MORTGAGE FINANCING AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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ABSTRACT

Banking sector institutions are considered to play a very crucial part especially in modern economy of any state. The significance of banking institutions is mostly witnessed especially when it comes to the economic development of any state as they allow money marketing in both developed and developing economies. In other words, for banks to continue to serve as intermediaries, they must have financial stability. However, some commercial banks in Kenya have been performing poorly as they have continued to report distressing financial results. This has been demonstrated by the decrease in ROE for some commercial banks over the years as well as their low global ranking. Therefore, the current study examined the nexus between mortgage financing and financial performance within the Banking sector in Kenya. Specifically, it examined interest charged. To achieve this a descriptive research approach was employed. All 43 licensed banking institutions were evaluated as the survey total population as per CBK. The study population comprised of all the financial institutions that offer mortgage financing as one of their products. The researcher used census survey to select all financial institutions in Kenya that offer mortgage financing. For the data analysis the researcher used correlation and regression model. Thereafter, editing, coding, classification and tabulation were the processing steps that were used to process data for better and efficient analysis. STATA was therefore used to aid the researcher in analysing the data. Based on the findings, it was established that interest charged had a positive and significant effect on the financial performance of commercial banks in Kenya. It was concluded that the rate of interest charged on mortgage issued did contribute significantly towards the financial performance of commercial banks in Kenya. It was, therefore, recommended that commercial banks in the country should consider lowering their mortgage interest rates in order to make mortgage loans accessible to all classes of customers. In addition, it was recommended that commercial banks in the country should strive to diversify their mortgage loans investment so as to enlarge their loan asset base and establish more capacity to provide much more mortgage financing to a wide range of interested customers.

Key Words: Interest Charged, Volume of Mortgage Lending, Mortgage Types, Mortgage Financing and Financial Performance.

INTRODUCTION

Globally, banking sector institutions are considered to play a very crucial part especially in modern economy of any state. The significance of banking institutions is mostly witnessed especially when it comes to the economic development of any state as they allow money marketing in both developed and developing economies (Zeitun & Haq, 2015). According to the findings of a study done by Hawaldar, Lokesha, Prakash, and Sison (2016) in Bahrain, it was revealed that profitability has an effect on capital adequacy and financial leverage, however the association between profitability and the efficiency of banks was not confirmed. This analysis also indicates that the implementation of a higher capital adequacy ratio will have an inverse impact on profitability of banking institutions. According to research carried out by Mabwe and Webb (2015), the regulatory environment around commercial banks in South Africa has become more technologically advanced and stringent since the country's become a democratic republic upon gaining independence back in 1994. As a result, banks in the country are now finding themselves facing stiff competition as well as increasing operational cost due to regulatory limitation, technological and financial innovations as well as entry of foreign owed financial institutions compounded by the latest financial crisis in 2008.

Karanja (2013) survey in Kenya made another crucial conclusion that indicated that loan extending by banks is the most crucial source of their overall revenue and, hence, such must always be prioritized as it usually affects their financial standings in the event where they are unable to generate enough revenues (Nyambura, 2016). As such, Nyambura (2016) further contends that financial institutions should therefore take full advantage of mortgage financing as a strategic way of enhancing their market edge especially in highly competitive economies as this will make it possible to enjoy a competitive advantage over their competitors. To achieve this, financial institutions ought to offer competitive mortgage interest rates, which in turn enhances the commercial banks' overall performance. These claims are supported by the author's assertion that financial institutions can easily use mortgage financing products to increase their market infiltration in highly competitive markets.

On the other hand, Carranza and Estrada (2017) contend that mortgage financing does not inevitably contribute to the commercial banks' overall financial performance. As such, Carranza and Estrada (2017) contend that mortgage financing can severely impact the financial standings of financial institutions particularly in the event of mortgage loan defaults.

Bank's financial performance is in part affected by its size. It has been established that business size is a crucial factor of performance. The enterprises' primary purpose has always been to increase their size so as to attain a viable edge over their sectoral rivals. This has been explained very clearly under the concept of economies of scale (Aduralere & Opeyemi, 2019). Shaheen and Malik (2015) defined firm size as the amount and variety of a company's production capabilities and potential, or the number and variety of services it can simultaneously offer to clients. The size of a company has a large and vital role in explaining the nature of its relationships within and beyond its working environment.

Statement of the Problem

Financial firms are vital to national economy of any nation. Continuously, these institutions move funds from depositing clients and prospective borrowers. In order to be able to undertake this crucial task and earn sufficient revenue to cater for their day-to-day operations. In other words, for banks to continue to serve as intermediaries, they must have financial stability. However, commercial banks have performed poorly in Kenyan as they have continued to report conflicting financial results. This has been demonstrated by the decrease of ROE for these banks throughout the years, as well as their low global ranking.

In 2020, as reported by World Bank (2020), commercial banks registered a decline in average ROE to 17.5% from 18.8% in 2019. Ranking commercial banks in terms of the ROE in Kenya, it has been reported to rank low in the overall top 1000 banks in the world. Return on Equity reduced to 2.62 percent in March 2019 from 2.67 percent in December 2018 (CBK, 2019). The numbers shown above point to an unsatisfactory overall performance on the part of the banking institutions across the country.

The performance of banking institutions in the country has been on the decline over the past few years. The profit before taxes for the Kenyan banking sector in 2015 fell with a total of Kshs. 7.1 billion to Kshs. 134 billion from Kshs. 141.1 billion that had been reported in the financial year 2014 (CBK Annual Report, 2015). In addition, the industry saw a dip in profitability in 2017, with profits before taxes dropping by 9.6% to Kshs. 133.3 billion from Kshs. 147.4 billion had been reported in 2016 (CBK 2018). In spite of the fact that some banks in Kenya are thriving, others have witnessed a decline in their financial standing, and still others have been put into receivership (Ayako & Girhui, 2015). Several financial institutions, such the Jamii Bora Bank, Spire Bank, Chase Bank have over the years experienced significant financial crisis forcing some to close while others have been put under receivership (CBK, 2016). Failure of some of these financial institutions has largely been attributed to lack of proper diversification in terms of the products they offer their customers as they continue to rely heavily on traditional financial services only.

There have only been a few studies that have looked at how mortgage lending affects the performance of banks. For instance, Abdulrahman and Nyamute (2018) investigated how mortgage lending impact the overall performance of Kenyan banks. Results illustrated that, the variation in the interest rates charged on mortgages had a substantial and a constructive impact on the banks performance. However, a contextual gap exists because the impact of interest charged on the banks performance in Kenya was not investigated irrespective of the fact that the extent to which performance of banks improves is significantly dependent on the rate of interest charged. Ndururi *et al*., (2019) investigated the effect that mortgages have had on profitability of Kenyan banks by conducting a primary survey. As per the findings, a constructive nexus was established to exist amongst the two.

Odhiambo (2016) examined how financial performance of listed Kenyan banks is influenced by their real estate financing services. As per the results, it was observed that financial performance of listed Kenyan banks was not significantly influenced by their real estate financing services. The size of the bank, cost of operations, market structure, and foreign ownership all had a significant influence on how well the bank performed. However, most studies conducted on the subject matter focused on other variables aside interest charged, volume of mortgage lending and mortgage types which the current study intends to use in establishing the nexus between mortgage financing and financial performance of commercial banks in Kenya.

General Objective of the Study

To evaluate the impact of mortgage financing on financial performance of selected commercial Bank in Kenya.

Specific Objective

To examine the effect of interest charged on financial performance of commercial banks in Kenya.

THEORETICAL REVIEW

Mortgage Value Theory

Mortgage Value Theory as proposed by Greenblatts (1989) was adopted to guide the survey. According to the theory, the key aim of financial firms is to maximize their profitability with mortgage financing being one of the key strategies that they employ in maximizing their wealth.

According to the theory, a bank's primary objective is to capitalize on anticipated profits within the constraints of liquidity, soundness, reputation, and legality. It is crucial to implement and utilize an integrated system of risk-return management that maximizes shareholder value (Glenn and Wayne, 2007). As a result, the key objectives that an integrated risk and return management tool should have include optimizing both the risk and reward relations of a given bank profile, identify risk/reward using the most efficient portfolio strategies, setting an efficient management targets for the risk/reward, ensuring that ongoing business strategies are effectively implemented, ensuring that all business lines are consistently and efficiently managed and ensuring accurate determination of the value of all loans granted to customers in comparison to the pricing set (Stephens, 2005).

Further, the theory argues that easily be predicted which allows strategic and tactical business decisions to be made based on predicted future probability (Doling, 1997). For this reason, the theory can be used in mortgage loans management by ensuring that value is driven from the new business lending through crucial understanding of any predicted economic monetary return at a given strategic and cohort level. This may be achieved by working with new customers, new products, and adjusting the already existing products in order to enhance profitability which in turn supports the growth of a banking institution as well as designing of new lending strategies by examining the likely risk level in the future using strategies such as risks scorecards (Stephens, 2003).

Based on this, the theory was of significant relevance to the current survey because it clearly explained the favourable influence of mortgage financing on bank performance by arguing that such institutions should only engage in offering this crucial financial service if they wish to report enhanced performance. The idea was utilized to provide justification for the variable that determined the amount of interest charged.

Empirical literature Review

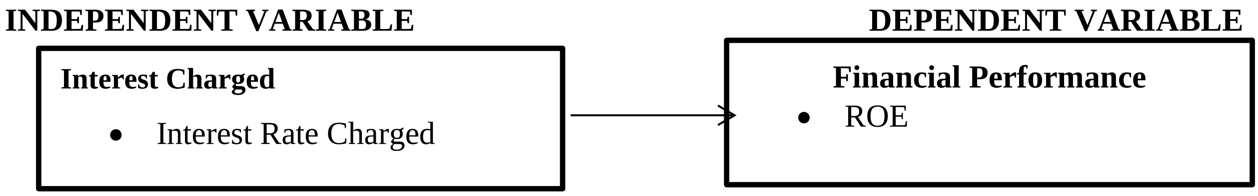
Interest Charged and Financial Performance

Obillo (2018) surveyed the connection between lending interest charged and profitability of banks in Kenya. To complete the survey, a descriptive research method was utilized together with secondary data over a five years period between 2014-2018 being gathered from published bank report and used in the study. ANOVA was also conducted. The study proved that lending interest charged have a considerable favorable impact on commercial banks' financial performance in Kenya. The nexus between commercial bank profitability and lending interest charged was likewise discovered to be linear. However, it was established that the higher lending interest charged results in more profit.

Ndegwa, Waweru, and Huka's (2019) study investigated the extent to which the financial performance of MFIs operating across Imenti North Sub-County are affected by the rate of interest. Descriptive research approach was employed with 42 respondents drawn from 14 MFIs across the Sub-County participating in the survey. Results obtained based on both regression and correlational analysis established that the interest rates charged by MFIs had a substantial impact on their financial performance. To encourage DTSs to accept loans, DTSs should charge interest rates comparable to those charged by commercial banks. However, Ndegwa, Waweru, and Huka's study was limited to Imenti North Sub-County and hence cannot be extrapolated to the MFIS in Kenya. The coverage area of the study was MFIS and not SACCOs; hence, a conflicting result may be produced when the same study is repeated in SACCOs. They also utilized primary data, which is susceptible to bias.

Kariuki and Ngahu (2020) examined how the performance of MFIs loans in Naivasha Sub-County is affected by the rate of interest they charge. Survey research approach was employed. As per the study findings, it was established that high correlation usually existed between the rate of interest charged and loan repayment among the sampled MFIs. High interest rates on borrowed money result in loan default, which leads to loan nonperformance, according to the study. Due to the fact that short-term loans have greater interest rates than long-term loans, customers also fail to repay their bills. However, the scope of Kariuki and Ngahu's analysis was limited to microfinance institutions and extension to SACCOs was limited. In addition, the study's dependent variable was loan performance; hence, the study's conclusions cannot be applied to other studies that used financial performance metrics such as ROE and ROI. The area of study was also limited to the Naivasha Sub-County; therefore, the conclusions cannot be extrapolated to the entire republic of Kenya.

Figure 1: Conceptual Framework



Source: Researcher (2023)

Research Design

A researcher can utilize a research approach as a blueprint to answer the questions that a study is seeking to answer (Siedlecki, 2020). As such, a descriptive research approach was employed in this survey. This research approach allowed the researcher to explore various aspects of the research objective. This decision was made based on the belief that descriptive designs are the best for investigating the impact of an independent variable on a dependent variable without modifying the dependent variable (Bloomfield & Fisher, 2019).

Target Population

It is viewed as the entire objects in the designated area on which the researcher desires to base his or her study. All the components of a research study that the researchers want to use to provide proof for a conclusion regarding a certain occurrence are referred to as the population target (Dahabreh & Hernán, 2019). Considering the distinctiveness of the traits the researcher is interested in, the researcher studies the constituent units. As a result, the target population consisted of all the forty-three (43) licensed commercial banks in Kenya that are duly registered with the Central Bank of Kenya.

Sampling Design

It is viewed as a subset of the larger population whose features are studied to learn more about it. This covers the constituent elements employed in the study that were chosen from the targeted study population, and the findings from such are extrapolated to the other elements that were not chosen for analysis (Sharma, 2017). Based on this, the selected elements are used to derive a full and reliable inference suitable for the investigation. 43 licensed commercial banks in Kenya (appendix II) that are duly licensed by CBK and offers mortgage financing as one of their products were used as the sample population. It is only those institutions which have been in operation over the 5 years were studied in order to view their financial statements and assess their financial performance. The investigation was undertaken between 2017 and 2021.

Data Collection Instruments and Procedures.

It is regarded as a structured plan that assists a researcher to acquire information pertinent to the study. As such, secondary data collection matrix was employed in gathering the required information from published reports of the targeted institutions over a five years period between 2017-2021. The obtained information assisted the researcher in analyzing their financial performance in comparison to the independent variable (interest rate charged, volume of mortgage and lending mortgage types).

Data Analysis and presentation

Obtained data was examined to enable the researcher to decide whether or not the research hypotheses were correct (Mishra *et al.*, 2018). STATA software was used to analyze the obtained data. Both descriptive statistics and inferential statistics were utilized during data analysis. The degree to which mortgages have an impact on a company's financial performance, as well as the correlations between that impact and the correlations between the two, was investigated using multiple regression techniques.

The model captured the physical association between the explanatory and dependent variables. A selection of commercial banks was employed, keeping in view the provision of mortgage services and the attendant consequence on the bank's financial performance. As such, the survey considered all 43 commercial banks and their mortgage service over a period of five years. As such, a panel regression model was adopted. Therefore, financial performance was expressed as a function of mortgage financing (interest charged).

$FP = \beta o + \beta_1 INT + + \mathcal{E}$

Where:

FP= Financial Performance

INT= Interest Charged

β_0 = Constant

β_1 = Beta Coefficient

$\mathcal{E}$ = Error term

The findings of the data analysis were presented in the form of graphs and tables.

RESEARCH FINDINGS AND DISCUSSIONS

Descriptive Statistics

The researcher ran a descriptive statistics between the variables utilizing the STATA software. The results are summarized in Table 1.

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Dev.
ROE	195	-218.11	33.22	7.59	19.83
Interest Charged	195	1.00	20.00	14.86	6.34

Source: Researcher (2023)

As per the results presented, it was observed that the mean ROE among the analysed institutions was 7.59 and a corresponding standard deviation of 19.83. In addition, ROE had a minimum and maximum values of -218 33.22 respectively. The findings are an indication that the ROE of commercial banks in Kenya varied between 7.59 and 19.83 is very significant. Percentage of interest charged on mortgage issued had an average value of 14.86, standard deviation of 6.34, and a minimum and maximum values of 1.00 and a 20.00 respectively. The finding is an indication that the overall percentage of interest charged had an effect on financial performance of commercial banks varying between 6.34 and 14.86.

Correlation Analysis

The researcher created a correlation matrix between the variables utilizing the STATA software. The results are summarized in Table 2.

Table 2: Correlation Analysis

		ROE	Interest Charged
ROE	r	1.00	0.46
	Sig.		0.00
Interest Charged	r	0.46	1.00
	Sig.	0.00	

Source: Researcher (2023)

According to the results that are shown in Table 2, a favourable and substantial link existed amongst interest rate and performance of Kenya banking institutions (0.46, P-Value 0.05). The outcomes of this investigation are consistent with the conclusions drawn by Obillo (2018), whose study similarly found that charging a higher interest rate on loans results in a greater profit.

Regression Analysis

Multiple regressing analysis was computed to derive the relationship between the variables.

Model Summary

The model summary test was done and the results shown in Table 3.

Table 3: Model Summary

Model	R	R-Square	Adjusted R Square	Std. Error of the Estimate
1	.597[a]	0.356	0.346	5.237

Source: Researcher (2023)

The results established R^2 to be 0.356 which is an indication that it is only 35.6% of the performance of Kenya banking institutions was influenced by their mortgage financing during the time. This suggests that 64.4% of the performance of Kenya banking institutions is affected by issues other than those related to mortgage financing.

Analysis of Variance (ANOVA)

The ANOVA test was done and the results shown in Table 4.

Table 4: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	2902.835	3	967.612	35.268	.000[b]
1	Residual	5240.206	191	27.436		
	Total	8143.041	194			

Source: Researcher (2023)

The acquired findings suggested that at the sig. level set of 0.000, then the model could be considered reliable since it was less than 5%. Because of this, it was determined that the model adequately explained the extent upon which the interest charged had impact upon the performance of Kenya banking institutions that is involved in the business of issuing mortgage advances.

Regression Coefficients

The regression output was done and represented in Table 5.

Table 5: Regression Coefficient

Model		Unstandardized Coefficients		Standardised Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	1.161	0.975		1.190	0.236
	Interest Charged	0.496	0.234	0.479	2.118	0.035

Source: Researcher (2023)

Regression coefficient results depicted in Table 5 is an indication that, when interest charged is held constant, then its total impact on the performance of Kenya banking institutions that is involved in the business of issuing mortgage advances would be 1.161.

On the effect of interest charged on the performance of Kenya banking institutions that are involved in the business of issuing mortgage advances, the regression outcomes indicated that interest charged had favourable and substantial impact on the performance of Kenya banking institutions that are involved in the business of issuing mortgage advances ($\beta = 0.496$, $P<0.05$).

$FP = 1.161 + 0.496\mathbf{INT} + \boldsymbol{\mathcal{E}}$

Where:

FP= Financial Performance

INT= Interest Charged

$\mathcal{E}$ = Error term

Results illustrated that, at critical level of significance, null hypothesis **(H_{01})** was to be rejected since interest charged by Kenya banking institutions that are involved in the business of issuing mortgage advances had no substantial impact on their financial performance during the period 2017 to 2021. Therefore, it is very clear that the findings are in full support of mortgage value theory upon which the variable of interest charged was anchored.

The study results support Khan & Sattar (2017) who examined how the fluctuations in interest rate charged affects profitability of banking institutions in Pakistan. In addition, the study findings agreed with Chikalipah (2019) who investigated the factors that influence MFI lending interest charges in Sub-Saharan Africa and established that various factors such as ROA, inflation rate, interest rate, financial expenses as well as operating expenses are among the key issues that impact lending rates in SSA. However, the findings disagreed with Obillo (2018) who surveyed the nexus that existed between the lending interest charged and how such affect banks' profits level across the country and found out that higher interest charged discouraged clients from obtaining loans thus causing a negative impact on their annual performance. The survey finding further contradicts the findings of one done by Ndegwa et al., (2019) that investigated the extent to which the financial performance of MFIs operating across Imenti North Sub-County are affected by the rate of interest.

Conclusion and Recommendations

Conclusion

The study objective aimed to examine the effect interest charged on financial performance of commercial banks in Kenya. According to the study findings, it was established that interest charged had a positive and significant effect on the financial performance of commercial banks in Kenya. Based on the findings, it was clear that the rate of interest charged on mortgage issued did contribute significantly towards the financial performance of commercial banks in Kenya.

Recommendations

The study results indicated that interest charged had a positive and significant effect on the financial performance of commercial banks in Kenya. Based on this, the study recommends that commercial banks in the country should consider lowering their mortgage interest rates in order to make mortgage loans accessible to all classes of customers. As a result, lowered interest rates will make mortgage loans more attractive to a wide range of customers and, thus, contribute to better financial performance of the country's banking institutions.

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