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Factors Contributing to Financial Distress in Commercial Banks of Kenya

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ABSTRACT: Commercial banks could provide important benefits to economies and facilitate the objectives of financial liberalization, by boosting competition in banking markets, stimulating improvements in services to customers and expanding access to credit, especially to domestic small and medium-scale businesses. But the attainment of these benefits has been jeopardized because commercial banks have been vulnerable to financial distress. Substantial numbers of banks have failed, mainly because of non-performing loans. Poor loan quality has its roots in the informational problems which afflict financial markets, and which are at their most acute in developing countries, in particular problems of moral hazard and adverse selection. The Kenyan financial sector plays major roles in the country in promoting economic growth and development. However, financial distress is one the challenges that is hindering commercial banks from continuing contributing according to their potential to the GDP wellness. Some of the banks such as Imperial bank limited, Chase bank and Dubai Bank have been put under statutory management of late. For the purpose of attempting to unfold the issues of major concern, it was necessary to assess the factors contributing to financial distress in commercial banks. The specific objectives of this study were based on financial leverage, liquidity, credit risks and capital adequacy. It was further guided by relevant theories; modern portfolio theory, agency theory, pecking order theory and cash management theory. The study used research works particularly the ones published in the journal articles which were related to the topic under the study. This was supplemented by information in books concerning financial distress and commercial banks. The information was analyzed through content analysis by considering all the constructs used. The research designs adopted were also put into account. Meta-analysis research design was used to analyze these research works in the academic journals. The findings are of importance to commercial banks and Central bank. It provides information that can help them prevent and manage financial distress. The study found out that financial distress leads to poor performance and failure in commercial banks. The study also showed that financial distress had a significant effect on financial performance of banks where performance was negatively affected. A rise in financial distress led to a decrease in financial performance and vice versa. Both descriptive and inferential findings showed that financial distress in commercial banks was contributed by leverage, liquidity, credit risks and capital adequacy. The study established the need to reduce financial distress by ensuring financial stability in banks to ensure shareholders confidence. It was recommended that banks should adopt appropriate credit management strategies to control their lending. They should also make effective decisions on the means to fund their operations in different economic and financial conditions. This should indicate when equity or debt funds are suitable. Central banks should be stricter on their regulations concerning liquidity and capital reserves of the commercial banks.

Key words: Financial distress, financial leverage, liquidity, credit risks, capital adequacy, commercial banks

I. Background of the Study

Financial distress is a term in corporate finance used to indicate a condition when promises to settle liability obligations are broken, or honored with difficulty. In some cases, financial distress leads to bankruptcy (Flannery, 2013). Financial distress can also be termed as severe liquidity problems that cannot be resolved without a sizable rescaling of the entities' operations or structure. It must be noted that companies may file for bankruptcy even though their performance and financial ratios do not predict this. On the other hand, some companies may only just be surviving corporate failure, but are actually classified as non-failed companies. Some companies may strategically file for bankruptcy to eliminate rising debts. Financial distress also implies the situation when a financial institution cannot continue to exist in its current form. It therefore needs delisting or major organizational restructuring.

According to Thakor, (2014), financial distress can be subdivided into four sub-intervals: deterioration of performance, failure, insolvency, and default. Whereas deterioration and failure affect the profitability of the company, insolvency and default are rooted in its liquidity. In general, financial distress is characterized by a sharp decline in the firm's performance and value. He also notes that, a company can be distressed without defaulting. However he notes that, default and bankruptcy cannot occur without the preceding period of financial distress. Managerial incompetence is the most common reason for a company's distress and possible failure but the ultimate cause of failure is often simply running out of cash and other liquid funds. Failure does not happen suddenly but it is a gradual process. As Menicucci and Paulucci (2016) points out, it's a dynamic process where a company moves in and out of financial trouble, as it passes through separate stages, each of which has specific attributes and consequently, contributes differently to corporate failure.

According to Kargi, (2011), changes in financial conditions affect the transition from one state of financial distress to another. If financial conditions become aggravated, the company most probably will face bankruptcy. Total distress costs consist of three classes of factors causing losses in sales: Customer-driven losses which reduce the willingness of the customers to pay for its products and customers ceasing to do business with the distressed firm, causing sales to collapse. Competitor-driven losses which result to competitors pursuing an aggressive marketing and price strategy in order to attract the customers of the vulnerable company and, therefore, squeeze the troubled competitor out of the market. An employee-driven loss decreases the incentives of the employees to work hard and stimulates them to renegotiate their compensation packages or to leave the company.

Financial Leverage is the amount of debt that commercial banks use for operations and acquisition of assets. Commercial banks have become increasingly sensitive to signs of corporate demise and bankruptcy due to financial leverage (Cheluget, 2014). It is due to financial leverage that many banks have failed. They have utilized depositors money to a point that they cannot give it out if required to. As such banks have to concentrate on corporate ethics and governance with a view to minimize the risks of corporate financial distress. The early prediction of distress is essential for financial institutions who wish to maintain financial stability. Financial distress is closely associated with bankruptcy, insolvency and liquidation. These are unfavorable occurrences to shareholders and investors. The cash flow to debt ratio is an indicator of financial distress. Financial distress is used in a negative connotation to describe the financial situation of a company confronted with a temporary lack of liquidity and with the difficulties that ensue in fulfilling financial obligations on schedule and to the fullest.

Liquidity contributes to the financial health of commercial banks. Lack of financial health leads to financial distress. According to Longstaff (2010), banks are financially distressed when they are technically insolvent and or illiquid. Insolvency is the inability of a business to have enough assets to cover its liabilities. A situation where a firm's operating cash flows are not sufficient to satisfy current obligations and the firm is forced to take corrective action. The financial health of the banking industry is an important prerequisite for economic stability and growth. The cost of bank failure is colossal and hence ailing banks require quick action by supervisory authority to salvage them before they collapse. Operational efficiency problems are typically captured with negative profit and poor corporate performance. Problems with the financing structure and liquidity adequacy are frequently explained by low cash-flow levels that are insufficient to cover maturing liabilities and by low interest coverage ratios. Financial distress is caused by sustained operating losses and visible when the risk-weighted actual return on capital invested is significantly and enduringly lower than the returns on similar investments (Bluddel-Wignall & Atinson, 2012).

Credit risks determine the profit is the ultimate goal of commercial banks but they also have other social and economic goals. This has a direct influence on the return on assets. The loans given out are treated as assets to banks and interests paid are part of bank earnings. Increased risks reduce chances on sufficient returns. Ongore and Kusa (2013) noted that high return on equity is favorable for a bank as it shows its ability to generate cash internally. It reflects how effectively a bank is using shareholders' funds. The second ratio is the return on asset ratio which is the ratio of income to its total asset and measures the ability of the bank to generate income by utilizing the assets at its disposal. A high ROA shows the bank is efficient in using its resources. The third ratio is the net interest margin ratio which measures the interest income generated by banks and the amount of interest paid out to their lenders. However it could also mean riskier lending practices associated with substantial loan loss provisions.

Capital adequacy determines the financial stability of a commercial bank. Most of the failed banks were undercapitalized, in part because the minimum capital requirements in force when they had been set up were very low (Andrade & Kaplan, 1998). Owners had little of their own funds at risk should their bank fail, which created a large

asymmetry in the potential risks and rewards of insider lending. The threat posed by insider lending to the soundness of the banks was exacerbated because many of the insider loans were invested in speculative projects such as real estate development, breached large-loan exposure limits, and were extended to projects which could not generate short-term returns with the result that the maturities of the bank's assets and liabilities were imprudently mismatched (Elloumi & Gueyie, 2001).

Even though bank supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment, even conservative managers might find market pressure for higher profits very difficult to overcome. External factors such as weak judicial systems and reduced customer buying ability are the main contributors of nonperforming loans in Banks. Most emerging economies have weak legal systems. There is therefore a need for governments in countries such as Kenya to strengthen their judicial systems if Banking crises are to be minimized.

Commercial Banks in Kenya

Banks put under statutory management or taken over by Central Bank of Kenya can be in most cases due to financial distress caused by insolvency and illiquidity. These contribute to the moral hazard on bank owners to take excessive risks with depositors' money (Kariuki, 2013). It includes low levels of bank capitalization, access to public sector deposits through the political connections of bank owners, excessive ownership concentration, and regulatory forbearance. Effective prudential supervision of the local banks and enforcement of banking legislation is essential in Kenya if the incidence of bank failures in this country is to be reduced. This is because its severity is such that it can cause high level of loan losses and even bank failure.

Loans management are the largest source of financial distress to commercial banks in Kenya. They are not aware of the need to identify measure and control credit risk (Muigai, 2016). Costs arising from financial distress can be huge and devastating to the economy as a whole since banks are the backbone of many economies all over the world. Financial distress is very real in Kenya and although most banks in Kenya are reporting profits there are a couple of banks declaring losses. In Kenya the commercial banks dominate the financial sector and any failure in the sector would have an immense implication on the economic growth of the country because it has a contagion effect that could lead to bank runs, crises and overall financial crisis and economic tribulations (Ongore and Kusa, 2013).

Moreover, the leading cause of financial distress in financial in Kenya is due to non-performing loans. Kenyan banks disposed-off Securities at a loss to meet cash shortfalls. This move was to help ease the liquidity crunch that the banks were experiencing. The sale of government securities by banks to meet cash shortfalls is a clear sign of financial distress which the banks were going through.

II. Research problem

Financial distress has been a great problem to many commercial banks worldwide. Its impact has been felt by most developing countries. Kenya is not an exception and many banks have been put under statutory management or collapsed due to financial distress. Given the important role that commercial banks play in any economy, it is crucial to understand the issues of concern that influence commercial bank’s stability and performance. The major objective of commercial bank is to maximize profit and by extension its wealth for survival in the future. However, under financial distress situations, the bank’s performance is inadequate hence stability is affected. Huge financial distress may result in liquidation especially for commercial banks in developing Countries due to inappropriate leverage levels, capital inadequacy, illiquidity and huge credit risks. Most of previous studies have not tackled this problem to satisfaction. Therefore, the current seminar was motivated by the need to understand the factors contributing to financial distress in commercial banks of Kenya. This will enable banks to take corrective measures if they find themselves in distress to avoid the devastating results. It is very important to ensure the growth of the banking sector in Kenya to ensure it is not deterred by financial distress.

III. Objectives of the Study

The main objective of the study was to assess the factors contributing to financial distress in commercial banks of Kenya. Specific objectives include the following:

i. To determine whether financial leverage contributes to financial distress in commercial banks in Kenya.
ii. To establish the influence liquidity on financial distress in commercial banks in Kenya.

iii. To establish the contribution of credit risks to financial distress in commercial banks in Kenya.
iv. To find out the effects of capital adequacy on financial distress in commercial banks in Kenya

IV. Research Hypotheses

H_{01}: The relationship between financial leverage and financial distress in commercial banks is not statistically significant.
H_{02}: There is no statistically significant relationship between liquidity and financial distress in commercial banks of Kenya.
H_{03}: Credit risks do not contribute to financial distress in commercial banks of Kenya.
H_{04}: Capital adequacy has no significant contribution to financial distress in commercial banks of Kenya.

V. Review of literature

This chapter looks at some of the theories of financial distress and conclusions drawn from empirical findings of researchers. It outlines the empirical review of literature, theoretical framework and conceptual framework.

Empirical review of literature

The researcher has reviewed selected journal articles that are related to factors contributing to financial distress in commercial banks. It focused on findings related to financial leverage, liquidity, credit risks, capital adequacy and financial distress.

Financial Leverage

Financial Leverage is the amount of debt that an entity uses to buy more assets and engage in other operations. Commercial banks employ financial leverage to avoid using too much equity to fund operations.

A research by Mwangi, Makau, and Kosimbei (2014) on the relationship between capital structure and performance of non-financial companies listed in the Nairobi Securities Exchange showed that financial leverage contributes to financial distress to a large extent. The study employed an explanatory non- experimental research design. A census of 42 non-financial companies listed in the Nairobi Securities Exchange, Kenya was taken. The study used secondary panel data contained in the annual reports and financial statements of listed non-financial companies. The data were extracted from the Nairobi Securities Exchange hand books for the period 2006-2012. Feasible Generalized Least Square (FGLS) regression results revealed that financial leverage had a statistically significant negative association with performance as measured by return on assets (ROA) and return on equity (ROE). On contrary, the current study focus on financial companies; commercial banks. The study does not link financial leverage to financial distress on all commercial banks. The seminar paper also adopted meta-analysis design to analyze findings of the previous journals considering the listed and non-listed commercial banks in Kenya.

Makori and Jagongo (2013), investigated Working capital management and firm profitability: Empirical evidence from manufacturing and construction firms listed on Nairobi securities exchange, Kenya. The study finds a negative relationship between profitability and number of day's accounts receivable and cash conversion cycle, but a positive relationship between profitability and number of days of inventory and number of day's payable. Moreover, the financial leverage, sales growth, current ratio and firm size also have significant effects on the firm's profitability. Based on the key findings from this study it has been concluded that the management of a firm can create value for their shareholders by reducing the number of accounts receivable. Financial leverage is about funding operations with debt. Inability to settle these debts leads to financial distress. Financial distress causes lack of confidence from shareholders and customers which later contribute to inadequate financial performance in commercial banks.

Menicucci and Paolucci (2016), sought to find out the determinants of bank profitability: empirical evidence from European banking sector. Regression findings revealed that size and capital ratio are significant company-level determinants of bank profitability in Europe, while higher loan loss provisions result in lower profitability levels. Findings also suggest that banks with higher deposits and loans ratio tend to be more profitable but the effects on profitability are statistically insignificant in some cases. The issue of higher loan loss provisions can be associated to higher leverage levels. The current study expands on this argument to link the loan loss provisions to financial distress.

A study by Muriithi (2016), on the effects of financial risk on financial performance of commercial banks in Kenya indicated that credit, market, liquidity and operational risks have significant negative effect on return on equity. The component of financial risk that had the most impact on financial performance was cost to income ratio. The conclusion of the study was that there exist inverse relationship between financial risk and financial performance of Kenyan commercial banks. Utilization of debts at higher levels can stimulate financial risks. This is financial leverage and leads to financial distress in commercial banks.

Andrade and Kaplan (1998), sought to find out how costly is financial (not economic) distress? Evidence from highly leveraged transactions that became distressed. In their study, findings revealed that there was a positive relationship between financial leverage and financial distress of the firm. Highly leverage transactions amounted to financial distress. For a subset of firms that do not experience an adverse economic shock, financial distress costs are negligible. The study was done on different firms with different characteristics. It came up with a general conclusion that highly leverage transactions lead to financial distress. However, the current study looks into a specific banking industry to establish the contribution of leverage to financial distress.

A study by Elloumi and Gueyie (2001), on financial distress and corporate governance: an empirical analysis. They examined a sample of Canadian firms. Results from logit regression analysis of 46 financially distressed and 46 healthy firms led them to the conclusion that leverage influences financial distress. The study found that higher debt levels were associated with firm distress. However, what matters is the utilization of the debt by the organization. For instance, if a firm borrows more funds and puts it in prudential investments, they can generate sufficient returns to settle their debt obligations. This view has not been expressed in the study. The current study puts into account the usage of the debt and capacity to pay. Difficulties in payments for the same are the one that has contributed to the financial distress in commercial banks of Kenya.

Omondi and Muturi (2013), did a research on factors affecting the financial performance of listed companies at the Nairobi Securities Exchange in Kenya. Study findings showed that leverage had a significant negative effect on financial performance. The study provides some precursory evidence that leverage, liquidity, company size and company age play an important role in improving company's financial performance. The study suggests that there is need to determine an optimal debt level that balances the benefits of debt against the costs of debt and developing sound techniques of managing current assets to ensure that neither insufficient nor unnecessary funds are invested in current assets as maintaining a balance between short-term assets and short-term liabilities is critical.

Liquidity

Liquidity is a measure of the extent to which an organization has cash to meet immediate and short-term obligations, or assets that can be quickly converted to do this. It reflects the amount of capital that is available for investment and spending including cash, credit and equity. Muigai (2016), carried out a study on the effect of capital structure on financial distress of non-financial companies listed in Nairobi securities exchange. Descriptive statistics and panel regression analysis techniques were used to analyze the data. F-test was used to determine the significance of the overall model; while significance of individual variables was determined by t-test. The study concluded that financial leverage, asset tangibility and external equity have a significant negative effect on financial distress of non-financial firms. Nevertheless, internal equity and long term debt play a significant role in mitigating financial distress in non-financial firms. The study further concluded that the firm size and the listing sector have significant moderating effect on the relationship between capital structure and financial distress. Liquidity is an element that can be traced in capital structure though this was not clarified in the study. Current study establishes the relationship between liquidity and financial distress.

Imbierowicz and Rauch (2014), did a research on the relationship between liquidity risk and credit risk in banks. Results showed that both risk categories do not have an economically meaningful reciprocal contemporaneous or time-lagged relationship. However, they do influence banks' probability of default. This effect is twofold: whereas both risks separately increase the financial distress, the influence of their interaction depends on the overall level of bank risk and can either aggravate or mitigate default risk. These results provide new insights into the understanding of bank risk and serve as an underpinning for recent regulatory efforts aimed at strengthening banks (joint) risk management of liquidity

and credit risks. The current study goes further to determine the relationship between liquidity and financial distress. Financial risks are part of financial distress that deters commercial banks from performing well.

Waemustafa and Sukri (2015), did a study on Bank specific and macroeconomics dynamic determinants of credit risk in Islamic banks and conventional banks. The finding shows that the banks specific determinants of credit risk are uniquely influenced the credit risk formation of Islamic and Conventional banks. The study found that risky sector financing; regulatory capital and Islamic Contract are significant to credit risk of Islamic banks. For Conventional Banks, loan loss provision, debt-to-total asset ratio, regulatory capital, size, earning management and liquidity are significant factors influencing credit risk. As for macroeconomic factors only inflation is significant to credit risk for both Islamic and Conventional banks. This study was about association between liquidity and credit risk. The current study is about relationship between liquidity and financial distress and the effect on financial performance of commercial banks.

Alshatti (2014), undertook a research on the effect of the liquidity management on profitability in the Jordanian commercial banks. The empirical results show that a positive effect of the increase in the quick ratio and the investment ratio of the available funds on the profitability, while there is a negative effect of the capital ratio and the liquid assets ratio on the profitability of the Jordanian commercial banks. This study is different from the current study undertaken on Kenyan Banks rather those Asian banks (Jordanian commercial banks). They operate under different market conditions. It is not only about profitability but the whole financial performance that is influenced by financial distress through liquidity management.

Ongore and Kusa, (2013), sought to determine factors affecting financial performance of commercial banks in Kenya. The findings showed that bank specific factors significantly affect the performance of commercial banks in Kenya, except for liquidity variable. But the overall effect of macroeconomic variables was inconclusive at 5% significance level. The moderating role of ownership identity on the financial performance of commercial banks was insignificant. Thus, it can be concluded that the financial performance of commercial banks in Kenya is driven mainly by board and management decisions, while macroeconomic factors have insignificant contribution.

A study by Kariuki (2013), on the effect of financial distress on financial performance of commercial banks in Kenya shows that in banks financial distress is caused by very low liquidity, negative cash flow and high leverage. The study found out that most of the banks under study had financial distress. The non-listed banks suffered more from financial distress as compared to the listed banks. The study also showed that financial distress had a significant effect on financial performance of banks where performance was negatively affected. A rise in financial distress led to a decrease in financial performance and vice versa. However, he did not clarify why non-listed banks were the ones mostly affected by financial distress. May be, they have more liquidity problems than the ones listed.

Cheluget (2014), investigated the determinants of Financial Distress in Insurance Companies in Kenya. Findings revealed that there is a significant relationship between liquidity and financial distress. The study established that there exists a significant positive relationship between the independent variables; profitability, liquidity, efficiency, leverage and the dependent variable, financial distress of insurance companies in Kenya. Based on the coefficient of determination findings from this study, one may conclude that the biggest determinant of financial distress amongst the insurance companies in Kenya is the lack of efficiency and low liquidity. It was further established that firm size had a significant moderating effect on the independent variables which, thus, led to financial distress in insurance firms. The current study is on effect of liquidity on financial distress in commercial banks not Insurance companies. The aforementioned study did not give insights on commercial banks in relation to liquidity and financial distress.

Longstaff (2010), sought to find out the subprime credit crisis and contagion in financial markets. He conducted an empirical investigation into the pricing of subprime asset-backed collateralized debt obligations (CDOs) and their contagion effects on other markets. Using data for the ABX subprime indexes, he found strong evidence of contagion in the financial markets. The results support the hypothesis that financial contagion was propagated primarily through liquidity and risk-premium channels, rather than through a correlated-information channel. Surprisingly, ABX index returns forecast stock returns and Treasury and corporate bond yield changes by as much as three weeks ahead during the subprime crisis. This challenges the popular view that the market prices of these toxic assets were unreliable; the results suggest that significant price discovery did in fact occur in the subprime market during the crisis.

Credit risk

Credit risk means the risk that a borrower may not repay a loan and that the lender may lose the principal of the loan or the interest associated with it.Mutua (2015), sought to establish the effect of mitigating credit risk on performance of commercial banks in Kenya: A case of Chuka town. The study found out that the banks had policies and strategies of mitigating credit risk which has direct impact on their performance with the credit section being recognized as the most important sector in the banking section. This is due to the fact that credit is the major investment that is being undertaken by commercial banks. It was also found that there was a significant relationship between bank performance in terms of return on asset and credit risk management in terms of risk identification, monitoring and credit sanctions. Better credit risk management results in better bank performance. Thus, it is of crucial importance that banks practice prudent credit risk management and safeguarding the assets of the banks and protect the investors' interests

A research by Wilner (2000), on the exploitation of relationships in financial distress: The case of trade credit noted that creditor firm relationships induce dependent trade creditors to grant more concessions in debt renegotiations than nondependent creditors. Anticipating these larger renegotiation concessions, not only do less financially stable firms prefer trade credit, but all firms agree to pay a higher interest rate for trade credit. He did not explain the effect of trade credit on financial distress in commercial banks.

The research by Musyoki and Kadubo (2012), on the impact of credit risk management on the financial performance of banks in Kenya for the period revealed that credit risks parameters had an inverse impact on banks' financial performance. They did not give a way in which banks could avoid financial distress that results from exposure to credit risk. Banks ought to design and formulate financial strategies that cannot only minimize the exposure of the banks to credit risk but will enhance profitability and competitiveness of the banks.

Kargi (2011), did a study on Credit risk and the performance of Nigerian Banks. The findings revealed that credit risk management has a significant impact on the profitability of Nigeria banks. Therefore, management need to be cautious in setting up a credit policy that might not negatively affects profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits. They indicate whether credit risk management contributes to financial distress. Financial distress is an impediment to banks profitability which is part of its financial performance. Therefore, performance of banks deteriorates as a result of financial distress when there are huge credit risks.

Aresearch by Chimkono, Muturi and Njeru (2016), on the effect of non-performing loans and other factors on performance of commercial banks in Malawi found that non-performing loan ratio, cost efficiency ratios and average lending interest rate had a significant effect on the performance of banks. Cash reserve ratio variable was positively related to bank performance but was not significant. However, they did not show how non-performing loans could lead to a situation of financial distress. Non-performing loans constitutes credit risks that leads to financial distress and poor performance.

Nyong'o (2014), aimed at determining the relationship between credit risk management and Non-performing loans in commercial banks in Kenya. The study concluded that most bank have a sound credit risk management system and the senior management banks develop policies and procedures for identifying, measuring, monitoring and controlling credit risk. The study further concludes that most banks in Kenya operate under a sound credit risk management process that reduces loan default which leads to low non-performing loans. The study also concluded that banks take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios. The component of financial distress has not been discussed in relation to credit risk management. For proper credit management process, banks should measure financial distress, establish effective risk management information systems that provide adequate information on the composition of the credit portfolio.

Capital Adequacy

Nworji, Adebayo and David (2011), did a study on corporate governance and bank failure in Nigeria. The result of the findings revealed that the new code of corporate governance for Banks is adequate to curtail Bank distress and that improper risk management, corruption of Bank officials and over expansion of Banks are the key issues why Banks fail. The study concluded that Corporate Governance is necessary to the proper functioning of banks and that Corporate Governance can only prevent bank distress only if it is well implemented. However, this corporate governance was not associated with capital adequacy. Corporate governance determines the relationship with shareholders and customers

and may have impact on the success of commercial banks. In worst case scenario, it amounts to financial distress in commercial banks. Corruption as shown in the study, leads to bank failure when funds are mismanaged. This leads to capital inadequacy thus financial distress.

A research by Flannery (2013), on measuring Equity Capital for Stress; Testing Large Financial Institutions found a positive and statistically significant association between return on assets and capital ratio. This pertains to the fact that in order to upturn capital, banks depends more on retained earnings. Another important finding of this study is that the certain features of the bank serves as significantly important factors for a bank response to changing capital requirement such as size has a statistically significant and a negative effect on capital, means that bigger banks are less inclined towards increasing capital as compare to small banks. On contrary, bigger banks are engaged in many operations and may be serving huge number of customers. They need to continue expanding. As such, they may need to increase their capital to correspond to their increasing operations. This will prevent them from falling to the trap of financial distress.

Warue (2013), investigated the effects of bank specific and macroeconomic factors on nonperforming loans in commercial banks in Kenya. The study found evidence that per capita income was negative and significantly related to NPL levels across bank size categories (large, t-value -6.13, medium, t-value -4.81, small, t-value -4.16). Similarly per capita income was negative and significantly related to NPL levels across bank ownership categories (Foreign; t-value -4.45, local; t-value -6.53, government; t-value -6.41). Further, return on assets (ROA) was negative and significantly related to NPLs levels in large banks (t- value -8.10) and small banks (t- value -4.73) but insignificant in medium banks. In addition the study found that return on asset (ROA) was negative and significant in local banks (tvalue-8.41) and government banks (t-value -3.99) but not in foreign banks. However, the study did not lay emphasis on financial distress. With high number of non-performing loans, it is likely that a commercial bank cannot settle its obligations effectively.

Thakor (2014), assessed relationship between Bank capital and financial stability. Empirical evidence revealed that, in the cross section of banks, higher capital is associated with higher lending, higher liquidity creation, higher bank values, and higher probabilities of surviving crises. Moreover, increases in capital requirements are met with modest declines in lending. The overarching message from research is that lower capital in banking leads to higher systemic risk and a higher probability of a government-funded bailout that may elevate government debt and trigger a sovereign debt crisis. The implications of higher lending as result of higher capital are not pointed in the study. If higher lending leads to high default cases, financial distress chips in and financial performance deteriorates.

Financial Distress

Outecheva (2007), did a study on corporate financial distress: An empirical analysis of distress risk. Empirical findings show that if the bank does not participate in public exchange, the distressed offer contains about 0.78 cents of senior debt per dollar of junior debt and the effect of public debt reduction is low. If private debt holders make concessions, waive a covenant or extend maturity, less senior debt is offered to the bondholders and the outcome of the exchange results in a larger reduction of public claims. Failure to settle debt obligations is what is termed as financial distress.

According to Wruck (1990), there are several pointers that can be used to detect financial distress in companies. A reduction in the level of dividends issued out, or non-issue of dividends can be a good indicator of financial distress. Retrenchment of employees and resignation of top management can be a good indicator of financial distress. According to Whitaker (1999), the process of financial distress starts with a company not being able to pay short term obligations, as and when they fall due. The main reasons behind financial distress can be attributed to inappropriate asset mix, corporate governance or financial structure.

Adeyemi (2011), sought to investigate the Bank failure in Nigeria: A consequence of capital inadequacy, lack of transparency and non-performing loans. Capital inadequacy, lack of transparency and huge non-performing loans were noted as the major causes of bank failure in Nigeria. These factors were examined and the extents to which they have been accountable for bank failure in Nigeria were determined. However, aside these factors, the author did not pay attention to financial distress that may be responsible for bank failure. Moreover, simple percentages were used to describe the data presented and the conclusion drawn was that these three factors have been the main reasons of the incessant bank failure.

Ooghe and De-Prijcker (2008), did a study on failure processes and causes of company bankruptcy. Research design was based on a literature overview and in-depth case study research. Findings indicated that lack of managers with

adequate management skills can also lead to corporate failures. Most managers focus and blame external factors when their business fails rather than evaluate internal factors too. Four types of failure processes were observed: the failure process of unsuccessful start- ups, the failure process of ambitious growth companies, the failure process of dazzled growth companies, and the failure process of apathetic established companies. Between these four failure processes, there exist major distinctions in terms of the presence and the importance of specific causes of bankruptcy includes errors made by management, errors in the corporate policy and the importance of external factors. The research did not link financial distress to company failure.

VI. Theoretical Framework

Theories that relate to financial distress and performance of commercial banks have been reviewed. They include; modern portfolio theory, agency theory, pecking order theory and cash management theory.

Modern Portfolio Theory

Modern portfolio theory describes attractive risk-reward characteristics (Killen, Jugdev, Drouin, and Petit, 2012). This means that investors should select portfolios not individual securities. (Markowitz 1952) James (1958) expanded on Markowitz's work by adding a risk-free asset to the analysis. This made it possible to leverage or deleverage portfolios on the efficient frontier. This led to the notions of a super-efficient portfolio and the capital market line. Through leverage, portfolios on the capital market line are able to outperform portfolio on the efficient frontier (Mangram, 2013). This theory provides a context for understanding the interactions of systematic risk and reward. Portfolio theory has enlightened on how institutional portfolios are managed and motivated the use of passive investment techniques. The mathematics of portfolio theory is used in credit risk management and was a theoretical precursor for today's value-at-risk measures.

Modern Portfolio theory applicable to the current seminar paper in that commercial banks engage in portfolio management. Inappropriate loan portfolios contribute to losses and financial distress.

Agency Theory

Agency theory posits that owners of the company who are the shareholders (principal) prioritize maximization of value where they delegate their authority to management (agents) to run company on their behalf (Jensen & Mackling, 1976). A conflict arises since the priorities of the shareholders are not always in congruence with those of the managers. This creates an agency problem which the shareholders seek to solve by employing a board of directors and other monitoring mechanisms to ensure that management do not act contrary to the principal's interests (Rodriguez-Fernandez, 2014). The agency problem is created because of the separation of ownership and control. The agency theory indicates that having independent directors and credible external auditors is one mechanism that shareholders use to monitor and control the operations of management and thus minimizing the agency conflict. Management is more inclined and motivated to work as required by shareholders when they have monitoring mechanisms such as a board of directors and auditing by external auditors to the firm. Government ownership is also expected to have increased monitoring ability on management and hence management are not expected to deviate from company objectives in a firm with high government ownership. By having control and monitoring mechanisms, shareholders are generally assured that management will not deviate from their aspirations and will not expropriate the company resources for their selfish interests.

In the current study, agency theory linked management of commercial banks, owners and stake holders. It has been touted that directors loaned themselves huge sums of money without following due process. This weakened the financial health of banks and because unsustainable to to a financial distress point. In this case, the interests of the agents who the managers and directors override the interests of depositors and owners. It means that inadequate performance contradicts the shareholders goal of profit and wealth maximization.

The Pecking Order Theory

The pecking order theory does not take an optimal capital structure as a starting point, but instead asserts the empirical fact that firms show a distinct preference for using internal finance (as retained earnings or excess liquid assets) over external finance (Frank and Goyal, 2003). If internal funds are not enough to finance investment opportunities, firms may or may not acquire external financing, and if they do, they will choose among the different external finance sources in such a way as to minimize additional costs of asymmetric information. The latter costs basically reflect the lemon premium that outside investors ask for the risk of failure for the average firm in the market. The resulting pecking order

of financing is as follows: internally generated funds first, followed by respectively low-risk debt financing and share financing. In Myers and Majluf model (1984), outside investors rationally discount the firm's stock price when managers issue equity instead of riskless debt. To avoid this discount, managers avoid equity whenever possible. The Myers and Majluf model predicts that managers will follow a pecking order, using up internal funds first, then using up risky debt, and finally resorting to equity. In the absence of investment opportunities, firms retain profits and build up financial slack to avoid having to raise external finance in the future. The pecking order theory regards the market-to-book ratio as a measure of investment opportunities. With this interpretation in mind, both Myers (1984) and Fama and French (2000) note that a contemporaneous relationship between the market-to-book ratio and capital structure is difficult to reconcile with the static pecking order model. Iteration of the static version also suggests that periods of high investment opportunities will tend to push leverage higher toward a debt capacity. To the extent that high past market-to-book actually coincides with high past investment, however, results suggest that such periods tend to push leverage lower.
The current study is supported by pecking order as it describes optimal capital structure. Capital adequacy from the capital structure contributes to financial distress

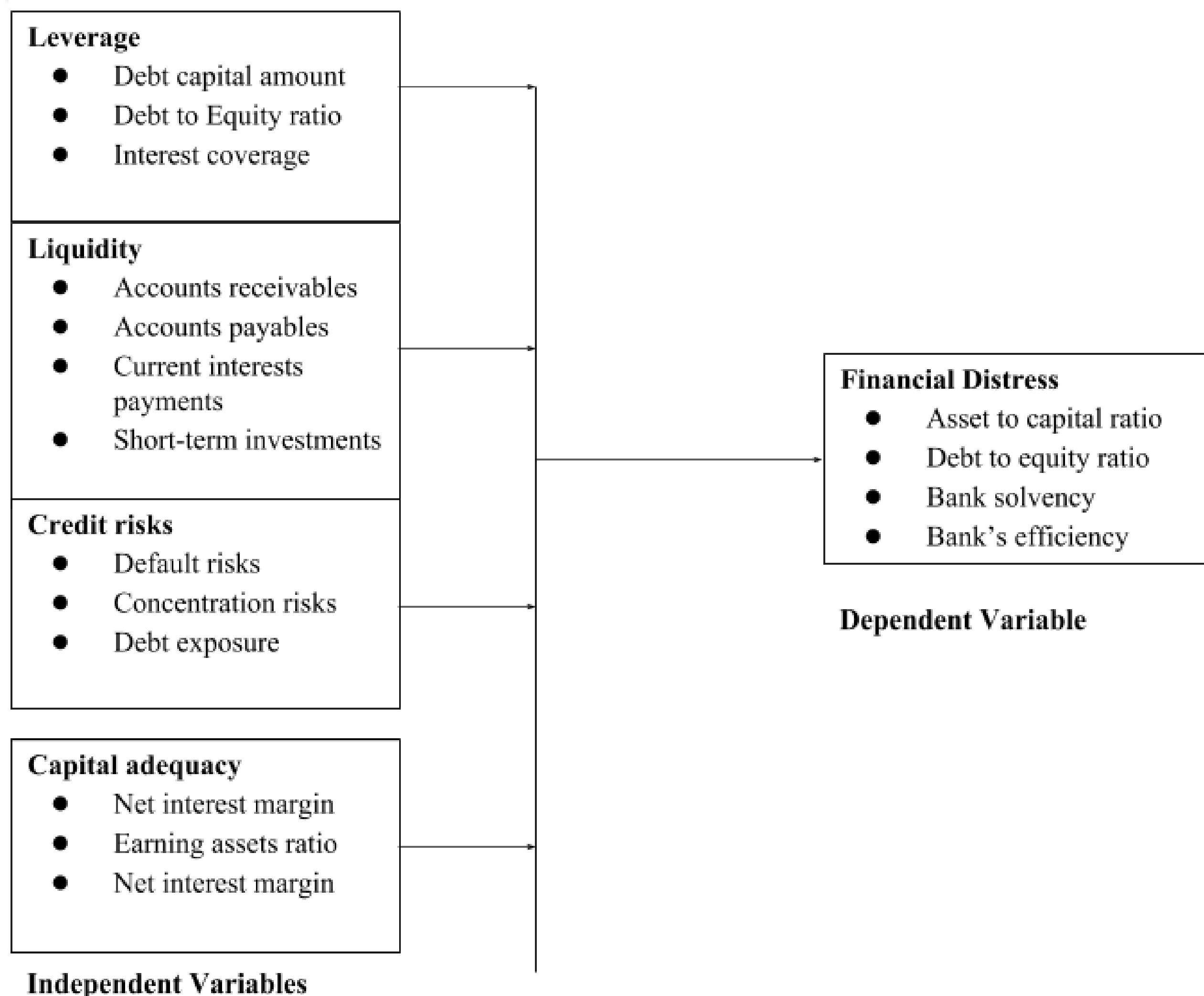
Cash Management Theory
Cash management theory is concerned with the managing of cash flows into and out of the firm; cash flows within the firm andcash balances held by the firm at a point of time by financing deficit or investment surplus cash (Ng'ang'a, 2017). Short-term management of corporate cash balances is a major concern of every firm. During some periods cash outflows, will exceed cash inflows because payments for taxes, dividends or seasonal inventory will build up. At other times, cash inflow will be more than cash sales and debtors may realize in large amounts promptly (Kamau, Namusonge and Bichanga, 2016).

Cash management theory integrates well into the study. Inapropriate cash balance in commercial banks can cause financial distress. An imbalance between cash inflows and outflows would mean failure of cash management function of the firm. Persistence of such an imbalance may cause financial distress to banks.

VII. Conceptual framework

Conceptual frame indicates the relationship between independent and dependent variables. Figure 1 illustrates the relationship between leverage, liquidity, credit risks and capital adequacy and financial distress.

Figure 1: Conceptual framework



VIII. Research Methodology

This section looks into the methodology that will be used in the study. It outlines research design, sampling technique, research data and data analysis

Research design

The research design refers to the method used to integrate the different components of the study in a coherent and logical way, thereby, ensuring effective address of the research problem logically and as unambiguously as possible. It constitutes the blueprint for the collection, measurement, and analysis of data. The function of a research design is to ensure that the evidence obtained enables you to effectively address the research problem. The current study adopted qualitative meta-analysis research design. Qualitative meta-analysis design helps the researcher to systematically evaluate and summarize the results from a number of individual studies to increase the ability of the researcher to study the current issue of interest. The seminar paper was generated from past research studies. Journals were used to extract information to assess contribution of financial leverage, liquidity, credit risks and capital adequacy to financial distress in commercial banks.

Sampling Technique

The study used judgemental sampling technique to select the suitable journals for the study. This sampling technique is based on the judgment of the researcher as to who will provide the best information to succeed for the objectives study. This was appropriate because journals were chosen based on the information that they contained. As such, the selected journals are the ones with information related to financial leverage, liquidity, credit risks, capital adequacy and financial distress and commercial banks.

Research data

The study used secondary data from research journals in the field of finance and particularly the ones relate to financial distress in commercial banks. Secondary data improves the clarity of the problem and the circumstances surrounding the issues under the study.

Data Analysis

Data analysis means organizing data so that a researcher can come to a conclusion. Data analysis allows one to meet objectives, solve problems and derive important information for the topic under the study. The researcher used conventional content analysis to obtain study variables from research findings in the journals of past scholars and researchers.

IX. Findings

Financial Leverage

Findings from majority of studies showed that financial leverage contributes to financial distress. The seminar paper had sought to assess the effects of leverage on financial distress in commercial banks that had affected their performance. The first null hypothesis (**H_{01}:)** was rejected since leverage has been contributing to financial distress to a large extent. This was confirmed by consolidated studies conducted from primary data by the past researchers. Findings also suggest that banks with higher deposits and loans ratio tend to be more profitable but the effects on profitability are statistically insignificant in some cases. The issue of higher loan loss provisions can be associated to higher leverage levels. Highly leverage transactions amounted to financial distress. For a subset of firms that do not experience an adverse economic shock, financial distress costs are negligible. The study was done on different firms with different characteristics.

Other studies provided precursory evidence that leverage, liquidity, company size and company age play an important role in improving company's financial performance. The study suggests that there is need to determine an optimal debt level that balances the benefits of debt against the costs of debt and developing sound techniques of managing current assets to ensure that neither insufficient nor unnecessary funds are invested in current assets as maintaining a balance between short-term assets and short-term liabilities is critical.

Liquidity

The second null hypothesis (**H_{02}:** There is no statistically significant relationship between liquidity and financial distress in commercial banks of Kenya)of the study was rejected.

Liquidity is a measure of the extent to which an organization has cash to meet immediate and short-term obligations, or assets that can be quickly converted to do this. It reflects the amount of capital that is available for investment and spending including cash, credit and equity. The empirical results show that a positive effect of the increase in the quick ratio and the investment ratio of the available funds on the profitability, while there is a negative effect of the capital ratio and the liquid assets ratio on the profitability of the Jordanian commercial banks. Findings further revealed that there is a significant relationship between liquidity and financial distress.. Based on the coefficient of determination findings from this study, one may conclude that the biggest determinant of financial distress amongst the insurance companies in Kenya is the lack of efficiency and low liquidity. The results shows that financial distress was propagated primarily through liquidity and risk-premium channels that led to bank failures

Credit risk

The researcher had sought to find out whether credit risks contribute to financial distress in commercial banks of Kenya. Most findings from journal articles revealed that default risks led to financial distress and insufficient performance of commercial banks. As such, the third null hypothesis **(H_{03}:** Credit risks do not contribute to financial distress in commercial banks of Kenya)was rejected.It was also found that there was a significant relationship between bank performance (in terms of return on asset) and credit risk management (in terms of risk identification, monitoring and credit sanctions. Kargi (2011), did a study on Credit risk and the performance of Nigerian Banks. The findings revealed that credit risk management has a significant impact on the profitability of Nigeria banks. Non-performing loan ratio, cost efficiency ratios and average lending interest rate had a significant effect on the performance of banks. Cash reserve ratio variable was positively related to bank performance but was not significant.

Capital Adequacy

Findings from majority of journal articles showed that lack of adequate capital causes financial failures and distress in commercial banks. This led to rejection of four null hypotheses (**H_{04}:** Capital adequacy does not affect financial distress in commercial banks of Kenya). Capital inadequacy, lack of transparency and huge non-performing loans were noted as

the major causes of bank failure in Nigeria. These factors were examined and the extents to which they have been accountable for bank failure in Nigeria were determined. A research by Flannery (2013), on measuring Equity Capital for Stress; Testing Large Financial Institutions found a positive and statistically significant association between return on assets and capital ratio. This pertains to the fact that in order to upturn capital, banks depends more on retained earnings. Empirical evidence revealed that, in the cross section of banks, higher capital is associated with higher lending, higher liquidity creation, higher bank values, and higher probabilities of surviving crises. Moreover, increases in capital requirements are met with modest declines in lending. The overarching message from research is that lower capital in banking leads to higher systemic risk and financial distress.

X. Conclusions and Recommendations

Financial distress in Kenya Commercial banks can be attributed to high amount of financial leverage increases which has put them in a difficult position to honor their debt and other related obligations. However, financial leverage can be favorable to banks that have put their funds into activities generating higher returns than the interests and costs of debt. Banks expects to use future cash-flows to settle their liabilities. However, these cash flows may not come as expected particularly when borrowers fail to repay loans. This results into credit risks that lead to financial distress in commercial banks. It is not guaranteed that debtors can pay and banks have to put into account for such eventualities in their financial management. The level of capital in banks is very crucial as it determines its success or failure. Failure means that financial distress has played has already been experienced due to inadequate capital to support operations.

Recommendations

Banks should most of time use financial leverage more appropriately rather than acquiring more equity capital, which could reduce the earnings per share of existing shareholders. However, this should put into account the prevailing economic and financial conditions. Any method adopted; either debt or equity should be favoured by the current situation. Commercial banks should engage in operations that have greater gains than the costs of debt. Commercial banks should plan for bad debts adequately and avoid depending on full payment of loans for their operations.

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