INFLUENCE OF LENDING PRACTICES ON INVESTMENT PERFORMANCE OF COMMERCIAL BANKS IN KISUMU CITY, KENYA

BY

JOSHUA OMOLLO OGALO

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DECLARATION

Declaration by the Candidate

This research project report is my original work and has not been presented for the award of a degree in any other learning institution.

Signed……..…… Date……...

Joshua Omollo Ogalo

MBA/BE/06015/2013

Supervisor

This research project report has been submitted for examination with my approval as university supervisor.

Signed …… Date ……

Dr. Robert B. K. Mule,

Department of Accounting and Finance,

Maseno University

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DEDICATION

This project report is dedicated to my family.

ABSTRACT

Globally, lending practices are central to the realization of critical banking objectives with investment performance being the baseline yardstick for the sector. Prior to 2015, Kenya's banking sector was vibrant and highly profitable. Sector loan book grew at an impressive compound annual growth rate of 16% from 2011 and 2015, lending to gross domestic product was 35%. However, after the interest rate cap in August 2016, there has been a general slowdown to lending, January, 2016 (16.8% growth); August, 2016, (5.4 %growth) and December, 2016, (4.3% growth). Non-performing loans increased across the sector from an industry average of 5.2% before 2015 to an average of 7.9% as at September 2016. Credit management and performance literature show that lending practices are important drivers of bank performance in terms of return on investment and market share. Prior local studies mainly focus on general credit management practices in different sectors and studies have not explored the influence of lending practices on investment performance of commercial banks. Given the critical role the commercial banks play in the Kenyan economy, it is not apparent how know your customers (KYC) procedures, loan repayment and cash lending policies influence investment performance of commercial banks in Kisumu city. The purpose of this study was therefore the influence of lending practices on investment performance of commercial banks in Kisumu city, Kenya. The specific objectives of the study were to: establish the influence of KYC procedures on investment performance; determine the effect of loan repayment policies on investment performance and establish the influence of cash lending policies on investment performance. The study was anchored on financial acceleration theory. A correlation research design was employed. The target population was 81 branch, credit and operation managers of 27 commercial banks in Kisumu city. Purposive sampling technique was used to arrive at study sample of71 respondents. The study used both primary and secondary data. A semi-structured self-administered questionnaire was used to collect primary data. Secondary data was collected through desk review. Reliability of questionnaires was tested on pilot data from 10 respondents and yielded a coefficient of above 0.701 implying internal consistency. Content validity test was done using expert reviewers. Data was analyzed using inferential statistics such a multiple regression analysis. The results indicate that KYC practice is a positive significant predictor of investment performance (β = .180 (p = .010), loan repayment practice is a positive significant predictor of investment performance (β = .408 (p = .000) and cash budgeting practice affects investment performance significantly positively (β = .407 (p = .007). The study concludes that embracing KYC practices, loan repayment and cash budgeting practices by commercial banks in Kisumu city leads to improved investment performance. The recommendations of the study are that commercial banks in Kisumu city should intensify use of KYC practices, managers of commercial banks in Kisumu city should enhance application of loan repayment practices and commercial banks in Kisumu city should continue embracing cash budgeting practices as this was found to improve investment performance. The study findings will be of significance to commercial bank policymakers and other stakeholders in designing the optimal lending practices and maximizing the investment performance. In addition, provide new evidence and form a basis for future research in the area of credit management and investment performance.

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DEFINITION OF TERMS IN THE STUDY

Loan repayment practices: Paying back the money borrowed from banks. It is the act of reversing money previously borrowed from lender

Lending rate: The money charged on loan received in periodicals

Interest rates: This is a rate which is charged or paid for the use of money. It is often expressed as an annual percentage of the principal. It is the price charged for borrowed money.

Investment performance: The sum of borrowed money upon which the debtor has made scheduled payments for business growth by cost of capital, customers' growth and return on investment.

Cash lending practices: This is giving out in money with security/give somebody loan of cash with guarantee control measure policy put in place to maintain value of currency rates of Dollars against Kenya shillings.

Lending practices: Lending practices include cash lending, know your customer procedures and loan repayment practices**.**

Know your customer practices: are the procedures employed by banks to maintain their customers notably bank protection, monitoring, due diligence, violation alerts and regular updates.

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CHAPTER ONE
INTRODUCTION

This chapter presents the background to the study, statement of the problem, research objectives, hypotheses, justification for the study and the conceptual framework.

1.1 Background of the Problem

Banking operations undertaken by commercial banks and the services offered are diverse and well spread out. According to Basel (2002), lending remains the principal operation that forms the backbone of banking services. Lending practices are central to the realization of critical banking objectives with investment performance being the baseline yardstick for the sector. All commercial banks understand clearly the sensitivity of lending practices and how they can influence banking services and investment performance. 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 investment 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 mobilize 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.

Advances in financial sector have rallied changes in the whole industry, making it crucial for the assessment of investment performance of banks in this modern age. Investment performance is the degree to which a bank'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).

Investment 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 investment 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 practices inform the credit risk status and the performance of risk assets therein influencing on the investment performance for commercial banks.

According to Decra (2012), the banking sector is considered to be an important source of financing for most businesses. Increase in investment 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.

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.

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).

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 investment 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. In this study, these practices include KYC procedures, interest rates, loan repayment policies and cash lending policies.

Know your customer (KYC) practice 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).

Prior studies (Ngetich and Wanjau, 2011) identify KYC practices as an important credit management practice. Whereas other studies (Kipngetich, 2011 and Mwangi, 2012) use diverse methodologies, ordinary least squares regression method, and not very clear sampling techniques (Arasa, 2015; Jagongo*et al*, 2014). This study adopted a correlation research design, Primary quantitative data to be collected through semi-structured questionnaires, Simple random sampling technique will be used to obtain a sampled population and regression analysis will be used to determine the influence of KYC procedures on investment performance. It can also be noted that the relationship between KYC procedures and investment performance is not clear, while some argue that it restricts investment performance, others are of the contrary opinion. Most of the research works highlighted were largely descriptive and exploratory. Little or no research work has been done on effect of KYC practices on investment performance in Kenya, in particularly Kisumu City.

Empirical evidence on loan repayment policies emphasize on lending constraints (Godquin, 2004; Santiago and Francisco, 2005). Other studies (Tomaki, 2013; Fishman and Love, 2004) identify loan repayment policies as one of the credit management policies adopted by financial institutions. On the contrary, other (Bhattacharya, 2011) focus on interest rate spread among financial institutions. Studies do not indicate how loan repayment policies may influence investment performance of commercial banks, a gap that the current study will bridge. While some employed purposive sampling method, the current study used simple random sampling technique. Regression analysis was used to determine the relationship between loan repayment policies and investment performance since it was unclear from the previous studies.

Prior studies (Frank, 2013) on cash lending policies and performance rely wholly on secondary data with few researchers depending on both interviews and secondary data. Whereas other studies (Andrain, 2011, Vermeulen, 2006) have focused on Repo lending practice, investment financing and cash shocks, they all lack clear research design, all

have different methodologies, sample sizes and study area, only one study was done in Kenya and consequently none was done in Kisumu city. The current study adopted correlation research design, Primary quantitative data to be collected through semi-structured questionnaires and regression analysis was used to determine the influence of cash lending policies on investment performance. Therefore, influence of cash lending policies on investment performance has not been studied.

Banking industry in Kenya is currently going through a development process that the majority of advanced economies have already been through, having introduced interest rate ceiling in August, 2016. The sector framework as at 31st December, 2015 comprised of 54 financial institutions, 42 of these are Banking institutions, and 12 are deposit taking micro finance institutions (DTMs) with the Central Bank of Kenya (CBK) as the regulatory body (Banking Survey, 2016), 1 mortgage finance company, 2 credit reference bureaus, 3 representative offices and 124 foreign exchange bureaus (CBK, 2014). Ideally, only 39 banking institutions operate (having excluded Charterhouse Bank which is still under suspension, Imperial Bank and Dubai bank which were both placed under receivership by the CBK in 2015.

Before the introduction of interest ceiling, Kenya's banking sector was observed as a vibrant, highly profitable sector, with the overall capital adequacy ratio averaged 19 % against a statutory minimum of 14.5 % and a liquidity ratio of 38.3 % as at end December 2015, (CBK, 2016). Industry's ROE's averaged at 20% while sector loan book grew at an impressive CAGR of 16%, lending to GDP was 35% on the back of high economic growth and low financial inclusion (AIB Capital, 2016), However, following the introduction of the interest rate cap in August 2016, Olaka, (2017), explains that there has been a general slowdown to lending, January, 2016 (16.8% growth); August, 2016, (5.4 % growth) and December, 2016, (4.3% growth), more to this, he noted that banks have resorted to staff reduction, close some branches. AIB Capital (2016), explains that non-performing loans increased across the sector from an industry average of 5.2% before 2015 to an average of 7.9% as at September 2016.

1.2 Statement of the Problem

The stability of the lending industry is an important prerequisite for economic stability and growth, this is because commercial banks provide enterprises with the much needed

capital to start business, the availed capital, if invested productively stimulates the economic growth. Before 2015, Kenya's banking sector was a vibrant, highly profitable sector, with industry ROE's average of 20%. Sector loan book grew at an impressive compound annual growth rate of 16% between 2011 and 2015. As at 2015, Kenya's lending to gross domestic product was 35%, as a result, Kenya's economy grew by 5.6% in 2015. However, following the introduction of the interest rate cap in August 2016, there has been a general slowdown to lending, January, 2016 (16.8% growth); August, 2016, (5.4 % growth) and December, 2016, (4.3% growth). Non-performing loans increased across the sector from an industry average of 5.2% before 2015 to an average of 7.9% as at September 2016. Studies relating to the lending practices and investment performance have given mixed results, some argue that it protects investment while others are of the opinion that lending practices an inefficient tool for enhancing performance and limits access to credit, reduces transparency and promotes lending to only individuals who are credit worthy. It is on this basis that the study seeks to establish the influence of lending practices on investment performance of commercial banks.

1.3 Objective of the Study

The general objective of the study was to establish the influence of lending practices on investment performance of Commercial banks in Kisumu City, Kenya.

Specifically, the study sought to:

i) Determine the influence of know your customers practices on investment performance of commercial banks in Kisumu City.
ii) Establish the influence of loan repayment practices on investment performance of commercial banks in Kisumu city.
iii) Assess the effect of cash lending practices on investment performance of commercial banks in Kisumu city.

1.4 Research Hypotheses

This study tested the following pertinent hypotheses:

$\mathbf{H_{01}}$: Know your customers practices have no on investment performance of commercial banks in Kisumu City.

$\mathbf{H_{02}}$: Loan repayment practices have no influence on investment performance of commercial banks in Kisumu city.

H_{03}: Cash lending practices have no effect on investment performance of commercial banks in Kisumu city.

1.5 Scope of the Study

This study sought to establish the influence of lending policies on investment performance of commercial banks in Kisumu city. The main variables under consideration were lending practices and investment performance. The study adopted correlation research design. Primary quantitative data was collected through semi-structured questionnaires while secondary data was collected from Bank Supervision Reports, published papers, official websites of commercial banks, and records kept by commercial banks.

1.6 Justification of the Study

The study will be useful to the management of the commercial banks and monetary policy makers of the government for it will provide a formative evaluation of investment process while highlighting the possible areas that pose challenge to the success. To the investors it identified the challenges and signal early warning towards the implementation of interest rates and other lending practices. This study will serve as a basis for further research on the influence of lending practices on investment performance of commercial banks. It may also stimulate further study on optimal lending practices and performance of firms in different sectors of the economy.

1.7 Theoretical Framework

This study was based on financial accelerator effect theory, borrowed from economic theory, and a variant of dynamic new Keynesian framework, the theory is attributed to Professor Ben Bernanke. According to Bernanke, Gertler and Gilchrist, (1996), financial accelerator results from changes in credit market conditions due to various economic shocks, which affect the intrinsic costs of borrowing and lending associated with asymmetric information. Miller, (2013) explains that asymmetric information where financial institutions are able to exploit information before its clients may lead to market imperfections resulting to adverse selection and moral hazard problems hence invalidating the standard competitive market results.

Bernanke et al., (1996), elaborates that the framework illustrates developments in the credit market that amplifies and propagate shocks to the macro economy. The key mechanism involves the link between "external finance premium", that is, the difference between the cost of funds raised externally and the opportunity cost of funds internal to the firm, and the net worth of potential borrowers (defined as the borrowers' liquid assets plus collateral value of illiquid assets less outstanding obligations). According to Almeida, Campello and Liu, (2006) the key idea behind the financial accelerator is the notion that shocks to the net worth of firms and households have a pro-cyclical effect. With credit-market frictions present, and with the total amount of financing required held constant, standard models of lending with asymmetric information imply that the external finance premium depends inversely on borrowers' net worth (Bernanke et al., (1996). Miller, (2013) argues that MFIs face difficulties in measuring the borrower's creditworthiness when making credit scoring decisions, raising two fundamental issues: Clients that have lower risk are adversely selected and are likely to receive some form of credit, those that remain, will either be of high risk, or low risk but unable to prove. MFIs being unable to differentiate, will charge an aggregated rate which is attractive to the high risk client raising the probability of default. On the other hand, clients borrowing at a higher rate might be required to make riskier investments in order to cover their borrowing costs again leading to high probability of default.

1.8 Conceptual Framework

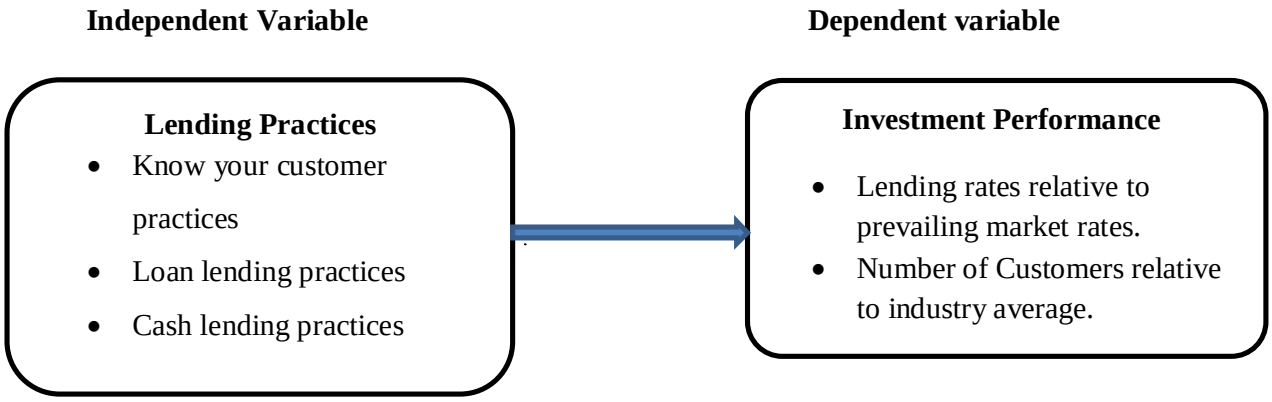

Figure 1.1: Lending Practices and Investment Performance

Source: Adapted from Maranga*et al.*, (2017) and Njagi (2009).

The conceptual framework is adapted from Maranga *et al*., 2017 by modifying it to suit the research purpose. Maranga *et al*. (2017) employ correlation research design in examining the investigating the effect of interest rates on business investment performance while Njagi (2009) explores the effectiveness of know your customer policies. Therefore, this study is relevant in conceptualizing this research. Concerns and aspects in Maranga*et al*. 2017 and Njagi (2009) are collated to three lending practices namely know your customers practices, Loan repayment practices and cash lending practices. These three constructs are hypothesized to influence bank's investment performance surrogated by lending rates and number of customers.

CHAPTER TWO
LITERATURE REVIEW

This chapter reviews both theoretical and empirical literature relating to lending practices and investment performance of commercial banks.

2.1 Theoretical Review

This study was guided by several theories; financial accelerator effect theory, Credit Rationing Theory, Liquidity preference theory and Default theory.

2.1.1: The Financial Acceleration Theory

This theory tries to find details on how undersized financial shocks can be moderately large in the effects of lending as well as borrowing behavior in financial market. The premise relies on the interaction among monetary agents' netting investment value as well as the external money premium that take place due to a symmetric in order between lenders along with borrowers. The financial accelerator product on domestic expenditure occurs since households, as well as firms, invest several of their expenditures by means of money borrowing. In particular, domestic deposit usually finances investments in somewhere to live as well as purchases of other long-lasting goods through raising funds within credit market. These money transactions are too characterized through asymmetric information evils flanked by the borrowers (home) along with the lenders (banks). Consequently, households' capacity with/or conditions beneath which they are able to get hold of funds, for this reason their expenditure, are also prejudiced via their net worth. Since pragmatic in a large amount of households' borrowings are protected by real estate investment, the prose has been listening carefully above all on the effect of rate changes in residence investing values (Lacoviello, 2005).

Financial increase of rate on domestic costs as follows. An optimistic shock to financial activity causes an increase in house deposit charge, which shows the way to boost in homeowners' disposable merit. This reduce the outside finance rate, which leads to an increase in housing investments as well as spills over interested in use demand of expenses (Aoki, 2004).

In the Short-run interest rate produce variation which has usually been measured as a product of a variety of financial shocks, which are conveying diverse transmission

machinery. One of the ordinary ways of thoughts concerning the invention of amount produced schedule in excess of a short-run stage is an auto regressive (AR) development (Blanchard, 2001).

Financial acceleration results to materialize outstanding in the direction of a symmetric order of difficulty that restrain the capability of banks to get hold of funds from borrowers in trade as well as in comprehensive inter-bank monetary marketplace. In view of the fact that banks come in the deposit market as borrowers given they can go insolvent as well as investors, there is no motivation to take for fixed so as to banks' capability to accumulate funds on the interest rate expenses of the funds which will not be biased through their bank resources. To the amount so as the financial shocks have an effect on banks net value it strengthens the influence of banks ability to attract customers for loans of investing finance (Gertler, 2010).

This theory gives an option on how commercial banks deal with calculation of interest rate on loan borrowers. The cash rationing hypothesis advice that lenders has to control the amount of credit they offer away to their borrowers depending on the existing interest rates in addition to available security or reserve of collaterals. Commercial as one of the lenders will be in determination to make conclusion to let somebody borrow or not on the way to lend depending of collateral that has been existing to them as a result of a borrower. If the lenders pay out loans at far above the ground of interest rates, they pull towards riskier investments along with chances of borrowers keeping away from them to convene their reimbursement supplies. The condition of money base on other bank option to security will give borrowers opportunity of non-payment on their loans because their association with the lender is not as physically powerful when guarantee is concerned. The financial credit distribution hypothesis suggests that the benefit that interest rate is extremely momentous in the influential of the interest rate on the amount of financial investors which will be keen to lend money to determine the ability of the borrower to pay back on the investment loan (Tessie, 2009). It deals with the emotional reaction people experience after realizing they have made an error in judgment. Interest rates is a selling stock, investors become affected by the price at which they purchased stock. So they avoid selling it as way to avoid the regret of having made a bad investment, as well as the embarrassment of reporting a loss. Regret theory can also hold true for the investors who find a stock they had considered buying but did not went up in value. Some

investors avoid the possibility of feeling this regret by following the conventional wisdom and buying only stock that everyone else is buying; rationalizing their decision with everyone else is doing it (Nwangbo and Onkonkwo, 2014).

2.1.3 Credit Rationing Theory

This is a situation where demand for loans exceeds their supply and since economic theory has traditionally viewed market clearing and equilibrium as one thing, a situation where supply does not equal demand is perceived as disequilibrium and may be caused by external factor such as interest rate ceiling. Credit rationing was a seminal work of Jaffee and Russell (1976) and later developed by Stiglitz and Weiss (1981), the theory provides another framework for analyzing financial market inefficiencies. According to Stiglitz and Weiss, information asymmetry is regarded as the main cause of financial market malfunctioning in developing countries. Banks that advance loans are primarily concerned about the interest rate they receive on the loan and the riskiness of the loan. The interest rate a bank charges on loans have the tendency of affecting the riskiness of a pool of loans by either sorting potential borrowers – adverse selection effect; or affecting the behaviour of borrowers – moral hazards (Akowuar, 2011). According to Riley, (1987) credit rationing predicts that as the cost of capital rises, the bank may find it unprofitable and very risky to lend to certain groups of customers for which informational frictions are particularly large. Recent theoretical work of Chari, chourideh and jones, (2010) and Kurlat (2010) has extended these ideas to analyze how informational frictions affect the availability of credit during a financial crisis.

2.1.4 The Liquidity Preference Theory

The theory gives facts which are predictable in raising capital to promote investment through Keynes. The favorite decision is of those investors who have a preference for better liquidity payable together with interest intimidation as well as defaulting turn over to maturity rates. Owners of long-term liquidity set in the danger that interest rates will increase during the payment period building their permanent rate in investments less priceless. Likewise adverse changes in the monetary conditions of the business are also a principle of time today certain than tomorrow, subsequently month is further convinced than subsequently as well as the opportunity of nonpayment increases period. Investors are as a result to lowly rate only on the through expression as well as most liquid investments (Cartel, 2004)

The theory of liquidity holds that long- term business securities should give higher returns than short term debt since investors are willing to give up a number of ways to spend in short loan obligations to keep away from the higher charge instability of extensive maturity rates (Reily, 2006). An increased partiality for liquidity within the interest rate model is as good as demand for money which increases more customers who believe interest rates are predictable to increase profits than credible go down. On the further, banks give borrowers a chance in their way only to invest where returns are on their asset not to go beyond the borrowing rates (Bain, 2007).

2.1.5: Default Theory

This theory was proposed by Vigenina in 2004 to explain investors defaulting payment in terms of changes in interest rate of money given for investment. The density of non-payment arises when money borrowers are capable to pay but reluctant to convene their money obligations. With combined legal responsibility, if a borrower discards to reimburse his or her share of the loan credit, the entire rate in the group is taken carefully as being default behind subsequent loans. This encourages the grouping of interest rates in the banks whichever to pay back for offending associate or to make use of social demands on him. As a result of this encouragement, the bank lenders are competent to attain repayment of each and every loan by means of high prospect. As soon as it comes in the direction of mortgage contracts (if a borrower discards mortgage repayment), the loan official once more plays the central role by means of warning as well as if necessary authorize non-payment clients. Apart from the danger of advertising the security within a small number of days, they can slash off borrowers commencing extra way in to loans. The assets of non-payment fear are the main official of highs interest rates within defaulting theory (Veginina, 2004).

2.1.6: Lending Practices

This section provides lending practices in relation to investment performance for commercial banks namely: know your customer (KYC) practices, loan repayment practices and cash lending practices.

2.1.6.1: Know Your Customer Practices

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).

2.1.6.2 Loan Repayment Practices

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).

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.

2.1.6.3: Cash Lending Practices

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. 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 judgment 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).

2.1.7: Investment Performance

Investment performance is an indicator of how profitable a company in relations to its total assets and cash inflows. It is measured by means of asset returns. In general investment performance in the last two years has been recovering through interest rate.

Nevertheless, this does not denote that all investors in the commercial industry are profitable since there are those that are pronounced in losses. This does not leave out interest rate on other Microfinance organizations (Oloo, 2009).

Reily (2006) observes that investment fluctuates sharply over the business cycle. Investment plays a crucial in long term growth. Investment is determined by return on investments; changes in the desired capital stock. Desired Capital stock is the amount of capital that allows firms to earn the largest expected profit which depends on benefits and cost of additional capital. The associate capital is real cost of using a unit of capital per year. This is called the user cost of capital (uc), which equals the sum of the real interest cost (r) and depreciation (d) and price of capital (p).

To measure the profitability of investment is simply taking variety of ratios used of which Return on Asset, Return on Equity as well as Net savings. Investment measures are articulated in terms of monetary units. The method is extensively used for investment investigative purposes include; ratio analysis. Ratio analysis gives a purpose of depiction of a company's investment performance because ratios do away with the dimension of outcome (Chandra, 2005).

2.2 Empirical Literature

2.2.1: Know your Customer Practices and Investment Performance

Arasa (2015) investigated the determinants of know your customers compliance among commercial banks in Kenya using exploratory research design. The findings of the study were that KYC procedure practiced were bank protection, monitoring, due diligence, violations alert and regular updates. However, the study did link the KYC to the investment performance, which the gap this study seeks to address.

Ngetich and Wanjau (2011) conducted a study on the effects of interest rate spread on the level of non- performing assets. The study focused on commercial banks in Kenya. This was a case study with an aim of establishing how interest rates affect non-performing loans in commercial banks operating within East Africa. Both quantitative and qualitative data were used in the study. The findings from the study revealed that the spread of interest rates affects the non-performing assets in commercial banks by increasing the cost of loans charged on the borrowers. When the cost of loans is high, there are high

chances of loan default and likelihood of having a huge non-performing loan portfolio. But they did not address the influence of know your customer on investment performance. Therefore, there is a gap to be filled by the study.

Kipngetich (2011) used regression model to investigate the relationship between interest rates and financial performance as the independent variable and interest rate as the dependent variable established that there is a positive relationship between the two variables though the effect of interest rates on profitability is not significant in the all the financial institutions. In his view all the other factors which influence profitability needs to be enhanced to in order to improve the financial performance of financial institutions in Kenya.

Mwangi (2012) carried out a study on the effect of non-performing loans on the investment financial performance of commercial banks in Kenya. The study found how the effects of non-performing loan portfolio distress the success of commercial banks within Kenya. Secondary data were obtained from the banks relating to two variables: Return on Assets which was the dependent variable and non-performing loans which was the independent variable. The study adopted simple linear regression model to establish the effect of non-performing loans on the commercial banks. The found out that there are high amount of non-performing loans in low ROA. However, later years showed a different trend in cost of capital to invest was higher in the non-performing loans which are slow.

Jagongo et al. (2014) did a survey of the factors influencing investment decisions. An individual investment is concerned with choices about purchases of small amounts securities for her own account. The objective of the study was to find factors affecting investment decisions; dividend growth and profit savings. Firm's positions and performance and economic conditions are based on profits. He established those investors are already holding stock in ways on sell and purchase of houses and individual stock brokers. They found that large investors generate abnormal volumes for buyer initiated trades after a positive recommendation only if the investor is unaffiliated. The same study is also shown from Nwangbo and Onkonkwo (2014) in Nigeria who asserted that high interest rate and requirement for collateral demanded by banks as a source of capital for investment in market gardening in the state.

Wanjira (2010) conducted a study the relationship between management practices and financial performance in Kenya. The main focus of this study was to establish how financial performance of investors is affected by the type of investment management practices. The study used primary and secondary data. The secondary data were obtained from the audited financial statements of the 46 commercial banks of Kenya. No sampling was done since a census was possible due to the small number of commercial banks in Kenya. The study revealed that the type of investment management practices determine their investment performance.

From the aforementioned literature, the methodology used in the stated literatures is different from that of the current study, while some used Ordinary least squares regression method, and not very clear sampling techniques. This study will adopt correlation research design, Primary quantitative data to be collected through semi-structured questionnaires, Simple random sampling technique will be used to obtain a sampled population and regression analysis will be used to determine the influence of KYC procedures on investment performance. It can also be noted that the relationship between KYC procedures and investment performance is not clear, while some argue that it restricts investment performance, others are of the contrary opinion. Most of the research works highlighted were largely descriptive and exploratory. Only few cases in Africa, like the case of Nigeria, little or no research work has been done on effect of KYC procedures on investment performance in Kenya, in particularly Kisumu City.

2.2.2: Loan Repayment Practices and Investment Performance

Godquin (2004) did a study on loan reimbursement performance of MFI borrowers within Bangladesh banks. Then his findings from the study disclose that mortgage with refinement periods which have considerably lower rate on loan criminal behavior than usual loans. His conclusion also hold up the argument that declining in the number of loan repayment customers stand to the possible to raise the competence in MFIs, as agreement loans are not related with high lend defaults. However, the study did not explore loan repayment policies and investment performance relationship in the context of commercial banks.

Another study by Santiago and Francisco (2008) studied the effects of bank lending and financing constraints in SME Investment in the Federal Reserve Bank of Chicago. The study shows that investment is sensitive to bank loans for unconstrained firms but not for constrained firms. He also found out that unconstrained firms use bank loans to finance trade credit provided to other firms and predicts investment.

Tomaki (2013) conducted a study on the determinants of bank interest rate on borrowing behavior of commercial banks in Turkish for a sample of eighteen from 25 banks. The main objective of the study was to identify the determinants of bank interest rate behavior. The data was enclosed 2003 to 2012 periods. The variables used were size, access to long term funds, interest rates, GDP growth rate and inflation rate. The finding reveals that bank size, access to long term loan and inflation rate have significant positive impact on the bank`s lending behavior but, interest rates is of no consequence.

Fishman and Love (2004) studied the effects of banks loan on investment assessment. The study used a new method to evaluate the investment in terms of loan given. It shows that it is easier to lend to encourage more business to borrow and repay the amount borrowed. Whether these firms can link their investment to either bank loans or trade credit but they did not discuss the effects of interest rate on investment.

Wool Cock (2002) in his study Micro enterprises and social capital the study observed that if the loan term is too short, the borrower fails to generate revenue to enable him/her make repayments while a longer loan term may make the client extravagant and the client may in the end fail to pay back. Hopenhayn (2002) examined the bank loans and investment variables. The study was interesting determinant of loans for financing their customers. The findings from the study show that desired amount of loans exceeds the supplied amount of loans at constrained firms, loans will predict the level of investment at constrained firms but he did not address interest rates on investment.

ZAMTIE (2003) studied the effects of interest levels in relation to factors affecting investments. Consistently high margins demanded by Commercial banks between their based rates and the actual cost of servicing bank loan and overdrafts. The study found out that current regimes of interest rates prevailing Kenya economy have been heavily induced by high government borrowing on domestic debt. Due to high government

borrowing, commercial holdings in bonds which have been increasing steadily while the level of lending to private sector has been declining. He argue that the main part of concern is where the government is in use of borrowed funds which are intended to the financing of consumptive expenditure and maintenance of large organization.

Bhattacharya (2011) studied the influence of interest cycles on domestic rates. The study objective was to integrate domestic financial sector with external sector. He established that there is slacking of restrictions in the cross movement of capital across business entrepreneurs. The economy would affect domestic financial market with a significant lag. According to market conditions of demand and supply of credit thereby enabling the economy to withstand and control the inflexible interest rate policy is prone to macroeconomic instability.

From the foresaid literature, it emerges that established loan repayment policies are only identified as one of the credit management policies adopted by financial institutions. Studies do not indicate how loan repayment policies may influence investment performance of commercial banks, a gap that the current study will bridge. While some employed purposive sampling method, the current study will use Simple random sampling technique. Regression analysis will be used to determine the relationship between loan repayment policies and investment performance.

2.2.3: Cash Lending Practices and Investment Performance

Frank Keane (2013) studied the effects of securities loans collateralized by cash in reinvestment risk. He found out that securities loan collateralized by cash are by far the most popular form of securities lending transaction. The study tried to argue that the standard compensation scheme for securities lending agents which typically provides for agents to share in gains but not losses, creates incentives for them to take excessive risk. It also highlights the need for greater scrutiny and understanding of cash reinvestment by practices especially in the light of investor's experience. He did not conclude any information about cash lending policies and investment performance in his study. In his conclusion, argues that risk seeking incentives in agent compensation arrangements are the of cash market reinvestment activities are an uneasy combination that did contribute to transactions in sourcing specific securities for guaranteed market transactions. While it might tempting to suggest eliminating lending of securities against cash collateral such a

policy response may be too extreme. An increase in data transparency in particular around cash reinvestment choices seems likely to lower the possibility of reasonable cost to bear if it mitigates financial systemic disruption.

Andrian (2011) studied the effects of Securities and Repo Lending in federal bank of New York. He used the descriptive analyzed and concluded that market participants should consider both the social benefit of increased transparency and the need to refine standard agent compensation arrangements to limit the risk seeking incentives of agent in the securities for cash, the industry carefully tracks investment income as a performance metric suggest that is not typical form of securities loan transactions. He found out that cash providers should carefully monitor the lending transaction as a credit extension when the intrinsic value of the collateral is not driving the transaction. A counterparty that extends large amount of cash will want a good understanding of reinvestment activity it supports. Admittedly such diligence might prove difficult or impossible in practice as cash if fungible and cash borrowers or security lenders may have incentives to disclose credible but inaccurate description of asset to invest.

Vermeulen (2006) studied the response of firm's investments and financing to adverse cash shocks. The objective of the study was the role of bank relationships in the European Centrel bank. His main purpose was to find out the effects of financial constraints, lending relationship, firm investment and firm financing. He found that in his economic theory suggested that lending relationships are useful in overcoming asymmetric information problems between creditors and their clients. Consequently, firms with deep lending relationships benefit from better credit conditions. He argue that it is especially in terms of adverse cash flow that financial constraints are more likely to be binding and that firms more strongly need external finance, they have to reduce spending, including investment spending. Single and multiple bank relationship firms show that the same investment reaction to cash flow in periods of adverse cash flow shocks. Single bank relationship is not especially helpful in alleviating financial constraints problems during bad times. Finally he investigated the determinants of the probability of obtaining extra bank debt. It found that a single bank have a lower probability of obtaining bank credit in adverse cash flow shock periods is higher the larger the firm and the lower initial leverages. From the findings it was concluded that really impedes investment in adverse cash flow periods is when firms cumulate a drop in cash flow and a contraction of

external bank credit. It depends more on the size and the initial leverage of the firm than on the number of bank relationships.

From the foregoing literature, it emerges that a number of them relied wholly on secondary data with few researchers depending on both interviews and secondary data. No clear research design, all have different methodologies, sample sizes and study area, only one study was done in Kenya and consequently none was done in Kisumu city. The current study will adopt correlation research design, Primary quantitative data to be collected through semi-structured questionnaires, Simple random sampling technique will be used to obtain a sampled population and regression analysis will be used to determine the influence of cash lending policies on investment performance.

CHAPTER THREE
RESEARCH METHODOLOGY

This chapter covers the theoretical and philosophical assumptions upon which the research is based. These includes research design, target population, study area, sample size, data collection methods, data collection instruments, Validity and reliability of the research instrument as well as the techniques that will be used to analyze data and presentation.

3.1 Research Design

Study adopted correlation research design. Kothari (2004), states that correlation analysis studies the joint variation of two or more variables for determining the amount of correlation between two or more variables. In general, a correlational study is a quantitative method of research in which the similarities between two or more quantitative variables from the same group of subjects are determined.

3.2 Study Area

The study was conducted in Kisumu City.It’s a port city in western Kenya,the third largest city in Kenya, the principal city of western Kenya, the headquarters of Kisumu County. It is the largest city in western Kenya and is the second most important city after Kampala in the greater Lake Victoria basin but according to the United Nations it is now recognized as a key city and for that reason was award the title of 'Millenium City' - the first of its kind in the world. The area of study was Kisumu City. Kisumu City is the headquarters of Kisumu City. Kisumu City is situated in western part of Kenya. Kisumu City is one of the new devolved counties of Kenya. Its borders follow those of the original Kisumu District, one of the former administrative districts of the former Nyanza Province in western Kenya. Its headquarters is Kisumu City. The land area of Kisumu City totals 2085.9km^2. Kisumu City's neighbors are Siaya City to the West, Vihiga City to the North, Nandi City to the North East and Kericho City to the East. Its neighbor to the South is Nyamira City and Homa Bay City is to the South West. The City has a shoreline on Lake Victoria, occupying northern, western and a part of the southern shores of the Winam Gulf. The banks are concentrated in Kisumu City but others have branches within the sub counties.

3.3 Target 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 population of interest to this study consisted of all commercial banks registered in Kenya and operating in Kisumu city. As per the CBK report (2016) there are 27 commercial banks in Kisumu city. The study will target three senior banking officials in each branch. The senior banking officials targeted will include, branch managers, credit managers and operations managers.

3.4 Sample Size and Sampling Technique

A total of 81 respondents were targeted for the survey. These included the branch managers, credit managers and operations managers as shown in Table 3.1 below.

Table 3.1: Study Sample

Category	Number of participants
Branch managers	27
Credit managers	27
Operations Managers	27
Total	**81**

Source: Commercial banks' Human resources database, 2017

3.5 Data Type and Collection Procedure

Data was collected from both primary and secondary sources. The primary data was obtained from the senior managers for the 27 banks branches operating in Kisumu city yielding a total of 81 participants. The questionnaires was administered through "drop and pick later" method. The questionnaire comprised closed and open - ended questions. Secondary data was obtained from the published financial statements of the banks in the sample.

3.6 Validity of Research Instruments

According to Kothari (2004) Validity is the most critical criterion and indicates the degree to which an instrument measures what it is supposed to measure. Validity can also

be thought of as utility. In other words, validity is the extent to which differences found with a measuring instrument reflect true differences among those being tested. Mugenda and Mugenda (2003) define validity as the accuracy and meaningfulness of inferences, which are based on research results. Content Validity of the questionnaire was ensured by giving it to the research experts in the field of finance to review.

3.7 Reliability of Research Instruments

Reliability is the degree to which results obtained from the analysis of the data actually represent the phenomenon under study. Kothari (2004) explains that a measuring instrument is reliable if it provides consistent results. As proposed by Mugenda and Mugenda (1999), the pilot was administered on 10 credit officers leaving an effective sample to be 71 respondents. These 10 respondents who participate in the pilot will not be included in the final study.

Table 3.1: Pilot test results using Cronbach's Alpha Reliability Test

Variables	No. of Items	Cronbach's Alpha
KYC practices	3	0.786
Loan repayment practices	3	0.871
Cash budgeting practices	3	
Investment performance	3	0.854

Source: Field Data, 2017

All the variables had alpha values of above 0.701, indicating strong internal consistency among measures of variable items.

3.8 Data Analysis and Presentation

Both descriptive and inferential statistics were used to summarize and analyze the data, involving measures of dispersion and central tendency where means and averages and regression analysis was used. Pearson r correlation and multiple regression analyses were also be used to address objective (i) to (iii). Data was presented using tables, figures and charts.

3.8.1 Multiple Regression Model

Multiple regression analysis was adopted to determine influence of lending practices and; dependent variable, investment performance of commercial banks. The model for the regression analysis is below;

$$Y_i = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} + \beta_3 X_{3i} + \varepsilon_i \qquad \textbf{3.2}$$

Y= Dependent Variable (investment performance).

X_{1i}= theoretically defined Independent Variable (KYC practices).

X_{2i}= theoretically defined Independent Variable (Loan lending practices).

X_{3i}= theoretically defined Independent Variable (cash lending practices).

β_0 =Y intercept in the equation.

$\beta_1, \beta_2, \beta_3$ = are the coefficients

ε = Residual in the equation.

$_i$ = Number of respondents under consideration.

CHAPTER FOUR
RESULTS AND DISCUSSIONS

This chapter presents results and discussions of the study according to the study objectives.

4.1 Response Return Rate

The questionnaires were distributed in person to the respondents. Out of the 71 questionnaires distributed to the respondents, 68 of them were returned constituting a response rate of 95.77 % of the administered questionnaires. The study sought to establish the background of the respondents in the study in terms of respondent's designation and length of service. The results were as shown in the following sections.

Table 4.1: Respondent's designation

Designation	Frequency	Percent	Valid Percent	Cumulative Percent
Branch manager	27	39.7	39.7	39.7
Operations manager	27	39.7	39.7	79.4
Credit manager	14	20.6	20.6	100.0
Total	68	100.0	100.0	

Source: Survey data (2017)

Table 4.1 indicates that 79.4 % of the total respondents were branch and operations managers. Only 20.6 % of the total respondents were credit managers.

Table 4.2: Length of service

Length of service	Frequency	Percent	Valid Percent	Cumulative Percent
0-6 months	2	2.9	2.9	2.9
7-12 months	6	8.8	8.8	11.8
13-18 months	12	17.6	17.6	29.4
18-24 months	16	23.5	23.5	52.9
Over 2 years	32	47.1	47.1	100.0
Total	**68**	**100.0**	**100.0**	

Source: Survey data (2017)

Table 4.2 shows the respondents length of service in the banking sector. The results indicate that majority (47.1 %) of bank managers had worked in their respective companies for over 2 years which is an indication of low labor turnover, 23.5 % had worked for the period 18-24 months while 2.9 % had worked for a period between 0-6 months years. This implies that the data was obtained from respondents who had gotten experience on the banking procedures and practices.

4.2: Influence of Know your Customer Practices and Investment Performance

The extent of practice of KYC practices was measured using five items. Respondents were asked to rate the extent of KYC practices elements practiced by banks in Kisumu city. Responses were elicited on a 5-point scale (1-very low, 2-low, 3-moderate, 4-high, and 5-very high). These responses were then analyzed using frequencies, means and standard deviations.

In order to assess the influence of KYC practices on investment performance, multiple regression analysis was performed and the results are summarized in the Tables 4.4 and 4.5 as shown below.

Table 4.3: Descriptive Statistics on the rating of Extent of KYC Practices

Constructs **Overall Mean = 4.00**	5	4	3	2	1	Mean	Std. Dev
a. Our bank follows stringent measures in analyzing customer profiles	25(36.8%)	14(20.6%)	12(17.6%)	11(16.2%)	6(8.8%)	3.00	1.196
b. We hardly notice any violations in KYC procedures	10(14.7%)	28(41.2%)	14(20.6%)	9(13.2%)	7(10.3%)	4.00	1.362
c. We have frequent monitoring of how KYC procedures are adhered to	24(35.3%)	27(39.7%)	10(14.7%)	4(5.9%)	3(4.4%)	4.00	1.071

Key: *Very high=5, High =4, Moderate=3, Low=2, Very low=1*

Source: Survey data (2017)

Results presented in Table 4.3 indicate that the rating of KYC in Kisumu is high. The overall mean response score for all the elements was 4.000, coded as high meaning that extent of KYC practice is highly practiced by commercial banks in Kisumu city.

Table 4.4: Multiple regression analysis results on influence of KYC on investment Performance

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.074	.242		.306	.761
KYC practice	.180	.068	.184	2.637	.010
Lending rate practice	.408	.111	.451	3.685	.000
Cash budgeting practice	.407	.147	.350	2.762	.007

a. Dependent Variable: Investment performance

Source: Survey data (2017)

Table 4.4 exhibits the results of the multiple regression analysis. The results indicate that KYC practice is a positive significant predictor of investment performance ($\beta = .180$ ($p = .010$). This value is statistically significant since the p-value is less than 0.05. It can be inferred from this value that a unit change in KYC practice leads to an increase in investment performance of 0.180 all things being fixed. This result corroborates the findings of Mwangi, 2012; Jagongo et al., 2014 who found a positive relationship between know your customer practices and performance. However, the results contradict the findings of Wanjira (2010) who found a negative and significant relationship between customer focus and performance of enterprises.

From the findings of objective one, it can be concluded that embracing KYC practices leads to improved investment performance.

Table 4.5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.943[a]	.890	.884	.45254

Source: Survey data (2017)

4.3: Influence of Loan repayment practices and investment performance

The extent of practice of loan repayment practices was measured using five items. Respondents were asked to rate the extent of loan repayment practices elements practiced by banks in Kisumu city. Responses were elicited on a 5-point scale (1-very low, 2-low, 3-moderate, 4-high, and 5-very high). These responses were then analyzed using frequencies, means and standard deviations.

To assess the influence of loan repayment practices on investment performance, multiple regression analysis was performed and the results are summarized in the table 4.7.

Table 4.6: Descriptive statistics on the rating of Extent of loan repayment practices

Constructs **Overall Mean = 4.00**	5	4	3	2	1	Mean	Std. Dev
a. Our customers are sensitive to loan repayment practices	16(23.5%)	19(27.9%)	22(32.4%)	6(8.8%)	5(7.4%)	4.00	1.165
b. Interest rates are continuously reviewed in line with the prevailing economic conditions	27(39.4%)	8(11.8%)	12(17.6%)	13(19.1%)	8(11.8%)	4.00	1.471
c. We regularly update our loan repayment practices	24(35.3%)	28(41.2%)	4(5.9%)	4(5.9%)	8(11.8%)	4.00	1.304

Key: *Very high=5, High =4, Moderate=3, Low=2, Very low=1*

Source: Survey data (2017)

Table 4.6 indicates that the rating of loan repayment practices in Kisumu is high. The overall mean response score for all the elements was 4.000, coded as high meaning that extent of loan repayment practice is highly practiced by commercial banks.

Table 4.7: Multiple regression analysis results on influence of Loan repayment on investment Performance

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.074	.242		.306	.761
KYC practice	.180	.068	.184	2.637	.010
Lending rate practice	.408	.111	.451	3.685	.000
Cash budgeting practice	.407	.147	.350	2.762	.007

a. Dependent Variable: Investment performance

Source: Survey data (2017)

Table 4.7indicates the results of the multiple regression analysis. The results indicate that loan repayment practice is a positive significant predictor of investment performance (β = .408 (p = .000). This value is statistically significant since the p-value is less than 0.01. It can be inferred from this value that a unit change in loan repayment practice leads to an increase in investment performance of 0.408 all things being fixed. This result is in tandem with the findings of Godquin (2004) and Tomaki (2013) who found a positive relationship between loan repayment practices and performance. However, the results contradict the findings of Santiago and Francisca (2008) and ZAMTIE (2003) who found a negative and significant relationship between interest rates andinvestment performance.

From the findings of objective two, it can be concluded that embracing loan repayment practices leads to improved investment performance.

4.4: Influence of Cash budgeting practices and investment performance

The extent of practice of cash budgeting was measured using five items. Respondents were asked to rate the extent of cash budgeting practices elements practiced by banks in Kisumu city. Responses were elicited on a 5-point scale (1-very low, 2-low, 3-moderate, 4-high, and 5-very high). These responses were then analyzed using frequencies, means and standard deviations.

To assess the influence of cash budgeting practices on investment performance, multiple regression analysis was performed and the results are summarized in the table 4.9.

Table 4.8: Descriptive statistics on the rating of Extent of cash budgeting practices

Constructs **Overall Mean = 4.00**	5	4	3	2	1	Mean	Std. Dev
a. We have favourable cash lending practices for our customers	28(41.2%)	18(26.5%)	16(23.5%)	2(2.9%)	4(5.9%)	4.00	1.145
b. Cash lending practice formulation is undertaken by experienced consultants	24(35.2%)	29(42.6%)	6(8.8%)	6(8.8%)	3(4.4%)	4.00	1.099
c. Input of customers is considered in crafting of credit policies	39(57.4%)	12(17.6%)	7(10.3%)	6(8.8%)	4(5.9%)	4.00	1.252

Key: *Very high=5, High =4, Moderate=3, Low=2, Very low=1*

Source: Survey data (2017)

Results in Table 4.8 indicate that the rating of cash budgeting practices in Kisumu city is high. The overall mean response score for all the elements is 4.000 meaning that extent of cash budgeting practice is highly practiced by commercial banks in Kisumu city.

Table 4.9: Multiple regression analysis results on influence of cash budgeting on investment Performance

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.074	.242		.306	.761
KYC practice	.180	.068	.184	2.637	.010
Lending rate practice	.408	.111	.451	3.685	.000
Cash budgeting practice	.407	.147	.350	2.762	.007

a. Dependent Variable: Investment performance

Source: Survey data (2017)

Results in Table 4.9show that cash budgeting practice is a positive significant predictor of investment performance (β = .407 (p = .007). This value is statistically significant since the p-value is less than 0.01. It can be inferred from this value that a unit change in cash budgeting practice leads to an increase in investment performance of 0.407 all things being fixed. This result is in tandem with the findings of Frank (2013) and Vermeulen (2006) who found document a positive relationship between cash budgeting practices and performance. However, the results are at variance with the findings of Andrian (2011) who report a negative and significant relationship between cash budgeting and investment performance.

From the findings of objective three, it can be concluded that embracing cash budgeting practices leads to improved investment performance.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

This chapter presents a summary of study findings, conclusions and recommendations based on the major findings.

5.1 Summary of Findings

Based on regression analysis, objective one found that KYC practices positively significantly influences investment performance of commercial banks in Kisumu city.

Objective two found out that loan repayment practices positively significantly influences investment performance.

Lastly, the findings of objective three were that cash budgeting practices positively significantly affects investment performance.

5.2 Conclusions of the Study

From the findings of objective one, it is concluded that embracing KYC practices by commercial banks in Kisumu city leads to improved investment performance.

From the findings of objective two, it can be concluded that use loan repayment practices leads to better investment performance.

Lastly, based on the findings of objective three, the study concludes that adopting cash budgeting practices improves investment performance.

5.3 Recommendations of the Study

Based on conclusion of objective one, commercial banks in Kisumu city should intensify use of KYC practices.

From the conclusion of objective two, managers of commercial banks in Kisumu city should enhance application of loan repayment practices as this was found to improve investment performance.

Similarly, from conclusion of objective three, commercial banks in Kisumu city should continue embracing cash budgeting practices as this was found to improve investment performance.

5.4 Limitations of the Study

The outcome of the study cannot be generalized to all commercial banks in Kenya since the study was limited to commercial banks in Kisumu city and did not incorporate all commercial banks in Kenya. The study adopted a correlational research design. The use of predetermined questions may have forced respondents to respond to questions even without properly understanding them.

5.5 Suggestions for Further Research

In order to improve this study, the researcher would like to suggest the following for further investigation. An exclusive study on the lending rates constraints facing commercial banks in Kenya should be carried out. Future research should be conducted on determinants of lending practices adoption and performance of commercial banks in Kenya and compare their performance over a period of time using secondary data. Further research could be conducted based on county regions in various parts of Kenya since such areas represent a variation in cultural orientation and habits. Comparisons could be done on whether or not there is any variation or similarity. Lastly, future research efforts could dwell on comparative analysis of cash budgeting practices and use more robust research designs such as time series and panel data.

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APPENDICES

Appendix I: Questionnaire

This questionnaire seeks to collect information on influence of lending practices on investment performance of commercial banks. You have been selected to participate in this survey. All information received will be treated confidentially and used for academic purposes only. I am therefore, kindly requesting for your support in terms of time, and by responding to the questions below.

Section A: Questionnaire to Respondents

1. Name of the bank ……..
2. Branch name……...
3. Respondent job Role (please select one).
   Branch Manager [ ] Operations Manager [ ] Credit Manager [ ]
4. How long have you worked in the department? (Your Experience)
   0-6 Months [ ] 7-12 Months [ ] 13-18 Months [ ] 18-24 Months [ ] Over 2 Years [ ]

KNOW YOUR CUSTOMER PRACTICES

5. How do you rate the following constructs of KYC in your organization? Key: Very High (5), High (4), Moderate (3), Low (2), and Very Low (1)

Indicators of KYC	Very High	High	Moderate	Low	Very Low
• Our banks follows stringent measures in analyzing customer profiles					
• We hardly notice any violations in KYC procedures					
• We have frequent monitoring of how KYC procedures are adhered to.					
• Others (Specify)					

LOAN REPAYMENT PRACTICES

6. How do you rate the following constructs of loan repayment practices in your organization? Key: Very High (5), High (4), Moderate (3), Low (2), and Very Low (1)

Indicators of Loan repayment practices	Very High	High	Moderate	Low	Very Low
• Our customers are sensitive to loan repayment practices					
• Interest rates are continuously reviewed in line with the prevailing economic conditions.					
• We regularly update our loan repayment practices.					
• Others (Specify)					

CASH LENDING PRACTICES

7. How do you rate the following constructs of cash lending practices in your organization? Key: Very High (5), High (4), Moderate (3), Low (2), and Very Low (1)

Indicators of cash lending practices	Very High	High	Moderate	Low	Very Low
• We have favourable cash lending practices for our customers.					
• Cash lending practice formulation is undertaken by experienced consultants.					
• Input of customers is considered in crafting of credit policies.					
• Others (Specify)					

INVESTMENT PERFORMANCE

8. How do you rate the following constructs of investment performance in your organization? Key: Very High (5), High (4), Moderate (3), Low (2), and Very Low (1)

Investment performance indicators	Very High	High	Moderate	Low	Very Low
• Number of our customers relative to the competitors.					
• We have lending rates slightly below the prevailing market rates.					
• Cost of capital of our finance relative to the industry average.					

Thank you!