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## **EFFECT OF BANKING REGULATIONS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA**

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### **Abstract**

*The objective of this study was to establish the effect of banking regulations on financial performance of commercial banks in Kenya. The population for this study included listed Commercial Banks in the Nairobi Securities Exchange in Kenya. The study used secondary data for the purpose of analyzing the relationship between bank regulation and financial performance of commercial banks in Kenya. The secondary data was collected from the financial statements of the banks. A linear regression model of financial performance versus regulations was then applied to examine the effect of banking regulations on financial performance of commercial banks in Kenya. Correlation analysis revealed that there exist a weak correlation between banking regulation and financial performance of commercial banks in Kenya while the regression analysis revealed that there was no significant relationship between dependent variable and independent variables. The study concluded that banking regulation does not affect financial performance of commercial banks in Kenya.*

**Key Words:** Banking regulation, Financial performance, Commercial Banks, Nairobi Securities Exchange.

### **1. Introduction**

Following the financial crisis of the 2007-2009, stringent regulatory measures have become more prominent as a move towards having stable and more competitive banking sector (Financial Service Authority, 2009). It is important to note that banks play a critical role in the allocation of society's limited savings among the most productive investments, and they facilitate the efficient allocation of

risks of those investments (Chang, 2015). However, the financial crisis showed that a breakdown in this process can disrupt economies around the world. The crises further revealed the importance of bank regulations to hedge against high risks attributed to imbalances in banks' statement of financial position. Well-functioning banking systems exert a first-order impact on economic growth and development of any country in the world (Leedy, 2014).

Banking systems, however, does not always function in a beneficial manner so as to achieve the important goal which regulation aims to achieve the recent global financial crisis underscores this unpleasant fact (Rosse, 2014). The response of policymakers to these situations is typically an assessment of what went wrong and what regulatory reforms can promote better functioning banking systems. Banking regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines, designed to create market transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things (Agoraki, 2014).

Financial performance means gauging the results of a company's policies and operations in financial terms. There are many aspects of the performance of commercial banks that can be analyzed; Maudos (2015) found out that the importance of bank profitability can be appraised at the micro and macro levels of the economy. At the micro level, profit is the essential prerequisite of a competitive banking institution and the cheapest source of funds. It is not merely a result, but also a necessity for successful banking in a period of growing competition on financial markets. Hence the basic aim of every bank management is to maximize profit, as an essential requirement for conducting business (Kim, 2012).

### **1.1 Research Problem**

A number of studies have been conducted in the area of banking regulation and financial performance of commercial banks. Agoraki, Delis and Pasiouras (2014) found out that capital requirements reduce credit risk, but this effect weakens for banks with sufficient market power. This study did not however address the aspect of financial performance. Beck and Levine (2015) pointed out a number of possible policy menu capable of bringing about a sustained commercial banks performance in Nigeria including banking regulations. The study however emphasized on sustainability without specific emphasis of financial performance. The context of the study was equally different from this study. On the other hand, Angelimi and Cetorelli (2013) found out that as the capital adequacy ratio internalizes the risk for shareholders, banks increase the cost of intermediation, which supports higher return on assets and equity pointing out the importance of capital regulation to the performance of banks and financial stability in Egypt.

Tsuma & Gichinga (2016) found out that Change in capital requirement affects financial performance of commercial banks because funds that are to be lent out to earn interest income are put up as capital thus denying commercial banks revenue. This study did not however address the specific aspects of financial performance variables that affect banks performance. Kim (2012) on the other hand found out that lending rates has a positive influence on the financial performance of financial institution because it is the main determinant of interest income. This study however focused on only lending interest rates as the aspect of regulation. From the aforementioned studies, it is clear that banking regulations is a significant issue and needs to be researched on more so as to bridge the gap in the literature.

### 1.1.2 Research objective

This study sought to establish the effect of banking regulations on financial performance of commercial banks in Kenya.

## 2.0 Methods

A cross-sectional correlation research design was used for this study. The populations for this research included listed Commercial Banks in the Nairobi Securities Exchange in Kenya. The study used secondary data for the purpose of analyzing the relationship between bank regulation and financial performance of commercial banks in Kenya. The secondary data was collected from the financial statements of the banks. To find out the effect of banking regulations on financial performance of commercial banks in Kenya, the following regression model was used:

$$Y = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

### Where:

Y = Return on Assets (Dependent variable).

a = Constant

$\beta_1$  = Coefficient of capital regulation requirement

$\beta_2$  = Coefficient of liquidity requirement ratio

$\beta_3$  = Coefficient of risk management

$X_1$  = Capital requirement

$X_2$  = Liquidity requirement

$X_3$  = Risk management

## 3.0 Results and discussion

The correlation analysis between independent variables and the dependent variables are as follows:

**Table 1: Pearson Correlation Coefficients**

	ROA	CAPITAL REQUIREMENT	LIQUIDITY REQUIREMENT	RISK MANAGEMENT
ROA	1			
CAPITAL REQ.	-.252	1		
LIQUID. REQ.	-.386	-.146	1	
RISK M.	-.149	.154	-.324	1

Table 1 above shows the Pearson correlation coefficients between the variables. Returns on assets had negative correlation -0.252 with the capital requirement which means that they are insignificant. Return on assets and liquidity efficiency had highest negative correlation of - 0.386. Then return on asset had a negative correlation with risk management of - 0.149. The only positive correlation exists between capital requirement and risk management of 0.158 while the other correlation was negative.

**Table 2: Analysis of Variance – ANOVA**

	Sum of Square	df	Mean Square	f	Sig.
<b>Regression</b>	5.860	4	1.465	.559	.0370
<b>Residual</b>	14.456	5	2.912		
<b>Total</b>	20.316	9			

Table 2 above shows that variations in the return on assets can be explained by the model to the extent of 5.860 out of 20.316 while other variables not captured by this model can explain the 71.15% (14.456 out of 20.316) of the variations in return on assets. The model had a p-value of 0.0370 indicating that the ANOVA was significant.

**Table 3: Regression Coefficients**

	Unstandardized Coefficients		Standardized Coefficients		Sig.
	B	Std. Error	Beta	t	
(Constant)	11.739	5.682		2.083	.087
Capital Requirement ( X <sub>1</sub> )	-.313	.259	-.268	-.568	.458
Liquidity (X <sub>2</sub> )	-.010	.065	-.461	-1.157	.245
Risk Management (X <sub>3</sub> )	-.048	.045	-.243	-.558	.498

From table 3 the following regression equation was established:

$$Y = 11.739 - 0.313X_1 - 0.110X_2 - 0.48X_3$$

The results indicate that a unit change in the capital requirement causes a decline of 31.3% change in the return on assets of the commercial banks. This indicates that Capital requirement does not have an influence on the return on assets of commercial banks in Kenya which means that capital requirement is not a predictor of financial performance of commercial banks. Liquidity is also not a predictor of financial performance of commercial banks in Kenya. A unit change in liquidity leads to a decline of

49% unit change in return on assets. A unit change in risk management leads to a negative change of 17% change in the return on assets of commercial banks. This means financial performance may be under influence of other factors other than capital requirement, liquidity and risk management used in the model. In terms of significance of each of the predictors, the p-values is greater than 0.05 meaning that capital requirement, liquidity and risk management are not significant in explaining financial performance of commercial banks in Kenya.

**Table 4: Model Summary – Goodness of Fit**

<b>Indicator</b>	<b>Coefficient</b>
R	0.443
R Square	0.295
Adjusted R square	-0.333
Std. Error of Estimate	1.04194

Table 4above shows the output for model fitness. The R coefficient of 0.443 indicates that the predictors of the model which are capital requirement ratio, liquidity ratio and risk management ratio have a correlation of 44.3% with the dependent variable of return on assets. The R square also called coefficient of determination of 0.295 indicates that the model can explain only 29.5% of the variations in the return on assets of commercial banks and that there are other factors which can explain 70.5% of the variations in return on assets. This shows that the independent variables are not significant predictors of financial performance of commercial banks in Kenya.

## **4.0 Conclusion and recommendations**

### **4.1 Conclusion**

This study sought to establish the effect of banking regulations on financial performance of commercial banks in Kenya. The Correlation analysis revealed that there exist a weak correlation between banking regulation and financial performance of commercial banks in Kenya while the regression analysis revealed that there was no significance between dependent variable and independent variables. The study therefore concluded that banking regulation does not affect financial performance of commercial banks in Kenya.

### **4.2 Recommendations**

Regulation is a key pillar of financial institutions operations in any country especially with recent case of global financial crisis of 2007-2009 worldwide. It is a key issue in enhancing the financial prosperity and stability of a country. It is therefore important for any government to develop policy and legal environment that is conducive to `good performance of financial institutions. Further studies should be conducted so as to establish more determinants of financial performance of commercial banks.

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