

**FACTORS AFFECTING NON-PERFORMING LOANS IN  
BANKING INDUSTRY: A CASE OF KCB BANK (TANZANIA)  
LIMITED; MOROGORO AND MSIMBAZI BRANCHES**

**MZUMBE UNIVERSITY**  
**SCHOOL OF BUSINESS**

**Factors affecting non-performing loans in Banking industry: A case of KCB  
Bank (Tanzania) Limited; Morogoro and Msimbazi Branches**

**By**  
**Carlo Msigwa**

**A Dissertation submitted in Partial/Fulfillment of the Requirement for the  
Award of the Degree of Masters degree in Accountancy and Finance**

**(MSc A&F) of Mzumbe University**

**2013**

**CERTIFICATION**

We, the undersigned, certify that we have read and hereby recommend for acceptance by the Mzumbe University, a dissertation entitled **Factors affecting non-performing loans in Banking industry: A case of KCB Bank (Tanzania) Limited; Morogoro and Msimbazi Branches**, in partial/fulfillment of the requirements for award of the degree of Masters in Accountancy and Finance (MSc A&F) of Mzumbe University.

*Signature*

-----

Major Supervisor

*Signature*

-----

Internal Examiner

Accepted for the Board of School of Business

.....

*Signature*

-----

DEAN/SCHOOL BOARD

**DECLARATION**

**AND**

**COPYRIGHT**

I, **Carlos Msigwa**, declare that this dissertation is my own original work and that it has not been presented and will not be presented to any other University for a similar or any other degree award.

**Signature** -----

**Date** -----

©

This dissertation is a copyright material protected under the Berne Convention, the copyright Act 1999 and other international and national enactments, in that behalf, on intellectual property. It may not be reproduced by any means in full or part, except for short extracts in fair dealings, for research or private study, critical scholarly review or discourse with an acknowledgement, without the written permission of Mzumbe University, on behalf of the author.

## ACKNOWLEDGEMENTS

I would have never been able to finish my dissertation without the guidance of my co-workers, help from friends and support from my family and wife.

I would like to express my deepest gratitude to my supervisor, Mr. Thomas Magambo for his excellent guidance, caring, patience and providing me with an excellent atmosphere while doing the research. I would like to thank Prof.Srivanus Madishet who let me experience the research on factors affecting nonperforming loans in commercial banks, patiently selected my research topic.

I would also like to thank Dr. Eliasante Ole Gabriel, Mr. Mzava and Dr. Tarimo for guiding my studies and helping me to develop my background of the study. I would also thank Dr. David Mazengo who was a good friend and was always willing to help and give his best suggestions and encouragements.

I would like to thank my wife Mrs. Aswe Msigwa who supported my research by providing financial and moral support. Without her, I would have been lonely and my field work would have been affected. I thank Mr. Robert Masala the Head of Human Resources at Diamond Trust Bank and his assistance manager Mr. Cosmas Gabriel for their understanding and support extended to me during the study.

I would like to thank Mr. Augustino Isdory for his support and assistance extended to me. He has been helpful all the time by assisting in collecting literatures for my research and giving advice when needed.

I would like to thank Upendo Makula, Asia Mwangonela, Nyangeta Mwikwabi and Amani Masinsi for their cooperation during my research time. Special thanks to Delphina Mvungi for her assistance extended to me during the dissertation writing.

## **DEDICATION**

This dissertation is dedicated to my brilliant, ever loving and supportive wife Mrs. Aswe Msigwa, our exuberant, sweet and kind hearted little boys Carlos (junior) Msigwa and Robert Carlos Msigwa and to my ever encouraging and faithful parents in law; Ching Ackimu Kajuni and Helena Kalinga.

## **ABBREVIATIONS AND ACRONYMS**

CAR	Capital Asset Ratio
EAD	Exposure at Default
FGDs	Focus Group Discussions
GDP	Gross Domestic Product
IMF	International Monetary Fund
LGD	Loss Given Default
MSc A & F	Masters degree in Accountancy and Finance
NPLs	Non Performing Loans
PD	Probability of Default
SPSS	Statistical Package for Social Sciences
URT	United Republic of Tanzania

## **ABSTRACT**

The problem of non-performing loans is seen as a burden on any country's economy or financial institution and putting downward pressure on its growth. This is because the role of banks as financial intermediaries does not function properly due to the problem of non-performing loans (NPLs). The general objective of the study was to examine the factors affecting non-performing loans in KCB Bank (Tanzania) Limited; Morogoro and Msimbazi branches.

Cross-sectional research design was used in the methodology. The sample size of 46 respondents (i.e. KCB workers and customers) was used. Data collected were analysed and processed by Statistical Package for Social Science (SPSS) computer software.

The findings showed that, diversion of funds for unnecessary expansion of business and speculations leading to investing in high risk assets to earn high income (70%) and legal environment which reflects the availability or non availability of foreclosure laws and ownership rights for both domestic and foreign investors (75%) have been factors influencing NPLs. However, Morogoro branch had higher NPLs ranging from 8% to 6.5% compared to Msimbazi branch which had NPLs ranging from 7.5% to 6.2% as reported by 90% and 85% of respondents respectively. Yet, enhancing training and development options to prevent the failure (85%), introducing and implementing of an aggressive debt collection policy (90%) have been the attempts made to alleviate NPLs.

The results indicate that banks need to put emphasis on reserving adequate amount of capital to improve their risk position. The research adds to the argument for enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans in order to alleviate NPLs to the minimum required for the bank to perform.

## TABLE OF CONTENTS

CERTIFICATION .....	ii
DECLARATION .....	iii
COPYRIGHT .....	iii
ACKNOWLEDGEMENTS .....	iv
DEDICATION.....	v
ABBREVIATIONS AND ACRONYMS .....	vi
ABSTRACT .....	vii
TABLE OF CONTENTS .....	viii
LIST OF TABLES.....	xi
LIST OF FIGURES .....	xii
LIST OF APPENDICES .....	xiii
<b>CHAPTER ONE.....</b>	<b>1</b>
<b>INTRODUCTION AND BACKGROUND .....</b>	<b>1</b>
1.0 Introduction .....	1
1.1 Background of the problem.....	1
1.2 Statement of the problem .....	5
1.3 Research Objectives.....	6
1.3.1 General objective.....	6
1.3.2 Specific Objectives.....	6
1.4 Research questions.....	6
1.5 Significance of the study.....	7
1.6 Scope.....	7
1.7 Limitations of the study .....	7
1.8 Organisation of the study .....	8
<b>CHAPTER TWO .....</b>	<b>9</b>
<b>LITERATURE REVIEW .....</b>	<b>9</b>
2.0 Introduction .....	9
2.1 Theoretical literature review .....	9
2.1.1 Banking.....	9
2.1.2 Role of Banks.....	10
2.1.3 Bank Lending.....	11

2.1.4	Credit Provision .....	12
2.1.5	Banking Risks .....	23
2.1.6	Meaning of Non-Performing Loans .....	27
2.1.7	Types of Non-performing loans .....	28
2.1.8	Causes of non-performing loans .....	28
2.1.9	Lending as a global concept.....	33
2.1.10	Non-Performing Loans in the Banking Industry.....	34
2.1.11	Strategies for recovery of non-performing loans .....	35
2.1.12	Literatures from various scholars.....	36
2.2	Empirical Literature Review .....	38
2.3	Conceptual Framework Model.....	41
<b>CHAPTER THREE .....</b>		<b>44</b>
<b>RESEARCH METHODOLOGY .....</b>		<b>44</b>
3.0	Introduction .....	44
3.1	Study Area.....	44
3.2	Research Design .....	45
3.3	Population and sample size .....	45
3.4	Sampling techniques .....	46
3.4.1	Simple random sampling .....	46
3.4.2	Purposive sampling .....	46
3.4.3	Stratification sampling.....	46
3.5	Data collection Methods .....	47
3.5.1	Primary data collection methods.....	47
3.5.2	Secondary data (Documentary Review) .....	48
3.6	Data Analysis Techniques.....	49
3.7	Research plan .....	49
<b>CHAPTER FOUR.....</b>		<b>50</b>
<b>PRESENTATION AND DISCUSSION OF THE RESEARCH FINDINGS.....</b>		<b>50</b>
4.0	Introduction .....	50
4.1	Factors influencing non-performing loans in KCB Bank (T) limited .....	50
4.2	Extent of non-performing loans in KCB Bank (T) limited .....	53

4.3	Attempts made by KCB Bank (T) limited to alleviate non-performing loans	54
<b>CHAPTER FIVE .....</b>		<b>57</b>
<b>SUMMARY, CONCLUSION AND RECOMMENDATIONS .....</b>		<b>57</b>
5.0	Introduction .....	57
5.1	The summary of findings .....	57
5.2	Conclusion and policy implications.....	58
5.3	Recommendations and areas for further research.....	59
5.3.1	Individual or entity’s borrowing decision.....	59
5.3.2	NPLs rectification .....	59
5.3.3	Enhancement of training and development .....	59
<b>REFERENCES .....</b>		<b>60</b>
<b>APPENDICES.....</b>		<b>65</b>

## **LIST OF TABLES**

Table 3.1: Sample size of the study population.....	46
Table 4.1: Factors influencing non-performing loans .....	51
Table 4.2: Extent of non-performing loans .....	53
Table 4.3: Attempts made to alleviate non-performing loans .....	55

## LIST OF FIGURES

Figure 2.1: Conceptual framework Model.....	42
---	----

## **LIST OF APPENDICES**

Appendix 1: Research plan.....	65
Appendix 2: Research budget.....	66
Appendix 3: Questionnaires for respondents.....	67
Appendix 4: Interview Guide questions for FGDs .....	70

# **CHAPTER ONE**

## **INTRODUCTION AND BACKGROUND**

### **1.0 Introduction**

This chapter provide the blue print to the examination of factors affecting non-performing loans in KCB Bank (Tanzania) Limited, Morogoro and Msimbazi branches. Section 1.1 describes the background of the problem, section 1.2 states the research problem, section 1.3 state the research objectives, section 1.4 state the research questions, section 1.5 indicate the significance of the study, section 1.6 show the scope of the research, section 1.7 indicate the limitation of the study, and section 1.8 show the organisation of the study

### **1.1 Background of the problem**

Banking industry is a major sector of the economy that has achieved renewed focus after financial sector reforms and the entry of private sector banks. This sector is the foundation of modern economic development and linchpin of development strategy (Waweru and Kalani, 2009). It forms the core of the financial sector of an economy. Through mobilization of resources and their better allocation, commercial banks play an important role in the development process. Commercial banks improve the allocation of resources by lending money to priority sector of the economy. Loans are of the major outputs provided by the bank (Singh, 2005). However, the loan is a risk output. 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 decrease the bank's performance (Chang, 1999). The risk of non-performing loans mainly arises as the external economic environment becomes worse off such as economic depressions (Sinkey and Greenawalt, 1991).

Banks with large sizes have more resources to evaluate and to process loans. These can improve the quality of loans and thus, effectively reduce the rate of non-

performing loans (Singh, 2005). Bank's sizes hence are anticipated to be negatively related to non-performing loans, but at a diminishing rate (McNulty *et al*, 2001). Interest groups engage in political lobbying in order to affect the administrative decisions. The state-owned banks monitored by both the administrative and legislative branches are more vulnerable to political lobbying than private banks. In a country with the corrupt private sector, private banks easily become family-owned business, illegally supplying risky loans to enterprises controlled by the same family. Mafias and local political schisms can also control financial institutes for illegal money wash and loan supply. That is, the non-performing loans rate caused by political lobbying strictly increases with the government stock share (Jin-Li Hu, 2002).

The return of loans is a bank's major source of revenues. Banks sometimes have to accept some risky loans because of the pressure of revenues (Singh, 2005). If banks can successfully diversify their sources of revenues, it should be able to ease the pressure of revenues from loans and thus, effectively reduce the rate of non-performing loans (Nobuo, 2005). Jin-Li Hu (2002) established a theoretical model to predict the relation between the government shareholding and the non-performing loans. Jin-Li Hu (2002) affirmed that, when both public and private sectors are corrupt (imperfect), the relation between the government shareholding and the non-performing loans rate can be either U-shaped or inverse U-shaped. That is, as the government shareholding arises, the non-performing loans rate will first go down (up) and then go up (down). Therefore, a mixed bank in average may have the lowest or highest loans non-performing rate.

McNulty *et al*, (2001) argues that non-performing loans are loans, especially mortgages that s lend to borrowers but do not capitalize on. In other words, the borrower cannot pay the loan back in full, or even enough for the bank to make a profit. When this happens, the bank can either work out a new payment option, or foreclose on what collateral the borrower has provided. Either option costs the bank money, so lenders try to avoid non-performing loans whenever possible (Yoonhee,

2006). Some of the factors influencing non-performing loans according to Yoonhee (2006) include; a) *Credit Culture* i.e. Most nonperforming loans are caused by borrower decisions. Sometimes borrowers decide to qualify for loans without thinking enough about the future and what else they need to buy with their income. When this occurs, a credit culture can develop where borrowers take out large loans not because it is financially wise but because they see others doing it. That can easily result in defaulted loans; b) *Sudden Market Changes* i.e. any sudden market change can change the loan market by affecting how much money people have to take out loans and make payments. If the market suddenly changes and the prices of objects increase due to shortages or greater demands, borrowers will have less money to pay off their loans, which can lead to greater overall nonperformance; c) *Real Estate Changes* i.e. the real estate industry and home loans--one of the staples of the loan industry--are closely connected. If prices in the real estate market fall--if houses sell for less and less--then lenders recoup less and less money from seizing properties in response to defaulted loans. This results in more loans becoming non-performing, losing the lender money instead of making it; d) *Bank Performance* i.e. bank performance also acts as a key cause of non-performing loans. An efficient and well-run bank should be able to adjust loan rates and terms to the current market in order to decrease the chance of nonperforming loans. Banks should also be selective as to which borrowers they accept. Banks that do poorly in these areas will create more nonperforming loans.

On a thorough analysis of the crisis on non-performing loans according to Swamy (2012) financial stability has once again emerged as an important area of concern in the financial systems across the globe. Financial stability is widely accepted as a situation in which financial system is capable of satisfactorily performing its three key functions simultaneously: (1) efficient and smooth facilitation of the inter-temporal allocation of resources from the surplus economic units to the deficit economic units; (2) managing the forward looking financial risks with appropriate pricing; and (3) to be prepared all the time to absorb the financial and real economic surprises and shocks. Here the core function of the payment system should therefore not fail as well.

The problem of NPLs in the financial sector has been a matter of concern for all economies and resolution of NPLs has become synonymous to functional efficiency of financial intermediaries (Swamy, 2012). Counterparty risk, being an important risk in the financial system more particularly of the banking system, poses a bigger challenge in order to achieve financial stability (Nubuo, 2005). Counter-party risk is an outcome directly related to the Non-Performing Loans (NPLs) of a financial institution. Even though NPLs are permanent phenomenon in the balance sheets of the financial institutions, if not contained properly, they eventually lead to crisis that can pose big threats of contagion that can engulf the financial health of the system. As per the Global Financial Stability Report of International Monetary Fund, (IMF, 2009), identifying and dealing with distressed assets, and recapitalizing weak but viable institutions and resolving failed institutions are stated as the two of the three important priorities which directly relate to NPLs.

The Tanzanian banking system has undergone significant transformation following financial sector reforms. It is adopting international best practices with a vision to strengthen the banking sector. Several prudential and provisioning norms have been introduced, and these are pressurizing banks to improve efficiency and trim down NPLs to improve the financial health in the banking system. The immediate consequence of large amount of NPLs in the banking system is bank failure (URT, 2007). Many researches on the cause of bank failures find that asset quality is a statistically significant predictor of insolvency (Dermirgue-Kunt 1989, Barr and Siems 1994), and that failing banking institutions always have high level of non-performing loans prior to failure. In view of this, it is essential to examine the factors affecting non-performing loans in KCB Bank (Tanzania) Limited which is the motive for this study.

## 1.2 Statement of the problem

Any country or financial institution might suffer its own version of the financial crisis because non-performing loans have risen steadily. The problem of non-performing loans is seen as a burden on any country's economy or financial institution and putting downward pressure on its growth (Yoonhee, 2006). This is because, first of all, the role of banks as financial intermediaries is not functioning properly due to the problem of non-performing loans (NPLs).

With their profitability eroding and their capital depreciating due to the problem of non-performing loans, banks are not eager to take on new risks and invest in new customers or growth areas. Occupied with the backward-looking work of solving the problem of non-performing loans, banks are unable to spare enough personnel or management focus for the forward-looking work of establishing a new earnings base. Secondly, the prolonged problem of non-performing loans has preserved inefficient corporations and industries and thus lowered the productivity of the banking industry as a whole. Thirdly, concerns about the stability of the financial system cannot be dispelled due to the problem of non-performing loans and, as a result, corporations and households have become prudent in their investment and consumption behavior, which in turn serves to block economic recovery (Swamy, 2012).

Financial institutions such as banks are expected to maintain their credit management due to the increasing rate of non-performing loans. The increasing number of non-performing loans of different entities and individual creates a significant impact and negative values to the financial streams. In the long-run, this same impact will reach the entire economy and leads to increase the credit crisis (Swamy, 2012). Nobuo (2005) argues that, if the non-performing loans are kept existing and continuously rolled over, the resources are locked up in unprofitable sectors; thus, hindering the economic growth and impairing the economic efficiency. Despite various correctional steps made by KCB Bank (Tanzania) Limited to solve and end this problem of non-performing loans; concrete results regarding non-performing loans still prevail and affect the bank. Non-performing loan is a sweeping and all pervasive virus confronting the institution. Under such circumstances, the study examines the

factors affecting non-performing loans for the growth of KCB Bank (Tanzania) Limited.

### **1.3 Research Objectives**

The objectives of this study were divided into two main categories, that is; general objective and specific objectives as itemized here below.

#### **1.3.1 General objective**

The general objective of the study was to examine the factors affecting non-performing loans in KCB Bank (Tanzania) Limited; Morogoro and Msimbazi branches.

#### **1.3.2 Specific Objectives**

The study attained the following specific objectives:

- i) To identify the factors influencing non-performing loans in KCB Bank (Tanzania) Limited
- ii) To examine the extent of non-performing loans in KCB Bank (Tanzania) Limited
- iii) To identify attempts made by KCB Bank (Tanzania) Limited to alleviate non-performing loans

### **1.4 Research questions**

The study addressed the following research questions;

- i) What are the factors influencing non-performing loans in KCB Bank (Tanzania) Limited?
- ii) What is the extent of non-performing loans in KCB Bank (Tanzania) Limited?
- iii) What are the attempts made by KCB Bank (Tanzania) Limited to alleviate non-performing loans?

### **1.5 Significance of the study**

This study examined the factors that affect non-performing loans in KCB Bank (Tanzania) Limited and alerted all stakeholders to take urgent steps to solve the problems.

This study created awareness regarding the factors that affect non-performing loans in banking industry for the purpose of conducting further studies in order to curb the challenges associated with them.

This study was important for the researcher for the fulfillment of Master degree in Accountancy and Finance (MSc. A & F) as the requirement of Mzumbe University

### **1.6 Scope**

The study focused on advance clerks, business bankers, credit manager, credit administrative manager, recovery officers and branch managers in KCB Bank (Tanzania) Limited, Morogoro and Msimbazi branches. The study examined the factors affecting non-performing loans in the mentioned bank branches.

### **1.7 Limitations of the study**

The limitations of the study were as follows;

*Financial Constraints*; the financial support expected from researcher's pocket money was limited. For that case, the researcher was unable to gather or collect the whole data from all respondents of the respective area and offices; hence taking a sample.

*Time factors*; the time allocated for data collection was very short compared to the importance and tedious work of collecting data. However, with the corporation of respondents the researcher managed to collect the data.

*Response rate*; it was expected that the response rate would be low due to respondents being in a hurry, very busy with their daily activities and others were absent at their working places sometimes. However, continuous follow-ups of respondents made the collection of data fulfilled.

*Lack of co-operation and confidentiality of* ; it was expected that, some respondents would show minimal co-operation as long as the required from them needed

confidentiality. However, respondents showed Maximum Corporation and were able to reveal what was needed.

*Wrong answers;* due to the nature of the problem studied, it was expected to have wrong answers from respondents because of touching ones sensitive issues (i.e. money). However, wrong answers were avoided by having questions which were neither vague nor ambiguous.

### **1.8 Organisation of the study**

The study consisted of five chapters. The first chapter was an Introduction and Background . The second chapter presented the Literature Review, the third chapter discussed the Research Methodology, the fourth chapter dealt with Presentation and Discussion of Research findings and the fifth chapter presented the Summary, Conclusion and Recommendations.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.0 Introduction

This chapter reviewed the literatures from different studies in order to capture ideas which guided the development of this study. Section 2.1 describes theoretical literature review; section 2.2 indicates the empirical literature review of the study and section 2.3 shows the conceptual framework.

#### 2.1 Theoretical literature review

##### 2.1.1 Banking

Banks are financial institutions that accept deposits from the general public and obtain money from such other sources as may be available to them (the 'haves') in order to extend loans to those in need of the money (the 'have-nots'). As Goosen *et al.*(1999) put it, banks provide channel (financial intermediation) for linking those who have excess funds with those who are in need of funds, thus ensuring the money available in economy is always put to good use. In so doing banks earn income when they lend money out at a higher interest rate than they pay depositors for use of their money. A Bank's main source of income is interest. A bank pays out at a lower interest rate on deposits and receives a higher interest rate on loans. The difference between these rates represents the bank's net income. Banks and other financial institutions exist in order to earn a profit and to ensure that shareholders' value is maximized (Nkusu, 2011). Currently in most jurisdictions commercial banks are regulated by government entities such as central banks and require a special bank license to operate. The requirements for the issue of a bank license vary between jurisdictions but typically include: Minimum capital, Minimum capital ratio (how do we arrive at this ratio?), 'Fit and Proper' requirements for the bank's controllers, owners, directors, or senior officers, approval of the bank's business plan as being sufficiently prudent and plausible (Goosen *et al.*, 1999).

### **2.1.2 Role of Banks**

The banking sector makes a meaningful contribution to the economic growth of every country. Banks contribution to the growth lies in the role they play in mobilizing deposits and allocating the resources efficiently to the most productive uses investment in the real sector (Adela and Julia, 2005). So making credit available to borrowers is one means by which banks contribute to the growth of economies. Banks pool resources together for projects that are too large for individual shareholders to undertake (Nobuo, 2005). They are also considered the most important enabler of financial transactions in any country's economy and are the principal source of credit. Bank finance is the primary source of debt funding. Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Saunders and Cornett, 2003). Besides, banks are also the custodians of nation's money, which are accepted in the form of deposits and paid out on the client's instructions (Harrison, 2006).

A bank's role has expanded considerably and is no longer limited to the taking of deposits and providing credit. Banks also perform the following activities (Beck *et al*, 2005): a) Money creators: Commercial banks create money by way of deposit liabilities. In contrast to liabilities of other businesses, bank liabilities (cheques) are generally accepted as a means of payment; b) Managers of the payment system: This refers to the payment of cheques through the Automatic Clearing Bureau (ABC). It also facilitates payments of credit and debit cards, internet and cell phone banking and automatic teller machines; c) Creators of indirect financial securities: Commercial banks hold assets that are subject to specific risks, while issuing claims against them in which these risks are largely eliminated through diversification; d) agents: Commercial banks developed sound databases of client and the is not publicly available (asymmetric ). The is only shared with other banks by way of a bank code or a full general bank report; e) Financial 'spectrum fillers': The capital market cannot supply the full range of instruments required by borrowers. Commercial banks assist in this regard by supplying specific instruments to fill the gap; f) Dealers in foreign currency: Due to the globalization of the world's economies this has become a very important function. Commercial banks assist in

the conversion of currencies, transfer of funds and negotiate foreign financing. Notwithstanding all other activities, banking industry considers lending as their most important function for utilization of funds. Since the major portion of gross profit of the industry is earned from loans; the administration of loan portfolios seriously affects the profitability of banks (Nkusu, 2011).

### **2.1.3 Bank Lending**

Investment on a productive sector is the precondition for achieving the economic growth from a country perspective. Capital formation positively supports this investment function. Once a satisfactory level of capital is formed, the option of sound investment comes, that ultimately leads to flow of capital in the future. Financial institutions, mainly banks do these functions through different mechanisms such as loans (Khemraj and Pasha, 2009). Provision of resources (granting loan) by one party to another is termed as lending. Lending presumes the fact that the second party doesn't reimburse the first party immediately rather arranges either to repay or return those resources at a later date, making it a debt. To enable them function as financial intermediaries, banks collect funds from savers in the form of deposit and then supply it to borrowers as loans. Thus banks accept customer deposits and use those funds to give loans to other customers or invest in other assets that will yield a return higher than the amount bank pays the depositor (Nobuo, 2005).

It follows that customers' deposit is the primary source of bank loan and hence, increasing or guaranteeing deposits directly has a positive effect on lending. Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Khemraj and Pasha, 2009). Bank finance is the primary source of debt funding. This intermediation functions benefit both the banks and the borrowers. The principal profit-making activity of commercial banks is making loans to its customers. In allocating funds, the primary objective of bank management is to earn income while serving the credit needs of its community. Lending represents the heart of the industry. Loans are the dominant asset and represent 50-75 percent to total amount of assets at most banks,

generate the largest share of operating income and represent the banks greater risk exposure (Harrison, 2006).

#### **2.1.4 Credit Provision**

Credit provision encompasses every activity involved in lending including sales, customer selection and screening, the application and approval process, repayment monitoring, and delinquency and portfolio management. It is also linked with the institutional structure pertaining to the credit process. Quality of credit provision is one of the most determinant factors for the efficiency, impact and profitability of the institutions. Thus getting the credit provision and product mix right is therefore one of the most demanding as well as rewarding challenges of every financial institutions (banks) (Nkusu, 2011).

Major issues in credit provision that include credit, credit analysis process, credit approval and credit monitoring processes. Getting these well significantly affect loan performance.

##### **a) Credit**

Engagement in financing begins with customer recruitment. An issue of knowing the customer, customarily known as KYC (Know Your Customer) is so vital before proceeding to details. Banks use various means to obtain such about the existing or potential customer. Use of financial statement, credit report from credit bureau, customers' history if not new is the potential sources of (Bloem and Gorter, 2001). According to The Federal Reserve (2004) a credit report is the organized presentation of about an individual's and/or company's credit record that a credit bureau communicates to those who request about the credit history of an individual's and/or company's experiences with credit, leases, non-credit-related bills, collection agency actions, monetary-related public records, and inquiries about the individual's credit history. Further according to Ferreti (2007), credit is usually integrated with data from other sources such as court judgments, electoral rolls and other private provided by others, which compile additional referring to a consumer. This naturally is ideal source of input for credit analysis.

The purpose of sharing is to communicate relationship from existing lending relationships to outside lenders. Credit providers use credit to conduct credit risk analysis of prospective borrowers in order to mitigate credit risk. Nobuo (2003) highlight that sharing is useful both at the origination stage and after credit has been extended. Especially at the origination phase, sharing reduces the problems of adverse selection. In fact the exchange of credit improves non-performing loan ratios, leads to fewer losses through write offs and decreases interest rates for good credit risks (Jentzsch, 2008). Jentzsch (2008) further supports that sharing credit between lenders intensifies competition and increases access to finance. Jappelli and Paggano (2005) indicate that credit sharing results in improved bank's knowledge of applicant's character, easing adverse selection and reduce the al rents that banks could otherwise extract from their customers. Credit also acts as a borrower disciplining device, by cutting insolvent debtors off from credit and eliminates or reduces the borrower's incentive to become over-indebted by drawing credit simultaneously from many banks without any of them realizing it.

Further, Nkusu (2011) highlight that sharing reduces adverse selection problems and thereby promotes financial stability; it serves as a borrower disciplining device and it reduces the al rents that banks can extract within the framework of their established customer relationships. According to Adela and Julia (2010), greater sharing of trade credit data, particularly in the informal sector, could greatly expand credit access for small and medium enterprises. In addition, Khemraj and Pasha (2009) show that exchange will assist in minimizing lending corruption in banks by reducing asymmetry between consumers and lenders, improving the bribery control methods and reducing al rent, and hence the bargaining power of lenders. The exchange of consumer credit disciplines borrowers to repay loans because borrowers do not want to damage the good report which can make it difficult for them to get credit (Swiss National Bank, 2008). Once credit on the loan request is obtained bank officers precede with credit analysis or assessment process.

## **b) Credit Analysis Process**

Credit analysis or assessment process is the first step in the process to tailor-make a solution to fit the customer's needs. The assessment starts with an understanding of the customer's needs and capacities to ensure there is a good fit in terms of the financing solution. Credit assessment is the most important safeguard to ensure the underlying quality of the credit being granted and is considered an essential element of credit risk management (Goosen *et al*, 1999). The credit quality of an exposure generally refers to the borrower's ability and willingness to meet the commitments of the facility granted. It also includes default probability and anticipated recovery rate (Saunders and Cornett, 2003). Credit assessment thus involves assessing the risks involved in financing and thereby anticipating the probability of default and recovery rate.

A credit analysis is used by the credit officials to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's (Strischek, 2000). The five C's are elaborated as hereunder.

### ***The Five C's of Credit***

The credit analysis process, traditionally employed by the first banks, does not differ fundamentally from the processes used today (Rose, 2002). The five C's are considered the fundamentals of successful lending and have been around for approximately 50 years. Initially only character, capacity and capital were considered. However, over the years collateral and conditions were added.

These provided an even more comprehensive view and clearer understanding of the underlying risk and resulting lending decision (Sinkey, 2002). According to Murphy (2004) these principles should be the cornerstone of every lending decision. The five C's are discussed as follows.

### **i) Character**

Character refers to the borrower's reputation and the borrower's willingness to settle debt obligations. In evaluating character, the borrower's honesty, integrity and trustworthiness are assessed. The borrower's credit history and the commitment of the owners are also evaluated (Rose, 2000). A company's reputation, referring specifically to credit, is based on past performance. A borrower has built up a good reputation or credit record if past commitments were promptly met (observed behavior) and repaid timely. Character is considered the most important and yet the most difficult to assess (Koch and MacDonald, 2003).

Bankers recognize the essential role management plays in a company's success. Critically analyzing quality of management has been one of the ways of assessing character. The history of the business and experience of its management are critical factors in assessing a company's ability to satisfy its financial obligations. The quality of management in the specific business is evaluated by taking reputation, integrity, qualifications, experience and management ability of various business disciplines such as finance, marketing and labor relations into consideration (Sinkey, 2002). These factors can be regarded as a risk mitigants if a banker views these positively. Much of its success can in fact be attributed to competent leadership. Companies with strong and competent management teams tend to survive in an economic downturn. On the other hand privately owned companies are generally managed by its owners. In this instance, succession planning must be in place, as the role of management remains vital to the success of the company (Koch and MacDonald, 2003).

### **ii) Capacity**

Capacity refers to the business's ability to generate sufficient cash to repay the debt. An analysis of the applicant's businesses plan, management accounts and cash flow forecasts (demonstrating the need and ability to repay the commitments) will give a good indication of the capacity to repay (Sinkey). To get a good understanding of a company's capacity evaluating the type of business and the industry in which it operates is also vital. It plays a significant role since each industry is influenced by

various internal and external factors. The factors that form the basis of this analysis includes; Type of industry, Market share, Quality of products and life cycle, whether the business is labour or capital intensive, the current economic conditions, seasonal trends, the bargaining power of buyers and sellers, competition and legislative changes (Koch and MacDonald, 2003). These factors lead the banker to form a view of the specific company and industry. The banker would regard this as a potential risk mitigant if he/she is confident about the company and industry and prospects for both appear to be positive. Besides, the financial position is also a critical indication of a business' capacity. The company's financial position is evaluated by assessing past financial performance and projected financial performance. A company's past financial performance is reflected in their audited financial statements. Financial projections consist of projected cash flows demonstrating the need for the facility and the ability to repay the facility (Sinkey, 2002).

In this regard at least three years audited financial statements (balance sheet and income statement) are required for data analysis. A financial spreadsheet is used to undertake the analysis. Commercial banks utilize the financial spread sheet (i.e. audited financial statement analysis and ratio calculations - DuPont) and it is applied through the Moody's Risk Advisor. The model also performs a peer comparison and calculates the probability of default (Koch and MacDonald, 2003). The following financial ratio analyses are very critical in assessing business' position. a) *Liquidity ratios* - reflect the company's ability to meet its short-term obligations. According to Conradie and Fourie (2002), the current ratio is calculated by dividing the current assets by the current liabilities; b) *Activity ratios*- indicate whether assets are efficiently used to generate sales; c) *Leverage ratios*- indicate the company's financial mix between equity and debt and potential volatility of earnings. High volatility of earnings increases the probability that the borrower will be unable to meet the interest and capital repayments; d) *Profitability ratios*- supply about the company's sales and earnings performance.

The cash flow analysis need to be done once the ratio analysis has been evaluated. The cash flow analysis allows the banker to distinguish between reported accounting profits (net income) and cash flow from operations (cash net income). Cash flow from operations gives an indication of how much cash is generated from normal business activities. The cash flow generated must be sufficient to service the banking facilities (Sinkey, 2002). These assumptions are evaluated against the company's past performance, industry averages and expected economic trends. An assessment of the financial capacity of a company should always include an evaluation of trends. Evaluating trends over a three to five year period gives a clear picture of the direction a firm is heading. Ratio results should always be compared to a peer group of or an industry comparison. Is the firm collecting faster or slower than the rest of the industry? Is this company more profitable than other companies just like them? In this regard making a maximum use of ratios by comparing the firm to its peers using established benchmarks is so vital. Comparison of the company to firms in the same line of business, geographic area and employee size provides a more accurate comparison (Harris, 2003).

The projections also reveal the purpose, amount and type of finance required. It also provides insight into the company's ability to generate sufficient cash flow to service the debt (Murphy, 2004). Banks must ensure that the type of financing is aligned to the purposed of finance. Analysis of the financial capacity of the should also be carried out in order to determine a borrower's ability to meet financial obligations in a timely fashion. Its ability to pay may be much more important. It is critical to understand the difference. Watching customer payment habits over time is an excellent indication of cash flow. Also, checking bank and trade references, as well as any pending litigation or contingent liabilities are pivotal.

Further checking for a parent company relationship is important as a parent company's guarantee may be available. Intercompany loans might affect financial solvency. Agency ratings that predict slow payment or default should be carried out before completion of investigating capacity of a borrower (Rose, 2000).

### **iii) Capital**

Capital refers to the owner's level of investment in the business (Sinkey, 2002). Banks prefer owners to take a proportionate share of the risk. Although there are no hard and fast rules, a debt/equity ratio of 50:50 would be sufficient to mitigate the bank's risk where funding (unsecured) is based on the business's cash flow to service the funding (Harris, 2003). Lenders prefer significant equity (own contribution), as it demonstrates an owner's commitment and confidence in the business venture.

### **iv) Conditions**

Conditions are external circumstances that could affect the borrower's ability to repay the amount financed. Lenders consider the overall economic and industry trends, regulatory, legal and liability issues before a decision is made (Sinkey, 2002). Once finance is approved, it is normally subject to terms and covenants and conditions, which are specifically related to the compliance of the approved facility. Banks normally include covenants along with conditions when credit facilities are granted to protect the bank's interest. The primary role of covenants is to serve as an early warning system. Covenants can either be negative or positive. Negative covenants stipulate financial limitations and prohibited events (Koch and MacDonald, 2003). Some examples of negative covenants are: a) Cash dividends cannot exceed 50% of the net profit after tax (financial limitation); b) No additional debt may be obtained without the bank's prior approval (prohibited event). Positive or affirmative covenants stipulate the provisions the borrower must adhere to (Rose, 2000). Some examples of positive covenants are; a) Audited financial statements must be provided within 90 days of the company's financial year-end; b) The borrower must maintain the following financial ratios: Interest cover ratio of 4:1 (defined as earnings before interest and tax divided by interest paid), Gearing ratio of 2:1 (defined as total liabilities divided by owners' equity). Conditions normally stipulate that all the security relevant to the loan should be in order before any funds will be advanced.

#### **v) Collateral**

Collateral (also called security) is the assets that the borrower pledges to the bank to mitigate the bank's risk in event of default (Sinkey, 2002). It is something valuable which is pledged to the bank by the borrower to support the borrower's intention to repay the money advanced. Security is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Koch and MacDonald, 2003). Supporting of the aforementioned, Rose and Hudgins (2005) define secured lending in banks as the business where the secured loans have a pledge of some of the borrower's property (such as home or vehicles) behind them as collateral that may have to be sold if the borrower defaults and has no other way to repay the lender.

The purpose of security is to reduce the risk of giving credit by increasing the chances of the lender recovering the amounts that become due to the borrower. Security increases the availability of credit and improves the terms on which credit is available. The offer of security influences the lender's decision whether or not to lend, and it also changes the terms on which he is prepared to lend, typically by increasing the amount of the loan, by extending the period for which the loan is granted and by lowering the interest rate (Harris, 2003). According to De Lucia and Peters (1998), in the banking environment, security is required for the following three reasons; a) to ensure the full commitment of the borrower to its operations; b) to provide protection should the borrower deviate from the planned course of action outlined at the time credit is extended, and c) to provide insurance should the borrower default.

The security value of an asset is based on the estimated re-sale value of the assets at the time of disposing of it (McManus, 2000). The specific type of property is valued by the bank to determine the property's market value for security purposes (Rose, 2000). Besides the physical collateral a third party can provide a suretyship for the debt of the borrower. Should the borrower not be in a position to repay the debt, the bank will then call on the surety for repayment (Koch and MacDonald, 2003). It is normal banking practice for the banks to take the suretyships of the

shareholders/directors when funds are advanced to a company (Rose, 2000). C's" are well-known credit assessment principles, commercial banks have developed their own qualitative credit risk assessment models to assess whether the bank will agree to lend to a specific business (Sinkey, 2002). Based on the credit obtained about the borrower and credit assessment carried out, either by quantitative or qualitative model (through the use of the five C's) or combination of both, credit sanctioning is done.

#### **b) Credit Approval process**

Extending credit is the careful balance of limiting risk and maximizing profitability while maintaining a competitive edge in a complex, global marketplace. Banks go through a thorough process in approving credit to hit the balance. Credit approval is the process of deciding whether or not to extend credit to a particular customer. It involves two steps: gathering relevant and determining credit worthiness (Goosen *et al*, 1999). As has been discussed in the preceding section, the credit analysis process consists of a subjective analysis of the borrower's request and a quantitative analysis of the financial provided. The individual steps in the credit approval process and their implementation have a considerable impact on the risks associated with credit approval. The quality of credit approval processes depends on two factors, i.e. a transparent and comprehensive presentation of the risks when granting the loan on the one hand and an adequate assessment of these risks on the other. Furthermore, the level of efficiency of the credit approval processes is an important rating element. Due to the considerable differences in the nature of various borrowers and the assets to be financed as well the large number of products and their complexity, there cannot be a uniform process to assess credit risks (Khemraj and Pasha, 2009).

The quality of the credit approval process from a risk perspective is determined by the best possible identification and evaluation of the credit risk resulting from a possible exposure. The credit risk can be distributed among the following risk components; i) Probability of default (PD), ii) Loss given default (LGD) and iii) Exposure at default (EAD) according to Saunders and Cornett (2003).

**i) Probability of default (PD)**

Default probability is the likelihood that the business will default on its repayment over the term of the facility. Reviewing a borrower's probability of default is basically done by evaluating the borrower's current and future ability to fulfill its interest and principal repayment obligations.

**ii) Loss given default (LGD)**

Exposure at default is the magnitude or exposure that would be materialized in the event of a default. It addresses what fraction of the exposure may be recovered through bankruptcy proceedings or through some other form of settlement in the event of a default. The loss given default is affected by the collateralized portion as well as the cost of selling the collateral. Therefore, the calculated value and type of collateral also have to be taken into account in designing the credit approval processes.

**iii) Exposure at default (EAD)**

The exposure at default corresponds to the amount owed to the institution. Thus, besides the type of claim; the amount of the claim is another important element in the credit approval process. Once has been gathered, the firm faces the hard choice of either granting or refusing credit.

Many financial managers use the "five C's of Credit" as their guide to identify and evaluate the credit risk resulting from a possible exposure to sanction the credit.

**c) Loan Follow Up or Credit Monitoring Process**

Lending decision is made on sound credit risk analysis/appraisal and assessment of creditworthiness of borrowers. But past records of satisfactory performance and integrity are no guarantee future, though they serve as useful guide to project trend in performance. A loan granted on the basis of sound analysis might go bad because of the borrower may not meet obligations per the terms and conditions of the loan contract. It is for this reason that proper follow up and monitoring is essential. Monitoring or follow-up deals with the following vital aspects; i) Ensuring

compliance with terms and conditions; ii) Monitoring end use of approved funds; iii) Monitoring performance to check continued viability of operations; iv) Detecting deviations from terms of decision; v) Making periodic assessment of the health of the loans and advances by noting some of the key indicators of performance that might include: profitability, activity level and management of the unit and ensure that the assets created are effectively utilized for productive purposes and are well maintained; vi) Ensuring recovery of the installments of the principal and interest in case of term loan as per the scheduled repayment program; vii) Identify early warning signals, if any, and initiate remedial measures thereby averting from possible default (Harris, 2006).

Basically there are three types of loan follow up systems. These are: Physical follow up, financial follow up and legal follow up.

i) *Physical Follow -up*

Physical follow-up helps to ensure existence and operation of the business, status of collateral properties, correctness of declared financial data, quality of goods, conformity of financial data with other records (such as taxes, register books), availability of raw materials, labour situation, marketing difficulties observed, undue turnover of key operating personnel and change in management set up among others.

ii) *Financial Follow- up*

Financial follow up is required to verify whether the assumptions on which lending decisions was taken continues to hold good both in regard to borrowers' operation and environment, and whether the end use is according to the purpose for which the loan was given.

iii) *Legal Follow- up*

The purpose of legal follow up is to ensure that the legal recourse available to the Bank is kept alive at all times. It consists of obtaining proper documentation and keeping them alive, registration, proper follow up of insurances. Specific issues pertaining to legal follow up include: ascertaining whether contracts are properly

executed by appropriate persons and documents are complete in all aspects, obtaining revival letters in time (revival letters refer to renewal letter for registration of security contracts that have passed the statutory period as laid down by the law), ensuring loan/mortgage contracts are updated timely and examining the regulatory directives, laws, third party claims among others.

### **2.1.5 Banking Risks**

Shareholder value maximization requires a firm to engage in risk management practices only if doing so enhances the value of the firm and, by implication, its value to shareholders (Ali, 2006). A volatile economy and recent credit crisis show the importance of banks to increase attention on how risks can be measured and kept under control. Bessis (2002) defines banking risks as “adverse impacts on profitability of several distinct sources of uncertainty”. Many risks are common to all financial institutions that include: credit, liquidity, market, operational, currency, solvency and interest rate, country risks among others. The key risks that banks are exposed to include;

#### **a) Credit risk**

According to Beck *et al* (2005) credit risk is the risk that a financial contract will not be concluded according to the agreement.

It is the risk that the counterparty to an asset will default. In other words it is the risk to earnings or capital due to borrowers’ late and nonpayment of loan obligations (reference). Credit risk encompasses both the loss of income resulting from the sector inability to collect anticipated interest earnings as well as the loss of principal resulting from loan defaults. Credit risk arises because the possibility that the expected cash flows from advances and securities held, might not be paid in full.

Credit risk is considered the most lethal of the risks banks face. Credit risk includes both transaction risk and portfolio risk. Under credit risk are also transaction and portfolio risks. Transaction risk refers to the risk within individual loans transaction risk is mitigated through borrower screening techniques, underwriting criteria and quality procedures for loan disbursement, monitoring, and collection. Portfolio risk

refers to the risk inherent in the composition of the overall loan portfolio (Khemraj and Pasha, 2009). Policies on diversification (avoiding concentration in a particular sector or area), maximum loan size, types of loans, and loan structures lessen portfolio risk.

#### **b) Liquidity risk**

Liquidity risk is the possibility of negative effects on the interests of owners, customers and other stakeholders of the financial institution resulting from the inability to meet current cash obligations in a timely and cost-efficient manner. Liquidity risk occurs when there is a sudden surge in liability withdrawals resulting in a bank to liquidate assets to meet the demand (Bessis, 2002). It usually arises from management's inability to adequately anticipate and plan for changes in funding sources and cash needs. According to Rose and Hudgins (2005) bankers and other financial institutions are concerned about the danger of not having enough cash to meet payment or clearing obligations in a timely and cost effective manner. Efficient liquidity management requires maintaining sufficient cash reserves on hand (to meet client withdrawals, disburse loans and fund unexpected cash shortages) while also investing as many funds as possible to maximize earnings (putting cash to work in loans or market investments).

#### **c) Market risk**

Market risk is the risk incurred in the trading of assets and liabilities when interest rates, exchange rates and other asset prices change (Saunders and Cornett, 2003). It is the current and potential risk to earnings and shareholders' equity resulting from adverse movements in market rates or prices. It arises from interest rate, equity and foreign exchange risks (Koch and Macdonald, 2003). According to Bessis (2002) due to increased competition the interest income of banks is declining and banks are concentrating more on non-interest income in order to mitigate this risk.

#### **d) Operational risk**

It is the risk of loss resulting from inadequate internal processes, people and systems or from external events (Koch and Macdonald, 2003). Operational risk is the possible

risk that existing technology or support systems will fail or malfunction. It also includes human errors, fraud and non-compliance with an institution's procedures and policies (Bessis, 2002).

**e) Currency risk**

Concerns the possible impact which fluctuations in exchange rates may have on the foreign exchange holdings or the commitments payable in foreign currencies by businesses (Beck *et al.*, 2005). It is the possibility that exchange rate fluctuations can adversely affect the value of a bank's assets and liabilities held in foreign currencies (Bessis, 2002). Currency risk is one of the market risks banks face.

**f) Capital or Solvency risk**

It is the risk that a bank may become insolvent and fail (Koch and Macdonald, 2003). It isn't considered a separate risk because all of the risks a bank faces, in one form or another, affect a bank's capital.

**g) Interest rate risk**

A bank is exposed to interest rate risk when the maturities of the bank's assets and liabilities are mismatched (Saunders and Cornett, 2003). Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. If interest rates rise and a mismatch occur in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities. Also known as asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets). Bessis (2002) states that interest rate risk could result in economic losses and insolvency. Interest rate risk is also one of the market risks.

**h) Country risk**

It is associated with the risk that foreign borrowers cannot repay the debt due to foreign currency shortages, adverse political and economical conditions or

interference by the foreign government (Saunders and Cornett, 2003). Besides the aforementioned risks Rose and Hudgins (2005) state that banks are also exposed to: Compliance risk, Reputation risk, Sovereign risk, Strategic risk, and Legal and regulatory risks. Financial institution managers (and regulators) review these risks in light of i) the institution's potential exposure to loss, ii) the quality of internal risk management and systems, and iii) the adequacy of capital and cash to absorb both identified and unidentified potential losses. In other words, management determines whether the risk can be adequately measured and managed, considers the size of the potential loss, and assesses the institution's ability to withstand such a loss

#### **i) Credit Risk Management**

Loan is a major asset, income source for banks, and risky area of the industry. Moreover, its contribution to the growth of any country is very clear. Bank credit is the primary source of debt financing available for most customers in the personal, business or corporate market. The underlying need for credit varies across these markets. Banks generally also want to increase the base of their income and use credit extension as an opportunity to cross sell other fee generating services when a customer applies for credit facilities (Koch and MacDonald, 2003). Any successful business must meet its customer needs and make a profit. Likewise, successful financial institutions must meet the desperate needs of depositors and borrowers. Depositors look for high rates, short terms and no risk, while borrowers seek low rates and long terms. Financial institutions are therefore, in the risk intermediation business. To be successful, financial institutions, banks in particular, must properly underwrite risk, manage and monitor the risk assumed (Rose, 2002).

Credit risk can be defined as the potential for a borrower or counter party to fail to meet their obligations in accordance with the terms of an obligation's loan agreement, contract or indenture (Saunders and Cornett, 2003). Credit risk is considered the oldest form of risk in the financial markets. Beck *et al* (2005) stated that "credit risk is as old as lending itself", dating back as far as 1800 B.C. The first banks, which started in Florence seven hundred years ago, faced very similar challenges that banks face today. Although managing credit risk is their core competency, many banks failed due to over-extension of credit. The most prominent

risk assumed by banks is credit risk. This is due to the various factors that influence a borrower's ability to repay the credit facility. The borrower's ability to repay is closely linked to the general economic conditions of a country. In favorable economic conditions the ability to repay increases, which could be due to a favorable interest rate environment, low inflation, increased income levels or a combination of these factors. The opposite is however true in poor economic conditions. The borrower's ability to repay is adversely effected under these conditions due to a reduction in disposable income (Koch and MacDonald, 2003).

Credit risk arises from uncertainty in a given counterparty's ability to meet its obligations. The increasing variety in the types of counterparties (from individuals to sovereign governments) and the ever-expanding variety in the forms of obligations (from auto loans to complex derivatives transactions) has meant that credit risk management has jumped to the forefront of risk management activities carried out by firms in the financial services industry (Jentzsch, 2008)). The risk profile of banks is fundamentally different from that of other financial institutions, like stockbrokers and insurance industry. An integral part of banking is the management of credit risk and it is done through well-diversified portfolios of exposure. Most banks fail because of poorly managed credit risk (Rose, 2002). Credit risk management primarily focuses on loss avoidance and the optimization of return on risk. Financial institutions in the world are facing two major challenges. Firstly, they need to deliver increasing returns and value to shareholders and secondly, they need to determine how to capitalize on the New Capital Accord's (Basel II) minimal capital requirements (Belmont, 2004). The need to put a strong credit risk management in place cannot overemphasized as failure which lead loan default and thereby crisis on banks.

#### **2.1.6 Meaning of Non-Performing Loans**

Non-Performing Loans are popularly known as non-performing assets. Commercial Banks loans are of various types. All those loans which generate periodical income are called as Performing Loans (PLs). While all those loans which do not generate periodical income are called as Non-Performing Loans (NPLs). If the customers do

not repay principal amount and interest for a certain period of time then such loans become non-performing loans (NPLs). Thus non-performing assets are basically non-performing loans (McNulty *et al*, 2001). A loan that is not earning income and: (1) full payment of principal and interest is no longer anticipated, (2) principal or interest is 90 days or more delinquent, or (3) the maturity date has passed and payment in full has not been made.

### **2.1.7 Types of Non-performing loans**

Non-performing loans have been divided or classified into four types according to Jin-Li Hu (2002)

- i) Standard Loans: Standard loans generate continuous income and repayments as and when they fall due. Such loans carry a normal risk and are not Non-Performing Loans in the real sense. So, no special provisions are required for Standard Loans.
- ii) Sub-Standard Loans: All those loans (loans and advances) which are considered as non-performing for a period of 12 months are called as Sub-Standard loans.
- iii) Doubtful Loans: All those loans which are considered as non-performing for period of more than 12 months are called as Doubtful loans.
- iv) Loss Loans: All those loans which cannot be recovered are called as Loss loans.

### **2.1.8 Causes of non-performing loans**

Non-Performing Loans arise due to a number of causes according to Yoonhee (2006) like; a) Speculation: Investing in high risk assets to earn high income; b) Default: Willful default by the borrowers; c) Fraudulent practices: Fraudulent Practices like advancing loans to ineligible persons, advances without security or references; d) Diversion of funds: Most of the funds are diverted for unnecessary expansion and diversion of business; e) Internal reasons: Many internal reasons like inefficient management, inappropriate technology, labour problems, marketing failure, etc. resulting in poor performance of the companies; and f) External reasons:

External reasons like a recession in the economy, infrastructural problems, price rise, delay in release of sanctioned limits by banks, delays in settlements of payments by government and natural calamities.

On the other hand, Rajan *et al* (2003) provide causes of non-performing loans such as interest rate, inflation rate, economic growth and unemployment rate. These are further elaborated as follows.

**a) Interest rate**

Interest is a fee paid on borrowed assets. It is the price paid for the use of borrowed money or money earned by deposited funds. As for banks, their main profits come from interest rate (i.e. interest rate differed according to years of payment). The longer it takes to make settlement, the higher it will be for the interest rate. At a time when interest rate is at its lowest, demand for financing is high by customers. This shows negative relationship between interest rate and demand for loan, whereas when interest rate is high, demand for financing is low. People choose to save their money when interest rate is high, and only apply for financing when the rate is decreasing. By doing so, the amount that needed to pay for bank as a result for making a loan is slightly lower compared to when the time when interest rate is high. When the interest rate is low, net NPLs is also low. And when interest rate is high, the amount of NPLs will also be increased. High credit growth in the past could generate higher NPLs in the future. According to all models, NPLs are very persistent, which would suggest that the response of credit losses to the macroeconomic cycle could take time to materialize, although it would also imply that NPLs would then cumulate to high levels (Arthur, 2003). An increase in interest rate weakens loan payment capacity of the borrower therefore non-performing loans and bad loans are positively correlated with the interest rates.

**b) Inflation rate**

The higher the inflation rate objective, the lower the probability of hitting the zero bound. Under inflation targeting regime, the policy interest rate is generally a single instrument to signal policy stance towards various economic variables with an

ultimate goal of price stability and sustainable economic growth. Recently, nonetheless, continued increases in the world prices of oil and other commodities, due to leapfrog expansion of emerging economies in particular China and India, exerted upwards pressure on global inflation. The increase in inflation ultimately forces interest rates upwards. It means that inflation rates is only profound the impact on the interest rate and not other factors. The level of output permanently falls as the inflation rate increases. An increase in inflation can result into higher output or lower output or no change in output.

There is an empirical evidence of positive relationship between the inflation in the economy and non-performing loans (Fofack, 2005). While Nkusu (2011) has explained that this relationship can be positive or negative according to the author inflation affects loan payment capacity of borrowers positively or negatively, higher inflation can enhance the loan payment capacity of borrower by reducing the real value of outstanding debt; moreover increased inflation can also weaken the loan payment capacity of the borrowers by reducing the real income when salaries/wages are sticky, moreover by highlighting the role of inflation in the presence of variable interest rate. Nkusu (2011) further explains that in this scenario inflation reduces the debt servicing capacity of the loan holders as lenders adjust the lending interest rates to adjust their real return. So according to literature relationship between inflation and non-performing loans can be positive or negative depending on the economy of operations.

### **c) Economic growth**

Non-performing loans can lead to efficiency problem for banking sector. It is found by a number of economists that failing banks tend to be located far from the most-efficient frontier. Because banks don't optimise their portfolio decisions by lending less than demanded. What's more, there are evidences that even among banks that do not fail; there is a negative relationship between the non-performing loans and performance efficiency. The phenomena that banks are reluctant to take new risks and commit new loans is described as the "credit crunch" problem. According to the United States Council of Economic Advisors (1991), credit crunch is "a situation in

which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects”. A “credit crunch” is a disequilibrium phenomenon. It is present when banks are unwilling to lend, especially when a firm with profitable projects cannot obtain credit in spite of low interest rates (lower than the expected marginal products). Credit crunch results in excess demand for credit and hence credit rationing, where loans are allocated via non-price mechanism. Eventually, it imposes additional pressure on the performance of the monetary policy.

#### **d) Unemployment rate**

Like any other market, the labour market consists of a supply side and a demand side. The labour supply of the population referred to as the economically active population or labour force, has two components; employed persons and unemployed persons. The labour demand of enterprises and other production units too, can be broken down in two components; jobs (filled posts) and job vacancies (unfilled posts). Due to the existence of multiple jobholding, the number of jobs tends to be larger than the number of employed persons. In most countries, statistics on the supply of labour are far better developed than statistics on the demand of labour. As a result, current international recommendations on labour market statistics deal almost exclusively with statistics on labour supply. Unemployment occurs when people are without jobs and they have actively looked for work within the past four weeks (International Labour , 2007). The unemployment rate is a measure of the prevalence of unemployment and it is calculated as a percentage by dividing the number of unemployed individuals by all individuals currently in the labour force. During unemployment, those who make loan from bank are unable to pay back to bank as the effect of losing their jobs. Without salary, they cannot pay their loan. So, when the unemployment rate is high, so does it go with NPLs amount. An increase in the unemployment in the country negatively affects the incomes of the individuals which increases their debt burden. It is obvious when a person losses his source of income it becomes difficult to return his loan, similarly an increased unemployment in the economy also negatively affects the demand of the products of firms which

ultimately affects the production/sales of the firms, this ultimately leads to decline in revenues of the firms and a fragile debt conditions.

Most of the empirical evidence suggests that banks' NPLs are closely linked to the economic activity. In other words, macroeconomic factors matter: downturns/slowdowns in the economy, recessions, low rate of savings, weak markets, depressions in industrial production, and reduction in per capita income levels and most importantly the inflation levels in the economy. A fair amount of the academic literature has dealt with determinants of banking crisis, which is the most severe of the consequences of bad loans in a banking system which is of valuable understanding as a backdrop for the study of NPLs (Demirguc-Kunt and Levine, 2005). From the simple transaction, different problems may arise on credit management. The failure of the customer to disclose any personal during the application can be the greatest reason that might influence the overall performance of the banks (Singh, 2005). The fact that the insufficient may affect the loan's fruitful expectations; this is also the representation of the bank's lack of capacity to investigate and build strong transactions, as well as the debt collection.

The purpose of loans is to support the financial needs of the customers according to their proposed businesses or specific needs which is endowed to the individual's/entity's capacity. If the bank doesn't see any fruitful investment in the proposed plan, they will only simply reject it (Yoonhee, 2006). However, due to the personal greediness, the individuals draw assumptions and deceive the banks. Where, on the other hand, the bank is incapacitated to extend its investigation to ensure that all they receive are true and legal. Since the problem that constitutes in the non-performing loans is associated with the operation of the banks, there should be an aggressive debt collection policy. The lack of aggressiveness is popular in the developing countries and this is perceived as the banks specific factor that can also contribute to the non performing debt problem (Waweru and Kalani, 2009). Banks should increase their competency and maintain it until they recover their position and have a normal operation.

The immediate consequence of large amount of NPLs in the banking system is bank failure. Many researches on the cause of bank failures find that asset quality is a statistically significant predictor of insolvency (Dermirgue-Kunt 1989, Barr and Siems 1994), and that failing banking institutions always have high level of non-performing loans prior to failure.

### **2.1.9 Lending as a global concept**

Lending practices in the world could be traced to the period of industrial revolution which increased the pace of commercial and production activities thereby bringing about the need for large capital outlays for projects. Many captains of industry at this period were unable to meet up with the sudden upturn in the financial requirements and therefore turn to the banks for assistance (Sergio, 1996). Lending which may be on short, medium or long-term basis is one of the services that commercial banks do render to their customers. In other words, banks do grant loans and advances to individuals, business s as well as government in order to enable them embark on investment and development activities as a mean of aiding their growth in particular or contributing toward the economic development of a country in general (Yoonhee, 2006).

Commercial banks are the most important savings, mobilization and financial resource allocation institutions. Consequently, these roles make them an important phenomenon in economic growth and development. In performing this role, it must be realized that banks have the potential, scope and prospects for mobilizing financial resources and allocating them to productive investments. Therefore, no matter the sources of the generation of income or the economic policies of the country, commercial banks would be interested in giving out loans and advances to their numerous customers bearing in mind, the three principles guiding their operations which are, profitability, liquidity and solvency (Waweru and Kalani, 2009). However, commercial banks decisions to lend out loans are influenced by a lot of factors such as the prevailing interest rate, the volume of deposits, the level of their domestic and foreign investment, banks liquidity ratio, prestige and public recognition to mention a few.

### **2.1.10 Non-Performing Loans in the Banking Industry**

Financial institutions such as banks are expected to maintain their credit management due to the increasing rate of non-performing loans. The increasing number of non-performing loans of different entities and individual creates a significant impact and negative values to the financial streams. In the long-run, this same impact will reach the entire economy and leads to increase the credit crisis (Harrison, 2006). There is an interest drawn by the researcher/s regarding the reason or several reasons that lead to non-performing loans. The major reason lies on the failures in management. Banks are absolutely strong to hold the financial crisis. But in the recent years, this characteristic of bank changed due to the various economic changes and challenges offered by the globalization (Waweru and Kalani, 2009). Added to this disadvantage is the growing numbers of non-performing loans that affects the financial stream and operations of the bank. The main objective of the bank in offering the financial credit and loans for the entities and small individuals can be viewed in the noble mission “to lessen the poverty”. The procedures and operations of the banks are tested through their model country. However, there are instances that the loan performance fails to follow its original plan and fail to produce the expected outcome because of the two aspects – the credit management of the financial institution and the failure of the individual or entities to wisely use the loans (Harrison, 2006).

#### **a) Credit Management**

From the simple transaction, different problems may arise. The failure of the customer to disclose any personal during the application can be the greatest reason that might influence the overall performance of the banks. The fact that the is insufficient may affect the loan’s fruitful expectations. This is also the representation of the bank’s lack of capacity to investigate and build strong transactions, as well as the debt collection.

### **b) Individual's/Entity's Capacity**

The purpose of loans is to support the financial needs of the customers according to their proposed businesses or specific needs. If the bank doesn't see any fruitful investment in the proposed plan, they will only simply reject it. However, due to the personal greediness, the individuals draw assumptions and deceive the banks. Where, on the other hand, the bank is incapacitated to extend its investigation to ensure that all they receive are true and legal.

#### **2.1.11 Strategies for recovery of non-performing loans**

Masoom (2013) contended that under the present overall socio economic dynamics the banks should prioritize to extend purpose-oriented credit facilities with required security/collateral support as their policy priority since diversion of fund is one of the identified causes of loan default. So it becomes of imperative need to keep a close watch on the borrower's business operations and the movement of its financial indicators in an empirical manner. Banks have to play the role of business partner rather than a conventional lender. A bank has to ensure that utilization of credit is in accordance with the purpose for which it is lent i.e. end use of the lending has to be ensured. The bank has to monitor the performance of the borrowing unit to verify whether the assumptions on which the loan was sanctioned continue to hold good with regard to operation and environment. It is also to be observed whether the promoters are adhering to the terms and conditions of sanction and this is done by devising a mechanism for obtaining at regular intervals from the borrowing units. The bank will review the performance of the unit from the broader perspective for having better insight, so that they can extend meaningful advice to the promoters for overcoming any business hurdles. It is an admitted fact that a bank's financial health is largely dependent upon the extent and size of performing assets. Credit losses are equivalent to capital losses. An increase in non-performing loan (NPL) has the multi-pronged adverse impacts on bank's balance sheet having consequential effect of erosion of capital impairing earning streams, profitability, liquidity and solvency. Any compromise with the quality of assets at the sanctioning process will be a contributing factor towards enhancement of NPLs. The bank management has no

choice but to stay focused on the issue of keeping credit portfolio performing to the maximum extent.

Other strategies include the formulation of a well-structured NPLs management strategy covering following areas; a) No compromise with due diligence in the sanctioning process. Keeping in mind "prevention is better than cure."; b) Action plan for potential NPLs; c) Identification of highly risk sensitive borrowers in the credit portfolio; d) Identification of geographical area-wise risk sensitivity; e) Targeting high value end NPL accounts; f) Prompt action on credit reports; and g) Capacity building of officers and executives in the recovery department.

#### **2.1.12 Literatures from various scholars**

Das and Ghosh (2003) argue that in addition to the standardized system, efforts have been made to improve the classification of loans. For example, more countries are shortening the period when unpaid loans become past due, intending to put loans on lenders' timetable sooner and require them to address these loans before losses start to escalate. The International Accounting Standard 39 revised in 2003 focuses on recognition and measurement of financial instruments and, most importantly, defines and establishes the measurement and evaluation of impaired loans. Singh (2005) contend that, as lenders usually make little or no loss provision for impaired loans, they are at risk to be suddenly forced to reclassify such loans as a loss and take a full write-down if the borrowers go bankrupt. The initiation of this standard is to prevent lenders from being caught off-guard. In addition, many global economists, rating agencies, and s such as the World Bank and the Asian Development Bank have begun to evaluate the effects of NPLs on GDP growth. They reduce growth estimates to reflect the time and cost of resolving large non-performing loan issues.

Stronger performance of real economy led by healthy competition among financial institutions result in lower NPLs. Boyd and Nicolo (2005) found that banks charge more rents on their lent assets in declining competition scenarios. In such situations higher lending rates augment the chances of borrower's bankruptcy. Khemraj and Pasha (2009) studied the relationship of various bank specific and macroeconomic

variables as determinants of NPLs in Guyanese banking sector. Based on empirical evidence, they argued that banks charging relative higher lending rates with excessive lending strategy are exposed to higher risk of incurring NPLs. Results of this study were in accordance with that of Keeton and Morris (1987) that took economic conditions into consideration and concluded that banks with higher risk appetite are exposed to increased risk of losses. Fofack (2005) highlighted causes and implications of nonperforming loans. His study revealed that macroeconomic shocks together with higher cost of capital through rise in interest rates are highly associated with the increase in NPLs of Sub-Saharan African countries. Collins and Wanjau (2011) also concluded higher lending rates as a key factor boosting NPLs. They recommended critical borrower analysis by banks to avoid mismatch between borrower's repayment capacity and the cost of borrowing.

Increase in non-performing loan portfolios of banks is common in all those economies where economic monitors including regulators and banking professionals lack understanding of systemic risks and macroeconomic effects pertaining to NPLs. Reddy (2002) stressed the importance of issues related to systemic risk and effects of macroeconomic variables faced by the economy specifically the banks by comparing India with other countries including China, Japan, Korea and Thailand for effectively solving critical problem of non-performing loans. As per their analysis, steep rise in the interest rates was the root cause of majority NPLs in Thailand. Research conducted by Asari, *et al.* (2011) was also on the same lines and concluded that NPLs and interest rates have significant relations. Their study suggested that increase in the non performing loans result in deterioration of bank assets and subsequently capital erosion. Interest rates and their volatility are among the most critical and closely watched variables in the economy. Paper by Adela and Iulia (2010) demonstrated the connection between average interest rate and nonperforming loans.

Study conducted by Espinoza and Prasad (2010) focused on macroeconomic and bank specific factors influencing non-performing loans and their effects in Banking System. After a comprehensive analysis, they found that higher interest rates increase NPLs but the relationship was not statistically significant. A similar study was

recently conducted by Nkusu (2011) investigating the macroeconomic determinants of loan defaults through panel regressions and panel vector autoregressive models. Author in this article suggested that hike in interest rates result in deterioration. Fuentes and Maquieira (1998) undertook an in depth analysis of loan losses due to the composition of lending by type of contract, volume of lending, cost of credit and default rates in the Chilean credit market. Their empirical analysis examined different variables which may affect loan repayment: (a) limitations on the access to credit; (b) macroeconomic stability; (c) collection technology; (d) bankruptcy code; (e) sharing; (f) the judicial system; (g) prescreening techniques; and (h) major changes in financial market regulation. They concluded that a satisfactory performance of the Chilean credit market, in terms of loan repayments hinges on a good sharing system, an advanced collection technology, macroeconomic performance and major changes in the financial market regulation. In another study of Chile, Fuentes and Maquieira (2003) analyzed the effect of legal reforms and institutional changes on credit market development and the low level of unpaid debt in the Chilean banking sector.

## **2.2 Empirical Literature Review**

There are many internal and external factors affecting NPLs while the internal factors might be taking up new projects, promoting associate concerns, business failure, cost overruns during the project implementation stage, strained labour relations, inefficient management, technology related problems, product obsolescence etc., the external factors include GDP growth, default in other countries, high inflation, accidents and natural calamities.

Das and Ghosh (2003) established relationship between nonperforming loans of India's public sector banks in terms of various indicators such as; asset size, credit growth and macroeconomic condition and operating efficiency indicators.

Bercoff, Giovanniz and Grimardx (2002) in their study of Argentinean banks tried to measure NPLs by using the various bank related parameters as well as macroeconomic parameters. Bank specific parameters in their study were Ratio of

Networth to Net Assets, Bank's exposure to peso loans, and type of banks such as foreign, private or public. Macroeconomic factors in this study were credit growth, reserves adequacy, foreign interest rate and monetary expansion.

They established that variables such as operating cost, exposure to peso loans, credit growth, and foreign interest rate had a negative effect on NPLs. The macroeconomic variables such as money multiplier and reserve adequacy had a positive impact on NPLs. However, their researches could not examine the extent of non-performing loans in banking industry.

Chen *et al.* (1998) study the relationship between the risks and the ownership structure, and it appears that a negative correlation exists between the managers' shareholdings and the risks faced by the financial institution. That means if the managers' shareholding percentage increases, the financial institution will reduce its own risk behavior.

While Berger and De Young (1995) mention that a management team with poor operating capability is unable to correctly appraise the value of collateral, which means that it is difficult for it to follow up on its supervision of the borrower, its poor credit-rating technology will result in management being unable to control and supervise the operating expenses efficiently, thus leading to a significant increase in NPLs.

Wahlen (1994) also points out that unexpected changes in the NPL Ratio may indicate that expected future loan losses are relatively nondiscretionary and negatively related to bank stock returns. Accordingly, banks face a number of challenges such as; worrying level of NPLs, stringent prudential norms, increasing competition, growing customer expectations, increasing pressure on profitability, liquidity and credit risk management, assets-liability management, shrinking size of spread, rising operating expenditure and so on.

Singh (2005) argues that globalization of operations and new technologies development are taking place swiftly and these has given rise to the increase in resource productivity, increasing level of profitability, deposits and credits and thereby decrease in NPLs. However, the studies have not identified attempts made by banking industry to alleviate non-performing loans.

Resti and Sironi (2001) examined corporate bond recovery rate referring to bond default rate, macroeconomic variables such as Gross Domestic Product (GDP) and growth rate, amount of bonds outstanding, amount of default, return on default bonds, and stock return wherein it was established that default rate, amount of bonds, default bonds, and economic recession had negative effect, while the GDP growth rate, and stock return had positive effect on corporate recovery rate.

Lis *et.al.*,(2000) used a simultaneous equation model in which they explained bank loan losses in Spain using a host of indicators, which included GDP growth rate, debt-equity ratios of firms, regulation regime, loan growth, bank branch growth rates, bank size (assets over total size), collateral loans, net interest margin, capital-asset ratio (CAR) and market power of default companies. They found that GDP growth (contemporaneous, as well as one period lag term), bank size, and CAR, had negative effect while loan growth, collateral, net-interest margin, debt-equity, market power, regulation regime and lagged dependent variable had positive effect on problem loans.

Sergio (1996) in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank's lending policy adducing to relatively unselective and inadequate assessment of sectoral prospects. Interestingly, this study refuted that business cycle could be a primary reason for banks' NPLs. The study emphasised that increase in bad debts as a consequence of recession alone is not empirically demonstrated.

However, according to Bloem and Gorter (2001) NPLs may be caused by wrong economic decision or by plain bad luck. Moreover, these studies could not identify the factors that influence non-performing loans in banking industry.

### **2.3 Conceptual Framework Model**

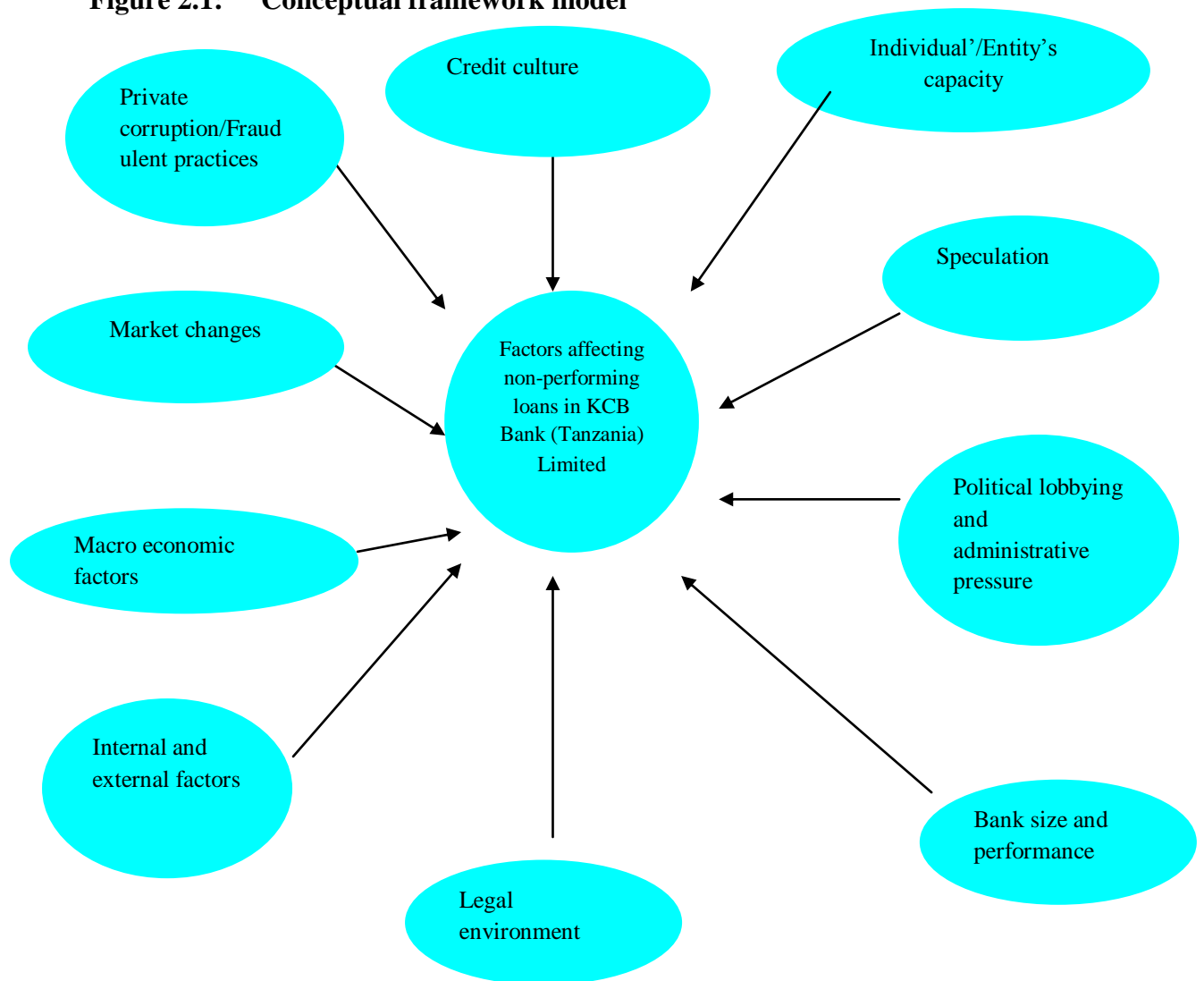
Figure 2.1 provides the conceptual framework model. This is defined as an abstract idea or a theory used to develop new concepts or to reinterpret existing ones (Kothari, 2004). It gives the relationship between the independent and dependent variables. From the figure the dependent variable is the factors affecting non-performing loans while the independent variables include; political lobbying and administrative pressure, private corruption/fraudulent practices, bank size and performance, credit culture, market changes, legal environment, individual's/entity's capacity, speculation, macro economic factors and internal and external factors.

Theoretically there exists a relationship among them (i.e. dependent and independent variables). The relationship can be expressed as factors affecting non-performing loans (Y) are the function of political lobbying and administrative pressure, private corruption/fraudulent practices, bank size and performance, credit culture, market changes, legal environment, individual's/entity's capacity, speculation, macro economic factors and internal and external factors ( $x_1, x_2, \dots, x_n$ ).

This is expressed mathematically as;

$$Y = f(\text{political lobbying and administrative pressure, private corruption/fraudulent practices, bank size and performance, credit culture, market changes, legal environment, individual's/entity's capacity, speculation, macro economic factors and internal and external factors})$$

**Figure 2.1: Conceptual framework model**



*Source: Constructed by the researcher, 2013*

These factors can be further elaborated as follows;

- a) Political lobbying and administrative pressure means; allowing domestic and foreign investment along with valid decisions
- b) Private corruption/fraudulent practices means; practices such as advancing loans to ineligible persons, advances without security or references etc
- c) Bank size and performance means; the larger the bank size, the more resources to evaluate and process loans while focusing on selective borrowers

- d) Credit culture means; the borrower decision to take a loan without thinking of the future results to defaulted loan
- e) Market changes means; the deviation from the supply and demand of market process leading to non-performance
- f) Legal environment means; the availability or non availability of foreclosure laws, bankruptcy laws, creditor rights and ownership rights for both domestic and foreign investors
- g) Individual's/Entity's capacity means; the success or failure of the individual or entity to wisely use the loans
- h) Speculation means; investing in high risk assets to earn high income
- i) Macro economic factors means; issues concerning with downturns and slowdowns in the economy, recession, low rate of savings, weak markets, depression in industrial products, inflation levels etc
- j) Internal and external factors means; issues concerning taking up projects, promoting associate concerns, business failure, costs of overruns during the performance, capital adequacy, credit growth, operational efficiency, branch spread etc

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.0 Introduction**

This chapter provided a blue print of investigation which was adopted in the study section 3.1 describe the study area, section 3.2 indicate the research design, section 3.3 show the population and sample size, section 3.4 indicate the sampling techniques, section 3.5 show data collection methods, section 3.6 focus on data analysis techniques and section 3.7 describe the research plan.

#### **3.1 Study Area**

Kenya Commercial Bank (KCB) dates back to 1896 when its predecessor, the National Bank of India opened an outlet in Mombasa. Eight years later in 1904, the Bank extended its operations to Nairobi, which had become the Headquarters of the expanding railway line to Uganda. Upon independence the Government of Kenya acquired 60% shareholding in National and Grindlays Bank in an effort to bring banking closer to the majority of Kenyans. In 1970, the Government acquired 100% of the shares to take full control of the largest commercial bank in Kenya. KCB Bank (Tanzania) Limited was incorporated in April 1997. KCB Bank (Tanzania) Limited with its head office at Harambee Plaza, Ali Hassan Mwinyi/Kaunda Drive, Oysterbay Dar-es-Salam, is a subsidiary of KCB Bank Group which operates also in Kenya, Uganda, South Sudan and Rwanda. KCB Bank (Tanzania) Limited has 11 branches; 6 in Dar es salaam one each in Arusha, Kilimanjaro, Mwanza, Morogoro and Zanzibar. These branches are linked on line with the rest of KCB Group branches in East Africa which makes a total of 222 branches (KCB Kenya -169, Uganda- 14, Rwanda – 9 and South Sudan -19)

### **3.2 Research Design**

Cross-sectional research design was used in which questionnaires and interviews were utilized to obtain the data from the field. The reason for using cross-sectional research design is that, it allows the collection of data at one point in time (in a short time as it is feasible).

With cross-sectional research design the quantitative and qualitative methods were also employed i.e. the quantitative method employed questionnaires while the qualitative method incorporated the focus group discussions (FGDs) and key informant interviews. The incorporation of focus group discussions and key informants interviews were to validate and elaborate the former (adding s which were not given by key respondents of the study) (Yin, 1994). However, s were collected from a number of cases or units of inquiry under investigation and only a sample of cases was examined (Robson, 1993).

### **3.3 Population and sample size**

The population of the study comprised of 100 respondents who were KCB workers and customers. The sample size of 46 respondents was used. Cooper and Schindler (2008) argued that, for any valid and reliable study to be carried, its sample shouldn't be less than 30% of its population. As it stands, the sample size was 46% of the population; hence fulfilling their argumentation. The study respondents comprised of branch managers, credit managers, credit administration officers, advance officers, recovery officers, successful and unsuccessful customers. Table 3.1 shows the distribution of respondents.

**Table 3.1: Sample size of the study population**

S/N	Category	Population	Sample size	Method employed
1	Branch Managers	2	2	Purposive
2	Credit Manager	1	1	Purposive
3	Credit Administration officer	1	1	Purposive
4	Business Bankers	2	2	Purposive
5	Advances clerks	2	2	Purposive
6	Recovery officers	3	2	Purposive
7	Successful customers	48	17	Simple random
8	Unsuccessful customers	41	19	Simple random
	<b>Total</b>	<b>100</b>	<b>46</b>	

*Source; analyzed data, 2013*

### **3.4 Sampling techniques**

The study used three sampling procedures namely; simple random, purposive and stratification sampling.

#### **3.4.1 Simple random sampling**

This method was utilized as each respondent had the same and independent chance of being selected. It was used to select the respondents (successful and unsuccessful customers) as identified above.

#### **3.4.2 Purposive sampling**

This method was used as it is a non-random sampling procedure in which personal experience regarding non-performing loans was considered to be key derived from the position one held or the roles s/he played in relation to that particular activity. Thus respondents were selected purposively in order to attain the above objectives.

#### **3.4.3 Stratification sampling**

This method was used to focus gender and age {number of years one has been working in KCB Bank (Tanzania) Limited} distribution as to obtain views from both male and female. The reason according to Yin (1994) is that, stratification serves the distribution among heterogeneous population which need to be incorporated for the purpose of gaining insights from it (i.e. opinions from working experience and both male and female were highly needed).

### 3.5 Data collection Methods

Primary and secondary data collection methods were used to get s from respondents and other sources.

#### 3.5.1 Primary data collection methods

Primary data collection method was used by the researcher to collect data from the field whereby interviews and questionnaires being employed.

##### i) Interviews

The interviews to the branch and credit managers were used in order to solicit s regarding the non-performing loans in the respective KCB Bank (Tanzania) Limited branches of Morogoro and Msimbazi.

**Table 3.2: sample size of the interview population**

S/N	Category	Expected population	Actual interviewees
1	Branch Manager	2	2
2	Credit Manager	1	1
	<b>Total</b>	<b>3</b>	<b>3</b>
	<b>Actual percent</b>		<b>100%</b>

*Source: Analyzed data, 2013*

The interview tool unveiled from these respondents views/opinions regarding the matter (see Appendix 4)

Yin (1994) affirms that the interview tool is very important source of getting s and it is helpful in handling cross-sectional related matters as the research design indicates.

## ii) Questionnaires

Both open ended and closed ended questions were used. Questionnaires were used to obtain s from the credit administrative officer, advances clerks, business bankers, and recovery officers, successful and unsuccessful customers.

**Table3.3: Sample size of the interview sent**

S/N	Category	Questionnaires sent	Questionnaires returned
1	Credit Administration officer	1	1
2	Business Bankers	2	2
3	Advances clerks	2	2
4	Recovery officers	3	2
5	Successful customers	48	17
6	Unsuccessful customers	41	19
	<b>Total</b>	<b>97</b>	<b>43</b>
	<b>Actual percent</b>		<b>44.32%</b>

*Source; Analyzed Data 2013*

These complemented and supplemented obtained under interview and documentary review (see Appendix 3).

The reason was to obtain consistency of responses to the questions asked in repeated measurements (Carmines and Zeller, 1979)

### 3.5.2 Secondary data (Documentary Review)

The researcher used different documents in order to access accurate and reliable data. The study used the latest available published secondary data and other available data from KCB Bank (Tanzania) limited for the years 2007-2012 which were compiled from financial Reports of the Bank and other inside available on Trends and Progress of Bank (i.e. The Bank reports on lending from year 2007-2012). The scope of the study was limited to five years data from KCB Bank (Tanzania) Limited on

respective branches. However, other documents comprised of personal profiles, guidelines, directives, policies, regulations, books, journals, internet and KCB Bank (Tanzania) Limited management performance reports.

### **3.6 Data Analysis Techniques**

Data collected were analyzed both qualitatively and quantitatively. These were summarized, coded and analyzed by Statistical Package for Social Science (SPSS). Frequency distribution and percentages were used to describe major variables. Qualitative data from interviews were analyzed using content analysis. In-depth interviews and FDGs were carried out to determine the factors that affect non-performing loans in the respective branches and the bank in general.

The collected data from the field were prepared through coding and editing of the data. They involved checking of data collection forms for omission, legibility and consistency as well as discarding the incomplete responses which had missing data. Thereafter, identified potential errors in data collection were discussed for their implications.

This method was used for coding both words and phrases depending on respondents' responses. This allowed open ended questions to be analyzed systematically while data being entered into a user friendly and retrievable database (SPSS version 16.0).

### **3.7 Research plan**

The study took eleven months commencing from 1<sup>st</sup> October 2012 to July, 2013 (the time table schedule for the all research activities is attached)

## **CHAPTER FOUR**

### **PRESENTATION AND DISCUSSION OF THE RESEARCH FINDINGS**

#### **4.0 Introduction**

This chapter provides major results and discussions which arose from the data analysis when examining the factors affecting non-performing loans in KCB Bank (Tanzania) Limited; Morogoro and Msimbazi branches. It is presented and discussed under three main sections; section 4.1 focuses on the identification of factors influencing non-performing loans and 4.2 section focuses on the examination of the extent of non-performing loans; and the third and last section focuses on the identification of attempts made by KCB Bank (Tanzania) limited to alleviate non-performing loans

#### **4.1 Factors influencing non-performing loans in KCB Bank (T) limited**

The first objective of this study was to identify the factors that influenced non-performing loans in KCB Bank (T) Limited. These factors included; political lobbying and administrative pressure, private corruption/fraudulent practices, bank size and performance, credit culture, market changes, legal environment, individual/entity's capacity, speculation, macro-economic factors, internal and external factors, higher interest rates and diversion of funds. The respondents' opinions were therefore sought on how they perceived and being able to identify these factors. The summary of findings is given in Table 4.1

**Table 4.1: Factors influencing non-performing loans**

Factor	Percentage %	
	Yes	No
Political lobbying and administrative pressure	81	19
Private corruption/fraudulent practices	78	22
Bank size and performance	75	25
Credit culture	89	11
Market changes	80	20
Legal environment	75	25
Individual/entity's capacity	82	18
Speculation	70	30
Macro-economic factors	80	20
Internal and external factors	85	15
Higher interest rates	90	10
Diversion of funds	70	30

*Source: Analysed data, 2013*

The results in Table 4.1 show the factors which influenced non-performing loans in KCB Bank (T) Limited from the respondents' opinions.

More specifically, the results from Table 4.1 show that the diversion of funds for unnecessary expansion of business and speculation which focuses on investing in high risk assets to earn high income were reported by (70%) of respondents as factors influencing NPLs. Moreover, bank size and performance influenced NPLs from the fact that the larger the bank size, the more resources to evaluate and process loans while focusing on selective borrowers as well as legal environment which reflects the availability or non availability of foreclosure laws, bankruptcy laws, creditor rights and ownership rights for both domestic and foreign investors due to the prevailing legal environment were reported by (75%) of respondents.

On the other hand, private corruption or fraudulent practices influenced NPLs through the practices such as advancing loans to ineligible persons, advances without security or references as affirmed by (78%) of respondents. Yet, market changes which focus on the deviation from the supply and demand of market process leading to non-performance and macro-economic factors which reflect issues concerning with downturns and slowdowns in the economy, recession, low rate of savings, weak markets, depression in industrial products and inflation levels were reported by (80%) of respondents.

However, political lobbying and administrative pressures as reported by (81%) of respondents influenced NPLs by allowing domestic and foreign investment along with valid decisions.

Finally, individual or entity's capacity which reflects the success or failure of the individual or entity to wisely use the loans (82%), internal and external factors which focus on issues concerning taking up projects, promoting associate concerns, business failure, costs of overruns during the performance, capital adequacy, credit growth, operational efficiency and branch spread (85%) were factors which influenced NPLs as attested by the mentioned respondents. Moreover, credit culture which focuses on the borrower's decision to take a loan without thinking of the future results to defaulted loan (89%) and higher interest rates (90%) put by various commercial banks have been factors influencing non-performing loans as reported by respondents.

In general the findings imply that, diversion of funds for unnecessary expansion of business and speculations on investing in high risk assets to earn high income (70%), bank size and performance from the fact that the larger the bank size, the more resources to evaluate and process loans and legal environment which reflects the availability or non availability of foreclosure laws, bankruptcy laws, creditor rights and ownership rights for both domestic and foreign investors were reported by (75%) of respondents. However, private corruption or fraudulent practices such as advancing loans to ineligible persons, advances without security or references (78%), market changes which focus on the deviation from the supply and demand of market process leading to non-performance; and macro-economic factors which reflect issues concerning with downturns and slowdowns in the economy, recession, low rate of savings, weak markets, depression in industrial products and inflation levels were reported by (80%) of respondents. Yet, political lobbying and administrative pressures as reported by (81%) of respondents, individual or entity's capacity which reflects the success or failure of the individual or entity to wisely use the loans (82%), internal and external factors which focus on issues concerning taking up projects, promoting associate concerns, business failure, costs of overruns during the

performance, capital adequacy, credit growth, operational efficiency and branch spread (85%) were factors which influenced NPLs. Moreover, credit culture which focuses on the borrower's decision to take a loan without thinking of the future results to defaulted loan (89%) and higher interest rates (90%) put by various commercial banks have been factors influencing non-performing loans as reported by respondents.

The results present the factors which influence NPLs because increased non-performing loans can cause the decline in commercial bank credits, as banks with high level of non-performing loans in their portfolio may become increasingly reluctant to take up new risks and commit new loans. However, their impact is vital which need to be reflected for better bank performance, as without keen reflection renders the performance of the bank to be poor.

#### **4.2 Extent of non-performing loans in KCB Bank (T) limited**

The second objective of this study was to examine the extent of non-performing loans in KCB Bank (T) Limited. To obtain on the extent of non-performing loans, the researcher asked the respondents to present the prevailing situation which would raise the awareness and enable steps to be taken. Table 4.2 summarizes the results as follows

**Table 4.2: Extent of non-performing loans**

Extent	Percentage %	
	Yes	No
Morogoro branch non-performing loans from 2009/12 was ranging from 8% to 6.5%	90	10
Msimbazi branch non-performing loans from 2007/12 was ranging from 7.5% to 6.2%	85	15

*Source: Analyzed data, 2013*

The results in Table 4.2 show the extent of non-performing loans which are supported with testimonies from respondents

More specifically, the results in Table 4.2 show that Morogoro and Msimbazi branches have different results regarding the extent of non-performing loans. While Morogoro branch has NPLs ranging from 8% to 6.5% in 2009-2012, Msimbazi branch has NPLs ranging from 7.5% to 6.2% in 2007-2012 as reported by 90% and 85% respondents respectively. These results reflect the level of performance of these different branches which are associated by the lending behaviours of the customers they serve. It was stated by one of the respondents that, *“when banks face higher non-performing loan level and lower capital ratio, they have the least incentive to increase their lending to customers. This happened to KCB (T) Ltd for those years, although the lesson learned has necessitated some strategies for rectification”*

In general, the results imply that Morogoro branch has higher NPL ranging from 8% to 6.5% compared to Msimbazi branch which has NPLs ranging from 7.5% to 6.2% as reported by 90% and 85% of respondents respectively. However, banks decide the degree of risk they will tolerate for a given level of expected return according to their risk preference. When the level of non-performing loans goes beyond a certain level that banks can accept, the re-balancing actions will be affected. It implies that the coefficient might change in reference to the amount of NPLs.

The results indicate that banks need to put emphasis on reserving adequate amount of capital to improve their risk position. However, banks with better risk position (lower non-performing loans) have higher inclination to extend loans. Yet, when banks have higher non-performing loans in the portfolio, may be more concerned about the risky, and hence, have lower tendency to increase loans. As a whole, some evidences show that non-performing loans reduce the incentive to increase lending when banks have non-performing loan rate above the threshold level.

#### **4.3 Attempts made by KCB Bank (T) limited to alleviate non-performing loans**

The study identified the attempts made by KCB Bank (T) Limited to alleviate non-performing loans by seeking opinions from the respondents.

These attempts included; enhancement of credit risk management practices for bank lending; estimating the non-performing loans and allocating them to the corresponding borrowers (but considering how unpaid loans are recorded in the accounts in such a way as to increment principal outstanding); estimate the interest received rather than the receivable on the interest payable so that the performing loans are not affected by the non-performing loans; introduction and implementation of an aggressive debt collection policy; enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans and enhancement of proper credit assessment and risk management mechanism. The summary of findings is indicated in Table 4.3.

**Table 4.3: Attempts made to alleviate non-performing loans**

Attempt	Percentage %	
	Yes	No
Enhancement of credit risk management practices for bank lending	80	20
Estimating the non-performing loans and allocating them to the corresponding borrowers	84	16
Estimating the interest received rather than the receivable on the interest payable	70	30
Introduction and implementation of an aggressive debt collection policy	90	10
Enhancing training and development options to prevent the failure	85	15
Enhancement of proper credit assessment and risk management mechanism	81	19

*Source: analyzed data, 2013*

The results in Table 4.3 show the attempts made by KCB Bank (T) Limited to alleviate the non-performing loans which were attested by respondents.

More specifically, results in Table 4.3 show that estimating the interest received rather than the receivable on the interest payable was an attempt utilized by the bank for the reduction of NPLs as supported by (70%) of respondents. However, the enhancement of credit risk management practices for bank lending was supported by (80%) and enhancement of proper credit assessment and risk management mechanism for the reduction of NPLs being supported by (81%) of respondents.

On the other hand, the results in Table 4.3 show that, estimating the non-performing loans and allocating them to the corresponding borrowers as reported by (84%) of respondents considered how unpaid loans are recorded in the accounts in such a way as to increment principal outstanding. Yet, enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans was supported by (85%) of respondents and introduction and implementation of an aggressive debt collection policy (90%) have been the attempts made to alleviate NPLs.

In general, the results in this part imply that estimating the interest received rather than the receivable on the interest payable (70%), the enhancement of credit risk management practices for bank lending (80%) and enhancement of proper credit assessment and risk management mechanism (81%) for the reduction of NPLs have been attempts to alleviate NPLs. Moreover, estimating the non-performing loans and allocating them to the corresponding borrowers (84%) while considering how unpaid loans are recorded in the accounts in such a way as to increment principal outstanding; enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans (85%) and introduction and implementation of an aggressive debt collection policy (90%) have been the attempts made to alleviate NPLs.

The results highlights the attempts made to alleviate NPLs. As financial intermediations, commercial banks' main function is to receive deposits and make loans to facilitate the flow of capitals. For most of the commercial banks, deposits are the main funding sources for commercial banks' assets. And loans take up the biggest proportion in the asset portfolio. With the expansion of the asset size, banks will expand the volume of the loans to re-balance the asset portfolio. However, proper assessment of individual's or entity's capability is essential for the reduction of these non-performing loans to the extent of making the bank to continue with its operations in profit making manner.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.0 Introduction**

Section 5.1 of this chapter gives the summary of findings; section 5.2 focus on conclusions and policy implications while section 5.3 indicate the recommendations and areas for further research which result from the study findings. It starts with the summary; then provides the conclusion and policy implications; recommendations and areas for further research are given..

#### **5.1 The summary of findings**

The findings from the study showed that, diversion of funds for unnecessary expansion of business and speculations leading to investing in high risk assets to earn high income (70%), bank size and performance for both domestic and foreign investors as reported by (75%) of respondents have been factors influencing NPLs. However, private corruption or fraudulent practices (78%), market changes which focus on the deviation from the supply and demand of market process lending to non-performance; and macro-economic factors which reflect issues concerning with downturns and slowdowns in the economy as reported by (80%) of respondents influenced NPLs. Yet, political lobbying and administrative pressures as reported by (81%) of respondents, individual or entity's capacity which reflects the success or failure of the individual or entity to wisely use the loans (82%), internal and external factors which focus on issues concerning taking up projects, costs of overruns during the performance and branch spread (85%) were factors which influenced NPLs. Moreover, credit culture which focuses on the borrower's decision to take a loan without thinking of the future results to defaulted loan (89%) and higher interest rates (90%) put by various commercial banks have been factors influencing non-performing loans as reported by respondents.

On the other hand, the results showed that Morogoro branch has higher NPL ranging from 8% to 6.5% compared to Msimbazi branch which has NPLs ranging from 7.5% to 6.2% as reported by 90% and 85% of respondents respectively. However, banks

decide the degree of risk they will tolerate for a given level of expected return according to their risk preference. When the level of non-performing loans goes beyond a certain level that banks can accept, the re-balancing actions will be affected. It implies that the coefficient might change in reference to the amount of NPLs.

Finally, the results showed that estimating the interest received rather than the receivable on the interest payable (70%), the enhancement of credit risk management practices for bank lending (80%) and enhancement of proper credit assessment and risk management mechanism (81%) for the reduction of NPLs have been attempts to alleviate NPLs. Moreover, estimating the non-performing loans and allocating them to the corresponding borrowers (84%) while considering how unpaid loans are recorded in the accounts in such a way as to increment principal outstanding; enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans (85%) and introduction and implementation of an aggressive debt collection policy (90%) have been the attempts made to alleviate NPLs.

## **5.2 Conclusion and policy implications**

Although making loans are still the most important function for commercial banks; with the innovation of financial instruments and less activity restriction, banks are expanding their business scope other than lending in order to obtain higher profitability and larger market power. Especially when banks have less risk constraints, i.e., less non-performing loans, they have more freedom to engage in various businesses. The results indicate that banks need to put emphasis on reserving adequate amount of capital to improve their risk position. As a whole, some evidences show that non-performing loans reduce the incentive to increase lending when banks have non-performing loan rate above the threshold level.

The research adds to the argument for enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to

generate the interests in their loans in order to alleviate NPLs to the minimum required for the bank to perform

### **5.3 Recommendations and areas for further research**

In light of the above findings, the researcher has proposed the following recommendations;

#### **5.3.1 Individual or entity's borrowing decision**

Individual or entity's capacity which reflects the success or failure of the individual or entity to wisely use the loans in line with the credit culture which focuses on the borrower's decision to take a loan without thinking of the future results to defaulted loan should be managed and enhanced for the betterment of bank performance.

#### **5.3.2 NPLs rectification**

Morogoro branch had higher NPLs ranging from 8% to 6.5% compared to Msimbazi branch which had NPLs ranging from 7.5% to 6.2%. These NPLs are not good signs for KCB (T) Ltd; hence there is a need to be rectified for the future performance.

#### **5.3.3 Enhancement of training and development**

Enhancing training and development options to prevent the failure in assessing the capabilities of the individuals or entities to generate the interests in their loans is vital for KCB (T) Ltd success.

The findings examined the factors affecting non-performing loans in KCB Bank (Tanzania) Limited; Morogoro and Msimbazi branches. It is advised that further studies be done on the following issues.

- i) How does KCB (T) Ltd manage its operations despite little decrease in NPLs?
- ii) To what extent has KCB (T) Ltd accommodated NPLs for the years 2012 and 2013?

## REFERENCES

- Adela, S and Julia I. (2010). Study of correlation between average interest rate and non- performing loans in the Romanian Banking system during 2006-February 2010, *The Journal of the faculty of Economics –Economics*, Issue 2, p 777-782
- Ali, F. (2006). Credit risk management: a survey of practices. *Managerial Finance* 32(3): p 227-233
- Asari, F.F.A.H., Muhamad, N.A., Ahmad, W., Latif, N.I.A., Abdullah, N. and Jusoff, K. ( 2011). An Analysis of Non-Performing Loan, Interest Rate and Inflation Rate Using Stata Software. *World Applied Sciences Journal*, vol 12, p41-48.
- Beck T.A, Demirguc-Kunt and R. Levine (2005). Bank concentration and Fragility: Impact and Mechanics, *NBER Working Papers* 11500, National Bureau of Economic Research Inc.
- Bercoff, Jose J., Julian di, Giovanni and Franque Grimard (2002). “*Argentinean Banks, Credit Growth and the Tequila Crisis: A Duration Analysis*” (Unpublished)
- Berger, A.N., and R De Young (1995). Problem loans and cost efficiency in commercial banks, *Journal of Banking & Finance* vol 21: p849–870.
- Bessis J. (2002). *Risk Management in Banking*. 2nd edition. London: John Wiley & Sons Ltd.
- Bloem E and Gorter, J (2001). *Banking Strategy, Credit Appraisal and Lending Decisions*. Oxford University Press. New Delhi
- Boyd, J.H. and Nicolo, G.D., 2005. The Theory of Bank Risk Taking and Competition Revisited. *The Journal of Finance*, 60, 1329-1343.
- Carmines, B and Zeller, A (1979) *Primary and Secondary data collection methods*. McMillan. New York

- Chang J (1999). *Risks associated with Loans*. Prentice Hall. New Jersey
- Chen, C.R., T.L. Steiner and A.M. Whyte (1998). Risk-taking behavior and management ownership in depository institutions, *The Journal of Financial Research* vol 21: p1–16.
- Conradie, W, M and Fourie, C, M, W. (2002). *Basic Financial Management for Entrepreneurs*, 2<sup>nd</sup> edition. Lansdowne: Juta & Co.
- Das A., and Ghosh S., (2003). *Determinants of Credit Risk*. Paper presented at the Conference on Money, Role and Investment held at Nottingham Trent University in Nov 2003.
- Fofack, H. (2005). Non-performing loans in sub-Saharan Africa: Causal Analysis and Macroeconomic Implications. *World Bank Policy Research Working Paper* No. 3769, November
- Harris, P. (2003). *A banker's view of BEE. Briefing to Business Map Foundation members, Johannesburg, July 25, 2003*.<http://www.businessmap.co.za> accessed on 2013/03/09
- Harrison, A., (2006) Non-Performing Loans – Impact on FISIM, *Advisory Expert Group on National Accounts* [Online] Available at: <http://unstats.un.org/unsd/nationalaccount/AEG/papers/m4loans.pdf> [Accessed 04 June 2013].
- IMF (2009). *Global Financial Stability Report- Responding to the Financial Crisis and Measuring Systemic Risks*, *World Economic and Financial Surveys*. International Monetary Fund, Washington DC, April 2009.
- Jappelli, T. and Pagano, M. 2005. *Role and Effects of Credit Sharing*. Cambridge: The MIT Press. Available from: <http://www.csef.it/WP/wp136.pdf> [Accessed 20 Nov 2012].

- Jentzsch, N. 2008. An economic analysis of China's credit monopoly, *China Economic Review*, 19: p 537-550.
- Khemraj, T., and Pasha, S. (2009). The determinants of non-performing loans: an Econometric Case Study of Guyana. *3rd Biennial International Conference on Business, Banking & Finance*. St. Augustine, Trinidad
- Koch, T, W and MacDonald, S. (2003). *Bank Management*, 5th edition. Ohio: South-Western Thompson Learning.
- Kothari, J (2004) *Research Methodology and Techniques*. Bangalore. India
- Lis, S.F. de, J.M. Pages, and J. Saurina (2000). Credit Growth, Problem Loans and Credit Risk Provisioning in Spain Banco de España — Servicio de Estudios, *Documento de Trabajo no. 0018*.
- McManus, S. (2000). *A Guide to Credit Management in South Africa*. Durban: Butterworths.
- McNulty, J.E., Akhigbe, A.O. and Verbrugge, J.A. (2001). Small Bank Loan Quality in a Deregulated Environment: The Advantage Hypothesis. *Journal of Economics and Business*, 53, 325-39.
- Murphy, L, B. (2004): Focusing on the Fundamentals (Again). *The RMA Journal*, 86(8): p 18-19.
- Nkusu, M. (2011). Nonperforming Loans and Macrofinancial Vulnerabilities in Advanced Economies. *IMF Working Paper 11/161*.
- Nobuo I (2005) *Non performing loans and the real economy*. Bank of Japan. Takashi Naganate. London School of Economics. Paper no 22
- Rajan, Rajiv and Sarat C. Dhal (2003). "Non-performing Loans and Terms of Credit of Public Sector Banks in India: An Empirical Assessment." *Occasional Papers*, 24:3, pp. 81-121, Reserve Bank of India.
- Reddy, P.K., 2002. A comparative study of non-performing assets in India in the global context similarities and dissimilarities, remedial measures. *United*

*Nations Public Administration*

*Netwrok*. Available at: <http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan013132.pdf> [Accessed 07 October 2012]

Robson, J (1993) *Research Methodology and techniques*. Prentice Hall. New York

Rose, P, S. (2002). *Commercial Bank Management*, 5 th edition. New York: McGraw-Hill/Irwin.

Ross, W and Jaffe, M. (1999). *Corporate Finance*. 5 th edition. Irwin/McGraw-Hill.

Saunders, A and Cornett, M, M. (2003). *Financial Institution Management*, 4 th edition. New York: McGraw-Hill/Irwin.

Sergio, M. (1996). Non-performing bank loans: Cyclical patterns and Sectoral risk. *Review of Economic Conditions in Italy*, Rome: Jan-Jun 1996, Issue 1.

Singh, C., (2005). Financial sector reforms and state of Indian economy, *Indian Journal of Economics & Business* Vol. 4 (1): 88-133.

Sinkey A and Greenawalt, P (1991) *Causes of non-performing loans. A Review of Perspective*. McGraw Hill. New York

Sobehart, J, R, Keenan, S, C and Stein, R. (2003). *Complexities and Validation of Default Risk Models*. (In *Frontiers in Credit Risk: Concepts and techniques for applied credit risk measurement*.) Singapore: Wiley

Striscek, D. (2000). The Quotable Five C's, *Journal of Lending & Credit Risk Management*, 82(7): 47-49.

Swamy, V (2012). Impact of Microeconomic and Endogenous Factors on non-performing bank assets. *International Journal of Banking and Finance*. Indian Business School. Hyderabad. India. Vol 9, p 27-28

Swiss National Bank. (2008). *The Emergence of Sharing in Credit Markets*. Zurich, Switzerland: Swiss National Bank.

United Republic of Tanzania report (URT), 1997 and 2007

Wahlen, J., (1994). The nature of in commercial bank loan loss disclosures, *The Accounting Review* . vol 69: p455–478.

Waweru, N. and Kalani, V. (2009) Commercial Banking Crises in Kenya: Causes and Remedies, *African Journal of Accounting, Economics, Finance and Banking Research* 4(4), [Online] Available at: [http://www.globip.com/pdf\\_pages/african-vol4-article2.pdf](http://www.globip.com/pdf_pages/african-vol4-article2.pdf) [Accessed 04 Aug 2010].

Yin, A (1994) *Valid and Reliable questionnaires*. McGraw Hill .New Jersey

Yoonhee T, Y (2006). *Role of non-performing loans and Capital adequacy in Banking Structure and Competition*. University of Bath. Working Paper Series vol. 16

## APPENDICES

### Appendix 1: Research plan

S/No	Details of work plan	Time framework
1	Research proposal write up	October, 2012
2	Submission of the research proposal	January, 2013
3	Data collection and editing	February, 2013
4	Data coding	March, 2013
5	Data interpreting and analyzing	April/May, 2013
6	Typing first draft of the findings	May, 2013
7	Submission of fist draft	May, 2013
8	Waiting the first draft and directives from the Research Supervisor	May/June, 2013
9	Finalization of the research by making collections as per supervisor directives	June/July, 2013
10	Submission of final research report	July, 2013

## Appendix 2: Research budget

S/No	Items	Description	Total Amount ( TZS)
1	Stationeries	3 rims of paper A4 One dozen of big envelope Pens one dozen Manila card and lamination paper Scientific calculator Portfolio/ brief case	24,000/= 10,000/= 7,000/= 12,000/= 70,000/= 100,000/=
2	Safari allowance and fare	Traveling allowance Within Morogoro Morogoro to Dar es Salaam four days@ 65,000 Transport costs(buses and taxi) Morogoro to Dar es Salaam  Within Morogoro region (Morogoro and its districts)	100,000/=  300,000/=  200,000/=  450,000/=
3	Communication	Air time Internet services	250,000/= 250,000/=
4	Entertainment to respondents	50 Staffs @ 10,000	100,000/= 500,000/=
5	Printing and editorial	200 questioners Proposal writing Photocopies Binding of first draft of report and final report Books Editorial cost Allowance to researcher assistants	10,000/= 45,000/= 60,000/= 400,000/= 75,000/= 700,000/=
6	Miscellaneous	10% of all of the above costs	392,500
	<b>TOTAL</b>		<b>4,075,500/=</b>

The really budget was TZS 4,075,500/=and was privately sourced

### Appendix 3: Questionnaires for respondents

*Topic: Factors affecting non-performing loans in banking industry: A case of KCB Bank (Tanzania) Limited, Morogoro and Msimbazi Branches*

#### **PART A: Factors influencing non-performing loans in KCB Bank (Tanzania) Limited**

1. Please indicate your agreement or disagreement regarding the factors influencing non-performing loans as follows; 1) SA=Strongly Agree 2) A=Agree 3) U=Uncertain 4) D=Disagree 5) SD=Strongly Disagree.

Factor	Choice				
	Strongly agree	Agree	Uncertain	Disagree	Strongly disagree
1. Political lobbying and administrative pressure (allowing domestic and foreign investment along with valid decisions)					
2. Private corruption/fraudulent practices (practices such as advancing loans to ineligible persons, advances without security or references)					
3. Bank size and performance (the larger the bank size, the more resources to evaluate and process loans while focusing on selective borrowers)					
4. Credit culture (the borrower decision to take a loan without thinking of the future results to defaulted loan)					
5. Market changes (the deviation from the supply and demand of market process leading to non-performance)					
6. Legal environment (the availability or non availability of foreclosure laws, bankruptcy laws, creditor rights and ownership rights for both domestic and foreign investors)					
7. Individual's/Entity's capacity (the success or failure of the individual or entity to wisely use the loans)					
8. Speculation (investing in high risk assets to earn high income)					
9. Macroeconomic factors (issues concerning with downturns and slowdowns in the economy, recession, low rate of savings, weak markets, depression in industrial products, inflation levels)					

10. Internal and external factors (issues concerning taking up projects, promoting associate concerns, business failure, costs of overruns during the performance, capital adequacy, credit growth, operational efficiency and branch spread)					
11. Higher interest rates					
12. Diversion of funds (funds diverted for unnecessary expansion and diversion of business)					

**PART B: The extent of non-performing loans in KCB Bank (Tanzania) Limited**

2. What is the extent of non-performing loans in KCB Bank (Tanzania) Limited at present (elaborate)

.....

.....

.....

.....

.....

3. Why is that extent attained? (elaborate)

.....

.....

.....

.....

.....

4. What are the reasons which facilitated that extent of non-performing loans in KCB Bank (Tanzania) Limited? (elaborate)

.....

.....

.....

.....

5. How have you managed these non-performing loans in KCB Bank (Tanzania) Limited? (elaborate)

.....  
 .....  
 .....

**PART C: Attempts made in banking industry (by KCB Bank (Tanzania) Limited) to alleviate non-performing loans**

6. Do think that the following attempts have been incorporated by your Bank? (*Tick where appropriate*).

No	Attempt	Yes	No
1	Enhancement of credit risk management practices for bank lending		
2	Estimating the non-performing loans and allocating them to the corresponding borrowers but considering how unpaid loans are recorded in the accounts in such a way as to increment principal outstanding		
3	Estimate the interest received rather than the receivable and on the interest payable so that the performing loans are not affected by the non-performing loans		
4	Introduction and implementation of an aggressive debt collection policy		
5	Enhancing training and development options to prevent the failure in accessing the capabilities of the individuals or entities to generate the interests in their loans		
6	Enhancement of proper credit assessment and risk management mechanism		

4. What other attempts do you incorporate other than the mentioned (Specify)

- i).....ii).....
- iii).....iv).....
- v).....vi).....

#### **Appendix 4: Interview Guide questions for FGDs**

i) What are the factors influencing non-performing loans in KCB (Tanzania) Limited?

ii) What is the extent of non-performing loans in KCB (Tanzania) Limited?

iii) What are the attempts made by KCB (Tanzania) Limited to alleviate non-performing loans?