

# Influence of Predatory Lender Practices on Loan Performance: Evidence from Commercial Banks in Kenya

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**Abstract:** *In Kenya, commercial banks contribute approximately 5% to Gross Domestic Product (GDP). Their role is pivotal to the progressive delivery of Kenya vision's 2030 economic Pillar. These institutions provide the payment system in the economy and access to credit to all other sectors in the economy through loans to individuals, corporate and government (s). However, loan performance trends have caught the attention of the economists and industry players. In the last ten (10) years, loan performance has deepened by over 185 points in the last decade (2012-2022). Recent statistics indicate that the consolidated nonperforming loans stood at a whopping over Kes 0.5 Trillion by 2022. The objective this study was to examine the influence of lender practices on loan performance among commercial bank in Kenya. The study applied a positivism research philosophy and a descriptive 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 stimulus variable and a secondary data collection sheet in the case of the response variable. In order to assess the internal consistency of the instrument, a pre- test was carried out using managers of three Micro Finance Banks in Nairobi, Kenya. Further, to enhance construct validity. Simple linear regression was used for inferential analysis after testing the data for Gaussian distribution, linearity and autocorrelation. The study found that 43.1% of the variations in loan performance could be explained by lender practices and that there is a statistically significance influence of lender practices on loan performance. The study recommended that commercial banks review should develop a profiling tool that identifies customers who have been on loan without a break, customer who might need financial counseling, analyze possibility of managing loan appetite for customer with questionable ability to repay, re-evaluate certain products associated with relatively higher default rates, review policy on recharging securities successively and allow potential borrowers to review loan all terms and conditions before loan award.*

**Keywords:** Lender practices, predatory, loan performance

## 1. Introduction

### 1.1 Background of the Study

The business model of commercial banks is such that it's financial performance is a function of interest earnings from loans. As such, loan performance is critical to the financial performance of commercial banks globally. 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. Commercial banks globally are losing trillions of shillings to bad loans every year. Between December 2019 and December 2020, Kenyan commercial banks' non-performing loans (NPLs) stock grew by 29.6%, from Ksh.336.6 billion to Ksh.436.1 billion. Kenya Bankers Association (2020) noted that NPLs remained at a double-digit fraction of gross loans of 12.6% by the end of 2019, almost the same as 12.7% of the previous year. Though the banking system was adequately capitalized, which is an implication that the banking system had the sufficient loss-absorbing ability to wither market shocks without triggering systemic instability, the ratio is way above the CBK recommended threshold of 5% and below. 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. Further, a well-regulated and transparent banking system provides debt financing critical in implementing the SDGs. Commercial banks are also crucial in realizing 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. The banking sector's failure would lead to the economy's downfall.

### 1.2 Problem Statement

The profile of commercial banks in Kenya portly a healthily performing sector. CBK has continued to caution and remind commercial banks to consider (among others) borrower's credit scores in lending decisions. The rationale for this is that the nonperforming loan continues to rise. In the last decade, loan performance had declined 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%. The ranking was based on 102 countries (World Bank, 2021). Over the last decade, African banks have struggled with numerous non-performing loans (NPLs), although they

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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, three times higher than the global average of 6.45% and were projected to increase significantly in the wake of the Covid-19 pandemic. The average for 2019 was based on 23 countries, with the highest value reported in Equatorial Guinea at 48.81% and the lowest value in Lesotho at 3.3% (World Bank, 2020). According to the World Bank (2018), 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%. 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. By March 2021, the properties on auction and sale in the Daily Newspaper began to fill up between six to ten pages daily, reflecting 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. This is a cause for great concern (World Bank, 2021). In the context of financial intermediation point that loan performance can be a function of a number of factors including lender driven practices. In a weak regulation environment, predatory practices of the lender would negate effects towards enhancing loan performance. This would inherently negate the efforts and contribution of the sector towards shared prosperity as enshrined in the sustainable development goals (SDGs) and further threatening their role of 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 lender practices loan performance among commercial bank in Kenya.

## 2. Literature Review

### 2.1 Agency Theory

The dilemma of agency conflicts cannot be overlooked because it affects every organization somehow. Jensen and Meckling (1976) proposed this hypothesis, noting that the agency problem stretches back to when human civilization started to be practiced, with businesses always aimed at maximizing profits. The agency problem has taken various forms and shapes as time passes. Due to differences in interests, information asymmetry between owners and management of a corporation has arisen, causing agency costs. Essentially, managers focus on achieving their personal goals, which may differ from the firm's values. This theory supported this study in that the relationship between the lender and the borrower is like that of the principal and agent. The borrower could begin as a depositor, where they become the principal and the bank the agent. However, the roles could reverse when the borrower procures credit from the bank, with the bank becoming the principal and the borrower the agent. The latter presents a case of the hunter becoming the hunted. The implementation of bank policies is made by the managers, who have the interest of the "agent"

at heart. As such management will rationally be interested in maximizing the bank earnings of the bank. Thus, the bank stands at an advantage in formulating the loan forms, sometimes hiding information in loan terms detrimental to the borrower, especially where the borrower has little or no financial literacy. This implies that banks practices can be used to in a predatory manner to maximize earnings from the borrower, through excessive charges and information asymmetry at loan contracting point, followed by rigid policies afterwards. This theory supported the objective that evaluated the influence of lender's practices on loan performance among commercial banks in Kenya.

### 2.2 Empirical Literature

Several studies have been done on the relationship between lender's practices and loan performance among financial institutions, including Abel and Andreas (2021), Fay (2021), Fuhmann (2022), Rundo and Stallo (2019), Rundo and Stallo (2021), CGAP (2018), Aguilar and Saakyan (2020), Daniel (2018), Greer and Levin (2015), Lip (2023), Jones (2022), Saruni (2020), Banking Act (2018), Montezemolo (2013), Evers (2022), Agarwal, Amromin, & Evanoff (2014), Larsen et al. (2021), European Central Bank (2017), Palinski (2018), Eckbo Su, & Karin (2021), Riggall (2022), Law Insiders (2022), and Okoth (2020). The factors considered in these studies include; loan refinancing, loan flipping, banks setting their interest rates, asymmetric information, poor transparency, hidden costs, insufficient or baseless disclosure, pay day loans (salary advances), financial insecurity of borrowers, cross-collateralization, customers credit data sharing among the banks, high overdraft fees, misleading information, persuasion to take loans soon after repaying the previous ones, lack of competent first counseling to potential clients, lack of financial counseling, imposition of substantial counseling fees, interest-only mortgages, reduced payments, allowance of grace period and arrears capitalization, renegotiation and debt forgiveness, penalty-free loan prepayment, refusal to lend money and recalling for immediate repayment of the outstanding principal and interest amount. Therefore, based on the reviewed literature, it was hypothesized that: Ho2: Lender practices do not statistically affect loan performance among commercial banks in Kenya.

### 2.3 Conceptual Framework

This study conceptualized the lender practices as the regress and for weighted loan performance. 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.

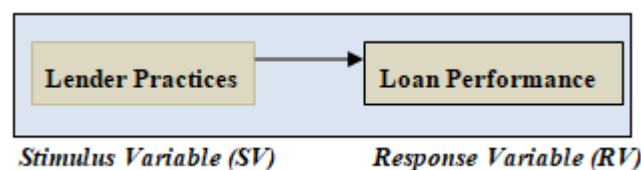


Figure 1: Conceptual Framework for Lender Practices and Loan Performance

## 2.4 Research Gaps

The study was carried out in carried out using precise parameters for the regressor and in the context of predatory finance. Further, the 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. The lender practices used in this study were, loan refinancing, interest rate variations, contract perfection, utility/ies financing, equity stripping, number of loans limiting, database perfection, cooling –off periods, loan education/counseling, balloon payments, loan spreading, cost padding and loans recalling to address the conceptual gaps. This study sought to assess the influence of these predatory practices on loan performance among commercial banks in Kenya.

## 3. Research Methodology

### 3.1 Philosophy, Design and Instrumentation and Data collection

This study was anchored on the four (4) principles of constructivism, which maintains that scientific knowledge is constructed by scientific community, which seeks to measure and construct models of the natural world. The principles were; phenomenism, objectivism, deductivism and inductivism and adopted a descriptive research design 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). Based on market share analysis, nine (9) are large peer group with 75.14% of the market share, eight (8) are in medium peer group with 16.29% of the market share and twenty two (22) are in the small peer group of commercial banks with 8.58 % of the market share (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 lender 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 Stability of Instrumentation

Internal consistency was done to assess the internal consistency using Cronbach Alpha Coefficient. The tool is said to be among the most widely used tool to assess the instrument for internal consistency. Internal consistency test results are presented in Table 1. The results in this Table show that reliability of this construct using Cronbach was 0.640. Mertens, (2010) and Bonett and Wright (2015), 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. These findings indicate that constructs required to me enhanced meeting this threshold. This was carried out during confirmatory factor analysis. This is a recommended approach to enhance reliability of the tool (Koshy (2010).

**Table 1:** Reliability test Results

Variable	Number of Items	Cronbach Alpha Coefficient
Lender Practices	13	0.640

## 3.3 Data Analysis and Presentation of Results

Data analysis was carried in four steps; that is, descriptive analysis, Confirmatory Factor Analysis (CFA), test of regression assumptions and then inferential analysis. The thirteen (13) parameters' mean and standard deviation 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  $\beta_1$  is Lender 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
<b>Total</b>	<b>234</b>	<b>190</b>	<b>81.20</b>

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 peer category bank. One hundred and ninety (190) questionnaires were totally filled and returned; 96 from large peer commercial banks, 48 from medium size peer commercial banks and 46 from small peer commercial banks. In total 190 questionnaires were filled and returned giving a composite response rate of 81.2%. This was deemed as an adequate response rate. Therefore, the response rate was regarded good for this study; an 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

Chatterjee & Simonoff (2013) stated that before data analysis is done, it is important to assess a number of statistical assumptions about the distribution of the dependent variable and the properties of the variables in general. The assumptions are basically on the response variable distribution and that of the residuals distribution.

### 4.2.1 Test of Normality for Loan Performance

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 computed for the measurement of loan performance was a composite measure computed by weighting the primary measure scores for loan performance and the secondary measure score for the loan performance. The same was labeled “weighted loan performance” measures. The Kolmogorov-Smirnov and Shapiro-Wilk statistics for numerical tests of normality for LP are presented in Table 3.

**Table 3:** Normality Test for Loan Performance Measures

	Kolmogorov-Smirnov <sup>a</sup>			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
<b>a. Lilliefors Significance Correction: *. This is a lower bound of the true significance.</b>						

Table 3 shows that the statistics are insignificant with p-values of Kolmogorov – Smirnov coefficients 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, 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 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).

### 4.2.2 Test of Autocorrelation

The test of independence for lender practices was carried out using Durbin-Watson *d* statistics. A Durbin-Watson *d*

statistics of 2.160 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).

### 4.2.3 Test of Linearity

The stimulus variable (lender practices) and the response variable (loan performance) were subjected to a linearity test using Pearson’s correlation coefficient (*r*). A correlation coefficient of 0.658\*\* was generated at p-value of .000. This statistic implied that indeed a linear relationship existed between lender practices and loan performance. Bivariate linear model was deemed appropriate for inferential analysis. (Chatterjee & Simonoff 2013).

## 4.3 Inferential Results

In order to assess the influence of lender practices on loan performance among commercial banks in Kenya, the following null hypothesis was tested by the study.

*H<sub>01</sub>: Predatory lender practices do not statistically significantly influence loan performance among commercial banks in Kenya.*

So as to test the null hypothesis, (H<sub>01</sub>) weighted scores of lender 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.

Model Fitness results were presented in Table 4 below.

**Table 4:** Model Fitness for Lender Practices and Loan Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.656a	.431	0.414	0.76565

Table 4 shows that the R was 0.656. This implies that lender practices had a moderate correlation with loan performance in commercial banks in Kenya. In addition, the R-Square was 0.431. This implies that lender practices accounted for approximately 43.1% of the variations in loan performance among commercial banks in Kenya. The model in Table 4 was further examined for its significance lender practices in predicting loan performance using ANOVA. The results for ANOVA for lender practices and loan performance are presented in Table 5.

**Table 5:** ANOVA Output for Lender Practices

		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	15.069	1	15.069	25.705	.000b
	Residual	19.931	34	.586		
	Total	35.000	35			

Table 5 show that F statistic of 25.705 and the associated p-value of 0.000< .05. This implies that the lender practices have statistically significant influence on loan performance among commercial banks in Kenya at a 5% level of

significance. Based on these results the Null hypothesis ( $H_0$ ) that stated: lender practices does not have statistically significant influence on loan performance among commercial banks in Kenya was rejected and instead confirmed that lender practices have a statistically significant influence on loan performance in commercial banks in Kenya. Regression coefficients of lender practices and loan performance are presented in Table 6.

**Table 6:** Regression of Coefficient for Lender Practices

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
1	(Constant)	-4.987	.992		-5.028	.000
	Lender Practices	1.783	.352	.656	5.070	.000

**a. Dependent Variable: Loan Performance transformed**

Table 6 shows that lender practices have beta coefficient of 1.783 and associated p value of 0.000. This implies that a unit change in lender practices is associated with a 1.783 change in loan performance in commercial banks in Kenya. The resultant Bivariate Linear Model for the lender practices will be in the form;

**Loan Performance = -4.987 + 1.873 (Lender Practices).....Model 1**

These findings agree with those of Rundo & Stallo (2019), Aguilar and Saakyan (2020) who also found that lender practices are positively related with non-performing loans. The findings are consistent with Consultative Group to Assist the Poor (CGAP), 2018 who found that lender costs were attributed to loan default. The results further agreed with those of Greer and Levin (2015) who found that lender practices were responsible for the deeping loan performance in America. The recommendations by Saruni (2020) on impact of Credit information sharing impact on loan performance were unsupported in this study. However these results are consistent with those of Montezemolo (2013) who found that absence of absence of loan-free holiday and financial counseling services was attributed to loan defaults on America.

## 5. Conclusions and Recommendations

### 5.1 Conclusions

The ANOVA statistics for lender 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 5% level of significance, there is a positive and statistically significant relationship between predatory lender practices and loan performance among commercial banks in Kenya. In addition, the study concluded that in terms of predatory finance theory, lender practices contribute to the rising rate of 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

This study recommends that commercial banks should over time analyze and consider lender practices that are likely to over-interest potential customers who might not have a loan repayment capability. The banks should develop a profiling tool that identifies customers who have been on loan without a break, customer who might need financial counseling, analyze possibility of managing loan appetite for customer with questionable ability to repay, re-evaluate certain products associated with relatively higher default rates, review policy on recharging securities successively and allow potential customers/ borrowers to review loan all terms and conditions before loan award. These practices are known to have a higher affinity to loan default and some appear predatory in nature.

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