management practices influence performance of commercial banks to a great extent. Similarly, Fan and Zou (2014) carried out a study on impact of credit risk management on profitability of commercial banks in Europe. In their study, they arrived at a conclusion that non-performing loans ratio has a great impact of both returns on equity and return on assets.

Bakaeva and Sun (2009) established a positive relationship between credit risk management and profitability of commercial banks in Sweden. Kithinji (2010) assessed the effect of credit risk management on the profitability of commercial banks in Kenya and found that banks' profitability is not affected by credit risk management. When it comes to both credit risk and liquidity risk, Ruziqa (2013) undertook a study on the impact of credit risk and liquidity risk on the financial performance of conventional banks in Indonesia. The findings indicated that credit risk was negatively related to profitability while liquidity risk had a positive effect on profitability.

5. Conceptualization

As shown in the figure below, there are four independent variables that constitute credit risk management practices. The dependent variable is performance of commercial banks as measured by proportion of nonperforming loans to total loans. The four independent variables directly affect the performance of the banks.

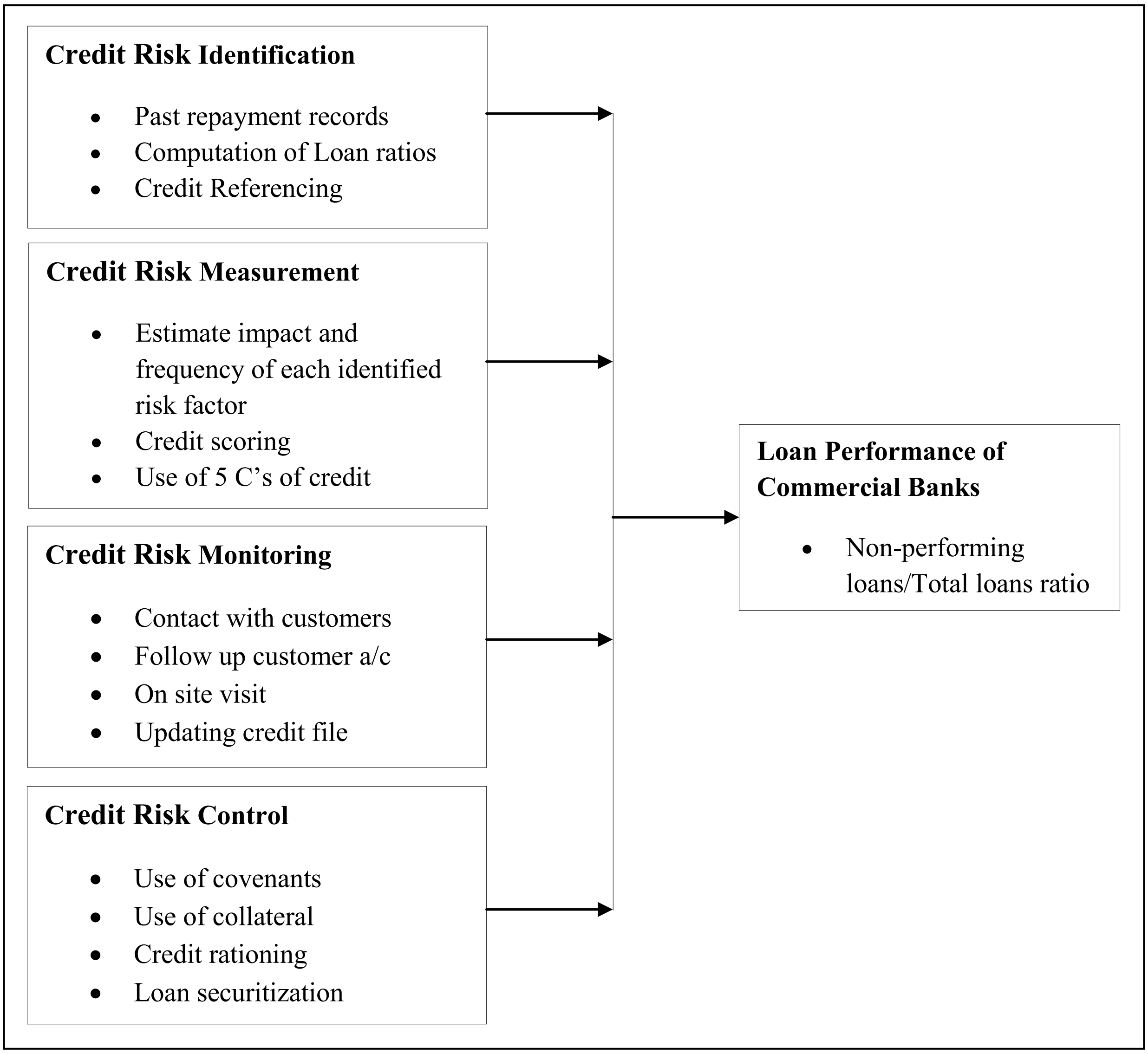

Figure 1: Conceptual Framework

6. Methodology

The study used a descriptive research design. All commercial banks within the county were included in the study. These are: Equity Bank, Kenya Commercial Bank, Cooperative Bank, Family Bank, Standard Chartered Bank, Eco Bank, Consolidated Bank, Jamii Bora Bank, Sidian Bank, National Bank of Kenya and Barclay Bank of Kenya. A census study was conducted where in each bank, the branch manager; credit manager and one credit officer were included in the study. A closed ended questionnaire was self-administered using drop and pick later method. Data collected was thereafter analyzed using descriptive statistics.

7. Results and Discussion

The study established that 100% of the commercial banks have a working credit policy. The policy outlines clearly the products on offer and requirements for each product. In addition to the credit policy, majority of the commercial banks have a credit risk management manual that elaborates on various ways of managing credit risk. The credit policy outlines what the credit officer is supposed to do, role of credit manager, operations and branch manager. In addition, it states what should be done at branch level and corporate level when assessing borrowers. At each of these levels, various checklists are used in assessing borrowers and establishing their credit worthiness.

The study also established that not all the commercial banks use quantitative credit scoring models. Precisely, while only 39% of the respondents indicated that they use it, 61% indicated that their credit assessment is based largely on personal judgment and intuition, mainly focusing on a check list method and the five C's namely borrower's capacity, character, condition, credit history and collateral.

Only a minority (46%) of banks have a well-developed credit rating model mainly based on degree of stability in terms of revenue generation. Their main argument being that uncertainty in revenue generation has a profound impact on the ability of a borrower to adequately maintain any financial commitments. In developing a rating model factors that have an impact on revenue generation are relied upon. For corporate and commercial borrowers, 93% of the banks develop models which generally have qualitative and quantitative sections outlining various aspects of the risk including, but not limited to, operating experience, management expertise, asset quality, and leverage and liquidity ratios, respectively. Once this information has been fully reviewed by credit officers and credit committees, the lender provides the funds subject to the terms and conditions presented within the contract.

For individual borrowers, most (88%) of the commercial banks said that they employ their own models (credit scorecards) to rank potential and existing customers according to risk, and then apply appropriate strategies. With products such as unsecured personal loans or mortgages, 67% of the commercial banks charge a higher price for higher risk customers and vice versa. With revolving products such as credit cards and overdrafts, risk is controlled through the setting of credit limits. Some of their products, however, require security, most commonly in the form of property which should be valued comprehensively insured and charged all at the cost of the borrower.

All the commercial banks (100%) maintain a customer's file that is updated from time to time and reference is always made from past records. In addition, 100% of the commercial banks are referencing their customers' credit history with the three registered credit reference bureaus in Kenya. Although different commercial banks have differing structures in the credit department, 98% of the respondents generally initiate screening of the customer at the credit officer level. To ensure accuracy and completeness of credit records, a Credit Officer will request a colleague to re-check his/her work and append initials on the file. Further, 98% of the respondents mentioned that depending on the loan amount, credit approval would therefore be done by the credit Manager, branch manager or at the head office. The power to approve is therefore distributed to different officers within the credit management structure.

Further, 54% of the respondents indicated that borrowers post-borrowing activities are monitored regularly to establish whether there are any changes that need to be taken care of to protect non-repayment of credits. When asked the main reason for the follow up, they noted it was meant to ensure early identification of potential or actual deterioration in credit risk. The rest, 46% don't have any follow up activity unless there is default on the side of the customer. All of the commercial banks in the study provide periodic reports to the board and senior management on the condition of the portfolios based on the internal ratings. Majority (89%) of the commercial banks use credit limits, inspection and review, rescheduling and various recovery procedures for controlling credit risk. Only 21% of the respondents mentioned that upon request by a customer who has consistently paid the loan for about half of the credit period, a reschedule of the outstanding balance for an extended period can be granted if and when a customer feels constrained by the periodic repayment amount. Majority (92%) of the commercial banks also conduct aging of the credit customers and necessary follow ups are done by the Credit Officers so as to establish the current financial condition of the borrower. All (100%) of the commercial banks said they closely monitor compliance with the existing terms and conditions and at the same time, identifies non-performing accounts and enforces proper classification and loan loss provisioning.

A majority of 69% of the commercial banks revise their credit policy from time to time whereas 22% said their policy is rarely updated. The remaining 8% indicated that their policy has been static. During such revisions, 73% of the banks involve their staff engaged in the credit risk management. The usual practice is to receive proposals for amendments from the branches and if found fit, are incorporated in the credit policy.

When asked about frequency of training of staff in the credit department, 87% of the commercial banks indicated they conduct various trainings where staff in the credit department participates whereas 13% have such trainings on a rare basis. All respondents (100%) mentioned that such trainings improve and update their knowledge in keeping with emerging trends. This improves the quality of staff and hence the credit risk management practices. Moreover, all banks mentioned that they are building (and some have already built) a computerised data base of customers with relevant information for assessing credit risk. A Computerised Management Information System is also used to produce various reports on demand or as scheduled. Such reports help in making various decisions on credit risk management.

When asked to rate the influence of each credit management practice on the amount of non-performing loans (the proxy of loan performance in this study), the respondents agreed that all the four practices have great influence. The ranking in order of how much influence each practice has on loan performance from the practice with greatest to the one with least influence was as follows: risk measurement (38%), risk identification (29%), risk control (19%) and finally risk monitoring (14%).

8. Conclusion

Risk identification and measurement has been shown to be the most important aspects of credit management and therefore more time and effort should focus on establishing how much risk a customer brings to the loan portfolio. Thus, managers should assess accurately the ability to pay back the loan. Risk control has a lot of importance as well but managers should strike a balance between either getting a customer, cost of which is the possibility of default or lock the customer out and lose the interest income that customer would have brought.

9. Recommendations

- Commercial banks should involve their credit officers in formulating credit policy since they are very key at credit identification stage

- Even with increasing competition, banks should set a threshold of the acceptable risk and stick to it so as to minimize bad debts
- Big accounts should be closely monitored and possibly reporting to be on a monthly basis so as to detect of and when a certain accounts starts to deteriorate.

References

1. Ahmad, N.H. and Ariff, M. (2007).Multi-country Study of Bank Credit Risk Determinants, *International Journal of Banking and Finance,* 5(1), 135-152.
2. Basel Committee on Banking Supervision (2001). Risk Management Practices and Regulatory Capital: Cross-Sectional Comparison (available at www.bis.org)
3. Brown Bridge, M. (1998) "Financial Distress in Local Banks in Kenya, Uganda and Zambia: Causes and Implications for Regulatory Policy", Development Policy Review Journal, Vol. 16 No.2, pp.173-89.
4. Coyle, B. (2000). *Framework for Credit Risk Management,* Chartered Institute of Bankers, United Kingdom
5. Fan, L. and Yijun, Z. (2014). The Impact of credit risk management on profitability of commercial banks: A study of Europe, Umea School of Business and Economics: Available at: http://www.diva-portal.org.
6. Gaakure, R.W., Ngugi, J.K., Ndwiga, P.M. and Waithaka, S. M. (2012). Effect of Credit Risk Management Techniques on the Performance of Unsecured Bank Loans Employed Commercial Banks in Kenya, *International Journal of Business and Social Research*, 2 (4), pp. 221-236. Available at: http://thejournalofbusiness.org.
7. Greuning, H. and Bratanovic, S.B. 2003, *Analyzing and Managing Banking Risk,* A Framework for Assessing Corporate Governance and Financial Risk. 2nd edition, The World Bank, Washington, DC.
8. Kargi, H.S. (2011). *Credit Risk and the Performance of Nigerian Banks*. Ahmadu Bello University, Zaria.
9. Kithinji, A.M. (2010). Credit *Risk Management and Profitability of Commercial Banks in Kenya*, School of Business, University of Nairobi, Nairobi.
10. Kolapo, T. F., Ayeni, R. K. & Oke, M. O (2012). Credit risk and commercial banks' performance in Nigeria: A panel model approach. *Australian Journal of Business and Management Research,* 2 (2), 31 – 38.

11. Psillaki, M., Tsolas, I.E. and Margaritis, D. (2010). Evaluation of Credit Risk Based on Firm Performance. *European Journal of Operational Research, 201(3), 873-888.*
12. Richard, E. 2006, Credit Risk Management Policy and Strategies: The Case of a Commercial Bank in Tanzania, BA Publications.
13. Ruziqa, A. (2013). The impact of credit and liquidity risk on bank financial performance: the case of Indonesian Conventional Bank with total asset above 10 trillion Rupiah. *International Journal of Economic Policy in Emerging Economies*, 6 (2), pp. 93--106.
14. Saunders, A. and Cornett, M.M. 2002, Financial *Institutions Management:* A risk management approach (4th edition). McGraw Hill, New York.

.