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Asset Quality and Financial Performance of Commercial Banks in Kenya

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Abstract:

There has been a tremendous increase in non-performing loan in the recent past as a result of poor loan quality and poor management of demand deposits in the recent past resulting to closure of various banks in Kenya. These has resulted to the decline in banks overall decline in return on equity. The study's aim was to determine effects of asset quality on financial performance of the commercial banks. The study target population was 43 commercial banks. The study adopted a census sampling design where causal research design was used. The study made use of secondary data and regression model was utilized. Statistical package SPSS was used for data analysis. Complete secondary data for the period 2013 to 2017 from 34 commercial banks was analyzed and presented in tables. This represented 79 per cent of the target population. The findings presented that there was a low variation in asset quality ratio amongst the commercial banks. The results showed that the average ROE for period 2013 to 2017 had huge significant dispersion amongst the selected commercial banks in Kenya. The study found that the average performance of the commercial banks for the year 2013 to 2017 as indicated by ROE was on the decline. The study concluded asset quality significantly explains the changes in the financial performance of commercial banks in Kenya.

Keywords: Asset Quality, Financial Performance, Return on Equity

1. Introduction

1.1. Background of the Study

The banking industry functions as the backbone of present trade as well as economic growth and through being a chief finance source to the economy, (Ongore and Kusa, 2013), The theory of profitability is of significance particularly to financial and non-financial institutions. Generally, major constituents of financial institutions are the commercial banks. The competitive marketing strategy adapted by the marketing unit of the commercial bank to assist the bank to compete effectively in the market determines its success and growth (Swarnapali, 2014).

This high profitability in commercial banking business in Sub-Saharan Africa was chiefly attributed to investment in risky ventures, (Hussain & Bhatti, 2010). Another possible explanation given for the high returns in the region is that there exist a wide mismatch linking demand and supply of bank services. Therefore, this infers that there exist few banks in SSA that do not match to the demand thereof; as such there is no strong competition among the banks and they enjoy high interest rates. For instance, in East Africa a small number of banks owned by the government dominate the market.

There are 43 banks totally in Kenya in which 30 banks are domestically owned and the rest are foreign owned. The later control approximately 35% of the banking assets (supervision Report, Central Bank of Kenya, December 2011). In the asset holding context, foreign banks control approximately 35 percent of the banking assets as of 2011. The financial sector the country is dominated by the commercial banks. In such cases where commercial banks dominate the financial sector, in case of banking crises there are massive repercussions on the country's economic growth. The effects are observed because any failure that might occur in the financial sector triggers serious implications causing banking crises and bank runs, which eventually lead to financial crisis and economic tribulations.

1.1.1. Financial Performance of Commercial Banks

Major transformations have been observed in the operating environments of the banking sector worldwide from the time when Structural Adjustment Programs (SAP) was introduced in the late 1980's. Liberalization by government has brought changes in banking such as have alleviated controls on interest rates and deceased government influence (Ismi, 2004). In addition, it has also opened access for foreign banks. As a result of these reforms, firms in the developing countries have become more notable by opening branches and holdings or by acquisition of overseas businesses. The number of foreign banks in countries worldwide has been massively rising in particular.

Failures, runs and crises are as a result of poor performance. Banking crisis can lead to financial crisis in a country. For instance, in the year 2007, banking crisis in the USA lead economic failure (Marshall, 2009). For this reason,

governments control the banks via their central banks to nurture a stable and wholesome banking systems that create conditions where banking crisis are avoided as well as safeguard the economy and creditors money (Shekhar and Shekhar, 2007; Heffernan, 1996). Therefore, crisis due consideration given to banking performance is avoided.

Return on Equity (ROE) may be defined as a financial ratio that refers to the total amount of profit that a firm made matched to the shareholder investment. In other words, it is simply referred to the earnings the investors anticipate to get from the investment they made. When a business has a high return on equity it has the potential of internally generating money. Thus, the higher the Return on Equity the better the business is in relation to generation of profit as stated by Khrawish (2011). He further argued that Return on Equity can be expressed as ratio of Net Income less Tax divided by Total Equity Capital. Return on Equity corresponds to rate of return earned from the shareholders' funds. ROE shows how effectively a bank management uses funds invested by shareholders. Consequently, it can be reasoned that the higher the Return on Equity, the more efficient the management is in utilizing the shareholder's funds.

Another ratio is Return on Asset (ROA) that gives a reflection on the financial performance of a business. ROA is expressed as a ratio of Income of a bank to the entire sum of its asset. According to Khrawish, (2011), Return on Asset measures the bank's management capability to earn income by way of utilizing the bank assets. He further explains that ROA simply indicates how well the company's resources are being exploited to with the aim of generating income. Moreover, ROA shows the effectiveness of the of a company management to generate net income using all the resources owned by the organization. The higher ROA, the more effective the business is in utilizing its resources (Wen, 2010).

Net Interest Margin can be defined as a measure of the gap between the interest income produced by banks and the total amount of interest paid out to their lenders (for instance, deposits), proportional to the amount of their assets (interest earning) is referred to as Net Interest Margin (NIM). NIM is regularly stated as a percentage of earnings which financial organizations/institution gets from loans within a specified period as well as added assets less the interest paid out on loans divided by the mean amount of the assets it earned income from within the specified period. According to Gul *et al.* (2011) Net Interest Margin is a variable that is obtained when the net interest income is divided by all the earnings assets.

1.1.2. Bank Management Principles

Among the internal factors; bank specific factors, capital affects bank's profitability level. Athanasoglou *et al.* (2005) noted that capital is the amount of bank's fund existing to fund its undertakings and function as a shield in the event of a hostile situation. In general, capital of banks establishes liquidity for the bank owing to the point that deposits are more delicate plus they are susceptible to bank runs. Furthermore, Diamond, (2000) reported that larger bank capital decreases the possibility of distress. Nevertheless, it's only with disadvantages that it provokes insubstantial demand for liability, the inexpensive fund sources. In additional, capital adequacy refers to the capital level required to enable the bank withstand risks which include credit, market as well as the operational risks that the banks subjected to in an attempt to soak up the possible loses and safeguard the bank's debtors.

1.2 Statement of the Problem

The profitability of Kenyan banks has experienced a deteriorating trend as indicated by the declining profit before tax which as a result led to decline in ROE for the period 2013 to 2016 (CBK Report, 2017). This in turn has generated debates by scholars and professionals. This is because Kenya is a bank driven economy and therefore the failure of the banking sector will have a multiplier effect on the economy as a whole.

Obamuyi (2013) evaluated the determinants of a bank's profitability in a developing economy and focused on the banking industry in Nigeria. The study found that efficient management of expenses, increased interest income and macro environment factors lead to improved profitability of commercial banks. This study did not evaluate the relationship between bank management principles on financial performance of the commercial banks and this will be a focus of the current study. It is clear therefore that studies show contradicting results on the influence of bank management principles on financial performance of commercial banks on financial performance and therefore this is the gap this study sought to fill.

1.3 Objective of the Study

To analyze the relationship between assets quality on financial performance of selected commercial banks in Kenya.

1.4. Research Questions

To what extend do asset quality affect financial performance of selected commercial banks in Kenya?

1.5 Significance of the Study

The study would make a contribution to existing knowledge on how to institute as well as implement bank management principles to strengthen financial performance. The study would be of great importance to the management on reducing non-performing loan and as well make a contribution to the bank management practices formulation for several financial institutions. The study would be of great importance to the management on knowing how to calculate and maintain the gap between liability and assets. It would as well broaden the understanding of the researchers on the subject of bank performance indicators and principles.

1.6. Scope of the Study

This research was carried out on the 43 Kenyan commercial banks (Appendix I). The study included data for period 2013 to 2017.

1.7. Limitation of Study

The study fully utilized the secondary data. The limitation of secondary data is the originality of data as the internet is characterized by different data from numerous sources. However, the researcher addressed this challenge by ensuring that the data used in the study was sourced from credible bodies such as the Government Bank (CBK) and the Kenya National Bureau of Statistics.

2. Literature Review

2.1. Theoretical Review

The theoretical framework tries to explain why the research problem under study exists by introducing and describing the theory. The theory used in this particular study was efficiency structure theory

2.1.1 Efficiency Structure Theory

Efficiency Structure Theory as developed by Demsetz (1973) as an alternative hypothesis. This theory postulates that the efficiency of any given firm has a direct impact on market structure and performance of that firm. Firms with high level management or advanced technology of production tend to have lower costs of production thus higher profits. According to Athanasoglou *et al.*, (2006) there exists two approaches in the efficiency structure; the Scale-efficiency and X-efficiency hypothesis.

Due to the current financial situations and economic turbulence worldwide asset quality management is a term that is receiving a lot of attention. This has led to business owners and managers devise a strategy of coping with day to day activities in order to meet expectation on profitability of the business and shareholder's wealth creation (Don, 2009). Profitability in today's business is affected by working capital. Thus, asset quality management is a crucial part in meeting and maintaining the firm's day-to-day operation for a smooth running and meeting stakeholder's expectation (Eljelly, 2004).

2.2 Empirical Review

Shipho and Olweny (2011) studied the impact of commercial bank's specific contributors on commercial bank's financial performance in Kenya. Explanatory method was employed by the use of panel research design. The study was interested in the periods 2002 to 2008 where financial statements of 38 commercial banks in Kenya were obtained from the CBK and commercial bank survey data for 2009. Multiple linear regression method was used to analyze data and to show the relationship between the study variables. The study found that the quality of asset has got a negative significant effect on commercial bank's financial performance in Kenya. However, the study did not conduct diagnostics tests before carrying out inferential analysis. In addition, the above study failed to include the moderating effects of inflation in the relationships between the variables sought.

In sub-sahara Africa, Ezra (2013) studied the determinants of the profitability of commercial banks in sub-Saharan Africa. The study focused on the period 1999 to 2006 where an unbalanced panel comprising of 216 commercial banks were utilized which were drawn from 42 countries in SSA. The analysis of the study was done within the framework of random effect panel methods. The variables included in the study were capital adequacy, bank size, operational efficiency, liquidity ratio, inflation rate and GDP. Findings of the study indicate that asset quality a negative significant effect on the commercial bank's profitability. The study reviewed above focused on cross country analysis while the current study concentrated on the local Kenyan analysis hence presenting specific local Kenyan findings.

Ifeacho and Ngalawa (2014) studied the macroeconomic variables and bank specific variables and their effects on financial performance of South Africa's banking sector. The study made use of annual data on the four largest banks in South Africa which are ABSA, Nedbank, First National Bank and Standard Bank for the period 1994 and 2011. These four largest banks hold over 70 percent of the banking assets in South Africa. The study considered the following independent variables; asset quality, liquidity, capital adequacy and banks earning's ability and the dependent variable as financial performance of the bank. The indicator of financial performance used was ROE. The study found that asset quality has a significant negative effect on ROE. Hence, the study was centered on South Africa; therefore, the results obtained may not be generalized for Kenya. The current proposed research problem seeks to fill the gap (contextual gap) as it focused on commercial bank's financial performance in Kenya.

Musyoka (2017) studied the effect of asset quality on financial performance of commercial banks in Kenya. The results revealed that there is a negative and insignificant relationship between assets quality and commercial banks in Kenya financial performance. This is an indication that there is no significant relationship between commercial banks in Kenya financial performance and assets quality. Jeanne and Svensson (2007) however suggest that asset quality is a key determinant of future earnings and, therefore, capital generation or erosion. The author argued that bank's asset is loans and they determine a greater percentage of the firm's income hence the quality of the loans is key.

According to Streeter (2010), management of asset quality in banks is among the key problems of management. In the year 2001 founded on questionnaires administered to the American Bankers Association Board members in the United States banks; the survey outcome proved that management of asset quality is a key matter for bankers in practice.

Similarly, executives such as Gene Miller (CEO of America Corp.) think of asset quality as the second most vital issue of management and formed a team to handle specifically rising bad assets risk.

2.3. Conceptual Framework

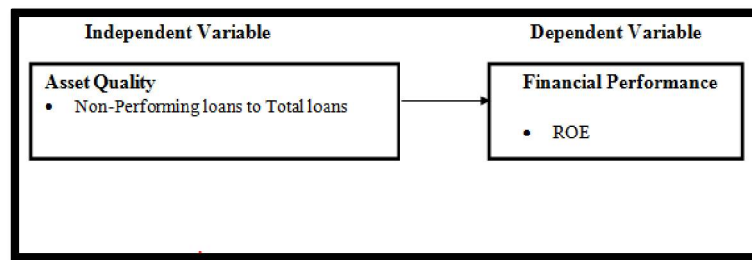


Figure 1: Conceptual Framework

3. Research Methodology

3.1. Research Design

The current study adopted descriptive and causal research design. The current focuses on the causal effects of bank management practices on financial performance in Kenya hence descriptive and causal design was appropriate. (What is a research design cite authors)

3.2. Target Population

The target population was 43 commercial banks in Kenya. The commercial banks considered were in operation in the years 2013 to 2017 and were presented in Appendix I. However, due to small number of the target population, the research collected data from all the 43 targeted commercial banks in a census

3.3. Data Collection

The study utilized data from secondary sources and therefore, data sourced from the 43 Kenyan commercial banks financial statements, the Kenya National bureau of statistics (KNBS) and the Central Bank of Kenya (CBK).

3.4. Data Analysis and Presentation

Inferential analysis and descriptive statistics were used to analyze the findings. After the collection of research data, the data was analyzed. The annual panel data was analyzed by the use of regression analysis.

3.4.1. Empirical Model

In conducting the analysis of the study, panel regression model based on a panel data was adopted. Therefore, Financial Performance was expressed as a function of liquidity, asset quality and capital adequacy.

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \epsilon_{it} \dots \dots \dots 3.1$$

Where:

Y_{it} – Financial Performance

X_{1it} – Asset Quality

β_1 is co-efficients of the independent variables and indicate the changes of the dependent variable as a result of changes in the independent variable.

ϵ_{it} = The model Error Term, it presents any uncaptured variable in the model

4. Data Presentation, Analysis and Interpretation

4.1. Descriptive Statistics

The study targeted 43 banks operating in Kenya as at 31 December 2017. Out of the 43 banks, complete financial data on the variable (asset quality and ROE) was obtained from 34 commercial banks. This represented 79.1 per cent of the target population which according to Mugenda and Mugenda (2003) is sufficient to help in report writing.

The parameters used in the study were; minimum, maximum, mean and standard deviation. The variables considered were asset quality and ROE. The study collected secondary data for the periods 2013,2014,2015,2016 and 2017. The results were presented in the subsequent sections.

4.1.1. Asset Quality

The researcher collected secondary data on the asset quality of the selected commercial banks. Non-performing loans to total loans ratio was used to measure asset quality. The lower the ratio (low non-performing loans compared to total loan book) the better the quality of the assets of the commercial banks.

	N	Minimum	Maximum	Mean	Std. Deviation
2013	34	.00	.29	.0743	.06534
2014	34	.00	.24	.0781	.05906
2015	34	.00	.26	.0968	.07306
2016	34	.00	.44	.1220	.09782
2017	34	.00	.52	.1316	.11185
Valid N (listwise)	34				

Table 1: Asset Quality
Source: Field Data (2019)

The findings in Table 1 indicate that the asset quality means for the periods under study were 0.0743, .0781, .0968, .1220 and .1316 for the periods 2013, 2014, 2015, 2016 and 2017 respectively. The maximum asset quality was 0.52 indicating 52 per cent of loans which are uncollectible and the minimum asset quality was 0.00 (zero per cent). A low percentage of asset quality indicated of low non-performing loans in the commercial banks selected. Victoria bank kept a record clean book on zero bad loan for the record five years. The low levels of standard deviations (.06534, .05906, .07306, .09782 and .11185) indicated low variation levels of asset quality amongst the selected commercial banks in Kenya for the period 2013 to 2017.

4.2. Return on Equity

The study sought to establish the financial performance of the selected commercial banks in Kenya. Return on equity was used as the indicator of financial performance. Profit after tax to Shareholders' Equity ratio was used as the indicator of ROE. The results were presented in table 4.2.

	N	Minimum	Maximum	Mean	Std. Deviation
2013	34	-26.20	37.00	20.2265	14.29745
2014	34	-29.10	49.40	17.3676	15.91907
2015	34	-27.20	47.20	15.0412	16.19205
2016	34	-19.70	30.70	12.2448	12.71864
2017	34	-41.00	31.60	8.6794	14.76589
Valid N (listwise)	34				

Table 2: Return on Equity
Source: Field Data (2019)

The results in Table 2 show that the average ROE for period 2013 to 2017 were 20.2265, 17.3676, 15.0412, 12.2448 and 8.6794 respectively. The minimum ROE was -41 per cent while the maximum ROE was 49.40 per cent. The study indicates huge values of standard deviation ranging from 12.71864 to 16.19205 which indicates a significant dispersion amongst the ROE values of the selected commercial banks in Kenya. The results of the findings concur with Musyoka (2017) study findings on effects of capital adequacy on performance of commercial banks in Kenya. The study found that the average performance of the commercial banks for the year 2012 to 2016 was 2.175 per cent and that the average capital adequacy was 23.16%. The study also found that the average value of quality of asset was 0.099.

4.3. Inferential Statistics

The section presented below indicates the inferences made from the selected commercial banks in Kenya.

4.3.1. Regression Analysis

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	64.028	38.545		1.661	.107
	Asset Quality	-72.130	31.379	-.379	-2.299	.029
Dependent Variable: ROE						

Table 3: Regression Co-efficients

The study coefficient column in the Table 3 indicates the relationship and the direction of changes of ROE when one variable changes. A negative coefficient indicates that the dependent and independent variables are negatively related. This indicates a negative change in one variable will result to a positive change in the other variable and that positive change in one variable will result to a negative change in the other variable. The study indicates that the relationship between asset quality and return on equity was negative and significant (B=-72.130, P=0.029). The findings indicate that a change in asset quality results to opposite change of return on equity. According to the findings a unit change in asset quality will result to opposite direction change of 72.12 units. The study

disagrees with Maina (2018) that the relationship between asset quality and profitability of the bank was positive and insignificant ($B=41.713$, $p=0.794$).

The significant values for all the variables were significant and therefore the adopted regression model was;

$$ROE = 64.028 + 72.13X_3 + \epsilon$$

5. Conclusions and Recommendations

5.1. Conclusions

Based on the findings on the third objective, the study concluded that relationship between asset quality and return on equity was negative and significant.

5.2. Recommendations

Based on the conclusions on the objective, effects of asset quality on financial performance of commercial banks in Kenya, the study recommends that commercial banks ought to adopt a credit risk grading system. This system ought to define the borrowers risk profile of to make sure that account management, structure as well as pricing are commensurate with the involved risk. Risk grading is a chief measurement of the asset quality of the bank, and as such, it's important that grading is a robust process. This requires organisation of the structure of funding sources to improve low-cost funds, giving credit to the productive sectors while applying the principle of prudence and improving competence.

5.3. Suggestions for Further Research

This study covered 34 selected commercial banks for period 2013 to 2017 in investigating the effects of bank management principles on financial performance of commercial banks in Kenya. The study recommends that another study covering more commercial banks and extent period of ten would be a milestone in uncovering the effects of bank management principles on financial performance of commercial banks in Kenya.

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Appendix

Bank	Year	ROE	Asset Quality
1	2013		
1	2014		
1	2015....2017		
2	2013		
2	2014		
2	2015....2017		
3	2013		
3	2014		
3....43	2015....2017		

Table 4: Data Collection/ Review Guide

List of Commercial Banks

- African Banking Corporation Ltd.
- Bank of Africa Kenya Ltd.
- Bank of Baroda (K) Ltd.
- Bank of India.
- Barclays Bank of Kenya Ltd.
- CFC Stanbic Bank Ltd.
- Citibank N.A Kenya.
- Commercial Bank of Africa Ltd.
- Consolidated Bank of Kenya Ltd.
- Co-operative Bank of Kenya Ltd.
- Credit Bank Ltd.
- Development Bank of Kenya Ltd.
- Diamond Trust Bank Kenya Ltd.
- Dubai Bank Kenya Ltd.
- Equatorial Commercial Bank Ltd.
- Equity Bank Ltd.
- Family Bank Limited.
- Fidelity Commercial Bank Ltd.
- First community Bank Limited.
- Guardian Bank
- Gulf African Bank Limited.
- I & M Bank Ltd.
- Jamii Bora Bank Limited.
- Kenya Commercial Bank Ltd.
- K-Rep Bank Ltd.
- Middle East Bank (K) Ltd.
- National Bank of Kenya Ltd.
- NIC Bank Ltd.
- Orient Bank
- Paramount Universal Bank Ltd.
- Prime Bank Ltd.
- Standard Chartered Bank Kenya Ltd.
- Trans-National Bank Ltd.
- UBA Kenya Bank Limited.
- Victoria Commercial Bank Ltd.
- Charterhouse Bank Ltd
- Chase Bank (K) Ltd.
- Ecobank Kenya Ltd.
- Fina Bank Ltd.
- Habib Bank A.G Zurich.
- Habib Bank Ltd.
- Imperial Bank Ltd.
- Giro Commercial Bank Ltd.