Non-Performing Loans and Commercial Bank Credit Lending Decisions in Kenya

Laban Kinyua Chege [1]
DR. Ambrose Jagongo, PhD [2]

1 (PhD Finance student, Kenyatta University, Kenya
2 (School of Business, Department of Accounting &Finance, Kenyatta University, Kenya:

Abstract: *The level of non-performing loans reported by the commercial banks in Kenya has been on an exponential rise in the last six years. As the credit risk evolved, commercial banks diversified their loan book by increasing the weight of loans to the public sector in their balance sheet. The growth of loans to the private sector has lagged behind the high growth of loans to the public sector. The study sought to assess the effect of non-performing loans on commercial banks credit lending decisions. The specific objectives of the study were to determine the relationship between non-performing loans and commercial banks credit lending decisions to the public sector and the relationship between non-performing loans and commercial banks credit lending decisions to the private sector. non-performing loans had a p-value of 0.00 indicating a significant relationship with commercial bank credit ending decisions to the private sector. non-performing loans were found to have an insignificant relationship with commercial bank credit lending decisions to the public sector.*
Key words: *Non-performing loans, Commercial bank credit lending decisions, private sector, public sector.*

I. Introduction and background

Non-performing loans refers to loans that demonstrate a lag in repayments. The commercial banking sector has been vulnerable to adverse credit risk movement (IMF, 2021). The persistence in deterioration of loan quality pauses a threat to the operational capacity of the banking system and a likely financial contagion to other sectors of the economy (KPMG, 2017). The most recent recommendations by Basel committee (2017) on commercial bank regulations proposes stricter capital adequacy measures that address total capital, bank liquidity and a forward looking loan administration. From the year 2017, commercial banks are required to have a common equity tier one capital of at least 4.5% of risk weighted assets, a tier one capital of at least 6% of risk weighted assets and total tier one and two capitals of at least 8% (Basel, 2017). A forward looking administration of loan book has made it mandatory for commercial banks to make loan loss provisions of actual and expected loan default.

Credit lending decisions refers to the allocation of loans to the public and credit sector. Lending is the primary activity of commercial banks accounting for more than 70% of income generation (Karim et al., 2013). At the heart of decision making in lending, credit risk arising from default informs the maturity transformation role of the commercial banks. Government and government led parastatals and state owned entities in Kenya and the private sector provides the clientele base for commercial banks. Central governments across the world result to domestic debt towards financing budget deficits (OECD, 2015). Domestic debt is regarded as default free owing to the ability by the government to result to printing its own currency in case of cash crunch and or raise funds though fiscal policy measures to meet debt obligations. The private sector is regarded as risky and oftentimes commercial banks impose high interest rates while lending to the private sector to warn of default. In a scenario where government and private sector are competing for available commercial loans, economic growth lags due to the crowding effect. The gross money multiplier by commercial banks ranks higher than government sector. It is important that commercial banks allocate a higher proportion of loans to the private sector to both support entrepreneurial activities and support economic growth (IMF, 2021).

II. Research problem

Commercial banks play an integral role as the primary custodian of wealth in an economy. Their role in financial intermediary and transmission of monetary policy is critical to the heath of country (CBK, 2021). Creation of loans through maturity transformation is the mainstay and primary business of a commercial bank (Richard, 2011). It therefore follows that lending constitutes the largest source of revenue for a commercial bank. Commercial lending activity exposes a bank credit risk arising from default in loan repayment (Equity

---

Bank, 2021). Therefore, a high volume of loans does not commensurate to higher profitability level unless such assets assume normal repayment behavior. The central bank of Kenya has reported a deteriorating nature of the loans held in the commercial banks with the level of NPLs registering an increase year to year.

Figure 1: Trend in Non-performing loans
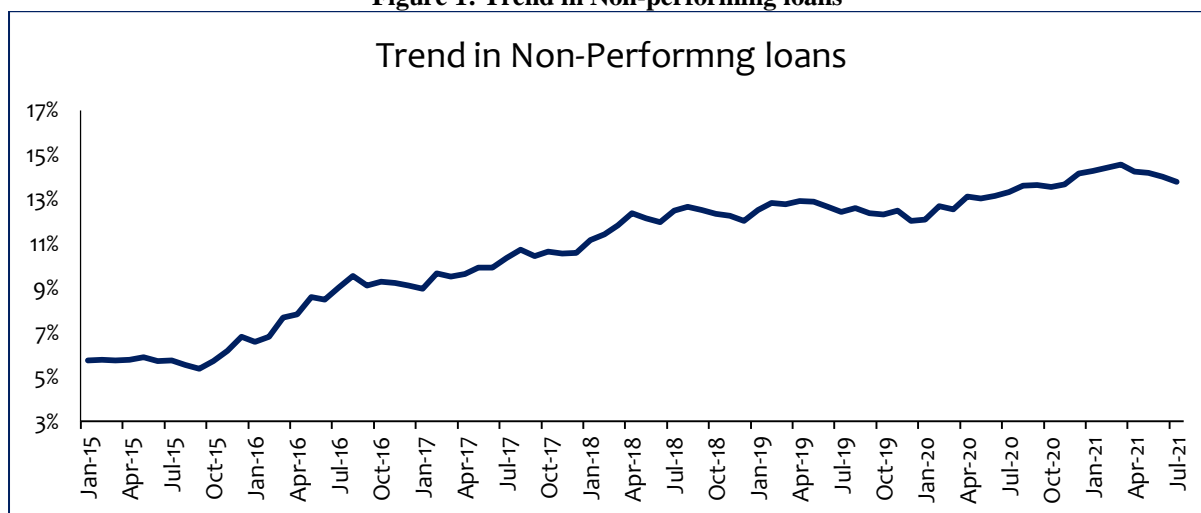
Source: CBK, 2021

The decline in the quality of the loan book held by the commercial banks has not been in isolation in that there has been a change in the operational framework of commercial banks. During the periods 2015 and 2021 commercial banks sector gross loans have risen by 54% as indicated in the CBK bank (2021) banking report. The loan profile is largely diversified since 2015—credit growth to the private sector has lagged the credit growth to the public sector.

Figure 2: Trends in credit growth
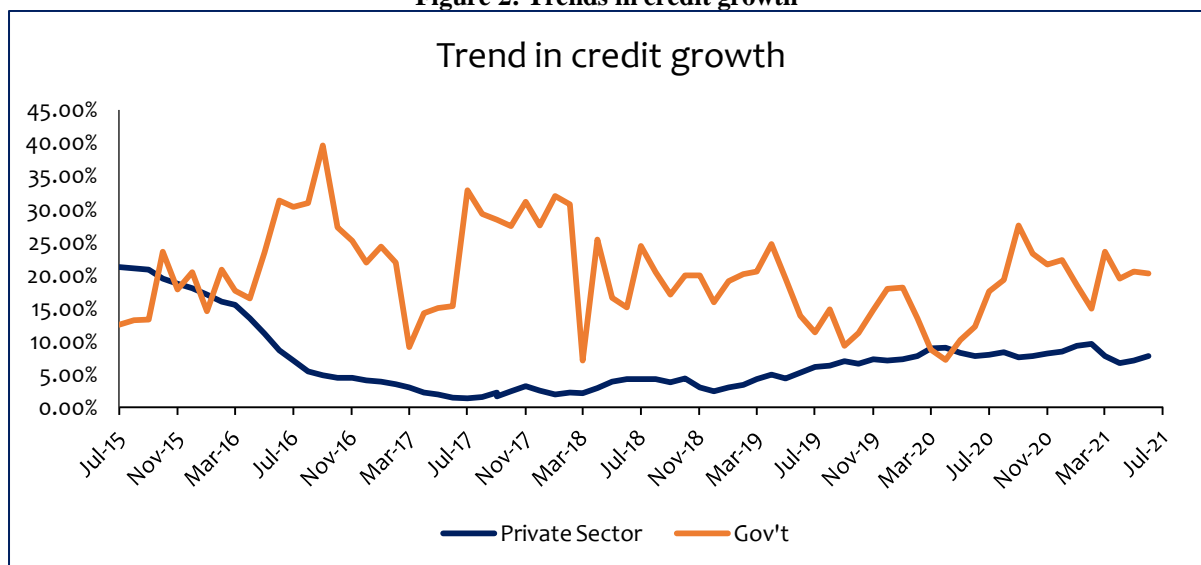
Source: Researcher 2021

The growth in the level of NPLs has defied the developments in the banking sector over the last six years (2015 to 2021) that includes: documentation of borrower's credit history through the establishment of credit reference bureau, stricter implementation of prudential guidelines on banks that enhanced capital adequacy, liquidity management and credit underwriting procedures and continuous capacity development programs for the staff as per the guideline of CBK. The general expectation was that lenders would enhance their credit underwriting procedures and henceforth a decline in the level of NPLs. However, the trend has assumed the contrary expectation. Therefore, the broad question of this study is to assess the relationship between non-performing loans and credit lending decisions of commercial banks in Kenya.

III.   Objectives of the study

The general objective of this study was to establish the relationship between non-performing loans and credit decision of commercial banks

The specific objectives of this study were:

i.   To establish the relationship between non-performing loans and commercial bank credit lending decisions to the private sector in Kenya.

ii.   To establish the relationship between non-performing loans and commercial bank credit lending decisions to the publicsector in Kenya.

IV.   Methodology

The target population of this study were the commercial banks in Kenya. The data collected was quantitative. The data on non-performing loans was collected from the central bank of Kenya between the year 2015 and 2021. The data on credit lending decision which referred to growth in gross loans advanced to the private and public sector was collected from the central bank of Kenya between the year 2015 and 2021. Linear regression method was adopted for analyzing the data.

The empirical model is shown below

1. $Y_t = \beta_0 + \beta_1 X_t + \varepsilon$

Where:

$Y_t =$ private sector lending at time t

$\beta_0 =$ Constant

$\beta_1 =$ Coefficient

$X_t =$ Non-Performing Loans at time t

$\varepsilon =$ Error term

2. $Y_t = \beta_0 + \beta_1 X_t + \varepsilon$

$Y_t =$ government sector lending at time t

$\beta_0 =$ Constant

$\beta_1 =$ Coefficient

$X_t =$ Non-Performing Loans at time t

$\varepsilon =$ Error term

V.   Results And Findings

Figure 3: relationship between Non-performing loans and commercialbank credit lending decision on private sector

Variable	Coefficient	Standard Error	T	P-Value
Constant	0.197604	0.0232626	8.494	2.02e -012
Non-performing loans	-1.14680	0.204418	-5.610	3.64e -07

Source: Researcher 2021

Non-performing loans were found to have a negative and significant relationship with commercial banks credit lending decisions to the private sector. A one percentage increase in non-performing loans would result to 1.1% decrease in the volume of loans advanced to the private sector.

Figure 4: Relationship between Non-performing loans and commercialbank credit lending decision on public sector

Variable	Coefficient	Standard Error	T	P-Value
Constant	0.236471	0.0374060	6.322	2.01e -08
Non-performing loans	-0.323177	0.328701	-.9832	0.3289

Source: Researcher 2021

Non-performing loans were found to have a negative and insignificant relationship with commercial bank credit sector lending decisions to the government sector.

VI.   Conclusions

The study concluded that the level of non-performing loans in the banking sector was found to be a significant determinant of loans advanced to the private sector. The study also concluded that the level of non-performing loans in the banking industry had an insignificant relationship with credit lending decisions to the public sector.

References

[1]. Basel Committee on Banking Supervision, (2013). Basel III: The Liquidity Coverage Ratio and Liquidity risk monitoring tools. *Bank of International Settlements*.
[2]. Central Bank of Kenya. (2021). Bank supervision: Prudential guidelines. Retrieved from https://www.centralbank.go.ke/monthly-economic-indicators/.
[3]. Equity bank (2021). Investor relations: Statement of financial position. Retrieved from https://equitygroupholdings.com/investor-relations/.
[4]. IMF (2021). Global financial stability. Retrieved from: https://www.imf.org/en/Publications/GFSR/Issues/2021/04/06/global-financial-stability-report-april-2021.
[5]. Karim, M. Z. A., Chan, S. G., & Hassan, S. (2010). Bank Efficiency and Non-Performing Loans: Evidence from Malaysia and Singapore. *Prague Economic Papers,2*.
[6]. KPMG (2017): Non-Performing loans. What can EU banks expect in 2018? https://home.kpmg/xx/en/home/insights/2017/12/non-performing-loan-fs.html
[7]. Richard, E. (2011). Factors That cause non-performing loans in commercial banks in Tanzania and strategies to solve them. *Journal of Management Policy and Practice, 12*(7), 50 – 57.