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Effect of Loan Management Strategies on Financial Performance of Commercial Banks in Rwanda

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Abstract: Despite the efforts done by Commercial banks in ensuring that all loans are recovered on time, a substantial amount of these loans remain un-recovered. This problem does not only endanger the achievement of objectives, but also threaten bank's sustainability and efficiency. Therefore, there is a need of an effective loan management where loans should be very well managed to minimize potential risks that may affect the bank's performance.The study examined the effect of loan management strategies on financial performance of selected commercial banks in Rwanda. The study adopted descriptive research design. The study findings revealed client appraisal had a positive influence which was statistically significant ($\beta = 0.399$, $p<0.05$) while loan risk control showed a positive and significant effect ($\beta = 0.204$; $p<0.05$) on financial performance of commercial banks. The study concluded that there was a strong positive link between predictor variables andfinancial performance of selected commercial banks in Rwanda. The findings have revealed that loan management strategies help to improve financial performance and to achieve objective of bank.

Keywords: Client appraisal loan risk controland financial performance

I. Introduction

Globally, loan management involves evaluating the steps which the bank management takes to identify and control risks throughout the credit process. The assessment strongly focuses on what management does to identify issues before they become problems. In recent years, more and more globally active financial institutions in the US and Europe have been proactively engaged in loan management, rebalancing their loan asset portfolios while utilizing the credit market's functions to the full Karim*et al.,* (2010). In the second half of the 1980s, US commercial banks faced declines in capital adequacy ratios and rising funding costs against the background of non-performing loans. Loan is the principal business activity for most commercial banks. The loan portfolio is typically the largest asset and the predominate source of revenue. As such, it is one of the greatest sources of risk to a bank's safety and soundness (Boateng, 2014).In USA, effective management of the loan portfolio's credit risk requires that the board and management understand and control the bank's risk profile and its credit culture. To accomplish this, they must have a thorough knowledge of the portfolio's composition and its inherent risks. They must understand the portfolio's product mix, industry and geographic concentrations, average risk ratings, and other aggregate characteristics. They must be sure that the policies,processes, and practices implemented to control the risks of individual loans and portfoliosegments are sound and that lending personnel adhere to them (Gilbert & Churchill, 2011)

Effective loan management begins with oversight of the risk in individual loans. Prudent risk selection is vital to maintaining favorable loan quality. Therefore, the historical emphasis on controlling the quality of individual loan approvals and managing the performance of loans continues to be essentialCholastem (2017). But better technology and information systems have opened the door to better management methods. Banks generate most revenue through issuing of loans to customers. In actual terms, loans are key assets of commercial banks representing 50-75% of the total amount of assets in the banks. Loans have significant contributions to towards economic growth of any country. Thus, efficient management of loans not only affects the lending institution but also the borrowers and the country in totality (Vatansever&Hepsen, 2013)

As stated by Mehdi & Mohammed (2014), performance may be referred to as how much financial related goals and objectives of a financial institution have been refined or are being accomplished. To measure performance profitability ratios are used, ROE (Return-on-Equity) which is probably the most basic pointer of a bank's profitability and growth potential. It is the rate return to shareholders. ROA (Return-on-Assets), which exhibits how much net income, is generated per dollar of Assets. Measuring profitability is the most basic measure of the accomplishment of the business (Mwangi, 2012). The banking sector is considered to be an important source of financing for most businesses. Increase in financial performance leads to more improved functions and activities of any organization. It has effect on total economy of the country and the activities of any organization. This is because banks form better sources of finance for better job opportunities development of new ideas, research and overall prosperity. Lending practices are long dated and for many years up to 2007, interest rates were very low in Western countries and money was cheap (Mwangi, 2012).

According to National Bank of Rwanda (2014), Rwandan banking sector is also exposed to Different types of related to poor loan management , through the National Bank of Rwanda (BNR) the government has set some tools and strategies to make sure that Loan Exposure Risks are mitigated. According to National Bank of Rwanda (2014), most of Rwandan financial institutions had a cut dawn in the process of loan Granting in the last quarter of the year 2012 up to first quarter 2013 and this drastic dawn word trend is suspected to be associated with Inability to apply right credit risk Management techniques. The aim of this research study was to analyze the relationship between proper loan management strategies and its financial performance. Commercial banks also have done a lot in setting determinants to ensure that the loans are repaid back in time without clashing with the clients so as to maintain the good relation between the client and the bank. However, evidence has shown that, despite the efforts done by Commercial banks in ensuring that all loans are recovered on time, a substantial amount of these loans remain un-recovered. This problem does not only endanger the achievement of objectives, but also threaten bank's sustainability and efficiency. Therefore, there is a need of an effective loan management where loans should be very well managed to minimize potential risks that may affect the bank's performance.

II. Review of Related Literature

2.1 Financial Accelerator Theory

The financial accelerator theory developed by Bernanke, (Grinnel and William. 2013) seeks to explain how small economic shocks have relatively large effects on the lending and borrowing activities. It relies on the interplay between economic agents' net worth and the external finance premium that arises due to asymmetric information between lenders and borrowers. Where economic agents' net worth is defined as the sum of liquid assets plus collateral value of illiquid assets less outstanding obligations and the external finance premium is defined as the difference between the cost of funds raised externally and opportunity costs internal to the firm (Bernanke, *et al.*, 2015). The theory argued that the less the amount of his own wealth the borrower contributes to the project, the more his interests will diverge from the interests of the supplier of the external funds.

Borrowers were more eager to undertake riskier projects. That is, projects that has a high probability of large return, but also those offering low returns. From the borrower's perspective these projects are preferred since the firms' losses in the cases when the project's return is low are limited to zero by legal regulation. From the lenders' point of view, these projects are unfavorable since they bear all, or most of, the costs in the case of low project returns. The theory further indicates that due to economic shocks, the borrowers may not have the ability to borrow and are likely to avoid repayment of their loans (Vatansever&Hepsen, 2013). This theory is relevant for this study because it recommends the commercial banks that should actively screen loan applicants to assess their characteristics and credit worthiness. However, the process of appraising and assessing borrowers by commercial banks before issue of loans require reliable and timely information. This is supported in the symmetric information theory.

2.2 Empirical review

According to William (2015) in his study on impact of risk management on non-performing loans and profitability of banking sector of Pakistan, they stated that non-performing loans are increasing due to lack of risk management which threatens the profitability of banks. The result revealed that there is no proper mechanism for risk management in banking sector of Pakistan. (Mwangi, 2012) inthe study conducted on the effect of credit management on the financial performance of microfinance institutions in Kenya**.** The study established that client appraisal, credit risk control and collection policy significantly influence financial performance of MFIs in Kenya. The study recommends that MFIs should enhance their collection policy by adapting a more stringent (strict) policy to a lenient policy for effective debt recovery.

Nduwayo (2012) in his research work on the effect of loan management on the financial performance of commercial bank stated the financial institutions are very prone to credit risk and therefore, there is a need of an effective loan management where loans should be very well managed to minimize potential risks that may affect the bank's performance. The study findings revealed that there is an effect of loan management on financial performance of Bank of Kigali, where it was noted that well management of loan was the main source of the positive financial performance achieved by Bank of Kigali. The study conducted Bandorayingwe (2017) on impact of loan portfolio management on financial performance of commercial banks in Rwanda. The research findings revealed that loan portfolio management effectively analyzed using (loan risk analysis; risk monitoring; loan risk diversification) affect financial performance of Cogebank through its profitability; liquidity. Cogebank should put more effort on the following actions in order to maintain the increasing of its profit Cogebank Ltd should make sure that all given collateral security are well analyzed in order to avoid the higher rate of non- performing loan.

Mwizerwa*et al.,* (2018), carried research on effects of loan portfolio management on financial performance of commercial banks in Rwanda. The study findings reveal that there is a close relationship between loan management and financial performance achieved by BPR from 2013 to 2016. Through the assessment of respondent's views on this relationship, the researcher found out that the loans risk analysis, loan risk diversification and loan risk monitoring were well managed, because all indicators considered at this level shown that the employees working in credit department have experience in credit management, there was professional training organized in order to keep them up to date, they have recognize being independent in loan review and the researcher found that there are lending procedures and guidelines designed and implement in order to improve loan management.Findings revealed also that there are factors considered in loan management like credit quality, Sufficiency of credit and collateral documentation and Compliance with internal policies and procedures and applicable laws and regulations.

Sarawan, (2014)also conducted research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (in terms of loan performance). Better credit risk management results in better performance. Thus, it is of crucial importance that financial institutions practice prudent credit risk management and safeguarding the assets of the institutions and protect the investors' interests. This is also true for micro finance institutions. In their study on Loan portfolio management strategies of selected financial institutions in Malaysia the majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk.

$H_0$1:*Client Appraisal has no significant effect on financial performance of commercial banks in Rwanda*

$H_0$2:*Loan risk control has no significant effect on financial performance of commercial banks in Rwanda*

II. Methodology

The study adopted descriptive research design which is concerned with finding out what, where and how of a phenomenon. Inferential statistics were used to draw inferences from the data.Multiple linear regression analysis was applied in the study to test the formulated hypotheses and expressed as;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$$

Where,
Y = Financial Performance
X_1= Client Appraisal
X_2= Loan risk control
β_0= Constant
β_1-β_2 = Coefficient of estimates
ε = Error tem

IV.Results

4.1 Correlation results

Statistical findings in Table 1 revealed that there was a positive and significant correlation between client appraisalandfinancial performance (r = 0.527, p<0.05). Again, the correlation between loan risk control and financial performance was a positive and significantly associated at (r = 0.423, p<0.05). Therefore, it was concluded that the client appraisalwere positively correlated to the performance at 5% level of significance.

Table 1 Correlation Matrix

	Financial Performance	Client Appraisal	Loan Risk Control
Financial Performance	1		
Client Appraisal	0.527*	1	
Loan Risk Control	0.423*	0.138*	1

* Correlation significant 5% (2-tailed).

4.2 Hypothesis Testing

The statistical findings in table 2 depicted that there is presence of the association between the variables (R^2 = 0. 514) implying that the combined prediction of the two predictor variables accounted for approximately 51.4% of the total variation on financial performance of commercial banks in Rwanda. The model was fit in predicting the contribution between the study variables which was statistically significant at 0.05 level of confidence (F = 9.352, p<0.05).The first hypothesis stated that client appraisalhas no significant effect on financial performance of commercial banks in Rwanda. The study findings revealed that client appraisal had a positive influence which was statistically significant (β = 0.399, p<0.05) hence client appraisal had a positive and significant effect on financial performance of commercial banks in Rwanda. This therefore implies that a unit change in client appraisal increases financial performance by 0.399 units. The second hypothesis stated that loan risk control has no significant effect on financial performance of commercial banks in Rwanda. Results showed that there was a positive and significant effect on loan risk control and financial performance of commercial banks in Rwanda (β = 0.204,p<0.05). This implies that a unit change in loan risk control enhances financial performance by 0.204 units.

Table 2: Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients		
		Beta	**Std. Error**	**Beta**	**T**	**Sig.**
1	(Constant)	0.954	0.121		7.88	0.01
	Client Appraisal	0.590	0.109	0.399	5.41	0.00
	Loan Risk Control	0.682	0.201	0.204	3.39	0.00
	Model Summary					
	R	0.717				
	R Square	0.514				
	F	9.352				
	Sig.	0.000				

* Significant at 0.5 level (2-tailed), ** Significant at 0.01 level (2-tailed)

V. Conclusion and Recommendation

The study is analyzed the effect of loan management strategies on the financial performance of selected commercial banks in Rwanda.The existing literature showed that loan management strategies improve financial performance of selected commercial banks.Given the findings, the researcher concluded that there is a strong positive link between that loan management strategies and financial performance of selected commercial banks in Rwanda. The researcher concludes that if loan is well managed greatly and positively influences the financial performance of commercial banks.Researcher concludes that adequate loan management can increase the financial performance commercial banks while on other hand the poor or wrong loan management can lead to poor performance of commercial banks. The findings have revealed that loan management strategies help to improve financial performance and to achieve objective of bank.

Suggestions for further research

Further researchers are suggested to increase on the sample size and techniques to be used in order to obtain more representatives of the population.

The researcher is also recommended to carry out studies on:

- The effect of non-performing loan on financial performance of commercial banks in Rwanda.
- The impact of ineffective loan management on financial performance of commercial banks in Rwanda.

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