

Effect of Lending Policy on Financial Stability of Commercial Banks: Empirical Evidence of Banking Sector in Kenya

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Abstract: *The study assessed the effects of Lending Policy on Financial stability of banks in Kenya. In achieving the objectives identified in this study, the collected data of listed banks were analyzed. Credit Risk Management Strategies has become an important topic for financial institutions, especially since the business sector of financial services is related to the conditions of uncertainty. The turmoil of the financial industry emphasizes the importance of effective risk management procedures. The research objective was formulated in order to gain a better understanding of credit risk management strategies and its impact on performance (Return on Assets). Credit risk has always been a vicinity of concern not only to bankers but also to all in the business world because the risks of a trading partner not fulfilling his obligations in full on due date can seriously jeopardize the affairs of the other partner. The axle of this study was to have a clearer picture of the process banks employ to manage their credit risk. The study results postulated clear and precise guidelines designed to enable Commercial Banks to make informed successful credit risk management. From the values of the coefficients the researchers discerned that the independent variables are correlated to the dependent variable. In conclusion, the study established that independent variables significantly affect credit risk management and that commercial banks need to formulate credit policies in order to minimize risk of collection but aim at increasing revenue. From the study, it is recommended that commercial banks should educate their clients on their credit policies in order to improve credit management. The study also recommends that further research should be done on the impact of credit reference reporting on credit risk management and the extent to which other hidden factors from Lending Policy for Financial Stability and performance.*

Keywords: Lending Policy, Financial Stability, Credit Risk and Defaulter, Bank performance

1. Introduction

Credit risk is the possibility that the actual return on investment or loan extended will deviate from that which was expected (Conford 2000). Coyle, (2000) defines credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time. Credit risk management strategy in a financial institution starts with establishment of sound lending principles and an efficient framework for managing the risk. Policies, industry specific standards and guidelines, together with risk concentration limits are designed under the supervision of risk management committee. These policies, standards and procedures also govern how credit risk is measured, monitored, reported and controlled (A.I. Tamimi & A.I. Mazrooei, 2007).

A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected.

2. Statement of the Problem

All over the world, financial institutions face enormous credit risks (Krestlow, 2013). Financial institutions particularly banks are very important in not only banking the low income earners in the society but also advancing credit facilities to their clients. However, just like other financial institutions, they experience many cases of default risks, moral hazard and adverse selection. CBK has set out a new directive on the treatment of credit risk management which thus has increased pressure on banks. The credit risk negates the profitability of financial institutions as they entirely depend on loan lending to increase its portfolios (Haneef et al., 2010). This is due to the fact that, when borrowers default in servicing their loans or in meeting their loan servicing obligations of the loans awarded to them, the lending institution will not get returns through interest charged on those loans. This is shown from the records of banks that borrowers do not effectively service their loans as and when it falls due in good time while others default completely.

Research Objectives

Effect of Lending Policy on financial stability of Commercial Banks.

Specific Objectives

To establish the effect of Lending policies on the financial stability of commercial banks in Kenya

3. Significance of the Study

Banks

Banks comprise the largest proportion of business in most economies and frequently offer the greatest potential for job creation. The findings of this study will help banks in zeroing in on the sensitive and critical variables of credit control and hence aid in identifying credit risks appropriately and reduce default rates consequently reducing losses in order to improve profitability.

Academicicians

Academic researchers through this study will be able to add to the existing body of knowledge the challenges faced by the financial institutions with regard to credit risk management and the relationship between credit risk management and stability.

Researchers

To the researcher it is a way of learning of its own as it will provide an opportunity of gaining skills in the aspect of research writing. The study may form a basis for further research into more facts that influence the financial performance of banks.

4. Theoretical Framework

The 5 C's Model of Client Appraisal

Financial Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower (Abedi, 2000). The 5Cs help Banks to increase Bank performance in regard to credit management level, as they get to know their customers better. These 5Cs are: character, capacity, collateral, capital and condition. Character basically is a tool that provides weighting values for various characteristics of a credit applicant and the total weighted score of the applicant is used to estimate his credit worthiness (Myers and Forgy, 2005). This is the personal impression the client makes on the potential lender. The factors that influence a client can be categorized into personal, cultural, social and economic factors (Ouma, 1996). The psychological factor is based on a man's inner worth rather than on his tangible evidences of accomplishment. Banks consider this factor by observing and learning about the individual. In most cases it is not considered on first application of credit by an applicant but from the second time. Under social factors, lifestyle is the way a person lives. This includes patterns of social relations (membership groups), consumption and entertainment. A lifestyle typically also reflects an individual's attitudes, values or worldview. Reference groups in most cases have indirect influence on a person's credibility. Banks try to identify the reference groups of their target as they influence a client's credibility.

5. Conceptual Framework

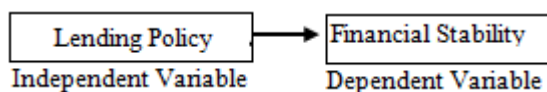


Figure: Relationship between Collection Policy and Financial Stability of Commercial Banks

6. Research Methodology

The Researchers adopted a descriptive survey design. Orodho (2003) defines descriptive survey as a method of collecting information by interviewing or administering a questionnaire to a sample of individuals. The descriptive survey method was preferred because it ensured complete description of the situation (in depth study of financial risk management), making sure that there are minimum bias in the collection of data. The study location for this research was Nairobi County Kenya. The target population was 254 Team Leaders and credit officers of the 5 banking institutions registered and operating in Nairobi County.

Table: Target Population

Category	Team Leader	Credit Officers	Total
KCB	8	45	53
CORP	7	42	49
Equity	10	62	72
NIC	4	36	40
Barclays	5	35	40
Total	44	220	254

A census survey of all 254 Team Leaders and credit officers in 5 Commercial Banks Operating in Nairobi Town was conducted. This study made use of a questionnaire as the research instrument for data collection. Before the actual data collection, pilot testing of the questionnaire was done. Galloway (1997) suggests that a population of 5-10% of the final sample is a considerably appropriate in any pilot study.

7. Results and Findings

In this section the study sought to establish whether lending policy is used to determine financial Stability and its effect on credit risk management and also to establish whether there exist a relationship between Financial Stability and involvement of Team Leaders and Credit officers in formulating credit terms.

Table: Lending Policy Respondents

Category	Frequency	Percentage %
Strongly Agree	40	83%
Agree	5	10%
Neutral	3	07%
Others	0	00%

From the analysis done, 40 respondents of the 48 whose questionnaires were received strongly agree to the use of lending policies in their banks. 5 Respondents agreed that they do have lending policies and only 3 Respondent were neutral. There were no disagreements to the usage of lending policies in the banks. This enabled us to conclude that lending policies is a key component when it comes to credit risk management. Some of these banks that strongly uses their lending policies have a very high profit margin. This indicates that there is a big correlation between lending policies and credit risk management since banks are in the business of allocating credit to make profit

8. Conclusion and Recommendations

8.1 Conclusion

The study established that credit risk management strategy is determined by formulating good Lending policies that will see banks collect its credits from its customers when it fall do. It was noted that credit lending policy significantly determined credit risk management. More importantly the study established that Banks will formulate their credit policies bearing in mind the need to increase revenue to their institutions. It therefore follows that if clients can be made aware of these factors that affect credit allocation, then they would service their loans so as to conform to the credit requirements and this will improve their credit rating.

8.2 Recommendations

The study established that lending policy positively correlated with credit risk management and Financial Stability of the firm. Commercial banks do formulate their credit policy bearing in mind the increase of revenue to the institution. The study therefore recommends that commercial banks educate their clients about their credit policies so that both the existing and potential clients wishing to apply for a loan would conform to certain requirements.

This will in turn improve the clients' credit rating thereby enhancing their chances of being granted credit once they apply. The study therefore recommends that commercial banks inform their clients whenever they are seeking information relating to their past loan serving from the credit reference reporting Bureaus.

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