European Journal of Accounting, Auditing and Finance Research
Vol.13, No. 1, pp.,1-17, 2025
Print ISSN: 2053-4086(Print),
Online ISSN: 2053-4094(Online)
Website: https://www.eajournals.org/
Publication of the European Centre for Research Training and Development-UK

Influence of Non-Performing Loans, Lending rate and Financial Performance of Commercial Banks in Kenya. A Review of the Literature

Otieno Ezekiel Juma
Catholic University of East Africa (C.U.E.A)

Dr. Beatrice Jemaiyo
Catholic University of East Africa (C.U.E.A)

doi: https://doi.org/10.37745/ejaafr.2013/vol13n1117 Published January 01, 2025

Citation: Juma O.E. and Jemaiyo B. (2025) Influence of Non-Performing Loans, Lending rate and Financial Performance of Commercial Banks in Kenya. A Review of the Literature, *European Journal of Accounting, Auditing and Finance Research*, Vol.13, No. 1, pp.,1-17

Abstract. *This study examined the impact of non-performing loans on the financial performance of publicly listed commercial banks in Kenya, focusing on the bank lending rate as a mediating variable. It analyzed the relationship between non-performing loans and banks' return on assets (ROA) and return on equity (ROE) through a review of empirical literature from Google Scholar and the Central Bank of Kenya reports. Studies show mixed results on the relationship between non-performing loans (NPLs) and bank performance. Previous studies have highlighted an inverse relationship between non-performing loans and return on assets (ROA), as noted by Siddique et al. (2022) and others. On the other hand, Mrindoko et al. (2020) discovered a negligible negative correlation with return on assets. Generally, the literature suggests an inverse relationship between NPLs and bank performance, emphasizing a diversified loan portfolio for improved profitability. Researchers have noted connections between NPLs and lending rates (Case et al., 2023; Rahmananingtyas, 2022; Koskei & Samoei, 2024), as well as between lending rates and bank performance (Hania & Himel, 2023; Dondi & Mule, 2023). This hypothesis suggests that lending rates play a mediating role in the relationship between non-performing loans (NPLs) and the financial performance of commercial banks in Kenya, highlighting the need for additional empirical research in this area.*

Keywords: financial performance, non-performing loans, lending rate, return on equity, return on assets.

INTRODUCTION

The banking sector serves as the foundation of financial intermediation, which is vital for the economic growth of a country(Naili & Lahrichi, 2022). The functions of commercial banks include: the receipt of deposits, the attraction of available resources from businesses and individual customers; the investment function, which provides loans to those in need, and the trade function that facilitates the transfer of money between account holders(Abimbola,2020).Banks allocate savings as productive capital and employ the surplus to create employment opportunities, thus fostering the economic prosperity of a nation(NCBA, 2022).Additionally, the banking industry must also focus on enhancing its credit management systems while consistently monitoring bank activities to ensure that operations proceed smoothly. The non-performing loan ratio (NPL) assesses a bank's overall strength by evaluating the quality of its assets. This ratio reflects the extent of non-performing credit risk present within the institution(Nugroho & Endri, 2022).Moreover, loans that remain unpaid for three months are classified as bad loans and are at risk of default thus a threat to the banking system (Akhter, 2023).

Research by Ari et al.(2021),highlighting on the effects of non-performing loans (NPLs) during the global financial crisis has revealed that many countries continue to grapple with substantial risks associated with bad debt. This ongoing challenge underscores the importance of understanding the dynamics of NPLs and their implications for the banking sector's overall health and stability(Ari et al., 2021).In a focused study on Kosovo's commercial banking sector, Aliu and Çollaku(2021) identified an inverse relationship between NPLs and return on assets (ROA). Their findings suggest that as the level of non-performing loans increases, the profitability of banks, as measured by ROA, tends to decline. This relationship indicates that higher levels of bad debt can erode the financial performance of banks, making effective management of NPLs crucial for maintaining profitability.

Similarly,Kadek et al.(2021) conducted research in Indonesia and reached a comparable conclusion, noting that NPLs have a detrimental effect on the return on assets of public banks. Their study further revealed that the capital adequacy ratio plays a mediating role in this relationship, suggesting that banks with stronger capital buffers may be better positioned to absorb the impacts of non-performing loans, thereby mitigating the negative effects on profitability. In the context of Bangladesh Uddin(2022) reported a negative correlation between NPLs and the profitability of commercial banks. This finding aligns with the broader trend observed in various countries, reinforcing the notion that high levels of non-performing loans can significantly hinder the financial performance of banking institutions.

Conversely ,Zaid and Farooque Khan(2023) presented a nuanced perspective from Yemen, where they noted that while NPLs positively affect return on equity (ROE), their impact on ROA is minimal. This suggests that other factors may play a more

significant role in influencing the performance of banks in Yemen, indicating a complex interplay between different financial metrics and the effects of bad debt. In Ghana, Korankye et al. (2022) also found a significant negative relationship between bad loans and both ROE and ROA. Their research highlights the pervasive impact of non-performing loans on the financial health of banks, emphasizing the need for effective risk management strategies to address the challenges posed by bad debt. Furthermore, Al Zaidanin and Al Zaidanin(2021)underscored the importance of the NPL ratio as a key measure of financial credit risk affecting ROA in commercial banks in the United Arab Emirates.

In the context of East Africa, the dynamics surrounding non-performing loans (NPLs) have become a focal point of financial analysis and policy formulation, particularly in Tanzania and Kenya. Mrindoko et al.(2020) provide a comprehensive overview of the situation in Tanzania, noting that while the ramifications of bad loans on the financial performance of listed banks in Tanzanian securities exchange has been on a decline since 2017, the ratio of these loans has consistently remained above the critical threshold of 5 percent. This persistent level of NPLs raises concerns about the overall health of the banking sector, as it suggests that a significant portion of the loans issued by banks are not being repaid, which can adversely affect liquidity and profitability(Mrindoko et al., 2020).However, the competitive landscape of the banking industry in Kenya is illustrated by the NCBA (2022) banking sector report, which highlights the dominance of tier 1 commercial banks. These institutions collectively hold a substantial market share of 75.14%, indicating a concentration of financial power that could influence lending practices and risk management strategies across the sector. The competitive nature of the banking industry may also exacerbate the challenges posed by non-performing loans, as banks may be incentivized to extend credit to riskier borrowers in an effort to maintain or grow their market share(NCBA, 2022).

In addition, research conducted by Kajirwa Isabwa and Wekesa Mabonga(2020) and Onyango and Olando(2020) reveals a negative correlation between bad loans and profitability, suggesting that as the volume of non-performing loans increases, the profitability of banks declines. This relationship underscores the importance of effective credit risk management and the need for banks to adopt robust strategies to mitigate the risks associated with lending(Kajirwa Isabwa & Wekesa Mabonga, 2020; Onyango & Olando, 2020). The issue of non-performing loans has not only attracted the attention of local researchers but has also become a significant concern for policymakers on a global scale(Shrestha, 2024; Siddique et al., 2022),and other scholars have highlighted the implications of rising NPLs for financial stability and economic growth. The Central Bank of Kenya's (CBK) annual report for 2024 paints a troubling picture, revealing an increase in non-performing loans, which rose to 15.5% in February 2024, up from 14.8% in December 2023. This upward trend is alarming and signals a potential crisis in the banking sector, necessitating urgent academic inquiry and policy intervention.

A recent investigation conducted by Case et al.(2023) has shed light on the complex dynamics between lending rates and non-performing loans (NPLs) within the banking sector. Their findings reveal an inverse relationship, suggesting that as non-performing loans increase, commercial banks are likely to tighten their lending practices. This response is primarily driven by the banks' desire to mitigate the risk of defaults, which can have detrimental effects on their financial stability. In essence, when banks observe a rise in NPLs, they may become more cautious, opting to reduce the volume of loans they extend to borrowers in order to safeguard their assets and maintain a healthier balance sheet. In contrast to Case et al.'s findings, Rahmananingtyas(2022) highlighted a direct correlation between bank interest rates and non-performing loans. This perspective posits that higher interest rates can lead to an increase in non-performing loans, as borrowers may struggle to meet their repayment obligations when faced with elevated borrowing costs. The implication here is that as interest rates rise, the financial burden on borrowers intensifies, potentially resulting in a higher incidence of defaults and, consequently, a greater number of non-performing loans on banks' books.

Further supporting the discourse on the relationship between interest rates and non-performing loans ,Koskei and Samoei(2024) confirmed that the interest rates set by lending institutions significantly influence the prevalence of non-performing loans. Their research underscores the importance of interest rate policies in shaping the risk landscape for banks, indicating that fluctuations in lending rates can have profound implications for the overall health of the banking sector. Additionally, Kariuki(2023) emphasized the critical role that lending interest rates play in the financial performance of commercial banks. According to Kariuki, lower interest rates tend to stimulate borrowing activity, as they make loans more affordable for consumers and businesses alike. Conversely, higher interest rates can deter borrowing, leading to a decline in loan origination and potentially impacting the profitability of banks. This interplay between interest rates and borrowing behavior is crucial for understanding how banks navigate the challenges posed by non-performing loans and the broader economic environment. In summary, the relationship between lending rates and non-performing loans is multifaceted, with varying perspectives from different researchers. While Case et al.(2023)suggest that banks may reduce lending in response to rising NPLs, Rahmananingtyas(2022)and Koskei and Samoei(2024) highlight the potential for higher interest rates to exacerbate the problem of non-performing loans. Additionally, Kariuki(2023) emphasizes the critical role of lending interest rates in this dynamic.

Moreover, in a study by Hania and Himel(2023) found a significant inverse correlation between lending rates and financial performance, indicating that higher borrowing costs can negatively affect a company's profitability. Their comprehensive analysis highlighted the importance of interest rates in the business landscape. Similarly Dondi and Mule(2023) confirmed this adverse effect, using a broader range of data to validate Hania and Himel's findings. Together, these studies emphasize the need for policymakers and financial institutions to consider the impact of lending rates on business performance, especially during economic uncertainty. Effective management of lending rates is crucial for creating a favorable environment for business growth.

This study aimed to conduct a comprehensive analysis of the current literature concerning nonperforming loans, lending rates, and financial performance. In this context, nonperforming loans are treated as the exogenous variable, meaning they are considered an external factor that influences other variables in the study. Financial performance, on the other hand, is identified as the endogenous variable, which indicates that it is the outcome being affected by the changes in nonperforming loans. Lending rates serve as the moderating variable in this analysis. This means that lending rates can influence the relationship between nonperforming loans and financial performance. By examining the interaction between these three variables: - nonperforming loans, lending rates, and financial performance, this study seeks to provide valuable insights into the dynamics of the financial sector. It aims to identify patterns and correlations that can help policymakers, financial institutions, and researchers understand the implications of nonperforming loans on overall financial health and stability. Furthermore, the findings could contribute to the development of strategies aimed at managing lending practices and improving financial performance in the face of rising nonperforming loans. Ultimately, this comprehensive analysis will enhance the existing body of knowledge and inform future research in the field of finance.

Problem Statement

Research underscores the critical importance of effective credit risk management for the long-term sustainability and success of banking institutions, as highlighted by Kwashie et al.(2022). In the context of the Central Bank of Kenya's recent findings, the banking sector is facing significant challenges, particularly in terms of profitability. The CBK(2024) report reveals a significant decline in the financial sector's profitability, with a drop of KSh 13.1 billion in 2023. Profit before tax fell by 6.4%, totaling KSh 205.0 billion, down from KSh 218.1 billion the previous year. This decline can largely be attributed to a substantial increase in operational expenses, which rose by KSh 13.8 billion, far exceeding the modest KSh 0.6 billion increase in income. Moreover, the quality of assets within the banking sector has shown signs of deterioration. The rise in gross non-performing loans (NPLs) from KSh 514.4 billion in June 2022 to KSh 576.1 billion in June 2023 indicates significant challenges in Kenya's economy and financial sector. This KSh 61.7 billion increase reflects concerns about borrowers' ability to meet debt obligations, driven by economic downturns, rising unemployment, and the lingering effects of COVID-19(CBK, 2023).The persistent high levels of non-performing loans among commercial banks represent a significant challenge that requires urgent attention and intervention. The situation has further worsened, with the non-performing loan rate climbing to 15.5% in February 2024, up from 14.8% the previous year (CBK, 2024).

The impact of non-performing loans on financial performance has been the subject of various studies, yielding mixed results. Some research suggests that non-performing loans have a negative but statistically insignificant effect on return on assets

(ROA)(Mrindoko et al., 2020; Uddin, 2022).In contrast, other studies have established a significant negative relationship between non-performing loans and overall financial performance(Korankye et al., 2022; Mrindoko et al., 2020).Interestingly, Zaid and Farooque Khan (2023) found a positive and significant correlation, indicating that the relationship between non-performing loans and financial performance may not be straightforward and could vary based on different contexts or methodologies. Furthermore, a considerable body of research on non-performing loans has been conducted outside of Kenya(Abimbola, 2020; Ozili, 2019; Ozurumba, 2016). This paper reviewed the existing literature concerning non-performing loans, lending interest rates, and the financial performance of publicly traded commercial banks in Kenya.

Research Objectives

This research paper examined how non-performing loans affect the financial performance of publicly traded commercial banks in Kenya, considering the bank lending rate as a mediating factor. Additionally, its aim was to explores the connection between non-performing loans and the banks' return on assets (ROA) and return on equity (ROE).

LITERATURE /THEORETICAL UNDERPINNING

Theoretical Underpinning

This research is based on two primary theoretical frameworks: information asymmetry theory and modern portfolio theory (Maaji et al., 2023). According to Maaji et al. these frameworks facilitate a thorough analysis of the link between non-performing loans and the financial performance of commercial banks. Information asymmetry theory highlights how unequal access to information can lead to issues like adverse selection and moral hazard in the banking sector. Ngweshemi and Isiksal(2021) emphasize the role of portfolio theory in assessing the relationship between non-performing loans and bank performance, noting that optimal asset distribution depends on expected returns, associated risks, and portfolio size. They also stress that bank management's decisions on portfolio diversification significantly affect profitability .Maaji et al.(2023) further assert that diversifying loan portfolios across various industries and borrower categories is crucial for mitigating risks related to non-performing loans.

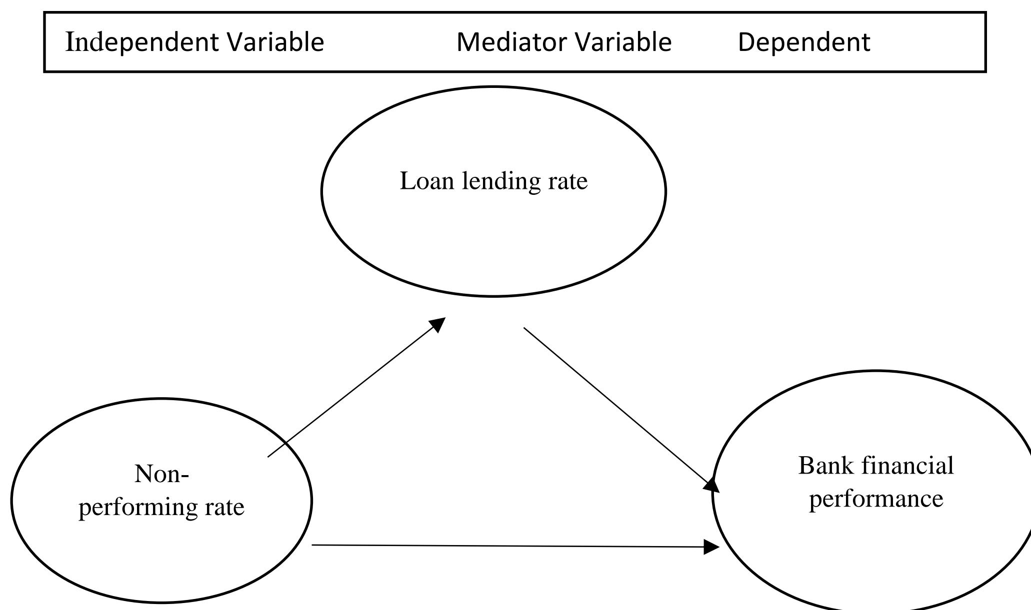

Figure1
Conceptual Framework
Source: Author

Conceptual Review

Commercial bank performance

Non-performing loans are intricately linked to a bank's ability to meet its financial commitments as they arise, as well as the types of investments it draws in, as noted by Singh et al.(2021).In a complementary perspective, Ali and Oudat(2020) characterize financial performance as a comprehensive evaluation of a bank's capacity to generate capital revenue. Moreover, research by Siddique et al.(2022) highlights that non-performing loans exert a considerable adverse effect on the financial performance of commercial banks.

Profitability

Research conducted by Korankye et al.(2022),provides a comprehensive definition of profitability, characterizing it as the temporal difference between total revenues and total expenditures. This definition underscores that profitability is achieved when a bank's income surpasses its costs, thereby indicating a positive financial outcome. Korankye et al. further notes that a significant portion of this income is derived from interest accrued on various assets held by the bank, as well as from the diverse service fees that banks impose on their customers. These revenue streams are essential for the financial health of banking institutions, as they contribute to the overall income that supports operational sustainability and growth(Korankye et al., 2022). Moreover,

Korankye et al. emphasize the importance of profitability as a critical metric for assessing a bank's overall performance. This metric serves as an indicator of the institution's effectiveness in managing its financial resources, reflecting how well the bank can generate income relative to its expenditures. A higher profitability ratio typically suggests that a bank is efficiently utilizing its assets and managing its liabilities, which is vital for maintaining investor confidence and ensuring long-term viability in a competitive financial landscape(Korankye et al., 2022).

In a related investigation, Al Zaidanin and Al Zaidanin (2021) focused on the concept of return on assets (ROA) as a key measure of profitability. Their study examined the interplay between credit risk management and financial performance among commercial banks in the United Arab Emirates. By utilizing ROA, they were able to provide insights into how effectively banks are converting their assets into net income, thereby highlighting the significance of asset management in achieving profitability. Similarly, a study conducted by Kajirwa and Wekesa (2020) in Kenya also assessed bank performance through the lens of profitability. Their research aimed to evaluate how various factors influence the profitability of banks in the region, further contributing to the understanding of financial performance metrics within the banking sector. By analyzing profitability, these studies collectively underscore its pivotal role in evaluating the operational success and financial health of banking institutions across different geographical contexts.

Return on asset (ROA)

Research shows that Return on Assets (ROA) is a key indicator of commercial banks' financial performance (Kadek et al., 2021). It reflects how effectively banks leverage their assets to generate profits, which is crucial for sustaining profitability and long-term viability. ROA, calculated by dividing net income after tax (NIAT) by total assets, illustrates a bank's profitability relative to its asset base (Shrestha, 2024). A higher ROA indicates better resource management and operational efficiency. Additionally, a strong ROA signifies effective asset management, which is vital in a competitive banking environment(Supriyadi, 2021). Banks with high ROA are often viewed favorably by investors, indicating robust financial health. However, factors like non-performing loans (NPLs) can negatively impact ROA, as they lead to increased provisions for loan losses and reduced net income (Aliu and Çollaku, 2021). High NPL levels can hinder a bank's ability to maintain a strong ROA.

Return on equity (ROE)

Shrestha (2024) highlights Return on Equity (ROE) as a key performance metric for shareholders, calculated by dividing net income by shareholder equity. A higher ROE indicates effective capital utilization and profit generation, making it crucial for investors assessing potential returns. Supriyadi (2021) notes that fluctuations in ROE can impact shareholder profitability expectations; rising ROE boosts investor confidence and stock prices, while declining ROE may raise concerns about financial health. Zaid and Farooque Khan (2023) further emphasize the positive link between

ROE and non-performing loans, suggesting that improved ROE correlates with better credit quality and risk management. Thus, a strong ROE not only reflects profitability but also indicates effective risk management, benefiting shareholders.

Non-performing loans

Akhter (2023) emphasizes that loans that remain unpaid for a period exceeding three months are categorized as non-performing loans (NPLs), which serve as a significant metric in the banking sector, reflecting a borrower's inability to fulfill repayment commitments. Furthermore, Akhter highlights that the standards for classifying NPLs can differ among financial institutions, resulting in discrepancies in both reporting and management practices. When borrowers default on their payments, their loans are classified as in default, adversely affecting their credit ratings and potentially leading to considerable financial losses for lenders. This classification plays a crucial role in the risk management strategies of banks, aiding in the evaluation of possible financial repercussions (Akhter, 2023). Additionally, Akhter points out that banks assess non-performing loans through the NPL ratio, which is derived by dividing the total amount of non-performing loans by the total loans and advances. This ratio serves as an essential indicator of the quality of the loan portfolio and is closely monitored by both regulators and investors. A high NPL ratio may signal underlying problems in lending practices or the economic circumstances of borrowers, thereby necessitating further examination. Moreover, Singh et al. (2021) elaborate that financial institutions allocate loan loss provisions to mitigate risks associated with potential defaults.

Lending rate

Feyen and Zuccardi Huertas (2020) defined the bank lending rate in their World Bank working paper as "a weighted average interest rate charged on short-to-medium-term loans with fixed interest rates and with own funds to individuals and corporations" (p.10). This definition emphasizes the calculation of lending rates and the factors influencing them, noting that varying interest rates depend on loan terms, risk profiles, and borrower financial health. The focus on short-to-medium-term loans highlights their importance for individuals and businesses needing immediate financing(Feyen & Zuccardi Huertas, 2020).Kariuki(2023) further emphasized the significant impact of lending interest rates on the financial performance of commercial banks. He argued that lending rates influence borrowing behavior; lower rates encourage borrowing, boosting consumer spending and business investments, which can stimulate economic growth. Conversely, higher rates can deter borrowing, potentially slowing economic activity.

Literature Review

Non-performing loan and commercial Bank performance

Korankye et al. (2022) analyzed Ghana's commercial banking sector and found a significant negative relationship between non-performing loans (NPLs) and key financial indicators like return on equity (ROE) and return on assets (ROA). This highlights a critical issue affecting banks' profitability globally, as increasing NPLs can

diminish financial returns, raising concerns for stakeholders and regulators. In a related study, Mrindoko et al. (2020) examined Tanzania's banking sector and noted a decline in NPLs exceeding the 5% industry benchmark, indicating improved loan portfolio quality. However, while NPLs negatively correlated with ROA and ROE, the relationship was statistically insignificant, suggesting other factors may mitigate their impact on financial performance. Contrasting these findings, Zaid and Farooque Khan (2023) reported a positive and significant relationship between NPLs and ROE, challenging the prevailing understanding of this dynamic.

Furthermore, Aliu and Çollaku (2021) found a significant negative correlation between non-performing loans (NPLs) and return on assets (ROA), indicating that higher NPLs lead to lower bank profitability. This suggests that NPLs negatively impact financial performance by increasing loan loss provisions and reducing interest income. In contrast, Uddin (2022) reported a negative but statistically insignificant relationship between NPLs and ROA in Bangladesh, implying that other factors may influence this relationship or that its impact varies by economic context. Similarly, Kadek et al. (2021) identified a significant negative association between NPLs and ROA in Indonesian public commercial banks, highlighting the importance of effective risk management to protect profitability. Additionally, research by Do et al. (2020) in a Vietnamese commercial bank confirmed that high NPL levels adversely affect profitability by increasing operational costs and reducing lending capacity.

A study in Kenya by Onyango and Olando (2020) found that non-performing loans (NPLs) in the commercial banking sector exceeded the 5% industry standard, raising concerns about financial health. Their research showed a significant negative correlation between NPLs and return on assets (ROA), indicating that higher NPLs reduce bank profitability. Kajirwa and Wekesa (2020) supported these findings, highlighting that high NPL levels threaten individual banks' stability and the broader financial system. In contrast, Siriba(2020) argued that the impact of NPLs on bank performance was statistically insignificant, suggesting that while NPLs are a concern, their direct effects may be less severe than previously believed. Siriba emphasized the importance of thorough credit assessments to mitigate default risks.

Loan Lending rate and non-performing rate

A study conducted by Case et al.(2023), revealed a negative correlation between lending rates and non-performing loans, suggesting that commercial banks tend to decrease their lending activities in response to rising non-performing loans in order to mitigate the risk of defaults. Conversely, Rahmananingtyas(2022),highlighted a positive relationship between bank interest rates and non-performing loans, indicating that higher interest rates may contribute to an increase in non-performing loans. In a similar vein Koskei and Samoei(2024),affirmed that the interest rates set by lending banks influence the levels of non-performing loans.

Loan Lending rate and bank performance

In a separate investigation conducted by Hania and Himel(2023),a notable inverse relationship was identified between lending rates and financial performance. Furthermore, the research undertaken by,Dondi and Mule(2023) also focused on the interplay between lending rates and financial performance, revealing a significant negative impact of lending rates on the latter variable.

METHODOLOGY

The research utilized a document review methodology(Kariuki, 2023).The paper, focused on the analysis of published annual reports from the Central Bank of Kenya alongside empirical studies found in peer-reviewed journal articles. The literature examined primarily addressed significant constructs, including non-performing loans, lending rates, financial performance, return on equity, return on assets, and the operations of listed commercial banks. Information was sourced online, particularly through the Google Scholar search engine. Relevant data was gathered from the Central Bank of Kenya's annual reports, which were accessed and downloaded from the CBK's official website. Additionally, empirical data was extracted from the downloaded journal articles and synthesized in accordance with their findings. The conclusions drawn in this paper are based on the identified trends.

FINDINGS

The findings of this research are organized in accordance with the study's objectives. Initially, the investigation aimed to evaluate the effects of non-performing loans, lending rates, and the financial performance of publicly listed commercial banks in Kenya. The literature reviewed reveals a substantial negative relationship between non-performing loans and the financial performance of these banks, as evidenced by multiple studies (Siddique et al., 2022; Shrestha, 2024; Onyango & Olando, 2020; Maaji et al., 2023; Korankye et al., 2022; Kajirwa & Wekesa Mabonga, 2020; Kadek et al., 2021; Aliu & Çollaku, 2021; Al Zaidanin & Al Zaidanin, 2021). Subsequently, the research sought to investigate the connection between non-performing loans and return on assets (ROA), with a significant body of evidence supporting an inverse relationship between these two variables (Al Zaidanin & Al Zaidanin, 2021; Aliu & Çollaku, 2021; Kadek et al., 2021; Kajirwa & Wekesa, 2020; Onyango & Olando, 2020; Singh et al., 2021). Thirdly, the study examined the link between non-performing loans and return on equity (ROE), with findings from Korankye et al. (2022), Maaji et al. (2023), and Siddique et al. (2022) indicating a significant negative correlation. Nevertheless, some studies presented conflicting results; for instance, Mrindoko et al. (2020) found a negative and statistically insignificant relationship between non-performing loans and both ROA and ROE. Additionally, Korankye et al. (2022) identified a notable inverse correlation between non-performing loans and ROE, while Zaid and Farooque Khan (2023) reported a positive and significant effect of non-

performing loans on ROE in the context of commercial banks in Yemen. The final aspect to consider is the mediating effect of lending rates on the connection between non-performing loans and the financial performance of publicly traded commercial banks in Kenya.A review of existing literature indicates a correlation between non-performing loans and lending rates (Case et al., 2023; Rahmananingtyas, 2022; Koskei & Samoei, 2024). Additionally, there is evidence suggesting a link between lending rates and the financial performance of these banks (Hania & Himel, 2023; Dondi & Mule, 2023). Consequently, it is possible to formulate a hypothesis regarding the mediating effect of lending rates on the interplay between non-performing loans and the financial performance of commercial banks in Kenya.

DISCUSSION

Research conducted by Ngweshemi and Isiksal (2021) highlights the critical relationship between the ratio of non-performing loans (NPLs) within a lending portfolio and the overall financial performance of commercial banks. Their findings suggest that a diversified loan portfolio can serve as a risk mitigation strategy, ultimately leading to improved profitability for these financial institutions. This is particularly relevant in the context of the banking sector, where the ability to manage and minimize NPLs is essential for maintaining a healthy balance sheet and ensuring sustainable growth(Ngweshemi & Isiksal, 2021).In a related context, the annual report from the Central Bank of Kenya (CBK, 2024) presents alarming statistics regarding the state of non-performing loans in the country. The report indicates that the non-performing loan rate in Kenya has reached a concerning 15%, which is significantly higher than the industry average of 5%. This disparity underscores the urgent need for commercial banks in Kenya to reassess and strengthen their credit management systems. By doing so, they can work towards reducing their non-performing loan ratios to align with the optimal industry benchmark of 5%(CBK, 2024). Achieving this goal is not merely a regulatory requirement; it is a strategic imperative that can enhance the financial performance of these banks, enabling them to operate more effectively in a competitive environment(Ngweshemi & Isiksal, 2021).

The relationship between non-performing loans and the financial performance of commercial banks is characterized by an inverse correlation, as evidenced by a plethora of studies conducted in recent years. Research by Siddique et al. (2022), Shrestha (2024), Onyango and Olando (2020), Mrindoko et al. (2020), Maaji et al. (2023), Korankye et al. (2022), Kajirwa and Wekesa (2020), Kadek et al. (2021), Aliu and Çollaku (2021), and Al Zaidanin and Al Zaidanin (2021) consistently supports the notion that higher levels of non-performing loans are associated with diminished financial performance. These studies collectively reinforce the idea that effective credit risk management and the maintenance of a healthy loan portfolio are crucial for the stability and profitability of commercial banks.Therefore, the findings from Ngweshemi and Isiksal (2021) and the alarming statistics from the CBK (2024) serve as a clarion call for commercial banks in Kenya. By prioritizing the reduction of non-

performing loans through improved credit management practices, these banks can not only enhance their financial performance but also contribute to the overall stability of the financial system(CBK, 2024).Moreover, Lending interest rates significantly affect the levels of non-performing loans as well as the overall financial performance of institutions. This relationship has been explored in various studies, highlighting the intricate dynamics between interest rates and loan performance metrics (Case et al., 2023; Daniel Odhiambo Dondi, Rober K. Mule, 2023; Hania & Himel, 2023; Rahmananingtyas, 2022).

Implication to research and practice

The study conducted by Ngweshemi and Isiksal (2021) underscores the critical importance of implementing effective risk management strategies within commercial banks to mitigate exposure to problematic loans. This necessity arises from the inherent risks associated with lending practices, which can lead to significant financial distress if not properly managed. The authors argue that a well-diversified lending portfolio is essential for banks to spread risk across various sectors and borrower profiles, thereby enhancing their resilience against potential defaults and economic downturns. In addition to risk management, the study highlights the significance of financial performance indicators, particularly return on assets (ROA) and return on equity (ROE), as vital metrics for assessing a bank's overall financial health. Shrestha (2024) emphasizes that these indicators provide insights into how effectively a bank is utilizing its assets to generate profits and how well it is delivering returns to its shareholders. A strong performance in these areas is indicative of a bank's operational efficiency and its ability to navigate the complexities of the financial landscape(Shrestha, 2024).

Further expanding on the relationship between lending practices and financial performance, Hania and Himel (2023) conducted a distinct analysis that revealed a clear inverse correlation between lending rates and the financial performance of banks. This finding suggests that as lending rates increase, the financial performance of banks tends to decline, potentially due to reduced borrowing activity and increased repayment burdens on borrowers. Similarly, research by Dondi and Mule (2023) corroborates this observation, uncovering a considerable negative effect of high lending rates on financial performance. Their findings indicate that elevated lending rates may deter potential borrowers, leading to a decrease in loan origination and, consequently, a decline in the bank's profitability.In light of these findings, the paper advocates for an empirical investigation into the mediating role of lending rate in the relationship between nonperforming loans and the financial performance of commercial banks in Kenya. By exploring this relationship, the study aims to provide deeper insights into how banks can better manage their capital in the face of rising nonperforming loans, ultimately enhancing their financial stability and performance in a challenging economic environment(Hania & Himel, 2023).

CONCLUSION

A substantial body of research indicates an inverse relationship between non-performing loans (NPLs) and the financial performance of commercial banks, suggesting that an increase in NPLs correlates with diminished profitability (Aliu & Çollaku, 2021; Ngweshemi & Isiksal, 2021). NPLs, defined by Akhter(2023) as loans that are either in default or approaching default, present considerable risks to financial institutions, as they can deplete capital reserves and diminish interest income. The escalation of NPLs compels banks to allocate more resources for loan loss provisions, which adversely affects their net income(Akhter, 2023). This situation underscores the critical necessity for robust credit risk management practices and vigilant oversight of loan portfolios (Aliu & Çollaku, 2021; Ngweshemi & Isiksal, 2021).

In contrast, Onyango and Olando (2020) assert that a reduction in NPLs is linked to enhanced earnings for banks. Lower NPL levels enable banks to concentrate on more productive lending activities, thereby increasing interest income and fostering greater investor confidence, which can subsequently elevate stock prices and improve access to capital. This finding emphasizes the vital role of effective loan management in maintaining the financial stability of banking institutions (Onyango & Olando, 2020). Furthermore, the study by Ngweshemi and Isiksal (2021) highlights that to maximize profitability, commercial banks should cultivate a well-diversified loan portfolio. Such diversification serves to mitigate risks associated with economic downturns or sector-specific challenges by distributing exposure across a range of industries and borrowers, thereby stabilizing earnings and enhancing resilience against financial shocks. Additionally, lending interest rates significantly influence both the levels of non-performing loans and the overall financial performance of commercial banks(Case et al., 2023; Daniel Odhiambo Dondi, Rober K. Mule, 2023; Hania & Himel, 2023; Rahmananingtyas, 2022)

Future Research

This paper proposes for an empirical investigation on the mediating effect of lending rate on nonperforming loans and financial performance of commercial banks in Kenya

REFERENCE

Abimbola, E. (2020). Impact of Non Performing Loan on Bank Performance in Nigeria A Case Study of Selected Deposit Money Banks. *Journal of Business & Economic Policy*, *7*(4), 56–70. https://doi.org/10.30845/jbep.v7n4p7

Akhter, N. (2023). Determinants of commercial bank's non-performing loans in Bangladesh: An empirical evidence. *Cogent Economics and Finance*, *11*(1). https://doi.org/10.1080/23322039.2023.2194128

Al Zaidanin, J. S., & Al Zaidanin, O. J. (2021). The impact of credit risk management

on the financial performance of United Arab Emirates commercial banks. *International Journal of Research in Business and Social Science (2147- 4478)*, *10*(3), 303–319. https://doi.org/10.20525/ijrbs.v10i3.1102

Ali, B. J. A., & Oudat, M. S. (2020). Financial Risk and the Financial Performance in listed Commercial and Investment Banks in Bahrain Bourse. *International Journal of Innovation, Creativity and Change*, *13*(12), 160–180. www.ijicc.net

Aliu, M., & Çollaku, B. (2021). Impact of Non-Performing Loans on Bank s Profitability: Empirical Evidence from Commercial Banks in Kosovo. *Journal of Accounting Finance and Auditing Studies (JAFAS)*, *7*(3), 226–242. https://doi.org/10.32602/jafas.2021.027

Ari, A., Chen, S., & Ratnovski, L. (2021). The Dynamics of Non-Performing Loans. In *The dynamics of non-performing loans during banking crises: a new database* (2395; ECB Working Paper Series No 2395 / April 2020, Issue 2395). https://doi.org/10.2139/ssrn.3580827

Case, C. A., Banks, C., Baruti, B. H., Arifaj, A. H., & Hoti, A. (2023). An Investigation into the Influence of Non-Performing Loans on Lending and An Investigation into the Influence of Non-Performing Loans on Lending and Capital : A Case Study of Commercial Banks in Kosovo. *Review of Economics and Financ*, *21*(1816–1821). https://doi.org/10.55365/1923.x2023.21.197

CBK. (2023). *The Kenya Financial Stability Report 2023* (Issue 13).

CBK. (2024). *MONETARY POLICY COMMITTEE MEETING[Press release]*. https://www.centralbank.go.ke

Daniel Odhiambo Dondi, Rober K. Mule, B. O. O. (2023). Effect of Interest Rates on the Financial Performance of Commercial Banks in Kenya. *THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT*, *11*(7), 42–52. https://doi.org/10.47604/ijfa.243

Feyen, E., & Zuccardi Huertas, I. (2020). Bank Lending Rates and Spreads in Emdes : Evolution, Drivers, and Policies. In *Bank Lending Rates and Spreads in Emdes : Evolution, Drivers, and Policies* (Issue September). https://doi.org/10.1596/1813-9450-9392

Hania, U., & Himel, H. (2023). An Analytical Overview of the Factors Affecting Non-performing Loans in Selected Banks of Bangladesh. *Canadian Journal of Business and Information Studies*, *7820*, 11–21. https://doi.org/10.34104/cjbis.023.011021

Kadek, N., Swandewi, M., & Purnawati, N. K. (2021). Capital Adequacy Ratio Mediates the Effect of Non-Performing Loan on Returns on Assets in Public Commercial Banks. *American Journal of Humanities and Social Sciences Research*, *5*, 651–656. www.ajhssr.com

Kajirwa Isabwa, H., & Wekesa Mabonga, M. (2020). Effect of Non Performing Loans on Profitability of the Banking Industry in Kenya. *International Journal of Finance and Banking Research*, *6*(2), 28. https://doi.org/10.11648/j.ijfbr.20200602.12

Kariuki, R. K. (2023). Influence of interest rates and performance of lending institution in Africa. A Critical Literature Review. *International Journal of Modern Statistics*, *3*(1), 1–11. https://doi.org/10.47941/ijms.1170

Korankye, M., Dzah, B., & Dunyoh, M. (2022). Effect of Non-Performing Loans on

the Profitability of Universal Banks: A Time Series Analysis of the Ghanaian Banking Industry. *Research Journal of Finance and Accounting*, *May*. https://doi.org/10.7176/rjfa/13-2-03

Koskei, L., & Samoei, D. (2024). Bank Lending Rates and Nonperforming Loans of Listed Commercial Banks in Kenya. *Asian Journal of Economics, Business and Accounting*, *24*(3), 19–25. https://doi.org/10.9734/ajeba/2024/v24i31236

Kwashie, A. A., Baidoo, S. T., & Ayesu, E. K. (2022). Investigating the impact of credit risk on financial performance of commercial banks in Ghana. *Cogent Economics and Finance*, *10*(1), 23322039. https://doi.org/10.1080/23322039.2022.2109281

Maaji, M. M., Barnett, C., & Long, C. (2023). Non-Performing Loans and Commercial Bank Profitability: Evidence from Cambodia. *Journal of Entrepreneurship and Business Innovation*, *10*(2), 1. https://doi.org/10.5296/jebi.v10i2.21229

Mrindoko, A. E., Macha, D., & Gwahula, D. R. (2020). NON-PERFORMING LOANS AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN TANZANIA. *International Journal of Business Management and Economic Review*, *03*(06), 152–180. https://doi.org/10.35409/ijbmer.2020.3219

Naili, M., & Lahrichi, Y. (2022). The determinants of banks' credit risk: Review of the literature and future research agenda. *International Journal of Finance and Economics*, *27*(1), 334–360. https://doi.org/10.1002/ijfe.2156

NCBA. (2022). *KENYAN BANKING SECTOR REPORT 2022 Expectations for the Banking Sector in 2023* (Issue February).

Ngweshemi, L. E., & Isiksal, A. Z. (2021). Analysis of the factors affecting bank profitability: Evidence of Tanzania commercial banks. *Studies of Applied Economics Volume 39-8, September 2021 // ISSN: 1133-3197 Analysis*, *39*(8). https://doi.org/10.25115/EEA.V39I8.4768

Nugroho, I. S., & Endri, E. (2022). Determinants of Non-Performing Bank Loans Listed on The Indonesia Stock Exchange For The 2016-2020 Period. *Journal of Social Science*, *3*(6), 1214–1232. https://doi.org/10.46799/jss.v3i6.470

Onyango, W. A., & Olando, C. O. (2020). Analysis on Influence of Bank Specific Factors on Non-Performing Loans among Commercial Banks in Kenya. *Advances in Economics and Business*, *8*(3), 105–121. https://doi.org/10.13189/aeb.2020.080301

Ozili, P. K. (2019). Non-performing loans and financial development: new evidence. *Journal of Risk Finance*, *20*(1), 59–81. https://doi.org/10.1108/JRF-07-2017-0112

Ozurumba, B. A. (2016). Impact of Non-Performing Loans on the Performance of Selected Commercial Banks in Nigeria. *Research Journal of Finance and Accounting*, *7*(16), 95–109. www.iiste.org

Rahmananingtyas, N. A. (2022). The Effect of Interest Rates and Inflation on Loan Growth and Non Performing Loan (Literature Review of Financial Management). *Dijemss*, *4*(1), 128–137.

Shrestha, S. R. (2024). Effect of macroeconomic and microeconomic variables on bank performance. *International Journal of Finance and Commerce*, *6*(July), 105–110.

Siddique, A., Khan, M. A., & Khan, Z. (2022). The effect of credit risk management and bank-specific factors on the financial performance of the South Asian commercial banks. *Asian Journal of Accounting Research*, *7*(2), 182–194.

https://doi.org/10.1108/AJAR-08-2020-0071

Singh, S. K., Basuki, B., & Setiawan, R. (2021). The Effect of Non-Performing Loan on Profitability: Empirical Evidence from Nepalese Commercial Banks. *Journal of Asian Finance, Economics and Business*, *8*(4), 709–716. https://doi.org/10.13106/jafeb.2021.vol8.no4.0709

Siriba, R. M. (2020). Credit Risk and Financial Performance of Commercial Banks in Kenya. *International Journal of Scientific and Research Publications (IJSRP)*, *10*(4), p10051. https://doi.org/10.29322/ijsrp.10.04.2020.p10051

Supriyadi, T. (2021). EFFECT OF RETURN ON ASSETS (ROA), RETURN ON EQUITY (ROE), AND NET PROFIT MARGIN (NPM) ON THE COMPANY ' S VALUE IN MANUFACTURING COMPANIES LISTED ON THE EXCHANGE INDONESIA SECURITIES YEAR 2016-2019. *International Journal of Economics, Business and Management Research*, *5*(04), 219–228.

Uddin, M. K. (2022). Effect of Leverage, Operating Efficiency, Non-Performing Loan, and Capital Adequacy Ratio on Profitability of Commercial Banks in Bangladesh. *European Journal of Business and Management Research*, *7*(3), 289–295. https://doi.org/10.24018/ejbmr.2022.7.3.1463

Zaid, M., & Farooque Khan, M. (2023). Non-Performing Loans Effects on Profitability and Lending Behavior of Commercial Banks: Evidence from Yemeni Commercial Banks Sector. *Studies in Economics and Business Relations*, *3*(2), 28–35. https://doi.org/10.48185/sebr.v3i2.737