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Effects of Credit Risk Management on Financial performance of Commercial Banks in Mombasa County

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Abstract
The objective of this study was to establish the effect of credit risk management on Financial Performance of commercial banks in Mombasa County. The study had three specific objectives of establishing the effect of liquidity risk management, determine the effect of market risk management and determine the effect of default risk management on credit risk management.Credit risk management is vital. The study thus utilized descriptive survey research design. Questionnaires were used to collect data. The banks that contributed to the study were 44 banks and were selected through simple random sampling. The sample size of the study was 50 credit managers of Commercial Banks. The list was obtained from 2014 central Bank of Kenya. Sampling involves a assortment of a number of individuals or objects from a population such that the selected group contained elements representatives of characteristics found in the entire group .Mugenda and Mugenda, (2003) recommends a representative sample of 10%-30% for descriptive survey research. The study found that there is a correlation between liquidity risk management, default risk management and market risk management with performance of the banks. It however found that the banks do not involve experts and consultants in market risk management thus recommendations were made for the banks to revise their credit risk management policies, open up and share information with other players on market risk thus involve consultants more in their market risk management and to be more proactive than reactive in risk management.
Keywords: Commercial banks, risk, Credit risk, Credit risk management, Market risk.

1. Introduction

Banks are germane to economic development through the financial service they provide. Their intermediation role can be said to be a catalyst for economic growth. The efficiency of effective performance of the banking industry over time is an index of financial stabilities and nation, the extent to which banks extent credit to the public for productive activities accelerates the pace of a nation economic growth and its long term sustainability. In the medium term, interest rates are expected to remain relatively stable, consistent with expected stability in most of the macroeconomic fundamentals. The Central Bank of Kenya will support interest rates stability by continued implementation of prudent monetary policy. However, in order to stimulate savings and investments, deposit rates must increase and lending rates must decline in line with return on investments and improvement in efficiency of the money market. Lower interest rate spreads will signal increasing efficiency in the financial market (Annual CBK Report, 2012).

Financial institutions are exposed to a variety of risks among them; interest rate risk, foreign exchange risk, political risk, market risk, liquidity risk, operational risk and credit risk (Yusuf 2003; Cooperman, Gardener and Mills, 2000). In some instances, commercial banks and other financial institutions have approved decisions that are not vetted; there have been cases of loan defaults and nonperforming loans, massive extension of credit and directed lending. Policies to minimize on the negative effects have focused on mergers in banks and NBFIs, better banking practices but stringent lending, review of laws to be in line with the global standards, well capitalized banks which are expected to be profitable, liquid banks that are able to meet the demands of their depositors, and maintenance of required cash levels with the central bank which means less cash is available for lending (Central Bank Annual Report, 2004). This has led to reduced interest income for the commercial banks and other financial institutions and by extension reduction in profits (Bocan, 2011).Credit risk is the possibility that the actual return on an investment or loan extended will deviate from that, which was expected (Conford, 2000). Kimeu, (2008) defines credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time.

Technological developments, particularly the increasing availability of low cost computing Power and communications, have played an important supporting role in facilitating the adoption of more rigorous credit risk, implementation some of these new approaches still has a long way to go for the bulk of banks. The likely acceleration of change in credit risk management in banks is viewed as an inevitable response to an environment where competition in the provision of financial services is increasing and, thus, need for banks and financial

institutions to identify new and profitable business opportunities and properly measure the associated risks, is growing (Waweru & Kalani, 2009).

Commercial banks have faced difficulties over the years for a multitude of reasons; the major cause of serious financial problems continues to be directly related to credit standards for borrowers, poor portfolio risk management or lack of attention to changes in the economic circumstances and competitive climate (Central Bank Annual Supervision Report, 2000).

The risk focused examination process has been adopted to direct the inspection process to the more risk areas of both operations and business. Skills in risk-focused supervision are continually being developed by exposing examiners to relevant training. By adopting this approach, the banking industry, and specifically the small banks are sensitized on the need to have formal and documented risk management frameworks (Chapman and Ward, 2010).

1.1 Statement of the problem

Commercial banks are in the risky business. In the process of providing financial services, they assume various kinds of financial risks (Alloyo, 2010). Over the last decade our understanding of the place of commercial banks within the financial sector has improved substantially. 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, (Mbole, (2004). 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. Risk management is an orderly process for the identification and assessment of pure loss exposure faced by an entity and the adoption of the most appropriate technique to cater for such exposure (Redja, 2008). Harvett (2013) also defined risk management as coherent activities which are undertaken to minimize the negative impact of uncertainty regarding possible losses. From the forgone, the process of risk management includes identification, measurement, administration of selected techniques and control.

Various researchers such as Ngare, (2008); Waweru & Kalani, (2009); and Buchan (2011) have emphasized the reasons why managers should take keen interest in risk management. This is because risk management is intended to help an organization meet its objectives such as the minimization of foreign exchange losses, reduction in the volatilities of cash flow, protection of earnings against fluctuations, (Chapman and Ward (2010) and to promote the survival of the firm through growth and profitability. The very nature of the banking business is so sensitive because more than 85% of their liability is deposits from depositors (Saunders, 2005). Banks use these deposits to generate credit for their borrowers, which in fact is a revenue generating activity for most banks. This credit creation process exposes the banks to high default risk which might lead to financial distress including bankruptcy.

Lending has been, and still is, the mainstay of banking business, and this is more true to emerging economies like Kenya where capital markets are not yet well developed (Mbole, 2004). To most of the transition economies, however, and Kenya in particular, lending activities have been controversial and a difficult matter. This is because business firms on one hand are complaining about lack of credits and the excessively high standards set by banks, while commercial banks on the other hand have suffered large losses on bad loans (Richard, 2006).It has been found out that in order to minimize loan losses and so as the credit risk, it is essential for commercial banks having an effective credit risk management system in place (Kimondo, Serakwane, & Davel, 2012). Given the asymmetric information that exists between lenders and borrowers, banks must have a mechanism to ensure that they not only evaluate default risk that is unknown to them ex ante in order to avoid adverse selection, but also that can evolve ex post in order to avoid moral hazards (Richard, 2006).

Are current credit risk policies affecting banks performance? Is there a lax in implementation of credit risk policies? This study thus attempted to answer these questions by evaluating the existing credit risk management policies of the bank in order to identify their impact on organizational performance and most importantly exploring ways of improving upon them.

1.2 Objectives of the study

The purpose of the study was to establish the effects of credit risk management on financial performance in Kenyan banks, a study of banks in Mombasa County.

To achieve the general objective, the following specific objectives guided the study;

i. Establish the effect of liquidity risk management on financial performance.
ii. Determine the effect of market risk management on the financial performance.
iii. Determine the effect of default risk management on financial performance.

2. Literature Review

The study reviewed selected literature that summarises a diverse spectrum of views on determinants of financial performance. This includes theoretical review, conceptual framework and measurement of financial performance.

2.1 Theoretical Review

According to Abor (2005) risk management has received extensive attention from both the corporate world and the academia, because, as Kikwasi (2009) puts it, it is the life blood of every organization and corporate officers deal with it decisively wherever it appears.

2.1.1 Purchasing Power Parity

One of the oldest frameworks for assessing the long-term movement of exchange rates is derived from purchasing power parity theory. The theory simply asserts that there is an impulse-response relationship between exchange rates and prices (Chortareas & Kapetanios, 2013). The PPP theory states that, in the long run, identical goods and services in different countries should cost the same in those countries. This is based on the belief that the exchange rate will adjust to eliminate the arbitrage opportunity of buying a product or service in one country and selling it in another country. PPP exchange rates are frequently used in the comparison of living standards internationally (Lafrance & Schembri, 2002). Specifically, PPP theory implies that a basket of goods should cost the same in different countries regardless of the country in which the goods are purchased after adjustment has been made for the exchange rate between the countries. Typically, "the basket" will involve many goods; these will be considered and weighted according to their importance within the economy.

2.1.2 Fisher Theory

Fisher formalised the quantity theory of money, which holds that the supply of money times its velocity—the rate at which a dollar circulates through the market is equal to output multiplied by the price level. Perhaps more important, he explained how changing velocity and prices could cause real interest rates to deviate from nominal ones. In this way, monetary forces could produce booms and busts, although they had no long-run effect on output. Furthermore, Fisher held that the dollar's value should be maintained relative not to gold but to a basket of commodities, making him the spiritual father of all modern central banks that target price stability.

Irving Fisher's real rate of interest framework is essential for the inflation-targeting framework. It provides a rationale for the idea that monetary policy should be concerned mainly (if not only) with managing inflation expectations in order to keep real interest rates at a stable level that promotes saving and investment. Some post-Keynesians, like Smithin (2003) or Mbole, (2004), have also promoted the use of this concept, even if the former claimed that it only represents a definition and does not have anything to do with Fisher. Many authors have challenged the notion of real rate at the empirical level but only a few have done it at the theoretical level.

2.3 Conceptual Framework

The conceptual model is an illustration of the key variables and their interconnection.

Figure 1 shows the adopted conceptual model, showing the variables of the study.

Independent variables *dependent variable*

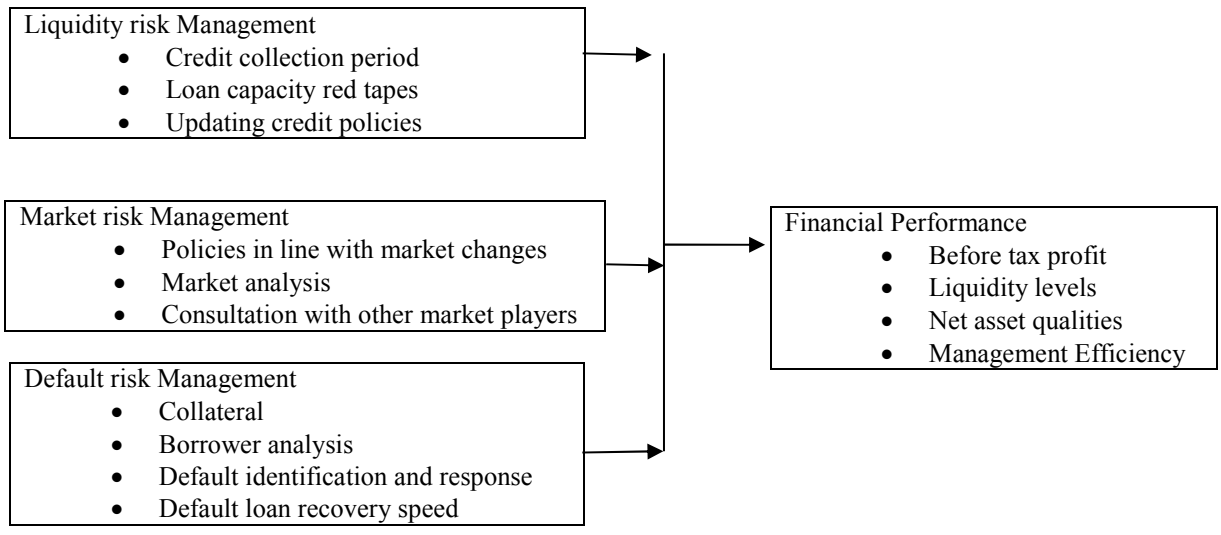

Fig: 2:3 conceptual framework (Source: Author, 2016)

2.3.1 Liquidity Risk Management

Liquidity is the ability to efficiently accommodate deposit as also reduction in liabilities and to fund the loan growth and possible funding of the off-balance sheet claims. The cash flows are placed in different time buckets based on future likely behaviour of assets, liabilities and off-balance sheet items. Therefore liquidity risk is the probability of solvent institutions not making agreed upon payments in a timely fashion. According to Devinaga

Rasiah (2010) commercial banks are required by regulators to hold a certain level of liquidity assets. And the reason behind this regulation is to make sure that the commercial banks always possess enough liquidity in order to be able to deal with bank operations.

On bank profits, people should first look at the amount of capital banks employ. The Kenya Commercial Bank has Kes 45 billion worth of capital, Equity Bank Kes 20 billion, Barclays Kes six billion this is the amount shareholders have put in. The capital supports infrastructure, deposits in the CBK (annual CBK report, 2014).Williams (2011) strongly criticises the Basel Committee on Banking Supervision announcement increasing the capital requirements as part of Basel III.

Commercial Bills could be considered to be eligible for this purpose as they are self liquidating transactions. As commercial Bills are accepted by Banks, it is less likely that they will be in default. The cardinal point in liquidity management to be remembered is that Commercial Banks cannot aim at zero risk. In that case they would need to their assets in currency and would have to charge their customers for accepting deposits. The solution is not to aim thoughtlessly at excessive liquidity, but in putting in place Robust Risk Management practices. Political risk is just among the complex risks they are required to manage every day (Etemesi etal, 2012). According to a Survey on factors influencing CEO agenda in Africa, investment decisions, risk management, achieving shared priorities with government and talent management were top on the list for 201 CEOs in 10 countries in Africa interviewed.

2.3.2 Market Risk Management

Market Risk may be defined as the possibility of loss to bank caused by the changes in the market variables. It is the risk that the value of on-/off-balance sheet positions will be adversely affected by movements in equity and interest rate markets, currency exchange rates and commodity prices. Market risk is the risk to the bank's earnings and capital due to changes in the market level of interest rates or prices of securities, foreign exchange and equities, as well as the volatilities, of those prices. Banking is about risk since funds are taken and lend to people, individuals, corporate with the hope that the money shall be gotten back. Banks take risk on the people they are lending to. Apart from that, most activities in the bank have a risk element. Risk management is very important for banks (Etemesi, 2012).For banks; credit-risk is number one on the list. It is an exposure area with a lot of processes to mitigate risks.

2.3.3 Default Risk Management

Risks identified in Africa include economic and policy threats, business operating threats and global threats. Among economic and policy threats, 77 per cent of CEOs in Africa are concerned about exchange rate volatility, followed by 74 per cent who cite uncertain or volatile economic growth. There is also concern about overregulation, inflation and governments response to the fiscal deficit and debt burden, business operating threats like the availability of key skills, energy costs, inadequate infrastructure and an increasing tax burden, all identified by over 60 per cent of CEOs (PWC Survey,2010).Fraud is a growing vice in Kenya. Fraudsters are now looking for individuals within banks who are vulnerable with financial problems, debt or living beyond their means. Fraudsters are very good in identifying people in distress (Etemesi, 2010).

At its most simple level, a firm goes bankrupt when the market (liquidation) value of its assets falls below its debt obligations to outside creditors. Models of this type can be found in (Harvett, 2013).All these are some of the elements of an effective credit management which aim at limiting risks which can appear when the client fail to accomplish his obligations of repaying loans , which may affect the profitability of a financial institutions like banks or any other lending institution.

2.4 Measurements of Financial Performance.

The financial performance of banks is expressed in terms of profitability and the profitability has no meaning except in the sense of an increase of net asset. Profitability is a company's ability to earn a reasonable profit on the owner's investment (Warren & Buffett, 2005). Most organizations exist is to earn profit and profitability ratios show a company's overall efficiency and performance. We can divide profitability ratios into parts: Profit margin and returns. Ratios that show margins represent the firm's ability to translate sakes dollars into profits at various stages of measurement. Ratios that show returns represent the firm's ability to measure the overall efficiency of the firm in generating returns for its shareholders (Bessis, 2005). The most popular profitability measurements are: Profit margin on sale, Return investment ratios, and return on equity.

Return on Asset = (Net Income / Total Assets) * 100

Return on Equity= (Net Income / Total Equity) * 100

Profit Margin= (Net Income / Net Sales) * 100

In accordance with the study by Waymond (2007), Profitability ratios are often used in a high stream as the indicators of credit analysis in banks, since profitability is associated with the results of management performance. ROA and ROE are the most commonly used ratios, and the quality level of ROE is between 15% and 30%, for ROA is at least 1%. Measuring profitability is the most important measure of the success of the business (Mishkin, 2002).

3. Methodology

This section discusses the procedure used in the study; more specifically it specifies the research design, the population of the study, the sample and the sampling procedure and finally data collection and analysis techniques. The study adopted a descriptive survey design in determining the strategies employed by the banks to manage credit risk in the banking industry in Kenya. To undertake the study, a descriptive research design was used. This is a scientific study done to describe a phenomena or an object (Brown *et al,* 2003). The study targeted risk managers in commercial banks within Mombasa County. Records from Central bank of Kenya show that there are 43 licensed commercial banks and 7 representative offices of foreign banks in Mombasa County making a total of 50 banks. These banks have a total of 163 branches. This gives a total target population of 163 risk managers from the 163 branches under study.

Questionnaires were used for data collection because as Baruch & Holtom,(2008) maintains that questionnaires give respondents freedom to express their views or opinion and also to make any suggestions. The researcher also involved the previous works from related articles including published Financial Reports from Commercial Banks and data related to those Banks available with the Central Bank of Kenya (CBK) annual reports on their performance.

To validate the research instruments the questionnaire were tested in two pilot banks that were not included in the study, they were administered through drop and pick later method. Data was analysed through statistical package for social science (SPSS 20.00) For Windows on a PC computer. Analysis was done through frequency counts, percentages means and standard deviation and the information generated was presented inform of charts, graphs and tables.

4. Findings

The stage first analyses the response rate and the demographic characteristics of the respondents to establish the suitability of the respondents thus validity of the study. This is followed by descriptive analysis of the questionnaire items and finally a factor analysis to determine the factors that have more weight on the independent variable.

4.1Response Rate

The Study used a sample of 50 credit risk managers as respondents. As a result, 50 questionnaires were dispatched for data collection. Of these, 47 were returned. However, 3 questionnaires were rejected during the sorting thus a total of 44 questionnaires were used for the study making a response rate of 88%. Since this is within the 67% accepted threshold for a scholarly study (Baruch & Holtom, 2008), the analysis was carried out.

4.2 Demographic Characteristics of the Respondents

The questionnaire items collected information on demographic characteristics of the respondents to determine their suitability of the study thus the validity of the responses.

4.3 Gender

The study used 56% male respondents and 44% female respondents. This therefore indicates that the study does not have any gender bias as the difference in the gender is within a healthy margin.

4.4 Length of Service

none of the respondents had served for between 1 and 3 years, 2 respondents had served for between 4 to 6 years, 11 respondents had served for between 7 and 9 years, 17 respondents had served for between 10 and 12 years, 15 respondents had served for between 13 and 15 years and 5 respondents had served for 16 years and above. This then shows that the respondents had served in the banks for long enough to have the required information.

4.5 Academic qualification

No respondent had a certificate qualification, 4 had diplomas, 32 had degrees and 8 had master's degree qualification. This shows that all the respondents had sufficient education to understand the requirements of the study.

4.6 Liquidity Risk management

The respondents agreed that the banks update credit policies whenever there is a slight change in the market, (mean 4.4615, standard deviation 0.76057), have a specific credit collection period (mean 4.1538, standard deviation 0.8339) and strictly adhere to maximum levels of loans allowed to customers (mean 3.9231, standard deviation 0.89098). The respondents were however neutral on whether the banks have specific credit red tapes (mean 2.7308, standard deviation 0.72430) and whether bigger loans are approved by higher ranking managers (mean 2.5385, standard deviation 1.42073). This implies that the banks update credit policies whenever there is a

slight change in the market, have a specific credit collection period and strictly adheres to maximum levels of loans allowed to customers. It also shows that the banks have specific credit red tapes that whether bigger loans are approved by higher ranking managers but not all the times as there are cases where this is not true. The standard deviation for the item on the whether bigger loans are approved by higher managers has a standard deviation of greater than one showing a wide spread in the responses such that in some banks it is highly implemented while in others it is not implemented at all.

4.7 Market Risk Management

The respondents agreed that the banks have specially skilled personnel in market risk management (mean 3.6538, Standard deviation 1.09334) and that the banks conduct regular market analysis to detect any changes in the market (mean 2.6154, Standard deviation 0.85215). However, it also shows that the respondents disagreed that the banks regularly consults with other players in the market (mean 2.2692, Standard deviation 1.00231) update business policies whenever there is a slight change in the market (mean 2,1923, Standard deviation 1.09615) and involve consultants and other experts to constantly conduct a market analysis (mean 2.00, Standard deviation 0.84853). This implies that the banks have specially skilled personnel in market risk management and conduct regular market analysis to detect any changes in the market but however do not regularly consults with other players in the market, update business policies whenever there is a slight change in the market and also do not consultants and other experts to constantly conduct a market analysis. This makes market risk analysis an internal affair of the banks without involving others.

4.8 Default risk Management

The respondents strongly agreed that the ability of the borrower to service the debt is considered before giving a credit facility (mean 4.7308, Standard deviation 0.45234), the banks collaborates with other players such as CRB before giving a loan (mean 4.6923, Standard deviation 0.47068), always takes collateral security on loans given (mean 4.6538, Standard deviation 0.48516) and that borrowers must provide the capital records as an indication of how much risk they themselves have undertaken should the business fail (mean 4.50, Standard deviation 0.5099). The tables also shows that the respondents agreed that the banks thoroughly weigh the character of borrower before approving a loan (mean 4.0385, Standard deviation 0.66216) and that the borrower must be sufficiently trustworthy to repay the loan or generate a return on funds invested in the borrower's company (mean 3.8077, Standard deviation 0.80096). The respondents were however neutral on whether the banks have a very effective default identification and response system (mean 3.1923, Standard deviation 0.80096) and whether debts by defaulting clients are recovered from collateral very fast (mean 2.7308, Standard deviation 0.72430).

This implies that the ability of the borrower to service the debt is considered before giving a credit facility, the banks collaborates with other players such as CRB before giving a loan, always take collateral security on loans given, borrowers must provide the capital records as an indication of how much risk they themselves have undertaken should the business fail, the banks thoroughly weigh the character of borrower before approving a loan and that the borrower must be sufficiently trustworthy to repay the loan or generate a return on funds invested in the borrower's company. However, it is seen that it not very clear whether the banks have a very effective default identification and response system and whether debts by defaulting clients are recovered from collateral very fast

5. Conclusion

The study shows the progressive importance of credit risk management and the weaknesses the banks have in doing this. It is thus imperative for the recommendations to be considered and given enough weight in order to ensure good performance.

5.1 Recommendations

The study recommends the following measures which will help improve credit risk management in banks hence improve the financial performance.

I. The banks are advised to revise their credit risk management policies and be broader by maintaining high liquidity, having stringent monetary policies, Utilization of collateral, background check on applicants, regular market analysis, collaboration with other players and using skilled personnel as opposed to the traditional observation of default risk, liquidity risk and market risk. This is because these measures are more action specific thus easily implemented and not implied as in the case used before.

II. The banks are also advised to open up and share information with other players on market risk thus involve consultants more in their market risk management. This is from the fact that market risk

analysis is an external activity and not internal and from the fact that these consultants have vast expertise and specialization in this field.

III. It is also imperative that the banks start thinking of more future oriented methods of risk management other than the traditional detection and action method. The banks should thus start using prediction and advance preventive measures methods. This calls for effective strategic management and projections. This is from the fact that the risks are coming so fast and wide thus catching up with them is becoming more difficult. The banks should thus run ahead of the risks.

IV. The study calls for a revision to specifically determine whether the banks have very effective default identification and response systems and whether debts by defaulting clients are recovered from collateral very fast. This is because these two areas are constantly neutral in a number of studies

V. Based on the recommendations it is also imperative to conduct a study on the best methods to project credit risks in the banking industry so that the banks can use these methods in projecting the future risks instead of detecting the risks once they have occurred.

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