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Non-Performing Loans and Financial Performance of Banks: An Empirical Study of Commercial Banks in Kenya

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Abstract: **The study focused on the effect of Non-Performing Loans on financial performance of commercial banks operating in Kenya. A descriptive survey and empirical research designs were adopted by the study where the target population comprised 44 commercial banks in Kenya. The study used a census of all commercial banks licenced by Central Bank of Kenya. Data sheets were used to collect secondary data from the central bank supervisory reports and banks published audited financial statements for the last five years 2011-2015. Data collected was analyzed using descriptive statistics which include the use of standard deviation and means. Inferential statistics included Pearson correlation, Multiregression and ANOVA. It was established that nonperforming loans had a statistically significant effect on financial performance proxied by ROA ($\beta 1= -7.042$, $t = -.968$, $p = .002$ and $\alpha = 0.05$). Other bank specific factors including Bank size, capitalization operating costs had a statistically significant effect on financial performance proxied by ROA. However; liquidity had a statistically insignificant effect on financial performance proxied by ROA. Outcome of this study would enable management of commercial banks in Kenya adopt feasible mechanisms to control the growing problem non-performing loan.**

Keywords: **Financial Performance, Non- performing loans, commercial banks and liquidity.**

I. INTRODUCTION

In the contemporary banking business, increasing Non-performing loans (NPLs) is a very critical but frequent issue in bank fund management. The situation of NPLs is not only a challenge worldwide but also in Kenya in Kenya .The situation of rising NPLs can damage the confidence of investors and might act as a contagious for financial malaise as it may drive away deserving loan borrowers out of the financial system. The problem of rising Non-performing loans may be attributed to inadequate or weak monitoring & controls and supervision on the part of banks, weaknesses of legal infrastructure, lack of effective lenders' recourse and poor debt recovery strategies (Adhikary, 2006). Currently, there is no universally accepted definition of NPLs at the practical level. NPLs may be described as portion of bank financial assets from which the bank is no longer receiving interest and/or instalment payments as initially agreed. Choudhury *et al.*, (2002) explains that NPLs is a multi-class concept since NPLs can be categorised into different categories based on the duration NPL has been overdue. NPLs results from the weaknesses in the administration and supervision of the financial system of which commercial banks are a part of. Study by Bonin and Huang (2001) hold that that the probability of crises in banking industry worsens if financial risks are not eliminated as soon as possible. The crises are known not only to degrade the standard of living but also can water down a number of the previous achievements of economic reform in a short time. Mwangi (2012) argues that there is an inverse relationship between banks financial performance and NPLs. Mwangi (2012) further explains that the greater the value of NPLs the lesser will the financial performance be as proxied by return on asset (ROA) and vice versa.

A. Statement of the Problem:

It is agreed globally that commercial banking institutions are very critical in availing financial services to the economic units in a country as well as offering loans and advances to borrowers. However, commercial banking institutions are currently facing the problem of NPLs. Nonperforming loans is not only harmful to the financial performance of commercial banks, but they also have other serious negative impacts in economic recovery and development of a country. Potential loan borrowers may be denied the opportunity to access loans from commercial banks since a big chunk of bank funds that could be made available to them as loans are still tied to Non-Performing Loans. Kenyan banks are not an exception on the problem of NPLs.Kenyan banking sector was being prepared for rise in problematic loans with majority of commercial banks expected to record growth in NPLs, (CBK,2015) .The figure of NPLs in the loan books of the domestic commercial banks operating in kenya increased to ksh.120 bn during the second last quarter of 2015 (CBK, 2015). Moreover the figure of NPLs rose by 0.7% and the quality of assets held by banks decreased from 2.7% in June 2015 to 2.5% in September 2015. The central bank of Kenya has put two banks on receivership as of April 2016 that is Chase Bank and Imperial Bank of Kenya due to poor performance majorly brought by NPLs. The critical nature of NPLs to the financial performance necessitated this current study which aimed at finding the effect of NPLs on financial performance of commercial banks operating in Kenya.

B. Objectives of the study:

The purpose of the research was to establish the effect of Non-performing Loans on financial performance of commercial banks operating in Kenya.

C. Hypotheses of the Study:

The study tested the following hypotheses:

$H_0$1: Non- performing has no significant effect on financial performance of commercial banks operating in Kenya.

$H_0$2: Bank size does not significantly affect the financial performance of commercial banks operating in Kenya.

$H_0$3: The effect of bank capitalization ratio on financial performance of commercial banks operating in Kenya is not statistically significant.

$H_0$4: Operating cost does not have significant effect on financial performance of commercial Banks operating in Kenya.

$H_0$5: bank liquidity has no significant effect on financial performance of commercial banks in Kenya.

II. LITERATURE REVIEW

A. Theoretical Review:

This study was based on two theories that is Moral Hazard and stakeholder theory. Moral hazard theory is based on moral hazards that refers to an a condition leading to risk that results when a banks customer provides information that is misleading about its financial statements or his or her credit capacity, or has an hidden incentive to take risks that are unusual in an attempt to earn a profit before the contract settles. The bank customer who is the borrower may not enter into the contract with the bank in good faith, hence gives misleading information about his or financial status or credit capacity. The theory postulates that, the problem of moral hazard may result from information asymmetric between banks customer and the bank which makes it almost impossible to distinguish bad from good prospective borrowers (Richard (2011). Researchers have noted that moral hazard problem has led to overtime pilling up of NPLs (Bofondi & Gobbi, 2003). This underpins this study since bank customers and financial institutions tend to hide key information concerning the lending and borrowing contracts. Efficient financial systems and financial intermediation requires accurate information about borrowers and the venture the credit are used for.

The study is also based on the stakeholder theory. The theory argues that that apart from stockholders there are numerous groups that have an interest in the running and management of corporations called stakeholders. Stakeholders are groups that have a direct interest in the running of an institution and have got rights that may be respected or violated by management of corporations. The major stakeholders may include shareholders, customers, creditors, employees, suppliers and the local communities. The theory of Stakeholder holds that businesses organizations have an obligation to the society. They are expected to take into account the interests of all stakeholders affected by their actions. According this theory, the management should consider all individuals affected by its action in addition to shareholders when making decisions pertaining to the organization. The theory of Stakeholder postulates that the goal of any institution should always be the prosperity of the organization as well as its key stakeholders (Freeman et al., 2004).Stakeholder theory is relevant for the current study as one of the stakeholder to a bank are the customers who borrow loans. When the customers fail to pay loan on time due to reasons like loan over prising, level of nonperforming loans raises hence poor financial performance of commercial banks.

B. Empirical Review:

Study by Talata (2011) examined the effect of non-performing loans on the financial performance. The finding showed that NPLs, loan recovered, cost-income ratio, and total revenue were statistically significant at one percent (1%) level of significance respectively. however liquidity risk was not statistically significant. The NPLs & cost to income ratio had a negative effect on financial performance while total revenue & loan recovered had a positive influence on financial performance. Study by Wangai , Bosire and Gathogo (2012) investigated the effect of non-performing loans on financial performance of microfinance banks (MFBs) in Kenya. The research was carried out in MFBs in Nakuru town, Kenya. The results showed that, credit risk had significant effect on financial performance of Micro finance Banks in Nakuru town. Awoyemi (2014) also analyzed the effect of Credit Risk Management on the performance of Commercial Banks in Nigeria. In the regression model, ROE and ROA were used as indicators of performance while NPLs and Capital Adequacy Ratio (CAR) were used as credit risk management proxies. The study collected data from annual reports of seven commercial banks for seven years beginning 2005 to 2011. From panel regression model, it was established that credit risk management practices have a statistically significant effect on the profits of commercial banks operating in Nigeria. Research by Muasya (2009) carried a comparative study to find out extent to which commercial banking institutions in Kenya and Europe were affected by problem of NPLs during the global financial crisis period 2008/2009 .The study results showed that Kenyan banks made less losses as comprared to banks in US and Europe in same period due to the negative effet of Non-Performing Loans.

Study by Kargi (2011) examined the effect of credit risk on the financial performance of banks in Nigeria. The study employed financial ratios as proxies for performance of the bank. Data on credit risk was extracted from the financial reports of sampled banks covering five years beginning from 2004 to 2008.The data was analyzed using the descriptive and inferential statistics that is pare wise correlation and regression techniques analysis. The results revealed that credit risk management had a statistically significant effect on the financial performance, measured by profits, in banks in Nigeria. The study held those banks' profits is negatively affected by volume of loans and advances, NPLs and deposits hence exposing banks to great liquidity risk and financial distress. Study by Epure and Lafuente (2012) studied bank financial performance in banking industry in the presence of risk in Costa-Rica during the period 1998 to 2007. The finding revealed that improvement in performance followed changes in regulations and that risk explains differences in banks. NPLs was found to negatively affect efficiency and ROA while the capital adequacy ratio had a significant and positive effect on the net interest cover margin. Study by Kithinji (2010) examined the impact of credit risk management practises on the profits of commercial banking institutions operating in Kenya. Data on the amount of customer credit advanced, level of NPLs and profits were collected for five years (2004 - 2008). The results showed that that the big chunk of the profits of commercial banks are not affected by total customer credit and NPLs suggesting that their exist other variables apart from total customer credit and NPLs loans that impact on profits. Chen and Pan (2012) assessed the credit risk efficiency of 34 commercial banks in Taiwanese for a period of four years (2005-2008). Chen and Pan used financial ratio as proxy for credit risk .Data was analyzed using DEA. The parameters of credit risk were credit risk allocative efficiency, credit risk cost efficiency and credit risk technical efficiency. The findings revealed that only one bank was efficient in all types of efficiencies over the study period evaluated.

Study by Felix and Claudine (2008) assessed the association between banks' performance and credit risk mangt. Practices. Findings showed that that ROA and ROE, both measuring profitability of financial institutions, were negatively related to the ratio of NPLs to total loan of financial institutions hence leading to a decline in profitability. Ahmad and Ariff (2007) did comparative study also analyzed the key determinants of credit risk of commercial banks in emerging and developed economy banking systems. The results revealed that regulation is an important determinant for banking systems that offer many products and ; quality of management was critical in the cases of loan-dominant banks in emerging economies. An increase in loan loss provision is also considered to be a significant factor affecting credit risk. Another study was carried out by Al-Khouri (2011) assessing the effect of bank's specific risks & the overall banking environment on the financial performance of 43 commercial banks operating in six of the Gulf Cooperation Council (GCC) countries over the period between 1998 and 2008. The study employed fixed effect regression model for analysis. The findings revealed that credit risk, capital risk and liquidity risk are the key banks specific risks that affect bank performance (ROA) while only Liquidity risk affects profitability when measured by ROE. Study by Ben-Naceur and Omran (2008) examined the influence of financial institutional development, bank regulations and concentration on commercial banks' margin and profitability in the Middle East and North Africa countries (MENA) from 1989-2005.The study revealed that capitalization of the bank and credit risk had a significant and positive impact on banks' cost efficiency, net interest margin and profitability. Ahmed, Takeda and

III. RESEARCH METHODOLOGY

A. Research Design and target population:

In this study, the researcher used descriptive survey and empirical research design. According to Saunders, Lewis and Thornhill (2009), descriptive survey research design is meant to give an output of statistical information about an aspect of a study that is of interest to policy makers in a bid to aid them in making informed decisions. The study described the effect of Non-Performing loans on financial performance of commercial banks in Kenya. The target population for this study was all the registered commercial banks in Kenya. According to CBK, there are 44 registered commercial banks in Kenya as of 31st December 2016 (CBK, 2016). Since this study was a survey of the entire banking industry, the sampling frame was the 44 commercial banks that operated between 2011 to 2015 financial years. A census was done in order to provide a true measure of population. As result, no sampling technique was necessary because the research utilized the entire population. The period of study was five years 2011, 2012, 2013, 2014 and 2015.

B. Data Collection Methods:

Due to the nature of financial studies, the researcher used secondary data sources. Secondary data was sourced from statistics maintained by the central bank of Kenya which is the regulatory body which supervises the banking industry in Kenya. The data was also collected using data collection sheet. Data of interest was return on assets, bank assets, loan losses, cash and cash equivalents .Reliability and validity of test instrument was also important concept for this study. For the purpose of this study, data reliability and validity was ensured by collecting data from official sources such as annual audited accounts and corporate websites.

C. Data Analysis Techniques and Procedures:

The data collected was examined before analysis commenced for completeness and consistency .The data was analyzed using descriptive and inferencial.The panel methodology was aided by Excel 2013 and SPSS Version 22 software. Descriptive statistics included measures of central tendencies and dispersion. Bivariate Pearson correlation, multiple regressions and ANOVA were used to test the significance of the effect of NPLs on financial performance of commercial banks operating in Kenya. The study used empirical model to test the significance effect of Non performing loans on financial performance (ROA) of commercial banks operating in Kenya. The model is represented by the regression formulae below.

$$ROA_{it} = \beta_0 + \beta_1 LLPR_{it} + \beta_2 LOGTA_{it} + \beta_3 EAR_{it} + \beta_4 OPCR_{it} + \beta_5 CASH\text{-}TA_{it} + \beta_6 GDP_t + \varepsilon_i$$

Where

ROA =Return on Assets of bank i at time t, **$LLPR_{it}$**= Loan loss Provision to loan ratio of bank i at time t, **$LOGTA_{it}$** = Natural logarithm of total assets of bank i at time t, **EAR_{it}** = Equity to asset ratio of bank i at time t, **$OPCR_{it}$**= Operating Cost Ratio of bank i at time t, **$CASH\text{-}TA_{it}$** = Cash and cash equivalents to to total assets ratio of bank i at time t, **GDP_t** = Gross domestic product at time t, **$\beta 0$** =intercept term, $\beta_1, \beta 2, \beta 3, \beta 4, \beta 5$ ***and*** $\beta 6$ = are the coefficients of the independent variables respectively**,** i= 1, 2…….44, t= 2011,2012,2013 , 2014 and 2015 *and* ε_i Error term

IV. RESEARCH FINDINGS AND DISCUSSION

A. Descriptive Analysis:

Out of the 44 commercial banks currently licensed by central bank of Kenya, only 37 had complete data and had operated in the study period hence were used in the study . This section provides the descriptive statistics as per the objectives of the study. That is effect of loans losses, banks size, capitalization, operating cost and liquidity on financial performance of commercial banks as shown in table 1.

TABLE 1 DESCRIPTIVE STATISTICS

	N	Minimum	Maximum	Mean	Std. Deviation
LLP	37	35.76	553.24	234.3991	319.35016
GDP	37	4.4	5.6	4.9200	.68000
OPC	37	433.97	18525.73	6417.6662	4442.54338
ROA	37	-7.54	7.14	2.6215	2.78052
TA	37	4475.40	350925.60	70543.8649	85933.99377

LOANS	37	982.60	204082.48	38008.6632	48434.04026
EQUITY	37	1052.80	62706.20	10959.7081	14390.61116
CASH	37	62.04	6480.46	1854.4664	1713.22111

The researcher wanted to establish the central tendency and distribution of data concerning loan loss provision, total assets, equity, cash to cash equivalents, ROA, operating costs and GDP among the 37 selected commercial banks in Kenya. From table 1, the mean loan losses provision was kshs. 234 Millions .The standard deviation for the loan losses provision was ksh. 319 million .The minimum loan losses provision were ksh. 35 million and the maximum loan losses provision was kshs. 553 million. From table 1.Average total assets for the 37 commercial banks studied were about 70 billion Kenya shillings. The standard deviation for the total assets was ksh. 85 billion .The minimum total assets were ksh. 4 billion and the maximum total assets was kshs. 350 billion.From table1.The mean equity was kshs. 10 Billion .The standard deviation for the total equity was ksh. 14 billion. The minimum equity was ksh. 1billion and the maximum total assets was kshs. 62billion. From table 1.The average operating cost for the 37 commercial banks studied was about 6 billion Kenyan shillings .The standard deviation for the operating cost was ksh. 4.4 billion .The minimum operating cost was ksh. 433 million and the maximum total operating cost was kshs. 18 billion. From table 1. The mean cash and cash equivalents for the selected 37 commercial banks in Kenya was kshs. 1.8 billion.The standard deviation for the cash and cash equivalent was ksh. 1.7 billion The minimum cash and cash equivalents was ksh. 62 million and the maximum cash and cash equivalent was kshs. 6.4 billion. Finally, mean ROA was 2.6%.The standard deviation for the ROA was 2.78% .The minimum ROA was -7.54% and the maximum ROA was 7.14%.

B. Correlation Analysis:

The researcher carried out par wise correlations analysis to assist explains the association between NPLs and other banks specific factors and financial performance of commercial banks operating in Kenya. The researcher used Bivariate Pearson Correlation to establish the relationship as shown in table 2

Table 2 : BIVARIATE PEARSON CORRELATION COEFICIENTS

		LLPR	LOGTA	EAR	OPCR	CASHTA	GDP	ROA
LLPR	Pearson Correlation	1	-.453**	-.221	.257	.353*	.012	-.435**
	Sig. (2-tailed)		.005	.188	.125	.032	.673	.007
LOGTA	Pearson Correlation	-.453*	1	-.216	-.299	-.247	.011	.618**
	Sig. (2-tailed)	.005		.199	.072	.140	.721	.000
EAR	Pearson Correlation	-.221	-.216	1	-.136	-.351*	.024	.021
	Sig. (2-tailed)	.188	.199		.422	.033	.456	.672
OPCR	Pearson Correlation	.257	-.299	-.136	1	-.047	.035	-.720**
	Sig. (2-tailed)	.125	.072	.422		.781	.453	.003
CASHTA	Pearson Correlation	.353*	-.247	-.351*	-.047	1	.070	-.135
	Sig. (2-tailed)	.032	.140	.033	.781		.661	.425
GDP	Pearson Correlation	.012	.011	.024	.035	.070	1	.013
	Sig. (2-tailed)	.673	.721	.456	.453	.661		.354
ROA	Pearson Correlation	-.435**	.618**	.021	-.720 **	-.135	.013	1
	Sig. (2-tailed)	.007	.000	.672	.003	.425	.354	
**. Correlation is significant at the 0.01 level (2-tailed).								

The researcher wanted to establish the association between NPLs and financial performance of commercial banking institutions operating in Kenya. Non-performing loans was proxied by loan losses to total loans advanced by commercial banks. Bivariate Pearson correlation coefficient was calculated at 0.01 level of significance. First, Pearson's correlation (r) indicated that there was a statistically significant negative correlation between loan non performing loans and ROA ($r = -0.435$, $p = 0.007$ and $\alpha = 0.01$). Negative relationship suggests that an increase in non performing loans leads to reduction in Profitability as shown by reducing ROA. Secondly, there was a statistically significant positive correlation between bank size and ROA ($r = 0.618$, $p = 0.000$ and $\alpha = 0.01$). Bank size being positively correlated with ROA suggests that an increase in bank size leads to an increase in banks Profitability . Thirdly, The capitalization of the commercial banks proxied by the ratio of Equity to total Assets of commercial banks had a positive insignificant association with financial performance of commercial bank ($r = 0.072$, $p = 0.672$ and $\alpha = 0.01$). Capitalization being positively correlated with ROA; this suggests that an increase in bank capitalization leads to an increase in Profitability as shown by increasing

ROA. Fourthly, the operating cost of commercial banks in Kenya proxied by the ratio of total operating cost to net operating revenues of commercial banks had a statistically significant negative relationship with financial performance measured by ROA (r = - 0.720, p = 0.003 and α = 0.01). Operating cost being negatively correlated with ROA suggests that an increase in operating costs leads to a decreases in Profitability. Lastly but not least, Liquidity that was proxied by ratio of cash and other cash equivalents to total assets of a bank had a statistically but insignificant negative association with profitability measured by ROA (r = -0.135 , p = 0.425 and α = 0.01). With liquidity being negatively correlated with ROA; this suggests that an increase in liquidity leads to reduction in Profitability as shown by reducing ROA.

C. Regression Analysis:

Regression analysis was multiple in natures as there were six independent variables. The independent variables were loan losses, banks size, and capitalization, operating costs, liquidity and gross domestic product. The dependent variable was financial performance measured by ROA.

TABLE 3: COEFFICIENT OF DETERMINATION SUMMARY

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.677[a]	.458	.370	2.20620
a. Predictors: (Constant), CASHTA, OPCR, EAR, LLPR, LOGTA and GDP				

In Table 3, The overall correlation coefficient (R) between independent variables (loan losses, liquidity, operating costs, capitalization ,size of banks and gross domestic product) and financial performance (ROA) value was 0.677 .This means that there was a strong positive association between NPLs & other bank specific factors and financial performance of commercial banking institutions in Kenya. Further, tables 3 indicate that the model explains only 45.8 % of the variations in financial performance (ROA) as shown by the coefficient of determination (R^2) of 0.458 %. .Therefore 54.2% Variations in Financial performance (ROA) is explained by other factors not included in the model.

TABLE 4 : ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	127.440	5	25.488	5.237	.001[b]
	Residual	150.887	31	4.867		
	Total	278.327	36			
a. Dependent Variable: ROA, b. Predictors: (Constant), CASHTA, OPCR, EAR, LLPR, LOGTA and GDP						

According to table 4 the overall significance of model 1 was 0. 001 with an F value of 5.237. The level of significance was lower than 0.05 and this means that non performing loans and other bank specific factors do show statistically significant effect on financial performance (ROA) .

TABLE 5: COEFFICIENTS OF INDEPENDENT VARIABLES

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-14.871	5.410		-2.749	.010
	LLPR	-7.042	7.272	-.157	-.968	.002
	LOGTA	1.437	.376	.661	3.818	.001
	EAR	0.907	0.344	.249	0.538	.134
	OPCR	-5.468	1.145	.060	-3.409	.000
	GDP	.245	.456	043	.382	.345
	CASHTA	-0.411	3.134	.174	-0.097	.281
a. Dependent Variable: ROA						

$$\mathbf{ROA_{it} = -14871 -7.042\ LLPR_{it}+1.437\ LOGTA_{it}+0.907\ EAR_{it} -5.\ 468\ OPCR_{it} -0.411\ CASH\text{-}TA_{it}+0.245\ GDP_{t} +\varepsilon_{i}}$$

Firstly, the researcher wanted to test the null hypothesis that non-performing loans has no significant effect on financial performance of commercial banks in Kenya. It was established that non-performing had a statistically significant effect on financial performance (ROA) (β1= -7.042, t = -.968, p = .002 and α = 0.05). Hence null hypothesis was rejected. Secondly, the null hypothesis that bank size has no significant effect on financial performance of commercial banks in

Kenya was tested using regression analysis. It was established that bank size had a statistically significant effect on financial performance ($\beta 2 = 1.437$, $t = 3.818$, $p = .001$ and $\alpha = 0.05$). The null hypothesis was thus rejected. Thirdly, The null hypothesis that capitalization has no significant effect on financial performance of commercial banks in Kenya was also tested, it was established that capitalization had a statistically insignificant effect on financial performance ($\beta 3 = 0.907$, $t = 0.538$, $p = .134$ and $\alpha = 0.05$).The null hypothesis was thus accepted. Fourthly, the null hypothesis that operating costs has no significant effect on financial performance of commercial banks in Kenya was tested. It was established that operating costs had a statistically significant effect on financial performance measured by ROA ($\beta 4 = -5.468$, $t = -3.409$, $p = .000$ and $\alpha = 0.05$).The null hypothesis was thus rejected .finally, the researcher tested the null hypothesis that liquidity has no significant effect on financial performance of commercial banks in Kenya .Results showed that liquidity had a statistically insignificant effect on financial performance ($\beta 5 = -0.411$, $t = -0.097$, $p = .281$ and $\alpha = 0.05$).The null hypothesis was thus accepted .

V. CONCLUSION

The study was carried out to establish the effect of non-performing loans financial performance of commercial banks in Kenya. The results of the study were as follows: Non-performing, Bank size, operating cost and liquidity had significant effect on financial performance (ROA) of commercial banks in Kenya. However capitalization had a statistically insignificant effect on financial performance ($\beta 3 = 0.907$, $t = 0.538$, $p = .134$ and $\alpha = 0.05$).The study recommends the following: Firstly , the study recommends that management of commercial banks in Kenya should strive to minimise as much as possible the Non-performing loans .Secondly , management of commercial banks to improve the volume and value of assets at its disposal. They should find ways of acquiring additional assets since assets generates revenues to the commercial bank. Thirdly, banks should just hold enough capital and should leverage by running its operation on borrowed finance that has more impact on revenues.Fourthly , management of commercial banks should continuously work on operational efficiency by minimising the operational cost through any means possible as long as it does no hamper on product generaton and revenues.Finaly, management of commercial banks to keep liquidity just enough to finance maturing short term obligations and the rest of liquid money given out as loans to generate interest income to the bank. Concerning areas of further research, the current study was limited to effect of nonperforming loans on financial performance of commercial banks in Kenya. Another study should be carried out that looks at effect of nonperforming loans on financial performance of micro finance institutions and deposit taking Sacco's in Kenya to see if results hold also in such institutions. Another study should also be carried out using long term data covering ten years since some variables can be best observed in a long period of time.

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