

**EFFECTS OF INFLATION ON LOAN REPAYMENT BEHAVIOUR IN KENYAN
BANKS: A CASE STUDY OF HABIB BANK A.G. ZURICH 2014**

BY

SIMON KIARIE MURIGI

UNITED STATES INTERNATIONAL UNIVERSITY

SUMMER 2014

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SIMON KIARIE MURIGI

**A project Report Submitted to the Chandaria School of Business in Partial
Fulfillment of the Requirement for the Degree of Executive Masters in
Organizational Development (EMOD)**

UNITED STATES INTERNATIONAL UNIVERSITY

SUMMER 2014

STUDENT'S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University in Nairobi for academic credit.

Signed: _____ **Date:** _____

Simon Murigi (I.D. NO 640562)

This project has been presented for examination with my approval as the appointed supervisor.

Signed: _____ **Date:** _____

Francis Gatumo

Signed: _____ **Date:** _____

Dean, Chandaria School of Business

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ABSTRACT

The purpose of this research was to determine-the effects of inflation on loan repayment behaviour. The research was guided by the following research questions: (i) What are the effects of inflation on loan repayment behaviour? (ii) To what extent is inflation connected to defaults in payment of loans? (iii) How does inflation contribute to changes in loan repayment?

A correlation research design was used to conduct the study. A sample of 30 employee of at Habib Bank AG Zurich was collected. Simple random sampling technique was used in this study. The primary data was collected using structured questionnaires. The data was analyzed using descriptive and inferential statistics. Descriptive statistics involved the mean while inferential statistics involved the calculation of the correlation coefficient in order to identify the relationships amongst the independent and dependent variables. The tool used to analyze and present the results in figures and tables were SPSS and Excel software.

Three conclusions were drawn from the findings of this study. First, inflation effects behaviour and in our case loanees loan repayment behaviour .Second, that negative impact of high inflation rates on loan repayment .Third ,that inflation does indeed have an impact on loan repayment .

According to the findings, the study concluded that changes in inflation affected loan repayment behaviour, clients were not able to repay loans which lead default if no intervention was introduced. There was behavioural change that was necessitated by the external forces that were beyond the clients and the banks control.

Based on the findings, study was able to establish that there is a correlation between inflation and loan repayment. In times of high inflation loan repayment capabilities are at times impaired and hence banks should be able to adjust repayment period of the borrowers affected to avert default.

The study further lead to the conclusion that inflation affected loan repayment, clients payments were affected positively on low inflation and negatively on high inflation rates which lead to default.

Since inflation affects loanees behaviour towards loan repayment, both the client and the bank should keep an eye on the inflation rates and should be able to predict movement. The client can hedge against inflation impact by agreeing on a flat rate with the lender and or requesting for an extension of the repayment period to ease the financial strain and hence be able to sustain or reinforce good repayment behaviour. The bank can as well elicit the help of Credit reference bureau and other debt collection agencies to help positively reinforce the loan repayment behaviour.

The study recommended that since there was a direct correlation to changes in inflation and loan repayment behaviour, Keep an eye on the inflation rate. It was important for banks and borrowers to keep an eye on inflation and come up with measures that are mutually favourable.

Rescheduling payment would save the bank from loss of money through default, extra provisions for loan defaults, cost of following up the defaulters. The bank should following up with the borrower, monitoring the repayment behaviour so as to identify default tendencies before it is too late (before default) and the strategy should recommended default mitigation mechanisms.

The borrower should be in a position to assess the impact of inflation to disposable income and incase of difficulties meeting loan repayment obligations request the bank for a reasonable repayment schedule.

Another recommendation was to keep track of inflation on a month to month basis with the aim of helping Habib bank AG Zurich and the borrowers know the likelihood of hard economic times and hence help both the lender and the borrower plan ahead. The lender can begin preparing to make provision as a prudent measure so that when the actual default happens it doesn't have to strain the banks bottom line. HBZ should upon sighting signs of high inflation begin to closely monitor the borrower and in some cases suggest rescheduling to the borrower to avoid making extra provision where the shareholders are sensitive on the profits of the banks. The benefit of planning ahead to the borrower would be better credit history. The recommendations should be agreeable to both HBZ and the borrower (Loanee).

On loan the impact of inflation on loan repayment, the study recommended that Habib bank AG Zurich should formulate strategies on what should be done in times of high

inflation which should include following up with the borrower, monitoring the repayment behaviour so as to identify default tendencies and the strategy should recommended default mitigation mechanisms. Some of the strategies include conservative lending, security perfection, timely period review and monitoring and adequate provisions in line with CBKs prudential guidelines. Business and corporate clients that have been borrowed for the business should be required on an annual basis to submit audited financial statements; these would help the bank in monitoring and evaluation of the business.

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This study would not have been successfully completed without the help of various people. Their guidance, encouragement, motivation and assistance was critical in making this project a success.

Thanks to God almighty for motivating me to pursue a Master degree and providing every resource needed. To His name be praise.

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I am equally indebted to all the staff of Habib Bank A.G Zurich who had to bear with erratic and odd hour's consultations that were necessary for the completing of this study.

To you all, I say, may the Almighty God richly bless you!

DEDICATION

This work is dedicated to my family and my special friend Esther, for standing with me and their words of encouragement and motivation while undertaking this challenging task.

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ABBREVIATIONS

- CBK** - Central Bank of Kenya
- GDP** - Gross Domestic Product
- HBZ** - Habib Bank AG Zurich
- MF** - Micro- Finance
- CRB** - Credit reference bureau
- SPSS** - Statistical Package for Social Sciences

CHAPTER ONE

INTRODUCTION

1.0 Introduction

This chapter contains the background of the study, profile of Habib Bank AG Zurich, statement of the problem, the purpose of the study, research questions, and significance of the study, justification and scope of the study.

1.1 Background to the study

In the last ten years, the banking sector in Kenya has metamorphosed into an innovative and responsive industry that is lead by market needs. Hitherto, banks were an authority unto themselves. Their products were not customer focused or inclusive. Consequently, banking was a preserve of the well to do in the society. It has been so for many decades. Today, there is a bank around the corner in urban and peri-urban areas be it real brick and mortar branch or an agent. To enhance financial inclusivity, players have partnered with other service providers to ensure the banking services are a text away on a mobile phone.

According to a banking survey (2013), the industries bread and butter, interest income on loans and advances constituted more than 60 percent of the industry's total income. Interest income on loans grew by over 50 percent in 2013 to Kshs.216 billion up from Kshs.142 billion. This was a reflection of the rising base lending rates on loans despite the Central Bank's rate gradually coming down. Overall, loanees were not deterred from borrowing even as the cost of borrowing went up.

According to Ray and Karl (1989), if people are not fully informed on what is happening with the economy during inflation or do not understand what is happening to prices in general, they make mistakes in their business dealings and these can lead to misallocation of resources. With loan charges increasing, loan repayment is adversely affected. During this time, the money at hand for disposal purposes is much lesser with the increase in prices so there is a likelihood some of the borrowers will be experiencing difficulties while repaying

Inflation and its related uncertainty can impose costs on real economic output as it makes the price mechanism a less effective apparatus in allocating resources efficiently (Friedman (1977); Payne (2008); Rahman and Serletis (2009)). For the emerging markets,

these costs may be higher than those in developed economies as inflation is still higher than desired in many of these markets. In particular, the population in the lower income strata may find it difficult to hedge against the costs of rising prices and inflation when combined with other distortions such as misaligned nominal exchange rates (Miles and Schreyer, 2009).

Lawrence (1995), when the U.S dollar raises, one dollar bill buys less each year thus meaning an ongoing fall in the overall purchasing power of monetary unit. Many individuals have little or no knowledge regarding inflation especially how it impacts on them and the country's economy. The state of a country's economy may be deteriorating but the cause may be unknown to many of its citizens. Inflation is a rise in the general level of prices of goods and services in an economy over a period of time. If the general price level rises, each unit of the functional currency buys fewer goods and services which consequently define inflation as a decline in the real value money because of the loss in purchasing power. It can also be referred as too much currency in relation to the physical volume of business being done in an economy.

Milton (1992) famously proclaimed "Inflation is always and everywhere a monetary phenomenon. "What he meant was that sustained inflation has historically always been due to sustained money supply growth, not to sustained velocity growth or sustained negative growth in real income. The occurrence of inflation does not always imply the downfall of an economy not unless a country failed to put up measures to protect itself from the effects, Inflation affects the economy as a whole and mostly in a negative way. Hyper inflation in the words of Keynes is the full inflation in the sense that it is the final stage of inflation.

According to Carlos and Christopher (2012), Young cohorts have few assets and wages are the main source of income. Old generations work less and prefer a high rate of return from their savings. When the government has access to lump-sum taxes and transfers, redistributive policy need not resort to distortionary measures (such as capital taxes or inflation). When lump-sum transfers are not possible but the planner is allowed to use inflation or deflation to achieve as much of the redistribution as possible, there exists a competitive equilibrium with a constrained efficient redistributive policy. The equilibrium requires optimal distortions on relative prices that are necessary to achieve the constrained efficient allocation.

When the old have more influence over this redistributive policy, the economy has a lower steady-state level of capital, a higher steady-state real rate of return, and a lower or negative rate of inflation. By contrast, when the young have more influence, the economy has more capital than the efficient level, wages are relatively high, and the market solution requires a low rate of return from money holdings—that is, a relatively high inflation rate.” (St Louise Fed President, Carlos and Christopher 2012)

James A.G (1881) The 20th President of the United States who lasted only 100 Days, two weeks before he is assassinated stated that whomsoever controls the volume of money in any country is absolute master of all industry and commerce and when you realize that the entire system is very easily controlled, one way or another, by a few powerful men at the top, you will not have to be told how periods of inflation and depression originate.

Price inflation greatly affects time value of money. It is a major component of interest rates which are at the heart of all time value of money calculations. Actual or anticipated changes in the inflation rate cause corresponding changes in interest rate to compensate for the fact that inflation will erode the value of their money over the term of the loan (Benjamin and Miller, 2004).

Henry H (2008) stated that mere inflation—that is, the mere issuance of more money, with the consequence of higher wages and prices—may look like the creation of more demand. But in terms of the actual production and exchange of real things it is not.

According to (Mishkin and Collins, 1995) inflation lenders or depositors who pay a fixed rate of interest on loans or deposits will lose purchasing power from their interest earnings while their borrowers benefit. A positive effect of inflation is derived from debt relief where debtors who have debts with a fixed nominal rate of interest will see a reduction in the real interest rate as the inflation rate rises. The "real" interest on a loan is the nominal rate minus the inflation rate. Therefore if one takes a loan, with an interest rate of 15% and the inflation rate is at 5% the real interest rate that one will pay for the loan is 10%. Banks and other lenders adjust for this inflation risk either by including an inflation premium in the costs of lending the money by creating a higher initial stated interest rate or by selling the interest at a variable rate.

According to Clayton (1995) businesses adjust their spending habits since business loans are being charged higher interest rates forcing factories to reduce cost of borrowing. Currently a number of factories have laid off workers as a result of decline in the goods/services being offered. If businesses do not do so, it means that loans acquired will be costly and some may end up being taken over by the banks as they are not in a position to service their loans.

Hardwick (1990), states that the cost push theory is another point of view causing inflation. If costs are on the increase in a country, households will search for the most favourable priced goods while firms have to incur cost of determining the new prices and disseminating the information. With loans becoming expensive, it may be strenuous to these firms when it comes to repaying the loans.

1.1.1 Profile of Habib Bank AG Zurich

Habib Bank AG Zurich is family bank incorporated in Zurich Switzerland offering diversified financial services group. The global bank provides corporate, personal, private and correspondent banking products as well as offering highly personalized service through international network of branches, subsidiaries and affiliates. Habib Bank AG Zurich has a group network in United Arab Emirates, United Kingdom, Pakistan, South Africa, Canada, Isle of Man, Hong Kong and Kenya. (HBZ 2014)

The bank has a long history of banking experience since 1967. Traditional banking values set in the context of international banking has determined HBZs corporate philosophy “service with security” for the 45 years the bank has been in operation. The Kenyan operation was established in 1978 with the first branch being in Nairobi. The Kenyan operation expanded to Mombasa and further set up two more branches in Nairobi that bring the total bank branches to 4 as at 2014. (HBZ 2014)

1.2 Research Problem Statement

Kenya statistics shows that inflation had been on the rise hitting a roof mark of 29.4% in November 2008 up from 28.4% in October same year. Inflation rate dropped to 20.50% in September 2010 from 26.30% in December 2009. However the latest month’s statistics

show that inflation rate has dropped to 7.76% in October 2013 from 8.29% in September 2013. Lending has become quite costly as lenders have resulted to increasing interest rate as compensation for the decrease in the purchasing power of money they will be repaid in the future.

Low and stable inflation refers to a price level that does not adversely affect the decisions of loanees' and producers. Price stability is a precondition for achieving a wider economic goal of sustainable growth and employment. High rates of inflation lead to inefficiency in a market economy and, in the medium to longer term, result in a lower rate of economic growth. Movements in the general price level are influenced by the amount of money in circulation, and productivity of the various economic sectors. The Central Bank of Kenya regulates the growth of the total money stock to a level that is consistent with a predetermined economic growth target as specified by Kenya Government and outlined in its Monetary Policy Statement

Roshaneh (2008) indicated that the profit spread of borrowers is affected with the rise in prices as a result of inflation which consequently affects their borrowing power. Overall, repaying of loans by the borrower will be costly thus straining their available financial resources in the prevailing economic conditions which may cause some to default in payments. If this impact on loan repayment is overlooked, banks are likely to incur debts due to default in payments by the borrowers so there is the need to understand the impact inflation has on loan repayment behaviour and this is the problem being solved. This research therefore sought to fill this gap by undertaking a study on the same.

1.3 Purpose of the Study

The purpose of the study is to determine the effects of inflation on loan repayment behaviour in Kenyan Banks. A case of Habib Bank AG Zurich.

1.4 Research Questions

In order to achieve the above stated purpose, the study seeks to answer the following research questions: (i) What are the effects of inflation on loan repayment behaviour? (ii) How is inflation connected to defaults in payment of loans? (iii) How does inflation contribute to changes in loan repayment?

1.5 Significance of the study

1.5.1 Borrowers

The borrowers of credit will understand why during inflation they need to watch the amounts of loan they acquire to avoid their property from being attached, so as to repay the loans they take. The borrowers of credit will also understand when they should take up credit to avoid defaulting.

1.5.2 Micro Finance Institutions

Help micro finance institutions understanding how the clients' ability to repay is affected, the micro finance can make more informed decisions in all inflation scenarios.

1.5.3 Researchers

Add new knowledge to already existing statistics and research by study and answering the research questions.

1.6 Scope of the study

The study was conducted only within Habib Bank AG Zurich Kenya that is a branch of a family owned bank incorporated in Switzerland and has its head office in Zurich Switzerland. The study was conducted in two months from February 2014 to March 2014. The study was conducted within Kenya operations within the three branches in Nairobi and one branch in Mombasa and targeted staff who were either in credit and risk department or had credit departments experience. Other parts of the areas in the world that HBZ operates have relatively stable inflation rates that can be predicted of even over five years in some areas.

1.7 Definition of Terms

1.7.1 Inflation

This is a persistent increase in the general price level of goods and services in an economy in a period of time.

1.7.2 Loan default

Default in simple terms is failure to honour an obligation that is due. In Finance default occurs where a debtor has not met his or her financial obligation according to the debt contract.

This study sought to assess the effects of Human Resource Management Practices on employee retention. It therefore gave an introduction and a Background to the Study. The study gave a profile of British American Investments limited. A Statement of the Problem was given and the specific objectives spelt out as the following: To establish how career development in an organization impacts on retention of employees in BRITAM, To establish how recruitment and selection procedures influence retention of employees in BRITAM and To determine the extent to which performance appraisal system affects employee retention in BRITAM. The various beneficiaries of the study were discussed, and the operational definition of terms was given.

1.8 Chapter Summary

The study's intent was to show the impact of inflation on loan repayment behaviour as well as identify whether there was a correlation between inflation and loan default. It therefore gave an introduction and a Background to the Study. The study gave a profile of Habib Bank AG Zurich .A statement of the problem was given and the specific objectives spelt out as the following: To establish are the effects of inflation on loan repayment behaviour, To establish how is inflation connected to defaults in payment of loans and To determine the extent to which inflation contributes to changes in loan repayment. The various beneficiaries of the study were discussed and the operational definitions of terms were given. The next chapter provides literature review of the research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter comprises of the literature review which covered recent research on inflation and its effects on cost and behaviour. Inflation describes the rising level of prices in a narrow set of assets goods or services. When prices continue to creep upward, usually as a result of overheated economic growth or too much capital in the market chasing too few opportunities, the wages creep upwards, also, so that companies can retain good workers. The chapter also discussed issued of interest rates, connection of inflation to loan repayment default. Unfortunately, the wages creep upward, .more slowly than do the prices, so that our standard of living can actually decrease. Inversely, the ability of borrowers to repay the loans they have acquired is affected as a result of the standard of living increased since one has to pay more and more for the same loans, services. Kimberly (2009).

2.2 Effects of Inflation on loan repayment behaviour

Inflation is a process of continuously rising prices, or equivalently, of continuously falling value of money (Laidler and Parkin, 1975). According to Helmut F.(1984) how to formulate the relationship between the change in expectation and the disturbance of the equilibrium the use of the concept of elasticity of expectation, or the relationship between the percentage change in the expected value of a variable and the percentage change in the actual value of a variable and the percent change in the change actual value of the same variable. Hick (1946) says that he defines the elasticity of a particular person's expectations of the price of commodity X as the ratio of the proportional rise in the expected future prices of X to the proportional rise in its current price.

The so-called monetarist debate has provided a critical analysis of the foundations of macroeconomics. The discussion reached a peak at the beginning of the 1970s in Milton Friedman's two articles "A Theoretical Framework for Monetary Analysis" (1970a) and "A Monetary Theory of Nominal Income" (1971) as well as in the theoretical debate

surrounding them. In addition, the writings of K. Brunner (1970), K. Brunner and A.H. Meltzer (1976), A. Meltzer (1977), H.G. Johnson (1972a), D.E.W. Laidler (1975a, 1976, 1981), and M.J. Parkin (1975) have significantly contributed to the formulation and popularization of monetarism as a macroeconomic theory. In these monetarist works the explanation of inflation has played a central role. Although these authors applied different theoretical approaches, three hypotheses continually reappear in their works: (a) Inflation is in essence a monetary phenomenon (b) Keynesian theory, which monetarists equate with a Phillips curve without adjustment for expectations, cannot explain the problem of inflation especially the acceleration of inflation. (c) The rate of growth and the acceleration of the money supply explain altogether the rate of inflation and its acceleration.

“Monetarism” (an expression Karl Brunner coined) contends to be more than just a theory of inflation, however. It can be conceived as an attempt to establish an alternative theoretical macroeconomic paradigm to the Keynesian view.

2.2.1 Behaviour

Behaviour can be defined as the action or reaction of something (as a machine or substance) under specified circumstances. (Online Dictionary). It can also be defined as the way a person behaves towards other people, the sum of responses or movements made by an individual in any given situation, the manner of acting or controlling yourself. Exforsys defines behaviour as a set of responses coming from vital emotions specific to a person. People behave differently in different situations: others will behave well and others will not behave well.

2.2.1.1 Theories of Behaviour Change

2.2.1.1.1 The social Cognitive Theory

It states that people are driven by inner forces and not external factors. Therefore, the way a human functions can be explained by a triadic interaction of factors that are environmental, personal and behaviour too. Environmental factors can be situational influences in which behaviour is preformed, personal factors could be traits, self drives instincts etc. There are some variables that help in the process of behaviour change, they

include: Self Control, Self Efficacy, Outcome Expectations and Reinforcements. (Bandura, A. (1986). Self control: This is how an individual is able to control their behaviour. Self Efficacy: One's ability to perform the behaviour, outcome Expectations: These are likely consequences that a behaviour will produce and the importance of these expectations and reinforcements: This is something that may decrease or increase the continuity of a behaviour.

2.2.1.2 The Planned Behaviour Theory

It suggests that one's behaviour is directly dependent on one's intention to perform the behaviour. An intention is determined by an individual's beliefs and values about the outcome of the behaviour and also what others think that one should do. Behaviour is determined by an individual's perception of their capability to perform behaviour. This is highly dependent on the nature of the situation.

Behaviour is linked to one's personal motivation. This implies that it's important that positive information shapes positive behaviour and its stresses on norms and opinions that support behaviour. Therefore, a person perceives the ability to perform the behaviour. (Grizzell, J. (2007, 1/27/2007).

2.2.1.3 The Trans theoretical Theory

It proposes change as a process of six steps. One is the stage where people are not planning to change, at least not in the near future also known as the precontemplation stage. Then followed by the contemplation stage where people have the intention of changing in the near future e.g. 6 months. It is at this stage that people are becoming aware of the benefits of changing and not changing. The third stage is the preparation stage where the people have an action plan intended for the immediate future e.g. a month. Fourthly is the action stage where people make the behaviour change and are closely followed by the fifth, maintenance stage where the individuals work to prevent a relapse. Finally is the termination stage, here the people have full control of their behaviour (Zanna, M. P., & Rempel, J. K. (1988)

2.2.2 Cost of Loan

Cost of loan simply refers to the interest rate charged on loans. Mike (1999) explained interest rate as the yearly price charged by a lender to a borrower in order for the borrower to obtain a loan, which is usually expressed as a percentage of the total amount loaned.

2.2.3 Cost of Inflation

Inflation reduces economic well-being. There are numerous sources of the costs to inflation. Price inflation imposes menu costs (the cost of changing prices), shoe leather costs (the costs of reducing monetary holdings), increased uncertainty among producers and consumers trying to determine the real costs of goods and services, tax distortions, and the cost of adjusting to unexpected changes in inflation. Unexpected inflation redistributes money from creditors to debtors and from employees to employers. In the case of hyperinflation, it can easily wipe out the value of financial assets. This leads to reduced investment and lower economic growth. Variable inflation rates create uncertainty that affects the level of economic output.

All of these inflationary problems result from price inflation of goods and services. Another inflationary problem that is often ignored is asset-price inflation in the stock market, real estate market, or other areas. Asset inflation creates artificial wealth, encouraging firms and consumers to borrow beyond their capacity. When the asset inflation ends, firms and individuals are unable to pay their debts leading to declines in demand and to economic slowdowns. The United States in the 1930s and Japan in the 1990s are examples of this problem. Asset inflation is deceptive because people feel wealthier when it occurs, but when asset values get out of line with the nation's productive capacity, there will be an inevitable period of "catch up" in which asset prices adjust downward to their real levels. Both price and asset inflation have their costs.

2.2.4 Importance of Interest Rates

If a government desires to increase its money supply, it may do so through its Central Bank. For instance, Benjamin (2004) clearly showed that the Federal Reserve System ("Fed"), the central bank of the U.S., does not publicly target a goal for the inflation rate. Instead, they announce goals for the Federal Funds Rate that is the interest

rate at which banks lend their excess reserves to one another. When the Fed wants to increase the money supply and thereby stimulate the economy, they publicly announce that they intend to lower the Fed Fund Rate. As banks compete for customers for these new loans, short term interest rates will tend to fall toward the Fed Fund goal. With credit readily available at low interest, loanees' will tend to take out more loans for high-end goods such as homes and cars, and businesses will invest more in facilities and employ more workers to meet the demand.

2.2.5 Base Rate

This is the rate of interest used by a bank as a basis for its lending rates. According to Collins (2006), it is the minimum rate at which banks are prepared to lend money and altered by the Central Bank. It forms the benchmark for all other interest rates. The base rate will be increased or decreased to suit the current economic condition facing a country. The Central Bank of Kenya through the monetary policy committee indirectly regulates the lending rates by determining the lending rates to commercial banks a rate referred to as the central bank rate (CBR). For instance, an article by the Central Bank of Kenya (2013) stated that Kenya's Central Bank revised its base lending rate to Commercial Banks downwards to 8.5% from 10% in a move to effectively reduce inflationary pressure and stabilize the financial markets. In January 2014 when the MPC met, they retained the rate at 8.5% (14th January 2014 MPC press release). Being the rate of interest on which financial institution base their lending, it is used to set all other rates of interest.

2.2.6 Normal Interest Rates and Real Interest Rates

Mike (1999), pointed the fact that when people discussed interest rates, they were generally talking about nominal interest rates and he further differentiated between nominal and real interest rate. A nominal variable, such as a nominal interest rate, is one where the effects of inflation have not been accounted for. Changes in the nominal interest rate often move with changes in the inflation rate, as lenders not only have to be compensated for delaying their consumption, they also must be compensated for the fact that a dollar will not buy as much a year from now as it does today. Real interest rates are interest rates where inflation has been accounted for.

2.2.7 Inflation and Interest Rates

Keynes (1930) stated that if Investment exceeds Saving, there will be inflation. If Saving exceeds Investment there will be recession. One implication of this is that, in the midst of an economic depression, the correct course of action should be to encourage spending and discourage saving. This runs contrary to the prevailing wisdom, which says that thrift is required in hard times. In Keynes's words, "For the engine which drives Enterprise is not Thrift, but Profit."

Keynes took issue with Say's Law - one of the economic "givens" of his era. Say's Law states that supply creates demand. Keynes believed the opposite to be true - output is determined by demand.

Keynes continued to argue that full employment could not always be reached by making wages sufficiently low. Economies are made up of aggregate quantities of output resulting from aggregate streams of expenditure - unemployment is caused if people don't spend enough money.

In recessions the aggregate demand of economies falls. In other words, businesses and people tighten their belts and spend less money. Lower spending results in demand falling further and a vicious circle ensues of job losses and further falls in spending. Keynes's solution to the problem was that governments should borrow money and boost demand by pushing the money into the economy. Once the economy recovered, and was expanding again, governments should pay back the loans.

Economically and socially successful economies have significant contributions from both the government and the private sectors.

Keynes's view that governments should play a major role in economic management marked a break with the laissez-faire economics of Adam Smith, which held that economies function best when markets are left free of state intervention.

Keynes (1930) writing in the Nation newspaper stated that the fact is - a fact not yet recognized by the great public - that we are now in the depths of a very severe international slump, a slump which will take its place in history amongst the most acute

ever experienced. It will require not merely passive movements of bank rates to lift us out of a depression of this order, but a very active and determined policy.

As a report by Bank of England (2008) puts it, interest rates have to be set based on what inflation might be over the coming years. This is because after a recession, when output has been falling, there will be plenty of spare capacity in the economy based on the fact - output will be able to rise quite strongly without generating inflationary pressure.

Pierre (2001), explained that changes in bank rate are often used by Central Banks to control the money supply. A change in the official bank rate may have some instant effects for example on loanees' confidence which may influence spending straight away. But more generally, a change in the official bank rate will take time to influence loanees' and firms' behaviour and decisions. Overall, a change in interest rates today will tend to have its full effect on output over a period of about one year, and on inflation over a period of about two years. This is, of course, a very approximate guide.

Monetary policy is the power of the government to control the flow of money in its society. Michael (2006) emphasized in his article that when interest rates are high, the tendency of people is to control their spending and as much as possible stay away from borrowing money. This in turn slows down the movement of money in society. In this sense, monetary policy has to look ahead. Interest rates have to be set based on what inflation might be over the coming two years, not what it is today - though that is a relevant consideration. Policy-makers have to judge what the likely economic developments will be over during that period, in particular what the rate of growth in demand will be relative to tin? growth in supply (output). This is why the Monetary Policy Committee uses forecasts of growth and inflation to help it decide on the right level for interest rates.

2.2.8 Significance of Changes in Interest Rates

When interest rates are changed, demand can be affected in the following way:

2.2.8.1 Spending and Savings Decisions

According to News Watch (2008), a change in the cost of borrowing affects spending decisions. Interest rates will affect the attractiveness of spending today relative to spending tomorrow. An increase in interest rates will make saving more attractive and borrowing less so. This will tend to reduce current spending, by both loanees' and firms. That includes spending by loanees' in the shops and spending by firms on new equipment, for instance investment. Conversely, a reduction in interest rates will tend to increase spending by loanees' and firms.

2.2.8.2 Cash Flow

Choi, Elyasiani and Kopecky (1992), elaborated on the change in interest rates in that this change will alter the firms financing costs which will inversely affect the amount of loan interest and principal payments thus impacting cash flows of the firm. A change in interest rates will affect loanees' and firms' cash flow that is, the amount of cash they have available. For savers, a rise in interest rates will increase the money received from interest-bearing bank and building society deposits. But it will also mean higher interest payments for people and firms with loans-debtors - who are being charged variable interest rates (as opposed to fixed rates which do not change). These include many households with mortgages on their homes. These fluctuations in cash flow are likely to affect spending. Lower interest rates will have the opposite effects on savers and borrowers.

2.2.8.3 Asset Price

As per what Philip (1990) wrote in his book, a change in interest rates affects the value of certain assets, such as a house and share prices. Higher interest rates increase the return on savings in banks and building societies. This might encourage savers to invest less of their money in alternatives, such as property and company shares. Any fall in demand for these assets is likely to reduce their prices. This reduces the wealth of individuals holding these assets, which, in turn, might influence their willingness to spend. Again, lower interest rates have the opposite effect in that they tend to increase asset prices.

2.2.8.4 Exchange Rates

A particular influence on prices comes through the exchange rate. News Watch (2008) stated that a rise in interest rates relative to those in other countries will tend to result in an increase in the amount of funds flowing into the country, as investors are attracted to the higher sterling rates of interest. This will tend to result in an appreciation of the exchange rate against other currencies. In practice, the exchange rate will be influenced both by expectations about future interest rates and any unexpected changes in interest rates. That is because if investors expect interest rates to rise, they may increase the amount they invest in a currency before interest rates actually rise. So there is never a simple relationship between changes in interest rates and exchange rates. Other things being equal, an increase in the value of the pound will reduce the price of imports and, because many imported goods are included in the CPI, this will have a direct influence on inflation. In addition, a higher pound will tend to reduce the demand abroad for goods and services. Any fall in export demand will, in turn, reduce output, as will any shift of domestic spending to imported goods. A reduction in interest rates will tend to have the opposite effect.

2.2.9 Effect of Increased Interest Rates

2.2.9.1 On the Borrower

Most loans are designed in money terms. Charles (1985) explained that borrowers tend to do very well out of inflation because they repay less in real terms than they borrowed. But this is not usually the case since the rates of interests are not high enough to compensate for the rate of inflation. Inflation has been rising over the past months in 2013 and currently, the rate stands at 7.21 % in January 2014.

The level of interest rates has a direct effect on a consumer's ability to repay a loan. For instance, when interest rates are low, people are willing to borrow because they find it relatively easy to repay their debt. During inflation, interest rates are high, people are reluctant to borrow because repayment on loans is more costly. Some loanees' may even find it difficult to meet their existing loan obligations, especially if interest rates increase faster than the rise in a consumer's income. If interest rates rise sharply and stay high for a long period, some loanees' will default on their loans.

2.2.9.2 On the Lender

Lenders are repaid the amounts of money originally lent, which are worth less in real terms if prices have increased in the meantime as a result of inflation. Charles (1985), stated that anyone whose income and assets are fixed in money terms (or whose income and assets increase in money value by less than the rate of inflation) loses as a result of inflations. The case is no different to loans. Hence, higher inflation must largely be offset by equivalently higher nominal interest rates to maintain the equilibrium real interest rate (David, Stanley & Rudiger, 1984).

Cochrane (2007) has strongly questioned the basic economic logic of current mainstream monetary policy analysis, arguing that the standard notion --that "determinacy" of a rational expectations (RE) equilibrium suffices to imply that stable inflation behaviour will be generated -- is incorrect. This is because New Keynesian (NK) models are typically consistent with the existence of RE paths with explosive inflation rates in addition to one or more stable paths that normally do not imply explosions in real variables relevant for transversality conditions. Consequently, the usual logic does not imply the absence of explosive inflation. That result does not, however, justify negative conclusions about NK analysis. For there is a different criterion that is logically satisfactory for the purpose at hand.

This is the requirement that, to be plausible, a RE solution must satisfy the property of least-squares learn ability. Adoption of this criterion, which should be attractive to analysts concerned with actual monetary policy, serves to justify in principle the bulk of current mainstream analysis.

A basic analysis cited by Cochrane is that of Obstfeld and Rogoff (1983), in which a model with medium-of-exchange money tends to rule out paths along which the price level approaches zero but not paths along which the price level explodes.

2.3 The Connection of Inflation to Loan repayment defaults

Default in simple terms is failure to honour an obligation that is due. In finance default occurs a debtor has not met his/her obligations according to the debt contract.

It is widely believed that central banks that are not independent will give in to pressure from politicians who may be motivated by short-run electoral considerations or may value short-run economic expansions highly while discounting the longer-run inflationary consequences of expansionary policies. Consequently, inflation will be sub-optimally high. Indeed, most empirical research focusing on the relationship between central bank independence (CBI) and inflation suggests that average inflation is negatively related to measures of CBI. The aim of this paper is to estimate the extent to which heterogeneity influences the relation between CBI and inflation. We use a random coefficient model with the Hildreth-Houck estimator as suggested by Bryk and Raudenbusch (1992) for some 120 countries in the period 1980 to 2005. We conclude that a heterogeneous model is the appropriate model for estimating the relationship between CBI and inflation. Our evidence suggests that there .We conclude that a heterogeneous model is the appropriate model for estimating the relationship between CBI and inflation. Our evidence suggests that there exists no general significant negative relation between CBI and inflation. CBI has only a significant effect in less than 20% of the countries.

What are the implications of our analysis? We certainly would not conclude that CBI is totally irrelevant. Even though our results suggest that CBI may be less important than generally thought, they also suggest that in various countries CBI is related to inflation. In our view, the major research question for future research is therefore to determine under which circumstances CBI matters.

2.3.1 History of inflation

At first, when prices rise, people say: "Well, this is abnormal, the product of some emergency. I will postpone my purchases and wait until prices go back down." This is the common attitude during the first phase of inflation. This notion moderates the price rise itself, and conceals the inflation further, since the demand for money is thereby increased. But, as inflation proceeds, people begin to realize that prices are going up perpetually as a result of perpetual inflation. Now people will say: "I will buy now, though prices are 'high,' because if I wait, prices will go up still further." As a result, the demand for money now falls and prices go up more, proportionately, than the increase in the money supply. At this point, the government is often called upon to "relieve the money shortage" caused by the accelerated price rise, and it inflates even faster. Soon, the country reaches the

stage of the "crack-up boom," when people say: "I must buy anything now--anything to get rid of money which depreciates on my hands." (Murry N.R 1990)

The supply of money skyrockets, the demand plummets, and prices rise astronomically. Production falls sharply, as people spend more and more of their time finding ways to get rid of their money. The monetary system has, in effect, broken down completely, and the economy reverts to other moneys, if they are attainable--other metal, foreign currencies if this is a one-country inflation, or even a return to barter conditions. The monetary system has broken down under the impact of inflation.(Murry N.R 1990)

This condition of hyper-inflation is familiar historically in the assignats of the French Revolution, the Continentals of the American Revolution, and especially the German crisis of 1923, and the Chinese and other currencies after World War II (George A and Unwin 1937)

A final indictment of inflation is that whenever the newly issued money is first used as loans to business, inflation causes the dread "business cycle." This silent but deadly process, undetected for generations, works as follows: new money is issued by the banking system, under the aegis of government, and loaned to business. To businessmen, the new funds seem to be genuine investments, but these funds do not, like free market investments, arise from voluntary savings. The new money is invested by businessmen in various projects, and paid out to workers and other factors as higher wages and prices. As the new money filters down to the whole economy, and the people tend to re-establish their old voluntary consumption/saving proportions. In short, if people wish to save and invest about 20% of their incomes and consume the rest, new bank money loaned to business at first makes the saving proportion look higher. When the new money seeps down to the public, it re-establishes its old 20-80 proportion, and many investments are now revealed to be wasteful. Liquidation of the wasteful investments of the inflationary boom constitutes the depression phase of the business cycle. (Princeton, N.J, D. Van Nostrand, 1963)

For government to use counterfeiting to add to its revenue, many lengthy steps must be travelled down the road away from the free market. Government could not simply invade a functioning free market and print its own paper tickets. Done so abruptly, few people

would accept the government's money. Even in modern times, many people in "backward countries" have simply refused to accept paper money, and insist on trading only in gold. Governmental incursion, therefore, must be far more subtle and gradual.

Until a few centuries ago, there were no banks, and therefore the government could not use the banking engine for massive inflation as it can today.

According to Murry N.R (1995), during the great boom of the 80's it was thought that inflation was a thing of the past and wise governments had monetary and fiscal policies, structural economic changes and efficient markets all aimed at ensuring that inflation disappeared but inflation didn't disappear but resurfaced back in full force and the depth of recession that it was during the boom in Australia.

2.3.2. Default

2. 3.2.1 Default by the Individuals

Jackson (2008) further indicated that a slowing economy and rising inflation signals trouble to commercial banks as this could lead to many customers being unable to pay their loans. Worst hit are unsecured personal loans, popular with salaried individuals. For the past five years, commercial banks have been on a lending spree, throwing all kinds of credit products at virtually anyone with, a steady income but now with the economy expected to shrink, there are concerns that many borrowers may not be able to repay their loans. As Walter (2006) highlighted, an individual real income is affected by inflation. When the prices of commodities are all increasing, an individual is hard hit when it comes to repayment of debts he had taken. Inflation, it is not easy to find the extra cash needed to pay off the loan as a result of increased cost of living.

2.3.2.2 Default by Firms and Businesses

A number of firms have been carrying out massive layoffs so as to cut the firms expenses in a bid to survive in this tough economic conditions brought by inflation.

Beryl (2006), pointed out that the global economy is in a tough spot caught between sharply slowing demand in many advanced economies and rising inflation everywhere, notably in emerging and developing economies. This means that firms in Kenya having realized their businesses are feeling the impact of inflation results in taking measures to

ensure they do not get entangled in debts with the credit lending institutions. Inflation calls for a change in spending in that a firm is forced to cut down on the loans since their revenues are on the decline. Maureene (2009) wrote on the General Motors case where in September 30th 2008, it had \$16.2 billion at hand, down from \$21 billion at the end of June. It needed \$ 11 billion to pay its monthly bills which included loans taken from banks. To repay these loans so as to clear its debts, the prospects of a forced liquidation rose which pushed the General Motors quest for new federal borrowing.

2.3.3 Causes of default

According to the social cognitive theory on behaviour change, people are driven by inner forces and not external factors. Therefore, the way a human functions can be explained by a triadic interaction of factors that are environmental, personal and behaviour too. Environmental factors can be situational influences in which behaviour is preformed, personal factors could be traits, self drives instincts etc. There are some variables that help in the process of behaviour change, they include: Self Control, Self Efficacy, Outcome Expectations and Reinforcements. (Bandura, A. (1986). Self control: This is how an individual is able to control their behaviour. Self Efficacy: One's ability to perform the behaviour, outcome Expectations: These are likely consequences that behaviour will produce and the importance of these expectations and reinforcements: This is something that may decrease or increase the continuity of a behaviour.

Planned behaviour theory suggests that ones behaviour is directly dependent on ones intention to perform the behaviour. An intention is determined by an individual's beliefs and values about the outcome of the behaviour and also what others think that one should do. Behaviour is determined by an individual's perception of their capability to perform behaviour. This is highly dependant on the nature of the situation.

Behaviour is linked to ones personal motivation. This implies that it's important that positive information shapes positive behaviour and its stresses on norms and opinions that support behaviour. Therefore, a person perceives the ability to perform the behaviour. (Grizzell, J. (2007, 1/27/2007).

Cost of living has significantly risen through the years. According to David, Stanley and Rudiger (1984), higher inflation causes the real money supply to reduce, interest rates

rises and aggregate demand falls with money growth remaining unchanged. This may lead to a certain amount of economic dislocation in that borrowers may find it difficult when repaying their debts to the banks since they are forced to incur more since the same loan they acquired is costly more bearing in mind that the purchasing power has reduced.

2.3.4 Consequences of Default in Loan Repayment

The lender of money is taking a risk that the borrower may not pay back the loan. Thus, interest provides also a certain compensation for bearing risk. Coupled with the risk of default is the risk of inflation. With this, the bank stands to incur massive losses should the borrowers fail to pay their debts. McGillivray (2009) states that inflation affects the buying power of money when it is repaid to the lender. The same amount of money today will be different tomorrow. On a Kshs.1(m) loan at 5% interest the lender will lose money if inflation runs at 10% because the Kshs1.05(m) paid in principal and interest at the end of a year will buy only about Kshs.0.95(m) would have bought when the loan was made. This in unison with the borrower failing to pay the full amount may lead to the bank revenue dropping significantly since debts are not being settled forcing them to claim the borrowers property so as to clear his/her debts. According to Jackson (2008), auctioning property is the last resort and most banks are not willing to travel this road as per the managing director of National Bank. The process involves the bank handing over a defaulter case to a debt collection agency. Upon receiving the case, notification letters are written to the defaulter, while establishing why they are unable to settle the debt. These agencies charge a commission of between 10 and 15 per cent, depending on the amount involved.

2.3.4 Steps taken to deal with default

According to Jackson (2008): banks are putting in place risk management programs. It is in anticipation of this High-risk exposure that banks are not taking chances. According to Adan (2009), Barclays Bank is pursuing a tight risk management regime on the ground that the bank intended to have a calculated growth on their loan book to avoid unnecessary risks. The reason behind this as Adan puts it is to improve the collection capability to track defaulting loans. But for the more liquid Equity Bank compared to Barclays Bank, the strategy put in place to deal with default is not slowing down lending. Instead, it is enhancing provisions on the loan book to maintain its quality in the light of the expected economic downturn.

2.4 Inflation's contribution to change in loan repayment duration

Loan repayment duration refers to the amount of time that a borrower takes to pay off a loan. If during inflation cost of the loan increases, the loan repayment duration will not remain untouched. Davis, George, Toma and Mark (1995) states that accretions in the inflation rate increase bank taxes because of their reserve requirements, which results in lower deposit rates.

2.4.1 Short Term Loans and Long Term Loans

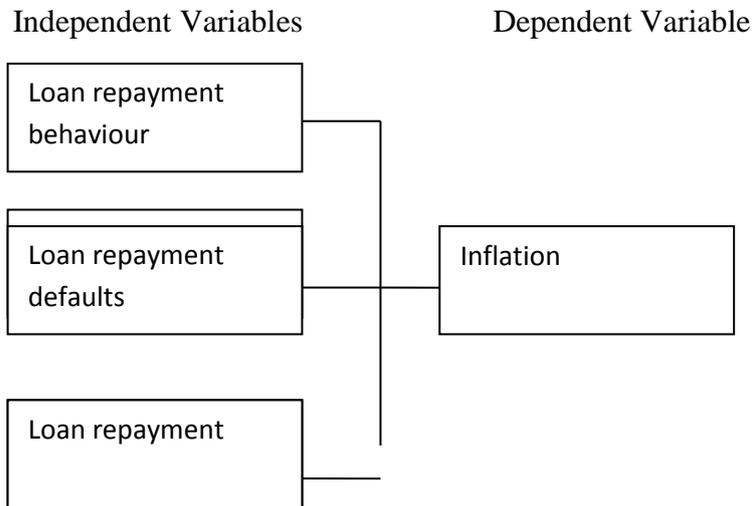
In regard to loan duration, with short-term loans, it is possible to predict risk factors and inflation rates to a certain extent but not for long term loans. Long term loans are difficult to estimate because the lender has to incorporate all possible risks to estimate the future value of the loan amount. A lender's priority would be to remain profitable. So, according to News Watch (2008), they will result to charging higher interest rates. Short term business loans are usually unsecured loans as such loans involve a shorter repaying duration. The repayment duration generally ranges from 3 to 10 years. This clearly implies that the borrower can repay short term business loan in few years. So the borrower can choose to repay the loan taking into account the loan amount and repaying ability. According to Brian (2009), a little disadvantage of short term business loans is its high cost. Since usually short term loan is unsecured loan, involving risks such as the risk of inflation lenders tend to charge interest at higher rate. However, on comparing the lender you always have the opportunity to take the loan at lower rate especially if your credit history.

2.4.2 Changes in the Loan Repayment Duration

An article by Jackson (2008), a managing director of National Bank suggested that an alternative way to deal with default is the rescheduling of loans as banks accept less payment over an extended repayment period. Immanuel (1975) said that the combination of fixed monthly payments with high" interest lends lo a progressive amortization pattern, where very little of the principal is paid early in the loan period. Another typical feature is that even a small change in the interest rate will lead to a considerable change in the repayment period, something that often takes the borrower by surprise. According to local market regulations, adjustment of the payments to interest rate variations can be handled

in different ways, either by changing the size of the monthly payments or the loan duration.

2.5 Conceptual Framework



2.6 Chapter Summary

An introduction to the literature review was given. An empirical review of past studies was done according to the specific objectives of this research. The subject of inflation was discussed and the effects of behavior and also effects of inflation to loan repayment . The importance of understanding effects of inflation on loan repayment behavior was cited as past studies involving the same were reviewed. Effects of increase in cost of loans were reviewed. The literature review on increase in interest rates and inflation itself was also conducted and its importance to how behavior changes and hence affecting repayment positively or default happening and towards the end of this chapter a conceptual framework was provided with all variables explained.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The purpose of this chapter outlines the method which provided the basic material for the research. It describes the location of the study, selection of the study sample and the sampling methods. In this chapter the researcher also describes the various data collecting method, research procedures and the data analysis procedures.

3.2 Research design

The study sought a descriptive design as it sought to clearly bring out how loan repayment was affected by inflation through broadly explaining some indicators that show that loan repayment was adversely impacted upon by inflation. In addition, the research examined if lenders and borrowers understand the phenomenon of inflation and how it affected loan repayment behaviour along with the measures and strategies that needed to be put in place.

Such a design was relevant since it evaluated the pattern of loan repayment during the period of inflation. Ultimately, the study sought to find out how inflation impacts on loan repayment with the research being conducted in Habib Bank AG Zurich staff most of whom had credit experience. For the purpose of this study, inflation served as the independent variable while loan repayment duration, loan repayment behaviour and loan default were the dependent variable.

3.3 Target population Population and sample design

The research targeted staff of Habib Bank AG Zurich who have cumulative experience in advance/credit department or were at the time working in advances department in all the branches

Table 3.3 Target Population

Category	TARGET POPULATION	Percentage
Loans clerks	15	50
Loans Supervisors	4	13
Advance heads	4	13
Risk officers	2	7
Ex Advances staff	5	17
Total	30	100

A sample of 30 staff was selected since this covered the entire sample size of employee were employee in advances or who have had experience in advances department that the researcher considered sufficient to lead to a conclusion on the study. Of the 30 staff selected 21 staff responded to the questionnaires administered to them.

3.3.2.2. Sampling Technique

The study employed the stratified random sampling technique that is characterized by the advantage of every element in the population being known and has an equal chance of being selected as a subject in this study. A stratified random sampling according to Serakan (2000) is the least bias of probability sampling design and offers great generalization. All the departments that deal with loans at Habib Bank AG Zurich were used as strata for sampling purposes distributed equally.

3.3.2.3. Sample Size

Kothari (2008) stresses that sample size chosen by the researcher should be capable of giving enough information about the population and one which can be analyzed with ease. From a population of about 30 staff 30 (100%) was included in the sample.

Category	TARGET POPULATION	Sample size 100%	Percentage
Loans clerks	15	15	50
Loans Supervisors	4	4	13
Advance heads	4	4	13
Risk officers	2	2	7
Ex Advances staff	5	5	17
Total	30	30	100

3.4 Data collection method

The research applied probabilistic techniques under which stratified random sampling was used. A sample of 30 Habib Bank AG Zurich staff who worked in advances department in the different branches was selected. Use of simple random sampling enabled the selection of a population that was easily accessible. Secondary data was also used and checklist method was used too.

Doodley (1984) defines reliability as the consistency of a measure when used again and again. Mugenda and Mugenda (2003) define reliability as a measure of the degree to which a research instrument yields consistent results after repeated trial. The research conducted a pilot study whereby some questionnaires were issued to at least three employees of Habib Bank AG Zurich who filled the questionnaires. These three employees were not included in the main study.

David et al. (2007) defines validity as the ability of an instrument to measure what you intent it to measure. Validity, according to Borg and Gall (1989) is the degree to which a test measures what it purports to measure. According to Borg and Gall (1989) content validity of an instrument is improved through expert judgment. As such, the researcher sought assistance of the assigned supervisor, who, as an expert in research, the supervisor helped improve content validity of the instrument.

3.5 Research procedures

Weller et al. (1998) describes data collection as the process of preparing and collecting data for the purpose of obtaining information to keep on record, to make decisions about

important issues and to pass information onto others. The study used survey method of data collection. Scheuren (2004) defines a survey as a research method for collecting information from a selected group of people using standardized questionnaires or interviews.

A structured questionnaire was used to collect data from the respondents. As Kothari (2008) observed questionnaires are objective than interviews because they gather responses in a standardized way.

Primary data was collected using questionnaires containing both open and closed ended questions. The respondents were staff serving in the loan department and credit officer's risk since they are knowledgeable in issues pertaining to loan.

The questionnaires included four sections with background information being the introductory part of the questionnaire consisting of closed ended questions. Section 1 contains questions on the first objective about the cost of the loan. Section 2 contained questions on the second objective whereas questions on the third objective are contained on the last section, Section 3. The use of questionnaire facilitated easy collection of data as they were easy to understand and not time consuming.

3.6 Data analysis

Once all the questionnaires had been filled out and collected, data analysis was conducted through the use of descriptive and inferential statistics. Descriptive statistics are used to reveal patterns through the analysis of numeric data. Inferential statistics are used to draw conclusions and make predictions based on the analysis of numeric data. Descriptive statistics and in particular the mean was used to reveal what the average responses to particular questionnaire items were as well as what the frequency was on various options of a particular questionnaire item. This information was presented in the form of tables and bar graphs. The tools used for the analysis were SPSS and Excel software.

The research used primary source of data. Secondary data regarding the inflation rate as well as the interest rates movement is readily available at the official website of the Kenya National Bureau of Statistics as well as the official Central Bank of Kenya.

After identifying the actual study elements, the researcher decided on the data to be collected. The data to be collected was on the impact of inflation on loan repayment.

Due to the limited time that respondents were likely to avail to the researcher, the researcher prepared short questionnaires that the respondents could easily understand making it easy to fill the required information. The questionnaires mainly adopted multiple choice questions in section A, B and C structured in a logical manner such that the information required for the study was easily obtained. The respondents were asked questions aimed at getting their perception as to how inflation impacts on loan repayment, how inflation contributes to loan payment default and also how inflation contributes to changes in loan repayment duration.

3.7 Ethical Considerations

According to Antonior A. (March 2004), conflict of interest arises in any situation in which an interest interferes, or has any potential to interfere with a person; organization or institution has a right to do so. Conflict of interest is also defined as a situation where a professional, or a corporation, has a vested interest which may make them an unreliable source. The interest could be money, status, knowledge or reputation for example. When such a situation arises, the party is usually asked to remove themselves, and it is often legally required of them. (Wall Street Journal)

Ethics are norms governing human conducts which have a significant impact on human welfare. It involves making a judgment about right and wrong behaviour. Ethics has been defined as an individual's moral beliefs about what is right or wrong and good or bad, that provides a guide to his/ her behaviour. It is an individual matter, which concerns a person's behaviour towards others; for instance, whether he or she behaves according to generally accepted social norms of right or wrong. (Greenberg, Baron, 2003, P. 40). Bell and Bryman (2007) states that it is the responsibility of the researcher to carefully assess the possibility of harm to research participants, and the extent that it is possible; the possibility of harm should be minimized. The researcher recognizes that the issues under study were sensitive because involved the core business of the organization. Therefore, there was need to protect the identity of the respondents as much as possible hence the questionnaires did not require the respondent's names or details that may reveal their identity.

3.8 Chapter Summary

This chapter provided an overview of the researcher methodology the study intended to apply. It described the research design to be used, what the target population and the sample were, the sampling procedure and the instrumentation that were applied and how data was collected and analysed. The next chapter provides results and findings of the research.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND FINDINGS

4.1 Introduction

This chapter presents the findings of the study and discusses the analysis of the data collected from the various respondents who filled in the questionnaires. In analyzing and presenting the research findings, the research objectives were considered. Thirty questionnaires were issued but only twenty one were received back and analyzed as seen in table 4.1 which formed the basis for discussion, conclusion and interpretation of the findings and recommendations of the study.

Table 4.1: Response Rate

Sample	Actual Respondents	Percentage
30	21	70.00%

Table.4.1 give a summary of the response rate to the total sample .Of the total sample size of 30, 21 responded as the response was required to facilitate compilation of data. The total response was 70.00% out of the expected 100%.

4.2 Background Information

4.2.1 Number of years worked in the Bank

Table 4.2.1: Number of years worked in the Bank

No of years	Frequency	Percentage
1yr- 5 yrs	11	52.38%
5yrs- 10 yrs	2	9.52%
10yrs – 15 yrs	2	9.52%
Above 15 yrs	6	28.57%
Total	21	100.00%

In table.4.2.1 the question the respondents were asked concerned the period the bank had existed. From the findings, 52.38% had been in the bank for between 1-5years, 9.52% 5yrs -10 years, and 10-15 years as per the findings. Only 28.57% had been in the bank for more than 15 years.

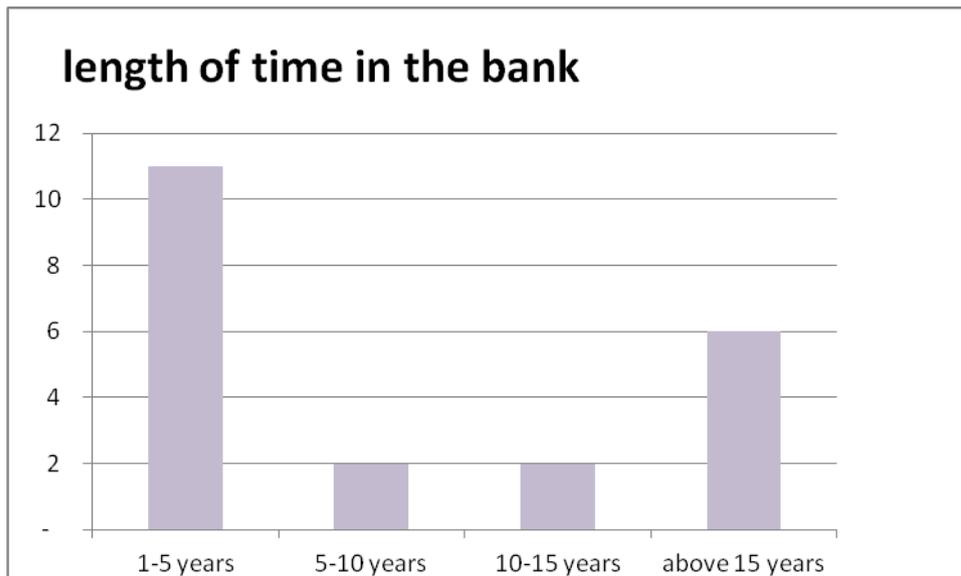


Figure 4.2.1: Length of time in the bank

Figure.4.2.1 the question asked was on how long the selected employee had been in the bank. The Graph above demonstrates that majority of the respondents had been in the institution between 1-5 years.

4.2.2 Bank's clients

Table 4.2.2: Bank's clients

Majority of bank's clients	Frequency	Percentage
Corporate	6	28.57%
Personal	3	14.29%
Business	10	47.62%
All are equal	2	9.52%
Total	21	100.00%

In table.4.2.2 the question asked was on different categories of the bank clients and what was the proportion of each to the overall composition. According to the respondents the biggest proportion is made up of Business clients at 47.62% followed by corporate clients at 28.57%, Personal clients constituting 14.29%. 9.52% of the respondents believe that all categories are equal.

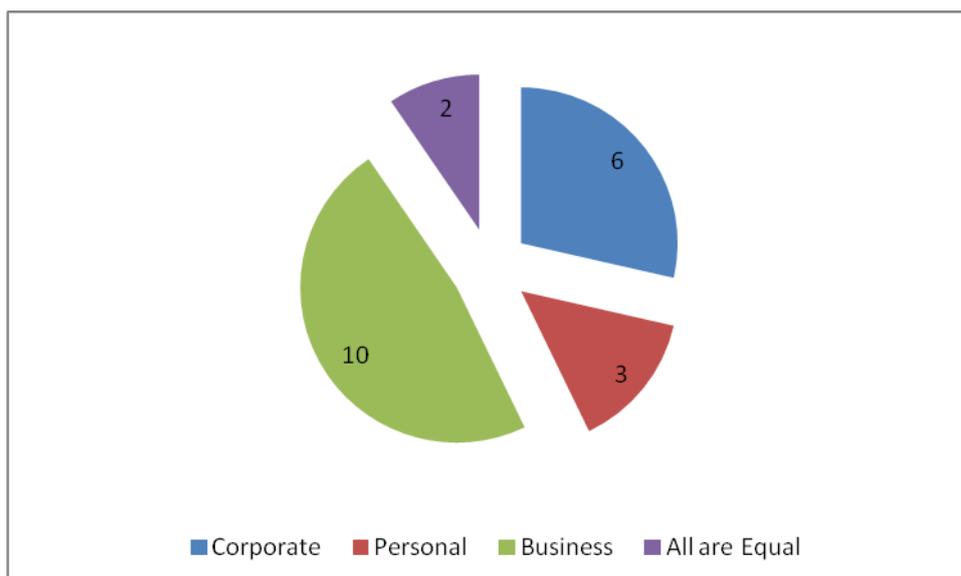


Figure 4.2.2: Majority bank's clients

Figure 4.2.2 further demonstrates the frequency of respondents and the proportion of each category of response on Table.3. The question asked was on the category of borrowers that constituted a majority of the bank's client. Business borrowers constituted the majority borrowers in most banks with a percentage of 47.62% (10 respondents) whereas corporate constituted 28.57%(6 respondents) of the majority client in some banks. Personal borrowers constituted 14.29% of the 3 respondents and the remaining 9.52% (2 respondents) who stated that all the three categories of borrowers were equal in size.

4.2.3 Cost of bank products during inflation

Table 4.2.3: Effects of inflation on Cost of bank products during inflation

Increase in cost of bank products	Frequency	Percentage
Strongly agree	4	19.05%
Agree	15	71.43%
Indifferent	1	4.76%
disagree	1	4.76%
Strongly Disagree	0	0.00%
Total	21	100.00%

As indicated in Table 4.2.3 above, the question being responded to was on whether the bank had increased its costs of products during this period of inflation. 71.43% of the banks agreed that the cost of bank products had increased as a result of inflation. Those

was a tie on them that were indifferent and them that disagreed that the cost of bank products increased during inflation. With inflation, prices tend to increase and so do the prices of bank products hence for most respondents having agreed to this.

4.2.4 Introduction of new credit services during inflation

Table 4.2.4: Introduction of new credit services during inflation

Increase in cost of bank products	Frequency	Percentage
Strongly agree	0	0.00%
Agree	8	38.10%
Indifferent	12	23.81%
Disagree	8	38.10%
Strongly disagree	0	0.00%
Total	21	100.00%

The question in Table.4.2.4 was whether new credit services had been introduced so as to suit the borrowers' 38.10% agreed that there was an introduction of new credit services during inflation periods while the same number of respondent disagreed. 23.81% of the respondents were indifferent on this. So as to remain in business during inflation when the economic condition is greatly affected, the bank didn't introduce new credit services so as to suit the borrower during this period as shown below rather there restructured the existing credit facilities for the borrowers whose credit servicing ability was strongly affected by inflation.

4.3 Effects of inflation on loan repayment

4.3.1 The policy during inflation

Table 4.3.1: Policy during inflation

Policy adopted	Frequency	Percentage
Adjusted rates upwards	17	94.44%
Adjusted rates downwards	1	5.56%
Total	18	100.00%

In table.4.3.1 the question being responded to was on what the bank policy was during inflation. The same shows that 94.44% of the banks adjusted rates upwards during inflation. Only 5.56% indicated that rates are adjusted downwards in time of inflation.

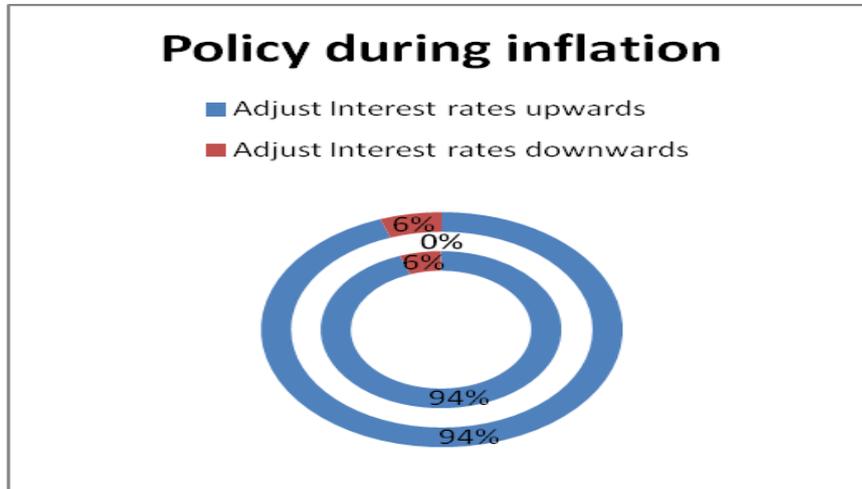


Figure 4.3.1: Policy during inflation

The respondents in Figure.4.3.1 were of the opinion that inflation will force the cost of loan to rise with banks adjusting the interest rates upwards as observed by 94% of the respondents and 5.56% indicating that policy is to reduce rates in times of high inflation.

4.3.2 Effect on the base rate during inflation

Table 4.3.2: Effect on the base rate during inflation

Effects on the base rate	Frequency	Percentage
Adjusted upwards	18	90.00%
Adjusted downwards	2	10.00%
Both	0	00.00%
Total	20	100.00%

Table 4.3.2. explores effects on the base rate during inflation where the respondents were responding to the question about the base rate and what happens to it during inflation. 90.00% the respondents indicated that the base rate is either adjusted upwards and 10% downwards depending on the perceived inflation.

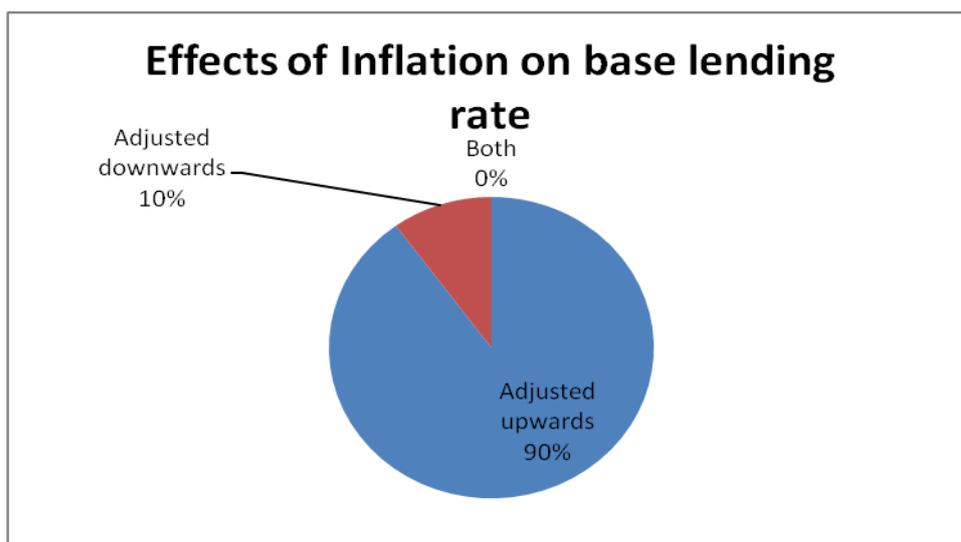


Figure 4.3.2: Effect of inflation on base rate during inflation

The Central Bank of Kenya will adjust the inflation according to what the economy might be going through as was the response of respondents as was illustrated in figure.4.3.2. Price stability is a precondition for achieving a wider economic goal of sustainable growth and employment. High rates of inflation lead to inefficiency in a market economy and, in the medium to longer term, result in a lower rate of economic growth. Movements in the general price level are influenced by the amount of money in circulation, and productivity of the various economic sectors. The Central Bank of Kenya regulates the growth of the total money stock to a level that is consistent with a predetermined economic growth target as specified by Kenya Government and outlined in its Monetary Policy Statement.

4.3.3 Impact of inflation on the other cost of loans

Table 4.3.3: Impact of inflation on cost of loans during inflation

Impact on other costs of loans	Frequency	Percentage
Adjusted upwards	7	33.33%
Remain constant	14	66.67%
Adjusted downwards	0	0.00%
None	0	0.00%
Total	21	100.00%

The respondents were responding to the question on what happens to other costs of loan such as legal costs, commitment fees in times of inflation. Table 4.3.3 shows that 66.67% of the respondents were for the opinion that the impact on the other costs of loan such as legal cost and commitment fees remained constant during inflation. Those for the opinion of these costs being adjusted upwards constituted 33.33% and none for cost being adjusted downwards.

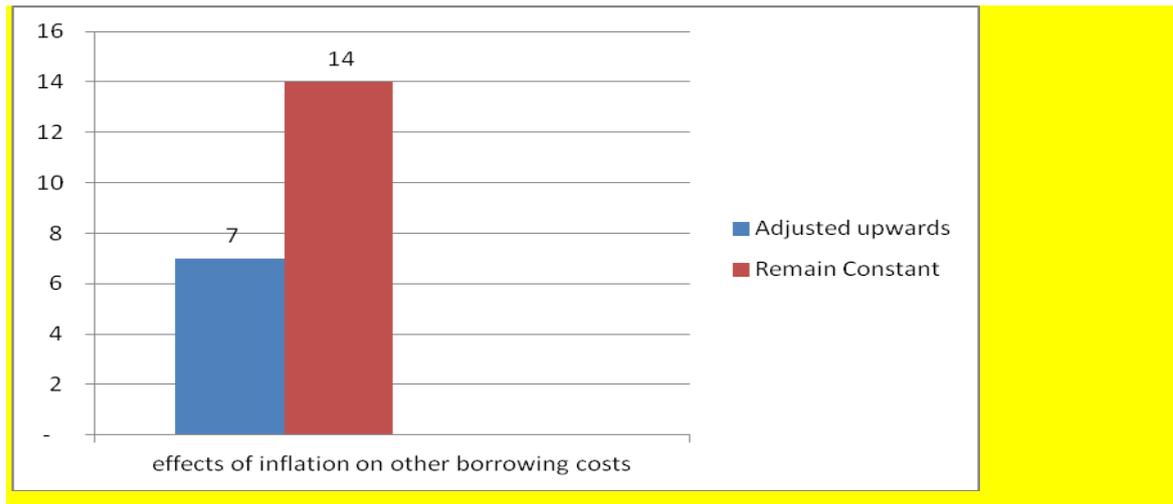


Figure 4.3.3: Effects on other cost of loans

Figure 4.3.3 illustrate the responses of respondents who were of the opinion that in times high inflation other costs other than interest rates remain the same with 14 respondents agreeing with that fact and 7 respondents alluding to the fact that other cost remain the same.

4.3.4 Impact on the cost of loan on loan repayment

Table 4.3.4: Impact on the cost of loan on loan repayment

Impact on other costs of loans	Frequency	Percentage
Strongly agree	10	47.62%
Agree	10	47.62%
Indifferent	0	0.00%
Disagree	1	4.76%
Strongly disagree	0	0.00%
Total	21	100.00%

The findings on table 4.3.4 were on the question on whether the impact on the cost of loan affects the borrower's ability to repay back the loan. Of the 21 respondents, 47.62% agreed that the impact of inflation on the cost of loan affected borrower's ability to repay back the loan, 47.62% the same percentage as respondents who agree, strongly agreed. Respondents who agreed to this argued that the impact of inflation on the cost of loan affects the ability to repay since the borrower will be expected to pay more unlike before due to the high interest rates.4.76% disagreed.

4.3.5 Fixed cost loans

Table 4.3.5: Loans with fixed costs

Loans with fixed costs	Frequency	Percentage
Yes	8	38.10%
No	13	61.90%
Total	21	100.00%

In table.4.3.5 the question asked was on whether there were loans whose cost was fixed. 61.90% of the respondents indicated that the bank do not offer such loans to their clients or borrowers. 38.10% of the respondents said the bank offers fixed cost loans.

4.3.6 Impact of inflation on fixed cost loans

Table 4.3.6: Impact of inflation on fixed cost loans

Significant impact on fixed loans cost	Frequency	Percentage
Strongly agree	3	14.29%
Agree	12	57.14%
Indifferent	1	4.76%
Strongly disagree	4	19.05%
Disagree	1	4.76%
Total	21	100.00%

Table 4.3.6 shows the findings on the question that sought to find out whether loans whose cost was fixed were not significantly affected during inflation. 57.14% of the respondents agreed that fixed cost loans are not significantly affected during inflation since the pricing of such loans is not possible to change hence they are not affected by

inflation. 19.05% disagreed arguing that inflation affects all loans may it be fixed or variable. Only 14.29% of the respondents strongly agreed to this.

4.4 Connection of inflation to loan repayment default

4.4.1 Default in loan repayment during inflation

Table 4.4.1: Default in loan repayment is highest during inflation

High default on loan repayment during inflation	Frequency	Percentage
Strongly agree	7	33.33%
Agree	13	61.90%
Indifferent	1	4.76%
Disagree	0	0.00%
Strongly disagree	0	0.00%
Total	21	100.00%

Table.4.4.1 demonstrated the answer to the question asked as to whether default in loan repayment was highest during inflation. A total of 13 respondents agreed that default in loan repayment was at its highest during inflation owing to the tough economic situation affecting the borrower of loans. Those who strongly agreed were 7 respondents, 1 respondent was indifferent and none disagreed or strongly disagreed since default can occur anytime and not necessarily at its highest during inflation.

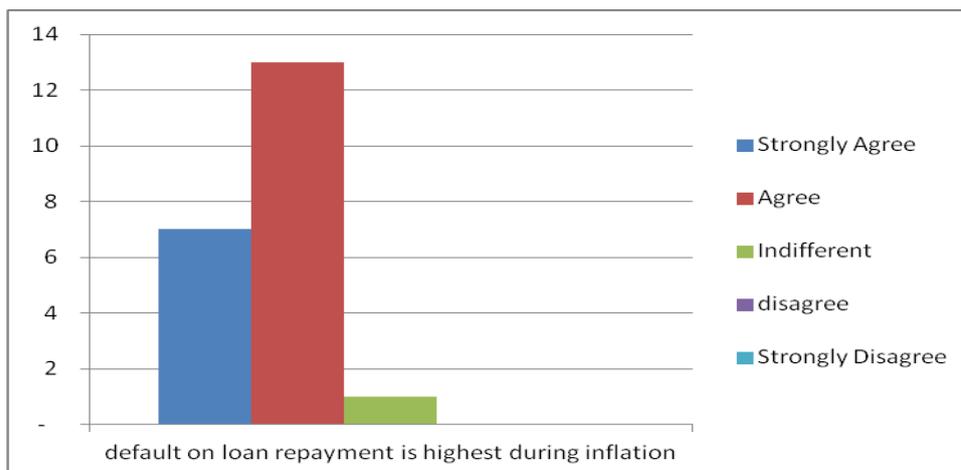


Figure 4.4.1: Default in loan repayment during inflation

Figure.4.4.1 demonstrated the answer to the question asked as to whether default in loan repayment was highest during inflation. A percentage of 61.90% agreed that default in loan repayment was at its highest during inflation owing to the tough economic situation affecting the borrower of loans. Those who strongly agreed constituted 33.33% and 4.76% felt indifferent and none strongly disagreed since default can occur anytime and not necessarily at its highest during inflation. Due to the high cost of living, individuals are likely to have difficulties servicing the loans.

4.4.2 Effect of default on bank lending capacity

Table 4.4.2: Effect of default on bank lending capacity

Effect of default on bank lending capacity	Frequency	Percentage
Strongly agree	5	23.81%
Agree	13	61.90%
Indifferent	1	4.76%
Disagree	2	9.52%
Strongly disagree	0	0.00%
Total	21	100.00%

In table.4.4.2 respondents were responding to the question on whether default in loan repayment affects the bank lending capacity. A majority of the respondents constituting 61.90% agreed that default in loan repayment affects bank lending capacity since failure to repay loans implies the bank has no money to lend because most of it is being held by the borrowers. 23.81% of the respondents strongly agreed to the effect of default on bank lending capacity while 4.76% and 9.52 were respondents that were indifferent and disagreed respectively.

4.4.3 Bad debts records during inflation

Table 4.4.3: Bad debts records during inflation

Increase in bad debts	Frequency	Percentage
Strongly agree	4	19.05%
Agree	16	76.19%
Indifferent	1	4.76%
Disagree	0	0.00%
Strongly disagree	0	0.00%
Total	21	100.00%

Findings on the table 4.4.3 were on the question on whether records of bad debts are on the rise in time of inflation. Table 4.4.3 shows increase in bad debts during inflation with 23.81% strongly agreed while 76.19% of the respondents agreed, 4.76% were indifferent. As inflation rises, records of bad debts are likely to increase since during inflation borrowers are finding it difficult to repay loans previously acquired owing to the increased cost of services and goods which they are unprepared for. While this is the case ,banks are required by Central Bank of Kenya to make adequate provisions for all the loans advanced.

4.4.4 Degree of default by the different categories of borrowers

Table 4.4.4: Degree of default by the different categories of borrowers

Borrower at most risk of default	Frequency	Percentage
Corporate	1	4.76%
Business	5	23.81%
Personal	5	23.81%
All of the above	10	47.62%
Total	21	100.00%

The question asked was on which category of borrower was at most risk defaulting. Table 4.4.4 indicates the borrower at most risk of defaulting were personal borrowers and business borrowers constituting 23.81% each as a result of inflation affecting disposable income and so the income available is just enough to cater for the basic necessities in the case of personal borrowers and small businesses. Majority of the respondents 47.62%

suggested neither of the categories of borrowers had a higher risk of defaulting than the other since inflation affects all the borrowers and so the risk of defaulting was equal to all.

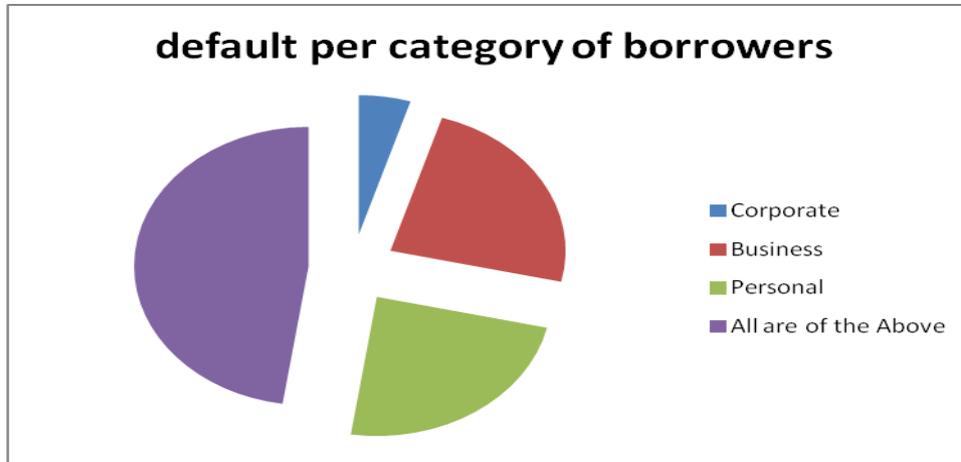


Figure 4.4.4: Degree by the different borrowers

Figure.4.4.4 the respondents strongly agreed that the defaulters list was a high mix of all the three categories i.e corporate, business and personal category.10 respondents agreed that the portfolio was a mix of all three categories of borrowers, 5 respondents each were of the view that business and personal borrower formed the list of defaulters with one respondent of the view that corporate borrowers formed the highest degree of defaulters.

4.4.5 Impact of default on bank profits

Table 4.4.5: Impact of default on bank profits

Negative impact on profits	Frequency	Percentage
Strongly agree	4	19.05%
Agree	16	76.19%
Indifferent	1	29.41%
Disagree	0	4.76%
Strongly disagree	0	0.00%
Total	21	100.00%

In table.4.4.5 respondents were responding to the question on whether bank profits are negatively affected by defaults 76.19% of the responses agreed that bank profits are negatively affected by defaults. At the end of the financial period, the bank has to do a

provision for bad debts which reduce the profits and the higher the category of default, the higher the provision required. 4.76% were indifferent on the bank profits being negatively affected by defaults and 19.05% strongly agreed.

4.4.6 Are there Strategies to deal with default

Table 4.4.6: Are there Strategies to deal with default

Presence of strategies	Frequency	Percentage
Yes	21	100.00%
No	0	0.00%
Total	21	100.00%

In table.4.4.6 the question asked was if the bank had put in place strategies to deal and avoid the risk of default and what were some of the measures that had been taken. All responded yes thus represented by 100% which means that strategies were in place to deal and avoid the risk of default. Conservative lending, fully secured lending backed by financing ability by the clients. Audited balance sheets are provided on an annual basis by companies, stock reports for debentures on stocks are some of the measures that have been implemented by the bank

4.5 Inflations contribution to change in loan repayment duration

4.5.1 Effects of inflation

Table 4.5.1: effects of inflation on the loan repayment duration

Impact of inflation on the loan repayment duration	Frequency	Percentage
Strongly agree	4	19.05%
Agree	16	76.19%
Indifferent	1	4.76%
Disagree	0	0.00%
Strongly disagree	0	0.00%
Total	21	100.00%

Table 4.5.1 was on the question as to whether inflation has had an effect on the loan repayment duration with 76.19% of the respondents having agreed, 19.05% strongly agreed and 4.76% were indifferent.

4.5.2 Adjustment of the loan repayment duration for some loans

Table 4.5.2: Adjustment of the loan repayment duration for some loans

Adjustment of the duration during inflation	Frequency	Percentage
Strongly agree	0	0.00%
Agree	18	85.71%
Indifferent	1	4.76%
Disagree	2	9.52%
Strongly disagree	0	0.00%
Total	21	100.00%

Table.4.5.2 was seeking to answer the question as to whether banks resolve to adjust the loan repayment duration for some loans during inflation periods, 85.71% agreed the banks adjust the loan repayment duration, 9.52% disagreed while 4.76% of the respondents were indifferent.

4.5.3 Manner of adjustment of the repayment duration

Table 4.5.3: Manner of adjustment of the repayment duration

Manner of adjustment	Frequency	Percentage
Duration is extended	17	80.95%
Duration is reduced	2	9.52%
Neither of these	2	9.52%
Total	21	100.00%

The question asked was on how the loan repayment duration for some loans will be adjusted in times of inflation. According to table 4.5.3, 80.95% indicated the loan repayment duration for some loans is extended. Spreading the loan repayment over a large period gives the borrower time to organize their income hence their repayment schedules.9.52% represent the responses for the duration being reduced and another 9.52% for neither of the two.

4.5.4 Extension of the repayment duration during inflation

Table 4.5.4: Extension of the repayment duration during inflation

Extension of the duration inflation	Frequency	Percentage
Strongly agree	2	9.52%
Agree	16	76.19%
Indifferent	0	0.00%
Disagree	2	9.52%
Strongly disagree	1	4.76%
Total	21	100.00%

Table.4.5.4 responds to the question on whether loan repayment ought to be extended during inflation, 76.19% of the respondents agreed to this. 9.52% of the received questionnaires strongly agreed and 9.52% of the respondents disagreed about the loan repayment duration being extended. 4.76% of the respondents disagreed strongly.

4.5.5 Adjustment of the repayment duration with the adjustments intention being to deal with default

Table 4.5.5: Adjustment of the repayment duration with the adjustments intention being to deal with default

Adjustment of the repayment duration to deal with default	Frequency	Percentage
Strongly agree	3	14.29%
Agree	15	71.43%
Indifferent	2	9.52%
Disagree	1	4.76%
Strongly disagree	0	0.00%
Total	21	100.00%

Lastly table 4.5.5 breaks down the responses. Of the total responses to the question on whether adjusting the loan repayment duration is intended to deal with default in fear of it happening, 71.43% agreed to this. Adjustment to the loan repayment duration is not

necessarily meant to deal with default but mostly that is the case.14.29% of the respondents agreed, 9.52% were indifferent while the other 4.76% disagreed on this.

4.6 Chapter Summary

The chapter has analysed the data which was collected from the field. After the background information the first section provided findings on effects of inflation on the cost of loan. The second session provided findings on effects of inflation on default in loan repayment the final section provided information on the effect of inflation on the duration of loan repayment. The chapter presented the data in tables and in charts ranking respective factors according to the data collected from the questionnaires. The data was presented as per the research questions. The next chapter provides discussion, conclusions and recommendations of the research.

CHAPTER FIVE

SUMMARY OF FINDINGS, DISCUSSIONS, RECOMMENDATIONS AND CONCLUSION

5.1 Introduction

This chapter is concerned with summarization of results, after which conclusions are derived from the research findings which are thereafter discussed in light with of the objectives of the study. It also gives the recommendation, limitation of the study and suggestions for further research.

5.2 Summary of findings

The purpose of this study was to establish whether there is a correlation between inflation and loan repayment among Kenyans. The study was guided by the following research questions.

- a.) What is the effect of inflation on loan repayment behaviour?
- b.) How is inflation connected to defaults in payment of loans?
- c.) How does inflation contribute to changes in loan repayment?

The type of research design adopted was a descriptive survey in form of a case study approach. Judgmental sample identified the bank to study as Habib Bank AG Zurich. The population consisted of 30 respondents drawn from all the four branches of the bank. Data was collected through self administered questionnaires and data analysis method was quantitative in nature. Descriptive statistics based on mean and mode were used to analyse data and make comparisons among desired variables. The findings were presented using tables and graphs.

5.3 Discussion

5.3.1 Effects of inflation on loan repayment behaviour

The purpose of the study was to evaluate the effect of inflation on loan repayment. The study established that there was a direct relationship between interest rate and inflation whereby if inflation is rising, the bank was forced to increase the interest rates. As a report by Bank of England (2008), interest rates have to be set based on what inflation might be over the coming years. This is because after a recession, when output has been

falling, there will be plenty of spare capacity in the economy based on the fact - output will be able to rise quite strongly without generating inflationary pressure.

Though we have not had recession in Kenya, the MPC regulates that rates based on the movement of inflation. Pierre (2001), explained changes in bank rates are often used by Central Banks to control the money supply. A change in the official bank rate may have some instant effects for example on loanees' confidence which may influence spending straight away. But more generally, a change in the official bank rate will take time to influence loanees' and firms' behaviour and decisions. Overall, a change in interest rates today will tend to have its full effect on output over a period of about one year, and on inflation over a period of about two years. This is, of course, a very approximate guide. There are some variables that help in the process of behaviour change, and outcome expectation and reinforcements are some of the factors (Bandura, A. 1986).

Most banks indicated an adjustment of the interest rates upwards during inflation. Behaviour is linked to ones personal motivation. This implies that it's important that positive information shapes positive behaviour and its stresses on norms and opinions that support behaviour. Therefore, a person perceives the ability to perform the behaviour. (Grizzell, J. 2007).

In the study behaviour of both the lender and the loanee was affected as established by the study. Banks adjustment interest rates upwards during inflation and the adjustment was done so as to compensate the lender who was Habib Bank AG Zurich for the loss in value in the shilling therefore increased cost of loans. In line with the findings, inflation has had effects on loan repayment duration in relation to the cost of loan since the borrower was expected to incur more in terms of monthly repayments. Although majority of HBZ loans had varied costs, the bank does offer loans with fixed cost loans but the impact of inflation on these loans is not quite significant because of their fixed nature which is not easy to alter.

Choi, Elyasiani and Kopecky (1992), elaborated on the change in interest rates in that this change will alter the firms financing costs which will inversely affect the amount of loan interest and principal payments thus impacting cash flows of the firm. A change in interest rates will affect loanees' and firms' cash flow that is, the amount of cash they have available. The cash flow changes do not only affect firms but individuals who are

affected by the same inflation adjustments and who would desire to act ethically. Ethics has been defined as an individual's moral beliefs about what is right or wrong and good or bad, that provides a guide to his/ her behaviour. It is an individual matter, which concerns a person's behaviour towards others; for instance, whether he or she behaves according to generally accepted social norms of right or wrong. (Greenberg, Baron, 2003). Individuals would be seen to act ethically when meeting their financial obligations inspite the effects if inflation. If you can think of only two choices, then you are probably thinking too hard. (MarkKula Center of Applied Ethics ,2009) .The better choice for both firms and individuals is to service loans and hence we can conclude that yes inflation affects loan repayment behaviour.

5.3.2 The connection of Inflation to defaults in payments of loans

According to planned behaviour theory, it is suggested that ones behaviour is directly dependent on ones intention to perfume the behaviour. An intention is determined by an individual's beliefs and values about the outcome of the behaviour and also what others think that one should do. Behaviour is determined by an individual's perception of their capability to perform behaviour. This is highly dependant on the nature of the situation. (Grizzell, J. 2007). In times of high inflation, borrowers tend to avoid payment of the loans borrowed. Some borrowers many not see renegotiation as a better out come out of high amounts being paid and hence this behaviour leads to default.

The level of interest rates has a direct effect on a consumer's ability to repay a loan. For instance, when interest rates are low, people are willing to borrow because they find it relatively easy to repay their debt. During inflation, interest rates are high, people are reluctant to borrow because repayment on loans is more costly. Charles (1985). A basic analysis cited by Cochrane is that of Obstfeld and Rogoff (1983), in which a model with medium-of-exchange money tends to rule out paths along which the price level approaches zero but not paths along which the price level explodes.

The study found out that inflation contributed to a large extent to the cases of default in loan repayment so there exist a direct relationship between inflation and default. With the existence of inflation, the borrower disposable income is affected in that it decreases hence one may find difficulties in meeting his or her obligation to the bank. It was noted that a relationship exist between default and the bank lending capacity. According Choi,

Elyasiani and Kopecky (1992), the change in interest rates will alter the firms financing costs which will inversely affect the amount of loan interest and principal payments thus impacting cash flows of the firm. A change in interest rates will affect loanees and firms cash flow that is, the amount of cash they have available. Charles (1985) explained that borrowers tend to do very well out of inflation because they repay less in real terms than they borrowed but the reverse is true in times of inflation where the borrowers have to pay more. Default in loan repayment would mean loss of funds thus affecting the bank credit base.

While most respondents felt that all categories of borrowers were found exposed to the risk of default, Personal and business borrowers were found to be the group at most risk of defaulting since of their limited income which might not be enough to service the loan since of the high cost of living. In the case of business, these were small scale businesses. Corporate borrowers have a diversified source of income as well as high value securities thus the risk of default is less.

Strategies have been put in place to deal with default. Some of the strategies include conservative lending, security perfection, timely period review and monitoring and adequate provisions in line with CBKs prudential guidelines. Business and corporate clients that have been borrowed for the business are required on an annual basis to submit audited financial statements, these is aimed at helping the bank in monitoring and evaluation of the business.

5.3.3 Contribution of Inflation to changes in Loan Repayment

The supply of money skyrockets, the demand plummets, and prices rise astronomically. Production falls sharply, as people spend more and more of their time finding ways to get rid of their money. The monetary system has, in effect, broken down completely, and the economy reverts to other moneys, if they are attainable--other metal, foreign currencies if this is a one-country inflation, or even a return to barter conditions. The monetary system has broken down under the impact of inflation.(Murry N.R 1990). Jackson (2008) further indicated that a slowing economy and rising inflation signals trouble to commercial banks as this could lead to many customers being unable to pay their loans. Worst hit are unsecured personal loans, popular with salaried individuals.

During inflation, interest rates are high, people are reluctant to borrow because repayment on loans is more costly. And for them that have loans they might not be able to service them properly hence have to be forced to either have their property auctioned, or engage in more borrowings. As Walter (2006) highlighted, an individual real income is affected by inflation. When the prices of commodities are all increasing, an individual is hard hit when it comes to repayment of debts he had taken. Inflation, it is not easy to find the extra cash needed to pay off the loan as a result of increased cost of living.

Beryl (2006), pointed out that the global economy is in a tough spot caught between sharply slowing demand in many advanced economies and rising inflation everywhere, notably in emerging and developing economies Kenya being one of the developing countries.

According to David, Stanley and Rudiger (1984), higher inflation causes the real money supply to reduce, interest rates rises and aggregate demand falls with money growth remaining unchanged. This may lead to a certain amount of economic dislocation in that borrowers may find it difficult when repaying their debts to the banks since they are forced to incur more since the same loan they acquired is costly more bearing in mind that the purchasing power has reduced.

According to Murry N.R (1995),when describing the recession in Australia that took place in the 80's said that it was thought that inflation was a thing of the past and wise governments had monetary and fiscal policies, structural economic changes and efficient markets all aimed at ensuring that inflation disappeared but inflation didn't disappear but resurfaced back in full force and the depth of recession that it was during the boom in Australia. Once inflation steps in there is a reduction of repayment of loans and hence a slowdown in profits. Banks have to make extra provisions for loans that go bad, provision that is made from profits that the banks have already made. Debt collectors might have to be called in to help in collecting debts that that too is money. The debt collectors and the bank might be force to take legal actions on some of the borrowers that might have defaulted which would mean that more money would have to be used to redeem back the money defaulted. Default in simple terms is failure to honour an obligation that is due. In

finance default occurs a debtor has not met his/her obligations according to the debt contract.

Loan repayment duration for some loans are extended during periods of inflation. The study revealed that, inflation contributed to the adjustment of loan duration and so as to align the increase in monthly repayment. The study also recognized that adjustment of loan duration aided borrowers with time to service the loan effectively. The bank ought to extend the repayment duration in times of inflation as per the indication from the respondents. Adjustments in loan repayments in time of inflation are not necessarily done to deal with default.

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notably in emerging and developing economies Kenya being one of the developing countries.

According to David, Stanley and Rudiger (1984), higher inflation causes the real money supply to reduce, interest rates rises and aggregate demand falls with money growth remaining unchanged. This may lead to a certain amount of economic dislocation in that borrowers may find it difficult when repaying their debts to the banks since they are forced to incur more since the same loan they acquired is costly more bearing in mind that the purchasing power has reduced.

According to Murry N.R (1995),when describing the recession in Australia that took place in the 80's said that it was thought that inflation was a thing of the past and wise governments had monetary and fiscal policies, structural economic changes and efficient markets all aimed at ensuring that inflation disappeared but inflation didn't disappear but resurfaced back in full force and the depth of recession that it was during the boom in Australia. Once inflation steps in there is a reduction of repayment of loans and hence a slowdown in profits. Banks have to make extra provisions for loans that go bad, provision that is made from profits that the banks have already made. Debt collectors might have to be called in to help in collecting debts that that too is money. The debt collectors and the bank might be force to take legal actions on some of the borrowers that might have defaulted which would mean that more money would have to be used to redeem back the money defaulted. Default in simple terms is failure to honour an obligation that is due. In finance default occurs a debtor has not met his/her obligations according to the debt contract.

Loan repayment duration for some loans are extended during periods of inflation. The study revealed that, inflation contributed to the adjustment of loan duration and so as to align the increase in monthly repayment. The study also recognized that adjustment of loan duration aided borrowers with time to service the loan effectively. The bank ought to extend the repayment duration in times of inflation as per the indication from the respondents. Adjustments in loan repayments in time of inflation are not necessarily done to deal with default.

5.4 Conclusions

5.4.1 Effects of inflation on loan repayment behaviour

In line with the findings, inflation has had effects on loan repayment duration in relation to the cost of loan since the borrower was expected to incur more in terms of monthly repayments. There was a direct correlation to changes in inflation and loan repayment behaviour. Borrowers of all the categories in Habib were found to default in times of high inflation. To mitigate against this default Central Bank Of Kenya through its role of safeguarding depositors interest had over time introduced provisions on all levels of borrowers. Banks are required to make provision according to the five categories of classification namely normal accounts, watch accounts, substandard accounts, doubtful accounts and loss accounts.

5.4.2 The connection of Inflation to defaults in payments of loans

As established in the study, there is a clear correlation between inflation and loan repayment. Once the income of an individual or organization is strained by high inflation, they are not able to meet their obligations on time. This is clearly controlled by the prudential guidelines that require banks to make provisions on all types of loans. Banks and the clients can come up with a rescheduling of loans in times of high inflation to help them avoid making provisions against defaults. The provisions made eat into the banks bottom-line. For the case of Habib Bank AG Zurich strategies have been put in place to deal with default. Some of the strategies include conservative lending, security perfection, timely period review and monitoring and adequate provisions in line with CBKs prudential guidelines. Business and corporate clients that have been borrowed for the business are required on an annual basis to submit audited financial statements, these is aimed at helping the bank in monitoring and evaluation of the business.

5.4.3 Contribution of Inflation to changes in Loan Repayment

When inflation is high there is a tendency of having loans rescheduled where borrowers are not able to meet their obligations on time. Most banks in times of high inflation adjust their interest rates upwards to be able to meet cost of lending. Upon default or delay in repayments the banks are obligated by the prudential guidelines to scale down loans to the lower class that require higher provision. Any further provisions made by the bank would mean that the banks profit is being reduces which is not good for the investors who would be expecting returns in a given period. The study revealed that, inflation contributed to

the adjustment of loan duration and as so banks and borrowers are to align the increase in monthly repayment which is mostly caused by increase in interest rates in times of high inflation. The study also recognized that adjustment of loan duration aided borrowers with time to service the loan effectively and also saved the banks hemorrhage of profits through provisions .The bank ought to extend the repayment duration in times of inflation as per the indication from the respondents. Adjustments in loan repayments in time of inflation are not necessarily done to deal with default but also to save the bank from loss of revenue.

5.5 Recommendations

5.5.1 Recommendations for improvement

The study came up with the following recommendations that may benefit Habib Bank AG Zurich and the clients of the bank.

5.5.1 Effects of inflation on loan repayment behaviour

Having established in the study that there is a direct relationship to changes in inflation and loan repayment behaviour, it was important for banks and borrowers to keep an eye on inflation and come up with measures that are mutually favourable. Rescheduling payment would save the bank from loss of money through default, extra provisions for loan defaults, cost of following up the defaulters. The bank should following up with the borrower, monitoring the repayment behaviour so as to identify default tendencies before it is too late (before default) and the strategy should recommended default mitigation mechanisms.

The borrower should be in a position to assess the impact of inflation to disposable income and incase of difficulties meeting loan repayment obligations request the bank for a reasonable repayment schedule. The recommendations should be agreeable to both the lender and the borrower.

5.5.2 The connection of Inflation to defaults in payments of loans

Since there is a correlation between inflation and loan repayment as established in the study, bank(s) should formulate strategies on what should be done in times of high inflation which should include following up with the borrower, monitoring the repayment behaviour so as to identify default tendencies and the strategy should recommended

default mitigation mechanisms. Some of the strategies include conservative lending, security perfection, timely period review and monitoring and adequate provisions in line with CBKs prudential guidelines. Business and corporate clients that have been borrowed for the business are required on an annual basis to submit audited financial statements, these is aimed at helping the bank in monitoring and evaluation of the business.

5.5.3 Contribution of Inflation to changes in Loan Repayment

Inflation movement both upwards or downwards should act as an indicator of what both the borrower and the lender should do. Inflation can be used as a measure of determining tendencies and trends on repayment which may at times lead to default on loan repayment. Keeping track of inflation on a month to month basis should help the bank and the individual know the likelihood of hard economic times and hence help both the lender and the borrower plan ahead. The lender can begin preparing to make provision as a prudent measure so that when the actual default happens it doesn't have to strain the banks bottom line. The lender should upon sighting signs of high inflation begin to closely monitor the borrower and in some cases suggest rescheduling to the borrower to avoid making extra provision where the shareholders are sensitive on the profits of the banks.

For the borrower, Keeping a keen eye on the inflation movement will help them better plan on when to readjust expenditure inorder to meet their repayment obligation without much strain on themselves or the lender. This will help the borrower stay away from being listed as a defaulter by the credit reference bureau(C.R.B) and hence ruining even their creditworthiness and ultimately their credit history which might be costly and complicate borrowing opportunities in future incase they would need to borrow.

Most banks in times of high inflation adjust their interest rates upwards to be able to meet cost of lending. Upon default or delay in repayments, banks are obligated by the prudential guidelines to scale down loans to the lower class that require higher provision. Any further provisions made by the bank would mean that the banks' profit is being reduces which is not good for the investors who would be expecting returns in a given period. The study revealed that, inflation contributed to the adjustment of loan duration and as so banks and borrowers are to align the increase in monthly repayment which is mostly caused by increase in interest rates in times of high inflation. The study also

recognized that adjustment of loan duration aided borrowers with time to service the loan effectively and also saved the banks hemorrhage of profits through provisions .The bank ought to extend the repayment duration in times of inflation as per the indication from the respondents. Adjustments in loan repayments in time of inflation are not necessarily done to deal with default but also to save the bank from loss of revenue.

The government should encourage disclosure of costs by the lender so that the borrower is better able to plan for days of high inflation. The government should in some way discourage banks from arbitrarily adjusting their rates in terms of high inflation. And in as much as the government would need money from banks, they should look for other sources of income so that banks are left to lend to customers who will invest in the economy and hence reduce high inflation.

The monetary policy committee should continue to use the fiscal policies at its disposal it ensure that inflation remains stable and that way no adjustments will have to be made by the lender and the borrowers on loan repayments.

5.5.4 Areas for further Research

Scholars should carry out further research on this especially to find out how each category of borrower is affected in terms of loan repayment. Also this study will be of use to scholars who may seek to understand how inflation affects the bank in its service delivery and how inflation affects banks profitability notwithstanding the need for further research.

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APPENDIX

QUESTIONNAIRE ON THE EVALUATION OF EFFECTS OF INFLATION ON LOAN REPAYMENT

SECTION A: BACKGROUND INFORMATION

BACKGROUND INFORMATION

1. How long have you been working in the bank?
 1 year -5 years 5 years – 10 years
 10 Years – 15 years Above 15 years

2. Which category of borrowers constitutes the majority of the bank's clients?
 Corporate Personal
 Business All are equal

3. Inflation has been rising so has the prices of goods and services. Being an employee of the bank, the cost of the products offered has also been increased.
 Strongly agree Agree Indifferent Disagree
 Strongly disagree

4. New credit services have been introduced so as to suit the borrower's economic situation in this time of inflation?
 Strongly agree Agree Indifferent Disagree
 Strongly disagree

5. Any other information on the background not mentioend above.

.....

.....

.....

SECTION 1: EFFECT OF INFLATION ON THE COST OF LOAN

1. What is the policy of the bank during inflation?

Adjust interest rates upwards Adjust interest rates downwards

Explain why?

.....
.....
.....

2. In times of inflation, what happens to the base lending rate?

Adjusted upwards Adjusted downwards Both

Explain why?

.....
.....
.....

3. What happens to the other costs of loan such as legal costs in times of inflation?

Adjusted upwards Remain constant
 Adjusted downwards None

4. The impact of inflation on the cost of loan affects the borrower's ability to repay back the loan.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

5. a) Are there loans whose cost is fixed?

Yes No

b) Loans whose cost is fixed are not significantly affected during inflation

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

Explain why?

.....
.....

6. Any other factor/aspect affecting cost of loan not mentioned above.

.....
.....

SECTION 2: EFFECT OF INFLATION ON DEFAULT IN LOAN REPAYMENT

1. Default in loan repayment is highest during inflation.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

2. Default in loan repayment affects the bank lending capacity?

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

Explain why?

3. Records of bad debts are on the rise in time of inflation.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

4. Which category of borrower is at most risk of defaulting?

Corporate Business Personal All of the above

Explain why?

.....
.....

5. Bank profits are negatively affected by defaults.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

6. Do banks put in place strategies to deal and avoid the risk of default?

Yes No

What are some of these measures taken to deal with default?

.....
.....

7. Any other factor affecting default not mentioned above.

.....
.....

SECTION 3: EFFECT OF INFLATION ON THE DURATION OF LOAN REPAYMENT

1. Inflation has had an effect on the loan repayment duration.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

2. Banks resolve to adjust the loan repayment duration for some loans during inflation periods.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

3. How will the loan repayment duration for some loans be adjusted in time of inflation?

Duration is extended Duration is reduced Neither of these

Explain why?

.....

4. The loan repayment duration ought to be extended during inflation.

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

5. Adjusting the loan repayment duration is intended to deal with default in fear of it happening?

Strongly Agree Agree Indifferent Disagree
 Strongly Disagree

6. Any other factor affecting loan repayment duration not mentioned above.

.....

APPENDIX:II**IMPLEMENTATION SCHEDULE****Project Activities****Time Frame**

1.Proposal development	3 Months(Sept 13 – Nov 13)
2.Data Collection	2 Months(March 14- April 14)
3. Data Analysis & Interpretation	1 Week (First week of May 14)
4.Report Writing & Final submission	1 Week (Second Week of May 14)

APPENDIX:III RESEARCH BUDGET

Budget line items	Cost in (Kshs)
1. Proposal development	
• Materials	5,000
• Printing	1,000
• Photocopying	1,000
2. Data Collection(Field work)	
• Photo coping	3,000
• Dispatch	3,000
• Research Assistance	10,000
3. Data Analysis	
• Printing	2,000
• Miscellaneous	5,000
TOTAL COST	30,000