Effect of Client Appraisal on Financial Performance of Financial Institutions in Rwanda: A Case Study of Guaranty Trust Bank Rwanda PLC

Mulyungi, W.D, [1] Mulyungi, M.P[2]

Jomo Kenyatta University of Agriculture and Technology

Abstract: ***A well-structured and sound Client appraisal is a prerequisite which is able to attain stability, continued profitability and long term sustainability amongst the financial institutions. The purpose of this study was therefore to establish the Effect of Client appraisal on financial performance of Financial Institutions in Rwanda based on a case study of Guaranty Trust Bank Rwanda Plc. A descriptive research design embracing qualitative and quantitative approaches was conducted on 80 employees of Guaranty Trust Bank Rwanda Plc. The data thereof obtained was analyzed by use of Statistical Package for the Social Sciences (SPSS) for descriptive and inferential statistics. Pearson correlation analysis and multiple linear regression analysis were computed to test for the relationship between client appraisal and financial performance. The results confirmed a linear, positive and significant relationship between client appraisal and financial performance with coefficient*** **R is** ***.948 and statistic p value 0.00 less than 0.005 at 4 degrees of freedom. Further, the coefficient R squared .899 suggested that client appraisal as a predictor of financial performance could explain for approximately 90% of the variations in financial performance of the banking sector in Rwanda. Thus, the study concludes that client appraisal, on the basis individuals and businesses financial and physical characteristics in credit scoring models and utilization of the credit reference bureau and client credit risk analysis on individuals is key in identifying appropriate and reliable clients for disbursement of bank loans. Hence, it is imperative that banks in Rwanda adopt appropriate appraisal strategies that enhance identification of suitable clients and borrowers to minimize on loan defaulters. Such strategies may include a combination of individual and businesses characteristics, financial and physical characteristics, credit scoring models, utilization of the credit reference bureau and client credit risk analysis amongst others.***

Keywords: Client appraisal and bank performance

1. Introduction

Credit is one of the many factors that can be used by a firm to influence demand for its products. Myers and Brealey (2013) define credit as a process whereby possession of goods or services is allowed without spot payment upon a contractual agreement for later payment. Timely identification of potential credit default is important as high default rates lead to decreased cash flows, lower liquidity levels and financial distress. In contrast, lower credit exposure means an optimal debtors' level with reduced chances of bad debts and therefore financial health.

According to Scheufler (2012), in today's business environment risk management and improvement of cash flows are very challenging. With the rise in bankruptcy rates, the probability of incurring losses has risen. Economic pressures and business practices are forcing organizations to slow payments while on the other hand resources for credit management are reduced despite the higher expectations. Therefore it is a necessity for credit professionals to search for opportunities to implement proven best practices. By upgrading your practices five common pitfalls can be avoided. Scheufler (2012) summarizes these pitfalls as failure to recognize potential frauds, underestimation of the contribution of current customers to bad debts, getting caught off guard by bankruptcies, failure to take full advantage of technology, and spending too much time and resources on credit evaluations that are not related to reduction of credit defaults.

Client appraisal is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. It is the process to ensure that the default risk is evaluated and eliminated or reduced to the least manageable levels, hence assurance that the customer will be able to pay for the products delivered or the services rendered. According to Armendariz et al., (2011), credit appraisal is a method by which a lender approximates the soundness of a loan request from the financial and technical feasibility or liability point of view. Banks must assess the credit worthiness of a borrower which is summed up in numerous Cs. These Cs constitute: capacity, character, collateral, cash flow, commitment, collateral, condition, credit history and common sense. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting.

It is a prerequisite for any entity dealing with credit transactions since it is impossible to have a zero credit or default risk. The higher the amount of accounts receivables and their age, the higher the finance costs incurred to maintain them. If these receivables are not collectible on time and urgent cash needs arise, a firm may result to borrowing and the opportunity cost is the interest expense paid. As an important aspect of credit management, Client appraisal should be in the heart of every organization that offers financial institution that extends credit to its customers. Nzotta (2014) opined that credit management greatly influences the success or failure of commercial banks and other financial institutions. This is because the failure of deposit banks is influenced to a large extent by the quality of credit decisions and thus the quality of the risky assets. He further notes that, credit management provides a leading indicator of the quality of deposit banks credit portfolio.

Without proper client appraisal, credit management will be ineffective. Credit management cant starts with the MEle and does not stop until the full and final payment has been received. It is important as part of the deal as closing the MEle. In fact, a MEle is technically not a MEle until the money has been collected. It follows that principles of goods lending shall be concerned with ensuring, so far as possible that the borrower will be able to make scheduled payments with interest in full and within the required time period otherwise, the profit from an interest earned is reduced or even wiped out by the bad debt when the customer eventually defaults (Armendariz et al., (2011

2. Statement of the Problem

The rate at which the non-performing loans have grown in the recent years in Rwanda reflects unhealthy banking system. The trend shows that banks have difficulty collecting interest and principal on their credits. That has led to poor performance for the banks in Rwanda and, possibly, bank closures (The Global Economy 2018). The National Bank of Rwanda raised concerns over the level of non-performing loans, which stood at 8.2 per cent as of June 2018. The central bank attributed the increasing non-performing loan levels to slowdown in economic activity as well as inadequate monitoring of some large facilities (National Bank of Rwanda 2019).

Bank non-performing loans to total gross loans are the value of non-performing loans divided by the total value of the loan portfolio (including non-performing loans before the deduction of specific loan-loss provisions). The loan amount recorded as non-performing should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.

Table 1: Non –Performing loans in Rwanda as a percentage of loan amounts disbursed financial years 2013 to 2018.

Year	% of Non-Performing Loan
2013	5.93
2014	5.22
2015	5.91
2016	7.08
2017	7.22
2018	8.20

3. Conceptual Framework

A conceptual framework depicts the relationship between the independent and dependent variables in a given study. The independent varible being client appraisal and dependent variable on the other hand comprised of financial performance.

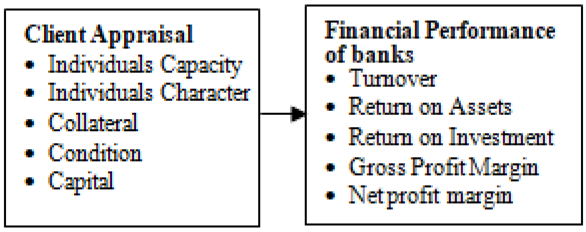

Figure 1: Conceptual Framework

4. Empirical Review

4.1 Client Appraisal

The sharp increase in the debt to income ratio in developed countries has raised concerns about a parallel rise in financial fragility that would affect financial performance of financial institutions (Rinaldi L. & Sanchis-Arellano. A (2016). Timely identification of potential credit default is important as high default rates lead to decreased cashflows, lower liquidity levels and financial distress, and ultimate low financial performance of the institution, A. Kagoyire and J. Shukla (2016), in their study on Effect of credit management on performance of commercial banks in Rwanda. Financial institutions employ credit policies that guide the technique of advancing credit (Woldie et al., 2017). Employment of appropriate client's appraisal techniques was essential to enhance financial performance (C.Simotwo, A. Nyang'au (2018). Firms can only benefit from credit if the profitability generated from increased sales exceeds the added costs of receivables. Thus the scholars were focused on effects of credit management policies with no focus on effects of client appraisal policy on financial performance. Thus financial performance of financial institutions cannot be delinked from sound client appraisal before loan disbursement. According to Armendariz et al., (2011), credit appraisal is a method by which a lender approximates the soundness of a loan request from the financial and technical feasibility or liability point of view. Banks must assess the credit worthiness of a borrower which is summed up in numerous Cs. These Cs constitute: capacity, character, collateral, cash flow, commitment, collateral, condition, credit history, common sense and computer. This study will however be restricted to the 5 main Cs which are capacity, condition, collateral, capital and character. Das (2018) notes that capacity is a critical element of establishing credit worthiness and should be the priority area since every other factor comes to aid capacity. According to Sundaremen and Dawsonera (2018), capacity is the ability to remit loan installments according to the schedule. The key variable when establishing capacity is the nature of the client's cash flows. Srinivamen (2014) argues that cash is the quintessential element especially since loan installments are remitted in cash.

Character is the other significant aspect of establishing the suitability of lending. An individual's stability is a pointer of their character strength. Goldberg and Palladini (2012) portends that character can be evaluated by examining payment patterns for utility bills as well as credits. Moreover, analysis of a bank account discloses bad habits such as habitual missed loan repayments and bouncing of checks. Capital is the other critical element. Goldberg and Palladini (2012) defined capital as owners' equity that is acquired via fresh injection of cash from personal resources or via ploughing back business profits. Borrowers must have adequate stake in the enterprise for them to strive for business success, wholly aware that mismanagement of the enterprise would be catastrophic individually (Schuster, 2015). Collateral is normally taken as a measure of last resort, and is accessed when all recovery endeavors have failed. Effendi (2013) argues that the collateral requested must possess such qualities as ready market, readily transferable as well as extrinsic and intrinsic value. Effendi (2013) further elaborates that the collateral taken should be an item that the borrower typically would not desire to lose since the loss would leave a huge void.

5. Methodology

The research used descriptive research design. The target population for this study included all the 16 commercial banks, and 331 micro finance institutions. According to the Human Resources manager of Guaranty Trust Bank Rwanda PLC staff working in the operations and credit departments and the management of these branches were 100. The study sampling frame included all 100 respondents. This research utilized primary information which was obtained by use of questionnaires structured in accordance to the specific objectives of the research, Secondary data was obtained from review of journals and reports in making sure that the study findings are reliable and accurate. Data analysis encompasses examining, categorizing, tabulating, testing or recombining both quantitative and qualitative evidence aimed at tackling the research questions (Jupp & MEpsford, 2016). This study used descriptive and inferential statistics in the analysis of data. Once data was collected, it was crosschecked and verified for errors, completeness and consistency. Data was then coded, entered and analyzed descriptively using IBM Statistical Package for Social Sciences (SSPS 23). Pearson correlation analysis was used to test the strength and direction of the relationship between variables in the study. Regression analysis was used to test the study hypotheses. Thus, multiple linear regression model for the study was $Y = \alpha + \beta 1X1 + \beta\ 2X2 + \beta\ 3X3 + \beta\ 4X4 + \varepsilon$

6. Results and Findings

6.1 Effect of client appraisal on financial performance of Guaranty Trust Bank Rwanda PLC

The study sought to establish the effect of client appraisal on financial performance of Guaranty Trust Bank Rwanda PLC. The findings of the study were presented in a five point Likert's scale as indicated in Table 1 below.

a) Effect of client appraisal on individuals and businesses before lending financial performance

Results as shown in table1, suggest that a cumulative 100% agreed that appraisal of the borrowers capacity on the basis of character, condition, credit history and collateral had an effect on the financial performance of the banks. Of the 100% respondents, 72.7% opined that client appraisal on individuals had some effects while, 27.3% of the respondents rated this aspect to have much effects.

b) Effect of financial and physical characteristics in credit scoring models on the financial performance of the bank

Cumulatively, 81.8% of the respondents as shown in table 1, opinioned that financial and physical characteristics in credit scoring models had effects on financial performance of the bank, split between 18.2% much effect and 63.6% some effect.

c) Effect of Utilization of the credit reference bureau on financial performance of the bank

A majority 54.5% posited that Utilization of the credit reference bureau had an effect on financial performance of the bank while a minority 18.2% rated this aspect has having much effect on the financial performance of the bank.

d) Effect of Client Credit risk analysis on individuals and businesses before lending on financial performance of banks

Results in table 1: suggest that a majority 54.5% rated this aspect as having some effect while a minority 9.1% were of the opinion that Client Credit risk analysis on individuals and businesses before lending had much effect on the financial performance of the banks

e) Effect of appraisal strategies on the financial performance of the bank

The study further sought to find out whether application of strategies for granting credits focusing on who, how and what ought to be done at the branches and Head office levels while appraising borrowers had effects on financial performance of the bank. Results in table 2; indicate that cumulatively 100% of the respondents alluded to the fact that use of appraisal strategies on borrowers before lending hand an effect on the financial performance. The foregoing results suggest that client appraisal, on the basis individuals and businesses financial and physical characteristics in credit scoring models and utilization of the credit reference bureau and client credit risk analysis on individuals and businesses have an effect on the financial performance of banks in Rwanda.

Table 2: Effect of client appraisal on financial performance of Guaranty Trust Bank Rwanda PLC

Statement		ME	SE	N	NE	NEA	T
Loan appraisal and subsequent approvals are on the basis of borrower's capacity, character, condition, credit history and collateral	%	27.3	72.7	0	0	0	100
Consideration of financial and physical characteristics in credit scoring models for individual loans.	%	18.2	63.6	9.1	9.1	0	100
Utilization of the credit reference bureau in choosing the right customers to lend to	%	18.2	54.5	9.1	18.2	0	100
Credit risk analysis on individuals and businesses before lending	%	9.1	54.5	9.1	27.3	0	100
Applying strategies for granting credits focusing on who, how and what ought to be done at the branches and Head office levels while appraising borrower	%	18.2	81.8	0	0	0	100

Key: ME=Much Effects, SE=Some Effects, N=not sure, NE=No Effects, NEA=No Effects at all and T=total

6.2 Correlation test for the effect of client appraisal on financial performance of banks in Rwanda

Results in table 3, indicate that the coefficient R is .948. This implying that client appraisal is strongly and positively related to the financial performance of banks in Rwanda. On the other hand the coefficient R squared is .899 suggesting that client appraisal as a predictor of financial performance could explain for close to 90% of the variation in performance within the banking sector in Rwanda.

Table 3: Correlation test for client appraisal on financial performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.948[a]	.899	.892	1.43813
Predictor(constant): Client appraisal				

6.2.1 Testing for the significance of the Correlation between client appraisal and financial performance

From the Analysis of Variance (ANOVA) table4, the statistic p value 0.00 less than 0.005 at 4 degrees of freedom. The findings imply that the relationship between client appraisal and financial performance is statistically significant and not by chance.

Table 4: An analysis of Variance (ANOVA) for the Correlation between client appraisal and financial performance

Model		Sum of Squares	df	Mean Square	F	Sig
1	Regression	1122.930	4	280.733	135.737	.000[b]
	Residual	126.160	61	2.068		
	Total	1249.091	65			

a. Dependent Variable: Financial performance
b. Predictors: (Constant), Clients appraisal

7. Discussions

The study confirmed a strong linear and significant relationship between client appraisal and financial performance in the banking sector Rwanda. The current findings are in consisted with previous studies by Kagoyire and Shukla (2016) who posited that timely identification of potential credit default is important in enhancing financial performance of the institution. Further, the current findings are in support of Simotwo, and Nyang'au (2018), who observed that adoption of appropriate appraisal techniques were essential in minimizing financial losses amongst Savings and Credit Co-operative Societies in Kenya.

8. Conclusions and Recommendations

8.1 Conclusions

The findings confirmed a significant positive relationship between client appraisal and financial performance of Guaranty Trust Bank. Hence, the study concludes that client appraisal, on the basis individuals and businesses financial and physical characteristics in credit scoring models and utilization of the credit reference bureau and client credit risk analysis on individuals is key in identifying appropriate and reliable clients for disbursement of bank loans.

8.2 Recommendations

Based on the conclusion of the study it is imperative that banks in Rwanda adopt appropriate appraisal strategies that enhance identification of suitable clients and borrowers to minimize loan default and financial losses with the sector. Such strategies may include a combination of individual and businesses characteristics, financial and physical characteristics, credit scoring models, utilization of the credit reference bureau and client credit risk analysis amongst others.

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