

Insights on Non-Performing Loans: Evidence from Zimbabwean Commercial Banks in a Dollarised Environment (2009-2012)

¹Laurine Chikoko, ²Tendekayi Mutambanadzo and ³Takaiona Vhimisai

¹Department of Banking and Finance,
Midlands State University, P Bag 9055, Senga, Gweru.

²Department of Banking,
National University of Science and Technology P O Box AC939, Ascot Bulawayo.

³Department of Banking,
National University of Science and Technology P O Box AC939, Ascot Bulawayo.

Corresponding Author: Laurine Chikoko

Abstract

This study was prompted by the gradual deterioration in asset quality in most commercial banks in Zimbabwe after the adoption of the multiple currency exchange rate regime. The poor asset qualities were reflected by the non-performing loans trending towards the watch list category. In this regard we investigated the commercial bank credit process with the objective of understanding the fundamental causes of the impaired assets that are bedeviling the Zimbabwean banking sector so that some of the mistakes are not repeated and correctional measures are put in place. The methodology adopted a survey research design with use of questionnaires and interviews with commercial banks head credit risk, head retail and head corporate banking division from 15 registered commercial banks in Zimbabwe. Research findings show that some banks were sitting on non-performing loans due to poor credit analysis processes; wrong products offered to the clients; lending based on balance sheet strength instead of cash flow based lending; banks taking too much comfort in security; information asymmetry leading to moral hazard; economic environment and political influence. Key recommendations include an urgent setting up of the Credit Bureau; banks should not adjust clients request and the need for banks to consider the economic environment and adjust their credit culture. The central bank needs to tighten its supervisory role and ensure prudential guidelines are not violated.

Keywords: credit analysis, loan products, non-performing loans, Zimbabwean commercial banks, dollarised environment.

INTRODUCTION

Zimbabwe adopted a multiple currency regime in 2009. A multiple currency system allowed trade to be conducted using major trading currencies, for example, the United States Dollar (USD), Pound Sterling, South African Rand, and the Botswana Pula. After the adoption of the multiple currency system, the banking sector experienced marked improvements in the intermediary role which resulted in improved financial support to the key productive sectors of the economy (Reserve Bank of Zimbabwe (RBZ), 2010). A research conducted by the International Monetary Fund in 2010, indicated that the profitability of banks had improved following a more favourable economic environment during the new regime. While officially reported, aggregate banking soundness indicators do not raise major red flags, they mask vulnerabilities specific to a fully dollarised banking system experiencing rapid credit growth, as well as a significant variation in prudential indicators across individual banks. The Reserve Bank of Zimbabwe (2012) also noted that there has been gradual deterioration in asset quality as reflected by the level of non-performing loans trending towards

the watch list category. The implication is that borrowers were struggling to repay loans leading to the problem of banks sitting on non-performing loans.

Each non-performing loan in the financial sector is viewed as an obverse mirror image of an ailing unprofitable enterprise. From this point of view, the eradication of non-performing loans is a necessary condition to improve the economic status of the financial institution. Continuously rolling over non-performing loans locks up resources that could otherwise be invested to profitable sectors of the economy. Intuitively this hinders economic growth and impairs economic efficiency. Consequently this study seeks to provide insights on Zimbabwean commercial banks non-performing loans. The ultimate objective is to draw lessons from commercial banks lending in Zimbabwe during the multiple currency regime. The paper is organised as follows. In the second section, we present brief review of literature. In the third section we present the research methodology; in the fourth section a

discussion of the findings. Finally we present conclusions and recommendations.

LITERATURE REVIEW

A non-performing loan is an advance by a financial institution that is not earning income and full payment of principal. As such interest is no longer anticipated (Van Greuning, & Bratavonic, 2003). There is no global standard to define non-performing loans at the practical level. Variations exist in terms of the classification system, the scope, and contents. This pitfall potentially adds to disorder and uncertainty in the non-performing loans subject. For instance, as described by Park (2003), during the 1990s, there were three different methods of defining non-performing loans: the 1993 method based on banking laws; the “Bank’s Self-Valuation” in March 1996; and the “Financial Revival Laws-Based Debt Disclosure” in 1999. These measurements have gradually broadened the scope and scale of the risk-management method in the banking industry.

The literature that examines non-performing loans has increased as more researchers attempt to understand the major factors that cause financial instability. This trend has arisen due to the role played by impaired assets in financial instability as evidenced by the strong association between non-performing loans and banking crises. In most of the economies that collapsed, credit risk preceded financial crises. Khemraj (2005) revealed that the banking crises in East Asia and Sub-Saharan African countries were preceded by high non-performing loans. This stimulated research in trying to establish the causes of non-performing loans in banks. Caprio (1998) had earlier presented stylised evidence and found that inadequate regulation and lack of supervision at the time of the liberalisation could play a key role in explaining why deregulation and banking crises were so closely entwined. The analysis of Kaminsky and Reinhart (1999) provides interesting insights on the links between financial crises with financial liberalisation. The study found that the proxy variable for financial liberalisation which was the growth in domestic credit as a ratio of output, accelerated greatly as the crises emerged.

Earliest studies to examine the causes of loan losses were by Keeton and Morris (1987). The study showed that local economic conditions along with the poor performance of certain sectors explain the variation in loan losses recorded by the banks. The study also reports that commercial banks with greater risk appetite tend to record higher losses. Garey (1991), also concur with the early studies of Keeton and Morris. Garey (1991) found that loan loss-experience of large commercial banks in the US was influenced by both internal and external factors. This study found a significant positive relationship between the loan-loss rate and internal factors such as

high interest rates, excessive lending, and volatile funds. Non-performing loans were influenced by gross domestic product growth, high real interest rates, lenient credit terms and excessive lending by commercial banks (Goacher, 2002; Howells and Bain, 2002; Heffernan, 2005; Freixas, 2007 and Machiranju 2008). Despite the abundant literature on non-performing loans, to the researchers’ knowledge, no study has been done on causes of non-performing loans on Zimbabwean commercial banks after dollarisation in 2009.

METHODOLOGY

A survey research design was used in this study. The survey allowed the collection of large amount of data in an economical way (Saunders et al, 2003). Data obtained through use of questionnaires was standard which allowed easy comparison. The limitation to the survey strategy was the fact that data collected may not be as wide-ranging as those collected by other research strategies. There is a limit as to the number of questions that any questionnaire can contain if the goodwill of the respondent is not to be presumed on too much. To mitigate this weakness, personal interviews were used in the survey strategy. Data was collected from 15 registered commercial banks in Zimbabwe. The key informants were departmental heads of credit risk, retail and corporate banking divisions. In addition account relationship managers were randomly selected in the survey. The study was carried out in Harare mainly because that is where all commercial banks are headquartered. Data from the survey was analysed using STATA version 11. Tabulations were used to show percentages and frequencies of respondents in each response category, with cross-tabulation tables showing percentages and frequencies between two given categories. Cross-tabulations were computed together with correlation test between two variables by using Pearson chi-square.

LIMITATION OF THE STUDY

The issue of non-performing loans is a sensitive and confidential issue since it has a bearing on bank performance and reputation. To this end, we had challenges in getting a detailed account from some of the respondents. However, to overcome this we had to interview many respondents from the same institution in order to fill in the missing details.

EMPIRICAL FINDINGS

On average the banks were in business for thirty seven years but varied from five up to one hundred and eighteen years. Table 1 summarises the ages of the fifteen commercial banks.

Table 1: Tabulated Zimbabwe Commercial Banks Years in Business

Variable	Observation	Mean	Std Dev	Min	Max
Years in business	15	37.5333	40.2347	5	118

From the survey, age had nothing to do with the problem of non-performing loans as reflected by a χ^2 statistic of 5.86 (P=0.210). Of the banks surveyed, 20% were internationally owned banks and 80% were locally owned banks. It was evident from the survey that locally owned banks had the problems of non-performing loans while internationally owned banks did not have problems of non-performing loans. This was shown by the observed differences in ownership and non-performing loans which were statistically significant as shown by the χ^2 statistics of 17.26 (P<0.001).

Of interest was the credit culture adopted by the Zimbabwean commercial banks after dollarisation. 27% of the banks adopted a values driven credit culture, 40% adopted a current profit driven credit culture while 33% adopted a market share driven credit culture. From the research 73% of the banks showed that they had problems of non-performing loans whilst the 23% which adopted the values driven credit culture did not have a problem of non-performing assets leading to these banks having good loan books.

Zimbabwe Commercial Banks Loan Products

The loan products that were being offered by Zimbabwe commercial banks after the multiple currency are presented in table 2.

Table 2: Loan Products

Type of Client	Products
Individuals	Salary based loans; Overdraft facilities (for executive individual clients only)
Small to Medium Size Enterprises	Short-term loans; working capital loans
Corporate Companies	Overdraft; short-term loans; order financing; bills discounting; bankers acceptances; international letter of credits; local guarantees

Source: Authors Findings 2012

Based on the survey 73% of the banks had problems with non-performing loans. Based on respondents from these banks, it revealed that non-performing loans varied with the type of clients. Corporate clients were exposing banks to credit risk more than the individuals. Further to these descriptive statistics, we then sought to know from the respondents of the banks that had problems with non-performing loans the various reasons they were sitting on non-performing loans. Some of the various reasons are presented below.

1. Unpreparedness of the economy

All the respondents cited lack of preparedness of the economy as a major contribution to non-performing loans. The background of the economy prior to the shift into the multiple currency era was characterised by lack of financing which saw most of the

Zimbabwean companies operating with inadequate working capital whilst in need of capital expenditure. Companies needed to worry about recapitalisation first before going ahead to borrow working capital. The banks that were aggressive in lending appeared to have overlooked this factor and advanced loans without fully advising the clients. Most banks rushed to give borrowers funds without properly analysing clients' requirements and trading activities. When there is a major economic change there is need to properly strategise to ensure that the general environment is conscientised and is prepared for the changes.

2. Lack of client knowledge

Respondents also indicated that when the economy shifted to the multiple currency systems, companies did not have financial statements. Documentation that was supplied by the companies was in Zimbabwean dollars and in particular share capital contributed by the companies. The basis of lending was mostly historically based with bias towards listed companies. Most of the lending was based on historical data and information. The research findings also pointed that some banks over depended on financial information. Most of the information that was provided by borrowers suffered from creative accounting. Lenders confirmed that they did not take time to consider the non-financial aspects on carrying out loan assessments. There was lack of due diligence and proper knowledge of the client's business. This saw most banks lending to borrowers with no capacity to service and repay back their loans.

3. Ethics and Corporate Governance Issues

Based on research findings, another major cause of non-performing loans in Zimbabwean commercial banks was centered on ethics and corporate governance issues. Some respondents highlighted that loans at their banks were being granted based on relationships with the requirers of funds. Loans were being approved for the directors' and senior management's relatives. In some instances paper work would come after disbursements of funds. It was also noted that functions of committees such as Asset and Liability Committee, Credit Committees and all credit sanctioning committees were reduced from decision making to rubber stamping already made up decisions. Most of such borrowers would fail to honor their obligations because they would not have been properly assessed. This was cited to have led to moral hazards with other borrowers having access to information on how bad a director's loan was performing and deliberately defaulted.

4. Multi-borrowing

Another cited cause of non-performing loans was that clients were overburdened. Most companies and individuals, even executives of companies accessed loans from more than one bank. Individuals were reported to moving pay points from one bank to another in-order to have access to loans. In addition to bank loans, most individuals had purchased goods

from other retail credit offering institutions. The absence of a Credit Bureau (CRBs) made it difficult for lenders to access to such information. Some clients deliberately borrowed from multiple sources with no intention of repaying loans and thrived on the information asymmetry that prevailed.

5. Weak Internal Systems

All locally owned banks were caught unaware on the strength of their internal systems. The shift from the Zimbabwean dollar to the multiple currency systems required re-alignment of the usual systems to suit the new environment. Most banks rushed to grow their loan books as soon as the economy was dollarised. When a bank grants more loans, it tends to loosen its loan standards, which resulted in higher non-performing loans. Policies and Procedure Manuals are to be reviewed on an annual basis to take into account of changes in the environment. However, respondents of some banks highlighted that they continued operating using Zimbabwe dollar era policies which made it difficult to make sound assessments in the dollarised era. Monitoring of loans was also cited as a major cause contributing to non-performing loans. Most banks took a reactive rather than a pro-active approach. The failure by some commercial banks to carry out a proper monitoring of loans including ad hoc site visits led to clients' misuse of the funds advanced.

6. High lending rates

Some respondents cited high lending rates as the reason to non-performing loans. Figure 1 below which presents trends on average deposit interest rates, average lending rates and interest rate spreads.



Figure 1: Various Interest Rates in Zimbabwe Commercial Banks
(Source: RBZ 2011)

Commercial banks borrow at low prices and lend at high prices. The differences between these are what constitute the banks' gross profit. There were wide

spreads between lending rates and deposit interest rates in Zimbabwe during the multiple currency era. Ideally lending rates should be linked to inflation in a manner that results in positive real rates as well as taking into consideration the risk premium of the borrowing clients. The 30 day Bankers Acceptances were ranging from 30% to 40%. Banks managed to maintain the high lending rates because the Reserve Bank of Zimbabwe was pursuing moral suasion and not controlling interest rates in the economy. The high lending rates also contributed to most borrowers failing to service their loans.

7. Over dependency on Balance Sheet Strength

Banks were comforted with the immovable security but overlooked the secondary risk of failure to dispose of the asset due to liquidity problems in the market. Most of the mortgaged properties were over-valued. Some borrowers even misrepresented the status of their assets and banks only discovered at the point of disposal rather than visiting the properties before registering the bonds. Banks were not continuously checking the security value, ownership, physical status and other legal status.

8. Inadequate Supervision by the Central Bank

From the survey, all respondents pointed to inadequate supervision by the Reserve Bank of Zimbabwe which led to gross violation of prudential guidelines. Insider lending, lending to connected parties and prudential lending limits were violated. All these contributed to non-performing loans.

CONCLUSION

Asset quality challenges can potentially heighten liquidity risk given the challenging operating environment where credit is largely financed by volatile short-term deposits. In this regard, banks need to enhance credit risk management systems with special emphasis on credit assessment, origination, administration, monitoring and control standards. It is critical to consider the operating environment when lending. The strong banks in Zimbabwe were the ones that considered the operating environment and did not lend or were passive in lending. These had very good loan books. This was achieved by values driven credit culture the banks adopted. It can be concluded that banks should lend only when it is safe.

RECOMMENDATIONS

- Upgrade Information and Communication Technology (ICT) in order to be able to implement models that will mitigate risks arising out of the environmental changes.
- There is need to urgently setting up of a credit bureau that will facilitate the dissemination of credit information.
- Credit analysts to be trained in credit intelligence to equip them with adequate and efficient skills in loan management.
- Commercial banks need to come up with workout strategies that clearly define how

different types of loans at different stages are dealt to be dealt with.

- Supervisors should come up with devices that would enforce commercial banks to adhere to prudential guidelines.
- In cases of importers, commercial banks should ensure that documents are in place before making payments through swift. Clients have tendencies to misrepresent and then divert the funds to other uses.
- Conventional banks may adopt the Bai (meaning buy and sale) mechanism from Islamic banking whereby the bank purchases goods and services on behalf of the clients and sell the goods and services to them. Conventional banking believes in funding directly which is difficult to look after the ultimate fund.

Thomson, J. B. (1989). *An Analysis of Bank Failures: 1984 to 1989*. Federal Reserve Bank of Cleveland, Working Paper 8916

Van Greuning, H., & Bratavonic, S. B. (2003). *Analysing and Managing Banking Risk- A Framework for Assessing Corporate Governance and Financial Risk* (3rd ed.).

REFERENCES

Freixas, X., and Rochet, J. C. (2007). *Microeconomics of Banking* (3rd ed.). London: The MIT Press.

Gary W (1991). A Proportional Hazards Model of Bank Failure: An Examination of its Usefulness as an Early Warning Tool. *Economic Review*, Vol.27, No.1, pp.21-31

Goacher, D. (2002). *The Monetary and Financial System* (4th ed.). UK: CIB publishing House.

Heffernan, S. 2005). *Modern Banking*: John Wiley and Sons.

Howells, & Bain. (2002). *The Economics of Money, Banking and Finance-A European Text* (2nd ed.): Pearson Education.

Machiraju, H. R. (2008). *Modern Commercial Banking*: New Age International.

RBZ Risk-Based Supervision Policy Framework Guideline No. 2 - 2006/BSD

Reserve Bank of Zimbabwe (2010). *Monetary Policy Statement*.

Reserve Bank of Zimbabwe (2011). *Monetary Policy Statement*.

Reserve Bank of Zimbabwe (2012). *Monetary Policy Statement*.

Saunders, M., Lewis, P., & Thornhill, A. (2007). *Research Methods for Business Students*. Essex: Pearson Education Limited.