

COMMERCIAL BANKING CRISES IN KENYA: CAUSES AND REMEDIES

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ABSTRACT

Many Financial institutions that collapsed in Kenya since 1986 failed due to non performing loans. This study investigated the causes of non performing loans, the actions that bank managers have taken to mitigate that problem and the level of success of such actions. Using a sample of 30 managers selected from the ten largest banks the study found that national economic downturn was perceived as the most important external factor. Customer failure to disclose vital information during the loan application process was considered to be the main customer specific factor. The study further found that Lack of an aggressive debt collection policy was perceived as the main bank specific factor, contributing to the non performing debt problem in Kenya.

Key Words: Banks, Financial institutions, non performing loans, Kenya

JEL Classification: G21, G20, N27

I. INTRODUCTION AND MOTIVATION

In recent decades, a large number of countries have experienced financial distress of varying degrees of severity, and some have suffered repeated bouts of distress (Hardy, 1998). Pazarbasioglu (1999) believes that the best warning signs of financial crises are proxies for the vulnerability of the banking and corporate sector. He showed that full-blown banking crises are associated more with external developments, and domestic variables are the main leading indicators of severe but contained banking distress. He adds that the most obvious indicators that can be used to predict banking crises are those that relate directly to the soundness of the banking system.

In the 1980's and early 1990's, several countries in developed, developing and transition economies experienced several banking crises requiring a major overhaul

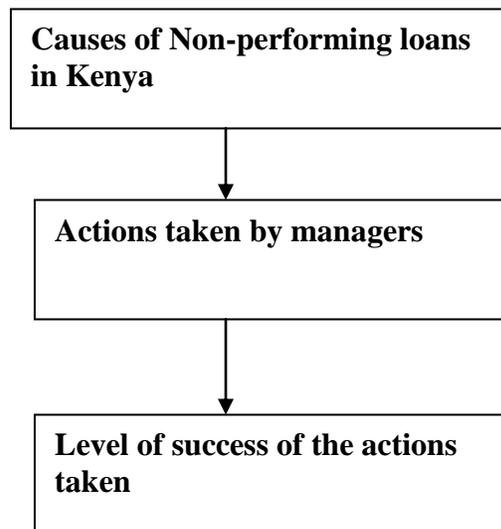
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of their banking systems (IMF, 1998). Kenya has experienced banking problems since 1986 culminating in major bank failures (37 failed banks as at 1998) following the crises of; 1986 - 1989, 1993/1994 and 1998 (Kithinji and Waweru, 2007; Ngugi, 2001). Presently, several developed countries including the USA are experiencing a banking crisis. For example the Citibank group alone, has written off more than \$39 billion in losses (Elliot, 2008). Despite the problems facing the global financial market, Canadian banks have remained relatively stable. Eliot (2008) attributes this to a combination of regulatory discipline and cultural mindset among Canadian banks.

This paper investigates the causes of non-performing loans in Kenya and the actions that bank managers have taken to mitigate this problem. We also investigate the perceived level of success of these initiatives. The study framework is shown in figure 1 below;

Figure 1: Study Framework



According to Kroszner (2002), non-performing loans are closely associated with banking crises. Sultana (2002) also links the Japanese financial crisis to non-performing loans. According to Sultana (2002), Japanese banks still suffer under the weight of thousands of billions of yen of bad loans resulting from the collapse in asset prices a decade ago in the country's financial system.

According to Central Bank of Kenya [CBK], (2003), there was a 4.5 per cent decline in pre-tax profit for the banking industry in the year 2002. Non-performing loans can be treated as undesirable outputs or costs to a loaning bank, which decrease the bank's performance (Chang, 1999). The risk of non-performing loans mainly arises as the external economic environment becomes worse off such as economic depressions (Sinkey and Greenawalt, 1991). Controlling non-performing loans is very important for both the performance of an individual bank (McNulty, Akhigbe, and Verbrugge, 2001) and the economy's financial environment.

Due to the nature of their business, commercial banks expose themselves to the risks of default from borrowers. Prudent credit risk assessment and creation of adequate provisions for bad and doubtful debts can cushion the banks risk. However, when the level of non-performing loans (NPLs) is very high, the provisions are not adequate protection. According to the CBK (July, 1999) the level of NPLs in 1998 was estimated at Shs. 80 billion or 30% of advances, up from 27% in 1997 as compared to 81.3 billion or 33.4% of total loans in November 2001. This can be compared with levels of NPLs in other countries. According to Taiwan News (2002), the NPL ratio among Taiwanese banks was estimated at 7.7 percent by the end of 2001, while the ratio among grassroots financial institutions was 16.37 percent. In the Philippines non-performing loans ratio as at July 15, 2001 stood at 16.81 percent of the total loan portfolio, up from 16.76 percent a month before, (Batino, 2001). Comparing, the ratio of non performing loans in Kenya of 33% to similar African economies as at the end of 2000, the ratio is much lower in Zimbabwe (24%), Nigeria (11%) and South Africa (3%) (CBK 2001)

According to Mikiko (2002), during the past several years, major Japanese banks have struggled in the red, with business profits swallowed by the disposal of NPLs. This has seriously dented public confidence in the deposit system. Kenya has experienced banking problems since 1986 culminating in major bank failures (37 failed banks as at 1998) following the crises of; 1986 - 1989, 1993/1994 and 1998 (Kithinji and Waweru, 2007). The crises were mainly attributed to NPLs (Murugu, 1998). For example, Daima bank, according to Mullei (2003) was placed under statutory management for failing to meet the minimum core capitalization threshold - among as well as poor management of loan portfolios.

Net loans at the level of Shs. 215 billion as at December 31st, 2001 accounted for 51% of total net assets of the Kenyan's banking sector. As this date, the proportion of non performing loans to total loans was 30% (CBK 2004). The trend of non performing loans in Kenya over the period 1995-2003 is shown in Table 1:

Table 1: Non Performing Loans 1995-2003

Year	Non-performing loans (in Kshs. billion)	Total Loans (in KShs. billion)	Percentage (%)
1995	31.8	180.2	17.6
1996	37.9	213.7	17.7
1997	69.0	248.2	27.8
1998	83.5	268.6	31.1
1999	97.3	284.2	34.2
2000	90.2	272.9	33.1
2001	73.6	245.0	30.0
2002	76.1	255.0	29.8
2003	74.6	270.1	27.6

The decrease of non performing loans during the period 2001-2003 is mainly attributed to the collapse of some financial institutions (e.g. Trust bank in 2001) and the write-offs made by some banks so as to clean their balance sheets (CBK 2003). This research sought to document the causes of non- performing loans in Kenyan banks and the relative importance of these causes with the help of questionnaires send to bank officials. The research also put on record the level of success of the steps taken by bank management to improve the management of loans. This research set out to answer the following research questions;

- 1) *What are the causes of non- performing loans in Kenyan banks?*
- 2) *What specific steps have bank managers taken to deal with the problem of non- performing loans?*
- 3) *What is the level of success of the actions?*

The remainder of this paper is organized as follows. Section 2 presents a review of related literature. The research method adopted is outlined in section three. Section four presents and discusses the findings, with conclusions and implications in the final section.

II. LITERATURE REVIEW

A. The causes of non- performing loans in banks

According to Gorter and Bloem (2002) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of nonperformance in the form of bad loan provisions, or they may spread the risk by taking out insurance.

The problem of NPL's is widespread. Nishimura, Kazuhito, and Yukiko, (2001) state that one of the underlying causes of Japan's prolonged economic stagnation is the non-performing or bad loan problem. They explain that some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This delayed structural reforms and prevented the financial intermediary system from functioning properly

In their study, Fernández, Jorge and Saurina, (2000) state that the growth of bank credit in Spain and its prudential implications is an ever-present item on the agenda of banking supervisors, since most banking crises have had as a direct cause the inadequate management of credit risk by institutions. They further assert that even though bank supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. They claim that even conservative managers might find market pressure for higher profits very difficult to overcome.

According to a World Bank report (1994) in Uganda the country's banking industry was described as extremely weak, with huge non-performing loans and some banks teetering on the verge of collapse. Mukalazi (1999) notes that reeling

from years of economic mismanagement and political interference, Uganda's banking industry posted huge losses in the early 1990s.

To help address credit risk management in Ugandan banks, the government has introduced a statute that deals with several issues such as insider lending, following the recent scandal in which billions of shillings were lent without sufficient collateral to Greenland Bank by the newly privatized Uganda Commercial Bank Ltd. The statute further seeks to reduce owner concentration (Mukalazi, 1999).

The central bank of Kenya defines NPLs as those loans that are not being serviced as per loan contracts and expose the financial institutions to potential losses (CBK, 1997). It is important to note that non-performing loans refer to accounts whose principal or interest remains unpaid 90 days or more after due date. According to the Central Bank of Kenya Supervision Report (CBK, 1999), the level of non-performing loans has been increasing steadily from shs.56 billion in 1997, to Shs. 83 billion in 1998 to shs.97 billion in 1999. This high level of non-performing loans continues to be an issue of major supervisory concern in Kenya.

According to a study by Brownbridge (1998), most of the bank failures were caused by non-performing loans. Arrears affecting more than half the loan portfolios were typical of the failed banks. Many of the bad debts were attributable to moral hazard: the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at high interest rates to borrowers in the most risky segments of the credit markets.

According to Brownbridge (1998), the single biggest contributor to the bad loans of many of the failed local banks was insider lending. In at least half of the bank failures, insider loans accounted for a substantial proportion of the bad debts. Most of the larger local bank failures in Kenya, such as the Continental Bank, Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians. The threat posed by insider lending to the soundness of the banks was exacerbated because many of the insider loans were invested in speculative projects such as real estate development, breached large-loan exposure limits, and were extended to projects which could not generate short-term returns (such as hotels and shopping centres), with the result that the maturities of the bank's assets and liabilities were imprudently mismatched. He sites three forces behind insider lending and lists them as political pressure, under- capitalization, over concentration in ownership. He further observes that second major factor contributing to bank failure were the high interest rates charged to borrowers operating in the high-risk segments of the credit market. This involved elements of moral hazard on the part of both the banks and their borrowers and the adverse selection of the borrowers.

B. Specific steps taken to deal with the causes

The most profound impact of high non-performing loans in banks portfolio is reduction in the bank profitability especially when it comes to disposals. According to the International Monetary Fund [IMF] (2002), banks' net profits had been sluggish for the last ten years. According to Nagarajan (2003) a general awareness of

the significance of structured risk management system is discernible. In the wake of mounting level of non-performing loans and sporadic instances of scams and systemic hiccups, the area of risk management has caught the closer attention of regulators. He points out that the Reserve Bank of India has set out detailed guidelines for the management of credit risk. Banks in India, no longer content with traditional measures such as exposure limits and credit rating, and are in the process of overhauling their entire system of risk management. The banks will be moving towards Risk-Adjusted Return on Capital framework for appraising of loans which calls for data on portfolio behavior and allocation of capital commensurate with credit risk inherent in loan proposals (Nagarajan, 2003).

Goulet and David (1996) stated that the banking industry has changed dramatically over a relatively short period, from being a virtual cartel to a highly competitive market. Financial deregulation and increasing globalization have brought new competition to domestic banking, and allowed considerable diversification by banks, insurance companies and co-operatives. Information technology has provided many opportunities for creating new financial products and distribution methods, for example Automatic Teller Machines (ATMs), Telephone Banking and Computer Banking, and reduced the need for investment in conventional branch infrastructure

According to the Central Bank of Kenya supervision report (Central Bank of Kenya Supervision Report, 1999) profitability of the banking sector declined sharply from shs.4.4bn in 1998 to only Shs 0.2 billion in 1999. This was due to increased provisions for the non-performing loans by most institutions. Non-performing loans remained a major problem for the co-operative Bank of Kenya Ltd. for instance. Although the volume of total non-performing loans declined, provisions on loan losses increased in 2002. The bank made provisions to the tune of Kshs 4.7 billion showing that it is still adversely weighed down by non-performing loans. Besides the impact of these provisions on profitability, the concentration of such loans made recovery hard owing to the poor state of the economy (Co-operative Bank, 2003).

In his address to the Annual General Meeting the Kenya Commercial Bank [KCB] Chief Executive, Davidson (2003) observed that the bank had reported a loss principally caused by an increase in loan loss provisions, which increased from KShs 2.8 b in 2001 to KShs 4.9 b in 2002. These provisions were largely applied to the non-performing loans that were booked in the nineties. Davidson further observed that KCB has gone a further step and segregated the non-performing loans into a separate area. The aim is to centralize all the non-performing loans into one unit in order to be accounted for separately. The end result will be a computerized debt management system, which will enable the bank to monitor progress far more accurately.

In response to the challenge of non-performing loans, banks have been forced to become innovative in their efforts to remain in business. According to Chudasri (2002) retail customers have now taken centre stage in Bangkok in banking business. State banks have moved aggressively to increase new lending, in line with

government policy. All banks, private and state-owned alike, have also sharply increased their efforts in the consumer market, leading to a boom in credit cards, personal loans and hire-purchase lending.

An International Monetary Fund Report (2003) on Singapore states that despite falling overall loan volume and interest rates, banks have generally managed to maintain their net interest margins in 2002 through lower deposit rates. The sustained demand for loans from households has also helped partially offset the decline in corporate loan demand.

According to a report by KPMG (1999) in Hong Kong, the other operating income of the majority of the banks decreased by 2% to 41%. The decline was generally due to a contraction in lending portfolios, in particular in commercial lending and trade finance business. Banks, which have the capacity to diversify into areas such as investment banking and insurance, recorded a growth in the income derived from these businesses. This helped offset the decline in income driven by traditional lending products. The demand for corporate lending is still low. Consequently banks have turned to other business areas to compete, most notably the mortgage market.

In Kenya, banks have also responded to the competitive environment. According to the Co-operative Bank of Kenya Ltd. (2003), the bank signed a partnership with International Moneygram Worldwide Network for the provision of cash transfer services across the world and this product has grown remarkably. The bank followed this by launching the Co-op Cash Visa Electron Card, popularly known as Co-op Cash. The bank has completed the centralization of banking services by networking all its branches and operations countrywide, making it a branchless operation. This achievement has been extremely vital in the consolidation of the banks business. Muriuki (1998) adds that the bank has developed high quality products through its personal and consumer-banking department to meet the needs of its retail customers and other emerging markets. These products include the Personal Loan, the launch of ATMs and the friendly service structure among others.

According to Omuodo (2003), as pressure mounts on the banking industry's profitability resulting from over reliance on interest income by banks, it is strategically imperative that banks focus on other revenue streams. National Industrial Credit Bank, NIC, has introduced new products to diversify revenue and to keep its head above the water. Omoudo adds that part of NIC Bank's strategy has been to diversify revenues, by expanding the scope of its activities in addition to its predominant asset finance focus and offering more general commercial banking facilities and other products. Premium financing and provision of custodial services have reduced over reliance on interest income.

According CBK (2002), public sector banks that gave loans without proper documentation are finding the loans difficult to recover. They have now shifted away from security based lending to the emphases on the customers ability to meet the loan repayments.

C. The level of success of the actions

Since banking crises in emerging economies has multiple causes, there is no single solution to them (Tirapat 1999). However, Goldstein and Turner (1996) suggest that there are several measures that can significantly reduce the incident of each of the factors underlying banking crises. For example, greater macroeconomic stability, a larger role for foreign owned banks, the wider use of market-based hedging instruments and higher levels of bank capital would help to make the consequences for the domestic banking system less damaging.

Limiting the allocation of bank credit to particularly interest-rate-sensitive sectors, close monitoring of lending by weakly capitalized banks and employing the right mix of macroeconomic and exchange rate policies would similarly limit vulnerability to lending booms, asset price collapses and surges of capital inflows, content Goldstein and Turner (1996). Strict asset classification and provisioning practices could reduce the increases of bad loans and protection against loan losses

Tirapat (1999) agrees with Goldstein and Turner on the role of Government in determining to a great extent the success of efforts to managing such crises. It starts out by reviewing the banking structure, problems faced and some of the causes of recent banking crises. Drawing from the experience of 23 countries Tirapat gives some of successful guidelines all of which show the important role of government in its regulatory role.

According to the Bank of Japan (2003), the remedies to the problem of Non-performing loans can be grouped into three broad categories, all of which work towards enhancing the banks' earning power. First is to further improve efficiency through cost reduction. Secondly is to pursue a new lending strategy backed by appropriate credit risk evaluation, and third is to provide new financial services to increase fee income.

In china for example, one method that has been successfully used is turning over the non-performing assets to Asset management companies (China Daily, 2002). According to Reddy (2002), appropriate provisioning for non-performing assets (up to 50% of gross non performing assets) has been successfully used to cushion banks agents the debilitating effects of non-performing loans.

According to the Central Bank of Kenya (1999), Formation of a Credit Reference Agency where banks can exchange information on the bad borrowers is one method on trial. Furthermore, a private sector credit reference bureau is now in operation, but its full operation has been hampered by lack of legislation that may allow banks to exchange information.

According to CBK (2001), improvement in the County's judicial system is critical for a speedy resolution to the NPLs problem. While formation of Credit Reference Bureaus and improvement in the credit risk assessment may prevent future loans becoming delinquent, the current stock of the non-performing loans needs to be quickly resolved. The success of this would be possible if the judicial and court systems are operating efficiently. A number of initiatives have been taken

to improve the judicial system through appointment of more judges, provision of physical facilities and amendment of the relevant laws.

Due to increased customer awareness and availability of choice in the sector, institutions in order to retain their customers have been forced to invest in modern information systems in order to offer better quality services. Greater use of automated technology has reduced risks of manual processing errors. However these have been transformed to system failure risks (CBK, 2002). Internationally active institutions have moved into new products especially financial derivatives in line with international trends in demand. In attempt to equip their staff with the understanding of these products, the banks have had to invest in staff training (CBK, 2002).

Several banks in Kenya are already harvesting the fruits of prudent risk management practices. As reported by Wahome (2004), the Cooperative Bank of Kenya announced a 70 per cent rise in its pre-tax profitability for year 2003 and declared its first dividend in six years. This is the second straight year of profitability for the bank, which had earlier reported a Sh2 billion loss in 2000. The chief executive officer attributed the impressive results to aggressive cost management, focus on non-funded income, debt recovery and prudent liquidity management contributed significantly to the bank's performance in the year (Wahome, 2004).

III. RESEARCH METHODOLOGY

The population for this research comprised of all the commercial banks in Kenya that have been in existence in the last five years, licensed and registered under the Banking Act. This therefore excluded any banks that may have gone under during the period, or been brought under statutory management of the Central Bank of Kenya. According to the Central Bank of Kenya, there were 46 licensed banks in Kenya as at 31st December 2002.

A sample of the top ten banks was selected, based on the value of their net assets, as at 31st December 2002 (Appendix A). The respondents were purposively selected middle level managers in the 10 selected banks. They comprised the credit manager, and 2 credit analysts of each bank and hence a total of 30 respondents. They were selected from the head office of each bank which all, like all other Kenyan banks, happened to be in the Nairobi. The respondents were informed about the intended study through e- mail and a personal visit. The researcher relied on referral from senior personal acquaintances in the banks to get to the relevant managers.

Primary data was collected through questionnaires given out to the respondents. The data collected aimed to provide answers to the research questions as to the causes of non performing loans in Kenyan banks, the steps bank managers have taken as a result of the effects of the NPL's problem and how successful the steps have been.

The questionnaire was developed from an extensive review of literature and was designed on the on the basis of the research questions, namely as to the causes

of non performing loans in Kenyan banks, the steps bank managers have taken as a result of the effects of the NPL's problem and how successful the steps have been. This was pre-tested with a group of academicians and practitioners. Completed questionnaires were collected directly from the respondents. This enabled the researchers to clarify any issues that were not clear to the respondents.

Data was analysed using the SPSS software package. These include frequencies, total scores, means and percentages. Spreadsheets were used in order to come up with appropriate charts and tables for data presentation, while total scores were used to rank the responses. Internal consistency of the multi item scales was tested using Cronbach's alpha. In this study all the alpha values obtained were above 0.6 and therefore considered acceptable. Skewness and Kurtosis tests confirmed that the sample was drawn from a normal population. Confirmatory factor analysis was used to test the reliability of the items in the multi item scales, while the t-test was used to test for significant differences between the factor means. Simple regression analysis was used to test the relationship between the perceived success of the actions taken by the managers (dependent variable) and the independent variable (actions taken by the managers). The model is shown below:

$$Y = B_0 + B \cdot x_i$$

Where:

Y is the dependent variable; are the total scores of success of each of the actions taken by the managers

B_0 is the constant

B is the regression coefficient

x_i are the observed number of managers who said "Yes" to each action

IV. RESULTS AND FINDINGS

A. The causes of non- performing loans in Kenyan banks

Table 1 below summarizes the general factors perceived to have contributed to the increase in non- performing loans in Kenyan banks. General factors are described as those considered to be outside the direct scope of the bank management.

According to the results national economic downturn was ranked first followed by reduced consumer ability. Thirteen respondents (43.3 %) strongly agreed that the national economic downturn was a major cause of NPLs. The remaining 57.7% agreed that this was a major factor. Further all the respondents agreed/strongly agreed that the reduced buying ability of consumers was also an important factor. Forty percent strongly agreed while the remaining 60% agreed. According to the results most of the respondents (90%) agreed that legal issues contributed to the increase in levels of NPLs. Twenty six point seven percent (26.7%) strongly agreed and 63.3% only agreed.

Table 2: General Factors (0.76)						
Factor	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Total Scores
National economic downturn	0	0	0	17	13	133
Reduced consumer buying ability	0	0	0	18	12	132
Legal Issues	0	0	3	19	8	125

Notes. Five-point scales were used with the following anchoring: 1=Strongly disagree; 2=disagree; 3=Neutral; 4= Agree; 5=Strongly Agree

The table 3 summarizes the bank specific factors that were considered to have led to the deterioration in the asset quality in the banks surveyed. These factors are described as those considered to be within the direct scope of the bank management.

Table 3: Bank specific factors (alpha 0.84)						
Factor	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Total Scores
Lax credit risk assessment and untrained personnel	0	3	3	18	6	117
Lack of aggressive credit Collection method	0	0	7	17	6	119
Banks negligence in monitoring loans	0	7	7	15	1	100
The speedy process in granting loans	1	1	2	23	3	116
Insider lending and Owner Concentration	1	9	4	8	8	103

Notes. Five-point scales were used with the following anchoring: 1=Strongly disagree; 2=disagree; 3=Neutral; 4= Agree; 5=Strongly Agree

According to the findings lack of aggressive credit collection policy was rated the most important factor, while poor credit assessment and untrained personnel was ranked second. Most of the respondents (80%) strongly agreed/agreed that lack of aggressive credit collection methods contributed to bad loans. Only 53% of the respondents strongly agreed/agreed that the bank negligence in monitoring loans and insider lending/owner concentration loans contributed to the problem of bad debts.

Table 4 below summarizes borrower specific factors perceived by the respondents as having increased borrower's default rate.

Factor	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Total Scores
Clients start new business without experience	0	1	6	16	7	118
The simultaneous operation many kinds of businesses	0	0	7	23	0	113
The inappropriate use of the loan	0	0	0	25	5	125
Debtors conceal vital data in their applications	0	0	2	16	12	130
Insufficient collateral	0	1	9	19	1	110

Notes. Five-point scales were used with the following anchoring: 1=Strongly disagree; 2=disagree; 3=Neutral; 4= Agree; 5=Strongly Agree

Failure of the debtor to disclose vital information in their loan application was ranked first followed by inappropriate use of the facilities granted. Lack of borrower's business knowledge was ranked third. Twenty three respondents (76.6%) felt that bank clients started new businesses in which they had no experience while all the respondents felt that most of the clients who had defaulted had diverted their loan proceeds to other uses. Most of the respondents (93.3%) felt that debtors conceal some vital data in their applications and this was a cause of NPLs. Forty percent of these strongly agreed while 53.3% that perceived failure to disclose vital information to the bank as a major cause of bad debts in Kenya.

There are no significant differences between the bank specific factors; mean equals 111 and the client specific factors; Mean equals 119.2 ($t=2.64$, $p=0.09$). However there are significant differences between the general factors and the bank specific and client specific factors ($t= 3.48$, $P=0.0317$). We may therefore conclude that general factors are perceived to be the main causes of non performing loans in Kenya. The results further reinforce our earlier finding that debtors' concealment of vital information in their applications is perceived the most important factor contributing to non performing loans within the client specific factors.

B. Specific steps/ actions taken by bank managers

Table 5 summarizes fourteen different actions that banks have adopted over time in order to reduce the default rate in their respective banks. The majority of the managers surveyed (70%) felt that the banks were not involved enough in government policy formulation. Only 30% said the banks were involved. Reduction

of interest rates and proper loan monitoring were ranked highest with 29 respondents (96.7%) agreeing that these were the best actions that had been taken by the banks.

As shown in table 5, majority (93.3%) of the managers agreed that there had been improvement in quality of credit information asked for during the loan application request. Only 6.7% felt there was no improvement.

Factor	Yes	No	% Yes
Involve of Bank in Govt. fiscal policy formulation	9	21	30%
There is reduction of interest / Lending rates	29	1	96.7%
Improved credit info. during loan application	28	2	93.3%
Increased training of loans officials	25	5	83.3%
Increased use of credit reference bureaus	9	21	30
Info. sharing among banks about borrowers	16	14	53.3%
Emphasis on creditworthiness of borrowers	27	3	90%
Use specific limits, ratios in the evaluation process	27	3	90%
Emphasis on forecasts and feasibility studies	23	7	10
Use of specific lending & project appraisal techniques	24	6	76.7%
The use of procedures for mgt of problem loans	27	3	90%
Use of contents of loan files to monitor loan quality.	29	1	96.4%
Std loan process from enquiry to lending decision	26	4	86.7%
Total	299	91	76.6%
Mean	23	7.5	t=5.768**

Most of the respondents (70%) felt that the use of credit reference bureaus was not an important action that had been taken by banks to deal with NPLs. Fifty-three point three of the respondents reported the increased use of information sharing among banks about credit worthiness of borrowers as an action against loan defaulting. Emphasis on creditworthiness of borrowers is widely used as a way of reducing the risk of default according to 90% of the respondents. As indicated, most of the managers (90%) agreed that the use of specific limits, ratios, based on cash flows used by the bank in the evaluation process was an important action. The respondents were divided as to whether there was emphasis on forecasts and feasibility studies. However majority (76.7%) felt this was a method used by their respective banks to manage lending risk.

The findings indicate that 26 respondents (86.7%) felt that the standard loan process from the client's initial enquiry or the bank's marketing efforts, to the final lending decision, and the credit decision process was proper and described. Majority

of the managers (83.3%) said that as a way of improving management of loans, there was increased training of loan officials.

There is a significant difference between the managers who are taking the above specified actions and those who were not ($t= 5.768$, $P= 0.0015$). Furthermore, 76.6% of the respondents supported the above specified measures. We may therefore conclude that taking the actions specified above would reduce the problem of non performing loans in Kenya

C. The level of success of the actions of managers

Table 6 shows the levels of success achieved by the actions of managers in attempting to reduce bad loans in the banks. Managers were divided as to the level of success of their involvement in government policy on fiscal and economic matters. The majority (60%), however felt it was average and above. Thirty percent said it was poor while 10% felt it was very poor. As shown in the table a majority of the respondents (90%) ranked the success of reducing interest rates as at least good, with 43.3% saying it is very good and 46.7% saying it was good.

The survey revealed that a majority (56.7%) felt that the success achieved in controlling NPLs through information sharing among the banks was poor. Another 26% felt it was average while the remaining 16.7% felt it was good. The results indicate that improvement in the use of the quality of credit information asked for during the loan application request was a success. Eighty six percent of the respondents said it was at least successful while only 6.7% thought it was not successful.

Factor	Very Poor-1	Poor 2	Average 3	Good 4	Very Good- 5	Total Score
Involvement. of Bank in Gov. fiscal policy formulation	3	9	16	2	0	77
There is reduction of interest / Lending rates	0	0	3	14	13	130
Info. sharing among banks about borrowers	0	17	8	5	0	78
Increased training of loans officials	0	1	5	17	7	120
Increased use of credit reference bureaus	1	18	6	5	0	75
Improved credit info. requested in loan appl.	0	2	1	26	1	118
Emphasis on	0	0	4	18	8	124

creditworthiness						
Use of specific limits, ratios in evaluation process	0	0	2	18	10	128
Emphasis on forecasts and feasibility studies	0	3	11	12	4	107
Use of specific lending & project appr. techniques	0	4	7	12	7	104
Use of procedures for mgt of problem loans	0	3	8	14	5	111
Use of loan files to Monitor the quality of loans.	0	3	4	13	10	120
Std loan process from Enquiry to lending decision.	0	1	8	17	4	114

The success in using credit reference bureaus by banks was generally considered poor. Majority (60%) felt it was poor and 3.3% felt it was very poor. All of the respondents evaluated the success of emphasis on creditworthiness as average and above. The majority (86.7%) felt it was good while 26.7% said it was very good. All respondents considered the success of emphasis on the use of specific limits, ratios, based on cash flows used by their banks in the evaluation process as average and above. The majority (60.7%) felt it was good while 33.3% said it was very good.

As indicated, most of the respondents (90%) evaluated the success of emphasis on forecasts and feasibility studies in the evaluation process as average and above. Thirty six percent felt it was good while 33.3% said it was very good. Another 6.7% said it was average. Only 10% felt it was poor. As for the use of specific lending procedures and techniques for project appraisal, approvals and legal finalization of projects, procurement and disbursement, 23.3% said the success was very good. Forty percent reported that it was good while those who thought it was average were 23.3%. Only 13.3% respondents rated the action as unsuccessful.

We used regression analysis to test for a significant relationship between the specific actions that had been taken by the managers (number of respondents who said "Yes") and the perceived success of the actions (total scores of each factor). The results indicate a significant relationship ($R^2 = 0.402$, $P = 0.0197$). We therefore conclude that the actions that have been taken by the managers have been successful in reducing the non performing loans in Kenya.

V. CONCLUSIONS AND IMPLICATIONS

This study examined the causes of non performing loans in Kenya, the actions that have been taken to try and solve this problem and the perceived level of success of such actions. The results indicate that the unfavorable economic environment was perceived as the most important external factor. Specifically, the national economic

downturn leading to the depression of business in general was found as an important factor. In a similar vein, a study conducted by Brownbridge (1998), macroeconomic instability was found to be an important cause of NPLs. In the current study, the majority of respondents felt it was an extremely important factor. Legal issues leading to delays in settling commercial disputes was also identified as a contributing factor. In Uganda for example, Mukalazi (1999) stated that the government moved in and introduced a statute that deals with several issues such as insider lending and lending without adequate collateral.

Internal factors affecting non-performing loans include the procedures used in banks for credit risk assessment particularly the lack of proper skills amongst loans officials. Other factors include the speedy process of evaluating loans mainly due to external pressure, the high interest rates charged, insider lending and owner concentration among others. The findings are consistent with those of Fernández, Jorge and Saurina (2000), who found that most banking crises have directly led to the inadequate management of credit risk by institutions. They further assert that even though bank supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. They claim that even conservative managers might find market pressure for higher profits very difficult to overcome.

The major findings regarding the steps that had been taken to deal with the causes of non-performing loans are split into general factors and those that are bank and customer specific. The general factors are those considered to be outside the direct control of bank managers while the reverse is true for the bank specific factors. The only general action investigated in this study was the involvement of the bank management in government policy formulation regarding economic matters. The findings indicate that this was not an important action that bank managers have emphasized as a solution to NPLs in Kenya.

As pertains to solutions to internal causes, the reduction of interest rates was perceived as an important action that had been taken by bank management to deal with bad debts. Earlier, Brownbridge (1998) had identified lending at high interest rates, to borrowers in high-risk segments of the credit market this as major a factor contributing to bank failure.

Our findings are consistent to those of Nagarajan (2003) in India. Nagarajan itemizes detailed guidelines on credit risk management for Indian banks provided by the reserve bank of India, which goes beyond traditional measures such as exposure limits and credit rating. The current study showed that there is emphasis on creditworthiness of borrowers, forecasts and feasibility studies, specific lending procedures and techniques for project appraisal and legal finalization of projects. The study also revealed that there was emphasis on the use of specific limits and ratios, based on cash flows used in the evaluation process.

The Bank of Japan (2003) documented one of the remedies to the problem of Non-performing loans as the pursuance of a new lending strategy backed by

appropriate credit risk evaluation used successfully in Japan. The current study revealed that reduction of interest rates, as a new lending strategy has been a success. The Central Bank of Kenya (2002) has also documented that interest rates in Kenya have reduced significantly. As a result of the debate among the political and business fraternities on the negative effects of high interest rates to the growth of the economy, interest rates have reduced from 20 % in 2001 to 18 % in December 2002.

As pertains to credit information asked for during the loan application process, the study found that the success ranged from average to very good. This includes the findings on such specific areas of credit risk assessment such as the use of specific limits and ratios, based on cash flows as well as the use of forecasts and feasibility studies, the use of a standard lending procedure and the use of clear loan files to monitor the quality of loans.

According to the CBK (2002) there is a private sector credit reference bureau in operation in Kenya. Its full operation has however been hampered by lack of legislation to allow banks to exchange information with third parties. The findings of the study were congruent to the findings by CBK. The current study found that information sharing among individual banks as to the creditworthiness of borrowers was poor. Similarly, the use of credit reference bureaus was found to be poor. It also found that the success in the use of instruments and remedies at the disposal of banks to ensure debtors paid their debts was good.

This study makes several contributions to Banking Crises research. First, our results indicate that external factors such as weak judicial systems and reduced customer buying ability are the main contributors of non performing loans in Banks. Most emerging economies have weak legal systems (Waweru, Gelinas and Uliana, *forthcoming*). While studying corporate governance in Africa, Okeahalam (2004) reported that the efficiency of the judicial system in Kenya lags behind South Africa, Zimbabwe and Nigeria. There is therefore a need for governments in countries such as Kenya to strengthen their judicial systems if Banking crises are to be minimized.

Secondly, to our knowledge, this study represents the first attempt to examine the actions taken by bank managers to reduce the default rate and the perceived level of success of such actions in an emerging economy. Our findings report a strong positive relationship between the actions taken by the managers and their levels of success, suggesting that banks taking such actions may be able to reduce their levels of non performing loans.

This study is subject to all usual limitations associated with survey research (e.g. the perception of the respondents). Furthermore, the sample is small with only 30 respondents. It is however important to note that the sample included 10 credit managers who are based in the selected banks' head offices. These managers are the credit policy makers in these banks. They also participate in lending decisions particularly where the amounts requested are high. The sample is therefore considered representative.

The research relied on referral from senior personal acquaintances in the banks to get to the relevant managers. Although this could have resulted to some selection bias, it enabled the researchers to introduce some elements of qualitative research (i.e. collecting the completed questionnaires directly from the respondents and clarifying any issue that may not have been clear to the respondent), thus strengthening the reliability of our data.

Further research may be directed towards the examination of how Kenya banks have adopted the Basel 11 recommendations (Bank Committee of Banking Supervision, 2005) and how such recommendations have affected their credit risk management. The recommendations stipulate the best practices of credit risk management. These include the involvement of the board of directors in approving and reviewing credit risk policies, documenting the banks credit procedures and the setting up a system for monitoring the overall composition and quality of the banks credit portfolio. A multiple case study approach is recommended to provide an in-depth understanding of how and why certain actions have been taken to mitigate the non performing loan problem in Kenya. This approach is also expected to improve the reliability and validity of the research findings (Yin, 2003)

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APPENDIX

List of top ten Kenyan Commercial Banks

NAME OF INSTITUTION	NET ASSETS (SHS ' 000)
1. Barclays Bank of Kenya Ltd.	86,027
2. Standard Chartered Bank (K) Ltd.	61,736
3. Kenya Commercial Bank Ltd.	56,844
4. Citibank N.A.	30,191
5. Co-Operative Bank of Kenya Ltd.	28,994
6. National Bank Of Kenya Ltd	25,205
7. Commercial Bank Of Africa Ltd.	16,345
8. CFC Bank Limited	9,610
9. National Industrial Credit Bank Ltd.	9,329
10. Stanbic Bank Kenya Limited.	7,977

Source: Central bank of Kenya