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Credit Risk Management And Financial Performance Of Selected Commercial Banks In Kenya

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Abstract: *The study sought to determine the impact of credit risk management on financial performance of selected commercial banks in Kenya. Empirical evidence indicates that the effects credit risk management on financial performance of commercial banks in Kenya are positive.The study employed descriptive research design while probability method of sampling was used to obtain a sample of 42 respondents from five banks. Data was collected using questionnaires. The study found that debt recovery process does not significantly affect bank performance whereas loan appraisal process, lending requirements and credit policies were found to have a significant effect on bank performance. The study concluded that the banks need to maintain credit risk exposure within acceptable parameters to maximise a bank's risk adjusted rate of return. Based on the findings, the study made recommendations to commercial banks management, academicians and policymakers. The study recommended that commercial banks in Kenya should put stringent measure when conducting loan appraisal process and ensure that officers responsible should adhere to all the lending requirements stipulated in order to enhance financial performance. Future researcher should focus on the challenges commercial banks face when implementing credit risk management strategies.*

Key Words: *credit risk management, financial performance, commercial Banks.*

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I. Introduction and Background

The government owned banks in Kenya had an asset quality ratio of 30% above the industry average of 28% (CBK, 2015) .This was attributed to the high level of nonperforming loans. By contrast three of the major foreign owned banks had an asset quality of less than 10% (Mwega, 2009). Credit risk management practices and poor credit quality continue to be a dominant cause of bank failures and banking crisis worldwide (Mwega, 2009). The extent to which banks manage their credit risk have an impact on their entire financial performance or survival. Darrell (2012) asserted that credit creation is the main income generating activity of banks .However; it exposes the banks to credit risk. The Basel Committee on Banking Supervision (2001) defined credit risk as the possibility of losing the outstanding loan partially or totally, due to credit events (default risk). The higher the exposure of a bank to credit risk, the higher the tendency of the banks to experience financial crisis and vice-versa.

Financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties due to poor loan appraisals,inadherence to set credit policies, poor portfolio risk management, inadequate lending requirements, or lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties .Nonperforming loans emanate from lax procedures used in credit risk assessment, negligence in monitoring credit facilities advanced, insider loans, lack of trained personnel and unaggressive credit collection methods (Bolton, 2011).Darrell (2012) asserted that poor credit quality , high concentration of credit in certain sectors e.g. tea sector ,speculative lending , lax credit standards have contributed majorly in NPLs posing a challenge in collecting debts recording high costs of loan provisioning hence greatly affecting their profitability.

It is mandatory for a bank to prepare credit policies guidelines for making investment and lending decisions and which reflect a bank tolerance for credit risk. The firm's credit policies are the chief influences on the level of debtors, measuring the manager's position to invest optimally in its debtors and be able to trade profitably with increased revenue .Loan appraisal process and control systems are necessary for the assessment of loan application, which then guarantees a bank's total loan portfolio as per the bank's overall integrity. Boyd (2010) asserts that it is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk policy and strategies that clearly summarize the scope and allocation of bank credit facilities as well as the approach in which a credit portfolio is managed.

Financial performance is measuring the firm's policies and operations in monetary terms. It's also a measure of a firm's financial health over a given period of time (Saunders, 2010). Failure of Kenyan banks cited earnings as the major predictors of bank failure .Hefferman (2013) indicates that failure to effectively manage credit risk mostly contributes to banks' financial crisis. Commercial banks in Kenya are regulated by the Central Bank of Kenya which was established by an act of parliament Central Bank of Kenya Act Cap 491. When a bank classifies a facility as non-performing, CBK guidelines indicated that banks should start to make specific provisions CBK (2002). The specific provisions require banks to forego interest received besides allocating provisions for the NPLs from their own resources. Provisions for bad debt eat into banks profits. Profitability is a bank's first line of defence against unexpected losses, as it strengthens its capital position and improves future profitability through the investment of retained earnings.

II. Research Problem

The future of banking will undoubtedly rest on credit risk management dynamics. Only those banks that have efficient credit risk management system will survive in the market in the long run (Bessis, 2012).The effective management of credit risk is a critical component of comprehensive risk management which is essential for long-term success of a banking institution. Credit risk management practices and poor credit quality continue to be a dominant cause of bank failures and banking crisis worldwide (Mwega, 2009). The extent to which banks manage their credit risk have an impact on their entire financial performance or survival.

Oretha (2010) studied the relationship between credit risk management practices and financial performance of commercial banks in Liberia and found out that market fundamentals and institutional factors such as lack of capacity for credit risk managers which results in the use of consultants by banks in formulating credit risk policies influence financial performance. The study concludes that variations in the credit policies are attributable to bank efforts to maintain threatened profit margins.Suleiman (2015) in his study conducted in Jordan where the main aim was to examine the effect of credit risk management on financial performance found out that inspite of a large number of unpaid loans; NPL ratio has a positive effect on profitability. There is a positive effect of the credit risk indicators of Non-performing loans/Gross loans ratio on financial performance, and a negative effect of Provision for Facilities loss/ Net facilities ratio on financial performance, and no effect of the Capital adequacy ratio and the credit interest/Credit facilities ratio on banks' financial performance when measured by ROA. The study concluded that the credit risk management indicators are important variables in explaining profitability.

III. Research Objectives

The study sought to achieve the following specific objectives:

i. To determine the effect of loan appraisal process on financial performance of selected commercial banks in Kenya.
ii. To determine the effect of lending requirements on financial performance of selected commercial banks in Kenya.
iii. To establish the effect of debt recovery process on financial performance of selected commercial banks in Kenya.
iv. To establish effect of credit policy on financial performance of selected commercial banks in Kenya.

Null hypotheses were formulated and tested in view of each respective specific objective.

IV. Significance of the Study

The study could be valuable to other scholars and researchers especially those dealing with studies relating to credit risk management and financial performance because it provided them with empirical studies that they can use in their study. Scholars could use this study as a basis for discussions on credit risk management and financial performance. The study provided empirical data for policy makers in formulating appropriate policies and possible solutions of credit risk management in commercial banks which affects their financial performance. The study could be of a benefit to the top bank management because they could be able to make better decisions in credit risk management and devise ways on how to curb losses incurred through credit facilities advanced. The study could also be a beneficial to bank regulators in setting the guidelines that pertains credit risk management. The study could also be beneficial to the government as it provides information that is useful in diagnosing the problems commercial banks are facing in credit risk management and financial performance.

V. Review of Literature

The section reviews general theoretical literature and empirical literature relevant to the study

A. Theoretical Literature

The study was based on three theories: loanable funds theory, theory of financial intermediation and transaction cost theory .In economics, the loanable funds doctrine is a theory of the market interest rate which owes its origin to the Swedish economist Knut Wicksell. According to this approach, the interest rate is determined by the demand for and supply of loanable funds which is a prerequisite component in the evaluation of credit requirements in the economy .Interest rate is the risk premium that the borrower pays to acquire credit hence affect the demand for loan able funds in our current study (Gyntelberg et al, 2007).

The financial intermediation theory is based on the theory of informational asymmetry and the agency theory. The approach of financial intermediaries is based on the method of regulation of the monetary creation, of saving and financing of economy. The method of regulation influences the liquidity and solvability of intermediaries (Gurley & Shaw, 1960). Rajan (2010) show that the regulations regarding the capital of intermediaries influence their health, the ability for refinancing and the method for recovering debts. Furthermore, because financial institutions are able to break down assets into small units, they can reduce transaction costs and also employ diversification for the benefit of both their customers and equity holders. Secondly, financial institutions act as evaluators of credit risk for the depositor.

Transaction cost theory has its origins in Ronald Coase's (1937) classic article, The Nature of the Firm. According to Coase (1960) transaction costs include information acquisition costs and negotiation costs. Richter (1997) indicates that transaction costs include the costs of drawing contracts, signing contracts and the cost of monitoring and enforcing contracts. He observes that market prices govern the relationships between firms but within a firm decision are made on a basis of maximizing profits. Transaction costs incurred by financial intermediaries and financial institutions in financial exchange are associated with credit risk in the form of collateral requirements, uncertainty, investments in specific issues and hefty costs incurred in monitoring granted credit facilities.

B.Empirical Review

The study reviewed various studies in view of the study variables and study conceptualization .Kargi (2011) evaluated the impact of credit risk on the profitability of Nigerian banks. Financial ratios as measures of bank performance and credit risk were collected from the annual reports and accounts of sampled banks from 2004-2008. The findings revealed that credit risk management has a significant impact on the profitability of Nigerian banks. He concluded that banks' profitability is inversely influenced by the levels of loans and advances, non-performing loans and he recommended the banks to closely monitor credit advances and adopt other appropriate steps necessary to control or mitigate the risk.Mekasha (2010) investigated on credit risk management and its impact on financial performance on Ethiopian Commercial Banks. The researcher used 10 years panel data from the selected commercial banks for the study, to examine the relationship between ROA and loan provision, non-performing loans and total assets. The study revealed that there is a significant relationship between bank performance and credit risk management and recommended that banks should establish appropriate credit risk management strategies by conducting rigorous credit appraisal before loan disbursement and drawdown.

Claudine (2012) in Spain investigated the relationship between bank performance and credit risk management. It could be inferred from their findings that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. He concluded that good risk management is good banking, which ultimately leads to profitable survival of the institution. Fernandez (2010) on credit risk management and its impact on financial performance found that there is a significant relationship between bank performance and credit risk management. He recommended that it is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk, policy and strategies that clearly summarize the scope and allocation of bank credit facilities as well as the approach in which a credit portfolio is managed i.e. how loans are originated, appraised, supervised and collected, a basic element for effective credit risk management

VI. Methodology

The study adopted a descriptive research design. the target population of interest was five commercial banks in Kenya that is: Kenya Commercial Bank , Equity bank, Cooperative Bank, Barclays bank and Standard chartered bank; 6 branch managers,6 branch operation managers,6 credit managers, 15 credit officers and 6 credit analysts were selected from the banks making a total of 42 respondents. Purposive sampling was used to identify respondents from the five commercial banks sampled for the study. Data was collected using questionnaires. Data was collected upon getting a research permit from the Kenya National council for Science, Technology and Innovation. Permission was also sought from the five targeted commercial banks. The drop and pick technique was adopted for purposes of collecting data. Secondary data on bank performance was obtained from financial statements and other from the sampled banks reports. Data was analyzed using descriptive analysis (means and standard deviation) and multiple regression analysis (standard). The regression model is captured below:

A multiple linear regression model adopted as captured hereunder:

$Y= \beta_0+ \beta_1 x_1 + \beta_2 x_2+ \beta_3 x_3+ \beta_4 x_4 + \varepsilon$ where:

Y= Financial performance

x_1= Loan appraisal process

x_2= Debt recovery process

x_3= Lending requirements

x_4= Credit Policies

β_0 = Constant

β_1- β_4 = Regression Coefficients

ε = Error terms

A number of preliminary diagnostic tests were carried out to precede multiple regression analysis. These confirmed the suitability of the data for the purposes of running the regression analysis. Normality test was conducted to determine whether sample data was drawn from a normally distributed population (Normadiah & Wah, 2011). Multicollinearity was tested using correlation matrices. The Variance Inflation factor was found to be 1.211. Heteroscedasticity was tested using the Levene statistic which SPSS computes test for homogeneity of variances (Hedayat, 2009). The p-value was zero which was less than 0.05 indicating the null hypothesis of equal variances was rejected. R-value was .723 indicating that there as a strong positive correlation between credit risk management and bank performance of five selected commercial banks in Kenya

VII. Results and Findings

The results of the analyses were presented in tables as shown below. The hypotheses were to test the relationship between loan appraisal process, debt recovery process, lending requirements, credit policy and financial performance. The results of regression analysis output of the study are presented in this section. This was performed using the field data and the results interpreted according to the R values, R^2 values, the beta values and F ratio at the 95% level of significance.

Table 1 below presents results on correlation analysis and coefficient of determination

Table 1: Model Summary Table

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.723[a]	.523	.461	.30794

a. Predictors: (Constant), Credit policy, Debt recovery process, Loan appraisal process, Lending requirements.

The model summary in Table 1 above indicates an R value of 0.723 indicating that there is a strong positive relationship between credit risk management factors on financial performance in commercial banks. R-Squared value of 0.523 indicated that the independent variables (loan appraisal process, debt recovery process, lending requirements and credit policy factors) collectively explain 52.3% changes in financial performance of the selected commercial banks in Kenya.

Table 2: ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.220	4	.805	8.489	.000[b]
Residual	2.940	31	.095		
Total	6.160	35			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Credit policy , Debt recovery process , Loan appraisal process , Lending requirements

The results of ANOVA table above indicate that F-statistic was 8.489 and implies that the regression model was a good fit since the P-value was 0.000.(which is less than the significance level of 0.05). Hence, credit risk management has collectively significant effect on bank performance of the five selected commercial banks in Kenya.

TABLE 3 below presents coefficients and p-values for purposes of extracting the regression function and testing hypotheses

Table 3: Regression coefficients

Model	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	1.982	.464		4.267	.000
Loan appraisal process	.198	.053	.493	3.763	.001
Lending requirements	.152	.057	.380	2.682	.012
Debt recovery process	.087	.052	.221	1.662	.107
Credit policy	.124	.055	.311	2.250	.032

a. Dependent Variable: Financial performance.

Table 3 above indicates that the beta coefficients of the resulting model indicate that loan appraisal process, debt recovery process, lending requirements and credit policy had a positive effect on financial performance of commercial banks with slopes of β_1= 0.198, β_2= 0.087, β_3= 0.152 and β_4= 0.124 respectfully. This implies that holding all other variables constant, the financial performance in commercial bank increase by 0.198 units when loan appraisal process increases by one unit all else held constant; financial performance increases by 0.087 units when debt recovery process increases by one unit all else held constant; financial performance increases by 0.152 units when adherence to lending requirements increases by one unit all else held constant. Lastly, financial performance increases by 0.124 units when adherence to credit policy increases by one unit all else held constant. From the regression coefficients table above, the regression equation is extracted as follows:

$$Y= 1.982 + 0.198X_1 + 0.152X_2 + 0.087\ X_3 + 0.124X_4$$

In view of the regression function comma holding all factors constant, financial performance in commercial banks would be 1.982.

Hypotheses were tested at a significance level of 0.05. The study found out that loan appraisal process has a significant effect on financial performance of commercial banks with a P-value of 0.001.Debt recovery process was found to have an insignificant effect on financial performance of commercial banks with a P-value of 0.107. Lending requirements had a significant effect on financial performance of commercial banks with a P-value of 0.012. Credit policy had a significant effect on financial performance of commercial banks with a P-value of 0.032.

The study established that loan appraisal process, debt recovery process, lending requirements and credit policy have a significant effect on financial performance commercial banks in Kenya. From the regression analysis, the study found a positive relationship between financial performance and credit risk management. Pastory (2013) sought to establish the relationship between credit risk management and commercial banks performance. The study found that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. Ahmad (2012) examined effects of credit risk management on financial performance of commercial banks and found that credit risk of commercial banks on emerging economy banking systems compared with the developed economies. The study found that regulation is important for banking systems that offer multi-products and services; quality management is critical in the cases of loan dominant banks in emerging economies. An increase in loan loss provision is also considered to be a significant determinant of potential credit risk which has positive and significant impact on banks' net interest margin, cost efficiency and profitability.

VIII. Conclusion and Recommendation

The study established that credit risk management affect financial performance of commercial banks in Kenya. In this regards this study conclude that effective credit risk management system reduces the level of nonperforming loan which leads to improved financial performance. The study concluded that loan appraisal process is a major factor that influence financial performance of commercial banks in Kenya and need to be considered in order to enhance financial performance of commercial banks. This study further concludes that lending requirements is a factor that influence financial performance of commercial banks in Kenya and in this regards borrowers' historical and projected cash flows and adequate collateral margins should be evaluated in order to improve financial performance. The study established that debt recovery process had a significant effect on financial performance of commercial banks therefore concludes that debt recovery processes such as managing daily and monthly loan portfolio at risk by calling the customers and issuance of demand letters and follow-ups of non-performing loans are essential in credit risk management. The study established that credit policy had a significant effect on financial performance of commercial banks and concluded that strict adherence to credit policies will salvage the bank from non performing loans. The study concludes that the bank need to maintain substantial amount of capital reserve to absorb credit risk in event of failure, the bank also needs to enhance lending criteria, portfolio grading and credit mitigation techniques to reduce chance of default. The study recommends the adoption of sound management practices and corporate governance will reduce credit risk.

The study recommends that commercial banks in Kenya should put stringent measure when conducting loan appraisal process and should adhere to all the lending requirements stipulated in order to enhance financial performance. Further the study recommends that commercial banks need to come with credit policies and devise strategies that will not only limit the banks exposition to credit risk but will establish a proper credit risk management strategies by conducting sound credit evaluation before granting loans to customers. This study therefore recommends that the banks to closely monitor credit advances and adopt other appropriate steps necessary to control or mitigate the risk. There is a need for commercial banks to adopt non-performing loans management practices. Such practices include ensuring sufficient collaterals, limiting lending to various kinds of businesses, loan securitization, ensuring clear assessment framework of lending facilities and use of procedures in solving on problematic loans among others.

IX. Contribution to Knowledge

The findings of this study are of paramount importance to top bank management because they could be able to make better decisions in credit risk management. The study could also be a beneficial to bank regulators in setting the guidelines that relates to credit risk management. The study could also be beneficial to the government as it provides information that is useful in diagnosing the problems commercial banks are facing in credit risk management and performance. The study could be valuable to other scholars and researchers especially those dealing with studies relating to credit risk management and financial performance because it provided them with empirical studies that they can use in their study. The study made several contributions to both knowledge building and practice improvement in credit risk management and financial performance. It added the body of knowledge in the finance discipline by bridging gaps in credit risk management research in general. Scholars could use this study as a basis for discussions on credit risk management and financial performance. The study provided empirical data for policy makers in formulating appropriate policies and possible solutions of credit risk management in commercial banks which affects their financial performance.

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