

Effect of Strategic Management Practices on Bank Loan Recovery by Commercial Banks in Kenya: A Case of Family Bank Limited

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Abstract: *Debt is a two-edged sword. When employed wisely and in moderation it enhances people's welfare. On the other hand, when used imprudently and in excess, the result can be disastrous. Bad debts (or loans) are said to be dependent more on the industry performance than other sectors of the economy. One of the primary roles of commercial banks is to advance loans to their customers. However, not all borrowers honour the agreement between them and the banks on loan repayment. As such, they end up defaulting on loan repayment and the banks concerned suffer financially. The main objective of the study was to establish the effect of strategic management practices on loan recovery by commercial banks in Kenya. Specifically, the study sought to establish the effect of debt collection strategies on loan recovery in Family Bank Limited. The study was limited to Family Bank Limited, Nairobi Region. The study adopted a cross-sectional survey design. The target population comprised of 73 credit and 88 management staff of Family Bank Limited working in the bank's branches in Nairobi Region. A sample of 62 respondents was derived from the target population using Nassiuma's formula. The respondents were selected using stratified random sampling method. A structured questionnaire was used to collect data from the sampled respondents. A pilot test of the instrument was conducted prior to the ultimate study in order to assess the reliability and validity of the instrument. Both descriptive and inferential analyses were carried out with the aid of the Statistical Package for Social Sciences tool. It was established that, debt collection strategies influenced how the bank recovered loans. The relationship between the aforementioned variables was established to be statistically significant. It was as such concluded that collection strategies are fundamentally important to the recovery of loans and bad debts by commercial banks in Kenya. It is recommended that, commercial banks need put in place to formulate and implement strategies that can enhance more efficient and cost-effective recovery of loans. All commercial banks are further advised to put in place strategic debt monitoring strategies that will enhance recovery of loans. Scholars in the field of strategic management and financial management are recommended to conduct further studies on how strategic management practices affect recovery of bad debts in other firms such as SACCOs and microfinance institutions.*

Keywords: Bad debts, credit risk, doubtful debts, debt collection strategies, loan recovery, strategic management practices

1. Introduction

Debt is asserted to be a two-edged sword. On one hand, when employed wisely and in moderation it enhances people's welfare. On the other hand, when used imprudently and in excess, the result can be disastrous [3]. It is further argued that over-borrowing leads to bankruptcy and financial ruin of individual households and firms. Finance is asserted to be one of the building blocks of modern societies as it spurs economies to grow. It is argued that without finance and without debt, countries are poor and stay poor. On the other hand, when individuals can borrow and save, they can consume even without current income. More so, when debt is available, businesses can invest when their sales would not otherwise allow it. However, historical trends indicate that borrowing can create vulnerabilities. It is posited that when debt ratios reach certain levels, financial crises become inevitable and more severe.

Bad debts are said to be dependent more on the industry performance than other sectors of the economy. It is posited that public sector banks have demonstrated significant performance in containing bad debts. Private banks are noted to have continued to being stable in containing bad debts due to the fact that they have better risk management procedures and technology. It is revealed that a considerable amount of academic literature has dwelt on determinants of banking crisis as a consequence of bad loans in the banking system. In a study of non-performing loans in Italy, it was established that, an increase in the riskiness of loan assets

stems from a bank's lending policy [19]. The study further emphasized that as bad debts increase as a result of recession alone is not empirically demonstrated. Nevertheless, it is asserted that non-performing assets (NPA) such as bad debts may be occasioned by wrong economic decision or plainly by bad luck [2].

It was alleged that there exists a relationship between non-performing loans of India's public sector banks and operating efficiency indicators [5]. The indicators considered in the study included asset size, credit growth, and macroeconomic conditions. Moreover, a study of Argentinean banks [1] sought to measure NPAs by employing various bank-related parameters in addition to macroeconomic parameters. It was established that variables such as operating cost, exposure to loans, credit growth, and foreign interest rate had a negative effect on NPAs. It was opined [8] that, in case of Taiwanese banks, the rate of non-performing loans decreases as the government shareholding in bank goes higher up to 63.51 per cent and increases thereafter. Against this backdrop, nonetheless, it is averred that only few studies have indicated a relationship between the bank size and the level of bad loans. In the few studies that have addressed the aforementioned relationship, bank's sizes are often found to be negatively related to the rate of non-performing loan.

A study was conducted on aspects of credit management and bad debt in Nigeria commercial banks and their implication on development [4]. The study established that there exists

inefficient credit management which results in high bad debts portfolio. The latter is noted to be the principal cause that drives banks to their untimely collapse. Bad debts are said to destroy loans which are banks earning assets and as such negatively compromise banks' profitability. The higher the bad debts written off from the profit of the bank, the lower the net profit and, thus, the amount available for distribution as dividends to shareholders and the amount ploughed back into the business is affected.

There are a number of factors that contribute to default in loan repayment among commercial bank customers. It is observed [16] that, if and when the value of collateral increases the default rate is bound to decline. However, income variance as a result of economic and natural circumstances, credit service ability of borrowers decreases leading to increase in default rate. Income variances are argued to be commonplace in both manufacturing and agricultural sectors. More so, it is argued that the higher the interest rate, the more the outstanding balance the borrower has to pay relative to the principal. As such, interest rate can be argued to influence default rates and ultimately bad debts. Rate of inflation is asserted to have a link with the real interest to be paid by the borrowers. If inflation is higher than the interest rate, it implies that the lending bank would be paying borrowers to take its loans. The close monitoring of borrowers to ensure a loan is not diverted to unproductive use, though costly, has a lot of bearing on ability of the borrower to repay.

The more effort is put in ensuring utilization of a facility, the less chance of default. Commercial banks in Kenya have witnessed a high rate of loan default from borrowers which have, needless to say, led to the banks incurring huge losses [10]. The foregoing according to the scholars can be partly attributed to failure by banks to have adequate and requisite (credit history and credit worthiness) information regarding would-be borrowers. Commercial banks in Kenya are alleged to have been lending loans to serial defaulters due to banks having varied credit information regarding borrowers while on the other hand, the borrowers have capitalized on the aforementioned information asymmetry to borrow several loans from commercial banks. As a consequence, the level of NPAs is increased in Kenya's banking sector. It is further observed that effective credit risk assessment, risk management, and adequate provisions for bad and doubtful debts can reduce the banks' credit risk.

In a study on effects of interest rate spread on the level of NPAs in Kenya's commercial banks [14], it was noted that, many bad debts are attributed to moral hazard. In other words, the negative incentives on bank owners to adopt imprudent lending strategies such as lending at high interest rates to borrowers in the most risky segments of the credit market could be blamed for bad debts. A report by Pricewaterhouse Coopers looked at how new bad debts guidelines impacted on Kenya's banking institutions [18]. According to the report, Kenya Revenue Authority (KRA) issued guidelines in April, 2011 on the deductibility of bad debts. The guidelines were to come to effect from 2011 Financial Year. It is asserted that the impact of the new guidelines was to increase the amount of tax that banks paid in the short term by disallowing the bulk of their provisions

for specific bad debts. The rules were bound to negatively affect profitability of banks' profitability given that it was not guaranteed, as it used to be previously, for banks to enjoy tax relief on bad debts.

In a study on the impact of credit risk management on the financial performance of banks in Kenya [12], it was argued that, there exists a cost that is associated with non-performing loans. It was further argued that, this cost is as a result of a bank agreeing to lend a given sum of assets to a debtor and granted with expected repayment; however, in many cases the debtor is unable to repay the debt by a certain date. The fact that commercial banks can never do without lending, and that not all borrowers repay loans as agreed, then cases of bad debts are inevitable. In tandem with earlier arguments that bad debts are associated with costs, it is then fundamentally important to study the effect of such debts on profitability of commercial banks in Kenya.

2. Statement of the Problem

One of the primary roles of commercial banks is to advance credit to their customers. However, not all borrowers honour the agreement between them and the banks on loan repayment. As such, they end up defaulting on loan repayment and the banks concerned suffer from bad debts. It is asserted that, bad debts destroy loans which are banks earning assets and as such negatively compromise banks' profitability [4]. The higher the bad debts written off from the profit of the bank, the lower the net profit and, thus, the amount available for distribution as dividends to shareholders and the amount ploughed back into the business is affected.

It is noted [10] that, indeed commercial banks in Kenya have witnessed a high rate of loan default from borrowers which have led to the banks incurring huge losses. Bad debts affect not only commercial banks who are the principal lenders, but also the shareholders and the employees at large. Given that bad loans are presumed to negate banks' profits, then shareholders are likely to reap minimal dividends at the end of financial year. On the other hand, employees' financial appraisal can also be affected by the constrained profitability of the banks. Prior and after KRA guidelines of 2011, banks can claim for tax reliefs as a result of bad debts. This implies that the taxman is deprived of a certain proportion of taxes which would have otherwise contributed to the country's economic growth. The foregoing factors necessitated this study which sought to establish the effect of strategic management practices by commercial banks in Kenya.

3. Objectives

3.1 General Objective

To establish the effect of strategic management practices by commercial banks in Kenya

3.2 Specific Objective

To determine how debt collection strategies affect loan recovery by Family Bank Limited

4. Research Question

How do debt collection strategies affect loan recovery by Family Bank Limited?

5. Conceptual Framework

The empirical studies reviewed are outlined in form of a framework of variables as shown in Figure 1.

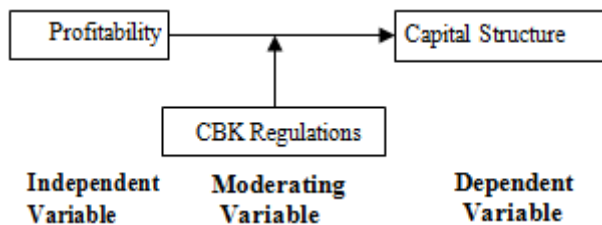


Figure 1: Conceptual Framework

As illustrated by the conceptual framework, the independent variable is debt collection strategies. On the other hand, loan recovery is the dependent variable. It is presumed that the aforementioned independent variables affect loan recovery. The presumed relationship between the two sets of variables is hypothesized to be moderated by Central Bank of Kenya's (CBK's) regulations. This is due to the fact that all financial operations of commercial banks in Kenya are regulated by the CBK.

6. Literature Review

The section reviewed theories, concepts, and empirical studies relative to strategic management practices and loan recovery in financial institutions, particularly in commercial banks.

6.1 Theoretical Review

6.1.1 Theory of Debt Maturity

This theory states that maturing risky short-term debts can impose a stronger debt overhang effect than long-term debt do, thus altering a firm's investment decisions according to [6]. The theory is said to aid in understanding implications of debt maturity structure, excessive defaults and underinvestment during recession, among others. The theory further postulates that if assets display higher volatility due to interim bad news, then equity holders with short-term debt are bound to be knocked out and lose more of the investment benefits that come in the future. The theory predicts that, granted everything else is equal, firms with higher degree of countercyclical volatilities will employ long-term debt if they object to maximize their incentive to invest.

It was argued [9] that, maturity and leverage are jointly endogenously determined. He established a positive relationship between maturity and growth opportunities. In tandem, it was asserted [6] that early default for growth firms might be more costly which pushes optimal maturity structure towards long-term. It was further noted [7] that, default receivables (debts) recording and verification have gained a great deal of attention. In tandem, banks are called

upon to be more efficient in accounting due to the fact that it would enable them to develop the risk of default. Consequently, banks' management can determine the overall strength of the banking system and its ability to handle adverse debt default conditions.

It is, moreover, stated that, the best method of analyzing and recording bad debt objected at estimating debts that are likely to go bad will depend not only on the data structure, the characteristics of the data, but more importantly on the ability of a person handling the task to classify the data, and also on the objectives of the classification. Doubtful debts occur when circumstances have rendered their ultimate recovery uncertain. On the other hand, bad debts are uncollectible and as such, are worthless to the financial institution in [7]. In context of commercial banks, the aforementioned theory can enable the management to appropriately classify the various types of debts and come up with suitable mechanisms of combating them. The theory can also be employed to understand the banking system and how best to enhance loan recovery.

6.1.2 Theory of Multiple Lending

In line with this theory, commercial banks should be less inclined to share lending (that is, loan syndication) when there is well developed equity markets and after a process consolidation. It is further noted that, both outside equity and mergers and/or acquisition enhances lending capacity of banks, thus minimizing the need of greater diversification and monitoring through share lending. The theory is highly applicable in commercial banks since their primary activity through which they earn profits is lending.

The aforementioned theory also addresses credit market theory. This is due the argument that lending and credit are closely related. A model of neoclassical credit market avers that the storms of credit clear the market. In tandem, holding collateral and other agreements constant, the interest rate is argued to be the only price mechanism with an increasing demand for credit and a given customer supply, the interest rate goes up, and the reverse is true. In other words, the higher the interest rates, the higher the chances of defaulting in credit repayment. When formulating strategies to circumvent credit risk, it would be essential for commercial banks to factor in inherent characteristics of the credit market and as such be able to determine the interest rate to fix on loans. In line with the theory of multiple lending, it is fundamental for commercial banks to assess their lending capacity prior to advancing any credit to prospective borrowers.

6.2 Empirical Review

The following section reviewed empirical studies hitherto conducted on management practices and loan recovery from strategic point of view. More specifically, studies touching on debt collection strategic and loan recovery were reviewed. The review was done from global perspective which narrowed down to regional and local (Kenyan) perspectives.

6.2.1 Debt Collection Strategies

A study on non-performing loans in Italy brought to the fore evidence that, an increase in the riskiness of loan assets stems from the bank's lending policy [19]. It is argued that adopting an aggressive lending policy may enhance the riskiness of loans and as such raise the level of NPAs. Yet, the foregoing could be contained if and when the banks on question have competent credit management expertise. The foregoing should encompass centralized debt collection function. Contrary to the general perception, lending rates have been established not to be so significant in affecting the NPAs. Indeed, it is argued that, there is very thin difference between debtors who "can't pay" and those who "won't pay". Another study [17] revealed that, there has been an increase in importance of credit risk management for both borrowers and lenders, particularly, in developing countries. The foregoing has persuaded financial institutions to start reviewing their lending policies. It is further averred that evaluating alternative lending policies can enhance minimizing credit default risks amongst financial institutions. Indeed, commercial banks are advised to establish a realistic loan repayment plan.

In Turkey [17], it was noted that, lending policies of financial institutions presented a moderate positive correlation between income and loan size. This implied that, the amount of credit advanced is determined by the borrower's level of income. It is asserted that the starting point of a sound lending and credit policy begins with knowledge of the legitimate credit need of the potential borrower. In tandem, the lending institution should ensure that debt collection strategies are constantly updated and effective. It is further noted that legitimate credit furthers the growth and stability of the community and economic wellbeing of its inhabitants including the customers. In a study on Nigeria commercial banks, it is observed that lending is one of the major functions of banks albeit it is the most risky [4]. However, every bank can only survive through lending.

Due to the fact that lending has been argued to be necessary evil, management of commercial banks are advised that they should put in place sound lending policies, adequate credit administration procedure and an effective and efficient machinery to monitor lending function with established guidelines, and reduce interest rates on lending. Ngugi (2001) in an empirical analysis of interest rate spread in Kenya observed that when commercial banks increase the lending rates, there is a likelihood of increased non-performing assets. The scholar noted that banks failed to reduce their lending rates against the backdrop of the Central Bank of Kenya lowering the rate of Treasury bill. The foregoing was argued to be as a result of declining income from NPAs.

More so, it was argued [15] that many of the bad debts result from moral hazard, that is, the adverse incentive on bank owners to adopt imprudent lending policies, specifically, insider lending and lending at high interest rates to borrowers in most risky segments of the credit markets. It has been noted that, banks employ various approaches for collecting debt depending on the ages of loans. It is alleged that failure of most of the local banks such as Trade Bank,

Pan African Bank and Continental Bank was attributed to extensive insider lending, often to politicians [14]. The scholars, in tandem, recommend that commercial banks ought to apply rigorous policies on loan advances with the object of ensuring that loans are advanced to only those with the capacity to repay and mitigate moral hazard such as insider lending and information asymmetry.

6.2.2 Loan Recovery

A study identified the relationship between the Japanese government's reluctance to solve the bad loan problem and the economic slowdown. It is, moreover, opined that in the case of Thailand, the causes of NPAs include factors like liberalized capital and current account, a legal system that made credit recovery time consuming and difficult amongst other factors. It is posited that as capital base of commercial banks increases, confidence of bank customers also increases and gets reflected in their performance. The foregoing results in effective recovery of bank loans and bringing down the level of NPAs. It is asserted that the lending rates play a significant role in bank lending. The lower the rate, the more is the recovery rate, while on the other hand, the higher the rates the higher the defaults in loan repayment.

Prior to bank lending credit to borrower, it often request for securities or collateral. According to the diagnosis of the Nigerian banking system [4] some of the securities held by banks before any lending is made to any individual, enterprise, or government have been noted to be rather unsatisfactory. Some banks request borrowers to pledge immovable securities such as buildings, heavy plants and machinery, land among others. The aforementioned collateral is advantageous given that it is stationary, and as such banks can be confident to recover their debts in case of loan default. It is alleged that, sometimes fraudulent bank officials are bribed before approving loans, while others bargain the percentage of the credit to be granted to them prior to the loan approval. The foregoing leads to poor appraisal of such credit facility, in addition to the danger of becoming a doubtful debt since the concerned bank officials may lack the moral justification to pursue and recover the advanced loan.

According to the findings of an empirical study on Kenya's commercial banks, it is recommended that banks need to allocate more funds to default rate management and reduce spending on bad debt costs in order to reduce risk on loans and achieve maximum profitability [12]. It is further asserted that, one factor that commercial banks deliberate on prior to deciding whether to advance a credit facility is the estimated chance of recovery. The aforementioned can only be achieved through credit information of the borrower including his or her previous loan processing behaviour. However, it is alleged that such information regarding a potential borrower may not be readily available which is likely to compromise optimal decision making regarding awarding the applicant the requisite loan.

7. Research Methodology

The chapter presents the step-by-step procedure that was used to arrive at study findings in tandem with the research

objectives. The study adopted a cross-sectional survey. This was due to the fact that the study took place at a specific point in time, that is September/October, 2014. It also cut across different respondents within the Family Bank Limited, Nairobi Region. The target population constituted the 73 credit officers, and 88 management staff of Family Bank Limited working in Nairobi Region. This is ascertained by the assertion that the target population is the group of individuals to whom the survey applies and also to whom the study findings will be generalized. The study being a survey employed stratified random sampling method which is an example of probabilistic sampling. Every member of the target population has a known, non-zero probability of being included in the sample. The object of such a sample is to eliminate subjectivity and thus obtain a sample that is free of bias and a representative of the target population. Moreover, the probabilistic sample enabled drawing of statistical inferences. On the other hand, stratified sampling enabled categorizing of the target population into different strata (credit and management staff), each stratum was sampled separately using Nassiuma formula [13] which resulted in a sample of 28 credit officers and 34 management staff.

Cross-sectional survey studies employ questionnaires to collect data from the sampled respondents. In this study, a structured questionnaire was used to collect data. The questionnaire contained questions and/or statements that sought responses and/or comments on a Likert scale. A pilot study was conducted before the final study in order to determine the reliability and validity of the research instrument. Reliability was tested using the Cronbach alpha coefficient (α). The study variables were deemed reliable after they attained $\alpha \geq 0.7$. In this study, the researcher sought to determine the content validity of the instrument. It is argued that there is no statistical test for content validity [11]. Therefore, the researcher sought expert advice from his University supervisors in order to determine the validity of the research instrument

7.1 Data Processing and Analysis

The collected questionnaires were assessed to ensure that the study only used the appropriately completed ones. This was followed by grouping the questionnaires according to the aforementioned strata. This was followed by both descriptive and inferential data analyses respectively which were with the help of the Statistical Package for Social Sciences (SPSS) tool. The former was in form of measures of central tendencies (means), measures of distribution (frequencies and percentages), and measures of variability (standard deviations). On the other hand, inferential analysis was in form of Pearson’s correlation coefficient. The correlation analysis enabled the researcher to determine the strength and significance of relationship between each individual independent variable and the dependent variable.

7.2 Research Findings

Out of the 62 questionnaires issued to the sampled respondents, 47 were sufficiently filled and returned. This equalled to 75.81% response rate. Some of the respondents failed to fill the questionnaires because they were

inaccessible when the filled questionnaires were being collected

7.2.1 Descriptive Findings and Discussions for Debt

Collection Strategies

The researcher sought to investigate the opinions of the respondents on issues associated with debt collection strategies in commercial banks in Kenya. Table 1 shows the results of the analysis. Collection strategies in commercial banks in Kenya

Table 1: Descriptive Statistics for Debt Collection Strategies

	Min	Max	Mean	Std. Dev.
1) Family Bank has centralized debt collection function	1	5	3.71	1.225
2) Family Bank categorizes debtors who “can’t pay” from those who “won’t pay”.	1	5	1.92	.997
3) The bank has early establishment of a realistic loan repayment plan.	2	5	3.98	.774
4) Family Bank ensures that debt collection strategies are constantly updated and effective.	1	5	3.08	1.418
5) The bank employs different collection approaches for different ages of debts.	1	5	3.64	1.432

The respondents agreed (mean ≈ 4.00) that, Family Bank has centralized debt collection function; the bank has early establishment of a realistic loan repayment plan; the bank employs different collection approaches for different ages of debts. On the other hand they disagreed (mean ≈ 2.00) that, Family Bank categorizes debtors who “can’t pay” from those who “won’t pay”. Furthermore, respondents were indifferent (mean ≈ 3.00) whether or not the bank ensures that debt collection strategies are constantly updated and effective.

7.2.2 Descriptive Findings and Discussions for Loan Recovery

Moreover, the study described the factors regarding teachers’ turnover in form of mean and standard deviation. The descriptive findings are indicated in Table 2

Table 2: Descriptive Statistics for Loan Recovery

	Min	Max	Mean	Std. Dev.
Debt collection strategies are crucial in loan recovery	4	5	4.85	.140

The findings showed that respondents strongly concurred (mean ≈ 5.00 ; std dev < 0.500) that, decision support system influences recovery of loans; debt collection strategies are crucial in loan recovery; and that, strategic debt recovery affects recovery of loans

7.2.3 Effect of Debt Collection Strategies on Loan Recovery

In line with the specific objective, the study sought to find out the relationship between debt collection strategies and loan recovery in Family Bank Limited. Table 3 illustrates the results of the pertinent analysis.

Table 3: Table 4.9: Effect of Debt Collection Strategies on Loan Recovery

Debt Collection Strategies	Loan Recovery	
	Pearson Correlation	.810*
	Sig. (2-tailed)	.000
	n	47

**Correlation is significant at the 0.01 level (2-tailed).

The findings indicate that there exists a very strong and positive relationship ($r = 0.810$; $p < 0.01$) between debt collection strategies and loan recovery. Interpretatively, debt collection strategies had a huge implication on recovery of loans by Family Bank Limited.

8. Summary, Conclusions and Recommendations

The section presents major descriptive and inferential findings in line with the study objectives. Pertinent conclusions are then drawn. Ultimately, relevant recommendations are suggested.

8.1 Summary

The respondents agreed that, Family Bank has centralized debt collection function; the bank has early establishment of a realistic loan repayment plan; the bank employs different collection approaches for different ages of debts. On the other hand they disagreed that, Family Bank categorizes debtors who “can’t pay” from those who “won’t pay”. Furthermore, respondents were indifferent whether or not the bank ensures that debt collection strategies are constantly updated and effective. The findings indicated that there exists a very strong and positive relationship between debt collection strategies and loan recovery. Interpretatively, debt collection strategies had a huge implication on recovery of loans by Family Bank Limited. The findings showed that respondents strongly concurred (mean ≈ 5.00 ; std dev < 0.500) that, decision support system influences recovery of loans; debt collection strategies are crucial in loan recovery; and that, strategic debt recovery affects recovery of loans

8.2 Conclusions

It was inferred that, Family Bank has centralized debt collection function. It was also concluded that, debt collection strategies had a huge implication on recovery of loans by Family Bank Limited.

8.3 Recommendations

The study recommends that, commercial banks ought to formulate and implement strategies that can enhance more efficient and cost-effective recovery of loans

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