

EFFECTIVENESS OF CREDIT APPRAISAL ON LOAN PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract: For commercial banks to minimize loan losses, it's essential they develop an effective credit risk management. Credit management starts with the sales and does not stop until the full and final payment has been received. The central bank annual supervision report 2015 indicated high incidence of credit risk reflected in the rising levels of non-performing loans by the commercial banks in the last 10 years. This results in loan losses when ultimately loan recovery flops and also creation of provision for doubt debts thus affecting overall profitability. Therefore, this study aims at assessing the effectiveness of credit appraisal on loan performance in commercial banks in Kenya. This study was intended to be of significance to various parties namely the banks management, customers, investors and even the government. This study suffered difficulties due confidentiality of credit information but the researcher obtained an introductory letter from the university and assured respondents of confidentiality. Descriptive research design was used. The population comprised of 86 respondents. That is, one credit manager and one credit officer from one branch of each of the 43 commercial banks registered with central bank of Kenya as at this year. A census study was conducted since the target population was small. Data was collected using a self-administered questionnaire through drop and pick later method. The questionnaire was both open and closed ended. Test retest method was used to ensure reliability while piloting was used to check the validity of the research instrument. Data was analyzed using frequencies, percentages and means. Correlation was used to compute the degree of association between variable. The hypothesis were tested using chi square. Data was thereafter presented using table and pie charts. Credit appraisal was found to be very important in influencing performance of commercial banks. Findings revealed that lending placed much reliance on use of past information and thus credit referencing and credit history were applied more in credit appraisal. It was recommended that credit appraisal should be carried out by the technical people who are experienced and competent credit officers. Use of a multi-variate approach to credit risk appraisal was also recommended.

Key words: Credit, Credit Appraisal, Loan Performance, credit risk.

INTRODUCTION

Commercial banks are financial institutions and play a very important role in an economy. Specifically, they channel financial resources from savers (surplus units) to lenders (deficit units). In developing economies, they help borrowers who have no access to capital markets, (Akkizidiz, 2008). According to Fallon, (1996) commercial banks face three types of risks, financial risk-with credit risk being a component, operational and strategic risk. These risks have different impact on performance of commercial banks. The magnitude and the level of loss caused by credit risk compared to others is severe in causing banks failures.

The concept of credit can be tracked back in history and it was not appreciated until and after the second world war when it was largely appreciated in Europe and later in Africa (Haron, 2004). Banks in USA advanced credit to customers with high interest rate which sometimes discouraged borrowers and 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 (IFSB, 2003). In Africa the concept of credit was largely appreciated in the 50's when most banks started opening the sections and department to give loans to white settlers. In Kenya credit was initially given to the rich people and big companies and was not popular to the poor.

Poor loan quality arise from the information processing mechanism. It starts all the way from the loan application stage and increase further at the loan approval, monitoring and controlling stages especially when credit risk management guidelines in terms of policy and procedures for credit processing do not exist or are weak or are incomplete. Upon a client making a loan application, a credit officer should identify all probable risk factors associated with that particular credit. Commercial banks should put in place a very effective forecasting ability to calculate risk under all market conditions.

Credit appraisal is mainly carried out to determine whether to accept or reject the proposal for credit. It involves evaluating the loan application to find out the borrower's repayment capacity. The primary objective is

to ensure the safety of the money of the bank and its customers. The appraisal process involves an evaluation of credit worthiness of the borrower and future expected stream of cash flows with the amount of risk attached to a specific borrower.

Loan performance refers to the non-performing loans (represents credits which the banks perceive as possible loss of funds due to loan defaults) as a proportion of total loans. This is the non performing loan ration (NPLR). A non performing loan is either in default or close to being in default. This requires bank to create a provision for such a doubtful debt. Subsequently, if the loan is not repaid ultimately, it becomes a bad debt. From the accounting point of view both bad debts and provisions for doubtful debt impacts negatively on the banks profitability. Once a loan becomes a non performing one, the probability of it being repaid later is considered to be substantially very low. Should the debtor start making payments again on the non performing loan, it becomes a re-performing loan even if the debtor may be up to date with all outstanding installments.

Statement of the Problem

The success of commercial banks largely depend on the effectiveness of their credit management system because these institutions generate most of their income from interest earned on loans extended to small and medium entrepreneurs. The central bank annual supervision report, 2015 indicated high incidence of credit risk reflected in the rising levels of non-performing loans by the commercial banks in the last 10 years, a situation that has adversely impacted on their profitability. This trend not only threatens the viability and sustainability of the commercial banks but also hinders the achievement of the goals for which they were intended which are to provide credit to the middle and upper income class but also to the rural unbanked population and bridge the financing gap in the mainstream financial sector.

Bad credit can be stemmed out by proper risk identification and appraisal. Thus effectiveness of risk appraisal has a direct influence on loan performance. However, according to Auronen (2003), the asymmetric information theory holds that it is difficult to differentiate a good borrower from a bad borrower. This calls for critical appraisal of all the identified risk factors so that only good borrowers are granted the credit. When this is successfully done, the chances of default would be reduced drastically. This study therefore aimed at establishing the influence of credit appraisal on loan performance of commercial banks in Kenya.

The main objective was to determine the effect of credit appraisal on loan performance of commercial banks in Kenya.

LITERATURE REVIEW

Modern portfolio theory (MPT) proposes how rational investors should use diversification in order to optimize their portfolios. It also discusses how a risky asset should be priced. This does not mean that early economists ignored financial markets. Fisher(1930) had already outlined the basic functions of credit markets for economic activity, specifically as a way of allocating resources over time and had recognized the importance of risk in the process. In developing the theories of money, Maynard (1936), had already conceived of portfolio selection theory in which uncertainty played an important role.

However, for many economists during this early period, financial markets were still regarded as mere casinos rather than markets properly speaking. In their view, asset prices were determined largely by expectations and counter expectations of capital gains and thus they were held up by their own bootstraps as it were. John Maynard Keynes beauty contest analogy is representative of this attitude (Maynard 1936).

As such, a good amount of ink was spent on the topic of speculative activity (i.e. the purchase/temporary sale of goods or assets for later resale). For instance, in their pioneering work on futures markets, Maynard (1923, 1930) and John(1939) argued that the price of a futures contract for delivery of a commodity will be generally below the expected spot price of that commodity (what Keynes called normal backwardation).this, Keynes and Hicks argued ,was largely because hedgers shifted their price risk onto speculators in return for a risk premium. Nicholas (1939) went on to analyze the question of whether speculation was successful in stabilizing prices and, in so doing, expanded Keynes theory of liquidity preference considerably.

Holbrook (1962) disputed this, arguing that there was, in fact, no difference between the motivations of hedgers and speculators. This led to an early empirical race (Hendrik Houthakker 1969) finding evidence in favor of normal backwardation and Lester Telser (1958,1981) finding evidence against it.

Williams (1938) was among the first to challenge the casino view economist view economist held of financial market and questions of asset pricing. He argued that asset prices of financial assets reflected the instruct value of an asset, which can be measured by the discounted stream of future expected dividend from the asset. This fundamentalist notion fit well with riving fishers (1930) theory, and the value –investing approach of practitioners such as Benjamin graham.

Markowitz (1999) realized that as the fundamentalist notion relied on expectations of the future, then

the element of risk must come into play and thus profitable use could be made of the newly developed expected utility theory of Neumann and Morgenstern (1994). Markowitz formulated the theory of optimal portfolio selection in the context of trade-offs between risk and return, focusing on the idea of portfolio diversification as a method of reducing risk- and thus began what has become known as modern portfolio theory or simply MPT.

Waweru and Kalani (2009) studied banking crises in Kenya. They found that some of the causes of non-performing loans in Kenya banks were national economic downturn, reduced consumer, buying ability and legal issues. This current study appreciate that the nonperforming loan and loan delinquency concepts are similar. However this study differs significantly from Waweru and Kalani (2010) in terms of area of study, and study methodology. Although commercial banks have a primary role of providing credit, there is historical evidence of credit rationing even to creditworthy borrowers by commercial banks all over the world only 1.5 percent of MSEs receive loans from commercial banks in Kenya (international centre for economic growth 1999). It is unclear, how the rest, who form the majority, meet their working and investments needs.

Mohammad (2008) did a study on risk management in Bangladesh banking sector. His main objective was to investigate the contribution of credit risk on non-performing loans. He found that, the crux of the problem lies in the accumulation of high percentage of non-performing loans over a long period of time. As per him unless NPL ratio of the country can be lowered sustainability they will lose competitive edge in the wave of globalization of the banking service that is taking place throughout the world. Since they have had a two-decade long experience in dealing with the NPLs problems and much is known about the cause and remedies of the problem, he concluded that it is very important for the lenders, borrowers and policy makers to learn from the past experience and act accordingly.

RESEARCH METHODOLOGY

Descriptive research design was used. This design was appropriate because the study involved an in depth study of credit appraisal and the relationship between credit risk appraisal and loan performance of commercial banks. The population comprised of 86 respondents. That is, one credit manager and one credit officer from one branch of each of the 43 commercial banks registered with central bank of Kenya as at January, 2016. A census study was conducted since the target population was small. Data was collected using a self-administered questionnaire through drop and pick later method. The questionnaire had both open and closed ended questions. Test retest method was used to ensure reliability while piloting was used to check the validity of the research instrument. Data was analyzed using frequencies, percentages and means.

Research Findings

This study was set out to establish the influence of credit appraisal techniques on loan performance of commercial banks. First, the research sought to find out the specific methods used by commercial banks as shown in the next section.

Credit Appraisal Methods

Respondents were asked to state whether they agree or not to their bank using the following methods in credit appraisal. Their response was as shown in the table below.

Table Credit Appraisal Methods used by Commercial Banks

Response	Agree	Neutral	Disagree	Total
Checking repayment history	77%	15%	08%	100%
Use of past financial Ratios	76%	10%	04%	100%
Use of forecasts	66%	19%	15%	100%
Credit scoring models	54%	08%	34%	100%
Referencing with CRB	91%	09%	00%	100%
Use of the 5Cs of credit	87%	07%	06%	100%

From the aforementioned, commercial banks apply various techniques in credit appraisal and mostly a combination of methods at a go. The mostly used method as per the respondents is referencing with CRB (91%) followed closely by the use of 5 Cs of credit at (87%). The five Cs are the character, collateral, condition, capital and capacity. The customer past credit history has been applied in commercial banks since 77% of the respondents felt that way. The credit scoring model however, was not as popular as the other techniques. Only 55.4% of the respondents believe this method is applied in their institution. The wide and consistent use of the aforementioned techniques is expected to enhance the loan performance to great extent.

Appraisal Techniques and Performance of Commercial Banks

This section presents results of how various techniques affect performance of commercial banks.

Table Appraisal Techniques and Performance of Commercial Banks

Response	Agree	Neutral	Disagree	Total
Repayment history	89%	01%	10%	100%
Credit scoring models	76%	22%	2%	100%
Use of past financial Ratios	69%	10%	21%	100%
Use of forecasts	66%	19%	15%	100%
Referencing with CRB	98%	0%	02%	100%
Use of the 5Cs of credit	84%	10%	06%	100%

The table above reveals that all techniques influence loan performance in the commercial banks. Most of the respondents (98%) felt that credit bureau referencing has the most influence on loan performance. This could possibly because of accumulation of credit information and sharing of the same. Repayment history and application of the 5Cs of credit had 89% and 84% of the respondents mentioning that these techniques influence performance. Only 76% felt that quantitative credit scoring models have an influence on loan performance. The findings of this study are consistent with those of Anthony (2006) who established that the 5Cs have a significant relationship with performance.

An analysis of credit appraisal and loan performance indicated a relationship between the two as evidenced by a computed chi square value of 6.314 at 3 degrees of freedom and a computed p-value of 0.023 which was less than 0.05 at 95% confidence level. The null hypothesis that credit appraisal has no relationship with performance was rejected and it was concluded that credit appraisal has significant influence on loan performance. .

Conclusion

Credit appraisal was found to be very important in influencing performance of commercial banks. This is because it is the screening stage and those would be bad payers are sieved out and those expected to be good payers given their credit history and credit score are granted. Findings revealed that lending placed much reliance on use of past information and thus credit referencing and credit history were applied more in credit appraisal. The other techniques were also deemed effective but not as much as credit referencing and use of credit history of the borrower.

Recommendations

The commercial banks should ensure that credit appraisal is carried out by the technical people who are experienced and competent credit officer in order to stem out those with intolerable credit risk at the earliest possible opportunity.

Commercial banks should ensure a multi-variate approach to credit risk appraisal. This would ensure that there is very little chance that a would be defaulter is identified and locked out of the loan book.

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