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The Effect of Credit Collection Policy on Loan Performance in the Banking Sector in Central region of Uganda

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Abstract

This study examined the effect of credit collection policy on loan performance in the banking sector of Central Uganda. Despite the presence of formal credit collection frameworks, commercial banks in Uganda continue to experience persistent loan defaults, raising concerns about the effectiveness of existing collection practices in improving loan performance. Anchored in a pragmatic research paradigm, the study adopted a mixed-methods approach. Quantitative data were collected using structured questionnaires administered to selected commercial banks and analyzed through Covariance-Based Structural Equation Modeling (CB-SEM) using Jeffrey's Amazing Statistical Program (JASP) version 0.19.3.0. Exploratory Factor Analysis (EFA) was employed to validate the measurement model. Qualitative data were obtained through key informant interviews and analyzed thematically to complement and explain the quantitative findings. The results revealed that credit collection policy had a negative but statistically non-significant relationship with loan performance ($\beta \approx -0.04$, $p > 0.05$). While the measurement model demonstrated acceptable construct validity and reliability, the structural model indicated that formal credit collection policies did not significantly influence loan performance outcomes. Qualitative findings provided further insight, showing that collection practices were largely reactive, with recovery efforts typically initiated only after loans became non-performing. In addition, heavy reliance on third-party debt collectors and delayed borrower engagement weakened internal ownership and accountability in the credit recovery process. The study contributes empirical evidence from Uganda's banking sector by demonstrating that the effectiveness of credit collection policy is determined less by formal policy design and more by proactive implementation and early borrower engagement. By integrating quantitative SEM results with qualitative insights, the study offers a nuanced explanation for the weak linkage between credit collection policies and loan performance, with implications for strengthening credit risk management policies in developing economies.
Keywords: Credit Collection Policy; Loan Performance; Commercial Banks; Structural Equation Modeling; Central Uganda.

INTRODUCTION

Background of the Study

The banking sector plays a critical role in economic development by mobilizing savings and extending credit to households and businesses (Chelangat and Namusonge, 2018). In Uganda, commercial banks remain the primary source of formal financing, particularly in the Central Region, which hosts the largest concentration of banking activities. However, the sustainability of bank lending is increasingly threatened by persistent loan defaults and rising levels of non-performing loans (NPLs). Effective credit risk management is therefore essential to safeguard financial stability and enhance loan performance (Arnone et al., 2024).

Among the various credit risk management tools, credit collection policy is a key post-disbursement mechanism aimed at ensuring timely loan recovery and minimizing default risk. Credit collection policies encompass practices such as Know Your Customer (KYC) compliance, assessment of borrower attitude and commitment, timeliness of repayment, and integrity in borrower-bank relationships (Akmel, 2019). These components enable banks to better understand borrower profiles, detect early warning signals, and improve recovery efficiency. When effectively implemented, such policies can reduce days past due, improve debt turnover ratios, and enhance overall loan performance. Loan performance is commonly assessed using indicators such as loan impairment ratios, loan portfolio growth, debt management effectiveness, debt turnover ratios, and loan repayment periods (Owich and Mutswenje, 2021). Together, these indicators provide a comprehensive assessment of a bank's asset quality, liquidity position, and operational efficiency. However, the effectiveness of credit collection policies in improving these performance indicators may be influenced by moderating factors such as government regulations and technological capabilities, which shape how policies are applied in practice.

Problem statement

Despite the existence of formal credit risk management and collection policies, Uganda's banking sector continues to experience recurrent deterioration in loan performance. Evidence from Bank of Uganda supervision reports 2017 indicates fluctuating but persistently high NPL ratios over the years, reflecting on-going weaknesses in credit recovery mechanisms. These challenges have had severe consequences, including bank failures, reduced profitability, job losses, and constrained access to credit for businesses and households (Bernanke, 2018). The collapse of several banks, notably Crane Bank, highlights the systemic risks associated with ineffective loan recovery and escalating NPLs. Rising loan impairment has not only undermined bank stability but has also negatively affected economic growth and community development by limiting access to financial services (ADOKO and NO, 2020). Although commercial banks have adopted various credit risk management strategies, including credit appraisal, monitoring, and control, loan defaults remain a significant concern. This persistent problem raises questions about the effectiveness of credit collection policies in improving loan performance, particularly in the Central Region of Uganda, where lending activity is most concentrated (Acen, 2011).

Existing literature suggests that effective credit collection policies contribute to improved loan performance by enhancing borrower screening, strengthening recovery processes, and reducing default risk. Studies from developing and emerging economies indicate that strong KYC compliance, ethical lending practices, and borrower commitment assessments are associated with improved repayment behaviour and reduced delinquency rates. Similarly, rigorous credit evaluation and recovery frameworks have been linked to better portfolio quality and financial stability in banking systems (Kyi, 2024). Conversely, other studies highlight that credit collection practices in many banks tend to be reactive rather than proactive, with recovery efforts initiated only after loans become non-performing. Heavy reliance on third-party debt collectors and delayed borrower engagement has been found to weaken internal accountability and reduce the effectiveness of formal collection policies (Sangwan et al., 2021). While these studies provide valuable insights, most focus broadly on credit risk management without isolating the specific role of credit collection policy, particularly within the Ugandan banking context. Although prior studies have examined credit risk management and loan performance, there is limited empirical evidence on how credit collection policy specifically influences loan performance in Uganda's banking sector. Existing research often emphasizes pre-disbursement controls such as credit appraisal, with insufficient attention to post-disbursement recovery practices. Furthermore, few studies integrate quantitative evidence with qualitative insights to explain why formal credit collection policies may fail to translate into improved loan outcomes (Khan, 2022).Therefore, this study sought to address this gap by empirically examining the effect of credit collection policy on loan

performance in the banking sector in Central Uganda. By adopting a mixed-methods approach, the study provides a nuanced understanding of both the statistical relationship and the practical implementation challenges of credit collection policies, thereby offering novel context-specific insights for policymakers and banking practitioners. The main objective of this study was to examine the effect of credit collection policy on loan performance in the banking sector in the Central Region of Uganda.

Literature review

Credit Collection Policy in Commercial Banks

Credit collection policy constitutes a critical post-disbursement mechanism within credit risk management frameworks, guiding how banks recover outstanding loans and manage delinquency (Mai, n.d.). The policy typically encompasses practices such as Know Your Customer (KYC) compliance, borrower attitude and commitment assessment, ethical conduct during recovery, timeliness of follow-up, and enforcement procedures (Mousset, n.d.). Existing literature generally agrees that well-structured collection policies enhance banks' ability to identify high-risk borrowers, reduce days past due, and improve recovery efficiency. Empirical studies indicate that strict enforcement of collection policies strengthens KYC practices by compelling banks to maintain accurate borrower profiles and continuously monitor repayment behaviour (Semwayo, 2021). Strong KYC processes reduce information asymmetry and enable early detection of default risk, thereby supporting improved loan outcomes. Conversely, weak or inconsistently applied collection policies have been associated with inadequate borrower screening and higher exposure to loan losses (Yanney, n.d.). This suggests that the effectiveness of KYC is closely linked to how disciplined and risk-sensitive a bank's collection policy is, particularly in environments dominated by informal economic activity. Beyond compliance, borrower attitude and commitment have been identified as behavioural dimensions influenced by collection policy design. Proactive collection approaches that emphasize early engagement, clear communication, and structured follow-up have been found to encourage repayment discipline and reduce strategic default. In contrast, passive or excessively punitive approaches may damage borrower relationships, resulting in resistance and higher default rates (Goel and Rastogi, 2023). Ethical standards embedded within collection policies also shape borrower trust and cooperation, which are essential for sustainable debt recovery, especially in developing banking systems.

Timeliness is another widely examined component of credit collection policy. Studies consistently show that delayed recovery actions increase default risk and impair loan performance, while prompt follow-up improves recovery rates and liquidity. Efficient collection timelines, supported by systematic monitoring and communication mechanisms, enable banks to resolve delinquent accounts before they deteriorate into non-performing loans (Mateyas, 2025). However, literature also notes that institutional inefficiencies, reliance on manual systems, and third-party outsourcing often undermine timely recovery efforts in developing economies.

Loan Performance and Measurement Indicators

Loan performance reflects the quality and sustainability of a bank's loan portfolio and is commonly measured using indicators such as loan impairment ratios, loan portfolio growth, debt management effectiveness, debt turnover ratios, and loan repayment periods (Owich and Mutswenje, 2021). These indicators collectively capture asset quality, recovery efficiency, and borrower compliance, offering a comprehensive assessment of a bank's financial health. Prior research suggests that effective credit collection policies are associated with lower loan impairment ratios and improved debt turnover, as timely recovery reduces the accumulation of non-performing loans. Sustainable loan portfolio growth has also been linked to effective post-disbursement controls, where banks expand lending without compromising asset quality (Gatimu et al., 2018). Conversely, persistent weaknesses in debt management and recovery practices have been associated with declining profitability, liquidity constraints, and increased vulnerability to

systemic risk (Kaufman, 2000).

Despite these insights, much of the existing literature emphasizes pre-disbursement controls such as credit appraisal and approval, with relatively limited focus on how post-disbursement collection practices directly influence loan performance outcomes. This imbalance leaves an incomplete understanding of how recovery mechanisms shape long-term portfolio quality.

Theoretical Perspectives: Credit Risk Theory

Credit Risk Theory provides a foundational framework for understanding the relationship between credit collection policy and loan performance. The theory posits that credit risk arises from the possibility that borrowers may fail to meet their contractual obligations, and that effective risk management requires continuous identification, assessment, monitoring, and control throughout the loan lifecycle (Koulafetis, 2017). Within this framework, credit collection policy functions as a control mechanism that mitigates realized credit risk after loan disbursement. Practices such as KYC, borrower monitoring, timely intervention, and ethical recovery are consistent with the theory's emphasis on reducing information asymmetry and enforcing repayment discipline. However, Credit Risk Theory also implies that formal policies alone are insufficient; their effectiveness depends on consistent implementation, institutional capacity, and responsiveness to borrower behaviour (Tweneboah Senzu, 2020). This theoretical insight underscores the importance of examining not only policy design but also how collection policies operate in practice.

Empirical Evidence across Contexts

Studies from developed economies have demonstrated that shorter collection periods and efficient recovery mechanisms are associated with lower default rates and improved loan performance. Similar findings have been reported in African banking systems, where prolonged collection cycles have been linked to higher non-performing loan ratios. In East Africa, evidence suggests that personalized collection strategies and data-driven monitoring improve recovery rates and asset quality (Msomi, 2022). However, while these studies provide valuable comparative insights, their applicability to Uganda remains limited due to contextual differences. Uganda's credit market is characterized by high informality, inconsistent borrower records, and varying enforcement capacity, which may weaken the effectiveness of collection practices observed in other regions (Mujabi et al., 2025). Consequently, direct replication of foreign models may not yield the desired improvements in loan performance.

Research Gap and Justification for the Study

Although existing studies acknowledge the importance of credit collection policies, there remains a notable gap in understanding how these policies interact with local economic conditions, borrower behaviour, and institutional constraints in emerging economies such as Uganda (Nanyondo, 2017). Much of the literature treats credit collection components in isolation, with limited attention to how their combined application influences loan performance in practice. Moreover, few studies integrate quantitative evidence with contextual explanations to clarify why formal collection policies may fail to deliver expected outcomes. Therefore, this study addresses this gap by examining the effect of credit collection policy on loan performance within the specific context of Central Uganda. By grounding the analysis in Credit Risk Theory and incorporating contextual realities, the study contributes to a deeper understanding of post-disbursement credit risk management. The findings are expected to inform policymakers and banking practitioners on how to design and implement collection policies that are both context-responsive and effective in improving loan performance

Methodology

The paper adopted a descriptive, exploratory, and cross-sectional mixed-methods research design. This design enabled the simultaneous collection and integration of quantitative and qualitative data, allowing the study to benefit from the strengths of both approaches while mitigating their individual limitations (Green et al., 2015). The mixed-methods strategy facilitated triangulation and complementarity, thereby enhancing the depth, validity, and robustness of the findings. A convergent concurrent design was employed, whereby quantitative and qualitative data were collected during the same phase of the study to generate complementary insights into credit risk management and loan performance.

The target population comprised 7,000 employees drawn from commercial banks operating in the study area. This population included personnel directly involved in credit creation, risk management, and operational oversight, such as branch managers, credit managers, loan officers, auditors, and cashiers. These categories were selected because of their direct engagement with credit risk processes and loan performance monitoring. The sample size was determined using Yamane's (1967) formula, applying a 5 percent margin of error. Based on a population of 7,000 respondents, a sample size of 378 participants was obtained. A stratified sampling technique was used to ensure proportional representation of the different staff categories within the banking institutions. This approach enhanced the representativeness of the sample and ensured that perspectives from key functional roles were adequately captured. Primary quantitative data were collected using a structured questionnaire consisting of closed-ended items measured on a five-point Likert scale ranging from strongly disagree to strongly agree. The questionnaire was divided into sections covering respondents' demographic characteristics and constructs related to credit risk management and loan performance. To enrich the quantitative findings, qualitative data were gathered through document reviews, open-ended questionnaire responses, and in-depth interviews. These methods provided contextual and experiential insights into credit risk management practices that could not be fully captured through numerical data alone.

Quantitative data were first cleaned to address missing values and outliers before analysis. Descriptive statistics were used to summarize respondents' characteristics and key study variables. Reliability of measurement scales was assessed using Cronbach's Alpha, supported by inter-item correlation analysis to confirm internal consistency. Exploratory Factor Analysis (EFA) was conducted to examine the underlying factor structure and assess item loadings prior to model estimation. Subsequently, Structural Equation Modeling (SEM) was employed to evaluate both the measurement and structural models. SEM enabled the simultaneous assessment of construct validity, model fit, and hypothesized relationships between credit risk management variables and loan performance. Data analysis was performed using JASP software (version 0.19.3.0).Qualitative data were analyzed thematically, allowing emerging patterns and explanations to complement and contextualize the quantitative results. The integration of findings from both strands facilitated methodological triangulation and strengthened the credibility of the study's conclusions.

Results and Discussion

Table 1: CCP Rotated Component Matrix

	Factor 1	Factor 2	Factor 3	Uniqueness
CCP10	0.907			0.452
CCP8	0.435			0.751
CCP6	0.424			0.693
CCP1	0.315			0.756
CCP9		0.742		0.524

Table 1: CCP Rotated Component Matrix

	Factor 1	Factor 2	Factor 3	Uniqueness
CCP7		0.571		0.723
CCP5			0.733	0.485
CCP3			0.528	0.696
CCP2				0.741
CCP4				0.857

Note. Applied rotation method is varimax.

Base on table 1 Exploratory factor analysis was conducted to examine the dimensionality of the Credit Collection Policy (CCP) construct using principal component factoring with Varimax rotation. The analysis initially included ten measurement items. The rotated component matrix revealed the emergence of three components; however, only the first component demonstrated conceptual clarity and statistical adequacy. Components two and three were characterized by a limited number of items with meaningful loadings, rendering them weak and theoretically unstable. Prior methodological guidance indicates that factors supported by fewer than three items lack interpretability and should not be retained in exploratory factor analysis. Consequently, only the first component was considered suitable for further analysis. Based on factor loading strength and cross-loading behaviour, four items (CCP10, CCP8, CCP6, and CCP1) were retained under the Credit Collection Policy construct. These items exhibited substantial primary loadings on the first factor, with CCP10 showing a particularly strong association. Items CCP2 and CCP4 were excluded due to inadequate primary loadings and excessive uniqueness, suggesting poor contribution to the underlying construct. The retained items collectively represented a coherent dimension of credit collection policy and were therefore used to operationalize the construct in subsequent analyses. Following item retention, additional tests were performed to evaluate convergent validity and internal consistency reliability, the results of which are presented in

Credit Collection Policy: EFA and Validity Results

Table 2: Credit collection policy Results for EFA and Validity Analysis

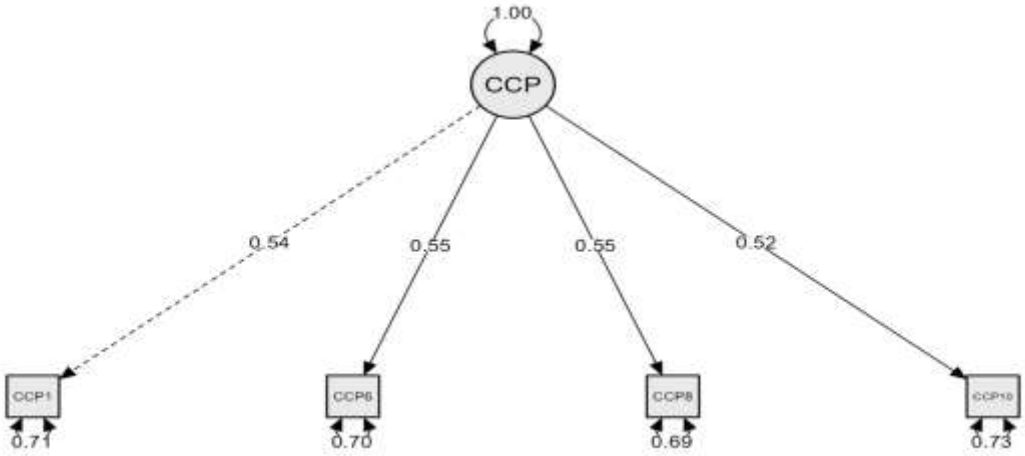
item	Factor loadings	Formed Factor	KMO	Sig Barttlet	Cronbach's alpha	Average Variance Extracted (AVE)
CCP10	0.647	KYC	0.698	< 0.001	0.625	0.564
CCP8	0.607					
CCP6	0.560					
CCP1	0.569					

Base on table 2 The adequacy of the data for factor analysis was assessed using the Kaiser–Meyer–Olkin (KMO) measure and Bartlett's Test of Sphericity. The KMO statistic of 0.698 indicates an acceptable level of sampling adequacy, suggesting that the correlation structure among the items was suitable for factor extraction. In addition, Bartlett's Test of Sphericity was statistically significant ($p < 0.001$), confirming that the correlation matrix was not an identity matrix and that meaningful relationships existed among the observed variables. Together, these diagnostics confirm the appropriateness of applying exploratory factor

analysis to the credit collection policy data. The retained items-CCP10, CCP8, CCP6, and CCP1-demonstrated satisfactory standardized factor loadings, ranging from 0.560 to 0.647, all exceeding commonly accepted minimum thresholds for practical significance. These items loaded onto a single underlying dimension interpreted as Know Your Customer (KYC), indicating that the credit collection policy construct in this study is strongly anchored in borrower identification, monitoring, and information quality. Internal consistency reliability was assessed using Cronbach's alpha. The coefficient of 0.625 falls within the acceptable range for exploratory research, indicating a reasonable level of consistency among the retained indicators. Convergent validity was further examined using the Average Variance Extracted (AVE). The AVE value of 0.564 exceeds the recommended minimum of 0.50, suggesting that the construct explains more than half of the variance in its indicators.

Overall, the results confirm that the refined credit collection policy construct demonstrates adequate factorial validity, acceptable reliability, and satisfactory convergent validity, thereby justifying its inclusion in subsequent structural equation modeling analyses.

Measurement Model Results for Credit Collection Policy



The measurement model for the credit collection policy construct was evaluated using confirmatory factor analysis to assess indicator reliability and overall model adequacy. The standardized factor loadings for the retained indicators-CCP1, CCP6, CCP8, and CCP10-were all above the acceptable minimum threshold of 0.50, indicating that each item contributed meaningfully to the underlying construct. Specifically, the standardized loadings ranged between 0.52 and 0.55, reflecting satisfactory indicator reliability and alignment with established SEM guidelines.

Model fit was examined using multiple goodness-of-fit indices to ensure robustness. The results indicate a strong fit between the measurement model and the observed data. The normed chi-square value was within acceptable limits ($\chi^2/df = 1.916$), and the associated p-value was non-significant ($p = 0.088$), suggesting minimal discrepancy between the hypothesized model and the data. Incremental fit indices further supported model adequacy, with both the Tucker–Lewis Index (TLI = 0.960) and the Comparative Fit Index (CFI = 0.967) exceeding recommended thresholds. In addition, the Standardized Root Mean Square Residual (SRMR = 0.046) and the Root Mean Square Error of Approximation (RMSEA = 0.053) were within acceptable ranges, indicating low residuals and reasonable approximation error.

Collectively, these findings confirm that the measurement model for credit collection policy exhibits adequate construct validity and an overall satisfactory fit, supporting its suitability for inclusion in the subsequent structural model analysis.

This study examined the effect of credit collection policy on loan performance using a mixed-methods approach. The structural equation modeling results revealed a negative but statistically insignificant

relationship between credit collection policy and loan performance. Specifically, the path coefficient from credit collection policy to loan performance was negative and non-significant ($\beta = -4.636$, $t = -0.375$, $p > 0.05$), leading to the failure to reject Hypothesis H01b. These findings indicate that, within the context of the sampled commercial banks, the existence of formal credit collection policies does not translate into measurable improvements in loan performance.

The qualitative findings provide important contextual insight that helps explain the weak quantitative association. Interviews consistently indicated that credit recovery efforts are largely reactive rather than preventive, with most banks initiating collection actions only after loans have already transitioned into non-performing status. This delayed intervention undermines the preventive intent of structured collection policies, as early borrower engagement critical for minimizing arrears and defaults is largely absent. The predominance of reactive recovery practices weakens the capacity of collection policies to influence loan performance outcomes meaningfully.

Furthermore, the widespread outsourcing of loan recovery to third-party agents emerged as a significant theme. While outsourcing may improve short-term recovery efficiency, it appears to reduce internal ownership and accountability for credit risk management. Respondents noted that reliance on external collectors distances relationship managers and credit officers from the recovery process, thereby weakening continuous borrower monitoring and engagement. This structural disconnect diminishes the strategic role of collection policy as an integrated component of credit risk management, which may explain the observed negative but insignificant statistical relationship

Borrower engagement also emerged as a critical issue. Qualitative evidence suggested that customers are rarely contacted early when repayment stress begins to surface. The absence of timely communication limits opportunities for renegotiation, restructuring, or behavioral correction, thereby increasing default risk. In such an environment, credit collection policies function more as procedural documents than as active risk mitigation tools. As a result, their potential influence on loan performance remains constrained.

Taken together, the convergence of quantitative and qualitative findings suggests that the effectiveness of credit collection policy depends less on its formal design and more on its operational execution. When collection practices are delayed, externally driven, and weakly integrated into ongoing credit monitoring processes, the impact of such policies on loan performance is significantly diluted. This explains why, despite the presence of documented collection frameworks, no statistically significant improvement in loan performance was observed.

These findings underscore the importance of shifting from reactive recovery approaches toward early-warning, borrower-centric, and internally driven collection strategies. For commercial banks operating in contexts similar to Central Uganda, strengthening internal accountability, enhancing early borrower engagement, and integrating collection activities into the broader credit lifecycle may be more effective in improving loan performance than relying solely on post-default recovery mechanisms.

Conclusion

This study examined the effect of credit collection policy on loan performance in commercial banks operating in Central Uganda, using a mixed-methods approach grounded in credit risk theory. The findings demonstrate that while credit collection policies are formally established within banks, their practical influence on loan performance remains limited. The quantitative analysis revealed that credit collection policy did not exhibit a statistically meaningful relationship with loan performance. This indicates that the mere presence of structured collection frameworks is insufficient to improve key loan performance outcomes. Rather than functioning as proactive risk mitigation tools, collection policies appear to operate primarily at the point of loan distress, thereby limiting their potential impact on overall portfolio quality.

The qualitative findings provided critical explanatory depth to these results. Evidence from interviews showed that collection practices are predominantly reactive, with banks initiating recovery efforts only after loans become non-performing. Early borrower engagement, continuous monitoring, and preventive follow-ups were largely absent. In addition, heavy reliance on third-party debt collectors reduced internal accountability and weakened ownership of the recovery process. These practices dilute the strategic role of credit collection policies and undermine their effectiveness in influencing borrower behavior and repayment discipline. Taken together, the findings suggest that the effectiveness of credit collection policy is not determined by policy design alone, but by how consistently, timely, and ethically the policy is implemented. In the context of Central Uganda characterized by borrower informality, information asymmetry, and varying enforcement capacity collection policies that are applied late in the credit lifecycle are unlikely to yield meaningful improvements in loan performance. This explains the observed disconnect between formal policy frameworks and actual loan outcomes.

Overall, the study concluded that credit collection policy, as currently operationalized in many commercial banks, plays a limited role in enhancing loan performance. To achieve tangible improvements, banks must reposition collection policy as a proactive, integrated component of credit risk management rather than a post-default recovery mechanism. Based on the study's findings, several recommendations are proposed for practice, policy, and future research. First, commercial banks should strengthen early-stage collection and monitoring mechanisms. Credit collection policies should emphasize preventive engagement, including early warning systems, timely borrower communication, and continuous repayment tracking. This would enable banks to address repayment challenges before loans deteriorate into non-performing status. Second, banks should enhance internal ownership of the collection process. While third-party collectors may remain useful, core recovery responsibilities should be retained within the institution to ensure accountability, relationship continuity, and effective feedback into credit decision-making processes. Third, the integration of technology-driven collection tools such as automated reminders, digital monitoring platforms, and data analytics is recommended. These tools can improve timeliness, consistency, and borrower engagement, particularly in environments where manual follow-ups are slow or inefficient. Fourth, regulators and policymakers should support banks by promoting context-responsive credit risk guidelines that recognize the unique characteristics of informal and semi-formal borrowers. Strengthening credit information systems and enforcement frameworks would enhance the effectiveness of collection policies across the sector. Finally, future research should extend beyond policy existence to examine how collection policies interact with borrower behavior, institutional capacity, and technological adoption. Longitudinal studies and comparative analyses across regions or bank types would provide deeper insights into how proactive collection strategies influence loan performance over time.

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