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COLLATERAL SECURITY AS A DETERMINANT OF COMMERCIAL BANKS FINANCIAL PERFORMANCE

[1*] **Arnety Nangila Makokha**
Alupe University College
BOX 845-50400 Busia, Kenya
Email: nangila09@gmail.com

Abstract

Despite of implementing a number of determinants to improve financial performance of Commercial Banks, Banks still declare deficit on the outcome of operation in Kenya today hence need for further study. The purpose of this study was to investigate the effect of collateral security as a determinant of Commercial banks financial performance in Kenya. Mixed method which comprised of quantitative and qualitative designs was applied in this study. Target population was one hundred and seventeen (117) managers from 39 licensed commercial banks of Kenya. Cronbach Alpha test of 0.869 was obtained indicating the reliability of the research instrument. Content and criterion validity were ensured through incorporating the experts' suggestions in the final paper. Data was analyzed using descriptive statistics and inferential statistics. A strong positive statistically significant relationship between collateral security and financial performance was obtained. This enhances the understanding of the commercial banks that, the practice of taking collateral security before a loan is issued does not only give them confidence that loans will be repaid but also contributes towards improving financial performance therefore a variety of collateral security should be considered.

***Keywords**: collateral security, commercial banks, financial performance*

1.0 Introduction

Financial institutions play a vital role in the operation of an economy by channeling funds from savers to borrowers for investment which enables economic growth of a country. Otuori (2013) explained that, Commercial banks contribute positively to economic growth of a country by channeling surplus funds to their most productive uses. Kamau (2009) noted that banks dominated the financial sector therefore financial intermediation in the country depends heavily on commercial banks. Athanasoglou, Delis and Staikorous (2006) explained that good performing banks have higher profitability which in turn rewards the shareholders for their investment and increases confidence level for additional investment hence increasing economic growth. Ongore and Kusa (2013) indicated that banking environment in Kenya has for the past decade, undergone many regulatory and financial reforms which have brought about expansion in their operations.

Ongore and Kusa (2013) examined CBK annual reports and highlighted that not all banks were profitable despite the overall profitability experienced in the banking sector for the past 10 years that attracted other macro and micro banking institutions. Oloo (2011) echoed that commercial banks still declared losses despite of the good overall performance. Onjala (2012) explained that increase in the number of banks has fueled competition over customers. Several authors around the world inspected the determinants of financial performance in commercial banks, Duraj and Moci (2015) studied on factors influencing banks profitability in Albania, period 1999 to 2014 using multiple regressions on 16 commercial banks.

Several studies have also been done in Kenya pertaining to determinants of commercial banks financial performance. Tsuma and Gichinga (2016) studied on financial performance of fifteen (15) large banks from 2001 to 2010 using panel data.

Olweny and Shipho (2011) studied on profitability of forty three commercial banks using panel data for the period 2002 to 2008. Onjala (2012) studied on the basic specific factors affecting the commercial banks financial performance on forty three banks (43) using panel data for the period 2001 to 2010. Even though different studies have been conducted on the determinants of commercial banks financial performance, their results are not conclusive as far as the effects of determinants of financial performance are concerned hence informing the study of collateral security as a determinant of commercial banks financial performance.

This study therefore investigates the influence of collateral security as a determinant of commercial banks financial performance in Kenya. In practice it has been observed that for the banks to approve credit facility there must be a collateral security pledged. Karumba, M., & Wafula, M. (2012) indicated that 90% of firms in different sectors of the economy reported that collateral is a requirement for loan approval since it increased the banks confidence of issuing a loan. Baker (2009) noted that the lender has the right to obtain the collateral from the borrower in lieu of payment if he defaults on the loan.

2.0 General Objective of the paper

To evaluate the influence of collateral security as a determinant of Commercial Banks financial performance in Kenya

2.1 Hypothesis

The following hypothesis was to be tested:

H_o. Collateral security has no significant effect on commercial banks financial performance in Kenya

H_A. Collateral security has a significant effect on commercial banks financial performance in Kenya

3.0 Statement of the problem

Despite the global and local studies, Wamiori, Namusonge and Sakwa (2016) explained that there are other determinants of commercial banks financial performance in Kenya. The annual report (CBK, 2016) indicated a net deficit of KES 4,640M for the year ended 30 June 2016 compared to net surplus of KES 49,725M for the year ended June 2015. This is evident that more studies should be conducted to establish other determinants of financial performance. In light of the above facts the aim of this research was to investigate the influence of collateral security as a determinant of commercial banks financial performance in Kenya.

Baker (2009) noted that the lender has the right to obtain the collateral from the borrower in lieu of payment if he defaults on the loan. Bagaka and Memba (2015) studied on influence of collaterals used by small and medium microenterprises on loan performance of commercial bank in Kisii County, Kenya. The study applied descriptive design and census on the fourteen (14) commercial banks and established that most banks prefer motor vehicles on security in order to reduce the risk of default. Further most banks discourage clients from using land and buildings as collaterals.

4.0 Research Methodology

Mixed method of research design was applied. Namusonge (2010) explained that approach of mixed method was most suitable because it involves collecting information from the people on their habits, opinions, attitudes and any other educational or social issues. Kariuki, Namusonge and Orwa (2015) applied this research design in their study on the determinants of corporate cash holdings among private manufacturing firms in Kenya hence most preferred in the study of collateral security as a determinant of commercial banks financial performance.

5.0 Findings

This section consists of explanations under descriptive and inferential analysis for the independent (collateral security) and dependent variable (financial performance).

5.1 Descriptive Results

a). Descriptive results for collateral security

The perception of the respondents was evaluated basing on their agreement on various statements pertaining collateral security as a determinant of commercial banks financial performance. Table 5.1 findings indicate that 49% of the respondents agreed that the clients property is attached until the credit facility is repaid in full, 46% of the respondents agreed that the attachment of property has increased borrowers commitment in repayment of loans, 60% of the respondents agreed that defaulted loans leads to non-performing loans. Further 64% of the respondents agreed that the bank has standard type of security requirements for different types of loans, 51% of the respondents agreed that employers are considered a prerequisite for loan guarantor this ensures that the employer, 61% of the respondents agreed that loaning policies are verified by the Board of Directors, 43% of the responses agreed that banking management decides on the type of property to be attachment. The mean score for responses for this section was 3.117 which implied that collateral security was a determinant of commercial banks financial performance. These findings were supported by Karumba, M., & Wafula, M. (2012) indicated that 90% of firms in different sectors reported collateral as a requirement for loan approval. Baker (2009) noted that the lender has the right to obtain the collateral from the borrower in lieu of payment if he defaults on the loan. While Bagaka and Memba (2015) indicated that most banks prefer motor vehicles as security in order to reduce the risk of default.

Table 5.1: Descriptive statistics on collateral security

S/N	Statement	SD%	D%	U%	A%	SA%	Mean
1	Our bank attaches clients property to the credit facility taken until it is repaid in full	12%	25%	14%	39%	10%	3.1000
2	Attachment of property has increased borrowers commitment in repayment of loans	20%	29%	5%	34%	12%	2.8900
3	Defaulted loans leads to non-performing loans	15%	18%	7%	48%	12%	3.2400
4	Our bank has standard type of security requirements for different types of loans	17%	11%	8%	33%	31%	3.5000
5	Employers are considered a prerequisite for loan guaranteeing	24%	22%	3%	33%	18%	2.9900
6	Loaning policies are verified by the Board of Directors	15%	22%	2%	49%	12%	3.2100

7	Banking management decides on the types of property to be attached	19%	24%	14%	35%	8%	2.9890

b) Descriptive results for financial performance

Descriptive analysis was performed to establish the respondents' perception concerning the financial performance of banks. Table 5.2 findings indicate that 63% of the respondents agreed banks improved its mechanism of increasing profits, 46% of the respondents agreed that banks have good liquidity position, 52% of the respondents agreed that interest received on savings increased, 56% of the respondents agreed that financial statements are audited and published on time, 55% of the respondents agreed that the overall profitability of the banks increased, 53% of the respondents agreed that banks have several sources of income, 56% of the responses agreed that banks experienced substantial profits in the past five (5) years. The mean score responses of 3.284 indicated that majority of the respondents exhibited higher profits frequently. These imply that profitability is a key factor in measuring financial performance in commercial banks. Athanasoglou *et al.* (2006) explained that good performing banks have higher profits. The weighted mean for the above responses was rated based on the key provided by Kariuki, Namusonge and Orwa (2015). Strongly Disagree meant the mean values of 1 and 1.80 were never exhibited, Disagreed meant the mean values of 1.81 to 2.60 were rarely exhibited, Neutral meant mean values of 2.61 to 3.40 were frequently exhibited, Agreed meant the mean values of 3.41 to 4.20 were always exhibited and Strongly Agree meant that the mean values of 4.21 to 5.0 ever exhibited.

Table 5.2: Descriptive results of financial performance

S/N	Statement	SD %	D %	N %	A %	SA %	Mean
1	Our bank has improved its mechanism of mechanisms of increasing profits	11	18	8	35	28	3.5100
2	The bank has good liquidity position	13	17	24	32	14	3.1700
3	Interest received on savings increased	14	23	11	28	24	3.2500
4	Financial statements are audited published on time	12	25	7	30	26	3.3300
5	The overall profitability of the banks increased	15	17	13	39	16	3.2400
6	Our banks has several sources of income	16	23	8	21	32	3.3300
7	Our banks experienced substantially five (5) years	16	24	4	37	19	3.1900

5.3 Relationship between collateral security and performance

5.3.1 Correlation results

Correlation analysis showed the relationship between the variables (Jahangir & Begum, 2008; Kariuki, Namusonge & Orwa, 2015). Table 5.3 findings showed a strong positive correlation of 0.780 between collateral security and financial performance. The P value was 0.000 at 1 % (0.01) level of significance. Namusonge and Sakwa (2015) interpretation of correlation coefficient is that 0.9 shows very high correlation, 0.7 and above high correlation, 0.5 and above moderate correlation. This means collateral security is a strong determinant of Commercial banks financial performance in Kenya. This was consistent with the findings of Ngumi (2013) who lauded that when significance level is very small (less than 0.01) them the correlation is significant between the two variables.

Table 5.3: Relationship between Collateral security and Financial performance

Variable		Financial Performance (FP)	Collateral Security (CS)
Financial Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Collateral Security	Pearson Correlation	0.780**	1.000
	Sig. (2-tailed)	0.000	

5.3.2 Simple regression analysis

The Regression analysis was run to test the above hypothesis and Table 5.5 established that the coefficient determination of R^2 was 0.608 which indicate that 60.8% of changes in financial performance were caused by collateral security. The correlation coefficient (R) of 0.780 indicates the strength of association between the observed (collateral security) and predicted variable (financial performance). The findings imply that collateral security was an important predictor of financial performance in commercial banks in Kenya.

Table 5.4: Collateral Security and Financial Performance Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.780	0.608	.604	.52847

a. Predictors: (Constant), Collateral Security

Further the researcher run the regression analysis slope coefficient representing the influence of the collateral security on financial performance.

The t- statistic was used to test the hypothesis on the significance of slope coefficient (β) at 5% level of significance. Findings of Table 5.5 show that linear regression model of collateral security on financial performance was $Y = \beta_o + \beta_1 X_1 + \varepsilon$ which becomes $FP = 0.635 + 0.851X_1$. The beta coefficient of 0.780 indicate that collateral security had strong effect on financial performance this has been supported by t= 12.487 at P =0.000 at 5% level of significance. The null hypothesis was rejected and alternative hypothesis accepted that collateral security significantly determine financial performance among commercial banks in Kenya.

Table 5.5: Collateral security and financial performance regression coefficients

Variable	B	Std. Error	Beta	T	Sig.
(Constant)	0.635	.223		2.851	.005
Collateral Security	0.851	.0068	.780	12.487	.000

a. Dependent Variable: Financial Performance

6.0 Explanations of the findings

P value of 0.000 at 5% level of significance indicated a statistically significant relationship of collateral security on financial performance therefore the null hypothesis was rejected and alternative hypothesis accepted that collateral security significantly determine commercial banks financial performance. The regression model: $Y = \beta_o + \beta_1 X_1 + \varepsilon$ becomes $FP = 0.635 + 0.851X_1$. Several authors supported this study that collateral security influences commercial banks financial performance in Kenya. Karumba and Wafula (2012) indicated that since 90% from different sectors reported collateral as requirement for loan approval suppose a variety of collateral securities are deposited financial performance will improve. Baker (2009) noted that lenders obtain collaterals from borrows in lieu of payment if they default on the loan. Bagaka and Memba (2015) supported that motor vehicles were preferred securities to reduce risk of default. Because this has brought discipline lenders should widen the bracket to accommodate all borrowers even those who doesn't own vehicles but need credit facility.

7.0 Conclusion and Recommendation

The findings revealed that collateral security does not only prompt borrowers to pay on time and increase the level of lenders' confidence but also it influences the commercial banks financial performance. The study therefore recommends that to enhance financial performance a variety of collateral security should be applied when taking credit facility because not all borrowers have the fixed assets (vehicles, land and buildings).

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