Effects of Credit Appraisal Methods on Non-Performing Loans in Government Owned Financial Institutions, A Case of Kenya Commercial Bank Limited

John Njenga Githama[1], Paul Gachanja[2]
[1]*Master of Arts in public policy and administration student, Kenyatta University, Kenya*
[2]*Lecturer, Kenyatta University, Kenya*

ABSTRACT

Financial institutions have in the recent past become a major player in the Kenyan economy. Consequently, for the institutions to sustain viable credit programmes, the criteria for assessing credit risk are essential so as to minimize the loan default. There are various known methods and tools which can be employed by credit offices to ensure that they lend quality loan. These methods try to establish the creditworthiness of the potential borrower. Quality loans means good returns to the business since there is less provisions for bad debt in the books of the lending institution. One of the criteria for establishing the creditworthiness of a borrower is the C's of credit model. These are initials for;-character, capacity , capital, collateral , common sense, contribution and conditions The C's of credit refers to the borrower's specific attributes which, if well used can help the lender arrive at a better decision of whether to lend or not to lend, the amount to lend and possibly the period to allow. Lending institutions, however, have continued to record non-performing loans, despite there being elaborate known methods to aid in credit appraisal. The objectives of this study were to establish the factors that have contributed to non performing loans in financial institutions, whether the appraising persons are well versed on C's of credit and challenges affecting appraising persons during the appraising process. To arrive at reliable findings, the researcher engaged respondents from selected financial institutions who were supplied with questionnaires in order to collect the sought data. The researcher employed descriptive research design which entails distributing questionnaires to respondents. The respondents were sampled from twenty financial institutions where respondents were chosen randomly. The target population in this case was credit officers irrespective of their cadres. For ease of collection of data, the study was located in Nairobi County where most financial institutions are based. The data so collected was coded to facilitate analysis. The researcher employed both descriptive and inferential statistics to analyze the data. The researcher further employed the credit scoring model which uses data on observed borrower characteristics, either to calculate the probability of default or to sort out borrowers into different default risk classes.

Key Words: *Non-Performing Loans, Credit Appraisal, Government Owned Financial Institutions*

DOI 10.35942/ijcab.v4i2.123

Cite this Article:

Githama, J., & Gachanja, P., (2020). Effects of Credit Appraisal Methods on Non-Performing Loans in Government Owned Financial Institutions, A Case of Kenya Commercial Bank Limited. *International Journal of Current Aspects*, 4, 2, 2020, PP 1-12. ttps://doi.org/10.35942/ijcab.v4i2.123

1. Introduction

According to Seibel (1966) in recent years, a growing number of developing countries, including Kenya, have embarked on reforming and deregulating their financial systems, transforming their institutions into effective intermediaries and extending viable financial services as a sustainable basis to the populace. By gradually increasing the outreach of their financial institutions, some developing countries have substantially alleviated poverty through lending, institutional strategies and financial systems approach. In the process, a new world of financial institutions has emerged. Financial institutions are important because they are the main channels of savings and the allocators of credit in an economy. They offer instruments that are money substitutes and they operate the payment system. The efficiency of the banks affects the entire economy, and their failure erodes public wealth and confidence in the economy. Omino (2005) argue that financial institutions, including Micro Finance Institutions (MFIs), provide an enormous potential to support the economic activities of the public and thus contribute to poverty alleviation. This puts emphasis on the sound development of financial institutions as vital ingredients for investment, employment and economic growth. At inception, MFIs were restricted to provision of loans or credit to the members of the society and help them engage in productive activities or grow their enterprises. However, this concept has broadened over time to include not only provision of credit but also savings, provision of insurance services as well as financial advice. This development came as a result of realization that the low income earners, who lack access to the formal financial institutions, also require a variety of financial products.

Like many other industries, banking faces many risks which if not properly mitigated, can lead to massive losses. Such risks include theft, fraud, losses which include loss due to revaluation of foreign currencies and loss resulting from non-performing loans and advances. A loan facility is considered non- performing or in default after it has not been serviced for a period of ninety days. The financial institution is therefore required to do a provisioning in its books which has an adverse effect on its profitability. One of the principle objectives of bank supervision or regulation by the Central Bank is that of fostering the liquidity, solvency and proper functioning of a stable market based financial system. The mandate includes the maintenance of soundness and efficiency by minimizing failure through the regulation process (Central Bank of Kenya Act Section 4(2). Central bank has set a guideline on how to provide for loans and advances depending on its prudential guidelines on classification of loan and advances based on the number of days they have not been paid. As these loans and advances age, they are classified into normal, watch, substandard, doubtful and loss. Each classification has its percentage of provisioning depending on the collateralization at the inception. Numerous approaches have been developed for incorporating risk into decision making process by lending organizations. They range from relatively simple methods such as the use of subjective or informal approaches to the use of fairly complex methods like computer simulation methods. For financial institutions to be able to sustain viable credit programs, borrowers should be able to make sustained and regular payments as agreed and on time. As such, the criteria for assessing credit risk are essential. Successful and effective credit risk appraisal determines the success of the credit journey.

Many lending decisions by the financial institutions are based on the decision maker's subjective feelings about the risk in relation to the expected repayment of the borrower. Lending institutions commonly use this approach in decision making because it is simple and inexpensive (McGrugan et al 1993). While each institution would have its own method of determining risk and quality of clients, depending on the target group, many financial institutions use the credit appraisal models to evaluate credit application from their customers. According to Savery (1977), Sparks (1979) and Galitz (1983), the traditional five (5) credit appraisal models are character (the willingness to repay the debt), capacity (the financial ability to repay debt), capital or collateral (possession or equities from which payment might be made) and conditions (reflecting the general economic environment, or special conditions applying to the borrower or the type of credit). There are various credit appraisal models used to assess credit risk and creditworthiness of customers. The Cs of credit comprises the 5Cs, the 6Cs and the 7Cs of credit. Other models of credit appraisal include;-CAMPARI (Capital, Ability, Margin, Purpose, Rate and Insurance), the credit migration approach, as proposed by J.P Morgan and the actuarial approach, and which only focuses on default as proposed by Credit Suisse Financial Products (CSFP).These models are important because their elements cover almost all areas that affect credit risk assessment and evaluation of a customer and the customer's character. This study therefore aims at determining the extent of use of credit appraisal models with a bias on Cs of credit, and establishes its relationship with loans and advances in lending institutions. Lending institution use the credit appraisal technique to evaluate a customer, considered as a potential borrower. The credit appraisal model helps the lending institutions to decrease the default risk, as they get to know their customers. According to Sinkey (1992), granting credit to customers is an important activity for any lending institution, hence, the importance of credit risk management in these institutions. Lenders must therefore ensure a thorough credit risk assessment to forestall default. The goal of credit risk management is to maximize risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Financial institutions need to manage the credit risk inherent in the entire portfolio. Thus risk is a critical component of a comprehensive approach to risk management and essential to the long term success of any lending institution.

2. Statement of the Problem

Financial institutions play a major role in the economy. They are the conduits of savings and the allocators of credit in an economy. They facilitate transfers in form of cash, drafts and other negotiable instruments. They also provide investment platforms in the money market among other functions. However, the main objective is to offer credit which constitutes their biggest source of revenue to financial institutions. These institutions face various challenges and risks in the course of their operations. Credit risk is the most profound risk faced by financial institutions. Morgan (1998) defined credit risk as the degree of value fluctuations in debt instruments and derivatives due to changes in the underlying credit quality of borrowers and counterparties. Hempel, Simpson and Coleman(1994) defined credit risk as the promised cash that flows from loans held by financial institutions which may not be paid in full. Virtually, all financial institutions face risk. Financial institutions which give long tenures are more exposed than those which offer shorter tenure. If not properly managed, credit risk can lead to massive losses resulting from non-performing loans and advances. Loss from non-performing loans and advances start with provisioning and end up being written off. This largely affects their balance sheets and by and by, profitability. These institutions make efforts to cushion themselves against such losses by collateralizing borrowing, besides putting in place credit policies to govern their lending processes. They have also invested in training and enlightening their personnel on various known credit appraisal methods. Bulterworths (1990) asserts that effective credit risk management from the viewpoint of financial institutions is the key to the future success in lending institutions and therefore, these institutions are and still will increasingly be those that develop focused strategies, lower their overhead ratio, ingenuously exploit their advantages and know how to calculate their risks. Despite there being various well known credit appraisal methods, financial institutions have continued to record Non Performing

Loans (NPL) and advances in their books. This happens despite there being measures put in place to ensure that such loans are properly appraised and in most cases, by not a single person but several people before such a facility is granted.

3. Objectives of the Study

The general objective of the study was to examine the effects of non-performing loans and advances and the use of credit appraisal methods in financial institutions in Kenya.

The study was guided by the following specific objectives;

i. To examine the factors that have contributed to non-performing loans in Kenya Commercial Bank
ii. To examine the methods used by appraising persons during appraisal process in KCB.
iii. Assess the effect of credit appraisal methods on loans in KCB.

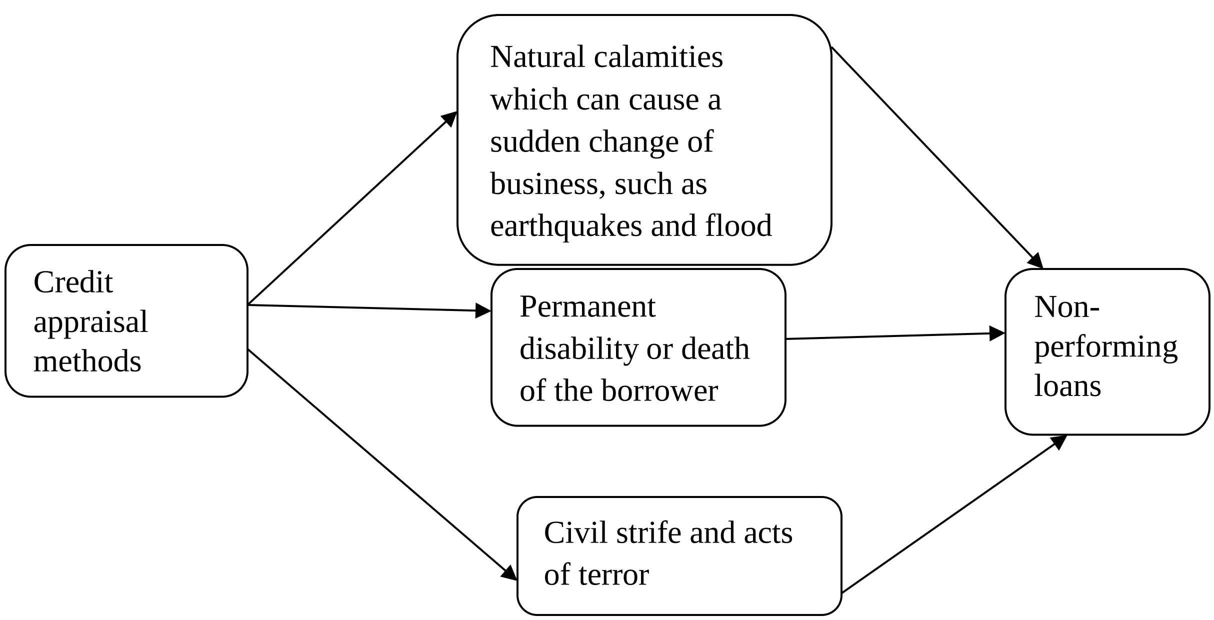
4. Literature Review

This is the risk that the promised cash flows from loans held by financial institution may not be paid in full. Virtually, all financial institutions face this risk. Financial institutions which give long tenures are more exposed than those which give short tenures. This means that banks, thrift and life insurance companies are more exposed to credit risk than MFIs or money market mutual funds that give loans with shorter tenures (Hempel, Simpson and Coleman, 1994). Saunders (2002) argues that it is therefore incumbent on financial institutions to estimate the expected default risk on loans and to demand risk premiums that commensurate with that risk exposure. The return distribution for credit risk suggests that financial institutions need to both monitor and collect information about firms whose assets are in their portfolio, thus, managerial efficiency and credit risk management strategy affect the shape of the loan return distribution. Credit risk may be classified as firm specific credit risk, which is the risk of default by the borrowing firm associated with the specific types of project risk taken by the firm, and the systematic credit risk which is the risk of default associated with the general economy wide or macro conditions affecting borrowers. This study agrees to a great extent with the observations of Saunders (2002) in that credit appraisal methods and more so the Cs of Credit will give the lender an in depth knowledge of various aspects the borrower, such as those that are borrower specific like character, as well as those that are market specific like condition. Awarding credit is a journey, the success of which depends on the methodology applied to evaluate and award the credit. This journey starts from the application for credit and ends at the time the loan is fully paid. It has smooth paths, impediments and detours before the destination is reached. According to Clarke (Clarke et al, 1999), credit needs to be effectively controlled for it to succeed eventually. Credit control can rightly be said to start at the first contact.This is when the lender decides to grant credit and by and by starts the journey called credit control and the nature of the journey will be influenced by the quality of the decision.

Thygerson, (1995) opines that credit control is the general guideline governing the process of giving credit. The policy sets rules on who should get what credit and when and why. In addition, the policy defines the repayment arrangements, necessary collateral, guarantees and chattels as an obligation by the borrower. The method of assessment and evaluation of risk for each prospective applicant are part of a credit control policy. There is need for an effective credit control policy at all times to manage credits risk in order to ensure a fairly healthy credit management program, with minimum expensive bad debts and minimized credit risk. Lending institutions need to measure the probability of default of borrowers. The ability to do this largely depends on the amount of information the financial institutions have about the borrower. At the retail level, much information need to be collected internally or purchased from external credit agencies. At the wholesale level, the information sources include publicly available information such as certified accounting statements, stock and bond prices and analysis reports. The availability of more information along with lower average cost of collecting such information allows financial institutions to use more sophisticated and usually quantitative methods in assessing default probabilities for large borrowers compared to small borrowers (Saunders 2002).

Gardener, Mills and Cooperman (2000) argue that, advances in technology and information collecting are making quantitative assessment of even smaller borrowers increasingly feasible and less costly. Financial institutions have therefore employed many different models to assess the default risk on loans. These vary from the relatively qualitative to highly quantitative models. These models are not mutually exclusive, in that more than one model may be used to reach a credit pricing or loan quantity rationing decision. In the absence of publicly available information on the quality of borrowers, the financial institution's manager has to assemble information from private sources such as credit and deposit files and/or purchase such information from credit bureau. Thygerson (1995) argues that the amount of information assembled varies with the size of potential debt exposure and the cost of collection. A number of key factors enter into the credit decision. These include borrowers' specific factors which are idiosyncratic to the individual borrower, as well as market specific factors that have an impact on all borrowers at the time of credit decision. Savery (1977), Sparks (1979) and Galitz (1983) observe that the C's of credit are common reference to the major elements of a financial institution's analysis when considering a request for a loan. The traditional 5C's of credit are character-the willingness to repay debt, capacity-the financial ability to repay debt, capital or collateral-possession or equities from which payment might be made and condition-reflecting the general economic environment or special conditions applying to the borrower or the type of credit. According to Abedi (2000), a more recent addition to the traditional 5C's of credit is common sense. The C's are character, capacity, condition, collateral, contribution and common sense. Lending institution use the C's of credit appraisal technique to evaluate a customer as a potential borrower. The C's of credit model helps the lending institutions to decrease the risk default, as they get to know their customer.

5. Conceptual Framework



Independent variable **Intervening variables** **Dependent variables**

Source: Researcher (2020)

6. Research Methodology

The study made use of Nairobi County where most Kenya Commercial Bank branches are located. This is because the bank has more branches concentrated in Nairobi as compared to other areas. The credit risk assessment and evaluation of a particular customer was done at a particular point in time and in time and not over time, when the customer applies for a loan. The population of interest was credit officers, credit analysts, and also debt collection officers. The researcher categorized credit officers into micro credit officer, Small and Micro Enterprise (SME) officers and corporate in order to get a wider coverage. The researcher took 30 respondents from a population of 74 officers. The sample frame consisted of 30 respondents from different branches in Nairobi County. Simple random sampling technique was sued to select respondents per branch. The branch chosen were perceived to serve different clientele e.g. Kariobangi (Micro), Enterprise (Corporate), SME (River road).Sampling was preferred because it's effective and easy to conduct.

Primary data was collected using semi structured questionnaires and administered to credit officers in the sampled branches. A drop and pick back approach was used since it is an appropriate method for this study since it gave respondent time to fill the questionnaires before picking them to ensure completeness in response. The respondents were contacted and issued with questionnaires. Other related sources were also considered as sources of data. Such sources include annual reports publications, government (CBK) publications, research scholars and websites. The data collected was analyzed by qualitative and quantitative statistics. Qualitative method of data analysis was employed to deal with qualitative data resulting from interviews to analyze all data of numerical nature. Data from the completed questionnaires was coded to facilitate statistical analysis. Both descriptive and inferential statistics were used to analyze the data, including means, standard deviation and frequency distribution

7. Data Analysis and Discussion

The respondents were asked to state the factors they considered most important in the establishment of a credit control policy. Most considered overhead costs as the most important, followed by state of the economy, then general trend of credit extended and finally existing credit policy in that order.

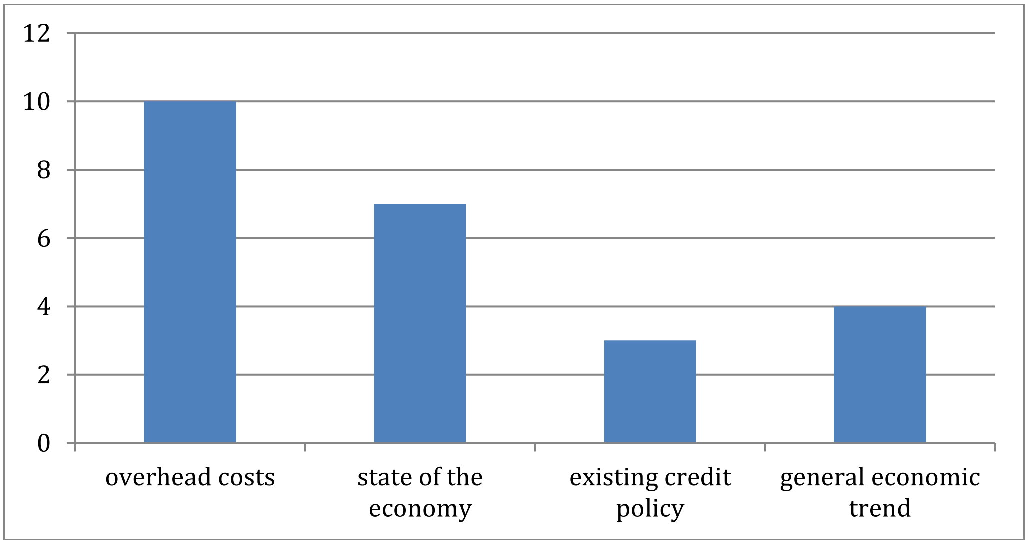


Figure 1: Responses on Credit Control Policy

They respondent were asked to state their credit policy objectives. Most respondents consider training of employees, followed by competitive tool to gain market advantage, then followed by a tool to minimize credit costs and finally to encourage movement of surplus money in that order.

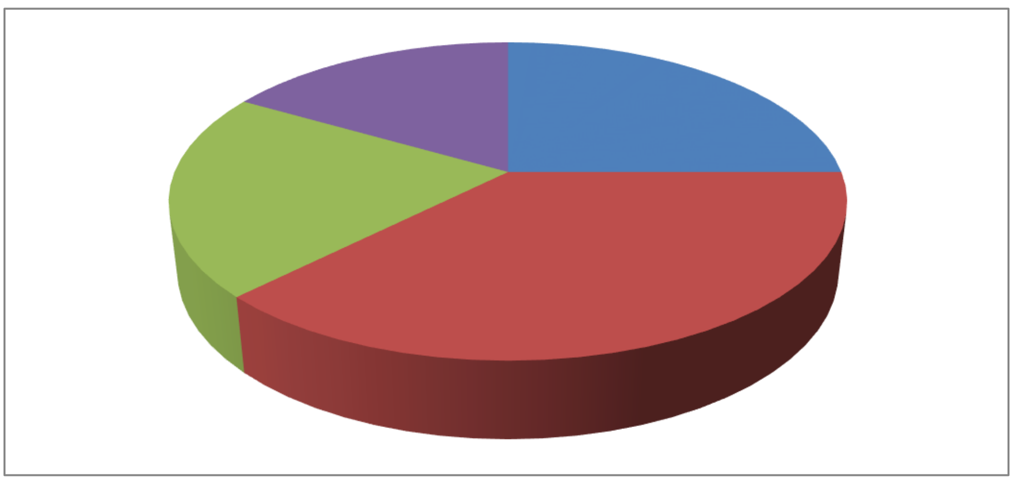


Figure 2: Responses on credit policy objectives

The respondents were asked to state the factors that KCB consider when setting up the credit policy. The respondents considered credit terms with the highest frequency of 12 followed by products/services to cover, with a frequency of 6.

Cost of debtors had a frequency of 4 while cost of debtors came fourth with a frequency of 2.These findings indicate that the bank has clear objectives relating to its credit policy and as such credit risk assessment is based on sound foundation of facts.

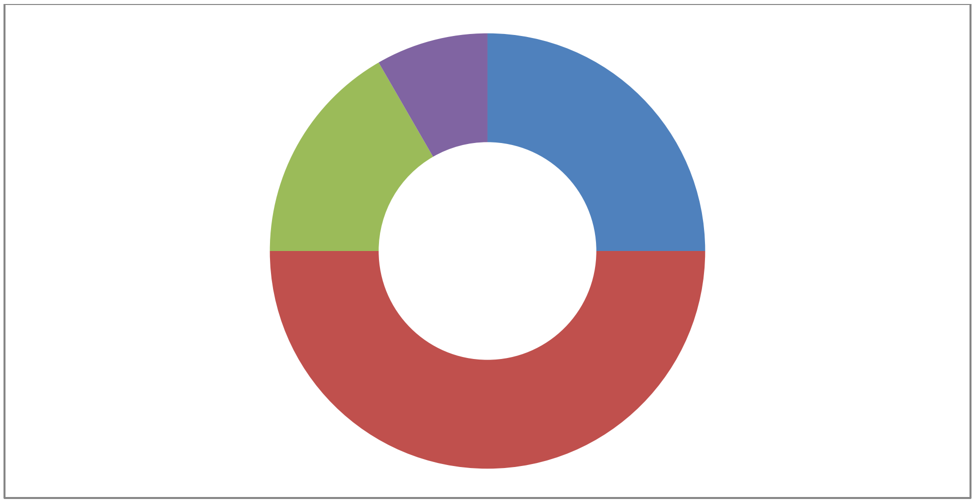


Figure 3: Responses on credit policy objectives

According to 50% of the respondents, the type of operations funded by the bank is provision of additional capital. This is a situation where the customer has the need to increase his capital by, may be increasing stock. A total of 33.3% of the respondents indicated that the banks funds working capital (debtors). This is more so for customers who are in supplies business where often than not they find themselves in a situation where they have done supplies and are awaiting payment but they still have got other orders to take care of.

16.66% of the respondents indicated that the bank also finances startup capital. This is however not very popular with the bank given the challenges of starting up a business.

The chart below summarizes this.

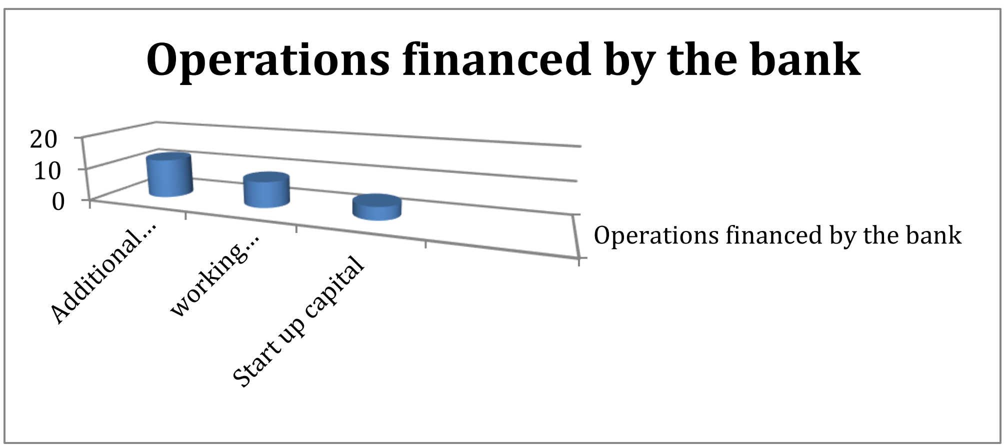


Figure 4: Responses on operations financed by the bank

The respondents were requested to state the average lending period for loan facilities. The lending period ranged from less than one year to over ten years depending on the purpose. Mortgages are normally lent out with a longer tenure than other loans. Loans with less than one year recorded a frequency of 5.Those with tenure of between one year and two years also received a frequency of 6.For tenures of over three years but not more than eight the frequency was 9.For facilities with tenure of over eight years, the frequency was 4.These findings indicate that depending on the purpose of the loan facility, the bank tends to tie the tenure to match the purpose. The bank also considers other factors such as the collateralization of the loan facilities where collaterals such as motor vehicles tend to secure loans which attract less tenure due to their rate of depreciation. Shorter tenures also help the bank to detect early warnings of defaulting customers.

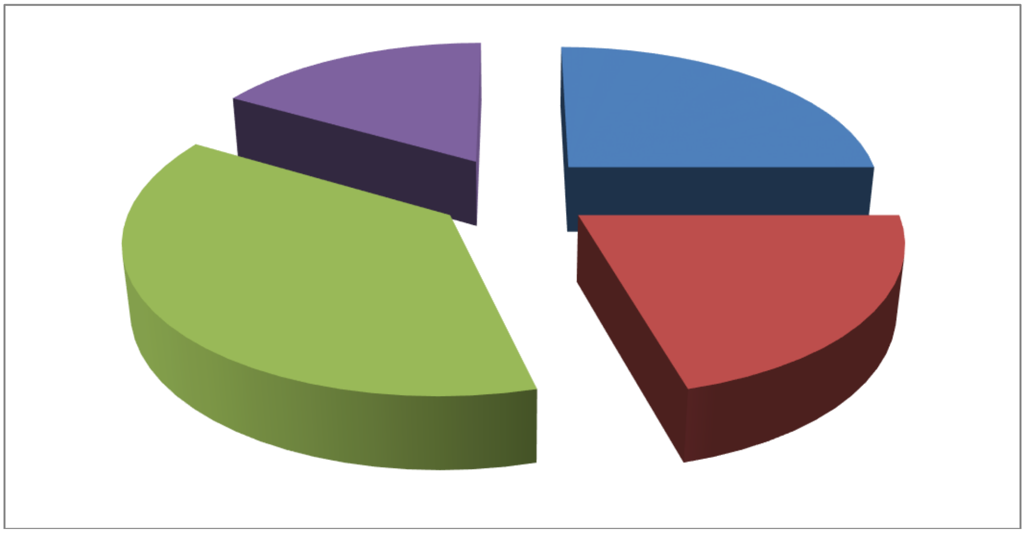


Figure 5: Responses on average lending period

The respondents were asked to classify the methods used in credit appraisal. The study revealed that 70% use mainly qualitative techniques while 20% use a combination of both qualitative as well as quantitative techniques.10% of the respondents indicated that they used quantitative techniques in their credit appraisals. This shows that majority used qualitative techniques in their credit appraisal and they have not fully use of quantitative techniques.

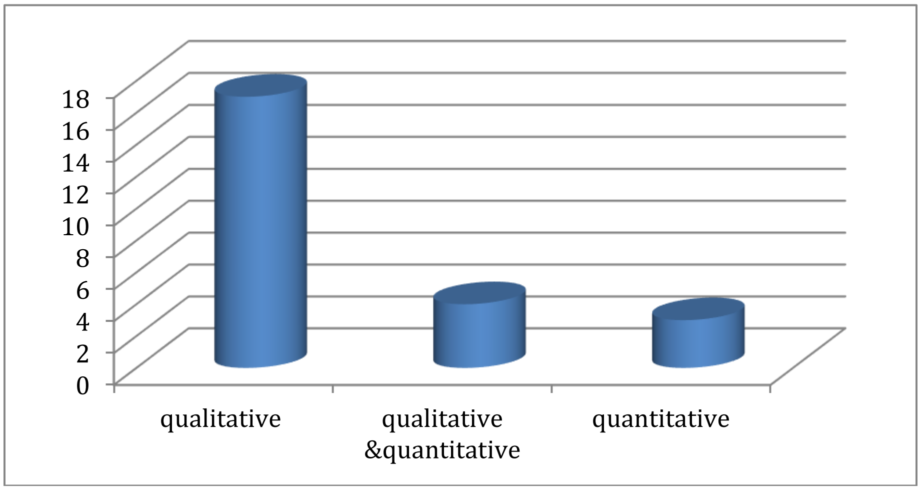


Figure 6: Responses on credit appraisal methods

When respondents were asked how they are made aware of credit risk in the bank, a frequency of 11 indicated that credit manual played a major role in employees' awareness. A frequency of 6 indicated that supervision on one to one basis was the manner in which the employees are made aware of credit risks. Training on regular basis recorded a frequency of 4, while regular meetings employees aware of credit risk. The findings show the importance of the credit manual as a policy tool.

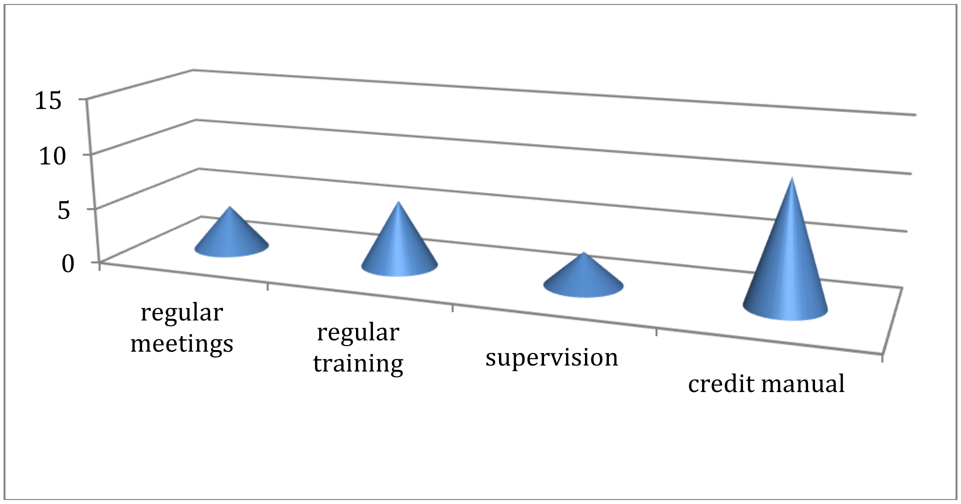


Figure 7: Responses on how employees are made aware of credit risks

To establish the criteria used by the bank in evaluating credit risk, the respondents were asked to specify which factors they considered when appraising credit risk to their customers. The factors most considered were capacity with a frequency of 8, contribution with a frequency of 6, and character with a frequency of 4, commonsense with a frequency of 3, condition with a frequency of 2 and collateral with a frequency of 1.These findings shows that the C's of credit model is popular and is widely applied in loan appraisal by the bank employees. It further indicates that the 6C's do not carry the same weight when it comes to their application by the appraising persons.

The table chart below illustrates the findings as respondent to by the respondents.

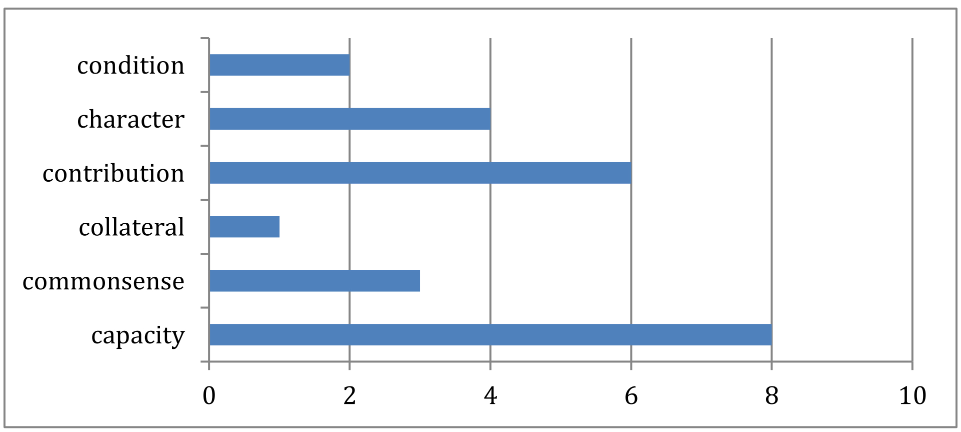


Figure 8: Credit appraisal using the C's of credit

The purpose of the study was to analyze the effects of credit policy on non-performing loans. The study specifically set out to investigate the effect of credit policy on non-performing loans in government owned financial institutions, the case of Kenya Commercial Bank. In an effort to achieve its objectives, a questionnaire was designed, given out to respondents and analyzed by the researcher in close consultation with supervisors. The sample included a total of 30 respondents. The return rate of the questionnaire was 80%. The most important finding of the study is that there are several factors that have contributed to non-performing loans in government owned financial institutions, the case of Kenya commercial bank. These factors are encountered by appraising officers who has made financial institutions continue to record increasing numbers in non-performing loans. These non-performing loans get provided for and finally eat into the institutions profitability. This include lack of credit policy manual, lack of training, frequency of review of the credit policy, information dissemination, types of businesses being financed, loan tenure, among other factors.

8. Conclusion and Recommendations

Appraising personnel usually arrive at their conclusion of lending or not lending by applying credit appraisal models. The most widely applied method of credit appraisal is the C's of credit model. With regard of the C's of credit appraisal model, the factors most considered by the financial institution in the order of occurrence are capacity, contribution, character, common sense, condition and finally collateral. These findings are also supported by the results of the regression analysis undertaken. The default rate for the institution depends on the nature of the facility granted. However, on average, a facility is termed as default when it clocks ninety days. On the basis of research findings and the conclusion drawn, the following recommendations have been made. Financial institutions play a pivotal role in economic development of the country. It is therefore imperative that their programmes are sustained for the benefit of majority of the populace as well as the institutions themselves. For this to happen, financial institutions need to manage the inherent credit risk in the entire portfolio as well as the risk in the individual credit transactions. This will be achieved by deliberately training the staff on different credit appraisal models. As such, applying appropriate credit risk assessing and evaluation techniques should proactively manage credit risk. This can be achieved by use of The C's of credit model.

REFERENCES

Abedi N.(2000) "Highway to success "Credit Management Journal,(electronic edition)source;http;//www.leatherspinsters.com/doyoutalktoyourbanker.html

Besley, Timothy and Stephen Coate.1995."*Group Lending, Repayment Incentives and Social Collateral.*

Edwards B.(1997),*Credit Management Handbook*, Fourth edition; Gower Publishing Company

Gardner M.J, Mills D.L, and Cooperman E.S(2000)*Managing Financial Institutions, an asset liability approach,* Fourth Edition.

Hempel G.H., Simon D.G, and Coleman A.B (1994) *Bank management; Text and Cases,* Fourth edition, John Willy&Sons Inc. Publishers

Hulme, David and Paul Mosley,(1996)*Finance Against Poverty*,Routlegde Publishers, London.

McGrugan et al,(1993),*Managerial Economics*; West Publishing company, New York

Mudiri J.L (2003) *Credit techniques applied by financial institutions offering micro credit in Kenya.* Unpublished MBA Project; University of Nairobi

MutwiriM.J(2003)*The use of 6Cs credit appraisal model and its relationship to the level of non performing loans in of commercial banks in Kenya.* Unpublished MBA Project; University of Nairobi

Murdoch J(1999)*The micro-finance Promise: Journal of electronic literature,vol 37,No4(December,1999)pp 1569-1614)*

Omino G (2005) Regulation and Supervision of Micro-finance institutions in Kenya; Essay on regulation and supervision,source:www.cgap.org/regulation.

Saunders A. (2002) *Financial Institutions Management; A modern Perspective*; Third` Edition, MC Graw Hill Publishers

Savery,B.A(1977)*Numerical Points Systems In credit Screening*, draft manuscript December 15,pp 36-50

Seibel, Hans Dieter,(2001) *Financial Systems Development and Micro-finance*,DeutscheGesellschaft fur TecnischeZusammanarbeit(GTZ)Publication.

Sinkey J F Jr (1992) *Commercial Bank Financial Management in the Financial Service Industry*, Fourth Edition, Macmillan Publishers

Thygerson K,J.(1995)*Management of Financial Institutions;*Haper Collins College Publishers, New York.