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EFFECT OF CREDIT MANAGEMENT ON PERFORMANCE OF COMMERCIAL BANKS IN RWANDA A CASE STUDY OF EQUITY BANK RWANDA LTD

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ABSTRACT: *Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. As with any financial institution, the biggest risk in bank is lending money and not getting it back. The study sought to determine the effect of credit management on the financial performance of commercial banks in Rwanda. The study adopted a descriptive survey design. The target population of study consisted of 57 employees of Equity bank in credit department. Entire population was used as the sample giving a sample size of size of 57 employees. Purposive sampling technique was used in sampling where the entire population was included in the study. Primary data was collected using questionnaires which were administered to the respondents by the researcher. Descriptive and inferential statistics were used to analyze data. The study found that client appraisal, credit risk control and collection policy had effect on financial performance of Equity bank. The study established that there was strong relationship between financial performance of Equity bank and client appraisal, credit risk control and collection policy. The study established that client appraisal, credit risk control and collection policy significantly influence financial performance of Equity bank. Collection policy was found to have a higher effect on financial performance and that a stringent policy is more effective in debt recovery than a lenient policy. The study recommends that Equity bank should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.*

KEYWORDS: Credit Management, Commercial Banks, Equity Bank Rwanda

INTRODUCTION

Credit is one of the many factors that can be used by a firm to influence demand for its products. According to Horne and Wachowicz (1998), firms can only benefit from credit if the profitability generated from increased sales exceeds the added costs of receivables. Myers and Brealey (2003) define credit as a process whereby possession of goods or services is allowed without spot payment upon a contractual agreement for later payment.

Timely identification of potential credit default is important as high default rates lead to decreased cash flows, lower liquidity levels and financial distress. In contrast, lower credit exposure means an optimal debtors' level with reduced chances of bad debts and therefore financial health. According to Scheufler (2002), in today's business environment risk management and improvement of cash flows are very challenging.

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With the rise in bankruptcy rates, the probability of incurring losses has risen. Economic pressures and business practices are forcing organizations to slow payments while on the other hand resources for credit management are reduced despite the higher expectations. Therefore it is a necessity for credit professionals to search for opportunities to implement proven best practices. By upgrading your practices five common pitfalls can be avoided. Scheufler (2002) summarizes these pitfalls as failure to recognize potential frauds, underestimation of the contribution of current customers to bad debts, getting caught off guard by bankruptcies, failure to take full advantage of technology, and spending too much time and resources on credit evaluations that are not related to reduction of credit defaults.

Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. It is the process to ensure that customers will pay for the products delivered or the services rendered. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting. Nelson (2002) views credit management as simply the means by which an entity manages its credit sales. It is a prerequisite for any entity dealing with credit transactions since it is impossible to have a zero credit or default risk.

The higher the amount of accounts receivables and their age, the higher the finance costs incurred to maintain them. If these receivables are not collectible on time and urgent cash needs arise, a firm may result to borrowing and the opportunity cost is the interest expense paid. Nzotta (2004) opined that credit management greatly influences the success or failure of commercial banks and other financial institutions. This is because the failure of deposit banks is influenced to a large extent by the quality of credit decisions and thus the quality of the risky assets. He further notes that, credit management provides a leading indicator of the quality of deposit banks credit portfolio.

A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It follows that principles of goods lending shall be concerned with ensuring, so far as possible that the borrower will be able to make scheduled payments with interest in full and within the required time period otherwise, the profit from an interest earned is reduced or even wiped out by the bad debt when the customer eventually defaults. Credit management is concerned primarily with managing debtors and financing debts. The objectives of credit management can be stated as safe guarding the companies‟ investments in debtors and optimizing operational cash flows. Policies and procedures must be applied for granting credit to customers, collecting payment and limiting the risk of non-payments.

According to the business dictionary financial performance involves measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firms return on investment, return on assets and value added. Stoner (2003) as cited in Turyahebya (2013), defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. In agreement with this, Sollenberg and Anderson (1995) assert that, performance is measured by how efficient the

enterprise is in use of resources in achieving its objectives. Hitt et al., (1996) believes that many firms' low performance is the result of poorly performing assets.

Commercial banks earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. Bank financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans.

Credit management is the method by which you collect and control the payments from your customers. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting. A proper credit management will lower the capital that is locked with the debtors, and also reduces the possibility of getting into bad debts. According to Edwards (1993), unless a seller has built into his selling price additional costs for late payment, or is successful in recovering those costs by way of interest charged, then any overdue account will affect his profit. In some competitive markets, companies can be tempted by the prospects of increased business if additional credit is given, but unless it can be certain that additional profits from increased sales will outweigh the increased costs of credit, or said costs can be recovered through higher prices, then the practice is fraught with danger. Most companies can readily see losses incurred by bad debts, customers going into liquidation, receivership or bankruptcy. The writing-off of bad debt losses visibly reduces the Profit and Loss Account. The interest cost of late payment is less visible and can go unnoticed as a cost effect. It is infrequently measured separately because it is mixed in with the total bank charges for all activities. The total bank interest is also reduced by the borrowing cost saved by paying bills late. Credit managers can measure this interest cost separately for debtors, and the results can be seen by many as startling because the cost of waiting for payment beyond terms is usually ten times the cost of bad debt losses. Effective management of accounts receivables involves designing and documenting a credit policy. Many entities face liquidity and inadequate working capital problems due to lax credit standards and inappropriate credit policies. According to Pike and Neale (1999), a sound credit policy is the blueprint for how the company communicates with and treats its most valuable asset, the customers. Scheufler (2002) proposes that a credit policy creates a common set of goals for the organization and recognizes the credit and collection department as an important contributor to the organization's strategies. If the credit policy is correctly formulated, carried out and well understood at all levels of the financial institution, it allows management to maintain proper standards of the bank loans to avoid unnecessary risks and correctly assess the opportunities for business development

Statement of the problem

Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. According to Gitman (1997), the probability of bad debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective .Such delays on collecting cash from debtors as they fall due has serious financial problems, increased bad debts and affects customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a

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total loss is incurred. On that basis, it is simply good business to put credit management at the 'front end' by managing it strategically.

JoEtta (2007) also conduct 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).

Lending or credit creation seek to maximize profitable objective of bank, the rate at which commercial banks borrow from the central bank has gone down to 7% from 7.5%. This is expected to facilitate commercial banks to borrow cheaply so that they also lend cheaply in an attempt to continue supporting Rwanda's economy. The purpose of this study was to understand the effect of credit management on commercial banks financial performance.

Objectives of the study

The general objective for this study was to establish the effect of credit management on the financial performance of commercial banks in Rwanda

Specific Objectives

1. To determine the effect of credit appraisal on financial performance in Equity bank
2. To determine the effect of credit risk control on financial performance in Equity bank
3. To determine the effect of collection policy on financial performance in Equity bank

Research Questions

1. What is the effect of credit appraisal on financial performance in Equity bank?
2. What is the effect of credit risk control on financial performance in Equity bank?
3. What is the effect of collection policy on financial performance in Equity bank?

MATERIALS AND METHODS

This chapter discusses the methodological approach to which was used in the study. This includes; study design, study population, sample size and sampling technique, data collection and analysis.

The Research Design

This study was carried out through a descriptive cross-sectional research design. Orodho (2008) defines a research design as the scheme, outline or plan that is used to generate answers to research problems. Creswell (2008) stated that the descriptive method of research is to gather information about the present existing condition. The emphasis was on describing rather than on judging or interpreting. The descriptive approach was quick and practical in terms of the financial aspect

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Target population

Target population as described by Borg and Crall (2009) is a universal set of study of all members of real or hypothetical set of people, events or objects to which an investigator generalized the result. The target population of this study was staff from credit department of Equity bank. The department has a total of 57 members of staff according to the human resource manager.

Sample Size

Sample size refers to the number of units or people that are chosen from which the researcher wish to gather information or data (Evans et al., 2000). Since the population of this study was small (57), there was no need of determining sample size order to achieve accuracy. Instead the entire population was considered as the sample size because it was possible to collect data from the whole population.

Sampling Technique

Total population sampling technique was employed in this study. Total population sampling is a type of purposive sampling technique that involves examining the entire population that have a particular set of characteristics (Pratt et al., 1995. Since total population sampling involves all members within the population of interest, it is possible to get deep insights into the phenomenon of interest. Total population sampling has a wide coverage of the population of interest reducing risk of missing potential insights from members that are not included (Pratt et al., 1995)

Data Collection Instruments

Questionnaires

The questionnaire was used to obtain and gather information to analyze and compare different practices of credit risk management in the bank. A questionnaire is defined as a survey instrument intended to self-administered questions (Mannheim and Richard, 1995). The method was mainly employed in primary data collection although observation method was used for confirmation of secondary data like annual accounts. The questionnaire was formulated with close ended questions based on the objectives of the study.

Data collection procedure

The questionnaires were administered to the bank credit staff through drop and pick method. This method was selected because it doesn't inconvenience the respondents since they could answer the questions during their free time

Data processing and Analysis

According to Hyndman (2008), data processing involves translating the answers on a questionnaire into a form that can be manipulated to produce statistics. This involves coding, editing, data entry, and monitoring the whole data processing procedure. The data that was collected through questionnaires was tabulated and analyzed using the Statistical Package for the Social Sciences (SPSS) software package. Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was coded to enable the responses to be grouped into various categories. Descriptive and inferential

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statistics was used to analyze data. The findings were presented using tables and percentages. Tables were used to summarize responses to facilitate comparison.

RESULTS AND INTERPRETATION

Client Appraisal

Table 5.1: Extent to which Equity bank use client appraisal in Credit Management

	Frequency	Percentage %
Great extent	24	36
Moderate extent	10	45
Low extent	19	19
Total	53	100

The study sought to determine the extent to which Equity Bank used client appraisal in Credit Management. From the findings 36% of the respondents indicated to a great extent, 45% of the respondents indicated to a moderate extent whereas 19 % of the respondents indicated to a low extent, this implies that Equity bank used client appraisal in Credit Management to a moderate extent.

Table 5.1: Level of agreement on credit appraisal

Statement	SA	A	N	D	SD	Mean	Std. dev
Client appraisal is a viable strategy for credit management	21	30	2	0	0	1.70	0.26
Equity bank has competent personnel for carrying out client appraisal	16	33	4	0	0	1.77	0.27
Client appraisal considers the character of the customers seeking credit facilities.	15	36	2	0	0	1.75	0.29
Aspects of collateral are considered while appraising clients.	18	32	3	0	0	1.72	0.27
Failure to assess customers capacity to repay results in loan defaults	16	35	2	0	0	1.74	0.29

SA=Strongly agree A=Agree N=Neutral D= Disagree SD=Strongly disagree

The study sought to establish the level at which respondents agreed or disagreed with the above statements relating to client appraisal in Equity bank. From the findings majority of respondents agreed that Client appraisal is a viable strategy for credit management as shown by a mean of 1.70, Aspects of collateral are considered while appraising clients as shown by a mean of 1.72. Failure to assess customer's capacity to repay results in loan defaults as shown by a mean of 1.74, Client appraisal considers the character of the customers seeking credit facilities as shown by a mean of 1.75 and that the Equity bank have competent personnel for carrying out client appraisal as shown by a mean of 1.77

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Credit Risk Controls

Table 5.2: Extent to which Equity bank use credit risk control in Credit Management

	Frequency	Percentage %
Great extent	15	28
Moderate extent	30	57
Low extent	8	15
Total	53	100

The study sought to determine the extent to which Equity Bank used credit risk control in Credit Management. From the findings 57 % of the respondents indicated to a great extent, 28 % of the respondents indicated to a moderate extent whereas 15 % of the respondents indicated to a low extent, this implies that Equity Bank used credit risk control in Credit Management to a moderate extent.

Table 5.2: Level of agreement on credit risk control in Equity bank

Statement	SA	A	N	Mean	Std. dev
Imposing loan size limits is a viable strategy in credit management	22	28	3	1.64	0.25
The use of credit checks on regular basis enhances credit management	17	30	6	1.79	0.24
Flexible repayment periods improve loan repayment	14	37	2	1.77	0.30
Penalty for late payment enhances customers commitment to loan repayment	20	32	1	1.64	0.28
The use of customer credit application forms improves monitoring and credit management as well	18	35	0	1.66	0.30
Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk	35	15	3	1.40	0.28
Interest rates charged affect performance of loans in the bank	38	15	0	1.28	0.31

The study sought to establish the level at which respondents agreed or disagreed with the above statement relating to credit risk control in Equity Bank. From the findings, the study established that majority of the respondents strongly agreed that interest rates charged affect performance of loans in the Equity Bank as shown by a mean of 1.28, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk as shown by a mean 1.40 other agreed that. The use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers' commitment to loan repayment as shown by a mean 1.64 in each case. The use of customer credit application forms improves monitoring and credit management as well, as shown by a mean 1.66. Flexible repayment periods improve loan repayment as shown by a mean 1.77, and that the use of credit checks on regular basis enhances credit management as shown by a mean 1.79

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Collection Policy

Table 5.3: Extent to which Equity Bank use collection policy in Credit Management

	Frequency	Percentage %
Great extent	18	60
Moderate extent	32	34
Low extent	3	6
Total	53	100

The study sought to determine the extent to which Equity Bank use collection policy in Credit Management. From the findings 60% of the respondents indicated to a great extent, 34% of the respondents indicated to a moderate extent whereas 6% of the respondents indicated to a low extent, this implies that Equity bank use collection policy in Credit Management to a great extent.

Table 5.3: Level of agreement on collection policy of Equity bank

Statement	SA	A	N	Mean	Std. dev
Available collection policies have assisted towards effective credit management	12	6	6	1.89	0.27
Formulation of collection policies have been a challenge in credit management	36	10	7	1.45	0.28
Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults	33	10	10	1.57	0.25
Staff incentives are effective in improving recovery of delinquent loans	22	30	1	1.60	0.27
Regular reviews have been done on collection policies to improve state of credit management.	15	35	3	1.77	0.28
A stringent policy is more effective in debt recovery than a lenient policy	17	36	0	1.68	0.30

The study sought to establish the level at which respondents agreed or disagreed with the above statements relating to collection policy of Equity bank. From the findings, majority of the respondents strongly agreed that formulation of collection policies have been a challenge in credit management as shown by a mean of 1.45 others agreed that enforcement of guarantee policies provided chances for loan recovery in case of loan defaults as shown by a mean of 1.57, staff incentives are effective in improving recovery of delinquent loans as shown by a mean of 1.60, a stringent policy is more effective in debt recovery than a lenient policy as shown by a mean of 1.68. Regular reviews have been done on collection policies to improve state of credit management as shown by a mean of 1.77, and available collection policies have assisted towards effective credit management as shown by a mean of 1.89.

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Regression Analysis

Table 5.4: Model Summary

Model	R	R square	Adjusted R Square	Std. Error of Estimate
I	.892(a)	.796	.761	.2467

a. Predictors: client appraisal, credit risk control and collection policy

Adjusted R squared is coefficient of determination which tells the variation in the dependent variable due to changes in the independent variable, from the findings in the above table the value of adjusted R squared was 0.761 an indication that there was variation of 76.1% on performance of commercial banks in Rwanda due to changes in client appraisal, credit risk control and collection policy at 95% confidence interval. This shows that 76.1% changes in performance of commercial Banks in Rwanda could be accounted for by client appraisal, credit risk control and collection policy. R is the correlation coefficient which shows the relationship between the study variables, from the findings shown in the table above there was a strong positive relationship between the study variables as shown by 0.892.

Table 5.5: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
I	Regression	0.896	4	.224	2.213	.012
	Residual	5.184	48	.108		
	Total	6.08	52			

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.012 which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. There is an indication that client appraisal, credit risk control and collection policy significantly influences financial performance of Equity Bank in Rwanda. The significance value was less than 0.05 indications that the model was statistically significant.

Table 5.6 Coefficients

Model I		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
I	Constant	.218	.141		1.608	.039
	Client Appraisal	.239	.165	.205	1.653	.029
	Credit risk controls	.392	.271	.027	1.087	0.032
	Collection policy	.284	.157	.413	1.852	0.012

From the data in the above table the established regression equation was

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Y = 0.218 + 0.239 (Client Appraisal) + 0.392 (Credit risk controls) + 0.284 (Collection policy)

From the above regression equation it was revealed that holding client appraisal, credit risk control and collection policy to a constant zero, performance of commercial Banks would be 0.218, a unit increase in client appraisal would lead to increase in performance of commercial Banks in Rwanda by a factor of 0.239, a unit increase in credit risk control would lead to increase in performance of commercial Banks in Rwanda by a factor of 0.392 and also unit increase in collection policy would lead to increase in performance of commercial Banks in Rwanda by a factor of 0.284.

The study also found that the p-values of client appraisal (0.029) Credit risk controls (0.032) and Collection policy (0.012) were less than 0.05 an indication that the influencing of client appraisal, Credit risk controls and Collection policy was enough to improve financial performance of commercial Banks in Rwanda.

CONCLUSION AND RECOMMENDATIONS

introduction

This chapter presents the summary of data findings, conclusion drawn from the findings highlighted and recommendations made. The conclusions and recommendations drawn were focused on addressing the objective of the study. The study sought to determine the effect of loan management on the performance of commercial banks in Rwanda.

Summary of findings

To determine the effect of client appraisal on financial performance in Equity bank

The study revealed that commercial Banks in Rwanda use client appraisal in Credit Management to a moderate extent. Further it established that client appraisal is a viable strategy for credit, Aspects of collateral are considered while appraising clients, failure to assess customer's capacity to repay results in loan defaults, client appraisal considers the character of the customers seeking credit facilities and that commercial Banks in Rwanda have competent personnel for carrying out client appraisal.

To determine the effect of credit risk control on financial performance in Equity bank

The study established that commercial Banks in Rwanda use credit risk control in Credit Management to a moderate extent. The study further established that interest rates charged affects performance of loans in the commercial Banks in Rwanda, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk, the use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers commitment to loan repayment, the use of customer credit application forms improves monitoring and credit management, flexible repayment periods improve loan repayment and finally that the use of credit checks on regular basis enhances credit management.

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To determine the effect of collection policy on financial performance in Equity bank

The study revealed that commercial Banks in Rwanda use collection policy in Credit Management to a great extent. Formulation of collection policies have been a challenge in credit management, enforcement of guarantee policies provides chances for loan recovery in case of loan defaults, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more effective in debt recovery than a lenient policy, regular reviews have been done on collection policies to improve state of credit management, and finally that available collection policies have assisted towards effective credit management.

Conclusion

From the findings, the study found that client appraisal; credit risk control and collection policy had effect on financial performance of commercial banks in Rwanda. The study established that there was strong relationship between performance of commercial Banks in Rwanda and client appraisal, credit risk control and collection policy. The study revealed that a unit increase in client appraisal would lead to increase in performance of commercial Banks in Rwanda; this is an indication that there was positive association between client appraisal and financial performance of commercial Banks in Rwanda, an increase in credit risk control would lead to increase in performance of commercial Banks in Rwanda, which shows that there was positive relationship between financial performance of commercial Banks in Rwanda and credit risk control and a unit increase in collection policy would lead to increase in performance; this is an indication that there was a positive relationship between financial performance of commercial Banks in Rwanda and collection policy. Client appraisal, credit risk control and collection policy significantly influence performance of commercial Banks in Rwanda.

Recommendations

The study recommends that commercial Banks in Rwanda should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery. The study also recommends that there is need for commercial Banks in Rwanda to enhance their client appraisal techniques so as to improve their financial performance. Through client appraisal techniques, the commercial Banks in Rwanda will be able to know credit worth clients and thus reduce their non-performing loans. There is also need for commercial banks in Rwanda to enhance their credit risk control this will help in decreasing default levels as well as their non-performing loans. This will help in improving their financial performance.

Further studies should be conducted using various methods of data collections such as interviews and focus group discussion to improve on accuracy of the results. Larger sample size should also be used for more accurate findings

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