EFFECT OF CREDIT RISK MANAGEMENT ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This Project is my original work and has not been presented for a degree in any other University.

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This Project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

To my Parents, Mr. Edward Mutua and Josephine Ndila who encouraged, supported and sacrificed all to ensure I got the best education.

TABLE OF CONTENTS

LIST OF TABLES

ABBREVIATIONS

ATM- Automated Teller Machine

CBK – Central Bank of Kenya

CRM – Credit risk management

GDP- Growth Domestic Product

NIM- Net interest margins

ROA- Return on assets

ROI- Return on investment

ABSTRACT

The main objective of the study was to carry out a survey of credit risk management practices on the performance of commercial banks in Kenya. This paper seeks to contribute to the literature by broadening the understanding of the concept of credit risk beyond the technical considerations in the accounting, banking and finance literature. The objectives of this study was to identify the types of credit risks that Commercial Banks in Kenya face, to establish the impact of credit risk management practice on performance of commercial banks in Kenya. This study used a descriptive research design to enable the researcher to generalize the findings to a larger population. The study targeted auditors of all commercial banks in Kenya; the population of the study were the credit controllers of all the 43 commercial banks in Kenya. Primary data was collected using questionnaires which were administered using drop and pick method by the researcher. The data was then analyzed using quantitative techniques. The study concluded that bank considers risk identification as a process in credit risk management, that the bank focuses in interest rate risks in the risk identification map and that the bank focuses in foreign exchange risks. The study also concludes that in view of risk analysis as a credit risk management practice in the bank the application of modern approaches to risk measurement, particularly for credit and overall risks is important for commercial banks and that risk analysis helps the bank management to discover mistake at early stages and that risk monitoring can be used to make sure that risk management practices are in line with proper risk monitoring. The study recommended that commercial banks management should understand how they can edge themselves against the eminent dangers of over exposure to credit risk whose importance cannot be understated as can be realized from the findings that can impact negatively on their profitability.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

A comprehensive framework of risk management is applicable equally to a conventional bank (Iqbal and Mirakhor, 2007). The process of risk management is a two-step process. The first is to identify the source of the risk, which is to identify the leading variables causing the risk. The second is to devise methods to quantify the risk using mathematical models, in order to understand the risk profile of the instrument. Once a general framework of risk identification and management is developed, the techniques can be applied to different situations, products, instruments and institutions. It is crucial for banks to have comprehensive risk management framework as there is growing realization among that sustainable growth critically depends on the development of a comprehensive risk management framework (Greuning and Iqbal, 2007).

A robust risk management framework can help banks to reduce their exposure to risks, and enhance their ability to compete in the market (Iqbal and Mirakhor, 2007). A reduction in each institution's exposure will reduce the systemic risk as well. Hence, it is necessary that Banks have in place a comprehensive risk management and reporting process to identify, measure, monitor, manage, report and control different categories of risks. In addition, this process should pay attention to compliance with Shariah rules and principles.

Commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of financial risks. Over the last decade the understanding of the place of commercial banks within the financial sector has improved substantially. Over this time, much has been written on the role of commercial banks in the financial sector, both in the academic literature and in the financial press. Suffice it to say that market participants seek the services of

these financial institutions because of their ability to provide market knowledge, transaction efficiency and funding capability. In performing these roles they generally act as a principal in the transaction. As such, they use their own balance sheet to facilitate the transaction and to absorb the risks associated with it (Santomero, 1997).

To be sure, there are activities performed by banking firms which do not have direct balance sheet implications. These services include agency and advisory activities such as trust and investment management, private and public placements through best efforts or facilitating contracts, standard underwriting , or the packaging, securitizing, distributing and servicing of loans in the areas of consumer and real estate debt primarily. These items are absent from the traditional financial statement because the latter rely on generally accepted accounting procedures rather than a true economic balance sheet. Nonetheless, the overwhelming majority of the risks facing the banking firm are in on-balance-sheet businesses. It is in this area that the discussion of risk management and the necessary procedures for risk management and control has centered (Altman, 993).

1.1.1 Credit Risk Management

Credit risk refers to the risk that a borrower will default on any type of debt by failing to make required payments. The risk is primarily to the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs. The loss may be complete or partial and can arise in a number of circumstances. Risk management framework is important for commercial banks. The theory of asymmetric information argues that it may be impossible to distinguish good borrowers from bad borrowers (Auronen, 2003) which may result in adverse selection and moral hazards problems. Adverse selection and moral hazards have led to

substantial accumulation of non-performing accounts in the commercial banks (Bofondi and Gobbi, 2003).

BCBS (2006) hold that risk management processes, require supervisors to be satisfied that the banks and their banking groups have in place a comprehensive risk management process. This would include the Board of senior management to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. In addition, as suggested by Al-Tamimi (2002) in managing risk, commercial banks can follow comprehensive risk management process which includes eight steps: exposure identification; data gathering and risk quantification; management objectives; product and control guidelines; risk management evaluation; strategy development; implementation; and performance evaluation (Baldoni, 1998; Harrington and Niehaus, 1999).

The scope of internal auditing within an organization is broad and may involve topics such as an organization's governance, risk management and management controls over: efficiency/effectiveness of operations, the reliability of financial and management reporting, and compliance with laws and regulations. Internal auditing may also involve conducting proactive fraud audits to identify potentially fraudulent acts; participating in fraud investigations under the direction of fraud investigation professionals, and conducting post investigation fraud audits to identify control breakdowns and establish financial loss. Internal auditors are responsible for the execution of company activities; they advise management and the Board of Directors (or similar oversight body) regarding how to better execute their responsibilities (Walker, 2002).

According to Boston Consulting Group (2001) credit risk is the oldest and important risk to which institutions are exposed. The importance of credit risk and credit risk management are

increasing with time because of some reasons like; economic crises and stagnation, company bankruptcies, infraction of rules in company accounting and audits, growth of off-balance sheet derivatives, declining and volatile values of collateral, borrowing more easily of small firms, financial globalization and BIS risk-based capital requirements. Greuning and Iqbal (2007) define credit risk as the risk of losses caused by the default of borrowers. Default occurs when a borrower cannot meet his financial obligations. Credit risk can alternatively be defined as the risk that a borrower deteriorates in credit quality. This definition also includes the default of the borrower as the most extreme deterioration in credit quality. Credit risk is managed at both the transaction and portfolio levels. But, institutions increasingly measure and manage the credit risk on a portfolio basis instead of loan-by-loan basis.

Harrington (1999) posits that most organizations track interest rate risk closely. They measure and manage the firm's vulnerability to interest rate variation, even though they cannot do so perfectly. At the same time, international organizations with large currency positions closely monitor their foreign exchange risk and try to manage, as well as limit, their exposure to it. In a similar fashion, some institutions with significant investments in one commodity such as oil, through their lending activity or geographical franchise, concern themselves with commodity price risk. Others with high single-industry concentrations may monitor specific industry concentration risk as well as the forces that affect the fortunes of the industry involved.

1.1.2   Financial Performance of Commercial Banks

Financial performance is the measure of the results of the firm's policies and operations within a specified time period in monetary terms. The results are expressed inform of profit or losses. Financial performance of commercial banks is the measure of the level commercial banks profit or loses within a specified time. Several measures have been used to measure the financial performance of commercial banks.

There are external factors that can cause bank failure which may include lack of information, deregulation (Mugenda, 2008) Some useful measures of financial performance are coined into what is referred to as CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and sensitivity) referring to the six components of a bank's conditions that are assessed. CAMELS' framework regulates the banking sector by giving a guide on governance. (Madhyam and Stichele 2010).

Solvency level is a measures of degree at which debts are secured and obtained by computing debt to asset ratio. *Asset quality*; according to (Mugambe, 2008) the solvency of financial institutions typically is when their assets become impaired. So it's important to monitor indicator of quality, assets of financial institutions in Uganda in term of over exposure to specific risk trends in non- performing loan, the profitability and health of bank borrowers especially the corporate sector

Liquidity; initially solvent financial institution may be driven toward closure by poor management of short-term liquidity. Indicators should cover funding sources and capture large maturity mismatches. An unmatched position potentially enhances profitability but also increase

the risk of losses (CBK, June 2001) the key dimensions of measuring financial performance in the commercial banks in Uganda are Capital adequacy, Asset quality, Earnings, Liquidity.

Financial performance of banks can be determined by several factors. These factors are divided in to two, the internal factors and the external factors. The internal factors include: Capital adequacy, Asset Quality, Management efficiency and liquidity management. It is important to note that these factors differ from one financial institution to another. External factors are the factors beyond the management's control. They include: political stability of a country, inflation rate, GDP growth rate, Interest rates and financial institution policies and a country (Naceur, 2003).

1.1.3 Credit Risk Management and Financial Performance of Commercial Banks

Financial institution performance is determined by so many factors with the main one being the risks. The risks include: credit risk, interest rate risk, political risk, operational risks, liquidity risks and market risk. These risks are either internal or external. Commercial banks have closed due to the poor performance of loans. This called for effective management of its asset (Naceur, 2003)

In the recent years banks have developed sophisticated systems of risk management. Many banks have been exposed to more risk of loan defaulting due to the increase of the amount of loans advanced. In addition to the system, management have had to up there game in securing there assets (Morsman, 1993). .

Commercial banks have policies which guide on the process of advancing credit. These policies define on who should access credit and the collaterals involved. In addition it guards its back through insurance. Once this is achieved the banks financial performance is expected to go up.

For the past years, banks have reported increase in profits. The asset base of most banks has been increasing and the proportion of loans also has been on the growing trend (IFSB, 2005).

1.1.4 Commercial Banks in Kenya

In the recent years commercial banks in Kenya have been on growing trend. Banks have installed ATM's in almost every part of the country. According CBK's directory there are forty three commercial banks in the country some of which are internationally based. The headquarters of these banks are in Nairobi and they serve both retail and corporate customers. The banks in the country perform the following function: creation of money, community savings, ensure smooth support of payment mechanisms, ensure smooth flow of international transactions, storage of valuable goods and provision of credit services.

As the country grows, the need for credit advancement grows. The central bank has been involved in setting of the interest rate, thus the banks have to be more careful in making decision of credit advancements. In July 2014, the CBK governor announced decrease of the base lending rate to 9.8 and banks were urged to reduce their interest rate to affordable levels. Customers can only put their money on banks which have a perpetuity growth, thus calling for good management of the banks risk. For an individual to make a decision on the bank to safe with, the financial performance acts as a guide. The commercial banks in Kenya have observed credit management with care.

1.2 Research Problem

Granting credit to the members is an important activity to commercial banks thus the importance of credit risk management in these institutions. Weak credit risk management is the primary cause of many commercial banks' failures. Mc Menamin (1999) and Hempel et. al (1994) carried

out studies of national banks that failed in the mid 1980s in the U.S.A and found out that the consistent element in the failures was the inadequacy of the bank's credit risk management system in the controlling of loan quality. A common approach to customer's credit selection and analysis is the use of the "six Cs" of credit as an initial screening and risk assessment advice. These Cs are: the capacity, capital, character, collateral, conditions and control. Generally institutions are expected to manage their credit risk to avoid exposing themselves to unnecessarily high level risk and subsequently a decline in returns.

According to Bhattacharya (1993) the risks contained in a bank's principal activities, such as those involving its own balance sheet and its basic business of lending and borrowing, are not all borne by the bank itself. In many instances the institution will eliminate or mitigate the financial risk associated with a transaction by proper business practices; in others, it will shift the risk to other parties through a combination of pricing and product design. The banking industry recognizes that an institution need not engage in business in a manner that unnecessarily imposes risk upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather, it should only manage risks at the firm level that are more efficiently managed there than by the market itself or by their owners in their own portfolios (Economist, 1993)

Financial risks faced by businesses are defined by their operating environment; the operating environment is made up of the customer complexity, the infrastructure and the regulations. While credit risk emanates from customer composition, the complexity of the risk and its ability to manage it depends on the approach taken by the institution to ensure successful management. The aim of this study is to establish the relationship between credit risk management practices employed by commercial banks in Kenya and their performance. The study seeks to unearth the variable approaches to credit risk management.

From March to June this year central bank of Kenya has advanced 50 billion loan to various sectors of the economy. Loan and advances from the commercial banks in Kenya grew by 0.05 trillion from March to June 2013 translating to 3.6% growth. Of the loans advanced, 21.9 billion was household/personal loans, 16 billion trade loan, 1.2 billion agriculture, 1 billion manufacturing and 8.8 billion real estate. However, the banks were faced with the challenge of collecting the debts from their clients resulting to an increase in the ratio of non-performing loans to gross loan advanced by 5.3% with the defaulting rate increasing by 10%. The defaulted loans stood at 77.3 billion in June 2013. Despite the increase in default rate, the quality of asset measured as a proportion of the non- performing loans decreased by 0.3% from March to June 2013 (Kinyanjui, 2014).

In the resent years, the urge of banks to advance unsecured loans has increased, has been fuelled by the increase in completion among the financial sector and entry of new lenders like Safaricom through Mshwari loans. Banks have been reporting growth in their financial performance for the last few years. The study is aimed to understanding how credit risk management affects the financial performance of commercial banks in Kenya since their main component of revenue is interest rate.

1.3 Research Objective

The objective of the study is to establish the effects of credit risk management on the financial performance of commercial banks in Kenya.

1.4 Value of the Study

The study is valuable to the to the banking industry stakeholders and the commercial banks management, it provided an insight into the best credit risk management practices that they can

adopt in order to enhance performance in their industry. It helped the government in policy making regarding taxation and other regulatory requirements of the commercial banks. To the researchers and academicians: the study provided a useful basis upon which further studies on credit risk management practices in the private sector can be conducted

The study will improve not only researcher's scope of understanding risk management but also entire public hence gain exposure to the banking industry .The dissertation will be used as reference material by future researchers interested in further research on credit risk management and its effects on financial performance of commercial bank.

2.1 Introduction

This chapter presents theoretical background and defines the process of risk management by the commercial banks. It will help the researcher clarify the strengths and guide each stage of research from the formulation of topics to the utilization of literature on credit risk management and performance of commercial banks.

2.2 Theoretical Background

Theories are formulated to explain, predict, and understand phenomena and, in many cases, to challenge and extend existing knowledge, within the limits of the critical bounding assumptions. A theory consists of concepts, together with their definitions, and existing theory/theories that are used for the particular study (Torraco, 2011).

2.2.1 Capital Asset Pricing Model

The Markowitz-Tobin theory was not very practical. Specifically, to estimate the benefits of diversification would require that practitioners calculate the covariance of returns between every pair of assets. In their Capital Asset Pricing Model (CAPM), William (1964) and Lintner (1965) solved this practical difficulty by demonstrating that one could achieve the same result merely by calculating the covariance of every asset with respect to a general market index. With the necessary calculating power reduced to computing these far fewer terms (betas) optimal portfolio selection became computationally feasible.

The capital asset pricing model (CAPM) of William (1964) and Lintner (1965) marks the birth of asset pricing theory (resulting in a Nobel Prize for William in 1990). Before their breakthrough,

there were no asset pricing models built from first principles about the nature of tastes and investment opportunities and with clear testable predictions about risk and return. Four decades later, the CAPM is still widely used in applications, such as estimating the cost of equity capital for firms and evaluating the performance of managed portfolios.

The attraction of the CAPM is its powerfully simple logic and intuitively pleasing predictions about how to measure risk and about the relation between expected return and risk. Unfortunately, perhaps because of its simplicity, the empirical record of the model is poor - poor enough to invalidate the way it is used in applications. The model's empirical problems may reflect true failings. (It is, after all, just a model.) But they may also be due to shortcomings of the empirical tests, most notably, poor proxies for the market portfolio of invested wealth, which plays a central role in the model's predictions. We argue, however, that if the market proxy problem invalidates tests of the model, it also invalidates most applications, which typically borrow the market proxies used in empirical tests (Lintner, 1965).

2.2.2 Arbitrage Pricing Model

The famous theory of option pricing by Fisher and Myron (1972) relies heavily on the use of arbitrage reasoning. Intuitively, if the returns from an option can be replicated by a portfolio of other assets, then the value of the option must be equal to the value of that portfolio, or else there will be arbitrage opportunities. Arbitrage logic was also used by Ross (1973) to value multi-period securities. All this spills over into the Neo-Walrasian theories of general equilibrium with asset markets (complete and incomplete) developed by (Oliver & Hart 1975) and many others since.

The famous Modigliani-Miller theorem on the irrelevance of corporate financial structure for the value of the firm also employs arbitrage logic. This famous theorem Modigliani and Miller (1963) can actually be thought of as an extension of the Separation Theorem originally developed by Fisher (1930). Effectively, Fisher had argued that with full and efficient capital markets, the production decision of an entrepreneur-owned firm ought to be independent of the intertemporal consumption decision of the entrepreneur himself. This translates itself into saying that the profit-maximizing production plan of the firm will not be affected by the borrowing/lending decisions of its owners, i.e. the production plan is independent of the financing decision.

Modigliani-Miller extended this proposition via arbitrage logic. Viewing firms as assets, if the underlying production plans of differently-financed firms are the same, then the market value of the firms will be the same for, if not, there is an arbitrage opportunity there for the taking. Consequently, arbitrage enforces that the value of the firms to be identical, whatever the composition of the firm's financial structure.

2.2.3 Loan Portfolio Diversification and Modern Portfolio Theory

Modern Portfolio Theory (MPT) proposes how rational investors should use diversification in order to optimize their portfolios. It also discusses how a risky asset should be priced. This does not mean that the early economists ignored financial markets. Fisher (1930) had already outlined the basic functions of credit markets for economic activity, specifically as a way of allocating resources over time and had recognized the importance of risk in the process. In developing their theories of money, Maynard (1936), John (1934, 1935, 1939), Nicholas (1939) and Jacob (1938) had already conceived of portfolio selection theory in which uncertainty played an important role.

13

However, for many economists during this early period, financial markets were still regarded as mere casinos rather than markets properly speaking.   In their view, asset prices were determined largely by expectations and counter-expectations of capital gains and thus they were held up by their own bootstraps as it were. John Maynard Keynes's beauty contest analogy is representative of this attitude (Maynard 1936).

As such, a good amount of ink was spent on the topic of speculative activity (i.e. the purchase/temporary sale of goods or assets for later resale). For instance, in their pioneering work on futures markets, Maynard (1923, 1930) and John (1939) argued that the price of a futures contract for delivery of a commodity will be generally below the expected spot price of that commodity (what Keynes called normal backwardation). This, Keynes and Hicks argued, was largely because hedgers shifted their price risk onto speculators in return for a risk premium. Nicholas (1939) went on to analyze the question of whether speculation was successful in stabilizing prices and, in so doing, expanded Keynes's theory of liquidity preference considerably.

 Holbrook (1962) disputed this, arguing that there was, in fact, no difference between the motivations of hedgers and speculators. This led to an early empirical race (Hendrik Houthakker 1969) finding evidence in favor of normal backwardation and Lester Telser (1958, 1981) finding evidence against it.

Williams (1938) was among the first to challenge the casino view economists held of financial markets and questions of asset pricing. He argued that asset prices of financial assets reflected the intrinsic value of an asset, which can be measured by the discounted stream of future expected dividends from the asset.   This fundamentalist notion fit well with Irving Fisher's

(1907, 1930) theory, and the value-investing approach of practitioners such as Benjamin Graham.

Markowitz (1999) realized that as the fundamentalist notion relied on expectations of the future, then the element of risk must come into play and thus profitable use could be made of the newly developed expected utility theory of Neumann and Morgenstern (1944). Markowitz formulated the theory of optimal portfolio selection in the context of trade-offs between risk and return, focusing on the idea of portfolio diversification as a method of reducing risk -- and thus began what has become known as Modern Portfolio Theory or simply MPT.

As noted, the idea of an optimal portfolio allocation had already been considered by Keynes, Hicks and Kaldor in their theories of money, and thus it was a logical step for Tobin (1958) to add money to Markowitz's story and thus obtain the famous two-fund separation theorem. Effectively, Tobin argued that agents would diversify their savings between a risk-free asset (money) and a single portfolio of risky assets (which would be the same for everyone). Different attitudes towards risk, Tobin contended, would merely result in different combinations of money and that unique portfolio of risky assets.

2.3 Determinant of Financial Performance of Commercial Banks

The determinants of bank performances can be classified into bank specific (internal) and macroeconomic (external) factors (Al-Tamimi, 2010). These are stochastic variables that determine the output. Internal factors are individual bank characteristics which affect the banks performance. These factors are basically influenced by internal decisions of management and the board. The external factors are sector-wide or country-wide factors which are beyond the control

of the company and affect the profitability of banks. The overall financial performance of banks in Kenya in the last two decade has been improving.

2.3.1 Risk Identification

Risk identification refers to the process of identifying dangerous or hazardous situations and trying to characterize it. It is a procedure to deliberately analyze, review and anticipate possible risks (Barton, 2002). The first step in organizing the implementation of the risk management function is to establish the crucial observation areas inside and outside the corporation (Kromschroder and Luck, 1998). The departments and the employees must be assigned with responsibilities to identify specific risks for example interest rate risks or foreign exchange risks are the main domain of the financial department.

It is important to ensure that the risk management function is established throughout the whole corporation; apart from parent company, the subsidiaries too have to identify risks and analyze them. Other approaches for risk identification include scenario analysis or risk mapping. An organization can identify the frequency and severity of the risks through risk mapping which could assist the organization to stay away from high frequency and low severity risks and instead focus more on the low frequency and high severity risk. Risk identification process includes risk-ranking components where these ranking are usually based on impact, severity or dollar effects (Barton, 2002). Accordingly, the analysis helps to sort risk according to their importance and assists the management to develop risk management strategy to allocate resources efficiently.

2.3.2 Risk Analysis

This is the process of determining the likelihood that a specified negative event will occur. Investors and business managers use risk assessments to determine things like whether to

undertake a particular venture, what rate of return they require to make a particular investment and how to mitigate an activity's potential losses. There are many conceptual studies made on risk analysis in reference to measurement and mitigation of risk. In practice, it is useful to classify the different risks according to the amount of damage they possibly cause (Fuser et al, 1999). This classification enables the management to divide risks that are threatening the existence of the corporation from those which can cause slight damages. Frequently, there is an inverse relationship between the expected amount of loss and its corresponding likelihood, i.e. risks that will cause a high damage to corporation, like earthquakes or fire, occur seldom, while risks that occur daily, like interest rate or foreign exchange risks, often cause only relatively minor losses, although these risks can sometimes harm the corporations seriously.

A comprehensive risk analysis and mitigation methods for various risk arising from financing activities and from the nature of profit and loss sharing is the source of funds especially investment account holders are explained by Sundararajan (2007). He concludes that the application of modern approaches to risk analysis, particularly for credit and overall banking risks is important for Banks. Also, he suggests that the need to adopt new measures is particularly critical for Banks because of the role they play and the unique mix of risks in finance contracts.

However, (Navajas and Tejerina, 2006) indicates that banks are perceived not to use the latest risk measurement techniques and Shari'ah compliant risk mitigation techniques due to different Shari'ah interpretation of these techniques. Also, appropriate measurement of credit and equity risks in various finance facilities can benefit from systematic data collection efforts, including establishing credit and equity registry. Moore (2007) suggests that bank need to start collecting data, and there can be significant advantages in pooling information and using common

definitions, standards, and methodologies for credit risk which is argued can lead to significant losses in all financial institutions. Finally, he found out that risk analysis particularly on measuring risk in banking institutions is important for risk management practices.

2.3.3 Non-performing Loan

A nonperforming loan is either in default or close to being in default. Once a loan is nonperforming, the odds that it will be repaid in full are considered to be substantially lower. If the debtor starts making payments again on a nonperforming loan, it becomes a reperforming loan, even if the debtor has not caught up on all the missed payments. Institutions holding nonperforming loans in their portfolios may choose to sell them to other investors in order to get rid of risky assets and clean up their balance sheets. Sales of nonperforming loans must be carefully considered since they can have numerous financial implications, including affecting the company's profit and loss, and tax situations (Akkizidis, 2008).

2.3.4 Loan and Advances

Loans and advances can be arranged from banks in keeping with the flexibility in business operations. Traders may borrow money for day to day financial needs availing of the facility of cash credit, bank overdraft and discounting of bills. The amount raised as loan may be repaid within a short period to suit the convenience of the borrower. Thus business may be run efficiently with borrowed funds from banks for financing its .loans and advances working capital requirements are utilized for making payment of current liabilities, wage and salaries of employees, and also the tax liability of business. Loans and advances from banks are found to be economical for traders and businessmen, because banks charge a reasonable rate of interest on such loans/advances (Khrawish, 2011).

2.4 Empirical Evidence

Nelson (2002) did a study on Commercial banking crises in Kenya and investigated the causes of nonperforming loans. Their objectives included, to investigate the actions that bank managers have taken to mitigate that problem and the level of success of such actions. Using a sample of 30 managers selected from the ten largest banks the study found that national economic downturn was perceived as the most important external factor. Customer failure to disclose vital information during the loan application process was considered to be the main customer specific factor. They found that many financial institutions that collapsed in Kenya since 1986 failed due to non-performing loans. The study concluded that lack of an aggressive debt collection policy was perceived as the main bank specific factor, contributing to the non performing debt problem in Kenya (Nelson, 2002).

Valsamakis et al (2005) carried out a study on risk to earnings or capital due to borrowers' late and nonpayment of loan obligations. His objective was to assess whether risk of non repayment will result to loan default. He found that Credit risk encompasses both the loss of income resulting from the sector inability to collect anticipated interest earnings as well as the loss of principal resulting from loan defaults. Credit risk arises because of the possibility that the expected cash flows from advances and securities held, might not be paid in full. He concluded that credit risk is considered the most lethal of the risks firms face.

Waweru and Kalani (2009) studied commercial banking crises in Kenya. They found that some of the causes of non-performing loans in Kenyan banks were national economic downturn, reduced consumer, buying ability and legal issues. This current study appreciate that the nonperforming loan and loan delinquency concepts are similar. However this study differs significantly from Waweru and Kalani (2010) in terms of area of study, and study methodology.

These researchers covered commercial banks in Kenya while this current study focuses on microfinance institutions in Kenya. The banking and microfinance sectors operate under different regulatory authorities. Although Commercial banks have a primary role of providing credit ,there is historical evidence of credit rationing even to creditworthy borrowers by commercial banks all over the world only 1.5 percent of MSEs receive loans from commercial banks in Kenya (International Centre for Economic Growth 1999). It is unclear, how the rest, who form the majority, meet their working and investment needs

Mohammad (2008) did a study on risk management in Bangladesh Banking Sector. His main objective was to investigate the contribution of credit risk on non-performing loans. He found that, the crux of the problem lies in the accumulation of high percentage of non-performing loans over a long period of time. As per him unless NPL ratio of the country can be lowered substantially they will lose competitive edge in the wave of globalization of the banking service that is taking place throughout the world. Since they have had a two-decade long experience in dealing with the NPLs problem and much is known about the causes and remedies of the problem, he concluded that it is very important for the lenders, borrowers and policy makers to learn from the past experience and act accordingly.

Aboagye and Otieku, (2010) conducted a study on Credit Risk Management and Profitability in financial institutions in Sweden. The main objective was to find out if the management of the risk related to that credit affects the profitability of the financial institutions. They found that credit risk management in financial institutions has become more important not only because of the financial crisis that the world is experiencing nowadays but also the introduction of Basel II. They concluded that since granting credit is one of the main sources of income in financial

institutions, the management of the risk related to that credit affects the profitability of the financial institutions (Aboagye and Otiekun, 2010).

Haron and Hin (2007) did a study on credit risks experienced by commercial banks. His objective was to find out the complexities of a number of their products, as well as their relative novelty in the contemporary financial services market, combined with the fiduciary obligations of the bank when it acts as a custodian, imply that for Banks, credit risk is very important for consideration. He found that Investment Account Holders may be considered in the absence of misconduct and negligence by the bank to bear credit and market risks of assets if their funds have been invested by the bank, the latter must be considered as being exposed to the credit risk arising from its management of those funds. He concluded that that Banks are exposed to a number of credit risks that differ from those that are faced by conventional banks.

Khan and Ahmad (2001) carried a study on risks arising from profit-sharing investment deposits. The objective of the study was to find out whether bankers considered these unique risks more serious than conventional risks faced by financial institutions. The results of survey of risk perception in different modes of financing showed that risk level is considered elevated. They concluded that the high perception of risks may be an indication of the low degree of active risk management due to the absent of risk control through internal processes and control, especially in the case of credit risk.

According to a study done by Atieno (2001) Commercial banks and other formal institutions fail to cater for the credit needs of smallholders, however, mainly due to their lending terms and conditions. It is generally the rules and regulations of the formal financial institutions that have created the myth that the poor are not bankable, and since they can't afford the required

collateral, they are considered un-credit worthy .The results showed that the limited use of credit reflects lack of supply, from the rationing behavior of both formal and informal lending institutions. The study concluded that given the established network of formal credit institutions, improving lending terms and conditions in favor of small-scale enterprises would provide an important avenue for facilitating their access to credit.

Ngugi (2001) postulates that in order to determine the needs of the local banking sector with regard to risk management, the central bank of Kenya conducted a survey in September 2004 that would provide a status position on the extent to which risk management is practiced in the financial institutions operating in Kenya. The survey revealed that there is a high level of awareness in banking institutions on the importance of employing systematic methods of identifying, analyzing and controlling or mitigating risks

There have been debate and controversies on the impact of credit risk management and bank's financial performance. Some scholars e.g., (Li Yuqi 2007; Naceur and Kandil 2006; Kinthinji 2010; Kolapo, Ayeni and Ojo 2012; Kargi (2011;) amongst others have carried out extensive studies on this topic and produced mixed results; while some found that credit risk management impact positively on banks financial performance, some found negative relationship and others suggest that other factors apart from credit risk management impacts on bank's performance. Specifically, Kargi (2011) found in a study of Nigeria banks from 2004 to 2008 that there is a significant relationship between banks performance and credit risk management. He found that loans and advances and non performing loans are major variables that determine asset quality of a bank.

Musyoki and Kadubo (2011) also found that credit risk management is an important predictor of bank's financial performance; they concluded that banks success depends on credit risk management. Kithinji (2010) analyzed the effect of credit risk management (measured by the ratio of loans and advances on total assets and the ratio of non-performing loans to total loans and advances on return on total asset in Kenyan banks between 2004 to 2008). The study found that the bulk of the profits of commercial banks are not influenced by the amount of credit and non-performing loans. The implication is that other variables apart from credit and non-performing loans impact on banks' profit. Kithinji (2010) result provides the rationale to consider other variables that could impact on bank's performance

2.5 Summary of Literature Review

Generally, from almost all surveys reviewed in the literature, it is evident that credit risk management is essential in optimizing the performance of micro financial institutions. In addition, an effective credit risk management involves establishing an appropriate credit risk environment, operating under a sound credit granting process, maintaining appropriate credit administration that involves the identification, analysis and monitoring process as well as adequate controls over credit risk.

According to Parrenas (2005), organizations have long viewed the problem of risk management as the need to control risks which make up most, if not all, of their risk exposure, credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise,

most hospitals would view legal risks as arising from their credit decisions or, more likely,

proper process not employed in financial contracting.

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter presents the research design and methodology that will be used to carry out the research. It presents the research design, the population, sample size and sampling procedure, data collection and analysis.

3.1 Research Design

Research design refers to the way the study is designed, that is, the method used to carry out a research. In Descriptive Research is the investigation in which quantity data is collected and analysed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. Descriptive research design will be used because it will enable the researcher to generalise the findings to a larger population. This study therefore will be able to generalise the findings to all the commercial banks in Kenya.

3.2 Target Population

Target population can be defined as a complete set of individuals, cases/objects with some common observable characteristics of a particular nature distinct from other population Mugenda and Mugenda,(2003) a population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. This definition ensures that population of interest is homogeneous. This is a survey of all the commercial banks in Kenya and therefore, the population of this study is the credit control managers of all the 43 commercial banks in Kenya as at 30th August 2014.

3.3 Data Collection

The researcher will use both primary and secondary data. Primary data will be obtained through self-administered questionnaires with closed and open-ended questions (see appendix I). As much as possible, a 5-point likert scale will be used to determine the impact of credit management practices on performance of commercial banks in Kenya. The closed ended questions will enable the researcher to collect quantitative data while open-ended questions will enable the researcher to collect qualitative data. The questionnaire will be divided into two sections. Section one is concerned with the general information about respondents. Section two deals with the impact of credit management practices on performance of commercial banks. Secondary data will be collected by use of desk search techniques from published reports and other documents. Secondary data includes the banks publications, journals, and periodicals.

3.4 Data Analysis

Data analysis is the process of systematically searching, arranging, organizing, and breaking data into manageable units, synthesizing the data, searching for patterns, discovering what is important and what is to be learned. Respondents' responses were rated on a five Likert scale. A likert scale was constructed. This model proposes that each observed response (measure 1 through measure 5) is influenced partially underlying common factor. The paired samples correlations co-efficient between dependent and the independent variables were calculated and interpreted. If the paired t-test statistics is low and significant, it indicates that the two variables are not related and are independent of each. The statistical tool for the analysis was the statistical package for the social sciences (SPSS). The results were presented on frequency distribution tables, pie charts and bar charts. The regression model to be used was as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where;

Y= the dependent variable (Financial Performance)

α - Is a constant; the concept explaining the firms performance given and it's the Y value when all the predictor values (X_1, X_2, X_3, X_4) are zero

β_1, β_2, β_3, β_4 – Are constants regression coefficients representing the condition of the independent variables to the dependent variables.

X_1 – Risk identification

X_2 – Risk analysis

X_3 – Non-Performing loan

X_4 - Loan and advances

ε - (Extraneous) Error term explaining the variability of Financial Performance as a result of other factors not accounted for.

e - Stochastic disturbance (error) term

3.4.1 Non-performing Loan

A non-performing loan (NPL) is a loan that is in default or close to being in default. The important reasons for NPLs, as mentioned by the International Journal of Business and Management Tomorrow Vol. 2 No. 3are: willful defaults, siphoning of funds, fraud, disputes, management disputes, mismanagement, misappropriation of funds.

3.4.2 Risk Identification

Risk identification refers to the process of identifying dangerous or hazardous situations and trying to characterize it. It will be measured by; Loan defaulters, Market rate risks, Liquidity risks and Credit risk.

3.4.3 Risk Analysis

The process of determining the likelihood that a specified negative event will occur. It will be measured by; a substantial degree of standardization of process and documentation is required. The quality of its loan portfolio at any time, along the lines of the report presented. That total receivables, including loans, leases and commitments and derivatives, are reported in a single format.

3.4.4 Loan and Advances

Loans and advances can be arranged from banks in keeping with the flexibility in business operations. It will be measured by the amount of loans and advances granted to customers.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction

This chapter presents the findings of the study as per questionnaires distributed for data collection. It shows the response rate and further presents the analyzed data using the SPSS 20 software. Regression Analysis was used to investigate the effect of credit risk management on the financial performance of commercial banks in Kenya. Credit risk management practices on financial performance (dependent variable) are explained by the Risk Identification, Risk Analysis, Non-performing loans and Loan and advances (independent variables). The data was gathered exclusively from the questionnaire as the research instrument. The questionnaire was designed in line with the objectives of the study. It also presents the response rate, respondents' characteristics and preliminary findings.

4.2 Response Rate

Forty (43) questionnaires were distributed to credit risk managers of the commercial banks. Out of the 43questionnaires sent, 37 were fully filled contributing to a response rate of 86 %. A response rate of above 60% is acceptable (Kothari, 2004).

4.3 Data Validity

This is a measure of the degree to which a research instrument yields consistent results or data after repeated trials (Mugenda and Mugenda, 2003). During the pilot study, two repeat mailings

of the instrument were carried out to improve the overall response rate before sending the actual instrument to allow for pre-testing of the research instrument.

Cronbanch's alpha for each value was established by the SPSS application and gauged against each other at a cut off value of 0.7 which is acceptable according to Cooper and Schindler (2008). According to table 4.1 all the values were above 0.7 which concludes that the data collection instrument was reliable.

Table 4. 1: Reliability test

Variable	Cronbach's Alpha
Risk identification	.8045
Risk analysis	.7168
Non-performing loan	.7263
Loan and advances	.8177

4.4 Descriptive Statistics for the Model Variables

The table below shows the median, mean score, minimum and maximum values and the standard deviations for the value of variables; both dependent and independent used found from the data collected. According to the table, Risk analysis had a mean of 0.3372 with a standard deviation of 0.1013 between a maximum and a minimum value of 0.4671 and 0.2231 respectively. Since as Bogan, (2008) advanced, credit risk management is defined as having a Risk analysis level of 100% or more and the $e^{0.3372} = 1.401$ is 140%, means that the financial institutions are managing their credit levels.

Table4. 2

	Median	**Mean**	**Minimum**	**Maximum**	**Std. Deviation**
Financial Management	3.589098%	7.589098%	4.7093%	5.4788%	2.1176330%
Risk analysis	4.337204%	0.337204%	0.2231%	0.4671%	0.1013428%
Risk identification	3.598767%	17.576467%	15.4249%	18.4081%	1.2324235%
Non-performing loan	2.654098%	8.589098%	6.7093%	9.4788%	1.1176330%
Loan and advances	4.245888%	18.454888%	17.5044%	18.9335%	.5667863%

4.5 Correlation Analysis

To compute the correlation (strength) between the study variables and their findings the researcher used the Karl Pearson's coefficient of correlation (r). From the findings, it was clear that there was a positive correlation between Financial Performance and Risk identification as shown by a correlation figure of 0.512, it was also clear that there was a positive correlation between Financial Performance and Risk analysis adopted with a correlation figure of 0.609, there was also a positive correlation between Financial Performance and Non- performing loans with a correlation value of 0.732 and a positive correlation between Financial Performance and Loans and advances with a correlation value of 0.518. This shows that there was a positive correlation between Financial Performance and Risk identification, Risk analysis, Non-performing loans, and Loans and advances.

Table4. 3. Coefficient of Correlation

	Financial Performance	Risk identification	Risk analysis	Nonperforming loans	Loans and advances
Financial Performance	1				
Risk identification	.5120	1			
Risk analysis	.6090	.3381	1		
Non-performing loans	.7320	.1210	.0608	1	
Loans and advances	.5180	.3370	.0000	.1580	1

4.6 Regression Analysis

In addition, the researcher conducted a linear multiple regression analysis so as to test the relationship among variables (independent) on the financial performance practices. The researcher applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study.

Table4. 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.896[a]	.881	.132	.3295

Source: Research, 2014

The adjusted R^2 is the coefficient of determination. This value explains how financial performance practices varied with Risk Identification, Risk Identification, Non-performing loan and Loan and advances. The four independent variables that were studied, explain 88% of the financial performance practices and commercial banks al performance as represented by the R^2. This therefore means that other factors not studied in this research contribute 12% of the financial performance giving room for further research to investigate the other factors (12%) that affect financial performance implementation.

Table4. 5: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11.534	3	2.868	52.410	.0072
	Residual	186.555	34	2.139		
	Total	198.089	37			

According to Mugenda and Mugenda (2003) ANOVA is a data analysis procedure that is used to determine whether there are significant differences between two or more groups or samples at a selected probability level. `An independent variable is said to be a significant predictor of the dependent variable if the absolute t-value of the regression coefficient associated with that independent variable is greater than the absolute critical t-value. The regression analysis also yields an F-statistic where if the calculated F-value is greater than the critical or tabled F-value, the prediction will be rejected. In this study, the significance value is .0072 which is less that 0.05 thus the model is statistically significant in predicting Risk Identification, Risk analysis, Non-performing loan and Loan and advances. The F critical at 5% level of significance was 3.23. Since F calculated is greater than the F critical (value = 52.400), this shows that the overall model was significant.

Table4. 6: Coefficient of determination

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.757	1.033		0.787	0.255
	Risk Identification	0.554	0.107	0.159	1.091	0.002
	Risk Analysis	0.879	0.139	0.085	0.687	0.005
	Non-performing loan	0.568	0.097	0.145	0.97	0.013
	Loan and advances	0.685	0.069	0.210	0.349	0.032

Source: Research, 2014

The researcher conducted a multiple regression analysis so as to determine the relationship between financial performance implementation and the four variables. As per the SPSS generated table above, the equation ($Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$) becomes:

$Y = 3.757 + 0.554\ X_1 + 0.879 X_2 + 0.568\ X_3 + 0.685 X_{4+}\ \varepsilon$

Where:

Y = financial performance of Commercial Banks

X1 = Risk Identification

X2 = Risk Analysis

X3= Non-Performing loan

X4= Loan and advances

ε = the error

According to the regression equation established, taking all factors into account (Risk Identification, Risk Analysis, Non-performing loan and Loan and advances) constant at zero, financial performance on commercial banks performance will be 3.757. The data findings analyzed also show that taking all other independent variables at zero, a unit increase in Credit Risk Identification will lead to a 0.554 increase in financial performance; a unit increase in Risk Analysis will lead to a 0.879 increase in Financial performance, a unit increase in Non-performing loan will lead to a 0.568 increase in Financial performance and a unit increase in Loan and advances will lead to a 0.685 increase in financial performance on commercial banks in Kenya. This infers that Risk Analysis contribute more to the financial performance on commercial banks performance followed by the Risk Identification.

At 5% level of significance and 95% level of confidence, Credit Risk Identification had a 0.002 level of significance; Risk Analysis showed a 0.005 level of significant, Non-performing loan

showed a 0.013 level of significant, Loan and advances had a 0.032 level of significant, and hence the most significant factor is Risk Identification.

4.7 Discussion of the Research Findings

The study aimed at investigating the effects of financial performance practices on commercial banks performance in manufacturing sector in Commercial banks in Kenya.

The study found out that majority (83%) of the respondents agreed that Risk Identification contribute to financial performance in the commercial banks through the advertisements and meetings of the stake holders while 17% of the respondents were not for the opinion that Credit Risk Identification contribute to financial performance in the commercial banks. The researcher sought to establish the extent to which risk identification was coordinated across the organization. Majority of the respondents agreed to a very great extent 47.6% that risk identification was coordinated across the organization;25.5% of the respondent agreed to a great extent that risk identification was coordinated across the organization;15.5% agreed to a moderate that risk identification was coordinated across the organization; 9.5% of the respondent agreed to a less extent that risk identification was coordinated across the organization while the remaining 1.9% of the respondents did not agree if risk identification was coordinated across the organization.

The study found out that Risk Analysis contributed to financial performance of commercial banks in Kenya. According to the findings, 80% of the respondents indicated that Risk Analysis contribute to financial performance of commercial banks in Kenya while 20% of them indicated that Risk Analysis does not contribute to financial performance of commercial banks in Kenya. The study sought to investigate who are involved in risk analysis in the organization. From the

study, 26.2% of the respondents indicated that Credit controllers were mostly involved in risk analysis, 23.0% indicated that Credit analysts were also involved in risk analysis, 14.8% of the respondents indicated that Credit manager/head of credit were mostly involved in risk management; of them indicated no extent, while 9.8% indicated little extent.

The study found out that Sixty four percent (64%) of the respondents felt that Non-performing loan contribute to financial performance practices in the commercial banks while 36% of them were of the opinion that Non-performing loan does not affect contribute to financial performance practices in the commercial banks. The study also found out that Non-performing loan contributes to financial performance practices in the commercial banks , 36% of the respondents indicated that Non-performing loan contributes to financial performance practices in the commercial banks to a great extent, 27% to a very great extent, 24% to a moderate extent, 7% that it did not at all affect financial performance practices, while only 6% indicated that Non-performing loan contributes to financial performance practices in the commercial banks to a little extent.

The study found out that Loan and advances contributed to financial performance of commercial banks in Kenya, 67% of the respondents indicated that Loan and advances contributed to financial performance in the commercial banks while only 33% of the respondents indicated that Loan and advances do not contribute to financial performance in your commercial banks in Kenya. From the study findings, 31% of the respondents indicated that Loan and advances contribute to financial performance in the commercial banks to a very great extent, 29% of the respondents indicated Loan and advances contribute to financial performance of commercial banks to a great extent, 26% of the respondents indicated that Loan and advances contribute to financial performance of commercial banks to a moderate extent, 12% of the respondents

indicated that Loan and advances contribute to financial performance in the commercial banks to a little extent while only 4% of the respondents indicated that Loan and advances did not contribute to financial performance in the commercial banks at all

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter provides the summary of the findings from chapter four. The chapter also gives the conclusions and recommendations of the study based on the objectives of the study. The objective of this study was to investigate the effect of credit risk management on the financial performance of commercial banks in Kenya.

5.2 Summary of the Findings

The study aimed at investigating the effects of financial performance practices on commercial banks performance in manufacturing sector in Commercial banks in Kenya.

The study found out that majority (83%) of the respondents agreed that Risk Identification contribute to financial performance in the commercial banks through the advertisements and meetings of the stake holders while 17% of the respondents were not for the opinion that Credit Risk Identification contribute to financial performance in the commercial banks. The found out the Credit Risk Identification contributed to financial performance practices in the commercial banks.

The study found out that Risk Analysis contributed to financial performance in your commercial banks. According to the findings, 80% of the respondents indicated that Risk Analysis contribute to financial performance in your commercial banks while 20% of them indicated that Risk Identification does not contribute to financial performance in the commercial banks . According to the findings, 40% of the respondents indicated that Risk Analysis contribute to financial

performance in the commercial banks , 28% of the respondents indicated that Risk Analysis contribute to financial performance in your commercial banks , 21% of the respondents indicated that Risk Analysis contribute to financial performance in the commercial banks to a moderate extent, 4% of the respondents indicated that Risk Analysis contribute to financial performance in the commercial banks to a great extent while only 2% of the respondents indicated that Risk Analysis contribute to financial performance in your commercial banks at a great extent.

The study found out that Sixty four percent (64%) of the respondents felt that Non-performing loan contribute to financial performance practices in the commercial banks while 36% of them were of the opinion that Non-performing loan does not affect contribute to financial performance practices in the commercial banks. The study also found out that Non-performing loan contributes to financial performance practices in the commercial banks , 36% of the respondents indicated that Non-performing loan contributes to financial performance practices in the commercial banks to a great extent, 27% to a very great extent, 24% to a moderate extent, 7% that it did not at all affect financial performance practices, while only 6% indicated that Non-performing loan contributes to financial performance practices in the commercial banks to a little extent.

The study found out that Loan and advances contributed to financial performance of commercial banks in Kenya, 67% of the respondents indicated that Loan and advances contributed to financial performance in the commercial banks while only 33% of the respondents indicated that Loan and advances do not contribute to financial performance in your commercial banks in Kenya. From the study findings, 31% of the respondents indicated that Loan and advances contribute to financial performance in the commercial banks to a very great extent, 29% of the respondents indicated Loan and advances contribute to financial performance of commercial

banks to a great extent, 26% of the respondents indicated that Loan and advances contribute to financial performance of commercial banks to a moderate extent, 12% of the respondents indicated that Loan and advances contribute to financial performance in the commercial banks to a little extent while only 4% of the respondents indicated that Loan and advances did not contribute to financial performance in the commercial banks at all.

5.3 Conclusions

The study concludes that majority of the respondents agreed that Credit Risk Identification contribute to financial performance in the commercial banks through the quality products and meeting of the recommended standards while some of the respondents were for the opinion that Credit Risk Identification doesn't contribute to financial performance in the commercial banks.

The study concludes that the commercial banks Risk Identification contributed greatly to financial performance in the commercial banks. According to the findings, majority respondents indicated that Risk Identification contribute to financial performance in the commercial banks at a great extent.

The study concludes thatmajority of the respondents felt that Non-performing loan contribute to financial performance practices in the commercial banks. The study also concludes thatNon-performing loan contributes to financial performance practices in the commercial banks, since majority of the respondents indicated that Non-performing loan contributes to financial performance practices in the commercial banks to a great extent. The study also concludes that majority of the respondents argued that Non-performing loan factors influence financial performance practices in the commercial banks.

Finally the study concludes that commercial banks al Loan and advances contributed to financial performance in your commercial banks , majority of the respondents indicated that the commercial banks al Loan and advances contributed to financial performance in the commercial banks . From the study findings, majority of the respondents indicated that Loan and advances contribute to financial performance in the commercial banks to a very great extent and only a few respondents thought Loan and advances did not contribute to financial performance in the commercial banks at all.

5.4 Recommendations

Policy and practice for financial performance should be carefully evaluated and the results of that evaluation fed back into improved approaches. It is important that the evaluation considers the full range of costs and benefits. The commercial banks should have sufficient special techno-economic knowledge and openness to new, effective methods when assessing financial performance. Staffs should be equipped with the specific skills and competencies needed to design and manage contracts (including the associated training, after-sales service and Employ human resources with specific training and equipment for performing functional and performance tests in order to be able to accept the end product and verify performance.

Financial performance initiatives appear to be instrumental for improving financial performance, by harmonizing loans, launching co-ordination initiatives, setting standards and building skills. As such, the management of the commercial banks should adopt financial performance initiatives. However, the main focus of financial performance is to produce cost savings. It targets services, and therefore does not stimulate the financial performance implementation.

The commercial banks should create supporting structures of expertise with the help of public authorities that have R&D-review as core business and Introduce clear incentives by stating that

one percent of the total volume of loans should be allocated to risk minimization. In this manner, financial performance can become a strategic issue for the commercial banks in Kenya.

On financing investment, the commercial banks in Kenya should adopt new financing methods to save costs, to improve customer relationships, business processes and procedures and to open new business opportunities. It might also help the commercial banks to respond better to existing challenges and improve the anticipation of future developments in financial performance.

5.5 Limitations of the Study

The study faced some limitations with respect to the time frame within which the data was to be collected from respondents. The respondents were very busy hence requiring constant reminder so as to attend to the questionnaire. Out of the questionnaires send to the field, a number was not received back. The receipt of this could have led to an improvement in the conclusions drawn in the study.

The period of data collection entailed a lot of traveling and frequent communication with the respondents making it an expensive exercise all together. At the same time the inadequacy of finances did not allow me to employ sophisticated data analysis measures that could have improved my findings tremendously.

Some respondents could not volunteer divulge all the vital information that I had requested through my questionnaire for fear of losing their jobs. The management also feared that the employees may expose some of their weaknesses by responding to the questionnaires. Could I have accessed some of this data, my findings could have improved.

5.6 Suggestions for Further Research

This study has investigated the relationship between the credit risk and financial performance of commercial banks in Kenya. To this end therefore a further study should be carried on micro finance institutions and Sacco's to see whether the same results also hold by testing the variables in this study. The impact of moral hazard on credit risk administration in Kenyan commercial banks. Moral hazard in credit mainly arises from information asymmetry. If information asymmetry is not checked, it will lead to obtaining of improper information that subsequently leads to wrong credit decisions.

This study could be further developed by including more independent variables to the regression model and increasing the sample size. The variables would help improve the results of the study since it would include all the other factors that affect the profitability of the banks. The increased sample size would give a better representation of the banking sector. Also, the study could be further enhanced by examining Basel II effect on profitability after Basel II has been fully implemented in the Kenyan commercial banks.

The development of credit reference bureau in Kenya will go hand in hand in reducing the credit risk posed by lending and hence a study is needed to investigate the cut in insurance costs associated with loans and cutbacks in profitability of these firms. Lastly, profitability indicator could be developed by adding other relevant dependent variable to grasp the whole variations in profitability. Moreover, if this study is supplemented with qualitative study of credit risk management, the findings would be more objective and informative.

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APPENDICES

APPENDIX I: RESEARCH INSTRUMENT

RISK IDENTIFICATION

1. To what extend do the following factors considered in establishing credit risk identification in your organization? (Please tick appropriately). Where 1 is most important and 5 is least important.

	1	2	3	4	5
Existing Credit Policy	[ ]	[ ]	[ ]	[ ]	[ ]
Overhead cost	[ ]	[ ]	[ ]	[ ]	[ ]
General trend of credit	[ ]	[ ]	[ ]	[ ]	[ ]
Extend to your organization	[ ]	[ ]	[ ]	[ ]	[ ]
State of the economy	[ ]	[ ]	[ ]	[ ]	[ ]
Any other specify	[ ]	[ ]	[ ]	[ ]	[ ]

2. Tick below the people who are involved in risk identification

    Where 1 is least formulate and 5 is most formulate

	1	2	3	4	5
Executive management	[ ]	[ ]	[ ]	[ ]	[ ]
Employee suggestions	[ ]	[ ]	[ ]	[ ]	[ ]
Board of directors	[ ]	[ ]	[ ]	[ ]	[ ]
Credit manager	[ ]	[ ]	[ ]	[ ]	[ ]
Credit analyst	[ ]	[ ]	[ ]	[ ]	[ ]
Credit committee	[ ]	[ ]	[ ]	[ ]	[ ]

3. The following are the most useful systems of risk identification used in credit risk management, please indicate the extent to which your banks commonly apply.

	Not at All	Least Extent	Moderate	Great extent	Very Great extent
Workshops					
Interviews					
Comparisons with other organizations					
Brainstorming					
Questionnaires					
Analysis of processes					

4. How effective is your process of identifying, assessing and managing business risks?

Not effective [ ]   less effective [ ] effective [ ] very effective [ ]

5. To what extent is risk identification coordinated across the organization?

Not at all   [ ]

Least extent   [ ]

Moderate   [ ]

Great extent   [ ]

Very great extent   [ ]

RISK ANALYSIS.

1. To what extent do you agree with the statement, banks need to conduct risk analysis periodically to prevent it from failing in its obligations and meeting it objective?

   Strong Disagree   [ ]

   Disagree   [ ]

   Neutral   [ ]

   Agree   [ ]

   Strongly Agree   [ ]

2. The following are techniques used in credit risk management, please indicate the extent to which your banks adopts. (Tick where applicable)

	Not at All	Least Extent	Moderate	Great extent	Very Great extent
Credit Scoring Mechanism					
Risk identification					
Risk analysis and assessment					
Portfolio Asset Quality/Portfolio Management					
Banks Loan Policy Procedure					
Credit enhancement					
Diversification across bank Members					

3. Who are involved in credit risk analysis in your organization?

	Least involved		Most involved		
	1	2	3	4	5
• Credit controllers	[ ]	[ ]	[ ]	[ ]	[ ]
• Credit analysis's	[ ]	[ ]	[ ]	[ ]	[ ]
• Credit manager/head of credit	[ ]	[ ]	[ ]	[ ]	[ ]
• Credit committee	[ ]	[ ]	[ ]	[ ]	[ ]
• Any other, specify	[ ]	[ ]	[ ]	[ ]	[ ]

4. How important are the risks listed below to your institution?

	Least important		Most important		
	1	2	3	4	5
Foreign exchange risk	[ ]	[ ]	[ ]	[ ]	[ ]
Technology risks	[ ]	[ ]	[ ]	[ ]	[ ]
Interest rate risks	[ ]	[ ]	[ ]	[ ]	[ ]
Market rate risks	[ ]	[ ]	[ ]	[ ]	[ ]
Liquidity risks	[ ]	[ ]	[ ]	[ ]	[ ]
Credit risk	[ ]	[ ]	[ ]	[ ]	[ ]
Any other specify	[ ]	[ ]	[ ]	[ ]	[ ]

5. Which of the two statement does your bank Assign priority to risks.

a. Risks for which there is an obvious, cost-effective solution that can be easily

implemented [ ]

b. Risks that threaten the entity's public image and reputation [ ]

6. How importance is risk analysis in your organization?

    Not important   [ ]

    Less   [ ]

APPEDIX 2 LIST OF COMMERCIAL BANKS IN KENYA

1. ABC Bank (Kenya)
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank (Kenya)
6. CFC Stanbic Bank
7. Chase Bank (Kenya)
8. Citibank
9. Commercial Bank of Africa
10. Consolidated Bank of Kenya
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank Kenya
16. Ecobank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank Limited
21. First Community Bank
22. Giro Commercial Bank
23. Guaranty Trust Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich
28. I&M Bank
29. Imperial Bank Kenya
30. Jamii Bora Bank

31. Kenya Commercial Bank

32. K-Rep Bank

33. Middle East Bank Kenya

34. National Bank of Kenya

35. NIC Bank

36. Oriental Commercial Bank

37. Paramount Universal Bank

38. Prime Bank (Kenya)

39. Standard Chartered Kenya

40. Trans National Bank Kenya

41. United Bank for Africa

42. Victoria Commercial Bank

43. Bank of China