PROCEEDINGS

Lessons and Solutions in Managing Non-Performing Loans to SMEs in Africa

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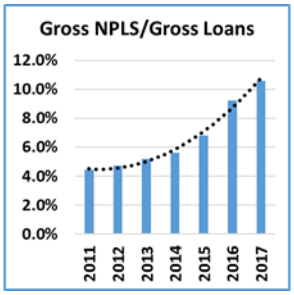
Executive Summary

To successfully manage non-performing loans (NPLs), it is necessary for a lender to have the right approach, specifically to develop good governance, choose the right business model and make accurate pricing decisions. It is also important to ensure that there is proper understanding of customer information and that the right data is being used in developing scoring models. Moreover, there is a need to realize that NPL management is a people business – the bank's people have to deal with real people, real borrowers.

Current NPL Situation in Kenya



From 2012-2016, Kenyan banking industry assets experienced significant growth. The rapid growth of the banking industry's assets has been occasioned by a double-digit growth in credit to the private sector. From an annual average high of nearly 26 percent, private sector credit growth rate has subsequently plummeted to single-digit levels. Regarding the evolution of NPLs, there was a rise in rates following stable levels between 2011 and 2014. This relates to what is a broader weakness in the rest of Sub-Saharan Africa, where the day-to-day growth in NPLs has risen. *Source:*

Source: Kenya Bankers Association

Causes of NPL Level Increases

Causes Specific to Kenya

- Credit toward government-driven growth is associated with delayed payments.

- Some economic sectors have been affected in Kenya, particularly tourism, which is very sensitive to the political situation in the country, including incidents such as the Westgate shopping mall attack.
- The expansion strategy among market players from 2004-2014, was associated with heightened risk appetite on the part of the banks.
- The eventual slowdown in the rate of credit growth on the back of market volatility resulted in three large bank failures (2015-2016), resulting in more cautious asset classification and attendant volatility.
- The slowdown in economic growth in 2017 has implications regarding expectations about private sector credit, and how this could influence the NPL position of the banking sector.
- The year 2017 was a challenging year for the banking sector in Kenya due to numerous factors, such as the droughts that affected the food supply and a very prolonged government election, negatively impacting economic activities.

General

- A study by Nelson M. Waweru and Victor M. Kalani identifies three causes of NPLs. The first cause is the national economic downturn or *"external factor*". The second cause concerns customer failures to provide high quality information during the loan application process, that is, the "*customer specific factor.*" This has implications for the ability to score the borrower. The last cause is that banks lack an aggressive debt collection policy, that is, the "*bank specific factor*". There must be a good policy or agreement in place on how to collect debt.
- The housing bubble in the United States (U.S.) was a lesson about the need to be very cautious about easy credit.
- Information asymmetry causes bank failures, whether banks are using technology or traditional methods. For example, if there is good information for 10 percent of the loans, the remaining 90 percent of loans will be a problem. If a bank borrowed from 100 lenders and none of them is talking to one another, what stops the customer from borrowing excessively from multiple providers. As a result, the bank may have an exposure of $100,000, when the bank was only capable of having an exposure of $10,000. Thus, those who have capital in the bank are exposing themselves to unnecessary risk. At the macroeconomic level, this is suicidal for the economy at large as it creates banking sector instability.
- Many financial institutions have a problem in extending credit because they are not able to score their borrowers very well.
- Institutions must be very careful in managing and mitigating information asymmetry, and to price in the related risks, even with the benefit of technology.
- NPLs are very similar all over the world. One of the causes of NPLs is fraud from the borrowers and in some cases from some of the bank staff. Strong institutions are characterized by strong management with adequate capacity to ensure effective corporate governance and internal controls to mitigate operational risks. The use of technology for instance linking credit and debit cards to mobile phones has enhanced fraud detection and prevention.

Key Issues for Analysis

- Given the link between economic performance and private sector credit growth, there is need for a better understanding of the relationship between NPLs and the business cycle.
- The link between NPLs and public sector-driven growth must be analyzed, particularly when it comes to the management of NPLs associated with lending to agencies doing business with the government.

- The regulation that capped interest rates resulted in banks being discouraged from lending to the private sector because it prevents lenders from implementing proper risk-based pricing practices. It is critical to understand the connection between this form of regulation and the quality of assets. It is also important to understand the link between this form of regulation and the pooling of assets
- The market is currently leaning toward short-term credit. Banks prefer current assets and transactional accounts as opposed to fixed account deposits. This has negatively impacted on economic performance. More consideration is needed regarding how this phenomenon affects NPLs.
- There are regulatory issues that could have an impact on asset quality. For instance, in January 2018, International Financial Reporting Standards (IFRS) 9 replaced International Accounting Standards (IAS) 39. The critical difference between IFRS 9 and IAS 39 lies in the way in which impairment on financial assets is recognized. IFRS 9 introduces the Expected Credit Loss model that replaces the Incurred Credit Loss model under IAS 39, and requires recognition of expected loss over the life of the asset in the event of asset quality deterioration. Basel principles have driven banks to ensure credit exposures are managed proactively and priced appropriately so that they generate the desired returns given the related capital charges on exposures.

Bangladesh's Experience with NPLs

- The BRAC Bank has been conducting small business lending for 17 years with loan amounts ranging from US$3,000-25,000. In 2015, it disbursed 63 percent of all collateral-free loans in the industry. Currently, it holds a 37 percent market share of the collateral-free small business portfolio. Currently, it is the most profitable bank in Bangladesh.
- The key to BRAC Bank's success lies in the continuous development of its business model, product features, governance culture and product pricing.
- BRAC Bank started its collateral-free small business lending journey by embracing the model of BRAC NGO's microfinance operation which helped the Bank to rapidly grow its small business portfolio and footprint across the country. However, this model started showing very high NPLs after 5 years of operation due to lack of governance culture at field level. In 2009, BRAC Bank changed its small business lending model again where loans were given for longer tenor which resulted in low repayment rates from its borrowers & a very high portfolio growth. A separate team collected the debt and had no relationship with customer lending. In 2013, BRAC Bank transitioned to a new model where the Bank established strong governance, including a monitoring team. The key success factor of the model is accountability both at the Area Credit Manager (credit) and Customer Relationship Officer (business) levels, which has resulted in better quality loan booking as well as stronger collection.
- Designing the product specifically for its customers, including competitive pricing, has allowed BRAC Bank to attract higher quality clients.
- During BRAC Bank's experimental years, the NPL level reached around 15.6 percent. In recent years, this level has dropped to 2.6 percent. BRAC Bank's collateral-free portfolio is much better than its collateralized book. The collateral-free NPL rate was 17 percent, and has now decreased to 1.9 percent, and the PAR (portfolio at risk) has also dropped from 22.7 percent to 3.1 percent.
- BRAC Bank is planning to transition to Fintech, moving away from its very high cost business model. BRAC Bank wants to design a scoring model and a scorecard in collaboration with its area credit managers.

Managing NPLs

- NPLs are normal in the banking business. Every bank should develop experts in NPLs, and these loans should be maintained in one unit, separate from the bank's regular lending business. One mistake that banks make is losing NPL expertise during good financial periods. Suggestions for improving expertise include recording it, having video group discussions, bringing people back to mentor others, and collecting data.
- Bank procedures must be the same for every NPL in every department or branch. In this context, banks should bear in mind that customers speak with one another and follow social media reports.
- The key to managing NPLs is to recover as much cash as possible for the bank at a reasonable cost, time and risk. IFRS9 implies that time is money.
- Whatever a bank decides to do, the balance sheet must be stabilized. If it is not stabilized, then regulators, shareholders, and depositors lose confidence in the management of the bank. One example is Kabul Bank, in Afghanistan, that ran out of cash because customers launched a panic run on the bank, taking all of their money out of the bank. It was definitely insolvent, but had the balance sheet been stabilized, the government and interntional donors could have had time to repair the problem. Instead, they were forced to take emergency action.
- There is a need to find structures for holding good assets that will recover easily in the future, such as Asset Management Corporations (AMCs).
- A bank may decide to manage NPLs instead of packaging and selling them off. The key points to consider are: consistency, meaning treating all customers the same; transparency, in terms of being open about procedures and requirements, including procedure manuals, instructions, and a strong internal audit; and finally, honesty is important, in telling the customers and staff the truth. If you don't tell the truth, you will be found out.
- Managing NPLs is a people business, the bank's people, the borrower's people and everyone should be treated consistently and fairly.

The Future of NPLs

In Kenya

- Many of the causal factors of NPLs in Kenya may disappear in the near future. The slowdown in economic growth of 2017 is expected to be reversed. The country has experienced good rainfall and a new government is in place. The interest rate capping law is still being discussed.
- Optimism influences expectations regarding the provision of private sector credit, and it has an impact on the position vis-à-vis NPLs.
- The policy of fiscal consolidation needs to be seen in the context of its potential to lower the extent to which the government is a core driver of economic growth. It should also be viewed in the context of how it impacts the degree to which the private sector gathers momentum and demands more credit. Both of these aspects will have an influence on the NPL position.
- The major concern for central bank regulators is what causes banks to fail and what role NPLs play in the process.
- The regulatory response to NPLs is contained in Kenya's Banking Act section 20(2): "Every institution shall: (a) make provision for loans, advances and other assets before any profit or loss is declared; and (b) ensure that the provision for loans, advances and other assets made under paragraph (a) is adequate according to such guidelines as may be prescribed by the Central Bank."
- The Central Bank's "Prudential Guideline on Risk Classification of Assets and Provisioning" requires licensed banks to make adequate provisions for perceived losses.

- The minimum amount for provisioning is determined by the classification of loans. It ranges from 1 percent for loans classified as “normal”, 20 percent for loans classified as “substandard”, and 100 percent for loans classified as a “loss”. However, the issue is not the loan classification itself. Rather, it is the lender not doing a good job in properly classifying its borrowers, and recognizing losses promptly.

In general

- There is a need for discussion regarding the regulation of loan providers, credit and technology. It is essential to know who is providing lending, how are they lending, and if they are classifying the loans properly.
- Financial institutions must ensure they assess the risks around new technology used in internal systems and services offered to customers to mitigate the impact of these risks, including those resulting from fraudulent activities.
- Innovation and technology must overrun the fraudsters.
- Non-collateralized loans can deliver reasonably good results in terms of NPL levels if credit managers are appropriately rigorous and proactive in assessing and managing the risks of the exposures.