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Volume of Deposits, A determinant of Total Long-term Loans Advanced by Commercial Banks in Kenya: Case of Bungoma County.

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Aabstract: *Commercial banks have exponentially increased their total loans advanced over the period 2002-2013. However commercial banks in Kenya have shown varying long term lending behavior. The main objective of this study was to establish the effect of determinants of long term lending in the Kenyan banking industry, a case of Bungoma County. This study was guided by the following specific objective; to determine the effect of volume of deposit on total loan advanced, of selected commercial banks in Kenya. The target population comprised 13 commercial banks in Bungoma County with a sample size of 52 respondents. From the findings, for every unit increase in volume of deposits, a 10.9%, unit increase in total loans advanced is predicted. The model hypothesizes that there is functional relationship between the dependent variable and the independent variable. The study then recommends that commercial banks should focus on mobilizing more deposits as this will enhance their lending performance.*

Keywords: *Commercial banks, Lending behavior, Long term lending, total loans advanced.*

I. Introduction

Banks, the world over, thrive on their ability to generate income through their lending activities. The lending activity is made possible only if the banks can mobilize enough funds from their customers. Since commercial banks depend on depositor's money as a source of funds, it means that there are some relationships between the ability of the banks to mobilize deposits and the amount of credit granted to the customers, (Ewert, R., Szczesmy, a. & Schenk, g. 2000). Thus, the main function of financial institutions of mobilizing funds from the surplus economic agents to the deficit economic agents is put to test in order to generate economic growth. However, the efficiency of performing this function depends on the level of development of the financial system. The finance literature provides support for the argument that countries with better/efficient financial systems grow faster, while inefficient financial systems bear the risk as Diamond, d. (1991) and Ojo, J. A. T. (1999). According to Oloyede, B. (1999*)*, when a banking system does not work well there is potential for financial instability. The efficiency of a financial system is gauged by how speedily and cheaply the financial system is able to channel funds from the surplus economic agents to the deficit agents for productive investments, while ensuring reasonable returns for the financial intermediaries. Degryse H., Masschelein, N. & Mitchell, J. (2004) argues that the financial sector of an economy does matter in economic development, and that it can assist in the break away from plodding repetition of repressed economic performance to accelerate growth. But the financial systems of most developing countries lack the sophistication required for economic growth (Idowu, K.O. (2005).

The global financial crisis has posed serious challenge for deposit mobilization by banks, apart from the greater financial deepening which has created several alternative investment outlets for investors. This development has serious consequences for banks deposits and lending activities. As Adedoyin and Sobodun (1996), opined, due to reforms and developments in the capital market, particularly the developments of non – banking financial companies, there is much more awareness among the investors, and deposit mobilization has become competitive and challenging for the banking industry. According to him, the present investors are ready to face the situation by investing their money in the high-risk and high returns investment, which also facilitates other avenues like tax exemptions and concessions. The process of financial liberalization has intensified competition between financial institutions, thus forcing commercial banks to compete for deposits in various forms (Haron and Azmi, 2006). According to Bologna (2011), deposits play a pivotal role in bank funding, as a major portion of a commercial bank's assets is usually financed through customer deposits. To enhance deposit mobilization from the public, banks have used various strategies and most increasingly adopt a marketing

approach for deposits mobilization, which focuses on the identification of customer needs and offering of products accordingly

In some developed countries like japan, long term bank loans represent more than 70% of its total long-term debt. The recent cross-country evidence shows that banks in the emerging and developing countries' economies are reluctant to extend long-term credit to private businesses. The scarcity of long-term credit availability in developing market economies is recognized as an obstacle to their growth. Caprio and Demirguc-kunt, (1997) observes that non-financial firms in such markets consider the scarcity of long-term credit as one of the most important impediments to their operations. They show that firms that grew faster than predicted, exhibited higher levels of long-term debt to total assets. The long-term credit availability is also sensitive to the development level of a country's financial and legal institutions.

According to a report by the financial sector deepening (FSD, 2011), commercial banks in Kenya have continued their aggressive drive for new bank accounts. The total number of deposit accounts increased over the year from 11.8m to 14.4m, an increase of 22% in a year. Equity bank with over 6.5m accounts as at the year end, accounted for 46% of the accounts in the banking system. In addition co-operative bank, Kenya commercial bank (KCB) and Barclays have passed the million account threshold with family close to this number. While a bank is irrevocably committed to pay interest on deposits it mobilized from different sources, the ability to articulate loanable avenues where deposit funds could be placed to generate reasonable income; maintain liquidity and ensure safety requires a high degree of pragmatic policy formulation and application. Therefore the purpose of this study is to establish the determinants of long term lending behavior in the Kenya banking industry.

Statement of problem

Although recent cross-country evidence shows that banks in the emerging and developing countries' economies are reluctant to extend long-term credit to private businesses, the situation has been different in Kenya. Although there is a broad body of literature that addresses issues of banking long term lending behaviour, it either focuses on the demand side of debt (firms access to credit) or on the cross-country variation of bank lending behavior Chodechai, S. (2004). This study therefore is to map the extent of volume of deposit on total loan advanced.

General objective

To establish the determinants of total long-term loans advanced by commercial banks in Kenya

Specific objective

To determine the effect of volume of deposit on total long-term loans advanced by commercial banks in Kenya

Research Question

To what extent does volume of deposit affect total long-term loans advanced by commercial banks in Kenya?

Significance of the study

This study will shed some light on the lending decision of Kenyan commercial banks. It is quite important to understand the functioning of the banking system in emerging markets in general and in Kenya in particular to know how banks regard and rate them.

Limitation

It proved challenging at times to get the respondents from individual banks due to their busy schedules.

II. Literature Review

The Real Bills Doctrine theory

The real bills doctrine or the commercial loan theory states that a commercial bank should advance only short-term self-liquidating productive loans to business firms. Self-liquidating loans are those which are meant to finance the production, and movement of goods through the successive stages of production, storage, transportation, and distribution. When such goods are ultimately sold, the loans are considered to liquidate themselves automatically. For instance, a loan given by the bank to a businessman to finance inventories would be repaid out of the receipts from the sale of those very inventories, and the loan would be automatically self-liquidated. The theory states that when commercial banks make only short term self-liquidating productive loans, the central bank, in turn, should only land to the banks on the security of such short-term loans. This principle would ensure the proper degree of liquidity for each bank and the proper money, supply for the whole economy. The central bank was expected to increase or diminish bank reserves by rediscounting approved loans. When business expanded and the needs of trade increased, banks were able to acquire additional reserves by rediscounting bills with the central banks. When business fell and the needs of trade declined, the volume of rediscounting of bills would fall, the supply of bank reserves and the amount of bank credit and money would

also contract. Such short-term self-liquidating productive loans possess three advantages. First, they possess liquidity that is why they liquidate themselves automatically. Second, since they mature in the short run and are for productive purposes, there is no risk of their running to bad debts Menkhoff, l. (2000). Third, being productive such loans earn income for the banks.

Despite these merits, the real bills doctrine suffers from certain defects. First, if a bank refuses to grant a fresh loan till the old loan is repaid, the disappointed borrower will have to reduce production which will adversely affect business activity. If all the banks follow the same rule, this may lead to reduction in the money supply and price in the community. This may, in turn, make it impossible for existing debtors to repay their loans in time. Second, the doctrine assumes that loans are self-liquidating under normal economic conditions. If there is depression, production and trade suffer and the debtor will not be able to repay the debt at maturity. Third, this doctrine neglects the fact that the liquidity of a bank depends on the sale-ability of its liquid assets and not on real trade bills. If a bank possesses a variety of assets like bills and securities which can be readily should in the money and capital markets, it can ensure safety, liquidity and profitability. Then the bank need not rely on maturitis in time of trouble. Fourth, the basic defect of the theory is that no loan is in itself automatically self-liquidating. A loan to a retailer to purchase inventor is not self-liquidating if the inventories are not sold to consumers and remain with the retailer. Thus a loan to be successful involves a third party, the consumers in this case, besides the lender and the borrower. Fifth, this theory is based on the "needs of trade" which is no longer accepted as an adequate criterion for regulating this type of bank credit. If bank credit and money supply fluctuate on the basis of the needs of trade, the central bank cannot prevent either spiraling recession or inflation.

Volume of deposit

A commonly used statistic for assessing a bank's liquidity by dividing the banks total loans by its total deposits. This number, also known as the LTD ratio, is expressed as a percentage. If the ratio is too high, it means that banks might not have enough liquidity to cover any unforeseen fund requirements; if the ratio is too low, banks may not be earning as much as they could be.

Olokoyo (2011) found out in his study on Nigerian banking that volume of deposit has the highest impact and influence on the lending of commercial banks and a change in it will yield the highest change in banks' loans and advances. Therefore banks should strive hard to manage their deposits efficiently so that their objective of profitability can be achieved and the multiplier effects maintained to the maximum. This implies that generation of more deposits is tangent to the survival of Nigerian banks as a whole.

Chernykh and Theodossiou (2011), by using a sample of Russian banks, found that the median banks assign only 0.5 percent of its total assets in terms of long-term loans to business and there is large cross-sectional disparity in this ratio among banks. they argued that the bank's capacity to expand long-term business loans depends on various factors including its capitalization, size and the availability of long-term liabilities, however, the ownership of banks did not matter. They also concluded that the banks hesitated to issue business loans with more than three years maturity. their results exhibit that the banks with lower level of capital, the banks having lower funding for long term loans and banks in most competitive areas are reluctant to supply long term loans.

Caprio and Demirguc-kunt (1997) find that non-financial firms in such markets consider the scarcity of long-term credit as one of the most important impediments to their operations. They show that firms that grew faster than predicted, exhibited higher levels of long-term debt to total assets. The long-term credit availability is also sensitive to the development level of a country's financial and legal institutions. If the legal environment and the enforcement of debt contracts are weak then, as stipulated by diamond (1991), banks will mitigate potential credit risks by extending short-term rather than long-term loans.

In Fig 2.1, the volume of deposit is conceptualized to mean the total amount of money mobilized by the commercial banks through deposit accounts and available for lending at a return. These variable is operationalized to have a relationship with the total loan amounts advanced by lending institutions.

III. Research Methodology

The researcher applied descriptive survey research to achieve the objective of the study. The population of study comprised of 13 banks in Bungoma County and purposive sampling was applied to choose 4 respondents from loans department of each bank. The sample of respondents for this survey was considered suitable due to its relevance in the focus and purpose of the study. Self-administered questionnaires were used to collect data which is analyzed by Statistical Package for Social Sciences (SPSS). Inferential statistics was carried out using regression model to establish the effect of independent research variable on the dependent variable and the extent to which the independent variable explained the dependent variable. The findings have been presented using tables. The model for prediction is $LA = \alpha_0 + \alpha_1 vd + \mu$, Where: LA loans and advances, vd

-Volume of deposits, μ-error term controlling for unit-specific residual in the model and α0-intercept of the regression line

IV. Research Findings And Discussion

Volume of deposits.

Table 4.1 shows the extent the nature of accounts held by the bank affect the amount of loans advanced. 31% of the respondents indicated that current accounts affected loans advanced to a very high extent, 40% to a high extent while 11.4% were neutral. 54.3% of the respondents indicated that savings accounts affected loans advanced to a very high extent, 40% to a high extent while 5.7% were neutral. 28.6% of the respondents indicated that fixed accounts affected loans advanced to a very high extent, 54.3% to a high extent while 14.3% were neutral.

Table 4.2 shows that respondents reported with a mean of 2.26 that volume of deposits held in current accounts affects loans advanced, they also reported with a mean of 1.51 that volume of deposits held in savings accounts affects amount of loans advanced and the volume of deposits held in fixed deposit accounts affects amount of loans advanced with a mean of 1.91.

Relationship between Variables

For meaningful analysis inferential statistics was carried out using regression model to establish the effect of independent research variable on the dependent variable. Regression model *LA = 0.81 + 0.109vd* established how and to which extent the independent variable explained the dependent variable. From the findings, for every unit increase in volume of deposits, a 0.109 unit increase in total loans advanced is predicted.

V. Summary, Conclusions And Recommendations

Volume of deposits.

From the findings, 31% of the respondents indicated that current accounts affected loans advanced to a very high extent, 40% to a high extent while 11.4% were neutral. 54.3% of the respondents indicated that savings accounts affected loans advanced to a very high extent, 40% to a high extent while 5.7% were neutral. 28.6% of the respondents indicated that fixed accounts affected loans advanced to a very high extent, 54.3% to a high extent while 14.3% were neutral.

Conclusion

From the findings, volume of deposits explained 10.9% of total loans advanced, investment portfolio explained 44.9% and interest rate explained 9%.

Recommendation

Commercial banks should strategize on how to attract and retain more deposits so as to further improve on their lending performance.

Areas for further research

Further studies should be done on the other avenues that will create wealth to the banks leading to increase in bank resources.

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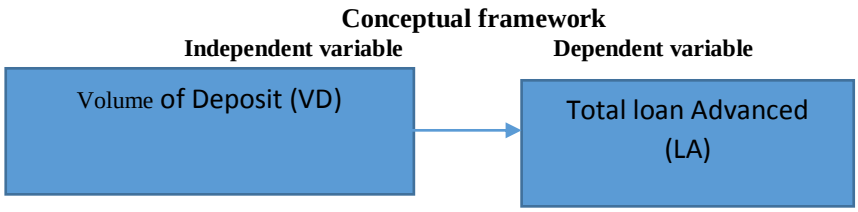

Figure 2.1 Conceptual framework

Table 4.1 Nature of accounts and Loans advanced

	Current		Savings		Fixed	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Very high extent	11	31.4	19	54.3	10	28.6
High extent	14	40	14	40	19	54.3
Neutral	4	11.4	2	5.7	5	14.3
Low extent	2	5.7	0	0	1	2.8
Very low extent	4	11.4	0	0	0	0
Total	35	99.9	35	100	35	100

Table 4.2. Volume of deposits.

Volume of deposits	N	Mean	Std. Deviation
Current A/C	35	2.26	1.291
Savings A/C	35	1.51	0.612
Fixed A/c	35	1.91	0.742
Valid N (listwise)	35		