

Effects of Lending Policies on Loan Performance of Selected Commercial Banks in Kisii County, Kenya

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Abstract— *Lending policy is a word that used by bank employees to as a determinant of rejecting or granting loan request. Loan performance of most commercial banks in Kisii County, Kenya reveals that there is a challenge to the banking sector; the acceptance of loan reports of performance is unclear on to what extent they affect lending policies and there links to certain commercial banks. This paper analyzes the effect of lending policies on loan performance of selected commercial banks operating in Kisii County. The research used descriptive survey approach because the units of more than one and their operational features were not the same because of varying situations of the respondents. In response rate, a target population size was 270 employees and a sample size of 244 was usable in the study representing 36.4% of population size. The paper used s content validity as it measures the magnitude of validity of a content to for which the sample of the sample of the items' representation was designed for measurement. Quantitative data was analyzed using descriptive statistics tools. The results and findings of this study, would help commercial banks in Kisii County to identify whether repayment period policy, interest rates policy or collateral policy affect the performance of loans positively or negatively, so that they can be able to minimize the risks of non-performing loans.*

Keywords— *Lending policy, loan performance, interest rate policy, repayment period, collateral policy.*

I. INTRODUCTION

Commercial banks are financial institutions which accept deposits, make business loans and offers related financial services. Commercial banks also allow for a variety of deposits account such as checking, saving and time deposit. These institutions had to make a profit are and owned by a group of individual. Yet some would be members of the feral services to individuals, they are primarily concerned with receiving deposits and lending to business (Sanchez, 2009). Commercial banks in Kisii County issues different types of loans like, mortgages, loan and credit cards to meet the needs of business, government and customers. The banks' performance is based on their ability to attract a large number of customers through comparative proportion of account holders relative to other bans amount of deposits and profit was realized. Loan officers are aware of legal restrictions and basic credit principle that would make new approaches or restraints necessary to ensure that level of return was up to their expectation. Banks also allocated the remaining funds to investments in obligation of central government in meeting their obligations to their depositors, shareholders and community (Calomiris, 2009).

The Banking Act, the Companies Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK), governs the Banking industry in Kenya. In 1995 the banking sector in Kenya was liberalized and exchange controls lifted. The CBK, which falls under the Minister for Finance's docket, was responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. The Central Bank of Kenya (CBK) publishes information on Kenya's commercial banks and non-banking financial institutions, interest rates and other publications and guidelines. The Central Bank of Kenya acts as the main regulator of commercial banks in Kenya (CBK Annual Report, 2009).

Commercial banks in Kisii County played an important role in the pass-through of monetary interest rates. Nevertheless, the efficiency of transmission of decisions of central banks was a complicated process and would depend on many factors, such as level of competition in financial industry, perception of credit risk, risk aversion, availability of close substitutes for loans, etc. Moreover, banks would influence the external finance premium not only via the interest rates but also modifying the available maturity of loans or changing collateral requirements. Finally, as evidenced by broad literature on bank lending channel, credit rationing and uncertainty about creditworthiness of borrowers would markedly influence banks' risk taking thereby influencing their willingness to lend. The aspect of bank lending channel, namely risk taking channel, would play an important role in the monetary transmission (Radevic et al., 2010).

II. LITERATURE REVIEW

Two issues focused by bank channels are centered whether there are categories of borrowers who depend on bank lending in that any change in banks' willingness to lend immediately affects their investment and spending decisions. The other issue is whether monetary policy changes directly constrain bank lending to borrowers. Both conditions are necessary for bank lending to play a special role in the monetary transmission channels according to Amidu, (2006). Some recent research provided support for the view that certain borrowers, especially small businesses, were very dependent on banks for financing (Larossi, 2009).

According to Financial Sector Deepening, Kenya (2009) study, the determinants of non-performing loans in banking

sector. The empirical results show that GDP growth is inversely related to NPLs, suggesting that an improvement in the real economy translates into lower NPLs. Besides that, banks which charged relatively higher interest rates and lend excessively were likely in high risk of NPLs. Although, in contrary to earlier studies, their evidence does not support the view that large banks are more effective in investigating and monitoring loan customers when compared to their smaller fellows.

Ewert et al. (2000) study the determinants of bank lending performance in Germany using credit file information of 260 medium-sized firm borrowers for the period 1992-1998. The study aimed at testing the several theories involved with collateral to interest rate premiums and therefore lending performance, using a random effects model on panel data analysis to eliminate the borrower and time-specific effects. Two models were estimated with interest rate premiums and probability of distress as the two predicted variables. Interest rate premium was set to be predicted in a random effects model by among other variables: collateral; bank relationships; bank firm rating; firm characteristic and firm size. The highlight of this study's finding was that interest rate premium increased with rise in the collateral pledged. However, estimation of distress probabilities of the same firms revealed that more collateral and covenant in credit contracts lead to lower distress probabilities. Putting the above findings, the study gives controversial finding that riskier credit contracts are assigned lower interest rate premiums by banks.

The in 1990s the liberalization of the economy where exchange rate were made flexible and interest rates control were removed, ushering in a new era in monetary policy where open market operations (OMO) was the major strategy. This was a period featured by widening interest spread and high interest, which affected the importance of flexible interest rate policy such as improving financial savings and minimize the cost of capital. Competing against double digit inflation rate spurred on by excessive money supply and allowing of troubled banks, CBK used indirect tools to tame inflation in an atmosphere of instability and extreme uncertainty. In 1996, the CBK Act was amended and this allowed the CBK to shift from targeting broad money to targeting broader money as the principal concept of money stock (Owojori et al., 2011).

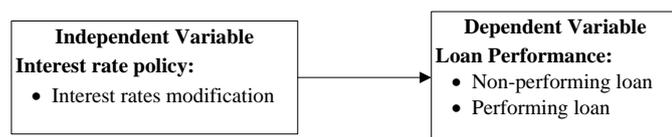


Fig. 1. Schematic conceptual framework.

General Objective

The main objective is to establish the effects of lending policies on loan performance in selected commercial banks in Kisii town, Kisii County, Kenya.

Specifically, the study intended to establish the influence of interest rate policy on loan performance in selected commercial banks in Kenya.

Research Question

In an attempt to achieve the above objective, the study developed the following question; what is the influence of interest rate policy on loan performance in selected commercial banks in Kenya?

Limitations of the Study

The study was limited to survey study design for banks. It was also limited for data of between 2002 to 2016 following years in the banking sector. Moreover, among the target population other employees were not available when the researcher wanted to conduct the study. Further, the study was limited to lending policies therefore any area outside the lending policies would not be part of this study.

III. RESEARCH METHODOLOGY

Model Specification

A multiple regression model was applied to determine the relationship between lending policies and loan performance of selected commercial banks in Kisii County, Kenya.

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Y = Y is the (dependent variable) Performance of Commercial Banks in Kisii County

X₁ = is repayment period policy

X₂ = is interest rates policy

X₃ = Collateral Policy

β₁, β₂, β₃ = Coefficients of determination of the independent variables

ε = Error term

β₀ = Intercept of the systematic component of the regression relationship.

Data Variables

Data was collected from 270 bank employee from 18 Commercial banks operating in Kisii Kenya which constituted the sample size to the study (Kenya Bankers Association, 2015). The study adopted a census sampling technique therefore all respondents in the target population was included in the sample; therefore the sample size was 224 respondents which was representing 83% of target population. Data was collected through the use of simple data collection forms which were distributed to commercial banks in Kisii County. The study used both Primary data and secondary data in which secondary data was used d to focus on already existing data (publications) to have a better understanding and provide an insightful interpretation of the results from the study. The data underwent analysis with the aid of a computer Statistical Package for Social Science (SPSS) version 21.0 programme to analyze the data using descriptive statistics.

Analytical Approach

Quantitative data was analyzed using SPSS. Inferential statistics viz. Pearson's correlation analysis, regression analysis and analysis of variance were applied.

Pearson Correlations Analysis

Table I shows the Pearson correlations for the interest rate policy variable.

TABLE I. Correlation between interest rate policy and loan performance.

		Loan Performance of Commercial Banks in Kisii County.	Interest Rate Policy
Loan performance of Commercial Banks in Kisii County.	Pearson Correlation	1	.402**
	Sig.(2-tailed)		.000
Interest Rate Policy	Pearson Correlation	.402**	1
	Sig.(2-tailed)	.000	
	N	244	244

** Correlation is significant at the 0.01 level (2-tailed).
Source: Research data (2017)

In a correlation analysis to determine the correlation between interest rates policy and loan performance; the sig value indicated that there is a significant relationship between interest rate policy and loan performance. However, the Pearson correlation value indicated that the strength of the relationship is just moderate and not so strong ($r = 0.402, p < 0.01$). Which means that as interest rate policy goes up or down so will the loan performance, in condition that other existing variables remain constant. As Pearson's r is 0.402 which is close to 0, it illustrates that interest rate policies have minimal effects on loan performance.

Regression Analysis

In order to answer the research question regarding this objective, multiple regression analysis has been conducted to determine if there is significant relationship between independent variables and loan financial performance as shown in table II.

Regression Model Summary

The results from table II shows that (R square= 0.820) 82.0% of the loan performance of Commercial Bank in Kisii County is explained by the above regression model. This provides a very strong relationship between the independent variables and the dependent variable.

TABLE II. Regression model summary.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.906 ^a	0.820	0.818	.209

a Predictors: (Constant), Repayment policy, interest rate policy, collateral policy.
Source: Researcher (2017).

Analysis of Variance (ANOVA)

TABLE III. ANOVA results.

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	193.207	14	48.303	245.839	0.0005
	Residual	59.482	181	0.886		
	Total	252.689	194			

Source: Researcher (2017)

The probability value of 0.0005 from table III above indicates that the regression model was highly significant in predicting how repayment period policy, interest rate policy and collateral policy influenced loan performance. The F calculated at 5% level of significance was 245.839 since F

calculated is greater than the F critical (value = 4.5185), this shows that the overall model was highly significant. Meaning that repayment period policy, interest rate policy and collateral policy influenced loan performance effectively.

Coefficient of Estimate

TABLE IV. Coefficient of estimate.

	Unstandardized Coefficients		Standardized Coefficients		Sig.
	B	Std. Error	Beta	T	
(Constant)	3.096	0.389		1.003	0.323
Interest rate policy	.522	.017	.904	31.385	0.000

a Dependent Variable: Performance of Bank
Source: Researcher (2017)

$$Y = \beta_0 + \beta_1 X_1 + \epsilon$$

$$Y = 3.096 + 1.812 X_1 + \epsilon$$

Finally from the significant values found in the regression; we can deduce that:

There is also a significant relationship between financial interest rates policy of lending policies and loan performance of Commercial Banks in Kisii County since the p sig. value is 0.000. Further, study results revealed that interest rates policy of lending policies had significant and positive effect on loan performance of Commercial Banks in Kisii County ($\beta_2 = 0.522, p < 0.05$). The positive relationship can be accrued by the shift from focusing and in exchanging it with diversifying the various lending policies offered by the bank. This result seems to be complemented by the findings of a study by Hirtle (2008) who argued that losses in one sector or location can be compensated from the gain obtained from other sector or location. On the other hand, if the interest rates policy level increases, it leads to rising of costs that are undertaken and interest rates policy may not be associated with higher returns in every circumstances. It is important to make strategic decisions for a bank, in cases of risk and return preferences (Kumar, 2007).

IV. CONCLUSIONS

There is statistical significant relationship between influences of interest rate policies on loan performance in selected commercial banks in Kenya. There is evidence from the study showing that interest rates policy of have led to improved loan performance of the commercial banks operating in Kenya. This points out to the fact that the bank is able to provide a wide range of services to their client base. This ultimately leads to customers spending more on using these borrowing services, thus increasing the profit margin of the bank. Consequently the ripple effect is that there is improved loan performance of the bank courtesy of the interest rates policy.

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