# INFLUENCE OF CREDIT POLICY ON THE PERFORMANCE OF LOANS AMONG COMMERCIAL BANKS IN KENYA

**By**

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## DECLARATION

I, Elijah Githaiga Wairagu, hereby submit my research project for examination, entitled "Influence of Credit Policy on the Loan Performance among the Commercial Banks in Kenya" and truthfully declare that the above-titled paper is a product of my original research investigation and has not been presented for a degree award in any other institution

I further declare that, should the faculty eventually discover that a substantial portion of my paper is lifted, in total, from original sources, using exactly the words of the author in more than 50% of the whole content, I reserve the right to KCA University to recall my M.Sc. and cancel the degree granted to me.

**Signed this day of __________________________ at KCA University.**

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

**……………………….** **…………………………….**

**Signature** **Date**

# DEDICATION

This study is dedicated to my loving family, my wife and our beloved children, for their understanding support, encouragement, perseverance and patience during the entire period of my study and continued prayers towards successful completion of this course.

# ACKNOWLEDGEMENT

I thank the Almighty God for enabling me reach this far. It has been a challenging project. In addition, I would also like to thank the individuals who have contributed to the successful completion of this proposal.

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Last but not least, am also grateful to KCA University for availing an opportunity where I could study while working.

# ABSTRACT

Sound credit management policy is a prerequisite for a financial institution's stability and financial performance with continuing profitability. The general objective of this study was to assess the influence of credit policy on the performance of loans among commercial banks in Kenya. This study was led by the following specific objectives: To determine the effect of credit terms on performance of loans among commercial banks; To evaluate the effect of credit appraisal process on the performance of loans among commercial banks; and to establish the effect of credit risk control on the performance of loans among commercial banks. The study focused on 43 licensed commercial banks in Kenya whose head offices are within Nairobi. The study applied a descriptive research. Credit manager and analyst from each bank were selected upon giving a sample of 86. Purposeful sampling was used because the selected respondents are more knowledgeable on the subjects of the study. Primary data was collected through a structured questionnaire. Data was analyzed through qualitative and quantitative approaches. A multiple regression analysis was used to establish the relationship between credit policy aspects and performance of loans among commercial banks. The study found out that credit terms give the credit period and the credit limit and stipulate the credit period, banks need to take a close look at the borrowers' economic, legal and environmental situation, segmentation was done to differentiate the services offered to individualize the respective marketing efforts and it was necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy. The study concluded that commercial banks had adopted credit term policy loan ratio in determination of how much a client would borrow, applied collection policy, that credit period of funds do increase the level of loans defaults while credit appraisal through frequency of loan reviews and that commercial banks uses credit risk control practices in credit risk management to a very great extent reducing default rates indicated by reduction in level of non-performing Loans. The study recommends that commercial banks should have clear credit policy with proper monitoring and review from time to time in order to reduce the cases of non-performing loans, commercial banks should have operational credit policy manual and credit committees should be employed to approve

loans and enhance usage of credit risk control practices in credit risk management determine how to respond to bank risks.

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## ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| ANOVA | Analysis of Variance |
| C&I | Commercial and Industrial |
| CBK | Central Bank of Kenya |
| CBR | Central Bank rate |
| CP | Collection policy |
| CRB | Credit Revenue Bureau |
| CRC | Credit Risk Control |
| CTP | Credit terms and policy |
| DTM | Deposit Taking Microfinance |
| GDP | Gross domestic product |
| KBA | Kenya Bankers Association |
| KBA | Kenya Bankers Association |
| LP | Loan performance |
| MFI | Microfinance institution |
| MFI's | Microfinance Institutions |
| NPLs | Non-performing loans |
| SACCO | Savings and Credit Cooperatives Organizations |
| SASRA | SACCO Societies Regulatory Authority |
| SPSS | Statistical Package for Social Sciences |
| USA | Unites States of America |

## DEFINITION OF KEY TERMS

**Credit Appraisal Process:** The process of evaluating a loan application to ascertain the qualification criteria of an applicant (Duffie, & Singleton, 2012).

**Credit Policy:** Credit policy is an institutional method for analyzing credit requests made by customers and its decision for accepting or rejecting applications based on certain criteria and policies that govern the credit administration of the institution (Kiyotaki & Moore, 2012).

**Credit Risk Control:** Measures put in place to check on the risk exposure in the Bank (Duffie, & Singleton, 2012).

**Credit term**: is a contractual stipulation under which a firm grants credit to its customers (Lemmon, & Roberts, 2010) and give the credit period and the credit limit.

**Loan performance**: How well the advanced loans are being paid in accordance with the agreed terms. High default in repayment leads to greater repayment exposure among commercial banks due to the provisions that have to be made in books (Kenya Banker, 2002).

# CHAPTER ONE

# INTRODUCTION

## 1.1 Background of Study

The concept of extending credit from one individual to another or from an institution or group to an individual or a group of individuals can be traced back in history over thousands of decades but this concept was not appreciated until after the Second World War when it was largely appreciated in Europe and later to Africa starting with the colonial masters (Stein, 2013). In the traditional setting credit was extended from one individual to another, by preconceived terms and conditions. The one giving and receiving the credit had a verbal agreement of how, when and where the credit payments would be done. In trade the granting of trade credit is a powerful selling aid, and is a fundamental foundation upon which all trading relationships are built on. Both the seller and buyer gain advantage from credit facilities, but they also have to assume risks attached to extending of credit. Risks may include slow, late or non-payment of the offered credit and cost in the form of the interest expense incurred from the date of the sale to receipt of the funds (Pagano & Volpin, 2010).

Banks in Europe and the USA were the first to adopt the giving of credit to customers at an interest rate. Their interest rates were high which sometimes discouraged borrowers hence the concept of credit didn't become popular until the economic boom in USA in 1885 when the banks had excess liquidity and wanted to lend the excess cash (Stein, 2013). In Africa the concept of credit was largely appreciated in the 1950's when most banks started opening the credit sections and departments to give loans to white settlers. The credit was initially given to the rich people and big companies and was not popular to the poor for fear they would be unable to pay back the loan extended.

Even today, most banks are wary of extending credits to customers who may be unable to repay back the loan in its full amount. With such concerns banks have created mechanisms within their systems for effective credit management by efficiently managing customer credit lines.

In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It may be difficult to establish an optimal credit policy as the best combination of the variables of credit policy is quite difficult to obtain. A firm will change one or two variables at a time and observe the effect. It should be noted that the firm's credit policy is greatly influenced by economic conditions (Pandey, 2008). As economic conditions change, the credit policy of the firm may also change.

### 1.1.1 Credit Policy

A credit policy is the blue print used by financial institutions in customer credit underwriting to determine whether to extend a credit facility on not to the applicant. It is an institutional method utilized in the analysis of credit requests by customers with the aim of reaching a decision for accepting or rejecting an application based on set criterion and organizational policies governing credit administration (Kiyotaki and Moore, 2012). It helps avoid extending credit to high risk customers who run a high degree of being unable to pay their credit extended as and when it falls due. Credit policy for some larger businesses can be quite formal; involving specific documented guide lines, credit checks and customer credit applications, written terms and conditions before a customer is extended a specific credit. But for small businesses; their credit policy tends to be quite informal and lacks structured system before an offer is made for the extension of credit. Many small business owners rely on their business instinct, personal values and relationship with customer as their credit policy (Pagano & Volpin, 2010). Furthermore, upon extension of the credit, what measures and regulations by law are set to encourage prompt payment of the credit and measures to discourage non-payment of the credit extended?

Credit policy is designed to minimize costs associated with credit with the objective of having an optimal recovery from debtors (Kakuru, 2000). Three decision variable are commonly applied by credit administration managers to measures credit worthiness of an applicant including: credit standards, credit terms and collection efforts (Meyer, 2002). Credit standards comprise criterion applied in deciding the types of customers fit for purpose of extending credit to them such as capital adequacy and asset quality. Credit administration is the process that starts from credit application form appraisal and end whenever the loan beneficiary completes repaying what is advanced plus an agreed upon interest rate (Crane, 1997).

Credit policy is important since it has a direct effect on the cash flow of any business unit. Therefore the credit policy shouldn't be too strict so as turn away potential customers who reduces sales and decrease the amount of cash inflows to the business. But at the same time the credit policy shouldn't be too liberal to attract slow paying or even non-paying customers who increase the business average collection period for accounts receivables, leading to cash inflow problems. A good credit policy should help the management of the business to attract and retain customers, without having negative impact on the business's cash flow (Kiyotaki & Moore, 2012).

A credit policy is important in the management of accounts receivables of any business unit. A firm has time flexibility of shaping credit policy within the confines of its practices. It therefore is a means of reducing high default risk implying that the firm should be discretionary in granting loans to the customers (Saunders & Marcia, 2011). Financial performance is company's ability to generate new resources, from day- to- day operations, over a given period of time; performance is gauged by net income and cash from operations. A portfolio is a collection of investments held by an institution or a private individual (Kiyotaki & Moore, 2012).

### 1.1.2 Performance of Loans

Loan performance refers to how well the advanced loans are being paid in accordance with the agreed upon terms. This is measured in terms of how well the loan beneficiary adheres to the agreed repayment periodicity and amounts. Failure to pay the agreed amounts on the agreed upon dates leads to lapse on collection thus probability of bad debts. Commercial banks insist on evaluation the ability of a loan applicant to repay their loans through evaluation of their financial strengths or their weakness so as to gain a better understanding on the risk factor of the loan applicant (Berger, Espinosa-Vega, Frame & Miller, 2011). This enables commercial banks to make informed decisions regarding the creditworthiness of their customers (Duffie & Singleton, 2012). This is important whenever commercial banks want to grow their loan book and market share but at the same time improve on their non performing loans (Gatuhu, 2013).

Non-performing loans (NPLs) comprise loans that are 90 days or more past due date for payments. As a result of their non repayment status for the 90 days consecutive, the banks stop charging more interest and instead start making a provision for non repayment. If the repayment status on these kinds of loans persists, they then turn into uncollectible loans especially where security is worthless and the proceeds have not covered the total debt (Saunders, 2008).

### 1.1.3 Banking industry in Kenya

The history of banking in Kenya dates back to the colonial period, where banks started operations in the 1890s. The British commercial banks served only the European customers by providing services for financing exports and imports (Beck, Randa & Trandafir, 2010). But after World War II, commercial banks expanded their lending capacities to support commerce and industry and they also increased the number of branches opening for the first time in African districts. Commercial banks operating in Kenya largely ignored the African population for most of the colonial period. The banks, on the whole, tended to see the encouragement of Africans savings and the financing of operations. But after independence, the number of commercial banks operating in Kenya increases as both local and foreign owned banks entered the scene.

In 1968, the government established the Co-operative Bank of Kenya to provide specialized banking services for the members of the growing co-operative movement. In the same year the National bank of Kenya wholly owned by Kenya was established. In 1974, moreover, two American banks, the First National Bank of Chicago and the first

National City Bank of New York, were established (CBK, 2012). Several commercial banks have so far joined the Kenyan market to offer banking services. Currently we have 43 banks operating in the Kenyan market.

### 1.1.4 Commercial Banks

The Kenyan banking industry is regulated by the Central Bank of Kenya Act, Banking Act, the Companies Act among other guidelines issued by the Central Bank of Kenya (CBK) (CBK, 2015). The Kenya Bankers Association (KBA) which lobby's for the players in the banking industry and helps in addressing the issues affecting the banking sector. The local banking industry was liberalized back in 1995 and exchange controls revoked. The banking system comprised 43 commercial banks, 17 micro-finance institutions and 116 Forex Bureaus at the end of December 2014.

Commercial banks render services to both the corporate customers and individual ones. Commercial Banks have two core business divisions: Wholesale Banking that is majorly ideal for the corporate customer and Personal Banking for individual customers. These two business divisions are supported by all the departments within the banking group including the operations and technology, finance, human resources division and corporate and legal affairs departments of the banking group.

## 1.2 Statement of the Problem

Sound credit management policy is a prerequisite for a financial institution's stability and financial performance with continuing profitability. According Njanike (2009), the probability of bad debts increases as credit standards are relaxed. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good business to put credit policy at the 'front end' in effective credit management. Ho, Fun and Yusoff (2009) established that majority of financial institutions in Malaysia experienced high default rates as a result if inability in enforcement of credit policy on customers.

Alabi (2014) carried out a study on impact of credit policy on the performance of Nigerian Commercial Banks using Zenith Bank Plc as a case study and established that a good credit policy led to reduced levels of bad debts by non-payment of the credit by individual customers, groups and institutions. Kitaka (2001) carried out a survey on the use of financial performance indicators by MFI's in Kenya and recommended that credit policies need to be formulated with the aim of maximizing profits for the health financial status of commercial banks. It acknowledges the difficulties encountered in ensuring an optimal credit policy as the best combination of the variables of credit policy is quite difficult to obtain. Kurui and Kalio (2014) did a study on the influence of credit risk management practices on loan performance of microfinance institutions in Baringo County and established that there existed strong relationship between client appraisals and loan performance. This was inferred following the observation that an increase in client appraisal always led to an increase in loan performance. In conclusion, credit risk management practices significantly influenced loan performance.

Gatuhu (2013) studied the effect of credit management on the financial performance of MFIs in Kenya. From the findings, it was established that client appraisal, credit risk control and collection policy positively affected financial performance. The collection policy was found to have a higher effect on financial performance and that a stringent policy is more effective in debt recovery than a lenient policy and thus the study recommended that MFIs should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery. Nyawera (2012) investigated the effect of credit policy on the financial performance of deposit taking microfinance institutions in Kenya and found that credit policies affected the financial performance. In order for DTM's financial performance to improve it was important that the institution adopt credit policies reflecting the changes in financial market. These studies have investigated the credit policy and its impact on loan performance of deposit taking microfinance institutions (DTM's) and MFI's; studies done on commercial banks were done in other countries thus creating a research gap.

### 1.3 Objectives of the Study

#### 1.3.1 General Objectives

The general objective of this study was to assess the influence of credit policy on the performance of loans among commercial banks in Kenya.

#### 1.3.2 Specific Objectives

This study was led by the following specific objectives:

i. To determine the effect of credit terms on performance of loans among commercial banks
ii. To evaluate the effect of credit appraisal process on the performance of loans among commercial banks.
iii. To establish the effect of credit risk control on the performance of loans among commercial banks.

### 1.4 Research Questions

i. What is the effect of credit terms on the performance of loans among commercial banks?
ii. How does credit appraisal process affect the performance of loans among commercial banks?
iii. What is the effect of credit risk control on the performance of loans among commercial banks?

### 1.5 Significance of the Study

The findings of this study would be important to the management and staff of commercial banks in Kenya. For the commercial banks they would be able to know the importance of their credit policy, the impact it has on the performance of loans and how they can be able to use their credit policy to their benefit and their success. Furthermore this information would guide them in future financing strategies in their quest to improve the performance of loans extended to customers.

The government of Kenya and the financial industry would benefit from this study by gaining information on the importance of implementation of various legal frameworks in relation to credit policy, developing policy papers on the same, making policy while regarding credits and other regulatory requirements of commercial banks in Kenya. These policies would guide the commercial banks in Kenya in their credit lending process.

The study would be also important to other researchers and academicians since it would contribute to the literature on credit policy and its impact on performance of loans of commercial banks. The study would contribute to the general knowledge and form a basis for further research for the future scholars.

## 1.6 Scope

The study focused mainly on the licensed commercial banks in Kenya. Currently the banking sector in Kenya is comprised of 43 commercial banks whose head offices are within Nairobi. The study was limited to the credit policies adopted to enhance performance of loans of the commercial banks in Kenya. The objectives of the study were credit terms, credit appraisal process and credit risk control mechanism.

## 1.7 Limitation of the Study

The researcher anticipated that since the respondents are staff of commercial banks, they were reluctant to give out information since this is an industry characterized by confidentiality clauses to protect the customers' information. In order to overcome this challenge the researcher assured the respondents that the information they provide were held in confidence and that it was used for academic purposes only.

## 1.8 Assumptions

The study assumed that the respondents are knowledgeable on the credit policies adopted to enhance performance of loans among commercial banks in Kenya.

The study assumed that the researcher received all necessary cooperation from all respondent commercial banks and the respondents were truthful and willing to provide accurate and valid information freely.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 Introduction

This chapter presents the literature information from other researchers who have carried out their research in the same field of study. The specific areas covered here are theoretical review. The chapter is organized according to specific research questions so as to ensure relevance to the research problem. The review is undertaken to eliminate duplication of what has been done by other scholars and to provide a clear understanding of the existing knowledge base in the problem area.

## 2.2 Theoretical Review

### 2.2.1 The 5 C's Model of Client Appraisal

Credit Unions use the 5Cs model that developed for credit to evaluate a customer as a potential borrower (Pride, Hughes, & Kapoor, 2008). The 5Cs evaluate a customer's character, capacity, capital, collateral and conditions of the applicant and how all these affect their ability to repay the loan prior to disbursing it. The 5Cs help check the ability of the loan applicant to repay the applied amount of credit as and when they fall due thereby increasing credit performance of the institution (Sarajar, 2013). This model is used to determine the credit worthiness of potential borrowers solely based on the information declared by the applicant (Kealy, 2014).

Analysts' check the character of the applicant in terms of their value system, ethics and credit history from CRB system. Character basically is a tool that provides weighting values for various characteristics of a credit applicant and the total weighted score of the applicant is used to estimate his credit worthiness (Moti, Masinde, Mugenda, & Sindani, 2012). Furthermore, they check their capacity-financial performance by looking at the income statements, their revenue remittances and any other income generating venture they pursue; they also check their capital by analyzing their assets and their liabilities. According to Golin, and Delhaise, (2013) capital is measured by the general financial position of the borrower as indicated by a financial ratio analysis, with special emphasis on tangible net worth of the borrower's business. Thus, capital is the money a borrower has personally invested in the business and is an indication of how much the borrower has at risk should the business fail. The analysts also look at collateral (security) tangibility of liquidity of the assets owned by the applicant. Collateral is any asset that customers have to pledge against debt (Harris, 2013). Collateral represents assets that the company pledges as alternative repayment source of loan. Most collateral is in form of hard assets such as real estate and office or manufacturing equipment. But accounts receivable and inventory can be pledged as collateral. Lastly the condition or do an economic survey of the industry. Condition refers to the borrower's sensitivity to external forces such as interest rates, inflation rates, business cycles as well as competitive pressures. The conditions focus on the borrower's vulnerability (Moti, et al, 2012).

The theory informs the study in that, the SASRA regulated SACCO's will consider the cash flow from the business, the timing of the repayment, and the successful repayment of the loan. The success of SACCOs largely depends on the effectiveness of their credit policy and credit management systems because these institutions generate most of their income from interest earned savings and on loans extended to members. The SACCOs will consider the member ability to repay credit facility from the business, the timing of the repayment and the successful repayment of the loan (Biwott, 2014).

### 2.2.2 Asymmetric Information Theory

Information asymmetry refers to a situation where business owners or manager know more about the prospects for, and risks facing their business, than do lenders (PWHC, 2012) cited in Lewis, (2011). It describes a condition in which all parties involved in an undertaking do not know relevant information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with investment projects for which the funds are earmarked. The lender on the other hand does not have sufficient information concerning the borrower Morellec, and Schürhoff (2011) point out that perceived information asymmetry poses two problems for financial institutions: moral hazard  in terms of monitoring the applicant's financial behavior and adverse selection. Banks will find it difficult to overcome these problems because it is not economical to devote resources to appraisal and monitoring where lending is for relatively small amounts. This is because data needed to screen credit applications and to monitor borrowers are not freely available to banks. Bankers face a situation of information asymmetry when assessing lending applications (Berger, Espinosa-Vega, Frame, & Miller, 2011). The information required to assess the competence and commitment of the entrepreneur, and the prospects of the business is either not available, uneconomic to obtain or difficult to interpret. This creates two types of risks for the Banker (Berger et al., 2011). The risk of adverse selection which occurs when banks lend to businesses which subsequently fail (type II error), or when they do not lend to businesses which go on to become" successful, or have the potential to do so (type I error) (Freedman and Jin, 2011).

This theory is applicable in this study as it helps the lending institution during the credit appraisal process by getting information from the borrower and using that information to evaluate the credibility of the borrower. Since if the borrowers do not pay their loans then the lending institution and in this case the commercial banks will make a loss which affects their financial performance.

### 2.2.3 Agency Theory

The agency theory was hypothesized by (Jensen & Meckling, 1976) and postulates that firm management are shareholders agents who are the actual owners of respective companies. This theory is founded on the premise that individual stakeholders interests at the firm will divert or conflict. In this regard, engaged company agents need to act in an appropriate manner so as to enhance the overall wellbeing of the principals. They therefore need not engage in activities that would lead to compromise of their independence while they execute their tasks. In essence, both principals and agents always seek to maximize utility so as to capitalize on potential returns. This common agenda may lead to the collision of the interests of both parties.

The company agents may at times not act in accordance with the principals best interests. This may be caused by various factors for instance differences in risk appetite. This may in turn lead to agents not fully exploiting available opportunities hence not optimally add value to principals objectives and expectations. In the engagement of both principals and agents, risk preferences need to clear and made initially so as to minimize the occurrence of agency problem (Jensen and Meckling, 1976). This theory explains how credit officers of the commercial banks act on behalf of the bank and its shareholders and directors to ensure that the credits yield interests for the lending institutions.

## 2.3 Empirical Review

### 2.3.1 Credit Terms and Performance of Loans

A credit term is a contractual stipulation under which An organization extends credit facilities to its customers (Lemmon & Roberts, 2010) in a prudent manner to ensure that the beneficiaries will be in a position to repay the loans as and when it falls due. The credit terms in the policy need to attractive to act as an incentive to clients without incurring increasing the level of NPL in the long run. The whole idea behind the credit terms should be to encourage good performance of the loans. Credit terms normally stipulate the credit period, interest rate, method of calculating interest and frequency of loan installments. It is evaluated by the position of the client as indicated by the ratio analysis, trends in cash flow and looking at capital position (Love & Zaidi, 2010). Maturity of a loan which is the period it takes for a loan to mature with the interest there on. Klapper, Laeven, and Rajan (2012) explain the significance of discounts in credit terms. For instance, several strategies like discounts are offered to clients from time to time to induce them into paying the advances amount within the stipulated period or before the end of the agreed upon credit period .This discount is normally expressed as a percentage of the loan.

Duffie and Singleton (2012) observe that credit terms are normally looked at as the credit period terms of discount and the amount of credit and choice of instrument used to evidence credit. These may include; the period taken to approve loans which runs from the time the application is received by a financial institution to the time that the loan is disbursement or received by the applicant. The interest charged on loans form part of the cost which may change from one institution to another. Lemmon, and Roberts (2010) pointed out that the maximum loan amount per cycle are determined basing on the purpose of the loan and the ability of the client to repay (including guarantee).

Owino (2013) did a study on the effect of the lending policies on the levels of non-performing loans (NPLS) of commercial banks in Kenya. They describe a bank lending policy as a statement of its philosophy, standards, and guidelines that its employees must observe in granting or refusing a loan request. The internal policies act as a criterion upon which the institution extends credit to loan applicants. It identifies the grounds upon which credit application can be declined. The findings revealed that lending policies are related to the NPLs, and therefore banks need to lend prudently in an effort to lower their risk level.

Ahmed and Malik (2015) examined credit risk management and loan performance through an empirical investigation of micro finance banks of Pakistan. The study specifically sought to establish the influence of credit risk management practices on loan performance (LP) while taking the credit terms and policy (CTP), client appraisal, collection policy (CP) and credit risk control (CRC) as the dimensions of the credit risk management practices. The study findings reveal that the CP and client appraisal had positive and significant impact on LP. The credit terms and policy (CP) and credit risk control (CRC) had positive but insignificant impact on loan performance (LP). This study brought out the importance of having good credit terms and policies since they positively impact the loan performance which is a key source of income for financial institutions and especially the commercial banks.

### 2.3.2 Credit Appraisal Process and Performance of Loans

Credit appraisal process describes the activities that are undertaken by the financial institution to determine whether to extend credit facility to the applicant or not (Chor & Manova, 2012). It begins once the applicant has submitted the application form to the institution. This may involve reviewing the borrowers' economic and legal situation in order to determine the repayment ability without straining (Duffie & Singleton, 2012). Different financial institutions have varying benchmarks on the period that the credit appraisal should take. The vast majority of credit institutions serve a number of different customer segments. This segmentation is mostly used to differentiate the services offered to individualize the respective marketing efforts (Chor & Manova, 2012). Segmentation is based on several basses including customer demands, age, income, business industry, business size among others. Most organizations apply credit policies in determining the demands of its customers and the range of products that they would prefer (Manova, 2012).

Brealey, Myers, Allen, and Mohanty (2012) pointed out that the activities in the process of commercial and industrial (C&I) loans follow eight steps. These steps include: application, credit analysis, decision, document preparation, closing, recording, servicing and administration and collection. These activities and the primary tasks for those responsible for these activities must be well documented. Loan application covers the initial interview and screening of a loan request (consultative group to assist the poorest, CGAP, 2000). It involves the loan applicant filling in the various forms provided by the financial institution and submitting them for review. Once the forms have been received in the financial institution, the credit department and credit officers do credit analysis to determine the credit worthiness of the applicant. This involves the application of several methods including the 5Cs mentioned above so as to determine the ability of the applicant to meet his or her obligations as and when they fall due. Once done with the appraisal process, the analyst then prepares a report to the loan officer providing information on whether the loans should be granted or disqualified. They also accompany their report with reasons justifying their final decision.

In the fifth step, the loan officer obtains gets in touch with the borrower for consent by appending signatures to offer letters after which he or she surrenders the collateral pledged (Brealey et al., 2012). Once these are executed, the loan is then disbursed into the beneficiary's account. After this, the arrangements are made to start receiving the periodic repayment of the principal and interest (Ogboi & Unuafe, 2014). The process that follows is about monitoring the repayment to ensure that the loan does not go into default and into NPL (Ogboi & Unuafe, 2014). Khemraj and Pasha (2009) studied the determinants of non-performing loans using an econometric case study of Guyana. And established a growth in gross domestic product (GDP) as the non-performing loans reduce in number.

### 2.3.3 Credit Risk Control and Performance of Loans

Credit risk control involves several activities done by the bank to ensure that the loan applicant adhered to the stipulated repayment schedule (Sorge, 2011). Credit risk control ensures that appropriate measures are put in place for a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy (Basel, 1999). Most studies have been inclined to focus on the problems of developing an effective method for the disposal of bad debts, rather than for the provision of a good credit policy framework for their prevention and control of quality portfolio (Campbell, 2007). It's therefore evident that the credit policy influences the financial performance of the organizations.

Dermine (2009) studied on Bank Valuation and Value-based Management: Deposit and Loan Pricing, Performance Evaluation, and Risk Management. The findings credit management in terms of pricing of loans, the evaluation of performance of the borrower and valuation of the risk inherent and perceived of the borrower had a significant impact on the performance of loans and in the end it affected the valuation of the whole banking system.

Key Credit controls included loan product design, credit committees, and delinquency management (Churchill, 2010). SACCOs can mitigate a significant portion of default risk by designing loan products that meet client needs. Loan product features include the loan size, interest rate and fees, repayment schedule, collateral requirements and any other special terms. Loan products should be designed to address the specific purpose for which the loan is intended. By establishing a committee of persons to make decisions regarding loans is an essential control in reducing credit (and fraud) risk. If an individual has the power to decide who will receive loans, which loans will be written off or rescheduled, and the conditions of the loans Patton, (2015), this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, getting involved in delinquency management.

Caouette, Altman, Narayanan, and Nimmo (2011) posit that a logical first step toward developing a zero-tolerance institutional culture is to communicate this concept to each new client before she receives a loan. SACCOs can also remind clients who have had recent delinquency problems that their repayment day is approaching. Creating staff involvement in discouraging delinquency, through a staff incentives system, can be effective. Delinquency Penalties: Clients should be penalized for late payment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance. Nashikkar et al. (2011) further argued that there are various policies that an organization should put in place to ensure that credit management is done effectively; one of these policies is a collection policy which is paramount as not all customers pay the firms bills in time. Some customers are slow payers while some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses (Kariuki, 2010)
Pasiouras (2008) in a journal on ‘Estimating the technical and scale efficiency of Greek commercial banks: the impact of credit risk, off-balance sheet activities, and international operations’. The study revealed that credit risk control affected the financial performance through its loan performance.

## 2.4 Conceptual Framework

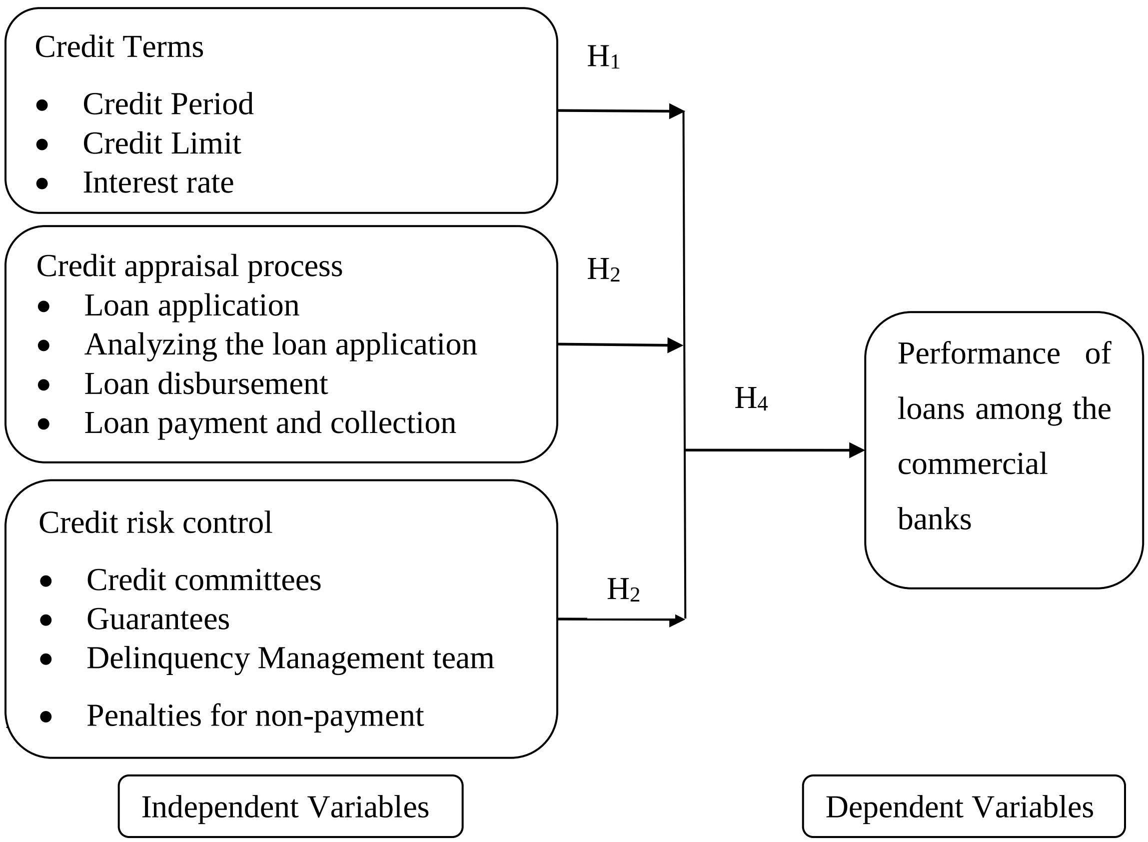


**Figure 2.1: Conceptual Framework**

## 2.5 Hypothesis

**H$_{O1}$**: There is no significant influence of credit terms on loan performance among the commercial banks

**H$_{O2}$**: Credit appraisal process has no influence on the loan performance among the commercial banks.

**H$_{O3}$**: There is no significant effect of credit risk control on loan performance among the commercial banks.

## 2.6 Operationalization

**Table 2.1: Operationalization**

| **Objective** | **Variable Type** | **Indicators** | **Type of data analysis** |
|---|---|---|---|
| To determine the effect of credit terms on loan performance among the commercial banks | **Independent** Credit terms | • Credit Period<br>• Credit Limit<br>• Interest rate | Descriptive Correlation Regression |
| To evaluate the effect of credit appraisal process on the loan performance among the commercial banks. | **Independent** Credit appraisal process | • Loan application<br>• Analyzing the loan application<br>• Loan disbursement<br>• Loan payment and collection | Descriptive Correlation Regression |
| To establish the effect of credit risk control on the loan performance among the commercial banks. | **Independent** Credit risk control | • Credit committees<br>• Guarantees<br>• Delinquency Management team<br>• Penalties for non-payment | Descriptive Correlation Regression |
| | **Dependent** Performance of loans of commercial banks | • Level of NPL | Descriptive Correlation Regression |

# CHAPTER THREE
# RESEARCH METHODOLOGY

## 3.1 Introduction

This chapter discusses the methods that were used to carry out the research, looking at the techniques, models and procedures that will be used by the researcher to collect and analyze the data. The chapter discussed the research design, population and sampling method, data collection methods, research procedures, data analysis methods and the chapter summary.

## 3.2 Research Design

The researcher used a descriptive research to establish the influence of credit policy on the performance of loans of commercial banks. According to Yin (2013), a research design provides a framework of the methods and the procedures for collecting and analyzing data. This type of research describes what exists and has a purpose to observe, describe and document aspects of a situation as it naturally occurs. Descriptive research seeks to establish factors associated with certain occurrences, outcomes, conditions or types of behavior

## 3.3 Target Population

Target population in statistics is the specific population about which information is desired. According to Fowler (2013), a population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. The target population for this study included the 43 commercial banks that are operating in Kenya according to the annual CBK report (2015)

## 3.4 Sampling Technique and Sample Size

A sample is a set of data collected or selected from a statistical population by a defined procedure. The study adopted a census of all the 43 commercial banks currently operating in Kenya. To avoid data redundancy, the study will randomly select credit manager and analyst from each bank giving a sample of 86. The study adopted purposeful sampling because the selected individuals are more knowledgeable on the subjects in the study.

### 3.5 Instrumentation

The researcher used primary data for this study. This data was collected through structured questionnaires. The questionnaires were selected upon since they have advantages over other types of research instruments in that they do not require as much effort as verbal or telephone surveys, and often have standardized answers that make it simple to compile data and analyze it (Gray, 2013).

Questions were constructed using a Likert Scale whose end points were ‘strongly agree’ and ‘strongly disagree’. Bowling (2014) asserts that a Likert Scale allows a participant to provide feedback that is slightly more expansive than a simple close-ended question, but that is much easier to quantify than a completely open-ended response.

### 3.6 Data Collection Procedure

The respondents were required to fill out the questionnaire which is the research instrument correctly and honestly. The researcher preferred using questionnaires as they tend to be confidential and provide honest answers without a feeling of intimidation. Drop and pick method was applied, as the bank staff are busy all the time, this will give them sufficient time to fill the questionnaire.

### 3.7 Pilot Test

A pre-test was conducted on 10 credit analysts to ensure the questionnaires that used pass the reliability and validity test. According to Hair and Lukas, (2014) the validity of a questionnaire refers to the extent to which it measures what it claims to measure. The piloted questionnaire was scrutinized to vet out unclear and ambiguous phrases, then it was redone ensure its validity. This ensured that the questionnaire administered for the final study will be capable of eliciting the information required (validity). It also makes it possible for a similar study to be reciprocated with consistent outcomes (reliability). The data from the pilot test was analyzed using Cronbach's alpha which determines the internal consistency or average correlation of items in a survey instrument to gauge its reliability. Emphasis are that the smaller the variability, the greater the internal consistency reliability of the survey instrument.

### 3.8 Diagnostic Tests

The study will use the F Statistic to determine the validity of the regression model adopted. This statistic shall be compared to the F Critical value where the regression model will be referred to as valid if F Statistic is greater than F Critical. Otherwise, the conclusion made will be that the model is invalid. This shall be based from the results in the ANOVA Table.

The regression model would be used to determine if the regression assumptions used in the study are valid before performing the inference. Since if there any violations, subsequent inferential procedures may be invalid resulting in faulty conclusions. And in constructing our regression models we assumed that the responses Y to the explanatory variables were linear in the parameters and that the errors were independent and identically distributed.

### 3.9 Data Analysis

Data will be analyzed through qualitative and quantitative approaches. These methods are valuable so as to gather as much information as possible on the influence of credit policy on the loan performance of commercial banks. According to Grbich (2012) in order to construct a rich and meaningful image of a situation that is complex and multifaceted, then qualitative research is used. This analysis will use SPSS (Statistical Package for Social Sciences) version 21 as it is user friendly and appropriate for analysis of management related attitudinal responses (Grbich, 2012).

The study will also conduct a multiple regression analysis using the following model. The regression model is as shown;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where: $Y$ = Performance of loans

$\beta_0$ = Constant

$X_1$ = Credit Terms

$X_2$ = Credit Appraisal Process

$X_3$ = Credit Risk Control

$\varepsilon$ = Error Term

### 3.10 Ethical Issues

During the process of carrying out of the research, the researcher sought permission from the management of the commercial banks which are to be respondents to carry out the research. This was done through a formal letter explaining the nature of the study, objectives and purpose of the study.

The respondents were assured of confidentiality of the information they were giving to the researcher and the information would be solely used for the research study. In addition the research tools to be used was tested thus were reliable to ensure the data collected is true and conclusive.

# CHAPTER FOUR

# DATA ANALYSIS, PRESENTATIONS AND DISCUSSION

## 4.1 Introduction

This chapter presents the data analysis, presentation and discussion. The main objective of this study was to assess the influence of credit policy on the performance of loans among commercial banks in Kenya. Data was collected using questionnaires as the data collection instruments and summarized by use of descriptive statistics which involves the use of frequency tables, percentages, mean and standard deviation.

### 4.1.1 Response Rate

A total of 86 questionnaires were distributed out of which 63 questionnaires were filled and returned giving a response rate of 73%. This response was good enough and representative of the population and conforms to Mugenda and Mugenda (2003) stipulation that a response rate of 70% and above is excellent. These findings are well illustrated in the Figure 4.1.

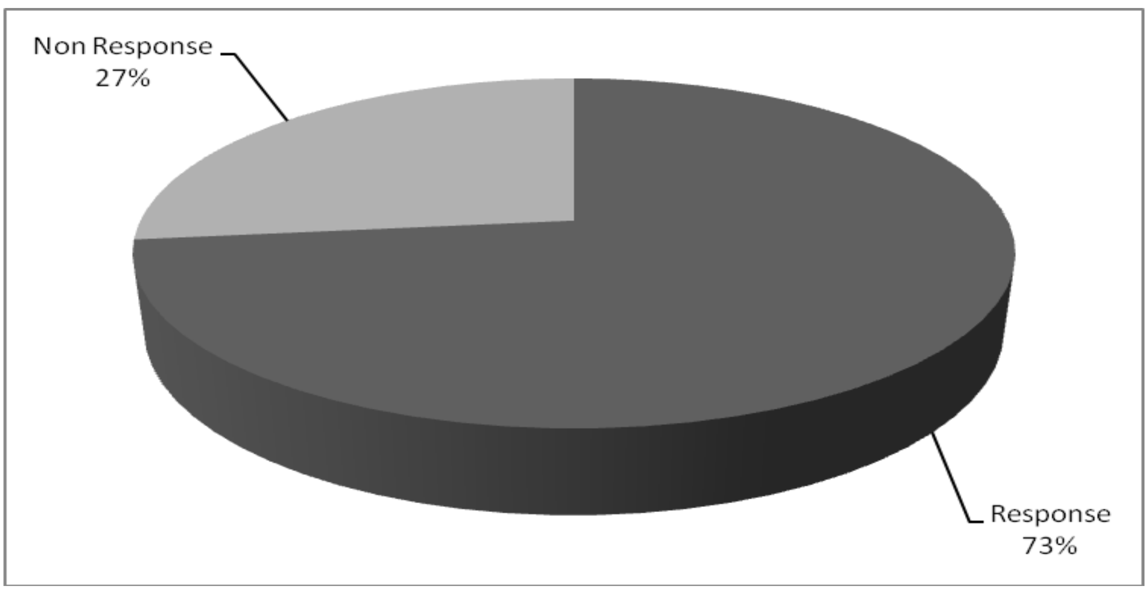


**Figure 4.1: Response Rate**

## 4.2 General Information

The study in this section sought to enquire from the respondents' general information including, gender distribution, highest level of education attained, Period working in the Bank, period working in the Banking industry and the position in the bank in order to ascertain their suitability in the study. This general information is presented in the following subsections.

### 4.2.1 Gender Distribution

The study sought to determine the gender distribution of the respondents. The findings are shown in Figure 4.1.

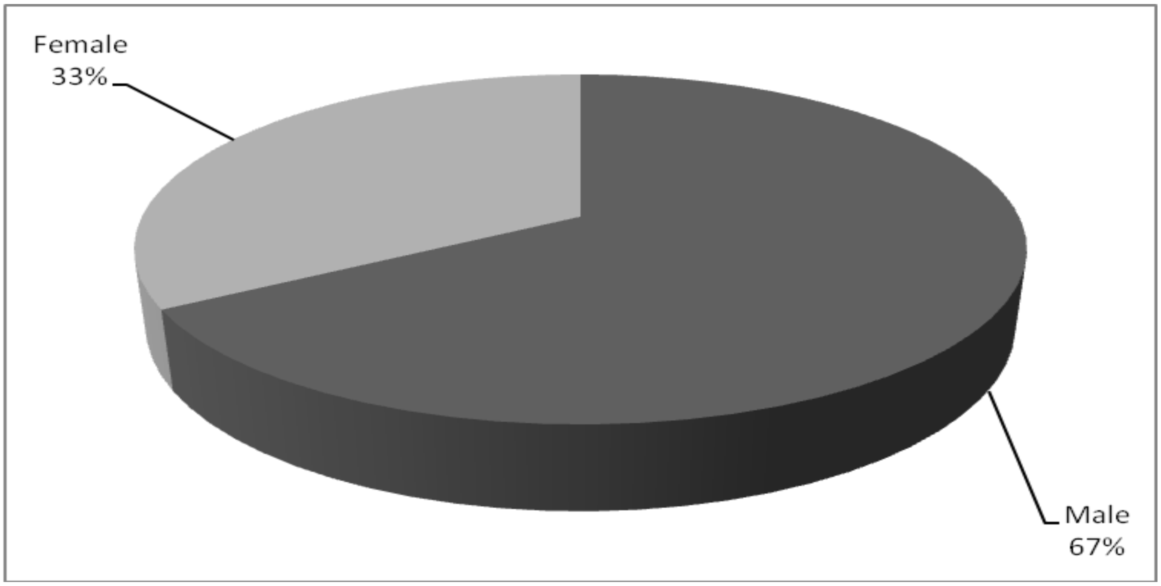


**Figure 4.2: Gender Distribution**

From the findings, 33% of the respondents were female while 67% were male. This shows that all gender were included thus provided a good representation for the study

### 4.2.2 Highest Level of Education Attained

The respondents were asked to indicate their highest level of education attained. The findings are shown below in Table 4.1.

**Table 4.1: Highest Level of Education Attained**

| | Frequency | Percent |
|---|---|---|
| Certificate | 6 | 9.5 |
| Diploma | 11 | 17.5 |
| Bachelors Degree | 14 | 22.2 |
| Masters | 30 | 47.6 |
| PhD | 2 | 3.2 |
| **Total** | **63** | **100.0** |

From the findings on Table 4.1, 9.5% of the respondents had certificate, 17.5% had diploma, 22.2% had bachelor's degree, 47.6% had Masters Degree and 3.2% had PhD. This implied that majority of the respondents had relevant knowledge on influence of credit policy on the performance of loans among commercial banks in Kenya thus they had ease in addressing the question and provided the correct responses hence the data collected was reliable for the study.

### 4.2.3 Period Working in the Bank

The study sought to determine the period of time the respondents had been working with their respective banks. The findings are shown on Table 4.2.

**Table 4.2: Period Working in the Bank**

| | Frequency | Percent |
|---|---|---|
| Below 3 years | 16 | 25.4 |
| 3-6 years | 24 | 38.1 |
| 6-9 years | 10 | 15.9 |
| 10 years and above | 13 | 20.6 |
| **Total** | **63** | **100.0** |

As shown on Table 4.2, 25.4% of the respondents had worked for a period below 3 years, 38.1% for a period between 3-6 years, 15.9% for a period between 6-9 years and 20.6% for a period of 10 years and above. This shows that data was collected from respondents who had experience and gave valid information on influence of credit policy on the performance of loans.

### 4.2.4 Period Working in the Banking Industry

The respondents were requested to indicate the period of time they had been working in the banking industry. The findings are shown in Table 4.3.

**Table 4.3: Period Working in the Banking Industry**

| | Frequency | Percent |
|---|---|---|
| Below 3 years | 4 | 6.3 |
| 3-6 years | 8 | 12.7 |
| 6-9 years | 6 | 9.5 |
| 10 years and above | 45 | 71.4 |
| **Total** | **63** | **100.0** |

As indicated in Table 4.3, 6.3% of the respondents had worked for a period below 3 years in the banking industry, 12.7% for a period between 3-6 years, 9.5% for a period between 6-9 years and 71.4% for a period of 10 years and above. This shows that the respondents had quite sufficient experience in the banking industry and they had vast knowledge on influence of credit policy on the performance of loans thus their responses are dependable and can be used to form an opinion.

### 4.2.5 Position in the Bank

The respondents were required to indicate their positions in their respective banks. The results are presented in Table 4.4.

**Table 4.4: Position in the Bank**

| | Frequency | Percent |
|---|---|---|
| Head of credit division | 12 | 19.0 |
| Credit Manager | 7 | 11.1 |
| Credit Analyst | 14 | 22.2 |
| Credit Officer | 30 | 47.6 |
| **Total** | **63** | **100.0** |

From the finding in Table 4.4, 19% of the respondents were heads of credit division, 11.1% were credit Managers, 22.2% were credit analysts and 47.6% were Credit Officers. These findings show that the study sought information from various positions concerned with credit policy in banks thus findings are more reliable for the study.

## 4.3 Effect of Credit Terms on Performance of Loans

Several statements on credit terms and how it influences the performance of loans in commercial banks were identified and the respondents were required to indicate the extent to which they agree or disagree with the statements. A scale of 1-5 where 1= No extent, 2= little extent, 3=moderate extent, 4=great extent and 5=very great extent was used. From the responses, mean and standard deviation were used for ease of interpretation and generalization of findings. The findings are clearly illustrated on Table 4.5.

**Table 4.5: Effect of Credit Terms on Performance of Loans**

| | Mean | Std. Dev |
|---|---|---|
| A Credit term is a contractual stipulation under which a firm grants credit to its customers | 3.76 | 1.201 |
| Credit terms give the credit period and the credit limit. | 3.96 | 1.031 |
| Credit terms normally stipulate the credit period, interest rate, method of calculating interest and frequency of loan installments | 3.68 | 1.189 |
| Maturity of a loan, this is the time period it takes a loan to mature with the interest | 4.15 | 1.095 |
| By understanding the borrower, the risk premium can be ascertained and the profit erosion from bad debts can be decreased hence increasing bank performance. | 3.76 | 1.146 |
| Discounts are offered to induce clients to pay up within the stipulated period or before the end of the credit period | 3.80 | 1.133 |
| Discounts are meant to accelerate timely collection to cut back on the amount of doubtful debts and associated costs. | 4.01 | 1.054 |
| The cost of loan is the interest charged on loans and it is different for financial institutions dependent on the market rate and competition | 3.93 | 1.029 |

From the finding in Table 4.5, a credit term is a contractual stipulation under which a firm grants credit to its customers had a mean of 3.76 with a standard deviation of 1.201, credit terms give the credit period and the credit limit had a mean of 3.96 with a standard deviation of 1.031, credit terms normally stipulate the credit period, interest rate, method of calculating interest and frequency of loan installments had a mean of 3.68 with a standard deviation of 1.189, maturity of a loan, this is the time period it takes a loan to mature with the interest had a mean of 4.15 with a standard deviation of 1.095, by understanding the borrower, the risk premium can be ascertained and the profit erosion from bad debts can be decreased hence increasing bank performance had a mean of 3.76 with a standard deviation of 1.146, discounts are offered to induce clients to pay up within the stipulated period or before the end of the credit period had a mean of 3.80 with a standard deviation of 1.133, discounts are meant to accelerate timely collection to cut back on the amount of doubtful debts and associated costs had a mean of 4.01 with a standard deviation of 1.054 and the cost of loan is the interest charged on loans and it is different for financial institutions dependent on the market rate and competition had a mean of 3.93 with a standard deviation of 1.029. The mean values for the responses ranges from 3.76-4.15 which indicates that the respondents were in agreement with the statement and this finding concur with that of Lemmon, and Roberts (2010) who pointed out that the maximum loan amount per cycle are determined basing on the purpose of the loan and the ability of the client to repay (including guarantee).

### 4.3.1 Extent to which Credit Terms Influence Financial Performance

The respondents were asked to indicate the extent to which credit terms influenced performance of loans in their Bank. The findings are shown in Table 4.6.

**Table 4.6: Extent to which Credit Terms Influence Financial Performance**

| | Frequency | Percent |
|---|---|---|
| No Extent | 3 | 4.8 |
| Little Extent | 2 | 3.2 |
| Moderate Extent | 7 | 11.1 |
| Great Extent | 28 | 44.4 |
| Very Great Extent | 23 | 36.5 |
| **Total** | **63** | **100.0** |

As shown in Table 4.6, 4.8% of the respondents indicated that credit terms influenced performance of loans in their Bank to a no extent, 3.2% indicated little extent, 11.1% indicated moderate extent, 44.4% indicated great extent and 36.5% indicated very great extent.

## 4.4 Effect of Credit Appraisal Process on the Performance of Loans

Several statements on credit appraisal process and how it influences the performance of loans in commercial banks were identified and the respondents were required to indicate the extent to which they agree or disagree with the statements. From the responses, mean and standard deviation were used for ease of interpretation and generalization of findings. The findings are clearly illustrated on Table 4.7.

**Table 4.7: Effect of Credit Appraisal Process on the Performance of Loans**

| | Mean | Std. Dev |
|---|---|---|
| To assess the credit risk, banks need to take a close look at the borrowers' economic, legal and environmental situation | 3.98 | .958 |
| Segmentation is done to differentiate the services offered to individualize the respective marketing efforts | 3.76 | 1.088 |
| The first step in loan processing is the application where initial interview and screening is conducted by a loan officer. | 4.04 | .974 |
| Credit analysis is done based on provided information from the borrower | 3.69 | 1.101 |
| Loan officers check for collateral and guarantors | 3.85 | 1.060 |
| Loan officers inputs the loan application into the bank's commercial loan system and files the application | 3.73 | 1.207 |
| Loan servicing and administration is done a loan officer, who also prepares the loan payment notices to notify the borrower and is responsible for receiving periodic payments. | 3.90 | 2.644 |
| The loan officer makes periodic visits to customers to obtain financial statements and verify information so as to avoid bad debts | 4.06 | .895 |
| The loan officer adjusts loan terms and conditions as deemed necessary and takes legal action if non-collectible procedures and foreclosure on the loan are required. | 3.87 | .888 |

As indicated in Table 4.7, to assess the credit risk, banks need to take a close look at the borrowers' economic, legal and environmental situation had a mean of 3.98 with a standard deviation of 0.958, segmentation is done to differentiate the services offered to individualize the respective marketing efforts had a mean of 3.76 with a standard deviation of 1.088, the first step in loan processing is the application where initial interview and screening is conducted by a loan officer had a mean of 4.04 with a standard deviation of 0.974, credit analysis is done based on provided information from the borrower had a mean of 3.69 with a standard deviation of 1.101, loan officers check for collateral and guarantors had a mean of 3.85 with a standard deviation of 1.060, loan officers inputs the loan application into the bank's commercial loan system and files the application had a mean of 3.85 with a standard deviation of 1.060, loan servicing and administration is done a loan officer, who also prepares the loan payment notices to notify the borrower and is responsible for receiving periodic payments had a mean of 3.90 with a standard deviation of 2.644, the loan officer makes periodic visits to customers to obtain financial statements and verify information so as to avoid bad debts had a mean of 4.06 with a standard deviation of 0.895 and the loan officer adjusts loan terms and conditions as deemed necessary and takes legal action if non-collectible procedures and foreclosure on the loan are required had a mean of 3.87 with a standard deviation of 0.888. The mean values for the finding ranges from 3.73-4.06 which implies that the respondents agreed with the statements and this is in line with the finding of Brealey, Myers, Allen, and Mohanty (2012) who pointed out that the activities in the process of commercial and industrial (C&I) loans follow eight steps. These steps include: application, credit analysis, decision, document preparation, closing, recording, servicing and administration and collection.

### 4.4.1 Extent to which Credit Appraisal Process Influence Financial Performance

The respondents were asked to indicate the extent to which credit appraisal process influenced performance of loans in their Bank. The findings are shown in Table 4.8.

**Table 4.8: Extent to which Credit Appraisal Process Influence Financial Performance**

| | Frequency | Percent |
|---|---|---|
| No extent | 3 | 4.8 |
| little extent | 5 | 7.9 |
| moderate extent | 12 | 19.0 |
| great extent | 25 | 39.7 |
| very great extent | 18 | 28.6 |
| **Total** | **63** | **100.0** |

From the finding in Table 4.8, 4.8% of the respondents indicated that credit appraisal process influenced performance of loans in their Bank to a no extent, 7.9% indicated little extent, 19% indicated moderate extent, 39.7% indicated great extent and 28.6% indicated very great extent.

## 4.5 Effect of Credit Risk Control on the Performance of Loans

Several statements on credit risk control and how it influences the performance of loans in commercial banks were identified and the respondents were required to indicate the extent to which they agree or disagree with the statements. From the responses, mean and standard deviation were used for ease of interpretation and generalization of findings. The findings are clearly illustrated on Table 4.9.

**Table 4.9: Effect of Credit Risk Control on the Performance of Loans**

| | Mean | Std. Dev |
|---|---|---|
| It is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy | 3.85 | 1.029 |
| Financial institutions should focus on a good credit policy framework for their prevention and control of quality portfolio | 4.03 | .915 |
| Credit policy influences the financial performance of the organizations. | 3.98 | 1.023 |
| Financial ratios and credit indicators are used as a measure of the bank's performance | 3.87 | 1.039 |
| Key Credit controls included loan product design, credit committees, and delinquency management | 4.07 | 1.036 |
| By establishing a committee of persons to make decisions regarding loans; this is an essential control measure in reducing credit risk | 4.06 | 1.060 |
| Clear communication is a logical first step towards developing a zero-tolerance institutional culture on credit risks | 3.90 | 1.291 |
| Creating staff incentives system is an effective way of discouraging delinquency | 3.88 | .881 |
| Delinquency Penalties: Clients should be penalized for late payment. | 3.84 | 1.110 |
| Organizations should have policies like collection policy to encourage loan repayment | 3.82 | 1.008 |

As indicated in Table 4.9, it is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy had a mean of 3.85 with a standard deviation of 1.029, financial institutions should focus on a good credit policy framework for their prevention and control of quality portfolio had a mean of 4.03 with a standard deviation of 0.915, credit policy influences the financial performance of the organizations had a mean of 3.98 with a standard deviation of 1.023, financial ratios and credit indicators are used as a measure of the bank's performance had a mean of 3.87 with a standard deviation of 1.039, key credit controls included loan product design, credit committees, and delinquency management had a mean of 4.07 with a standard deviation of 1.036, by establishing a committee of persons to make decisions regarding loans; this is an essential control measure in reducing credit risk had a mean of

4.06 with a standard deviation of 1.030, clear communication is a logical first step towards developing a zero-tolerance institutional culture on credit risks had a mean of 3.90 with a standard deviation of 1.291, creating staff incentives system is an effective way of discouraging delinquency had a mean of 3.88 with a standard deviation of 0.881, delinquency Penalties: Clients should be penalized for late payment had a mean of 3.84 with a standard deviation of 1.110 and organizations should have policies like collection policy to encourage loan repayment had a mean of 3.82 with a standard deviation of 1.008. The mean values for the finding ranges from 3.82-4.07 showing that the respondents were in agreement with the statement which is consistent with the finding of Nashikkar et al. (2011) that there are various policies that an organization should put in place to ensure that credit management is done effectively; one of these policies is a collection policy which is paramount as not all customers pay the firms bills in time.

### 4.5.1 Extent to which Credit Risk Control Influence Financial Performance

The respondents were asked to indicate the extent to which credit appraisal process influenced performance of loans in their Bank. The findings are shown in Table 4.10.

**Table 4.10: Extent to which Credit Risk Control Influence Financial Performance**

| | Frequency | Percent |
|---|---|---|
| No extent | 1 | 1.6 |
| little extent | 5 | 7.9 |
| moderate extent | 14 | 22.2 |
| great extent | 21 | 33.3 |
| very great extent | 22 | 34.9 |
| **Total** | **63** | **100.0** |

From the finding in Table 4.10, 1.6% of the respondents indicated that credit risk control influenced performance of loans in their Bank to a no extent, 7.9% indicated little extent, 22.2% indicated moderate extent, 33.3% indicated great extent and 34.9% indicated very great extent.

## 4.6 Performance of Loans

The respondents were required to indicate the extent to which credit policy had affected the performance of loans in their banks. From the responses, mean and standard deviation were used for ease of interpretation and generalization of findings. The findings are clearly illustrated on Table 4.11.

**Table 4.11: Performance of Loans**

| | Mean | Std. Dev |
|---|---|---|
| Credit policy has led to reduced level of NPL | 4.04 | .957 |
| Credit policy has improved the recovery of loans written off | 3.87 | 1.023 |
| Credit policy has reduced the issuance of bad loans | 3.85 | 1.013 |
| Credit policy has improved loan applicant vetting | 3.79 | .986 |

From the finding in Table 4.11, Credit policy has led to reduced level of NPL had a mean of 4.04 with a standard deviation of 0.957, credit policy has improved the recovery of loans written off had a mean of 3.87 with a standard deviation of 1.023, credit policy has reduced the issuance of bad loans had a mean of 3.85 with a standard deviation of 1.013 and credit policy has improved loan applicant vetting had a mean of 3.79 with a standard deviation of 0.986. The mean values for the finding ranges from 3.79-4.04 an indication that the respondents agreed with the statements. This finding concurs with that of Berger, Espinosa-Vega, Frame & Miller (2011) that commercial banks insist on evaluation the ability of a loan applicant to repay their loans through evaluation of their financial strengths or their weakness so as to gain a better understanding on the risk factor of the loan applicant.

### 4.7 Regression Analysis

The study carried out a multiple regression analysis to establish the influence of credit policy on the performance of loans among commercial banks in Kenya. The findings are shown in the subsequent sections.

**Table 4.12: Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .762[a] | .581 | .559 | 1.30458 |

From the findings in Table 4.12, R was 0.762 meaning that there was a positive relationship between all the three factors that influence of credit policy on the performance of loans. $R^2$ was 0.581 implying that only 58.1% of the dependent variable could be explained by the independent variables while only 41.9% of the variations were due to other factors. This implies that the regression model has very good explanatory and predictor grounds.

**Table 4.13: ANOVA**

| Model | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|
| Regression | 139.014 | 3 | 46.338 | 27.227 | .000[b] |
| Residual | 100.414 | 59 | 1.702 | | |
| **Total** | **239.429** | **62** | | | |

From the findings on Table 4.13, the significance value is 0.000 which is less that 0.05 thus the model is statistically significant in predicting how credit terms, credit appraisal process and credit risk control influence the performance of loans among commercial banks in Kenya. The F critical at 5% level of significance was 2.75. Since F calculated (value = 27.227) is greater than the F critical (2.75), this shows that the overall model was significant.

**Table 4.14: Coefficients**

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (Constant) | 2.427 | 1.128 | | 2.151 | .036 |
| Credit Terms | .019 | .040 | .062 | .485 | .629 |
| Credit Appraisal Process | .143 | .033 | .517 | 4.338 | .000 |
| Credit Risk Control | .095 | .034 | .295 | 2.762 | .008 |

The established regression equation becomes;

$$\mathbf{Y = 2.427+0.019X_1 + 0.143X_2+ 0.095X_3+ \varepsilon}$$

Where: Y= performance of loans, $X_1$= credit terms, $X_2$=credit appraisal process, $X_3$= credit risk control and ε = Error Term.

From the findings of the regression analysis if all factors (credit terms, credit appraisal process and credit risk control) were held constant, performance of loans would be at 2.427. An increase in credit terms would lead to an increase in performance of loans by 0.019. An increase in credit appraisal process would lead to an increase in performance of loans by 0.143. An increase in credit risk control would lead to an increase in performance of loans by 0.095. Credit appraisal process and credit risk control had p-values less than 0.05 an indication that they were significant in the study.

# CHAPTER FIVE

# SUMMARY, CONCLUSION AND RECOMMEDATIONS

## 5.1 Introduction

This chapter presents summary of the findings, conclusion and recommendations of the study based on the objective of the study which was to assess the influence of credit policy on the performance of loans among commercial banks in Kenya.

## 5.2 Summary

This section presents a summary of the findings as per the research objectives and the research questions.

### 5.2.1 Effect of Credit Terms on Performance of Loans

The study found out that credit terms give the credit period and the credit limit and stipulate the credit period, interest rate  method of calculating interest and frequency of loan installments, maturity of a loan, this is the time period it takes a loan to mature with the interest, by understanding the borrower, the risk premium can be ascertained and the profit erosion from bad debts can be decreased hence increasing bank performance, discounts are offered to induce clients to pay up within the stipulated period or before the end of the credit period, discounts are meant to accelerate timely collection to cut back on the amount of doubtful debts and associated costs and the cost of loan is the interest charged on loans and it is different for financial institutions dependent on the market rate and competition.

### 5.2.2 Effect of Credit Appraisal Process on the Performance of Loans

The study established that to assess the credit risk, banks need to take a close look at the borrowers' economic, legal and environmental situation, segmentation was done to differentiate the services offered to individualize the respective marketing efforts, the first step in loan processing is the application where initial interview and screening is conducted by a loan officer, credit analysis was done based on provided information from the borrower, loan officers check for collateral and guarantors, inputs the loan application, loan servicing and administration, made periodic visits to customers to obtain financial statements and verify information so as to avoid bad debts and adjusts loan terms and conditions.

### 5.2.3 Effect of Credit Risk Control on the Performance of Loans

The study revealed that it was necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy, credit policy influences the financial performance of the organizations, financial ratios and credit indicators are used as a measure of the bank's performance, key credit controls included loan product design, credit committees, and delinquency management, , clear communication was a logical first step towards developing a zero-tolerance institutional culture on credit risks, creating staff incentives system was an effective way of discouraging delinquency, and organizations should have policies like collection policy to encourage loan repayment.

## 5.3 Conclusion

The study concluded that commercial banks had adopted credit term policy loan ratio in determination of how much a client would borrow, applied collection policy, considered non-performing loans and total loans, loan–loss provision coverage ratio and application of credit policy which increased the performance of loans to a great extent.

The study further concluded that credit period of funds do increase the level of loans defaults while credit appraisal through frequency of loan reviews and considerations made during credit approval do decrease the level of nonperforming loans of commercial banks. Further the study conclude that encouraging movement of surplus money is the most important objective in credit policy and that majority of the commercial banks approves loans with very high approval limits ceiling.

The study concluded that there existed a significant positive relationship between use of credit risk control and level of non-performing loans. Hence use of credit risk control practices to a very great extent led to decrease in level of Non-performing loans in commercial banks in Kenya. From the results, the study revealed that commercial banks uses credit risk control practices in credit risk management to a very great extent reducing default rates indicated by reduction in level of non-performing Loans.

## 5.4 Recommendation

The study recommends that commercial banks should have clear credit policy with proper monitoring and review from time to time in order to reduce the cases of non-performing loans, have operational credit policy manual and should employed credit committees to approve loans based on the basic assumption of power in numbers. The study also recommends that credit risk managers only should not be used to approve loans and their approval limits ceilings as this may lead to biased approval.

The study also recommends that commercial banks should have operational credit policy manual and credit committees should be employed to approve loans this is based on the basic assumption of power in numbers. The study also recommends that credit risk managers, only, should not be used to approve loans and their approval limits ceilings as this may lead to biased approval.

The study recommends that commercial banks should enhance usage of credit risk control practices in credit risk management because through engaging in loan securitization, carrying out external and internal audit of the business activities to determine how to respond to bank risks, vetting clients before approving loan facility, use of guarantors and adopts legal department checks mechanisms such as in signing of a binding contract and imposes penalties would minimize occurrence of non-performing loans.

## 5.5 Area for Further Research

The study may be replicated by adding more dimensions of the credit policies and to further test the impact of studied variables on the performance of loan to add to the current findings. It is further suggested that the secondary data may also be incorporated in such studies to better explore the influence of credit policy on performance of loan.

The study recommends that a further study should be carried out to determine the impact of credit management policy and level of non-performing loans in financial institution including deposit taking micro finance institutions and deposit taking SACCOs in Kenya

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# APPENDICES

## APPENDIX I: QUESTIONNAIRE

Please fill out the questionnaire in the spaces below. Kindly tick only one response.

**SECTION A: GENERAL INFORMATION**

1. Name of the Bank (Optional) ________________________________
2. What is your gender?

Male [ ] Female [ ]

3. What is your highest level of education attained?

Certificate [ ] Diploma [ ]

Bachelors Degree [ ] Masters [ ]

PhD [ ]

4. Please indicate the number of years worked in this Bank?

Below 3 years [ ] 3-6 years [ ]

6-9 years [ ] 10 years and above [ ]

5. How long have you worked in the Banking industry?

Below 3 years [ ] 3-6 years [ ]

6-9 years [ ] 10 years and above [ ]

6. What is your position in the Bank?

Head of credit division [ ] Credit Manager [ ]

Credit Analyst [ ] Credit Officer [ ]

**SECTION B: CREDIT TERMS**

7. Below are several statements on credit terms and how it influences the loan performance among the commercial banks. Kindly indicate the extent to which you agree or disagree with these statements. Use a scale of 1-5 where 1= No extent, 2= little extent, 3=moderate extent, 4=great extent and 5=very great extent.

| STATEMENT | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| A Credit term is a contractual stipulation under which a firm grants | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| credit to its customers | | | | | |
| Credit terms give the credit period and the credit limit. | | | | | |
| Credit terms normally stipulate the credit period, interest rate, method of calculating interest and frequency of loan installments | | | | | |
| Maturity of a loan, this is the time period it takes a loan to mature with the interest | | | | | |
| By understanding the borrower, the risk premium can be ascertained and the profit erosion from bad debts can be decreased hence increasing bank performance. | | | | | |
| Discounts are offered to induce clients to pay up within the stipulated period or before the end of the credit period | | | | | |
| Discounts are meant to accelerate timely collection to cut back on the amount of doubtful debts and associated costs. | | | | | |
| The cost of loan is the interest charged on loans and it is different for financial institutions dependent on the market rate and competition | | | | | |

8. In general, to what extent has credit terms influenced financial performance of your Bank?

| | |
|---|---|
| Very great extent | [ ] |
| Great extent | [ ] |
| Moderate extent | [ ] |
| Little extent | [ ] |
| No extent | [ ] |

**SECTION C: CREDIT APPRAISAL PROCESS**

9. Below are several statements on credit appraisal process and how it influences the loan performance among the commercial banks. Kindly indicate the extent to which you agree or disagree with these statements. Use a scale of 1-5 where 1= No extent, 2= little extent, 3=moderate extent, 4=great extent and 5=very great extent.

| STATEMENT | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| To assess the credit risk, banks need to take a close look at the borrowers' economic, legal and environmental situation | | | | | |
| Segmentation is done to differentiate the services offered to individualize the respective marketing efforts | | | | | |
| The first step in loan processing is the application where initial interview and screening is conducted by a loan officer. | | | | | |
| Credit analysis is done based on provided information from the borrower. A recommendation report is made on granting or | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| denying the loan applicant | | | | | |
| Loan officers check for collateral and guarantors | | | | | |
| Loan officers inputs the loan application into the bank's commercial loan system and files the application | | | | | |
| Loan servicing and administration is done a loan officer, who also prepares the loan payment notices to notify the borrower and is responsible for receiving periodic payments. | | | | | |
| The loan officer makes periodic visits to customers to obtain financial statements and verify information so as to avoid bad debts | | | | | |
| The loan officer adjusts loan terms and conditions as deemed necessary and takes legal action if non-collectible procedures and foreclosure on the loan are required. | | | | | |

10. In general, to what extent has credit appraisal process influenced the financial performance at your Bank?

| | |
|---|---|
| Very great extent | [ ] |
| Great extent | [ ] |
| Moderate extent | [ ] |
| Little extent | [ ] |
| No extent | [ ] |

**SECTION D: CREDIT RISK CONTROL**

11. Below are several statements on credit risk control and how it influences the loan performance among the commercial banks. Kindly indicate the extent to which you agree or disagree with these statements. Use a scale of 1-5 where 1= No extent, 2= little extent, 3=moderate extent, 4=great extent and 5=very great extent.

| STATEMENT | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| It is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk by use of an optimum credit policy | | | | | |
| Financial institutions should focus on a good credit policy framework for their prevention and control of quality portfolio | | | | | |
| Credit policy influences the financial performance of the organizations. | | | | | |
| Financial ratios and credit indicators are used as a measure of the bank's performance | | | | | |
| Key Credit controls included loan product design, credit | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| committees, and delinquency management | | | | | |
| By establishing a committee of persons to make decisions regarding loans; this is an essential control measure in reducing credit risk | | | | | |
| Clear communication is a logical first step towards developing a zero-tolerance institutional culture on credit risks | | | | | |
| Creating staff incentives system is an effective way of discouraging delinquency | | | | | |
| Delinquency Penalties: Clients should be penalized for late payment. | | | | | |
| Organizations should have policies like collection policy to encourage loan repayment | | | | | |

12. In general, to what extent has credit risk control influenced financial performance of your Bank?

Very great extent [ ]

Great extent [ ]

Moderate extent [ ]

Little extent [ ]

No extent [ ]

**SECTION E: PERFORMANCE OF LOANS**

13. Below are statements on performance of loans. Kindly indicate the extent to which credit policy has affected the performance of loans in your bank. Use a scale of 1-5 where 1= strongly disagree, 2= Disagree, 3= Neither Agree nor Disagree, 4=Agree and 5=Strongly Agree.

| STATEMENT | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Credit policy has led to reduced level of NPL | | | | | |
| Credit policy has improved the recovery of loans written off | | | | | |
| Credit policy has reduced the issuance of bad loans | | | | | |
| Credit policy has improved loan applicant vetting | | | | | |

**THE END**

## APPENDIX IV: A LIST OF COMMERCIAL BANKS IN KENYA

1. Bank of Africa
2. Bank of Baroda
3. Bank of India
4. Barclays Bank
5. Brighton Kalekye Bank
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Eco bank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. Fina Bank
22. First Community Bank
23. Giro Commercial Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank AG Zurich
27. I&M Bank
28. Jamii Bora Bank
29. Kenya Commercial Bank
30. K-Rep Bank
31. Middle East Bank Kenya
32. National Bank of Kenya
33. NIC Bank
34. Oriental Commercial Bank
35. Paramount Universal Bank
36. Prime Bank (Kenya)
37. Standard Chartered Kenya
38. Trans National Bank Kenya
39. United Bank for Africa
40. Victoria Commercial Bank
41. Faulu Bank
42. First Bank
43. Southern credit bank

**Source: Central Bank of Kenya (CBK)**