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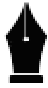

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RELATIONSHIP BETWEEN CREDIT COMMITTEE SIZE AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA, (2013-2017)

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Abstract

Commercial banks in any country play critical role in the growth of their economies. However, limited knowledge exists on the relationship between credit committee size and financial performance. This study therefore sought to establish the relationship between credit committee size on financial performance of commercial banks in Kenya. The target population was all the commercial banks operating in Kenya. The study adopted longitudinal research design that covered a period of five years (2013- 2017). The study used secondary data extracted from annual consolidated and financial reports. Information on specific financial performance was indicated by ROA (return on assets). Data was analyzed using SPSS through regression

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analysis. The study found that there is a significant positive relationship between credit committee size and financial performance. The study found a positive correlation between credit committee size and financial performance with the following coefficients (Pearson correlation of r= 0.591, p=0.020, R^2 = 0.350, Adjusted R^2= 0.300, p<0.05).The study recommends commercial banks to focus on enhancing credit committees so as to manage risk exposure thus enhancing financial performance.

Keywords: Credit Committee Size, Financial Performance, Commercial Banks, Kenya

INTRODUCTION

Commercial banks contribute to economic development of both developed and developing countries (Miencha & Selvam, 2013; Ntow & Laryea, 2012). Despite this crucial role, the banking industry faces risk exposure challenges that can lead to their collapse if not managed. After the collapse of various institutions and financial distress in the world in the 1990s, regulators of financial institutions in various countries developed policies and strategies of minimizing risk occurrence (Mohamed, 2015). This led to the passing of the Basel Accord I, Basel Accord II and Basel Accord III that details the bank supervision rules (Lexicon, 2017). In the United States, the legislators enacted the Sarbes Oxyley Act in 2002, which acted as a risk prevention mechanism (Mohamed, 2015).

Banks have also instituted other banking anti-risk mechanism such as the institution of boards of governance whose mandate includes the bank oversight role executed through various board committees (Nibedita, 2018). The board committees play an important role in corporate governance by preparing reports for the full board of governance that use them to develop bank policies (Chen & Wu, 2016).Banks are facing various sorts of risks and one of the major risks faced by the banks is the credit risks. Credit risk can be said to be the change in the net asset value because of the changes in the perceived ability of debtor to meet their contractual obligations (Pyle, 1997). Credit risk occurs when one party to a contract default his obligation as agreed with the lender. Default is failure to honor a contract or agreement to meet payments or failure to pay taxes insurance and premium due. Tshorhe, Aboagye, & Coleman (2011) define credit risk as the probability that some of the assets of the banks, especially its loans, will decline in value and possibly become worthless. Credit risk is among the main risks faced by banks. This kind of risk is generated by the crediting activity of the clients. The main reason why banks manage credit risk is because the credit risk affects financial performance of the banks (Alshatti, 2015). To deal with the credit risks exposures, commercial banks ought to

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identify the various sources of the risks and to screen their exposures. These exercises mean a better information of the current and potential customers and their financial conditions, by implementing new scoring techniques.

In the banking sector, the large proportion of the assets comes from the loans. In most cases, the portfolio of the banks relatively exhibits the highest credit risk (Koch & MacDonald, 2000). The management of credit risk is important to banks for the reason that banks more often hold small of value relative to their resource base and that a little percentage of credit not performing can make a financial institution to collapse. In this way, management of credit risk is very important a bank and undoubtedly the whole financial sector framework (Tshorhe, Aboagye, & Coleman, 2011). In order to minimize credit risk, commercial banks use various methods and strategies more importantly credit risk committees.

Loan practices requires due consideration as management of the credit risk is one of the important factors among the issues considered by banks and other financial institutions. The risk management factor is not only important for sustainability but it is also for development of the commercial banks. Improper management of risk may result in liquidity risk brought about by the indebtedness of the commercial banks. Commercial banks may collapse if there is poor or reduction in the quality of the loans advanced to the creditors (Sufi & Qaisar, 2015).

Kinuthia (2007) carried out a study which found that the finance institutions were incurring losses due to loan default which affected the wealth of members. The study recommended that institutions should provide guidelines on loan policy and credit extension to members. It also highlighted the need for integration of information system to employers. The same study reported that growth of the institution was related to the control of loan default. Most banks have adopted various forms of managing its risk exposures and this includes the use of credit committees and credit information sharing. It is for this reason therefore that commercial banks have adopted various ways of managing risk especially by used of credit committees.

Statement of the problem

Commercial banks in Kenya play a significant role in the economic development of the country by providing financial access and savings. Commercial banks are expected to report good financial performance and stability for the interest of the shareholders and all the stakeholders. Indeed, a total of twenty-two commercial banks have collapsed in Kenya (InfoHub Kenya, 2016), while three namely Chase Bank, Imperial Bank and Dubai Bank were placed under receivership by the Central Bank of Kenya. According to Kinuthia (2007) commercial banks are making losses because of non-performing loans. Commercial banks have put in place some of the mechanisms to manage its risk exposure especially the credit risk. Commercial banks have

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established credit committee size and because there is no standard size of these credit committees, different banks have different sizes and therefore there is limited knowledge on the relationship between credit committee size and financial performance of commercial banks.

The main objective of this study was to establish the relationship between credit committee size and financial performance of commercial bank.

LITERATURE REVIEW

Credit committee draws its powers from the board of governance. The responsibility of the credit committee is to review and monitor credit portfolio quality, ensure implementation and adherence to credit policies, periodically monitor concentrations in credit portfolio and assess efficacy of thresholds and action plans in case of threshold breach in the bank.

According to findings of Kinuthia (2007), finance institutions incur losses due to loan default hence affects the wealth of members. The study thus recommended that institutions should provide guidelines on loan policy and credit extension to members while highlighting the need for integration of the information system of institutions to employers and the management. Kinuthia (2007) also underscores the need for Ministry of Co-operative Development and Marketing to liaise with Ministry of Immigration and Registration of Persons to be able to instantly access information on departing employees.

According to Ghosh, Islam, & Hasan (2014), to minimize the credit risk there should be proper framework of risk management. A study done by Muriithi (2016) on the various types of risk, found that financial risk components had a negative impact on the financial performance hence there is need to study how risk governance mechanisms affect the financial performance of commercial banks. Kithinji (2010) observed that the bulk of the profits of the commercial banks are not influenced by the credit risk. This contradicts a study done by Muriithi (2016), that found credit risk to be the main determinant of financial performance. The study however failed to look at the credit risk governance mechanisms by use of credit committees affect the financial performance of the commercial banks.

Magnifique (2013), found that credit risk management in Rwanda predicts the financial performance of the commercial banks and that credit analysis has a significant impact on the financial performance on commercial banks. The study however failed to explain the extent to which the credit analysis and management affects the financial performance hence a need to do a similar study here in Kenya. Magnifique (2013), therefore recommended that more studies should be carried out using other mechanisms of risk governance to establish the effect of the credit risk variables on the financial performance of the commercial banks. According to Ahmed & Qaisar (2015), credit risk management practices, had a positive influence on loan

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performance in Pakistan. This study adopted the measures of credit to be credit risk control, the credit policy of the bank, credit terms and policy and client appraisal. There was need therefore to carry out comparative study here in Kenya.

Alshatti (2015), recommended that the banks should establish adequate risk management policies and sound credit-granting process. Banks should put in place sound credit controls. The study however failed to show the effect of risk governance mechanisms through credit committees affect financial performance, justifying a need to look into how size of credit risk committee will affect the financial performance of the commercial banks in Kenya. A study done by Mwangi (2012), showed that there is a significant relationship between the credit risk management and financial performance of the commercial banks suggesting that the banks should adopt credit risk grading system. The study however failed to explain how risk governance mechanisms affect financial performance. Similarly, the study failed to show the extent to which the risk committee size affects the financial performance.

A study done by Gathaiya (2017), on the analysis of issues affecting collapsed banks in Kenya from 2015 to 2016 found that the reasons affecting the commercial banks ranges from insider lending in the banks and weak corporate governance practices. There is also weakness in the regulatory and supervision systems and poor risk management strategies. Commercial banks do not have strong internal controls (Gathaiya, 2017). The proposed study will therefore establish the effect of various risk governance mechanisms dynamics of different banks and the relationship with their financial performance.

Ghosh, Islam, & Hasan (2014), found that credit monitoring, reliability and assurance have an impact on the risk management. Whereas the study showed that credit monitoring, assurance and reliability had an impact on the risk management, there is need to carry out a similar research here in Kenya to establish how the various risk management strategies especially by use of credit risk committee affects the financial performance of commercial banks. Magnifique (2013) found that credit risk management predicts the financial performance of the commercial banks in Rwanda. Similarly, credit risk scoring and assessment had a significant effect on financial performance in commercial banks in Rwanda (Magnifique, 2013). The commercial banks in Kenya have adopted risk governance mechanisms for example by using credit committee to manage risks. There was however limited knowledge on the effect of credit committee on financial performance of commercial banks.

Alshatti (2015) observed that credit risk management has a significant impact on the financial performance of the Jordan commercial banks. The study recommended that banks should improve on the credit risk management by adopting credit risk mechanisms to achieve more profits. The study however failed to capture effect of credit committee on financial

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performance (Alshatti, 2015). Kauna (2015), found that there is a significant positive relationship between credit risk identification, credit risk monitoring and financial performance of the commercial banks in Kenya. The study recommended that commercial banks should put emphasis on the credit risk identification (Kauna, 2015). Commercial banks should therefore put emphasis on risk governance as a risk identification strategy by forming credit committee. The proposed study therefore adds new knowledge on relationship between the risk governance through the risk committee size and the financial performance of the commercial banks in Kenya.

Adverse selection theory

This study will be guided by adverse selection theory. This theory was developed by Arkelof (1970) and was later advanced by Stiglitz (1976). Arkelof states that it is difficult to distinguish good borrowers from the bad borrowers. Commercial banks that deals with lending are exposed to the adverse selection problems in trying to control the credit risks associated with money lending. According to (Otwori, 2013), adverse selection occurs when commercial banks face challenges in obtaining information on credit profile of borrowers. This disadvantages the good borrowers and increases the cost of credit facilities (Otwori, 2013). The lenders in the context of asymmetrical information settings are forced to price their credit facilities in terms of the probability of the borrowers to repay (Mwigwi, 2013).

METHODOLOGY

The study employed longitudinal research design. This enabled the analysis and comparison of secondary data collected from the commercial banks for the study period (2013-2017). The five years period (2013-2017) was selected because this is the period that most banks faced risks and some were placed under receivership and the banks began to put in place mechanisms to manage risks. The latest financial reports from the commercial banks when the study was conducted was for the financial year 2017. For this study, longitudinal research design was ideal to establish the relationship between risk governance mechanisms and financial performance of commercial banks in Kenya. The study targeted all the 42 active commercial banks regulated and licensed by the Central Bank of Kenya (CBK, Annual report and Financial Statements, 2017). The banks were categorized into tiers, tier I, II and III. Secondary data from published financial statements and consolidated reports published by the banks each financial year was extracted. Financial performance was measured using (RoA) return on assets. The sample size and categories of the bank tiers is presented in table 1. The data collected was subject to descriptive and inferential analysis.

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Table 1 Category of Bank Tier

Category	Number	Sample size
Tier I	8	8
Tier II	11	11
Tier III	23	23
Total	**42**	**42**

Source: CBK annual report 2017

ANALYSIS AND FINDINGS

Credit Committee Size and Return on Assets of Commercial Banks

Credit committee size was selected as one of the predictors of risk governance mechanisms in this study. Commercial banks adopt risk committees to help screen out and manage risk exposures hence improving their performance. There is no set standard number on the size of credit committee and therefore commercial banks have different sizes. Data on credit committee sizes was therefore extracted from all the commercial banks. The data was recorded in the extraction form, analyzed and categorized according to the tiers for the various years under study. The findings are presented in Table 2.

Table 2 Credit Committee Size of Commercial Banks 2013- 2017

Tier	2017	2016	2015	2014	2013	Mean
I	3.88	3.63	6.13	6.13	5.88	5.13
II	3.80	4.20	3.70	4.40	4.50	4.12
III	3.88	3.79	3.63	3.84	3.74	3.78
Mean	**3.85**	**3.87**	**4.49**	**4.79**	**4.70**	**4.34**

From the analysis in Table 2, tier I has the highest average size (5.13) of credit committee members while tier III commercial banks have the least number (3.78) of credit committee members. Even though there was an increase in the credit committee size from 4.7 in 2013 to 4.79 in 2014, this was followed by a decrease to mean of 3.85 in the year 2017. To examine the relationship between credit committee size and RoA, a regression analysis was done. This aimed at testing the relationship between credit committee size and financial performance of commercial banks. The findings are presented in Table 3.

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Table 3 Regression analysis between Credit Committee Size and Return on Assets (2013-2017)

	β	SEb	β	T
Constant	-2.842	2.110	-	
Main effects				
Credit committee size	1.259	0.476	0.591	
R				0.591
R Square				0.350
Adjusted R Square				0.300
R Square Change				0.350
Model F Change				6.992
Model Summary df				1
Sig. F Change				0.020
Durbin Watson				2.746

Note: Dependent variable, Risk committee

*The significance levels *p<0.05; p**<0.01*

The results indicated a significant positive relationship between credit committee size and financial performance measured by the return on assets with (Pearson correlation of r= 0.591, p=0.020, R^2 = 0.350, Adjusted R^2= 0.300, p<0.05). This indicates that credit committee size is significantly positively correlated with the financial performance measured by the RoA with a coefficient of r=0.591. The study also found that the model only explains 35 percent of the financial performance of the commercial banks in Kenya. When the credit committee size is zero the financial performance measured by the RoA will be -2.842. From the findings of the study, a one-unit change in credit committees' size, the return on asset changes by 1.259 units. The regression equation for this model will therefore be:

$$Y = -2.842 + 1.259_{CC}$$

From these findings, it can be concluded that as the size of the credit committee increases, the financial performance of the commercial bank also increases. The findings of this study confirm previous studies by Magnifique (2013) who observed that credit risk management significantly predict financial performance, while Alshatti (2015) observed that risk management significantly impact the financial performance of commercial banks in Jordan a country with different GDP as Kenya.

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CONCLUSION AND RECOMMENDATIONS

The study found a significant positive relationship between credit committee size and financial performance. This study therefore concludes that credit committee size and financial performance are positively correlated. This study recommends that commercial banks should fully adopt use to credit committees and also increase the number of members to this committee. This will help commercial banks to identify, manage and finally eliminate risk exposure and improve performance of the commercial banks. Central bank of Kenya being the regulator should also pass a policy requiring all commercial banks to implement credit committee as a mechanism of managing risk exposure.

This study was limited only to commercial banks regulated by the Central Bank and the findings is only limited to commercial banks. The study recommends that further study can be done on other banking sectors like micro finance banks that have a smaller market share compared with the commercial banks and SACCOs (Savings and Credit Cooperative Societies) that is regulated by Sacco Societies Regulatory Authority. This is because of the difference in the asset base and operating principles between commercial banks, micro finance banks and Saccos. The study used longitudinal research design and there may have been difference in the economic conditions across various years, this study therefore recommends further studies should be done using other methodologies like cross sectional research design and this will eliminate the issue of difference in economic conditions across the years under study.

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