EFFECT OF LENDING PRACTICES ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA: A SURVEY OF SELECTED BANKS WITHIN NAIROBI

BY

ANN NJERI MAINA

UNITED STATES INTERNATIONAL UNIVERSITY – AFRICA

FALL 2016
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A Research Project Report Submitted to Chandaria School of Business in Partial Fulfilment of the Requirement for the Degree of Masters in Business Administration (MBA)

UNITED STATES INTERNATIONAL UNIVERSITY-AFRICA

FALL 2016
DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than United States International University in Nairobi for academic credit.

Signed: ___________________________  Date: ___________________________

Ann Njeri Maina (ID 645118)

This project has been presented for examination with my approval as the appointed supervisor

Signed: ___________________________  Date: ___________________________

Dr. Juliana Namada

Signed: ___________________________  Date: ___________________________

Dean Chandaria School of Business
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ABSTRACT

This study was undertaken to examine the effect of lending practices on financial performance of commercial banks in Kenya. The study was driven by the realization that NPLs continue to be a major challenge that is likely to threaten the profitability of commercial banks. The main objective of the study was to examine; the effect of know your customer procedures, interest rates, and bank credit policies on financial performance for commercial banks. Essentially the purpose of the study was to determine the effect of lending practices on profitability of commercial banks in Kenya. The focus of the study was commercial banks that are listed in Nairobi Securities Exchange.

The study adopted a descriptive research design to accomplish the research objectives. The target population for the study was all the listed commercial banks in Nairobi County. Purposive sampling was used to select 57 respondents to participate in the study. The study relied on a structured questionnaire as the main tool for data collection. The questionnaire was split into two sections with initial section covering the background information about the respondent. Succeeding sections covered the intricacies of the study where closed questions were presented to the respondent with a 5 – point scale which indicated the different levels of satisfaction. Upon completion of the field survey, the results questionnaires were computed in the SPSS software version 20, and results from the survey were presented using tables capturing different measures of dispersion.

The study found that KYC procedures were extremely useful in shielding the commercial banks against exposures to negative credit transactions with unqualified borrowers. Using regression analysis, the study found a significant relationship between the KYC procedures and the financial performance of commercial banks. The study found that interest rates wielded significant influence on the rate and volume of borrowing in commercial banks. Further the study used regression analysis to pinpoint the significant relationship that existed between the interest rates and the financial performance. The study found that credit guidelines policies were vital in enhancing efficiency in the lending operations and finally the study found that there exists a significant relationship between credit policy guidelines and financial performance of commercial banks.

The study concluded that, KYC procedure serve as the critical defence line for the commercial banks against fraudulent transactions. Further, the study makes a conclusion that higher interest rates result in slowdown in borrowing but consequently result in
positive financial performance in terms of revenues for commercial banks. The study makes a conclusion that, credit policy guidelines define the official operational model that a commercial bank operates when making all transactions related to the lending services, that’s why experts, customers and scholars contribute suggestions on best policy direction.

The study recommends for adoption of global standards in effecting KYC procedures in commercial bank. Also the financial institutions should be free to share information about customers amongst the industry players and also the authorities to ensure smoothness in carrying out lending operations. The study finally recommends for the adoption of innovative strategies in creating credit products in the face of interest rate capping (ROK, 2016), as it only way of staying afloat in the turbulent times.
ACKNOWLEDGEMENT

In bringing this study to fruition, many individuals have contributed, and I express my
grateful to them all. First of all I would like to thank God almighty for giving me the
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Her consistency and constructive criticism have been invaluable to me in bringing this
study to completion. Finally I am also grateful to the writers and scholars whose works I
have cited within this study.
DEDICATION

This research project is dedicated to God for giving me life, wisdom and strength throughout the research period, to my parents for showing me the importance of education and learning at a tender age in life and to my husband Nicholas Murimi for support accorded to me.
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<td>ANOVA</td>
<td>Analysis of Variance</td>
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<tr>
<td>CBA</td>
<td>Commercial Bank of Africa</td>
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<td>CBK</td>
<td>Central Bank of Kenya</td>
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<tr>
<td>CIS</td>
<td>Credit Information Sharing</td>
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<td>CRBs</td>
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<td>DTM</td>
<td>Deposit Taking Microfinance’s</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>KYC</td>
<td>Know Your Customer</td>
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<td>LLR</td>
<td>Loan Loss Reserve Ratio</td>
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<td>MPC</td>
<td>Monetary Policy Committee</td>
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<td>NPLs</td>
<td>Non-Performing Loans</td>
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<td>NSE</td>
<td>Nairobi Stock Exchange</td>
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<td>RCR</td>
<td>Risk Coverage Ratio</td>
</tr>
<tr>
<td>SPSS</td>
<td>Statistical Package for Social Sciences</td>
</tr>
<tr>
<td>USA</td>
<td>United States of America</td>
</tr>
<tr>
<td>WOR</td>
<td>Written-Off Ratio</td>
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<tr>
<td>FATF</td>
<td>Financial Action Task Force (on money laundering)</td>
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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Problem

Banking operations undertaken by commercial banks and the services offered are diverse and well spread out. Lending however remains the principal operation that forms the backbone of banking services (Basel, 2002). Lending practises are central to the realization of critical banking objectives with financial performance being the baseline yardstick for the sector. All banks understand clearly the sensitivity of lending practices and how they can influence banking services. They are at the top of the priority list for the banking operations. The realization that lending practices form a major component of banking services; any shortcoming in practice can significantly hurt the overall financial performance of the bank (Kenneth & Thygerson, 1995).

Commercial banks are one of the major sources of funding to business activities as well as other projects in Kenya. They mobilise deposits from surplus sectors to deficit sectors in form of loans and advances. Daniel and Wandela (2013) noted that commercial banks play a great role to developing economies by providing borrowers with access to capital in form of loans. According to a survey carried out in 2006 on the banking sector in Ghana, Loans account for a total of 50% of bank’s assets which had increased from 41.5% in 2005 (Appertey and Arkaifie, 2006). In 2009 the figure had increased to 59% of the industries total assets (info data associates, 2010). A financial report of ADB in 2009 indicated that 66.5% interest income earned by commercial banks was from loans and advances. The reason why banks give much attention to lending activity.

Advances in financial sector have rallied changes in the whole industry, making it crucial for the assessment of financial performance of banks in this modern age. Financial Performance is the degree to which a bank’s, a company’s or a firm’s financial objectives are accomplished by measuring the company’s policies and operations in monetary terms and further used to monitor financial risk management (Kenneth & Thygerson, 1995).

Financial performance of an organization, institution or a bank is used to benchmark the particular bank’s financial health within the industry or related firms performance (Riahi-belkaoui, 2003). In the face of positive financial performance, consistency is central to
long-term profitability. Compounded by the market volatility and intense competition, financial institutions are faced with urgent need to reassess the most critical portfolio’s that are central to profitability and these are the risk assets credit performance. Lending practises inform the credit risk status and the performance of risk assets therein influencing on the financial performance for commercial banks. Kenneth and Thygerson (1995) acknowledged that accomplishing credit risk management was paramount for the financial institution to understand its financial analysis, documentation on loans, loan servicing and covenants including also the environmental analysis.

According to Decra (2012), the banking sector is considered to be an important source of financing for most businesses. Increase in financial performance leads to more improved functions and activities of any organization. It has effect on total economy of the country and the activities of any organization. This is because banks form better sources of finance for better job opportunities development of new ideas, research and overall prosperity. Various factors have been considered important in shaping the performance of banking institutions. These factors as noted in (Decra, 2012) include bank size as measured by its assets, profitability as measured by returns on assets and equity, size of deposits and loans as well as the percentage of NPLs in the total. Of particular importance to underscore in the aforementioned factors are loans and the percentage of NPLs.

In modern economy, most money takes the form of bank deposits (Houghton, 2009). According to Houghton, the principle way through which these deposits are created is through banks giving loans. Whenever, a bank makes a loan, it simultaneously creates a matching deposit in the borrowers account, thereby creating new money. Rather than banks receiving deposits when households save and then lending them out, lending creates deposits. In normal times, the central bank does not fix the amount of money in circulation nor is the central bank money multiplied into more loans and deposits (WBR, 2007). Though commercial banks create money through lending, they cannot do so freely without limits. Banks are limited in how much they can lend if they are to remain profitable in a competitive banking systems. Prudence in lending practices and prudential regulation also act as constraints on banks activities in order to maintain resilience of the banking system.

Financial analysis guide the financial performance of a firm/industry, the analysis is based on financial/accounting procedures using the respective financial statements:
balance sheets, comprehensive income statement, cash flow statements among other statements (Riahi-belkaoui, 2003). The financial statements give a guide on two important factors profitability and financial soundness of a firm however; they do not reveal all the information related to the financial operations (Basel, 2002). The analysis is done concerning the following ratios: working capital ratio, profitability ratio, financial structures ratio and many more. The profitability ratio has a direct link to the lending practices and process/procedures taken up by the respective firms or banks since these significantly determine their financial performance and well-being.

The decision to lend out finances by the commercial banks is always influenced and guided by numerous factors based on the prevailing circumstances like interest rates, economic fluctuations, and potential of the borrowers to repay the loans or advance among other factors (Bessis, 2005). The other factors guiding the lending capacity of banks are inclusive of: the bank’s liquidity ratio, level of domestic and foreign investment in the economic as well as in the bank and volume of deposit for a given period. Costumer’s deposits directly determine the ability of the commercial banks to lend out their finances, whenever the banks gives loans or advances in excess of its cashing ability deposits amounts, the bank soon runs into difficulty in meeting its customers’ cash drawings and lending ability (Zeller, 2001).

Lending practices are long dated and for many years up to 2007, interest rates were very low in Western countries and money was cheap (Berend, 2013). Banks need to lend as much as they can if they are going to make the level of profits that they were used to. Some banks for instance in the USA lent to poorer people who had less chance of paying back their loans than the traditional customers (Berend, 2013). To manage risks, banks invented new and complex ways to lending processes and invested in new ways way to package up the debts. This involved turning loans that could not be traded into type of security that could be traded in ultimately. This allowed these debts to spread out to other banks so they did not feel so exposed to risks, lending looked safe because it was in form of mortgages on people’s home. People were buying many goods, Western economies were growing, inflation was low and there were cheap goods to purchase from China and other emerging economies (Berend, 2013).

Commercial banks are a financial institution that accepts deposits and gives loans or advances legally and are also known as joint stock banks (Gallegher, 1989). The
economic growth of a country, region, continent, and globally in general is vitally influenced by the commercial banks trading, which are the most important financial savings and lending, mobilization and financial resource allocation institutions in an economy. According to Omowunmi, (2011) commercial banks in Nigeria need to understand how to manage these huge assets in terms of their loans and advances.

Lending practice influence the profitability level of the commercial banks significantly, if proper procedure and regulation are taken up for loan repayment and recovery processes, the loan are the greatest source of revenue/ profits to the banks compared to customer deposits (Zeller, 2001). A study by Omowunmi in (2011) notes that the current trend in Nigerian banking and finance sector in 2011, suggested that the days of cheap profits were over and only banks with well conceptualized lending and credit administration policies and procedures could survive the emerging competition. The policy instruments set in Nigeria by 2011 to regulate banking operations were inclusive of rigidly administered interest rate structure, unremunerated reserve requirements, directed credit, and stabilizing liquidity control measures.

In the modern economy, commercial banks have a myriad of functions (Zeller, 2001). Firstly, they provide a safe deposit for money and other valuables. Secondly, they lend money to borrowers partly because they charge interest on the loans, which is a source of income for them, and partly because they usually lend to commercial enterprises and help in bringing about development. Thirdly, they provide safe and non-inflationary means for debt settlements using cheques, in that no cash is actually handled. This is particularly important where large amounts of money are involved. Fourthly, they act as agents of the central banks in dealings involving foreign exchange on behalf of the central bank and issue travelers’ cheques on instructions from the central bank. Finally, they offer management advisory services especially to enterprises, which borrow from them to ensure that their loans are properly utilized (Bessis, 2005; Tang and Jiang, 2003).

The aforementioned scenario is not new in Kenya and other African countries. Kenya continues to experience banking problems that have led to failure of major banking institutions. According to Waweru and Kalani (2009), at the heart of the financial performance of many financial institutions is lending. Central Bank of Kenya report (2001) indicated that Kenya had comparatively high levels of NPLs at 33% compared at NPLs of other African economies at the end of 2000 which has a ration than these countries. For instance Zimbabwe was at (24%), Nigeria it was (11%) and South Africa it
was 3% which was lowest among most African economies. According to Mullei (2003), banks were placed under statutory management for failing to meet the minimum core capitalization threshold as well as poor management of loan portfolios. Lending practices therefore denote prudence measures that banking institutions undertake before issuing loans to client. As concerns to this study, these practices include KYC procedures, interest rates, partnership with credit reference bureau and credit policy principles.

1.2 Statement of the Problem

Lending activities are the heartbeat of all financial institutions. Basel (2002) found that lending portfolio formed the largest source of operating income. Despite its strong contribution to the financial performance of banking institutions, lending portfolio is still exposed to shocks that have the potential derailing all the positives. Houghton (2009) observed that weaknesses in lending standards amongst lenders was a major factor in derailing the performance of the loan portfolio with NPL’s being cited as the major pitfall in the sector. Lenders weaknesses in mitigating NPL’s has been the biggest contributor in the stumbling the financial performance of commercial banks (Basel, 2002; Houghton, 2009). This said, Kenya still struggles with the problem of NPLs that has caused stagnation of economic resources and provoked cautious behaviour of corporation and consumers due to decline in confidence in the financial markets.

Various studies have been undertaken to establish lending practices and financial performance. Nkrumah (2014), undertook a study to investigate the factors affecting NPLs at the Commercial Bank of Africa. He highlighted that macro-economic factors shaped people’s loan repayment schedules. He found a negative significant relationship between market forces that keeps the economy functioning due to real GDP, per capital growth, past inflation rates and real effective interest rates on NPLs. Khole (2012), on effects of unsecured lending on loan performance of commercial Banks in Kenya established a significant negative effect on loan performance influenced by unsecured commercial bank loans raising the need for right policies and controls to uphold the policies in lending right from origination, approval, monitoring and debt recovery. Pyle (2007), in his study on bank risk management held that banks and similar financial institutions need to meet forthcoming regulatory requirements for risk measurement and capital. However, he underscored that it was a serious error to think that meeting regulatory requirements was the sole or even the most important reason for establishing a sound, scientific risk management system. It was held, managers need reliable risk
measures to direct capital to activities with the best risk/reward ratios. They need the
estimate of the size of potential losses to stay within limits imposed by readily available
liquidity, by creditors, customers and regulators. Parker and Nagarajan (2001) in his study
of risk management for microfinance institutions in Mozambique found that risk
management is a dynamic process that requires careful planning and commitment by
building robust institutional infrastructure with skilled human resources and inculcating
client discipline to minimize risks related losses through diligent management of portfolio
and cash flow. Achou and Tengu (2008), research on bank performance and credit risk
management, found that there is a significant relationship between financial institutions
performance (in terms of profitability) and credit risk management (in terms of loan
performance). Though there are notable efforts to examine the link between banks credit
policy guidelines and financial performance, no conclusive evidence has been provided to
examine how credit policy guidelines affect financial performance for commercial banks
in Kenya.

From the mentioned empirical studies there’s a need to take a close look at the
relationship between the lending practises that are currently practised by commercial
banks and the resulting financial performance of the banking institutions. This study will
seek to evaluate the mechanisms that drive the lending practises and the consequent
outcome on the financial performance of commercial banks. The study will examine the
efforts that revolve around the external factors and how it influences the internal lending
practices and procedures by commercial banks and how it affects financial performance.
It is therefore on this basis that this study shall be undertaken to establish the relationship
between lending practices and financial performance of commercial banks in Kenya.

1.3 Purpose of the Study

The purpose of this study was to determine the effect of lending practices on financial
performance of commercial banks in Kenya.

1.4 Research Questions

The study was guided by the following research questions:

i. What are the effects of Know Your Customer procedures (KYC) during lending
   practices on financial performance of commercial banks in Nairobi?

ii. To what extent does interest rate on loans affect financial performance of
    commercial banks in Nairobi?
iii. What is the effect of bank’s credit policy guidelines on financial performance for commercial banks in Nairobi?

1.5 Justification of the Study

Banking industry in Kenya plays a significant role towards promotion of country’s economic growth and development. Efficient lending practices will be extremely significant on the financial performance of commercial banks and enhance effective delivery of financial services to many customers in different industrial sectors and this impact positively on country’s economic development. This study will play an important role in helping bank managers to understand the nature and characteristics of different lending practises that contributes towards realization of increased financial performance of commercial banks. The findings will also assist bank managers to develop a guiding framework on how to successfully implement lending practises.

1.6 Significance of the Study

This study contributes to the betterment of the following areas of specialisation.

1.6.1 Researchers and Scholars

The study is of practice significance to both academicians and general practitioners as a source of knowledge and influence of lending practises on the financial performance of commercial Banks. The study report will act as reference and stimulate the interest among academicians and this will encourage further research on how lending practises contributes towards realization of positive organization performance. It is expected to contribute to literature and form part of empirical review and may inspire prospective researchers to explore more dimensions within the context of lending practice and financial performance. The study is also expected to inform and enlighten the public the importance of prudent lending practices undertaken by financial institutions.

1.6.2 Policy makers

The findings will important to regulators of commercial banks in Kenya in particular to the Central Bank of Kenya (CBK) that conducts the overall supervision. CBK fosters solvents, liquidates and monitors proper functioning all the financial institution inclusive of the commercial banks by ensuring that all financial institutions are governed by the appropriate rules, laws and regulations and further ensure that the laws remain relevant by continuous reviewing it based on the current financial and market trends. The information will be useful in their role of promoting financial institutions performance through
incorporation into the CBK act, banking act and other related Acts which help in monitoring lending procedure and practice within the commercial banks in Kenya—an example is the Finance Act (2012), to provide a platform for sharing of both negative and positive credit information among banks by use of Credit Information Sharing (CIS) and Credit Reference Bureaus (CRBs).

1.6.3 The Management of Banking Institutions

The board members and stakeholders including the management are responsible for putting structure in place to ensure that that prudence is observed during lending. This study will seek to examine the extent to which each practice relates with financial performance in the quest to determine the most suitable and effective lending practice. The study is of great significance to board members and stakeholders in commercial Banks since the obtained findings will help them understand the relationship between lending practices and organization performance. This will help them to clearly understand how effective lending practices can contribute towards realizations of increased commercial banks performance.

The study findings will also be of great significance to the managers in the commercial banks since the obtained findings will equip Bank managers with competitive strategic management skills enabling them develop credit risk management policies that will result to effectively formulated and implemented lending practices to achieve their long term goals. The findings will further influence the Bank management to fully understand how lending practices affects the level of organization performance and measures that should be embraced to support successive lending policies that leads towards realization of increased banks performance.

1.7 Scope of the Study

The study will seek to examine the effect of lending practices on financial performance of banking institutions in Kenya. The study will mainly focus on major banks within Nairobi County. The study will focus on lending practices and particularly limit itself to: the effect of know your customer procedures (KYC), interest rates and credit policy guidelines on financial performance of commercial banks. The target population for the study will be banks managers within the top, middle and lower level categories as well as credit managers. The study will be conducted over a period of six months.
1.8 Definition of Significant Terms

1.8.1 Credit policy guidelines
Statements that guide the bank on what is procedures to be followed during lending process and approval of loans to clients (Araga, 2011)

1.8.2 Financial Performance
A subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is also used to measure overall firm’s financial health over a given period (Waweru & Kalani, 2009).

1.8.3 Interest
The proportion of the loan that is charged as interest to the borrower, typically expressed as an annual percentage of the loan outstanding (Grand Valley State University, 2015)

1.8.4 Know Your Customer (KYC)
Customer identification procedures to prevent identity theft, financial fraud, money laundering and terrorist financing. While opening different accounts, the Bank collects documents to identify and verify the customer as required under the existing laws to demonstrate that it has performed the existing KYC procedures (Coinonline 24, 2015).

1.8.5 Lending
Making funds available to another party (organizations or individuals) to be repaid at an interest and other associated fee. Banking institutions are lenders and provide funds for variety of reasons such as mortgage, automobile, loan or small business loan.

1.8.6 Non-Performing Loan (NPL)
A loan that has not been receiving payments for ninety days or more. The magnitude of non-performing loans is a key element in the initiation and progression of financial and banking crises (Tiffany and Greenidge, 2010).

1.9 Chapter Summary
This chapter has introduced the study on lending practices in relation to financial performance of banking institutions in Kenya. A description of financial performance as a core indicator of measuring the well-being of banking institutions is given. With banks offering credit facilities in terms of loans, exposure to credit risk has been highlighted as eminent given the increasing rate of NPLs. This has been considered as the basic premise under which application of lending practices come into place. The study seeks to answer the question on the extent to which lending practice affect financial performance. The chapter further covers problem statement, purpose of the study, research questions, and
the scope, significance of the study and definition of key terms. The subsequent chapters are on literature review, chapter three deals with the research methodology, in Chapter four the researcher made a summary of the results and findings of the study. And in Chapter five conclusion and recommendations of the study are provided.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction
This chapter provides the literature review on lending practices in relation to financial performance for banking institutions in Kenya. The study examines lending practices with reference to the effect of Know Your Customer procedures (KYC) during lending practices, the effect of interest rates on loans on financial performance and bank’s credit policy guidelines affect financial performance.

2.2 Know Your Customer (KYC) Procedures and Financial Performance
Know Your Customer (KYC) is a business practice that entails verifying the identity of clients. It is the due diligence and bank regulation that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them (Roebuck, 2012). A key aspect of KYC is monitoring transactions of a customer against their recorded profile, history on the accounts and with peers. The objective of KYC guidelines is to prevent banks from being either intentionally or unintentionally through criminal elements of anti-money laundering activities. As such, know; your customer procedures enable banks to understand their customers better and their financial dealings. In order to manage their risks prudently, banks frame their KYC policies including incorporating the elements of customer policy, customer identification procedures, monitoring of transactions and risk management (Builov, 2007).

The main objective of regulation in the banking sector is to safeguard public savings, instil stability in financial systems and prevent abuse of the financial system (Peter & Hudgins, 2005). Sound KYC procedures are critical elements in the effective management of banking risks. It safeguards go beyond simple account opening and recordkeeping and require banks to formulate a customer acceptance policy and a tiered customer identification program that involves more extensive due diligence for higher risk accounts. Customer due diligence consists of identifying the customer and verifying their identity; identifying the beneficial owners of the customer and assessing on a risk-sensitive basis whether or not to verify those beneficial owners; and obtaining information on the purpose and intended nature of the business relationship (Builov, 2007).
2.2.1 Customer Identification and Financial Performance

In explaining, the importance of KYC, Tsivagnanasih (2009), indicated customer identification procedure is carried out at different stages while establishing banking relationship. Carrying out a financial transaction or when the bank has doubt about the authenticity or adequacy of the previous obtained customer data. Being satisfied means that the bank must be able to satisfy competent authorities that due diligence was observed based on the risk profile of the customer in compliance with the extent guidelines in place. Such risk-based approach is considered necessary to avoid disproportionate cost to banks and burdensome regime to customers (Abrams et al, 2007). KYC conformity in banking institutions creates auditable evidence of due diligence activities.

In addition to need of customer identification, , Abrams et al (2007) indicated that KYC conformity was important in ensuring that banking institutions are not defrauded and other financial crimes such as money laundering or organized crime do not take place. He further underscored the importance of banking institutions knowing the sources of funds in their customers’ accounts. In the observation of Woldsberg group (2002), it was noted that bank have to confirm the identity of business account holders and generate profiles on them in order to detect any activity that is contradictory with account holder’s business or income. Pieth and Aiolfi (2003), indicated that it was the responsibility of banks’ internal audit and compliance functions to evaluate and ensure compliance with KYC policies.

Prevention of money laundering has been the largely emphasised reason why banks have to undertake KYC procedures. Valsamis (2003) placed emphasis on the need for banks and building societies to set up KYC systems for prevention of money laundering which underpins all the other activities. According to the Federal Financial institutions Examination Council (2011), all commercial banks must have written Customer identification Program which must be implemented to enable banks to form reasonable beliefs that it knows the true identity of each of its customers. The program must include account-opening procedures that should specify the information to be obtained from each customer. Adequate verification processes must follow to ensure the bank has no reasonable doubt on its customers.
Establishment of a relationship between a bank and its customer is initially pegged upon information received from the customer and how the staff handling the customer perceives and goes about ascertaining the validity and reliability of this information (Builov, 2007). False information delivered with or without evil intentions creates a permanent untruthful view of the customer by the bank. Whether any further KYC information is required or verified will depend on the money laundering/terrorist financing risk relevant to the provision of the designated service. The regulations on the customer and beneficial owner classification in the financial organizations brought the new dimension emphasized in global documents— the dimension of beneficial owners’ identification (Valsamis, 2003).

Banks are required to know all types of their customers not only at a customer level but also at a contract level monitoring the clients' accounts movements. A financial institution is required to obtain proof of identity of its customers, especially new customers opening accounts. The customer names and addresses are then to be compared to sanctions lists of suspicious or designated persons that are regularly produced by government agencies (Wolfsberg Group, 2002). The anti-money laundering policy is a global policy designed to ensure that all employees and businesses of the entity are well informed with respect to their customers and the nature of the transactions processed through their accounts. The policy addresses the significance of thorough KYC procedures and monitoring of foreign correspondent bank relationships (Builov, 2007).

Gibbons (2003) suggested that it was critical to ensure observance regarding customer identification (“Know Your Customer” principles), obtaining verifying information and record keeping, it is incumbent upon the relationship manager to perform the requisite KYC due diligence involved in a new customer relationship. Builov (2007) further states that KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently. Banks should frame their KYC policies incorporating the following four key elements: Customer Acceptance Policy; Customer Identification Procedures; Monitoring of Transactions; and Risk management.

The policy approved by the Board of banks should clearly spell out the Customer Identification Procedure to be carried out at different stages i.e. while establishing a banking relationship; carrying out a financial transaction or when the bank has a doubt about the authenticity/veracity or the adequacy of the previously obtained customer
identification data (Markov, 2007). Customer identification means identifying the customer and verifying his/her identity by using reliable, independent source documents, data or information (Vargas & Backhouse, 2003). Banks need to obtain sufficient information necessary to establish, to their satisfaction, the identity of each new customer, whether regular or occasional, and the purpose of the intended nature of banking relationship.

Being satisfied means that the bank must be able to satisfy the competent authorities that due diligence was observed based on the risk profile of the customer in compliance with the extant guidelines in place (Gibbons, 2003). Such risk based approach is considered necessary to avoid disproportionate cost to banks and a burdensome regime for the customers. Besides risk perception, the nature of information/documents required would also depend on the type of customer (Vargas & Backhouse, 2003). The level of due diligence to be undertaken depends on a number of factors, including the type of customer. For example, there are different requirements for individuals, corporations, trusts, partnerships, associations, co-operatives and government bodies. Simplified verification procedures are available for domestic listed companies and some regulated trusts (Markov, 2007).

For other types of companies and trusts, more detailed information (including information on directors, beneficial owners and trust beneficiaries) may be required. In certain circumstances, for instance, where a suspicious matter arises, it may be necessary for a reporting entity to carry out a customer identification procedure on an existing customer or to re-verify a customer that has already been the subject of a customer identification procedure (Gibbons, 2003). Customer identification is at the core of any bank’s reputation and as such agents should take steps to ensure they know their customers (Hopton, 2009). Establishing your customers’ identity reduces the likelihood of a bank facilitating money laundering. It assists banks to look at potentialities of fraud customers who cannot account for their source of wealth. Customer identification ensures that only legitimate and bona fide customers are accepted. Reliable and independent documentation should be used to facilitate this process.

### 2.2.2 Money Laundering and Financial Performance

According to Strategic Intelligence Unit of the Crime and Misconduct Commission, money laundering is the process by which proceeds from criminal activity are disguised...
to conceal their illicit origin’. Normally the money involved is derived from an illegal enterprise and the aim is to make that money appear to have come from a legitimate source. It basically refers to the activities and financial transactions that are undertaken with the aim of hiding the true source of the funds. (FATF, 2004). Around 2000, the IMF (2003) as well as the World Bank estimated that 2-4% of the world gross domestic product (GDP) stems from illicit (criminal) sources. Money laundering involves concerted efforts aimed at covering traces of illegally acquired money (Agarawal and Agarwal, 2005).

Agarwal and Agarwal (2006) estimate from forecasts, from regression analyses and taken from economic intelligence units, that global money laundering amounts to more than 2.0 to 2.5 trillion US$ annually or about 5-6% of World GDP in 2006 (44,444 trillion US$ in 2006) to be contrasted against an observed figure of US$ 500 billion to one trillion in 2004 (Agarwal and Agarwal, 2004) within the banking sector only. Recent IMF estimates on money laundering by the drug traffickers who “introduce” the proceeds gained through the role of drugs into the legitimate financial market amount to between 2-5% of world’s GDP, about 600 billion annually. The IDB (2004) reaches the conclusion that for Latin America a rough estimate appears to be somewhere between 2.5 and 6.3 % of annual GDP of Latin American countries. A great deal of the money derives from drug-dealing, with total revenue of 338 Billion USD in 2006.

Reuter and Truman, (2004) on the severity of harm was that Drug traffickers are unable to manage large sums of money in small denominations frequently. Other blue-collar crimes involve illegal gambling and bookmaking, people smuggling, and organ trafficking for which money laundered is net profits from the activities. Crimes such as white-collar category which includes embezzlement, fraud and tax evasion have money laundering as a component (Hutter, 2005). Public officials stand to benefit from their decisions through bribery and corruption. Terrorism is said to put both legitimate and criminally derived funds to criminal use and the funds used are believed to be modest.

The process of money laundering involves three common stages which are ‘Placement’, ‘layering’ and ‘integration’ through which criminal proceeds are laundered (Molander, Muzzington and Wilson 1998). They can occur either at the same time (in the course of a single transaction) or in separate transactions. While the three stages are not always present in every money laundering activity, they are a useful way of analysing the process of legitimisation process of legitimisation. Knowing your customer makes it easy for
banks to monitor their customer accounts and transactions to prevent and detect illegal activities (Muller et al, 2007). When financial institutions are used for money laundering, their financial soundness and stability is jeopardized. This also jeopardizes the confidence of a financial system as a whole.

According to Ottichulo (2015), commercial banks are custodians of public funds and therefore undergo a statutory inspection exercise by the Central Bank of Kenya as the regulator in order to determine way of running business and further KYC compliance and their effectiveness within the institution. Various frameworks are centred on the inspection framework to determine how best banks mitigate risk against them. Much of the banking industry's counter measures will stem from a solid KYC procedure with a tiered monitoring system of certain accounts wherein “red flags” for any un-usual behaviour are set and these risks will vary along bank-product lines (Peter and Hudgins, 2005). These principles as laid down have been widely accepted and adopted by jurisdictions throughout the world as a benchmark for commercial banks and a good practice guideline for all other categories of financial institutions.

The collapse of several Kenyan banks in the 1980 – 1990s gave credence to the fact that an ineffective regulator possibly due to political and other forces interference played a bigger role in the performance of the industry. KYC procedures have been underscored by various researchers as important in preventing malpractices in banking. Scherrer (2006) indicated that the integrity of banking and financial services market place depended heavily on the perception that its functions are within a framework of high legal, professional and ethical standards. KYC procedures in place are the most valuable assets of a financial institution (Murithi, 2013). It prevents institutions from being drawn into active complicity with criminals and becoming part of criminal networks.

When evidence of complicity is established within a banking system, Scherrer (2006) noted that there would be a damaging effect on the attitudes of other financial intermediaries, regulatory authorities as well as customers. According to FATF (2003), KYC procedures that thwart malpractices were said to make banking institutions more credible and attract more clients and in return enable the bank make substantial profits. The integrity of the banking and financial services marketplace depends heavily on the perception that it functions within a framework of high legal, professional and ethical standards. A reputation for integrity is the one of the most valuable assets of a financial institution (Hutter, 2005).
If funds from criminal activity can be easily processed through a particular institution – either because its employees or directors have been bribed or because the institution turns a blind eye to the criminal nature of such funds – the institution could be drawn into active complicity with criminals and become part of the criminal network itself (Murithi, 2013). Evidence of such complicity will have a damaging effect on the attitudes of other financial intermediaries and of regulatory authorities, as well as ordinary customers (FATF, 2006). Potential negative macroeconomic consequences of unchecked money laundering, one can cite inexplicable changes in money demand, prudential risks to bank soundness, contamination effects on legal financial transactions, and increased volatility of international capital flows and exchange rates due to unanticipated cross-border asset transfers (Agarwal and Agarwal, 2006).

Also, as it rewards corruption and crime, successful money laundering damages the integrity of the entire society and undermines democracy and the rule of the law. Full implementation of anti-money regulations will make the bank more credible and attract more clients and in return the bank will make substantial profits (FATF, 2003). Commercial banks should be aware that the statutory definitions of the crime of money laundering and, even more so, the predicate offenses that are held to generate illicit proceeds, vary considerably among jurisdictions (Hutter, 2005). Accordingly, and not always in a clear a priority manner, there can be wide variation in what constitutes unusual and suspicious activity and legally reportable conditions of suspicious activity.

2.3 Interest Rates and Financial Performance

Interest rate is the amount charged, expressed as a percentage of principal by a lender to a borrower for the use of assets (Investopedia, 2015). According to Christiano and Fisher (2003), interest rate is the price of money and the link between income and capital and this is the percentage of premium paid on money on one date in terms of money to be in hand one year later. Interest rate on loans is therefore the money the lender charges the borrower for using borrowed funds (Crowley, 2007). According to Lloyd (2006) and McConnell (2009), interest rates are a price paid for borrowing funds expressed as a percentage per year. It can also be defined as the price a borrower needs to pay to the lender for transferring purchasing power to the future.

Wensheng (2002) carried study on the Impact of Interest Rate Shocks on the Performance of the Banking Sector. The study found out rise in the Hong Kong dollar risk premium,
signified by a widening of the spread between Hong Kong dollar and US dollar interest rates would influence banks’ profitability mainly through its impact on asset quality that affects provisioning charges and net interest margin. A change in the domestic interest rate along with the US interest rate had little impact on the margin in the period under study. If expectation of the people is that interest will rise many people will avoid borrowing this in return will affect bank performance due to reduced earning on interest rate, but people expect interest rate to drop people would be willing to borrow and this will improve banks performance due to increase in interest rate earning (Bekaert, 1998).

2.3.1 Interest Rate Spread and Financial Performance

Interest rate spread is the margin between interest income and interest expense as a percentage of total earning assets (Brock & Rojas, 2000). Spread is defined by market microstructure characteristics of the banking sector and the policy environment. Risk-averse banks operate with smaller spread than risk-neutral banks since risk aversion raises the bank’s optimal interest rate and reduces the amount of credit supplied. Emmanuelle (2003) argued actual spread, is influenced by monetary and fiscal policy. A major indicator of banking sector efficiency is interest rate spreads (Randall, 1998; Brock and Suarez, 2000; Chirwa and Mlachila, 2004; Gelos, 2006; Crowley, 2007).

Asmare (2014) found critical importance of interest rates spread on economic growth and financial performance. Quaden (2004), for instance, argues that a more efficient banking system benefits the real economy by allowing ‘higher expected returns for savers with a financial surplus, and lower borrowing costs for investing in new projects that need external finance’. Therefore, if the banking sector’s interest rate spread is large it discourages potential savers due to low returns on deposits and thus limits financing for potential borrowers (Ndung’u and Ngugi, 2000). Valverde et al (2004) elucidate by noting that because of the costs of intermediation between savers and borrowers, only a fraction of the savings mobilized by banks can be finally channelled into investments. An increase in the inefficiency of banks, increases these intermediation costs, and thereby increases the fraction of savings that is ‘lost’ in the process of intermediation.

The financial systems in most of the developing and underdeveloped countries are subject to structural, informational and institutional inefficiencies that ultimately lead to high margins between lending and borrowing rates of commercial banks (Asmare, 2014). These high spreads emanate from elevated and volatile lending rates and leads to a higher
cost of capital for the borrowers, consequently reducing investments or promoting only short term high risk ventures. The impact of relatively higher banking spreads could be devastating for businesses with less financial flexibility especially small and medium enterprises. Lastly, sustained high spreads is a vital indicator of the poor performance of financial system inter alia inadequacy of banking regulation and can ultimately retard economic growth (Afzal, 2011).

The one thing that typically distinguishes banks from other financial institutions is the provision of loans and deposit products. Deposits are liabilities while loans are asset for banks. A bank’s core activity is to act as financial intermediary. It pays interest to depositors, while it receives income from borrowers; the difference between these two rates is termed as interest rate spread (Asmare, 2014). The interest rate spread, or the financial intermediation spread is an important indicator for the banking system and the intermediation process. The financial intermediation is associated with cost of intermediation. Interest rate between lending and deposit rate used for making judgment on banks efficiency in case of individual bank spread, or banking system’s efficiency in case of overall spread of banking system (Maudos and Solis, 2009).

In assessing determinants of interest rates, Cooperman et. al., (2005) found out that interest rates represent the cost of borrowing capital for a given period. Price changes are anticipated in the real world and these expectations are part of the process that determines interest rates. Keynes (1936) indicates that the rate of interest represent the cost of borrowing capital for a given period. Given that borrowing is a significant source of finance for the firms, interest rates are of great importance to them since it greatly affects their income and by extension their operations. According to Cargill (1991), interest rates for lending by commercial banks and other financial intermediaries represent both a composition for the loss in value of the loaned capital arising mainly from inflation as well as profit margin to compensate the lender for the default risk he exposes himself to during the loan period.

Institutions lend at a higher rate than the expected inflation rate over a similar period. This rates form a basis upon which banking institutions fix their interests. Asmare (2014) paralleled the risk factors on the shifts in interest rates spread. Risks involved on money borrowed are referred to as the risk premium and are implicitly included in the interest rate parity. Thus, when a country’s currency depreciates, the interest rates must be higher than the rate at which the shilling depreciates. According to a study by Bernstein (1996),
developing countries have liberalized interest rates by allowing the markets forces to determine interest rates. Hence uncompetitive banking systems, inadequate regulatory framework and borrowers that are insensitive to interest rates undermine the efficiency of market based credit allocation and disrupt the transmission of monetary signals with adverse consequences for macroeconomic policy.

In her study, Naude (1995) found out that interest rates were maintained below the market rates and direct control of credit was the primary monetary control instrument of the authorities. The Kenyan government adopted the CBK amendment Act (the Donde Act) in 2001. The act allows CBK to regulate interest rates. Interest rate influences the overall level of economic activity, flow of goods and services and financial assets within the economy. It is believed that fluctuations of market interest rates exert significant influence on the performance of commercial banks. According to Samuelson (1945), under general conditions, financial institutions’ profits increase with rising interest rates. He argued that the banking system as a whole is immeasurably helped rather than hindered by an increase in interest rates.

Studies by (Demigurc-Kunt & Huizinga, 1999; Demigurc-Kunt, Laeven & Levine, 2003; Tennant, 2006) asserts that increase in reserve requirements are associated with a growth in interest rate spreads since banks pass on the cost of holding un-loanable funds to consumers via an increase in lending rates or a reduction in deposit rates. However, reserve requirements relative to the size of the spread were small for the Organization for Economic Co-operation and Development (Randall, 1998) accounting for less than 10% of the average spread between the period 1991 to1996. Martin (2010) estimated that 50% of the spread is attributable to reserve requirements, based on the zero-profit methodology. Finally, a weak legal system heavily contributed to the accumulation of nonperforming loans in Kenya, which in turn pushed up lending rates and increased net interest margins (Ngugi, 2001).

2.3.2 Commercial Banks’ Interest Rate Setting and Financial Performance

The banks’ interest rate setting behaviour generally assumes that banks operate under oligopolistic market conditions (Lim, 2000). This means that a bank does not act as a price-taker but sets its loan rates taking into account the demand for loans and deposits. The interest rate on loans depends positively on the real GDP and
inflation. Better economic conditions increase the chances of projects becoming profitable in terms of the expected net present value and therefore increase credit demand (Kashyap, Stein & Wilcox, 1993). An increase in permanent income has a positive influence on the loan demand while the effect due to the transitory part could also be associated with a self-financing effect that reduces the proportion of bank debt (Friedman and Kuttner, 1993).

An increase in the money market rate raises the opportunity cost of other forms of financing such as bonds making lending more attractive (Friedman and Kuttner, 1993). This mechanism also boosts loan demand and increases the interest rate on loans. The interest rate on deposits is negatively influenced by real GDP and inflation. A higher level of income increases the demand for deposits and reduces therefore the incentive for banks to set higher deposit rates (Hancock, 1991). In this case the shift of deposit demand should be higher if the transitory component of GDP is affected. On the contrary, an increase in the money market rate, ceteris paribus, makes more attractive to invest in risk-free securities that represent an alternative to detain deposits; the subsequent reduction in deposits demand determines an upward pressure on the interest rate on deposits.

Furthermore, other factors such as the costs of intermediation, riskiness of the credit portfolio and interest rate volatility have an impact on the interest rates on loans. The costs of intermediation have a positive effect on the interest rate on loans and a negative effect on that of deposits. Banks that invest in riskier projects have a higher rate of return in order to compensate for the higher percentage of bad loans that have to be written off. A high volatility in the money market rate should increase lending and deposit rates. Following the dealership model by Ho and Saunders (1981) and its extension by Angbazo (1997) the interest rate on loans should be more affected by interbank interest rate volatility with respect to that on deposits. This should reveal a positive correlation between interest rate volatility and the spread.

Finally, monetary policy changes influence banking interest rates. A monetary tightening determines a reduction of reservable deposits and an increase (reduction) of market interest rates (Kashyap et al, 1993). This has a direct and positive effect on bank interest rates through the traditional interest rate channel. Nevertheless, the increase in the cost of financing could have a different impact on banks depending on their specific characteristics. A monetary tightening has effect on bank loans because the drop in reservable deposits cannot be completely offset by issuing other forms of funding or
liquidating some assets. Kishan and Opiela (2000) claimed that the market for bank debt is imperfect. Since non-reservable liabilities are not insured and there is an asymmetric information problem about the value of banks’ assets, a “lemon’s premium” is paid to investors.

According to some scholars, small, low liquid and low-capitalized banks pay a higher premium because the market perceives them more risky. Since these banks are more exposed to asymmetric information problems they have less capacity to shield their credit relationships in case of a monetary tightening and they should cut their supplied loans and raise their interest rate by more. Moreover, these banks have less capacity to issue bonds and therefore they could try to contain the drain of deposits by raising their rate by more (Lim, 2000). Banks that heavily depend upon non-deposit funding such as bonds will adjust their deposits rates more quickly than banks whose liabilities are less affected by market movements (Berlin and Mester, 1999).

The intuition of this result is that, other things being equal, it is more likely that a bank will adjust her terms for passive deposits if the conditions of her own alternative form of refinancing change (Lim, 2000). Therefore an important indicator to analyze the pass-through between market and banking rates is the ratio between deposits and bonds plus deposits. Banks which use relatively more bonds than deposits for financing purpose fall more under pressure because their cost increase contemporaneously and to similar extent as market rates (Friedman and Kuttner, 1993). Direct links between interest rates and performance is not proven. However, stable interest rates generally have an effect on financial performance especially that of commercial banks.

High interest rates will lead to increased bank interest income but at the same time lead to low demand for loans that may jeopardize the performance of the bank (Kishan and Opiela, 2000). Certain factors determine the interest rates of banks including deteriorating local economy, low Gross Domestic Product (GDP) and inflation. Interest rate volatility is expected to affect the financial performance of banks. Interest rates are very vital to banks as they allow them to cover their operational costs (Kashyan, 1993). High interest rates reduce the demand for loans. Similarly, inflation press interest rates upwards, which reduces loans demands. The above have an effect on the profitability and overall performance of banks. Exchange rates usually have indirect impacts on bank performance. High exchange rates increase the value commercial banks get from selling foreign currency which increases profitability (Reilly and Brown, 1979).
Declined GDP results into reduced interest rates and a fall in the profitability of commercial banks. Interest rates have led to high profitability of commercial banks in Sub-Saharan Africa in the last two decades. This is due to the high rate of lending practices and in return high interest rates because of increased investment in risky ventures. In addition, the demand for bank service as compared to its supply has huge gaps that are yet to be filled giving banks an advantage of less competition (Ngure, 2014). Interest rates have led to high profitability of commercial banks in Sub-Saharan Africa in the last two decades (Lim, 2000). This is due to the high rate of lending practices and in return high interest rates because of increased investment in risky ventures. In addition, the demand for bank service as compared to its supply has huge gaps that are yet to be filled giving banks an advantage of less competition (Ngure, 2014).

2.4 Regulations Guidelines on Lending and Financial Performance

Even though bank serves social objective through its priority sector lending, mass branch networks and employment of many people, maintaining quality asset book and continuous profit making is important for banks continuous growth. Bank loans are one of the most important long-term financing sources in many countries (Freixas & Rochet, 2008). The Companies Act, the Banking Act, the Central Bank of Kenya Act and the various prudential guidelines issued by the Central Bank of Kenya (CBK), governs the Banking industry in Kenya. The banking sector in Kenya was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Minister for Finance’s docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system (Ngure, 2014).

The CBK operates under a monetary policy programming framework that includes monetary aggregates (liquidity and credit) targets that are consistent with a given level of inflation and economic growth (KIPPRA, 2006). The Central Bank of Kenya acts as the main regulator of commercial banks in Kenya (CBK Annual Report, 2009). Commercial banks play an important role in the pass-through of monetary interest rates. Moreover, banks may influence the external finance premium not only via the interest rates but also modifying the available maturity of loans or changing collateral requirements (Altunbas et al, 2009). Banking policies and guidelines on lending help in determining which retail or corporate clients the commercial banks approved for loans and which will be avoided, and must be based on the bank lending laws and regulations.
2.4.1 Lending Policies and Financial Performance

The first decade after independence can be characterized as passive in the conduct of monetary policy in Kenya, mainly because no intervention was necessary in an environment of 8% GDP growth and below 2% inflation rate (Kinyua, 2001). The first major macroeconomic imbalance arose in the second decade in the form of 1973 oil crisis and the coffee boom of 1977/78. In these first two decades, monetary policy was conducted through direct tools which were cash reserve ratio, liquidity ratio, credit ceilings for commercial banks, and interest rate controls. The banks very frequently suffer from poor lending practice (Koford & Tschoegl, 1999). Monitoring, and other appropriate steps, are necessary to control or mitigate the risk of connected lending when it goes to companies or individuals (Basel, 1999).

The CBK issued guidelines which address the general principles that are prepared for governing the implementation of more detailed lending procedures and practices within the banks (Kinyua, 2001). It is mandatory for a bank to prepare Credit Policies Guidelines (CPG) for making investment and lending decisions and which reflect a bank tolerance for credit risk. Prior to consent to a credit facility, the bank should make an assessment of risk profile of its customers, such as of their business, and which can be done through the credit procedure. Benedikt et al., (2007) studied the credit risk management policies for ten banks in the United States and found that advance credit risk management techniques help permanent to achieve their target in loan level.

The loan allocation and the loan portfolio of any individual financial institution e.g. commercial banks will be dictated by lending decisions (Lim, 2000). The nature, size, and the structure of loan portfolio is a reflection of financial institutions lending decisions. The lending decisions should be guided by the following factors: The size of the lending institution: - This is very vital in determining the size of the loan to lend. Its loaning decisions will also depend on the business potential on the areas of its coverage. The small financial institutions should therefore consider their local community and immediate environment when drawing up the lending decisions. Multinationals will consider a wider environment (George & Simonson, 2000).

Economic conditions: - It refers to the economic activities around financial institutions operating environment. Many banks are usually located in areas where economic activities are either dominated by manufacturers or service industry, etc. Lending policies
should therefore be tailored according to the pre-dominant business activity in the bank’s environment (Lim, 2000). Of great importance here is to focus on the flow of business within this environment and design policies that are able to tap the benefits to the business. In periods of corporate bankruptcy, it is also important to notice that certain loan policies are important to help re-organize bankrupt institutions and transform them into highly profitable organizations (Dyer, 1997).

Credit Analysis-The purpose of credit analysis is to assess the likelihood that a borrower will default on a given loan (Hutter, 2005). Credit analysis consists of evaluating a borrower’s needs and financial conditions which includes: Character or the person’s traits such as honesty, ethical considerations, integrity, etc. This is usually based on the borrower’s past behaviour in both banking & repayments of loans borrowed earlier. Capacity of the borrower which focuses on whether the borrower has the ability to generate sufficient funds to liquidate the loan and still stay financially healthy. This will include assessing the manager’s ability, policy documents of the firm, investment policies, strategic plans, credit statements, etc. as well as judge the market potential of the institution. The judgement should be both on liquidity as well as solvency of the institution (Muller et al, 2007).

Collateral is the ability of the borrower to pledge specific assets to secure a loan (CBK, 2005). According to the provisions of Central Bank, all loans offered by banks must be secured to protect the borrower’s funds. The value of the security should be ascertained and title documents charged to the loan which should not exceed 2/3 of the value of the securities. Capital or the money personally invested into the business by the borrowers and is an indication of how much the borrower has at risk should the business fail. Interested lenders and investors will expect the borrowers to have contributed from their own assets and to have undertaken personal financial risk to establish the business before advancing any credit (George & Simonson, 2000).

2.4.2 Credit Risk Management and Financial Performance

Credit risk is defined as the change in the value of the asset portfolio of a bank, due to the failure of an obligor to meet his payment commitments (CBK, 2005). Effective management of the loan portfolio and the credit function is fundamental to a bank’s safety and soundness. Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled (CBK, 2005).
of the LPM process is so important, it is a primary supervisory activity. Assessing LPM involves evaluating the steps bank management takes to identify and control risk throughout the credit process (Chodechai, 2004). The assessment focuses on what management does to identify issues before they become problems.

For decades, good loan portfolio managers have concentrated most of their effort on prudently approving loans and carefully monitoring loan performance (Chodechai, 2004). Although these activities continue to be mainstays of loan portfolio management, analysis of past credit problems, such as those associated with oil and gas lending, agricultural lending, and commercial real estate lending in the 1980s, has made it clear that portfolio managers should do more. Traditional practices rely too much on trailing indicators of credit quality such as delinquency, non-accrual, and risk rating trends. Banks have found that these indicators do not provide sufficient lead time for corrective action when there is a systemic increase in risk (Sanchez, 2009). Effective loan portfolio management begins with oversight of the risk in individual loans (CBK, 2005). Prudent risk selection is vital to maintaining favourable loan quality.

Therefore, the historical emphasis on controlling the quality of individual loan approvals and managing the performance of loans continues to be essential. But better technology and information systems have opened the door to better management methods (Sanchez, 2009). A portfolio manager can now obtain early indications of increasing risk by taking a more comprehensive view of the loan portfolio (Hirtle, 2008). There are various policies that an organization should put in place to ensure that credit management is done effectively, one of these policies is a collection policy which is needed because all customers do not pay the firms bills in time. Some customers are slow payers while some are non-payers (CBK, 2005). The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses (Kariuki, 2010).

### 2.5 Chapter Summary

The chapter has provided the literature on various lending practices in relation to profitability of banking institutions. KYC procedures facilitate customer identification in order to prevent banks from intentional or unintentional elements of anti-money laundering. The description of customer identification and money laundering practice as important aspects in KYC procedures have been discussed. Loan interest rates otherwise defined as price paid for borrowed funds has been examined. The literature reviewed the
impact of interest rates spread on the financial performance of commercial banks. The literature closes with an extensive assessment of the credit policy guidelines and the impact on the financial performance of commercial banks. The next chapter will present pertinent research methods that will be used to conduct this research.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter provides a discussion of the methodology that was used to study lending practice in relation to financial performance of banking institution in Kenya. The chapter covers the study research design, target population, sampling and sample size, data collection.

3.2 Research Design

Research design is the planning, organization, collection and analysis of data to provide information and also solutions to the existing problem of the study (Greswell, 2009). The study adopted descriptive research design. According to Shield and Kukuska (2006), a descriptive research design is used to describe characteristics of a population or phenomenon being studied. It does not answer the question about how/when/why the characteristics occurred, but addressed the question what are the characteristics of the population or phenomenon being studied. Kothari et. al., (2010) further adds that a descriptive research design provides a description of situations in their natural phenomenon. Descriptive research design was considered suitable in this study since it sought to examine the lending practice, as it exists within banking institutions and how this practice impacts on the profitability of banking institutions and answering the respective research question to the study.

3.3 Population and Sampling Design

3.3.1 Population

Population is the collection of individuals or objects that is the focus of a scientific query (Cooper and Schindler, 2003). Kothari et. al., (2010) defines research population as a well-defined collection of individuals or objects s known to have similar characteristics. The study targeted senior managers of 8 large banks that are listed at the Nairobi Securities Exchange (NSE) as of 31st December 2015. The senior banking officials targeted include, top level, middle level and low level management officials. According to Kenya Bankers Association (2013), Nairobi region has about 572 officials serving in the three categories in different banks within the city. The study settled on the region as was informed by the basis of accessing the respondents who would add quality to the
findings. Major commercial banks, the regulator and the research centres for financial institutions in Kenya are situated in the city of Nairobi. Furthermore, official in head offices of commercial banks are well parsed with information regarding lending practices across a wide landscape.

### 3.3.2 Sampling Frame

The sampling frame is the source of material or device from which a sample will be drawn (Yin, 2009). Sampling frame is a list of all those within population who can be sampled and may include individuals, households or institutions. The sampling frame was the list of banking institutions listed in NSE as of 31\textsuperscript{st} Dec 2015. These banks were selected because of availability of information and data on lending practices and financial performance. The exercise involved individuals staff and management of the target banks (population) for the study.

#### 3.3.2.1 Sampling Design

Sample design is the approach or roadmap that serves as basis for selection of a survey sample and that which affects many other important aspects of a survey as well (Kothari et al., 2010). In this study, the sampling design involved the selection of managers and credit officers from sampled banking institutions.

#### 3.3.2.2 Sampling Technique

Sampling technique is the specific process by which the entities of the sample are selected (OECD, 2004). The study relied on purposive sampling to select and determine the banking institutions to participate in the study. Purposive sampling enables a researcher to choose specific people within the population with particular characteristics who will give the most relevant information to the study (Enkivillage, 2015). According to Mugenda (2009), purposive sampling entails selecting of study participants based on identified criterion, for example experience, expertise opinion or a special group. In the case of this study, commercial banks selection was based in their listing in Nairobi securities exchange as of 31\textsuperscript{st} December 2011.

#### 3.3.2.3 Sample Size

Sample size is the subset of representative units from the target population (Shao and Zhuou, 2007). All banks listed in Nairobi Securities exchange were included in the study. The study sample size was therefore based on the number of respondents picked from the
selected commercial banks. The participants in the study were members of staff in management positions from different banking institutions listed at the Nairobi securities exchange. Nairobi region has about 572 senior management staff from major banks (KBA, 2013). The study leveraged on 10% of the target population. 10% of 572 are about 57.2; this formed a total sample of 57 respondents.

Table 3.1 illustrates on how the purposive sampling technique of staff and manager from the various banks was carried out to achieve the required sample population.

**Table 3.1: Target population and Sample Size**

<table>
<thead>
<tr>
<th>Category</th>
<th>Target Population</th>
<th>Sample Size</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Management Staff</td>
<td>120</td>
<td>12</td>
<td>10%</td>
</tr>
<tr>
<td>Middle level Management Staff</td>
<td>200</td>
<td>20</td>
<td>10%</td>
</tr>
<tr>
<td>Lower Level Management Staff</td>
<td>250</td>
<td>25</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>570</strong></td>
<td><strong>57</strong></td>
<td><strong>10%</strong></td>
</tr>
</tbody>
</table>

**3.4 Data Collection Methods**

Data collection is the process of gathering and measuring information on targeted variables in an established systematic fashion, which then enables one to answer relevant questions and evaluate outcomes (Lescroel et al, 2015). Data collection instrument is a device used to collect data in an objective and a systematic manner for the purpose of the research (Orodho, 2009). The main data collection instrument used in this study were questionnaires containing both open ended and close ended questions with the quantitative section of the instrument utilizing a nominal Likert-type scale format. According to Kiess & Bloomquist (2009), likert scale format yields equal-interval data, thus allowing for the use of more powerful statistical statistics to test research variables. Questionnaire was preferred since according to Dempsey (2003) are effective data collection instruments that allow respondents to give much of their opinions pertaining to the researched problem. According to Kothari (2006) the information obtained from questionnaires is free from bias and researchers influence and thus accurate and valid data was gathered. The questions addressed by the questionnaires sought to gather quantitative
and qualitative data on the influence of lending practises on the financial performance of commercial banks in Kenya.

3.5 Research Procedure

Research procedure is the step by step sequence of activities that will be followed in the same order to perform this research (Lescroel et al, 2015). The researcher sought permission from relevant institutions by submitting an official request inform of a letter, explaining the intention to conduct the field survey. The researcher personally administered all the questionnaires to the respondents who were given ample time to respond. The respondents were assured of confidentiality for the responses provided.

Primary data presents the actual information that is obtained for the purpose of the research study. Primary data was gathered through the use of a structured questionnaire (open and close ended questions). The questionnaires were self-administered to a total of 57 respondents and later collected for data analysis.

Secondary data involved previously collected and tabulated data through the use of graphs, charts and reports. This type of data was collected from reference materials with key information helpful to this research study. Collection of secondary data was obtained through desk research mainly from past published scholarly articles on the influence of lending practises on the financial performance of commercial banks.

3.5 Data Analysis Methods

Data analysis is the process of evaluating data using analytical and logical reasoning to examine each component of the data provided (Business Dictionary, 2016). Since the study gathered both quantitative and qualitative data using semi structured questionnaires, the study applied descriptive statistics data analysis method to analyze numerical data gathered using closed ended questions. The Statistical Package for Social Sciences (SPSS) version 20, computer software was used for analysis. The data was cleaned, coded, categorized per each of the research variables and then analyzed using descriptive such as percentages, mean and standard deviation. Regression analysis was used to draw relationship between the dependent and the independent variables. Finally the results were presented inform of tables.
3.7 Chapter Summary

This chapter has provided the approach to be used by the researcher in examining the effect of lending practices on financial performance commercial banks in Kenya. The chapter has provided the methodology that was used in accomplishing the research objectives. A descriptive survey design was used with the population of study being listed banking institutions. Purposive sampling technique was used to select respondents to participate in the study. The study sample was composed of 57 respondents. Questionnaires were used for data collection while consent to collect data was obtained from the branch managers of the institutions to be studied. Both qualitative and quantitative techniques were used to analyse data. The results and findings of this study are presented in chapter four.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

This chapter presents the data gathered from the field survey and it covers the background information of the respondents and the responses on the questions that were presented to them. The beginning part of the chapter will cover the demographic details which include; the gender distribution, age distribution, level of education, work experience, job designation and size of work force in the organization. The succeeding section will cover the intricacies of the research objectives in relation to the topic of study.

4.2 Response Rate

The researcher distributed a total of 57 questionnaires. The researcher identified the respondents in good time and informed them on the intention to carry out the study. Close communication with the respondents ensured that all the questionnaires that were handed out were duly filled to the best ability of the respondents and consequently availed to the researcher to move ahead and carry out the analysis. All the questionnaires that were handed out were successfully returned. Thus a response rate of 100 percent was achieved, and as Mugenda (2003) put it, a response rate of above 50 percent was fit to carry out statistical reporting.

4.3 Background Data

Background data includes all the demographic details that were captured for the respondents of the study. They include; gender, education level, job designation, work experience and the number of employees in the organization.

4.3.1 Gender Distribution

Table 4.1 Gender distribution

<table>
<thead>
<tr>
<th>Gender</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>30</td>
<td>53%</td>
</tr>
<tr>
<td>Female</td>
<td>27</td>
<td>47%</td>
</tr>
<tr>
<td>Total</td>
<td>57</td>
<td>100%</td>
</tr>
</tbody>
</table>
The study involved 57 participants and as table 4.1 shows; Male representation was about 53% while the female participation was about 47 percent. These findings show that the gender representation in the banking sector is fairly balanced with a slight favour in the men representation. The findings also demonstrate a positive progress in gender participation. In accordance to the constitution of Kenya (2010), all public organizations are required to adhere to the one-third gender rule. For a value of 47 percent against 53 percent is a significant achievement, especially for the fact that the banking industry is a vital part of the country economy.

4.3.2 Level of Education

Table 4.2 Level of education

<table>
<thead>
<tr>
<th>Education</th>
<th>Frequency</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificate</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Diploma</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>Degree</td>
<td>30</td>
<td>53</td>
</tr>
<tr>
<td>Post-graduate</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Majority of the respondents indicated that they had attained a university degree in education, about 53 percent. Furthermore, about 33 percent of the respondents indicated that they had attained a Diploma in their education level. About 9 percent indicated that they had attained a certificate. Finally, about 5 percent of the respondents, they indicated that they had attained an education to the post-graduate level. The study makes findings that, majority of the people working in the banking sector are well educated with many having attained a university degree. This is also a positive outcome as education enables people to acquire the necessarily technical skills that are needed in ensuring effectiveness in service delivery for a particular organization.
4.3.3 Work Designation

Table 4.3 Work designation of respondents

<table>
<thead>
<tr>
<th>Job description</th>
<th>Frequency</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit officer</td>
<td>31</td>
<td>54</td>
</tr>
<tr>
<td>Bank manager</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Departmental manager</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

The study makes a finding that an overwhelming majority of the respondents were designated as the credit officer’s staff with a participation of about 54 percent (table 4.3). Departmental managers at banks were also well represented, and were about 33 percent of the respondents. Further, 9 percent of the participants indicated that they were bank managers. Finally a marginal 4 percent of the participants indicated that they worked in different sections other than the ones pre-identified. The study was centralized on the issues of lending affairs of the commercial bank, which is greatly dominated by credit officials. Therefore the diversity of the participant’s occupation was valuable in identifying existing relationships between lending division and other banking departments.

4.3.4 Work Experience

Table 4.4 Work experience in the banking sector

<table>
<thead>
<tr>
<th>Work experience</th>
<th>Frequency</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 5 years</td>
<td>26</td>
<td>46</td>
</tr>
<tr>
<td>6 – 10 years</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>11 – 15 years</td>
<td>8</td>
<td>14</td>
</tr>
<tr>
<td>Over 15 years</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Majority of the respondents, about 46 percent of the respondents had a working experience of about 0 – 5 years. Next was about, 33 percent among the respondents who
indicated that they had a working experience of about 6 – 10 years. Further, about 14 percent of the respondents indicated that they had working experience of about 11 – 15 years. Finally, 7 percent of the participants indicated that they had a working experience of over 15 years. The study makes a finding that majority of the respondents indicated to have an experience enough to have exposed them to the intricacies of lending operations. Therefore their opinions will reflect on the realities on ground from the first hand experience.

4.3.5 Employees in the Organization

Table 4.5 Number of employees in the bank

<table>
<thead>
<tr>
<th>No. of employees</th>
<th>Frequency</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>200 – 1000 employees</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>1000 – 3000 employees</td>
<td>27</td>
<td>48</td>
</tr>
<tr>
<td>Over 3000 employees</td>
<td>11</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>57</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Majority of the respondents, about 33 percent indicated that in the bank where they work had between 200 – 1000 employees. About 48 percent, indicated that the bank where they worked had about 1000 – 3000 employees. Finally, about 19 percent of the respondents indicated that, at the institution which they worked had over 3000 employees. The study makes a finding that; majority of commercial banks in the country has an average of between 1000 - 3000 employees.
4.4 Know Your Customer Procedures

Table 4.6 Mean and Standard deviation of know your customer procedures

<table>
<thead>
<tr>
<th>Know your Customer procedures</th>
<th>(Sample)N</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>KYC procedures protected the bank against frauds</td>
<td>57</td>
<td>4.77</td>
<td>.423</td>
</tr>
<tr>
<td>We frequently monitor KYC procedures adherence</td>
<td>57</td>
<td>4.75</td>
<td>.434</td>
</tr>
<tr>
<td>KYC procedure enhance due diligence</td>
<td>57</td>
<td>4.74</td>
<td>.444</td>
</tr>
<tr>
<td>We report any violations of KYC procedures</td>
<td>57</td>
<td>4.61</td>
<td>.491</td>
</tr>
<tr>
<td>Every employee are aware of KYC procedures</td>
<td>57</td>
<td>4.61</td>
<td>.526</td>
</tr>
<tr>
<td>Bank strictly analyze customer profiles</td>
<td>57</td>
<td>4.51</td>
<td>.601</td>
</tr>
<tr>
<td>We hardly notice violations in KYC procedure</td>
<td>57</td>
<td>4.40</td>
<td>.623</td>
</tr>
<tr>
<td>We cooperate with others in leaning KYC policies</td>
<td>57</td>
<td>4.14</td>
<td>.581</td>
</tr>
<tr>
<td>We regularly update our KYC procedures</td>
<td>57</td>
<td>4.11</td>
<td>.489</td>
</tr>
<tr>
<td>We experience instances of KYC violation</td>
<td>57</td>
<td>2.93</td>
<td>.753</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>57</strong></td>
<td><strong>4.36</strong></td>
<td><strong>0.537</strong></td>
</tr>
</tbody>
</table>

The first objective of the study was to evaluate the extent to which KYC procedures impacted on the financial performance of commercial banks.

Table 4.6 presents the mean and standard deviation for the questions on the impacts to which know your customer procedures impact on the financial performance of commercial banks. The study used a scale of 1 – 5 where; 1 – Strongly Disagree, 2 – Disagree, 3 – Undecided, 4 – Agree, 5 – Strongly Agree. The statement in relation to know your customer procedure had an average mean of 4.36 which indicates that the respondents were all in agreement with the influence of KYC procedures on the financial performance of commercial banks. The statement; KYC procedures have been
instrumental in protecting the banks against major frauds with a mean of 4.77, was the highest ranked in accordance to respondents.

Thus the study draws a finding that, the KYC procedures are a strong line of defence for the commercial banks against exposure to fraud. The respondents ranked the statement; we have experienced instances of KYC violation from time to time with a mean of 2.93, as the least impacting. The study draws a finding that strong KYC procedures which are dynamic have been central to sanitizing credit operations in commercial banks. Furthermore, the effective implementation of these procedures has prevented any instances of violation.

4.4.1 Regression Test of KYC Procedure versus Financial Performance

Table 4.7 Model Summary, between KYC procedures and financial performance

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.116(^a)</td>
<td>.113</td>
<td>.105</td>
<td>.506</td>
</tr>
</tbody>
</table>

a. Predictors: (Constants), Bank Protection, Monitoring, Due Diligence, Violations Alert, Employee Awareness, Customer Strictness, Industry Cooperation, Regular Update

The R value computed in the model is 0.116 whereas the R Square value is 0.013. This outcome indicates that, KYC procedures variables; Bank Protection, Monitoring, Due Diligence, Violations Alert, Employee Awareness, Customer Strictness, Industry Cooperation and Regular Update account for about 11.3 percent in the variability of financial performance. The findings also indicate that, 88.7 percent of the variability can be accounted for other factors.
Table 4.8 ANOVA, KYC Procedures and Financial Performance

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
</table>
| 1          | Regression     | .191| 1           | 9.191| 77.49| .391b  
|            | Residual       | 14.054| 55          | .256| - | -  
|            | Total          | 14.246| 56          | -   | -   | -  

a. Dependent Variable: Financial performance  
b. Predictors: (Constant), KYC Procedures; Bank Protection, Monitoring, Due Diligence, Violations Alert, Employee Awareness, Customer Strictness, Industry Cooperation, Regular Update.

The analysis of variance between the two variables is presented in table 4.8. The results on the table indicate that, F (1, 55) = 77.49, p = 0.391. The F statistic value 77.49 is reflected at significance level of 0.391 which indicates that it’s significant at this level. This means that, KYC Procedures variables; Bank Protection, Monitoring, Due Diligence, Violations Alert, Employee Awareness, Customer Strictness, Industry Cooperation and Regular Update have significant effect on the financial performance of Commercial Banks.
Table 4.9 Coefficient, KYC Procedures and Financial Performance

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>1.043</td>
<td>2.326</td>
<td>-.449</td>
<td>.656</td>
</tr>
<tr>
<td>KYC procedure</td>
<td>.138</td>
<td>.160</td>
<td>.216</td>
<td>8.866</td>
</tr>
<tr>
<td>Bank regulations</td>
<td>.071</td>
<td>.173</td>
<td>.060</td>
<td>5.411</td>
</tr>
<tr>
<td>Monitoring</td>
<td>.121</td>
<td>.133</td>
<td>.150</td>
<td>5.914</td>
</tr>
<tr>
<td>Due diligence</td>
<td>.197</td>
<td>.145</td>
<td>.206</td>
<td>5.359</td>
</tr>
<tr>
<td>Violations Alert</td>
<td>.124</td>
<td>.209</td>
<td>.107</td>
<td>4.594</td>
</tr>
<tr>
<td>Employee Awareness</td>
<td>.137</td>
<td>.177</td>
<td>.133</td>
<td>2.773</td>
</tr>
<tr>
<td>Customer Strictness</td>
<td>.154</td>
<td>.151</td>
<td>.150</td>
<td>1.023</td>
</tr>
<tr>
<td>Industry Cooperation</td>
<td>.024</td>
<td>.144</td>
<td>.028</td>
<td>1.169</td>
</tr>
<tr>
<td>Regular Update</td>
<td>.027</td>
<td>.111</td>
<td>.040</td>
<td>0.244</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Financial Performance

The results in table 4.9 indicate that KYC procedures variables t-statistic values include; Bank regulations t(56) = 2.411, Monitoring t(56) = 5.914, Due Diligence t(56) = 5.359, Violations Alert t(56) = 4.594, Employee Awareness t(56) = 2.773, Customer Strictness t(56) = 1.023, Industry Cooperation t(56) = 1.169 and Regular Update t(56) = 0.244 have statistical significant effect on the financial performance. KYC procedures thus have a significant impact on the financial performance of commercial banks as represented by t-statistic value t(56) = 8.866, p= 0.391 at 95% confidence level. A change in the KYC procedures will result in a 0.216 units change in the financial performance of commercial banks. This shows that positive increase in the KYC procedures implementation will result in a positive increase in the financial performance of commercial banks.

4.5 Interest Rates

The second objective of the study was to assess the extent to which, interest rates influence the financial performance of the commercial banks.
Table 4.10 presents the results of 5-point likert scale level of satisfaction for different factors of interest rates. Each of the 57 respondents contributed their opinions on the influence of interest rates on the financial performance of commercial banks.

Table 4.10 Mean and Standard deviation of interest rates

<table>
<thead>
<tr>
<th>Interest rates factors</th>
<th>Sample (N)</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>We have favourable lending rates for our customers</td>
<td>57</td>
<td>4.72</td>
<td>0.453</td>
</tr>
<tr>
<td>Interest rates influence the repayment rate</td>
<td>57</td>
<td>4.60</td>
<td>0.495</td>
</tr>
<tr>
<td>Interest rates affects competitive advantage</td>
<td>57</td>
<td>4.56</td>
<td>0.501</td>
</tr>
<tr>
<td>Interest rates volatility affects the profitability</td>
<td>57</td>
<td>4.40</td>
<td>0.593</td>
</tr>
<tr>
<td>Capping interest rates impacts on bank earnings</td>
<td>57</td>
<td>4.19</td>
<td>0.743</td>
</tr>
<tr>
<td>Interest rates drive the borrowing volumes</td>
<td>57</td>
<td>3.81</td>
<td>0.743</td>
</tr>
<tr>
<td>Interest rates should continuously be reviewed</td>
<td>57</td>
<td>3.75</td>
<td>0.635</td>
</tr>
<tr>
<td>Most customers are sensitive to loan interest rates</td>
<td>57</td>
<td>3.44</td>
<td>0.598</td>
</tr>
<tr>
<td>Our lending rate is below market rate</td>
<td>57</td>
<td>3.14</td>
<td>0.549</td>
</tr>
<tr>
<td>Our customers are based on interest rates</td>
<td>57</td>
<td>2.84</td>
<td>0.56</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>57</strong></td>
<td><strong>3.95</strong></td>
<td><strong>0.587</strong></td>
</tr>
</tbody>
</table>

Table 4.10 presents the measures of central tendency (the mean) and the dispersion (std. deviation) of the factors of interest rates and the impact on the financial performance of commercial banks. In a scale of 1 – 5 where; 1 – Strongly Disagree, 2 – Disagree, 3 – Undecided, 4 – Agree, 5 – Strongly Agree, an average mean of 3.95 was obtained, which on round-off will be categorized in level 4 indicating that the respondents were in agreement with the statements all through.

The highest ranked factor in interest rates was the item on favourable interest rates at mean of 4.72. This demonstrates that majority of the respondents were strongly convinced that the banking institution in which they worked for had the best rates in the market. The
least supported statement was on the issue of customers being solely based on interest rates, with a mean of 2.84. The study makes a finding that; most financial institutions have diverse financial services which attracts customers and not necessarily interest rates. The context of banks and customer networks is however though enhanced by recognizing the customer perception on the interest rates they are offered.

### 4.5.1 Regression Analysis of Interest Rates versus Financial Performance

The results below present the regression analysis of the independent variable (interest rates) versus the dependent variable financial performance to establish the type of relationship that they share.

**Table 4.11 Model Summary, between interest rate variables and the financial performance**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.217&lt;sup&gt;a&lt;/sup&gt;</td>
<td>.257</td>
<td>.243</td>
<td>.499</td>
</tr>
</tbody>
</table>

<sup>a</sup> Predictors: (Constant), Lending Rate, Repayment Rate, Competitive Advantage, Volatility, Capping, Borrowing Volumes, Review, Sensitivity, Market Rate

The model summary in table 4.11 indicates the R Square value to be estimated at about 0.243. This indicates that Interest rates variables contribute to about 25.7 percent of the variability in the financial performance whereas 74.3 percent of the variability can be accounted for other factor.

**Table 4.12 ANOVA, Interest Rates and Financial Performance**

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>.004</td>
<td>1</td>
<td>.004</td>
<td>45.16</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>13.715</td>
<td>55</td>
<td>.249</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>13.719</td>
<td>56</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

<sup>a</sup> Dependent Variable: financial performance

<sup>b</sup> Predictors: (Constant), Lending Rate, Repayment Rate, Competitive Advantage, Volatility, Capping, Borrowing Volumes, Review, Sensitivity, Market Rate
The ANOVA results presented at table 4.12 indicate that the F (1, 55) = 45.16 and p= 0.900. The F value, 0.016 reflected a significant value of 0.900. Thus the test statistic is significant at this level. The outcome demonstrates that interest rates have a statistical significant effect on the financial performance of commercial banks.

The results on table 4.13 indicate interest variables coefficient t – statistic values including: Lending Rate t(56) =11.540, Repayment Rate t(56) =11.190, Competitive Advantage t(56) = 8.367, Volatility t(56) = 7.531, Capping t(56) = 7.508 , Borrowing Volumes t(56) = 6.248, Review t(56) = 5.915, Sensitivity t(56) = 4.890 and Market Rate t(56) = 4.660.

The study makes a conclusion that interest rates factors have a statistically significance effect on the financial performance of commercial banks as shown by t (56) = 12.127, p= 0.900 at 90% confidence level. An extra rise in the interest rate will result in a change of 0.317 units on the financial performance of commercial banks. This shows that interest rates have direct impact on the financial performance of commercial banks.

**Table 4.13 Coefficients, Interest rates Variables and Financial Performance**

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>4.215</td>
<td>1.187</td>
<td>9.075</td>
</tr>
<tr>
<td></td>
<td>Interest Rates</td>
<td>.014</td>
<td>.112</td>
<td>.317</td>
</tr>
<tr>
<td></td>
<td>Lending Rate</td>
<td>.011</td>
<td>.105</td>
<td>.187</td>
</tr>
<tr>
<td></td>
<td>Repayment Rate</td>
<td>.154</td>
<td>.129</td>
<td>.141</td>
</tr>
<tr>
<td></td>
<td>Competitive Advantage</td>
<td>.041</td>
<td>.113</td>
<td>.046</td>
</tr>
<tr>
<td></td>
<td>Volatility</td>
<td>.056</td>
<td>.105</td>
<td>.067</td>
</tr>
<tr>
<td></td>
<td>Capping</td>
<td>.058</td>
<td>.114</td>
<td>.066</td>
</tr>
<tr>
<td></td>
<td>Borrowing Volumes</td>
<td>.031</td>
<td>.126</td>
<td>.032</td>
</tr>
<tr>
<td></td>
<td>Review</td>
<td>.074</td>
<td>.081</td>
<td>.111</td>
</tr>
<tr>
<td></td>
<td>Sensitivity</td>
<td>.236</td>
<td>.125</td>
<td>.236</td>
</tr>
<tr>
<td></td>
<td>Market Rate</td>
<td>.169</td>
<td>.102</td>
<td>.254</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Financial Performance
4.6 Credit Policy Guidelines

The study utilized a 5 – point Likert scale to seek respondent’s opinions on different factors of credit policy guidelines and how they impact on the financial performance of commercial banks. The 5 – point scale relied on levels of satisfaction from the least to the highest, against which the respondents were required to mark across. The interest was to assess the extent to which credit policy guidelines influenced the financial performance of commercial banks.

Table 4.14 Mean and standard deviation of credit policy guidelines

<table>
<thead>
<tr>
<th>Factors on credit policy guidelines</th>
<th>Sample (N)</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry standards adopted in policy formulation</td>
<td>57</td>
<td>4.63</td>
<td>.487</td>
</tr>
<tr>
<td>Banks employees trained on credit policy guidelines</td>
<td>57</td>
<td>4.63</td>
<td>.487</td>
</tr>
<tr>
<td>Policies compatible to internal control mechanisms</td>
<td>57</td>
<td>4.44</td>
<td>.655</td>
</tr>
<tr>
<td>Banks continuously review credit policies</td>
<td>57</td>
<td>4.40</td>
<td>.495</td>
</tr>
<tr>
<td>Policies form the basis for performance evaluation</td>
<td>57</td>
<td>4.05</td>
<td>.718</td>
</tr>
<tr>
<td>Formulation of policies done by consultants</td>
<td>57</td>
<td>3.86</td>
<td>.667</td>
</tr>
<tr>
<td>Quality of policies impact on the performance</td>
<td>57</td>
<td>3.72</td>
<td>.559</td>
</tr>
<tr>
<td>Credit policies are dynamic</td>
<td>57</td>
<td>3.46</td>
<td>.503</td>
</tr>
<tr>
<td>Input of customers considered in policy crafting</td>
<td>57</td>
<td>3.35</td>
<td>.517</td>
</tr>
<tr>
<td>Banks can ignore credit policy guidelines</td>
<td>57</td>
<td>1.98</td>
<td>.719</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>57</strong></td>
<td><strong>3.852</strong></td>
<td><strong>0.5807</strong></td>
</tr>
</tbody>
</table>

The third objective of this study was to evaluate the extent to which credit regulation policies influenced the financial performance of commercial banks. The study used a scale of 1 – 5 where; 1 – Strongly Disagree, 2 – Disagree, 3 – Undecided, 4 – Agree, 5 – Strongly Agree to establish respondents level of agreement with different statements of credit policy guidelines. An average value for mean across all the statements was 3.852
therefore the study makes a finding that, credit policy guidelines play a very critical role in the financial performance of commercial banks in Kenya. The statement; banks adopt industry standards in formulation of policies related to lending operations was the highest ranked by the respondents with a mean of 4.63. This shows that commercial banks formulation of credit policy is guided by industry accepted standards.

The study makes a finding that the banking sector is greatly regulated by industry acceptable standards to ensure consistency in operation across board. The statement; banks can ignore credit policy guidelines that are unfavourable to certain customers, was the least supported among the respondents with a mean of 1.98 thus showing that majority of the respondents disagree with its context. The study makes a conclusion that credit policy guidelines are industry standard and its implementation is fair across all cadres of customers, without any forms of preferential treatment.

4.6.1 Regression analysis of Credit Policy Guidelines versus Financial Performance

Table 4.15 Model Summary, Credit Policy Guidelines and Financial Performance

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.186a</td>
<td>.271</td>
<td>.259</td>
<td>.651</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Industry Standards, Employee Training, Compatibility, Review, Evaluation, Expertise, Quality, Dynamic, Customer Input

The model summary presented in table 4.15, indicate that the R Square value for the relationship is 0.271. This indicates that, credit policy guidelines factors account for 27.1 percent of the variability in the financial performance of commercial banks, thus about 72.9 percent of variability in financial performance is influenced by other factors.
The ANOVA results presented in table 4.16 indicates that, $F (1, 55) = 40.9$, $p=0.525$. The $F$ value, 40.9 is reflected at significance level of 0.525 which means that the test statistic is significant at that level. This implies that credit policy guidelines have a significant statistical effect on the financial performance of commercial banks and this demonstrates that the model is fit.
Table 4.17 Coefficients, Credit Policy Guidelines and Financial Performance

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>5.348</td>
<td>4.940</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Industry Standards</td>
<td>.113</td>
<td>.176</td>
<td>.486</td>
</tr>
<tr>
<td></td>
<td>Employee Training</td>
<td>.134</td>
<td>.221</td>
<td>.092</td>
</tr>
<tr>
<td></td>
<td>Compatibility</td>
<td>.443</td>
<td>.208</td>
<td>.323</td>
</tr>
<tr>
<td></td>
<td>Review</td>
<td>.074</td>
<td>.195</td>
<td>.052</td>
</tr>
<tr>
<td></td>
<td>Evaluation</td>
<td>.305</td>
<td>.174</td>
<td>.310</td>
</tr>
<tr>
<td></td>
<td>Expertise</td>
<td>.390</td>
<td>.148</td>
<td>.360</td>
</tr>
<tr>
<td></td>
<td>Quality</td>
<td>-.153</td>
<td>.176</td>
<td>-.120</td>
</tr>
<tr>
<td></td>
<td>Dynamic</td>
<td>-.036</td>
<td>.228</td>
<td>-.025</td>
</tr>
<tr>
<td></td>
<td>Customer Input</td>
<td>.136</td>
<td>.138</td>
<td>.138</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Financial Performance

Table 4.11 presents the coefficient relationship between the independent variable credit policy guidelines factors t-statistic values include; Industry Standards $t(56)=7.640$, Employee Training $t(56) = 6.609$, Compatibility $t(56) = 5.134$, Review $t(56) = 4.381$, Evaluation $t(56) = 4.759$, Expertise $t(56) = 3.641$, Quality $t(56) = 2.867$, Dynamic $t(56) = 2.157$ and Customer Input $t(56) = 1.985$. The result shows credit policy guidelines has a statistical significant effect on the financial performance of commercial banks as shown in t-statistic value $t (56) = 7.64$, $p = 0.525$, at confidence level 95% . An extra change in credit policy guidelines will result in a change of 0.486 units in the financial performance of commercial banks. This shows that enhancing the credit policy guidelines will impact positively on the financial performance of commercial banks.
4.7 Chapter Summary

This chapter presented the data collected from the field survey by utilizing tables and correlations tests to draw out the findings of the study. The chapter on the first part covers the demographic data of the respondent’s background information. The chapter progresses on with presentation of the main findings of the study in respect to the object of the study. The presentation relied on measures of central tendencies and dispersion to compute the level of agreement through which respondents agreed with various items. The section also relied on the regression analysis to draw the existing relationship between the independent and the dependent variable. Chapter five provides the summary, discussion of the findings, conclusion and recommendations.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This is the final chapter of the study where the researcher put together the final bits of the study. The section will commence by summarizing the main findings of the study in respect to the objectives of the study. The study will discuss the findings of the study for all the objectives of the study and proceed to offer a perspective approach on what the findings on the existing literature. The study will also offer requisite recommendations for all the study objectives. The chapter will conclude with an input from the researcher on what areas which need to be considered for future studies.

5.2 Summary

The general objective of the study was to assess the effects of lending practices on the financial performance of commercial banks. The study was guided by the following specific objectives; evaluation on the extent to which KYC procedures impacted on the financial performance of commercial banks, assessment on the extent to which interest rates impacted on the financial performance of commercial banks and finally the extent to which credit policy guidelines impact on the financial performance of commercial banks.

The study adopted descriptive research methodology. The target population for the study was about 570 people who included, top management staff, middle level management staff and lower level management staff of commercial banks within Nairobi region. A sample size of 57 respondents participated in the study which represented about 10 percent of the target population and the diversity of participants was representative of the whole target population. The research relied on random sampling technique to select the participants of the study. The researcher used the questionnaires to gather filed data from the respondents where was computed in SPSS v20 to help in producing the descriptive statistics of the study.

The first objective in this study was to evaluate the extent to which know your customer procedures influenced the financial performance of commercial banks. The study established that KYC procedures have been influential to protecting the banks against major frauds. The study established a 4.77 support on the likert scale which indicates that, an overwhelming majority of the respondents strongly agreed on the influence of KYC
procedure in insulating the banks against frauds. Furthermore, the respondents rejected
the suggestion that during the period when stringent KYC procedures have been in place
there have been cases of KYC violations. The study establishes that not only do KYC
insulate banks against frauds; they also serve as requisite deterrence to any attempts of
violation.

The second objective in this study was to investigate the extent to which interest rates
impacted on the financial performance of commercial banks. The study established that
commercial banks make customers as the most critical consideration in setting the interest
rates. The interest rates are central in attracting and retaining customers, thus it’s
fundamentally rational to ensure that they are favourable to them. The study confirmed
that lending is the most critical operation in the banking industry and the backbone of
financial performance. Similarly, interest rates are the main determinant of the customer
lending volumes. The study makes a finding that it’s a positive strategy for commercial
banks to ensure that their customers are comfortable with the interest rates that they set.

The third objective of this study was to assess the extent to which credit policy guidelines
influenced financial performance of commercial banks. The study established that
commercial banks adopted industry best standards in formulating policies that are related
to credit operations. An average of 4.63 was registered in the likert scale indicating that
majority of the respondents were in agreement with the synopsis. The study further makes
a finding that the implementation of credit policy guidelines is parallel across board. This
means that, there is no preferential implementation of the credit policy on case to case
basis or relaxation of the policy in special cases. The study establishes that, official
operational principle for lending operations is anchored on effective and fair
implementation of credit policy guidelines across different scenarios.

5.3 Discussion

5.3.1 Know Your Customer Procedures on the Financial Performance

The findings of the study support the existing literature on the importance of know your
customer procedures in the financial performance of commercial banks. The findings
indeed demonstrate that the stability in financial systems and prevent abuse of the
financial systems. According to Peter and Hudgins (2005) sound KYC procedures are
critical elements in the effective management of banking risks. It safeguards go beyond
simple account opening and recordkeeping and require banks to formulate a customer
acceptance policy and a tiered customer identification program that involves more extensive due diligence for higher risk accounts. Customer due diligence consists of identifying the customer and verifying their identity; identifying the beneficial owners of the customer and assessing on a risk-sensitive basis whether or not to verify those beneficial owners; and obtaining information on the purpose and intended nature of the business relationship (Builov, 2007).

The study found that enforcing strict screening of customers serves as a critical defence against fraudulent transactions. The findings support strict assessment of the customers. Roebuck (2012) was objective that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them. A key aspect of KYC is monitoring transactions of a customer against their recorded profile, history on the accounts and with peers. The objective of KYC guidelines is to prevent banks from being either intentionally or unintentionally through criminal elements of anti-money laundering activities. As such, know-your-customer procedures enable banks to understand their customers better and their financial dealings. In order to manage their risks prudently, banks frame their KYC policies including incorporating the elements of customer policy, customer identification procedures, monitoring of transactions and risk management (Builov, 2007).

The adherence to know your customer procedures is vital in ensuring that lending operations are above board. The findings supported the fact that KYC procedure enhance due diligence in lending operations. KYC conformity in banking institutions creates auditable evidence of due diligence activities (Abrams et al, 2007). Furthermore, Abrams et al (2007) suggestions that in addition to need of customer identification indicated that KYC conformity was important in ensuring that banking institutions are not defrauded and other financial crimes such as money laundering or organized crime do not take place. The findings support the need for commercial banks to implement stringent measures in analyzing customer profiles. Abrams et al (2007) further underscored the importance of banking institutions knowing the sources of funds in their customers’ accounts.

The study findings support the importance of information sharing across players in banking sector with regard to the customer data. Furthermore, the study findings demonstrate the need for commercial banks to work together with authorities in sharing critical customer information that is related to banking operations. The study support
Tsivagnanasihi (2009) suggestion, that being satisfied means that the bank must be able to satisfy competent authorities that due diligence was observed based on the risk profile of the customer in compliance with the extent guidelines in place. Valsamis (2003) placed emphasis on the need for banks and building societies to set up KYC systems for prevention of money laundering which underpins all the other activities.

5.3.2 Interest Rates and the Financial Performance

The study findings support the previous studies on the critical importance of interest rates on the financial performance of commercial banks. Commercial bank customers are the depositors and also the borrowers and it’s vital for them to be considered when setting the interest rates. The findings support Lin (2000) observations that commercial banks do not act as a price-taker but sets its loan rates taking into account the demand for loans and deposits. The findings also support the studies that have paralleled the economic conditions and the profitability of commercial banks and how interest rates influence both. Better economic conditions increase the chances of projects becoming profitable in terms of the expected net present value and therefore increase credit demand (Kashyap, Stein and Wilcox, 1993). An increase in permanent income has a positive influence on the loan demand while the effect due to the transitory part could also be associated with a self-financing effect that reduces the proportion of bank debt (Friedman and Kuttner, 1993). An increase in the money market rate raises the opportunity cost of other forms of financing such as bonds making lending more attractive.

The findings support the theory that interest rates drive the levels of borrowing and consequently the income derived from lending operations. The correlations analysis established a negative relationship between financial performance and interest rates. However, subjective to individual borrower income gets directly impacted. On the other hand net income improves for the total earnings. The findings thus indicate that in case interest rates increase, number of borrowers will likely to reduce. Berlin and Mester (1999) suggested that, stable interest rates generally have an effect on financial performance especially that of commercial banks. High interest rates will lead to increased bank interest income but at the same time lead to low demand for loans that may jeopardize the performance of the bank.

The findings support the context that interest rate determinants form individual entities which directly influence on the performance of the lending portfolio in commercial
banks. Keynes (1936) indicates that the rate of interest represent the cost of borrowing capital for a given period. Given that borrowing is a significant source of finance for the firms, interest rates are of great importance to them since it greatly affects their income and by extension their operations. According to Cargill (1991), interest rates for lending by commercial banks and other financial intermediaries represent both a composition for the loss in value of the loaned capital arising mainly from inflation as well as profit margin to compensate the lender for the default risk he exposes himself to during the loan period.

The study found that interest rates impact on the volumes of borrowing and consequently impact on the volumes of trade. Saunder (1995) asserts that interest rates influence the overall economic activity including the flow of goods, services and financial assets within the economy and as well as the whole world. He points out that interest rates relate the present value to the future value of money. A high interest rate leads to a high discount rate thus the present value of money. On the other hand, a low interest rate leads to a future cash flow at a lower discount rate. Reilly and Brown (1979) noted that interest rates including those for the banking institutions are determined by three main factors that include inflation, level of government borrowing and risk involved. Inflation sets the floor for interest rates. Institutions lend at a higher rate than the expected inflation rate over a similar period.

The study found that continuous review and regulating interest rate was vital in enhancing the stability of the lending operations in the market. In her study, Naude (1995) found out that interest rates were maintained below the market rates and direct control of credit was the primary monetary control instrument of the authorities. The Kenyan government adopted the CBK amendment Act (the Donde Act) in 2001. Interest rate influences the overall level of economic activity, flow of goods and services and financial assets within the economy. It is believed that fluctuations of market interest rates exert significant influence on the performance of commercial banks. According to Samuelson (1945), under general conditions, financial institutions’ profits increase with rising interest rates. He argued that the banking system as a whole is immeasurably helped rather than hindered by an increase in interest rates.

5.3.3 Credit Policy Guidelines and the Financial Performance
The study findings support the theory that proper credit policy guidelines contribute to positivity in the performance of the commercial banks. The findings support for
professional approach in formulating credit policy guidelines, as they impact on the financial performance of many players in the sector. The findings are in agreement on the need for industry regulation on the element of formulation of credit policies. This is why the CBK issued guidelines which attention to general principles that are prepared for governing the implementation of more detailed lending procedures and practices within the banks. Benedikt et al., (2007) studied the credit risk management policies for ten banks in the United States and found that advance credit risk management techniques help permanent to achieve their target in loan level.

The findings also support the importance of formulating credit policy guidelines that are relative to emerging and prevailing needs. This can also be paralleled on the need for understanding the market of operation and basing credit policy on the market activities. The findings support Dyer (1999) observation that lending policies should therefore be tailored according to the pre-dominant business activity in the bank’s environment. Of great importance here is to focus on the flow of business within this environment and design policies that are able to tap the benefits to the business. In periods of corporate bankruptcy, it is also important to notice that certain loan policies are important to help re-organize bankrupt institutions and transform them into highly profitable organizations (Dyer, 1999).

The study found that credit policy guidelines had a direct impact on the financial performance of commercial banks. The study findings support the literature that, failure to follow proper guidelines was disastrous for financial institutions. The banks very frequently suffer from poor lending practice (Koford & Tschoegl, 1999). Monitoring, and other appropriate steps, are necessary to control or mitigate the risk of connected lending when it goes to companies or individuals (Basel, 1999). Thus CBK issued guidelines which attention to general principles that are prepared for governing the implementation of more detailed lending procedures and practices within the banks. The findings support the mandatory preparation of Credit Policies Guidelines (CPG) by commercial banks for making investment and lending decisions and which reflect a bank tolerance for credit risk.

The study also supports the factor that credit guidelines should form the basis of all decision making in regard to credit portfolio. For instance the loan allocation and the loan portfolio of any individual financial institution e.g. commercial banks will be dictated by lending decisions (Lim, 2000). The nature, size, and the structure of loan portfolio is a
reflection of financial institutions lending decisions. The lending decisions should be
guided by the following factors: The size of the lending institution: - This is very vital in
determining the size of the loan to lend. Its loaning decisions will also depend on the
business potential on the areas of its coverage. The small financial institutions should
therefore consider their local community and immediate environment when drawing up
the lending decisions. Multinationals will consider a wider environment (George &
Simonson, 2000).

The study also supports for dynamic and constant update of the credit policy guidelines.
These efforts should ensure that at any particular time the policies being implemented are
those which enhance the efficiency of the lending operations. There are various policies
that an organization should put in place to ensure that credit management is done
effectively; one of these policies is a collection policy which is needed because all
customers do not pay the firms bills in time. Some customers are slow payers while some
are non-payers (CBK, 2005). The collection effort should, therefore aim at accelerating
collections from slow payers and reducing bad debt losses (Kariuki, 2010).

5.4 Conclusions

5.4.1 Know Your Customer Procedures on the Financial Performance

The study makes a conclusion that knows your customer procedures wield significant
influence on the financial performance of commercial banks. The study concludes that,
the KYC procedures play a crucial in banking operations by shielding the lending
operations against negative practices like fraud. The study concludes that, some of the
best KYC initiatives are seeking industry wide cooperation in sharing critical information
about respondents. Industry cooperation ensures that for instance, customer details in
previous transactions can be relied on for making possible determination of the credit
worthiness of a customer. Such information will help in shielding the finance institution
against any exposures to frauds. The study concludes that, having a working relationship
with the authorities will ensure that incase of fraud detection, the authorities can swing
fast into action and avoid any chance of resulting in worse outcomes.

The study makes a conclusion that ensuring stringent implementation of KYC procedures,
has a direct impact on the banking operation of the commercial bank. The study
concludes that, KYC procedures demonstrate the level through which commercial
institutions are serious with due diligence. The study concludes that, the banking staff
more especially those who are attached to the credit division should be well versed on the intricacies of KYC procedures. This will guide them well when making transactions related to lending operations. The study makes a conclusion a single employee understanding of KYC is the most critical step in implementation. As they form the frontline team that ensures credit operations is undertaken smoothly.

5.4.2 Interest Rates and the Financial Performance

The study makes a conclusion that interest rates influence the financial performance of commercial banks to a great extent. The study concludes that customers ought to be the biggest consideration when setting the level of interest rates. The study make a conclusion that the market volatility wields heavy influence on the shifts in interest rates and directly impacts on the net turnover of commercial banks. When there is market is volatile there will be more need for borrowing and consequently will mean that the financial institutions are posed to realize positive increase in financial performance from the returns on the credit income. The study consequently makes a finding that, increase in interest rates will result in decrease in the volumes of borrowing and consequently result in reduced income from the individual borrowers however realize higher income for those borrowing at higher rates.

5.4.3 Credit Policy Guidelines and the Financial Performance

The study concludes that credit policy guidelines are vital in ensuring that there is consistency in transactions relating to credit operations. The study concludes that, a weak and poor credit policy guideline has a potential of exposing the commercial banks to major losses which can wield a negative outcome in the financial performance. The study makes a conclusion that the regulators are well placed to set the standards for credit policies that should be implemented across board. The study makes a conclusion that, a situation of weak credit policy execution in an isolated case has the potential of hurting the whole industry thus the base minimum standards on the quality of credit policies should be industry anchored. The study makes a conclusion that the implementation of credit policy guidelines is consistent across board amongst all customers as this is vital in ensuring effectiveness and competitiveness of the lending operations.

5.5 Recommendations

Recommendations for improvement;
5.5.1 Know your customer procedures on the financial performance of financial banks

The researcher recommends for consistent implementation on the KYC procedures to ensure uniformity in the lending operations. This should ensure that all the credit staff that is attached to the lending operations in the financial institution is well trained in the intricacies of KYC procedures. Having a team that is well versed on the implementation of KYC procedures will be critical in eliminating any loopholes that can potentially result from weak follow-up on KYC requirements. Such loopholes can expose the entire financial institution to risks. Furthermore, the study recommends for more concerted efforts in sharing of customer information with all industry players as this will limit any chances of customers defrauding commercial banks. Sharing of information will also contribute to faster detection of fraudsters and detaining them. This can happen in case, a previous fraudster whom couldn’t be traced and pops up suddenly from the cold. If his information was shared across all banks, he should be placed on a watch list with a notification system so as soon as they show up in a financial institution, the authorities can be alerted to apprehend the crook. Finally, the researcher recommends for tightening of the KYC procedures as it can serve as an excellent deterrent.

5.5.2 Interest rates and the financial performance of commercial banks

The study recommends for the moderation in the levels of interest rates that are set by financial institutions. Before the year 2016, interest rates charged for different loans weren’t fixed and commercial banks were at mercy to exercise their derogative in setting the levels interest rates. This means that the interest was capped and the players are expected to obey the new requirements. Despite this being a positive outcome for the borrowers, it’s definitely a wakeup call for the lenders. The study makes a recommendation that, customer’s needs should consider when setting the levels of interest rates. This should be guided by the state of the economy. Furthermore, the banks should adopt more measures in conducting extensive market survey to ensure that they understanding the areas where they can tap into and create lending products that is relative to market needs. The researcher finally submits that, formulation of interest rates should seek customers input and draw parallels on the suggestions. Through this the commercial banks will be in a position to set interest rates that can be deemed considerate of the borrowers and likely to retain them for the long haul.
5.5.3 Credit policy guidelines and the financial performance of commercial banks

The study recommends for commercial banks to adopt abrasive approach in formulating internal credit lending operations. This should be considerate of the standards and quality that are consistent with the global best practices. The study recommends for the involvement of regulators, consultants and researchers in the field of credit policies for financial operations in formulation of industry base standards on credit policy. Having a strong practice in adhering to industry should be made a mandatory requirement for all the stakeholders. The study recommends for cooperation in ensuring concurrent execution of credit policy guidelines as a tool for ensuring prosperity. This is informed by the fact that, isolated cases of weak implementation of credit policy guidelines can result in outcome which can hurt the whole sector. An example can be drawn from a scenario where weak credit policy resulting in losses and the information spreads regionally. Foreign investors will have a diminished perception on the banking standards in the country, as they relate an isolated case to a spread out problem. Thus, adherence to industry standards on credit policy guidelines shouldn’t be an option, but a mandatory requirement across board.

5.6 Suggestions for Further Studies

This study sought to assess the extent to which lending practices impacted on the financial performance of commercial banks in Nairobi. The researchers suggest the following areas which need to be dissected further in future studies;

i) An investigation into the methodologies for formulation of credit policies for commercial banks and the impact on financial performance in the area.

ii) The study on importance of customer feedback in setting interest rates for commercial banks.

iii) The contribution of technology in establishing the credit worthiness of borrowers and its impact on the financial performance of commercial banks in Kenya.

iv) Finally, this study was limited in scope and covered Nairobi region, future researchers should expand the scope of study and cover the whole country and regionally.
REFERENCES


Keynes, J. M. (1936). The general theory of interest, employment and money.


Mohan & Rakesh (2003). Transforming Indian Banking – In Search of a Better Tomorrow, Speeches from RBI Bulletin,


Tracey D.M., and Kimberly T.K, (2011); Designing And Conducting Research in Health and Human Performance. John Willey and Sons Inc


APPENDICES

APPENDIX I: COVER LETTER

Ann Njeri Maina

United States International University

P.O.BOX 14634-00800

NAIROBI

10th Oct 2016

Dear Respondent,

REF: REQUEST FOR YOUR PARTICIPATION

This structured questionnaire is for collecting data on effect of lending practices on financial performance of commercial banks in Kenya (A survey of selected banks within Nairobi). You are kindly requested to provide the required data in the questionnaire. The process will take you only about 8 minutes. The information that you provide will remain confidential and is sought exclusively for the completion of an MBA research project.

Thank you very much for taking the time to complete this survey. Your input will go a long way in enhancing bank managers understanding on the nature and characteristics of different lending practises that contributes towards realization of increased financial performance of commercial banks and also assist them in developing a guiding framework on how to successfully implement lending practises not only to gain competitiveness but also optimize their performance potential (growth and profitability prospects). If you would like to receive a copy of this report, please indicate so by writing your email address on the back of the questionnaire.

Kind Regards,

MBA Student
APPENDIX II: QUESTIONNAIRE

Section A: GENERAL INFORMATION

1. Kindly indicate your gender
   a. Male □
   b. Female □

2. How long have you worked in your organization
   a. 0-5 years □
   b. 6-10 years □
   c. 11-15 years □
   d. Over 15 years □

3. Please indicate your designation
   a. Credit officer □
   b. Bank Manager □
   c. Departmental manager at the bank □
   d. Other (Please Specify)…………………………………………………..

4. Indicate the level of education
   a. Certificate □
   b. Diploma □
   c. Degree □
   d. Post-Graduate □
   e. Other (Please Specify)…………………………………………………..

5. How many employees does your organization have?
   a. 200-1000 employees □
   b. 1000-3000 employees □
   c. over 3000 employees □
**SECTION B: KNOW YOUR CUSTOMER PROCEDURES**

To what extent do you agree with the following with regard to know your customer procedures. Use: 1- Strongly Disagree, 2- Disagree, 3- Undecided, 4- Agree and 5- Strongly Agree.

<table>
<thead>
<tr>
<th>Know your customer procedures</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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</thead>
<tbody>
<tr>
<td>a. Our bank follows stringent measures in analysing customer profiles</td>
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<td>b. KYC procedures has been instrumental in protecting the bank from major frauds</td>
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<td>c. We hardly notice violations in KYC procedures</td>
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<tr>
<td>d. Every employee is well aware of KYC procedures in place for our bank</td>
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<td>e. We have frequent monitoring of how KYC procedures are adhered to</td>
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<td>f. We report to authorities any violation of KYC procedures</td>
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<td>g. We regularly update our KYC procedures to improve on any implementation shortcomings</td>
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<td>h. We cooperate with other banks in leaning our KYC policies</td>
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<tr>
<td>i. We experience instances of KYC violation from time to time</td>
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<td>j. KYC procedure enhance due diligence in lending operations</td>
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</tbody>
</table>
SECTION C: INTEREST RATES

To what extent do you agree with the following with regard to loan Interest rates procedures? Use: 1- Strongly Disagree, 2- Disagree, 3- Undecided, 4- Agree and 5- Strongly Agree.

<table>
<thead>
<tr>
<th>Loan Interest Rates</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Most customers are sensitive to loan interest rates</td>
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<td>b. We have favourable lending rates for our customers</td>
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<tr>
<td>c. We have a lending rate slightly below the prevailing market rate</td>
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<tr>
<td>d. Interest rates volatility affects the profitability of our bank</td>
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<td>e. Our customers are strictly based in our interest rates</td>
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<td>f. Interest rates for different loan facilities affects competitive advantage</td>
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<td>g. Capping interest rates has a direct impact on bank earnings</td>
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<td>h. Interest rates influence the repayment rate amongst borrowers</td>
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<tr>
<td>i. The interest rates drive the borrowing volumes among different financial institutions.</td>
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<td>j. Interest rates are continuously reviewed in line with prevailing economic conditions.</td>
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</tbody>
</table>

SECTION D: CREDIT POLICY GUIDELINES
To what extent do you agree with the following with regard to banks credit policy guidelines in regard to lending? 1- Strongly Disagree, 2- Disagree, 3- Undecided, 4- Agree and 5- Strongly Agree.

<table>
<thead>
<tr>
<th>Credit policy guidelines</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
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</thead>
<tbody>
<tr>
<td>a. Formulation is undertaken by experienced consultants.</td>
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<td>b. Banks adopt industry standards in formulation of policies</td>
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<td>c. Input of customers considered in crafting of credit policies</td>
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<td>d. Banks continuously review credit policies to suit emerging lending issues.</td>
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<td>e. Banks can ignore credit policy guidelines that are unfavourable to certain customers.</td>
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<td>f. Credit policies for financial institutions are compatible to internal control mechanisms</td>
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<td>g. Quality of credit policies impact on the overall performance of the lending portfolio</td>
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<td>h. Credit policies are dynamic to an extend of varying in applicability on case to case basis</td>
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<tr>
<td>i. Credit policy guidelines form the basis for performance evaluation of the lending division.</td>
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<tr>
<td>j. Banks employees trained thoroughly on the intricacies of credit policy guidelines</td>
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</table>

**SECTION E: FINANCIAL PERFORMANCE**
To what extent do you agree with the following with regard to the financial performance of commercial banks? Use: 1- Strongly Disagree, 2- Disagree, 3- Undecided, 4- Agree and 5- Strongly Agree.

<table>
<thead>
<tr>
<th>Financial performance</th>
<th>1</th>
<th>2</th>
<th>3</th>
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</thead>
<tbody>
<tr>
<td>a. Financial institutions base profitability on the performance of lending portfolio</td>
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<tr>
<td>b. Growth of loan book indicate positive growth in profitability</td>
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<td>c. Effectiveness of lending policies translates to increased regular turnover</td>
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<tr>
<td>d. Creativity in lending products impacts on the performance of the lending portfolio</td>
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<td>e. Performance of lending portfolio is the main determinant for expansion programs</td>
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<td>f. Flexibility of the lending procedures influence the growth rate of the banking institution</td>
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<td>g. Cost reduction has a direct proportional effect on profitability of banking institutions.</td>
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<tr>
<td>h. Investors in banking sector base investment decision on the performance of the lending portfolio</td>
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<tr>
<td>i. Lending portfolio growth rate is a determinant of ROI for the banking sector</td>
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<td>j. Banking institutions stock value is determined by veracity of the lending portfolio</td>
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</table>

End

Thank you for your participation