

**CREDIT MANAGEMENT AND LOAN PERFORMANCE
IN SELECTED COMMERCIAL BANKS IN
BUJUMBURA, BURUNDI**

By

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**A THESIS SUBMITTED TO THE COLLEGE OF ECONOMICS AND
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DECLARATION

I hereby declare that this is my original work, and to the best of my knowledge, it has never been submitted by any other person for any academic award in and out of Kampala International University.

Rukundo Alain Romaric

Sign:

Date:

APPROVAL

I hereby certify that this thesis was compiled under my supervision, and is herein submitted for examination with my approval as the designated University supervisor.

Assoc. Prof. Emenike O. Kalu

Sign:

Date:

DEDICATION

I wish to dedicate this research work to my family, especially my mother Mrs. Inamahoro Jacqueline, Uwikukiye Godefroid family, my sister Mrs. Gahimbare Larissa, and my brother Mr. Shingiro Aristide for all the encouragement, moral and financial support that has got me to where I am today.

I also dedicate it to my friends who inspired me in education. Thank you for being there for me, showing me your love and tolerance for the long hours away from home as I pursued my studies.

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LIST OF ACRONYMS

ADB	-	African Development Bank
BANCOBU	-	Banque Commerciale du Burundi
BBCI	-	Burundi Bank of Commerce and Investment
BCB	-	Banque de Crédit de Bujumbura
BIF	-	Burundian Franc
BRB	-	Bank of the Republic of Burundi
CAPM	-	Capital Asset Pricing Model
CRC	-	Credit Risk Control
CRM	-	Credit Risk Management
EIB	-	European Investment Bank
EU	-	European Union
IBB	-	Interbank Burundi
IDA	-	International Development Association
KCB	-	Kenya Commercial Bank
MPT	-	Modern Portfolio Theory
NPLs	-	Non-Performing Loans
SMEs	-	Small and Medium Enterprises
OPEC	-	Organization of Petroleum Exporting Countries
UK	-	United Kingdom
VAR	-	Value at Risk

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ABSTRACT

This study was aimed at determining the effect credit management on loan performance. The study was based on four specific objectives; to assess the effect of credit standards on loan performance in commercial banks, to determine the effect of implementation of credit policy on loan performance in commercial banks, to analyze how credit terms affect loan performance in commercial banks and to establish the effect of collection policies on loan performance in commercial banks in Burundi. A review of existing literature revealed that very few studies have been done on factors affecting credit management as many of the studies concentrated largely on non-financial loans and credit allocation yet it is through improved credit management that banks' loan portfolios can enlarge and banks would meet their ultimate goal of stimulating growth and performance in the economy. Despite many researches it is quite clear that very little research studies has been done on factors affecting credit management as many of the researches concentrates largely on nonfinancial loans and credit allocation yet it is through improved credit management that banks would be able to expand their loan portfolios. The study aims to fill that knowledge gap. The study adopted a descriptive survey design, with the study population comprised of 58 employees of 3 selected commercial banks. Data was collected using questionnaires and was analyzed using descriptive and regression analysis to determine the effect of credit management on loan performance. The findings of the study revealed that the various components of credit management, that is credit standards (average mean 4.73 and standard deviation 0.68), credit policy (average mean 4.71 and standard deviation 0.63), credit terms (average mean 4.57 and standard deviation 0.57) and collection policy (average mean 4.63 and standard deviation 0.61), have a positive and significant effect on loan performance in commercial banks in Bujumbura, Burundi. The study concluded that having objective and appropriate parameters for credit standard, enabling banks to adequately assess the credit records, and clear guidelines in the processing and issuance of loans and monitoring their repayment schedules has a direct bearing on the levels of default and repayment. It was also concluded that the policy on loan repayment collections is another key determinant of loan performance, where the rate of asset recovery and transfer of loans is directed related to the level of losses from loan default. The study recommended that Commercial banks should consider having in place effective credit standards, credit policy, credit terms and collection policies or procedures as mechanisms to guide their business, since the effectiveness of credit management is important to the successful management of banking institutions; that Commercial banks should operate their credit businesses based strictly on established lending guidelines that clearly outline the business growth priorities of the senior management, as well as the conditions to satisfy in order to qualify for loan approval; and that there should be prior customer evaluation before loans are granted, and a continuous process of assessment before and during the course of loan repayment. This study's contribution to knowledge is its ability to add to the body of existing knowledge on financial and credit management discipline and bridging

gaps in credit management research as a whole, by informing policy makers and managers of the best practices in appraising their credit policies and to review their operations critically for more result oriented approaches in the dealing with credit facilities.

CHAPTER ONE

INTRODUCTION

1.0 Introduction

This study examined the effect of credit management on loan performance among selected commercial banks in Bujumbura, Burundi. This chapter presents the background of the study, the statement of the problem, purpose of the study, objectives, research question, scope and significance of the study.

1.1 Background to the Study

1.1.1 Historical perspective

The idea of exchanging goods or services in return for a promise of future payment developed only after centuries of trade; money and credit were unknown in the earliest stages of human history. Nevertheless, as early as 1300 B.C., loans were made among the Babylonians and Assyrians on the security of mortgages and advance deposits. By 1000 B.C., the Babylonians had already devised a crude form of the bill of exchange so a creditor merchant could direct the debtor merchant in a distant place to pay a third party to whom the first merchant was indebted (Gestel & Baesens, 2009). Installment sales of real estate were being made by the Egyptians in the time of the Pharaohs. Traders in the Mediterranean area, including Phoenicia, Greece, Rome and Carthage, also used credit. The vast boundaries of the Roman Empire encouraged widespread trading and a broader use of credit. In the disorganized period that marked the decline and fall of the Roman Empire, credit bills of exchange and promissory notes were widely used to reduce the dangers and difficulties of transferring money through unorganized trading areas.

In Europe during the Middle Ages, a period which spanned 1,000 years from about 500 to 1500 A.D., credit bills were essential to the trading activities of the prosperous Italian city-states (Hill & Satoris, 2005). Lending and borrowing, as well as buying and selling on credit, became widespread practices; the debtor-creditor relationship was found in all classes of society from peasants to nobles. A common form of investment and credit, especially in Italy, was the “sea loan” whereby the capitalist advanced money to the merchant and thus shared the risk. If the voyage was a success, the creditor got the

investment back plus a substantial bonus of 20 to 30 percent; if the ship was lost, the creditor stood to lose the entire sum. Another form of credit was the “fair letter,” which was developed at fairs held regularly in the centers of trading areas during the Middle-Ages Europe. The fair letter amounted to a promissory note to be paid before the end of the fair or at the time of the next fair (Gestel & Baesens, 2009). It enabled a merchant, who was short of cash, to secure goods on credit. This gave the merchant time either to sell the goods brought to the fair or to take home and sell the goods that had been purchased on credit.

In the UK credit dealings were a personal affair, as people tended to borrow from businesses in their community. Whether borrowers were purchasing goods on credit from local merchants or borrowing money from their local bank, lenders typically knew their borrowers well – either personally or through their standing in the community. However, in larger communities this was more difficult (Gallinger & Poe, 2008). So tradesmen would share information on customers who failed to repay their debt. One such group were London tradesmen who, in 1803, pooled their knowledge of customers to avoid. As tradesmen saw the benefit of working together to protect their businesses, other units also formed across the country. In 1826, the Society of Guardians for the Protection of Tradesmen against Swindlers, Sharpers and other Fraudulent Persons was created in Manchester. Members received a monthly circular, informing them of people who defaulted on their debts, and it was seen as a member’s duty to share information to protect others from fraud (Emery, 2010). However, as information was often based on hearsay, it was still lacking in accuracy. By 1857, the Society’s name had evolved to the Manchester Guardian Society and it even had a ‘data accuracy officer’ to ensure that information was reliable and not based on gossip. Information on creditworthiness was becoming more efficient and rooted in fact.

In the Americas, credit is traced back to 1620 when a London merchant provided credit to facilitate the transportation of pilgrims to the American colony of Virginia. In return, the Pilgrims contracted to work for seven years (Gallinger & Poe, 2008). At the end of that period, payment would be made to the creditors based on the size of the individual

investment. The original credit of £1800 could not be paid at the end of seven years, so an alternative arrangement was agreed upon: £200 to be paid annually for a term of nine years. This arrangement had to be renegotiated and finally, after 25 years, the last payment was made. Also, to finance the American Revolution, the Second Continental Congress issued bills of credit. After the signing of the Treaty of Paris, bringing an official end to the war and official recognition of the United States by England, trading resumed and American importers and wholesalers would extend generous terms to their customers, ranging from 6 to 12 months, but it was not uncommon for an account to remain unpaid for a much longer period, sometimes up to 24 months or more (Emery, 2010).

With the restoration of pre-Revolutionary trade customs and habits, credit references assumed importance, although in most instances, proper information was still lacking (Gestel & Baesens, 2009). Some prospective purchasers took the precaution of using the names of prominent people they knew when placing orders on credit. While credit references sometimes accompanied orders, in most cases merchants took their chances. The 12-month period, which had prevailed, gradually became shorter. By the 1830s, the average term of sale was about six months. Hard financial times hit the country in the mid-1830s. The population was rapidly growing and business was expanding. The sale of land on credit went virtually unchecked and the banking system was not centralized (Hill & Satoris, 2005). By the summer of 1837, bank after bank closed its doors and thousands of businesses went into bankruptcy. The financial panic of 1837 saw the beginnings of the Mercantile Agency, established in 1841 by Lewis Tappan. It was this credit information agency that eventually became Dun & Bradstreet and helped transform credit and, with it, the course of American commerce.

In Africa, credit management is not a new concept, spanning back during the early colonial days. During the 1950s, at the peak of colonial rule, indigenous credit institutions developed alongside colonial ones (Seidman, 1986). However, while colonial credit institutions benefitted from centuries of experience in credit management, African institutions could not build on the same traditions and the lax regulatory regime was not enough to prevent the challenges associated with fraud, embezzlement and high default.

Consequently, African credit institutions suffered waves of failure compounded by heavy restrictions on access to credit by colonial authorities. After independence, a relaxation of the restrictions did remove some constraints, but the limitations and loopholes in regulation still presented challenges (Seidman, 1986). African credit institutions have served entrepreneurs and communities with very minimal state intervention or regulation. Instead of seeking recourse from the state to enforce credit contracts, merchants relied on institutions such as extended family connections, kinship groups, religious fraternities and codes of honor to safeguard their credit. Long term commitments entailed a moral authorization matrix, rather than a legal contractual matrix as a basis for trust.

In Burundi, credit management is grounded in the country's history of fragility resulting from political instability since independence (Nkuruzinza, 2015). This in turn has led to severe economic fragility as illustrated by the slow growth of the economy and declining income per capita over the years. The most brutal conflict was the 1993 – 2003, which had the most devastating effect on the economy, from which the country is still yet to recover. Credit access was always limited to a few, connected individuals, and was acquired at very unrealistic terms. To date, credit management in Burundi is still not fully regulated and many of those that deal in credit still rely on informal contractual arrangements (Nkuruzinza, 2015).

1.1.2 Theoretical perspective

The theoretical foundation of this study is grounded in the Modern Portfolio Theory (MPT) and the Capital Asset Pricing Model (CAPM). According to the Modern portfolio theory of Markowitz (1959), risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward. This theory states that it is possible to construct an efficient frontier of optimal portfolios offering the maximum possible expected return for any given level of risk. The theory also asserts that, the concept of credit risk management is built on the principle of management of working capital. A sound policy on the management of working capital is essential in business and therefore the company must have adequate working capital at all times, funds tied up in working capital should be collected as quickly

as possible so as to enhance the company's profitability (Nzuve, 2013). The theory was pioneered by Markowitz in his paper portfolio selection published in 1952 by the journal of Finance, which explains the four basic steps involved in portfolio construction as; security valuation, asset allocation, portfolio optimization and performance management. The essence of coming up with the theory is to validate construction of an efficient portfolio that optimizes returns of a particular investment.

The Capital Asset Pricing Model (CAPM) of Sharpe (1964) introduced the notions of systematic and specific risk. According to the CAPM, all investors will hold the market portfolio, leveraging or de-leveraging it with positions in the risk-free asset in order to achieve a desired level of risk. CAPM decomposes a portfolio's risk into systematic and specific risk. Systematic risk is the risk of holding the market portfolio. As the market moves, each individual asset is more or less affected. To the extent that any asset participates in such general market moves, that asset entails systematic risk. Specific risk is the risk which is unique to an individual asset. It represents the component of an asset's return which is uncorrelated with general market moves (Lintner, 1965).

1.1.3 Conceptual perspective

Loan performance is not only considered as a largest asset as well as pre-dominate source to generate revenue but one of the biggest risk source for the financial institution's soundness and safety as well (Richard et al., 2008). Despite of the efforts made by the financial institutions, in recent years, a number of problems increased significantly in both, emerging as well as matured economies of the world (Basel, 2004). Most important of all the risks associated to financial institutions is weak credit management, being a threat for the banking sector (Chijoriga, 2011). Well formulated loan policy is beneficial for institutional performance. Hence it helps organizations to follow the same for risk management as well as fulfilling regulatory requirements. Loan review is a part of policy and is crucial, helping management in problem identification on regular basis to check either loan officers are following the policy in true letter and spirit or not. The review policy is better implemented by commercial bank hence they were easily able to top up loans in no time through use of modern technology unlike institutions (Craig, 2006).

Loan appraisal is an application/request for funds, evaluated by financial institution. The aspects to be focused in appraisal includes: purpose of the client, need genuineness, repayment capacity of the borrower, quantum of loan and security. Loan appraisal plays important role to keep the loan losses to minimum level, hence if those officers appointed for loan appraisal are competent then there would be high chances of lending money to non-deserving customers (Boldizzoni, 2008). Collection procedure is a systematic way required to recover the past due amount from clients within the lawful jurisdiction. The collection aspects may vary from institution but those should be complaint to existing laws such as third party collection agencies may involve in a collection process. It does not just involve in collection procedure details provided by the institution but also the procedure in which the lawful collection takes place (Latifee, 2006). Well administered collection is needed for better performance of the loan. If financial institutions do not follow well administered collection procedures, this would results in loan defaults (Boldizzoni, 2008). Previous studies indicate that microfinance institutions need to have strong and effective credit risk management policies for ensuring consistent recoveries from clients (Frank et al., 2014).

Credit management is the combination of coordinated tasks and activities for controlling and directing challenges confronted by an organization through the incorporation of key risk management tactics and processes in relation to the organization's objectives (Nikolaidou & Vogiazas, 2014). Credit management practices are not developed and aimed to eliminate credit risks altogether but they aim at controlling opportunities and hazards that may result in risk (Frank et al., 2014). Moreover, Ross et al. (2008) contend that credit management practices also ensure that financial institutions must have strong and rational frameworks for decision making by which firm's objectives can be attained (Ross et al., 2008). García et al., (2013) on the other hand, note that effective credit management practices have never been successful to eliminate the human element in making decisions about controlling risks associated with credit.

Credit management is basically the handling of uncertainties faced by an investor to lose money that a borrower fails to repay. This may result in default or default risk. Investors may lose interest and principal that can result in increased cost of collection and decreased cash flows. Previous studies have noted that high credit risk controls (CRC) result in low chances of defaults (Ross et al., 2008). Therefore, credit risk could be alleviated by utilizing danger based evaluating, contracts, credit protection, tightening and broadening (Ross et al., 2008). Moti et al. (2012) argue that intelligent and effective management of credit lines is a key requirement for effective credit management. Furthermore, to minimize the risk of bad debt and over-reserving, banks ought to have greater insight into important factors like, customer financial strength, credit score history and changing payment patterns (Moti et al., 2012).

Credit management variation indicates the change in health of loan portfolio managed by bank (Cooper et al., 2003) resultantly performance of financial institution would also varies accordingly. Miller & Noulas (1997) depicted that if financial institutions are exposed more too high risk loans, there would be accumulation of unpaid loans along with less profits. Credit risk is most critical and expensive risk associated with financial institutions. Its impact is quite significant compared to any other risk associated to the banking sector as it is direct threat to solvency of the institution (Chijoriga, 2011). Credit management is not only directly associated to solvency but it's magnitude as well as level of loss is severe compared to other risks. It may results in loan losses of high level and even failure of financial institution (Richard et al., 2008; Chijoriga, 2011).

For microfinance institutions, the main source of income is the credit, which is why they need to have strong policies for credit risk management. The advance reimbursements may be questionable and the accomplishment of giving out credit relies on the philosophy connected to assess and to grant the credit (Moti et al., 2012). Subsequently the credit choice ought to be focused around a careful assessment of the danger states of the loaning and the qualities of the borrower. Various approaches have been created in customer evaluation preparation by budgetary establishments which run from generally straightforward techniques, for example, the utilization of subjective or casual

methodologies, to reasonably mind boggling ones, for example, the utilization of mechanized reproduction models (Horne, 2007).

1.1.4 Contextual Perspective

In Burundi, a towering appetite for loans has prompted commercial banks to give increase loan provision rapidly. Available statistics from the Central Bank of Burundi indicate that total loans in the Industry have grown from BIFX6.1 trillion in 2011 to BIFX 11.7 trillion in 2016 (BRB, Annual Supervision Report, 2017) The introduction of other players like Bank of Africa, KCB Bank, Ecobank, Diamond Trust Bank, Interbank Burundi and Finbank in the industry has also led to the increase in the loans. However, banks face a real danger of recording substantial bad loans on the back of tougher economic times, regulatory and institutional environment in which the banks operate, while others are attributable to internal characteristics of the banks themselves (Robinson, 2012). The research report states that corporate governance weaknesses, strategic risk concerns especially with new product development and weaknesses in operational risk management posed challenges to Banks.

The Burundi Bank of Commerce and Investment (BBCI) is the country-owned development institution. The bank is mandated to finance enterprises in key growth sectors of the economy. In order to deliver this aspiration, the Bank focuses on the key growth sectors of the economy by financing development projects at attractive terms. The bank supports Small and Medium Enterprises (SMEs) and large-scale development projects in the various key growth sectors, notably infrastructure development, industrialization, agriculture, services sector, real estate among others.

The Government of Burundi, through the Bank of the Republic of Burundi (BRB), in a number of cases guarantees the BBCI's large credits which it obtains from external financiers, notably African Development Bank (ADB), International Development Association (IDA), European Investment Bank (EIB), European Union (EU), Kuwait Fund and the Organization of Petroleum Exporting Countries (OPEC) Fund. The bank uses these funds to build up a significantly large loan portfolio in form of term loans to major

industries and most of these loans are non-performing, some are written off, and others are under recovery with the ratio of non-performing loans to the total loan book in excess of 42% (BBCI Financial Report, 2017).

Currently, the banking sector comprises 8 commercial banks, but highly concentrated with the two mature banks, the Banque de Crédit de Bujumbura (BCB) and the Banque Commerciale du Burundi (BANCOBU) accounting for a commanding share of the market. These two banks account for 43 percent of deposits, 42 percent of total assets, and 42 percent of credit allocated in 2014. Together with the Interbank Burundi (IBB) created, the three largest banks represented 78 percent of total assets, 77 percent of credit, and 82 percent of deposits in 2018, as well as most bank branches in the country (BRB, Annual Supervision Report, 2017).

State ownership in the banking sector is low, representing only 6.6 percent of total capital of commercial banks. However, the government still has substantial influence in the banking sector through its public entities that own up to 31.6 percent of the capital of all banks combined. The government is also a majority shareholder in two out of the three most important banks (BANCOBU and BCB). Hence, the government is still able to influence the management of banks through the nomination of its representatives to the board of directors. The government's presence also has implications in the allocation of credit, directly through borrowing by state entities and indirectly through political pressure on bank management (BRB, Annual Supervision Report, 2017).

1.2 Problem Statement

It is widely recognized that all over the world, financial institutions face enormous credit management challenges (Krestlow, 2013). Financial institutions particularly banks are very important in not only banking the low income earners in the society but also advancing credit facilities to them (clients). However, just like other financial institutions, they experience many cases of default risks, moral hazard and adverse selection. Whereas Burundi did not suffer direct effect of the 2008 global financial crisis, the second round effects/shocks caused a stagnation in the financial sector in Burundi from 2010-2017,

causing pressures on the central bank and commercial banks. Banks were forced to increase interest rates by an average of over 8% compared to the period prior to the crisis (BRB, Annual Supervision Report, 2017). This pushed the Central Bank of Burundi to set out a new directive on the treatment of credit risk management which thus has increased pressure on banks. The credit management challenges negate the profitability of financial institutions as they entirely depend on loan lending to increase its portfolios (Haneef et al., 2010). This is due to the fact that, when borrowers default in servicing their loans or in meeting their loan servicing obligations of the loans awarded to them, the lending institution will not get returns through interest charged on those loans. According to the BRB Annual Supervision Report (2017), the three banks (Burundi Bank of Commerce and Investment [BBCI], Banque de Crédit de Bujumbura [BCB] and the Banque Commerciale du Burundi [BANCOBU]) were not just the busiest banks in the country, they also posted the highest percentage of non-performing loans, (23% for BBCI, 27% for BCB and 19.6% for BANCOBU), leading to cash flow stress in BCB in the second quarter of 2017. The continuous rise in commodity prices also increased inflationary pressure on the economy, affecting the general loan repayment capacity of borrowers, and since these three banks have the biggest loan portfolio market, they were affected more than the others. This is shown from the records of the banks indicating that borrowers do not effectively service their loans as and when they are due in good time while others default completely.

Credit management challenges are not only argued to affect performance of loans but they also have far reaching implications. This is due to the fact that, other potential borrowers may fail to access credit facilities since part of the funds could have been extended as loans by commercial banks are still tied up due to default of clients from repaying. Ineffective credit management too affects the entire economy of a country which explains why the Central Bank of Burundi sets guidelines to enable financial institutions to mitigate risk of default by having credit reference bureaus. The purpose of credit management is to mitigate the risk of default which can result to reduction in lending institutions loan portfolio and its failure of granting loans to borrowers is an important activity in management of financial institutions (Motiet al., 2012). Despite many researches it is quite clear from the foregoing that very little research studies has been done on factors affecting

credit management as many of the researches concentrates largely on credit allocation yet it is through improved credit management that banks' loan portfolios will enlarge and banks would meet their ultimate goal of stimulating growth and performance in the economy. The importance of credit management to loan performance necessitated this study which aimed to establish the effect of credit management on loan performance of commercial banks in Bujumbura, Burundi.

1.3 Purpose of the Study

The purpose of this study was to examine the effect of credit management practices on loan performance in selected commercial banks in Burundi.

1.4 Specific Objectives

- i. To assess the effect of credit standards on loan performance in commercial banks in Burundi.
- ii. To determine the effect of implementation of credit policy on loan performance in commercial banks in Burundi.
- iii. To analyze how credit term affects loan performance in commercial banks in Burundi.
- iv. To establish the effect of collection policies on loan performance in commercial banks in Burundi.

1.5 Research Questions

- i. What is the effect of credit standards on loan performance in commercial banks in Burundi?
- ii. What is the effect of implementation of credit policy on loan performance in commercial banks in Burundi?
- iii. What is the effect of credit terms on loan performance in commercial banks in Burundi?
- iv. What is the effect of the collection policies on loan performance in commercial banks in Burundi?

1.6 Hypotheses

H₀₁ – Credit standards have no significant effect on loan performance in commercial banks in Burundi.

H₀₂ – Credit policy has no significant effect on loan performance in commercial banks in Burundi.

H₀₃ – Credit terms have no significant effect on loan performance in commercial banks in Burundi.

H₀₄ – Collection polices have no significant effect on loan performance in commercial banks in Burundi.

1.6 Scope of the study

1.6.1 Geographical Scope

The study area for this research was Bujumbura city, the capital of the Republic of Burundi, and Burundi Bank of Commerce and Investment (BBCI), Banque de Crédit de Bujumbura (BCB) and the Banque Commerciale du Burundi (BANCOBU) in Bujumbura were selected as the main sources of information for the study. These were selected because they are the three leading banks in the country with the highest market share in the banking industry.

1.6.2 Content scope

The study investigated the various credit management practices, specifically, credit standards, credit policy, credit terms as well as collection policy and how they affect loan performance in commercial banks in Bujumbura, Burundi.

1.6.3 Theoretical Scope

The study was guided by the Modern portfolio theory, which stresses that investment portfolios are based on the maximization of expected returns of the portfolio and the simultaneous minimization of investment risk (Fabozzi, Gupta, & Markowitz, 2002), and

risk component of Modern Portfolio Theory is measured using various mathematical formulations, and reduced via the concept of diversification which aims to properly select a weighted collection of investment assets that together exhibit lower risk factors than investment in any individual asset or singular asset class.

1.6.4 Time Scope

The study focused on credit management practices in the selected banks over an eight-year period (2010 to 2017) and how they have influenced loan performance over that period. The study will be carried out in three months.

1.7 Significance of the study

The study will be useful in understanding the current framework for credit management in commercial banks in Burundi and how it affects loan performance in those commercial banks.

The study will also be instrumental in exposing and evaluating the various risks faced by commercial banks in their credit taking operations and the various mechanisms put in place to mitigate them.

The study will also assess the linkages between the various government institutional framework regulations and the success of commercial banks in operating profitable loan portfolios.

The study will also help to explore the challenges faced by commercial banks in the credit market as well as lay out measures of addressing these challenges.

The study will help the author to acquire practical research skills, as well as help him to partially fulfill the requirements for the award of a Master of Science Degree in Accounting and Finance of Kampala International University.

1.8 Operational Definition of Key Terms

Credit: Is the amount of credit/loan issued to an individual or business.

Credit management: Are the various procedures put in place to prevent, minimize or mitigate the challenges associated with issuance of credit.

Credit standards: Are the procedures put in place to ensure that the credit supplier gains an acceptable level of confidence to attain the maximum amount of credit at the lowest as possible cost.

Credit policy: Is an institutional method for analyzing credit requests and its decision criteria for accepting or rejecting applications. A credit policy is important in the management of accounts receivables.

Credit terms: Is the collateral, repayment periods and interest rate, the security given by a borrower to a lender as an assurance that the loan will be paid and operates as a broad insurance against uninsurable risk or intentional default leading to non-payment of the loan.

Collection policy: Are the procedures an institution follows to collect past due account, the procedures that financial institutions use to ensure that they realize their collections on due accounts.

Loan performance: Is the measurement of the returns on loans issued by financial institutions in form of loan premium repayment, interest repayment as well as other costs and charges.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This is a review of the theories which were relevant to this study, and the existing literature about the effect of credit management on loan performance. It explored the findings of the various previous researchers who have studied the same or related topics to analyze the applicability of their findings.

2.1 Theoretical Review

2.1.1 Modern Portfolio Theory

Modern Portfolio Theory is an investment framework for the selection and construction of investment portfolios based on the maximization of expected returns of the portfolio and the simultaneous minimization of investment risk (Fabozzi, Gupta, & Markowitz, 2002). Overall, the risk component of Modern Portfolio Theory can be measured, using various mathematical formulations, and reduced via the concept of diversification which aims to properly select a weighted collection of investment assets that together exhibit lower risk factors than investment in any individual asset or singular asset class. Diversification is in fact, the core concept of Modern Portfolio Theory and directly relies on the conventional wisdom of “never putting all your eggs in one basket” (Fabozzi, Gupta, & Markowitz, 2002; McClure, 2010; Veneeya, 2006).

Modern portfolio theory tries to look for the most efficient combinations of assets to maximize portfolio expected returns for given level of risk (McClure, 2010). Alternatively, minimize risk for a given level of expected return. Portfolio theory is presented in a mathematical formulation and clearly gives the idea of diversifying the assets investment combination with a purpose of selecting those assets that will collectively lower the risk than any single asset. In the theory, it clearly identifies this combination is made possible when the individual assets return and movement is opposite direction (Veneeya, 2006). An investor therefore needs to study the value movement of the intended asset investment and find out which assets have an opposite movement. However, risk diversification lowers the level of risk even if the assets' returns are not negatively or positively correlated.

The modern portfolio theory explains ways of maximizing return and minimizing risk by carefully choosing different assets (McClure, 2010). The Primary principle upon which the modern portfolio theory is based is the random walk hypothesis which states that the movement of asset prices follows an unpredictable path: the path as a trend that is based on the long-run nominal growth of corporate earnings per share, but fluctuations around the trend are random. Since the 1980s, banks have successfully applied modern portfolio theory (MPT) to market risk. Many financial institutions are now using value at risk (VAR) models to manage their interest rate and market risk exposures (Veneeya, 2006). Unfortunately, however, even though credit risk remains the largest risk facing most banks, the practical of MPT to credit risk has lagged.

The framework for Modern Portfolio Theory includes numerous assumptions about markets and investors. Some of these assumptions are explicit, while others are implicit. Markowitz built his portfolio selection contributions to modern portfolio theory on the following key assumptions (Markowitz, 1959): investors are rational (they seek to maximize returns while minimizing risk); investors are only willing to accept higher amounts of risk if they are compensated by higher expected returns; investors timely receive all pertinent information related to their investment decision; investors can borrow or lend an unlimited amount of capital at a risk free rate of interest; markets are perfectly efficient; markets do not include transaction costs or taxes; and it is possible to select securities whose individual performance is independent of other portfolio investments. These foundational assumptions of modern portfolio theory have been widely challenged. Many of the criticisms leveled at the theory are discussed later in this essay.

Modern portfolio theory maintains that “the essential aspect pertaining to the risk of an asset is not the risk of each asset in isolation, but the contribution of each asset to the risk of the aggregate portfolio” (Royal Swedish Academy of Sciences, 1990). Risk of a security can be analyzed in two ways: stand-alone basis (asset is considered in isolation), and portfolio basis (asset represents one of many assets). In context of a portfolio, the total risk of a security can be divided into two basic components: systematic risk (also known as

market risk or common risk), and unsystematic risk, also known as diversifiable risk. Modern Portfolio Theory assumes that these two types of risk are common to all portfolios.

Risk and Return trade-off relates to modern portfolio theory's basic principle that the riskier the investment, the greater the required potential return. Generally speaking, investors will keep a risky security only if the expected return is sufficiently high enough to compensate them for assuming the risk (Ross, Westerfield & Jaffe, 2002). In modern portfolio theory, risk is synonymous with volatility, the greater the portfolio volatility, the greater the risk. Volatility is the amount of risk or uncertainty related to the size of changes in the value of a security. This volatility is measured by a number of portfolio tools including: calculation of expected return; the variance of an expected return; the standard deviation from an expected return; the covariance of a portfolio of securities, and the correlation between investments (Ross, Westerfield & Jaffe, 2002).

It suggests that it is not enough to look at expected risk and return of a particular stock, but by investing in more than one stock, an investor can reap the benefits of diversification, particularly a reduction in the riskiness of a portfolio. MPT quantifies the benefits of diversification also known as not putting all your eggs in one basket. It considers that, for most investors, the risk they take when they buy a stock is that the return will be lower than expected. In other words, it is the deviation from the average return. Each stock has its own standard deviation from mean which MPT calls it risk. Markowitz theory asserts that, the risk in a portfolio of diverse individual stock will be less than the risk inherent in holding any one of the individual stocks provided the risk of the various stocks are not directly related. He showed that investment is not just about picking stocks, but about choosing the right combination of stocks which to distribute ones' nest egg (Seibel, 2006).

An increasing body of analytical work has attempted to explain the functioning of credit markets using new theoretical developments. Challenging the model of competitive equilibrium, they have explored the implications of incomplete markets and imperfect information for the functioning of credit markets in developing countries. These provide a new theoretical foundation for policy intervention. . In this explanation, interest rates

charged by a credit institution are seen as having a dual role of sorting potential borrowers and affecting the actions of borrowers. Interest rates thus affect the nature of the transaction and do not necessarily clear the market. Both effects are seen as a result of the imperfect information inherent in credit markets (Horne, 2006).

Adverse selection occurs because lenders would like to identify the borrowers most likely to repay their loans since the banks' expected returns depend on the probability of repayment. In an attempt to identify borrowers with high probability of repayment, banks are likely to use the interest rates that an individual is willing to pay as a screening device. Since the bank is not able to control all actions of borrowers due to imperfect and costly information, it will formulate the terms of the loan contract to induce borrowers to take actions in the interest of the bank and to attract low risk borrowers. The result is an equilibrium rate of interests at which the demand for credit exceeds the supply. Other terms of the contract, like the amount of the loan and the amount of collateral, will also affect the behavior of borrowers and their distribution, as well as the return to banks (Moti et al., 2012).

Raising interest rates or collateral in the face of excess demand is not always profitable, and banks will deny loans to certain borrowers. Since credit markets are characterized by imperfect information, and high costs of contract enforcement, an efficiency measure as exists in a perfectly competitive market will not be an accurate measure against which to define market failure. These problems lead to credit rationing in credit markets, adverse selection and moral hazard. Adverse selection arises because in the absence of perfect information about the borrower, an increase in interest rates encourages borrowers with the most risky projects, and hence least likely to repay, to borrow, while those with the least risky projects cease to borrow (Ewert et al., 2000).

Interest rates will thus play the allocation role of equating demand and supply for loan funds, and will also affect the average quality of lenders' loan portfolios. Lenders will fix the interest rates at a lower level and ration access to credit. Imperfect information is therefore important in explaining the projects have identical mean returns but different

degrees of risk, and lenders are unable to discern the borrowers' actions. An increase in interest rates negatively affects the borrowers by reducing their incentive to take actions conducive to loan repayment. This will lead to the possibility of credit rationing (Boland, 2012).

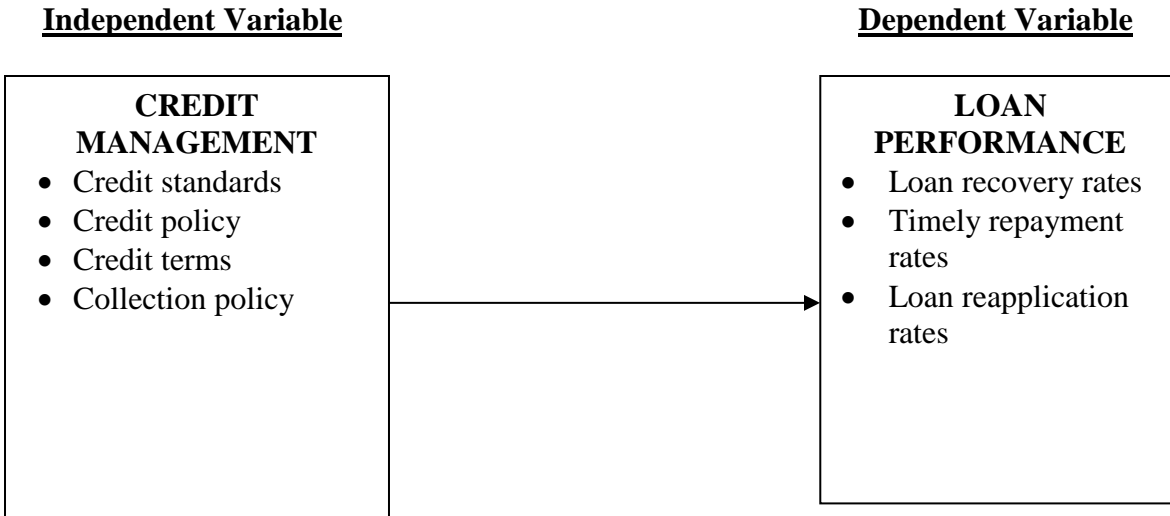
2.1.2 Capital Asset Pricing Model (CAPM)

According to the Capital Asset Pricing Model (CAPM), no matter how much we diversify our investments, it's impossible to get rid of all the risk. As investors, we deserve a rate of return that compensates us for taking on risk. The capital asset pricing model (CAPM) helps us to calculate investment risk and what return on investment we should expect. Here we look at the formula behind the model, the evidence for and against the accuracy of CAPM, and what CAPM means to the average investor (Sharpe, 1964). When the CAPM was first introduced, the investment community viewed the new model with suspicion, since it seemed to indicate that professional investment management was largely a waste of time. It was nearly a decade before investment professionals began to view the CAPM as an important tool in helping investors understand risk.

The key element of the model is that it separates the risk affecting an asset's return into two categories. The first type is called unsystematic, or company-specific, risk. The long-term average returns for this kind of risk should be zero. The second kind of risk, called systematic risk, is due to general economic uncertainty. The CAPM states that the return on assets should, on average, equal the yield on a risk-free bond held over that time plus a premium proportional to the amount of systematic risk the stock possesses (Markowitz, 1959). The treatment of risk in the CAPM refines the notions of systematic and unsystematic risk. Unsystematic risk is the risk to an asset's value caused by factors that are specific to an organization, such as changes in senior management or product lines. For example, specific senior employees may make good or bad decisions or the same type of manufacturing equipment utilized may have different reliabilities at two different sites. In general, unsystematic risk is present due to the fact that every company is endowed with a unique collection of assets, ideas and personnel whose aggregate productivity may vary.

2.2 Conceptual Review

The conceptual framework in this study examines the interconnection between the variables in the study. It explores how the independent variable influences or determines the dependent variable.



Source: *Adopted from Ross, Westerfield and Jordan (2008)*

Description of the Model

The graphical presentation of the conceptual framework depicted above shows the credit management as the independent variable, while loan performance as a dependent variable. It shows how credit management determines loan performance in Burundian commercial banks. Credit management is conceptualized by aspects of; credit standards, credit policy, credit terms and the collection policy. Loan performance in commercial banks in Burundi is conceptualized by aspects of; loan recovery rates, timely repayment rates and loan reapplication rates. Other factors such as the fiscal regime and macro-economic stability play a supplementary role in determining how credit management processes influence loan performance in commercial banks in Burundi. Using this model, the four dimensions of the independent variable capture the key aspects of credit management discipline that together play a leading role in determining the performance of loan portfolios of commercial banks in Burundi.

2.3 Related Literature

2.3.1 The effect of credit standards on loan performance

According to Ross et al. (2008), in advancing loans, credit standard must be emphasized such that the credit supplier gains an acceptable level of confidence to attain the maximum amount of credit at the lowest as possible cost. Credit standards can be tight or loose (Moti et al., 2012). Tight credit standards make a firm lose a big number of customers and when credit are loose the firm gets an increased number of clients but at a risk of loss through bad debts. A loose credit policy may not necessarily mean an increase in profitability because the increased number of customers may lead to increased costs in terms of loan administration and bad debts recovery. In agreement with other scholars. Horne (2007), advocated for an optimum credit policy, which would help to cut through weaknesses of both tight and loose credit standards so, the firm can make profits. This is a criteria used to decide the type of client to whom loans should be extended.

Cooper et al. (2003) noted that it's important that credit standards be basing on the individual credit application by considering character assessment, capacity condition collateral and security capital. Character it refers to the willingness of a customer to settle his obligations (Richard et al., 2008) it mainly involves assessment of the moral factors. Social collateral group members can guarantee the loan members known the character of each client; if they doubt the character then the client is likely to default. Saving habit involves analyzing how consistent the client is in realizing own funds, saving promotes loan sustainability of the enterprise once the loan is paid. Other source should be identified so as to enable him serve the loan in time. This helps micro finance institutions not to only limit loans to short term projects such qualities have an impact on the repayment commitment of the borrowers it should be noted that there should be a firm evidence of this information that point to the borrowers character (Chijoriga, 2011).

According to Boldizzoni (2008) the evaluation of an individual should involve; gathering of relevant information on the applicant, analyzing the information to determine credit worthiness and making the decision to extend credit and to what tune. They suggested the use of the 5Cs of lending. The 5Cs of lending are Capacity, Character, Collateral,

Condition and Capital. Capacity refers to the customer's ability to fulfill his/her financial obligations. Capacity, this is subjective judgment of a customer's ability to pay. It may be assessed using a customer's ability to pay. It may be assessed using the customer's past records, which may be supplemented by physical or observation. Collateral is the property, fixed assets, chattels, pledged as security by clients. Collateral security, This is what customers offer as saving so that failure to honor his obligation the creditor can sell it to recover the loan. It is also a form of security which the client offers as form of guarantee to acquire loans and surrender in case of failure to pay; if borrowers do not fulfill their obligations the creditor may seize their asset (Latifee, 2006).

According to Craig (2006), security should be safe and easily marketable securities apart from land building keep on losing value as to globalization where new technology keeps on developing therefore lender should put more emphasis on it. Capital portends the financial strength, more so in respect of net worth and working capital, evaluation of capital may be by way of analyzing the balance sheet using the financial ratios. Condition relates to the general economic climate and its influence on the client's ability to pay. Condition, this is the impact of the present economic trends on the business conditions which affects the firm's ability to recover its money. It includes the assessment of prevailing economic and other factors which may affect the client ability to pay (Miller & Noulas, 1997))

Appraisal of clients is a basic stage in the lending process. Ross et al. (2008) describes it as the 'heart' of a high quality portfolio. This involves gathering, processing and analyzing of quality information as way of discerning the client's creditworthiness and reducing the incentive problems between the lenders as principals and the borrowers as agents. The bank's credit policy, procedures and directives guide the credit assessment process. Banks should base their credit analysis on the basic principles of lending which are Character, Capacity, Capital, Collateral and Conditions (Moti et al., 2012). It is designed to ensure lenders take actions which facilitate repayment or reduce repayment likely problems. This information about the riskiness of the borrower makes the financial institution to take remedial actions like asking for collateral, shorter duration of payment, high interest rates

and other form of payment (Abedi, 2000) when a financial institution does not do it well, its performance is highly affected.

Abedi (2000) stressed the importance of credit analysis when he observed that its abandonment often resulted into several banks using credit card to process. The variables, according to Ross et al., (2008) included the length of time taken to process applications, credit experience, proportion of collateral security to the loan approved. It was found out that long waiting time reflected a shortage of credible credit information required to make informed credit decisions. This in turn leads to greater risk more intense credit rationing and low repayment rates. Horne (2007) also observed that loan experience indicated the ability to manage the business loans better hence good quality borrowers for the business. A less experienced borrower has less ability to manage a business loan and therefore is not credit worthy (Moti et al., 2012; Frank et al., 2014). This implies that there are big risks associated with new borrowers since the loan officer has no familiarity of recovery from them.

According to Latifee (2006) on the management of credit risk, the following was observed: Many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process. They noted too that many banks find carrying out a thorough credit assessment (or basic due diligence) a substantial challenge (Boldizzoni, 2008). For traditional bank lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence. Globalization of credit markets increases the need for financial information based on sound accounting standards and timely macroeconomic and flow of funds data.

When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with simple indicators of credit quality, especially if they perceive a need to gain a competitive foothold in a rapidly growing

foreign market (Craig, 2006). Banks may also need new types of information, such as risk measurements, and more frequent financial information, to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions. Chijoriga (2011) argue that credit criteria are factors used to determine a credit seeker's creditworthiness or ability to repay debt. The factors include income, amount of existing personal debt, number of accounts from other credit sources and credit history. Richard et al. (2008) suggested that giving out loans to borrowers who are already overloaded with debt or possess unfavorable credit history can expose banks to unnecessary default and credit risk. In order to decrease these risks, banks need to take into consideration several common applicants' particulars such as debt to income ratio, business and credit history and performance record and for individual loan applicants their time on the job or length of time.

According to Basel (2004), one of the features that banks deliberate when deciding on a loan credit application is the estimated chances of recovery. To arrive at this, credit information is required on how well the applicant has honored past loan obligations. This credit information is important because there is usually a definite relationship between past and future performance in loan repayment. Chijoriga (2011) in a study of the response of National Bank of Kenya Ltd. to challenges of non-performing loans concludes that the reliance of the bank on qualitative credit analysis methods that entails such factors as character of the borrower, reputation of the borrowed and the historical financial capability of the borrower as opposed to the used of quantitative techniques that emphasized on the borrowers projected cash flows and analysis of audited financial books of accounts have contributed to immensely to the non-performing loan portfolio.

2.3.2 The effect of credit policy on loan performance

A credit policy is an institutional method for analyzing credit requests and its decision criteria for accepting or rejecting applications (Nikolaidou & Vogiazas, 2014). A credit policy is important in the management of accounts receivables. A firm has time flexibility of shaping credit policy within the confines of its practices. It is therefore a means of reducing high default risk implying that the firm should be discretionary in granting loans

(Richard et al., 2008; Chijoriga, 2011). Policies save time by ensuring that the same issue is not discussed over and over again each time a decision is to be made. This ensures that decisions are consistent and fair and that people in the same circumstance get treated in the same manner (Ross et al., 2008). According to Moti et al. (2012), credit policy provides a frame work for the entire management practices.

Most financial institutions have written credit policies which are the cornerstone of sound credit management, they set objectives, standards and parameters to guide micro finance officers who grant loans and manage loan portfolio (Cooper et al., 2003). The main importance of policies is to ensure operation's consistency and adherence to uniform sound practices. Policies should always be the same for all and is the general rule designed to guide each decision, simplifying and listening to each decision making process. A good credit policy involves effective initiation analysis, credit monitoring and evaluation. Credit policies are set of objectives, standards and parameters to guide bank officers who grant loans and manage the loan portfolio. Thus, they are procedures, guidelines and rules designed to minimize costs associated with credit while maximizing the benefit from it (Boldizzoni, 2008).

The main objective of credit policy is to have an optimal investment in debtors that minimizes costs while maximizing benefits hence ensuring profitability and sustainability of microfinance institutions as commercial institutions. The credit policy of an organization may be stringent or lenient depending on the manager's regulation of variables. There are three main variables namely credit terms, credit standards and credit procedures (Latifee, 2006). Managers use these variables to evaluate clients credit worthiness, repayment period and interest on loan, collection methods and procedures to take in case of loan default. A stringent credit policy gives credit to customers on a highly selective basis. Only customers who have proven creditworthiness and strong financial base are given loans, the main target of a stringent credit policy is to minimize the cost of collection, bad debts and unnecessary legal costs (Horne, 2007).

2.3.3 The effect of credit terms on loan performance

Credit terms have been understood to mean collateral, repayment periods and interest rate (Ayyagari et al., 2003). Collateral is the security given by a borrower to a lender as an assurance that the loan will be paid and operates as a broad insurance against uninsurable risk or intentional default leading to non-payment of the loan. Loan repayment period is the time in which the borrower should repay the loan (Nkundabanyanga, 2014). Interest rate is the rate which is charged or paid for the use of money and is used as a means of compensating banks for taking risk. According to Stiglitz and Weiss (1981), credit terms are part of a general exercise to help determine the extent of risk for each borrower. According to Malimba and Ganesan (2009), grace period, collateral, interest rate charges and number of official visits to the credit societies, have a strong effect on loan repayment. Nkundabanyanga et al. (2014), found out that the higher interest rates induce firms to undertake projects with lower probability of success but higher pay offs when they succeed.

Nanayakkara and Stewart (2015) further indicated that since the financial institution is not able to control all actions of borrowers due to imperfect and costly information, the MFI will formulate terms of the loan contract to induce borrowers to take actions in the interest of the financial institution and to attract low risk borrowers. According to Ifeanyi et al. (2014), the interest rate has an effect on the use, repayment of the loan and the overall performance of the business. When the interest rate charged is high, there is a tendency for the borrowers to keep part of the borrowed money to pay the interest or to use the business capital to pay the interest. Malimba and Ganesan (2009) further argue that interest on borrowing is one of the costs of production. The higher the interest rate the higher the likelihood of loan repayment default as the costs of servicing the loan increase. Anderson (2002) indicated that an increase in interest rates negatively affects the borrowers by reducing their incentive to take actions that are conducive to loan repayment.

According to Makorere (2014), Grace period is the period given by the financial institution to the borrower before the first installment is due. In other words, it is considered to be the time between when the loan was disbursed to the loan applicant and when the first

installment is paid. While conducting a study in Tanzania, Makorere (2014) found out that most of the financial institutions tend to provide a grace period of one month only, which was seen not to be sufficient for the small business enterprise owners to start realizing enough revenue for them to start paying their loans. Makorere (2014) further found out that businesses that get enough grace period have never defaulted. Woolcock (1999) observed that if the loan term is too short, the borrower fails to generate revenue to enable him/her make repayments while a longer loan term may make the client extravagant and the client may in the end fail to pay back.

Kakuru (2008) found that when Small and Medium Enterprises perceive repayment period as not being flexible, they will not apply for the loans. For successful results, the loan terms should match the cash patterns to help the client budget cash flows (Stiglitz and Weiss, 1981). The findings made by Atieno (2001), indicates that stringent lending terms discourage borrowers to apply for bank debt even when they are searching for finance to execute valuable investment projects. For example, pledging business collateral limits the firms' ability to obtain future loans from other lenders which creates a position of power for the lending bank (Mann, 1997). According to Atieno (2001), collateral value requirements deter SME borrowers from seeking credit. Stiglitz and Weiss (1981) found out that SMEs hesitate to seek credit when they do not understand why requirements like collateral are imposed on them. Banks, however, prefer borrowers with collateral.

For example, Ifeanyi et al. (2014) observed that commercial banks usually provide larger loans, longer repayment periods and lower interest rates when borrowers offer collateral. This means that a borrower who cannot provide the type of assets lenders require as collateral often gets worse loan terms than otherwise. Indeed Atieno (2001) notes that borrowers who provide more collateral receive a better rating. Access to finance is particularly difficult for SMEs with insufficient collateral that do not have any established track record or credit history. Nevertheless, some studies (Ayyagari et al., 2003; Nkundabanyanga, 2014) indicate that higher availability of collateral is expected to increase the supply of bank debt as collateral can mitigate the information asymmetries between the borrower and lender. This means that commercial banks' requirement for

collateral positively affects access to formal credit where collateral is readily available. Contrarily, where collateral is not readily available, the demand for it will negatively affect access to formal credit. In the majority of studies, this distinction has not always been made explicit.

2.3.4 The effect of collection policy on loan performance

Collection policy refers to the procedures micro finance institutions use to collect due accounts. Atieno (2001) defines a collection methods as the procedures an institution follows to collect past due account. The collection process can be rather expensive in terms of both product expenditure and lost good will (Ayyagari et al., 2003; Nkundabanyanga, 2014). Collection efforts may include attaching mandatory savings forcing guarantors to pay, attaching collateral assets, courts litigation. Methods used by financial institutions could include letters, demand letters, telephone calls, visits by the firm's officials for face to face reminders to pay and legal enforcements.

Makorere (2014) asserts that collection policy is a guide that ensures prompt payment and regular collections. The rationale is that not all clients meet their obligations, some just take it for granted, others simply forget while others just don't have a culture of paying until persuaded to do so. According to Ifeanyi et al. (2014), many micro finance institutions may send a letter to such individuals (borrowers) when say ten days elapse or phone calls and if payment is not received with in thirty days, it may turn over the account to a collection agency.

Collection procedure is required because some clients do not pay the loan in time some are slower while others never pay. Thus collection efforts aim at accelerating collections from slower payers to avoid bad debts. Prompt payments are aimed at increasing turn over while keeping low and bad debts within limits (Malimba and Ganesan, 2009). However, caution should be taken against stringent steps especially on permanent clients because harsh measures may cause them to shift to competitors. Anderson (2002) states that collection efforts are directed at accelerating recovery from slow payers and decreases bad debts losses .This therefore calls for vigorous collection efforts .The

yardstick to measurement of the effectiveness of the collection policy is its slackness in arousing slow paying customers.

The collection process can be rather expensive in terms of both product expenditure and lost good will (Ayyagari et al., 2003). Collection efforts may include attaching mandatory savings forcing guarantors to pay, attaching collateral assets, courts litigation. Methods used by commercial banks could include letters, demand letters, telephone calls, visits by the firm's officials for face to face reminders to pay and legal enforcements. Nkundabanyanga (2014) asserts that collection policy is a guide that ensures prompt payment and regular collections. Collection procedure is required because some clients do not pay the loan in time hence collection efforts aim at accelerating collections to avoid bad debts.

According to Ifeanyi et al. (2014) posited that prompt payments aimed at increasing turn over keeping low bad debts. Collection efforts are directed at accelerating recovery from slow payers and decreases bad debts losses increase profitability of the banking institution Methods used by Micro finance institutions could include letters, demand letters, telephone calls, visits by the firm's officials for face to face reminders to pay and legal enforcements (Ayyagari et al., 2003; Nkundabanyanga, 2014). Stiglitz and Weiss (1981) assert that collection policy is a guide that ensures prompt payment and regular collections.

2.4 Empirical Review

Waweru and Kalani (2009) studied commercial banking crises in Kenya. They found that some of the causes of non-performing loans in Kenyan banks were national economic downturn, reduced consumer, buying ability and legal issues. This current study appreciate that the nonperforming loan and loan delinquency concepts are similar. However this study differs significantly from Waweru and Kalani (2009) in terms of area of study, and study methodology. These researchers covered commercial banks in Kenya while this current study focuses on microfinance institutions in Kenya. The banking and microfinance sectors operate under different regulatory authorities.

Mohammad (2008) did a study on risk management in Bangladesh Banking Sector. His main objective was to investigate the contribution of credit risk on non-performing loans. He found that, the crux of the problem lies in the accumulation of high percentage of non-performing loans over a long period of time. As per him unless NPL ratio of the country can be lowered substantially they will lose competitive edge in the wave of globalization of the banking service that is taking place throughout the world. Since they have had a two-decade long experience in dealing with the NPLs problem and much is known about the causes and remedies of the problem, he concluded that it is very important for the lenders, borrowers and policy makers to learn from the past experience and act accordingly.

Aboagye and Otioku, (2010) conducted a study on Credit Risk Management and Profitability in financial institutions in Sweden. The main objective was to find out if the management of the risk related to that credit affects the profitability of the financial institutions. They found that credit risk management in financial institutions has become more important not only because of the financial crisis that the world is experiencing nowadays but also the introduction of Basel II. They concluded that since granting credit is one of the main sources of income in financial institutions, the management of the risk related to that credit affects the profitability of the financial institutions (Aboagye and Otioku, 2010).

There have been debate and controversies on the impact of credit risk management and bank's financial performance. Some scholars e.g., (Naceur & Goaid, 2003; Kinthinji 2010; Kolap & Funso 2010; Kargi (2011;)) amongst others have carried out extensive studies on this topic and produced mixed results; while some found that credit risk management impact positively on banks financial performance, some found negative relationship and others suggest that other factors apart from credit risk management impacts on bank's performance. Specifically, Kargi (2011) found in a study of Nigeria banks from 2004 to 2008 that there is a significant relationship between banks performance and credit risk management. He found that loans and advances and non-performing loans are major variables that determine asset quality of a bank.

Musyoki and Kadubo (2011) also found that credit risk management is an important predictor of bank's financial performance; they concluded that banks success depends on credit risk management. Kithinji (2010) analyzed the effect of credit risk management (measured by the ratio of loans and advances on total assets and the ratio of non-performing loans to total loans and advances on return on total asset in Kenyan banks between 2004 to 2008). The study found that the bulk of the profits of commercial banks are not influenced by the amount of credit and non-performing loans. The implication is that other variables apart from credit and non-performing loans impact on banks' profit. Kithinji (2010) result provides the rationale to consider other variables that could impact on bank's performance

Most relevant to this study is a working paper by Sadaqat *et al.*, (2016) which studied financial and nonfinancial business risk. Data were collected from a sample of 28 commercial banks from 2011 to 2013. To test the importance of the factors that affect the financial and non-financial risk the multi-variant regression model was used. They found that non-financial and financial risk had a positive relationship with bank size. But operating efficiency build negative relationship with non-financial risk, and non-performing loans ratio established the negative and significant relationship with operational risk. The result proposed that the banking system of Pakistan is well diversified. Moreover the size of market also effect the tendency of risk management practices (Chaudhry *et al.*, 2015).

Mujtaba (2016) also investigated credit risk management and 10 domestic and foreign banks in Pakistan was the sample. Different statistical analysis was performed on the collected data to achieve the aim of this research. The findings of this research relates that Bank size has an insignificant relationship with credit risk in foreign banks, alternatively in domestic banks have positive and significant relationship with the earlier mentioned scenario. Liquid assets have a positive and insignificant relationship with credit risk with domestic banks and negative but significant relationship in foreign banks. They suggested that credit risk can be reduced if the size of the banks maintain and the banks increase their liquidity.

Different researchers had investigated the risk management in case of different countries and found different phenomenological ideas related to the under consideration issue. Selma *et al.*, (2016) investigated risk management in Tunisian commercial banks. They surveyed 16 commercial banks through a questionnaire. The data were analyzed using descriptive statistics, one sample t-test and Friedman test. The main results are that Tunisian banks are practicing the tools and also known about the importance and role of effective risk management and don't use widely economic capital and market Value at Risk (VAR) for different risk types. The role of transparency is well known by the Tunisian bankers and also found that risk management is an ongoing process and it will be developed in future, past and present. Risk information is disclosed in the financial statements according to Basel II. However the contribution of information towards risk management is of significant importance (Chaudhry *et al.*, 2015).

Banks registered in stock exchanges of their respective countries are volatile towards the new significant information in the market. However the efficient stock markets may react according to the information of the current market situation and which risk may arise due to unexpected circumstances (Mehmood *et al.*, 2016). According to Dionne (2013), the risk management practices should be deployed by organizations and most specifically by the financial institutions to manage their risk. Financial institutions must implement policy reforms for under consideration issue. However, application of derivatives for risk management practices is of significant importance.

Masoud *et al.*, (2016) studied risk management in Iranian banks. Financial data was collected from 10 Iranian banks from 2009 to 2014. The Regression model is used to test the data and result shown that capital adequacy had an inverse relationship and credit risk found a positive relationship with debt to equity ratio. The size of the bank, debt to equity ratio and Cash to asset ratio, had an inverse relation to liquidity risk and liquidity risk had a positive relationship to capital adequacy. And also found that the size of the bank, cash ratio and capital adequacy had a negative relation to operational risk.

Kanchu and Kumar (2017) also investigated the risk management in the banking sector of India. Data were collected through secondary sources and GAP analysis was adopted to find the results. The conclusion of this paper was that function of risk management depends upon the quality of the balance sheet and size of the bank. The activity of the efficient management information system, networking and computerization are the important factors of the effectiveness of risk management. Level of risk and level of performance may vary from person to person as the individual traits varies (Mehmood & Mehmood, 2017). In case of accounting and management perspective, risk management is of considerable debate and hence influence the decision making of the organizations and most specifically in case of commercial banks (Hall *et al.*, 2015). However, corporate risk are of managerial concern and should be heightened and addressed for proper administration and for attaining economies of scale (Garcia *et al.*, 2015).

2.5 Summary and Gaps

Generally, from almost all surveys reviewed in the literature, it was evident that credit management was essential in optimizing loan performance in commercial banks. According to Parrenas (2005), organizations have long viewed the problem of credit management as the need to control risks which make up most, if not all, of their risk exposure, credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most organizations would view legal risks as arising from their credit decisions or, more likely, proper process not employed in financial contracting. From the literature above, its clear that there is plenty of studies that have been conducted about credit management and loan performance in commercial banks and other financial institutions. However, the most of the existing literature reviewed is specifically focused on credit risk, and not credit management in general, which leaves an empirical gap. Also, the various empirical studies reviewed in the previous section have made any effort to explain the link between credit management and the modern portfolio theory, which leaves a theoretical gap. Additionally, none of these studies were conducted in Burundi, and given the fact that every country has a different set of financial condition

in which its financial institutions operate, which leave a geographical gap. These were the knowledge gaps that this study intended to fill.

CHAPTER THREE

METHODOLOGY

3.0 Introduction

The chapter presents the research design, research population the sample size, sampling procedures, the research instrument, validity and reliability, data gathering procedures, data analysis and ethical considerations in the study.

3.1 Research Design

The study employed a descriptive cross sectional design (Mugenda & Mugenda, 2003). It will be descriptive because it was interested in establishing the effect of credit risk management practices on loan performance in selected commercial banks, and cross sectional because it spanned across three separate commercial banks in Bujumbura, Burundi.

3.2 Target population

The target of the study comprised of General Managers, financial managers, credit analysts, operation managers, internal auditors making a total of 58 officers, according to the staff structure manuals from the three selected commercial banks of Burundi Bank of Commerce and Investment (BBCI), Banque de Crédit de Bujumbura (BCB) and the Banque Commerciale du Burundi (BANCOBU) in Bujumbura.

3.3 Sample size

Since the study population was a census population, the study took the entire population of 58 people as participants in the study. Therefore all the general managers, financial managers, credit analysts, operation managers, and internal auditors of the three selected commercial banks were involved in the study.

3.4 Sampling Procedure

Considering the small number of the research population, the study adopted a census sampling method, taking the entire population as participants in the study. This was because the study population was small and reasonably possible to cover in its entirety.

Therefore, all people in the research population participated in the study (Mugenda & Mugenda, 2003).

3.5 Research Instruments

3.5.1 Questionnaires

These were questions relating to the topic of study. During the course of the study, the researcher printed the questions and distributed them to selected respondents, the respondents answered the questions and the research assistants collected them and returned them to the researcher.

3.6 Validity and reliability of instruments

In order to test the validity of the instruments, the researcher availed the questionnaire to two experts to check each item for language, clarity, relevance, and comprehensiveness of the content. The items were be rated as follows: 3 – Very relevant, 2 – Quite relevant, and 1 – Somewhat relevant. The researcher then put the items in 2 groups, with category 1 in one group and the other 2 and 3 in the other group. The researcher then computed the score using the Content Validity Index formula below:

$$\text{CVI} = \frac{\text{Items rated as very relevant and relevant (2 and 3)}}{\text{Total number of items}}$$

For the instrument to be valid, the CVI will have to fall within the accepted statistical range of 0.7 to 1.

$$\text{CVI} = 7(9)$$

$$\text{CVI} = 0.7777$$

The validity score is **0.77**, indicating that the instruments will produce valid data.

Cronbach alpha (Cronbach, 1951) reliability coefficient of 0.7 points and above was used to measure the internal consistency or average correlation of items in a questionnaire instrument to gauge its reliability. The higher the score, the more reliable the generated scale is. For instance, Nunnally (1978) argues that a 0.7 alpha coefficient is an acceptable reliability coefficient.

The reliability was calculated using the Cronbach's Alpha Coefficient formula:

$$\rho_{KR20} = \frac{k}{k-1} \left(1 - \frac{\sum_{j=1}^k p_j q_j}{\sigma^2} \right)$$

where

k = number of questions

p_j = number of people in the sample who answered question j correctly

q_j = number of people in the sample who didn't answer question j correctly

σ^2 = variance of the total scores of all the people taking the test = $\text{VARP}(R1)$ where $R1$ = array containing the total scores of all the people taking the test.

Values range from 0 to 1. A high value indicates reliability, while too high a value (in excess of .90) indicates a homogeneous test.

$$\begin{aligned} \text{Reliability } (P_{KR20}) &= 9 \div 5(0.5) \\ &= 0.90 \end{aligned}$$

Therefore reliability is **0.90**, indicating that the instrument is reliable

The Content Validity Index was computed and all items scored above 0.7 as shown above. The instrument was also checked for accuracy, reliability, consistency and completeness using the alpha cronbach test (cronbach, 1951). The acceptable reliability results were those of 0.7 points and above as shown above.

3.7 Data Gathering Procedure

3.7.1 Before data gathering

In this stage the researcher obtained a reference letter from the College of Economics and Management, Kampala International University, which he presented to the authorities in the field. He then made preparations based on the conditions in the field of study. The

researcher made an assessment of the weather conditions, physical locations and linguistic characteristics in the study area so as to determine the best methods to use as well as preparing questionnaires and interview guide.

3.7.2 During data gathering

At this stage the researcher made appointment schedules with all the respondents so as to enable him meet all respondents at the scheduled time. This helped the researcher to keep time and ensure the convenience of respondents.

3.7.3 After data gathering

At this stage, the researcher organized the data obtained from the field systematically in preparation for presentation, analysis and presentation.

3.8 Data Analysis

The collected data was analyzed through descriptive analysis that is means and standard deviation to determine the extent to which credit management practices influenced the loan performance of commercial banks. Regression analysis was used to establish the relationship between the independent variable (credit management practices) and the dependent variable (loan performance of commercial banks). Credit management was quantified from 1-5 Likert scale questions. A linear regression model was applied to examine the relationship between the variables. The model treated loan portfolio performance of in commercial banks as the dependent variable while the independent variables were the credit management practices which include credit standards, credit policy, credit terms and collection policy. The relationship model was represented in the linear equation below:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$$

Where:

Y= Loan performance

α = Constant,

β = Coefficient factor,

X1= Credit standards,

X2= Credit policy,

X3= Credit terms,

X4= Collection policy

e = Error Term

The hypotheses testing were done by the linear regression model using the distribution (F-statistic) test, to determine where to accept or reject the hypotheses. The decision rule was as follows:

Accept H_0 If (Sig. F) > 5%.

Accept H_1 If (Sig. F) < 5%.

3.9 Ethical Consideration

This involved seeking permission by the researcher from the relevant authorities. Permission was also sought from the relevant authorities with respect to the respondents' views.

It also involved explaining to the respondents the purpose of the study. Respondents were assured that the information obtained from them would be used for academic purposes only.

The researcher ensured that he used only those techniques for which he was qualified by education, training and experience. Whenever in doubt, the researcher would seek clarification from the research community especially the immediate supervisor and research colleagues.

The researcher ensured that data was interpreted according to general methodological standard and that elements that were irrelevant to data interpretation were excluded from the report.

The researcher kept all the information given to him very confidential and used it only for purposes indicated as the justification of the study.

3.10 Limitations of the Study

During the investigations, the researcher encountered the following limitations;

- The study was limited by inadequate funding as it was costly in terms of movement and buying of materials to use. Here, the researcher tried to mobilize for more funds by soliciting funds from sponsors.
- There was also a problem of some respondent's failure to give out their views and also fill the questionnaires. Here, the researcher supplemented this information by carrying out face to face interviews.
- The study was also limited by time because there were a lot of activities that had to be done which at times would create a lot of fatigue for the researcher. Here, the researcher hired research assistants to help him during the course of data collection.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTERPRETATION OF RESULTS

4.1 Introduction

This chapter gives the presentation, analysis and interpretation of the results of the study on the impact of credit management on loan performance in commercial banks in Bujumbura, Burundi. The findings were presented in line with the objectives of the study, but for a more systematic presentation, the first section deals with the demographic characteristics of the respondents who participated in the study.

4.2 Demographic Characteristics of Respondents

This section presents the background information about the respondents, including age, gender, marital status, education levels, position and years in service.

Table 4.1: Demographic Characteristics of respondents

		Frequency	Percent
Gender	Male	31	53.4
	Female	27	46.6
	Total	58	100
Age	18 – 25 years	7	12.0
	26 – 35 years	23	39.7
	36 – 45 years	19	32.8
	46 yrs and above	9	15.5
	Total	58	100
Marital status	Single	27	46.6
	Married	20	34.5
	Widowed	11	19.0
	Total	58	100
Education levels	Master’s degree	14	24.2
	Bachelor’s degree	35	60.3
	Diploma	7	12.0
	Certificate	2	3.5

	Total	58	100
Position held	General manager	3	5.2
	Financial manager	6	10.3
	Credit analyst	12	20.7
	Internal auditor	37	63.8
	Total	58	100
Length in the position	1 – 3 years	21	36.2
	3 – 5 years	23	39.7
	5 – 10 years	14	24.2
	Over 10 years	0	0.0
	Total	58	100

Source: *Field data, 2017*

The results in table 4.1 indicate that on the gender of respondents, 53.4% of the respondents were male while 46.6% were female. This implies that both genders were adequately represented in the study. Documenting the gender differences of the respondents was important in determining the gender distribution of roles and responsibilities in the various selected commercial banks in Bujumbura, Burundi.

Regarding the age categories of respondents, the results indicate that 12.0% of the respondents were aged 18 – 25 years old, 39.7% of the respondents were aged 26 – 35 years old, 32.8% of the respondents were aged 36 – 45 years old, and 15.5% of the respondents were aged 46 years and above. This implies that respondents were sourced from various categories of people working within the various selected commercial banks in Bujumbura, Burundi.

The information regarding the respondents' marital status indicates that 46.6% of the respondents were single (unmarried), 34.5% of the respondents were married, and 19.0% of them were widowed. The information on the marital status of respondents was gathered and considered for purposes of determining the level of individual responsibility of the various respondents. And the results show that majority of the respondents were single.

Information on the education levels of respondents indicates that 24.2% of the respondents were Master's degree holders, 60.3% of the respondents were Bachelor's degree holders, 12.0% of the respondents were Diploma holders, and 3.5% of the respondents were Certificate holders. This implied that respondents were from the various educational backgrounds, which helped to expand the pool of information collected, from the least to the most qualified.

Information on the position held by the respondents indicates that 5.2% of the respondents were general managers, 10.3% of the respondents were financial managers, 20.7% of the respondents were credit analysts, and 63.8% of the respondents were internal auditors. This implied that respondents were from the various positions within the various selected commercial banks in Bujumbura, Burundi.

The information about the length of stay in the position of employment indicates that 36.2% of the respondents had been in their positions for 1 – 3 years, 39.7% of the respondents had been in their positions for 3 – 5 years, and 24.2% of the respondents had been in their positions for 5 – 10 years, and none of them had been in their positions for over 10 years. This implies that the majority of the respondents had spent an average of 4 years working in the various selected commercial banks in Bujumbura, Burundi.

4.3 Credit standards and loan performance

The first specific objective of the study was to examine the effect of credit standards on loan performance in commercial banks in Burundi. The information from the findings is presented in the following table.

Table 4.2: Effect of credit standards on loan performance

Statement	Mean	Std. dev.
There is a credit standard in place to manage credit risk	4.62	0.61
Credit standard reduces banks' exposure to bad credit	4.54	0.58
Credit standard helps to determine the borrowers' credit worth	4.68	0.61
Borrowers' past performance determines their credit worth	4.81	0.72
Market conditions also determine credit repayment capacity	4.83	0.72
Tighter credit standard reduces losses on loan default	4.87	0.85

Source: *Field data, 2018*

Table 4.2 revealed the results from the respondents' responses on how the various banks' credit standards affect loan performance in those banks. The findings revealed that majority of the respondents asserted that there are credit standards in place to manage credit risk in the commercial banks, as indicated by the mean and standard deviation scores of 4.62 and 0.61 respectively. Also, the findings show that majority of the respondents agreed with the assertion that credit standards reduce banks' exposure to bad credit with the mean and standard deviation scores of 4.54 and 0.58 respectively. Furthermore, the study findings revealed that majority of respondents still assented to the assertion that credit standards help to determine the borrowers' credit worth with the mean and standard deviation scores of 4.68 and 0.61 respectively. The findings also revealed that majority of respondents alluded to the fact that borrowers' past performance determines their credit worth with the mean and standard deviation scores of 4.81 and 0.72 respectively. Further still, respondents also agreed with the assertion that market conditions determine credit repayment capacity, with the mean and standard deviation scores of 4.83 and 0.72 respectively. Additionally, majority of respondents said that tighter credit standard reduces losses on loan default, with the mean and standard deviation scores of 4.87 and 0.85 respectively. This implied that majority of the respondents agreed that credit standards has an effect on loan performance in commercial banks in Bujumbura, Burundi.

4.4 Credit policy and loan performance

The second specific objective of the study was to examine the effect of credit policy on loan performance in commercial banks in Burundi. The information from the findings is presented in the following table.

Table 4.3: Effect of credit policy on loan performance

Statement	Mean	Std. dev.
There is a credit policy in place to manage credit risk	4.59	0.54
Credit policy helps to determine the loan limit to customers	4.77	0.61
Helps banks to determine the volume of credit they can issue	4.63	0.58
Credit policy considers customers cash flow over the past years	4.86	0.75
Considers customers balance sheet and financial condition	4.60	0.56
Considers the condition of the customers' market and industry	4.82	0.71

Source: *Field data, 2018*

Table 4.3 revealed the results from the respondents' responses on how the various banks' credit policy affects loan performance in those banks. The findings revealed that majority of the respondents asserted that there is a credit policy in place to manage credit risk in their banks, with a mean score of 4.59 and a standard deviation score of 0.54. The results also show that majority of the respondents agreed that the credit policy helps to determine the loan limit to customers, as indicated by the mean and standard deviation scores of 4.77 and 0.61 respectively. The results also show that majority of the respondents agreed that the credit policy helps banks to determine the volume of credit they can issue, indicated by a mean score of 4.63 and a standard deviation of 0.58. Additionally, the majority respondents strongly agreed that credit policy considers customers cash flow over the past years, as shown by the mean score and standard deviation of 4.86 and 0.75 respectively. Furthermore, majority of the respondents agreed that credit policy considers customers balance sheet and financial condition with a mean score of 4.60 and standard deviation of 0.56. Further still, majority of the respondents strongly agreed that credit policy considers the condition of the customers' market and industry, indicated by the mean and standard

deviation scores of 4.82 and 0.71 respectively. This implied that majority of the respondents agreed that credit policy has an effect on loan performance in commercial banks in Bujumbura, Burundi.

4.5 Credit terms and loan performance

The third specific objective of the study was to examine the effect of credit terms on loan performance in commercial banks in Burundi. The information from the findings is presented in the following table.

Table 4.4: Effect of credit terms on loan performance

Statement	Mean	Std. dev.
Clear credit terms are in place to manage credit risk	4.79	0.66
Credit terms determine the amount of credit a customer can get	4.64	0.59
Credit terms also spell out the loan repayment schedules	4.43	0.48
Credit terms indicate the type and amount of interest charged	4.22	0.45
Credit terms indicate collateral and guarantees needed for loans	4.76	0.64
Credit terms spell out the other charges imposed on loans	4.70	0.58

Source: *Field data, 2018*

Table 4.4 showed the results from the responses on how the credit terms in the various commercial banks affect loan performance in those banks. The findings indicated that majority of the respondents agreed that clear credit terms are in place to manage credit risk, with a mean score of 4.79 and standard deviation of 0.66. The findings also revealed that majority of the respondents agreed that credit terms determine the amount of credit a customer can get, as indicated by the mean and standard deviation scores of 4.64 and 0.59 respectively. The findings further showed that respondents agreed that credit terms also spell out the loan repayment schedules, as indicated by the mean of 4.43 and standard deviation of 0.48. Also, the findings revealed that respondents agreed that credit terms indicate the type and amount of interest charged as shown by the mean and standard deviation scores of 4.22 and 0.45 respectively. Additionally, the findings showed that majority of the respondents agreed that credit terms indicate collateral and guarantees

needed for loans with a mean score of 4.76 and standard deviation of 0.64. Further still, the credit terms spell out the other charges imposed on loans with a mean score of 4.70 and standard deviation of 0.58. These findings implied that majority of the respondents. This implied that majority of the respondents agreed that credit terms have direct effect on loan performance in commercial banks in Bujumbura, Burundi.

4.6 Collection policy and loan performance

The fourth and last specific objective of the study was to examine the effect of the collection policy on loan performance in commercial banks in Burundi. The information from the findings is presented in the following table.

Table 4.5: Effect of collection policy on loan performance

Statement	Mean	Std. dev.
A collection policy is in place to manage account receivables	4.72	0.74
Spells out the incentives and rewards for early repayment	4.69	0.77
Spells out penalties for late and missed repayment schedules	4.79	0.71
Customers are notified severally when their repayments are due	4.70	0.38
New and poorly performing customers have tighter collection terms	4.63	0.60
Long-standing and trusted customers have more flexible collection terms	4.24	0.47

Source: *Field data, 2018*

Table 4.5 showed the results from the responses on how the collection policies in the various commercial banks affect their loan performance. According to the findings, majority of the respondents agreed that there are collection policies in place to manage account receivables in their banks, with a mean score of 4.72 and standard deviation of 0.74. The findings also revealed that majority of the respondents agreed that the collection policy improves loan performance by clearly laying out the incentives and rewards for early repayment of the loans, with mean and standard deviation scores of 4.69 and 0.77 respectively. Also, the findings showed that majority of the respondents agreed that the

collection policy spells out penalties for late and missed repayment schedules which discourages irregular and late loan repayments, with a mean score of 4.79 and standard deviation score of 0.71. Additionally, the findings indicated that respondents agreed that through the collection policy, customers are notified severally when their repayments are due, which helps to prevent delays and missed payment schedules, with a mean of 4.70 and a standard deviation of 0.38. Furthermore, the respondents also agreed that the collection policy ensures that new and poorly performing customers have tighter collection terms, which discourages them from irregular repayment schedules as a way of avoiding tight repayment terms, with mean and standard deviation scores of 4.63 and 0.60 respectively. Further still, the respondents also agreed that through the collection policy, long-standing and trusted customers have more flexible collection terms, which serves to incentivize them to maintain their trusted status as well as encourage others to also strive to build their trust, with a scores of 4.24 and 0.47 for mean and standard deviation respectively. This implied that majority of the respondents agreed that the collection policy is of fundamental importance in determining the performance of the loan portfolio in commercial banks in Bujumbura, Burundi.

4.7 Regression Analysis

Table 4.6: Regression Analysis

Model		Unstandardized coefficients		Standardized coefficients	t	Sig.
1		B	Std.Error	Beta		
	(Constant)	3.911	0.899	.381	4.350	.000
	Credit standards	.854	0.158	.658	5.405	0.002
	Credit policy	.746	0.189	.547	3.947	0.003
	Credit terms	.662	0.157	.402	4.216	0.003
	Collection policy	.732	0.151	.293	4.847	0.004

i. Independent: (Constant) Credit standards, Credit policy, Credit terms and Collection policy

ii. Dependent: Loan performance

The established regression equation was;

$$Y = 3.911 + .854X_1 + .746X_2 + .622X_3 + .732X_4 - e$$

Where:

Y= Loan performance

α = Constant,

β = Coefficient factor,

X1= Credit standards,

X2= Credit policy,

X3= Credit terms,

X4= Collection policy

e = Error Term

The regression model presented in table 4.6 above shows loan performance at a coefficient of 3.911, with the credit management practices that affect it, that is; credit standards, credit policy, credit terms and collection policy held at zero constant.

4.7.1 Testing Hypotheses

The first hypothesis stated a null assumption that credit standards have no significant effect on loan performance in commercial banks in Burundi. The regression analysis was used to test the hypothesis, showing that credit standards have a positive and significant effect on loan performance in commercial banks in Burundi (B= .854, $p=0.002<0.05$). Since the relationship was found to be significant, the null hypothesis (H_{01}) was rejected and the alternate hypothesis which recognizes credit standards as having a positive and significant effect on loan performance.

The second hypothesis stated a null assumption that credit policy has no significant effect on loan performance in commercial banks in Burundi. The regression analysis was used to test the hypothesis, and the results show that credit policy has a positive and significant effect on loan performance in commercial banks in Burundi (B= .746, $p=0.003<0.05$).

Since the relationship was found to be significant, the null hypothesis (H_{01}) was rejected and the alternate hypothesis which recognizes credit policy as having a positive and significant effect on loan performance.

The third hypothesis stated a null assumption that credit terms have no significant effect on loan performance in commercial banks in Burundi. The regression analysis was used to test the hypothesis, and the results show that credit terms have a positive and significant effect on loan performance in commercial banks in Burundi ($B = .662$, $p = 0.003 < 0.05$). Since the relationship was found to be significant, the null hypothesis (H_{01}) was rejected and the alternate hypothesis which recognizes credit terms as having a positive and significant effect on loan performance.

The fourth hypothesis stated a null assumption that collection policies have no significant effect on loan performance in commercial banks in Burundi. The regression analysis was used to test the hypothesis, and the results show that collection policies have a positive and significant effect on loan performance in commercial banks in Burundi ($B = .732$, $p = 0.004 < 0.05$). Since the relationship was found to be significant, the null hypothesis (H_{01}) was rejected and the alternate hypothesis which recognizes collection policies as having a positive and significant effect on loan performance.

These results therefore implied that the credit management practices (credit standards, credit policy, credit terms and collection policy), when adopted and applied in banking operations, have potential to significantly affect loan performance in commercial banks.

CHAPTER FIVE

DISCUSSION OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the findings of the study, the conclusions reached in the study as well as the recommendations made by the study.

5.2 Discussion of Findings

5.1.1 Discussion of findings on credit standards and loan performance

The findings of the study on the effect of credit standards on loan performance revealed that majority of the respondents believed that credit standard was one of the credit management practices in place in their banks and that this had a significant effect on the loan performance in the commercial banks in Bujumbura, Burundi, with average mean score of 4.73 and standard deviation of 0.68. This implied that the respondents understood and appreciated the importance of having credit management practices in their operations, and the effect that this has on the performance of their loan businesses.

These findings are echoed by those of Selma *et al.*, (2016) who asserted that credit standards can be tight or loose, that tight credit standards make a firm lose a big number of customers and when credit are loose the firm gets an increased number of clients but at a risk of loss through bad debts. They noted that it's important that credit standards be basing on the individual credit application by considering character assessment, capacity condition collateral and security capital. Character it refers to the willingness of a customer to settle his obligations, it mainly involves assessment of the moral factors. Mujtaba (2016) found out that social collateral group members can guarantee the loan members known the character of each client; if they doubt the character then the client is likely to default.

5.1.2 Discussion of findings on credit policy and loan performance

The findings of the study on the effect of credit policy on loan performance revealed that majority of the respondents believed that there was a credit policy in place in their banks and that this had a significant effect on their loan performance, with average mean score of 4.71 and standard deviation of 0.63. This implied that the respondents understood and

appreciated the importance of having credit policy in their operations, and the effect that this has on the performance of their loan businesses.

These findings are supported by Sadaqat *et al.*, (2016), who found out that credit policy is important in the management of accounts receivables, and that a firm has time flexibility of shaping credit policy within the confines of its practices. A loose credit policy may not necessarily mean an increase in profitability because the increased number of customers may lead to increased costs in terms of loan administration and bad debts recovery. In agreement with other scholars. Kanchu and Kumar (2017), advocated for an optimum credit policy, which would help to cut through weaknesses of both tight and loose credit standards so, the firm can make profits. It is a means of reducing high default risk implying that the firm should be discretionary in granting loans. Policies save time by ensuring that the same issue is not discussed over and over again each time a decision is to be made, thus ensuring that decisions are consistent and fair and that people in the same circumstance get treated in the same manner. According to Masoud *et al.*, (2016), credit policy provides a frame work for the entire management practices.

5.1.3 Discussion of findings on credit terms and loan performance

The findings of the study also revealed the effect of credit terms on loan performance revealed, and on this majority of the respondents agreed that credit terms are a major determinant of loan performance in their banks, with average mean score of 4.57 and standard deviation of 0.57. This implied that the respondents understood the role played by credit terms in their loan business operations and how important it is towards loan performance in commercial banks in Bujumbura, Burundi.

These findings are echoed by the works of Nkundabanyanga *et al.* (2014), who asserted that credit terms are part of a general exercise to help determine the extent of risk for each borrower. According to Mehmood *et al.*, (2016), grace period, collateral, interest rate charges and number of official visits to the credit societies, have a strong effect on loan repayment, and that the higher interest rates induce firms to undertake projects with lower probability of success but higher pay offs when they succeed. Nanayakkara and Stewart

(2015) further indicated that since the financial institution is not able to control all actions of borrowers due to imperfect and costly information, the MFI will formulate terms of the loan contract to induce borrowers to take actions in the interest of the financial institution and to attract low risk borrowers. According to Ifeanyi et al. (2014), the interest rate has an effect on the use, repayment of the loan and the overall performance of the business. When the interest rate charged is high, there is a tendency for the borrowers to keep part of the borrowed money to pay the interest or to use the business capital to pay the interest. Anderson (2002) indicated that an increase in interest rates negatively affects the borrowers by reducing their incentive to take actions that are conducive to loan repayment.

5.1.4 Discussion of findings on collection policy and loan performance

The study also revealed results on the effect of the collection policy on loan performance, and here, the findings show that majority of respondents agreed that the collection policy has a significant effect on loan performance, with average mean score of 4.63 and standard deviation of 0.61. This implied that the respondents appreciated the importance of having a well-functioning collection policy in place to help guide the procedures for collection on loans issued to borrowers, and how it affects loan performance in the commercial banks in Bujumbura, Burundi.

These findings are supported by research by Chaudhry *et al.*, (2015), who said that collection efforts may include attaching mandatory savings forcing guarantors to pay, attaching collateral assets, courts litigation. Methods used by financial institutions could include letters, demand letters, telephone calls, visits by the firm's officials for face to face reminders to pay and legal enforcements. Makorere (2014) saw the collection policy as a guide that ensures prompt payment and regular collections. The rationale is that not all clients meet their obligations, some just take it for granted, others simply forget while others just don't have a culture of paying until persuaded to do so. According to Ifeanyi et al. (2014), collection procedure is required because some clients do not pay the loan in time some are slower while others never pay. Thus collection efforts aim at accelerating collections from slower payers to avoid bad debts. Prompt payments are aimed at

increasing turn over while keeping low and bad debts within limits, according to Garcia *et al.*, (2015).

5.1.5 Discussion of findings of the regression analysis

The results from regression analysis revealed that credit standards have a positive and significant influence on loan performance in commercial banks in Bujumbura, Burundi, with scores (B= .854, $p=0.002<0.05$). The information from the above table also revealed that the credit policy has a significant effect on loan performance in commercial banks in Bujumbura, Burundi, with scores (B= .746, $p=0.003<0.05$). Furthermore, the findings from the regression analysis above also reveal that credit terms adopted by commercial banks in Bujumbura, Burundi, have a significant effect on loan performance (B=.662, $p=0.003<0.05$). Additionally, the results from the regression analysis above also show the collection policy to significantly affect the loan performance in commercial banks in Bujumbura, Burundi, with scores (B=.732, $p=0.004<0.05$). These results therefore implied that the credit management practices (credit standards, credit policy, credit terms and collection policy), when adopted and applied in banking operations, have potential to significantly influence loan performance in commercial banks.

These findings are in line with Nanayakkara & Stewart (2015), who indicated that since the financial institutions are not able to control all the actions of borrowers due to imperfect and costly information, they have to formulate terms of the loan contracts that will induce borrowers to act in the interest of the financial institution and to attract low risk borrowers. Ifeanyi *et al.* (2014) also added that the interest rate has an effect on the use, repayment of the loan and the overall performance of the business, observing that commercial banks usually provide larger loans, longer repayment periods and lower interest rates when borrowers offer collateral. By this, he (Ifeanyi, 2014) meant that a borrower who cannot provide the type of assets that lenders require as collateral often gets worse loan terms than otherwise and their likelihood for loan repayment is lower than those whose collateral can get them better loan terms. Additionally, Makorere (2014) asserted that collection policy is a guide that ensures prompt payment and regular collections. The rationale is that not all clients meet their obligations, some just take it for

granted, others simply forget while others just don't have a culture of paying until persuaded to do so.

5.3 Conclusions of the Study

From the findings of the study, it was concluded that the management of credit forms the core of any sound financial business dealing, and is an essential requirement for financial stability and liquidity in any banking institution. On this note, it was also concluded that since financial institutions are in the business of selling money, that is credit, conversely, poor management of credit is the main cause of less than optimum financial performance in banking institutions. As lending institutions, the biggest threat to commercial banks is the potential for default on the credit that they issue to borrowers. This study concluded that in order to minimize the risk of default on credit, each commercial bank must have in place mechanisms to ascertain the credit worthiness of all its existing and potential customers. The study further concluded from the findings that the various components of credit management, that is; credit standards, credit policy, credit terms and collection policy, have a positive and significant effect on loan performance in the various commercial banks.

Having objective and appropriate parameters for credit standard, enabling banks to adequately assess the credit records, and clear guidelines in the processing and issuance of loans and monitoring their repayment schedules has a direct bearing on the levels of default and repayment. From the findings of the study, it was also concluded that the various aspects of the credit policy such as signing of loan agreements, taking out insurance policies on loans issued, customer credit rating models, as well as accurate assessment of the customers' financial conditions as well as repayment periods, have a significant effect on loan performance in commercial banks. Also, the findings on the credit terms pointed to the conclusion that the structuring of the various terms of loan issuance/acquisition such as the security for loans or collateral, grace period before start of repayment, the rates of interest charged on loans as well as the repayment period also significantly affect loan performance in commercial banks. It was also concluded that the policy on loan repayment collections is another key determinant of loan performance,

where the rate of asset recovery and transfer of loans is directed related to the level of losses from loan default.

5.4 Recommendations

From the findings of the study analyzed in the previous chapter and the conclusions reached, the researcher made various recommendations, which in his opinion, if properly considered, have the potential to improve the effectiveness of credit management and thereby improve loan performance in commercial banks. These recommendtaions are:

Commercial banks should seriously consider having in place effective credit standards, credit policy, credit terms and collection policies or procedures as mechanisms to guide their business, since the effectiveness of credit management is important to the successful management of banking institutions. In order to ascertain the level of credit to issue out to a borrower, the banks should use credit standards to appropriately evaluate the borrower's liquidity and cash flow, as well as the performance of their business and saving culture, that can be used in determining the borrower's ability to repay the loan.

Commercial banks should operate their credit businesses based strictly on established lending guidelines that clearly outline the business growth priorities of the senior management, as well as the conditions to satisfy in order to qualify for loan approval. These lending guidelines (credit policy) should be regularly updated in order to keep their consistency with the prevailing changes in the credit market and the overall outlook of the economy.

There should be prior customer evaluation before loans are granted, and a continuous process of assessment before and during the course of loan repayment. In this way, the bank will be in position to accurately ascertain the trajectory of the borrower's performance in terms of repayment. This should be cemented by effective customer relationship management, where the bank not only acts as a source of credit, but also as a source of vital information business management in order to improve the business performance of the borrowers, which will consequently improve loan performance.

5.5 Suggestions for further Research

Further research should be carried out to determine the relationship between customers' financial information, the level of credit worth and the performance of commercial banks. This will help to generate more knowledge on the impact of accurate customer credit rating on the performance of loans in commercial banks.

5.6 Contribution to the Knowledge

The findings of this study will be invaluable to research and scholarly investigations, forming the basis for further research on credit management in financial institutions, as well as guiding scholarly discussions on credit management and financial performance. It adds to the empirical studies that scholars can use when exploring similar or related studies (Parrenas, 2005). The study will also contribute to both knowledge increment and practice improvement in credit management and financial performance. From a theoretical point of view, the findings of this study propose a comprehensive framework that can be used to study changes in credit management and the performance of loan portfolios. From a managerial point of view, the study will also contribute in aiding policy makers in their effort to revamp and streamline the credit sector, especially offering great relevance to the banking institutions under study as well as other financial institutions. From the societal view point, other non-financial organizations such as service and manufacturing-oriented firms will also benefit from the findings of the study, as it will inform them of the best practices in appraising their credit policies and to review their operations critically for more result oriented approaches in the dealing with credit facilities.

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APPENDIX I
Questionnaire

Dear Respondent,

My name is Rukundo Alain Romaric, a student of Master of Business Administration and Management Studies at Kampala International University. I am conducting a study on “Credit risk management and loan performance in commercial banks in Burundi”. You have been selected to participate in this study by answering the following questions. Please tick the most appropriate response or elaborate where necessary. The information obtained from you shall be kept confidential and used for academic purposes only. You are also free to withdraw from participating at any time.

Thank you in advance for your participation.

Section A: Respondents’ Demographic Information

- | | | |
|---------------------|-------------------|-----|
| 1. Gender | Male | [] |
| | Female | [] |
| 2. Age | 18 – 25 | [] |
| | 26 – 35 | [] |
| | 36 – 45 | [] |
| | 46 and above | [] |
| 3. Marital status | Single | [] |
| | Married | [] |
| | Widowed | [] |
| 4. Education levels | Masters’ degree | [] |
| | Bachelor’s degree | [] |
| | Diploma | [] |
| | Certificate | [] |

Section B: Credit policy

Please tick the most appropriate option in the ranking of the questions; Use the following Likert scale to rate your answers:

1 – Strongly Agree (SA)

2 – Agree (A)

3 – Not Sure (NS)

4 – Disagree (D)

5 – Strongly Disagree (SD)

Alt.	Statements	Rankings				
		1	2	3	4	5
a.	There is a credit policy in place to manage credit risk					
b.	Credit policy helps to determine the loan limit to customers					
c.	Helps banks to determine the volume of credit they can issue					
d.	Credit policy considers customers cash flow over the past years					
e.	Considers customers balance sheet and financial condition					
f.	Considers the condition of the customers’ market and industry					

Section D: Credit terms

Please tick the most appropriate option in the ranking of the questions; Use the following Likert scale to rate your answers:

1 – Strongly Agree (SA)

2 – Agree (A)

3 – Not Sure (NS)

4 – Disagree (D)

5 – Strongly Disagree (SD)

Alt.	Statements	Rankings				
		1	2	3	4	5
a.	Clear credit terms are in place to manage credit risk					
b.	Credit terms determine the amount of credit a customer can get					
c.	Credit terms also spell out the loan repayment schedules					
d.	Credit terms indicate the type and amount of interest charged					

e.	Credit terms indicate collateral and guarantees needed for loans					
f.	Credit terms spell out the other charges imposed on loans					

Section E: Collection policy

Please tick the most appropriate option in the ranking of the questions; Use the following Likert scale to rate your answers:

1 – Strongly Agree (SA)

2 – Agree (A)

3 – Not Sure (NS)

4 – Disagree (D)

5 – Strongly Disagree (SD)

Alt.	Statements	Rankings				
		1	2	3	4	5
a.	A collection policy is in place to manage account receivables					
b.	Spells out the incentives and rewards for early repayment					
c.	Spells out penalties for late and missed repayment schedules					
d.	Customers are notified severally when their repayments are due					
e.	New and poorly performing customers have tighter collection terms					
f.	Long-standing and trusted customers have more flexible collection terms					

Section F: Loan Performance

Please tick the most appropriate option in the ranking of the questions; Use the following Likert scale to rate your answers:

1 – Strongly Agree (SA)

2 – Agree (A)

3 – Not Sure (NS)

4 – Disagree (D)

5 – Strongly Disagree (SD)

Alt.	Statements	Rankings				
		1	2	3	4	5
a.	The level of collateral influences loan repayment performance					
b.	Lower interest rates improve loan repayment performance					
c.	Borrowers' past credit information affects loan performance					
d.	Length of grace period before commencement of repayment influences loan repayment performance					
e.	Strict penalties imposed for non-payment also affect loan repayment performance					
f.	Flexibility of the bank's collection policy also affects loan repayment performance					

Thank you very much for your time

APPENDIX II

Introduction Letter



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Directorate of Higher Degrees and Research Office of the Director

Our ref. 1163-05026-07523

Monday 1st October, 2018

Dear Sir/Madam,

**RE: INTRODUCTION LETTER FOR RUKUNDO ALAIN ROMARIC
REG. NO. 1163-05026-07523**

The above mentioned candidate is a student of Kampala International University pursuing a Master's degree of Science in Finance and Accounting.


He is currently conducting a research for his dissertation titled, "*Credit Management and Loan Performance in Selected Commercial Banks in Bujumbura, Burundi*".

Your organization has been identified as a valuable source of information pertaining to the research subject of interest. The purpose of this letter therefore is to request you to kindly cooperate and avail the researcher with the pertinent information he may need. It is our ardent belief that the findings from this research will benefit KIU and your organization.

Any information shared with the researcher will be used for academic purposes only and shall be kept with utmost confidentiality.

I appreciate any assistance rendered to the researcher.

Yours Sincerely,


Dr. Claire M. Mugasa
Director

C.c. DVC, Academic Affairs
Principal CEM



Dep. Dir.

"Exploring the Heights"