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CREDIT RISK MANAGEMENT PRACTICES AND FINANCIAL PERFORMANCE OF SELECTED COMMERCIAL BANKS IN KENYA

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Abstract: Commercial banks all over the world enhance the economic growth of nations by providing funds to customers of investments. The survival of commercial banks like every other financial institution depends largely on their profitability. However, the profitability of these banks is dependent on the risk management practices which they adopt. This is because granting of loans to borrowers is accompanied with its own risks. Studies relating to credit risk management practices were done in developed and other developing countries other than Kenya. Similarly, some of these studies focused on microfinance banks and Sacco societies. The current study seeks to fill the research gap by focusing on credit risk management practices and commercial banks financial performance in Kenya. Therefore, the specific objectives of the study are to determine the effect of client appraisal, credit terms and conditions, credit collection policies and credit control practices commercial banks' financial performance in Kenya. The research utilized descriptive research design and the sampling design was purposive sampling design. The research made use of a multiple regression model for the analysis. Findings of the study indicate that there exist a positive and significant effect of credit risk management practices that is, credit terms and conditions, client appraisal, credit practices and credit control practices on financial performance of commercial banks in Kenya. The study recommends that credit managers should come up with efficient terms and conditions and client appraisal that will enhance credit control and collection.

1. INTRODUCTION

1.1 Background of the Study

The banking sector plays a vital role in the economic resource allocation of countries all over the world (Ongore, 2013). Banks promote a nation's economy by availing funds to borrowers for investments (Otuori, 2013). Notably, the profitability of Commercial banks has been very high in Sub-Saharan Africa (SSA), average returns on assets were about 2 percent over the last 10 years, which is significantly above the returns of banks in other parts of the world (Flamini, Valentina, McDonald, & Liliana, 2009).

However, in some developing countries, the banking sector has experiences several cases of collapses, these banks include Savannah Bank Plc in the 90's, Societe General Bank Ltd which occurred in early 2000's, and Alpha Merchant Bank Ltd, (for Nigeria). In the case of Kenya, notably the case of chase bank among others which have attracted the attention of stakeholders which include professionals and policy makers.

One of the core pillars of financial intermediation is lending which is accompanied with the risk of default which affects the performance of banks. McNaughton (1992) asserts that is a vital role of commercial banks, therefore, banks succeed when the risk management practices and appropriate. Anyanwu (2014) is of the view that for banks to ensure they survive the adherent lending risk and cater for the financial needs of the economy, they must relook at their bureaucratic tendencies.

According to Conford (2010), credit risk refers to the uncertainty that the actual return on achievement or loan extracted will deviate from expectations. This implies that credit risk is the losses from the inability or refusal of borrowers repay loans in full or on time. Therefore, credit risk management refers to the practice of mitigating against those losses associated with lending by commercial banks and other financial institutions. Waweru and Kalam (2010) identified volatile interests, inadequate organizational capacity, inappropriate laws and loan policies and poor management as the main causes of credit risks.

Bank performance is of great concern to all stakeholders, these stakeholders include the debtors, the owners, the managers of banks, the investors, the regulators, the creditors, the depositors and the government (Bentum, 2012). Bank performance serves as a guide for stakeholders in in their decision making. The banking sector in Kenya comprises of 13 and 40 foreign owned and locally owned banks respectively (Central Bank of Kenya, 2015).

1.2 Statement of the Problem

The banking sector was at the center of the world's recent financial crisis. The fall in value of their asset portfolios, which was largely attributed to their poor credit management, formed one of the major causes of this crisis. In Kenya, a number of banks have collapsed which include the Capital Finance Ltd and chase bank among others. Similarly, Njanike (2009) opined that the absence of effective credit risk management practices brought about the banking crises and the global financial crises at large. The seemingly trend poses a threat to commercial banks' sustainability and financial viability which could hinder the availability of loans to the rural unbanked areas.

Credit risk management and banks' performance have sparked the interests of many scholars. This is because poor credit management has led to the collapse of some banks which has caused panic in the society (Kiplimo and Kalio, 2012). Most studies relating to credit risk management practices were done in developed and other developing countries other than Kenya. Similarly, some of these studies focused on microfinance banks and sacco societies. These studies among other findings have indicated a high default rates among commercial banks which in turn leads to low performance of these banks. The ongoing study seeks to fill the conceptual and contextual gaps found in literature by focusing on credit risk management practices and financial performance of commercial banks in Kenya.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of this study is to determine the effect of credit risk management practices on financial performance of commercial banks in Kenya.

1.3.2 Specific Objectives

The specific objectives of the study were:

- **i.** Determine the effect of credit terms and conditions on commercial banks' financial in Kenya.
- **ii.** Assess the effect of client appraisal on commercial banks' financial performance in Kenya.
- **iii.** Determine the effect of credit control practices on commercial banks' financial performance in Kenya.
- **iv.** Establish the effect of credit collection policies on commercial banks' financial performance in Kenya.

1.4 Scope of the Study

The research focused on all commercial banks situated in Kenya for the period 2012 to 2016 thus, making it the time scope of the study. Thus, the study was centered on 40 commercial banks which existed during the study period. The research made use of a multiple regression model for the analysis of the study.

2. LITERATURE REVIEW

2.1 Theoretical Review

Assymetry Information Theory in lending is based on the notion that information asymmetry exists when a client usually the borrower who applies for a loan usually posses superior knowledge on the potential risks and returns regarding the business or investments for which the loan is being applied for (Arora & Kumar, 2014). The lender usually doesn't have complete of information about the borrower and the intended project. In the context of financial institutions, information asymmetry problems are generally categorized into two, that is moral hazard and adverse selection (Rukwaro, 2001). Commercial banks encounter challenges in addressing these dominant problems because it is not rational to commit financial resources for monitoring and appraisal of small amounts of loans. This is because the data needed to screen applicants and monitor borrowers may have some costs attached to it (Ali, 2015). Therefore, commercial banks face a problem of information asymmetry in their operations.

Modern portfolio theory introduced by Markowitz (1954) was refined and extended by the likes of Tobin (1918) and later Sharpe (1934), among other scholars in the subsequent years. This is a finance theory which seeks to maximize the expected returns of portfolio with consideration to specified amount of portfolio risk. In other words, it seeks to minimize risk as guided by a given rate of expected return, by choosing in the right proportions of various assets.

The portfolio theory views diversification as a way of maximizing expected return of portfolios. It integrates the process of efficient portfolio formation to the pricing of individual assets. It is of the view that diversifications in this case holding an adequate combination of financial assets aids in the elimination of risk associated with individual assets (Bodie *et al.*, 1999).

The 5Cs model is an instrument used by financial organizations in credit management in evaluating a potential customer (Abedi, 2009). The 5Cs include collateral, character, condition, capital and capacity. Character is used in estimating the credit worthiness of a customer, it is usually used in weighting values for the different characteristics of the customer (Njanike, 2009). Economic, cultural and personal factors are believed to influence a customer (Ouma, 2008; Migiri, 2012). Similarly, the psychological factor is not dependent on an individual's visible evidences of achievement but on his inner worth. These factors are considered by banks by enquiring and studying about the customer (Kibor *et al.*, 2015).

2.2 Empirical Review

Various studies have been carried out on credit risk management and performance. These studies include Ben-Naceur and Omran (2008), Felix and Claudine (2008), Juanjuann *et al*. (2009), Kithinji (2010), Gaitho (2010), Korir (2011), Chepkoech (2015). However, these studies are characterized by various research gaps. Most of these studies relating to credit risk management practices were done in developed and other developing countries other than Kenya. Similarly, some of these studies focused on microfinance banks and Sacco societies. Also, previous studies ignored the moderating role of interest rates on the relationship between credit risk management practices and commercial banks' performance.

The ongoing study seeks to fill the conceptual and contextual gaps present in literature by focusing on the effect of credit risk management practices on financial performance of commercial banks in situated Kenya. In addition, the current study assessed the moderating effect of interest rates on the relationship between credit risk management practices and commercial banks' financial performance situated in Kenya.

3. RESEARCH METHODOLOGY

3.1 Research Design

Cooper and Schindler (2009) are of the view that research design forms the basis for the collection, measurement and analysis of research data. Research design refers to an outline plan which is adopted in a study by a researcher to generate answers to research questions (Mugenda & Mugenda, 2003). The study adopted descriptive research design. Descriptive studies provide description of the general characteristics of the study population and also give description of the characteristics of the research variables (Cooper and Schindler, 2009).

3.2 Population

40 commercial banks situated in Kenya between the year 2012 to 2016 were the focus of this study, thus constituting the target population of the study. Similarly, the audited financial statements of the banks formed the unit of observation of the research.

3.3 Sampling Design

The study made use of purposive sampling design as it was based on 40 banks situated in Kenya. Mugenda and Mugenda (2003) asserts that purposive sampling allows the researcher to use his judgements to choose the respondents of the study. Similarly, the respondents of the study will be the compliance managers, risk managers and collection managers of the 40 commercial banks situated in Kenya. Therefore, making the total number of respondents to be 120.

3.4 Data Collection instruments

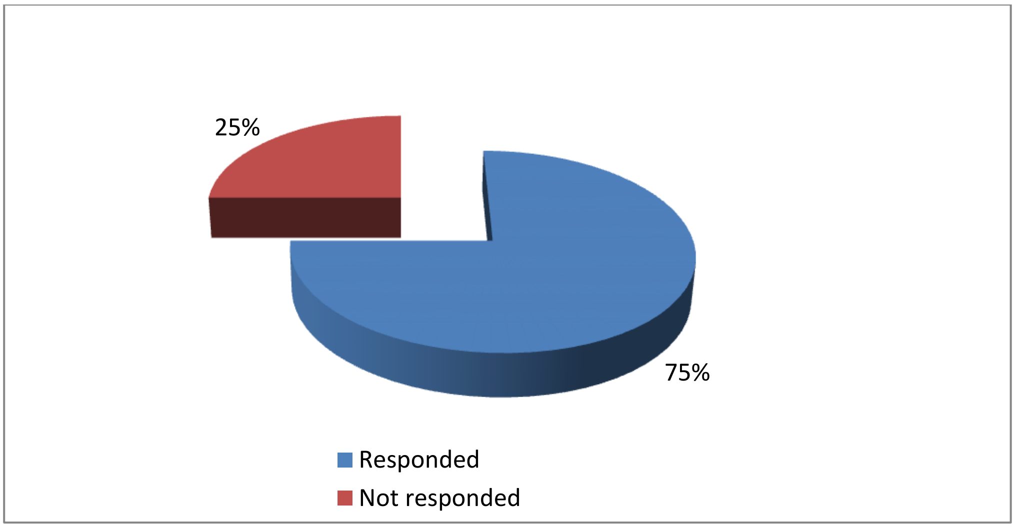
This research utilized both secondary and primary data. Primary data was gathered with the use of questionnaire. Questionnaire is a method of data collection whereby the respondents provide written answers to written questions. The choice of questionnaire as a method of data collection for this study is attributed to the fact that questionnaires are cost effective when compared to face-to-face interviews. In addition, questionnaires are easy to analyze. Moreover, questionnaires are familiar to most people as it is the most common method of data collection in a research.

4. DATA ANALYSIS AND PRESENTATION

4.1 Response rate.

The response rate was analyzed on the basis of the proportion of the questionnaires that were duly filled and returned as presented in Figure 4.1 below.

Figure 4.1: Response rate



Source: Survey Data (2018)

The results in Figure 4.1 shows the response rate was 75% which was good and representative. This is consistent with Mugenda and Mugenda (2012) that a response rate of 50% and above is adequate for analysis and drawing conclusion.

4.2 Background information of the respondents.

The study sought to determine the background characteristics of the respondents in terms of the gender, age and education level.

4.2.1 Gender

The table 4.1 below indicates the demographic characteristic based on the gender

Table 4.1: Gender of the respondents

	Frequency	Percent
Female	29	33.0
male	59	67.0
Total	**88**	**100.0**

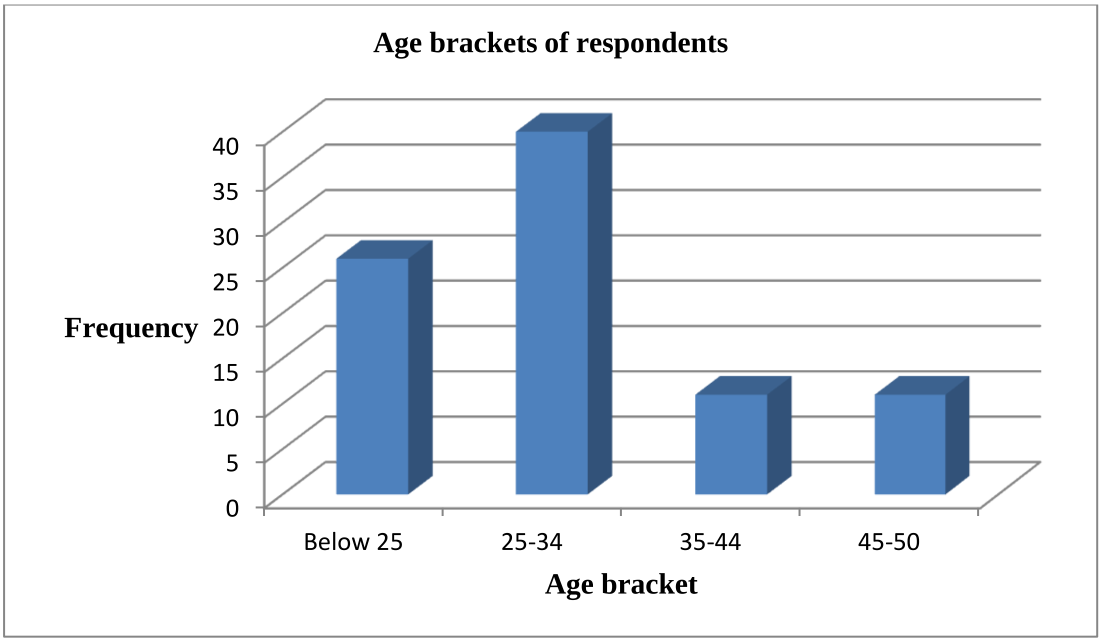
Source: Survey Data (2018)

According to the findings, majority of the respondents were male at 67% while female constituted 33%. However the two types of gender were fairly represented in the study.

4.2.2 Age bracket

The study also sought to determine the age brackets of the respondents. The results are presented in figure 4.2 below;

Figure 4.2: Age brackets of the respondents



Source: Survey Data (2018)

From the findings, majority of the respondents were between the age of 25-34 years at frequency 40, followed by those below the age of 25 years at 26, then those between the age of 35-44 years and 45-50 years at 11 each.

4.2.3 Level of education

The study sought to determine the levels of education for the respondents and the results presented in table 4.2 below;

Table 4.2: Levels of Management.

	Frequency	Percent
Diploma/certificate	23	26.1
undegraduate	32	36.4
Masters	22	25.0
Phd	11	12.5
Total	**88**	**100.0**

Source: Survey Data (2018)

From the findings, the support staffs were the majority of respondents were undergraduates at 36%, followed by diploma at 23%, masters at 25% and Phd at 12.5%.

4.3 Descriptive Analysis

The researcher used mean and standard deviation to present the summary measures of the sample that was observed. Analysis of descriptive statistics was conducted on the basis of the data collected on the variables that were at the core of this study. The basic feature of the observed sample formed the basis for quantitative data analysis for this study.

4.3.1 Credit terms and conditions.

The researcher analyzed the data collected on the measures of credit terms and conditions used by commercial banks in Kenya and presented the results in Table 4.3.

Table 4.3: Descriptive Statistics on credit terms and conditions

	N	Minimum	Maximum	Mean	Std. Deviation
The bank has an internal credit rating system	88	3.00	5.00	4.2386	.67797
The organization has clear credit standards and objectives	88	3.00	5.00	3.9886	.66944
We have strong credit systems and controls	88	1.00	5.00	4.1477	.86489
There is clear credit information disclosure	88	1.00	5.00	3.9091	.68877
Management capacity of the loan applicants is rated	88	1.00	5.00	3.4432	.98094
Average scores				**3.9455**	**.77640**

Source: Survey Data (2018)

From the findings, credit rating system had the highest mean of 4.2386, followed by credit systems and controls at 4.1477, followed by credit standards and objectives at 3.9886, credit recovery measures at 3.9091 and management capacity at 3.4432. The average mean is 3.9455 meaning that most respondents agree that credit terms and conditions do affect the financial performance of the commercial banks in Kenya.

4.3.2 Client appraisal practice.

The researcher conducted the analysis of the data collected on the descriptive statistics of the client appraisal practices and displayed the results in Table 4.4;

Table 4.4: Descriptive Statistics on Client appraisal practice

	N	Minimum	Maximum	Mean	Std. Deviation
Business plan is analyzed in order to identify risk exposure	88	3.00	5.00	4.3182	.70377
Cash flow projections of the projects are considered before financing	88	3.00	5.00	4.5682	.52073
Borrowers capability is considered before giving loan	88	3.00	5.00	4.3864	.53459
Long term business viability and clients trustworthiness of every loan applicant	88	2.00	5.00	3.9886	1.18898
We look at the collateral as a secondary source of repayment	88	3.00	5.00	4.5341	.54560
Average scores				**4.3591**	**.69873**

Source: Survey Data (2018)

From the findings most of the respondents on agree that clients' appraisal affects the financial performance of the commercial banks in Kenya positively. Business plan analysis had a mean of 4.3182. Cash flow projections had a mean of 4.5682, borrower's capability had a mean of 4.3864, business viability and client's trustworthiness had a mean of 3.9886 while collateral had the mean of 4.5341. The average mean is 4.3591 implies that most respondents agree that clients' appraisal has a positive effect on the financial performance of Banks in Kenya.

4.3.3 Credit control practices

The researcher analyzed the data collected on the measures of credit control practices and presented the results in Table 4.5.

Table 4.5: Descriptive Statistics on Credit control practices.

	N	Minimum	Maximum	Mean	Std. Deviation
The institution has regular training on credit policy	88	1.00	5.00	3.0341	1.22661
We have clear portfolio guidelines	88	2.00	5.00	3.5000	.88409
There are clear documented credit policies	88	3.00	5.00	4.2273	.82667
Efficient data management	88	3.00	5.00	4.0114	.78043
The institution has sufficient risk tools	88	2.00	5.00	3.8750	.81385
Clients are requested to provide financial guarantees	88	3.00	5.00	4.4545	.72570
Average scores				**3.8504**	**0.87623**

Source: Survey Data (2018)

From the findings most of the respondents on agree that credit control practices affect the financial performance of the commercial banks in Kenya positively. Regular credit policy had a mean of 3.0341. Portfolio guidelines had a mean of 3.5000, policy documentation had a mean of 4.2273, efficient data management had a mean of 4.0114, and risk tools had a mean of 3.8750 while financial guarantees had the mean of 4.4545. The average mean is 3.8504 implies that most respondents agree that clients' appraisal has a positive effect on the financial performance of Banks in Kenya.

4.3.4 Credit collection policies

The researcher analyzed the data collected on the measures of credit collection policies and presented the results in Table 4.6.

Table 4.6: Descriptive Statistics on Credit collection policies

	N	Minimum	Maximum	Mean	Std. Deviation
Debtors are reminded before the repayment falls due	88	2.00	5.00	3.7273	.69028
Defaulters are followed up	88	2.00	5.00	3.8068	.78576
Clients are given grace period when repayment falls due	88	2.00	5.00	3.5341	.89634
Retaining of collateral is the last option when debtors are unable to repay the loans	88	2.00	5.00	4.1591	.60432
Collection procedures are made clear to clients before granting of any loans	88	2.00	5.00	3.2159	1.04440
Average scores				**3.6886**	**0.80422**

Source: Survey Data (2018)

From the findings most of the respondents on agree that credit collection policies affect the financial performance of the commercial banks in Kenya positively. Debt reminder had a mean of 3.7273. Defaulters follow up had a mean of 3.8068, grace period had a mean of 3.5341, collateral retaining had a mean of 4.1591, and collection procedures had a mean of 3.2159. The average mean is 3.6886 implies that most respondents agree that credit collection policies has a positive effect on the financial performance of Banks in Kenya.

4.4 Inferential Analysis

This section focused on the Correlation test, model summary, ANOVA, and multiple regression analysis on the effect of credit risk management practices (credit terms and conditions, client appraisal practice, credit control practices and credit collection policies) on the performance of commercial banks.

4.4.1 Analysis of Variance (ANOVA)

This study made use of the ANOVA statistics to find out the significance of the association between the financial performance of commercial banks in Kenya and the independent variables.

Table 4.7: Analysis of variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	16151.109	4	4037.777	271.502	.000[b]
	Residual	1234.376	83	14.872		
	Total	17385.485	87			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), Credit collection policies, Credit terms and conditions, Credit Client appraisal practices

Source (Survey data, 2018)

From the findings, the model was significant with a p-value of 0.000 which implies that the model was good for estimation.

4.4.2 Model summary

The study also determined the percentage of variation in the dependent variable as a result of a percentage change in the predictor variables. The results are presented in table 4.8 below

Table 4.8: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.964[a]	.929	.926	3.8564231

a. Predictors :(Constant), Credit terms and conditions, Client appraisal, Credit control practices, Credit collection policies

Source (Survey data, 2018)

The model had an adjusted R-square value of 0.926. The R-square value of 0.926 implies that the predictor variables explain 92.6% of the changes in the financial performance of commercial banks in Kenya.

4.4.3 Regression Analysis

This study further sought to determine the multiple regression effect of credit risk management practices on the financial performance of commercial banks in Kenya. Table 4.9 exhibits the regression analysis results.

Table 4.9: Multiple Regression Analysis

Model	Unstandardized Coefficients		Standardized Coefficients			95.0% Confidence Interval for B	
	B	Std. Error	Beta	t	Sig.	Lower Bound	Upper Bound
1 (Constant)	1.090	.231		4.724	.000	.631	1.549
X1	9.998	1.180	.288	8.471	.000	7.651	12.346
X2	15.412	1.398	.413	11.022	.000	12.631	18.193
X3	14.954	1.398	.365	10.699	.000	12.174	17.734
X4	13.907	1.195	0.359	11.636	.000	11.529	16.284

a. Dependent Variable: Financial performance

Source: Survey Data (2018)

The regression model that was estimated through the results of regression analysis is presented below.

$$\mathbf{Y=1.090+9.998X_1+15.412X_2+14.954X_3+13.907X_4+\varepsilon}$$

Without the inclusion of the predictor variables, the performance increases by 1.090 times. A unit increase in credit terms and conditions (X1) results in the increase in the financial performance of Banks by 9.998 times. Secondly, a unit increases in client appraisal practices (X2) other factors held constant, results in an increase in performance of Banks by 15.412 times. Thirdly, a one unit increase in credit control practices (X3) other things held constant, results in an increase in the performance by 14.954 times. Lastly for a unit increase in the credit collection practices there is an increase in financial performance of commercial banks by 13.907 other factors held constant times. The p values also indicate that all the variables, are significant at 0.05 level of significance with p values of 0.000.

4.5 Interpretation of the findings

The researcher sought to establish the effect of credit terms and conditions on financial performance of commercial banks in Kenya. The results of regression analysis in Table 4.12 demonstrate that Without the inclusion of the predictor variables, a unit increase in credit terms and conditions (X1) results in the increase in the financial performance of Banks by 9.998 times. With the inclusion of the moderating variable, the financial performance increases by 10.006 times. The p values also indicate that the credit terms and condition was significant at 0.05 level of significance with p values of 0.000.

The researcher sought to establish the effect of client appraisal on financial performance of commercial banks in Kenya. The results of regression analysis in Table 4.12 demonstrate that Without the inclusion of the predictor variables, a unit increase in client appraisal (X2) results in the increase in the financial performance of Banks by 15.412 times. With the inclusion of the moderating variable, the financial performance increases by 15.414 times. The p values also indicate that the client appraisal was significant at 0.05 level of significance with p values of 0.000.

The researcher sought to establish the effect of credit control practices on financial performance of commercial banks in Kenya. The results of regression analysis in Table demonstrate that Without the inclusion of the predictor variables, a unit increase in credit control practices (X3) results in the increase in the financial performance of Banks by 14.954 times. With the inclusion of the moderating variable, the financial performance increases by 14.756 times. The p values also indicate that the credit control practices were significant at 0.05 level of significance with p values of 0.000.

The researcher sought to establish the effect of credit collection policies on financial performance of the commercial banks in Kenya. The results of regression analysis in Table 4.12 demonstrate that Without the inclusion of the predictor variables, a unit increase in credit collection policies (X4) results in the increase in the financial performance of Banks by 14.954 times. With the inclusion of the moderating variable, the financial performance increases by 14.756 times. The p values also indicate that the credit control practices were significant at 0.05 level of significance with p values of 0.000.

5. POLICY RECOMMENDATIONS

The policy recommendations of this research are based on the study objectives. In respect to effect of credit terms and conditions on financial performance of commercial banks in Kenya. The study recommends that the management of commercial banks should ensure and enhance effective terms and conditions regarding the lending habit of banks.

Secondly, with respect to client appraisal and financial performance of commercial banks in Kenya. The study recommends that the credit managers should put in place a sound and effective appraisal system which will ensure the proper appraisal of customers before any loans and advances are issued. Thirdly, the study recommends that bank management adopt control policies that will monitor and stabilize bank credit to customers. This in turn will bring about greater financial performance of commercial banks in Kenya. Lastly, the study recommends that credit managers should adopt measures that will improve credit collection as this significantly determines bank performance.

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