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DETERMINANTS OF INVESTMENT DECISIONS AND THEIR EFFECT ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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ABSTRACT

This study sought to identify the relevant determinants of investment decisions by commercial banks in Kenya and how they affect financial performance. Specific objectives included establishing the determinants of investment decisions of commercial banks in Kenya and establishing inherent effect of the determinants on financial performance. The study considered risk aversion, interest rates, financial tools and financial literacy as determinants of investment decisions, and return on average capital employed as a measure of financial performance. The study used a descriptive research design as well as a census approach on all commercial banks in Kenya. Findings indicated that banks are aware of the four determinants of investment decisions and that are all considered when undertaking investment decisions. Even though all determinants were found to be fairly distributed among banks, the occurrence of financial literacy had a unique distribution among banks with lower tier banks seemingly compromising on stringent requirements otherwise put on the determinants by the top tier banks. Lower tier banks were found to be flexible on financial literacy. All the four determinants were found to have a strong and significant linear correlation with return on average capital employed. From the regression analysis, the study identified that the determinants of investment decisions do influence the return on average capital employed even though none of them presented an acceptable significance level. Interest rates presented a negative effect on return on average capital employed. The study concluded that the determinants of investment decisions are important but do not entirely determine the return on average capital employed.

Key terms: determinants of Investment decisions; Financial performance; Investment decisions.

1.0 Introduction

An investment decision is defined by Stores (2015) as the competitive selection of expenditure points within income-producing assets. Ezejiofor, Peace and Okoye (2016) add that the selection involves committing funds to the long-term assets. According to Vorobyev (2012) and Njiiri (2015), investment portfolios tend to be associated with rate of return, bank size, deposit liabilities, banking sector concentration, credit risk levels and banks' fee-based activities income, market share, and the rate of inflation. In addition, tight bank regulations and bank activities restrictions tend to affect the extent to which bankers conduct business, affecting efficiencies in the financial sector. Other factors expected to affect investment decisions are financial tools, interest rates, financial literacy and taxation (Eisner & Strotz, 1963; Amedu, 2012; Farinha & Prego, 2013, Abdikadir, 2017).

Financial performance is multidimensional. Murthy and Sree (2000) and Muchai (2013) indicate profits, cash-to-cash cycle time, market position, revenue, per share earnings and profits as the key dimensions. Measuring financial performance, as argued by Johnson and Scholes (2007), requires use of gross receivables. The Kenya Financial Stability Report (2011) proposes the use of CAMELS, which is a factor combination measure tool for capital adequacy, liquidity and earnings, and management effectiveness. Important is also the use of ratios: Return on Equity (ROE), Return on Asset (ROA), Return on average capital employed (ROACE) and net interest margin proposed by Nyathira (2012) and Muchai (2013). This study used Return on Average Capital Employed (ROACE) in determining how commercial banks in Kenya performance financially.

As depicted by Deo and Sundar (2015) and Abdikadir (2017), the interaction between financial performance and the determinants of financial performance is causal. To be specific, the determinants enhance choosing of better investment decisions. Better choices are equally characterized and result in better financial performance among firms. As far as general banking is concerned, a firm's financial performance is subject to the ability of the banks to service their obligations duly, rather with immediacy and timeliness. These obligations range from financial customer requirements and operational expenses to promoter's financial expectations (Murthy & Sree, 2000). Not fulfilling such obligations directly amounts to performance failure. However, when it comes to investments, financial performance is purely based on the ability of the investment to have better returns relative to the involved cost. It is also worth noting that a failure in an investment project, for example, negatively affects delivery of obligations. This means that failure in investment decision leads to failure in part of general financial performance.

Weighing in, Drehmann and Nikolaou (2009) add that then, from the failure, institution start defaulting with shareholders and depositors incurring losses in the worst-case scenario. At this point, partial or full closure of an institution is eminent. To prevent such occurrence, better investment decisions ought to be made under the various determinants that include risk aversion,

financial literacy and interest rates. Better financial tools, like fundamental and technical analysis-based, should also be considered. On a broader sense, the investment failure argument is expounded by Farag, Harland and Nixon (2013) who insists that poor investments negatively affect liquidity levels. In most cases, they add, investment decision reduces liquidity coverage which is essential in effecting and settling obligations as they arise. Considering such a relation, the decision to invest can be said to equally equate to assigning of resources, which is mostly in form of liquid asset(s) deployment. It is therefore essential that better financial tools, risk aversion, financial literacy and interest rates are considered before making investment choices.

With the aid of appropriate determinants, sound investment decisions and choices boost efficient management of liquidity levels to a point of realization of optimized operations. Vorobyey (2012) asserts that when investment decisions are poorly made, partly or solely due to inadequate consideration of the determinants of investment decisions, input resources are wasted with minimal or no returns at all. Otherwise, resources are efficiently utilized and positive financial performance obtained. Financial literacy, as indicated by Thilakam (2012) provides ability to interpret the known and unknown about an investment. Financial tools, interest rates and risk aversion on the other hand ensure that better yielding investments are selected (Baker & Nofsinger, 2010; Njiiri, 2015).

2.0 Objectives of the study

The general objective of this study was to establish the determinants of investment decisions by commercial banks in Kenya and how they affect financial performance. The Specific objectives included;

- i. To establish the determinants of investment decisions of commercial banks in Kenya.
- ii. To establish determinants of investment decisions and their effect on financial performance of commercial banks in Kenya.

3.0 Methods

The study adopted a descriptive research design in identifying the determinants of investment decisions and their effect on financial performance. The target population for this study comprised of all commercial banks in Kenya which were 43 in number. Primary data was used for the study. The following regression model was used;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon$$

Where, Y represent financial performance as depicted by return on average capital employed (ROACE), X_1 represent risk aversion, X_2 represent financial tools, X_3 represent interest rates and X_4 represent financial literacy. β_0 represent the model's constant term while ε represent the error term. β_1 , β_2 , β_3 and β_4 represent co-efficient of the independent variables X_1 , X_2 , X_3 and X_4 .

4.0 RESULTS

Table 1: Correlation Matrix

Correlation Variables		ROACE	Risk Aversion	Interest Rates	Financial Tools	Financial Literacy
Pearson Correlation	ROACE	1.000				
	Risk Aversion	.828	1.000			
	Interest Rates	.557	.632	1.000		
	Financial Tools	.778	.850	.685	1.000	
	Financial Literacy	.751	.882	.689	.771	1.000

Table 1 shows existence of a strong correlation on three determinants of investment decisions which include consideration on risk aversion, use of financial tools and importance of financial literacy. This means that consideration of risk aversion, use of financial tools and financial literacy have a positive association with return on average capital employed. However, consideration of interest rates contained moderate correlation with return on average capital employed. Therefore, there is enough evidence indicating existence of significant linear relationship between the four determinants of investment decisions and return on average capital employed.

Regression Analysis

Regression analysis was performed on the dependent variables and independent variables to depict the relationship that the study was seeking. Table 4.7 indicates the summary estimates of the regression model parameters that were obtained.

Table 2: Regression Parameters

Model	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	-12.939	3.674		-3.522	.002
Risk Aversion	3.433	1.852	.534	1.854	.076
Interest Rates	-.201	1.098	-.030	-.183	.856
Financial Tools	2.263	1.841	.277	1.229	.231

Financial Literacy	.582	1.682	.087	.346	.732
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a. Dependent Variable: ROACE

From the regression parameters, the following regression model was obtained:

$$Y = -12.939 + 3.433X_1 - 0.201X_2 + 2.263X_3 + 0.582X_4$$

The significance column of the regression table indicates that none of the significant parameters was below 0.05, therefore the determinants' influence was insignificant. This also means that none of the four determinants was able or useful in explaining occurrence of financial performance of banks using ROACE. In this case, Y is financial performance which involves the return on average capital employed, X_1 is the consideration of risk aversion, X_2 is the consideration of interest rates, X_3 is the use of financial tools and X_4 is the involvement of financial literacy. The model indicates that when all determinants of investment decisions are held constant, the value of ROACE is -12.939. However, with a unit higher in the consideration of risk aversion, ROACE is enhanced by 3.433 units. A unit higher in the consideration of interest rates will result in the decline of ROACE value by 0.201. A higher level in the use of financial tool by one unit is likely to enhance ROACE by 2.263 units. A one unit increase in the financial literacy of the investment decision makers is also likely to enhance ROACE by 0.582.

5.0 Conclusion and Recommendation

Risk aversion is a major determinant in making investment decision. Its high correlation with return on average capital employed equally translates to high influence. Its significance, as established by the study, implies that all banks should prudently prioritise investment options with better and acceptable risks. This means that none of the banks should go for investments based on positive anticipations on already unacceptable risks. Based on the findings of this study, the tendency to compromise on risk aversion was observed among second and third tier banks who in turn recorded low ROACE. Interest rates as a determinant was found to have a moderate correlation and a negative influence on ROACE. Among the considered determinants, interest rates are normally influenced by external and operating environment. Therefore the investment decision makers lack substantial control over it and cannot adequately factor it in with absolute certainty. It is then important for commercial banks to be flexible when using interest rates as determining factor.

The use of financial tools was found to be the second most reliable factor to risk aversion. With its high correlation and influence, commercial banks are expected to factor the use of financial tools in every decision they make concerning investment options. The determinant is important as it provides all relevant quantitative data on all investment options. The data include but not limited to expected project life, budgets and returns. Through the use of financial tools, viable investment options are selected. It is therefore important for all commercial banks to engage the use of financial tools. Financial literacy was found to have a strong correlation and high

influence on ROACE. The determinant is important as it defines the ability of those tasked with the responsibility of making investment decisions. The assumption is based on the fact that lack of particular knowledge and skill might lead to selection on unworthy investment options. However, it is still important that those tasked with the responsibility of making investment decisions be of sound financial literacy.

The determinants are important to investment decision makers, especially portfolio managers and whoever is tasked to provide portfolio analysis. They, the determinants, act as pre-requisites for confidence in success. They unsure that cons of a particular investment option are evident and that they are measured against those of another investment option, and the best selected. As evident in the study, only through such analysis can banks ensure that they have avoided resource-wasting investments and that the right anticipations are made. However, the management of these banks must be aware of the fact that the determinant-based analysis of portfolios does not alone guarantee success of the selected options. The determinants aid only in the execution of the best options but their success rests partly on the implementation process of the investment option. A part from using the determinants in ensuring better returns through better options, it is also important that commercial banks find and optimise the other contributing factors/aspects. The study concludes that determinants of investment decision are important to the performance of commercial banks in Kenya.

5.1 Recommendation

This study recommends that all commercial banks in Kenya must generally ensure that they don't give compromises on determinants, especially the lower tier banks associated with low return on average capital employed. The non-compromising nature on the top tier banks perhaps explain why they comparatively perform much better. Allowing some degree of vices within the analysis of determinants of investment decisions might lead to investment on an awkward option. The second recommendation is on the literacy level of those entrusted with investment decision-making. Banks must ensure that all investment decision-makers are equipped with all the necessary skills and knowledge without compromise. Lastly, the study recommends that banks focus on determinants of investment decisions as pre-requisites towards ensuring that the investments/options selected are prudently executed and implemented. The investment execution process should be as good as the initial analysis of the determinants

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