

ASSET QUALITY AS A DETERMINANT OF COMMERCIAL BANKS FINANCIAL PERFORMANCE IN KENYA

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Abstract

The bank's asset is a bank specific variable that affects the financial performance of a bank. The bank asset includes among others current assets, credit portfolio, fixed assets, and other investments. Often a growing asset size is related to the age of the bank More often than not the loan of a bank is the major asset that generates the major share of the banks income. Loan is the major asset of commercial banks from which they generate income. The quality of loan portfolio determines the profitability of banks. The highest risk facing a bank is the losses derived from delinquent loans. Thus, nonperforming loan ratios are the best proxies for asset quality. It is the major concern of all commercial banks to keep the amount of nonperforming loans to low level. This is so because high nonperforming loan affects the profitability of the bank. This study examined and evaluated banks asset quality and financial performance in Kenya using secondary data obtained from the annual reports and accounts of the 11 banks in Kenya listed in Nairobi securities exchange based on annual reports with a sample interval of six year period from 2012 to 2017. The study adopted the use of ratios as a measure of bank financial performance and asset quality since it is a verifiable means for gauging the firms' level of activities while the data were analyzed using the Pearson correlation and regression tool of the SPSS 23.0 .The findings revealed that asset quality had a statistically significant relationship

and influence on bank financial performance. Based on the findings the study recommends policies that would encourage revenue diversification, minimize credit risk, and encourage banks to minimize their liquidity holdings. Further research on factors influencing the liquidity of commercial banks in the country could add value to the profitability of banks and academic literature.

Keywords: Asset quality, asset size, credit portfolio, loan-loss ratio, investments to asset ratio

INTRODUCTION

The present world of business operation is characterized by considerable amount of uncertainty regarding the demand, supply and market price as there are operational costs for every business activities while business information is costly and not evenly distributed. Similarly, every firm has its own limits on the production capacity and technology in terms of core competency which determine the nature of investments and financing risk. The above problems impose the requirement for the provision of sufficient assets to support various aspects of business operations.

The banking business is not immune from this market trends as their stock in trade is money which they deal in terms of deposits from various economic agents as well as onward lending to different set of economic agents in forms of loans and advances. However, this bank money creation process requires adequate asset for survival, sustenance and development as its shapes the fortune of the firm in both the short and long run of business process (Omolumo, 1993). Asset quality as an aspect of bank management entails the evaluation of a firm's asset in order to facilitate the measurement of the level and size of credit risk associated with its operation. It relates to the left-hand side of a bank balance sheet and focuses on the quality of loans which provides earnings for a bank. Asset quality and loan quality are two terms with basically the same meaning while its management is considered extremely important by the banking sector. According to the Basle Committee on Banking Supervision, the core principles for effective banking supervision comprises twenty-five core principles out of which seven are designed to address the relevant issues of bank asset quality or credit risk management (Basle, 1997). This implies that asset quality is of general concern to financial supervisory authorities in every country throughout the world.

This deterioration in bank asset quality affects its operating and financial performance as well as the general soundness of the financial system in which it is an entity. Yin (1999) observed that the deterioration of bank asset quality arising from the ignorance of loan quality is

one of the proximate cause of the Asian Financial Crisis while Tsai (1999) stated that based on the Standard and Poor's (S&P) 1994 global credit rating reports which comprise sixty-one countries' financial systems, Taiwan belonged to the division of frail financial systems. Banking institutions residing in a country with frail banking systems should pay more attention to managing asset quality in order to warrant the sound development of the banking industry.

The banking sector in Kenya registered strong capitalization levels on the back of retained earnings and additional capital injection. However, asset quality declined with the gross net profit ratios increasing Liquidity risk. From a systemic point of view, most emerging market banks tend to have a particularly pronounced negative (contractual) short term liquidity gap due to the short term nature of deposits, largely as a result of volatile interest rates, the lack of an extended savings culture and low financial intermediation. However, the trend of the mismatch over time, as well as the size thereof, is important, since an increase in the mismatch could indicate a potential funding problem (CBK, 2012).

This banking challenge raised a research enquiry on the nature of the relationship between banks asset quality and financial performance in Kenya due to the indispensable nature of banking operation in the financial intermediation process and development. The remaining aspects of the study comprise a brief literature review, research methods, result presentation and discussion as well as conclusions and recommendations.

LITERATURE REVIEW

Many of the local banks set up in African Kenya, Nigeria, Uganda and Zambia have been closed down or taken over by their Central Banks because of insolvency and illiquidity caused by non-performing loans (Brownbridge, 1998). The severity of bad debt problems was attributable to problems of moral hazard and adverse selection. Several factors contributed to the moral hazard on bank owners to take excessive risks with depositors' money. These included low levels of bank capitalization, access to public sector deposits through the political connections of bank owners, excessive ownership concentration, and regulatory forbearance. He further suggested that the local banks can make a potentially valuable contribution to the development of financial markets in Sub-Saharan Africa, especially by improving access to loans for the domestic small and medium scale business sector. They can also inject much needed competition into financial markets and offer customers better services. Local banks have survived and operate as sound institutions in all four of the countries covered here despite the very difficult conditions such as acute macroeconomic instability, which suggests that the risk of licensing local banks is worth taking, although local banks will inevitably face greater risks than the established foreign banks in view of the nature of the markets which they serve.

If the probability of bank failure can be reduced by better regulatory policies, the net benefits to the economy provided by the local banks will increase. Effective prudential supervision of the local banks and enforcement of banking legislation is essential if the incidence of bank failures in this sector is to be reduced. Supervisors should place particular emphasis on the monitoring of credit risks, especially insider lending, through regular on-site inspections. Regulatory policy should aim to enhance incentives on bank owners for prudent management. Reforms to facilitate this objective include imposing higher minimum capital requirements and stricter limits on ownership concentration.

Bank asset quality is a popular issue in banking literatures because most authors on bankruptcy agreed that before a bank can be declared bankrupt, a sizeable amount of non-performing loans must exist since bank asset quality is an indicator for the liquidation of banks (Demirguc-Kunt, 1989 and Whalen, 1991). Similarly, investigation on the production efficiency of financial institutions has reported that normal financial institutions have comparatively higher costs and lower profits than the most efficient financial institutions with the visible signs of inefficient output to include acquisition, brokerage problems, company governance, and foreign holding factors (Berger et al., 1993). Osayameh (1986), Orji (1989), Omolumo (1993) emphasized that when loans are not repaid as it often happens, banks get into problems, as such debts are sometimes written off as bad. The balance sheet of any lending bank is believed to confirm this. Orji (1989), explained further that ability to repay the point of any lending decision, one may then ask why bad debt does occur? Some reasons given by Orji and Osayameh (1986) include non-existence of a loan policy set out by the banks, non-compliance with such a loan policy analysis of financial data, bad judgement, inadequate project monitoring, incomplete knowledge of customers' activities etc.

However, asset quality and bank efficiency are non-related, because operating personnel normally are not involved in the selection and supervision of borrowers, and loan and credit personnel do not engage in the management of operations. However, banks at the edge of bankruptcy appear to have a high non-performing loan ratio as well as a low cost efficiency. Some authors discovered that the level of liquidated banks and high efficient banks (the most efficient banks) is huge (DeYoung and Whalen, 1994; Wheelock and Wilson, 1995). Other researchers found that banks having non-bankruptcy problems exhibit a negative relationship between efficiency and non-performing loans (Kwan and Eisenbeis, 1994).

DeYoung (1997) opined that a bank's ranking is significantly affected by asset quality which is always an essential factor in rating and management evaluation. Marshall (1999) also observed that one of the key features that the best community banks hold is good quality assets. Given that bad quality assets can prompt a bank rating downgrade and that it becomes

more difficult to earned depositors' trust, such banks can therefore only attract deposits by having a higher deposit rate. Together, a conclusion can be drawn: asset quality will not only influence the operating costs of banks, but will also affect the interest costs of the banks as well as their operating performance. Streeter (2000) reported that asset quality management is considered one of banks major management problems in 2001 based on the self-administered questionnaires served to the members of American Bankers Association Board which composed of one-third of bank officials from all U.S. banks, the result of the above survey sufficiently proves that asset quality management is a common issue for bankers in practice. Similarly, Gene Miller (CEO of America Corp.) considered asset quality as the second most important management issue and formed a task force to specifically handle rising bad assets.

According to Achou and Tenguh (2008), non-performing loans (NPL) has an inverse relationship with banks' profitability. Hence, they suggested that it is of crucial importance that banks practice prudent credit risk management and safeguarding the assets of the banks and protect the investors' interests. Similarly, Aboagye and Otieku (2010) contended that for banks to continue operations; they must make enough money through lending and fiduciary activities or services to cover their operational and financing costs, plough back retained earnings to finance future operations. This will enhance not only the survival but also their growth and profitability. From the management accounting perspective, bank asset quality and operating performance are positive related because if a bank's asset quality is insufficient such will have to increase its bad debt losses as well as expend more resources on the collection of non-performing loans (Abata, 2010). When banks list the loan amount for collection, banks will incur extra operating costs from non-value-added activities so as to handle and supervise the collection process such as a regular tracking the debtor's financial status, being vigilant of the collateral value, rearranging the amortization plan, paying expenses for contract negotiation, calculating the costs to withhold etc. The costs include winning the trust from management and the public, preserving the safety and completeness of the banks, preventing the banks from being rated poor as a consequence of external affairs, reducing deposits because of a loss in clients' faith, extra costs to monitor loan quality, and higher future costs generated by the ignorance of the problems from other operations that is generated when the loan quality issues grips the attention of the senior management (Khalid, 2012).

METHODOLOGY

The study adopted the use of secondary data obtained from the annual reports and accounts of the 11 banks listed on the Nairobi securities exchange based on market capitalization with a sample interval of six-year period from 2012 to 2017. The study exploited the use of ratios as a

measure of bank performance and asset quality since it is a verifiable means for gauging the firms' level of activities. The surrogate employed in the model specified below is based on standard measures stipulated by the CBK as well as the availability of data while the return on asset (ROA) was used as a proxy for firm performance, the surrogates used for asset quality comprise the loan-loss ratio (LLR) and the total Investments to total assets ratio (TTR).

Using the statistical packages for social scientist (SPSS 23) software, the relationship among the specified variables was examined through the use of regression and correlation matrix while the Ordinary Least Square (OLS) regression model is represented as:

$$ROA = \beta_0 + \beta_1 LLR + \beta_2 TTR + \varepsilon \text{-----} 1$$

$$ROA = \beta_0 + \beta_1 TTR_{it} + \varepsilon \text{-----} 2$$

Where,

ROA = Return on Assets of Selected Banks (Earnings before Tax/Total Asset)

LLR = loan-loss ratio (Classified Loan & Advances/Total loan Portfolio)

TTR = Total Investments to total assets ratio (Total Loan / Total Asset)

Hypotheses

H₀- There is no relationship between bank asset quality and its performance.

H₀- There is no relationship between bank loans and its profitability.

RESULTS AND DISCUSSION

Table 1: Asset Quality Statistics

	2012	2013	2014	2015	2016	2017	Average
Mean	0.0484	0.0513	0.0525	0.0660	0.0661	0.0863	0.0649
SD	0.0643	0.0719	0.0723	0.0734	0.0626	0.0900	0.0699
Skewness	2.4922	2.2694	2.3577	1.7359	1.4591	2.1290	1.8654
Kurtosis	6.0602	4.1319	5.0900	2.4346	1.6738	5.2497	2.7489
Max	0.2729	0.2670	0.2989	0.2906	0.2620	0.4271	0.2769
Min	0.0010	0.0013	0.0018	0.0009	0.0023	0.0015	0.0015

The statistics on Table 1 show that the non-performing loan in the commercial banks in Kenya averages 5% as seen in year 2012 but the trend is slowly rising to the 10%. On the higher side, some banks hold a significant amount of non – performing loans in their books as with statistics showing one bank with over 42% non – performing loans.

These mean statistics indicate that the provision for bad loans are ever increasing with year on year average of over 5% and these tends to affect the profitability of the commercial banks. The skewness statistic for average asset quality ranges from 1.6738 to 2.4922 indicating indicate that the data is skewed towards right with heavier distribution on the right of the normal distribution. The kurtosis statistic ranges between 1.6738 and 6.0602 indicating that the data points are all heavy-tailed (leptokurtic distribution).

Table 2: ANOVA statistics on Asset Quality

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	.018	2	.009	2.596	.088
Within Groups	.131	9	.004		
Total	.149	11			

Table 2 shows that the ANOVA statistic, $F(2,9) = 2.596$, $p > 0.05$, indicating that are no significant difference in asset quality between the commercial banks according to the size of bank. Thus, any differences in asset quality cannot be explained by the size of the commercial banks in Kenya.

Diagnostic Test Results

Unit Root Test

Table 3: Augmented Dickey-Fuller test for unit root test

	Test Statistic	1% Critical	5% Critical	10% Critical	Mackinnon
	Z(t)	value	value	value	approximate
Asset quality	-0.901746	-2.5750	-1.9422	-1.6158	p-value = 0.3246

The unit root testing was done using the ADF simplified statistics found in Table 3. This concerns the unit root testing for the study variable. Since the p-value is 0.3246, the null hypothesis that asset quality has a unit root is not rejected which implies that the series is stationary.

Table 4. Model 1 Summary^b

Model	R	R Square	Adjusted R Square	Std. Error of Estimate	Durbin-Watson
1	.870 ^a	.756	.513	1.09947644	2.114

a. Predictors: (Constant), LLR, TTR

Table 5. ROA Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	-17.746	8.026		-2.211	.158
	TTR	55.722	22.745	3.039	2.450	.134
	LLR	17.649	7.119	3.075	2.479	.131

Table 6. Correlations

		ROA	TTR	LLR
ROA	Pearson Correlation	1	.088	.159
	Sig. (2-tailed)		.888	.798
	N	15	15	15
TTR	Pearson Correlation	.088	1	-.960**
	Sig. (2-tailed)	.888		.010
	N	15	15	15
LLR	Pearson Correlation	.159	-.960**	1
	Sig. (2-tailed)	.798	.010	
	N	15	15	15

** . Correlation is significant at the 0.01 level (2-tailed).

The model above represents the relationship between the dependent variable; ROA and the independent variables; TTR and LLR. From the above model, the correlation (R) value of 0.870 indicates the existence of a strong positive correlation among the specified variables. Similarly, the regression value of the two specified independent variables showed that the ROA is negative without the influence or interaction of either the LLR or TTR while their interaction influences the ROA positively with the TTR having the greatest influence. The coefficient of determination value (R^2) of 0.756 indicates that about 75.6% of variation ROA can be explained by the combined influence of TTR and LLR. The Durbin Watson test statistic of serial correlation value of 2.114 showed that there is no autocorrelation among the successive values of the variables in the model. The pair wise correlation output shows positive relationship between asset quality indicators and profitability. Hence, we reject the null hypothesis and accept the alternative hypothesis, that there is a relationship between bank asset quality and its performance

Table 7. Model 2 Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.092 ^a	.009	-.322	1.81106416	2.888

a. Predictors: (Constant), TTR

b. Dependent Variable: ROA

Table 8. Regression Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients			
	B	Std. Error	Beta	t	Sig.	
1	(Constant)	2.928	4.502		.650	.562
	TTR	-1.737	10.810	-.092	-.161	.883

a. Dependent Variable: ROA

Table 9. Correlations

		ROA	TTR
ROA	Pearson Correlation	1	-.092
	Sig. (2-tailed)		.883
	N	15	15
TTR	Pearson Correlation	-.092	1
	Sig. (2-tailed)	.883	
	N	15	15

The model above show the relationship between the ROA and TTR, with the correlation (R) value of 0.092 indicates a very weak positive correlation which is near zero while the coefficient of determination value (R^2) of 0.009 indicates that ROA can hardly be explained by TTR. The Durbin Watson statistic measure of serial correlation value of 2.888 indicates that there is no autocorrelation among the successive values of the variables in the model. Hence, we accept the null hypothesis that there is no relationship between bank loans and its profitability.

It is clear from analysis that there is a strong positive relationship between good asset quality and profitability, with the coefficient of correlation being 0.756. This means banks that monitors their credit loans tend to be more profitable than those that pay less attention to assets quality and vice-versa. This is in line with the theory that increased exposure to credit risk is normally associated with decreased bank profitability (Kosmidou, 2008). The second hypothesis

showed that there is no relationship between bank loans and its profitability though this contradicts Khalid (2012) which reported that asset quality and profitability are negatively correlated in the banking industry.

LIMITATIONS OF THE STUDY

The study is limited in scope in that it only analyzed the commercial banks listed in Nairobi securities exchange which are 11 out of the 43 commercial banks operating in Kenya, in addition the study is limited to a period of 6 years from 2012 to 2017, notwithstanding the limited research studies done touching on the commercial banks in the region and Kenya. Due to the limitation, the researcher examined widely other studies done on other countries context and thus was able to resolve the insufficiency of the information.

Secondly different factors had different impacts on the various banks, in addition the secondary data collected from the central bank supervision reports could not be verified independently. Finally, the study relied on publicly available data since banks could not disclose a lot of information due to sensitivity issues

CONCLUSIONS AND RECOMMENDATIONS

The study examined the influence of bank asset quality and its performance in Kenya. it is therefore concluded that there is a relationship between bank asset quality and its performance while there is no relationship between bank loans and its profitability. Hence, It is therefore, concluded that linear relationship exist between the dependent and the independent variables of the model. The evidence established that the independent explanatory variables (asset indicators) have individual and combined impact on the return of asset of banks in Kenya.

This study shows that there is a significant relationship between bank performance (in terms of profitability) and asset quality (in terms of loan performance). Loans and advances, loan loss provisions and non-performing loans are major variables in determining asset quality of a bank. These risk items are important in determining the profitability of banks in Kenya Where a bank does not effectively manage its risk, its profit will be unstable. This implies that the profit before tax has been responsive to the credit policy of Kenyan banks. The asset structure also affects profit performance. Banks become more concerned because loans are usually among the riskiest of all assets and therefore may threaten their liquidity position and lead to distress. Better credit risk management results in better bank performance. Thus, it is of crucial importance for banks to practice prudent credit risk management to safeguard their assets and protect the investors' interests.

The Central Bank of Kenya (CBK) should regularly assess the lending attitudes of financial institutions. One direct way is to assess the degree of credit crunch by isolating the impact of supply side of loan from the demand side taking into account the opinion of the firms about banks' lending attitude. Finally, strengthening the securities market will have a positive impact on the overall development of the banking sector by increasing competitiveness in the financial sector. When the range of portfolio selection is wide people can compare the return and security of their investment among the banks and the securities market operators.

Management need to be cautious in setting up a credit policy that will not negatively affect profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits and maximization of profit. Improper credit risk management reduces the bank profitability, affects the quality of its assets and increase loan losses and non-performing loan which may eventually lead to financial distress. As a result, banks still need to make efforts to improve their financial soundness via the following:

- The use of collaterals as security of granting loans should be further reviewed to reduce further incidence of bad debts;
- All credit risk managers and lending officers should adhere strictly to good lending practice; they should know the purpose of the loan and ensure the feasibility of every loan proposed.
- Bankruptcy law should be enforced to the letter and a sound credit culture should be introduced;
- Credit management should be viewed as part of a coordination group efforts made by all departments involved with customers to minimize bad debts and maximize profit instead of leaving it in the hands of the credit risk management department.

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