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Effects of Credit Risk Management Practices on Financial Performance of Commercial banks in Kenya

David Njine Kimotho

Jomo Kenyatta University of Agriculture and Technology

Supervisor: DR. Mouni Gekara

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Abstract:

Financial risk in a banking organization is possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings or capital or may result in imposition of constraints on bank's ability to meet its business objectives. The purpose of this study was to examine the effects of credit risk management practices on financial performance of Commercial Banks in Kenya. The study examined the effects that credit risk identification have on financial performance of commercial banks in Kenya; the effects of credit risk insurance on financial Performance of commercial banks in Kenya; the effects of credit risk monitoring on financial performance of commercial banks in Kenya and the effects of credit appraisal analysis on financial performance of commercial banks in Kenya. The study adopted descriptive research design and the target population consisted of credit risk managers, credit analysts and debt recovery managers from any branch of all commercial banks in Nairobi as licensed by the Central Bank of Kenya. The study used a census method to select the sample size since the target population is manageable. Primary data from the respondents was collected using a semi-structured questionnaire. Secondary sources of data gave insights into the concept prior to the study being conducted. The data was analyzed using Statistical Package for Social Sciences (SPSS) version 20. The study revealed that credit risk management procedures are used to influence profitability of the bank positively and also recommends the management of the banks to oversee facilitation of credit risk management as a substantial degree of standardization of process and documentation. It is important for banks management to understand how they can edge themselves against the eminent dangers of over exposure to credit risk whose importance cannot be understated as can be realized from the findings that can impact negatively on their profitability. Commercial banks should also try to keep their operational cost low as this negates their profits margin thus leading to low financial performance. Commercial banks should also try to keep their operational cost low as this negates their profits margin thus leading to low financial performance. The bank should consider risk identification as a process in credit risk management and focus in interest rate risks and foreign exchange risks to a great extent in the risk identification map

(Keywords: credit management, risk insurance, risk monitoring, risk identification, risk appraisal, financial performance)

Introduction

Background of the Study

Commercial banks play an important role for economic development, and foster economic growth of any country through their intermediation role and financial services that they provide to community and nations. The credit facilities that they offer facilitate the exploration and expansion of productive investments avenues by individuals and institutional investors. It is evident that the efficient and effective performance of banking industry over time guarantees financial stability of any nation (Oke et al 2012). The health of financial sector depends chiefly on sound baking system. Failures in financial intermediation can disrupt the development process (Abhiman & Saibal, 2007). Commercial banks` main profitable business among others is lending. It remains to be primary business of every commercial bank in the world, Dasah, etal, (2012), which is the source of net interest income. Granting credit is indeed one of the main sources of income, Hosnaetal, (2009), Bashir, (2000) and Fries *et al*., 2002: 10); hence large credit portfolio ought to mean improved profitability of commercial banks (Aburime, undated).

Commercial banking is a combination of related activities such as providing products and services to the customers, engaging in financial intermediation and management of risk. In recent years, risk management has received increasing focus as a central activity of commercial banks. According to Pagano (2001), risk management is an important function of financial institutions in creating value for shareholders and customers. The corporate finance literature has linked the importance of risk management with the shareholder value maximization hypothesis (Ali & Luft, 2002). The lack of a standard definition for credit risk is the most obvious example of the lack of standardization between firms. In essence

firm specific definitions often express much the same sentiment but in local terminology. They are also a reflection of the internal solution, organizational structure and culture particular to that firm. Issues of substance also exist between firms; differ significantly as to whether business or strategic risk is a credit risk. By recognizing, understanding and managing risks, more risks can be assumed and performance increased. Enterprise risk management applies organizational knowledge to make better decisions about risk and reward through market pricing and capital charges (Ciborra, 2006).

The concept of credit risk emerged as a risk category that describes residual risk not captured in market and credit risk management practices (Basel Committee, 2001; Power, 2004; Ciborra, 2006). The Basel II accord, which gave significance and visibility to credit risk in its consultative document defines this category of risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events" (Basel Committee, 2001). In principle, the aim of the Basel consultative document is to enhance credit risk assessment efforts and to encourage the banking and financial services industry "to develop methodologies and collect data related to managing credit risk" (Basel Committee, 2001). In reality, however, the concept of credit risk transforms internal control into risk management, with a focus on deeper ways of analyzing and managing internally generated risk (Power, 2004; Ciborra, 2006).Credit risk has different classification, such as people for example workforce disruption, fraud- process for example documentation risk, settlement failure- systems for example failure, security and external risks for example suppliers, disasters, infrastructure utilities failures. Day-to-day credit risk management involves decisions about opening times, cleaning standards, secure electricity supply,

security controls and other management decisions not suitable to real-time spreadsheet analysis. There is a tension between the top-down imposition of a charge and the bottom-up nature of these detailed decisions (Ciborra, 2006).

Statement of the problem

Consistent stream of failures and scandals in the banking and financial services industry has served as a catalyst for anxiety about risk (Power, 2004). The risk anxiety generated by these events has led to the proliferation of new categories of risk and new models for managing these risks (Power, 2004; Ciborra, 2006). In particular, the events that have resulted from the above failures and scandals have now been put into a category of risk referred to as credit risk; a label that is intended to allow for risk visibility, particularized risk management, and regulatory intervention. For a concept with a contestable foundation, the technical rational approach to investigating credit risk forecloses a number of important factors that are essential to understanding how events and objects come to represent credit risk.

Although there are industry standards on what is a good credit policy and what is not and further banks have different characteristics. The market may thus be seen to regard an individual banks' poor performance more lenient when the entire banking sector has been hit by an adverse shock such as a financial crisis. Banks may be forced to adjust their credit policy in line with other banks in the market where a herding behavior is practiced by banks. Looking at the emphasis that is laid on credit risk management by commercial banks the level of contribution of this factor to profits has not been analyzed. An effective system that ensures repayment of loans by borrowers is critical in dealing with asymmetric information problems and in reducing the level of loan losses, thus the long-term success of any

banking organization (IAIS, 2003). Effective CRM involves establishing an appropriate CR environment; operating under a sound credit granting process; maintaining an appropriate credit administration that involves monitoring process as well as adequate controls over CR (Greuning & Bratanovic, 2003; IAIS, 2003) a gap this study sought to fill. Risks are uncertainties resulting in adverse variations of profitability or in losses.

Locally Ndung'u (2003) in his study on the determinants of profitability of quoted Commercial Banks in Kenya finds that sound asset and liability management had a significant influence on profitability. Ngumi, (2013) found that Bank innovations namely automated teller machines, debit and credit cards, interest Banking, mobile banking, electronic funds transfer and point of sale terminals had statistically significant influence on financial performance of Commercial Banks in Kenya. Empirical evidence in Kenya showing the credit risk management practices by Commercial Banks in Kenya is not fully researched and related studies are not fully documented and this is the gap this study seeks to fill. This study seek to bridge the research gap by answering the research question: what are the effects of credit risk management practices on the financial performance of commercial banks in Kenya?

Objective of the Study

The objective of the study was to establish the effects of credit risk management practices on financial performance of Commercial Banks in Kenya.

Literature Review

Credit Risk Management Practices on Financial Performance

Credit Identification

Risk identification refers to the process of identifying dangerous or hazardous situations and trying to characterize it. It is a procedure to deliberately analyze, review and anticipate possible risks (Barton et al. 2002). The first step in organizing the implementation of the risk management function is to establish the crucial observation areas inside and outside the corporation (Kromschroder & Luck, 2008). The departments and the employees must be assigned with responsibilities to identify specific risks for example interest rate risks or foreign exchange risks are the main domain of the financial department. It is important to ensure that the risk management function is established throughout the whole corporation; apart from parent company, the subsidiaries too have to identify risks and analyze them. Other approaches for risk identification include scenario analysis or risk mapping.

An organization can identify the frequency and severity of the risks through risk mapping which could assist the organization to stay away from high frequency and low severity risks and instead focus more on the low frequency and high severity risk. Risk identification process includes risk-ranking components where these ranking are usually based on impact, severity or dollar effects (Barton et al. 2002). Accordingly, the analysis helps to sort risk according to their importance and assists the management to develop risk management strategy to allocate resources efficiently. Risk identification is positively significant to influence risk management practices. In the case of banks, studies made especially on risk

identification and risk mitigation includes the work of Haron & Hin Hock (2007) on market and credit risk, and Haron (2007) specifically on operational risk. Haron & Hin Hock (2007) explain the inherent risk; credit and market risk exposures in Banks.

Credit risk insurance

Wever, (2000) refers to credit insurance as the distribution of insurance products through banking networks; in other words, as the collaboration between banks and insurers to distribute insurance products to bank customers. Staikouras & Nurullah, (2008) find that banking and insurance entities have more similarities than differences, characteristics that may favour joint production and business synergies. Korhonen*et al.* (2006) applied the expert panels and the analytical hierarchy process (AHP) to explore the most preferred alternative alliances between banks and insurance companies from executive management perspectives, supervisory authorities, and customers, respectively. Wu *et al.* (2008) adopt the modified Delphi method to construct the framework of mutual fund performance and the AHP model to design an assessment method for mutual fund performance.

Casu & Girardone, (2004) find an increase in profit efficiency of financial conglomerates, defined as all Italian banking groups, supposing that they generally experienced a trend towards conglomeration during the observed period. Vander &Vennet (2002) measures cost and profit efficiency in European banks in 1995-1996, showing that financial conglomerates, defined as combinations between commercial banking and investment banking or insurance, are more revenue efficient than specialized banks. More recently, insurance literature appears devoted to investigate other issues, like the influence of efficiency on profitability (Greene &

Segal, 2004) or the relationship between performance and market structure, in terms of concentration and competition (Fennet al., 2008; Bikker & Van Leuvensteijn, 2008).

Credit Risk Monitoring

The main function of the risk manager is to monitor; measure and control credit risk. The Risk Manager's duty includes identification of possible events or future changes that could have a negative impact on the institution's credit portfolio and the bank's ability to withstand the changes. The areas to examine critically are: Economic or industry changes, Market – risk events and Liquidity conditions. Effective risk management requires a reporting and review structure to ensure that risks are effectively identified and assessed and that appropriate controls and responses are in place (IRM, AIRMIC and ALARM; 2002). Risk monitoring can be used to make sure that risk management practices are in line and proper risk monitoring also helps bank management to discover mistake at early stage (Al-Tamimi & Al-Mazrooei, 2007). Monitoring is the last step in the corporate risk management process (Pausenberger & Nassauer, 2002). According to Parrenas, (2005), the shareholders of the institutions can use their rights to demand information in order to judge the efficiency of the risk management system. The director's report enables the shareholders to assess the status of the corporation knowledgeably and thoroughly.

Khan and Ahmad (2001) conducted a survey of risk management practices and found that on average the lowest percentage is on the measuring, mitigating and monitoring risk that is 69% score as compared to risk management policies and procedures that is 82.4%, and internal control of banks that is 76%. Al-Tamimi and

Al-Mazrooei (2007) found that there is significant difference between UAE national and foreign banks in risk monitoring and controlling. Also, the UAE commercial banks have an efficient risk monitoring and controlling system and it has positive influence on risk management practices.

Credit Risk Analysis and appraisal

This is the process of determining the likelihood that a specified negative event will occur. Investors and business managers use risk assessments to determine things like whether to undertake a particular venture, what rate of return they require to make a particular investment and how to mitigate an activity's potential losses. A comprehensive risk analysis and mitigation methods for various risk arising from financing activities and from the nature of profit and loss sharing is the source of funds especially investment account holders are explained by Sundararajan (2007). He concludes that the application of modern approaches to risk analysis, particularly for credit and overall banking risks is important for Banks. Also, he suggests that the need to adopt new measures is particularly critical for Banks because of the role they play and the unique mix of risks in finance contracts.

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

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

Financial Performance

Marrison, (2002) articulate that the main activity of bank management is not only deposit mobilization and giving credit. Effective credit risk management reduces the risk of customer default. They add that the competitive advantage of a bank is dependent on its capability to handle credit valuably. Bad loans cause bank failure as the failure of a bank is seen mainly as the result of mismanagement because of bad lending decisions made with wrong appraisals of credit status or the repayment of non-performing loans and excessive focus on giving loans to certain customers. According to Pagano (2001), risk management is an important function of financial institutions in creating value for shareholders and customers. The corporate finance literature has linked the importance of risk management with the shareholder value maximization hypothesis. This suggests that a firm will engage in risk management policies if it enhances shareholder value (Ali & Luft, 2002). Thus, effective risk management either in non-banking firms or in banking entities is expected to enhance the value of the firm and shareholder wealth.

Profitability of Commercial banks

Linbo Fan, (2004) examined efficiency versus risk in large domestic USA banks. He found that profit efficiency is sensitive to credit risk and insolvency risk but not to liquidity risk or to the mix of loan products. HoHahm, (2004) conducted an

empirical study on interest rate and exchange rate exposures of institutions in pre-crisis Korea. Results indicated that Korean commercial banks and merchant banking corporations had been significantly exposed to both interest rate and exchange rate risks, and that the subsequent profitability of commercial banks was significantly associated with the degree of pre-crisis exposure. The results also indicated that the Korean case highlights the importance of upgrading financial supervision and risk management practices as a precondition for successful financial liberalization. This implies that for companies to operate profitably, they should be appropriately capitalized. Company's absolute value as perceived by the investor takes cognizance of its total market value as opposed to considering the basic accounting values relating to Return on Equity (ROE), Return on Assets (ROA) and Earning Per Share (EPS).

Returns on Assets

Return on assets (ROA) is a comprehensive measure of overall performance of an entity from an accounting perspective. It is a ratio of Income to its total asset (Khrawish, 2011). It measures the ability of the bank management to generate income by utilizing company assets at their disposal. In other words, it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the management of a company in generating net income from all the resources of the institution (Khrawish, 2011). Wen (2010), state that a higher ROA shows that the company is more efficient in using its resources. According to Mitchell & Mulherin (1996), ROA is a primary indicator of managerial efficiency as it indicates how capable the management of an entity has been converting the entity's assets into net earnings. It is computed by dividing the

Earning after interest and taxes over the total assets of an entity. ROA is expected to be significantly correlated with share price since it is a profitability ratio.

Earnings Per Share

Investors and market analysts resort to financial statement analysis when it comes to share investing. The information on Earnings Per Share (EPS) is presented on the Income Statement The broad area of financial accounting and reporting offers a number of fundamental measures of a firm's performance for a particular accounting period. One of these financial measures is the earnings per share (EPS). Previous studies on EPS as a predictor of share price generated mixed results. Some research works concluded that EPS is a significant predictor when the firm consistently increases its EPS over a longer period of time. Various news releases, particularly of US firms, reported that many firms did not experience any increase in share price despite increases in their quarterly EPS. This seemed to suggest that EPS may not be a good predictor of share price on a short-term basis (Menaje, 2012).

Return on Equity

ROE is a financial ratio that refers to how much profit a company earned compared to the total amount of shareholder equity invested or found on the balance sheet. ROE is what the shareholders look in return for their investment. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. Thus, the higher the ROE the better the company is in terms of profit generation. It is further explained by Khrawish, (2011) that ROE is the ratio of Net Income after Taxes divided by Total Equity Capital. It represents the rate of return earned on the funds invested in the bank by its stockholders. ROE reflects how effectively a bank management is using shareholders' funds. Thus, it can be deduced from the above statement that the better the ROE the more effective the management in utilizing the shareholders capital.

Research Methodology

Research design

The research design constitutes the blue print for the collection, measurement and analysis of data, Kothari, (2003). This research problem can best be studied through the use of a descriptive research design. Descriptive research is the investigation in which quantitative data is collected and analyzed in order to describe the specific phenomenon in its current trends, current events and linkages between different factors at the current time. Descriptive research design was chosen because it enables the researcher to generalize the findings to a larger population. The descriptive research design approach has been credited due to the fact that it allows analysis the relations of variables and also allows greater

flexibility in terms of money and time as well as avoiding the hardship of hunting for respondents more than once to produce high response rate.

Target Population

The target population of this study was 129 credit department staff from the commercial banks in Kenya. The study population consisted of credit risk managers, credit analysts and debt recovery managers from any branch of each of the 44 commercial bank within Nairobi as licensed by the Central Bank of Kenya as at 2nd August 2014 exclusive of Dubai bank of Kenya which collapsed in August 2015. A census method was used in this study where the researcher sampled the 129 credit department staff (credit risk managers, credit analyst's and debt recovery managers) from any branch of the 43 commercial banks in Kenya. Census method was used because the target population was manageable and data was collected from the whole population.

In this survey, questionnaire and interview schedule was used. The questionnaire was selected because it is straight forward and less time consuming for respondents. The instruments ensured that enormous data is obtained. A questionnaire with both closed and open-ended questions formed the major instrument of data collection in this study.

Data Analysis and presentation

Data analysis is the process of systematically searching, arranging, organizing, and breaking data into manageable units, synthesizing the data, searching for patterns, discovering what is important and what is to be learned. Respondents' responses were rated on a five Liker scale. The paired samples correlations co-efficient

between dependent and the independent variables will be calculated and interpreted. If the paired t-test statistics is low and significant, it indicates that the two variables are not related and are independent of each. The statistical tool for the analysis was the statistical package for the social sciences (SPSS). The results were presented on frequency distribution tables, pie charts and bar charts. The regression model was used as follows:

$Y = \alpha + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$ Where; Y= the dependent variable (Financial Performance) α - Is a constant; the concept explaining the firms performance given and it's the Y value when all the predictor values (X_1, X_2, X_3, X_4) are zero

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

X_1 – Credit Risk Identification X_2 – Credit Risk Insurance X_3 – Credit Risk monitoring

X_4 –Credit appraisal analysis

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

Results and Findings

Multiple Regressions

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

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.898[a]	.806	.0.797	.19758

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (Financial Performance) that is explained by all the four independent variables (credit risk identification, credit risk insurance, credit risk monitoring and credit appraisal analysis). The four independent variables that were studied, explain only 79.7% of the financial performance as represented by the R^2. This therefore means that other factors not studied in this research contribute 20.3% of the financial performance. Therefore, further research should be conducted to investigate the other factors (20.3%) that affect financial performance.

ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11.007	4	2.752	3.804	.006[b]
	Residual	78.853	109	.723		
	Total	89.860	113			

The significance value is .006 which is less that 0.05 thus the model is statistically significant in predicting credit risk identification, credit risk insurance, credit risk monitoring and credit appraisal analysis. The F critical at 5% level of significance is 2.4473 Since F calculated (value =3.804) is greater than the F critical, this shows that the overall model is significant. The coefficients of the multiple regression model are presented in the table below.

Multiple regression analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.396	.850	.085	6.345	.000
	Risk identification	.254	.059	.008	1.907	.017
	Risk Insurance	.108	.090	.290	1.094	.029
	Risk Monitoring	.437	.138	.162	3.167	.002
	Risk appraisal analysis	.242	.137	.085	1.767	.021

Therefore the generated model is given by $Y = 2.396 + 0.254X_1 + 0.108X_2 + 0.437X_3 + 0.242X_4 + \varepsilon$. This infers that credit risk monitoring influence financial performance most. All the variables were significant as their P-values were less than 0.05. At 5% level of significance and 95% level of confidence; credit risk monitoring showed a 0.002 level of significant; risk identification showed a 0.017 level of significant; risk appraisal analysis showed a 0.021 level of significant, risk insurance showed a 0.029 level of significant

The P value show the level of significance of each variable, from the p-value of all variable were less than 0.05 this is an indication that they were statistically significant. The study further revealed that there was positive relationship between credit risk identification, credit risk insurance, credit risk monitoring and credit appraisal analysis and financial performance of commercial banks in Kenya.

Conclusions

From the findings, the study found that credit risk identification, credit risk insurance, credit risk monitoring and credit appraisal analysis had effect on financial performance of commercial banks. The study established that there was strong relationship between financial performance of commercial banks and credit risk identification, credit risk insurance, credit risk monitoring and credit appraisal analysis.

Credit risk identification

The study revealed that a unit increase in credit risk identification would lead to increase in financial performance of commercial banks in Kenya; this is an indication that there was positive association between credit risk identification and

financial performance of commercial banks. Based on the above findings, the study concludes that the bank considers risk identification as a process in credit risk management to a little extent, that the bank focuses in interest rate risks to a great extent in the risk identification map and that the bank focuses in foreign exchange risks to a moderate extent. The study concluded that banks should consider risk identification as a process in credit risk management and focus in interest rate risks and foreign exchange risks to a great extent in the risk identification map. Further, the banks should involve internal auditors, external auditors, middle and lower level employees as well as senior employees in the process of risk identification. Auditors should be involved by making them begin the inherent risk evaluation process by generating expectatins of accunts balances, by letting them determine how changes should interact with historic trends to produce an expected balance in the account to a moderate extent and also by letting them identify changes that have occurred in the firm or its environment to a moderate extent. In order to manage credit bank risks effectively, management of commercial banks have to know what risks face the bank. The important thing during risk identification is not to miss any risks out through organizing the implementation of the risk management function is to establish the crucial observation areas inside and outside the corporation (Kromschroder & Luck, 2007)

Credit risk assurance

The study revealed that a unit increase in credit risk assurance would lead to increase in financial performance of commercial banks in Kenya; this is an indication that there was positive association between credit risk assurance and financial performance of commercial banks. Insurance products will increase productivity of banks and enhance their profitability. Through sale of insurance products, the banks accrue a number of financial benefits. These benefits include improved income generation, in the form of commissions and/or profits from insurance business; decreased effect of the bank fixed costs because they are spread over the life insurance relationship and employee productivity.

The study concluded that network by banks would increase penetration of insurance products. The banking sector has achieved a deeper penetration especially within the rural areas, where the insurance companies do not have branches. With increased integration of financial services and banks seeking to expand the range of services offered to clients, a perfect opportunity exists for the two sectors to enter into a bancassurance partnership hence an avenue to reach more customers. The diversification of insurance products and services would widen sources of revenue and hence increasing their revenues. The banks are able to sell these diversified products to their wide customer base hence ensuring that there is a wider uptake

reaching new markets. Banking and insurance entities have more similarities than differences, characteristics that may favor joint production and business synergies. Through diversification, the bancassurance approach reduces the resources required to manage risk, which in turn results in lower costs (Staikouras & Nurullah, 2008)

Credit risk monitoring

The study revealed that a unit increase in credit risk monitoring would lead to increase in financial performance of commercial banks in Kenya; this is an indication that there was positive association between credit risk monitoring and financial performance of commercial banks. Monitoring is the last step in the corporate risk management process (Pausenberger & Nassauer, 2002). Monitoring reports should be frequent, timely, accurate, and informative and should be distributed to appropriate individuals to ensure action, when needed Penalty for late payment enhances customers commitment to loan repayment, the use of customer credit application forms improves monitoring and credit management, flexible repayment periods improve loan repayment and finally that the use of credit checks on regular basis enhances credit management. The study revealed that commercial use collection policy in Credit Management to a great extent. Formulation of collection policies have been a challenge in credit management ,

enforcement of guarantee policies provides chances for loan recovery in case of loan defaults, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more effective in debt recovery than a lenient policy, regular reviews have been done on collection policies to improve state of credit management, and finally that available collection policies have assisted towards effective credit management. The study is in line with literature by IRM, AIRMIC and ALARM (2002) that an effective risk monitoring requires a reporting and review structure to ensure that risks are effectively identified and assessed and that appropriate controls and responses are in place

Credit appraisal analysis

The study revealed that a unit increase in credit appraisal analysis would lead to increase in financial performance of commercial banks in Kenya; this is an indication that there was positive association between credit appraisal and financial performance of commercial banks. The study concluded that commercial banks use credit risk appraisal analysis in Credit Management to a great extent. Further it established that client appraisal is a viable strategy for credit, Aspects of collateral are considered while appraising clients, failure to assess customer‟s capacity to repay results in loan defaults, client appraisal considers the character of the

customers seeking credit facilities and that commercial banks have competent personnel for carrying out client appraisal.

The study established that commercial banks use credit risk control in Credit Management to a great extent. The study further established that interest rates charged affects performance of loans in the commercial banks, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk, the use of credit checks on regular basis enhances credit management.

Recommendation

Risk is corporally related to competitiveness and profitability of commercial banks. It is important for banks management to understand how they can edge themselves against the eminent dangers of over exposure to credit risk whose importance cannot be understated as can be realized from the findings that can impact negatively on their profitability. This can be achieved through strong adherence to the use of credit appraisal model.

Commercial banks are recommended to establish sound and competent credit risk management units which are run by best practices in risk management such as the institution of a clear loan policy and the adherence to underwriting authority and limits. Staffs of commercial banks credit units such as project and advance managers, credit/loan officers and field officers perform a range of functions from project appraisals through credit disbursement, loan monitoring to loans collection.

Thus issues pertaining to their selection, training, placement, job evaluation, discipline, and remuneration need to be tackled effectively.

The bank should consider risk identification as a process in credit risk management and focus in interest rate risks and foreign exchange risks to a great extent in the risk identification map. Further, the banks should involve internal auditors, external auditors, middle and lower level employees as well as senior employees in the process of risk identification. Auditors should be involved by making them begin the inherent risk evaluation process by generating expectatins of accunts balances, by letting them determine how changes should interact with historic trends to produce an expected balance in the account to a moderate extent and also by letting them identify changes that have occurred in the firm or its environment to a moderate extent.

Finally, the research recommends credit risk management procedures be used to influence profitability of the bank positively, and also recommends the management of the banks to oversee facilitation of credit risk management as a substantial degree of standardization of process and documentation. Further, since credit risk management leads to standardized ratings across borrowers and a credit portfolio report that presents meaningful information on the overall quality of the credit portfolio it should be used to ensure that all credits are monitored, and reviewed periodically to allow the bank to report the quality of its loan portfolio at any time.

The study recommends that commercial banks should also try to keep their operational cost low as this negates their profits margin thus leading to low financial performance. This is depicted by the strong effect of earnings on financial performance. Commercial banks should also check their credit policy

and practices. By this they would reduce loss on nonperforming loans which raises their expenses and consequent reduction in financial performance.

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