Credit Risk Mitigation Strategies Adopted By Commercial Banks in Kenya

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Abstract

The study's overall objective was to investigate credit risk mitigation strategies adopted by 44 the commercial banks currently operating in Kenya. The study was descriptive in nature. The study opted for both primary and secondary forms of data. The secondary data was collected from the documentations obtainable from the banks and the primary data from various banks. The collected data was examined to make inferences through a series of operations. Data was analyzed using descriptive statistics involving percentages and charts. The study found out that the banks had policies and strategies that governed the loan lending. Though this existed most of the banks didn't seem to efficiently implement the same. The banks assumed some of the economic factors which could affect their loan performance. The banks also concentrated highly on collateral as the main security for loans which at times made the banks assume other strategies of preventing risk.

Key words: Credit, Risk, Mitigation, Bank

1.0. Introduction

Ingham (2004) describes credit as the provision of resources such as granting a loan by one party to another party where the second party does not reimburse the first party immediately, thereby generating a debt, and instead arranges either to repay or return those resources or material(s) of equal value at a later date. According to Henderson (2011), credit risk occurs when there is a loss in value as a result of a debtor's non-payment of a loan or other line of credit, either the principal or interest (coupon) or both. The classical definition of risk was provided by Knight (1994) as the situation in which the decision maker has the advantages of knowledge of the problem structure, understanding of the complete range of possible outcomes and ability to objectively assess the likelihood of each outcome occurring. At its simplest level, Knight (1994) saw risk as a form of measurable as opposed to un-measurable uncertainty. Other than industry characteristics (IC) and organizational strategy (S), Risk (R) partly determines an organization's performance (P).

Mathematically expressed: $P = f (IC, S, R)$

Further, risk is essentially an endogenous variable because strategic managers tend to assume, both explicitly and implicitly, that it is a variable that can be managed. The nature of risk is itself primarily dependent on the industry characteristics and the strategy pursued (Bettis, 2009). All human actions entail some risks. Some will be risk seekers or accepters by temperament while others are risk avoiders. There is even evidence that removal of some risks will cause persons purposely to subject themselves to a new one, suggesting that they seek some kind of undefined risk balance in their lives. Risk is an elusive element in most decisions, largely because it is so hard to pin down. Also, there will always be risks associated with mitigation strategy developments and maintenance (Jappelli, 2006). The pervasiveness and complexity of credit risk presents strong challenges to managers, one of the most important being lack of efficient determination of credit worthiness of a potential customer. This, therefore, means establishing mechanisms of insulating the company's value against huge defaults (Bowman, 2000). Kenyan banking industry advances credit to people of different categories including low-cadre earners and self-employed individuals whose default risks are very high yet the banks cannot be pushed out of the niche. In addition, the business environment has become too competitive to the extent of not letting go any quality of clientele. This implies that the banks are subject to a heightened credit risk levels as opposed to other economies with higher-income earning potentials.

Given that the industry is still growing with new entrants still finding space, great effort must be spent to ensure that comprehensive and effective strategies are developed that minimize risk and maximize loan performance at any particular point while in operation. If appropriate set of tools are not determined and sustained in time, the likelihood of loss will gradually increase and subject the banks, especially in peer groups I and II, into penalties of illiquidity and downsized profitability.

The table below gives an overview of the banking sector in relation to Asset Base, Loans and advances, Non-Performing Loans and Provision for the non – performing loans for the years 2008 to 2011

	2008(million)	2009(million)	2010(million)	2011(million)
Asset Base	1,183,655	1,353,499	1,678,112	2,020,818
Loans and advances	670,372	757,760	914,910	1,190,985
Non-Performing Loans	61,869	60,741	57,637	52,958
Provision for the non – performing Loans	25,519	26,306	28,645	28,945

Based on such decline, it is imperative to investigate the overall relationship between the risk arising from advanced credits vis-à-vis subsequent determination of appropriate management techniques to mitigate against it. This is in line with this study whose intent will seek to draw recommendations, based on findings, on how to bolster efficiency in the banks' risk management processes in order to reduce non – performing asset and increase overall returns.

2.0. Methodology

2.1. Research Design

This study adopted descriptive research design for the purpose of accessing the study's general intent. This design involves a set of methods and procedures that describe the intended variables using statistical logic. It is the mainstay of research because it generally allows the researchers to make comprehensive inferences about the investigated variables in the target populations (Burns *et al*, 2000). The study's target population constituted a total of 44 banks tasked with credit risk management in the 44 commercial banks currently operating in Kenya. The Central Bank of Kenya (CBK) categorizes commercial banks in peer groups based of their market share index. Market share index is the composite of net assets, deposits, capital, number of loan accounts and number of deposit accounts.

Those banks with more than 5% market share index are categorized as Large Peer Group and there are 6 of such banks in Kenya. Medium Peer Group constitutes banks with between 1% and 5% market share index where there are 15 banks under this peer group while Small Peer Group are those with less than 1% market share index where there are 23 banks under this tier (CBK, Bank Supervision annual report, 2011).

2.2 Instrumentation and Data Collection

The study opted for both primary and secondary forms of data. The secondary data was collected from the documentations obtainable from the banks. To ascertain the primary data from various banks, the researchers preferred the use of self administered questionnaires. Saunders and Schumacher (2000). Argue that well standardized and tested questionnaires are most effective elements of a structured survey. Keeping the central objective of study in mind, the researchers will adopt both open-ended and closed question items that are sufficient to yield only relevant information.

2.3 Analysis of Data

Data was analyzed using descriptive statistics involving percentages and mean scores to determine varying degrees of response-concentration regarding credit risk mitigation. Standards deviations to measure response-disparity particularly for the Likert-scale question items will also be adopted. Descriptive statistics will be invaluable in describing the sample data in such away as to portray the typical respondent and to reveal the general pattern of responses. In addition, regression analysis will be used to determine relationship between the study's quantifiable variables.

3.0. Empirical Results

Figure 1. Bank Category
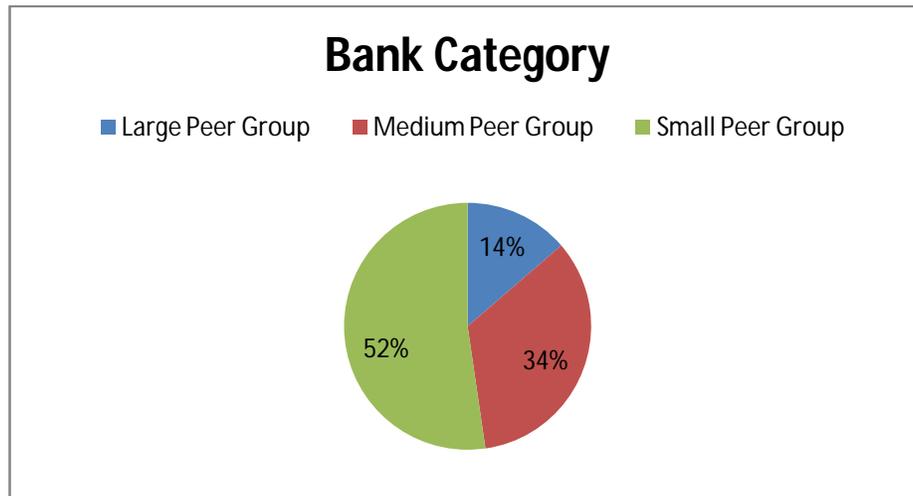
Figure 1 shows that the most banks in Kenya are in small peer group. This implies that most banks have a market share index of less than 5 %.

Figure 2. Forms of credit risks in banks
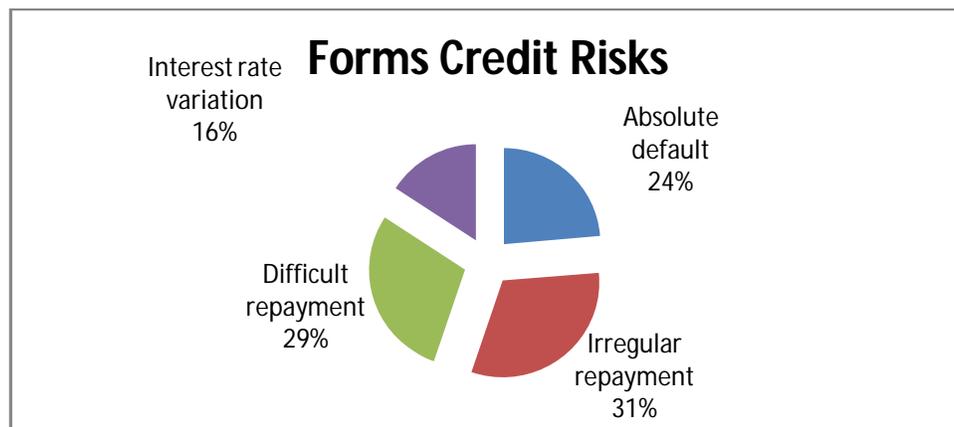
The analysis indicated that higher percentage of the credit risk usually dealt with in banks is the irregular payments by the borrowers whereby the credit is not paid as per the agreed systematic installment agreed on in the lending of credit facilities.

The results of the analysis also showed that a high percentage of the banks also experience credit risks whereby the borrower experience difficulty in repayment which could be as a result of the increased standard of living which subjects the borrower to higher cost of living leading to financial constraints that cause them to have difficulty in repayment. This way the value of money of the lender tend to decrease in value if the payments are delayed hence the credit risk.

Figure 3. Preferred strategies in mitigating existing credit risks
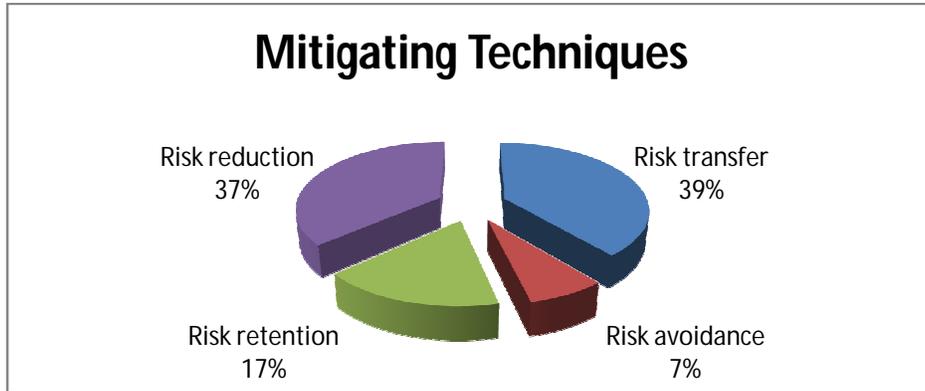
According to analysis it showed that most banks used the risk transfer technique of hedging their financial risk whereby the banks transfer the risk e.g. to the insurance i.e. acquiring insurance coverage where the risk is shifted from one party to another.

Analysis also indicated that a reasonable percentage of banks also use risk reduction technique as a method of hedging them against higher credit risk. This whereby the banks/lenders try to reduce the risks by avoiding fair lending problem in various products and various stages of the lending process and also develop an action plan customized for their institution that include positive steps to eliminate fair lending risks. These banks also seek to identify and eliminate the risk factors that examiners look for during each fair lending examination. From the analysis it indicates that they used risk retention as a technique of mitigating the credit risk they could be associated with. This is where the banks /lender decide to retain some risk or where it's a method of self insurance where by the organization retains a reserve fund for the purpose of offsetting unexpected financial claims. There is though a strategy that was considered for small risks where the cost of insuring against the risk would be greater overtime than the total losses sustained.

A small percentages banks once in a time could use risk avoidance technique where the firm completely did not take any risks i.e. it makes a decision not to enter into a new way of working because of the inherent risks their would introduce. This cause them to be less active in lending unsecured credit e.g. mortgages for fear of higher risks. This could be more dependent of the repayment capability of the borrowers which could result in to non-performing loans that could lead the banks into a deficit.

Figure 4. Extent of various credit transfer techniques
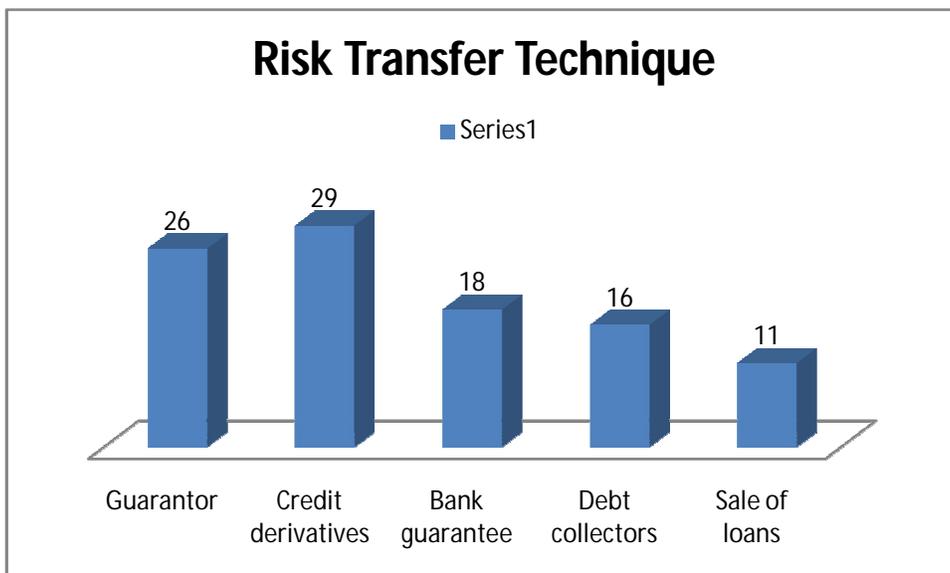
Figure 4 shows that 29% of the banks indicated that they transferred their risk through credit derivatives whereby it's a bilateral contract between the buyer and seller under which the seller sells protection against credit risk of the reference entity where parties will select which credit events apply to a loan sector e.g. bankruptcy ,failure to pay. 26% of the banks indicated that the banks transfer the credit risk through guarantor's technique whereby the loans in case of default or other financial crisis. This way the credit risk is transferred to the guarantors.

The analysis showed that 18% of the banks indicated that the banks used bank guarantee as a means of transfer technique. 16% indicated that debt collector's technique is used as a risk transfer technique. While 11 % indicated that sale of loans is also used as a risk transfer technique

Figure 5. Features in the policy that determine the retention level

From the analysis interest on suspense highly determined the retention level of the bank whereby the banks recognized the interests in suspense as the amount of interest which is pended from the date when any particular account is considered as not recovered. Securitization is averagely applied by banks to retain the risk where it is known to reduce the risks of bankruptcy where a borrower may go bankrupt and thereby obtain lower interest rates from the potential lender. it is used by banks as a structured finance process that distribute risk by aggregating debt instruments in a pool then issues nerd scurries backed by the pool. This way the banks are not subjected to great loss of return from retaining the risk.

Risk mitigation propensity is determined of retaining risk. This is commonly used and easy to use to determine the retention level is the risk mitigation propensity is high then the banks opt to retain the risk and when the risk mitigating propensity is low then the bank decides to curb risk. The analysis indicates that the banks offer to retain the risk determined by value under insurance at an average level

Figure 6. Mechanisms that influence the risk retention ability

From the analysis where was the observation that provision for bad debts determined highly the ability of the banks to retain the risks. This shows that the funds available or allocated for making provisions for bad debts determine the amount of risk that a bank could retain much risk. The analysis show that loan loss reserve averagely determine the risk retention ability where lenders are set as a size reserves for a non accrued loan in which interest and principal payment are no longer collected. The amount f this loan loss reserve determined the amount of risk retention that the bank may be in a positive to effect. When the loss financing cost gets high then banks tend to retain less risk and vice versa. For banks to retain high risk then its needed that they increase their capital to be in a position to cater for the losses.

Figure 7: Techniques used to maintain loan to deposit ratio at a required level
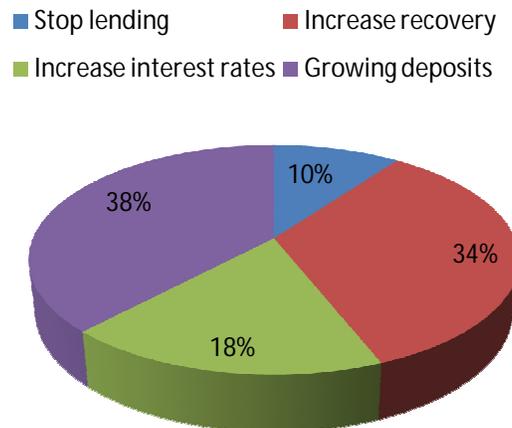
Majority of the banks seemed to be using the techniques of growing the deposits i.e. the deposits that either don't bear interest don't reprise in tandem with market rates or reprise more favorably than market rate at time of reprising .Generally, core deposit inflow have a positive on the banks interest rate risk profile and bottom-line profitability by enhancing margins, on interest income and potentially the banks to compete for and retain loan customers.

Figure 8: Factors determining the highest amount to lend to customers
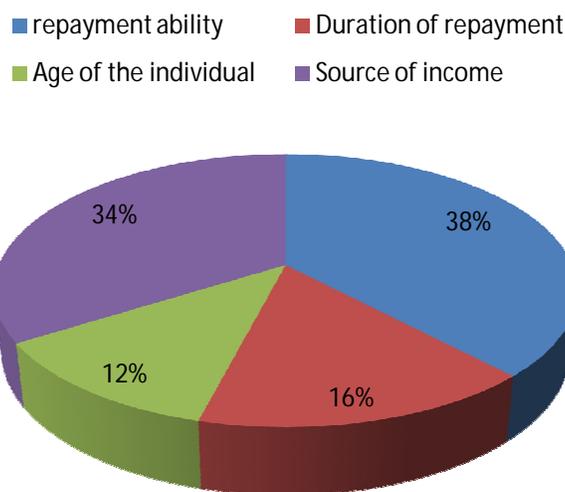
From the analysis duration for the repayment is used to determine the amount to be granted to the borrower .In this the loans amount are determined by the duration of repayment different products have different repayment time and this causes the difference in amount to be granted.

The analysis indicate the banks are highly in granting housing loans, look at the age of the individual as a determinant of loan to be granted. The age hence play a major role in determining the earnings potential of an individual incase a property is co-owned, the co-owner can not be a minor. Also the co-owner cannot be above a certain age limit. The age limit also affects the tenure of home loan. The retirement age is set to retire at 60 yrs then maximum loan tenure available will be 15years.The analysis also indicate that some banks have an age limit and mostly to a limit of 75 years hence a limit of loan to be granted.

4.0. Discussion

The research of the study aimed at investigating the credit risk mitigation strategies adopted by the commercial banks in Nairobi to improve on the loan performance. The findings of the research were that by means of appropriate risk mitigation measures, the residual risk on any potentially eligible asset can be equated and brought down to the level consistent with the risk tolerance of the banks. The analysis found out that eligibility decisions were based on an economic cost benefit analysis. There was the finding that loan operations and advances were highly based on adequate collateral to help reduce credit risk. The analysis showed that all banks at some level banks give uncollateralized loans. Though this is done by some banks others don't e.g. Central Bank as their function and area of expertise is to implement monetary policy to achieve price stability, not to be credit risk managers.

It was found out that assets have a different risk characteristic which implies that different risk mitigation measures are needed to deal with different types of risk. The banks were seen to be highly hedging their risks in various ways. These are: risk transfer, risk retention, risk reduction and risk avoidance. The risk mitigation measures differed in cost and most were considered to be costly since they had to be differentiated across asset types, the costs of these measures also differed. The same applied to handling costs for different assets types hence some types of collateral tended to be costly consequently. The majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and financial transactions. It was found out that banks face losses as a result of a fall in financial value of their assets due to actual or perceived deterioration in asset credit quality during recession or crisis.

The research found out that the banks had policies and strategies that governed the loan lending. Though this existed most of the banks didn't seem to efficiently implement the same. The banks also assumed some of the economic factors which could affect their loan performance. The banks also concentrated highly on collateral as the main security for loans which at times made the banks assume other strategies of preventing risk.

5.0. Conclusion

Summing up considerations on credit risk, it is conclusive that this kind of risk is one of the fundamental kinds of banking risks. And following this train of thought, many assumptions are rife that if credit activity of a bank is the core of contemporary banking, the risk related to it significantly influences profits or losses of the bank. Further, defining the effect of the credit risk on banking activity, there is agreement that it is the most important kind of risk within bank activities. Similarly to the whole banking risk, also for credit risk the factors influencing it are of complex character as well as multidimensional character of operating.

In reality, a bank can only adjust for risks through a variety of conventional mechanisms and strategies, but still there are no certainties. Hence, risk managers are constantly obliged to consolidate reliable risk profiles and refined mitigating processes suiting every rate of change within the environment. The other challenge is of understanding the potential risks associated with new credit products in a given business line which is heightened when firms attempt to see how those risks intersect with the risks from its other business lines. Thus, a firm may be hedging its risks or enhancing diversification by offering new products but at the same time adding to risks it already has. Furthermore, an institution has to pay attention to the behavior and performance of its risk mitigants, whose appropriateness and applicability may also vary with changes in the market. The bottom line for today's banking institutions, particularly the largest and most complex ones, is that they must continue to monitor very carefully the embedded risks of their credit products and services, pay close attention to subtle changes in business practices that could affect the risks related to a given product, and fully understand how the risks in all their business lines intersect and combine to affect the risk profile of the consolidated entity.

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