Factors That Cause Non– Performing Loans in Commercial Banks in Tanzania and Strategies to Resolve Them

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This paper reports reasons for non performing loans (NPLs) in commercial banks(CBs) in Tanzania and strategies employed in dealing with NPLs. A semi-structured questionnaire was administered face to face to 48 bank officers from 14 CBs that provide corporate loans and had been in operations for at least five years. Bank officers participated were those involved in lending activities for at least five years. Findings suggest that use of funds for purposes different from agreed ones as a major factor that cause NPLs. Creating an environment to make banks seen as problem solvers and trusted advisor to borrowers was cited as the main strategy towards solving NPLs problems.Findings imply that close monitoring of borrowers is critical to lending business.

INTRODUCTION

Financial Institutions (FIs) are very important in any economy as they mobilize savings for productive investments and facilitating capital flows to various sectors in the economy, thus, stimulating investments and increase productivity (DFID, 2004). There is strong empirical evidence that robust financial sector support economic growth (Rajaraman and Visishtha, 2002). In most economies Commercial Banks (CBs)[1] are the dominant FIs (Rose, 1997). They are the principal source of credit for millions of households as well as business firms. CBs are key provider of financial services to different market segments; small, medium and large businesses. They play even a most critical role to emergent economies where most borrowers have no access to capital markets (Greuning and Bratanovic, 2003). The health of the CBs, and so as the financial sector as a whole is very important as failure in financial intermediation can critically disrupt the development process (Rajaraman and Vasishtha, 2002). Well functioning CBs accelerate economic growth, while poorly functioning CBs impede economic progress and exacerbate poverty (Barth, Caprio and Levine, 2001; Khan and Senhadji, 2001).

Over the years, there has been increased number of significant bank problems in both, matured as well as emerging economies (Brownbridge and Harvey, 1998; Basel, 1999, 2004). Bank problems, mostly failures and financial distress have afflicted numerous banks, many of which have been closed down by the regulatory authorities (Brownbridge, 1998). This in turn led to contraction of activities, decline in output, and imposition of substantial costs on the economy (Chijoriga, 1997; Brownbridge and Harvey, 1998). Borio and Lowe (2002) observed that the cost of banking crises in terms of output loss has been high; typically double digit percentage of GDP. Studies in other countries show that most of the bank failures have been caused by non performing loans (NPLs)[2] (Brownbridge, 1998). National economic downturn, insider lending, political connection of bank owners, customer failure to disclose vital information during the loan application process, lack of proper skills amongst loan officials were among major factors identified in other countries to cause non performing loans (Santomero, 1997; Brownbridge and Harvey, 1998; Basel, 1999; Waweru and Kalani, 2009). Despite lessons obtained from these studies, CBs do still suffer from NPLs. It is thus the essence of this study to establish factors behind NPLs in CBs in Tanzania and strategies at place for catering the same. The paper is organized as follows: the next section gives a review of literature on the subject. The third section presents a methodology. The fourth section presents finding while the last section provides discussion of results and conclusion.

LITERATURE REVIEW

The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers (Auronen, 2003), which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender) (Auronen, 2003). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction (ibid). Adverse selection and moral hazards have led to substantial accumulation of nonperforming assets (NPLs) in banks (Bester, 1994; Bofondi and Gobbi, 2003). The very existence of banks however, is often interpreted in terms of its superior ability to overcome three basic problems of information asymmetry, namely, ex-ante, interim, and ex-post (Uyemura and Deventer, 1993), thus be able to reduce the NPLs.

Lending has been, and still is, the mainstay of banking business. This is more true to emerging economies like Tanzania where capital markets are not well developed (Richard, 2008). Firms in Tanzania on one hand are complaining about lack of credits and the stringent requirements set by banks, while banks on the other hand have suffered large losses on bad loans (Richard, 2008). The average loan loss in studied CBs as measured by a ratio of NPLs to total loans for the five years period from 1999 to 2004 is as shown below:

TABLE 1
LOAN LOSS - RATIO OF NPLS TO TOTAL LOANS

Year	1999	2000	2001	2002	2003	2004
Average Loan Loss	30.8	30.6	29.1	28.3	26.7	24.9

Constructed from their respective financial reports

There is a slightly decrease in the level of loan loss with time, however, the loss remain 25 percent and above. This situation caused CBs in Tanzania to be very risk averse and maintain a high liquidity level as indicated in table 2 despite the fact that they can lend up to a maximum of 80 percent of total deposits. This situation implies that CBs do not perform their key intended role and in turn they retard investments and economic growth.

TABLE 2
LENDING TO DEPOSIT RATIO

Year	1999	2000	2001	2002	2003	2004
Lending to Deposit Ratio	37.91	33.65	32.29	36.42	42.66	45.65

Source: BOT Economic Bulletin for the Quarter Ended 30th September 2005

The level of NPLs can be compared to that of other countries. The ratios between 2001 and 2002 were: 33 in Kenya, 24 in Zimbabwe, 16.81 in Philippines, 11 in Nigeria, 7.7 in Taiwan and 3 in South Africa (Waweru & Kalani, 2009). Apart from Kenya, the rest of the countries had lower NPLs level than Tanzania. Performance of CBs in terms of performing loans is very crucial not only for sustainability and growth of the CBs, but also in the stability of currency and the economy as a whole (Greuning and Bratanovic, 2003). This is because NPLs create a credit risk that on one hand can cause CBs be more risk averse hence reduce the capital flow to different sectors in the economy and on the other hand can cause liquidity risk and can make CBs insolvent which in turn can influence payment system thus, destabilize the economy in the long run.

Studies to established reasons behind non performing loans have been conducted in other countries. In Spain, Fernandez, Jorge and Saurina, (2000) pointed out that despite bank supervisors being aware that most banking crises were directly related to inadequate management of credit risk by respective institutions, it was difficult for supervisors from central banks to pursue bank managers to follow more prudent credit policies during economic upturn, that even conservative managers might find market pressure for higher profits very difficult to overcome. Nishimura, Kazuhito and Yukiko (2001) studied the situation in Japan and concluded that some of the loans made to companies during the bubble era became non- performing when the bubble burst. Gorter and Bloem (2002) argued that 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.). In Africa, Brownbridge, (1998) concluded that many of the bad debts in banks were attributable to moral hazards; the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending at high interest rates to borrowers in the most risky segments of the credit market. To the borrowers' side, they also tend to divert the funds to risky investments once they are granted the loans.

CBs have employed different strategies in attempt to reduce the level of loss caused by NPLs. In Japan among other strategies, they pursue a lending strategy backed by appropriate credit risk evaluations (Bank of Japan, 2003 quoted in Waweru & Kalani, 2009). In China, turning over the NPLs to asset management companies was proved very successfully (China Daily, 2002 quoted in Waweru & Kalani, 2009). In Kenya banks shift away from concentration on security based lending and put more emphases on the customer ability to meet the loan repayment. Reduction of interest rates however, was observed to be a successful action taken by bank management. Others were mostly associated with proper appraisal of borrowers in particular use of credit limit ratios, based on cash flows, use of forecasts and feasibility studies and use of standard lending procedure (Waweru & Kalani, 2009). The nature of CBs business expose them to risks one of them being associated with default from borrowers. Literature shows that their default may be caused by factors external or/and internal to the bank. Given the fact that external factors are uncontrollable by CBs, emphasis on tackling internal factors was expected.

RESEARCH METHODOLOGY

Semi structured questionnaires which were face to face administered to bank officials were used. This is part of the PhD study whose data was collected in 2004 in banks providing loans to corporates and that were in operation for at least five years. The sample was constructed at two levels; the first level of sampling was choice of sample banks and the second level of sampling was choice of respondents. In 2004 there were 26 CBs operating in the country. Of these, one was in the process of being privatized, two focused on SMEs and four were in operation for less than five years. The seven banks therefore were removed from the basket. Four of the remaining 19 banks declined to participate in the study. Of the 15 remaining banks 14 had their head office in Dar es Salaam and of these, 7 had only one branch (which was the head office). The rest except the two banks had an average of two branches which mostly were located in Dar es Salaam, Arusha and/or Mwanza. The location is mostly related with business opportunity. For practical consideration and cost constraints, banks in Dar es Salaam, Arusha and Mwanza were selected thus made a total of 14 banks participated in the study. Two main reasons for the selection of these regions; one is the high concentration of banks especially in Dar es Salaam, and two, the selected regions are considered to be amongst the leading commercial regions in the country, thus high business volume.

At the second level of sampling choice of respondents, a letter was sent to Credit Officers of selected banks with a list of targeted officers (using titles) intended to participate in the study and a note that they should be involved in corporate lending activities for at least five years was provided. 48 bank officials participated in the study. However, data from 41 respondents was used in this study as 7 respondents had working experience of less than five years. Frequencies, percentages and cross tabulations were used in analysis.

THE STUDY RESULTS

Respondent Profile

Table 3 provides working position of the respondents

TABLE 3
WORKING POSITION OF RESPONDENTS

Current Role	Frequency	Percent
Credit Analyst	15	37
Relationship Manager	10	24
Credit Processing Officer	6	15
Credit Approval Officer	3	7
Credit Documentation Officer	3	7
Branch Manager	2	5
Director of Credits	2	5
Total	**41**	**100**

Most respondents were credit analysts, relationship managers and credit processing officers. Their working experience is indicated in tables 4 and 5 respectively.

TABLE 4
WORKING EXPERIENCE I BANKING INDUSTRY

Number of Years	Frequency	Percent
5 – 10 Years	19	46
More than 10 Years	22	54
Total	**41**	**100**

TABLE 5
WORKING EXPERIENCE IN LENDING ACTIVITIES

Number of Years	Frequency	Percent
5 – 10 Years	34	83
More than 10 Years	7	17
Total	**41**	**100**

All respondents had worked with the bank for more than five years; majority however, had more than ten years in the banking industry. All respondents were also involved with lending activities for five years and above with 17 percent been involved in the lending activities for more than ten years. This shows that all respondents had enough knowledge of the lending activities. This was evidenced in the kind of training attended by respondents since they started working with the banking industry. The results showed that all respondents were trained on important aspects of loan management i.e. from credit appraisal, monitoring and supervision as well as loan structure and documentation (100 percent). Only very few respondents obtained training on issues like relationship management, legal issues in banking industry, management skills and computer and change management and customer services (2 percent). Relationship management has a significant influence on monitoring of borrowers. Lack of this training to most of the respondents indicates weakness of the banks in managing its borrowers. When asked about value added from training attended, majority of respondents (78 percent) indicated that they gained knowledge on techniques used in analyzing borrowers' financial position. Few of them (7 percent) added that they also gained techniques to communicate with borrowers and make them feel free to discuss any issue with the bank while 12 percent mentioned that they gained techniques to deal with problem loans.

CAUSES OF NON-PERFORMING LOANS

Table 6 summarizes major factors pointed out to have caused non-performing loans. The higher the percentage indicates the most ranked factor.

TABLE 6
FACTORS THAT CAUSE NON-PERFORMING LOANS

Factor	Frequency	Percent
Diversification of funds/poor management of funds	25	61
Weak loan portfolio management by bank staff especially weak credit analysis from the beginning	13	32
Integrity of borrowers/lack of transparency by borrower	11	27
Change of country policies	8	20
Court injunction instituted when bank intends to dispose properties/low prices fetched when disposing mortgaged assets/ Country law do not favor lending business	8	20
Business failure/inexperienced or lack of entrepreneurial knowledge on borrowers side	6	15
Natural calamities/change in economic conditions like inflation etc	2	5
Death of key person	1	2
Unfaithfulness of bank staff (corruption)	1	2
Lack of reliable market information	1	2
Other		
Most businesses actually they do have a single owner	1	2

The most ranked factor contributed to non-performing loans was allocation of funds by borrowers to businesses other than agreed one (61 percent). The second significant factor was weak loan portfolio management especially weak credit analysis at the application stage (32 percent) followed by lack of integrity of borrowers (27 percent). Change in country policies, court injunction instituted when bank intends to dispose properties, low prices fetched when disposing mortgaged assets and business failure were ranked as modarately. It may be concluded therefore that, factors internal to CBs were major causes of NPLs. This is contrary to what the researcher speculated earlier that CBs learned from other countries' experiences.

STRATEGIES USED TO OVERCOME THE PROBLEM OF NON-PERFORMING LOANS

Respondents were asked as to what they did to tackle the problem of non-performing loans given that they knew what caused them. Table 7 below provides their responses.

TABLE 7
STRATEGIES APPLIED IN REDUCING NON-PERFORMING LOANS

Strategy	Frequency	Percent
Frequent contact with borrowers; Creating environment to make the bank seen as a problem solver and trusted advisor	21	51
Frequent contact with borrowers; Creating environment to make the bank seen as a problem solver and trusted advisor; Attend some of their (borrowers) business meetings	11	27
Creating environment to make the bank seen as a problem solver and trusted advisor	6	15
Frequent contact with borrowers; Attend some of their (borrowers) business meetings	2	5
Creating environment to make the bank seen as a problem solver and trusted advisor; Attend some of their (borrowers) business meetings	1	2
Total	**41**	**100**
Others		
Perform offsite supervision through management accounts.	14	34
Conduct dinner party and other social events.		
Frequent follow up on key business issues.	5	12
Through caring the customers and make sure we deliver good service and	7	17
give reasonable charges.	8	20

All respondents mentioned a strategy of creating an environment to make the bank seen as a problem solver and trusted advisor to borrowers. 83 percent mentioned further that they make sure they contact their borrowers frequently and 34 percent added that they attend some of their borrowers' business meetings. Also performing offsite supervision through management accounts (34 percent) was implemented in the effort of reducing NPLs. Groups that indicate attending some of borrowers' business meeting are the relationship managers (24 percent), credit processing officers 15 percent) and credit approval officers (7 percent). In banking business, relationship managers are the ones responsible for monitoring borrowers. These results suggest their innovative ways of monitoring borrowers.

DISCUSSION AND CONCLUSION

Findings suggest that factors controllable by CBs to be the major contributor to non-performing loans specifically, the diversification of funds and weak credit analysis. This is inconsistent with what was established in Kenya (Waweru & Kalani, 2009) who found unfavourable economic environment specifically the national economic downturn leading to the depression of business to be perceived as the most important factor that caused NPLs. The results however, are consistent with moral hazards concept explained in asymmetric information theory. Debt contracts require borrowers to pay a fixed amount to the lender and let them keep any profits above this fixed amount. This situation provides an incentive to borrowers to take on investment projects that are riskier than the lender would like due to 'high risk high return' principal (Bester, 1994; Cornett and Saunders, 1999; Mishkin, 2001). The situation becomes worse if the borrower is not honest and decides to hide the actual performance of the investment in order to avoid paying his/her obligations to the lender. This was also evidenced in this study where results show that some borrowers lack integrity and are not transparent.

Weak credit analysis might have also been caused by unfaithful staff (though this was found out to be a minor contributing factor). Fernandez et al., (2000) and Waweru & Kalani (2009) found that most banking crises have directly led to the inadequate management of credit risk by institutions and lack of skills amongst loan officers respectively. Our findings are slightly consistent with the above two studies although the data indicated that all respondent were trained of how to appraise, monitor and supervise borrowers. Allan and Olomi (2003) however, concluded that banks have capacity constraints in credit and risk management. These findings therefore suggest that maybe the trainings obtained were not satisfactory or probably the number of staff do not tally with the number of borrower to monitor and supervise. Factors uncontrollable by CBs were court injunction instituted when bank intends to dispose properties, low prices fetched when disposing mortgaged assets and change in policies. An example here was the issue of exportation of hard wood logs business which was stopped when several banks had issued loans in respect to that business. Others were natural calamities, change in economic conditions like inflation etc, and death of key person (borrower's side) as well as lack of reliable borrowers information. The World Bank (2002) during their study on establishing business environment in Tanzania used a credit information index[3] while establishing the situation of getting credit information. Tanzania scored zero compared with the regional average of 2.1. By the time the WB study was conducted, the Tanzania Credit Information Bureau (TCIB)[4] was not launched yet. The results from the study however, inform us that on average, in Tanzania getting credit information even from other sources is problematic.

Establishing a good relationship with borrowers was found to be the most favourable strategy employed by banks in the effort of reducing non-performing loans. This was done through assisting borrowers by advising them on how to solve their problems, attend some of borrowers' business meetings, deliver good services and provide reasonable charges and also go further and organize dinner party and other social events where banks invite their borrowers. These findings suggest that innovation on new ways of dealing with borrowers is necessary for banks to be able to recover their money. CBs in Tanzania need to strengthen their loan management process especially in monitoring their borrowers and probably come up with new ways of monitoring them. As to whether these strategies worked our positively is another issue to be studied further though results in this study suggest so. Also, further research may be conducted to include corporate borrowers in the sample thus enriches further the body of knowledge.

NUMBERED NOTES

1 The term Commercial Bank in Tanzania refers to all banks that operate cheque accounts (BOT Act, 2006).
2 Non performing loan is defined as loans whose principal or interest remains unpaid 90 days or more after due date (BFIA, 2006).
3 The index measures the scope, access and quality of credit information available through public and/or private bureau. The index ranges from 0 – 6, with higher values indicating the availability of information.
4 TCIB was launched in 2003

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