EFFECT OF CREDIT RISK MANAGEMENT STRATEGY ON GROWTH OF REAL ESTATE SECTOR IN KENYA

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ABSTRACT

Given the ever dynamic and challenging business environment, real estate sector is bound to be exposed to various risks. The problem is that real estate companies that don’t adapt and/or institutionalize enterprise risk management strategies are likely to witness poor growth patterns compared with those that adapt ERM. The poor growth or failure of the real estate sector may lead to serious negative consequences as far as the achievement of Vision 2030 is concerned owing to the important role real estate companies are expected to play in providing affordable housing for citizens. The purpose of this study was to establish the effect of credit risk management strategy on the growth of real estate sector in Kenya. This research used a quantitative cross sectional survey research design as the design provided accurate means of assessing information that captures respondents’ similarities and differences. The study sample comprised of all real estate firms registered by Kenya Property Developers Association (KPDA) which are 69 in number, thus a census. Primary data was gathered by use of structured questionnaires and captured through a 5-point type likert scale questionnaire. Descriptive statistics including the mean and standard deviation was used to capture the characteristics of the variables under study. Inferential statistics included use of correlation and regression analysis. Multiple regression analysis was used to establish the nature and magnitude of the relationships between the variables and to test the hypothesized relationships. All the analysis was done using SPSS statistical package. The results of data analysis were presented using figures and tables for easy understanding and interpretation. The study findings indicated that that the real estate firms were concerned with the growth of their companies and thus to enhance this growth they had adopted risk management strategies to mitigate any risks that may arise during their operations. This therefore implies that those firms that had adopted use of risk management strategies had outstanding growth as compared to those that had not adopted risk management strategies. The study concludes that credit risk management was statistically significant in explaining growth of real estate sector. The study recommends that the management should also employ robust risk management practices to curb and detect fraud which may affect their growth negatively. The study further recommends that the firms should therefore adopt credit policies that would help improve prudential oversight of asset quality and to establish a set of minimum standards that should be applied before credit is advanced to customers.

Key Words: Credit Risk Management, Growth, Real Estate,
1. Introduction

Enterprise risk management refers to the joint management of firm risk using multiple risk management techniques and considering the interrelations or correlation between risk exposures. Rather than focusing on traditional risk management (insurance buying, physical mitigation, liability reduction) or financial risk management (purchasing options and derivatives, diversifying investments), enterprise risk management simultaneously considers all forms of firm risk, the interrelatedness of the risks, and creates a plan to treat overall firm risk. ERM researchers and risk management consultants typically define four sources of firm risk: financial, operational, hazard, and strategic (Ai, Brocket, Cooper and Golden, 2011).

Property markets can be hard to anticipate as the demand is continually changing; therefore developers must be careful if they are analysing past trends to determine future demand (Harvard, 2008). Harvard (2008) does point out that there are also opportunities for the risk-taking developer to spot or to anticipate trends in the market. Understanding of the market they operate in will keep them well-informed of developments in those markets. As identified by Qu and Boon (2010) it is important to note that the risk profile of the development may change due to changes in the economy or with technology throughout the length of the development.

Financial risks are the risks that will need to be most closely monitored in times of financial instability. The major risks concerned with finance as identified by Harvard (2008) are interest rate fluctuations, project over runs, withdrawal of support by lender and incorrect forecasting of future values or cash flows. Interest rate fluctuations can be solved at the beginning of a project by using a fixed rate loan; this gives certainty to the profitability of the project and cash flow.

Financial risk is often defined as the unexpected variability or volatility of returns and thus include (Finance dictionary, 2009). Financial risk includes credit risks, liquidity risks and market risks. Credit risk is the risk that a borrower will be unable to make payment of interest or principal in a timely manner (Scott, 2003). The Farlex finance dictionary (2009) defined liquidity risks as the risk that an individual or firm will have difficulty selling an asset without incurring a loss. The Dictionary of Financial Terms (2008) defines market risk (systematic risk) as risk that results from the characteristic behavior of an entire market or asset class. Market risks are environmental in nature and encompass risks that might arise from financial losses due to changes in market interest.
rates (interest risk), or due to inadequate protection from fluctuations in currencies (foreign exchange risk), or due to long term asset and liability management (investment portfolio risk). There exist several financial risk strategies that may be used to address the financial risks.

Ekka, Chaudhary and Sinha (2011) indicated that institutions apply the following conventional risk management strategies to mitigate credit risks; (a) Loan size limits. These mitigate an organization's exposure, especially to new clients who do not have collateral. (b) Standardised (simple) loan terms. (c) Zero tolerance on delinquency. (d) Group-based lending. Diamantini (2010) asserts that real estate sector is particularly vulnerable to foreign exchange rate risk, since they operate in developing countries where the risk of currency depreciation is high. Furthermore, extreme currency depreciation tends to be highly correlated with a general deterioration of local economic conditions, which can cause higher loan delinquencies and a reduction in profitability of financial activities.

2. Statement of the Problem

The real estate industry must be supported and it will have to grow at a faster pace than it currently does. The Kenya industry is benefiting from economic growth of the country and the inflow of foreign aid is being regarded as a very promising venture. The government is also heavily investing in this industry in various ways such as the inclusion of the ministry of housing in the government body, availing of funds to the housing ministry; enforcement of laws to do urban planning, regulatory laws in license permits (Homes Expo Kenya, 2012)

Given the ever dynamic and challenging business environment, real estate sector is bound to be exposed to various risks. The problem is that real estate companies that do not adapt and/or institutionalize ERM strategies are likely to witness poor growth patterns compared with those that adapt ERM. The poor growth or failure of the real estate sector may lead to serious negative consequences as far as the achievement of Vision 2030 is concerned owing to the important role real estate companies are expected to play in providing affordable housing for citizens.

A study by Aon Risk Solutions and Wharton School in 2011 revealed an existence of a positive relationship between the maturity of a firm’s risk management framework and its performance. The findings of the study reflect that higher risk maturity is associated with improved firm
performance and stock performance for most firms. Ernst and Young (2012) also reinforces this point of view by suggesting that companies with more mature risk management practices outperform their peers financially, and tend to generate the highest growth in revenue.

A number of studies have been conducted on risk management by companies in Kenya but little has been studied on real estate industry. A study on the effect of risk management practices on the financial performance of commercial banks in Kenya by Mwangi (2010) showed evidence that risk management and the related practices are considered significantly important to the operations and financial performance of these commercial banking institutions. The study also found that some risk management practices have a greater significance on financial performance than others, that is, the existence of a risk management policy and the integration of risk management in setting of organizational objectives were considered to be the key risk management practices that had a direct effect on financial performance.

Based on the study findings there is scarcity of studies on effect of enterprise risk management on growth of real estate sector in Kenya. The previous studies focused on the relationship between the various risk management practices adopted by companies in Kenya and their financial performance and aimed at addressing the challenge of ever emerging risks within the sector. The current study differs significantly from the above reviewed studies as it built a case for adopting ERM and the effect such adoption would have on the growth of real estate sector. The current research hoped to bridge all these research gaps by analyzing the effect of credit risk management on the growth of real estate sector in Kenya.

3. Purpose of the Paper

The purpose of this study was to establish the effects of credit risk management strategy on the growth of real estate sector in Kenya.

4. Literature Review

4.1 Credit Risk Management Strategies

Financial risk is often defined as the unexpected variability or volatility of returns and thus include (Finance dictionary, 2009). Financial risk includes credit risks, liquidity risks and market risks. Credit risk is the risk that a borrower will be unable to make payment of interest or principal in a
timely manner (Scott, 2003). The Farlex finance dictionary (2009) defined liquidity risks as the risk that an individual or firm will have difficulty selling an asset without incurring a loss. The Dictionary of Financial Terms (2008) defines market risk (systematic risk) as risk that results from the characteristic behavior of an entire market or asset class. Market risks are environmental in nature and encompass risks that might arise from financial losses due to changes in market interest rates (interest risk), or due to inadequate protection from fluctuations in currencies (foreign exchange risk), or due to long term asset and liability management (investment portfolio risk).

There exist several financial risk strategies that may be used to address the financial risks. The financial risks are both direct and indirect. They potentially affect both the short run cash flow events and have long-run impact on total enterprise value. In this element of risk the focus relates to the impact of real estate on both the income statement and the balance sheet. Some examples of these risks include: the resulting impact on the income statement of a decision to use floating rate debt for capital investment programs if unanticipated inflation occurs; a lowering of the firm’s valuation multiple due to the presence of substantial real estate on the balance sheet; or the impact on the firm’s financial ratios or credit rating due to a change in the accounting treatment of long-term leasehold obligations (Christensen, 2009).

Siba (2012) carried out a study on the relationship between financial risk management practices and financial performance of commercial banks in Kenya. The objective of the study was to find out if there was any relationship between financial risk management practices and financial performance of commercial banks in Kenya performance. The subject of the study were 40 commercial banks operating in Kenya and the study employed questionnaire method for the primary data collection, while secondary data was obtained from the CBK annual supervision reports. The findings showed that all banks had a formal risk management system in place and that all the banks had similar risk management environment, policies and procedures. Similarly, the banks used very efficient levels of risk monitoring and management information systems and internal controls. They, however, had various mixes of risk monitoring schedules and there was a disparity between the various banks in the responsibility for identifying, managing and controlling risks as well as back up of system and data files. The overall finding was that banks have highly effective risk management practices and there was a strong relationship between bank performance and efficiency of the bank’s risk management practices.
Wanjohi (2012) analyzed the effect of financial risk management on the financial performance of commercial banks in Kenya. The study found out that majority of the Kenyan banks were practicing good financial risk management and as a result the financial risk management practices had a positive correlation to the financial performance of commercial banks in Kenya. The study recommended that banks should devise modern risk measurement techniques such as value at risk, simulation techniques and Risk-Adjusted Return on Capital. The study also recommended use of derivatives to mitigate financial risk as well as develop training courses tailored to the needs of banking personnel in risk management.

5. Methodology

This study used a correlational survey research design. A survey research design is an attempt to collect data from the members of a population in order to determine the current status of that population with respect to one or more variables. The choice of correlational survey research design was because it is used to explore relationships between variables and to predict a subject score on one variable on given his or her score on another variable. This method permits one to analyze interrelationships among a large number of variables in a single study. It also allows one to analyze how several variables either singly or in combination might affect a particular phenomenon being studied. The method also provided information concerning the degree of relationships between the variables being studied. Reviewed studies, for instance, Tseng (2007), Hoyt and Liepenberg (2010) used correlational survey research design in their attempt to link ERM strategies to performance of firms.

The target population was the management employees of real estate firms, registered under the (KPDA) in Kenya. According to the Kenya Property Developers Association, the estimated number of real estate firms as at close of 2012 was 69 firms spread across the country. The study used purposive or convenient sampling technique. The sample size for this study was 276 employees who were obtained by purposively selecting four respondents from the 69 real estate developers who included the operations manager, finance managers, real estate portfolio manager and property development manager. The study used primary data specifically a structured questionnaire to collect data. Data was collected, coded and analyzed using SPSS version 20.0.
The findings were presented in form of tables and pie charts and discussions and interpretation of the same given.

6. Results and Discussions

6.1. Response Rate

The number of questionnaires, administered to all the respondents, was 276. A total of 216 questionnaires were properly filled and returned from the real estate in Kenya. This represented an overall successful response rate of 78%. According to Mugenda and Mugenda (2003), a response rate of 50% or more is adequate. Babbie (2004) also asserted that return rates of 50% are acceptable to analyze and publish, 60% is good and 70% is very good. Therefore, a 78% response rate from this study is considered to be very good and satisfactory hence it was appropriate for this study.

6.2. Descriptive Statistics

The objective of the study was to investigate whether credit risk management strategy leads to growth of real estate sector in Kenya. Table 4.19 illustrates that 79.6% of the respondents agreed that the credit department checked on the interest rate during credit review, 87.1% agreed that the credit department always check on conditions of the loan during credit review and 75.9% agreed that prior to disbursing the credit, the individual credit exposure was subjected to a final check. Seventy nine point six (79.6) percent of the respondents agreed that the credit Disbursement review covered compliance with internal guidelines, 80.1% agreed that the government had introduced mortgage-backed securities and secondary mortgages market development to enhance growth and 87% agreed that the credit department applied stringent debt collection practices.

In addition, 83.8% of the respondents agreed that the real estate industry experienced adequate protection from market interest rates (interest risk), 65.2% agreed that the real estate industry experienced adequate protection from fluctuations in currencies (foreign exchange risk) and 77.8% agreed that the real estate industry experienced adequate protection from fluctuations on long term asset and liability management (investment portfolio risk). The mean score for the responses was 4.02 which indicates that majority of the respondents agreed that credit risk management strategy was a key determinant of growth in real estate firms in Kenya. The study findings agree with those of Diamantini (2010) who asserted that real estate sector is particularly vulnerable to foreign
exchange rate risk, since they operate in developing countries where the risk of currency depreciation is high. Furthermore, extreme currency depreciation tends to be highly correlated with a general deterioration of local economic conditions, which can cause higher loan delinquencies and a reduction in profitability of financial activities.

6.3. Regression Analysis

Regression analysis was conducted to empirically determine whether credit risk management strategy was a significant determinant of growth of real estate sector in Kenya. Regression results in Table 1 indicate the goodness of fit for the regression between credit risk management and growth was satisfactory. An R squared of 0.361 indicates that 36.1% of the variations in growth are explained by the variance in credit risk management strategies employed by real estate firms. This implies that 63.9% of the unexplained variations in growth is accounted for by the other variables including operations risk management, regulatory risk management and strategic risk management strategies.

Table 1: Model Summary for Credit Risk Management Strategies

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.601a</td>
<td>0.361</td>
<td>0.358</td>
<td>0.66785</td>
</tr>
</tbody>
</table>

F-test was carried out to test the null hypothesis that there is no relationship between credit risk management strategies and growth of real estate sector. The overall model significance was presented in table 2. Results show that, the F statistic is 120.784 with a P-value of 0.0000 which implies that the regression model is significant. Therefore meaning that null hypothesis is rejected and alternative accepted concluding that there is a relationship between credit risk management strategies and growth of real estate sector and that credit risk management strategies were statistically significant in explaining growth of real estate in Kenya.

Table 2: Goodness of Fit Model of Credit Risk Management on Growth

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>53.873</td>
<td>1</td>
<td>53.873</td>
<td>120.784</td>
</tr>
</tbody>
</table>
The results of regression analysis as presented in the Table 3 below, shows that credit risk management strategies by real estate sector has a positive significant effect (β=0.671, P-value =0.000) on growth of real estate. The results show that credit risk management strategies contribute significantly to the model since the p-values for the constant and gradient are less than 0.05. The findings imply that one positive unit change in credit risk management strategies effectiveness led to a change in growth of real estate at the rate of 67.1%. This confirms the positive effect of credit risk management strategies on growth of real estate in Kenya. The study findings are in agreement with Wanjohi (2012) who analyzed the effect of financial risk management on the financial performance of commercial banks in Kenya and found out that majority of the Kenyan banks were practicing good financial risk management and as a result the financial risk management practices had a positive correlation to the financial performance of commercial banks in Kenya.

The regression equation obtained from this output is:-

\[
\text{Growth} = 1.187 + 0.671 \text{Credit Risk Management Strategies}
\]

Table 3: Coefficients for Credit Risk Management Strategies

<table>
<thead>
<tr>
<th>Mode</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Constant</td>
<td>1.187</td>
<td>0.248</td>
<td>4.794</td>
</tr>
<tr>
<td></td>
<td>Credit Risk Mgt</td>
<td>0.671</td>
<td>0.061</td>
<td>0.601</td>
</tr>
</tbody>
</table>

a Dependent Variable: Growth

7. Conclusions and Recommendations

The study concluded that real estate sector had effective credit risk management strategies in place that had promoted growth. This was enhanced by having in place effective credit risk management practices such as knowing your customer concept, effective debt collection practices, interest risk
management practices, liquidity risk and market risk management practices. The study therefore concluded that credit risk management strategies were statistically significant in explaining growth of real estate sector.

The study recommends that companies and/or firms should have stringent credit appraisal techniques if it is to ensure that their profitability or growth is not adversely affected resulting from poor screening of clients. The firms should therefore adopt credit policies that would help improve prudential oversight of asset quality and to establish a set of minimum standards that should be applied before credit is advanced to customers. Further, as borrower selection is the key to successful lending, firms should focus on the selection of true borrower.

References


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