International Journal of Economics, Commerce and Management
United Kingdom Vol. VI, Issue 8, August 2018
http://ijecm.co.uk/ ISSN 2348 0386

INFLUENCE OF PERSONAL LOANS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract

The main purpose of the study was to determine the influence of personal loans on financial performance of commercial banks in Kenya and a corresponding hypothesis was formulated and tested. A census of 42 fully operational commercial banks in Kenya was done for a period of ten years from 2006-2015 due to increased loan portfolio, using across-sectional survey design. A questionnaire was used on primary data that involved collecting data from one key person in the finance/credit department of each bank. Secondary data was collected from audited financial statements and other relevant financial sources using data analysis sheet. Both descriptive and inferential statistics were used. Statistical package for social sciences (SPSS) and STATA version 14 were used to analyze data. Research findings established that personal loans influence the financial performance of commercial banks. The study findings are supported by the Utilization of loan pricing theory and Asymmetric information theory.

Keywords: Personal loans, financial performance, Commercial banks, Loan pricing theory, Asymmetric information theory

INTRODUCTION

Personal lending which is unsecured form of debt is one of the main activities of commercial banks in Kenya and other parts of the world. This is evidenced by the volume of loans that constitute banks assets and the annual substantial increase in the amount of credit granted to borrowers in the private and public sectors of the economy. According to Comptroller (1998) cited in Lwanga (2011), lending is the principal business for most commercial banks. Loan portfolio is therefore typically the largest asset and the largest source of revenue for banks. In view of the significant contribution of loans to the financial performance of banks through interest income earnings, these assets are considered the most valuable assets of banks. A survey in 2006 on the Ghanaian banking sector revealed that loans accounted for about 50% of total bank assets which had increased from 41.5% in 2005 (Appertey & Arkaifie, 2006 cited in Kabiru, 2014). In 2015, the figure increased to 53% of the industry's total assets of GH¢ 7,795.6 million (Info data Associates, 2016). The reason why banks give much attention to the lending activity, especially in periods of a stable economic environment, is that a substantial amount of banks income is earned on loans which contribute significantly to the financial performance of banks. A financial report of ADB in 2016, indicated that out of the total interest income earned in that year, about 66.5% was earned on loans and advances. Loan pricing theory explains why it is not prudent for banks to set very high interest rates to optimize profit from loan sales. If banks set up very high interest rates, they could induce the problem of adverse selection and moral hazard by attracting borrowers with very risky projects into their portfolio. The theory of Asymmetric information explains how information imbalance between the lenders and borrowers can influence the loan portfolio and financial performance in the banking sector. The literature available suggests that most banks do lend substantial amount of money in the form of personal loans, however, there is little research that has been done on how this form of unsecured debt influences the entire financial performance of commercial banks hence the study is set to address this research gap.

Personal Loans

The Federal Trade Commission defines unsecured lending as a debt that is not tied to any asset. In this project, personal loans (unsecured credit) is considered to be credit that is not collaterized by any assets to which the creditor can have recourse in case of failure by the debtor to meet the credit obligations. The CBK views the following products as forms of unsecured lending: credit card; overdrafts; commercial papers, personal loans; and financing provided to small and medium enterprises (CBK, 2012). Unsecured loans are monetary loans that are not secured against the borrower's assets (no collateral is involved). Unsecured lending, specifically personal loans were mostly marketed to the low income earners in the 1990s. The profile of customers taking up personal loans has changed over time. Unsecured credit has been growing at a far higher rate than secured credit, more so since the implosion in the mortgage market in 2008 (CBK, 2012). Various commentators and government representatives recently expressed concern about the rapid growth of this portfolio over the last few years especially the personal loans and commercial papers.

The demand for unsecured personal loans is seen in the increasing number of applications that have been made by consumers. This is a product that credit providers have focused on in meeting the demand for credit. Factors that have influenced growth in this regard include the relative ease and speed at which the likes of unsecured personal loans can be obtained. Unsecured personal loans have represented an attractive market opportunity for credit providers who have actively pursued a lending growth strategy in this product, particularly as a result of the margins that can be made in the current market (CBK, 2012). Majority of commercial banks have entered into memorandum of understanding (MOU) with employers who have agreed to deduct loan monthly repayments from their payrolls and submit the funds direct to the banks.

Lending which may be on short, medium or long-term basis is one of the services that commercial banks do render to their customers. In other words, banks do grant loans and advances to individuals, business organizations as well as government in order to enable them embark on investment and development activities as a means of aiding their growth in particular or contributing toward the economic development of a country in general. The banks and financial institutions require collateral to secure the advanced loan or credit. According to the Banking and Financial Institution Act [Act No. 12/91: Sec 37(3) and (5)], the banks are prohibited from granting or permitting unsecured advances unless such advances have been unanimously approved by all of its directors and have been notified in advance to the Central Bank of Kenya. However, this clause was changed with the CBK allowing the banks to issue unsecured loans to customers with good credit history.

Financial Performance of Commercial banks

Financial performance is a measure on how well a business can use its assets from its primary mode of operations to generate revenues. This is normally measured by the profitability of a business and the liquidity status. Returns on assets, return on equity and current ratio have been used in this case as indicators of bank's financial performance. Competition in the financial sector in Kenya is growing more intense and fierce (Nguta, M. H., & Huka, G. S, 2013). For a long period non-bank financial institution (e.g. private financial funds, credit unions, mutual societies and general deposit warehouses) have enjoyed almost monopoly power of credit facilities to teachers without any competition from other financial institutions. This made the non-bank financial institutions to relax and forget to continuously market their product, diversify their services and improve their quality as well as introduce new products. Today, they have been caught unaware by commercial banks that have aggressively penetrated into their business circles by introducing the personal loans (unsecured loans) targeting members of public including members of credit unions. Majority of commercial banks in Kenya have joined the competition of provision of unsecured loans to the general public (CBK 2012). Personal loans portfolio has immensely increased the total loan book of commercial banks and hence the importance of knowing the relationship between unsecured lending in terms of personal loans and financial performance of commercial banks in Kenya.

Commercial Banks in Kenya

A commercial bank is a type of financial institution that accepts deposits, offers checking account services, and makes business, personal and mortgage loans, and offers basic financial products to individuals and business. In Kenya, there exists 42 operational commercial banks all regulated and monitored by the Central Bank of Kenya as per the provisions of the laws of Kenya and the Banking Act cap 488 and Prudential Guidelines thereon issued. The commercial banks have to maintain certain minimum capital levels as well as capital ratios and other ratios as a way to mitigate banking risk exposures: minimum statutory liquidity ratio is 20% and total capital to risk weighted assets minimum statutory ratio is 12% (CBK, 2014). Kenyan commercial banks risk weighted assets has increased over the years (Waweru & Kalani, 2009). Several financial institutions including commercial banks have also collapsed in Kenya in the past as a result of non-performing loans (Waweru & Kalani, 2009).

The Kenyan banking sector had an asset base of KES 3.6 trillion as at June 2015. This asset base grew by 1.4% to a new base of KES 3.7 trillion in September 2015, which is a 6.9% growth; deposits were at a base of KES 1.6 trillion, which attracted a gross profit of KES 24.7 billion as at 31 March 2014. Deposits from customer accounts were at 14.36 million and the personal loan accounts were at 2.032 million by the end of March 2014 (CBK, 2014).

Commercial bank assets are dominated by loans since they get a larger share of operation incomes from them. However, loans pose great risks to commercial banks like those of non-performing loans that result from borrowers who default in their payments. Further, loan defaulters affect the financial performance of a bank. Through the provisions made by commercial banks towards non-performing loans, bad debts are written off. This act reduces the bank's profit reserves. Commercial banks attach opportunity costs to the non-performing loans in that, the money given out as a loan could have been utilized in a different investment that could have been more viable. Further, there are other costs incurred in the recovery of the non-performing loans. These costs also affect the commercial banks' financial performance.

The growth momentum in the banking sector of Kenya is largely spurred by the adoption of cost effective channels on the delivery of services and the continued increase of the Kenyan banks in the East African region and in Southern Sudan. Therefore, the CBK expects the sector to be able to sustain this growth experienced by the banks. However, inflation risks and high rates of interest are anticipated to drop (CBK, 2014).

In the past 10 years, Themba & Tobias (2011) noted that the banking sector recorded an increase in the financial and overall performance. However, a thorough examination of the sector revealed that not all banks are making the said profits. The enjoyment of a huge financial performance by big firms in the banking sector (Tier 1) as opposed to medium (Tier 2) and small banks(Tier 3) is a possible indicator of remarkable factors that affect commercial banks' performance on their finances.

Personal Loans and Financial performance

Since personal loans are not a full substitute for secured lending, it is true that the value of loans include both unsecured and secured lending. Banks are increasingly measuring the financial performance of loan portfolios by their risk adjusted returns (Koch & MacDonald, 2000). Banks may be forced to adjust their Loan Portfolio in line with other banks in the market where a herding behavior is practiced. Rajan (1994) notes that expanding lending in the short run boosts earnings, thus the banks have an incentive to ease their credit standards in times of rapid credit growth, and likewise to tighten standards when credit growth is slowing in an optimal portfolio mix. Themba and Tobias (2011) notes that on one hand firms complain about the lack of credit due to the high rates set and the excessively high standards set by banks while banks on the other side have also suffered losses on bad loans.

There are several Local Studies on personal loans (unsecured Lending) and financial Performance of Commercial Banks. Maina (2003) carried out a research on the risk based capital standards and the riskiness of bank portfolios in Kenya. Okundi (2011) did a study on the financial challenges facing savings and credit co- operative societies in Kenya. The results showed that savings and credit co- operative societies in Kenya suffered challenges as members of the societies preferred loans from bank to the one from societies because the amount of the loan granted is not pegged on savings as is the case in societies. None of these studies focused on the influence of personal loans on financial performance of commercial banks. It is clear that the area of unsecured lending factors and the financial performance in commercial banks in Kenya have not been explored fully. It was therefore vital to measure the influence of unsecured lending (personal loans) on commercial banks' financial performance. This study therefore sought to test the hypothesis that Personal loans have a significant positive influence on the commercial banks' financial performance in Kenya.

METHODOLOGY

The study adopted a descriptive research design. The population of the study was all the 42 operational commercial banks in Kenya in the period of study which also served as the target population of the study, therefore all commercial banks in operation informed the unit of analysis.

Both the primary and secondary data were used. The secondary data was sourced from the annual reports that are available from their websites and the Central bank of Kenya website. Data on financial performance and personal loans were sourced from the financial statements of the commercial banks.

Reliability was conducted using test-retest approach and Cronbach's alpha coefficient of 0.7 and above was interpreted to mean satisfactory internal consistency reliability. Content validity was done by testing and retesting the data sheet and construct validity attained through the operationalization of the study variables. Both descriptive and inferential statistics were used. SPSS and STATA version 14 were used to analyze data.

ANALYSIS AND FINDINGS

The study used descriptive statistics and inferential statistics to establish the influence of personal loans on financial performance of commercial banks. Linear regression was carried out to test the influence of the variables on the financial performance of the commercial banks. The model was tested for statistical significance at a level of significance of 95%.

The statistical model used was $Y = \alpha + ß_1X_1 + \varepsilon$

Where,

y = Financial performance measured in terms of ROE, CR and ROA; $ß_1$= the coefficient of personal loans (variable) and ε = error term.

Response rate

Out of 42 questionnaires administered to bank managers 34 were returned presenting a response rate of 80.59%. According to Mugenda and mugenda above 70% rate of response is the acceptable level of generalization. Also out of the 42 commercial banks 39 commercial banks were however studied. This translated to approximately 92.86% of target population, which is good representation as supported by Gray, D. and S. Malone, (2013) who posit that 20% of the target population is sufficient sample size for small population with less than 1000 units.

Summary Statistics

Table 1: Categorical Summary statistics

	Variable	Obs	Mean	Std. dev	Min	Max
Tier 1	Size	60	15.195	0.786	13.534	17.097
	Personal loans	60	0.252	0.110	0.006	0.843
	ROA	60	0.236	0.081	0.108	0.594
	ROE	60	2.425	5.754	0.113	45.011
	CR	60	0.855	0.879	.023	3.945
Tier 2	Size	130	15.938	1.673	11.897	20.012
	Personal loans	130	0.196	0.146	-0.032	0.884
	ROA	130	0.254	0.064	0.111	0.51
	ROE	130	3.161	14.448	-24.140	76.149
	CR	130	7.755	12.198	-9.154	39.372
Tier 3	Size	190	16.481	1.490	13.466	19.663
	Personal loans	190	0.199	0.149	0.001	0.687
	ROA	190	0.277	.102	0.106	0.819
	ROE	190	2.309	62.044	0.050	582.059
	CR	190	12.916	53.525	0.095	507.728

Key: ROA= Return on assets; ROE= Return on equity; CR=Current ratio

As shown in Table 1, for all the Tier 1 commercial banks in Kenya, the average ROA during this period was 23.60% with the lowest value of 0.1080, highest value of 59.40 and a standard deviation of 0.0812. This meant that on average banks had a positive ROE even though their majority are to the right of the distribution like the ROA shows. 10.76% was the mean ROA with a standard deviation of 0.15793 and a low and high of -0.54 and 1.64 respectively. This showed that banks were generally profitable to reward the assets investment. Standard deviations showed the fluctuation of returns of ROE being higher than that of the ROA. The average personal loans over the period were 38.30%, minimum of 0.3121 and maximum of 0.6187.

The above findings disagreed with those of Amare (2012) who after examining the simultaneous effect of the financial default risk on financial performance of commercial banks found out that such increased loans can affect ROA and ROE as a measure of financial performance among commercial banks. Equally Amare (2012) found out that credit risk is real among commercial banks as both ROA and ROE were affected thus a significant negative relationship on banks' performance thus more loans means higher chances of non-performance hence poor bank performance. As it is displayed in Table 1, the mean value of firms' current ratio (CR) is 8.55 percent, and it deviates 8.79 percent. It means that value of liquidity can deviate from mean to both sides by 8.79 percent. Its minimum value is 0.23 percent while the maximum is 3.945 percent.

At Tier 2, the average ROE over the period was 31.61%, with the lowest value being 0.65, highest value of 7.13 with a standard deviation of 1.524. This shows that though on average banks had a huge positive return on equity, the majority of firms ROE are to the right of the distribution just like ROA. The mean ROA was 25.4% with a standard deviation of 0.640 and a low and high of 11.10 and 5.10 respectively. This showed that banks were generally highly profitable towards their investment in assets. Standard deviations showed the fluctuation of returns of ROE being marginally higher than that of the ROA. These results are echoed by Kabiru, J.M.G. (2014) who concluded that banks at Tier 2 have a higher ROE than ROA with a higher variability in ROE too. The result in Table 1 shows that the mean value of firms' current ratio is 7.755 percent, and it deviates 12.198 percent. It means that value of liquidity can deviate from mean to both sides by 12.198 percent. Its minimum value is -9.154 percent while the maximum is 39.372 percent. The average personal loans over the period were 17.9%, minimum of -0.0320 and maximum of 0.3646.

At Tier 3, the average ROE for this period was 23.09%, with the lowest value being 0.65, highest value being 7.13 with a standard deviation of 1.524. This shows that though on average banks had a huge positive return on equity, the majority of firms ROE are to the right of the distribution just like ROA. The mean ROA was 27.5% with a standard deviation of 0.1000 and a low and high of 0.1060 and 0.8190 respectively. This shows that banks were generally highly profitable towards their investment in assets. Standard deviations showed the fluctuation of returns of ROE being marginally higher than that of the ROA. These results are supported by Kabiru, J.M.G. (2014) who concluded that banks at Tier 2 have a higher ROE than ROA with a higher variability in ROE too. According to the result in Table 1 the mean value of firms' current ratio is 12.916 percent, and it deviates 53.525 percent. It means that value of liquidity can deviate from mean to both sides by 53.525 percent. Its minimum value is 0.095 percent while the maximum is 507.728 percent. The average personal loans over the period were 19.3%%, minimum of 0.0001 and maximum of 0.6136.

Descriptive Analysis of personal loans and financial performance

To analyze the influence of personal loans on financial performance, the study tested the descriptive statistics for the variable by employing a five-point Likert scale to measure the respondents' agreement level. The scores 1, 2, 3, 4, and 5 were assigned strongly disagree, disagree, neutral, agree and strongly agree respectively. For the purpose of setting up the index of personal loans, the means of individual ranking on the items were calculated. The mean obtained were therefore used as an index for personal loans. The overall response for the items indicates the mean is 4.08 and Standard Deviation is 0.869. In this study, the descriptive analysis was conducted after the reliability test. Table 2 shows the mean of responses for personal loans is 4.08 which was above average, this meant that the respondents agreed with personal loans in their respective banks.

The lower the score's mean, the less the respondent supported the statement. The vice versa of this statement was also true. The standard deviation figures indicate the degree of variation in the answers; the higher the figure for SD, the more variation in the responses. The findings are in line with Agu & Okoli, (2013) who argued that personal loans borrowers at times may face inability to pay as debtors make payments on their loans and interests within a scheduled time leading to a negative impact on the financial status and performance of the lender. Further, Chelagat, (2012) findings also agreed non-payment of loans can lead to poor overall performance of the concerned financial institutions.

Table 2: Descriptive Analysis for Personal loans

	N	Mean	SD
Tenure of personal loans influences the return on assets of this bank	34	3.88	1.038
Personal loans disbursed influences the return on asset of this bank	34	4.03	0.797
Repayment of personal loans influences the return of assets of this bank	34	4.29	0.719
Default of personal loans influences the return of assets of this bank	34	4.18	0.673
Tenure of personal loans influences the return on Equity of this bank	34	4.09	0.830
Personal loans disbursed influences the return on equity of this bank	34	4.12	0.729
Repayment of personal loans influences the return on equity of this bank	34	4.03	1.029
Default of personal loans influences the return on equity of this bank	34	4.21	0.978
Tenure of personal loans influences the current ratio of this bank	34	4.15	0.784
Personal loans disbursed influences the current ratio of this bank	34	4.18	0.716
Repayment of personal loans influences the current ratio of this bank	34	4.00	0.985
Default of personal loans influences the current ratio of this bank	34	3.88	1.149
Average		**4.08**	**0.869**

Test of Hypothesis

The research endeavored to establish the influence of personal loans on the financial performance of commercial banks in Kenya. The results are shown in Table 3.

Table 3: Regression Results of Personal loans as Independent Variable-Random Effects and Fixed effect Model

	Personal loans	Coefficient	Std. Error	Z	T	P>|z|	Model
Model 1a	CR	-75.14	12.98	-5.79		0.000	Random-effect
Model 1b	ROE	-91.07	15.01	-6.07		0.000	Random-effect
Model 1c	ROA	13.60	2.26		6.02	0.000	Fixed effect
Statistics	**Model 1a**	**Model1b**	**Model1c**				
Wald chi2(1)	33.51	36.81					
Prob > chi2	0.000	0.000	0.000				
R-Squared	0.080	0.087	0.094				
Rho	0.000	0.000	0.220				

As shown in Table 3, results on the influence of personal loans on ROA show that the coefficient of personal loans was 13.60 hence personal loans had a positive influence on ROA. The p value was 0.000 which is less than 5% level of significance. This indicates that personal loans had a significant positive influence on ROA. With regard to CR, the coefficient of personal loans was -75.14 hence personal loans had an inverse relationship with CR. The p value was 0.000 which is greater than 5% level of significance implying a significant influence of personal loans on CR. With regard to ROE, the coefficient of personal loans was -91.074 hence personal loans had a negative influence on ROE. The p-value was 0.000 which is less than 5% level of significance. This indicates that personal loans had a significant negative influence on ROE. The study concluded that personal loans influenced the financial performance of the banks under study this was confirmed by majority of the respondents who felt repayment of personal loans influenced the return of assets and the current ratio of the banks. Personal loans had a significant relation with ROA, and a significant inverse correlation with ROE and current ratio.

The study findings are in congruent with findings by Ayele (2012) that personal loans had an inverse correlation with ROE and a positive correlation with ROA. Agu and Okoli (2013) displayed that the statistics acquired from liquidated banks in Nigeria clearly showed the major contributor to the financial crises of the liquidated banks was their inutility in the collection of personal loans and advances extended to customers. In 1995 when the distress was at its peak, 60 banks were in crises out of the 115 operational banks. The ratio of their non-performing loans and leases to their total loans and leases was 67%. This ratio regressed to 79% in 1996 and 82% in the following year; By December 2002, 35 of the disconsolate banks licenses had been revoked. At the time of the revoking of the banking licenses some of the institutions recorded ratios of performing credits that were less than 10% of loan portfolios (Ayele, 2011)

According to Lwanga (2011) the rising number of applications being made by customers shows the growth in demand for personal loans. This is a product that depository financial institutions in Kenya have set their eyes on the credit demand. Growth influencing factors in this scenario encompass reasons like the speed and relative easiness with which one can obtain unsecured personal loans. Personal loans have opened up an attractive market opportunity for creditors who have valiantly chased a lending growth strategy in this product, specifically because of the margins that stand to be made in the current market. Majority of commercial banks have entered into memorandum of understanding (MOU) with employers who have agreed to deduct loan monthly repayments from their payrolls and submit the funds direct to the banks.

CONCLUSION

This study aimed to establish the influence of personal loans on the financial performance of commercial banks in Kenya. It was conducted through a cross-sectional survey. It adopted both descriptive and inferential statistics to analyze the data. Simple linear regression analysis was used to determine the influence of personal loans on the financial performance of commercial banks .The study tested and confirmed the hypothesis that personal loans have a positive and significant influence on the financial performance of commercial banks in Kenya. This implies that those commercial banks that practice appropriate loan management practices expect significant influence and better results on their financial performance. However the study had a limitation of self-reported data which is a form of bias when collecting information from the same people who reported it. To address this limitation, the researcher attempted, without shutting out details, to control biases by combining different aspects of questions in research tools.

RECOMMENDATIONS

The main insight gained from this study is the degree to which personal loans influence banks' financial performance. The results show that an increase of personal loans leads to a decrease in a bank's ROE and CR. Policy makers could implement tighter restrictions on banks' ability to make new personal loans. Tighter restrictions may help reduce the number of banks that fail in terms of low profitability. The study on the influence of personal loans influences on bank's financial performance has many possible extensions. Breaking personal loans down by specific categories may reveal insights into the types of personal loans that are more risky than others. Also, using bank failures as the dependent variable may reveal how strong, or weak, the relationship between loans and bank failures is

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