

BANK LENDING RATES AND NONPERFORMING LOANS IN LISTED COMMERCIAL BANKS IN KENYA

ABSTRACT

The interest rate on loans has an implicit cost that is inherent to bank credit and has an impact on loan defaults. In this sense, a large percentage of non-performing loans (NPLs) may impede economic expansion since many banks will not provide new loans. The study investigated the influence of bank lending rates on nonperforming loans in listed commercial banks in Kenya using secondary monthly data from November 2019 when the interest capping was repealed to September 2023. Secondary data was obtained from the Central Bank of Kenya Monthly Statistical Bulletin. Inferential statistics using regression analysis was utilized to analyze the data. The results from the study showed a statistically significant positive relationship between bank lending rates and nonperforming loans implying that bank lending rates influence nonperforming loans of listed commercial banks in Kenya.

Keywords: Bank lending rates, Nonperforming loans, Commercial Banks, Kenya

1.1 INTRODUCTION

Many countries' aggregate NPLs increased dramatically during the global financial crisis in 2008, compared to the previous period, which had relatively smaller numbers (Ozili, 2019). Before the global financial crisis, Basel II was implemented in 2004 to increase risk management in banks. However, when the financial crisis hit, several nations had yet to adopt it. A nonperforming loan (NPL) crisis prohibits banks from allocating credit in an economy. This is because, as banks seek to cover the risks of lending, their profitability declines, income falls, provisioning rises, and expenses rise. NPLs can harm a country's growth prospects. Banks with a large number of NPLs have less capacity to issue fresh credit (Baudino, Orlando, and Zamil, 2017). Banking systems with large NPLs have limited profitability and growth.

In the banking industry, non-performing loans (NPLs) are a vital indicator of a bank's loan portfolio's credit quality. A country's banking system stability can be determined by looking at

the entire credit quality of the loans held by the banking sector. Thus, non-performing loans (NPLs) are an important indicator of a financial system's exposure to credit risk. Since NPL levels have an impact on banks' capital provisions, their capacity to extend new loans, and their overall performance, they are much more significant (Ozili, 2019). The increase in non-performing loans (NPLs) reduces the efficiency of a financial system and may cause the monetary policy to be implemented more slowly. Banks should strive to maintain a low non-performing loan (NPL) ratio to sustain growth and stability (Kuzucu & Kuzucu, 2019). For risk management, both banks and regulators tasked with overseeing bank stability must have a thorough grasp of the primary variables affecting non-performing loans (NPLs) as well as an analysis of how sensitive these loans are to lending rates.

The percentage of non-performing loans (NPLs) in the US decreased from 5% in 2009 to 0.9% in 2019 following the global financial crisis. The Covid-19 epidemic was mostly to blame for the minor increase in the NPL ratio to 1.1% in 2020; however, in 2021, the ratio dropped to 0.9% (Statista, 2022).

Conversely, the prevalence of non-performing loans (NPLs) has increased over time in Asian and African nations. China's GDP fell to 1.51% in 2017, but it has since increased gradually to about 3% in 2021 (Statista, 2022). India's non-performing loan (NPL) increased from 2.3 in 2011 to 7.3 in 2021, per CEIC Data (CEIC). South Africa recorded a low of 2.8 in 2017 and a high of 5.2% in 2021, the pattern for African nations was essentially the same (CEIC, 2022). Government inefficiencies and inadequate policies have been primarily blamed for the increase in non-performing loans (NPLs) (Giammanco, Gitto & Ofria, 2022).

Throughout the COVID-19 period, the banking industry in East Africa as a whole encountered several difficulties. During the year 2011–2022, a sample of the leading Kenyan banks revealed an average 8% increase in non-performing loans (NPLs). The rise of troublesome loans led to a decline in ROE, which in turn affected Kenya's banking industry's credit rating (The Banking Supervision Report, 2022).

1.2 Statement of the problem

Non-performing loan rates are still rising in Kenya despite policy changes implemented by CBK in 2016 that established minimum requirements for core capital, capital adequacy, liquidity management, asset risk classification, and provisioning. The year 2018 saw the release of a guidance note by CBK regarding the application of IFRS 9, which mandated that banks record credit losses consistently and adjust the amount recorded at every reporting date to account for variations in the credit risk of financial instruments. NPLs, however, have been increasing dramatically in Kenya over time. The latest bank supervision annual report of 2022 from the Central Bank of Kenya has highlighted the rising amount of non-performing loans in the banking industry. A 12.1% increase from Kshs 172.459 billion recorded in December 2021, net non-performing loans now total an alarming Kshs 193.368 billion. The asset quality, measured by gross nonperforming loans to gross loans ratio deteriorated from 14.5 percent in June 2023, to 15.0 percent in September 2023. This was due to a higher increase in gross NPLs of 6.0 percent compared to the increase in gross loans of 3.1 percent (CBK Credit Survey Report, 2023).

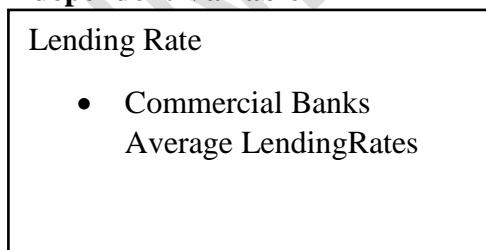
The Kenya Bankers’ industry report (2023) pointed out that raising the monetary policy rate has contributed to an increase in lending rates, negatively impacting asset quality through credit channels, and eroding the value of interest-sensitive assets such as bonds held for sale/trading.

1.3 Objective of the study

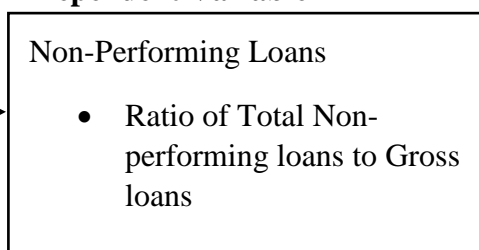
To compare the influence of bank lending rates on nonperforming loans in tier one and tier two commercial banks in Kenya.

1.4 Conceptual Framework

Independent Variable



Dependent Variable



2.0 LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Information Asymmetry Theory

Asymmetric information predominates in transnational relationships when one party has greater knowledge than the other, according to the theory of information asymmetry. Scholars Brennan, Kirwan, and Redmond (2016) argue that the literature on information asymmetry from the perspective of financial decision-making addresses the impact of decisions made with varying information and diverse stakeholders. Because lenders lack sufficient information on their borrowers, they are unable to distinguish between creditworthy clients and those who are not, so they assume a significant risk when extending credit facilities to borrowers in financial institutions. According to the "lemon Principle," information asymmetries also cause adverse selection. Akerlof initially described the issues surrounding moral hazard in 1970. Using this theory, the study demonstrated how interest rates lead to non-performing loans (NPLs). If the lenders are unable to differentiate between creditworthy borrowers and those who are not, they will charge all of them a standard interest rate that reflects their combined experience. However, by raising the interest rate, some borrowers are instantly removed from the borrowing pool. This separates the borrowers who qualify for credit from those who do not. The high-quality ones due to unfavorable selection dislodge the low-quality debtors in this instance.

2.1.2 Loan Pricing Theory

The loan pricing theory suggests that banks should not be expected to arbitrarily determine the interest rate for a given transaction; that is, they should not aim to maximize interest income while making loans (Mudzingwa, 2013). Since only high-risk consumers would be ready to apply for loans with high-interest rates, banks may experience adverse selection issues when interest rates are very high. However, when these borrowers get the loans they were hoping for, they are more likely to develop moral hazard behaviors forcing them to engage in activities that carry a bigger risk but offer a higher chance of profiting from the higher interest rates (Chodechai, 2004). Interest rate spread is one of the factors that the loan pricing theory considers important when analyzing non-performing loans (NPLs) among Kenyan commercial banks. To lessen the interest burden on their loans, the banks, according to the theory, should set up systems for identifying and realizing the possible risk the borrower bears and, if they try to charge a lower interest rate, for doing so. Spreading interest rates is one method of lowering the

cost of borrowing money (IRS). The ability of individual CBs to determine their unique interest rate spread makes this conceivable (Sheefeni, 2016).

2.2 Empirical Review

Maivald & and Teplý (2020) investigated the effect of low interest rates on bank non-performing loans. They used the GMM to look at a sample of 823 banks from 2011 to 2017 that were only allowed to operate in the Eurozone, Denmark, Japan, Sweden, and Switzerland. In the variable that controls for the below-zero monetary interest rates under which the NPL grows, they discovered a significant one-year delayed effect on the NPL ratio. They did not, therefore, disprove their hypothesis. Additionally, they found that the interbank 3-month interest rate has a marginally significant self-correcting effect. The NPL ratio moved in tandem with the prevailing year's interbank interest rate; however, the movement in the opposite direction was corrected by the interbank interest rate lag, which had a smaller effect.

Mwenda (2017) looked into how lending interest rates affected Kenyan commercial banks' financial performance. The research design employed was the descriptive approach. The study employed a census, incorporating all 43 Kenyan Commercial Banks registered with the CBK. For this study, secondary data were utilized. Models of multiple regression analysis were employed to evaluate the gathered data. Given that lending rates are a significant factor in determining interest revenue, the findings indicated that lending rates had a positive effect on financial institution performance

Ngondo (2018) evaluated the impact of Kenyan commercial banks' CBK rates on loan performance. Secondary data was collected for all commercial banks licensed between 2013 and 2017. Nonetheless, complete data was acquired for 35 commercial banks, since many institutions lacked information for certain years during the research period. The study found a significant positive association between NPLs and loan rates. Furthermore, the relationship between interest rates and loan performance was moderated by central bank rates. However, the study was unable to demonstrate the moderating impact of CBK rates.

The effects of bank lending rates and non-performing loans of Kenya's commercial banks were examined by Kinyoti and Koori, (2022). Thus, the analysis concluded that bank lending rates, as

expressed in terms of the weighted average rates of commercial banks, significantly affect commercial banks. Accordingly, a rise in bank lending rates increased Kenya's commercial banks' non-performing loans (NPLs). The study also established that, in Kenyan commercial banks, CBR significantly modified the relationship between BLR and NPLs. This suggested that the relationship between bank lending rates and non-performing loans in Kenyan commercial banks is significantly impacted by increases in central bank rates. Research findings indicated that the non-performing loans (NPLs) of commercial banks in Kenya were positively impacted by bank lending rates. It is therefore imperative that the management of the commercial banks devise appropriate plans to raise lending interest rates to boost loan profitability. There is a bigger difference between the rate the bank charges its customers and the federal funds rate, which contributes to the rise in loan profitability. These conditions improve the company's and end customers' demand for loans, which boosts bank profitability. When interest rates rise, the difference between long-term and short-term rates also rises because short-term rates grow more slowly.

Baradine (2018) investigated the relationship between non-performing loans and lending rates in Malaysian banks. Causal research was utilized for the analysis, which involved gathering data from 142 Malaysian banks. According to the study, credit rates are inherent costs borne by customers when they take out bank credit, which leads to credit defaults. The research moreover demonstrated that the quantity of non-performing loans in these commercial banks hindered economic expansion to the point that the majority of clients declined to repay credit. The results of the 18 analyses showed that there is an unbalanced association in the near term between lending rates and non-performing loans, but a symmetric relationship over the long term.

3.0 METHODOLOGY

A causal research design was employed by the study because of its ability to describe the cause-and-effect relationships between variables. Secondary monthly data sets for average bank lending rates and gross non-performing loans ratio were obtained from the banking supervision reports held by the Central Bank of Kenya (CBK) as well as the Kenya National Bureau of Statistics (KNBS). The data used is from November 2019 when the capping on interest rates was repelled in Kenya to October 2023 for listed commercial banks resulting in 98 observations. In

data analysis, inferential statistics were utilized using regression analysis, and all statistical analysis was done using advanced Microsoft Excel.

The following regression model for the study is;

$$NPL_t = \beta_0 + \beta_1 LBR_t + \varepsilon_t$$

Where:

NPL_t = Non-performing loans over time t

LBR_t = Bank lending rates

β_0, β_1 = Beta Coefficients

4.0 RESULTS AND FINDINGS

Table 1: Model Summary

<i>Regression Statistics</i>	
Multiple R	0.443394
R Square	0.196598
Adjusted R Square	0.179505
Standard Error	0.684796
Observations	49

Table 1 results present the model summary. The R-squared for bank lending rate and non-performing loans is 19%. This implies that the independent variable (Bank lending rates) explains 19% of the dependent variable (non-performing loans).

Table 2: ANOVA results

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	5.393459	5.393458517	11.50126	0.0014186
Residual	47	22.04042	0.468945086		
Total	48	27.43388			

Table 2 results of analysis of variance exhibited that there was a statistically significant difference between bank lending rate and the non-performing loans of listed commercial banks

in Kenya as indicated by $(F(1, 48) = 11.50126)$, with a P-value of 0.0014186 which is less than 0.05

Table 3: Regression coefficients

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	5.634196	2.38721137	2.360157844	0.02247	0.83174581	10.43665
Lending rate	0.653786	0.192780483	3.391350499	0.001419	0.26596188	1.04161

The regression model results in Table 3 indicated that bank lending rates had a positive and statistically significant effect on non-performing loans of listed commercial banks in Kenya as illustrated by a P-value of 0.001419 which is less than 0.05. The results implied that lending rates do influence non-performing loans of listed commercial banks in Kenya as measured by the gross non-performing loans ratio.

Discussion of findings

The findings from this study are consistent with the work of Kinyoti and Koori, (2022) who analyzed the effect of bank lending rates on non-performing loans of commercial banks in Kenya for the period 2016 to 2020. Kinyoti and Koori's findings from the inferential statistics found that bank lending rates as measured in terms of Commercial banks' weighted average rates, have a significant and positive effect on non-performing loans of commercial banks in Kenya.

The findings of this study are in line with the work of Maina (2016) who used a descriptive research approach to explore whether bank lending rates affect Kenyan commercial banks' NPLs. Using Primary data Maina discovered that bank lending rates had an impact on NPLs in Kenyan commercial banks. As a result, the study concluded that there is a positive and significant relationship between bank lending rates and non-performing loans.

5.0 CONCLUSION

The study examined the influence of bank lending rates on nonperforming loans in Listed Commercial Banks in Kenya. The regression model results pointed out that bank lending rates had a positive and statistically significant effect on non-performing loans of listed commercial banks in Kenya. The results implied that lending rates do influence non-performing loans of listed commercial banks in Kenya as measured by the gross non-performing loans ratio.

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