THE RELATIONSHIP BETWEEN CREDIT RISK MANAGEMENT PRACTICES AND FINANCIAL PERFORMANCE AMONG COMMERCIAL BANKS IN KENYA.

BY

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DECLARATION

This research project is my own original work and it has not been presented for any academic award in any university or institution of higher learning.

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This research project has been presented for examination with my approval as the University supervisor.

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DEDICATION

Dedication is to my parents Mr. John Kalume and Mrs. Pascalia Kalume who through their teaching profession have always encouraged me to continue learning.

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LIST OF ABBREVIATIONS

BDD	Bad and Doubtful debts
CBK	Central Bank of Kenya Limited
CAR	Capital Adequacy Ratio
CRB	Credit Reference Bureau
EL	Expected Loss
EDF	Expected Default Frequency
KBA	Kenya Bankers Association
LGD	Loss Given Default
MPT	Modern Portfolio Theory
NPL	Non-Performing Loan
SPSS	Statistical Package for the Social Sciences.
VAR	Value At Risk

ABSTRACT

Commercial banks in Kenya face tough competition as all the 42 banks fight for the same customers. While most banks try to adopt flexible solutions for the purpose of gaining a competitive advantage in the industry, there is a temptation to break rules on lending guidelines. This is what leads to credit risk that must be managed by all commercial banks. Credit risk management practices must be adopted by all commercial banks to ensure the continuity of business. This is because the core business of commercial banks is lending. This study therefore sought to establish the relationship between credit risk management practices and financial performance among commercial banks in Kenya. The credit risk management practices that were used in this study were: credit risk identification, credit risk evaluation, credit risk control and the credit risk policy manual. This study's objective was to establish the relationship between the practices and financial performance. The population of the study was the 42 commercial banks in Kenya and a descriptive research design was adopted. Data collection was done using questionnaires which were given to staff working in credit departments. The questionnaires were to provide information on the extent of use of credit risk management practices which was done using a likert scale. Secondary data was also used to collect information on return on assets for the commercial banks in Kenya. The multiple regression analysis was done using the SPSS data analysis tool in order to analyze the relationship between the dependent variable (financial performance) and the independent variables (credit risk management practices). The results of the study indicated that there was a positive relationship between credit risk management practices and financial performance among commercial banks in Kenya. From the findings, it was observed that credit risk identification, credit risk evaluation, credit risk control and credit risk policy manual have a correlation coefficient of 85.8 % with the dependent variable (financial performance). The t-test was used in this study and the linear association of the variables showed that they were statistically significant. The study findings revealed that all credit risk management practices have a significant influence on financial performance of commercial banks in Kenya. The study concluded that credit risk management has a positive influence on financial performance. The study recommendations included improvement in risk control systems, and constant review of credit policy in order to improve on credit risk management practices.

CHAPTER ONE: INTRODUCTION

1.1. Background of the study

Commercial banks in Kenya have been under pressure to deliver the best services to its customers. The core business of banking is lending but many other micro finance institutions in Kenya have come up with credit products. This has forced a stiff competition in the financial services industry. A large percentage of the banking income comes from the interest income which results from lending. While banks try to adjust their terms and conditions to meet the demands of the customers, there is a risk on how lending is done. The banks must ensure they have sound lending principles so that when money is given out, customers can repay in good time, without any default. Banks must develop a risk management framework for sustainable growth (Greuning and Iqbal, 2007).Every country all over the world is affected by the status of its financial sector. (Das and Ghosh, 2007) The stability or instability of a financial sector affects the whole economy of a country. Banks must develop good controls in lending so they may not just earn short-term profits but also long-term benefits for sustainability. The performance of the financial sector in any economy should worry the government. Every government must get involved in ensuring a very good supervision is done on the banking industry and all other financial institutions. This is necessary because, every other sector in the country is dependent in good amount of finances. Literally, every sector requires money and finances in order to carry out its activities; this means if the financial sector fails, then all other sectors fail. When the financial sector obtains stability, then all other sectors in an economy can improve in their daily operations (Kamau, 2015).

As banks want to earn more from interest income through lending, there is a risk of losing funds if lending is not done in the right way. Some customers may have a poor credit history and may ask for loans and yet default or struggle at paying which lead to non-performing loans. Commercial banks engage in the money business to make money, so when loans are not paid well as per the contracts or not paid at all, then banks do not meet their objective of making money. As explained by the International Monetary Fund (IMF), a loan that has not been paid for ninety days is categorized as a non-performing loan. A loan may also be less than ninety days,

but when banks have seen early warning signs that such a loan may not be recovered, then it can also be classified as a non-performing loan. Commercial banks need to introduce good control systems to check on possible defaulters before granting loans. This is because, when a loan becomes non-performing, then banks lose income; the income lost here is the interest that was expected and also the whole amount of money lent to the borrower. If a borrower pays the loan, but not in the expected pattern, then commercial banks are also affected on how their revenue collection and other planning is. Commercial banks need to take good measures to avoid a huge amount of non-performing loans in their books. This is because, a huge amount of non-performing loans, will lead to losses. When commercial banks experience losses, their financial health deteriorates, and affects the whole economy (Boachie, 2016). Banks therefore need to manage this risk by laying out different principles right from collection of information about a customer, to finding out the purpose of a loan, to the disbursements and monitoring the progress of repayments. Banks may benefit a lot from good practices of credit risk management, as this will avoid losses and add to their profitability and the overall financial performance.

1.1.1 Credit risk management

When commercial banks give loans to borrowers, there is a possibility that such money may never be recovered. This poses a risk to the commercial bank, and this risk that the borrower may never pay back the funds, is known as credit risk (Brown and Moles, 2014). When banks have many defaulters, this simple means that amount borrowed shall never be recovered. If it has to be recovered, it may be through force like legal battles and use of auctioneers, which increases the cost of recovering debts. Defaulters who are followed up in order to repay, may not give regular payments which affects the commercial banks also. The Kenyan banking sector has been faced with problems on lending principles. Most commercial banks are struggling in the stiff competition; this gives some banks the temptation to lend recklessly. Some commercial banks may want to meet their targets and therefore lend to as many borrowers without proper evaluation. Other commercial banks may not have good control systems to ensure that the rate of defaulters is reduced. Such practices by commercial banks lead to losses arising from credit risk.

Credit risk comes about because of inadequate business verification, insufficient collateral management, poor loan documentation, and inadequate supervision and follow up mechanisms, fraud risk, failure to follow procedures, cut-throat competition, long turnaround time, a lot of information required. Commercial banks need to engage in activities that will ensure losses arising from credit risk are minimized. Such activities must include risk identification, evaluation and control. A combination of such activities leads to what is known as credit risk management (Early, 1996; Coyle 2000). Credit risk management is an essential tool and a mandatory practice that should take place in every commercial bank. Commercial banks learn how to manage their loan portfolios well, learn how to calculate interest rates based on the credit risk anticipated. A commercial bank must do an analysis before making any investment so as to know the kind of possible risk that may arise from such an investment. A commercial bank that is keen to identify risks, will easily know how to evaluate and manage such risks. This will also lead to an improvement in returns of the investments (Basel, 2000).

Most commercial banks in the tier one, which have a lot of capital can easily finance risky businesses since they have enough funding This is not the case for small sized banks falling in tier three. Such small banks have problems with their capital, and they may need to exercise extra caution while carrying out their lending business. At the same time, both small and big banks compete for the same customers and customers will go where services are reliable, flexible and efficient. Such stiff competition comes with disadvantages to the small banks and this is what may lead to poor credit standards. Some commercial banks may want to loosen their rules and break some common rules in lending so as to win customers, in the long run exposing the banks to higher risks (Basel, 2000).

Commercial banks can apply different ways in credit risk control. One example is risk based pricing and in this method, banks will at different investments based on the risk perceived per investment. A bank may charge very high rates from a risky business and lower rates from a less risky business. Covenants are also another method that banks can apply to control risk. Specific statements may be included in the loan agreements and credit contracts on what to do or not to do within that period of the loan. Such statements help in credit risk control. Diversification is another way of managing credit risk. With diversification, commercial banks can look for

different types of borrowers and invest in different businesses. A commercial bank that concentrates on lending heavily to salaried people of a particular company may suffer heavy losses when such a company closes down and all borrowers are unable to pay their loans. With diversification therefore, commercial banks can lend to different people, salaried people, manufacturers, farmers, technology experts, mining industry employees. In this case, it is very difficult for borrowers from all sectors to default at the same time (Fitzsimmonset al, 2010).

In credit risk management, commercial banks must develop policies and procedures that will guide them in exercising good lending principles. Good lending principles must start with a sound process of risk analysis where the credit risk can be easily identified and evaluated. This procedure must always be followed by good credit risk control and risk monitoring procedures. With good credit administration, there shall be policies on who qualifies for a loan, how analysis is done and good record keeping. Collecting data about the customer's history from credit reference bureaus and other sources is also very essential as it enables dealing with KYC (Know Your Customer) compliant transactions. Adequate controls may involve dual control on the process of credit administration and ensuring data input and authorizations are done by different people.

In summary, the ways used to manage risks are: performance monitoring tools, compliance checks, internal control systems, processes and procedure manuals, policies, and internal audit assurance (Vadova, P. 2003).

1.1.2 Financial performance

Firms have assets which form part of their capital. The efficiency and competence of managers will determine how these assets will generate income and this can be described as financial performance. Financial performance is a measure that can be used to assess the financial health of an institution during a specific period of time. The term financial performance means a measure that can be used when doing a comparison between two or more companies, in establishing which company performs better than the other, or which industry performs better

than the other. The profitability of commercial banks can be measured in different ways where one of them is the return on assets, ROA (Jami, M., &Bahar, M. N. (2016). One can get the measure of Return on Assets by dividing the net income of the bank by its total assets. A bank can also use the net interest margin, which is arrived at by subtracting interest expense from interest income in percentage of the total assets. The measure of return on assets can give one help in understanding the efficiency level of the management team. By use of ROA, profitability of a firm is measured in terms of assets and shows how well assets are generating revenue. Debt and equity both form the assets of a company. Debt and equity are both used to finance investments and other operations of a company. The ratio of Return on assets is preferred by many investors to be higher; this is because when it is high, then it means returns are higher than the cost of investments. Shareholders of any company the amount of income that comes with their investments. This is done using the return on equity. The measure of ROE shows how much revenue a firm is making from the amount of investment made by the shareholders. It is basically showing returns from what the owners of a company have invested. (Obamuyi, 2013), observed that the growth development of commercial banks would be affected by management efficiency, capital increase, interest income and how well the management of expenses is.

1.1.3 Credit risk management and financial performance among commercial banks in Kenya.

As the core business of banking is lending, caution must be exercised to ensure that sound principles of lending are followed. Credit risk arises due to default, delayed repayments and reckless lending (Vadova, P. 2003). Events like default, bankruptcy lead to credit risk. Commercial banks do lending as their core business and lending is therefore the basic source of credit risk to commercial banks. Credit risk in commercial banks can be identified in the whole loan book as well as other individual investments. If the risk of credit is not identified and managed well, this can lead to deterioration in bank profits. A bank that will not manage credit risk will end with huge value of non-performing loans, bad debts, and in turn will eat into the

profits of the bank. A bank ends up losing the principal lent, and the expected interest income. Poor management of loans also results into an increased cost of recovery especially when auctioning customer's assets to recover loan. This affects bank performance by getting the bank into reporting losses.

Olawale (2015) conducted a research on the problem of credit risk management. His study was carried out in Nigeria and the population was Nigerian Commercial banks. The indicators of credit risk management in Olawale's study were: loan performance ratio of loans to deposits and management of loan portfolio. Olawale wanted to understand how the practices above, are related to bank profitability; and from the conclusions of the study, there proved to be a relationship between bank's profitability and financial performance among Nigerian banks.

1.1.4 Commercial Banks in Kenya

According to the Central bank report, March (2016), the Kenyan banking sector was formed by 42 commercial banks, one mortgage finance company, 12 micro finance banks, eight representative offices of foreign banks, 79 forex exchange bureaus, seventeen money remittance providers, and three credit reference bureaus. The Central bank report further indicated that that the banking sector's total assets were 3.6 trillion with gross loans of 2.4 trillion. Deposits stood at 2.6 trillion while profit before tax was at 38.4 billion. For commercial banks to lend effectively, they are always required to have more deposits than loans. When the amount of loans is growing higher than the amount of deposits, this basically means that the banks will not have enough money to lend to new borrowers and will land into liquidity problems.

The CBK report at end of March (2016), indicated that there was an increase in the value of Non-performing from 117.2 billion in 2015 to 172.9 billion in 2016. This indicated a percentage increase of 47.5%. Non-performing loans in commercial banks are caused by poor repayment or non-repayment by the borrowers. Commercial banks need to be on the lookout on any signs of a likely defaulter. Risk identification plays a major role in ensuring that trouble loans are

discovered before causing losses to banks. The Central Bank report further shows that the ration of gross NPLs to gross loans increased to 7.8 percent in 2016 from 5.7 percent in 2015, same period. The cause of the increase resulted from the increase in Non-performing loans. From the Central bank report, it is evident that banks need to manage their portfolio well. The whole process of credit risk management must be followed strictly so as to ensure that banks reduce the level of Non-performing loans. The credit risk management practices which include risk identification, risk evaluation, control and monitoring and implementation of credit policy, must be followed. Commercial banks depend on interest income received from loans so as to grow their business. If the loans are not performing, it means the interest income is reducing and therefore a reduction in profits.

1.2 Research problem

Lending is the core business of commercial banks in Kenya and this proves how important credit risk management is. Commercial banks need to make profits just like any other business and this can be made possible only with good risk management practices. Credit risk can result from poor lending practices, poor portfolio management, and lack of diversity in investments, and political instability. If credit risk is not managed well, it can lead to serious problems including, loan defaults and non-performing loans. This may in turn lead to liquidity problems (Vadova, 2003).

Credit risk management is a very important aspect in all commercial banks. With good credit risk control measures, risk identification methods and sound risk evaluation models, commercial banks can minimize the loss that comes with credit risk. Commercial banks must manage risks so as to avoid running into liquidity problems; a loan portfolio that is not managed well will lead a bank into losses. With good credit risk management practices, commercial banks may gain good financial stability which will give their customers confidence and depositors will not be afraid to continue banking with such banks. On the other hand, a bank without good credit risk management practices may lose customers. Commercial banks must have good credit risk policy and implement the same (Raj 2015). Credit risk management will help banks to give loans to the

qualified customers who have the ability to repay, especially by considering the 5 c's of credit which include: collateral, conditions, capacity, character and capital (Petersen, 1999).

According to a research that was done by Kayode et al (2013), on credit risk and bank performance in Nigeria, it was found that, credit risk is negatively and significantly related to bank performance, measured by return on Assets (ROA). As per this study, it was concluded that an increased exposure to credit risk reduces bank profitability. The study showed that credit risk management strategy should be reliable so as to avoid losses resulting from credit risk. Credit risk management is a process that should not only be documented, but also implemented to ensure, it helps the bank's profitability. A study done Kessey (2015), on processes and challenges of credit risk management practices in the banking industry in Ghana, showed that, banks that do not implement the credit policy (as indicated in the credit manual policy), find it hard to manage credit risk. Korir (2010) identified a research problem on credit risk management and decided to focus his study on the deposit taking microfinance institutions in Kenya. Korir carried out the research to assess how financial performance of the said institutions is related to credit risk management practices. According to the findings of this study, there was proof that credit risk management practices had an influence on the financial performance of the deposit taking microfinance institutions. Kithinji (2010) did a study on how credit risk management affects bank's profitability in Kenya. Kithinji found out that credit risk management does not have a big influence in the profitability of commercial banks. His study showed that profitability in commercial banks is influenced by many other variables other that credit risk management. Gweyi (2013) found that most Commercial banks in Kenya were using collateral as a risk management practice. From the above studies, it is evident that credit risk management is an important issue to the banking industry, and wide research needs to be done in order to establish the relationship between credit risk management practices and financial performance. This study therefore sought to answer the question: What is the relationship between credit risk management practices and financial performance of commercial banks in Kenya?

1.3 Research objectives

The objective of the study was to establish the relationship between credit risk management practices and the financial performance among commercial banks in Kenya.

1.4 Value of the study

Credit risk management is very important as this helps in managing the loan portfolio in commercial banks. Good management of loan portfolio ensures that banks can achieve the expected financial results. This study will helpful to bank credit managers as it will help them on understanding the importance of having credit risk strategies as well as the importance of implementing such strategies. It will also help bankers to come up with innovative services that can compensate for the loss suffered through credit risk.
Commercial banks in Kenya can come up with services like bank assurance which can enable them have an alternative way of income generation.

Regulators like Central bank of Kenya and the government will also benefit from the study and know what new policies and controls to implement in order to assist the banking industry to achieve sustainability. The Central Bank of Kenya has an interest on how banks operate, since the stability of commercial banks can affect the entire economy. This is because all other industries like: manufacturing industries, agricultural industries, oil industries, small and medium sized enterprises, all depend on credit facilities, for business development. Academicians and researchers will also benefit from the study as it will be used as a basis for further research.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The contents of this chapter, consists of the literature that the researcher used in assisting the success of the study. The literature that was reviewed by the researcher includes theoretical and empirical review.

2.2 Theoretical review

Under this section, there are theories that were used in guiding the study. It consists of the theories explaining the concept of credit risk management for commercial banks. This section will specifically look into the theory Value At Risk (VAR), the Modern Portfolio theory and the Basel II accord.

2.2.1 Value at Risk theory.

In financial risk assessment, one of the tools applied is the value at risk methodology (Danielsson2000). Value at risk (VAR) is used by many investors when they need to measure how much loss they expect in a specified period of time (Markowitz, 1959). While in the process of risk management, the VAR can be used to determine the amount of assets that shall be needed to cover expected losses. Normally, commercial banks use the VAR modeling to have an early preparation on how to mitigate risks. Commercial banks have several departments and each department carries with it different kinds of risks. It is to the advantage of the commercial banks when they can estimate any possible loss using the VAR. The Value at Risk modeling is helpful to commercial banks. This is because VAR can give useful information on whether the capital held by the bank is sufficient to cover for the possible losses expected. In managing risk, one objective is to protect the firm from financial distress costs (Duffie and Pan 1997).

2.2.2 Modern portfolio theory

This theory was pioneered by Harry Markowitz (1952). The Modern Portfolio theory involves maximization of return from a given portfolio of assets. The main idea behind the theory is to ensure that investors assemble their portfolio of assets to gain more returns, and go for less risky portfolios. According to this theory, when an investor does an assessment of risk and return, he should not look at what an asset's risk and return is but how such an asset contributes to the overall risk, return of a portfolio. One assumption of the Modern Portfolio Theory is that investors are risk averse. Since investors are risk averse, then according to this theory, it is expected that whenever there are two portfolios promising the same returns, an investor will pay attention to the portfolio that offers a lower level of risk. Different investors have different risk appetite and will therefore go for different portfolios based on how they assess the risk. Commercial banks may also apply the Modern Portfolio Theory, in order to make a selection on which investments to pay attention to. Commercial banks may opt for lower risk investments and may as well decide to charge higher interest rates to borrowers which may seem to pose a greater risk. Given a rational investor with two portfolios at different expected returns, the investor will go for the portfolio that promises higher returns. The financial market is a volatile industry. Even though there are benefits and rewards in the financial sector, critical analysis is key. It helps in a credible evaluation of risks which in the long run adds to sound decision making on how to participate in the industry (Omisore et al, 2012).

2.2.3 The Basel II framework

The Basel committee on banking supervision keeps making recommendations on banking laws, procedures and regulations. All commercial banks and their regulatory authorities are needed to ensure they follow such guidelines for the better of the financial sector. Basel II consists of the revised version by the committee (Lind, 2005). The Basel II is relevant to this topic of the study, where it tackles issues related to credit risk management. Basel II involves three main areas and these are: market discipline, minimum capital requirements and supervisory review. On the first

issue of minimum capital, Basel II recommends that commercial banks must have minimum capital. A commercial bank must have enough capital to ensure that it is able to protect depositor's money in case of losses. Every commercial bank must ensure that the minimum capital held matches up to the risk taken. The second area guided by Basel II is supervisory review. This involves guidelines on risk management systems, how banks should review their systems, how to deal with different risks on strategic, concentration, reputational, systematic, pension, legal, liquidity. The third area that Basel II accord gives guidelines on is the market discipline. All commercial banks are required to disclose important information for the sake of their stakeholders. Information that relates to capital adequacy, risk exposures, risk assessment processes, capital should be disclosed by commercial banks. The Basel II accord puts its emphasis on credit risk analysis. It gives guidelines that focus on good criteria of capital allocation, ensuring that banks quantify risks objectively and by use of formal techniques (Basel committee on banking supervision, 2004).

2.3 Determinants of financial performance.

Credit risk management practices, typical for any commercial bank should include credit risk identification, risk evaluation, risk control and a good credit policy manual. The practices may slightly differ per bank but under such practices, financial institutions may be able to avoid losses resulting from credit risk.

2.3.1 Credit risk identification.

Any commercial bank that needs to undertake the risk management process must start with risk identification. Commercial banks must be able to determine the kind of hazards or risks that they are most likely to face or suffer in any planned transaction. The process and methods that commercial banks apply to identify hazards, is known as risk identification. When commercial banks suffer losses because borrowers fail to owner payments, then the commercial banks are said to have suffered a loss as a result of credit risk (Barton, 2002). Mangers in commercial banks need to make decisions on whether or not to give loans. With risk identification procedures, managers have the ability to make good decisions that will in the long run appease

all stakeholders. It is always advisable that organizations scrutinize the observation areas, both internally and externally, during the risk management process (Kromschroder and Luck, 1998). Methods used in risk identification include common risk checking, questionnaires, objective based and scenario based risk identification (Barton, 2002). Risk can be described in two broad categories i.e. concentration and settlement risk. Concentration risk is type of a risk resulting from investing in one type of investment. E.g., a bank may give credit to a particular sector without diversifying, when there are problems, in such a sector, the possibility of a loss to the bank will be high. When third parties are involved in transactions or clearing agents are used, then there is a possibility of a settlement risk. It is common practice for commercial banks to examine total risk perceived on the portfolio. Other risks that banks need to identify are country risk and industry risk. When commercial banks lend to customers from different nations, they are likely to face country risk. Events that result to country risk include political risk, economic risk, currency risk, and enforcement risk.

Industry risk is a form of concentration risk. When a specific industry is going through tough financial times, commercial banks need to worry for loans held by people in such industries. It is for this reason, that commercial banks are always encouraged to apply diversification in their daily lending.

Credit risk is triggered by certain events and this makes it different from all other types of risks. The events that contribute to credit risk normally influence the value of counterparty and affect also the value of a transaction. Such events are: obligation default, repudiation, bankruptcy, restructuring, failure to meet payment obligations when due.

2.3.2 Credit risk evaluation

Credit risk evaluation must be done before the customer is given any cash. This is when a lot of information is collected from the customers in order to find whether the customer should be granted the credit (Brown and Moles 2014). Information should be collected concerning the following: The firm's competitive environment; this includes information about how the firm is positioned, its brand image and innovation. Such information is helpful in credit evaluation. The second matter concerns industry risks. Before banks give credit, they should know the technology in the particular industry, regulatory requirements, and barriers to entry as well as

possible substitutes. The third concern to be checked in credit evaluation is capital structure; a bank should collect information of the debtor's capital structure which should include the customer's debt, information on how the customer services their debts, a check on any default cases and how frequently the default case is, the behavior of the customer on taxation and filling of tax returns, the interest rates on the customer's debts and the pattern of the rates. A bank should also look at how the customer makes repayments and how the installments are structured. Commercial banks should also look at business risk when considering to lend. The operating cash flows of any business may vary due to business risk which affects also the profit before interest. (Pike et al, 2006).

In credit risk evaluation, commercial banks should apply the measure of EDF (Expected Default Frequency). This measure can help the bankers in knowing how many times a client will default as well as knowing which investments to have a greater appetite on. The EDF measure will help bankers in knowing how high the interest should be for a particular loan, and for a particular customer. When commercial banks use the EDF measure, they can easily tell which loans may become troublesome at very early stages. This serves as a warning to the lender and will help in making sound decisions on the particular area to invest in. Worldwide, commercial banks are coming up with different and better ways to calculate the possible financial loss they may suffer; which in turn helps them to plan on the amount of capital required to cover for such losses. (Lopez 1999).

Commercial banks can also use CAMPARI as a way of analyzing credit risk. This stands for character, ability, means, purpose, amount, repayment, insurance. The term character, concerns issues related to integrity and commercial banks must check on the character of the managers of the business. Ability touches on how the rules and regulations of the business are, any terms on the contract and whether the managers can conduct business on behalf of the company. Commercial banks may need to analyze the ability of these managers before going into any contact. Before commercial banks, can give loans; they should check on the means which refers to the financial means of a borrower, the source of finances and the financial ability. Banks should also check on the purpose of the loan. A borrower who takes money to generate more income through business expansion is more likely to receive a loan than a borrower who needs money to go for a holiday. Amount, repayment and insurance are also very important aspects to look at. Commercial banks must look at the amount of loan borrowed and if it is justifiable

according to the purpose of the loan. Customers' repayment ability should also be analyzed so as to know whether the customers will be able to meet their obligations. This is also one way of avoiding bad loans and non-performing loans.

2.3.3 Credit risk control

Commercial banks must have internal control systems. There are different ways that can be used to control credit risk which includes: diversification, covenants and monitoring, risk pricing, loan loss provisioning, managing the loss given default. On managing the loss given default (LGD), banks can use collateral and collateralization. On such an occasion, the party taking credit gives a security against default. In case of default, the lender can claim a specific asset of the borrower. A credit guarantee is also another way of managing the loss given default. Mutua, (2015) in his study, the findings revealed a significant relationship between credit risk control and financial performance banks.

Diversification is about spreading the risk. Banks need to expand their target clients and give loans to customers from different sectors in terms of industry, geographical, and international factors. Diversification reduces the credit risk .A covenant involves a restriction or requirement imposed on the borrower and agreed to under the terms of a contract. Covenants are very important and commercial banks can use them on loan agreements. Covenants can restrict the borrower on selling of borrowed property which may in turn help in protecting the capital level of the firm. There are affirmative covenants, negative covenants and information covenants. All credit processed need monitoring, when exposures are monitored, problems can be recognized very early before they can become very complicated.

Provision of loan losses is another control, which bankers use to ensure any losses suffered may be covered for very quickly before they lead to liquidity problems. Risk pricing is also an adopted control where the required return changes based on the perceived risk.

2.3.4 Credit policy manual

Banks must have credit risk policy manual, for it is this manual that gives a detailed set of guidelines, procedures and processes. The policy manual should include matters related to the credit management mission statement, the goals of credit management, responsibilities, credit management policies, and compliance and regulation issues. It is very important for commercial banks to formalize their processes and procedures. The role and goals of the credit management should be clearly written; the credit policy should be well written for example, the maximum number of days outstanding for credit terms, collection systems, frequency of bad and doubtful debts. Responsibilities of different staff should be laid out in the policy manual, who has the authority for final authorization, who does the credit analysis. Commercial banks need to have well laid procedure on several issues including account opening procedures, processing of loan applications, credit reference bureaus, credit terms and conditions, credit reports, lines of credit. Written policies should also exist on how compliance checks should be done, monitoring and all procedures from opening accounts, to credit risk assessment, lending and monitoring the progress of loans. Credit policies can keep changing depending on the quality of borrowers (Rajan, 1994).

2.4 Empirical review

According to a research done by Kessey (2015), it was found that the issue of credit risk management is a big challenge. Kessey carried out his study in Ghana and he wanted to understand the practices adopted by banks in managing credit risk. The study done by Kessey in Ghana, was to establish any challenges faced on implementation of credit risk management practices, policies and strategies. In this study, it was observed that even though commercial banks may have sound credit policies, if such policies remain on paper without any implementation, then credit risk will always be a problem in such a company.

According to Kessey's study, some banks were found to have good credit policies but with very poor implementation practices.. The study examined the portfolio quality of the selected bank

and credit risk management policies were analyzed. The results of the study, showed that credit risk was still a major concern for the bank, and even though credit policies and strategies existed, it was found that implantation of the policies was a challenge. The study revealed that credit risk was causing low quality of loan portfolio at the bank under study. It was also noted that credit policy reviews were not done frequently, and there was lack of effective credit recovery measures.

Ugoani (2015), decided to focus on poor credit risk management practices. In his study, which was carried out in Nigeria, he wanted to find out whether the poor practices had an influence on bank failure. The study established that poor credit risk management practices led to a big number of non-performing loans, while weak corporate governance accelerates bank failure. According to this study by Ugoani, it was found that, credit risk management processes must be credible and be operated with integrity. In this study, it was also noted that objective decision making should be adopted when dealing with credit risk analysis and credit risk evaluation. This study done by Ugoani, showed that commercial banks should assess their risk appetite to calculate their expected margin of returns.

Das (2007) conducted a research in Bangladesh with the aim of evaluating the credit risk management practices among commercial banks. The study was also to be used in analyzing and suggesting any other better methods of enhancing the efficiency of credit risk management practices. The study done by Das, was to do an in depth analysis of the credit risk management practices, how well they are practiced and the extent of their effects on commercial banks. The results of the study showed that for commercial banks to be successful credit risk management, very credible and efficient risk management processes were to be followed. The study showed that there were many challenges facing the banking industry and the business environment at large; it also showed that commercial banks can survive stiff competition only if they implement efficient credit risk management practices.

Kanchu, and Kumar, (2013) did an empirical study on risk management in banking sector. This study was done for the main purpose of analyzing risks that are faced by the banking industry and how banks manage such risks. The authors examined the different techniques adopted by

banking industry and the process of risk management. The findings of the study showed that banks need to take risk more consciously. Banks can have a competitive advantage if they take risks more consciously and practice efficient management. The study also showed that risk management in banks depends on efficient management information systems, computerization and networking of the branch activities.

Alshatti (2015) targeted the Jordanian commercial banks, when he was studying the issue of credit risk management practices. According to this study, the researcher, wanted to find out how credit risk management and financial performance relate to each other. After his investigations, the researcher concluded that credit risk management practices had a direct influence on financial performance among commercial banks. This study on Jordanian commercial bans proved that it was necessary for all commercial banks to have sound credit risk management policies and practice them. From this study, the researcher, concluded that it was important for commercial banks, to have good structures on credit risk management and this included, the right employees with skills on different sections like monitoring, credit analysis, debt recovery loan account application and sales. The results of this study further showed that for commercial banks to gain more profits and increase more income, they have to put in place good structures for the management of risk. Commercial banks therefore need to give a priority to credit risk management practices, to have guidelines on credit risk management, implementation strategy and measures to test whether the short term objectives are being met.

Aduda and Gitonga (2011) did a research covering on credit risk management and bank's profitability. The study was the type of an empirical analysis where a regression model was used. This study concluded that credit risk management had an effect on the profitability of commercial banks in Kenya. This also proved that credit risk management, remains a crucial issue among commercials banks in Kenya.

Ogilo (2012), had his research on credit risk management and financial performance among commercial banks in Kenya. Ogilo's main aim of the study was to assess how credit risk management relates with financial performance using Return on Equity. This study used secondary data which was analyzed using regression analysis. In this study, earnings were found

to be affecting the financial performance of commercial banks. (CAMEL) was used as indictor of the credit risk management practices. The study revealed that indeed a relationship exited between profitability and credit risk management.

Ngare (2008) conducted a research also on credit risk management practices. His study was to survey or analyze and understand the credit risk management practices among commercial banks in Kenya. Ngare sought to identify, the sources of credit risk exposure and identifying the strategies that banks use to mitigate against credit risk exposure. The results showed that most banks, use strategies such as loan diversification, bank guarantees, and bank covenants to mitigate against credit risk. The study also found that in most banks, credit risk management was organized in units within the credit management department with persons responsible for credit risk management reporting to the credit manager. In the study, it was also found that most banks did not have an autonomous credit risk management department.

Mutangili (2011), in his study, he wanted to understand how credit risk management practices were related to the level of non-performing loans among commercial banks in Kenya. The findings showed that the level of no-performing loans is inversely affected by credit risk management practices i.e. a negative relationship. According to the results of the study, credit risk assessment methods, used in banks include: risk adjusted return on capital, and linear probability model. Credit criteria, credit culture, training of credit officers, credit control risk assessment are some of the credit risk management practices discovered by the study.

Musimbi (2015) had the interest to study how financial performance was affected by credit risk management practices. In his study, his target population was savings and credit cooperative societies in Kisumu. Musimbi found out that the credit risk management practices, had guidelines on different areas including collateral, policy, loan appraisals, covenants and risk monitoring. In his study, the results showed that credit risk management practices affected financial performance of Saccos in a positive direction.

2.5 Summary of literature review

From the review of the surveys and all studies done, it is very clear that credit risk is a factor we cannot overlook in the financial industry. The studies done by Kessey (2015), Ugoani (2015), Das (2015), Ngare (2008) focus mostly on the credit risk management practices by different banks. The results of these studies show that credit risk management practices affect banks. Mutangili (2011) looked at how credit risk management practices affect the level of non-performing loans; Musimbi (2015) looked at the effect of credit risk management practices on financial performance of Saccos in Kisumu. The results of these studies showed that credit risk management practices have an effect on non-performing loans and on financial performance. A study by Kithinji (2010), show that bank's profitability is influenced by many other than non-performing loans. Other studies done include those of Sinan and Philip (2010), Alshatti (2015), Aduda and Gitonga (2011).Not many studies have been done to show the relationship between financial performance of commercial banks and credit risk management practices. While other researchers, show that credit risk management practices have no significant effect on bank's profitability. This study was therefore to fill this gap by establishing whether a relationship exists between credit risk management practices and financial performance of commercial banks in Kenya.

CHAPTER THREE: RESEARCH METHODOLOGY

This chapter will deal with the procedures that were followed in order to accomplish the objectives of the study. Specifically, this chapter will deal with the research design that was adopted, the target population, the data collection methods that were applied and data analysis techniques that were used.

3.1 Research design

In this research project, the research design that was adopted was descriptive. The researcher had the intention of establishing a relationship between financial performance (dependent variable) and credit risk management practices (independent variables).

3.2 Population

The population of this study included the42 commercial banks in Kenya, staff in the credit and loan departments were of interest to this study. The period of this study was five years from 2011 to 2015.

3.3 Data collection

In this study, the researcher adopted qualitative as well as quantitative methods in data collection. Questionnaires were prepared and given to bank staff in credit and loan department. The questionnaires were structured effectively, and the drop and pick method was applied. Semi-structured questionnaires with closed and open ended questions were used to establish the relationship between credit risk management practices and financial performance of commercials banks in Kenya. The closed ended questions were to enable collection of quantitative data while the open ended questions were to enable collection of qualitative data. Secondary data which includes publications, journals, and periodicals was also used.

3.4 Data Analysis

Analysis of the data that was collected was accomplished using the Statistical package for the social sciences (SPSS). The results were then presented on frequency distribution tables, pie charts and bar charts. The regression model used was:

3.5 Analytical model

$$Y=\alpha+\beta 1X1+\beta 2X2+\beta 3X3+\beta 4X4+e$$

Y= the dependent variable, financial performance

Financial performance will be measured using Return on Assets.

Return on Assets = Net income/ Assets.

α= a constant, the concept explaining the firms performance given and it's the Y value when all the predictor values (X1, X2, X3, X4) are zero.

X1- Credit risk identification (measured using qualitative data on a likert scale)

X2- Credit risk evaluation (measured using qualitative data)

X3- Credit risk control (measured using qualitative data)

X4- Credit risk policy manual.(measured using qualitative data)

E - Error term, explaining the variability of financial performance as a result of other factors not accounted for.

3.6 Test of Significance

The t-test was used, to determine the overall significance i.e. to show whether there was a significant relationship between credit risk management practices and the financial performance of commercial banks in Kenya.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

Under this chapter, there will be a presentation of the research findings, data analysis, and presentations of the results of the study. These are presented based on the objectives of the study.

4.1.1 Response Rate

The designed questionnaires were presented to the respondents, personally, to enhance the response rate. A total of 42 questionnaires were sent to every commercial bank in the study population. Out of this, 30 were successfully filled and returned. Thus, the study achieved a response rate of 71.4% which was sufficient sample to provide credibility to the findings. According to Cooper & Schindler (2008), if the response rate is 60% and above then the social scientific study can proceed.

4.2 Demographic Information

This study measured the demographic characteristics of respondents. These characteristics of sample respondents were measured with respect to level/ position held in the bank, work experience in the bank and the number of years that the bank has been in operation. This demographic information was captured in section A of the questionnaire.

4.2.1 Level of Employment

In this study, data was also collected to establish the level of employment of the respondents in the targeted banks. Figure 4.1 below illustrate their responses. On the overall, 70% of the respondents were from the management and the senior management level making them the key respondents in the study. This shows that the information provided were reliable since they are more conversant with strategic and operational issues of the banks as well as credit risk management.

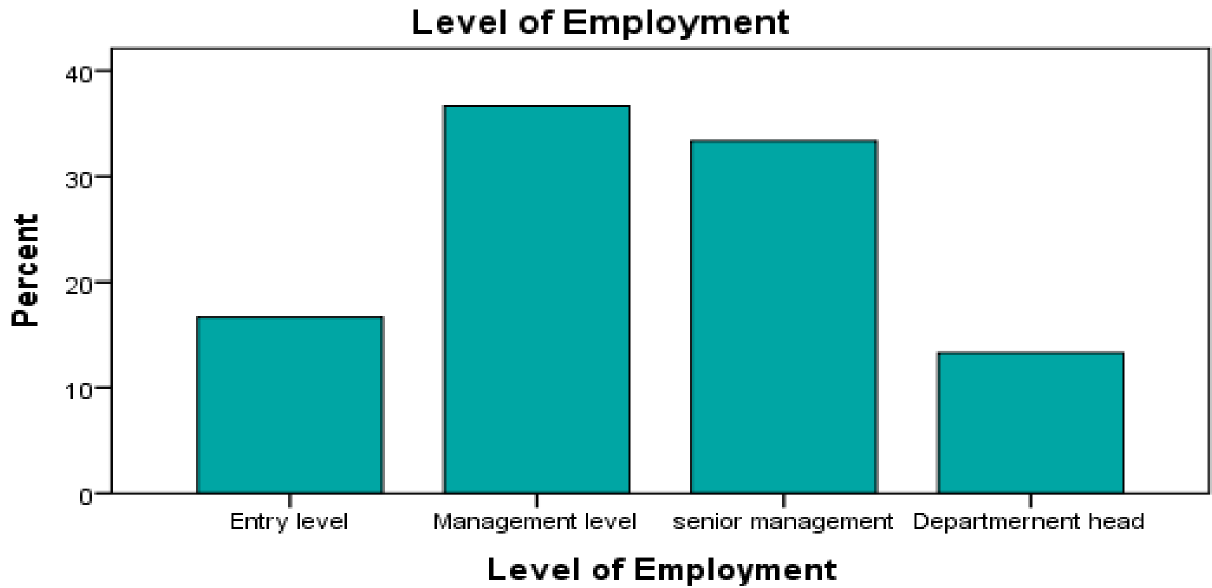

Figure 4.1: Respondents level of employment

Source: Research Data (2016)

4.2.2 Working Experience

The study did an assessment of the period of time that the employees have been working in the different commercial banks. The summary of the results are shown in Figure 4.2 below

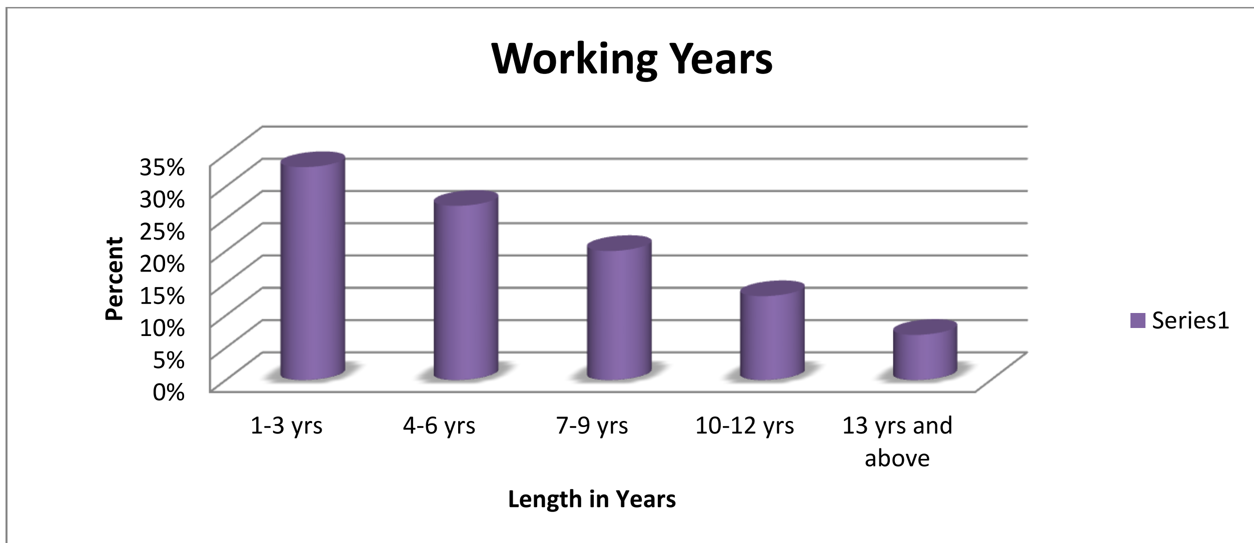

Figure 4.2: Work experience of respondents

Source: Research Data (2016)

This study that was carried out, analyzed how long the employees have worked in the different commercial banks. Checking on the length of their working experience was very important as this was to be used in ensuring that the researcher analyses the responses well. The researcher believed that well experienced employees may have better understanding of their areas of work and hence give responses that would be reliable and accurate for the purpose of the study. When respondents have worked in a particular sector for long, their response may be reliable on the topic of study. This is unlike, the response that may come from employees who have little experience in the area of study. Employees with high working experience will almost certain have technical experience on the problem under investigation (Braxton, 2008). In this study, 67% of the respondents were found to have worked in the commercial banks for more than 3 years. This was enough evidence that the majority of respondents clearly understood the problem under investigation which was "the relationship between credit risk management practices and financial performance".

4.2.3 Operational Years of the Bank

The other demographic factor that was surveyed by the study concerned the number of years that the Commercial banks had been in existence in Kenya. From the data collected, it was established that majority of banks have been in operation for over ten years. The summary of the results are displayed in Table 4.1 below.

Table 4.1: Operational Years

Years	Frequency	Percentage (%)
1-10 Years	3	10.0
11-20 Years	9	30.0
21-30 Years	10	33.3
31 years and above	8	26.7

Total	30	100.0

Source: Research Data (2016)

4.3 Credit Risk Management Practices

The researcher, collected data that was to show what kind of practices commercial banks use, to manage credit risk. On the questionnaire that was used to collect data, responses were collected using a likert scale with points 1 to 5. 1 was used to show never used, while point 5 was used to show mostly used. Table 4.2 below displays the summary of the findings.

Table 4.2: Credit risk management practices

The Practice / Extent of Use	Credit Risk Identification	Credit Risk Evaluation	Credit Risk Control	Credit Policy Manual
Never used	7%	8%	0%	7%
Rarely used	17%	3%	0%	14%
Fairly used	13%	1%	10%	17%
Used	33%	51%	37%	36%
Mostly used	30%	37%	53%	26%
Total	**100%**	**100%**	**100%**	**100%**

Source: Research Data (2016)

4.4 Credit Risk Identification

The researcher also wanted to measure the extent to which the banks apply the various risk identification methods provided in a five point likert scale. On the 5 point likert scale 1 represented very low extent and 5 which was the maximum represented very large/great extent.

The study used the mean scores to establish the average number of responses received from each item in the questionnaire and standard deviation which shows how much variation or diversity exists in a distribution. Standard deviation may increase or even decrease depending on the distribution of scores; how close the scores cluster around the mean, will cause standard deviation to increase or decrease. Standard deviation normally shows how the responses given by individual respondents differ from one another. When majority of the responses give opinions or answers that are almost similar, then the standard deviation, should be less than one. When the interviewees give very different answers or different opinions on a particular subject or a particular question, then the standard deviation will be greater than 1 (Kothari 2008).

The researcher designed the questionnaire such that the respondents would indicate the extent to which the banks use the various risk identification methods. Based on the mean score responses, the findings indicate that although their responses were varied as shown by their standard deviation, majority of the banks rarely use common risk checking, using lists with known risks as shown by a mean score of 2.600; and that they fairly use questionnaires as indicated by a mean of 2.800. However, the results show that majority of the banks to a large extent use objective-based risk identification method and scenario-based risk identification method as shown by a mean of 4.367 and 4.033 respectively as shown in Table 4.3 below.

Table 4.3: Extent of use of Risk identification Methods

Risk identification Method	**Mean**	**Std. Deviation**
Common risk checking, using lists with known risks	2.6000	1.3796
Questionnaire	2.8000	1.3493
Scenario-based risk identification method	4.0333	.7648
Objective-based, risk identification method	4.3667	.8087

Source: Research Data (2016)

4.5 Credit Risk Evaluation

The researcher had the objective, also to establish the extent to which the credit risk evaluation procedures provided in the questionnaires were being followed in the bank. The summary of the findings are shown in the Table 4.4 below.

Table 4.4: Risk Evaluation Methods

Risk Evaluation Method	Mean	Std. Deviation
Use of Expected Default Frequency (EDF) as a measure that provided early warning indicators of serious credit deterioration	3.3667	1.19578
Assessing capital structure of a company before granting credit to such a company	3.9333	.98027
Looking at integrity of the management of a particular business before granting credit	4.1333	.81931
Looking at the source of repayment ability of a borrower before granting credit	4.3333	.71116

Source: Research Data (2016)

Table 4.4 above shows that most of the banks, look very well at the source of repayment ability of a borrower before granting credit and the integrity of the management of a particular business before granting credit as shown by a mean of 4.333 and 4.133 respectively. However, the findings indicate that some of the banks use Expected Default Frequency (EDF) as a measure that provide early warning indicators of serious credit deterioration while others do not use as shown by their divergent responses showed by standard deviation of 1.195 and a mean of 3.367.

4.6 Credit Risk Control

The study, also sought to establish how better, the targeted commercial banks used the various listed methods to control credit risk. The summary of the findings are shown in Table 4.4 below

where 1 indicates used to a very low extent , 2-Low extent, 3-neutral, 4- great and 5 shows a very great extent.

Table 4.5: Credit Risk Control Methods

Risk Control Method	**Percentages (%)**				
	1	**2**	**3**	**4**	**5**
Diversification	2%	7%	20%	45%	26%
Covenants	15%	17%	27%	18%	23%
Monitoring	10%	0%	13%	43%	34%
Risk Pricing	20%	21%	23%	24%	12%
Loan Loss Provisioning	10%	0%	13%	57%	20%
Managing the Loss Given Default	0%	0%	10%	57%	33%

Source: Research Data (2016)

From Table 4.4 above, the findings indicates that majority (57%) of the banks use to a great extent the loan loss provisioning method to control credit risk and manage the loss given default method followed by diversification method (45%). However, the results showed that covenant is the least used method as shown by 18% of the respondents.

4.7 Credit Policy Manual

The respondents were further asked to show whether their banks maintain a credit policy manual. It was established that all of the banks do maintain a credit policy manual. In addition, the respondents were asked to show how the credit policy manual is communicated. 24% of the respondents indicated that they are communicated through meetings; 47% showed that they are communicated during induction and trainings; 22% used bank's e-library; 3% indicated that it is communicated via e-mails while 4% said that their banks use bank manuals.

Moreover, the respondents were asked how frequent the banks reviewed their credit policy. Figure 4.3 below shows their responses.

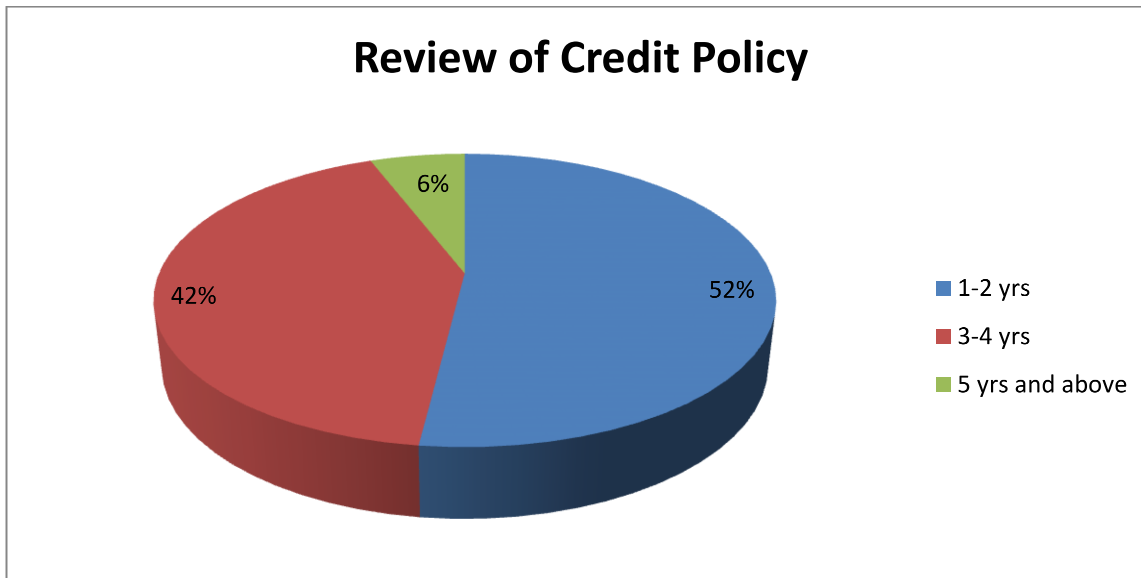

Figure 4.3: Frequency of reviewing credit policy

Source: Research Data (2016)

According to the results, many commercial banks (52%) review their credit policy between one and two years; 42% review between a period of three ad four years while 6% review at least in or after five years.

The respondents in this study, were also asked to indicate how much priority is given on implementation of the credit policy. Results showed that 50% of the commercial banks give very high priority, while 50% give high priority to implementation of the credit policy.

4.8 Regression Analysis

In any study, there are always independent and dependent variables; and in order for the researcher to explain better the relationship between these variables, this study adopted a multiple regression analysis. Under the multiple regression analysis, a researcher is required to compute measurements of multiple regressions. The researcher in this study used the statistical package for social sciences (SPSS) to get these measurements. In table 4.6 as displayed below, the letter R, has been used to stand for multiple correlation coefficient. The multiple correlation

coefficient is normally used in statistics in order to show the strength of a relationship between independent and dependent variables. R-squared, is the coefficient of determination, and this is used in statics to show what changes take place in a dependent variable as a result of the changes in independent variables. The researcher used the coefficient of determination in this study to explain the kind of change that may take place on financial performance (dependent variable) as a result of changes in the four independent variables (credit risk identification, credit risk evaluation, credit risk control and credit policy manual). The summary is explained in the Table 4.6 below.

Table 4.6: Coefficient of Determination

Model	R	R Square (R^2)	Adjusted R Square	Std. Error of the Estimate	Sig.
1	.858	.785	.638	.51325	0.001

Source: Research Data (2016)

As can be observed in table 4.5 above the value of R-squared is .785 which is close to 100 and this infers that the regression model is equally good to explain the indicators of credit risk management practices among commercial banks. This corresponded with Mugenda&Mugenda (2003) who observed that the R-squared value is always between 0 and 100%: Variability of response data around its mean may vary and its variability is measured using the R squared. When the model does not indicate the variability of the response data around its mean, then R-squared will be 0%. When the model explains all the variability of the response data around its mean, then R-squared will be 100%. A model fits the data better when the value of R-squared is high. The table below (table 4.5) summarizes the model of the indicators of credit risk management practices with the coefficient of determination R^2 = 0.785 and R =0.858 at 0.001 significance level which is significant as it is less than 0.005. The coefficient of determination indicates that 78.5% of the variation of the indicators of credit risk management practices can be explained by Credit risk identification (X1), Credit risk evaluation (X2), Credit risk control (X3) and Credit risk policy manual (X4). The remaining 21.5% is contributed by other variables not studied in this research hence further research should be conducted to establish these other factors not covered in this study. However, this shows that the model fits the data well as it has a value of above 75%.

4.6.2 Multiple Regression Analysis

To further determine the relationships and the strength of dependency between the indicators of credit management practices of the commercial banks, the study conducted multiple regression analysis to assess the dependence of measures of the variables studied. This analysis revealed the percentage of variance in financial performance scores explained by independent variable scores.

Table 4.7: Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	**Std. Error**	**Beta (β)**		
	(Constant)	.843	.207		2.687	.001
	Credit risk identification	.816	.131	.613	1.830	.002
	Credit risk evaluation	.910	.011	.702	1.371	.004
	Credit risk control	.745	.136	.593	1.356	.001
	Credit policy manual	.770	.105	.420	1.320	.003

Source: Research Data (2016)

According to the SPSS generated Table 4.6 above, the equation ($Y=\beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$) becomes $Y=0.843 + 0.613X_1 + .702X_2 + 593X_3 + .420X_4 + \varepsilon$. The multiple regression values in the table indicated that all the indicators of the credit management practices, that is, Credit risk identification, Credit risk evaluation, Credit risk control and credit policy manual studied have a positive and significant influence on financial performance of commercial banks. With more than 95 % confidence level the t-ratings indicate coefficient significance of 0.002, 0.004, 0.001 and 0.003 respectively which was less than 0.005, hence showing that these linear associations are statistically significant.

In addition, Table 4.6 above shows that taking all the factors into account, that is, Credit risk identification, Credit risk evaluation, Credit risk control and credit policy manual representing the independent variables, then financial performance of commercial banks will be .843 (84.3%). However, taking all the other independent variables at zero, then an improvement in Credit risk identification will lead to 0.613 (61.3%) increase in financial performance; increase in Credit

risk evaluation leads to 0.702 (70.2%) improvement in financial performance; the same improvement in Credit risk control increases financial performance by .593 (59.3%) and an improvement in credit risk policy enhances financial performance of commercial banks by 42%. This infers that all the credit management practices do have a significant influence on financial performance of commercial banks in Kenya.

CHAPTER FIVE:
SUMMARY, CONCLUSION AND RECCOMENDATION

5.1 Introduction

Under this chapter there will be a summary of findings, conclusions made by the researcher from the findings, recommendations and limitations of the study. The chapter includes also suggestions for further research.

5.2 Summary of the findings

From the results of the study, the response rate was 71.4 % meaning that the findings were credible. The results of the study showed that the credit policy manual was mostly used at 26%, risk control was mostly used at 53%, credit risk evaluation mostly used at 37% and risk identification mostly used at 30%.

The results on credit risk identification showed that, many commercial banks use objective risk identification and scenario based risk identification. This was evidenced by a mean of 4.367 and a mean of 4.033 respectively. From the findings of the study, the methods of credit risk evaluation applied by most commercial banks include looking at the integrity of the customer as well as the source of repayment. The mean on the source of repayment was 4.3 while that on integrity of management was 4.1.The results also showed that 57% of the banks use the loan loss provisioning method to control risk.

The findings indicated that the independent variables i.e. credit risk identification, credit risk evaluation, credit risk control and credit risk policy manual, have a correlation coefficient of 85.8%. This shows the strength of the relationship between the dependent variable and the independent variables. The findings also indicated that the changes in financial performance, resulting from credit risk management practices is at 78.5 %. This means that 21.5% remains unexplained meaning other variables other than credit risk management practices, affect financial performance.

The study findings indicated that the credit risk management practices (credit risk identification, credit risk evaluation, credit risk control, credit policy manual) have a positive and significant influence on financial performance of commercial banks. The results also showed that credit risk identification can cause changes in financial performance by 61.3 % increment, credit risk evaluation causing a 70.2 % change, credit risk control causing a change of 59.3% and the credit policy manual causing a change by 42%.

5.3 Conclusions

The study concluded that the credit risk management practices which in this study were indicated by risk identification, risk evaluation, risk control and credit risk policy manual, indeed have a positive influence on the financial performance of commercial banks in Kenya. The study concludes that credit risk identification has a positive influence on the financial performance of commercial banks in Kenya. It is therefore necessary for all commercial banks to ensure that they apply the various methods of credit risk identification due to the serious impact on the organization.

The study concludes that credit risk evaluation also has an influence on financial performance amongst commercial banks in Kenya. This means that before granting credit to borrowers it is very important to check at the scenario-based and objective based methods of credit risk evaluation. The study concludes that improvement in methods of credit risk evaluation methods leads to an increase in financial performance of commercial banks. The study also concludes that credit risk control methods which include diversification, risk pricing, covenants, also have a positive influence on financial performance among commercial banks in Kenya. Commercial banks need also to have credit policy manuals and ensure that the credit policy is communicated to the staff and implemented.

5.4 Recommendations for policy

Credit risk management affects all commercial banks in Kenya as well as in the world. Government institutions like the Central Bank of Kenya must play a vital role in the supervisory role. The Central bank of Kenya must come up with good control systems which shall ensure that supervision on commercial banks is thoroughly done. Reliable and efficient control systems by the Central Bank of Kenya will help in ensuring that commercial banks comply to credit risk management guidelines. As it is evident, that commercial banks must maintain a good liquidity ratio to continue in lending business, this means that their minimum capital should also be high. The Central Bank of Kenya should increase the minimum capital that commercial banks are to hold. A higher minimum capital will ensure that commercial banks commercial banks are protected incase of loans, as they will have no problem in returning money to depositors.

Commercial Banks in Kenya must take seriously the issue of credit risk management. Credit risk identification is a practice that must be embraced by all commercial banks. It is good for commercial banks to have a specific department that handles credit management. With the current ICT revolution, innovate ways must be adopted by the commercial banks to ensure reliable and efficient ways of credit risk identification. Credit risk evaluation is a practice that all commercial banks should adopt. Evaluation models should be applied in order to make objective decisions on lending to customers. Banks should develop IT systems that incorporate credit risk control systems, e.g., a core banking system may be configured to ensure that all trouble loans can be identified earlier with notifications from the system. If commercial banks use information system technology, in credit risk control, they will improve on their risk management practices. The credit policy manual should not just be kept in offices as a simple document. Everything outlined in the manual should be implemented. For easy of communication, commercial banks should ensure that the manual is shared online so as all staff can understand the guidelines on lending principles.

Stakeholders like the Kenya Bankers Association, should also ensure that continuous training is done to bankers so as to create awareness on the importance of credit risk management practices. The financial health of commercial banks, have an effect on the overall economy. It is therefore

very important for constant reviews to be made on the regulations related to credit risk management and lending.

5.5 Limitations of the Study

There were several challenges that came up during the time of the research. First, time was not sufficient to get response from all the 42 banks. Only 30 out of the 42 commercial banks gave their response on the questionnaire. If there was sufficient time, and all commercial banks gave their response, the results of the study and conclusions could have been different. Another limitation that was faced during the study was that most staff members did not want reveal a lot of information for fear of losing their jobs. Some staff also never returned the questionnaires due to the time frame given; they had busy schedules and were not willing to fill the questionnaires in a hurry.

Other factors that that led to limitations were financial resources, due to a lot of travelling and moving from one bank to another for data collection. This made the whole exercise a very expensive exercise.

5.6 Suggestions for further research

This research could be further developed by looking at other independent variables which have an effect on financial performance among commercial banks in Kenya. Commercial banks in Kenya have embraced technology and due to stiff competition, alternative means of income have also come up. Some banks have come up with new products like banc assurance which is an alternative channel of income generation. Such activities are also coming up with different types of risks which have an effect on financial performance. Other variables like reputational risk can also be studied because; some banks may be practicing good lending principles and still make losses.

The business environment is dynamic and commercial banks are also facing competition from micro finance institutions and SACCOs. These factors are also an influence to financial performance of an institution and must be looked at. This research can therefore be developed further by studying the mentioned variables. The guidelines used by Central Bank and other regulations from the government concerning lending, may also be studied so as to get a deeper understanding of how they affect bank’s profits. Strict rules from government like reduction of interest rates also affect the financial performance of commercial banks in Kenya. The study can therefore be developed further by incorporating these variables in the regression model.

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Appendix 1: Questionnaire.

PART A: General Information

1. Name of the Commercial Bank (Optional)……………..

2. The level of employment of the respondent: (Tick as appropriate)

   Entry level [ ]

   Management level [ ]

   Senior management level [ ]

   Department head [ ]

3. The length of service by the employee at the bank (In years)……………………..

4. The number of years that the Commercial bank has been in existence in Kenya….

PART B: Credit Risk Management practices

1. The following are credit risk management practices; which one does your bank use and to what extent? (Tick appropriately; where 1 is never used and 5 is mostly used

The practice	**1**	**2**	**3**	**4**	**5**
Credit risk identification					
Credit risk evaluation					
Credit risk control					
Credit policy manual					

2. To what extent does your bank apply the following risk identification methods? (Tick appropriately, where one means not applied at all and 5 means applied to a very great extent.)

Risk identification method	Extent of use				
	1	2	3	4	5
Common risk checking, using lists with known risks					
Quastionnaire					
Scenario-based risk identification, scenario analysis					
Objectives-based,risk identification					

3. How well are the following credit risk evaluation procedures followed in your bank? (Tick appropriately, where one indicates very poor and 5 indicates very well.).

	1	2	3	4	5
Use of Expected Default Frequency (EDF) as a measure that provides early warning indicators of serious credit deterioration					
Assessing the capital structure of a company before granting credit to such a company					
Looking at the integrity of the management of a particular business before granting credit					
Looking at the source of repayment and the repayment ability of a borrower before granting credit.					

4. To what extent does your bank use the following methods to control credit risk? (Tick appropriately, where one means not used and 5 means used to a very great extent).

Risk control method	1	2	3	4	5
Diversification					
Covenants					
Monitoring					
Risk pricing					
Loan loss provisioning					
Managing the Loss Given Default					

5. Does your bank maintain a credit policy manual?......................If yes, how is the policy communicated to staff?...

6. How often is the credit policy reviewed in your bank?...

7. On a scale of 1 to 5, tell us the extent to which priority is given on implementation of the credit policy (Tick appropriately, where 1 means no priority at all and 5 means very high priority.)

Very high priority [ ]
High priority [ ]
Medium priority [ ]
Less priority [ ]
Not a priority at all [ ]

Appendix 2: List of commercial banks in Kenya.

1. ABC Bank
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank of Kenya
6. CFC Stanbic holdings
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. Eco Bank Kenya
16. Equity Bank
17. Family Bank
18. Fidelity Commercial Bank Limited
19. First Community Bank
20. Giro Commercial Bank
21. Guaranty Trust Bank Kenya
22. Guardian Bank
23. Gulf African Bank
24. Habib Bank
25. Habib Bank AG Zurich
26. Housing Finance Company of Kenya
27. I&M Bank
28. Imperial Bank of Kenya

29. Jamii Bora Bank
30. Kenya Commercial Bank
31. Middle East Bank Kenya
32. National Bank of Kenya
33. NIC Bank
34. Oriental Commercial Bank
35. Paramount Commercial Bank
36. Prime Bank
37. Sidian Bank
38. Spire Bank
39. Standard Chartered Bank
40. Transnational Bank
41. United Bank of Africa
42. Victoria Commercial Bank.