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Debt Recovery Strategies And Loans Performance Among Tier I Commercial Banks In Kenya

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Abstract
The study investigated the relationship between debt recovery strategies and loan performance among Tier I commercial banks in Kenya. There has been a significant increase in loan defaulters among commercial banks subsequently resulting into high levels of non-performing loans. Failure by commercial banks to recover fully the loans advanced to customers poses a challenge to the functions of the banks. This paper examined the debt recovery strategies by Tier I commercial banks. The research was anchored on Stakeholder, information asymmetry, and financial instability theories. The target population was 39 commercial banks from which Tier I commercial banks which were purposively sampled. From each bank, 5 loan managers were selected making a sample size of 45 respondents. Primary data was collected through a semi - structured questionnaire. Data was analyzed using descriptive statistics as well as multiple regression. The findings showed a positive and statistically significant between third-party strategy and loan performance and a negative but statistically significant relationship with loan performance for proactive strategy. Proactive strategy had a positive but statistically non-significant relationship with loan performance. The paper concluded that third party strategy affects loan performance positively. The paper recommends for further policy and regulatory framework to provide an environment that supports use of third-part agencies in debt recovery. Such legislation should outline the requirements for qualifying as a third-party debt recovery agency while providing guidelines for the process of debt collection by third-party agencies that do not contravene the rights of borrowers. Further studies are recommended for other factors that affect loan recovery other than debt strategies.

Keywords: *Debt recovery strategies, performance, commercial banks*

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I. Introduction

The banking sector contributes to the entire economic growth of a nation by creating jobs, providing different investment opportunities to investors and financial services to its clients and the society Alam et al., (2021). There is also substantial evidence of an association between national development, economic growth, and commercial banks Abdullahi, (2020). Debt recovery techniques are an essential component on commercial banks performance as it makes sure that their main objective of issuing loans results into the preferred profit margin beyond the loans advanced Kamar & Ayuma, (2016).And based on this role, loan or debt recovery it is of utmost importance to all financial institutions (Sah, 2015).

The literature indicates that there is a myriad of debt collection strategies used by banks to recover loans. These include educating borrowers on collection charges and fees, product features, due dates, client rewards (Sakindi, 2017), proactive recovery strategies recovered and reduced classified loans (Siddiqua & Zaman, 2015), centralized debt collection function and realistic loan repayment plans (Kamau & Wagoki, 2014), collateral retention, auction, guarantors, and account transactions on performance of banks (Wandera, 2017). Other strategies include litigation measures (Dwivedi & Raza, 2016; Luvsannyam et al., 2021), engaging third-party debt collectors (Ogolla, 2013; Sigamoney & Deke, 2017; Mawele, 2020). These strategies can be categorized as proactive, reactive, and third-party strategies that were adopted as the independent variables for the study.

II. Statement Of The Problem

Kenya Commercial Banks' ratio of gross NPLs to gross loans increased from 12.5% in 2019 to 14.1% in 2020 (Central Bank of Kenya, 2020). The concentration of NPLs were reported in manufacturing, personal, trade, household, and real estate sectors increasing by 29.6% to Ksh.436.1 billion in 2020 from Ksh.336.6 billion in 2019 (CBK, 2020). In 2021, the total NPLs to gross loans ratio depreciated from 14.1% in December 2020 to 14.6% in March 2021. The sectors that recorded increased NPLs are personal and household, real estate, transport and communication, tourism, and trade (CBK, 2021). Between 2017 and 2021, there was a total of Kshs. 141, 261,000 and Kshs. 299,919,000 in loan defaults in 2017 and by 2021 this amount had increased to Kshs. This shows that commercial banks are facing challenges in recovering loans and there is a need to determine what strategies are used and how these contribute to loan performance. Therefore, this research examined debt recovery strategies used and their effect on loan performance among Tier I commercial banks.

Specific objectives

The objectives of the study included;

i. Determining the effect of proactive strategy on loan performance
ii. Establishing the effect of reactive strategy on loan performance
iii. Assess the effect of third-party strategy on loan performance

III. Literature Review

This section presents a review of literature and it presents the theories adopted for the study and an empirical literature of past studies. The conceptual framework is also presented herein.

Theoretical Literature Review

Stakeholder theory

Stakeholder theory (Freeman, 1984) advices managers to involve both internal and external parties of an organisation. The theory supports the idea for establishing relationships and likely partnerships with these parties that can subsequently contribute to long-term collaborations and mutual benefits (Gatimu, 2022). The main concepts of stakeholder theory include broad economic view of an organization, cooperative strategic stance, and joint interests (Haataja, 2022).

Internal stakeholders are employees in commercial banks while external stakeholders in this case include Credit Reference Bureaus (CRB), courts, loan guarantors, auctioneers, and third-party organisations engaged by commercial banks to collect loans on their behalf. The decisions made by management in terms of loan defaults can affect the guarantors of borrowers; the commercial banks also seek services from third parties such as auctioneers to recover debts and also outsource debt collection to professional firms undertaking loan recovery activities (Alio et al., 2017).

Information asymmetry theory

Information asymmetry theory (Akerlof, 1970) explains there are situations where there is an imbalance to information among two parties; this happens when one party has access to privileged information from the other. In business, this can happen between buyers and sellers when one of them has better information that allows them to take advantage of the other. In this case, a borrower has a better understanding and knowledge of their financial position than a commercial bank does and this gives them more advantage in a loan transaction (Nathan, Ibrahim, & Mwebaze, 2020).

Information asymmetry means it is difficult to be able to separate unfavourable and favourable good borrowers and thereby resulting into moral hazards and adverse selection problems. The party with privileged information is able to negotiate for a better deal than the other party. The party with less information may makes less informed decisions (Auronen, 2003). Using the perspective in debt recovery, an increase in loan defaults is due to adverse selection and moral hazards of borrowers who do not share information on their financial position when applying for a loan (Wairimu & Gitundu, 2015).

Financial instability theory

Financial instability theory **(**Minsky (1974) opines that crisis in an international scale led to an increase in optimism in the market and the proper risk and debt are affected. The rise in financial asset prices, the overall level of speculation increases thereby leading to an increase in loan defaulting (Kinoti, 2015). Borrowers can be classified into Ponzi, speculative, and hedge borrowers. Speculative borrowers can be able to pay interests to their loans but often roll their debts so as to repay their initial loan. Hedge borrowers are those that are able to pay all their debts from their cash flows. Lastly, ponzi borrowers are those not able to repay initial loans and interest and depend on their assets worth to increase to repay debt.

Bhattacharya et al. (2011) explains that in settings where there are long periods of optimism and prosperity on future predictions; financial organisations make more investments in assets that pose greater risks and this can make the economic system to be susceptible through increased defaults (Cheruiyot, 2018). In such a system, an unusual event can result in a decline of earlier optimistic expectations that contributes to commercial banks reluctance to finance investments and this cripples debt repayments (Cheruiyot, 2018; Muthami, 2016; Kinoti, 2015).

Empirical Literature Review

Kamau and Wagoki (2014) were motivated to find out what debt collection strategies were used on loan recovery by gathering information from 88 management staff and 73 credit officers using a cross-sectional survey.

There was a central debt collection role where there was early creation of a realistic prepayment plan for loans with borrowers. Siddiqua and Zaman (2015) conducted a comparison study on performance of 2 commercial banks debt recovery strategies. The study established that JB Bank management was more interested in adopting a proactive strategy to reduce its CLs. Sakindi (2017) assessed influence debt recovery and its relationship with financial performance with 56 staff using simple random method. The analysis indicated financial performance was positively influenced by debt recovery. The proactive strategies that commercial banks may employ include educating borrowers on collection charges and fees, product features, due dates, client rewards among other incentives resulted in positive effects on financial performance.

Mawele (2020) did an assessment of debt recovery by interrogating 40 management staff using a case study of Zanaco Bank using convenience sampling methods. Out of analysis, there were more respondents who preferred proactive means of communicating clients as a means to reduce loan defaults; the strategy for reaching clients early was reported to be useful in avoiding significant problems later in the process. Mutesi (2020) assessed to what degree management of credit portfolio and its influence on the financial outcome at the Bank of Kigali (BK) using descriptive qualitative methods to select 51 staff members using judgmental sampling methods. The collateral debt responsibilities and asset supported securities assist the bank to be able to proactively manage their portfolio by most respondents.

Owich and Mutswenje (2021) did an investigation on how debt management affected performance of loans focusing on proactive strategies adopted by banks in debt recovery using a causal research design. The target population consisted of Tier II and III from 108 managers selected using purposive sampling methods to reach 85 respondents. Periodic loan reviews, credit risk assessment, early warning signs, and loan collateral were indicators of proactive strategies while asset quality ratio was used to measure loan performance. Credit risk assessment positively affected loan performance while other strategies did not have any effects.

Wakhungu (2021) did an assessment of proactive debt recovery strategies and financial outcomes by adopting a descriptive research design among undergraduate students and managers in 18 private universities. Staff were in agreement there was adoption of strict debt recovery techniques; there were a positive association between financial performance and debt recovery techniques used.

Kamar and Ayuma (2016) investigated how debt recovery approaches on financial institutions performance where 125 staff from management and credit departments where judgmental sampling was used to recruit 125 respondents. The findings revealed that collateral retention, auction, guarantors, and account transactions respectively. Islam et al (2019) examined relationship on compulsory loan recovery techniques among 3 MFIs and its effect on borrowers. The sample consisted of 20 staff and 192 borrowers integrating qualitative and quantitative methods. The results revealed borrowers experienced being abuse, scolded, insulted, and threatened with police action from loan officers.

Luvsannyam et al. (2021) did research into Non-Performing Loan Recovery (NPLR) at Savings Bank Limited Liability Company (SBLLC) in Mongolia. The findings indicated that recovery of loans took an average of 4.2 years and a recovery rate of 83%. However, the NPLs recovered out of legal proceedings were less than that recovered though legal processes. Obeng and Krah (2016) comparative study on default risk and debt recovery strategies was among management and staff. The study found that ProCredit Savings and Loans Company Limited (PCSL) deducted repayments from guarantor’s income and these was effective as their NPLs to total loan portfolio was less than Strategic Initiatives Limited (SIL) that had higher NPLs to total loan portfolio suggesting that reactive strategies were instrumental in reducing loan defaults of MFIs.

Sikira (2021) conducted a study on loan recovery techniques at Self-Microfinance Fund (SMF), Nuru Financial and Business Services (NFBS), and Ameic Microcredit Limited (AML) by using a multiple cases approach by engaging 50 credit officers selected by judgmental sampling. The analysis confirmed there was use of reminders, direct contact, and using demand notices, and debt collection agencies to recover debts from borrowers. In a sample of MFIs in Kenya, Mutuku (2020) did research on interest rate reduction, debt rescheduling, and their influence on NPLs among 57 firms. The results showed that interest rates deductions and debt rescheduling had a positive influence on NPLs.

Rayah (2019) evaluated efficiency of debt recovery of 6 branches of Bank of Tanzania (BOAT) with 66 credit risk prevention officers, credit managers, branch managers, and recovery officers. The study revealed a negative association between both loan guarantee policy practices and debt recovery was confirmed. Wandera (2017) investigated determinants of loan collection performance through outsourcing techniques using a descriptive research design where 48 and 11 staff from Barclays Bank and Quest Holdings by employing stratified random sampling. By outsourcing debt collection, the bank was able to enjoy expertise, best practices, technology, and other resources that may be out of reach internally or hired internally.

Conceptual Framework

Figure 1 shows the study's conceptual framework which shows the interrelation between the independent variable and the dependent variable.

IV. Research Methodology

Population, sample size, and sampling method

The 39 commercial banks and 1 mortgage finance company made for the units of analysis while respondents were 5 loan department managers from each of the loan Tier, I bank made for the target population (CBK, 2022). The study adopted purposive sampling (Sharma, 2017). Thus, 9 Tier 1 banks were selected due to their value and any threats to their performance would have a cumulative effect on smaller banks.

Data collection instrument

A structured questionnaire based on a Likert scale type of items is the main tool for data collection; a 5-point Likert scale where respondents were asked to show to what degree they disagree or agree with the statements. The questionnaire had a section on respondent background information, proactive strategies, reactive strategies, third-party strategies, and performance section.

Data analysis

The statistical package for the social sciences was used to analyse the data by inferential statistics by undertaking a multiple linear regression analysis. The specified regression model was thus:

$NPLs = \beta_0 + \beta_1 PS + \beta_2 RS + \beta_3 TS + \varepsilon$

Where:
NPLs = Non-performing loans
PS = Proactive strategies (PS)
RS = Reactive strategies (RS)
TS = Third-party strategies (TS)
β_0 = the constant
β_1 - β_3 = the regression coefficient or change included in NPL by each factor
ϵ = error term

V. Results And Discussion

Table 2 provides a summary of the results from the multiple regression analysis that shows that the model explained 42.6 % ($R^2 = 0.426$) of variation in loan performance and this was statistically significant as shown by the ANOVA results ($F = 10.151$, $p < 0.05$).

Table 4.8: Model Summary, ANOVA, and Coefficients

R	R Square	Adjusted R Square	Std. Error of the Estimate
.653a	0.426	0.384	0.69659

	Sum of Squares	df	Mean Square	F	Sig.
Regression	14.777	3	4.926	10.151	.000[b]
Residual	19.895	41	0.485		
Total	34.672	44			

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.250	0.56		2.234	0.031
Proactive Strategy	-0.437	0.214	-0.318	-2.037	0.048
Reactive Strategy	0.248	0.185	0.197	1.34	0.188
Third-Party Strategy	0.658	0.124	0.689	5.316	0.000

Source: Survey Data (2024)

The coefficient results indicated that the proactive strategy ($\beta = -0.437$, $p < 0.05$) had a negative and significant effect on loan performance suggesting that using this strategy would lead to a decrease in loan performance. This outcome is not new as other research has found negative impacts of proactive strategies as Karungari (2012) research on debt collection strategies contribution to financial performance in local authorities (LAs) found proactive debt collecting strategies had a negative effect on performance of LAs.

In Zambia, Mawele (2020) found that borrowers with outstanding loans preferred proactive strategies adopted by banks indicating they were more likely to respond to these positively and thereby pay back their loans on time and improving loan performance for commercial banks. Owich and Mutswenje (2021) found that credit risk assessment as a proactive strategy contributed positively to loan performance. Murigi (2022) that found the most effective way and strategy will be the one that do not annoy debtors but instead a structure of contracting the liability collection to third parties is the better strategy.

Third-party strategy (β = 0.658, p < 0.05) had a positive and significant effect on loan performance implying that use of this strategy would contribute to better loan performance for commercial banks. The third-party strategy involves assigning the responsibility and action of loan recovery to another agency which allows the commercial bank to focus on its core operations. This result agrees with Wakhungu (2021) research that a positive association between financial performances by means of adopting outsourcing debt recovery. The result was the same for Wandera (2017) where the commercial banks by outsourcing debt collection were able to enjoy expertise, best practices, technology, and other resources that may be out of reach internally or hired internally.

The reactive strategy (β = 0.248, p > 0.05) had a positive but insignificant effect on loan performance implying there was not established relationship between these variables. The findings go against previous research that has established either positive or negative relationships between reactive strategy and loan performance. These include Laseinde and Olokoyo (2018) findings that revealed regular visits to customer's shop and house and use of litigation had a significant effect on customer relationship thereby resulting in better repayment of loans and overall loan performance. The positive outcome of reactive strategy was also reported in Tanzania where Sikira (2021) revealed reactive strategies that contributed to better loan performance for banks included issuing a final notice to customers to recover a loan was a prevalent practice.

VI. Conclusion

The paper concluded that proactive strategy to recover loans would yield a negative outcome on loan performance of commercial banks. Also the reactive debt collection strategy do not have any positive contribution to loan performance among commercial banks. But third-party strategy has a positive outcome for loan performance among commercial banks.

VII. Recommendations

Policy Recommendations

The findings indicated that third-party strategy had positive outcomes on loan performance of commercial banks. The paper recommends for further policy and regulatory framework to provide an environment that supports use of third-part agencies in debt recovery. Such legislation should outline the requirements for qualifying as a third-party debt recovery agency while providing guidelines for the process of debt collection by third-party agencies that do not contravene the rights of borrowers.

Recommendations for Practice

The paper established a negative effect of loan recovery on loan performance of commercial banks using proactive and reactive strategies. So the recommendation to commercial banks is for top management to adopt risk-based pricing for offering loans to borrowers which would be dependent on the perception of the likelihood a borrower will pay it back in time. One of the approaches to implement this would be using loan repayment history for their established clients.

Recommendations for further research

That a part from debt recovery strategies, further research be carried out other factors like client appraisals, income disruptions and loan management skills and loan performance among commercial banks.

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