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Impact of Credit Risk on the Performance of Commercial Banks in Zambia: A Case study for Zambia National Commercial Bank in Ndola District

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ABSTRACT

The study assessed how the performance of Zambia National Commercial Bank in Ndola District was impacted by credit risk. This study also wanted to explore how effective is credit risk understanding by the staff of commercial banks in Ndola district and different methods used in managing credit risk by commercial banks in Ndola district. The sample size consisted of members of staff from Zambia National Commercial Bank who were 57. The workers from the bank were selected for the study using Purposive sampling. The study approach was quantitative in nature and questionnaires were used to collect data. Data analysis was done using (SPSS version 20). The study discovered that 15 (26%) described the Zambia National Commercial Bank as a private bank, 35 (62%) said a public bank, and 7 (12%) said a foreign bank. Respondents were asked about main activities of Zambia National Commercial in Ndola district.

The study established that 21 (37%) said lending, 7 (12%) said financial literacy, 25 (43%) said deposit taking and 4 (7%) said self-customer. Respondents were asked how effective management of credit risk is to the achievement of organization's objectives. The research revealed that 13 (22%) said credit risk management is effective to the achievement of the organization's objectives because it reduce revenue losses, 9 (17%) said it helps in monitoring your credit risk, 14 (24%) said enables the business to maximise sales and 21 (37%) said it prevent late payment or non-payment. Participants were asked the reasons why ZANACO is not able to get back some of the money it lends out to its clients in Ndola district. The study established that 28 (49%) said loss of employment, 14 (25%) said insufficient collateral, 9 (16%) said lack of consistent cash flow and 6 (10%) said debt-to-Income ratio. Respondents were also asked about the methods that are used by Zambia National Commercial Bank (ZANACO) to prevent credit risks in Ndola district. The study discovered that 12 (21%) said transaction structure, 17 (30%) said collateral and guarantees, 20 (35%) said determining creditworthiness and 8 (14%) said they know your customer. The study found that credit risk has a positive and significant effect on performance of Zanaco Bank. The study therefore recommends that Zambia National Commercial Banks should continue improving on their credit risk management practices such as regular credit policy reviews, knowledge advancement, securitization and standardized loan terms in accordance with set guidelines.

Keywords: Credit risk, Commercial banks, Performance and management

1. Introduction

According to Fredrick (2010), commercial banks are very important in structuring the economy of every nation. This is because it can perform as the lifeblood for a sound economic system through loaning and backing developments of savers and industries. The process of loaning, commercial banks bear credit risk and that is the risk that a client is likely not to pay back to the lender the money that was given to the client by the commercial banks. The reason why commercial banks should have procedures, processes and the lending framework in place to manage the process of lending out money to customers (Jackson, 2011).

Ahmed (2007) postulates that credit risk is the method to limit losses by making sure that the capital of the bank is adequate and loan losses reserves in order for the bank to protect itself if there are shocks in the market at any given time. Although commercial banks try as much as they can to mitigate the losses arising from the customers not paying back what was lent to them. This is the oldest problem that commercial banks do face. The Basel Committee on Banking Supervision (BCBS) (2013) explains credit risk in commercial banks can be a result of reduction of the possibility that a bank debtor or counterparty will not be able to meet its responsibilities following terms and conditions in the agreed contract. Credit that is written-off prevents the banks in attaining their set goals and this makes credit risk management competence not achievable, diluting the financial performance of banks.

Credit risk is the potential in which the bank debtor or counterparty will fail to abide by the agreed terms and conditions in the lending contract. According to Chijoriga (1997), credit risk is also a costly risk to financial organisations and its impact can adversely affect the bank more than the other risks because it directly impedes the going concern of monetary institutions. The quantification of the loss caused by credit risk compared to other risks are severe and can push the bank out of existence or industry.

The outcome on the credit risk for performance of commercial banks is designed internally by bank management as an operation tool and the banks regulators externally to manage financial health of the banking sector so that the banking system is not interrupted. (Muhammad, 2012). Focusing on strategies is the need for asset change, weighing the equilibrium between risk and returns. Sound credit risk management to enhance the financial success of the bank is a good pointer of a healthy financial performance of a bank as a whole (Lipunga, 2014).

Jackson (2011), states that the essential to check credit risk on financial performance in the commercial banking area is predominantly important in emerging countries like Zambia. Because of the rise in non-performing loans (NPL) and dealing with its negative effects, the Bank of Zambia opted for a policy position and this was fully adopted by commercial Banks. It is believed that the adoption of policies on risk credit was to promote financial stability. This is as a result of the banks that are not adequately capitalised and managed to spur methodical risk and monetary stability be threatened (RBM, 2013).

According to the Bank of Zambia (2016), it was discovered that eight out of 19 banks in Zambia recorded losses in 2014 and this number increased to nine in 2015, but it however reduced to five banks at the end of 2016. Of the 19 commercial banks, one was not operating by 2016 December, following the possession of Intermarket Banking Corporation Zambia Limited by the Bank of Zambia on 29 November 2016. This was attributed to the slowed economic activity recorded in 2015 (3.2% from 5% in 2014) and 2016 due to falling copper prices. It can be established that the commercial banks' profits are usually affected by external factors showing the commercial banks' emergent need to build internal structures that will enable adaptability to change macroeconomic environments.

Caruso (2021) adds that credit risk is also one of the major threats banks are facing when delivering services to clients. The banking sector's main source of revenue is the interest on loans issued by banks. There are various types of risks that banks face ranging from legal, liquidity, market, reputational, operational and credit risks (MacDonald, 2014). Carey (2001) disclosed that the important way to manage an economy is by first controlling risk. This is the same as what happens in the commercial industry including microfinance institutions. In the aspect of microfinance institutions, credit risk must be given consideration due to the features of their debtors and the type of business involved in. Advanced risk management processes and systems have to be put in place to properly mitigate unwarranted outcomes.

1.1. Zambia National Commercial Bank (ZANACO)

The government established Zambia National Commercial Bank (ZANACO) in 1969 to expand bank branches in the rural areas and credit access for Zambians, (Musokotwane, 1969) The government announced in 1971 to nationalize all foreign financial institutions and commercial banks after seeing that ZANACO was not able to expand quickly to fulfil the demand (Harvey, 1991). Many financial intermediaries and non-financial institutions were formed by the government for different reasons. Indo-Zambia Bank was formed between the government and three Indian banks owned by the Indian government in 1984. In 1987 the Zambia Export and Import Bank was created to provide trade finance in Zambia. The banking sector was seeing growth at a fast rate when most sectors in the economy were going through a recession. This part of the study looks at the reasons why many commercial banks were formed and the problems faced by these banks two decades ago. Meridian Bank was also formed in 1987 to provide credit finance.

Commercial banks now value the importance of effective credit risk management and doing that in all their activities (Bank of Zambia, 2016). Commercial banks face financial risk in the funding and investment decisions they make. Because of this, the risk management department of every commercial bank must be aware of the different kinds of threats they pose and find ways to mitigate the risks. The financial crisis of the 1980s was caused by administration problems, not uncertainty or environmental factors (Harvey 1991). These are systematic risks that come from the market process and human nature. The bank finds ways of managing risks that ensure that human errors are monitored and properly handled. Credit Risk management systems must take into account how the environment and human error will be monitored and addressed. However, the main reason for the study was to find out the effect of credit risk on the performance of commercial banks in Zambia: A case study of Zambia National Commercial Bank (ZANACO) in Ndola district.

1.2. Theoretical Framework

Theoretical framework propositions several benefits to research study. This is because it delivers the construction upon which a scholar may define his/her work theoretically, epistemologically, procedure and analytically (Grant & Osanloo, 2014). A theoretical outline for this study was anchored on the theory of financial distress. As soon as an entity's processes worsen such that it is incapable to relax its responsibilities as they accumulate, it is labelled as having monetary suffering Scott and Baldwin (1984). The incapability to wage arrears and the decrease or absence of capacity to pay bonuses in this context are the first signals of financial distress.

Whitaker (1999), monetary distress starts with the cash flows cannot meet the growing debts. The firm is in a better location to settle its arrears when the cash flow exceeds the maturing responsibilities. Therefore, the incapability to meet its pledged duties is an indication of monetary distress. Nevertheless, a substantial quantity of monetary distress cases becomes clear proceeding to non-payment. Wruck (1990), qualities monetary distress to economic distress, deteriorated performance as well as faulty organisation and particularly of risks.

Proceeding in a bank's scrawny nature concerning liquidness and credit risks, there were factors like economic recession, and poor decision-making and mistakes that ultimately incline to be expensive on the bank. Therefore, the efforts should directly position the signs of monetary distress to begin to show up. The meaning of the theory stalks from the detail that banking is facing credit risks and liquidity (Baldwin and Scott, 1983). The bank's existence and standing is incapable of delivering cash to its savers once wanted.

Bank's incapability to loan to debtors once it is needed and it can also be an outcome of liquidness trials. According to Kiselak and Kiselakova (2013), the bank's cash flow and steadiness pivots on how actual credit risk is fingered to safeguard a well loan portfolio. This is a dangerous task that must be completed sufficient to deliver for variations in the monetary marketplace and also the bank's compassion to risk contacts. Labours must also be made to factor the result of other creditors when introducing actions to discourse credit risk.

2. Material and method

The research design refers to a plan and technique incorporating stages of comprehensive expectations to detailed methods of how data will be collected, analysed and interpreted (Chetty, 2019). This study approach will select quantitative in that it will be able to quantify the study on hand via the generation of numerical data, converted into statistics. The quantitative research method operates with statistics and anything quantifiable in an organized way of investigating occurrences and relationships. This approach also will make it easy for this researcher to apply statistics in the analysis of the problems. The approach encompassed the explanations, forecasts, and regulation of occurrences.

A plan of how and where data will be collected and analysed. To assess the impact of credit risk on the performance of commercial banks in Zambia, a descriptive research design will be employed. Hale (2018) defines descriptive research design as explaining the characteristics of a sample taken from the population and generalizing their conclusions to represent the entire population. This study will use a survey method of descriptive research design as participants will be meant to provide answers from questionnaires. The survey method of descriptive research design is suitable for this study as it will help in getting data that describe occasions thereafter, arranges, tabulates, portrays, and defines the data that assisted in responding to research questions for testing hypothesis of the current status on the impact of credit risk on the performance of commercial banks in Zambia in Ndola district, Zambia.

The sample size is a collection of items from the population or a subset of a group of interest that is studied in research (Macnee & McCabe, 2008). To select the number of workers to be part of the study, the researcher established the total number of workers to be 90. Therefore, the following formula by Cochran, (1963) was used to come up with the sample size for workers.

The formula: $$n = \frac{N}{1 + N(e)^2}$$

Whereas: N= Target population

n=Total sample size

e = Desired margin error

Respondents' sample size for pupils

N=90 desired margin error (0.05)

$n = 90/1+90(0.05)^2$ = **73 workers**

In the study, out of the 90 workers as the population size, 73 participants were sampled using the formula above; this is because there were limited resources and time for the researcher to collect data from a sample size bigger than the one used.

A reliable data collection instrument is questionnaire. It is used when collecting data over a large sample. They equally save time especially when time was a limiting factor in the study. The administration of the questionnaires to respondents was arrived at after creating an understanding between the researcher and the respondents, by explaining the purpose of the study. Also, the availability of many respondents at a time made it possible for the researcher to collect data within a short period, get a high response rate and also reduce the financial expenses.

The analysis of data will be done at the end of the data collection. The responses will be categorized based on information provided by respondents. The software called Statistical Package for Social Sciences (SPSS version 20) will be used to present and interpret data using frequency distribution tables, percentages, pie charts, and bar charts. The statistical test that was used in this study was the Chi-square T-test. All the findings were centred on the impact of Credit Risk on the Performance of Commercial Banks in Zambia.

3. Results and Discussion

The study was assessing the impact of credit risk on the performance of commercial banks in Zambia. The findings were summarized as stated below: Out of the total number of workers who were 57, the study established that 11 (19.3%) had certificate holders, 24 (42.1%) were diploma holders, 19 (33.3%) were degree holders, 3 (5.3%) had Master's degrees and none of the respondents had a PhD. The study discovered that 32 (56%) were females compared to male 25 (44%) who took part in the study. This shows that the majority of the respondents working in Zambia National Commercial Bank in Ndola district are females.

According to the findings of the study, the study revealed that workers had different working experiences, with the majority being 21 (37%) having 5-8 years of working experience. The next big share had 1-4 years of working experience forming 14 (25%). The other one had 9-12 years of work experience forming 11 (19%), 1 year was forming 7 (12%) and the least was 12 years and above had 4 (7%).

The study discovered that 15 (26%) described the Zambia National Commercial Bank as a private bank, 35 (62%) said a public bank, and 7 (12%) said a foreign bank. Respondents were asked for how long has Zambia National Commercial Bank been operating. The study revealed that 23 (40%) said 50 years, 11 (19%) said 52 years, 9 (16%) said 53 years and 14 (25%) said 54 years.

Respondents were asked the main activities of Zambia National Commercial in Ndola district. The study established that 21 (37%) said lending, 7 (12%) said financial literacy 25 (43%) said deposit taking and 4 (7%) said self-customer. Respondents were asked how effective credit risk management to the achievement of the organization's objectives is. The study revealed that 13 (22%) said credit risk management is effective to the achievement of the organization's objectives because it reduce revenue losses, 9 (17%) said it helps in monitoring your credit risk, 14 (24%) said enables the business to maximise sales and 21 (37%) said it prevent late payment or non-payment. In a similar study done by Mensah (1997), commercial banks also offer a wide range of other financial services, ranging from credit cover to the selling of pension plans and the provision of a mechanism to make deposits, transfer funds and store financial information.

The result of this study is in line with the findings of Felix and Claudine (2008), which found that effective credit risk management is related to banks' performance for better results. For instance, Fredrick (2010) found that there was a positive significant relationship between credit risk management and bank's financial performance in Kenya. Poudel (2012) also appraised the impact of the credit risk management in bank's financial performance in Nepal using time series data from 2001 to 2011. The result of the study showed that credit risk management has a strong positive relationship with the financial performance of the bank. Kargi (2011) suggests that an effectively managed credit risk has a strong significant relationship with bank performance (profitability). The study established that an inverse relationship was there between the performance (profits) of the bank and evaluated variables namely loan and advance levels, NPL and deposits. Thus, the banks are susceptible to liquidity risk and financial distress.

5.2 Credit criteria the bank is using to determine a borrower's creditworthiness or the ability to repay debt

Respondents were asked what credit criteria the bank is using to determine a borrower's creditworthiness or the ability to repay debt. The study found that 7 (12%) said character, 21 (37%) said capacity, 11 (19%) said capital and 18 (32%) said collateral and conditions. Furthermore, participants were asked if the loans were the largest and most obvious source of credit risk at Zambia National Commercial in Ndola. It was revealed that 36 (63%) said Yes and 21 (37%) said No. The finding validated that of Claessens and Duncan (1993), they highlighted the starting point for managing commodity risks, including that of any user of financial instruments by setting clear goals that do not interfere with successful resource allocation within the country. One of the prerequisites for effective market stabilisation is the financial risk control tools always above.

Ramanujan (1990) pointed out that the instrument for controlling product risks therefore leaves quantity risks only against demand risks and that the buffer stock hedges against revenue risks. In addition, Claessens and Duncan (1993) added that, in the absence of a readily available competing counter swap, financial commodity risks control the price risks on the swap through the use of short-dated futures and option markets. By dynamic hedging, the intermediary may replicate a long-term hedge risk resulting from adjustments in the spot-to-future price relationship. Asbury and Ashwell (2013) have offered a similar point of view, which argued that risk is detrimental or positive, hampering or helping to meet the organization's target, while Loch et al. (2006) claimed that risk management is a kind of tool that helps companies address change.

5.3 Reasons why Zambia National Commercial Bank (ZANACO) is not able to recover some of the money it lends out to its clients in Ndola district

Participants were asked the reasons why Zambia National Commercial Bank (ZANACO) is not able to recover some of the money it lends out to its clients in Ndola district. The study established that 28 (49%) said loss of employment, 14 (25%) said insufficient collateral, 9 (16%) said lack of consistent cash flow and 6 (10%) said debt-to-Income ratio. Respondents were also asked about the methods that are used by Zambia National Commercial Bank (ZANACO) to prevent credit risks in Ndola district. The study discovered that 12 (21%) said transaction structure, 17 (30%) said collateral and guarantees, 20 (35%) said determining creditworthiness and 8 (14%) said they know your customer. The findings of this problem suggest a clear awareness of the true purpose of risk management among Zanaco staff. The main aim of a risk management process, as argued in the Economist (2009), should be to maximize the company's profits, as should any actions having been taken by the company.

According to Ezirim's (2005) opinion, bank loaning choices are usually confronted with a lot of uncertainties that require more patience, and tact in this area of banking operations. Therefore, the performance of loaning activity is primarily due to good credit review, reports, structuring and monitoring by credit analysts. Abu Hussain and Al-Ajmi (2012) argue that banks' value for various types of risk depends on their asset holdings and how different types of banks perform their business lines subject to controlling necessities. Numerous investigation studies indicate that banks are faced with credit risk, liquidity risk, operating risk, legal risk, controlling risk, reputational risk, competitive risk, solvency risk, interest rate risk, return risk, transaction risk, stock (equity) danger, foreign exchange risk, nation (political) risk and remaining risk with differing exposure levels (Al-Tamimi and Al-Mazrooei, 2007)

5.4 How credit risks affect the financial performance of Zambia National Commercial Bank (ZANACO) in Ndola district

Respondents were asked how credit risks affect the financial performance of Zambia National Commercial Bank (ZANACO) in Ndola district. The study discovered that 18 (31%) said it reduces the bank profitability, 10 (18%) said it affects the quality of its assets, 16 (28%) said it increases loan losses and 13 (23%) said it causes economic downturn. In addition, respondents were asked if they receive any assistance from the government when the organization is overwhelmed with too many loan defaults. It was revealed that, 50 (88%) said Yes and 7 (12%) said No. The study established the relationship between credit risk management performances of commercial banks. It was discovered that the majority of the respondents strongly agreed that there was credit risk on the performance of commercial banks

Similarly, a study done by and Awartani (2014) shows the effect of credit risk on the bank performance by using two stages DEA. Hence, a direct relationship between credit risk and bank performance indicates that capital adequacy is crucial for the performance of commercial banks in Zambia. In addition, the findings of the current study support the relevant literature that, technically more efficient banks have less non-performing loans (Ahmad, 2012).

4. Conclusion and Recommendation

The study aimed at assessing the impact of credit risk on the performance of commercial banks in Zambia. This revealed how credit risks affect the financial performance of Zambia National Commercial Bank (ZANACO) in Ndola district. it was discovered that 18 (31%) said it reduce the bank profitability, 10 (18%) said it affects the quality of its assets, 16 (28%) said it increases loan losses and 13 (23%) said it causes economic downturn.

The study found that credit risk has a positive and significant effect on performance of Zambia National Commercial Banks. The study therefore recommends that Zambia National Commercial Banks should continue investing in their credit risk management practices such as regular credit policy reviews, knowledge advancement, securitization and standardized loan terms in accordance with set guidelines. In addition, Zambia National Commercial Banks should oversee facilitation of credit risk management as a very important component in its lending framework by standardization of process and documentation.

The study also found that credit policies have a positive and significant effect on financial performance of commercial banks. Therefore, the study recommended that Zambia National Commercial Banks should adopt a tighter credit policy to a good policy for effective CRM and by doing so they will improve their financial performance.

These findings are in congruence with the earlier findings as discussed in the literature reviewed. The study has contributed towards an enriched literature on the effect of credit risk management which is a critical component of an integrated approach to risk management and beneficial for the long-term success of any banking organization. The study findings could also be used by policy makers to review or make new policies to promote financial literacy and consumer protection. The Central bank could also refer to the study findings as a source of available information to scrutinize and give guidelines to be followed by institutions in order for the financial system to remain stable and efficient. Adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

The results of the study could also be beneficial for the management to focus on the variables used in the study so that the financial performance of banks may be improved. Furthermore, the study may be replicated by adding more variables of credit management, increasing the sample size and by taking more commercial banks on board to investigate and test the impact of studied variables on the financial performance of the players to add generalizability to current findings. The study results could also be used as a key ingredient to the successful exploitation of economic opportunities through initiatives and reforms to enhance financial inclusion, credit availability and better overall financial performance which is a precursor for propelling economic growth and development. It is further suggested that secondary data may be incorporated in such studies to better find out the influence of credit risk management on financial performance in that specific dimension.

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