THE EFFECTS OF CENTRAL BANK OF KENYA PRUDENTIAL REGULATIONS ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

BY

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DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university for academic credit.

Signed: ……………………………   **Date:** …………………………………….

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Supervisor Approval

This project has been submitted for examination with my approval as the university supervisor.

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ABSTRACT

Despite introduction of CBK prudential regulations of 2006 governing commercial banks in Kenya, there are no systematic studies that critically assess how regulations have affected the financial performance of commercial banks. Thus this study sought to establish the effects of CBK Prudential Regulations of 2006 on the financial performance of commercial banks in Kenya. This was a comparative study on the effects of CBK Prudential Regulations of 2006 on the financial performance of commercial banks. The study covered a twelve year period from 2001 to 2012; six years prior to implementation of the prudential regulations (2001-2006) and six years after implementation of the prudential regulations (2007-2010).

The descriptive research methodology was adopted in this study. The population of interest in this study consisted of all the duly licensed commercial banks operating in Kenya. The study used secondary quantitative data to determine the effects of CBK Prudential Regulations of 2006 on the financial performance of commercial banks. The data was sourced from Central Bank of Kenya's Bank Supervision Department. These were in form of financial reports of the banks involved covering a twelve year period from 2001 to 2012. Regression analysis was used to analyze the data.

The study revealed that there was great positive variation on the financial performance of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. This is an indication that CBK prudential regulations had great positive effects on the financial performance of commercial banks. The adjusted R squared value for the period after introduction of CBK prudential regulations 2006 was found to be greater than that of the period prior to to the regulations an indication that the regulations greatly influenced the financial performance of commercial banks.

The study recommended the need for CBK to enhance their prudential regulations on commercial banks in Kenya, as it was revealed that CBK prudential regulations enhance the financial performance of commercial banks in Kenya. However, a holistic and integrated regulatory policy approach is advocated to strengthen market regulation without stifling competition, innovation and financial access.

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LIST OF ABBREVIATIONS

Cap   Chapter

CBK   Central Bank of Kenya

IBEAC   Imperial British East Africa Company

MFI   Micro Financial Institutions

NBFI   Non Banking Financial Institutions

ROA   Return on Assets

ROE   Return on Equity

ROS   Return on Sales

SACCOs   Savings and Credit Cooperative Organizations

WOCCU   World Council of Credit Unions

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Llewellyn (1986) defined regulation as body of specific rules or agreed behaviour, either imposed by some government or other external agency or self-imposed by explicit or implicit agreement within the industry, that limits the activities and business operations of financial institutions. The core objectives of financial regulation are to preserve the stability and soundness of the financial system and to protect the deposits of the public. There are two main approaches to financial regulation: firstly, to impose limits or constraints on the supervisees so as to deter them to engage in certain activities that entail excessive risk and secondly, to provide financial firms with a set of incentives that would induce them to align their private objectives to social goals. Thus, regulation is meant to define the rules and incentives by which market participants must behave, but without constituting a barrier for the natural development of the industry. Indeed, it is stated that the challenge of financial regulation is to enhance competition, openness, and innovation in the financial sector while maintaining sound prudential oversight, appropriate incentives, and needed constraints (Stiglitz, 2001).

1.1.1 Central Bank of Kenya Prudential Regulations

The Central Bank of Kenya was established in 1966 through an Act of Parliament - the Central Bank of Kenya Act of 1966. The establishment of the Bank was a direct result of the desire among the three East African states to have independent monetary and

financial policies. The Central Bank of Kenya Act of 1966 set out objectives and functions and gave the Central Bank limited autonomy. Since the amendment of the Central Bank of Kenya Act in April 1997, the Central Bank operations have been restructured to conform to ongoing economic reforms. There is now greater monetary autonomy.

Section 4 of the Central Bank of Kenya Act states the core mandate of the Bank as follows: the principal object of the Bank shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices; the Bank shall foster the liquidity, solvency and proper functioning of a stable market- based financial system; and the Bank shall support the economic policy of the Government, including its objectives for growth and employment. The other objectives of the Bank are enumerated under Section 4A of the Act, and empower the Bank to: Formulate and implement foreign exchange policy; Hold and manage its foreign exchange reserves; License and supervise authorized dealers; Formulate and implement such policies as best promote the establishment regulation and supervision of efficient and effective payment, clearing and settlement systems; Act as banker and adviser to, and as fiscal agent of the Government; and Issue currency notes and coins.

CBK prudential regulations 2006 for institutions licensed under the banking act were issued under Section 33(4) of the Banking Act, which empowers the CBK to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient

banking and financial system. The effective date for implementation of the regulations was 1st January 2006.

1.1.2 Financial Performance

Financial performance is any of many different measures to evaluate how well a company is using its resources to generate income (Combs et al., 2005; Richard et al., 2009). Common examples of financial performance include operating income, earnings before interest and taxes, and net asset value. It is important to note that no one measure of financial performance should be taken on its own. Rather, a thorough assessment of a company's performance should take into account many different measures. In traditional management studies, ratios are classified according to the following performance aspects measured: profitability, liquidity, leverage, and efficiency (Richard et al., 2009). These ratios can be computed directly using financial statement information. Valuation ratios are added with the traditional classification of ratios, which incorporate more current assessments by the market of the company's "worth". Simple balance sheet and income statement items are use to compute ratios to analyze financial statements of the financial institutions.

According to Combs et al. (2005) some of the more commonly used ratios and measures in financial analysis are: (i) Ratios that measure the Profitability; Operating Income/Sales, Operating Income/Average Total Assets, Net Income /Sales, Net Income/Average Stockholders' Equity and Earning per share. (ii) Ratios that measure the

Operating Efficiency; Cost of Goods Sold/Average Inventories, Average Collection Period, Sales/Average Fixed Assets, Sales/Average Total assets, Gross Profit/Sales, Marketing and Administrative Expenses/Sales. (iii) Ratios that measure Financial Leverage: Earnings before Interest and Taxes/Interest Expenses, Total Liabilities/Total Equity. (iv) Solvency ratios; Current Assets/Current Liabilities, (Current Assets-Inventories-Prepayments)/Current Liabilities. (v) Ratios that measure Valuation; Price/Earnings, Net Asset Value, Market Value of Equity/Book value of Equity, divided per Share/Market Price per Share, Market capitalization.

1.1.3 Relationship between Prudential Regulations and Financial Performance

According to Claessens (2003), poorly regulated firms are expected to be less profitable, have more bankruptcy risks, lower valuations and pay out less to their shareholders, while well-governed firms are expected to have higher profits, less bankruptcy risks, higher valuations and pay out more cash to their shareholders. Claessens also explains that better regulations benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders.

On the other hand, it has been stated that weak regulation in the banking sector not only leads to poor firm performance and risky financing patterns, but can also provide conducive ground to macroeconomic crises. Other researchers contend that good

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regulations is important for increasing investor confidence and market liquidity (Claessens,2003).

With the size of firms increasing and the role of financial intermediaries growing, mobilization and allocation of capital has become more complex as a result of liberalization of financial and real markets, structural reforms including price deregulation and increased competition. These developments have made the monitoring of the use of capital more complex in certain ways, enhancing the need for good regulations (Claessens, 2003). Further, changes in bank ownership during the 1990s and early 2000s substantially altered governance of the world's banking organizations.

Several events are responsible for the heightened interest in regulations especially in developing countries such as Kenya. First, there has been a proliferation of scandals and crises across the globe in which the behaviour of the banking sector affected entire economies and deficiencies in regulation endangered the stability of the global financial system. Second, the private, market-based investment process is now more important for most economies than it used to be, and that the entire process is underpinned by better regulation (Claessens,2003).

1.1.4 Commercial Banks in Kenya

A commercial bank is an institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts,

such as checking, savings, and time deposit. The government of Kenya acknowledges the financial sector as a key player in the economic recovery process and recognizes the role played by commercial banks. The government through the economic strategy paper of March 2003 spells out measures that it intends to take in order to assist the financial sector to aid in job creation, poverty eradication and economic growth.

According to Upadhyaya (2011), the origins of commercial banking in Kenya lay in commercial connections between British East Africa and British India at the close of the 19th century. The establishment of the British Empire in East Africa began with the establishment of a trading frontier under the agency of Imperial British East Africa Company (IBEAC) incorporated in United Kingdom in 1888. IBEAC sought to inherit the centuries old long-distance trade that linked the African interior to the African coast, and from the African Coast to the Indian sub-continent through the Indian Ocean. The first two British banks to be established were the National Bank of India in 1896 and the Standard Bank of South Africa in 1910. The former became National and Grindlays Bank and the later became Standard Bank. National Bank of South Africa was established in 1916 but was later merged with Colonial Bank and Anglo-Egyptian Bank to form Barclays Bank (Dominion Colonial).

The Standard Bank of South Africa and Barclays Bank were just branches of British banks based in London. Their establishments in Kenya were in line with the practice of British banks to follow the development of trade in their colonies and concentrate on finance of international trade. National Bank of India operated mainly in India while the

Standard Bank of South Africa had its main business in South Africa. Since the banks had links with Europe, South Africa and India their businesses affected their operations, because they were mainly dealing with customers from their respective areas. Open opportunities for traders and settlers who had come to Kenya and the growing community provided initial sources of deposits in excess; and the surplus, which remained unutilized in Kenya were invested in London. Deposits were also made locally. This situation prevailed mainly because there was a gap between bankers and prospective borrowers (Upadhyaya, 2011).

The General Bank of Netherlands was set up in 1951. Bank of India and Bank of Baroda were established in 1953 while Habib Bank (overseas) Ltd was set up in 1956. The Ottoman Bank and the Commercial Bank of Africa were established in 1955. During the 1960s, the banking sector in Kenya experienced a new surge of energy change and in 1968 the Cooperative Bank of Kenya opened its doors. In 1968 again, the business of Ottoman was taken over by the National Bank of Kenya. In 1971 the National and Grindlays Bank, that operated as a retail commercial bank until 7th December 1971, was nationalized and formed Kenya Commercial Bank - the government owning 60% of the bank's share capital. The Merchant Bank division was incorporated into a new bank, Grindlays Bank International Ltd, which has changed to Stanbic Bank. In 1971, Barclays Bank (DC) changed its name to Barclays Bank International Ltd and became a wholly owned subsidiary of Barclays Bank Ltd based in Britain (Upadhyaya, 2011).

The post independence bank developments was as a result of emphasis on capitalist economy, attracting foreign investment and maintaining policies of Africanization of the economy facilitated by several political and regulatory factors. Currently there are forty three (43) duly licensed commercial banks in Kenya. Kenya banking sector is relatively developed and diversified. This is because as is the case with most developing economies major components of a functional banking system, including banks, non-financial banking institutions, microfinance institutions, credit cooperatives and contractual savings are in place in Kenya. Banking sector is dominated by 7 out of 43 operating commercial banks who account of about 70% of total deposits and lending in June 2010. Many commercial banks are located in major towns but have network of branches across the country. For example out of 488 banking outlets in the country as at June 2010, 10% were located in Nairobi and Mombasa (Kariuki, 2005).

The banking sector underwent rounds of bank failures in mid 1980s and 1990s (Ngugi, 2001). Between 1993 and 1996, six commercial banks and twelve NBFIs faced insolvency problems. In 1998, five banks were placed under statutory management. The main factors contributing to this crisis included; undercapitalization, non-performing loans, over investing in speculative property market which faced declining prices, insider lending to directors, and loans extended to unviable projects under influence of government officials (Ngugi, 2001). Following the worsening macroeconomic conditions in Kenya in the 1990s, the banking sector shifted from lending to the private sector to investing in government securities. Lending to the private sector declined from 54% in

1999 to 42% in 2001. Investment in government securities in the same period rose from16% to 22% resulting in a rise in the liquidity of the banking system from 32.1% in 1997 to 43.4% at the end of 2002. The level of interest income declined with interest income from banks falling 81.25% in 1997 to 67.2% in 2002, while non-interest income rose during the same period from 17.6% to 32.8%. This saw the banks closing unprofitable branches, retrenching staff and adopting new technology as they tried to control operating expenses. However the percentage of operating expenses to total expenses rose from 40.6% in 1997 to 72.7% in 2002. During this period, the level of non-performing loans increased to over 30% of the total loans, which partly contributed to the decline in profitability of banks (Ngugi, 2001).

According to Kariuki (2005) the banking sector is segmented, fragmented and dualistic. To the extent that there are multiple financial markets with different institutions serving heterogeneous needs, it's regarded as segmented. The lack of interaction among different units both across and within means the system is fragmented and the coexistence of both formal and informal sector is the case of dualism. In Kenya the banking industry is segmented in 3 groups (Kariuki, 2005). The first group caters for corporate business particularly the multinationals, UN agencies and other international organization. Banking for this group is dominated mainly by foreign owned multinational banks. The second group is the retail national business which appears to be catered for mainly by the large and medium sized locally owned banks. The third group is the personalized

business that appears to be community driven and is dominated by the small national banks.

1.2 Research Problem

There is a general consensus among some scholars that prudential measures mitigate the effects of economic crises and lead to the stability of the banking system and subsequently an improvement in the macroeconomic results (Naceur and Kandil, 2009; Adam, 2005; Scott, 2010). Jackson (1999) writes that banks mainly respond to strict prudential regulations related to capital requirements by reducing lending and that there is little conclusive evidence that capital regulation has induced banks to maintain higher capital to assets ratios than they otherwise would choose if unregulated.

CBK in 2006 spelt guidelines and regulations to ensure that there is prudential management in the banking industry. Some of these prudential guidelines relate to licensing of new institutions, corporate governance, capital adequacy requirements, liquidity management, risk classification and asset provisioning, foreign exchange exposure limits, publication of financial statements among others. Nonetheless, there are no systematic studies that critically assess how CBK prudential regulations 2006 governing Institutions Licensed under the Banking Act in Kenya have affected the financial performance of banks.

Studies done on regulations in Kenya include: The banking sector regulatory framework in Kenya: Its adequacy in reducing bank failure (Obiero, 2001); Evaluation of financial

performance of SACCOs before and after deregulation: The case of SACCOs based in Nairobi (Oyoo, 2002); An evaluation of financial performance of the Kenyan banking Sector (Kathanje, 2000); Financial regulatory structure reform in Kenya, and The perception of financial intermediaries in Kenya Regarding the case of a single financial regulator (Mathenge, 2007).

There is a gap between theory and evidence in application of prudential regulation to help improve financial performance in banking sector. The purpose of this study was to establish the extent to which the CBK 2006 banks guidelines and regulations have affected or influenced financial performance of commercial banks in Kenya. This study tried to answer the question-what are the effects of introduction the CBK prudential regulations on the financial performance of commercial banks in Kenya?

1.3 Objective of the study

To establish the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya.

1.4 Value of the study

The findings of this study will be of benefit to the following parties:

This study will be important to regulatory authorities and policy makers in the financial sector especially in the banking industry. The study will be useful source of information for their advisory role and in embarking on practical structural reforms and evaluating their effects on the sector.

This study will be useful to current and potential investors. Investors will be better informed by the findings on the future prospects of their investments choices in relation to the banking sector. They will also be able to understand the operations of their competitive environment and the safety and security of their investments.

The study will be useful to academicians. It will add to existing literature on effects of regulation on banking sector. The study will also fill the gap of knowledge and lay a foundation for further research in regard to the banking sector.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The review of literature is to guide us in the methodologies to be used, estimation procedures and interpretation of results. This chapter, therefore, focuses on both theoretical and empirical literature to understand regulation and financial performance. This chapter is divided into four broad sections. The first section reviews select theories of regulation. The second section assesses literature on measures of financial performance. The third section gives an overview of CBK prudential regulation 2006 for institutions licensed under the Banking Act. The final section reviews empirical studies on regulation and financial performance.

2.2 Review of Theories

This section will review theories of economic and banking regulations. The focus of the theories is whether there is need for more regulation or deregulation in the economy especially in banking sector.

2.2.1 Public Interest Theory and Market Failure

Pigou (1932) notes that the theory of economic regulation is rooted in perception that government must step in to regulate markets in instances when markets are unable to regulate themselves. These so-called "market failures" occur where the price mechanism that regulates supply and demand breaks down, forcing government to take action. Natural monopolies and external costs (externalities) are the most prominent types of

market failure. Natural monopolies occur when the fixed costs of supplying a commodity are so great that it makes sense for only one firm to supply that commodity. Public utilities like the delivery of electricity or water/wastewater services to your home usually require so much money to build the necessary infrastructure (erect utility poles and lay pipelines) that no company would take on the task without confidence that it would control a sizeable portion of the market. The problem is that the monopoly businesses that arise from this situation tend to use their market power in ways that can be highly detrimental to the community at large. This is where governmental regulation becomes important.

Externalities occur when the costs or benefits of producing a good or service are not fully incorporated into the price. Economists often cite air pollution as a cost incurred by almost any sort of economic activity, but which is often ignored when determining the prices. When the polluting activity is very concentrated, as in a manufacturing plant, the costs to the surrounding community can be considerable. Yet, without governmental regulation there is nothing that compels the plant to either minimize the environmental impact or otherwise compensate the community for bearing that part of the cost of production. These sorts of market failures, along with the general need for mechanisms of regular public disclosure by business, make regulation critical if the public interest is to be protected. In this view, regulation results from the need to protect the public from the negative impacts of such market failures and other harmful business behaviour.

2.2.2 Capture Theory and Monopoly Control

The public-spirited vision of the public interest theory of regulation began to be challenged systematically in the early 1970s when researchers suggested that the individual regulatory agencies of government did not work for the public interest at all. Instead, they worked for private interests who actually demanded to be regulated as way of enhancing profits. Going further, some even argued that each individual government agency was "captured" by the leading organized interest (a company or business association) in the industry over which a particular agency operated.

This view rests on the understanding that the political actors most interested in the regulation of a particular industry are the companies in that very industry. Because of this tightly focused interest orientation among economic actors, it is thought that each regulating agency has been isolated and essentially taken over by a single powerful interest or interest association representing the very industry under regulation. Furthermore, it is believed that powerful interests in one industry generally do not interfere with the regulating activities in other industries. This line of analysis implies that there is little or even no competition over control of public policy among economic interests. Within each industry a single company or industry association dominates, and each industry minds its own business being careful not to interfere with other industries and their particular public agencies. Citizens, meanwhile, are thought to be largely absent from the processes of economic regulation. This exclusion of citizens is thought to result from two things: the issues and processes involved are complex and arcane, and the

impact of regulation on any individual citizen is relatively light compared to the impact on the businesses under regulation. A citizen paying a few dollars more per month for electricity is relatively insignificant compared to the millions of dollars at stake for an electric utility company. In short, regulation exists not because citizens need it, but because the regulated industry wants it. The capture theory of economic regulation provides some of the theoretical foundation for the concept of "iron triangles" (also known as policy sub-governments), which depict a three-way relationship between a government agency, the industry over which it has responsibility and the relevant legislative committees (Stigler, 1971).

2.2.3 Special Interest Theory and Group Competition

This approach to understanding regulation developed as a response to the capture theory. Some researchers reject the capture theory's emphasis on monopoly control of individual agencies by one narrow group of powerful interests. Instead, they propose that multiple groups actually compete for control of an agency's activities. The average citizen is not a major factor in this model either. Instead, powerful groups fight among themselves to use the coercive authority of the government to makes rules and regulations that would help their particular businesses. Such rules might help one industry or company, but hurt others. As in the capture theory government regulation is not regarded by the regulated industries as an inherently bad thing. Instead, the regulated industries or companies actually demand regulation. The key difference between the capture theory and the

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special interest theory is that the latter holds that competition among special interests can be both widespread and intense (Becker,1983).

2.3 Measures of Financial Performance

Financial performance, which assesses the fulfillment of the firm's economic goals, has long been a central focus in management research on firm performance (Barney 2002).

While measuring financial performance is not as complicated as quantifying the effects of prudential regulations, it also has it explicit complications. There is little consensus about which measurement instrument to apply. Richard et al., (2009) writes that while firm performance is a multidimensional construct that consists of many different aspects such as operational effectiveness, corporate reputation, and organizational survival, the most extensively studied areas is its financial component, the fulfillment of the economic goals of the firm.

To assess the financial performance, researchers generally use either accounting-based measures of profitability such as return on assets (ROA), return on sales (ROS), and return on equity (ROE), or stock market-based measures such as Tobin's Q and market return (Combs et al., 2005; Hult et al., 2008). Both accounting-based and market-based measures of financial performance are generally accepted as suitable indicators of firm financial performance even though their relationship in is not well defined Keats (1988). The variety of measures, which represent different perspectives of how to evaluate a firm's financial performance, have different theoretical implications (Hillman and Keim,

2001) and each, is subject to particular biases. The application of different measures complicates the comparison of the results of different studies. Accounting measures capture only historical aspects of firm performance. They are subject, moreover, to bias from managerial manipulation and differences in accounting procedures (McGuire et al., 1986).

Market measures on the other hand are forward looking and focus on market performance. They are less susceptible to different accounting procedures and represent the investor's evaluation of the ability of a firm to generate future economic earnings (McGuire et al., 1988). But the stock-market-based measures of performance also yield obstacles. According to Ullmann (1985), the use of market measures suggests that an investor's valuation of firm's performance is a proper performance measure which may not be the case (McGuire et al., 1988). Even if the assumption of market efficiency holds, Bettis (1983) argues that a firms Stock price does not necessarily reflect its fundamental value because it is influenced by the information managers choose to disclose to investors.

Venkatraman and Ramanujam (1986) suggest that accounting-based and market-based measures can be unrelated because of the conflicts between achieving short-term and long-term economic goals. Among those who expect accounting and market measures to be related, there is a debate about whether their relationship is sufficiently high so that they can be treated as equivalent, interchangeable measures of firm financial performance (Combs et al., 2005; Richard et al., 2009).

Empirical findings are diverse about the relationship between accounting and market measures of financial performance. Hoskisson et al (1994), McGuire and Matta (2003) report a positive relationship between accounting and market measures of financial performance postulating relative stability of firm financial performance and because past performance is a good predictor of future performance (Jacobsen, 1988). Others report a negative relationship by suggesting that investors do not expect either high performance or low performance to last long (Nelson, 2003) whereas others report no relationship at all (Hillman, 2005). This varied relationship between accounting and market measures has important implications for organizational research because it concerns whether firm financial performance can be treated as a single dimensional construct (Richard et al., 2009).

Schwab (1999) argued that if accounting and market measures are highly correlated, that is, they demonstrate sufficient convergent validity it suggests that these measures can be treated as equivalent, interchangeable indicators of firm financial performance. In this situation, theories of firm financial performance that find support in accounting measures should also find support in market measures, and vice versa. Researchers can also increase measurement reliability by using both of them to create a composite measure of firm financial performance (Rowe and Morrow, 1999). On the other hand, if accounting and market measures are not correlated or are correlated only at a low level, it suggests that firm financial performance is not a single dimensional construct and that accounting and market measures capture its distinct dimensions.

2.4 Overview of CBK Prudential Regulations (2006) for Commercial Banks

According to the CBK prudential regulations 2006 for Institutions Licensed under the Banking Act, banks and other financial institutions in Kenya licensed under the Banking Act have to comply with a wide range of regulatory provisions in their day-to-day operations. These are:

2.4.1 Licensing of New Institutions

The CBK Regulations provides a clear guide on the conditions one must fulfill to be granted a license to conduct banking, financial or mortgage business in Kenya.

2.4.2 Corporate Governance

This Guideline is intended to provide the minimum standards required from directors, chief executive officers and management of an institution so as to promote proper standards of conduct and sound banking practices, as well as ensure that they exercise their duties and responsibilities with clarity, assurance and effectiveness. This Guideline should not restrict or replace the proper judgment of the management and employees in conducting day-to-day business. Each institution is therefore required to formulate its own special policies (taking into account the institution's special needs and circumstances) on the duties, responsibilities and conduct of its directors, chief executive officers and management. The separation of the responsibilities of the Board and the management has been clearly outlined in the Regulations to ensure transparency and accountability in the running of the banks.

2.4.3 Capital Adequacy

This Guideline is intended to ensure that each institution maintains a level of capital which (i)is adequate to protect its depositors and creditors, (ii) is commensurate with the risk associated with activities and profile of the institution, and (iii) promotes public confidence in the institution. The board of directors of each institution shall be responsible for establishing and maintaining, at all times, an adequate level of capital. The capital standards herein are the minimum acceptable for institutions that are fundamentally sound, well-managed, and which have no material financial or operational weaknesses. Higher capital ratios may be required for individual institutions based on some circumstances as identified by the Act.

2.4.4 Risk Classification of Assets and Provisioning

This guideline is intended to ensure that all assets are regularly evaluated using an objective internal grading system which is consistent with this guideline; and that timely and appropriate provisions and write offs are made to the provisions account in order to accurately reflect the true condition and operating results of institutions. It is also intended to encourage institutions to develop effective workout plans for problematic assets in accordance with this guideline. The Board of Directors of each institution shall be responsible for establishing an asset review system, which is consistent with this guideline, which accurately identifies risk, assures the adequacy of the provisions for non-performing assets, and properly reflects such results in the financial statements of the institution.

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2.4.5 Liquidity Management

The purpose of this Guideline is to: Ensure each institution meets the minimum liquidity requirements; Provide guidance on compilation of liquidity returns; Ensure accuracy and uniformity in the computation of the liquidity ratio in the banking sector; Ensure timely submission of liquidity and maturity analysis of assets and liabilities returns to the CBK; Guide institutions in the formulation of liquidity management strategies, policies, procedures, management information systems, internal controls and contingency plans for unexpected distress situations. It is the responsibility of the board of directors of each institution to develop and document liquidity management strategy and relevant policies. The strategy and policies should be communicated to executive and senior management and all other appropriate staff members for execution. It should be borne in mind that although the statutory prescribed minimum liquidity requirement is 20% of deposit liabilities, matured and short term liabilities, liquidity requirements vary from institution to institution depending on cash flow requirements. Each institution shall therefore identify its unique liquidity requirements over specific time periods and plan for appropriate funding.

2.4.6 Foreign Exchange Exposure Limits

This Guideline is intended to ensure that the potential risk of loss arising from foreign exchange rate fluctuations to a bank's capital base is within prudential limits.

2.4.7 Prohibited Business

This guideline applies to all transactions conducted by an institution and reflected on the balance sheet or reflected as off-balance sheet items. Notwithstanding the limits set forth in this guideline and the provisions of the Banking Act, institutions shall comply with sound banking practices and written policies, which have been adopted and approved by the institutions' board of directors. The board of directors of each institution shall be responsible for establishing appropriate policies and procedures which ensure that all business transactions made are fully compliant with the limitations set forth in the Banking Act and all business decisions made are administered in accordance with prudent banking practices.

2.4.8 Proceeds of Crime and Money Laundering Prevention

This guideline shall apply to all institutions licensed to transact business under the Banking Act. It highlights methods of prudent customer identification, record keeping, identification of suspicious activities and the need to report such activities to the appropriate authority for further investigation. It is the responsibility of the board of directors and management of an institution to establish appropriate policies and procedures and to train staff to ensure adequate identification of customers, their source of funds and the use of the said funds. Such policies should also ensure the effective prevention, detection and control of possible money laundering activities and terrorism financing.

2.4.9 Appointment, duties and responsibilities of External Auditors

The need for CBK's approval of the registered public accounting firm arises out of the desire to ensure that the registered public accounting firm appointed by the institutions has achieved acceptable standards of both competence and independence to enhance the supervisory role of the CBK. This guideline is therefore intended to assist the registered public accounting firm to discharge its functions more effectively. Every institution shall advise its registered accounting public firm to use this guideline in conjunction with the Banking Act. It is the responsibility of the board of directors to ensure that the institution's shareholders appoint a registered public accounting firm annually in accordance with this guideline and other applicable laws.

2.4.10 Publication of Financial Statements

This regulation is intended to enhance market discipline in the banking and financial sector in general. As custodian of public funds, banking institutions have the responsibility to safeguard their integrity and credibility in order to maintain public confidence. It is under these considerations that institutions are required to periodically publish their financial statements in order to avail timely information to all stakeholders. This would also encourage institutions to enhance prudent management of their affairs and exercise self- regulation.

The board of directors of each institution shall be responsible for the adherence and compliance with the provisions of this regulation.

2.4.11 Opening of a new place of Business, closing existing place of Business or changing location of a place of Business

This guideline provides clear regulatory requirement that should be fulfilled prior to an institution being granted an approval to open, close or change location of an existing place of business.

2.4.12 Mergers, Amalgamations, Transfer of Assets and Liabilities

This guideline shall be applicable to all institutions licensed to conduct business in Kenya under the Banking Act (Cap.488). It specifies application procedures and the minimum conditions that must be fulfilled by merging or amalgamating institutions and forms to accompany applications for transfer of significant shareholding.

2.4.13 Enforcement of Banking Laws and Regulations

This Guideline is intended to provide information and guidance to the banking industry on the approach the Central Bank will take in issuing prompt supervisory directives and corrective orders to institutions. Supervisory enforcement actions, contained in the CBK regulations 2006 has attempted to set forth the banking practices, conditions, and violations of law giving rise to the particular problems or weaknesses identified, ordinarily through on-site examinations. Supervisory enforcement actions are also to be used to provide an outline of specific corrective/remedial measures, including appropriate time frames and goals for achievement of compliance. Specific courses of enforcement action which may be considered for use by the CBK will be communicated to each individual institution as and when the need arises.

2.5 Review of Empirical Studies

Kathanje (2000) in evaluating the performance of the Kenyan banking sector notes that banks have seen growth in overall financial performance over the years. He further identified that the sector's assets increased as banks continued to expand their lending portfolio. Deposits have also increased following deposit mobilization and expansion of branch networks by banks.

Koros (2001) did a comparative study of performance of Non Bank Financial Institutions (NBFIs) prior to and after conversion to fully pledged banks. He found out that they did not register improved performance. Evidence from the study indicated insignificant and in many of the performance indicators a declining trend. It recommended to shareholders of NBFIs that have not converted to critically re-evaluate their business strategies while taking cognizance of radically changed operating and legislative environment so that they can arrive at informed decisions on the most suitable status (NBFI or bank) that would enable them to actualize their institutional objectives. The study recommended to regulators to consider adopting a more proactive approach of discharging their regulatory role over the banking sector in order to avoid crisis resulting from regulation. Self regulation for specific sectors of the industry and selective application of specific legislations to cover specific sectors of the industry where unique characteristics are paramount as opposed to blanket legislation is also recommended in the study.

Stiglitz (2001) noted that all the arguments that support the application of regulation to banks are naturally extended to nonbanks. However, the extent and nature of the regulation may differ markedly between banks and non-banks depending on the role the latter institutions play in the economy. Some issues involved in prudential regulation of non-banking institutions are different from the ones applied to banks because for the former ones, systemic risk, contagion and the potential disruption of the payments system do not constitute threatening issues. In the case of Micro Finance Institutions(MFIs), the task involves establishing an appropriate and cost-effective regulation that is compatible with the objectives of regulation of the financial system as a whole; and that allows sufficient margin for innovation and flexibility to facilitate the growth of the industry (Stiglitz, 2001).

Obiero (2002) in his study on the adequacy of the banking sector regulatory framework in reducing bank failure analyzed 39 banks which failed in Kenya in the period 1984 to 2001. He identified ineffective board and management malpractices as the most dominant reason for bank failure. Other causes of bank failure include: high incidences of non-performing loans, unsecured insider loans, undercapitalization and insolvency, poor lending practices, run on deposits, persistent violations of the banking act leading to closure and heavy reliance on parastatal deposits. He further noted that although the legal provisions of the banking regulatory framework is fairly comprehensive in coverage and adequate in content to reduce probability of failure, timely intervention by CBK is important if they are to be effective.

Oyoo (2002) in analyzing SACCOs that existed before deregulation(1992-1996) and after deregulation(1997-2001) for SACCOs based in Nairobi, concluded that the performance of SACCOs in the two eras were not significantly different, even though minor advantages were seen to have existed before deregulation especially where absolute mean ratios were used. SACCOs performed relatively better before deregulation since most of the World Council of Credit Unions (WOCCU) goals were met. Deregulation in this case means the transfer of control of Credit Unions from the government to Owners. This was officially initiated in Kenya in 1997.

Hardy et al., (2003) said that there are some other specific arguments that support MFI regulation. Regarding the protection of depositors, they argue that depositors of a MFI are in a disadvantaged position compared to other clients, not only because of the small amounts of their individual deposits but because any 'failure of an MFI would discourage them from participating in the financial system indefinitely'. Besides, these authors point out the need for some protection against fraudulent practices like the pyramid scheme that can be highly detrimental for small clients. Finally, it is stated that the monitoring of the financial situation of MFIs is meant to contribute to the stability and public confidence on the financial system, especially if the microfinance system is highly dependent on funding from commercial banks.

Steel and Andah (2003) in evaluating Rural and Micro Finance Regulation in Ghana postulated that it is valuable opening up (or leaving alone) different tiers of formal, semi-formal and informal MFIs that provide different products and services to different market

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niches. However, it is also clear that taking too promotional an approach and allowing too easy entry in the early stages tends to foster a number of weak institutions, especially when they are using relatively new methodologies that are relatively untested in the local market. This can both undermine the credibility of that category of institutions and drain scarce supervision resources or foster benign neglect until the problems become severe. Clearly, the biggest challenge in regulating MFIs is finding the right balance between ease of entry for greater outreach, prudential regulations to promote sustainability, and supervision capacity.

According to Gallardo et al (2005), designing the regulatory framework for MFIs requires that the goals and range of the regulation should be properly delineated. This is aimed at issue of whether regulation should focus on microfinance lending as an activity or on the institutions that are engaged in the microfinance business. Regardless, regulations should be established in an unambiguous way, with clear definitions of what is understood by microfinance services and of the legal and institutional form of MFIs in order to avoid regulatory arbitrage. Nonetheless, according to the literature, it is observed that a practical approach is to regulate microfinance as an activity rather than focusing on the institutional structure, due to the broad range of institutions that may be involved. It is imperative to be aware about the special features of microfinance operations in order to understand the arguments behind the definition of prudential standards for MFIs, which in some cases are recommended to be stricter than the ones applied to commercial banking. Compared to traditional financial activities, microfinance has some distinctive

characteristics regarding its lending methodology, composition of loan portfolio, capital structure and institutional form.

2.6 Summary of Literature Review

This chapter covered a review of the finance literature regarding the theoretical justifications for regulating the financial system and the various approaches of undertaking financial regulations. The theoretical literature supports the regulation of the banking sector and removal of monopolistic tendencies in the market. Theories revealed that regulation should be defined as clearly as possible in order to avoid regulatory arbitrage and that any potential impacts should not be taken for granted because financial regulation might impact in different ways the behaviour and performance of stakeholders in the financial institutions and markets which might entail significant financial and economic effects that need to be properly analysed. These theoretical concepts will form an important foundation in analyzing the effect of the prudential regulations on the financial performance of commercial banks. However, various empirical studies reviewed demonstrated that implementation of the regulatory standards should not only be country and sector-specific but also relevant and consistent with the chosen regulatory approach.

Based on the above, there is a gap between theory and evidence in application of prudential regulation to help improve financial performance in banking sector. Empirical evidence in Kenya showing the effects of prudential regulations on financial performance

of commercial banks in Kenya are not explicitly researched and related studies are not explicitly documented, and a gap exists which can be filled through more research on the area. Thus, there is need to carry out an empirical investigation to establish the extent to which the CBK 2006 banks guidelines and regulations have affected or influenced financial performance of commercial banks in Kenya. This is the gap this study will aim to fill.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the general methodology that was used to conduct the study. It specifies the research design, target population, data collection method and instruments, and data analysis and interpretation.

3.2 Research Design

A research design is a plan, structure and strategy conceived so as to obtain answers to research questions. It provides a framework for planning and conducting a study. The descriptive research methodology was adopted in this study. The methodology was preferred because the study used quantitative statistical data to describe the effects of CBK Prudential Regulations of 2006 on the financial performance of commercial banks. The study covered a twelve year period from 2001 to 2012; six years prior to implementation of the prudential regulations (2001-2006) and six years after implementation of the prudential regulations (2007-2012). The study compared the financial performance of commercial banks between the two periods: pre and post introduction of CBK Prudential Regulations of 2006.

3.3 Population

Cooper and Emory (1995) define population as the total collection of elements about which the researcher wishes to make some inferences. Element is the subject on which

the measurement is being taken and is the unit of study, according to Cooper and Emory (1995). The population of interest in this study consisted of all the 43 Commercial banks operating in Kenya (see Appendix I).

Since the population of the study was small, all the commercial banks were studied and therefore the target population is equal to the sample size. Therefore, the study purposively targeted all the commercial banks.

3.4 Data Collection

The study used secondary quantitative data. The data was sourced from CBK's Bank Supervision Department. These were in the form of financial reports of the banks involved and they covered a twelve year period from 2001 to 2012 - six years prior to implementation of the prudential regulations (2001-2006) and six years after implementation of the prudential regulations (2007-2012).

3.5 Data Analysis

The study sought to determine the effects of CBK Prudential Regulations of 2006 on the financial performance of commercial banks. The dependent variable was the financial performance measured by ROA. The independent variables were the CBK Prudential Regulations that were introduced in 2006. These were measured by selected regulatory parameters: Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. Regression analysis was used to analyze the data.

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3.5.1 Analytical Model

The following multiple regression model was used;

$$PERF = \beta_0 + \beta_1 CA + \beta_2 LM + \beta_3 RC + \beta_4 FE + \beta_5 CG + \beta_6 D + \ell$$

The equation above defines the regression equation used in this study where:

PERF is financial performance represented by ROA

CA is average Capital Adequacy measure for the banking industry,

LM is average Liquidity Management measure for the banking industry,

RC is average Risk Classification of Assets and Provisioning measure for the banking industry,

FE is average Foreign Exchange Risk Exposure measure for the banking industry,

CG is average Corporate Governance measure for the banking industry and

D is a dummy used measure the effects of the prudential regulations on the financial performance.

This study was a comparative study of pre and post effects of CBK Prudential Regulations on the financial performance of commercial banks. The study covered a twelve year period from 2001 to 2012; six years prior to implementation of the prudential regulations (2001-2006) and six years after implementation of the prudential regulations (2007-2012). The study compared the financial performance of commercial banks between the two periods: pre and post introduction of CBK Prudential Regulations of

2006. Means of the variables between pre and post introduction in 2006 were compared using the t-test. The paired samples correlations co-efficient between two periods was calculated and interpreted. If the paired samples t-test statistics is low in significance, it indicates that the two periods are not related and are independent of each. In order to test the relationship between the variables the inferential tests including the Pearson Product-Moment Correlation Coefficient was used. Pearson Product-Moment Correlation Coefficient as measures of association was used to examine the relationship between the independent and dependent variables. The relations were explored with the use of Pearson's correlation coefficient. Pearson's correlation coefficient calculates a relationship between two variables.

3.5.2 Measurement of Variables

3.5.2.1 Financial performance

This study used ROA ratios to capture company performance. The ROA ratio is computed by dividing profits before interest and tax payments by total assets. The ROA is a performance measure equal to profits before interest and tax per Kenya Shilling of assets. It provides information on how efficiently a firm is being run because it indicates average profits generated by each shilling of assets.

3.5.2.2 Capital Adequacy

For the purposes of this research study the provisions of the regulations in regard to total capital were employed. As provided by the regulations, commercial banks must maintain

a total capital of not less than twelve per cent of its total risk weighted assets plus risk weighted off- balance sheet items.

3.5.2.3 Liquidity Management

The regulations stipulate that commercial banks are required to maintain a statutory minimum of twenty per cent (20%) of all its deposit liabilities, matured and short term liabilities in liquid assets.

3.5.2.4 Risk Classification of Assets and Provisioning

Risk classification relating to the minimum provisioning allocations for potential losses arising out of loans classified "Normal" was used in the study as a measure of Risk Classification of Assets and Provisioning. The regulations provide that a provision of 1% shall be applied against the gross balance of a loan regardless of whether the loan is analysed individually or as part of a pool of loans.

3.5.2.5 Foreign Exchange Exposure Limits

For the study, limit on 'overall' foreign exchange risk exposure were employed. The regulations specify that overall foreign exchange risk exposure as measured using spot mid-rates and shorthand method shall not exceed 20% of the institution's core capital.

3.5.2.6 Corporate Governance

Dummy variables, CG1 and CG2, were introduced to measure Corporate Governace. CG1 will relate to the period prior to implementation of the prudential regulations (2001-2006) and CG2 after implementation of the prudential regulations (2007-2012).

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data findings on the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya. These data was collected from the CBK's Bank Supervision Department is form of financial statements of commercial banks. Multiple linear regressions were established through Ordinary Least Squares (OLS) so as to establish the effect of effects of CBK prudential regulations on the financial performance of commercial banks in Kenya. The study covered a period of 12 years from years 2001 to 2012.

4.2 Regression Analysis

In this study, a multiple regression analysis was conducted to test the influence among predictor variables. The research used Statistical Package for Social Sciences (SPSS V 20) to code, enter and compute the measurements of the multiple regressions

4.2.1 Regression analysis for year 2001 to 2006

Table 4.1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.839[a]	.704	.673	.01575

(Source: Research Findings)

Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the above table, the value of adjusted R squared was 0.673, an indication that there was variation of 67.3% on the financial performance (ROA) of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance at 95% confidence interval . This shows that 67.3% changes in financial performance of commercial banks could be accounted for by Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure And Corporate Governance. R is the correlation coefficient which shows the relationship between the study variables. The findings show that there was a strong positive relationship between the study variables as shown by 0.839.

Table 4.2: ANOVAa

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.002	2	.001	3.869	.015[b]
	Residual	0.609	30	.021		
	Total	0.611	42			

(Source: Research Findings)

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.015 which shows that the data is ideal for

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making a conclusion on the population's parameter as the value of significance (p-value)
is less than 5%. The calculated was greater than the critical value (2.262 <3.869) an
indication that Capital Adequacy, Liquidity Management, Risk Classification of Assets
and Provisioning, Foreign Exchange Risk Exposure And Corporate Governance were
significantly influencing financial performance (ROA) of commercial banks in Kenya
.The significance value was less than 0.05 an indication that the model was statistically
significant.

Table 4.3: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.251	.231		1.973	.106
	Capital Adequacy	.016	.009	.444	1.815	.009
	Liquidity Management	.182	.050	.231	3.616	.036
	Risk Classification of Assets and Provisioning	.053	.017	.075	3.159	.025
	Foreign Exchange Risk Exposure	.204	.240	.230	.850	.028
	Corporate Governance	.142	.082	.132	1.739	.034

(Source: Research Findings)

From the data in the above table the established regression equation was

$$Y = 0.251 + 0.016 X_1 + 0.182 X_2 + 0.053 X_3 + 0.204 X_4 + 0.142 X_5$$

From the above regression equation it was revealed that holding Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance to a constant zero , financial performance of commercial bankswould stand at 0.251, a unit increase in Capital Adequacy would lead to increase in financial performance (ROA) of commercial banks by a factor of 0.016, unit increase in Liquidity Management would lead to increase in financial performance of commercial banks by a factor of 0.182 , a unit increase in Risk Classification would lead to increase in financial performance of commercial banks by a factor of 0.053 , a unit increase in Foreign Exchange would lead to increase in financial performance of commercial banks by a factor of 0.204 and unit increase in Corporate Governance would lead to increase in financial performance of commercial banks by a factor of 0.142.

4.2.2 Regression analysis for year 2007 to 2012

Table 4.4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.943[a]	.889	.879	.46258

(Source: Research Findings)

Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the above table, the value of adjusted R squared was 0.879, an indication that there was variation of 87.9% on the financial performance (ROA) of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance at 95% confidence interval. This shows that 87.9% changes in financial performance of commercial banks could be accounted for by Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. R is the correlation coefficient which shows the relationship between the study variables. The findings show that there was a strong positive relationship between the study variables as shown by 0.943.

Table 4.5: ANOVAb

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.312	2	.656	3.366	.025[b]
	Residual	6.206	40	.214		
	Total	7.518	42			

(Source: Research Findings)

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.025 which shows that the data is ideal for

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making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. The calculated was greater than the critical value (2.262 <3.366) an indication that Capital Adequacy, Liquidity Management , Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance were significantly influencing financial performance (ROA) of commercial banks in Kenya .The significance value was less than 0.05 an indication that the model was statistically significant.

Table 4.6: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.573	.775		2.889	.034
	Capital Adequacy	.509	.253	.536	2.013	.011
	Liquidity Management	3.103	1.482	.776	2.094	.040
	Risk Classification of Assets and Provisioning	1.483	.492	1.118	3.016	.030
	Foreign Exchange Risk Exposure	1.317	7.063	.640	2.168	.032
	Corporate Governance	.643	.082	.586	7.835	.000

(Source: Research Findings)

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From the data in the above table the established regression equation was

$$Y = 1.573 + 0.509\ X_1 + 3.103\ X_2 + 1.483\ X_3 + 1.317\ X_4 + 0.643\ X_5$$

From the above regression equation it was revealed that holding Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance to a constant zero , financial performance of commercial bank would stand at 1.573 , a unit increase in capital adequacy would lead to increase in financial performance (ROA) of commercial banks by a factor of 0.509 , unit increase in Liquidity Management would lead to increase in financial performance of commercial banks by a factor of 3.103 , a unit increase in Risk Classification of Assets and Provisioning would lead to increase in financial performance of commercial banks by a factor of 1.483 , a unit increase in Foreign Exchange would lead to increase in financial performance of commercial banks by a factor of 1.317 and unit increase in Corporate Governance would lead to increase in financial performance of commercial banks by a factor of 0.643.

4.3 Interpretation of Findings

The study sought to establish the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya. In the year 2001 to 2006 the study found that greater variation in on the financial performance of commercial banks was due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. The study

further revealed there was a strong relationship between the study variables and that Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure And Corporate Governance were significantly influencing financial performance (ROA) of commercial banks in Kenya. The study also found that Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance were positively related to financial performance of commercial banks.

The study found that there was small changes on financial performance of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. This is an indication that Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance slightly influenced the change in financial performance of commercial banks in Kenya.

After the introduction of CBK prudential regulations of 2006, the study revealed that there was great variation on the financial performance of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance. The adjusted R squared value was found to be greater than that of the period before the introduction of the prudential regulations. Thi is an indication that CBK prudential regulations of 2006 resulted to Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance greatly

influencing the financial performance of commercial banks. The study further revealed that Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and Corporate Governance were significantly influencing financial performance of commercial banks in Kenya. The study further revealed that after the prudential CBK regulation there was greater change in financial performance of commercial banks due to change in Capital Adequacy, Liquidity Management, Risk Classification of Assets and Provisioning, Foreign Exchange Risk Exposure and corporate governance.

These findings concur with the findings of Stiglitz (2001) who noted that all the arguments that support the application of regulation to banks are naturally extended to nonbanks. However, the extent and nature of the regulation may differ markedly between banks and non-banks depending on the role the latter institutions play in the economy. Obiero (2002) who identified ineffective board and management malpractices as the most dominant reason for bank failure further noted that although the legal provisions of the banking regulatory framework is fairly comprehensive in coverage and adequate in content to reduce probability of failure, timely intervention by CBK is important if they are to be effective.

The research findings are also consistent with arguments that support MFI regulation especially protection of depositors meant to contribute to the stability and public confidence on the financial system and the need to open up or leave alone different tiers of MFIs serving different markets niches (Hardy et al., 2003; Steel and Andah, 2003).

According to Gallardo et al (2005), designing the regulatory framework for MFIs requires that the goals and range of the regulation should be properly delineated to ensure regulations are established in an unambiguous way, with clear definitions of what is understood by microfinance services and of the legal and institutional form of MFIs in order to avoid regulatory arbitrage.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

From the analysis and data collected, the following discussions, conclusion and recommendations were made. The responses were based on the objectives of the study. The researcher had intended determine the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya.

5.2 Summary

The study sought to establish the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya. In the year 2001 to 2006 the study found that greater variation in on the financial performance of commercial banks was due to changes in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance the study further revealed there was a strong relationship between the study variable the study also found that Capital Adequacy, Liquidity Management, Risk Classification , Foreign Exchange Risk Exposure and Corporate Governance were significantly influencing financial performance (ROA) of commercial banks in Kenya . The study also found that Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance were positively related to financial performance of commercial banks, the study found that there was small changes on financial performance of commercial banks

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due to changes in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance, this is an indication that Capital Adequacy, Liquidity Management , Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance slightly influenced the change in financial performance of commercial banks in Kenya.

After the CBK prudential regulations on the study revealed that there was great variation on the financial performance of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance. The adjusted R squared value was found to be greater than that of before CBK prudential regulation an indication that CBK prudential regulations resulted to capital adequacy, liquidity management, risk classification, Foreign Exchange Risk Exposure and corporate governance greatly influencing the financial performance of commercial banks. The study further revealed that capital adequacy, liquidity management, risk classification, Foreign Exchange Risk Exposure and corporate governance were significantly influencing financial performance of commercial banks in Kenya. The study further revealed that after the prudential CBK regulation there was greater change in financial performance of commercial banks due to change in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance.

5.3 Conclusion

The study revealed that there was great variation on the financial performance of commercial banks due to changes in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance. This is an indication that CBK prudential regulations had great effects on the financial performance of commercial banks. The adjusted R squared value was found to be greater than that of before CBK prudential regulation an indication that CBK prudential regulation resulted to Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance greatly influencing the financial performance of commercial banks .

The study found that there was greater change on financial performance of Commercial banks in Kenya dues to changes in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance. The study also revealed that there was significant change on financial performance of commercial banks in Kenya with changes on Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance after CBK prudential regulation. The study further revealed that after the prudential CBK regulation there was greater change in financial performance of commercial banks due to change in Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance.

5.4 Recommendations for Policy

There is need for CBK to enhance their prudential regulations on commercial banks in Kenya, as it was revealed that CBK prudential regulations enhance the financial performance of commercial banks in Kenya. However, a holistic and integrated regulatory policy approach should be adopted to strengthen market regulation without stifling competition, innovation and financial access.

5.5 Limitations of the Study

The following could be some of the limitations of the study;

The researcher relied on five regulatory parameters namely Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance to establish the effects of CBK prudential regulations of 2006 on the financial performance of commercial banks. The effects of the other eight regulatory parameters, although they are mostly qualitative in nature, may not have been clearly defined and measured.

The researcher used ROA as the measure of financial performance. ROA being an accounting measure of financial performance normally relies on historical data and may be subject to managerial manipulation and differences in accounting procedures.

CBK often issues such regulations to ensure supervision of efficient and effective payment, clearing and settlement systems depending on the prevailing circumstances in the economy. The applications of old regulations may therefore be superseded by newly

issued regulations. The impact of any other regulations issued after CBK prudential regulations of 2006, if any, may not have been reflected on in the study.

5.6 Suggestions for Further Research

The researcher suggests the following areas for further research:

This study focused on the five regulatory parameters namely Capital Adequacy, Liquidity Management, Risk Classification, Foreign Exchange Risk Exposure and Corporate Governance to establish the effects of CBK prudential regulations of 2006 on the financial performance of commercial banks. A further study could be carried out to establish the effects of the other eight regulatory parameters on the financial performance of commercial banks.

The researcher used ROA, an accounting measure of financial performance. A further study could be carried out using additional measures of financial performance including other accounting measures, market-based measures or composite measures of financial performance to increase measurement reliability.

Furthermore, prudential regulations issued prior to or subsequent to CBK prudential regulations of 2006 could be studied to establish their impact on financial performance of commercial banks in Kenya.

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APPENDICES

Appendix I: List of Commercial Banks Registered in Kenya as at June 2013

1	Kenya Commercial Bank Ltd
2	Barclays Bank of Kenya Ltd
3	Co-operative Bank of Kenya Ltd
4	Standard Chartered Bank Ltd
5	Equity Bank Ltd
6	CFCStanbic Bank Ltd
7	Commercial Bank of Africa Ltd
8	I & M Bank Ltd
9	Citibank N.A.
10	National Bank of Kenya Ltd
11	Diamond Trust Bank Ltd
12	NIC Bank Ltd
13	Prime Bank Ltd
14	Housing Finance Company of Kenya Ltd

15	Bank of Baroda Ltd
16	Ecobank Kenya Ltd
17	Bank of Africa Ltd
18	Chase Bank Ltd
19	Family Bank Ltd
20	Bank of India
21	Imperial Bank Ltd
22	Fina Bank Ltd
23	Development Bank of Kenya Ltd
24	Consolidated Bank of Kenya Ltd
25	Equatorial Commercial Bank Ltd
26	African Banking Corporation Ltd
27	Giro Commercial Bank Ltd
28	Gulf African Bank Ltd
29	Fidelity Commercial Bank Ltd
30	Habib AG Zurich
31	Guardian Bank Ltd

32	K-Rep Bank Ltd
33	First Community Bank Ltd
34	Victoria Commercial Bank Ltd
35	Habib Bank Ltd
36	Transnational Bank Ltd
37	Oriental Commercial Bank Ltd
38	Credit Bank Ltd
39	Paramount-Universal Bank Ltd
40	Middle East Bank of Ltd
41	UBA Kenya Bank Ltd
42	Dubai Bank Ltd
43	Jamii Bora Bank Ltd

(Source: CBK, Bank Supervision Department, June 2013)

Appendix II: List of CBK Prudential Regulations (2006) for Commercial Banks

CBK/PG/1	Licensing of New Institutions
CBK/PG/2	Corporate Governance
CBK/PG/3	Capital Adequacy
CBK/PG/4	Risk Classification of Assets and Provisioning
CBK/PG/5	Liquidity Management
CBK/PG/6	Foreign Exchange Exposure Limits
CBK/PG/7	Prohibited Business
CBK/PG/8	Proceeds of Crime and Money Laundering Prevention
CBK/PG/9	Appointment, duties and responsibilities of External Auditors
CBK/PG/10	Publication of Financial Statements
CBK/PG/11	Opening of a new place of Business, closing existing place of Business or changing location of a place of Business
CBK/PG/12	Mergers, Amalgamations, Transfer of Assets and Liabilities
CBK/PG/13	Enforcement of Banking Laws and Regulations

(Source: CBK, Bank Supervision Department, June 2013)

Appendix III: Letter of Introduction

Dear Sir/Madam,

<u>RE: Research Information</u>

I am a postgraduate student at the School of Business, University of Nairobi pursuing Master of Business Administration course. As part of the course requirements, am undertaking a research project to establish the effects of CBK prudential regulations on the financial performance of commercial banks in Kenya.

To fulfill information requirements for the study, I intend to collect secondary data from your institution. The information being requested is purely for academic purposes and will be treated in strict confidence, and will not be used for any purposes other than for my research.

I would really appreciate if you would allow me to access all the relevant information for the research project. Any additional information you might consider useful for the study is most welcome.

Thank you.

Njeule M.A.