

Predatory Loan Processing Practices and Their Influence on Loan Performance among Commercial Banks in Kenya

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Abstract: *Their role of commercial banks in any economy is critical and is known to have a strong correlation with development of a nation. In Kenya the sector contributed approximately 5% to Gross Domestic Product (GDP). The nation continues to depend on this sector to support the progressive delivery of Kenya vision's 2030 economic Pillar. However, in the last decade, loan performance has deepened by over 185 points raising concern over the stability of the sector. Recent statistics indicate that the consolidated nonperforming loans rose to slightly over Kes 0.5 trillion by 2022. The objective of this study was to examine the influence of loan processing practices on loan performance among commercial banks in Kenya. The study applied a post-positivism research philosophy and a mixed research design. The sampling frame and unit of analysis was the 39 commercial banks in Kenya (CBK, 2022). The unit of response was 234 managers of these 39 commercial banks. A closed ended questionnaire was used to collect primary data for the predictor and predictand. For triangulation, a secondary data collection sheet was used to collect secondary data for the regressand. Stability and construct validity of instrumentation were assessed using Cronbach alpha coefficient and Kaiser-Meyer-Olkin coefficients respectively using data from managers of three Micro Finance Banks in Nairobi, Kenya. Simple linear regression was used for inferential analysis after testing the data for Gaussian distribution, linearity and independence. The study found that 35.3% of the variations in loan performance could be explained by loan processing practices and that there is a statistically significant influence of these practices on loan performance. These practices include processing period as selling point, loan approval time, loan processing period appetite, disbursement timing, loan take over processing, loan processing commission, number of loans motivation, high-value to low-value loans, preferences, aggressive selling and marketing and preference to low level documentations. The study recommended that commercial banks should scan, analyze and standardize loan processing processes as they have a bearing on the quality and profiler of borrowers.*

Keywords: Triangulation, loan processing practices, predatory, loan performance

1. Introduction

1.1 Background of the Study

Bank stability would promote the sustainability of economic growth, productive employment, and decent work. CBK (2019) noted that banks are expected to accelerate the attainment of Social Development Goals (SDGs) by alleviating poverty by mobilizing savings and transforming them into investments through a loaning system. Stability of commercial banks is largely a function of loan performance. This is because their financial performance is a function of interest earnings from those loans. As such, loan performance is critical to the financial performance of commercial banks globally. An analysis of the global economy indicated the average global percentage of non-performing loans to gross loans at 5.86% in 2020. San

Marino had the highest ratio at 63.51%, and Macao had the lowest. Non-performing loans were also found to have burdened the balance sheets of many banks in Central, Eastern, and South-Eastern European (CESEE) countries. NPLs in the region increased from 3% in 2007 to 11% in 2011, destabilizing the banking system and weakening economic activity. The ranking was based on 102 countries in the world. (World Bank, 2021).

Banks advance a wide range of loans, including personal unsecured check-off loans, personal unsecured non-check-off loans, personal secured loans, salary advances and various business loans. Banks expect borrowers to repay the loans per the terms of the agreement. However, this is not always the case. Central Bank of Kenya (CBK) (2013-2022) Annual Supervisory Reports (ASR) indicated a rising trend in the ratio of non-performing loans in Kenya from 4.96% in 2013, 5.9% in 2014, 8.97% in 2015, 9.02% in

2016, 10.9% in 2017, 12.7% in 2018, 12.5% in 2019, 14.5% in 2020 and 14.1% in 2021. The recently released Annual Bank Supervisory report indicated a slight decrease in 2022 to 13.9%. The slight decline from 14.5% in 2020 to 13.9% in 2022 was attributed to the repayment of outstanding bills, intensive bank recovery measures and improved business activities as the economy continued to recover from the Covid - 19 pandemic. Commercial banks in Kenya are crucial to the economy in supporting realization of African Agenda 2063 through the flow of money in the economy for prosperity. Banks are at the center stage of attaining Kenya's Big Four Agenda. They are expected to facilitate the flow of money from the government to its citizens and back to the government through taxation and prices for public services. Exploring the root cause of the rising NPL and finding a dependable solution is key in order to safeguard the achievement of the development goals of the nation, the region and the globe at large.

1.2 Problem Statement

Over the last decade, African banks have struggled with numerous non - performing loans (NPLs), although they have not led to structural damage to their balance sheets. Global Financial Stability Report noted that NPLs in Africa stood at 10.99 % in 2019, far higher than the global average of 6.45%. Unfortunately, the situation had been projected to deteriorate significantly in the wake of the Covid - 19 pandemic. The profile of commercial banks in Kenya indicates that nonperforming loans continue to rise. In the last decade, loan performance index had risen by over 185%. The global economy analysis indicated that the average global percentage of non - performing loans to gross loans in 2020 stood at 5.86% with the highest value reported in San Marino at 63.51 % and the lowest value in Macao at 0.35%, based on a ranking of 102 countries (World Bank, 2021). In Eastern Africa Region, Burundi had the highest NPL ratio of 17.4 % in June 2017, trailed by Kenya (11%), Tanzania (8.2%), and Rwanda (8.2%), while Uganda had the lowest NPL ratio of 6.2% (WB, 2018). When a borrower fails to honor repayments, commercial banks at times resource to security seizures. Statistics released by CBK in 2021 showed that thousands of borrower properties had been flagged for auction for defaulting on loans. Similarly, the Daily Newspaper continues to report several pages of properties for auction running over ten pages almost daily, a reflection of the intensity of property recovery due to defaulted loans from commercial banks. The ratio of NPLs in Kenya was more than twice the global average, putting the business model of intermediation in disrepute. Based on literature review, a number of factors could either singly or jointly account for the rising non - performing loans, that is, lender driven practices, process driven practices, borrower driven practices or even regulatory constraints. Non performing loans pose a challenge on the economy as this institution are aimed at supporting robust financial intermediation for shared prosperity and growth the various sectors of the Kenyan economy, as aimed in Kenya Vision 2030 and beyond on one hand and as enshrined in the sustainable development goals (SDGs) on the other hand. This unfavorable trend has the effect of threatening commercial bank's role in financing the transition towards a sustainable,

low carbon economy in both developed and emerging markets.

1.3 General Objective

The general objective of the study was to assess the influence of loan processing practices loan performance among commercial bank in Kenya.

2. Literature Review

2.1 Information Asymmetry Theory

Akerlof propounded this theory in 1970, also known as information failure, which occurs when one party to an economic transaction possesses more excellent material knowledge than the other party. This usually occurs when a product or service supplier has more information about the product than the consumer. On the other hand, the borrower may have significantly more knowledge about his financial situation than the lender. The likelihood of a borrower's default may be unknown to the lender. To some extent, the lender would try to offset the risk by looking into the borrower's previous credit history and proof of a steady income. This, however, only provides a limited amount of information. As a result, lenders will demand higher interest rates to compensate for the risk. Banks would not need to impose this risk premium if all information they needed about the borrower was flawless. According to the World Bank (2019), information asymmetric is a phenomena of credit markets. Lenders addressed agency issues by requesting securities to help offset the loss should the borrower default on loan payments. Requiring collateral securities was always a big issue, especially in developing nations and new businesses where most SME owners lacked or had insufficient assets to be securities. Furthermore, the expenses associated with seizing and selling liquidated assets used as collateral are high, and the procedure is quite long and uncertain. One strategy identified to mitigate the effects of asymmetric information was monitoring and screening borrowers' behaviour. The borrower's Credit history could be a good predictor of future borrower behaviour (World Bank, 2019). Taiwo and Agwu (2016) indicated that information asymmetry occurs when one participant in a transaction has more or superior information than the other. This is common in transactions where the vendor knows more than the buyer, though it could also happen the other way around. This might be dangerous because one party could exploit the other's ignorance. Information asymmetries associated with lending to small borrowers have been attributed to hampering the flow of capital to small businesses. This theory alluded to the possibility of the unfair terms and rates used by lenders to cushion themselves against predatory borrowers as a possible cause of loan default by borrowers. Unreasonable terms such as processing fees, negotiation fees, balloon payments, and pre - payment penalties contributed to predatory loans. This theory of Information Asymmetry Theory supported the objective that sought to explore the influence of loan processing practices on loan performance among commercial banks in Kenya. This theory supported the objective that evaluated the influence of loan processing

practices on loan performance among commercial banks in Kenya.

2.3 Empirical Literature

Several studies have been done on the relationship between lender's practices and loan performance among financial institutions. For example, Jiri, Jiri, Jaroslav & Zuzana (2015) sought to investigate the model of the loan process in the context of unrealized income and loss prevention. The study recommended reducing the loan processing time to increase the number of loan customers. They further suggested that banks look for opportunities to improve the credit process for the SME segment, which was considered an essential factor for the financial performance of commercial banks and the increase of overall economic growth. Vasama (2017), in his study on operational differences between quick loan companies and traditional banks, sought to find out how the operations of quick loan companies differed from those of conventional banks. The study found that even though the bank products and those of quick loan companies seemed to be similar, they catered to somewhat different needs. The banks did not provide consumer credits for as small amounts of money as quickly as the quick loan companies. The supervisory bodies differed; banks were well supervised while fast loan companies were not. As a result, customers preferred quick loans to bank loans due to the speed of disbursement. Quick loan companies also did not require customers' information on other outstanding debts, which made them give loans to borrowers who were not credit - worthy.

Andoi (2022); Bernhardtsson and Kristen (2016) Dusko and Miroljub (2016), Wong et al. (2015), Bhowmika and Sarke (2021), Fahlenbranch et al. (2018), Thiong'o (2016); Nadeem (2020), Neacsu & Madar (2011); Wolff (2015); Tandi (2022); Credit Union Department, USA (2022), Fay (2022 found that loan processing practices had a bearing on market loan performance. A review of the past studies on loan processing practices indicated a concentration of studies in mortgage markets, SACCOs, and MFIs in the USA, England and Asia. This study analyzed the factors included in the reviewed literature and others as named below; processing period as a selling point, loan processing period appetite, disbursement timing, loan take - over processing, processing period commission, number of loans motivation, high - value to low - value loans preferences, aggressive selling and marketing and preference to low - level documentation aimed at establishing whether the findings could be generalized in Kenya and with a focus on the commercial banks in Kenya. Therefore, based on the literature reviewed, it was hypothesized that loan processing practices do not have a statistically significant influence on loan performance among commercial banks in Kenya.

2.4 Conceptual Framework

Based on economic theory and business model of the unit of analysis of this study, it was theorized that loan processing practices as the predictor (s) while the weighted scores of loan performance, the predictand. Loan performance was measured using secondary data (NPL/Gross Loans) and also

primary data (number of loans, frequency of occurrence and amount involved) for triangulation purposes.

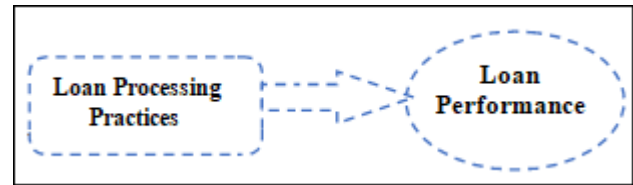


Figure 1: Conceptual Framework for Loan Processing Practices and Loan Performance

2.5 Research Gaps

Based on reviewed empirical literature and economic theory, financial intermediation business models have not been researched exhaustively and in the context of predatory finance. This study triangulated the assessment of loan performance by weighting the secondary data measures with the primary data measures to address methodological gaps in the study problem. This study sought to assess the influence of these predatory practices on loan performance among commercial banks in Kenya.

3. Research Methodology

3.1 Research Paradigm, Design and Instrumentation and Data collection

This study adopted a post - positivist research philosophy. This philosophy argue that the ideas, and even the particular identity of a researcher influences what they observe and therefore impacts upon what they conclude in a study. The paradigm commonly adopts an inferential approach and a deductive logic as the guiding tenet. In this study, the four (4) principles of phenomenalism, objectivism, deductivism and inductivism were upheld. This study adopted a mixed research designs (cross sectional - descriptive research) Mertens (2012); Sekaran & Bougie (2010).

The unit of response was six (6) head office bank managers; branch manager, branch operations manager, sales manager, credit manager, relationship manager and risk managers. On the other hand, the population was thirty nine (39) licensed commercial banks in Kenya (CBK, 2022). The population of interest was deemed to be small and hence the study adopted a census approach was taken since the population was regarded as small (Bryman, 2012, Cooper & Schindler, 2011). Primary data was collected using a structured questionnaire and in the case of secondary data, secondary data. The measurement of the loan processing practices was based on opinion, belief and an attitude based on the bank engagement with the borrowers. These constructs do not have a direct measure. As such a five point nominal scaled tool was used with the equivalences of strongly disagree (1) on one side with a scale, followed by disagree (2), neutral (3), agree (4) and strongly agree (5) on the other side of the scale (Charandrakandan, Venkatapirabu, Sekar & Anandakumar 2011). The measure for loan performance was triangulated in measurement by using a secondary measure in addition to a primary measure. The study utilized the Statistical Package for Social Sciences (SPSS) version 21 in

data analysis process. SPSS was preferred owing to its systematic capabilities on a wide range of statistical analyses and presentations (Porter & Gujarat, 2009).

3.2 Consistency of Instrumentation

The stability of instrumentation was assessed using Cronbach Alpha Coefficient. This approach to testing reliability of a data collection instrument is documented to be among the most widely used. Internal consistency test results are presented in Table 1. The results in this Table show that reliability of this construct using Cronbach was 0.740. and view that a Cronbach's coefficients of 0.7 should be acceptable as a rule of thumb to indicate a threshold for acceptable level of stability assessment. (Koshy (2010). Mertens, (2010); Bonett and Wright (2015).

Table 1: Internal Consistency Test Results

Variable	Number of Items	Cronbach Alpha Coefficient
Loan Processing Practices	10	0.740

3.3 Data Analysis and Presentation of Results

The mean and standard deviations of the ten (10) parameters of loan processing practices were generated for preliminary evaluation. This was followed by test of regression assumptions and finally inferential analysis. Hypothesis testing was done using Bivariate Linear Regression (BLR) model. Model R - Square, ANOVA statistics (F Statistic and associated p - value) and regression coefficients (Beta and associated p - value) were extracted. The equation used in this study was in the form; $Y/\text{Loan Performance} = \alpha + \beta_1 X + \epsilon$; where loan performance (LP) is (regressand) and β_1 is loan processing practices (regressor). This equation is supported by Montgomery, Peck, & Vining, 2001; Garson, 2012; Argyrous, 2011).

4. Findings & Discussions

4.1 Response Rate

Table 2: Response Rate

Bank Size	Questionnaires Distributed	Questionnaires Received	% Response
Small Bank	126	96	76.19
Medium Bank	54	48	88.89
Large Bank	54	46	85.19

Table 3: Normality Test for Composite Loan Performance Measures

	Kolmogorov - Smirnov ^a			Shapiro - Wilk		
	Statistic	Df	Sig.	Statistic	Df	Sig.
LP: Primary data Measure	.160	36	.200*	.955	36	.152
LP: Secondary Data Measures	.144	36	.159	.938	36	.143
LP: Weighted Measures	.133	36	.111	.958	36	.184

a. Lilliefors Significance Correction: *. This is a lower bound of the true significance.

Table 3 shows that the statistics are not statistically insignificant with p - values of Kolmogorov – Smirnov coefficients respectively. Similarly, the Table shows that the coefficient of Shapiro –Wilk statistics were .955 for the case of primary data measures, .938 in the case of secondary data measures and .958 in the case of weighted score for loan performance. These three statistics indicate that the three

Total	234	190	81.20
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A total of 234 (54 to large commercial banks, 54 to medium size commercial banks and 126 to small peer commercial banks) questionnaires were distributed to the three (3) peer category bank. A response rate of 85.19%, 88.89% and 76.19% were received respectively, giving a composite response rate of 81.2%. This was considered adequate for a descriptive study as it was a strong indicator that the results are generalizable and inferences could be drawn from the analysis. The response rate was attributed to anonymity and self - administration of the instrument. (Charandrakandan, Venkatapirabu, Sekar & Anandakumar, 2011)

4.2 Test of Regression Assumptions

Shevlin & Miles (2011), Chatterjee & Simonoff (2013) stated that before data analysis is done, it is important to assess a number of statistical assumptions. As such this study tested for the normality of loan performance, independence of loan processing practices and linearity of the independent variable and loan performance. In the first test, loan performance (LP) was measured using both primary data and also secondary data for the years 2017 - 2021. Average LP measures were computed for the five years and termed as “secondary measures of LP”. The primary data measuring loan performance was also weighted for the four (4) parameters used to measure the same: the number of non - performing loans, the frequency of reported non - performing loans, the amount of non - performing loans reported, and finally, the number of branches reporting non - performing loans. The resulting scores were labeled loan performance (primary data measures). The third measure loan performance was a “composite measure” computed by weighting the primary measure scores for loan performance and the secondary measure scores for the loan performance. This combined measure was labeled “weighted loan performance” measure. Kolmogorov - Smirnov and Shapiro - Wilk statistics for numerical tests of normality for LP are presented in Table 3.

measures of loan performance were normally distributed in general, implying that the data was adequate for a linear regression subject to satisfactory tests of other assumptions (Shapiro & Wilk, 1965; Garson 2012); Tabachnick & Fidell (2014). of .200*, .159 and .111 respectively for the three (3) measures of loan performance, that is, primary data measures, secondary data measures and the weighted scores,

Secondly, in the case of the test of independence for loan processing practices, Durbin - Watson d statistics d - statistic of 2.199 was extracted. This was within the recommended range of 1.5 and 2.5 for an acceptable level of no autocorrelation in a variable measure. Based on this statistic, the assumption of absence of autocorrelation in the parameters measuring the study variables was achieved (Bhattacharyya, 2011; (Argyrous, 2011). Thirdly, to test for linearity between the regressor and the regressand, Pearson's correlation coefficient (r) of 0.601** was generated at p - value of.000. This statistic indicated that a linear relationship existed between loan processing practices and loan performance. Based on this coefficient, simple linear model was deemed appropriate for testing the study hypothesis (Chatterjee & Simonoff 2013).

4.3 Hypothesis Testing

In this study, the null hypothesis H_0 : *Loan processing practices do not have a statistically significant influence on loan performance among commercial banks in Kenya*, was tested. In order to achieve this, the triangulated weighted scores of loan processing practices were regressed against weighted measures of loan performance. Model summary, ANOVA and regression model coefficients output were generated and the results presented in Table 4, Table 5 and Table 6 respectively.

Table 4: Model Fitness for Loan Processing Practices and Loan Performance

Loan Processing Practices	R	R ²	Sums of Squares	F (1, 35)	Beta (β)	t	Sig
Model Fitness	0.594	0.353					
ANOVA							
Regression			12.351	18.540			0.000
Residual			22.649				
Total			35.000				
Coefficients							
Constant					- 4.431	- 4.269	0.000
Personal Factors					1.921	4.306	0.000

Table 4 shows that there is a moderate correlation, $R=0.594$, between loan processing practices and loan performance in commercial banks in Kenya. Further, the Table shows that $R^2=0.353$, which means that approximately 35.3% of the corresponding variation in loan performance can be explained by a unit change in loan processing practices. Further, the Table shows the simple linear model robustness test at 95% level of confidence with $F=18.540$, p - value $p=0.000$, which is less than the level of significance set as $p=0.05$. Based on these results, this study hence rejects the null hypothesis that loan processing practices do not have a statistically significant influence on loan performance among commercial banks in Kenya and confirm that, indeed, there is a positive and statistically significant influence of loan processing practices on loan performance in commercial banks in Kenya.

The study was further interested in determining the significance of the bivariate linear regression between loan processing practices and loan performance. Test on the beta coefficients of the resulting model shows that the constant $\alpha = -4.431$ is statistically significantly different from zero (0), with a $p=0.000$ less than a p - value = 0.05. Similarly, the coefficient $\beta=1.921$ and an associated p - value of 0.000 was less than a p - value of 0.05, meaning that it is also significant in the bivariate linear regression model. The regression model coefficients show that a 1.921 change in loan processing practices is associated with a unit change increase in loan performance measures in commercial banks in Kenya. This implies that a unit change in loan processing practices accounts for a statistically significant change in loan performance in commercial banks in Kenya. The resultant bivariate linear model for the loan processing practices was hence be in the form;

$$\text{Loan Performance} = -4.431 + 1.921 (\text{Loan Processing Practices}) \dots\dots\dots \text{Model 1}$$

These findings agree with a study by Small Business Administration (2019) in their study on loan guaranty programs and loan performance found that lenders charged extra fees over the agreed loan fee as stipulated in the loan agreement, such as appraisal fees, insurance costs, negotiation fees, brokerage & referral fees which made the loans expensive and prone to default. The question before Congress was about the policies that would improve access to finance by small firms. Concern was also raised about the long - term adverse effects on the economy due to increased loan defaults. On the other hand, these findings vary from the findings of Obae et al. (2022), who sought to find out the influence of credit management practices on the loan performance of commercial banks in Kenya. They found out that the loan performance of commercial banks was primarily linked to efficiency in credit management practices adopted by the financial institutions. The study recommended that all commercial banks in Kenya adopt and apply credit management practices equally to reduce the amount of non - performing loans in the banking sector. Further, the results agreed with empirical studies done by: Square (2017), who noted that speed and convenience of application were some of the factors considered when evaluating a loan offer. Borrowers use time and speed of loan processing to rule out some lenders; Jilcha et al. (2019) found out that borrowers get frustrated when their loan applications take longer processing time. In response, most banks have explored ways of reducing loan processing time to improve the quality of service delivery; Financial Conduct Authority (2019) found out that payment of brokers through commissions leads to increased loan interest rates. The model created a solid incentive for brokers who overcharged the loans to earn higher commissions which in return led to

poor loan performance; Fahlenbranch et al. (2018) found out that banks in the USA with growth in the number of loans registered a significant number of under - performance in loans. Dusko and Miroljub (2016) found that the LTV ratio evaluation was a crucial quality aspect of the loan analysis, regardless of the type of loan. If the LTV ratio were inadequate, it would cause significant loan risks and financial instability. Fay (2022) indicated that most borrowers preferred simple loan documentation, but most lenders, on the other hand, preferred elaborate agreements unless the borrowers had a good credit history.

5. Conclusions and Recommendations

5.1 Conclusions

Test of robustness of the simple linear regression model for loan processing practices had an associated p - value of $p=.000 < p - \text{value of}.05$. Based on this, the associated objective's null hypothesis was rejected. This study therefore concludes that indeed, at 95% degrees of confidence, there is a positive and statistically significant relationship between predatory loan processing practices and loan performance among commercial banks in Kenya. Further, the study concluded that in terms of predatory finance theory, banks set loan processing practices, dealt with as a single predictor do actually contribute to the upward trend in nonperforming loan in the commercial banks in Kenya. Some selected practices by lenders allowing unlimited loan refinancing options for a loan, utility salary advances, multiple and open loan awards for a specify customer, failure to observe a breaks between one loan and the next new loan and locking out interest only payment during seasons of illiquidity.

5.2 Recommendations

An evaluation of the loan processing practices found that Kenyan Commercial banking is dominated by stiff competition, a characteristic of aggressive marketing and loan selling practices. Similarly, the study found that commercial banks have invested in reducing the loan processing level of documentation over time. In the reduction of documentation, it might imply that the loan "evaluation" stage might get compromised and, as such, end up not accurately profiling the potential borrower. This practice might compromise the loan performance in the end, so it should be implemented with certain controls. Policy guidelines will be a stopgap for the contributor's non - performing loans. However, certain practices should be sustained as they are likely to positively affect loan performance. These practices include; These practices include processing period as selling point, loan approval time, loan processing period appetite, disbursement timing, loan take over processing, loan processing commission, number of loans motivation, high - value to low - value loans, preferences, aggressive selling and marketing and preference to low level documentation to ensure that they are competitive in the loan processing times, de - emphasis compliance with customer pressures during the loan processing and controlling aggressive loan selling. These

practices are likely to provide reliable safeguards for loan performance.

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