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Financial Ethics and Performance of Kenyan Small and Medium Commercial Banks

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Abstract

Purpose: Past empirical investigations on financial ethics have failed to provide an empirical analysis of the primary unethical banking practices prevalent in Kenya's banking industry, or the perceptions of banking professionals on the type of concerns they believe might be influencing their resolution making. This study aimed at investigating the impact of ethical financial practices on the financial performance of small and medium banks in Kenya. The specific objectives of this research were to; analyse the effect of insider abuse and to investigate the effect of predatory lending on financial performance of small and medium sized commercial banks in Kenya.

Methodology: The research was informed by the Ethical Egoism Theory which predisposes that people should entirely act in their self- interest. The study involved 124 heads of key functional units of the 33 small and medium banks in Kenya that were operational at the time of the study. From the target population of 124 bank managers, a proportionate stratified sample of 94 bank managers was selected for the study. Utilizing both primary data, the study applied a semi-structured questionnaire as the main research instrument. Both descriptive and inferential statistics were used for data analysis using the 23rd version of SPSS. From the analyses, the independent variables (predatory lending and insider dealings) moderately influenced the dependent variable (ROA and ROE) with an adjusted $R^2 = 0.025$.

Findings: From the findings, the Multiple Determination Coefficient (R^2) was 0.056 meaning that linear regression of "Low fit goodness" explains only 5.6% of the variation in the economic performance of the small and medium banks in Kenya. To establish the cumulative effect of the variables of prediction on the dependent variable, the Analysis of Variance (ANOVA) was applied to determine and analyse the effects of interaction. The study concluded that, a number of insider dealings and predatory banking practices still prevail among the small and medium Kenyan banks despite the ongoing reforms in the banking sector.

Recommendations: The study recommends that commercial banks and other financial institutions in Kenya invest more in establishing systems that promote financial ethics in their service delivery to build their core competency in the dynamic market. At policy level, this study proposes that the Central Bank of Kenya, the Treasury and, other line agencies fast-track the fiscal reform agenda with regards to prudential banking and financial service delivery to mitigate the influence of systemic supervisory weaknesses.

Keywords: *Financial ethics, financial performance, small and medium commercial banks.*

1.0 Introduction

1.1 Background of the Study

The core competency of any financial institution critically depends on robust ethical standards. Ontologism, based on the concept of good versus evil (Menezes, 2016) aids to contextualize financial ethics. Towards this end, the products and services awareness need spring into the mind. With the current multifaceted financial transactions, all too often integrity and ethical considerations might get squeezed. As Ragonmal (2015) asserts, integrity and ethics constitute two trust pillars without which, no financial organization can guarantee confidence. Patil (2010) concurs with the above thesis by arguing that the simplified parallel of ontologism underpins the fact that the full awareness of the relative ethics on the importance of banking products and services to all economies, irrespective of their economic development.

In view of the above, financial ethics borders risk management given that it should be designed to avoid, detect and predict misconducts and unsuitable business behaviors (Patil, 2010). Financial ethics mechanisms are designed to form controls that alleviate the firm's exposure to risks of conduct. Expounding on this proposition, Menezes (2016) postulates that supporting and protecting the trust customers place in financial service firms is the ultimate goal of fostering a culture of compliance and ethical behavior in banking.

1.1.1 Financial Ethics Practices

Past empirical findings concur with the fact that Normative Ethical Theory offers very little in comprehending the composite processes through which financial service providers participate in making ethical decisions. However, it gives direction to the resolution of ethical predicaments and permits a broader comprehension of the theoretical constructs and concepts under investigation. There exist various theories relating to ethical studies, usually falling under two main categories, namely; applied and theoretical ethics (meta-ethics or normative ethics). Both classifications are useful in this research work. However, the application of ethics to professional and business contexts is of particular relevance. Theoretical ethics entails the study of ethical language, its conventions, relevance and use not forgetting moral decision justifications logic (Kitchener 2000). Conversely, Martin (2000) argues that applied ethics entails using insights and principles from normative ethics and meta-ethics to resolve problematic cases and particular moral issues. In the context of financial ethics, applied ethics also involves the study and evaluation of moral actions and beliefs within a particular business or professional setting. In other words, it is the study of people and how they make ethical decisions; how individuals should act towards each other and constitute justification rules for behavior (Kitchener, 2000). The chief area of study in this research is applied ethical theory. Nonetheless, applied ethics must be accompanied with normative ethical theory so as to provide context and foundation (Almond, 1995).

Behavioral ethics goes hand in hand with the explanation of individual behavior which is subjected to (Trevino, Weaver & Reynolds, 2006) or judged in accordance with generally conventional moral behavioral norms that prevail in the context of extensive social prescriptions (Kitchener, 2000). Martin (2000) validates by asserting that professional ethics consists of the moral requirements tied to a particular profession and enacted on all of its members. Expounding further, Townsend (2003) argues that the primary goal of professional ethics should be to encourage professionals to not only avoid evil in their decision making, but to ensure goodness prevails when dealing with the often-puzzling dilemmas they face time and again. With regards to financial ethics, professional ethics is viewed as the ethical issues that

arise due to the specialist knowledge that a financial expert gets, and how this knowledge should be used, within the ethical limits set for the profession, while providing services to clients. Complimenting Townsend and Preston (1996) stipulates that professional ethics test is not of satisfying personal motives of an individual, but of acting in ways that relate to the duties entrusted to the professional role.

Hitt (1990) suggests that values refer to long term beliefs or principles that a person bears, which guide their decision making and that regulate whether a certain course of conduct is preferable to another. These beliefs or principles are held strong, even though they may change over time. Velasquez, Andre and Meyer (2005) differentiated between two groups of values. First, there are terminal values, which define the consequences for which individuals strive, which include but not limited to wisdom, security and accomplishment. The second group is house important values that give the means to achieve those results that include obedience, courage, honesty, and responsibility. Francis and Armstrong (2004) go deep to differentiate between positive values, like truthfulness and negative values, like greed. Chiami and Fullenkamp (2002) opined that when a banking institution is looked at as ethical it gives it a competitive edge of survival against unethical practices that kill a system. Unscrupulous and unethical practice as explained by Dunn et al. (2003) in the USA Banking system had a major impact on operations of the banks. The phenomenal increase in banks increased the competition for deposits and customers that led to unprecedented increase in unethical practices including insider dealings and proliferation of financial institutions. The failure to abide by ethical banking has not only limited economic growth but has also resulted in the infliction of pain on depositors and other bank clients. Bein (2001) opines that depositors, external lenders, government and intergovernmental financial institutions are the four categories of agents who can trigger a crisis in a banking institution.

1.1.2 Legal and Institutional Frameworks

In Kenya, the development of macro-prudential financial institutions and regulatory systems has been accelerated in the post-crisis era. Towards this end, the treasury together with the Central Bank of Kenya (CBK) has put various measures in place to ensure ethical practices in the country's banking sector. The aim of the CBK is to ensure financial stability, hence its role as implementing agency of the country's fiscal policies and inducing the key mandate of regulating the banking sector. According to the CBK (2017), the central bank's supervisory agenda rests on transparency, governance and effective business models. To make this feasible, the CBK collaborates with the financial institutions to foster enhanced disclosure, improvement of quality of assets, integrity and governance. The CBK has in the last decade put significant efforts in strengthening the capital adequacy evaluation framework for banks, CBK issued direction on execution of the process of Internal Capital Adequacy Assessment alias ICAAP.

Globally, the Basel Committee on Banking Supervision (BCBS) has laid emphasis on the move towards essential clearing and the maintenance of higher transparency standards in its banking frameworks. The difficulty lies in how these adjustments and new regimes are implemented by national authorities, who must be more mindful of worries about extending and possibly undermining an already shaky economic recovery. The fragmentation risk of global regulatory tactics is rising. Taking the administrative viewpoint, the BCBS (2017) predisposes that; compliance with these new conditions should be seen as the bare minimum for banks in ensuring that they are prepared for uncertainties. Consequently, it is expected that banks and

other financial institutions in Kenya have robust plans in place to remain agile and responsive for the interest of customers and key stakeholders.

1.1.3 Commercial Banks and Development of the Economy

The centrality of commercial banks to economic development can be traced back to Schumpeter (1912) and Levin (1997) who posit that a well-functioning financial sector can spur economic growth. Corroborating Schumpeter and Levin's proposition is Young (2012) who argues that the financial sector provides positive avenues in numerous departments under the financial sector which indirectly increase people's living standards and lower poverty level. The multiplier effect of commercial banks is underpinned by Ragonmal (2015) who conducted an empirical analysis using time series data from 1983 to 2013 to examine the impact of financial development through commercial banks on economic growth in Vanuatu. Using granger non-causality tests and Vector-Error-Correlation Model (VEM) the study established a positive significant connection between commercial development and economic growth.

Banks are financial intermediaries that play a multifurled role economically both nationally and internationally. Rose (2012) refers to banks as vital economic institutions that play a major role in the economy by mobilizing savings from the surplus units and channeling this to deficit units. Commercial banks use depositors' money and creditors to operate. According to the Bank Supervisory Report of Kenya (2017), the banking sector encompasses the central bank as the regulatory authority, 43 institutions of which 42 are commercial banks with one mortgage (CBK, 2015). The Kenyan commercial banks fall in three classes, based on the market share analysis and using the weighted composite indexing. In this case, large banks have 5 percent composite index while small and medium have less than 1 percent and 5 percent respectively.

1.2 Statement of the Problem

The Kenyan banking sector has witnessed a number of banks go into financial distress over the last decade due to mismanagement and unethical financial practices. Towards this end, the financial service market in Kenya has severely suffered from some strain in the recent past including the increases in Non-Performing Loans (NPLs) where the debtor flees the country, as well as increased fraud risks. Recently, the emphasis in both ethical and financial discussions has been a natural consequence of the investments that are high-leveraged and excessive risk taken by banks, which contributed significantly to the 2007 – 2009 financial hiccup. Ethical behaviour and decision making in business context is predicted by numerous constructs (Hofmann, 2008) including individual, contextual and situational factors within the organization (Trevino, 1986).

The above predisposition had resonance in the current study given the fact that it focused on investigating the dynamics between ethical financial performances, practices and in particular the cognitive ethical reasoning utilized by operatives in commercial banks when engaging in decision making and the ethical context of commercial banks in Kenya raised competing priorities to act in different ways. While literature on business ethics abound, studies on ethical decision making in financial service delivery in Kenya remains scant. Against this backdrop, it is apparent that the most urgent issue to be given attention is the ethical aspect of the recent performance decline of commercial banks in Kenya in light of many diverse topics in financial ethics. Consequently, this study set out to explore the influence of financial ethics on the financial performance in the Kenyan small and medium sized commercial banks. Financial frauds and recent banking scandals have really undermined the already low confidence in the

banking sector, misconduct is still widespread and restoring confidence is crucial to overcome this crisis but still remains difficult. Evaluation of failures of banks globally reveal that unethical behaviour is one of the major reasons lying behind these undesired states. Despite the small number of individuals perpetrating the vice, their actions have had a considerable financial and legal ramification that have negatively impacted the financial performance of the banks as well as the trust of regulators and the public in general.

Even though banks, according to Economic survey (2015), have contributed greatly to the growth and the development of the country's economy, there have been corporate scandals that have led to the suspension of chief executives of Imperial Bank, Chase Bank, Bank of Baroda and others. This has subsequently created liquidity problems with banks trading below the profit margin, despite efforts as seen in the Global Competitive Report (2016). In this report, nations have come up with policies and systems that are people centred and embedded on the overall societal goals and the banking standards as issued by the regulatory authority. However, there is still a challenge in coming up with specific standards that anchor financial ethics. There is also the need to eliminate the unethical activities for the long-term sustainability and restoration of trust and performance. Despite these concerns, not much has been done as there is the general lack of ethics in financial institutions, hence necessitating this study.

1.3 Purpose of the Study

The purpose of this study was to explore the influence of ethical practices on financial performance of both medium sized and small commercial banks in Kenya.

1.4 Objectives of the Study

The broad aim of the study was to investigate financial ethics and financial performance of small and medium sized commercial banks in Kenya. The following specific objectives guided the main objective:

- i. To analyze the impact of insider abuse on the financial performance of medium sized and small commercial banks in Kenya.
- ii. To investigate predatory lending on financial performance of Kenyan small and medium sized commercial banks.

1.5 Hypotheses of the Study

H1_o: Insider abuse does not have a positive noteworthy influence on the financial performance of Kenyan small and medium sized commercial banks.

H2_o: Predatory lending practise does not have a positive significant influence on financial performance of small and medium sized commercial banks in Kenya.

1.6 Value of the Study

The study contributes significantly to the ongoing debates of public policy with regard to regulation of the modern banking service industry in Kenya. The input of the current study to commercial banks is twofold; foremost, it unravels the prime types of corrupt practices inclined to the financial service delivery and the insights of banking professionals on the prevailing ethical issues affecting ethical decision making among commercial banks in Kenya. Moreover, financial management professionals will be able to better understand the influence of compliance to ethical practices on economic performance of the banking sectors. On the basis of the findings, financial management professionals in the sector will be able to employ

corrective measures in areas considered as weak as far as financial ethical issues are concerned in their respective commercial banks. The regulators in the banking sector and policy makers will benefit by shaping their policies governing ethics in the banking industry based on strategic rather than regulatory grounds.

At the theoretical level, the current research work contributes to the present academic information based on ethical decision making and the contextual, situational, and individual factors that impact it. The study specifically makes a substantial contribution to the knowledge associated with professional ethics. Towards this end, the study identifies critical gaps in the ethical context of banking service delivery in Kenya. Ultimately, this study enhances knowledge in the area of financial ethics by generating standard data of the attitudes and perceptions of banking professionals to the ethical culture within the Kenyan banking industry.

1.7 Scope and Limitation of the Study

This study sought to examine the relationship between financial ethical practices and financial performance of Kenyan based small and medium sized commercial banks. Considering the population of the study was only 33 small and medium sized commercial banks as at 30th December 2016 (CBK, 2016), a census study was undertaken. The head office of all the 33 commercial banks are located in Nairobi and such, the primary data for the study was conducted within Nairobi City and its environs. Commercial banks records are highly sensitive and confidential. The banks have instituted policies to treat information regarding their operations as confidential and therefore accessing this information from the participants was one of the drawback in the study.

2.0 Literature Review

2.1 Introduction

A review of interrelated literature was steered to reveal the existing knowledge and give a more discerning view of the concepts and interplay between the study variables. This chapter thus presents the literature review with the ultimate goal of identifying the literature gaps. The chapter begins with a review of theoretical models on ethical financial practices before delving into the examination of empirical literature on financial ethics and performance. Financial ethics affecting firms is discussed and the methods of its measurement.

2.2 Ethical Egoism Theory

Ethical egoism theory refers to the situation whereby people behave completely in their self-interest (Jones et al., 2007). Hence the moral belief of ethical egoism proposes that an act is ethical when it promotes the long-term interest of an individual. The implication of this theory is that individuals will act in self-interest and at the expense of the banks goal which is performance, growth and reputation. Ethical egoism theory postulates that a person is obligated only to enhance his or her own prolonged welfare and that obligations to others are not compulsory and should only be defaulted if they stop to be advantageous to the individual (Beauchamp & Bowie, 2004). In essence, the welfare of others is relevant to an egoist only if it affects his or her well-being. Barry and Stephens (1998) argue that people and establishments should take the interests of others into their account in their decision-making practises and conduct. However, Kurt (1998) argued that ethical egoism is incorrect in addressing issues on purely rational grounds as Baier (1998) thought that the theory contradicts itself and no theory can be true if it is self-contradictory.

In the context of this research work, it is claimed that ethical egoism may be related with the current lending practices in Kenya and in particular predatory practices in loan sales. The significance of this theory to the current study is to address the question of whether the only obligation of commercial banks is to maximize profits in the interest of the investors (a form of egoism) or whether the responsibility outspreads to consideration of the clients and other stakeholder's as a form of utilitarianism.

2.3 Empirical Literature

The empirical literature for this study consists of literature pertaining to financial ethics practices adopted by commercial banks to enhance their financial performance. According to Krummeck (2000) ethical values should be critical part of the business strategy so as to enable firms and individuals to mitigate and detect dilemmas of fraud. Barbu and Boitan (2009) opines that the major characteristic of ethical banks is that they operate with a clear and established set of ethical values which are embedded and respected in the various hierarchical levels.

Numerous studies have been carried out on financial ethics. Adewale (2012) conducted a similar study on ethics and professionalism in banking services and found out that the failure to uphold code of ethics, weak bases of banking knowledge and reckless initiation of diverse insider abuses led to systematic bank failures, this was initiated with the fully knowledge of some bank employees to benefit the bank and themselves. Another study by Brennan (2003) looked at business etiquette in the commercial banks loan system in Kenya and found out that it was only meant to raise income for the institution that has the result of an individual centered rather than society centered, this concurring with the ethical egoism theory. Enofe et al. (2015) investigated the ethical factors influencing performance of Kenyan commercial banks, they discovered that insider related credits and unauthorized tempering with customers account both had positive and negative relationship to performance respectively. Nkepta et al. (2015) and Dogarawa (2004) found out that employment of ethical management practices enhanced performance, they advocated for code of conduct to be a must for all institutions. Ram et al. (2011) found out that unethical actions of manipulating customers to divert the loans for other purposes, delay in loan sanctioning negatively affected performance. In Kenya, Githui (2013) concurred that those usurious practices and embracement of universal value system were negatively affecting the performance banks.

2.4 Firm Characteristics

Golan et al. (2003) observed that a firm's resources and objectives shortened as firm characteristics influence performance of organizations. These include, market, capital-related and structure variables. Structure-related variables include ownership, age and size of the firm. Market-related variables include type of the industry, environment of the market, and environmental uncertainty. Capital-related variables include but not limited to liquidity and capital intensity. Firm size is probably one of the single most influential variables in organizational studies. Chen and Hambrick (1995), and Mintzberg (1997) summarize and give an overview of the importance of firm size. Firm size has also been proved to be related to vertical integration, industry-sunk costs, concentration, and overall profitability of the industry (Dean *et al.*, 1998). Larger firms are more likely to have extensive management layers incorporated with higher number of departments, diverse specialization of skills and functions, greater centralization, formalization, and bureaucracy than smaller firms (Daft, 2010).

Besides, recent research has found a relationship between size of the firm and ‘inertia,’ where inertia is typically an inadequate or slow adaptation to change or resistance to vital changes in conducting business (Miller et al., 1994). Inertia can be triggered by ‘constraints on action’ such as institutional networks, bureaucratic rigidity and insularity: all of which tend to be associated with size and age of the firm (Miller et al., 1994; Hannan & Freeman, 1984; Meyer & Zucker, 1989). Starbuck (1985), argues that inertia can make change more inflated and harder to attain and maintain. Based on these arguments, it is expected that firm size becomes an important predictor for firm performance.

A review of the literature above reveals that both, the nature of the firm and the behaviour of the entrepreneur are quite crucial since they institute firm characteristics which could extremely affect the overall achievement of a firm. It is therefore critical to explore the controlling influence of firm characteristics on the influence of financial ethical practices on performance of the firm. Considerable studies have been carried out to establish the relationship between firm characteristic and firm performance. Mohd (2005) stated that firm characteristics play an important role in determining the total performance of the firm.

The results of the study carried out by Wiklund and Shepherd (2005) indicate that firms that are able to bring into line attributes with the characteristics of the environment perform better than firms. Dean, Bülent and Christopher (2000) recognised that firm characteristics are essential determinants of the firm’s success. A clear picture of the controlling influence of firm characteristics on the connection between ethical financial practices and financial performance of commercial banks has not emerged from previous studies. The prevailing body of knowledge is insufficient in explaining the moderating impact of firm characteristics on the influence of financial ethical practices on firm’s performance, specifically in the banking sector, hence the impetus for this study.

2.5 Financial Performance

Financial performance has to do with degree to which financial goals have been attained (Herly & Sisnuhadi, 2015). From this perspective, Rouf (2011) views financial performance as the benefits arising from a firm’s stocks by the shareholders. In concurrence, Herly and Sisnuhadi (2011) contend that a firm’s performance can be noticed by looking at its financial statements, such that a good performing firm will strengthen management for quality discloser. Performance determination is imperative for effective financial management (Tekinus & Zaim, 2006), hence the need for the establishment of performance metrics to rate a firm’s performance over a given trading period (Gadene & Shrama, 2002).

Ibrahim and AbdulSamad (2011) outline the superiority of accounting-based performance measurement by arguing that such systems are considered effective indicators of a firm’s success and the business in comparison to benchmark annual return equivalent to the risk adjusted weighted mean cost of capital. According to Herly et al. (2011), some of the methods of measuring performance include: return on assets (ROA), Tobin-Q, profit margin, earnings per share, return on sales, expense to assets, ratio of price earnings, return on sales alias ROS, sales to assets, market value added, return on revenue, cost per service provided, and return on capital employed. This study used balanced scorecard to assess the performance of the firm.

2.6 Summary of the Research Gap

While past empirical studies reviewed above provide vital insights into the impact of business ethics on firm performance, most of them have failed to provide an empirical analysis of the primary unethical banking practices prevalent in Kenya's banking industry, or the perceptions of banking professionals on the type of issues they believe may be influencing their decision making. The above studies provide mixed findings on the ethical influences on bank performance. Furthermore, none of the study seems to be concentrating on the principles that are specifically anchored on Financial ethics in Banks in the Kenyan Context, the impetus of this study is therefore to come up with those specific set of principles that are addressing the performance of commercial banks in Kenya on financial ethics.

2.7 Conceptual Framework

In order to evaluate the research questions, the following theoretical framework was implemented. The independent variable is the Financial Ethics Practices of the banks which will be measured by Insider dealings and Predatory lending both of which will use Pearson Product Moment Correlation. In the context of the research hypotheses, the conceptual model is developed, as shown in figure 1.

Independent Variables

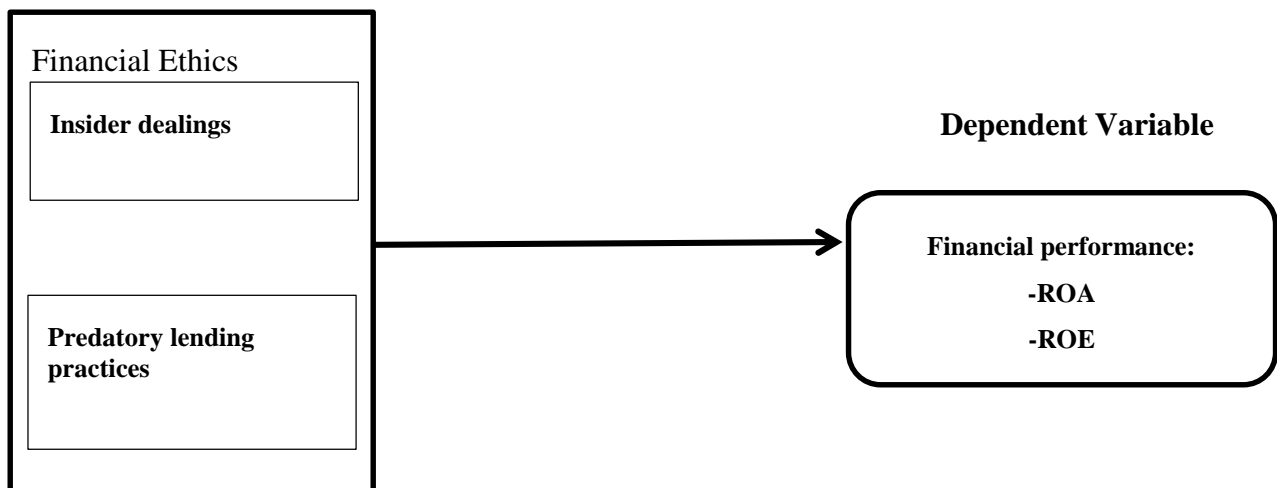


Figure 1: Conceptual framework.

3.0 Research Methodology

3.1 Introduction

Bryman (2004) describes research methodology as a technique used for data collection with the aim of analysis. This chapter elaborates research tactics and design, discussion on research philosophy, sampling design, research design, population of the study, data collection methods, Ethical considerations data collection methods and chapter summary.

3.2 Research Philosophy

According to Menezes (2016), a research philosophy is the expansion of knowledge and the knowledge nature. In this study, a positive approach was utilized and cuts across testing hypothesis, objective method using cross sectional design, and structured research design. Both

inductive and deductive methods were used by developing the hypothesis based on the extensive literature review, from the data collected using the research instrument, observations will be made to confirm or reject the hypothesis developed (Burney, 2008).

3.3 Research Design

According to Cooper and Schindler (2012), research design is the general strategy that is used to incorporate the different elements of the study in a coherent and logical manner. Hence, ensuring that the research problem gets addressed to the latter, it establishes the design for data collection, and analysis. Creswell (2003) posits that a descriptive research design is used when data is collected to describe people, organizations, settings, and phenomena. They are usually structured and explicitly designed to measure the characteristics outlined in research question. Therefore, for the purpose of this research, descriptive survey research design was adopted.

3.4 Population of the Study

Population refers to the complete group of people, things or events of interest that the researcher wishes to examine; the population forms a basis from which the sample or subjects for this study (Cooper & Schindler, 2012). The target population of this study entailed all the managers of the main functional units of the 33 small and medium sized Kenyan commercial banks, as at 30 December 2016 (CBK, 2016). A total of 124 heads of departments were on the roll.

3.5 Sampling Design

According to Ragonmal (2015), a sample design refers to the frame work for the selection of a survey sample which must focus on critical aspects of a survey as well. Towards this end, the sampling frame must be clearly defined so as to represent the population of interest, from which a sample is to be drawn.

3.6 Population and Sampling Frame

This study sought to examine the connection between financial ethical practices and financial performance of the 33 small and medium sized commercial banks in Kenya. Each of the targeted commercial banks were represented by five respondents (i) Head of Accounts, (ii) Head of finance; (iii) Head of procurement; (iv) Head of credit and (v) Head of operations. The sampling frame was drawn from the CBK current data base as shown in table 1.

Table 1: Population Distribution

Functional Unit	Frequency	Percent
Head of Finance	30	24.2
Head of Accounts	22	17.7
Heads of Procurement	12	9.7
Head of operations	26	21.0
Head of Credit	34	27.4
Total	124	100.0

Source: Researcher (2018).

3.7 Sampling Technique

According to Saunders et al. (2014), there are two groups of sampling methods; probability and non -probability. Probability sampling gives each element in the population equivalent

measure to get selected, while the non -probability sampling, the element in the population do not have a pre-set chance of getting selected. From the target population of 124 bank managers, the probabilistic sampling technique by Cochran and Snedecor (1989) was applied to attain the sample size.

$$n_o = \frac{Z^2 pq}{e^2}$$

Where,

n_o = Size of the sample

Z = 95% confidence interval or 1.96

e = degree of precision (set at 0.05)

p = 0.5 (Maximum variability) or (50% prevalence)

q = 1- p

But given that the population of the study is less than, 10,000, the formula will be adjusted to;

$$n = \frac{n_o}{1 + \frac{n_o - 1}{N}} \text{ (Mugenda \& Mugenda, 2008)}$$

Where,

N = Population size

In the current study

N= 124

$$n_o = \frac{1.96^2 * 0.5 * 0.5}{0.05^2} = 384.16$$

Hence;

$$n = \frac{384.16}{1 + \frac{384.16 - 1}{124}} = 93.92 = 94$$

According to Armstrong (2004), if there is limitation of the resources, where researchers tend to use a larger e. In case of an introductory study, researchers may use a larger e (for instance >10%). However, explanation for the selection of e should be stated clearly (such as limitation of resources) in the proposal of their research so that reviewers are well informed. In addition, the larger e should meet the assumption of normal approximation. A proportionate stratified sample of the 94 bank managers was chosen for the study as depicted in table 2.

Table 2: Proportionate stratified sample

Functional Unit	Population		Proportionate Stratified Sample
	Frequency	Percent	Sample Size (n)
Head of Finance	30	24.2	23
Head of Accounts	22	17.7	16
Heads of Procurement Manager	12	9.7	9
Head of operations	26	21.0	20
Head of Credit	34	27.4	26
Total	124	100.0	94

3.8 Data Collection Methods

In order to examine the research objectives, primary data was utilized. Saunders et al. (2014), observed that primary data is required to exhaustively answer the research question and is collected specially for research being done. Primary data collection involved the use of structured questionnaires containing both open and closed ended questions taking data between 2012 and 2016. This method is greatly regarded since it yields a high response rate and easy to administer.

4.0 Data Analysis and Presentation of Findings

4.1 Introduction

The study sought to investigate the impact of financial ethics on the financial performance of small and medium banks in Kenya. This chapter presents findings of the research by concentrating on; firm profiling, data investigation and proposals by the respondents based on the explicit objectives of the study.

4.2 Response Rate

A total of 94 questionnaires were given to the respondents. 65 of these questionnaires were brought back signifying an overall 69% rate of response. This response rate was enough and conforms to Mugenda and Mugenda (2006) who posits that a 50% response rate is adequate for investigation and reporting; a response rate of 60% is good whereas that of 70% is excellent.

4.3 Demographic Information

The demographic characteristics of the firm that were investigated were; age of the firm, existence of mechanisms for implementing financial ethics, firm experience in the implementation of financial ethics practices and the rationale for adopting financial ethics among the small and medium banks in Kenya.

4.3.1 Age of the Firm

The propensity to undertake process reengineering depends on a firm's existence in the respective market. Cognizant of the above, an analysis was made into the years the respective banks have been operating in Kenya. The results are portrayed in figure 2.

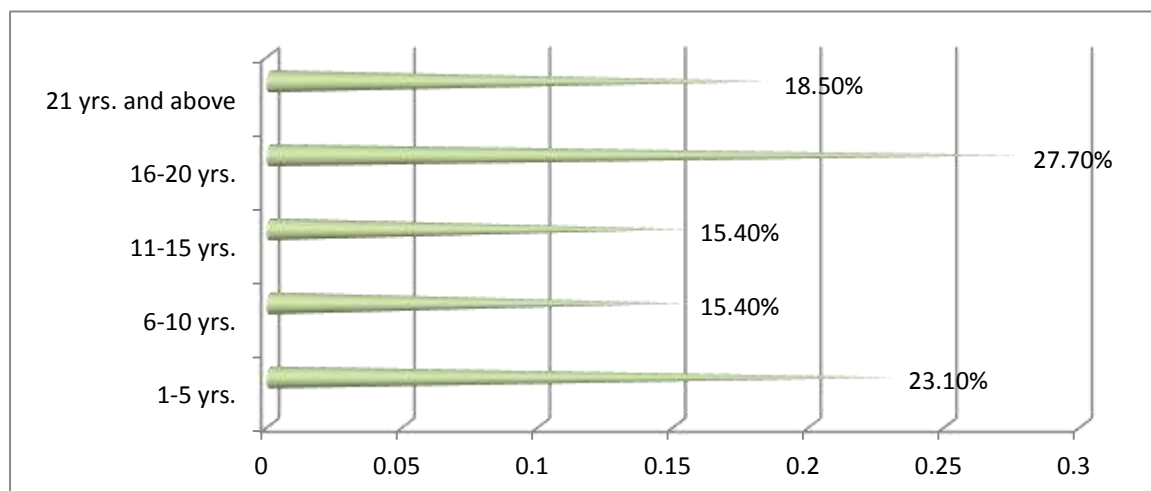


Figure 2: Age of the firm

The results in figure 2 indicate that most of Nairobi-based banks had been in operation for 16 to 20 years at 27.7% followed by those that have been operating in Kenya for 1-5 years and those who had operated in Kenya for over 18 years at 23.1 and 18.5 percent respectively. The fair spread of firms across the age spectrum implies that contrary to a priory theory, the adoption of ethical financial practices among small and medium banks in Kenya is not influenced by the firm age or experience in the market.

4.3.2 Existence of Mechanisms to Foster Financial Ethics

The study aimed at exploring the degree to which small and medium banks in Kenya have established mechanisms to ensure financial ethics in their operations. The results are shown in figure 3.

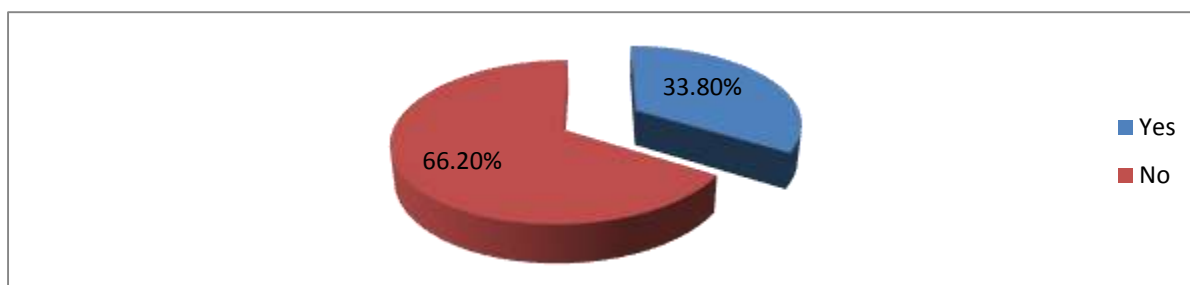


Figure 3: Existence of mechanisms for financial ethics

From the results in figure 3, only 33.85 percent of the banks in Kenya had put in place systems to foster financial ethics. The fact that up to 66.2% of the banks in Kenya have not established any structures to facilitate financial ethics implies that despite the centrality of financial ethics as a competitive tool in 21st century financial market, few banks in Kenya have found impetus to build their core competency by embedding financial ethics in their operations.

4.3.3 Firm Experience in the Implementation of Financial Ethics

The adoption and implementation of ethical financial practices calls for strategic change management which is pegged on firm experience. Towards this end, the study sought to investigate the number of years Kenyan based small and medium banks have adopted and implemented ethical financial practices. The findings are as presented in figure 4.

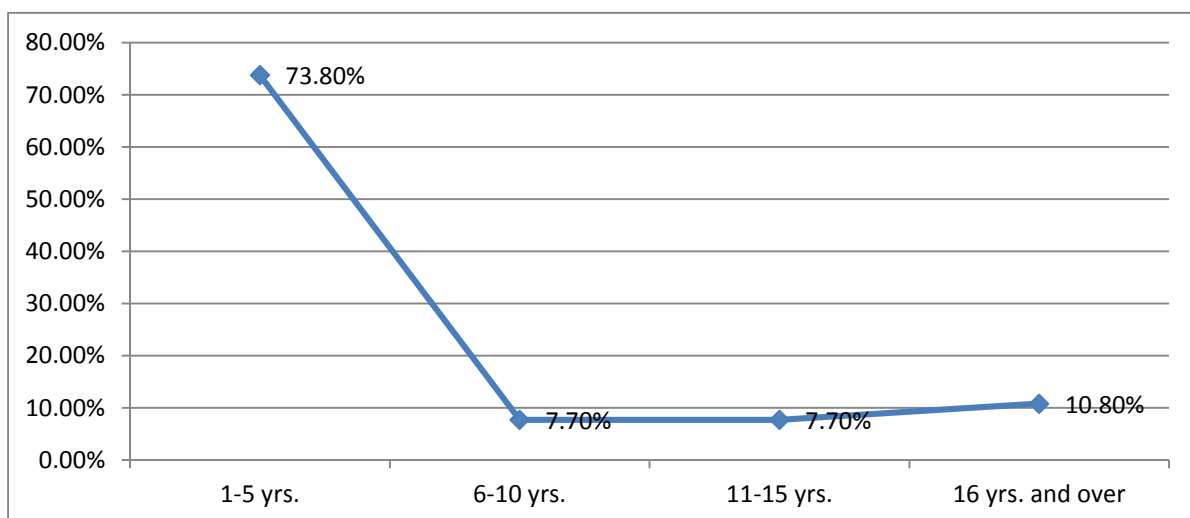


Figure 4: Firm experience in financial ethics

As per the findings in figure 4, majority of the small and medium banks had implemented financial ethics for less than five years at 73.8% followed by those that have implemented systems for financial ethics for 16 years and over at 10.8%. In addition, 7.7% had implemented the financial ethics between 6-10 years and 11-15 years. The fact that only 10.8% of the banks have over 16 years of experience in financial ethics implies that the concept of financial ethics is a relatively new phenomenon in Kenya.

4.3.4 Rationale for Adopting Financial Ethics

Driven by competitive forces in the financial market, banks in consultation with key stakeholders establish a set of operating standards deemed morally appropriate. In view of the above, an investigation was made into the drivers of financial ethics among the Kenyan small and medium banks. The findings are shown in figure 5.

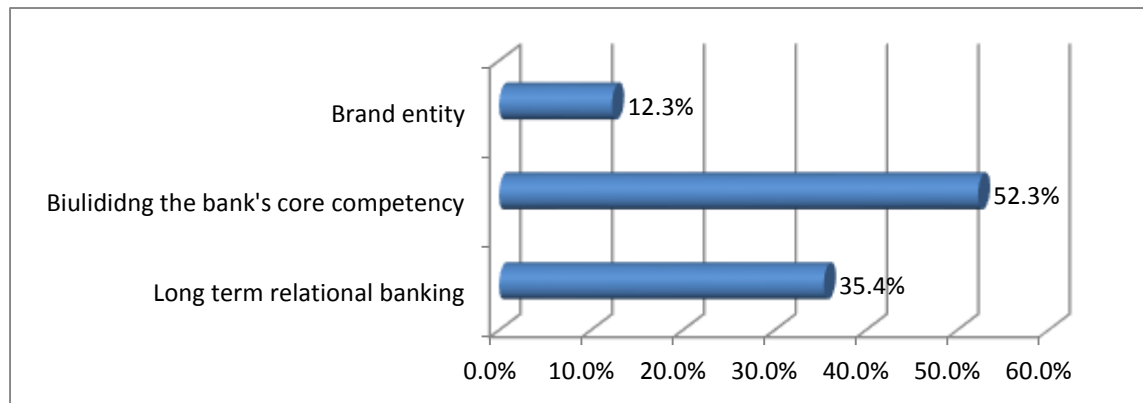


Figure 5: Rationale for financial ethics

Going by the results in figure 5, the quest to build the firms' core competence is the main driver of the adoption of financial ethics among the small and medium banks in Kenya at 52.3% followed by the need to develop long-term relational banking and brand entity at 35.4 and 12.3 percent respectively. The findings above imply that banks in Kenya are gradually embracing financial ethics as a major competitive strategy and market positioning. The results further imply that banks in Kenya are now following global trends in enhancing firm performance beyond the traditional performance drivers.

4.4 Analysis by Objectives

The broad goal of the study was to analyse financial ethics and financial performance of small and medium sized commercial banks in Kenya. The specific objectives of the study were to: evaluate the impact of insider abuse on the financial performance of small and medium sized commercial banks in Kenya; and investigate predatory lending on the economic performance of small and medium sized commercial banks in Kenya. Respondents were questioned on the degree to which various banking practices have been adopted in their corresponding banks and their impact on financial performance on a Likert scale of 1-5 where: 1 represented No extent; 2 indicated Small Extent; 3 = Moderate Extent; 4 = Large Extent; and 5 was Very Large Extent.

4.4.1 Insider Dealings

Many market participants believe that insider dealings pose a threat to financial markets. However, studies confirming attesting this argument remain scant. In light of the above, this

study sought to investigate the nature of insider dealings practiced by the small and medium Kenyan banks. The findings are as displayed in table 3.

Table 3: Nature of insider dealings

Nature of insider dealings	N Statistic	Mean Statistic	Std. Deviation Statistic
Academic qualifications	65	4.0923	1.46547
Excessive loans to insiders	65	4.1846	1.23608
Unsound lending practices	65	3.4462	1.34665
Unwarranted concentration of credit to one industry	65	3.8615	1.39056
Teller theft from cash drawer	65	2.4923	1.51165

According to the results in table 3, the outstanding practice of insider dealings is the provision of excessive loans to insiders followed by academic qualifications with a mean of 4.1846 and 4.0923 respectively revealing that the two practices have been adopted to a large extent based on the likert scale. The next insider practice that has been greatly embraced by the banks is the unwarranted credit to one industry at 3.8615. Other major forms of insider dealings are unsound lending practices and teller theft from cash drawers at 3.4462 and 2.4923 concurrently. The findings above thus imply that despite the recent call for financial ethics in the financial sectors, insider dealings are still rampant among the small and medium banks in Kenya.

Variation in responses regarding the occurrence of insider dealings was assessed using the standard deviation which indicates the level of variation apparent in the responses of the partakers in the study. A low standard deviation designates that the data points tend to be very close to the average response. Conversely, a high standard deviation indicates that the respondents extensively differed on their opinions regarding the several variables. The replies regarding academic qualification had the highest standard departure from the mean score at 1.46547 while those regarding excessive loans to insiders had the least deviation from the mean at 1.23608. Responses with respect to unsound lending practices, unwarranted concertation of credit to one industry and teller theft from cash drawers had a substantial departure from the mean as presented by the standard deviation of 1.34665, 1.39056, and 1.51165.

4.4.2 Predatory Lending

Predatory lending practices fall along a range between frauds and subprime lending. Cognizant of the above, the study sought to identify the various predatory lending practices undertaken by the small and medium banks in Kenya. The findings are depicted in table 4.

Table 4: Predatory lending practices

Predatory practice	N Statistic	Mean Statistic	Std. Deviation Statistic
Prepayment penalties	65	3.4000	5.54189
Mandatory arbitration clauses	65	4.5692	.99952
Required credit insurance	65	3.6923	1.19795
High upfront fees	65	3.2154	1.41964
High interest rates	65	3.9077	1.46547

From the results in table 4, mandatory arbitration clauses is the most significant predatory lending practice adopted by the small and medium banks in Kenya with an average of 4.5692 signifying that the practice is embraced to a very large extent. According to the findings, high interest rates is the next most influential practices with an average of 3.9077 implying that it is implemented extensively among the banks. Required credit insurance and prepayment penalties follow at 3.6923 and 3.40 respectively. The same findings indicate that high upfront fees is the least adopted predatory lending practice with an average of 3.2154 suggesting that the practice occurs moderately. A standard deviation was produced to illustrate the extent to which the measures of predatory lending had deviated from the mean. According to the findings in table 1.2, responses regarding prepayment of penalties had the highest departure from the mean score at 5.54189 while responses regarding mandatory arbitration clauses had the least deviation from the mean at 0.99952 implying that the respondents widely differed on the extent to which prepayment penalties are adopted among the banks. Responses with respect to high interest rates, high upfront fees and required credit insurance showed significant deviations from the mean with a standard deviation of 1.46547, 1.41964 and 1.19795 correspondingly.

4.4.3 Insider Dealings and Financial Performance

Insider dealings are often the major reason for nonperforming loan portfolio by commercial banks. Against this backdrop, the research sought to examine the level to which insider dealings have impacted the commercial performance of the Kenyan small and medium banks. On a 5-point likert scale those involved in the research were required to rate their belief on the extent to which different insider dealing practices have impacted on the performance of their corresponding banks. The outcomes are presented in table 5.

Table 5: Insider dealings and firm performance

Practice	N Statistic	Mean Statistic	Std. Deviation Statistic
Academic qualifications	65	4.0154	1.09676
Excessive loans to insiders	65	4.0923	1.31960
Unsound lending practices	65	4.0923	1.28359
Unwarranted concentration of credit to one industry	65	4.3385	1.14941
Teller theft from cash drawer	65	3.0769	1.16334

According to the results in table 5, unwarranted concentration of credit to one industry, unsound lending practices, excessive loans to insiders, and academic qualifications affect the performance of the banks greatly with an average of 4.3385, 4.0923, and 4.0154 respectively. Similarly, the outcomes indicate that teller theft from cash drawer affects the economic performance of the banks to a moderate extent at 3.0769. In a bid to decide the departure of the various responses from the mean, standard deviation was produced. Responses concerning the impact of excessive loans to insiders on financial performance had the highest departure with a mean standard deviation of 1.31960 while academic qualification had the least departure at 1.09676. Responses regarding unsound lending practices, unwarranted concentration on one industry and teller theft from cash drawer also registered substantial deviations from the mean as demonstrated by the standard deviations of 1.1494, 1.2835 and 1.16334 concurrently. The findings above imply that less stringent conditions underlying the facilities often characterize insider lending in which case insider borrowers have the impetus to ignore loan terms aware of

the relaxed terms. Towards this end, allowing insiders access to easy loans exposes the bank to financial risks due to their negative impact on profitability.

4.4.4 Predatory Lending practices and financial performance

Practically, differentiating predatory lending from aggressive lending practices could be problematic. To make progress, this study narrowed down on explore the extent to which various predatory lending practices have influenced the monetary performance of small and medium banks in Kenya. The results are shown in table 6.

Table 6: Predatory lending practices and financial performance

Predatory lending practice	N	Mean	Std. Deviation
	Statistic	Statistic	Statistic
Prepayment penalties	65	4.0769	1.14983
Mandatory arbitration clauses	65	3.5077	1.71504
Required credit insurance	65	3.1538	1.32560
High upfront fees	65	4.6308	.67475
High interest rates	65	4.3231	1.25135

From the findings in table 6, high upfront fees is the most significant predatory practice adopted by the banks with a mean of 4.6308 indicating that the practice affects financial performance to a very large extent followed by high interest rate and prepayment penalties at 4.3231 and 4.0769 concurrently. The next predatory practice that affects fiscal performance among the banks greatly is the mandatory arbitration clause with a mean of 3.5077. According to the results, required credit insurance has the least impact at 3.1538 indicating that it affects the financial performance of firms to a moderate extent. A standard deviation was produced to show the level of the impact of predatory lending practices on financial performance. Mandatory arbitration clauses had deviated from the mean with mandatory arbitration clauses registering the highest departure from the average with a standard deviation of 1.71504. As revealed by the findings, high upfront fees had the least deviation implying that the respondents did not widely differ on the impact of this variable on the commercial performance of the banks.

4.4.5 Establishing the relationship between financial ethics and performance

To establish the association between financial ethics and performance, a regression model was applied to govern the specific linkages between financial ethics and performance (ROA). The consequential regression constants have been used to construe the magnitude and direction of the relationship. The β coefficients represent the receptiveness of the dependent variable as a result of a unit variation in each of the independent variables. The fault term on the other hand captures the differences that cannot be clarified by the model. The regression model appears as presented in table 7.

Table 7: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.236 ^a	.056	.025	.2906308	.056	1.835	2	62	.168	1.748

- a. Predictors: (Constant), Predatory Lending, Insider Dealings
- b. Dependent Variable: Financial Performance (ROA)

The findings in table 7 reveal that the independent variables (predatory lending and insider dealings) moderately influenced the dependent variable (ROA) as demonstrated by the an adjusted $R^2 = 0.025$. From the findings, the Multiple Determination Coefficient (R^2) is 0.056 implying that the line of regression is of “*Low goodness of fit*” clarifying only 5.6% of the deviation in the financial performance of the Kenyan small and medium banks. 94.4% of the deviation could be due to other predictors absent in the model. To establish the combined effect of the forecaster variables on the dependent variable, the Analysis of Variance (ANOVA) was useful to estimate and test the effects of interaction. The results are as shown in table 8.

Table 8: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.310	2	.155	1.835	.168 ^a
	Residual	5.237	62	.084		
	Total	5.547	64			

a. Predictors: (Constant), Predatory Lending, Insider Dealings

b. Dependent Variable: Financial Performance (ROA).

As per the findings in table 8, the F static was 1.835 with p-value of 0.168. This suggests that the implication of ethical financial practices on the financial performance is not statistically important since the p-value is more than the level of alpha at 95% confidence interval. The coefficients of regression model are as elaborated in table 9.

Table 9: Model coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B		Collinearity Statistics	
		B	Std. Error	Beta			Lower Bound	Upper Bound	Tolerance	VIF
1	(Constant)	.788	.274		2.877	.006	.240	1.335		
	Insider Dealings	-.041	.032	-.158	-1.274	.207	-.104	.023	.985	1.015
	Predatory Lending	-.069	.054	-.157	-1.263	.211	-.177	.040	.985	1.015

As per the SPSS produced regression model coefficients in table 9, the regression line becomes;

$$Y = 0.788 - 0.041X_1 (0.32) - 0.069X_2 (0.054)$$

Where;

Y = Financial Performance (ROA)

β_0 = Constant

β_1, β_2 = Coefficients of determination

X_1 = Insider Dealings

X_2 = Predatory Lending

As indicated in the regression model above, taking the entire independent variable coefficient, the financial performance of the Kenyan based small and medium banks will be 0.788. We can also infer from the regression line that keeping the other independent variables constant, a unit rise in insider dealings will result in a 0.041 decline in the financial performance of the small and medium banks in Kenya. Conversely, keeping all the other predictor variables constant, a unit surge in predatory lending will result in a 0.069 decline in the financial performance of the small and medium banks in Kenya. Going by the results in table 1.7, all the forecaster variables have a p-value of larger than 0.05 implying that the effect of unethical financial practices on the performance of small and medium banks in Kenya is not statistically important since the p-value is greater than the alpha value at 95% confidence interval.

The mean square of financial ethics were regressed on the mean square of performance (ROE & ROA) as measured. Table 1.5 shows that the r was 0.236 and R Square 0.56. This implied that financial ethics accounts for approximately 56% of the variation in performance of small and medium banks in Kenya.

5.0 Summary of Findings, Conclusions and Recommendations

5.1 Introduction

The study aimed at investigating the effect of financial ethics on the financial performance of small and medium banks in Kenya. The goals of this investigative work were to: analyse the influence of insider abuse on the financial performance of small and medium sized commercial banks in Kenya; and investigate predatory lending on financial performance of Kenyan based small and medium sized commercial banks. The impact of various banking practices on commercial performance is tested and the standardized coefficient of these variables estimated with OLS-regression model.

5.2 Summary of Findings

The first objective of the study was to analyse the impact of insider abuse on the financial performance of small and medium sized commercial banks in Kenya. According to the study findings, the most significant practice of insider dealings is the provision of excessive loans to insiders followed by academic qualifications. Other major forms of insider dealings include unwarranted credit to one industry, unsound lending practices and teller theft from cash drawers. The findings above imply that less stringent conditions underlying the facilities often characterize insider lending in which case insider borrowers have the impetus to ignore loan terms aware of the relaxed terms. Towards this end, allowing insiders access to easy loans exposes the bank to financial risks due to their negative impact on profitability.

The second goal of the study was to explore predatory lending on financial performance of small and medium sized commercial banks operating in Kenya. From the findings of the study, a high upfront fee is the most significant predatory practice adopted by the banks followed by high interest rate and prepayment penalties. The next predatory practice that affects financial performance among the banks extensively is the mandatory arbitration clause. According to the results, required credit insurance has the least impact on the financial performance of firms to a moderate level. The results above are indicative of the fact that predatory lending practices in Kenya thrives in cases where the lenders possess private data on the borrower's future ability to repay loans enabling them set terms that make the repayment of the said loans untenable.

The fact that mandatory arbitration clauses is the most common predatory lending practice implies that; despite the recent legal and institutional reforms in the banking sector, significant lapses still exist which can be attributed to inadequate monitoring by the Kenyan central bank and other line agencies. The findings further imply that predatory lenders in Kenya go beyond risk-based pricing by failing to fully disclose to the borrowers the risk or associated costs.

5.3 Conclusion

The study concluded that various insider dealings and predatory banking practices still prevail among the small and medium banks in Kenya despite the ongoing reforms in the banking sector. The study establishes a connection between financial ethics and performance among the small and medium banks in Kenya in which the regression analysis resulted in Multiple Determination Coefficient (R^2) of 0.056 inferring that up to 5.6% of variation in the financial performance of the small and medium banks in Kenya can be linked to the ethical financial activities they have adopted in the recent past.

5.4 Recommendations

Going by the conclusions of the study, it is clear that financial ethics has a multiplier effect on the financial performance of small and medium banks operating in Kenya. Consequently, the study recommends that profit making banks and other financial institutions in Kenya invest more in establishing systems that promote financial ethics in their service delivery to build their core competency in the dynamic market. At a policy level, this study opines that the CBK, the Treasury and other line agencies fast-track the fiscal reform agenda with regards to prudential banking and financial service delivery to mitigate the influence of systemic supervisory weaknesses. The CBK should borrow leaf from the Global Systemically Important Financial Institutions (G-SIFI) regime with the ultimate aim of encouraging highly interconnected and important banks that are subject to systemic risk or may contribute to such risk due to supervisory failure.

In the context of the supervisory role of the implementing agency on matters prudential banking, the study recommends that the CBK and Treasury invest in complementary assets like retraining the bank operations supervisors and current technology in monitoring the activities of commercial banks in Kenya to counter unethical financial practices.

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