# FINANCIAL REGULATIONS AND LENDING PRACTICES OF COMMERCIAL BANKS IN MALAWI.

Masters in Business Administration (MBA)

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**UNIVERSITY OF MALAWI**

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A dissertation submitted to the Faculty of Commerce, The Malawi Polytechnic, University of Malawi, in partial fulfilment of the requirements for the degree of Masters in Business Administration.

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# DECLARATION

I declare that this thesis entitled "*Financial regulations and lending practices of commercial Banks in Malawi*" is the result of my own, unaided work, except where acknowledged in the text and references. The thesis has not been accepted for any degree and is not concurrently submitted in candidature of any other degree. The thesis is being submitted in partial fulfilment of the requirements for the award of MBA in the University of Malawi.

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## CERTIFICATE OF APPROVAL

We declare that this dissertation is from the student's own work and effort. Where he has used other sources of information, it has been acknowledged. This thesis is submitted with our approval.

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## DEDICATION

To my wife Edyth and my two children – Giovanni and Megan.

Let this work inspire you.

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**ABSTRACT**

Many researchers in Western and European countries have paid considerable attention to how financial regulations have influenced lending behaviour of commercial banks. Unfortunately, there is little literature for bank behaviour in sub-Saharan countries including Malawi. The absence of similar studies influenced the researcher to assess how financial regulations have influenced lending behaviour of commercial banks in Malawi.

The overall aim of this study was to establish the impact of financial regulations on bank's lending practices/behaviour in terms of asset allocation/substitution strategy, lending techniques and strategy and pro-cyclicality of commercial bank lending. Specifically, the first objective of the study was to investigate any desirable or undesirable lending practices. The second and third objectives were to evaluate the implications of financial regulations on lending practices and commercial banks' perception of financial regulations.

A descriptive study was conducted by gathering data from stakeholders at different levels: bank regulators or supervisors from Reserve Bank of Malawi, credit analyst and internal auditors from top five commercial banks in Malawi and external auditors from top audit firms – KPMG and Deloitte. Through a stratified simple random technique, a questionnaire was sent to 70 respondents from stakeholders and semi-structured interviews were also conducted to 10 respondents from the sample frame. The study adopted a triangulation mixed methods approach where the findings of one method were used to compare with the other. Data was analysed using an excel sheet.

The findings of the research are diverse. The study has identified that some Banks in Malawi are into strategic lending alliance due to financial regulations while others have changed their asset-holding portfolio structures. The study has also revealed that financial regulations have not controlled undesirable lending practices by commercial banks and they have encouraged banks to shift between different types of credit assets. The study

has also established that financial regulations have not eliminated cyclicality of lending behaviour and they do not control commercial bank's excessive risk. However, the study has established that financial regulations are playing a role in controlling bank failure in Malawi. In addition, the study also looked at the effects of introducing Basel II Accord in the banking industry and it has been revealed that the introduction of the accord will lead banks to decrease holding certain type of assets while increasing other assets however, it will not lead to decline in loan portfolio but a change in portfolio structure of banks.

Based on the finding above, the study has recommended that Reserve Bank of Malawi must continuously improve supervision and regulatory framework of financial markets to safeguard the markets from emerging risks as well as undesirable lending practices by commercial banks.

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# CHAPTER 1

# INTRODUCTION

## 1.0 INTRODUCTION

A well functioning banking system has a role in allocating resources, pooling capital, funding and fostering economic growth. For this reason, bank activities are scrutinised numerously to protect the depositors' funds, to foster stability and soundness of banking system and enhance public confidence in the financial system. The importance of a well functioning banking system cannot be overemphasized. It is imperative that there exist financial regulations that promote financial stability, financial growth and better banking system performance. Because of this, financial regulations are designed to control, monitor and foster bank activities. Researchers have paid considerable attention to how bank activities are controlled, monitored and enforced by bank regulators and supervisors. Several studies conducted on the impact of financial regulations on activities of commercial banks have shown mixed results. Nevertheless, most studies indicate that financial regulations centre on capital regulation. Capital is undoubtedly the main determinant that controls lending practices of commercial banks. This study analyses the effects of financial regulations on lending practices of commercial banks in Malawi. It emphasises on how capital regulations influence lending practices (behaviour) of commercial banks in Malawi.

## 1.1 BACKGROUND

Financial markets play an important role in the smooth and efficient functioning of the economy. The markets facilitate the transfer of surplus resources to those with deficient resources. These include activities and operations that accumulate investment capital and those that stimulate growth and development of the economy. The Central Bank also relies on the financial system to transmit the effects of monetary policy actions to the real economy. For this reason, it is important to understand the implications of new business lines and changing strategies for pricing assets and diversifying risks. To this end, a country's Central Bank sees it necessary to monitor and regulate certain aspects of activities and operations in vital areas of lending, borrowing and funding of the financial markets. This is because the role of the Central Bank has been seen to influence economic development, evolution of financial markets to ensure competition, promote safety, soundness and stability of the markets.

Financial markets are made up of financial institutions, financial intermediaries, individuals and other organisations. Financial institutions, which include commercial banks, play a central role in allocating resources, pooling capital, funding and fostering economic growth for both local and international markets. Collins (2006) outlines the importance of a well-functioning banking system. He asserts that the imperative existence of prudential supervision and regulations in the industry is to protect both the public and promote an efficient and competitive banking system. In this regard, bank regulators and supervisors continuously endeavour to ascertain that certain bank practices/activities are associated with financial stability, economic growth and better banking organisation performance. Therefore, the aim of financial regulations is to influence bank practices to improve the banking environment. This is because, according to him, bank regulators subject banks to certain requirements, restrictions and guidelines with the goal of upholding the soundness and integrity of the system.

Bank supervisors supervise the banking system with the aim of checking individual banking transactions, risk management processes, conflict of interest, capital requirements, entry regulations and compliance with the law (Lash, 1987). As such, banks must have a good understanding of financial regulations to successfully complete everyday operations and activities. Ordinarily, the banking industry is expected to adapt well to existing or new regulations. As observed by Lash, management understands well business parameters such as the kinds of products and services the bank can offer, restrains on market share, balance sheet composition and entry into non-traditional operations. However, Collins (2007) points out that the shifting profile of banking sector in certain lending activities is due to rising customer demands, new products, the growth of banks in scale and scope, increasing rigorous stakeholder demands and a global business environment. This leads to risks and opportunities and with related potential to either erode or enhance value, certain activities of the bank might change and one such example are lending practices.

Brealey et al. (2001) point out that banks perform a critical social and economic function by providing credit to borrowers, particularly small and medium enterprises who cannot raise capital on their own. Because of this important function, both to the bank and the economy as a whole, bank lending is subjected to considerable regulations. This point is also highlighted by Collins (2006) who sees regulatory goals having the greatest bearing on bank lending to safeguard bank safety, that is, ensuring that banks do not have appetite for inordinate risks and that lending practices are not made strictly in terms of minimising risks and maximising return.

In Malawi, the Reserve Bank of Malawi (RBM) is the only frontline regulator and supervisor of the financial system. Its powers to regulate and supervise the commercial banks are granted under the Banking Act (1989) and the Reserve Bank Act (1989). As outlined under part III section 14 (1) of the Banking Act as well as part III section 1 (h) of the Reserve Bank of Malawi Act, RBM has the responsibility for bank regulation and supervision. Part IX section 48 (1), (3) and (4) of the Reserve Bank of Malawi Act also gives the RBM responsibility to supervise banks and other financial institutions, to safeguard the liquidity and solvency of such institutions and ensure their compliance with monetary regulations under the Act, issue guidelines, regulations and directives and prescribe prudential ratios to be maintained by certain categories of banks and other financial institution, and to appoint inspectors who may at any time investigate the affairs of a bank or other financial institution at their premises.

The banking system in Malawi comprises eleven commercial banks. As at June 2009 the eleven banks were National Bank of Malawi, Standard Bank, NBS Bank, First Merchant Bank, INDEBank, Opportunity International Bank of Malawi, Malawi Savings Bank, NEDBank, ECOBank (formerly Loita Bank), FDH Bank and International Commercial Bank of Malawi. All of the banks are locally incorporated, offering similar homogenous lending products. However, there has been a rapid structural change in lending practices taking place in the financial markets. This may be due to spurred acceleration of financial innovation that is taking place in lending products or services, which raises a question whether it is a result of structuring of regulatory organisation. The question that arises here is how has financial regulations influenced the evolution of lending practices of commercial banks in Malawi?

## 1.2 PROBLEM STATEMENT AND JUSTIFICATION.

### 1.2.1 STATEMENT OF THE PROBLEM

Brealey et al. (2001) state that bank lending has historically been a business activity defined by competition, customer preferences, regulations and the ability by the bank to respond to the environment. Furthermore, advances in technology and financial markets appear to have accelerated these trends, prompting innovations in bank lending which results in uncertainty and rapid obsolescence of lending practices which at times spurs pockets of business failure.

The challenge for financial service stakeholders, that is, regulators, bankers and the general public alike is to establish a regulatory framework that is resilient and responsive to rapid changes; as past and future regulatory developments ought to be aligned with financial developments and innovations (Brealey et al., 2001). This is because the increased scope and scale of bank lending in existing or new regulatory framework has brought confidence to create innovative products or services which have undermined business behaviour and if left unchecked can often create fatal problems.

The problem is therefore the undesirable lending practices within the regulatory framework which can be inconsistent with the financial stability and economic growth. Collins (2007) identifies predatory lending and subprime lending as some examples of undesirable lending practices that have implicated the banking industry and affected the USA economy in 2006. The other problem is that as regulators responsible for financial integrity of financial system, Bank regulators need to address regulations arbitrage and pro-cyclicality of financial indiscipline in lending practices. As observed by Brealey et al. regulators tend to set requirements, restrictions and standards which they can easily monitor and enforce, while the regulated seek standards, restrictions and requirements they can comply with. They both fail to balance the organic and mechanistic aspects of regulations and lending practices which both can operate effectively along the continuum between innovations and strong regulatory framework. Often, this encourages banks to come up with techniques (such as lending techniques) that avoid the prudential rules set by the regulators (regulations arbitrage). This practice of shunning regulations can determine whether new regulations are warranted or whether changes to existing regulations may be needed.

Moreover, financial regulations raise public interest as sometimes strict controls by regulators can discourage banks from making consumer loans to households or discourage some types of loans in favour of others.

## 1.3 SIGNIFICANCE AND JUSTIFICATION OF THE STUDY

Monitoring of emerging risks in bank lending due to industry innovation is important for efficient, effective supervision and regulation. Identifying, predicting and responding to emerging risks ongoing basis helps to limit potential systemic risk and potential bank failure (Berry et al., 1993). This is because if there is strong evidence that lending practices endanger the financial stability, regulators may need to create significant new regulation, but if not, they may stress the application of existing supervisory guidance.

Llewellyn (2001) argues that regulation involves a process of creating incentive compatible contracts so that commercial banks have an incentive to act consistently with the objective of financial stability. This suggests that a well designed incentive contract induce appropriate behaviour by regulated bank. Conversely, if they are badly constructed and improperly designed, then they might have undesirable effect in the banking system.

This study is significant as it will provide an analysis on: (1) how commercial banks' lending practices in Malawi have changed in response to new or existing financial regulations, and (2) whether banks have the incentive and justification to engage in regulatory arbitrage. A key component of regulatory regime is the nature, timing and form of intervention by regulators in the event of either some form of compliance failure with a regulated firm or when financial distress occurs with banks (Llewellyn, 2001). The benefit is that prompt corrective action can be taken to address any problem before they reach critical proportions. This study is therefore important because it unveils specific lending practices that can lead banks into potential problems, and regulators will know beforehand what sort of bank behaviour will emerge due to existing or new regulations.

Commercial banks play a facilitating role in the monetary policies of any country and continued strength and stability of the banking system is a matter of government and public interest. There is a spiral effect between monetary policies of government, financial regulations and economic growth. By extending credit to qualifying borrowers, commercial banks perform a critical role of economic expansion. However, the value and type of credit is influenced by financial regulations. Nevertheless, the purpose of regulations is not to limit economic activity but to make sure that activities and operations are conducted in stable and flexible financial systems. Further, previous researches have investigated the link between bank capital regulation, the loss of bank capital or bank shrinkage, commonly referred to as a capital crunch, portfolio shrinkage, regulation arbitrage, and pro-cyclicality of lending behaviour (Mingo and Wilkowitz (1977); Peek and Rosengren (1995); Mullings (2003); Kashyap and Stein (2004); Llling and Paulin (2004); Rojas-Suarez (2004) and Stolz and Wedow (2005)). This research investigated whether the same bank regulations influenced lending practices of commercial banks in Malawi in terms of loan amounts, loan strategies and techniques.

It is against this background that the researcher found it necessary to assess financial regulations and lending practices of commercial banks in Malawi. Financial regulations are meant to bring order and stability in the financial system. However, the same regulations have led banks into some undesirable practices which have to be analysed in order to expose them and recommend action from regulators or supervisors. Furthermore, some undesirable practices occur because there are no regulations or prudential rules controlling, limiting or disallowing them. Hence if something is not explicitly disallowed it is presumed to be allowed. This poses a big challenge to RBM considering that different banks in Malawi specialise in different types of credit products[1] hence different types of risk characteristics, analysis and management control systems.

## 1.4 OBJECTIVES OF THE STUDY

### 1.4.1 MAIN OBJECTIVE

The main objective of the study was to evaluate the impact of financial regulations on lending practices of commercial banks in Malawi.

1. Most of the banks in Malawi offer retail banking products and services but differ in their specialization of products that includes consumer, real estate, mortgages, equity credit loans and small business loans. There are now only two merchant banks that assume market risks but not long term credit risks. The risk appetite, hence lending behavior differs on the basis of expertise.

### 1.4.2 SPECIFIC RESEARCH OBJECTIVES

Specifically the study:

- Investigated desirable or undesirable lending practices of commercial banks in Malawi.
- Evaluated the implications of financial regulations on lending practices of commercial banks in Malawi.
- Evaluated commercial banks' perception of financial regulations in Malawi.

## 1.5 RESEARCH QUESTIONS

The study in relation to the objectives above aimed to answer the following research questions:

- What are some of the tactical and strategic lending techniques that have developed due to financial regulations?
- What have been the changes in lending practices in response to new or existing financial regulations?
- What is the effect of financial regulations on lending practices of commercial banks in Malawi?

## 1.6 ORGANISATION OF THE STUDY

This research paper comprises five chapters. The organisation of the study is as follows:

Chapter 1 has provided introduction of the study covering the background, problem statement, significance of the study, objectives of the research work and research questions.

Chapter 2 provides a critical review of relevant literature on financial regulation and lending practices of commercial banks. The chapter summarises the types of financial regulations, relevant theories and examples of lending practices of commercial banks in other countries.

Chapter 3 discusses the research methodology that was used by the study. It presents the data collection methods and techniques and data analysis tools that were used. It gives a detailed set procedures and steps which were followed to obtain the research findings.

Chapter 4 provides the results and discusses the main findings. The discussions are focused on answering the research questions and objectives as a framework of addressing the research problem.

Finally, chapter 5 provides the conclusions and recommendations made from the study. It also summarises the major findings of the research work and possible areas for further research.

## 1.7 CHAPTER SUMMARY AND CONCLUSION

This chapter has introduced in detail the research study, the aims and significance of the study, the research objectives and questions. It has given the foundation of the problem which will provide the direction of the research work. Chapter 2 reviews relevant literature of the research study and it will provide a framework of how similar researches were conducted elsewhere. The chapter gives practical and theoretical knowledge of the research problem.

# CHAPTER 2

# LITERATURE REVIEW

## 2.0 INTRODUCTION

This chapter reviews relevant literature on financial regulations and lending practices of commercial banks. Firstly, the chapter focuses on defining financial regulation and lending practices of commercial banks. Secondly, the chapter reviews the supervision and regulation framework in Malawi and finally the chapter reviews theories related to financial regulations and lending practices.

## 2.1 DEFINITION OF FINANCIAL REGULATION

The term *regulation* refers to a set of binding rules issued by a private or public body.[2] Financial regulations are designed to ensure efficient and competitive banking system, protect the banking system from crisis, protect the public, increase institution solvency and place certainty around transactions (Collins, 2006). Thus, the definition of financial regulation is broad and in this context, it is used to mean rules that are applied by bank regulators in the fulfilment of their functions; and in the banking system they include prudential rules such as those influencing the conditions of access to the market, those controlling risks associated with financial activities, corporate governance, conduct of business rules and methods of supervision. The body issuing the rules must be given the authority to do so. In most countries, it has both authority to supervise compliance with the rules and power to issue sanctions against breach of the rules. Mwenda (2006) differentiates the two and sees a regulator as more concerned with preparing and issuing regulations, while a supervisor promotes a culture of compliance with these regulations. Compliance is checked through on-site and off-site supervision of financial transaction and

2. As defined by International Compliance Association (ICA). The association supports and educates compliance professionals in the fight against money laundering, corruption, terrorism and financial crime.

services. In Malawi, supervision and regulatory services are conducted by Reserve Bank of Malawi.

## 2.2 LENDING PRACTICES AND BANK BEHAVIOUR

Berry et al. (1993) define bank lending is when a loan or an advance is given out to a customer or when the bank takes up financial risk on the customer's behalf. Banks are able to provide this service by utilising surplus depositors' funds. Banks offer credit facilities which are structured in different ways depending on purpose, type and term of the facility and mode of repayment. Each facility granted affects the bank's on-balance sheet and off-balance sheet position hence safety and soundness of the Bank.

Bank lending is influenced by credit culture in an organisation. According to McKinley (1990) credit culture is a combination of several factors that establish a lending environment that encourages certain lending decisions. This could be bank's lending philosophy and policy or management's communication of strategic goals, values, beliefs and priorities. Lending decisions overtime are what determine management's lending practices or bank's lending behaviour. Parallel to lending education and training, management also gain lending experience through exposure to variety of situations. As stated by Berry et al. (1993), economic (business) fluctuations provide learning opportunities for bankers. They tend to considerably modify their lending practices (bank lending behaviour) in the light of their experiences during the pro-cyclicality of business cycle.

Lending practices concern bank lending in terms of safety, risks analysis, social consideration and others (Lash, 1987). The practices have to conform to bank regulations, prudential rules and guidelines as set by Central Bank. However, due to different bank's strategic goals and other factors such as competition, profitability, growth of bank's scope and scale, customer demands and technology; some banks use lending techniques and strategies which alter their lending practices. These lending practices occur due to regulation arbitrage and unclear or absence of prudential rules or guidelines disallowing them. Eventually, a particular bank's lending behaviour also change.

## 2.3 REGULATORY AND SUPERVISION FRAMEWORK IN MALAWI

As observed by Mwenda (2006), the regulatory framework for financial services is often comprised of a combination of two or more of the following: (1) primary enabling statute; (2) secondary legislation issued pursuant to the enabling statute; (3) principles, rules and codes issued by regulators; and (4) guidance or policy directives issued by the regulatory authority. He continues to say that since no business is without risk, many regulators adopt a risk-based approach process, ensuring that the various types of risk associated with a particular financial services industry or business are identified, quantified, managed and monitored properly.

Regulation and supervision of financial system in Malawi is currently done by Reserve Bank of Malawi (RBM). The Banking Act (1989) empowers RBM to issue operative guidelines and directives to promote and enforce sound and stable financial system. Part III section 26 of the Act authorises RBM to issue directives pertaining to solvency, liquidity and sound operating practices of banks and directives for any financial institutions, and such directives may vary for different classes of financial business. In particular, part III section 27 (1), 28 and 30 (1) of the Act also authorises RBM to issue directives on certain ratios to be maintained, directives as to loan, investments and uncovered positions and prudential limits as to size of loans, participation and immovable property.

Bank operations are subject of different risks which if not well managed can lead to financial distress and eventual failure. Supervision of banks is an on-going process which is conducted through off-site and on-site examination. Off-site examinations involve the analysis of weekly, monthly, quarterly and annual prudential returns or call reports. The examinations mainly focus on key parameters such as capital adequacy, asset quality, liquidity management and profitability. The findings of this exercise may prompt an on-site examination with the off-site results as an input. Thus, on-site examination involves physical call to a particular financial institution on ad hoc or programme basis. On-site examination enables supervisors to validate the information provided by the bank during the prudential reporting process. The process diagnoses and establishes the exact cause of bank problems in terms of quality of loan portfolio, adequacy of loan provisions and reserves, adherence to laws and regulations and also the terms stipulated in the banking license.

The supervisory framework of RBM contains a mixture of off-site and on-site inspection, periodic reporting and discussions with senior management and sometimes the Board of Directors. In Malawi, RBM has just adopted a risk-based supervision (RBS) process. All along, the Bank followed the traditional type of supervision where all areas of CAMEL[3] were assessed with no particular emphasis on a risk profile of a bank. The Bank was able to move to risk-based supervision since all the other systems were already in place.

## 2.4 FINANCIAL REGULATIONS THAT INFLUENCE LENDING PRACTICES

There are different types of financial regulations that can be identified as those that impact the asset and liability of the bank. Llewellyn (2001) identifies the following: (1) prudential rules with respect to allowable business; (2) prudential rules with respect to the prudential management of banks and other financial firms (for example, capital adequacy rules, large exposure limitations and rules on inter-related lending); and (3) rules with respect to conduct of business (for example, how financial firms conduct business with their customers and disclosure requirements).

A substantial literature exists on these different regulations that are enforced through prudential rules, guidelines, requirements and directives. The studies that were reviewed came up with the following literature.

### 2.4.1 CAPITAL ADEQUACY DIRECTIVE

In principal, bank capital[4] serves two functions: first, it represents the value of shareholder's equity, and secondly, it is the value of cushion available to absorb unexpected losses. As a result of the second function, minimum capital requirements have been determined relative to bank risk. "Capital adequacy" is described as the minimum capital that financial intermediaries are required to maintain all the times.[5] *Ceteris paribus*, a bank specialising in treasury bills would require less capital than a bank specialising in

[3] Capital-Asset Quality-Management-Earnings-Liquidity (CAMEL). Usually there is no separate assessment of market sensitivity (S), otherwise the acronym would have been CAMELS.
[4] Lash (1987) defines capital as the sum of retained earnings and the aggregate par or stated value of outstanding common stock. The definition of capital has also broadened to include reserves and long-term debt.
[5] As defined by International Organisation of Securities Commissions ( IOSCO)

risky-speculative loans (Lash, 1987). This suggests the effect of capital adequacy rules on risk taking behaviour by banks. The primary aim of capital adequacy regulation is therefore to limit excessive risk-taking by banks. If the bank has large capital base then it should be willing to take more risks simply because: first, it can shoulder or cushion large unexpected losses; and second, its lending limit (as authorised by bank regulators) should be higher than other banks hence the bank has high risk appetite.

Lash (1987) argues that low capitalised banks are usually at disadvantage because capital is more expensive source of funds than debt. These banks are pressured to make more high-risk high-return loans to increase earnings. The increase in earnings increases the capital of the bank hence the amount of loan to a particular individual or group of related individuals or Company. Furthermore, Brealey et al. (2001) argues that when banks are capital-constrained, they are induced to hold safer and more liquid assets. Banks would prefer to hold marketable securities than other types of assets. In this case, the bank is said to engage in asset substitution or allocation particularly because of low capital relative to its risk-weighted assets. Invariably, the increase in capital ratios by Central Banks (capital to asset ratio) will require banks to raise more capital either through credit expansion or asset reduction (Rodriguez, 2002). It can be argued that if banks are operating at low or maximum capital adequacy levels, any increase in the required limit[6] can put pressure on banks to increase capital or reduce its asset portfolio. This influences the lending activities in terms of credit type, amount and risk.

#### 2.4.1.1 THE BASEL ACCORD

While capital requirements have played an increasingly central role in the bank regulations, there has been some development on a well defined standard. The International Standard for bank capital arose out of discussions between the G-10 bank regulators which resulted in 1988 Basel Accord.[7] Again, from 1998, the Basel Committee undertook a detailed examination of portfolio models of credit risks. Jackson et al. (1999) observe the framework of Basel I Accord was established as a structure that was intended to: (1) make regulatory capital more sensitive to differences in risk profile among banking organisation;

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[6] Currently, banks are required to maintain 8% as ratio of capital to asset.
[7] The Basel Committee on Bank supervision sets risk-weighted minimum capital standards for internationally active banks.

(2) take off-balance sheet exposures explicitly into account in assessing capital adequacy; and (3) lower the disincentives to holding liquid and low risk assets. After 10 years of Basel I Accord (Basel I), the Basel Committee established a research task force to set up a working party on bank capital and behaviour to assess the empirical evidence on the impact of the 1988 Accord. The Committee attempted to fine tune the Accord and hence came up with the more recent Basel II Accord (Basel II). The major advantage of Basel II is that it gives equal consideration to minimum capital ratios, supervisory reviews and market discipline (Rodriguez, 2002). Again, Santomero (2002) indicates that Basel II has made substantial effort to incorporate risk management practices that banks (and other financial institutions) actually use in their processes and this has increased the risk sensitivity of minimum capital requirements.

Rodriguez (2002:7) in his policy analysis paper explains the Accord as follows:

> The Basel Accord divides capital into two tiers: Tier I (or core) capital is made up of equity capital and disclosed reserves from post-tax earnings; and Tier 2 (or supplementary) capital comprises undisclosed reserves from post-tax earnings, revaluation reserves from assets that have been re-valued to reflect more accurately their market (as opposed to historic or book) value, general provisions or general loan-loss reserves, which are created against the possibility of losses not yet identified and debt capital instruments.[8] Tier 2 capital also comprises subordinated debt (unsecured debt of a fixed maturity that is junior to all other claims)

Kashyap and Stein (2004) state that one of the central changes in Basel II regulatory framework is the concept of internal rating-based (IRB) capital requirements. Under this approach, the amount of capital a bank will have to hold against a given exposure is a function of the estimated credit risks of that exposure. The two authors point out that there are many potential benefits to the existing risk-based capital requirement as compared with the "one-size-fits-all" approach embodied in the original Basel I framework. IRB capital requirements should reduce pricing distortions across loan categories as well as the accompanying incentives for banks to engage in various forms of regulatory capital

[8] Capital instruments that combine characteristics of debt and equity.

arbitrage (Kashyap and Stein, 2004). However, Llling and Paulin (2004) point out that there is ample evidence that the current state of business cycle affects the internal rating. Bank's internal rating during economic downturn is bound to be different than during economic boom. This is also shared by Kashyap and Stein (2004) who state that the new capital standards will exacerbate business cycle fluctuations. The idea is that in downturn, the Bank capital base is likely to be eroded by loan losses hence its existing (non-defaulted) borrowers will be downgraded by the relevant credit-risk models, forcing the Bank to hold more capital against its current loan portfolio. It becomes difficult or costly for the Bank to raise fresh external capital in bad times, hence it is forced to cut bank on its lending activity, thereby contributing to worsening of the initial downturn. The same argument is also raised by Catarineu-Rabell et al., (2005) who assert that strongly pro-cyclical capital requirements could cause severe macroeconomic effects by creating credit crunches in recessions, thereby exacerbating the economic downturn. The same can also encourage excessive lending or easy credit in booms. The authors point out that an important policy issue is therefore whether banks would choose to adopt more stable ratings across the business cycle, which would moderate the pro-cyclical effects or whether they would adopt ratings conditioned on the point in the cycle even though this could lead to inability to meet demands for credit in a downturn (Catarineu-Rabell et al., 2005).

If external ratings are used, credit rating agencies argue that they take a "through-the-cycle" approach to ratings, that is, the ratings are based on the assumptions of an adverse confluence of events of a typical severity and probability regardless of the current economic conditions. According to Fisher (2002), Basel II has set standards which emerging markets and many developing economies cannot reasonably hope to meet. He state that the greatest concern relates to the reliance on external rating agencies in the standardized approach to calculate minimum capital requirements. Domestic rating agencies are not well developed in many developing countries and in other countries (including Malawi) they do not exist. Therefore, in the short-term, most domestic credit risk will tend to end up in the unrated 100% category as indicated by Basel II. This could increase the risk-sensitivity of most banks in the new system relative to the Basel I. In addition, the provisions of the Basel II Accord assume that project finance is of higher risk than corporate lending, implying an increase in capital requirements for loans belonging to the former category. As stated by Griffith-Jones and Spratt (2001), this could be a specifically problematic for developing countries, which rely on project finance in infrastructure development and economic growth.

### 2.4.1.2 CAPITAL ADEQUACY DIRECTIVE AND LENDING PRACTICES

Bank regulators have recognised that banks around the world differ very significantly, both in the nature and complexity of their activities and in their approach to risk management (Santomero, 2002). Thus, the capital regulation framework provides a range of regulatory capital approaches and risk management systems from which banks can choose subject to review by their supervisors. Santomero (2002) observes that regulators have made practical move to risk-based examinations rather than just looking at point-in-time balance sheets and financial ratios. This means that the regulations have the right incentives for industry to continue to seek advances in risk management and for regulators to continue to improve their skills in assessing the adequacy of risk-management systems in use. However, the risk-weights applied to different assets and contingent liabilities creates incentives for banks to misallocate the internal distribution of capital, to choose an uneconomic structure of assets and to arbitrage capital requirements (Llewellyn, 2001). The argument is that banks have an incentive to choose assets whose regulatory risk weights are low relative to the economic (true) risk weights.

Jackson et al. (1999) in their research of G-10 banks found out that bank's reaction to hitting regulatory constraints on their capital ratios are likely to vary according to the state of the business cycle and bank's own financial situation. The results are consistent with the view that banks respond to capital pressures in the manner they believe to be the most cost effective. For example, Jackson et al. outline that raising new capital or boosting retained earnings may be easier during economic boom where as cutting back loan book may be cost effective in economic troughs. Similarly, Rodriquez (2002) points out that bank's risk appetite may vary according to business cycle. Banks are willing to extend unsecured credit facilities during economic booms (as credit risk analysis is based more on cash flows) and during economic troughs, banks are more comfortable to extend secured lending as repayments cannot be lied on primary source only, that is, the cash flows[9] but also the secondary source of repayment which is the collateral pledged.

Regarding capital structure decisions, banks may well be sensitive to the higher cost of Tier 1 capital relative to Tier 2 capital (Jackson et al., 1999). The authors conclude that when cost of raising Tier 1 capital is prohibitive, banks may attempt to meet capital requirements where possible through issuance of Tier 2 capital. Nonetheless, some banks have a richer mix of equity relative to Tier 2 and even more than the capital regulations would require, probably because of market pressure (for example to meet large loan request by customers). Further, Gambacorta and Mistrulli (2003) observe that well-capitalised banks are less risk-averse. They observe that since minimum capital requirements take into account the quality of banks' balance sheet activities, excess capital represents a cushion that controls for the level of banks' risk and indicates a lower probability of a bank to go into default. Moreover, excess capital is a direct measure of banks capacity to expand credit because it takes into consideration prudential regulation constraints (Gambacorta and Mistrulli 2003). This is also supported by Hellman, Murdock and Stiglitz (2000) as reported by Gambacorta and Mistrulli (2003) who argue that higher capital requirements are the cause of excessive risk-taking by banks. This is because capital regulation increase banks' cost of funding (equity is more costly than debt) and reduces the value of the bank, management of the bank reacts by increasing the level of credit portfolio risk (Gambacorta and Mistrulli, 2003)

Other available research studies reviewed (Baba, 1996; Berger and Udell, 1994 and Hall, 1993) suggest that in order to meet minimum capital requirements, banks are likely to cut back lending when it would be too costly to raise new capital.

#### 2.4.1.3 CAPITAL ADEQUACY DIRECTIVE AND CREDIT CRUNCH

Peek and Rosengren (1995) indicate that there are several researches that have investigated the link between bank capital regulation (the loss of bank capital) and bank loan shrinkage, commonly referred to as credit crunch. They affirm that several studies in the past (Bernanke and Lown, 1991; Hancock and Wilcox, 1992; Peek and Rosengren, 1994) have

[9] This is probably because during economic troughs, most businesses do not generate adequate and reliable income to service the loan.

attributed the credit crunch to the large losses in bank capital in combination with adoption of new capital standards. Particularly, Peek and Rosengren (1994) have shown that loan supply as well as loan demand contributed to the observed slow loan growth, with poorly capitalised banks expanding loans less rapidly (decreasing loans more rapidly) than their better-capitalised competitors. This point is also shared by Brealey et al. (2001) who see capital requirements to have a potential disadvantage for binding capital-constraint banks which may reduce its lending hence leads to credit crunch. For example, it has been suggested that the scramble by US banks to meet the standards of the 1988 Basel Accord led to the US credit crunch in early 1990's.[10] Similarly, Chu et al., (2006) concluded that while the Basel II Accord may prevent some banks from engaging in excessive risk-taking behaviour that are prejudicial to depositors, it may also affect bank's lending strategies. The Basel II Accord use both used and unused commitments as a denominator of the capital adequacy ratio calculations; hence for instance, banks can reduce the use of lines of credit available to their customers simply to reduce or eliminate the negative impact of unused commitments on the calculation of its capital ratio.

The introduction of Basel II Accord led international banks into several strategies just to meet the minimum capital ratios that were set (Chu et al., 2006). For low capitalised banks, it meant that they had to either increase their Tier 1 or Tier 2 capital. But as explained, Tier 1 is more expensive (less cost effective) than Tier 2 and in addition, Tier 2 is more risky than Tier 1. The only alternative is to cut back on lending to reduce the amount of assets tied to capital. In addition, if a bank's capital-to-asset ratio becomes very low (due to dividend payment or credit losses) it must either (a) raise more capital, (b) curtail its lending, or (c) shift its portfolio towards assets with lower risk-weights. The bank must choose the most cost-effective way of meeting the capital adequacy requirements. However, increasing market innovations have enabled banks to use techniques that effectively arbitrage between the two tier capital thereby increasing risks relative to minimum capital levels (Chu et al., 2006). One such technique is securitisation[11] which transfers high risk-weighted assets to low risk-weighted assets.

[10] See Bernankhe and Lown (1991), *The credit crunch*, Brookings papers on economic activity 2, pp 205- 248
[11] Securitisation involves the sale of assets to a special purpose vehicle which finances this purchase through issuance of asset-backed securities to private investors.

The volume of securitisation is substantial. Chu et al., (2006) state that as at March 1998, outstanding non-mortgage securitisation by the then 10 largest US bank holding companies amounted to around US$ 200 billion (more than 25%, on average of these banks' risk-weighted loans). They explain that banks in different countries use securitisation to alter the profile of their books. For example banks can securitize their outstanding portfolio in credit cards and consumer loans. This makes a bank's capital ratio look artificially high relative to the riskness of the remaining exposures. They conclude that with increasing sophistication of the banks and the development of new innovative techniques in the markets, banks have started to find ways of avoiding the limitations which fix capital requirements on their risk-taking relative to their capital. The argument is that risk categories in Basel II Accord gives an incentives to banks to undertake capital arbitrage by transferring risk weighting between assets (for example by shifting from high risk-weighting assets into assets that bear relatively low-risk weights such as residential mortgages, short-term inter-bank exposures or Government securities) or reducing the loan portfolio through securitisation. Chu et al. describes the former technique as 'cherry-picking'[12] and it is one of the oldest forms of capital arbitrage.

### 2.4.2 DIRECTIVE ON CREDIT CONCENTRATION LIMITS FOR BANKS

In order to promote safety and soundness, the Banking Act (1989) section 30 (1) (a) prohibits commercial banks in Malawi from lending more than 25% of their core capital and surplus to a single customer or group of related customers. The direct impact is that each bank has a limit of loan amount it can lend to a particular borrower. Larger amounts can only be extended unless prior approval is obtained from the Reserve Bank of Malawi which usually is granted depending on social-economic value of the credit. Lash (1987) sees this requirement to be detrimental to portfolio growth of low capitalised banks. He argues:

> "… while the loan limit does encourage greater bank safety through diversification, it also prevents small banks from meeting the entire loan request of large customers and forces them to share large loans with other banks on participation basis."
>
> (Lash, 1987: 56)

[12] The practice of shifting portfolio's composition towards lower quality credit.

Loan participation (also known as loan syndication) is the only way low-capitalised banks are able to serve large loan request from their customers (Berry et al., 1993). In cases where the customers are rapidly expanding firms, the limit may ultimately cause the banks to lose these customers. This vindicates why low-capitalised banks concentrate more on small and medium enterprise customers as they are able to meet their loan request. However, credit limits do not apply to all forms of bank credit. For example, in Malawi, where the credit facility is guaranteed by Government or the portion in excess of the limitation above is so guaranteed or the credit facility is granted in respect of exports. According to RBM Directive No. DOS 3 – 93/CC, one of the objectives of credit concentration limit is to help banks follow the sound practice of credit diversification. It can be argued that credit limits have contributed to specialisation of bank lending of different banks. The argument is that high capitalised banks have high concentration limit than low capitalised banks. The big banks tend to attract big corporate customers who usually demand big loan amounts while the small banks tend to concentrate on low corporate customers or small and medium size enterprises. Furthermore, for smaller banks, it means they have to increase their capital. As capital increases through retained earnings, the concentration limit should improve (vice versa). This point to the conclusion that there is an incentive for banks to take high-risk high-return assets (to increase net income hence retained earnings) which can further deteriorate the bank's capital levels if not properly managed.

### 2.4.3 DIRECTIVE ON LARGE LOAN EXPOSURES

Diversification of risk is one of good aspect of bank lending. The Basel Committee of bank supervision at its international conference in Frankfurt - October 1990, recognised a major proportion of bank failure occurred due to credit risk concentration of one kind or another. The argument is that non-performance of a single large exposure weakens the performance of the bank in terms of profitability. In order to reduce this risk, banks are directed to limit the exposure to one particular counterparty or group of related parties.

It is not relatively simple to define a counterparty in terms of a single legal entity whether corporate, official or private. However, it has often been discovered that several of banks' large exposures are in practice related[13] so that in effect they constitute a single exposure. For example, separate borrowers, despite dealing on an independent basis with the bank, may represent a single risk because they are legally or economically inter-related. Thus repayment difficulties would arise for all if any one of them experience financial problems. Furthermore, a bank can maintain separate relationships with two distinct companies, but if there is a merger or a buyout, then credit concentration to the new holding company will have automatically changed.

The large exposure limits presently applied in most countries are expressed in terms of the bank's capital. Limits for single exposure generally fall within the range of 10 – 40% of total capital[14]. In Malawi the limit is set at 25% for any single or related customer of bank's present portfolio. Morris (2001) states that both the Basel Committee and the World Bank acknowledges that some countries have aggregate large exposure limits. For example, in Malawi, RBM do not permit a credit institution to incur large exposures (defined as exceeding 10 % of capital) which in total exceed 800 % of capital. The Basel Committee states that there are risks arising from an over-concentrated loan portfolio or from over-exposure to geographic areas or economic sectors.

One of the immediate effects of limiting exposure is that banks have managed to diversify their lending activities. Prudence suggests that banks should diversify their exposure to a certain degree (Lash, 1987). The argument is that directive on large exposures limits vulnerability of highly leveraged banks to sectors that experience rapid movement in commodity prices such as real estate, agriculture and transport.

Supervising large exposures can sometimes be a challenge and the question that arises is whether supervision should be conducted on consolidated basis or not. However, it is often argued that consolidation is impractical since there are a number of banks with different capital levels hence different large exposures. If these banks syndicate a loan facility to a particular customer, with time, an increase in capital base will mean the banks will no longer report the facilities as large exposures. In case of Malawi where there are no credit information exchange systems, the unavailability of comparable information may result in banks sharing credit loss hence systematic risks. Credit default of the single customer can

[13] The Basel Committee (1991) define the term "related" to refer to relationships between borrowers.
[14] Basel Committee on Banking supervision (1990)

result in credit losses for different banks. Supervisors therefore do not have useful measure of the quality of loan portfolio which should enable the supervisors to form a judgement about possible linked exposures, credit losses and systematic risks.

### 2.4.4 RISK MANAGEMENT GUIDELINES FOR BANKS

In February 2008, RBM issued operative risk management guidelines for banking institutions in Malawi. The guidelines outlines risk profile areas which all banking institutions should be aware and ensure that they have risk management systems in place to manage or mitigate these risks. The document has standards which are the framework for risk management. Richard et al., (2008) state that credit problems, especially weakness in credit risk management (CRM), have been identified to be a part of the major reasons behind banking failure. The authors continue to state that poor loan quality has its roots in the information processing mechanism. The problems begin at loan application stage, and increase further at the loan approval, monitoring and controlling stages, especially when CRM guidelines in terms of policy and strategies/procedures for credit processing do not exist or are weak or incomplete.

In Malawi, the CRM guidelines have been issued at a right time, just when there has been an increase in demand for credit by non-qualified and marginally qualified people. The only challenge is that the guidelines are not mandatory hence some banks may decide to ignore them. The theory of asymmetric information argues that it may be impossible to distinguish good borrowers from bad borrowers, which may result in adverse selection and moral hazard problems (Richard, et al., 2008). Due to other factors (such as interest rate reduction, economic boom which brings many opportunities and increased bank competition), banks realise that extension of credit to these customers may be profitable only if high enough interest is charged to cover the risks (Collins, 2000). Collins states that the significant portion of this type of lending appears to be in the so-called sub-prime and predatory lending markets. If this is the case, then the risk management guidelines which emphasise on sound risk management systems will enable banks to take risks knowingly and reduce the risks where appropriate. Unfortunately, the assertion that ‘high-risk high-returns’ has resulted in many banks undertaking predatory and subprime lending behaviour which if left unchecked can lead to financial distress and losses.

### 2.4.5 PREDATORY LENDING BEHAVIOUR

Collins (2000) observes that many developing countries do not have regulations that control, limit and reduce the effect of predatory lending. He admits that predatory lending is difficult to define because predatory loans are difficult to identify as they carry many of the same characteristics as suitable loans. He however quotes a joint paper released by USA Department of Treasury and the Department of Housing and Urban Development – 20th June 2000 which describes predatory lending situation as where:

> "The party that initiates the loan often provides misinformation, manipulates the borrower through aggressive sales tactics and/or takes advantage of the borrower's lack of information about the loan terms and their consequences. The results are onerous terms and conditions that the borrower often cannot repay…"
>
> (Home Ownership and Equity Protection Act, 1994: 2)

In USA, Federal Reserve Board has attempted to rein in predatory lending through the revised standards under Regulations Z. The basic structure of federal predatory lending regulation is set out in a 1994 statute, the Home Ownership and Equity Protection Act (Pyle, 2003). As pointed out by Pyle, Home Ownership and Equity Protection Act – regulation Z loans are barred from incorporating certain terms, including the following:

1. balloon payment in loans with a term of less than five years;
2. payment schedules that are negatively amortised and thereby allow the balance owed on a loan to increase rather than decrease;
3. increased interest rates in the event of default;
4. certain prepayment penalties and;
5. requirements that payments be bundled and paid in advance.

Collins (2000) argues that predatory lending involves the abuse of lending practices, such as risk-based pricing, credit insurance and balloon payments which are generally desirable. Banks are risk takers and they ordinarily price credit facilities according to prevailing risks. In addition, credit insurance helps banks to cover unavoidable risks such as death, but this also raises the cost of the loan to the borrower. However for these reasons, legislators and regulators are reluctant to outlaw these practices because they have proved to be effective most of the time. Collins gives an example of balloon payments which if used appropriately, young home owners are given a chance to own a house through mortgage whose financing is matched with their rising income. But, when used inappropriately, the bank may force the retired or low-income earners to refinance the loan at high costs, continuing the cycle of high-cost refinancing.

Mwenda (2008) illustrates that Banking Act (1989) under section 31 provides a situation where if a bank or financial institution is found conducting its business in unlawful or unsound manner, Reserve Bank may impose several remedial measures to rectify the situation. The definition of conducting business in unlawful or unsound matter has not been given by the Act, and Mwenda observes that RBM is not prohibited by any law from providing policy guidelines on the meaning of this concept.

While regulation Z exists in USA, in Malawi there are no guidelines or directives that should encourage supervisors to check and monitor predatory lending practice. The absence of such regulations may escalate the practice which harms the customer. Section 56 of the Banking Act empowers the Reserve Bank to act through the Minister to pass regulations pursuant to the Banking Act. The section provides the RBM with legal mandate to provide its own understanding of what 'conducting business in an unsound manner' means (Mwenda, 2008). Interestingly, Pyle (2003) outlines that most regulators primary mission is the safety and soundness of the banking system and not consumer protection hence they tend to be more sympathetic to the concerns of bank institutions than those who worry about the abuse in the banking industry. We can only hope that regulators in developing countries realise this complication and issue guidelines that protect the interest of the public in general.

### 2.4.6 SUBPRIME LENDING BEHAVIOUR

The typical lending practice by all banks in subprime lending markets, involves lending to borrowers who do not qualify for 'prime' rates. Collins (2004) explains that these borrowers may not have credit histories or have blemish credit histories or higher debt levels making them riskier than prime borrowers. The issues that are affecting the subprime markets bear the hallmark of previous credit cycles such as credit over-expansion (Collins, 2007). Most banks are over-optimistic, believing that asset prices will continue to rise. However, a fall in prices (due to macro-economic conditions such as economic recession) is followed by delinquencies, defaults and failure which impact the lenders. The effects can spill over to other banks causing financial distress. However, while subprime lending is a concern to all, Pyle (2003) points out its welfare advantage. He observes that in USA, most banks recognise that legitimate sub-prime loans increase social welfare because they help borrowers gain access to loans that they would not have obtained. Debatably, this is only effective during economic boom, whereby the economy experiences stable macro-economic conditions and the prevailing interest rates are constant or declining. However, any economy experiences business fluctuations such that the justification of sub-prime lending has a negative consequence which can lead to financial distress especially when the economy is experiencing a recession.

## 2.5 FINANCIAL REGULATIONS AND LENDING PRACTICES : THEORY AND RELEVANT LITERATURE

### 2.5.1 PROFIT MAXIMISATION MODEL

Many authors who have presented theoretical literature on financial regulation established a focal relationship between capital requirements and risk-taking behaviour of regulated banks. Previous research by Mullings (2003) examines whether the risk-based capital requirement led to increased capital or a reduction in risk-weighted assets of Jamaican banking sector.

The research by Mullings uses Furfine’s (2002) profit maximisation model. The conclusion of the research suggests that risk and capital requirements affect significantly the profit maximising behaviour of commercial banks in Jamaica. Further, he points out that there is marginal benefit associated with not exceeding capital requirements. Most Jamaican banks had high return and low default-risk securities relative to loans. This may have negative effects on funding for productive, private ventures and also for overall risk exposure of banks if there is significant interest rate risk (Mullings, 2003). The results show that Jamaican banks preferred to hold default-free assets on bank balance sheet relative to loans just not to exceed capital requirements while maximising profits. In addition, the policy implications for Central Bank of Jamaica was to reduce interest rates on default-free securities so as to increase the scope for productivity as well as to improve the favourability of loans as an investment options for banks.

Bouri and Ben-Hmida (2006) argue in the same line as Mullings (2003) that regulation on bank activities affects bank profitability and insolvency risk. Further, previous studies by Kohn and Santomero (1980); Kim and Santomero (1988) as pointed out by Bouri and Ben-Hmida (2006) assert that since capital requirement restrict the risk-return frontier of a bank, a forced reduction in capital requirement may induce banks to reconfigure the composition of their portfolio of risky assets; thus, leading possibly to an increase in risk taking behaviour. Contrarily, both authors also points out that Furlong and Keeley (1989) have shown that capital requirement may decrease bank risk since the option value of deposit insurance is decreasing in a bank's leverage. Therefore, the effect of capital adequacy requirement on bank risk is an empirical question and the minimum capital standards may increase risk –taking, contrary to their intent (Bouri and Ben-Hmida, 2006).

There are many researches on the responses of banks' portfolios to changes in capital. According to study by Shrieves and Dahl (1992), they concluded that risk exposure and capital levels are simultaneously related and the majority of banks mitigate the effects of increases in capital levels by increasing asset exposure, and vice versa. Further, Bouri and Ben-Hmida points out that many researches that investigated the impact of Basel capital requirements on banks behaviour extended the study of Shrieves and Dahl (authors such as Jacques and Nigro (1997); Aggarwal and Jacques (1998), (2001); Ediz et al., (1998); Rime (2001); Heid et al., (2004); Hassan and Hussain (2004); Van Roy (2003), (2005)). With the exception of Ediz et al., (1998), all use the simultaneous equation modelling framework that allows to compare the behaviour of undercapitalised and adequately capitalised banks with respect to changes in capital and risk and to see whether these changes are related. The results from these researches as reported by Bouri and Ben-Hmida, all supports the conclusion that there is a positive association between risk and capital in banks however not due to strictly consequence of regulatory influence, but rather it reflects the bank owner's and/or manager's private incentives and their conception about profitability and risk-taking behaviour.

The main goal for banks is to balance between risks and returns in conduit of financial intermediation. This exposes banks to various risks; however the major risks faced by banks in their lending activities are credit and market risks. Most banks have failed to recover credit from borrowers with questionable capacity or character and the bank may only protect itself against excessive credit or market risks during the initial credit-granting process, sound underwriting standards and an efficient balanced approval process.

Over the years, volatility of banks' earnings have been linked to the loan portfolio. While there are many contributing factors including market forces, poor risk measurement and weak risk management, a common underlying factor has been bank's tendency to underestimate or under price credit risk. However, the goal of management and the board is to maximise profits (utility) and not minimise credit or market risks. This puts pressure on bank managers whose actions is to increase risk-return frontier (while taking calculated risks) for the bank in order to maximise profits. An early research by Mingo and Wilkowitz (1977) points out in the same line of the argument that there are two important decisions for bank's balance sheet decisions: their contribution to profits and their effects to bank's soundness or risk of insolvency. The two authors also state that regulators in their effort to prevent bank failure underscore the risk-return nature of both assets and liabilities of the bank. Consequently, regulations, directives and prudential rules that affect balance sheet of commercial banks are bound to affect profits of the bank. Probably, among others, the corrective measure is for the banks to change type, nature or structure of lending activities.

### 2.5.2 THE CAPITAL BUFFER THEORY.

According to Calem and Rob (1996) and Rime (2001), the buffer theory predicts that a bank approaching the regulatory minimum capital ratio may have an incentive to boost capital and reduce risks in order to avoid the regulatory costs triggered by a breach of the capital requirements (Bouri and Ben-Hmida, 2006). Further, Kleff and Weber (2004) point out that banks may wish to maintain a certain capital buffer in excess of the minimum requirement in order to reduce the regulatory costs. They further point out that there are implicit and explicit regulatory costs, which is a result of falling very close to or below the regulatory minimum. Therefore, changes in portfolio risk and the capital ratio may be positively related, as banks may wish to maintain their regulatory capital ratio (Kleff and Weber, 2004).

The two authors argue that those banks that have left their target capital zone or have fallen close to the regulatory minimum have an incentive to return to their capital buffer by increasing capital and decreasing risk (Kleff and Weber, 2004). Therefore, according to the theory, a change to capital requirement will induce banks to adjust their portfolio risk (banks will reduce temptation of taking up high credit risk assets and unsecured assets or this may facilitate disposal of non-performing assets), and it is apparent to find a negative relationship between changes in capital ratio and the portfolio risk for less capitalized banks. However, Kleff and Weber (2004) also point out that the theory is not relevant for banks with an extraordinary high capital ratio. They argue that the banks are not forced to manage capital dependent on portfolio risk, as they are far away from experiencing regulatory costs.

Similarly, an argument raised by Lindquist (2003) on the buffer capital theory sees an important issue is how buffer capital varies with the risk profile of the bank's assets. From a regulator's perspective, banks with a relatively risky portfolio hold a relatively high level of buffer capital. Otherwise these banks are more likely to fall below the minimum capital ratio, which could give rise to a credit crunch (Lindquist, 2003). Therefore, in worst case or during economic downturn, poorly capitalized banks may spur systemic risk which may threaten financial stability. On the other hand, some researchers such as Stolz and Wedow (2005) see shocks to banks' capital buffer may force banks to raise capital and / or reduce lending. Shocks such as credit losses which reduce capital may force banks to reduce their risk-weighted assets, which may happen through a reduction in lending activities. Stolz and Wedow (2005) argue that forward-looking banks tend to expand their loan portfolio during economic upturn. This builds up their capital buffer which is easier in economic upturn than in an economic downturn. When economic downturn sets in, banks' capital buffers can absorb the materializing credit risk (credit losses) (Stolz and Wedow, 2005). Hence, given a forward-looking bank, the buffer capital is expected to behave pro-cyclically. This hypothesis shows how buffer capital changes in response to changes in business cycle.

Stolz and Wedow also observe that Ayuso et al. (2004) find a negative effect of the business cycle on the capital buffers of Spanish banks. However, in contrast, the same authors point out that Lindquist (2003) found a negative effect of the business cycle on the capital buffer of Norwegian banks. The point the researchers are trying to make is that positive effects implies that banks build up their capital buffers (through increase in loan portfolio) in a boom probably as a caution of credit losses during economic downturn, conversely, a negative effect implies that during economic boom where credit losses are low (or considered and expected to be low), banks maintain low capital buffer as a caution and during economic downturn, banks maintain high capital buffer as a caution of credit losses[15]. Similarly, Boucinha and Ribeiro (2007) on the study of Portuguese banks, conclude that there is a negative relationship between excess capital (buffer capital) and the effects of business cycle. The authors confirm the hypothesis that banks adjust their capital reserves in response to changes in risks they face. This is a result from changes in macroeconomic environment (business cycle) and those resulting from bank's own decisions. Similarly, Barajas, Chami and Cosimano (2005) on their work in 2001 show how capital regulations affect bank behavior. The Chami and Cosimono model treats bank capital as an endogenous variable. This reveals how the changes in regulations, as well as changes in other exogenous variables such as market structure and economic activity affect bank's choice of the level of capital. The level of capital in turn will affect a bank's future ability to extend credit (Barajas, Chami and Cosimano, 2005).

Other researchers such as Carey (2000), Kaplanski and Levy (2007) and Kim and Santomero (1988) point out that the imposition of capital requirements may actually induce banks to shift to capital markets or allocate capital to different asset portfolio. A strategy which is commonly referred to as tactical asset allocation strategies.

### 2.5.3 TACTICAL ASSET ALLOCATION THEORY

Arnott and Fabozzi (1988) as quoted by Rey (2004) see tactical asset allocation as a strategy of shifting asset mix of a portfolio in response to the changing patterns of reward available in the markets ( capital markets). The theory relates to capital market investment activities based on risk and return and investor's incentive of holding long-term versus short-term maturing assets. The theory has also been used by some researchers on bank lending activities. It notably refers to disciplined processes for evaluating prospective rates of return on various asset classes and establish a tactical asset allocation response intended to capture higher rewards (Arnott and Fabozzi, 1988).

[15] This point is propounded by Ayuso et al. (2002a) and Ayuso et al. (2002b) on Spanish banks

The same strategy has led some banks to restructure their portfolio holding structure to reduce credit and market risks as one way of increasing capital ratios for the bank. For example, Carey (2000) points out that currently, assets that make vastly different contributions to portfolio credit risks receive similar regulatory capital treatment. He argues that this provides incentives for banks to restructure their lending activities and balance sheet to take advantage of risk differentials between two or more assets in the market. This is in line with a survey which was conducted by European Central Bank on EU banks in 2004, which found out that banks engage in credit risk transfer as a focus on risk management and diversification, and due to new risk/return profile offered by structured products and availability of arbitrage gains arising from account and capital regulations. Banks therefore hold different portfolio asset mix as strategy of diversifying or hedging risks (portfolio management) and/ or portfolio intermediation.

The asset allocation theory[16] was developed from portfolio choice theory which was first developed by Markowitz (1959).[17] For many researchers, the question of asset allocation strategy is a notion of portfolio diversification, which redistributes risks by pooling numerous underlying asset risk-return profiles. The strategy enables the bank to reduce individual asset risk since the bank hold an asset portfolio that is not perfectly correlated. In addition, the strategy which calls for structured products is used to shed risk through formation of tailor-made credit products that establish long-term relationship with enterprises without creating excessive exposures to these clients.

Cabenoyan and Strahan (2001) points out that banks use the risk-reducing benefits of risk management to take on more profitable but higher risk lending activities and to operate with greater leverage. The authors agree with the idea of creating incentives for banks to improve their risk management systems; however their research results suggest that regulators should not expect better risk management to lead to less risk. They found out that banks that enhance their ability to manage credit risk are able to operate with greater leverage and will lend more of their assets to risk borrowers. Thus the benefits of advances

[16] Loeper (2001) points out that the roots of asset allocation theory started with a piece of work called “The Capital Asset Pricing Model” (CAPM- beta as a measure of risk) and evolved into “Modern Portfolio Theory” (MPT- Standard deviation as a measure of risk).
[17] Markowitz H M. (1959), *Portfolio Selection: Efficient Diversification of investments*, Wiley, New York

in risk management in banking will likely be greater availability rather than reduced risk in the banking system (Cabenoyan and Strahan, 2001).

Starting from a bank's point of view, asset allocation theory incorporate a strategy that seeks to diversify risks, hedge and shed risk and spread the risks and return frontier of the portfolio. On the other hand, from a regulator's point of view, the strategy leads to better portfolio management and intermediation. However, the strategy has been found out to increase incentives for banks to engage in more risk-taking activities since the bank enjoy a better leverage in risk management processes. Therefore, following the argument, the directive by regulators and supervisors for banks to engage in internal risk management processes, has been found to yield the negative results between risk-mitigating and incentive activities for banks.

## 2.6 CHAPTER SUMMARY AND CONCLUSION

This chapter has presented a fair meaning and understanding of financial regulations and lending practices of commercial banks. The chapter has provided related literature on regulatory framework, financial regulations and lending practices (behaviour) of commercial banks. The literature has revealed relevant variables whose understanding and analysis will help to answer the research questions and objectives. Some of the lending practices of commercial banks in other countries (America, Europe and Africa) have been discussed in relation to bank regulations. This will provide a methodology for the research work and a platform for discussion of the expected results.

The chapter has also discussed in detail related theories from notable researchers in financial regulations. The area is extensively researched in advanced economies especially in United States of America. However, the outcome of this study will be particularly important and interesting as it will assess the applicability of the theories in less advanced economies like Malawi. The chapter has therefore provided a platform which will be used in Chapter 3 which gives methods of data collection and analysis that were used.

# CHAPTER 3

# RESEARCH METHODOLOGY

## 3.0 INTRODUCTION

The aim of this chapter is to describe the research plan on how data were analysed and interpreted. The chapter also explains the research design and procedures that were followed to accomplish the specific aims of the research. It introduces the methodology that was followed, research instruments employed and data analysis tools used to arrive at the research findings. The chapter also illustrates the methods that were used to generate and collect data and its reliability.

## 3.1 RESEARCH METHODS AND DESIGN

In order to address and meet the research questions and objectives respectively, a descriptive study was conducted by gathering data from stakeholders at different levels: bank regulators and supervisors, lending managers/credit analysts, internal and external bank auditors. The research was carried out by pre-tested questionnaire and in some cases semi-structured interviews based on the structure of the questionnaire.

Each section of the questionnaire answered a particular research question or objective. Interpretation of the results involved grouping similar and/ or different answers on financial regulations and lending practices in terms of causal relationships, explanations, effects, motivations and views from the respondents. The results of the research study explained the root cause of the research problem which directed the research to solutions and answers of the problem.

### 3.1.1 REASONS FOR CHOICE OF METHODOLOGY

A triangulation approach was used in collecting and generating data. The findings of one method were used to compare with the other thereby confirming substantially the results. Berry et al. (1993) view the approach as a better method as it gives the researcher more confidence in the findings. Similarly, Tashakkori and Teddie (2003) argue that the mixed method approaches are useful as they provide better opportunities to the researcher to answer research questions and also allows better evaluation of the research whose findings can be trusted and inferences made from them. The use of questionnaire enabled the researcher to collect descriptive data which gave confidence that the research was addressing the research questions and objectives. Consequently, the use of semi-structured interviews allowed the researcher to obtain key issues that were important to the respondents which formed a qualitative content of the research findings.

The semi-structured interviews used the questionnaire as a guide on the type of questions to be asked during interviews. The reason for adding the interviews was to a degree to establish views from a different stand point. The plan also helped the researcher to obtain information from senior members of the targeted respondents who couldn’t find time to answer the questionnaire. There are a number of researches such as Greene et al. (1989) and Creswell and Plano Clark (2007) that have used mixed methods in collecting data. The main advantages of both techniques have long been established and account for their popularity in research. A summary of the main advantage for each technique is given below.

Questionnaire’s relative anonymity encourages respondents to freely divulge information that would normally be considered as confidential. The technique enables respondents to verify information with their records or consult their colleagues for appropriate information. On the other hand, interviews are open-ended and allow the researcher to probe for clarification or more information during the interview process. The interviews technique allows the researcher to be in control of the research as it enables him/her to establish key issues from respondents but also obtain some meaning behind some data, that is, it allows clarification of the content of some of the questionnaire results. As observed by

Saunders et al. (2007), the mixed research method approach enables triangulation[18] to take place. There are strengths and weaknesses if you are using mixed methods approach. For example, when using a questionnaire, the researcher cannot probe more into the responses of the questions. However, by combining and/ or conducting interviews, the researcher has the opportunity to probe and request for more information after the initial response. Nevertheless, Saunders et al. (2007) argue that there is inevitably a relationship between the data collection technique a researcher choose and the results obtained. They further state that all different techniques and procedures will have different effects on the results hence it makes sense to use different methods to cancel out the 'method effect'. Therefore, it also made sense for this research study to use the mixed method approach as it gives confidence on the conclusions.

### 3.1.2 RESEARCH PHILOSOPHY AND APPROACH

Several studies have been conducted in European countries and United States of America on correlation between financial regulations (bank regulations) and lending practices of commercial banks. While the results tend to be predictive, it is the belief of the researcher that the results developed from these studies cannot provide similar conclusive outcome. This is because the banking environment as well as the economic set up between these countries and Malawi is different, therefore cannot provide similar results.

The study used both qualitative and quantitative techniques to generate and collect data in order to answer the research questions and meet the objectives. According to Saunders et al. (2007) the most determinant of research philosophy that should be adopted is the research question. The main research question is derived from research problem which is the pivotal of the research program. The main research question for this study is; what is the effect of financial regulations on lending practices of commercial banks in Malawi? The question focuses on rational explanation of financial regulations and how they (or may) affect lending practices of commercial banks in Malawi. Therefore, by integrating qualitative and quantitative research approach, the study draws two research philosophies (subjectivism and objectivism) together and uses a concept of research

[18] The use of two or more independent sources of data or data collection methods within one study in order to help ensure that the data are telling you what you think they are telling you (Saunders et al., 2007).

paradigms of interpretive and functionalist paradigm[19]. Therefore, the conceptual framework of this research is objectivity which relies on statistics and subjectivity which relies on description and experiences of the respondents.

## 3.2 SOURCES OF DATA AND COLLECTION TECHNIQUES.

Sources of data for this study were bank regulators and supervisors, commercial bank credit managers and internal auditors and commercial bank external auditors. Questionnaires were sent to respondents by electronic mail and hand delivery, and only senior managers and head of departments were interviewed.

Data collection was done in Blantyre only which is the commercial city of Malawi. This is because Head offices of the Commercial banks and Audit firms (that were part of the sample) are in Blantyre and the supervisory department of financial institutions is also housed in RBM's Blantyre branch.

The researcher used a triangulation approach and used a sequential model in collecting and generating data. The model as propounded by Tashakkori and Teddie (2003) follows the following set up: The first stage was quantitative methods approach which used the questionnaire to build knowledge on key issues and elements of study. The information gathered was used for second stage - qualitative approach which used semi-structured interviews to probe for more information, validity and reliability of results from questionnaires.

### 3.2.1 SAMPLING TECHNIQUE.

Questionnaires and semi-structured interviews were addressed to financial service stakeholders who are the bankers, regulators and the auditors. The study only targeted lending managers/credit analyst and internal auditors in five selected banks, bank supervisors and regulators from RBM and external auditors from KPMG and Deloitte.

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[19] Saunders et al (2008) define interpretive paradigm as a philosophical position which is concerned with understanding the way we as humans make sense of the world around us, and functionalist paradigm as a philosophical position which is concerned with a rational explanations of behaviours and institutions such as why a particular organisational problem is occurring in terms of the functions they perform.

The respondents were stratified according to their nature of work, that is, lending managers, auditors, regulators and supervisors. From each stratum, respondents and interviewees were picked randomly. As observed by Saunders et al. (2007), conducting a simple random sampling gives each sample fraction (targeted stakeholders) an equal chance of being selected and hopefully reducing biasness. The sample frame were the managers in each bank, Reserve bank and audit firm but only those that are involved in credit underwriting, risk analysis, regulating, supervising and auditing of such activities. The selection of respondents to be addressed by the questionnaire or semi – structured interviews depended on the type of information to be obtained. For example, where the question required qualitative dimension other than just picking the answer, an interview was conducted. However, the questionnaire had also questions that were open-ended which the researcher believes enabled the respondents to give additional information.

Data obtained from one group of respondents was cross-checked with data from the other groups. This enabled the researcher to contrast the data and identify areas which were not considered by the questionnaire. The plan helped the researcher to form set questions for the semi-structured interviews to probe for more information, clarifications and validate the data from the questionnaires.

### 3.2.2 SAMPLE POPULATION

The study included top 5 Banks operating in Malawi. These are top 5 banks ranked according to their total assets as at December 2008. The study covered an 18 year period from 1990 to 2008. Table 1 below shows the targeted banks that were chosen depending on their incorporation date.

**Table 1: Top 5 banks in Malawi as at December 2008.**

| Name of Bank | Date of License (after amendment of Banking Act (1989)) |
|---|---|
| 1. National Bank of Malawi | 3rd September, 1990 |
| 2. Standard Bank | 3rd September, 1990[20] |
| 3. First Merchant Bank | 5th July, 1994 |
| 4. NBS Bank | 1st March, 2004[21] |
| 5. Malawi Savings Bank | 29th March, 1995 |

The study also included RBM which is the only frontline regulator and supervisor of financial institutions in Malawi. Two audit firms were also part of the sample frame. The two audit firms are KPMG and Deloitte. The firms were chosen because they are among the biggest audit firms engaged by commercial banks in Malawi. The study included the audit firms because of their involvement in auditing bank activities which includes lending practices.

Therefore, as observed above, the population sample included three key stakeholders: those that underwrite; those that regulate and supervise and those that audit lending activities of commercial banks. The sample is representative and enabled the researcher to obtain relevant data, avoided biasness and any lock-out of information.

### 3.2.3 SAMPLE SIZE.

The sample size that was specified from the sample population was a total of 10 respondents from each sample frame. There are seven sample frame drawn from five targeted Commercial banks and one each from Reserve Bank and Audit firms. A sample frame for banks included at least lending managers and credit analysts. A sample frame for Reserve Bank included bank regulators and supervisors and a sample frame for audit firms

[20] Previously known as Commercial Bank of Malawi (CBM). CBM had been in existence prior to 1990. Following the promulgation of the Banking Act 1989, all existing institutions were required to be issued with a new license under the new act. The bank later changed its name from Stanbic bank to the present name of Standard Bank Malawi.

[21] Previously known as New Building Society which was licensed on 7th February 1994 under the Building Societies Act.

included experienced auditors only that audit commercial banks. In total, 70 respondents (10 respondents from each sample frame) were selected to answer the questionnaire. Another 10 respondents from the sample population were also selected to be interviewed. The study only chose well-qualified and experienced respondents for the interviews. This allowed the researcher to explore responses from respondents on research questions and objectives given the nature of events that might have been occurring within the particular Bank or banking system.

The researcher only chose a total of 10 respondents from each sample frame due to shortage of experienced, technical and skilled human resources from the banks and audit firms. However, at least one respondent from each sample frame was selected for interviews. The questionnaire was also extensive and it captured a lot of information from the limited sample.

## 3.3 QUESTIONNAIRE AND SEMI-STRUCTURED INTERVIEW DESIGN

The research questions and objectives of the study were derived from the research problem. The steps followed in forming the questions and objectives were to establish financial regulations and lending practices of commercial banks in Malawi. This helped the researcher to set specific questions and establish objectives as a bench mark of addressing the research problem. For this reason, when the researcher was designing the questionnaire, the starting point was to refer to the research questions and objectives of the study. This strategy enabled the research instruments (questionnaire and semi-structured interviews) to include information needed to answer the research questions and meet the objectives. This technique meant that by answering the questions and addressing the objectives, the technique was directly finding solutions for the research problem which is a contextual plan of the study.

The researcher divided the questionnaire into sections, each covering one or more of the research questions and objectives. As observed by Berry et al. (1993), using this structure enables the researcher to proceed with more detailed aspects of the research design in logical and coherent manner. The researcher also took reference from other literature and similar researches involving financial regulations and lending practices to ensure terminology is understandable.

The research used a self-administered questionnaire and semi-structured interview to collect primary data from the sample. According to Saunders et al. (2007), a self-administered questionnaire is a data collection technique in which each respondent reads and answers the same set of questions in a predetermined order without an interviewer being present. Since in some cases, the questionnaire does not give chance to respondents to answer freely (in some cases give opinion) about events in relation to the subject area, a semi-structured interview was used. Semi – structured interview covers a wide-range category of the interview in which the interviewer commences with a set of interview themes but is prepared to vary the order in which questions are asked and ask new questions in the context of the research situation (Saunders et al., 2007)

In this study, the standardised questions allowed the respondents to give answers relating to lending practices of commercials banks and non-standardised questions (open-ended questions) allowed the respondents to specify and explain the lending practices and other types of lending practices of the banks. The standard questions (sometimes referred to as closed-ended or forced-choiced question) provide a number of alternatives which respondents were instructed to choose. The non-standardised questions also allowed the respondents to express their perception about financial regulations in Malawi.

The study included different stakeholders as respondents as a way of capturing different perceptions of financial regulations and lending practices in Malawi. Most researchers recognise this technique to give relevant reality since as far as human experience is concerned; it is that takes place in subjective experience, in social context and in historical manner. Thus, qualitative researchers are often more concerned about uncovering knowledge about how people think and feel about the circumstances in which they find themselves (Thorne, 2000). Hence by capturing experiences from different stakeholders, this research achieved a general comparative analytic approach called 'constant comparative analysis'[22]. This approach involved taking one piece of data (statement, interview, theme) and compare it with all others that maybe similar or different in order to develop conceptualisations of possible relations between two various pieces of data (Thorne, 2000)

[22] Originally developed for use in the ground theory methodology of Glaser B and Strauss A (1967), *The discovery of grounded theory,* Hawthorne, New York, Aldine.

The contents of the questionnaire were adopted from the works of various authors such as Berger, Herring and Szegö (1995); Currie (2005); Marzo (2007) and Peek and Rosengren (1995) but were refined to match the current research in comparison of the four research works. Given the complexity of designing a questionnaire, it was not possible for the researcher to produce a correct and desired questionnaire on first attempt. Therefore, the questionnaire was pre-tested, that is, piloted on a small sample of 15 respondents whose characteristics were as those of the sample population. The first phase of the pre-testing exercising was to get effects of different wordings, understanding of particular words, analysis of responses and non-responses. The last phase of pre-testing exercise involved polishing the questionnaire to improve the question order, filter questions and layout. Pre-testing exercise benefited the researcher to the extent that the exercise revealed possible responses and meanings attached.

The questionnaire was administered through electronic mail, delivery and collection method and personal interview method. The questionnaires were self-administered and the semi-structured interviews were conducted face to face with the interviewees. Delivery and collection method allows the researcher to deliver the questionnaire to the respondent and call to collect at a predetermined time (Saunders et al., 2007). The researcher chose this method because the respondents were easily identifiable. In addition, Saunders et al. states that the semi-structured interviews allow the respondents to talk freely throughout an in-depth interview and may encourage interviewee to talk as they wish. The researcher targeted senior managers and Head of departments as interviewees for semi-structured interview. The main reason for this choice was to capture the experience of the respondents and technical information that maybe known by themselves only.

The researcher was supported by one research assistant who assisted in collecting the data – questionnaires. Training was provided to the research assistant in data collection to ensure accuracy. Data collections for semi-structured interviews were done by the researcher only at an average of 3 days per week in interviewees' work places. It took a total of 8 weeks to administer the questionnaire and conduct the semi-structured interviews. This was because most of the respondents were not easily accessible due to work commitments.

The questionnaire consisted of five sections. Section A required the respondents to give his/her personal background. Section B aimed at establishing what type of lending practices that are undertaken by commercial banks. Section C explored the implications of financial regulations on banking system in Malawi. Section D investigated perceptions of financial regulations in Malawi. Lastly, Section E explored lending practices of Commercial banks in Malawi.

There were no control questionnaires which were administered as the researcher believes the research covered all relevant stakeholders – regulators, supervisors, credit underwriters, risk analysts and auditors.

## 3.4 <u>RESEARCH STRATEGY.</u>

The research was conducted through a pre-designed questionnaire and one-to-one semi – structured interviews. The questionnaire was derived from other studies on financial regulations and bank lending practices (behaviour). The researcher engaged one undergraduate student (final year student) to help in collecting and generation of data. The student also administered the questionnaires to respondents.

## 3.5 <u>FRAMEWORK FOR DATA ANALYSIS.</u>

The research collected two types of data set – descriptive (dichotomous) data and narrative data. The data per category were sorted using Microsoft excel software. The data sets were analysed to allow grouping of similar answers, themes and to conceptualise ideas. Thorne (2000) points out that in qualitative data analysis processes, actual data collection cannot be entirely distinguished from analytic processes. The theoretical lens from which the researcher approaches the phenomenon, the strategies the researcher uses to collect or construct data, and the understandings that the researcher has about what might count as relevant or important data in answering the research questions are all analytic strategies to transform the raw data into a new and coherent depiction of the thing being studied (Thorne, 2000).

### 3.5.1 QUANTITATIVE DATA ANALYSIS

The researcher used a questionnaire to obtain quantitative data – descriptive (dichotomous) data. The data set is a categorical data which is known as *dichotomous data* as the variables are divided into two categories (yes or no). The questionnaires were matched by using code numbers for respondents. The research assistant coded the responses from closed-ended questions on the questionnaires and the researcher coded the open-ended questions based on themes and terms used by respondents. Questions where there were no responses recorded, they were coded as “missing data”.

### 3.5.2 QUALITATIVE DATA ANALYSIS

The data was transcribed from recorded responses, conceptualised and codified into important information which formed part of the research findings. That is, the text collected was identified, coded and categorised with consideration of predetermined themes and sub-issues as per research question or objectives. According to Strauss and Corbin (1998), a researcher can categorise data depending on the similarity of terms used by the respondents through existing theories and literature. Since a qualitative research is an iterative process, new themes also arose out of data collection exercise. The new themes were also added as part of the findings.

The research used a narrative analysis tool as a strategy for laying out specific procedures for addressing research questions and objectives. The first step in the analysis was to look for consistency and diversity (identify analytic domains), major and minor thematic areas, majority and minority views from respondents. Quotations from some respondents were highlighted to illustrate important and distinctive findings. This process allowed the researcher to analyse the qualitative data systematically and rigorously and finally draw and verify conclusions.

### 3.5.3 DATA QUALITY ASSURANCE

All qualitative data was recorded in a research diary together with researcher’s ideas and reflections. The researcher also pilot-tested the research instruments prior to formal data collection. Supervision of the research assistant was done twice a week. This included spot checking the questionnaire with the research assistant in order to find out if he had any problems in understanding and explaining each question.

The researcher conducted the above exercise in order to collect accurate data which is essential in maintaining integrity of the research study. The primary justification for preserving data quality was to support the detection of errors in the data collection process, whether they were made intentionally (deliberate falsification) or not (systematic or random errors). Therefore, the researcher's aim of preserving data integrity was also to ensure scientific validity to study results.

#### 3.5.3.1 DATA VALIDITY

For higher validity, the researcher made sure that the questionnaires were filled by targeted respondents only. The respondents included only officers and managers that have a technical knowledge about lending practices of commercial banks in Malawi. Furthermore, data collection was done in two stages. The first stage involved administering of questionnaires and the second stage involved conducting semi-structured interviews which allowed confirmation and validation of results obtained from the questionnaire. The use of triangulation method ensured credibility and defensible results which lead to generalisation which is one of the common tests of improving validity or trustworthiness of the results (Patton, 2002).

#### 3.5.3.2 DATA RELIABILITY

Validity and reliability are two factors which any qualitative researcher should be concerned about while designing a study, analysing results and judging the quality of the study (Patton, 2002). To make the data reliable, the researcher only targeted specific respondents whose response would be the same over time. If the instruments (questionnaire and semi-structured interviews) are given twice to the same group of people, the reliability is the correlation between the consistent results on the two instruments. This research is therefore reliable because it only targeted specific respondents who were chosen because of their technical skills, knowledge and experience. Therefore, the results obtained where responses based on knowledge and experience which are consistent but limited over time.

However, the trick about test-retest reliability[23] is determining how long to wait between the two administrations. Nevertheless, as long as knowledge or skills are constant over time, the respondents will give results that are consistent as the information is based on knowledge or skills they have.

### 3.5.4 DATA ENTRY AND CLEANING

Data was entered by the research assistant and the principal researcher. It was checked for inconsistency, illogic relationships and illegitimate codes. For each possible error, the researcher identified the source of the error whether it occurred at coding or data entry stage. Appropriate correction was done by the researcher after identification of source of the error.

## 3.6 RESEARCH ETHICS

The research was conducted with guidance from codes of behaviour that are acceptable in conducting research. As suggested by Saunders et al. (2007), issues such as voluntary participation of the respondents, maintenance of confidentiality of data provided by respondents and their anonymity, respect for privacy of participants and non application of pressure to participants were observed in the study.

## 3.7 FACTORS THAT IMPEDED THE PROGRESS OF THE STUDY

The researcher met the following factors that impeded the progress of the study:

1. Some credit analysts were unwilling to disclose some information to the researcher because of the sensitive nature of the requested information.
2. Some of the respondents were suspicious of the research, bearing in mind that the researcher works for one of the commercial banks hence the information was thought to be for professional use.

[23] Test – retest reliability is a method that measures consistency of results between two research instruments administration.

However, since the study targeted different stakeholders, the researcher was able to obtain data from other respondents. Care was also taken on validity and reliability of the data.

## 3.8 CHAPTER SUMMARY AND CONCLUSION

The study used questionnaires and semi-structured interviews as research instruments in carrying out the research. The study involved collecting and generating quantitative and qualitative data hence triangulation mixed methods approach was used. The questionnaires were analysed in Microsoft excel in order to establish logical relationships, themes and interdependence.

The chapter has explained the tools the researcher used in analysing qualitative and quantitative data. This is the framework of this research work and the results are discussed in the next chapter. Chapter 4 will therefore discuss the empirical results on how financial regulations have impacted on lending practices of commercial banks in Malawi.

# CHAPTER 4

# PRESENTATION AND DISCUSSION OF THE FINDINGS

## 4.0 INTRODUCTION

This chapter presents and discusses the research findings. The chapter discusses the data as per sections of the questionnaire. It commences with discussion of the data, then moves on to generalise and analyse the data. The data re-presentation has been structured to follow a pattern from most simple to most complex research findings. This presentation strategy provides cross-section analysis of the questionnaire, and the results found address the research questions and objectives in coherent manner hence the overall research problem. The chapter also discusses what can be inferred from the data with relation to other research concepts or findings.

## 4.1 ATTRIBUTES OF DATA SET

A total of 70 questionnaires were administered to various stakeholders. A total of 61 questionnaires were completed and returned representing 87% response rate. A total of 4 questionnaires were not returned by respondents while the other 5 questionnaires were received but discarded due to incomplete information and missing pages. These questionnaires were thus treated as null and void.

The researcher also interviewed a total of 10 respondents from the sample population. The interviews were based on list of themes and questions covered in the questionnaire. The interviews were not standardised as some questions were omitted in particular interviews since the questions were varied and depended on the flow of conversation, profession and expertise. Since additional questions were asked during interviews, the researcher recorded the questions and responses using audio-recording device (Dictaphone) and in some cases notes were taken.

## 4.2 RESEARCH FINDINGS AND DISCUSSION

### 4.2.1 BACKGROUND INFORMATION

The questionnaire was administered to three stakeholders – bankers, regulators/supervisors and auditors. A large part of the questionnaire was administered to bankers since the study targeted 5 Commercial Banks in Malawi. This is evidenced by the percentage of responses as shown on Figure 1 below.

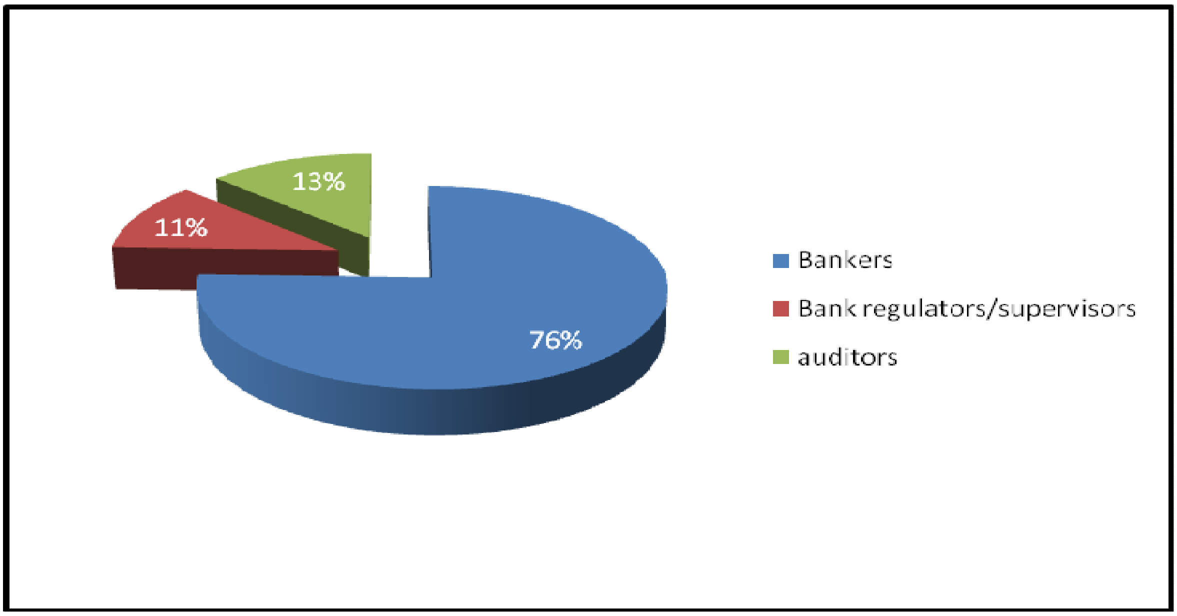


**Figure 1: Percentage of respondents per level of profession**

Figure 1 shows percentage of respondents per level of profession that answered the questionnaire. The figure shows that 76% of respondents (which represent 46 respondents) were from commercial banks (bankers), 13% of respondents (which represent 8 respondents) were external auditors from the two audit firms and 11% (which represent 7 respondents) were bank regulators/supervisors from Reserve Bank of Malawi.

On the other hand, the questionnaire was administered to Heads of department, middle managers and officers. This is shown by Figure 2 below which shows number of respondents per level of occupation.

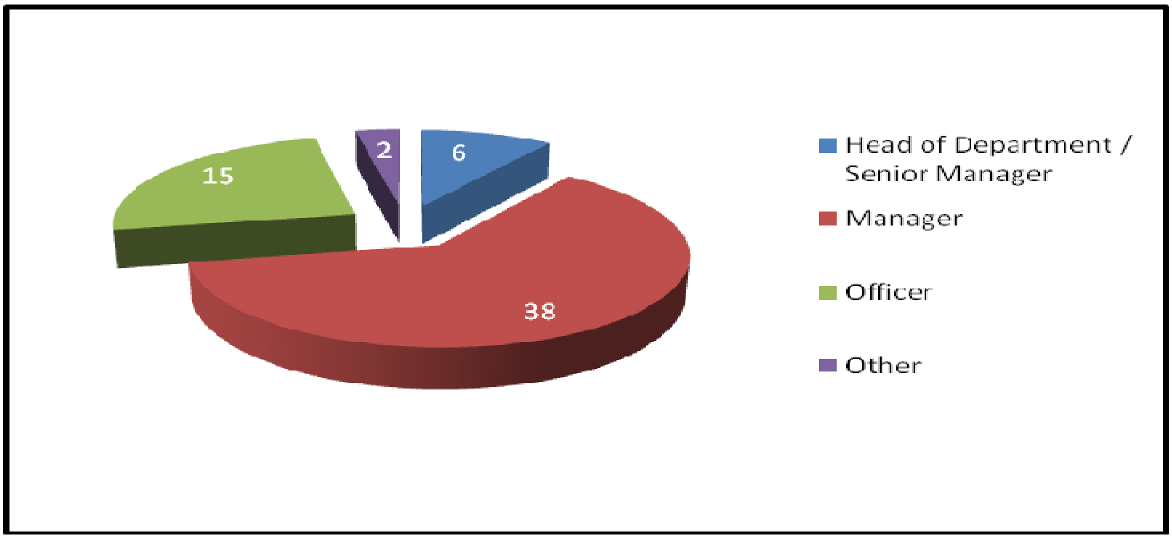


**Figure 2:** **Number of respondents per level of occupation**

Figure 2 shows number of respondents per level of occupation. The figure shows that 38 respondents were middle managers, 15 respondents were officers, 6 respondents were heads of deparment or senior managers and only 2 respondents were neither officers or managers. The figure shows that a large number of respondents that answered the questionnaire are middle managers more than officers and Heads of departments or senior managers. This huge difference rose from the fact that most Heads of departments or senior managers were reluctant to participate in answering the questionnaire and some of the officers referred the questionnaire to their middle managers. However, the researcher was able to cover the difference since the semi-structured interviews were conducted to Heads of department and senior managers only. Figure 2 above can be compared to number of respondents per level of experience who answered the questionnaire. This is shown on Figure 3 below which shows number of respondents per level of experience:

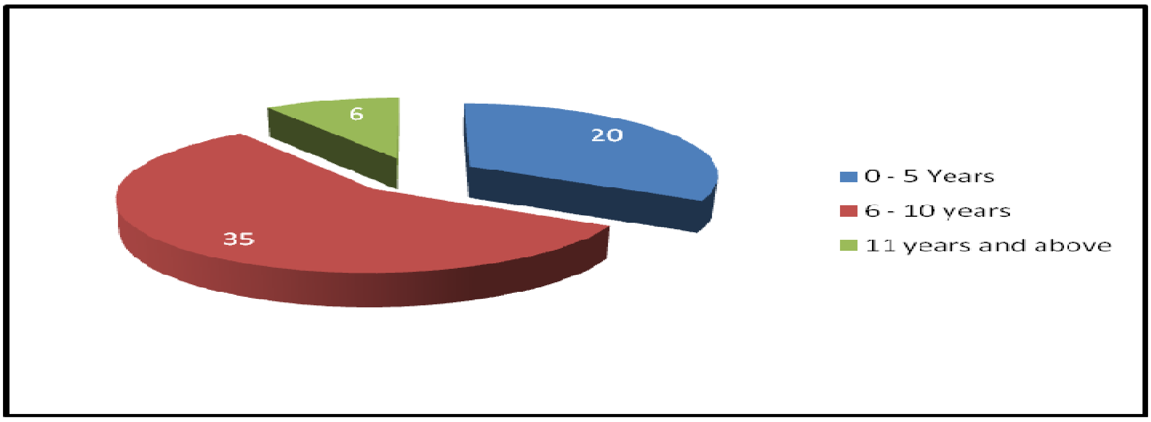


**Figure 3:** **Number of respondents per level of experience**

Figure 3 shows that a total of 35 respondents reported to have experience between 6 to 10 years, 20 respondents reported to have experience of less than 6 years and 6 respondents reported to have experience of above 11 years. The years of experience relates to the respondents' nature of work. The Figure specifies that the responses were from respondents who have adequate experiences in their nature of work. A total of 41 respondents who answered the questionnaire have over 6 years of experiences. This shows the responses were from respondents who have adequate authority and experience about financial regulations and lending practices of Commercial banks in Malawi. The respondents who answered the questionnaire were allowed to provide information for more than 2 banks. By keeping this option open, the study obtained more data from the questionnaire.

The study also interviewed some of the respondents from the three stakeholders. The study targeted a total of 10 interviewees. Figure 4 below indicates the number of respondents that were interviewed by the researcher.

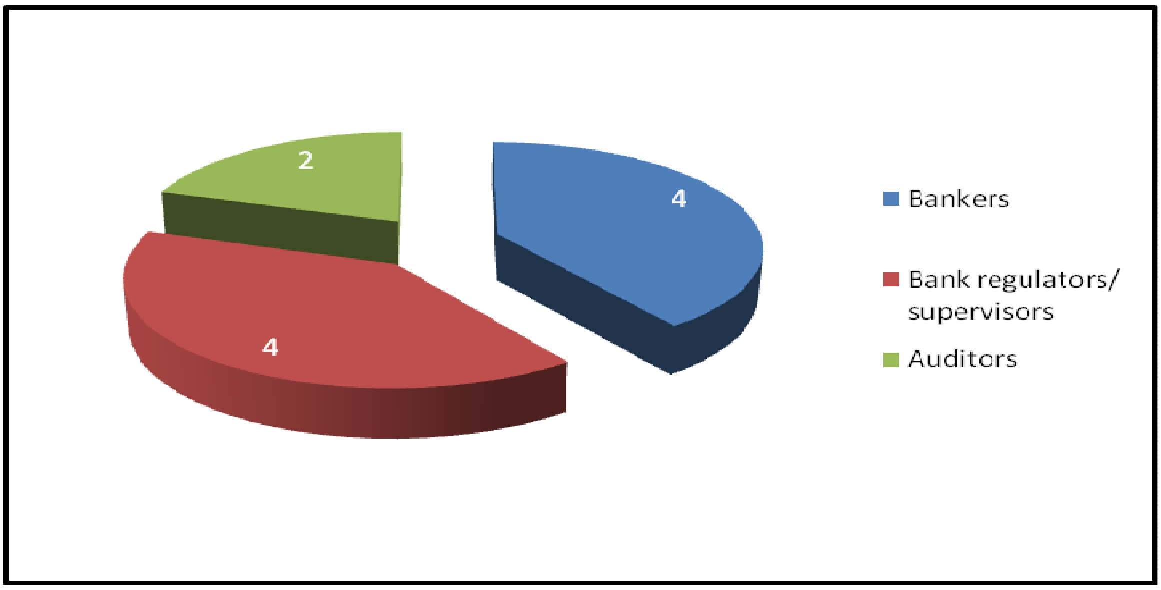


**Figure 4: Number of interviewees from three stakeholders**

It can be noted from the figure that 4 interviewee each were interviewed from banks and Reserve Bank and 2 interviewee from two audit firms. Since the interviewees were either Heads of department or senior managers, the information that was obtained formed the qualitative results for the study and it was combined with the data that was obtained from the questionnaire.

### 4.2.2 TACTICAL AND STRATEGIC LENDING TECHNIQUES

#### 4.2.2.1 LOAN SECURITISATION

Loan Securitization involves pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors. The practice is mostly undertaken by commercial banks that have financial instruments as part of its on-balance sheet or off-balance sheet assets. In Malawi, only one commercial bank has once been involved in securitising its assets. This is evidenced by the number of responses which all indicate one commercial Bank as shown on figure 5 below.

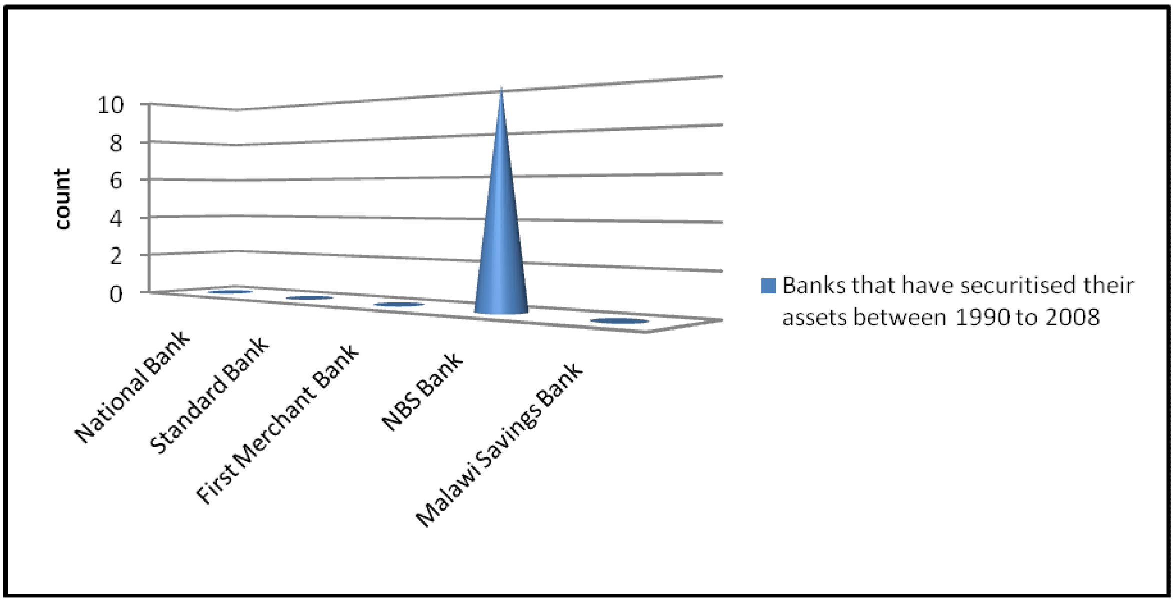


**Figure 5: Banks that have securitised its assets**

Figure 5 shows banks that have securitised their assets between 1990 to 2008. The figure shows 10 respondents indicating that NBS Bank has once securitised its assets between 1990 to 2008. This therefore indicates that securitisation has once taken place in the financial industry in Malawi. When asked to comment, a senior credit analyst at NBS Bank explained that loan securitisation was done as a process and not as a repackaged product like in other Western and European banking system. He advised that this was a once-off arrangement and the assets were not sold on capital market. The assets were sold to another financial institution within a subsidiary group of Companies. Another credit analyst explained that capital markets in Malawi are not advanced and any financier will currently find it hard to sell asset-backed securities (ABS). Consequently, loan securitisation that occurred in Malawi was on basis of private arrangement between subsidiaries or economically depended Companies.

Securitisation of assets can be done for on-balance sheet or off-balance sheet assets. Securitisation that was undertaken by NBS Bank was for on-balance sheet assets only. This is evidenced by the number of respondents as shown on table 2 below.

**Table 2: Type of assets and reasons for loan securitisation**

| | | |
|---|---|---|
| 1. What type of assets were securitised | **On-balance sheet assets** | 10 |
| | **Off- balance sheet assets** | 0 |
| 2. Tenor of products that were securitised | **12 months** | 0 |
| | **More than 12 months** | 10 |
| 3. Reasons for securitisation | **To improve capital ratio** | 3 |
| | **To improve liquidity** | 7 |
| | **To reduce portfolio growth** | 0 |
| | **To solve non-performing loan problem**. | 0 |

Table 2 above shows type and tenor of assets that were securitised and reasons for securitisation. The table shows that 10 respondents confirmed the assets that were securitized were on-balance sheet assets with a term of more than 12 months. This meant a reduction in portfolio of the bank. An interviewee from the Bank pointed out that since the assets were of similar type and the amount of securitised portfolio was low, the reduction was not reflected on annual financial statements of the Bank. Again, only on-balance sheet assets were securitised because most banks in Malawi do not have off-balance sheet assets which they can easily securitize such as operating lease. Non-existence of these types of assets means that there is no securitisation that can take place. Other assets that can be securitised such as letters of credit, futures or forwards are short term assets whose securitisation process can be complex, technical and non-existent due to low levels of the assets. The interviewees observed that since the assets are short-term and the transaction levels are low, securitisation is not profitable due to high administration costs. In addition, there are no discount houses or financial brokers that can act as agents or brokers between banks and customers (hence no demand for securitised off-balance sheet assets). This may explain why only asset backed securities were securitised by the bank and only those with a term of more than 12 months. The returns from such investments (asset back securities) are long-term and attractive.

When asked the reasons for securitising the assets, 3 respondents indicated that it was to improve the capital ratio and the other 7 respondents indicated that securitisation was done to improve the bank's liquidity. An interviewee from NBS Bank commented that in 2006, the bank securitised its staff mortgage portfolio as a technique of raising liquidity for the Bank in order to improve RBM's reserve requirement ratio. The assets were sold to NICO Life Insurance Company as an avenue of raising liquidity. Further, other interviewees from other banks commented that it was easy for the bank to securitise the assets since repayments from staff loans are guaranteed and the portfolio does not include non-performing assets. On the other hand, another respondent from NBS Bank also argued that the securitization process may have reduced the risk-weighting for the bank which improved its capital ratio. Since different assets have different risk profiles, it can be argued that NBS Bank was able to improve its risk-weighting profile hence the capital ratio.

The above findings indicate that securitisation is not commonly done by banks in Malawi. Further, only one bank is known to have securitised its on-balance sheet assets. The assets securitised were staff mortgage loans. The findings are consistent with the findings of Jackson et al. (1999) who explain that securitisation is one of the factors motivating capital arbitrage. Banks securitize high-quality loans that tend to exhibit more predictable loss rates. Nevertheless, such securitisation can reduce the bank's regulatory capital requirement relative to its requirement had the whole loans remained on its balance sheet (Jackson et al., 1999)

#### 4.2.2.2 LOAN SYNDICATION

Loan syndication is a process that involves several different lenders in providing various portion of a loan. During a syndication process, there is a lead bank that is in contact with the client and participating bank(s) who are not in contact with the client. The participating bank(s) provides the portion of the loan to the lead bank which provides a single loan amount to the client. The study has found out that this process is currently practised by most banks in Malawi. This is confirmed by the number of responses of respondents as shown on Figure 6 below.

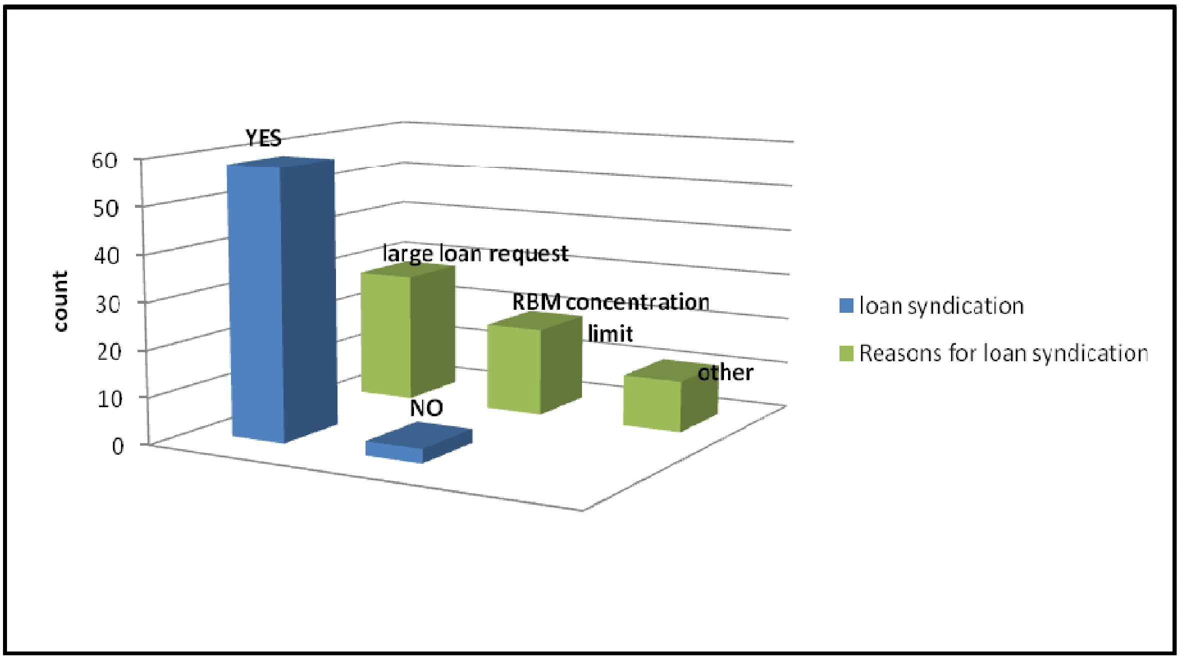


**Figure 6: Banks participating in loan syndication and the reason for participating**

Figure 6 above shows number of responses from respondents who indicated that banks participate in loan syndication and the reason for participating in the syndication process. The figure shows that banks in Malawi have participated in loan syndication between the period of 1990 - 2008. Four of the banks under study – National Bank, Standard Bank, NBS Bank and First Merchant Bank have once participated in loan syndication with other financial institutions. A Credit analyst from National Bank commented that syndication process at the Bank is usually initiated by smaller capitalised banks than large banks. The smaller banks usually syndicate in order meet large loan request from customers or due to Reserve Bank's concentration limit. This is substantiated by Figure 6 above which shows

28 respondents reported that loan syndication process is mainly to meet large loan request from their customers and 19 respondents view the reasons for syndicating a loan with other financial institutions is due to Reserve Bank's concentration limit. An external auditor interviewed explained that some banks syndicate with other banks simply because they do not offer a particular credit product or service. He gave an example of one particular Bank which participated in loan syndication because it does not offer mortgage facilities. He observed that most corporate customers request multiple component facilities which require different loan structures and terms. If this cannot be done by one bank then the lead Bank would request other banks to participate in loan syndication to gain expertise.

Figure 6 also shows that banks participate in loan syndication because of Reserve Bank concentration limit. The Bank regulators/supervisors that were interviewed also commented in the same line that banks are constrained by credit concentration limit and the only way to meet a large loan request from their corporate customers is to syndicate with other financial institutions. They pointed out that the technique may enable smaller banks not to lose big corporate clients; nonetheless, the process also increases interest income (profits) for the bank. However, the Bank regulators/supervisors pointed out that banks have an option of seeking a waiver from the Reserve Bank to lend above its concentration limit. The requests are considered based on purpose of the loan, the financial status of the corporate customer and that the total largest exposures for the bank do not exceed 800% of its core capital. On the other hand, an external auditor indicated that most banks are aggressive in the sense that they would prefer to participate in loan syndication for some loan requests in order to create room for RBM's waiver on other loans. Similarly, an internal auditor interviewed from one of the Commercial banks under study revealed that several banks have large exposures in their books but they are not considered large exposures since the loans are syndicated with other banks. He argued that if the customer defaults, the effects may spread across several banks since they are connected through the credit facility. Therefore, the rationale of regulating banks' large exposures through credit concentration limit may fail to control systematic risks due to the fact that loan syndication technique increases credit exposure (hence failure) of one customer to different banks.

Furthermore, the internal auditor commented that loan syndication can be viewed as a technique that arbitrage directive on credit concentration limit on one hand and directive on large exposures on the hand. By syndicating a loan, two or more banks are able to extend a large loan request to a single or group of related customers thereby avoiding the need to obtain authorisation from Reserve Bank if the exposure is above the bank's concentration limit. Furthermore, the loan may not be disclosed as a large exposure since the total facility is the sum of break down loan exposures from different banks. However, a Bank supervisor advised that the spirit of syndication is to allow many banks to share large loan to single customer. Supervisors are more concerned with one bank extending large loan request single-handedly.

The above results are consistent with the findings of Dennis and Mullineaux (2000) who explain that regulators limit the maximum size of any single loan to a portion of the bank's equity capital, so syndication can be a method to avoid "overlining". Syndication may also reflect voluntary diversification motive, a strategy of enhancing fee income or participating banks may be motivated by a lack of origination capabilities in certain geographic regions or in certain type of transactions (Dennis and Mullineaux, 2000). In addition, the results are also in-line with Gadanecz (2004) conclusions which state that banks syndicate to avoid excessive single-name exposure, in compliance with regulatory limits on risk concentration, while maintaining a relationship with the customer. Both authors conclude that in essence, arranging a syndicated loan allows the financier to meet large loan commitments without having to bear the market and credit risk alone.

#### 4.2.2.3 OFF – BALANCE SHEET ITEMS

Off-balance sheet assets are financial assets that generate income for the financial institution but they are not reported on the Company's balance sheet. There are several types of off-balance sheet assets/items which banks use to increase their income, and because they do not appear on the balance sheet, banks are mandated to disclose them when assessing capital adequacy through the Basel accord. In Malawi, most commercial banks have off-balance sheet items. This is evidenced by Figure 7 which shows different types of off-balance sheet assets of commercial banks.

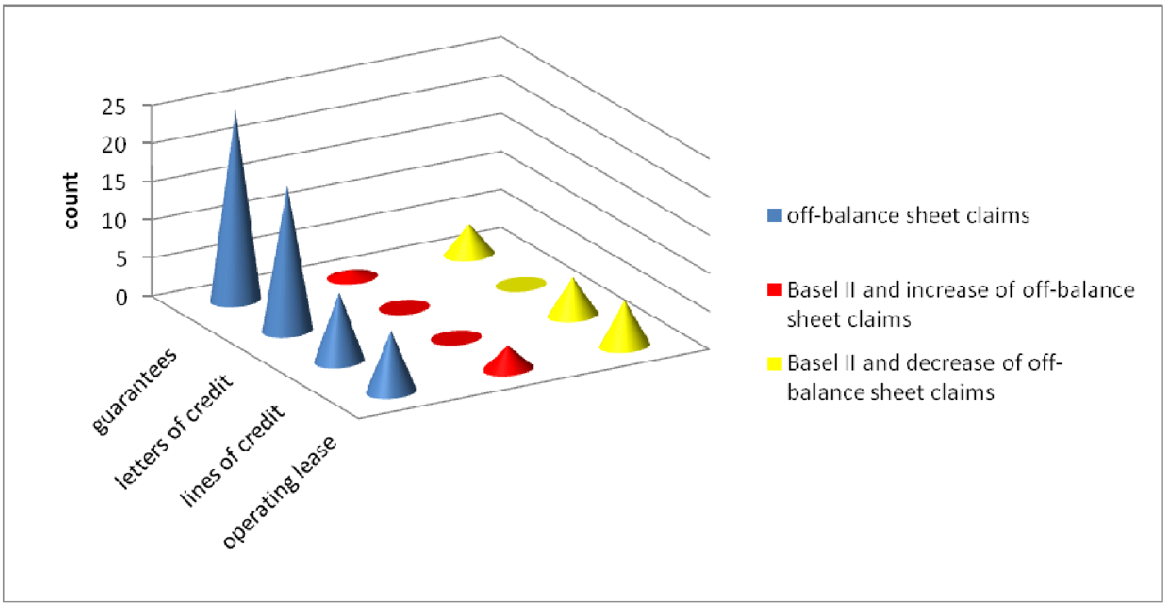


**Figure 7: Types of off-balance sheet claims and effects of introducing Basel II on off-balance sheet assets**

Figure 7 shows number of responses from respondents indicating types of off-balance sheet assets and the effects of introducing Basel II on off-balance sheet assets. The figure indicates that all the banks under study have at least one off-balance sheet item. The figure indicates 8 respondents reported that banks have an operating lease facility as an off-balance sheet item. Three interviewees confirmed that it is only National Bank of Malawi that has operating lease facility and that the other banks have other various forms of guarantees and letters of credit as off-balance sheet assets. The Figure also shows that guarantees and letters of credit are common form of off-balance sheet items. An interviewee from one Bank advised that guarantees and letters of credit are the major source of non-interest income for most banks hence their desirability over other non-interest bearing assets. Two bank supervisors interviewed also reported that banks have foreign lines of credit with foreign banks. The lines are used for letters of credit and other foreign currency payment.

Figure 7 above also shows number of responses from respondents indicating the effects of introducing Basel II on off-balance sheet assets. The results mainly indicate that introducing Basel II in Malawi will lead to decrease in off-balance sheet assets. This is substantiated by Figure 7 which shows 5 respondents reported that Basel II Accord will lead to decrease in lines of credit, 6 respondents reported that it will lead to decrease in operating lease, 4 respondents reported that it will lead to decrease in guarantees while there were no results for letters of credit. Two credit analysts interviewed argued that since lines of credit or guarantees only bring commitment fees as income unlike term loans which the bank can earn interest income and administration fees, bank managers will be more attracted to originate more term loans and reduce or decline granting credit lines or guarantees given the Basel II Accord regulation. They argue that the Accord requires all off-balance sheet items such as guarantees to be converted to equivalent on-balance sheet assets. The risk-weighting attached is 100% which is the same as on-balance sheet assets such as consumer loans. This directly reduces attractiveness of off-balance sheet assets in terms of income relative to capital ratio effects. Furthermore, the credit analyst explains that offering lines of credit is costly for most banks in Malawi who are lowly capitalised. Moreover, most credit lines granted are revocable commitments and can be withdrawn at discretion of the bank. Other off-balance sheet assets like operating lease will also likely decrease because the Basel II Accord aims at reducing the incentive for increasing such type of assets.

The study also found out that most banks have not entered into a contingent liability claim due to financial regulations. This is evidenced by number of responses from respondents as shown on figure 8 below.

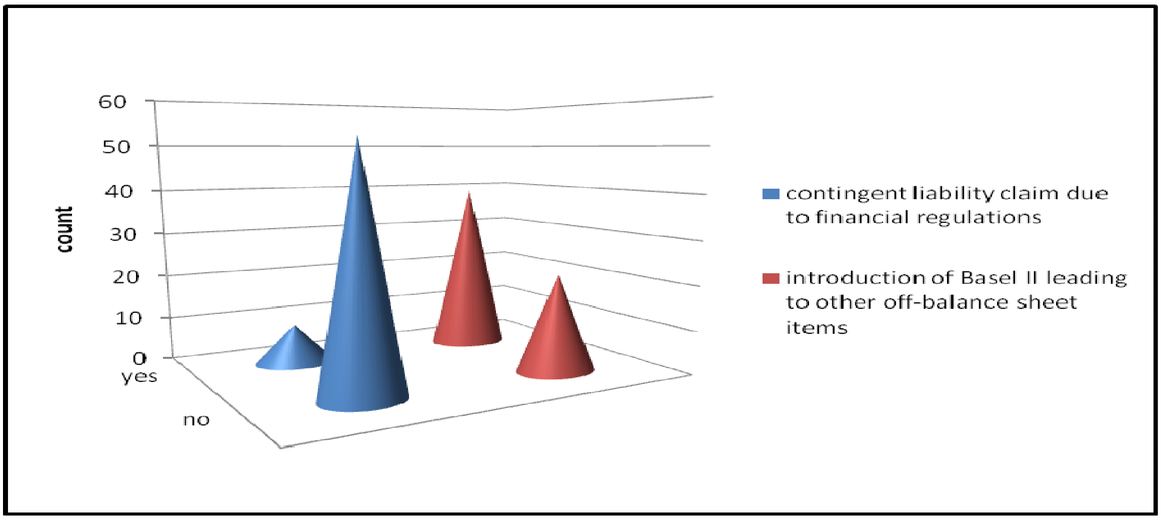


**Figure 8: Contingent liability claim due to financial regulation and effects of introducing Basel II leading to other off-balance sheet items**

Figure 8 shows number of responses from respondents who indicated banks enter into contingent liability claim due to financial regulations and the effects of introducing Basel II leading to other off-balance sheet items. The Figure shows that 52 against 9 respondents reported that there are no banks which entered into a contingent liability claim due to financial regulations. However from the interviews conducted, it can be inferred that National Bank and Standard Bank are changing the structure of their liability claims portfolio due to financial regulations. Credit analysts from both banks commented that the banks are increasing their short-term off-balance sheet exposures such as letters of credit and guarantees that are secured by cash. This reduces the capital ratio of the bank due to relative lower risk weighting attached to the assets. The argument is that claims that are secured by cash have lower risk weighting (when converted to on-balance sheet equivalents using credit conversion factors) than consumer loans. The technique is more profitable to the bank as all the risks are mitigated by the cash collateral that is in place.

Figure 8 also report 39 respondents confirmed that the introduction of Basel II Accord will lead to introduction of other off-balance sheet items. Only 22 respondents reported that the Accord will not lead to any innovation of off-balance sheets assets. 20 of the respondents defend their answer in the same line of argument. They explained that since banks in Malawi tend to copy what is happening in other developed economies; technology and the option of regulation arbitrage has led banks to be innovative. One respondent explained that banks are continuously developing financial instruments largely or to wholly free from prudential capital requirements. Banks in Malawi are no exception and will likely follow suit. Another respondent further explained that banks are motivated by techniques that increase the bank’s financial performance and existence of techniques that arbitrage capital regulation increases the chances for the banks to introduce those products or assets in Malawi. He gave an example of a financial instrument which is under advisory, management and underwriting functions. In particular, he gave an example of fiduciary services such as trust funds and portfolio management services which are currently being done by most banks. He explained that banks are slowly incorporating Investment bank activities in addition to traditional bank activities (deposit mobilization and lending). He has observed that banks are currently managing pension funds, gratuity schemes and other marketable securities. When asked to comment, an external auditor pointed out that if losses occur due to the bank’s negligence or malpractice, the bank may be legally obliged to reimburse customers or may feel obliged to do so in order to protect its reputation. However, this contingent liability is not reported in financial statements.

Similarly, other respondents explain that banks are now focusing on financial services in an effort to retain their customer base and boost income. One respondent goes on to explain that such services are not covered under the Basel I Accord but Basel II Accord since there are no direct financial claims involved. Services such as safe-keeping of securities and securities underwriting have provided the banks with alternative avenues of increasing non-interest income. On the other hand, a bank regulator argued that financial services such as securities underwriting which are currently being done by big banks in Malawi, may pose market or settlement risks. The regulator explained that the underwriter who undertakes to take up the whole or a pre-agreed part of a capital market issue at a predetermined price may face major risks due to underwriter’s inability to place the stock at the issue price or better. He pointed out that movement in prices resulting from changes in interest rates, unforeseen economic event or misjudgment of market share price poses a major risks and financial claim to banks which they should disclose in their statements. He noted that the exposure is very large relative to the size of the underwriting bank but generally very short-term. He however stated that these events expose banks to operational risk of different types. He further stated that the Basel II Accord has taken this into consideration and requires banks to charge capital against operational risks. When asked to comment, a credit analyst from FMB explained that a due diligence is conducted by the underwriter and although the events are likely to occur in other countries, it is not the case in Malawi due to attractiveness of IPO in Malawi. However, he agrees that the Basel II Accord has taken note of such operational risks however the challenge for most banks is on measurement and disclosure of such type of risks that emanate from off-balance sheet activities.

The findings above are consistent with the results found by Cintra and Prates (2006) in Brazil. They pointed out that Basel I Accord defined regulatory strategies focused exclusively toward banking credit risk, leaving remarkable gaps, like absence of prudential rules for the growing operations of banks in the securities market (Cintra and Prates, 2006). They observed that the Basel I Accord led banks to change the group of products and services offered and favored participation in the securities market, as there were not any obligations of a regulatory nature.

Further, when implementing Basel II, the two authors raised doubts on smaller banks implementing advanced risk measurement models leaving large banks with more flexibility in capital allocation. They observed that effective risk management will enable the financial institutions to introduce products and services to enhance revenues and decrease cost through improvement of efficiency and operational losses reduction resulting from better operational risk management and hence allocate capital in a more efficient way. Ward (2002) also concluded that risk measurement models and disclosure requirement is a challenge in developing countries because information is costly to produce, capital markets are smaller, thinner and easier to manipulate. The results are also in line with observations by Chu et al., (2006) who conclude that the Basel II Accord uses both used and unused commitments (such as credit lines or guarantees) as a denominator of the capital adequacy ratio calculations; hence for instance, banks can reduce its capital ratio by simply reducing or eliminating the negative impact of unused commitments.

#### 4.2.2.4 ON – BALANCE SHEET ITEMS

On-balance sheet items are financial assets of a financial institution that are reported on balance sheet of the Company. All the respondents indicated that banks in Malawi have on balance sheet assets. This is confirmed by Figure 9 below which shows number of responses from respondents indicating banks with on-balance sheet items as part of its portfolio assets.

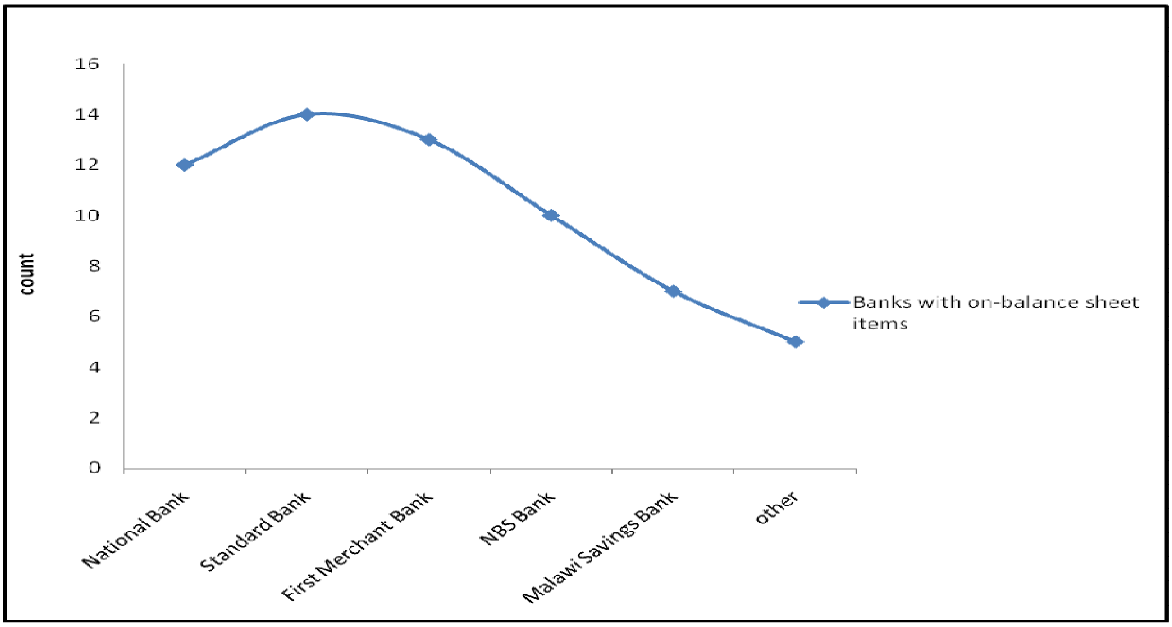


**Figure 9: Banks that have on-balance sheet items**

Figure 9 above indicates that all the banks have on-balance sheet items. Apart from the five commercial banks that were included as part of the sample, the respondents also included INDEBank and Opportunity International Bank of Malawi (OIBM) as other banks that have on-balance sheet assets.

The questionnaire also requested the respondents to indicate whether introducing Basel II Accord in Malawi will lead to decrease in on-balance sheet loan portfolio (credit crunch). Most of the respondents indicated that Basel II Accord will not lead to credit crunch in Malawi. This is evidenced by number of responses from respondents as shown on figure 10 below.

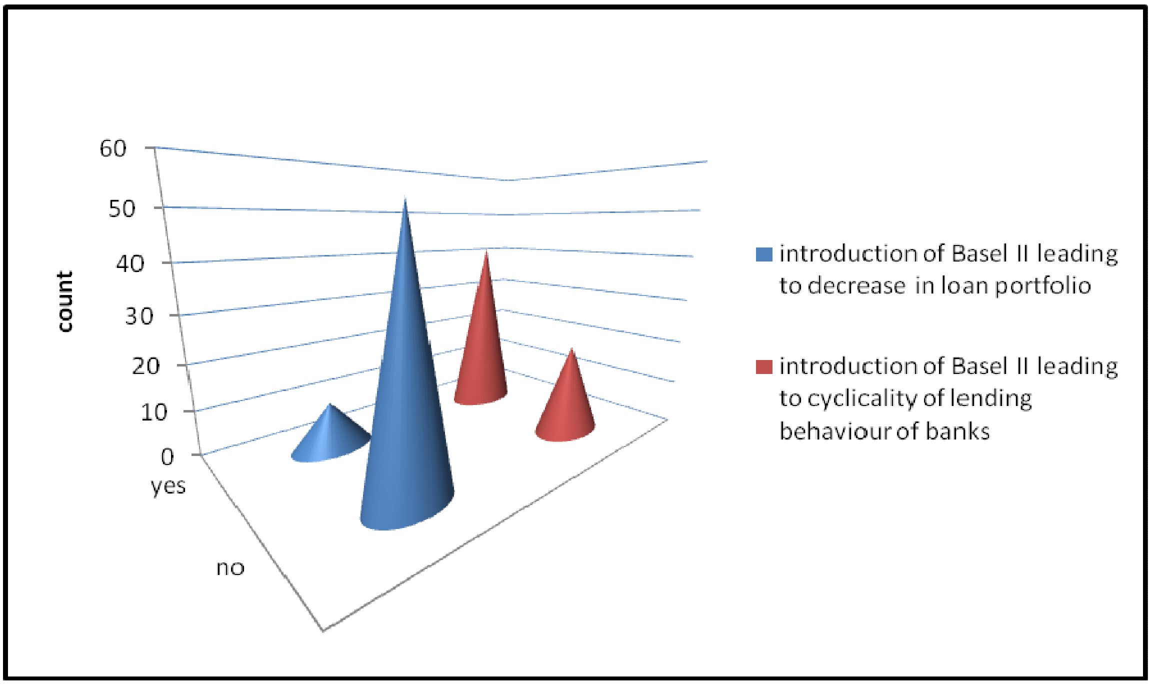


**Figure 10: Introduction of Basel II Accord leading to decrease in loan portfolio or cyclicality of lending behaviour of banks**

Figure 10 above shows number of responses from respondents indicating effects of introducing Basel II Accord leading to decrease in loan portfolio and cyclicality of lending behaviour of banks. The figure indicates that 51 respondents reported that the introduction of Basel II Accord in Malawi will not lead to reduction of loan portfolio of banks while only 10 respondents reported that it will lead to reduction in portfolio growth. A bank supervisor interviewed explained that all the banks under study are adequately capitalized since four of the Banks are listed on stock exchange and Malawi Savings Bank is wholly owned by Malawi Government. He explained that Government can sell its shares in the Bank just to raise capital. Another supervisor pointed out that banks have been operating for a number of years and have accumulated enough earnings which have increased their tier 1 capital. Above all, the banks maintain a capital ratio of above 8%. He observed that in Malawi, it is easy to book new profitable loans than dispose bad loans that can be subjected to long legal process or rigid security foreclosure market. An internal auditor interviewed from one of the Commercial banks under study also shared similar points as the supervisor. He further observed that Bank supervisors and regulators are continuously changing their supervisory framework and that currently the supervisory technique is more geared to Basel II framework. He pointed out that although the country has not adopted the Basel II Accord, regulatory supervision follows the 3 pillars as advocated by the accord.

For example, in February 2008, the Reserve Bank of Malawi issued risk management guidelines for banking institutions in Malawi as framework which banks can use to identify, quantify and manage risks. The guidelines identify several risks including credit, operation and market risks which are an epitome of pillar II. He pointed out that the guideline encourages banks to come up with their own internal risk rating approaches as a standard of measuring risks. Furthermore, in 2008, RBM issued a circular to all Commercial banks to increase their core capital from MWK200 million to MWK850 million. Therefore, commercial banks in Malawi are currently operating under the mirror of Basel II Accord and the introduction of the Accord will not change their capital requirements or change portfolio levels significantly.

Figure 10 also shows 10 respondents reported that the introduction of the Basel II Accord will lead to reduction of loan portfolio for banks. A senior credit analyst interviewed, explained that the Accord does not set capital standards only but also credit standards. The Basel II Accord will therefore only increase risk-averseness of most bank officers leading to slow growth or reduction of loan portfolio of most banks. He pointed out that low-capitalized bank will be more pressured to dispose bad loans to improve the bank's risk-weighting profile while high-capitalized banks will more likely charge high interest rates for high risk weighting assets which may dampen the demand for credit for small and medium enterprises. A combination of these and other macroeconomic factors such as economic cycle might accelerate decrease in loan demand and portfolio growth of most banks. The respondents were also asked to indicate whether introducing Basel II will lead to cyclicality in lending behaviour of Bank in Malawi. In general, the majority of respondents reported that the Basel II will lead to cyclicality in lending behaviour. This is evidenced by the responses of respondents as shown in Figure 10 above. The figure shows that 41 against 20 respondents reported that the Basel II Accord will likely lead to cyclicality in lending behaviour of most Banks in Malawi. When asked to comment, a bank supervisor pointed out that most banks in Malawi have not established internal ratings and some are in the process of establishing the credit risk models. The models will likely be influenced by economic fluctuations that have been occurring in Malawi. An external auditor argued that lack of credit rating agencies in Malawi will likely affect implementation of Basel II Accord. Most Banks will have to build their own data based on probability of default. A credit analyst commented that Banks in Malawi are directly influenced by price movements in commodity markets, financial markets and housing markets. Periodic price movement in these markets due to business cycle fluctuations influences lending cycle of the banks. The credit analysts agreed with the respondents that Basel II will not entirely eliminate cyclicality of lending behaviour of banks in Malawi. Nevertheless, a Bank supervisor advises that since Malawi will likely adopt the Basel II Accord, one of the important areas is to facilitate establishment of a rating agency in Malawi. On the other hand, another credit analysts pointed out that cyclicality in lending is less likely to happen in Malawi due to capital framework of most banks. He stresses that most banks maintain excess capital which may shoulder unexpected losses. In addition, banks make provisions for all non-performing assets against current earnings. The two strategy leverages the banks against losses due to macro-economic shocks.

The study also examined the effects of introducing Basel II on various types of term loans. The responses indicated that some term loans would increase while others would decrease. The results of the responses are shown on Figure 11 below which shows the effects of introducing Basel II leading to increase/decrease of term loans.

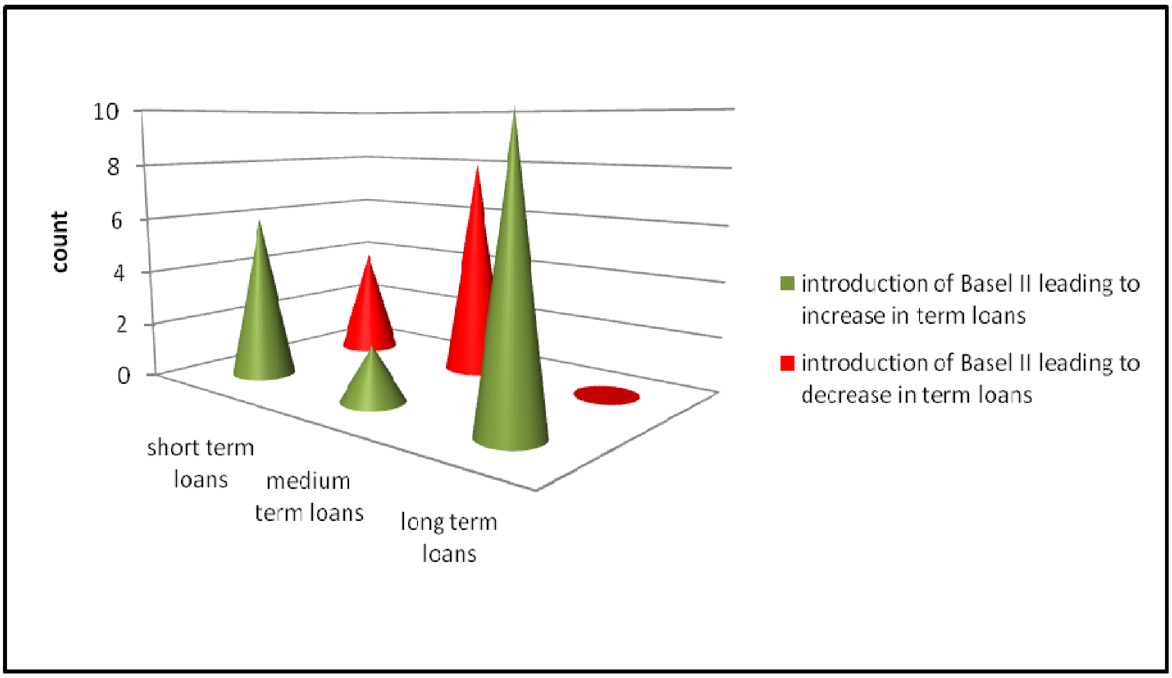


**Figure 11: Introduction of Basel II leading to increase/decrease in term loans**

Figure 11 shows number of responses of respondents indicating effects of introducing Basel II Accord on various types of term loans. The figure indicates that 4 respondents reported the Accord will lead to decrease in short–term assets and 8 respondents reported that it will lead to decrease in medium-term assets. A credit analyst interviewed, illustrated that most short and medium-term loans are granted on unsecured basis which raises their risk-profile. In addition, risk mitigating factors such as collateral further reduces the demand for short or medium-term credit.

On the other hand, the figure also shows 6 and 2 respondents reported that the Accord will lead to increase in short and medium term assets respectively. A bank supervisor explained that if the Accord is implemented in Malawi, given that deposit mobilization for most banks are short term (savings, cheque accounts and inter-bank lending) than long-term; in the process of transforming small short-term deposits into long-term loans, banks may face market risk due to price changes, credit risk due to counterparty default and operations risks due to failure of people processes, systems or external events. In this regard, banks will opt to increase short and medium term loans more than the increase in long-term loans. Nevertheless, figure 11 also shows 10 respondents reported that the Accord will likely lead to increase in long-term assets. A credit analyst interviewed pointed out that this is because of its attractiveness compared to other assets. He explained that long-term assets such as mortgages and Government bonds have low risk weighting as compared to other types of assets. Hence given an asset allocation structure, banks are more likely to increase long-term assets compared to short and medium-term assets.

The results above are inconsistent with findings by Francis (2006) who states that the removal of the ceiling[24] in Basel II Accord is expected to be of benefit to highly rated corporates in less highly rated countries, regardless of OECD membership. However, the emphasis of standardized approved on credit ratings would also imply increased difficulty in accessing bank financing for unrated companies, especially for small and medium sized Companies. In many developing countries, hardly any external ratings exist for a large part of corporate loans, and especially for SME. Because all unrated companies will be categorized under 100% weighting class[25], the approach would make their borrowing more expensive which forces banks to reclassify the products under retail exposures. The Accord has potential of decreasing loan portfolio growth which may lead to credit crunch. In

[24] The ceiling is 100% across-the-board for all corporate exposures in Basel I
[25] Under Basel II, all loans granted to unrated companies will be categorised under 100% weighting class hence banks are required to reserve capital for the full value of the outstanding capital of the loan.

addition, the findings above are consistent with findings of Kashyap and Stein (2004) who conclude that the new Basel II Accord has the potential to create an amount of additional cyclicality in capital charges hence lending at a minimum. Further, Ward (2002) observes the potential impact of the Basel II Accord on maturity of financial flows. He concluded that Basel II favors short-term lending to non-OECD banks. Interbank lending of up to one year receives 20% risk weighting, lending over a year – 100%. If the Accord has changed behavior, therefore, it will have shortened the maturity profile of lending to non-OECD banks hence increasing these borrower's liquidity risks (Ward, 2002).

### 4.2.3 IMPLICATIONS OF FINANCIAL REGULATIONS ON LENDING PRACTICES.

Compliance of new or existing financial regulation has a direct effect on changing the way banks conduct their business hence their lending behaviour/practice. The regulations influence the way banks incur risks associated with financial activities, their portfolio holding structure or terms and conditions of financial assets they offer to their clientele. The study has revealed that financial regulations have played a role in how banks conduct their lending behaviour. It has also revealed how banks have increased their capital base over the period between 1990 - 2008. The results show that Banks have increased their share capital through 3 ways as shown by number of responses on figure 12 below.

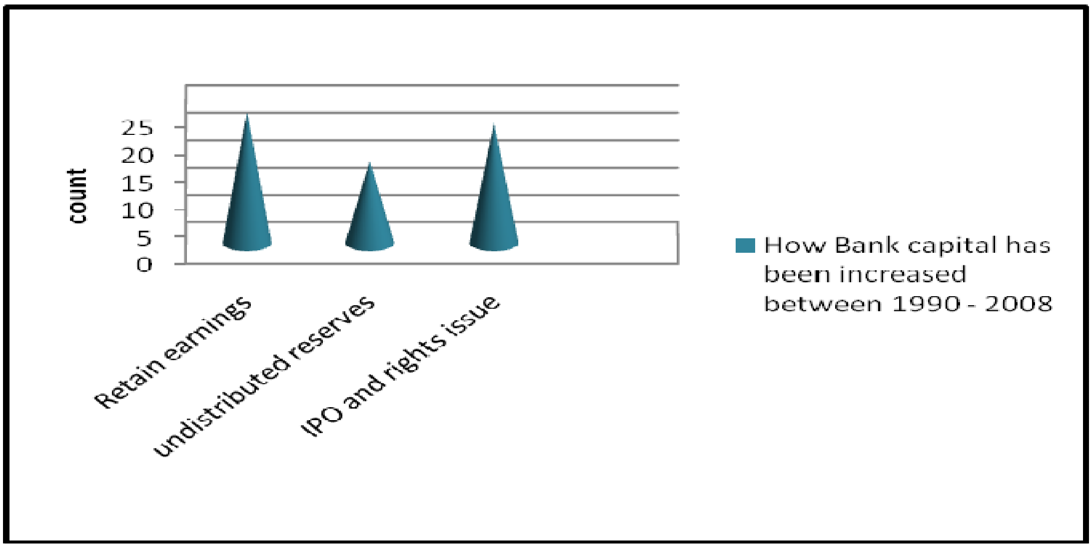


**Figure 12: How Bank capital has been increased between 1990 - 2008**

Figure 12 indicate how banks have managed to increase their capital between 1990 – 2008. The figure shows 22 responses indicated that banks under study have increased their core capital through Initial Public Offering (IPO). These banks are National Bank, Standard Bank, First Merchant Bank and NBS Bank. An external auditor interviewed pointed out that the four banks were privatized (sold part of their shares to the public) within the period under study – 1990 to 2008. Only First Merchant Bank was privately owned and the other banks were at some point owned by Government. He further pointed out that some banks increase their capital mostly through increase in retain earnings and in some cases undistributable reserves. This is substantiated by responses from 24 and 15 respondents who indicated that banks have increased their capital through increase in retain earnings and increase in undistributable/undisclosed reserves respectively. An internal auditor explained that the reserve includes the following: revaluation reserve arising from revaluation of properties, fair value reserve which relates to cumulative net change in fair value of available-for-sale investments until the investment is derecognized and general provisions which do not represent incurred losses. When asked to comment, a credit analyst interviewed observed that increase in share capital through retain earnings is much easier than other methods. He advised that banks are motivated to maximize their profits avenues in order to increase retain earnings. This notion affects banks' lending activities hence their behaviour.

A bank that aims to expand its balance sheet through new lending must grow its capital in proportion to its risk weighted assets. For example, credit analysts pointed out that banks are willing to lend to high risk sectors such as construction and transport as long as the facilities are adequately secured. The interest rates that are charged are higher than those charged for other credit facilities. The sentiments were similarly shared by another credit analyst who explained that increase in retains earnings raises bank's capital which offers more opportunity to the bank to increase its concentration limit but also influence stock prices. These motives are shown in lending practices in terms of amount, type and level of interest rates.

The study has also revealed that financial regulations directly influence the bank's composition of risk weighted assets, collateralised and uncollateralised loan portfolio as well as disposal of bad loans. This is substantiated by results on number of responses of respondents as shown on Table 3 below.

**Table 3: How financial regulations influence lending practices of commercial banks**

| | | |
|---|---|---|
| 1. Does financial regulation influence the following in the Bank? | **decrease of high risk weighted assets** | 8 |
| | **increase of low risk-weighted assets** | 15 |
| | **Loan composition of collateralised versus uncollateralized assets** | 23 |
| | **Accelerate disposal of bad loans** | 15 |
| 2. Does change in Bank Capital influence the following due to capital adequacy directive? | **Change in credit amount offered to customers** | 16 |
| | **Increase in loan amount due to increase in bank capital** | 24 |
| | **Decrease in loan amount due to decrease in bank capital** | 21 |
| 3. Have banks ever shifted from asset holding portfolio to Government securities due to financial regulations? | **YES** | **NO** |
| | 60 | 1 |
| 4. The shift was a result of the following? | **To ease associated regulatory burden** | 5 |
| | **To reduce risks as quality of portfolio assets weakened** | 8 |
| | **To benefit from high earning returns versus associated risks** | 41 |
| | **Other (s)** | 6 |

Table 3 shows responses from respondents indicating how financial regulations have influenced lending behaviour of commercial banks in Malawi. The results on the table show 8 respondents indicated that financial regulations have encouraged a decrease of high-risk weighted assets and 15 respondents reported that the regulations have increased the low-risk weighted assets. When asked to comment, a credit analyst pointed out that there is not a direct explanation to this but he has observed that capital adequacy rules have encouraged banks to extend loans that have low risk weighting and decrease high-risk weighted assets. The interviewee gives an example of National Bank and Standard Bank who have now ventured into mortgage lending. In addition, he pointed out that previous facilities which were secured by letters of credit or commercial and consumer loans which were offered on unsecured basis are now being encouraged to be secured by a cash collateral or mortgage over a real property.

Further, another interviewee pointed out that Government securities such as treasury bills and other marketable securities such as RBM bills considerably increased between the period understudy due to capital adequacy ratio rules in addition to other factors such as high returns. He pointed out that investment in the securities yielded an increase in capital adequacy ratio unlike investing in credit facilities. Similarly, an external auditor interviewed noted that risk-based capital adequacy ratios in emerging markets like Malawi may increase credit to public sector in detriment to private sector. He states that risk-weighted capital adequacy ratios can have a negative impact on credit to the private sector which can lead to a decline in economic growth. He therefore agreed with the credit analyst that among other things, capital adequacy ratio rules led banks in Malawi to allocate their asset holding portfolio which stifled supply of credit to private sector during early 1990's. The table also indicates 23 respondents reported that financial regulations encourage more loan composition of collateralized compared to uncollateralized assets. Only 15 respondents indicated financial regulation accelerate disposal of bad loans. An internal auditor explained that assets that are adequately collateralized provide the bank with an alternative source of loan repayment and that its risk-weighting is partially reduced. In addition, disposing bad loans releases capital needed to hedge the loss. Financial regulation therefore encourages banks to offer collateralized loans and dispose bad loans.

Table 3 also indicates that a change in bank capital influence various lending behavior of the bank. 16 respondents reported that it influences banks to change credit amount offered to customers, 24 respondents reported that it leads to increase in loan amount due to increase in bank capital and 21 respondents reported that it leads to decrease in loan amount due to decrease in bank capital. A bank regulator explained that since bank lending is directly linked to its credit concentration limit, a change in bank capital encourages banks to attract higher credit demand within their new credit limit. He further states that a significant decrease in bank capital due to credit losses compels the bank to reduce its lending appetite in terms of loan size and numbers. He therefore pointed out that there is a positive relationship between capital levels and loan size.

The study has also revealed that commercial banks in Malawi have shifted from holding credit assets as part of their portfolio to Government securities due to financial regulations. The results are shown by number of responses as indicated by Table 3 above. The table shows 60 respondents indicated that 4 banks under study have ever shifted from asset holding portfolio to Government securities. Only 1 respondent indicated that no bank has ever shifted from asset holding portfolio to Government securities. Consequently, 5 respondents confirmed that the shift was to ease associated regulatory burden. A credit analyst interviewed commented that banks preferred to hold Government securities such as Local registered stocks, Treasury bills and RBM bills as a way of easing regulatory burden. For example, instead of hold cash with Reserve Bank, commercial banks may hold securities as part of the amount required under reserve requirement ratio. The banks earn interest on assets but also the risk-weighting attached when calculating capital ratio is much lower than if they had invested in loans or real property.  8 respondents confirmed that the shift was to reduce the risks as quality of portfolio assets weakened. The credit analyst interviewed explained that during early 1990's when market rates were high, there were high default rates due to increase in credit risks which emanated from high interest rates. The banks preferred to invest in Government securities which were risk-free and offered high returns. The banks therefore shifted to high returns risk-free assets as a way of reducing risks as total portfolio increased. 41 respondents reported that the shift of asset holding from normal loans to Government securities was to benefit from high returns versus associated risks. This is confirmed by the credit analyst who pointed out that Government securities such at Treasury bills offered high returns in early 1990's compared to normal loans. In addition, he explained that high income return loans were associated with high risks as compared to Government securities which are risk-free.

Asset-liability management for most banks tends to favour investment in Government securities as compared to normal loans. This is also highlighted by one of the 6 respondents who reported that the shift was due to other factors. The response specifies that the strategy helps to improve asset-liability management of the banks. He/she pointed out that bank deposits which are short-term are better matched with assets which are short-term and risk free as opposed to long-term assets which are associated with various risks. Therefore, when bank liquidity increases due to large account deposits, banks benefit more from short-term investments such as Treasury bills and RBM bills as oppose to long-term investments in project and consumer loans. The credit analysts stated that this is a credit portfolio mix which is adopted by all the banks due to various reasons. For example, some of the responses obtained pointed out that banks also hold Government securities to use as security on inter-bank lending or discount window while another respondent commented that banks hold Government securities as an avenue of fund management services.

The findings above are consistent with the results of Ward (2002) who states that Basel II Accord encourages “cherry picking”. He advised that the framework in which several approaches to credit and operational risks are available replaces one form of regulatory arbitrage with another. For example, the internal risk based approach (IRB) generates higher capital requirements than the standardized approach on lower-quality assets, but lower requirement on higher-quality assets. A bank that uses IRB will therefore acquire all the high-quality assets and banks on standardized approach will acquire low-quality assets when adopting the Basel II. Furthermore, the results above are in line with the findings by Rixtel, Alexopoulou and Harada (2003) for Japan banking system that the Accord has tactical and strategic implications such as acceleration of bad loans (non-performing assets) and catalyst for more market-based credit markets. It was observed that the Accord will lead to improved lending practices of Japanese banks in terms of collateral management.

The findings above are also consistent with empirical results of Murinde and Yaseen (2004) who concluded that regulatory pressure variable has a negative and significant impact on bank’s risk, which indicates that banks increased or decreased the share of risk-weighted assets in their portfolio to approach the minimum capital requirements. In addition, the results above are also in line with conclusions of Furfine (2001) who concluded that banks in USA held a higher percentage of equity capital per loan than per Government securities. This reflected the presumption that loans are more risky than securities hence these requirements made lending relatively more expensive than purchasing securities, banks were given an incentive to shift their portfolios away from loans into securities. Similarly, the results above are in line with observations by Rey

(2004) who sees tactical asset allocation as a strategy of shifting asset mix of a portfolio in response to the changing patterns of reward or risks available in the markets.

### 4.2.4 COMMERCIAL BANKS' PERCEPTIONS OF FINANCIAL REGULATIONS

Financial regulations exist as standard rules, restrictions or requirement which commercial banks are required to comply. Compliance of these regulations depends on understanding by commercial banks and monitoring and enforcement of the regulations by regulators. The study has revealed that financial regulations have assisted commercial banks in managing various risks. This is shown by number of responses from respondents as shown on figure 13 below.

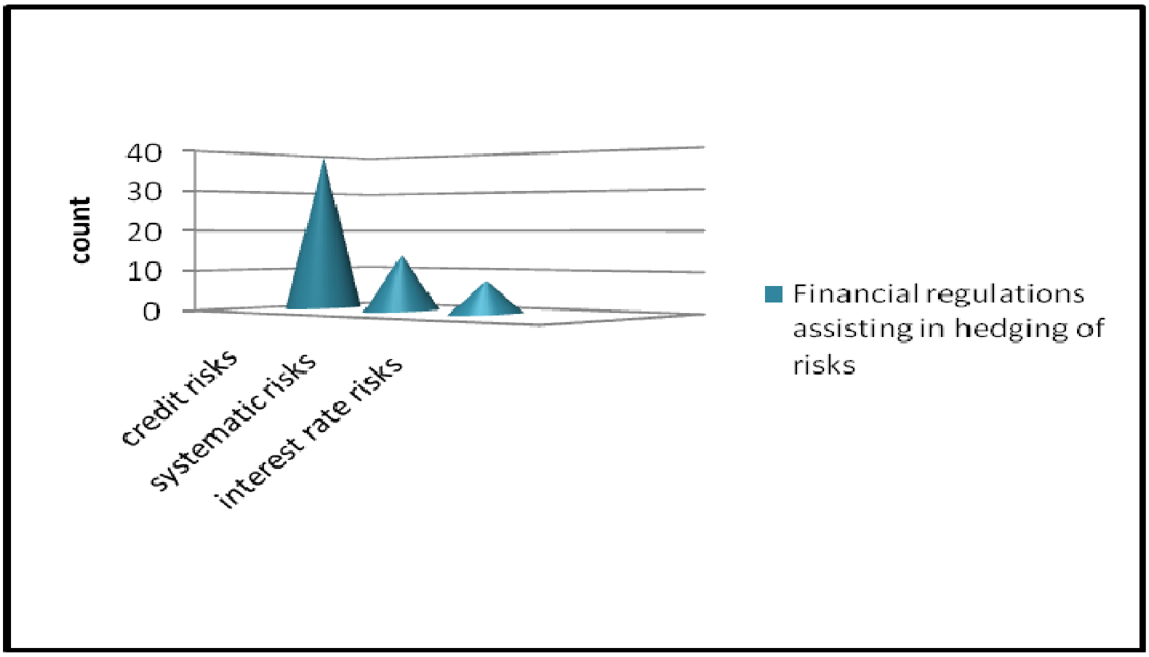


**Figure 13: Financial regulation assisting in hedging of risks**

Figure 13 shows responses from respondents indicating that financial regulations have assisted in hedging of credit, systematic and interest rate risks. The figure indicates that 39 respondents reported that financial regulations have assisted commercial banks in hedging occurrence of credit risks. In particular, a credit analyst interviewed explained that prudential guidelines on asset quality for banks prompt officers to recognize potential weakness in bank assets and its impact on its profitability. This prompts banks to take measures in hedging themselves against credit risks. For example, banks are currently insisting on life insurance policies and collaterals of various types as a way of hedging credit risks if they occur due to death, termination of employment or any other eventualities.

Figure 13 also shows that 14 and 8 respondents reported that regulations have managed to hedge against the occurrence of systematic risks[26] and interest rate risks respectively. The bank supervisor interviewed further explained that financial regulations aim to control systematic risks within the bank and the banking industry as a whole. Currently, bank supervisors have adopted consolidated risk based supervision process as a mechanism of identifying how various risks are correlated. Consequently, a credit analyst also commented that the risk management guidelines for banks in Malawi help financial institutions to identify and manage risk on consolidated basis. However, another credit analyst had a different view and pointed out that the current financial regulations do not explicitly control the occurrence of systematic risks in the banking sector. He argued that in event of regulation arbitrage and the fact that other financial sectors are less regulated (such as insurance and micro-finance sector which are directly linked with banking sector), the effects of failure of one party within this sector can have a spiral effects to other parties including banks. This can be due to transfer of risks from unregulated or less regulated sector to regulated sector which results in circle of systematic risks. For example, migration of various risks such as underwriting risks of non-life component of Insurance Companies and operations risks (embedded in risk assessment and management tools) of micro-finance institutions to credit risks for banks. He argued that if Insurance companies face catastrophic losses (due to weather related shocks and other factors), the events may force banks to impair their assets hence reducing their capital. The effects may bring contagion in the banking sector which accelerates systematic risks. In this regard, it is important for bank supervisors to separate risks from management tools and their users. The tools that transfer risks may also increase systematic risks if the counterparties fail to manage their exposures.

The study has also revealed that financial regulations have managed to control occurrence of bank failure in Malawi. This is evidenced by the number of responses as shown on figure 14 below.

[26] The risk that failure of one bank would have contagion effect on the whole banking industry.

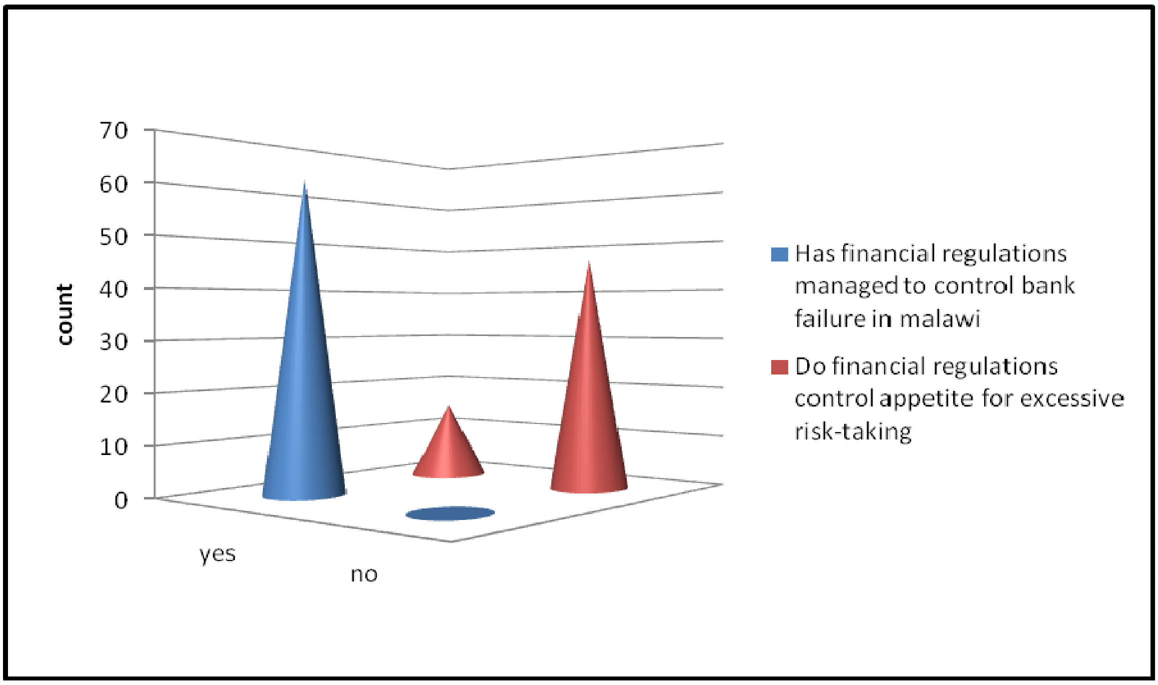


**Figure 14: Financial regulations controlling bank failure and appetite for excessive risk-taking**

Figure 14 shows number of responses from respondents indicating that financial regulations have managed to control bank failure in Malawi and appetite for excessive risk-taking. The figure shows that 61 respondents reported that financial regulations have managed to control the occurrence of bank failure in Malawi. Only Finance Bank of Malawi was liquidated in Malawi. A bank supervisor explained that the bank was voluntarily liquidated and the process of liquidation emanated from contravention of foreign exchange regulations. 15 respondents reported that financial regulations control the appetite of excessive risk taking while 46 respondents reported that the regulations do not control the appetite of excessive risk-taking. When asked to comment, a bank supervisor explained that asset quality directive encourages banks to be mindful of credit risks, which if they occur impair the bank's capital. Further, capital adequacy ratio which is calculated based on risk-weighting of assets encourages banks to hold a credit portfolio according to their risks or limit its exposure to certain type of assets.

Consequently, an external auditor commented that where the bank officers are able to adequately manage the risks, excessive risk-taking may increase. For example, the capital adequacy ratio favours assets which are backed by Government guarantee, mortgaged property and cash collateral. This encourages banks to grant high credit risk facilities as long as they are guaranteed by Government, hard or cash collateral. The technique however hedges the banks against credit risks and not against market risks. This has seen banks incur losses from their credit assets which were adequately collateralized due to movement in market prices. For example, a loss can occur after foreclosure due to movement of collateral prices of assets such as real property, shares and motor vehicles. Further, risk management guidelines (RMG) which advocate banks to manage risks using six tools – risk transfer, reduction, integration, hedging, disclosure and diversification may encourage banks to take on board excessive risks as they know that they have an appropriate tool to cover the effects of the risks. The study also verified if banks follow the risk management guidelines as issued by Reserve Bank of Malawi (RBM). The study has revealed that banks follow the risk management guidelines. This is evidenced by number of responses from respondents as shown on figure 15 below.

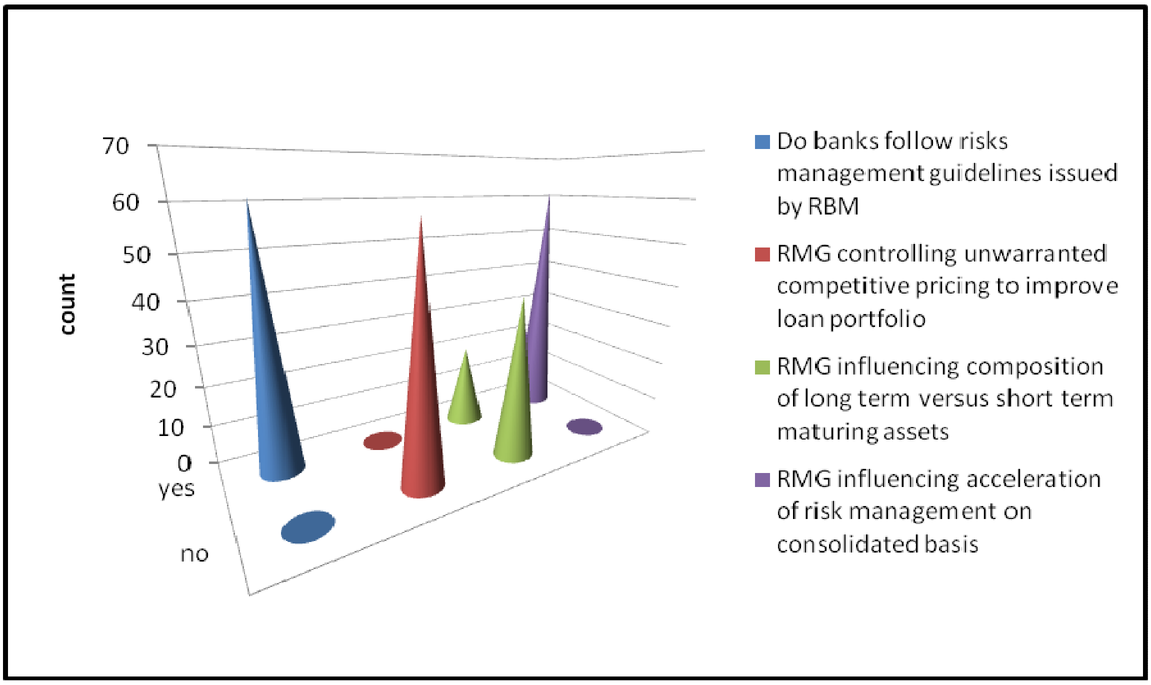


**Figure 15: Risk management guidelines influencing pricing, composition of assets and consolidation of risk management**

Figure 15 shows number of responses from respondents who indicated whether risk management guidelines have managed to control competitive pricing, term composition of maturing assets and consolidation of risk management. The figure shows that 61 respondents reported that all the banks follow risk management guidelines as issued by

Reserve Bank of Malawi. A bank supervisor advised that risk management process creates and protects value for bank assets and that processes are tailor-made. The only challenge is that the guidelines are not enforceable, hence in future, some banks may ignore or stop following the guidelines.

Figure 15 also shows that 58 respondents reported that risk management guidelines do not influence banks to manage unwarranted competitive pricing to improve loan portfolio. A credit analyst explained that asset pricing (interest rate) is based on bank-customer relationship and risk perceived. The figure also indicates that 40 respondents indicated that risk management guidelines influence composition of long-term versus short-term maturing assets and 21 respondents reported that the guidelines do not influence the term composition of assets. A credit analyst explained that the guidelines may influence banks on composition of long versus short- term maturing assets through asset-liability management techniques. The guidelines encourage banks to have an asset-liability management committee (ALCO) which oversees market and liquidity risks whose effects is embedded in investment strategies of banks. ALCO is therefore interested in assets maturity profiles to match with liquidity levels of the bank at the particular level. Further, risk management guideline encourages banks on risk integration. This enables banks to manage assets and liabilities in integrated way, that is, short-term assets should be matched with short-term liabilities and loan-term assets with long-term liabilities. This notion influences banks to manage assets composition in terms of term (maturity), product type and repayment structure.

Figure 15 also indicates that 61 respondents reported that risk management guidelines accelerate risk management on consolidated basis. According to bank supervisors, the aim of the guideline is to disclose type and degree of risks an organization may be exposed. This enables banks to establish how various risks are inter-linked or related. By focusing on all the risks at the same time, financial institutions are able to manage risks on consolidated basis. This practice aligns financial institution to consolidated supervision activities by Reserve Bank of Malawi. A bank supervisor advised that soon Reserve Bank of Malawi will introduce risk-based supervision approach, a risk-oriented process which is dynamic and structured supervision process which is designed to evaluate and validate the type, level, management and direction of risks on consolidated basis.

The study has also found out that banks follow the asset quality directive (AQD) as issued by Reserve Bank of Malawi. This is evidenced by number of responses as shown on figure 16 below.

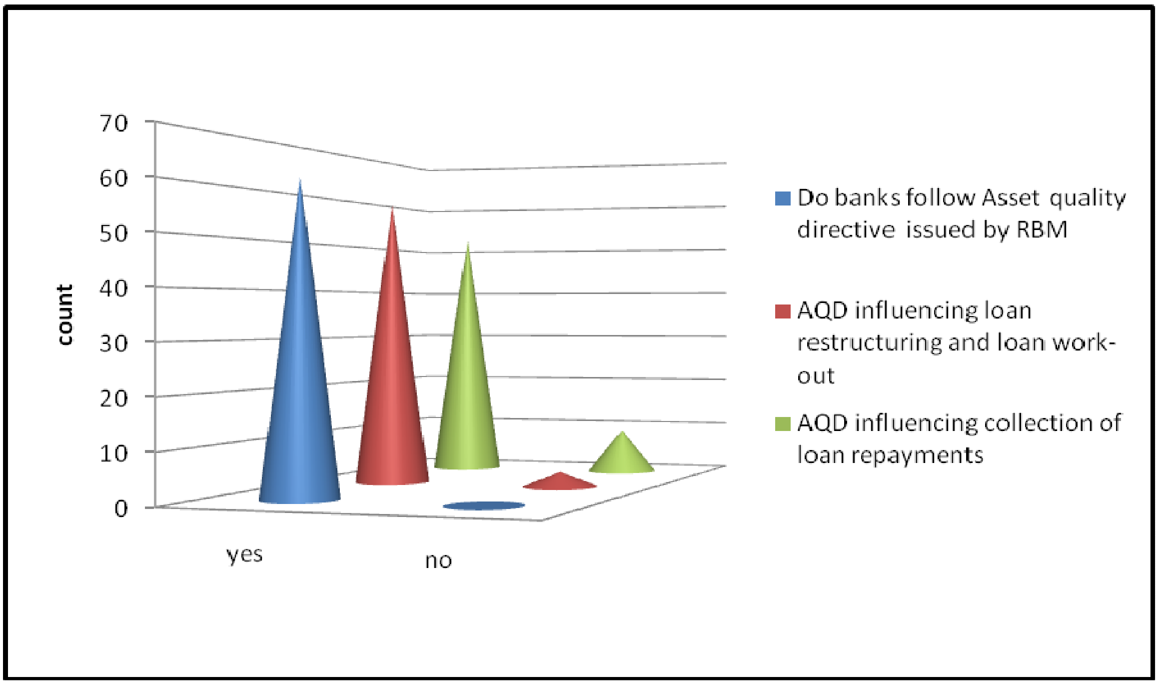


**Figure 16: Asset quality directive influencing loan restructuring, work-out and collection of loan repayments**

Figure 16 shows number of responses from respondents indicating that asset quality directive has influenced banks to restructure loans, loan work-out and stimulating collection of loan repayments. The figure indicates 61 respondents reported that all the banks follow asset quality directive issued by Reserve Bank of Malawi. 58 against 3 respondents reported that asset quality directive has influenced banks on loan restructuring and loan work-out. A credit analysts explained that the directive which calls for banks to recognize potential and existing problem assets and make allowance for losses, induce banks on loan structuring to match repayment term and income inflows (especially seasonal facilities) or loan work-out by adjusting term and/ or interest rate to reduce the instalment to match income inflows. This practice is done to reduce credit risks. Further, 52 against 9 respondents reported that the directive stimulate collections of loan repayments. According to the credit analyst, the reason is because potential or existing problem assets call for provisions for losses. Banks wouldn't want to impair its assets and the only way is to increase collection efforts. The credit analyst comments were also in line with explanation made by bank supervisors that the rationale of the directive is to stimulate collection efforts.

The study has also found out that financial regulations influence lending behaviour of banks in terms of credit allocation and loan amount. Furthermore, the study has also verified that directive on large loan exposures issued by Reserve Bank of Malawi may not entirely limit vulnerability of low capitalised banks. This is evidenced by number of responses from respondents as shown on Table 4 below.

**Table 4: Perception of financial regulations on lending behaviour of commercial banks in Malawi**

<table>
<tr><td rowspan="3">1. Do financial regulations influence the lending behaviour of commercial banks in the following?</td><td></td><td>YES</td><td>NO</td></tr>
<tr><td>Credit allocation</td><td>42</td><td>19</td></tr>
<tr><td>Loan amount</td><td>38</td><td>23</td></tr>
<tr><td rowspan="2">2. Does following directive on large loan exposures impact the bank in the following?</td><td></td><td>YES</td><td>NO</td></tr>
<tr><td>Diversifying in lending activities between large and small corporate clients</td><td>47</td><td>15</td></tr>
<tr><td rowspan="2">3. In your opinion, does following directive on large loan exposures limit vulnerability of low capitalised banks.</td><td>YES</td><td colspan="2">NO</td></tr>
<tr><td>33</td><td colspan="2">28</td></tr>
</table>

Table 4 indicates number of responses of respondents on perception of financial regulations on lending behaviour of commercial banks in Malawi. The Table indicates 42 respondents reported that financial regulations influence credit allocation by commercial banks while 19 respondents reported that they do not influence credit allocation. A credit analyst explained that due to perceived risks, banks diversify their portfolio to spread the risks. The directives on large loan exposures, credit concentration limits and capital adequacy ratio rules were designed to limit and diversify risks exposed by banks and this influences banks to limit, spread and diversify credit per industry or sector or customer types (corporate and individual). On the other hand, the credit analyst advised that credit allocation may also be due other reasons and not necessarily due to financial regulations such as the bank's branch geographical allocation and/or marketing strategy. Such that a bank that does not have a presence in a certain area, there will be no or few credit facilities extended in that area and usually marketing of the bank's products is non-existent. The table also shows that 38 against 23 respondents reported that financial regulations influence the bank in loan amount extended to the customer. Comments from a credit analyst contrasted the two views and advised that the more the bank is capitalized, the less is the size of credit that is affected by financial regulations such as capital adequacy rules and directive on large exposures and vice-versa is true. In addition, he advised that low capitalized banks are limited (without seeking waiver from Reserve Bank of Malawi) in terms of credit size they can extend to one or group customers. Therefore, financial regulations do influence the loan amount in terms of size or customer type.

Table 4 above indicates that 47 against 15 respondents reported that directive on large loan exposures impact the banks by diversifying lending activities between large and small corporate clients. Further, 33 against 28 respondents reported that the directive on large loan exposures limits vulnerability of low capitalized banks. A bank supervisor explained that the rationale of the directive was to limit risks or colossal losses from one customer impacting the performance of the bank. Credit exposures for the bank to different customers should be limited to an amount that can be shouldered by the bank's capital. This induces highly capitalized banks to have high risks appetite than low capitalized banks. The subsequent loan amounts granted by the two banks are also different such that high capitalized banks tend to focus more on large corporate customers than small capitalized banks. He gave an example of National Bank of Malawi and NBS Bank whereby NBM tend to concentrate on large corporate customers than NBS which has small corporate customers on its portfolio. The directive therefore influences the bank to diversify lending activities between large and small corporate customers depending on its capital levels. A credit analyst further explained that where the bank's capital level is low, the bank is limited in terms of risks appetite and number of large loan exposures it can hold under its portfolio. Therefore, the directive actually limit vulnerability of the bank's credit losses arising from one customer or group of customers as the capital levels of the banks are adequate enough to caution against such occurrence. On the other hand, the analysts pointed out that this does not limit vulnerability of the banks to other factors such as lawsuits and systematic risks.

The results above are consistent with observations by Saidenberg and Schuermann (2003) who noted that capital regulations protect the banks against credit risks and systematic risks. Further, the authors state that the Basel II Accord for bank capital regulation is designed to better align regulatory capital to the underlying risks by encouraging more and better systematic risk management practices, especially in the area of credit risks. However, Rojas-Suárez (2004) concluded that traditional prudential regulatory policies used in industrialised countries have had limited effectiveness in controlling the adverse impacts of capital account volatility on financial systems in developing countries. He asserts that the regulations have not taken into account particular characteristics of financial markets in developing countries hence they cannot effectively control excessive risk taking by financial institution. For example, he states that assets in developing countries have different risks characteristics than assets in industrialised countries leading to poor matching between risk assessments contained in the Basel II recommendations implemented in developing countries than the actual risks faced by banks in these countries.

The results above are also in line with conclusions of Furfine (2001) who concluded that regulatory standards and the way in which those standards are enforced have a significant impact on optimal portfolio allocation of commercial banks. Further, he concludes that the underlying risk-weights of assets increase incentives to make safer loans. This suggests that the Basel II Accord may increase incentive to allocate credit between different sectors depending on prevailing risks. The results above are also in line with findings of Cabenoyan and Strahan (2001) who points out that banks use the risk-reducing benefits of risk management to take on more profitable but higher risk lending activities and to operate with greater leverage.

### 4.2.5 COMMERCIAL BANK’S LENDING PRACTICES IN MALAWI

Bank’s lending practice or behaviour is influenced by several factors such as credit culture/lending philosophy, strategic goals, values and sometimes economic (business) fluctuations that provides lending experience. Some of the lending practices undertaken by banks are restrictive, predatory and unlawful to individual or corporate clients of the bank. These practices can be checked and controlled by financial regulations whose aim is to promote fair business conduct. The study has found out that currently, there are no financial regulations that control the occurrence of unfair and undesirable lending practices

**Table 5: Commercial bank's lending practices in Malawi**

| | | | |
|---|---|---|---|
| 1. Do financial regulations control the occurrence of the following lending practices in commercial banks? | | **YES** | **NO** |
| | **Sub-prime lending** | 9 | 52 |
| | **Predatory lending** | 2 | 59 |
| 2. Do banks conduct itself in the following manner? | | **YES** | **NO** |
| | **Offer prime interest rate to prime customers** | 55 | 6 |
| | **Offer prime interest rate to un-creditworthy customers** | 40 | 21 |
| | **Offer above prime interest rate to customers with no credit record** | 46 | 15 |
| | **Charge above prime interest rate on loans that are not secured** | 39 | 22 |
| 3. Do banks apply the following terms and conditions in loan agreement? | | **YES** | **NO** |
| | **Balloon repayment of loans with term of less than 5 years** | 0 | 61 |
| | **Increased interest rate in the event of default** | 48 | 13 |
| | **Charge penalties on prepayment of loans** | 11 | 50 |
| | **Other hidden costs** | 16 | 45 |
| 4. Do banks extend loans based on the value of security? | **YES** | **NO** | |
| | 37 | 24 | |

such as predatory lending or sub-prime lending. This is confirmed by number of responses from respondents as shown on table 5 above.

Table 5 above shows results on number of responses of respondents on commercial banks lending practices in Malawi. A large number of respondents reported that financial regulations have not controlled the occurrence of sub-prime and predatory lending practices of commercial banks in Malawi. Table 5 above shows that 52 against 9 respondents reported that financial regulations have not helped to control sub-prime lending and 59 against 2 respondents reported that financial regulations have not controlled predatory lending practices of commercial banks. When asked to comment, an external auditor advised that the rationale of financial regulations is mainly to protect the depositors, the financial institution and financial system. There are no regulations in Malawi that protect the interest of the borrowers and any such complaints are handled by the courts. Secondly, a credit analyst advised that sub-prime lending and predatory lending are difficult to identify or quantify in absence of regulations or prudential rules identifying and disallowing them. Further, predatory practices may exist but they are all in favour of the bank due to information asymmetry that exists between the bank and bank customers. This means not all customers can recognize predatory practices and if they occur, there are no prudential rules controlling or discouraging them.

Interestingly, Section 31 of the Banking Act 1989 deals with situations where a bank or financial institutions conducts business in an unlawful or unsound manner. However, unlawful business or in unsound manner has not been defined. The Credit analyst further advised that the Reserve Bank of Malawi through the Act is empowered to issue prudential guidelines to outline and clarify unlawful or unsound business conduct which may but not limited to defining unethical practices such as predatory lending, insider trading or paying excessive management fees. Consequently, sub-prime lending does exist in Malawi and the practice is common to all types of customers. This is confirmed by number of responses as shown on table 5 above. The table shows that 55 against 6 respondents reported that banks offer prime interest rates to prime customers. A credit analyst interviewed advised that most corporate customers dictate on the rate to be charged. The Companies are multi-banked which puts pressure on banks to charge competitive rates which are usually prime or sub-prime rates. 40 against 21 respondents reported that the banks offer prime interest rates to un-creditworthy customers. A bank supervisor explained that most banks would offer competitive rates to un-creditworthy customers based on other things other than credit risks. He explained that banks have other targets to achieve such as deposit mobilization which changes the pricing structure. 46 against 15 respondents reported that banks offer above prime interest rates to customers with no credit record and 39 against 22 respondents reported the bank charge above prime interest rates on loans that are not secured. According to a credit analyst, there are two situations a bank can extend a sub-prime facility. First, he explains that banks have customers which they target for business development and relationship. The bank would normally offer prime or sub – prime rates in order to attract or retain the customer. Secondly, where the interest rates have been declining, the bank may extend credit facilities to customers who would not normally qualify for the facility. However due to decline in the rates, the customers qualify for a sub-prime loan facility.

According to credit analysts from Standard Bank and First Merchant Bank, the recent financial crisis in the USA originated from falling house prices which were mortgaged to banks and re-sold to different financiers. They observed that what started the crisis in USA were low interest rates which encouraged people with poor credit and low income to take loans that they later defaulted due to falling house prices, unemployment and decline in wages; a situation that can occur in any collateral market from any assets pledged as collateral for bank loans such as motor vehicles or shares. Hence, although the effects of the crisis were heightened by complicated financial products and markets, the crisis originated from an economic situation which can occur in Malawi or other developing economies. For example, reducing market interest rates by Government as a monetary policy tool to spur development might promote easy credit in the short or long-term. However, any changes in market prices faced by Banks may create contagions which cause the crisis. Therefore, sub-prime lending of any form promote easy credit which if uncontrolled may cause economic crisis.

All the respondents reported that the banks do not offer balloon repayments for loans with term less than 5 years. Table 5 shows that 48 against 13 respondents reported that banks increase interest rates on event of default. When asked to comment, a credit analyst explained that most banks charge penalty rates above the effective rates to discourage customer on loan default. While 11 against 50 respondents reported that the banks charge penalty rate on loan prepayments and 16 against 45 respondents reported that banks charge other hidden costs. The credit analyst explained that banks charge penalty rate on loan prepayments to discourage customers repaying loans before expiry of loan term so as not to lose interest income while other hidden costs such as insurance premiums or loan commitment fees are charged without the knowledge of customers. If capitalised, the hidden costs increases cost of the loan. By offering one or more of these terms in a loan application without the consent or knowledge of the customer, the bank is said to practice predatory lending. The table shows that 37 against 24 respondents reported that the banks extend loans based on value of security. An external auditor illustrates that security based lending is common in most banks that deal with customers with no credit record or unstable cash flow. Other banks use security as a secondary source of loan repayment. The auditor observed that the practice in some cases deny credit to deserving customers which is unjust.

The findings above prove the importance of recommendations made by Mwenda (2008) on the need of RBM to issue prudential guidelines or regulations on 'unsafe and unsound practices'. This will provide policy guidance and prevent some of the practices that are currently being done by Commercial banks in Malawi.

## 4.3. CHAPTER SUMMARY AND CONCLUSION

This chapter has analysed the findings obtained from the questionnaire and semi-structured interviews that were conducted. The research findings were mixed but provided answers and solutions to research questions. This formed a framework where the research questions and objectives were answered and measured respectively.

Chapter 5 provides conclusions and recommendations drawn from the research work. It concludes with a general solution to the research problem and recommendations of the study and areas for further research.

# CHAPTER 5

# CONCLUSIONS AND RECOMMENDATIONS

## 5.0 INTRODUCTION

This chapter provides conclusions drawn from the findings of the study. It gives answers to the research questions hence specific solution to the research problem. It also suggests recommendations to the general solution of the research problem and analyses whether research objectives have been met. The chapter finally concludes with suggested areas for further research.

## 5.1 CONCLUSIONS

The first research question of the study was to investigate some of the tactical and strategic lending techniques that have developed due to financial regulations. For this purpose, the study identified some of the tactical and strategic lending techniques that some previous researchers identified to occur due to financial regulations. Using the mixed methods approach, the study has established that banks in Malawi are already using some of the tactical and strategic lending techniques. These techniques are practiced at a small scale while others were done only once. For example, securitization is one of the tactical lending techniques that were used by banks in Europe or America to reduce the effects of capital ratio calculation. The study established that only one Bank in Malawi used the technique and that process was a once off transaction. In addition, the study has also revealed reasons why the technique was introduced, and the type and tenor of lending products. The study concludes that tactical lending techniques such as securitization occurred in Malawi only once and at a small scale. The reasons for securitization were to improve the capital ratio as well as liquidity of the Bank.

The study has also confirmed that some of the Commercial Banks in Malawi enter into strategic lending alliance with other banks just to serve the customers. The technique that is currently practiced by most banks in Malawi is loan syndication/participation. The study has established that the reasons for strategic lending alliance are due to both bank-customer considerations and financial regulations. The technique is used when there is large loan request from the customer or when the loan request is above the credit concentration limit as set out by RBM directive. The study has concluded that the rationale of regulating large exposures through the directive on credit concentration limit for financial institutions may fail to control systematic risks in banking sector due to that the loan syndication technique increases exposure (hence failure) of one customer to different banks. The study has also concluded that loan syndication is a technique that arbitrage directive on credit concentration limit on one hand and directive on large exposures on the hand. By syndicating a loan, two or more banks are able to extend a large loan request to a single or group of related customers thereby avoiding the need to obtain authorisation from Reserve Bank if the exposure is above the bank's concentration limit. The study has also established that there is no bank under study that has entered into a contingent liability claim due to financial regulations. However, the study has revealed that some banks may have changed the structure of their contingent liability claims due to capital ratio regulations. Banks are encouraging customers to secure the claims by cash which has a lower risk-weighting than other facilities.

The second research question was to establish what have been the changes in lending practices in response to new or existing financial regulations. The Basel II Accord is one of the new financial regulations that will be introduced in Malawi. The study has established that introducing Basel II Accord in Malawi will lead to decrease in certain type of off-balance sheets assets as well as innovation of other products. The study has established that if Basel II Accord is implemented in Malawi, it may lead to decline in certain type of off-balance sheets assets such as guarantees and lines of credit. The study has also established that the Basel I Accord may lead banks into advisory, management and underwriting functions. The study concludes that under Basel I Accord, banks are motivated to introduce other off-balance sheet products or services since the Accord does not require banks to set aside capital to cover operational risks. However, under Basel II Accord, the bank will be required to set aside capital to cushion operational risks. The study has also established that implementing Basel II Accord in Malawi may not lead to decline in loan portfolio but may lead to change in portfolio structure for banks. This is because banks are already operating under the mirror of Basel II Accord and by the time the Accord is implemented, most banks would have already met Basel II Accord requirements. The study has also revealed that Basel II Accord may lead to decline in medium-term assets (for example corporate loans) in favour of short-term and long-term assets that have relatively lower risk weightings. The study has revealed that short-term and long-term assets (loans) have relatively lower risk-weightings because most of the loans are secured by cash, marketable securities and charge over residential or commercial properties respectively or are inter-bank loans. The study has also revealed that the Accord may lead to cyclicality of lending behaviour of commercial banks in Malawi because of poorly developed internal rating models that are influenced by business fluctuations. The study therefore concludes that the Basel II Accord will not entirely eliminate cyclicality of lending behaviour of commercial banks in Malawi.

The third research question of the study was to investigate the effect of financial regulations on lending practices of commercial banks in Malawi. The study has established that capital regulation encourage banks to decrease high risk-weighted assets (hence increase low risk-weighted assets). For example, banks have decreased unsecured corporate loans which are high risk-weighted assets in favour of Government securities or consumer loans secured by cash which are low risk-weighted assets. The study has also revealed that RBM directives on asset quality for banks encourages change of loan composition between collateralized versus uncollateralized assets as well as accelerating disposal of bad loans. It has been revealed that banks consider collateral as a secondary source of loan repayments. This encourages banks to extend more collateralized than uncollateralized assets. The study has also revealed that capital regulation influence credit amount offered to customers hence an increase (or decrease) in credit amount offered is usually due to increase (or decrease) in bank capital. This is because credit exposure to a single or a group of related customers is directly dependent on a percentage of bank's capital. The study therefore concludes that financial regulations have an effect on the bank's choice between collateralised and uncollateralised loans, accelerating disposal of bad loans as well as the credit amount offered to customers.

The first research objective was to investigate undesirable lending practices of commercial banks in Malawi. The study has established that the financial regulations have not controlled the occurrence of sub-prime and predatory lending practices of commercial banks in Malawi. The study has revealed that financial regulations mainly protect the depositors, the financial institution and financial system. There are no regulations that protect the interest of borrowers. In addition, lack of financial regulations makes it difficult to identify and disallow sub-prime and predatory lending practices of commercial banks in Malawi.

The study has also established that sub-prime lending practices are common in Malawi especially where the bank target customers for business development and relationship (name lending) or when there has been a decline in interest rates which normally qualify un-creditworthy customers. The study has also established that sub-prime lending promote easy credit which if uncontrolled may cause economic crisis. The study has also established that predatory lending practices do exists in Malawi and are practiced in different form by different banks. Predatory practices such as penalty rates on loan prepayments or loan defaults and hidden costs such as loan commitment fees can be found on most loan agreement forms. The study has therefore concluded that there are undesirable lending practices being conducted by commercial banks in Malawi.

The second objective of the study was to establish the implications of financial regulations on lending practices of commercial banks in Malawi. The study has established that banks have different asset-holding portfolio structures which they can change over time. The study has revealed that during the period under study, banks have shifted from a credit asset holding portfolio to Government securities and vice versa. The reasons for the shift was to reduce risks (Government securities are low risk compared to loans) as quality of portfolio assets weakened but also the banks wanted to benefit from high return earnings versus the associated risks. The study has also established that the change of bank capital has a direct effect on the loan amount offered to clients hence the bank’s lending behaviour. The study has established that banks with high capital base target big corporate customers while banks with low capital base target retail customers (small corporate customers). This has a direct effect on the bank’s lending behaviour as seen by the public either as a corporate lending bank or retail lending bank. The study concludes that capital regulations influences composition of risk-weighted assets for banks hence its asset holding portfolio but also the target choice of customers between corporate or retail customers.

The third research objective was to evaluate the perception of Commercial Banks on financial regulations in Malawi. The study has established that financial regulations have managed to control occurrence of credit risks. However, the study has also established that although systematic risks are not common in Malawi; the fact that other sectors in financial industry are less regulated coupled with poor supervision framework, the situation might lead to systematic risks due to direct links between less regulated sector (Insurance and Micro-finance) and more regulated sectors (commercial banks). The study concludes that financial regulation alone should not focus on users (Banking, Insurance, Micro-finance, etc) but also credit underwriting models to protect occurrence of systematic risks in banking sector. The study has also established that financial regulations have managed to control the occurrence of bank failure in Malawi. It has been revealed that the only bank that failed in Malawi – Finance Bank of Malawi was due to contravention of foreign exchange regulations. The study concludes that financial stakeholders perceive financial regulations are playing a part in controlling bank failure in Malawi. The study has also established that financial regulations do not control commercial bank's appetite for excessive risks. It has been revealed that effective risk management systems encourages banks to grant high credit risks facilities so long as the risks are adequately covered. The study has reveal that risks management guidelines helps banks to control credit risks but not market risks. For example, credit losses can occur due to movement in market prices of assets which were pledged as collateral.

The study has also established that all the banks follow the risk management guidelines issued by Reserve Bank of Malawi. It has been revealed that the guidelines have accelerated risk management of banks on consolidated basis. However, the study has also revealed that the guidelines do not influence composition of long-term versus short-term assets and that the guidelines do not encourage unwarranted competitive pricing to improve loan portfolio. The study has revealed that the RBM asset-quality directive calls on banks to recognize problem assets and make allowance for losses. This encourages banks to find ways for loan work-out to help the customer or the directive stimulate loan collection exercise to avoid loan impairment for losses (or losses). The study therefore concludes that RBM asset-quality directive for banks in Malawi influence loan restructuring and loan work-out as well as stimulating collection of loan repayments. In addition, it has been revealed that risks vary with a change in the percentage of bank's capital. Directives on credit concentration limit and large loan exposures encourage banks with different capital levels to have different risks appetite. The study has also concluded that directives on credit concentration limit and large loan exposures diversify lending activities between large and small corporate clients between banks.

## 5.2 RECOMMENDATIONS

The following have been identified as areas that need to be improved and in some cases, areas that require development so as to strength financial system and markets; non-availability of internal risk models that conforms to Basel II Accord, weak supervision framework of Reserve Bank of Malawi, weak regulatory framework of financial markets in Malawi and non-availability of risk and compliance function.

From the above problems, it is therefore recommended that:

### 5.2.1 EACH BANK IN MALAWI MUST DEVELOP ITS OWN INTERNAL RISK MODELS.

It is important for each bank to develop its own internal risk models that conforms to the specialized types of credit products offered by the bank. The models should be developed based on key parameters that mitigate credit, market and operational risks. It is also recommended that the in-house risk models should not be influenced by business fluctuations in asset prices to avoid lending cyclicality.

### 5.2.2 RESERVE BANK OF MALAWI MUST CONTINOUSLY IMPROVE SUPERVISION FRAMEWORK OF FINANCIAL MARKETS IN MALAWI.

The Reserve Bank of Malawi must continuously improve its supervision framework to safeguard the financial markets from emerging risks. The RBM has taken the right step in migrating to risk-based supervision from CAMEL process supervision. Further, the study recommends that RBM should also target risk underwriting models used by banks to ensure that banks are using effective risk management tools.

### 5.2.3 RESERVE BANK OF MALAWI MUST IMPROVE THE REGULATORY FRAMEWORK OF FINANCIAL MARKETS IN MALAWI.

There is a need for RBM to continuously improve the regulatory framework of financial markets in Malawi. In particular, the study recommends that RBM should introduce directives on enterprise-wide risk management and compliance which will enable RBM enforce risk management in each bank at all times. The study also recommends RBM to issue prudential guidelines and directives on sub-prime and predatory lending. This will allow the Bank to give a clear meaning of unfair business practice by banks in terms of predatory practices or financial indiscipline as well as protecting the borrowers from such lending practices. The study also recommends that RBM should establish a financial and banking ombudsman service to help settle disputes between consumers and financial institutions. This will provide an independent office for fair and reasonable decision or dispute resolution.

In addition, the study also recommends that computation of large loan exposures for banks should consider a facility as a large loan exposure for a specific period of time regardless the change of core capital of the bank. The study also recommends that syndicated loans should be disclosed as large loan exposures since the facilities are concentrated between two or more banks whose non-performance can cause contagion in the financial system.

### 5.2.4 EACH BANK SHOULD HAVE A RISK AND COMPLIANCE FUNCTION.

The Reserve Bank of Malawi has adopted a consolidated risk based supervision process. The process requires bank supervisors to analyze all the risks identified by the bank on consolidated basis. This requires each bank to have a section or department that coordinate risk management process in order to create value for the bank. The study recommends that each financial institution in Malawi (including banks) should have a risk and compliance manager who will coordinate risk management functions of the institution on consolidated basis. This will ensure enterprise-wide risks management process.

## 5.3 AREAS FOR FURTHER RESEARCH

The research was conducted during the period when the Reserve Bank of Malawi was in the process of adopting Basel II Accord. The results of the study have only indicated how various banks would respond to implementation of the Basel II Accord. It would be of interest to investigate the actual reaction from various banks after adopting the Accord. This is due to differences in skills and knowledge, credit structure and capital structure and portfolio levels of commercial banks in Malawi.

The researcher also recommends further research to be conducted on effectiveness of regulatory and supervisory framework on commercial bank operations and activities. This will assess whether there is need to change the regulatory framework or restructuring of supervisory framework.

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## 7.0 APPENDICES

**APPENDIX 1 (Survey questionnaire for financial stakeholders)**

This research is an evaluation of the impact of financial regulations on lending practices of commercial banks in Malawi. The researcher is requesting your valuable participation in the study by answering the questions contained in this document. The responses you provide will remain confidential and will strictly be used for this study.

**Purpose of the Questionnaire**

The main purpose of this questionnaire is to:

- Establish information used by Commercial banks in bank lending with respect to financial regulations.
- Establish lending practices of Commercial banks.
- Establish tactical and strategic lending techniques that have been developed by Commercial banks in Malawi.

**Filling in the Questionnaire**

*Please note that multiple answers can be given where necessary and please tick for an answer,*

[ √ ] **YES** [ X ] **NO**

**Table of Contents**

The questionnaire is split into five sections each dealing with separate lending practices and financial regulations as described below:

| | | |
|---|---|---|
| **SECTION A** | **PART 1** | Background information |
| **SECTION B** | **PART 1** | Loan Securitisation |
| | **PART 2** | Loan Syndication |
| | **PART 3** | Off – balance sheet items |
| | **PART 4** | On – balance sheet items |
| **SECTION C** | **PART 1** | Implications of financial regulations |
| **SECTION D** | **PART 1** | Commercial bank's Perceptions of financial Regulations |
| **SECTION E** | **PART 1** | Lending practices of Commercial banks |
| | **PART 2** | Credit conduct of Commercial banks |

Detailed definition of the terms and technical words has been given at the end of the questionnaire.

If you have any specific problems in answering the questionnaire, please contact:
Andrew E Kambalame on **09 99 943 071/ 01 876 222 or aekambalame@yahoo.com**

**Results of Survey**

The results of this survey will assist the researcher to analyse the impact of financial regulations on lending practices of Commercial banks in Malawi. Any published results will not identify the responses of any specific individual.

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**SECTION A**

**PART 1**

**BACKGROUND INFORMATION.**

1. Which of the institution below are you currently working for?

   Commercial Bank ☐

   Reserve Bank ☐

   Audit Firm ☐

   Other, please specify…………………………………………….

2. What is your present position and how long have you held the position?

   ……………………………………………………………………………………………………
   ………………………………………………….

3. The information that will be provided, will relate to the following Commercial bank (s).

   National Bank ☐

   Standard Bank of Malawi ☐

   First Merchant Bank ☐

   NBS Bank ☐

   Malawi Savings Bank ☐

   Other (s), please specify

   ……………………………………………………………………

## SECTION B

Questions in Section B are concerned with information about tactical and lending techniques which are known by yourself.

**Tactical and strategic lending techniques**

**PART 1**

**LOAN SECURITISATION**[i]

1. Has your bank/ any Bank ever securitised its loan portfolio between the period of 1990 to 2008? ☐ **YES** ☐ **NO**

2. Which of the following bank(s) below have ever securitised its portfolio between the period of 1990 to 2008?

   National Bank ☐

   Standard Bank of Malawi ☐

   First Merchant Bank ☐

   NBS Bank ☐

   Malawi Savings Bank ☐

   Other (s), please specify……………………………………………

   None ☐

3. What types of assets were securitised?

   On-balance sheet assets ☐

   Off-balance sheet assets ☐

4. What was the type and tenor of products that were securitised?

   Asset backed securities with a term of less than 12 months ☐

   Asset backed securities with a term of

more than 12 months ☐

Other (s), please specify…………………………………………...
…………………………………………………………………...……………………
……………………………………………..

5. The securitisation process was due to the following reasons.

To improve the capital ratio of the bank ☐

To improve bank's liquidity ☐

To reduce portfolio growth ☐

To mitigate or solve non-performing loan problem ☐

**PART 2**

**<u>LOAN SYNDICATION</u>**

1. Has your bank or any bank ever participated in loan syndication between the period of 1990 to 2008? ☐ **YES** ☐ **NO**

2. Which of the following bank(s) below have ever participated in loan syndication between the period of 1990 to 2008?

National Bank ☐

Standard Bank of Malawi ☐

First Merchant Bank ☐

NBS Bank ☐

Malawi Savings Bank ☐

Other (s), please specify……………………………………………

None ☐

3. The loan syndication process was done due to the following reasons.

To meet a large loan request by the bank customer ☐

Due to Reserve Bank's concentration limit ☐

Other (s), please specify…………………………………………………………………….

…………………………………………………………………………………………

…………………………………………………………………………………………

**PART 3**

**OFF-BALANCE SHEET ITEMS**

1. Does your bank have the following claims?

| | |
|---|---|
| Guarantees | ☐ |
| Letters of credit | ☐ |
| Lines of credit | ☐ |
| Operating lease | ☐ |

2. Has the bank or any bank ever entered into a contingent liability claim due to financial regulations? ☐ **YES** ☐ **NO**

3. If yes, do you think introducing the Basle Accord will lead to increase/decrease of the following?

| | **Increase** | **Decrease** |
|---|---|---|
| Guarantees | ☐ | ☐ |
| Letters of credit | ☐ | ☐ |
| Lines of credit | ☐ | ☐ |
| Operating lease | ☐ | ☐ |

4. Will the introduction of Basle accord lead to introduction of other off-balance sheet items? ☐ **YES** ☐ **NO**

5. If yes, please specify………………………………...………………………………………

…………………………………………………………………………….………………………

…………………………………………………………………………..……………..

**PART 4**

**ON-BALANCE SHEET ITEMS**

1. The following answers in PART 4 relate to the following Commercial bank (s).

National Bank ☐

Standard Bank of Malawi ☐

First Merchant Bank ☐

NBS Bank ☐

Malawi Savings Bank ☐

Other (s), please specify

…………………………………………………………………………

2. If the Basel II accord is introduced, will it lead to decrease of loan portfolio (credit crunch) of the bank?

☐ **YES** ☐ **NO**

3. If yes, will the introduction of the Basel II Accord lead to increase/decrease of the following.

| | **Increase** | **Decrease** |
|---|---|---|
| Short-term loans | ☐ | ☐ |
| Medium term loans | ☐ | ☐ |
| Long-term loans | ☐ | ☐ |

4. If the Basel II Accord is introduced, will it lead to cyclicality in lending behaviour of Banks in Malawi?

☐ **YES** ☐ **NO**

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## SECTION C

Questions in Section C are concerned with the implications of financial regulations on lending practices of Commercial banks in Malawi.

**PART 1**

### IMPLICATIONS OF FINANCIAL REGULATIONS ON LENDING PRACTICES

1. How has your bank increased its capital base over the years from 1990 to 2008?

By increasing retained earnings ☐

By increasing undistributable reserves ☐

Through increase in share capital
– IPO or rights issue ☐

2. Do financial regulations encourage the following in your bank?

Increase of high risk-weighted assets ☐

Decrease of low risk-weighted assets ☐

Loan composition of collateralised assets versus uncollateralized assets ☐

Accelerated disposal of bad loans ☐

3. In your own opinion, does change in Bank capital (Tier 1 and Tier 2) influence the following.

Change in credit amount offered to customers ☐

Increase in loan amount due to increase in Bank capital ☐

Decrease in loan amount due to decrease in Bank capital ☐

4. Has your bank ever shifted from asset holding portfolio to Government securities? ☐ **YES** ☐ **NO**

5. If yes, was the shift a result of the following?

To ease associated regulatory burden ☐ **YES** ☐ **NO**

To reduce risks as quality of portfolio assets weakened ☐ **YES** ☐ **NO**

To benefit from high earning returns versus associated risks ☐ **YES** ☐ **NO**

Other (s), please specify

…………………………………………………………………………….

## SECTION D

Questions in Section D concerns Commercial bank's perception of financial regulations in Malawi.

**PART 1**

**COMMERCIAL BANK'S PERCEPTION OF FINANCIAL REGULATIONS**

1. Has financial regulations assisted in hedging the occurrence of the following?

   Credit risks ☐

   Systematic risks ☐

   Interest rate risks ☐

   Please explain how they have hedged any of the risk (s) above.

   ………………………………………………………………………………………………

   ………………………………………………………………………………………………

   ………………………........

2. Has financial regulations managed to control the occurrence of bank failure in Malawi?

   ☐ **YES** ☐ **NO**

3. If yes or no, please briefly explain.

   ………………………………………………………………………………………………

   ………………………………………………………………………………………………

   ………………………………………………………………………………………………

4. Do financial regulations control the Commercial bank's appetite for excessive risks?

   ☐ **YES** ☐ **NO**

5. If yes or no, please briefly explain.

   ………………………………………………………………………………………………

   ………………………………………………………………………………………………

   ………………………………………………………………………………………………

6. Does your bank follow risk management guidelines issued by Reserve Bank of Malawi?

   ☐ **YES** ☐ **NO**

7. Do you think risk management guidelines as issued by Reserve Bank of Malawi influence banks to manage the following?

Unwarranted competitive pricing to improve
loan portfolio ☐ YES ☐ NO

Composition of long-term versus short-term maturing
assets ☐ YES ☐ NO

Accelerate risk management in the bank on
Consolidated basis ☐ YES ☐ NO

8. Does your bank follow Asset Quality Directive as issued by Reserve Bank of Malawi?
☐ YES ☐ NO

9. Does the Asset Quality Directive influence the behaviour of your bank in the following ways?

Loan restructuring and loan
work-out ☐ YES ☐ NO

Stimulate collection of
loan repayments ☐ YES ☐ NO

10. Do financial regulations influence the lending behaviour of Commercial banks in the following?

Credit allocation ☐ YES ☐ NO

Loan amount ☐ YES ☐ NO

11. Does following Directive on large loan exposures impact the bank in the following?

Diversifying in lending activities between large and small corporate clients
☐ YES ☐ NO

12. In your own opinion, does following Directive on large loan exposures limit vulnerability of low capitalised banks
☐ YES ☐ NO

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**SECTION E**

Questions in Section E concern Commercial banks lending practices in Malawi.

**PART 1**

**LENDING PRACTICES OF COMMERCIAL BANKS IN MALAWI**

1. Do financial regulations control the occurrence of the following lending practices in commercial banks?

| | | |
|---|---|---|
| Sub-prime lending [ii] | ☐ YES | ☐ NO |
| Predatory lending [iii] | ☐ YES | ☐ NO |

**PART 2**

**CREDIT CONDUCT OF COMMERCIAL BANKS**

1. Does your bank conduct itself in the following manner?

| | | |
|---|---|---|
| Offer prime interest rate to prime customers | ☐ YES | ☐ NO |
| Offer prime interest rate to Uncreditworthy customers | ☐ YES | ☐ NO |
| Offer above prime interest rate to customers with no credit record | ☐ YES | ☐ NO |
| Charge above prime interest rate on loans that are not secured | ☐ YES | ☐ NO |

2. Does your Bank apply the following terms and conditions in loan agreement?

| | | |
|---|---|---|
| Balloon repayment of loans with term Of less than 5 years | ☐ YES | ☐ NO |
| Increased interest rate in the event of default | ☐ YES | ☐ NO |
| Charge penalties on Prepayment of loans | ☐ YES | ☐ NO |
| Other hidden costs | ☐ YES | ☐ NO |

3. Does your bank extend loans based on value of security offered?

☐ YES ☐ NO

4. If yes, what percentage of loan is disbursed based on value of security?

……………………………………………..…………………………………………….

***Thank you for your time in answering the questionnaire.***

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Notes.

[i] Loan Securitization involves pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors.
[ii] Sub-prime lending involves lending to borrowers who do not qualify for 'prime' rates.
[iii] Predatory lending is where the party that initiates the loan often provides misinformation, manipulates the borrower through aggressive sales tactics and/or takes advantage of the borrower's lack of information about the loan terms and their consequences. The results are onerous terms and conditions that the borrower often cannot repay.